United States Economic Outlook

1st QUARTER 2016 | U.S. UNIT

01
Downward revision in global growth expectations near all-time lows, with China's progress a key factor in the scenario

02
Healthy consumption is the key to 2.5% growth in the U.S. for 2016, but risks are tilted to the downside

03
Increased uncertainty surrounding the pace of monetary policy normalization, though we continue to expect two rate increases in 2016, ending the year at 1.0%

Index

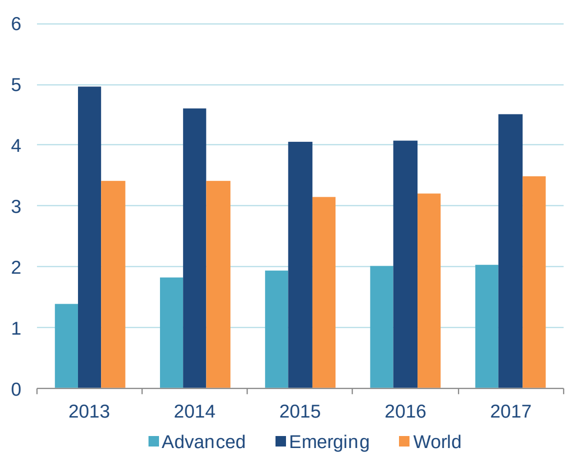
Closing Date: February 17, 2016

1 A Global Outlook of Anemic and More Fragile Growth

The intensification during the last quarter of 2015 of some of the risk clusters with a global impact led to a further downward revision of world economic growth forecasts for this year. The transition to a lower growth pattern in China, with economic reforms and changes to key objectives such as the exchange rate, is being accompanied by bouts of intense financial volatility and falling commodity prices. All this leads to a much less favorable global panorama for large commodity-exporting economies such as Russia or Brazil, but also for those perceived as more vulnerable financially.

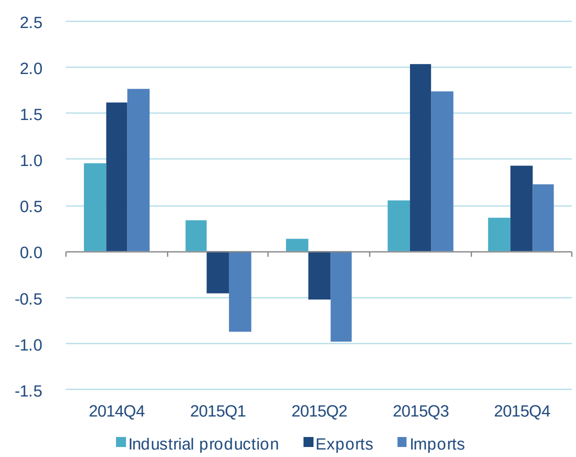
Although the level of activity seen in the second half of 2015 is consistent with quarterly growth of 0.75% in world GDP, above those seen in the first half of the year, the leading indicators (confidence indices) and the increase in financial stresses point to more moderate growth in early 2016 than was foreseen three months ago, as reflected in our estimates for the first few months of the year.[1] If this trend is confirmed, world GDP will grow by just 3.2% in 2016, repeating the advance of 2015 and postponing the recovery to 2017 when it should reach rates of around 3.5%. This lower growth rate, still the lowest since 2009, reflects slackening demand in the emerging economies, particularly those of Latin America, which look like contracting for two years in a row. Recovery in the developed economies is still fragile, and highly dependent on the eventual impact of the slowdown in world trade and the increase in financial instability on industrial output, corporate capital expenditure decisions and consumer spending. With the US growing at 2.5% and the euro zone by less than 2%, the tenuous improvement in activity in the developed economies as a whole will not be enough to offset emerging markets' expected relatively poor performance.

Figure 1
World GDP
(% YoY)



Source: BBVA Research and IMF

Figure 2
World industrial output and trade of goods
(% quarterly rates)



Source: BBVA Research and CPB

The recent behavior of the financial markets is largely explained by doubts about the strength of the world economic cycle. Activity indicators continue to show the greatest degrees of deterioration concentrated in manufacturing and trade; as to the former, world output grew by less than 2% YoY (the lowest rate since 2012), while in the case of exports, weighed down by developments in the U.S. and emerging Asia, the increase from

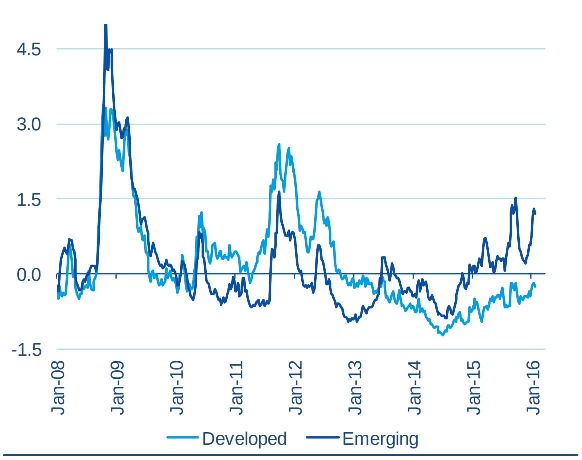
[1] Estimate based on the BBVA Research global activity indicator (GAIN). Details of methodology at http://bit.ly/1nl5RIn

the previous year was less than 1% (figures to October 2015 in both cases). Activity in services, which until now had benefited from the recovery of private consumption in the major developed economies, is also starting to show signs of less dynamism.

Even leaving the extent of China's slowdown out of the equation, the fact that the major emerging economies are all being affected by the persistent fall in commodity prices (with only a few net oil-importing countries likely to benefit from cheaper energy) has contributed to increasing risk aversion on a global scale. Moreover, a further source of uncertainty has arisen in the form of the Chinese yuan, a reserve currency with an exchange rate more subject to market forces since the summer of 2015 and on which the authorities are not succeeding in anchoring market expectations. In this situation, the capital outflows that the emerging economies have been suffering from since the beginning of 2015 are rivalling those seen in 2013, when the markets had factored in an interest rate hike by the U.S. Federal Reserve that in the end did not take place. As shown by the persistent withdrawal of capital across the board, with very little discrimination among economies, the nature of the current episode is such that it may have more serious consequences for access to financing and for the growth rate of those economies that are most reliant on external savings.

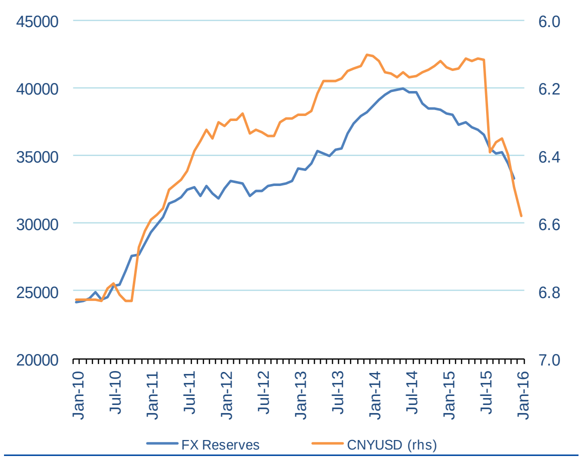
China and the Latin American countries are those with the biggest capital outflows and consequently those in which financial conditions are deteriorating the most. The BBVA Research Financial Stress Index for emerging countries has climbed back up to the levels seen in the summer of 2015 (first wave of the Chinese stock exchange crisis), reaching the stress levels of 2011. Unlike back then, volatility remains contained in the developed economies, in a context in which the reallocation of capital to financial assets with a lower risk profile is intensifying the flight-to-safety in sovereign bonds of countries such as Japan, the U.S., and Germany.

Figure 3
BBVA index of financial tensions (normalized values)



Source: BBVA Research and Bloomberg

Figure 4
China, FX reserves (US$100 million) and exchange rate



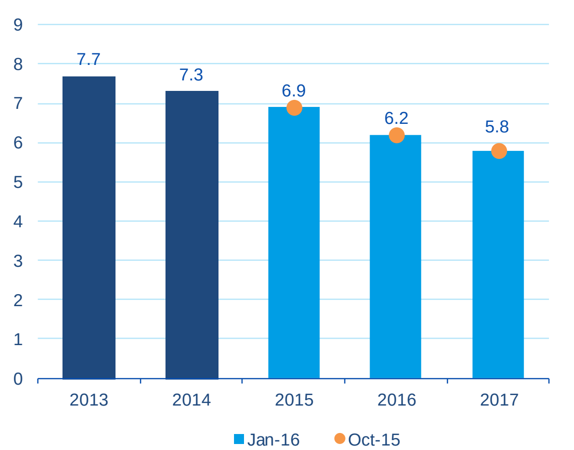
Source: BBVA Research and Haver

The depreciation of emerging currencies, which in some cases has brought their exchange rates to similar or even higher levels than those seen in the crisis of 2008, is one of the most clear signs of the punishment suffered by emerging financial markets. In addition to doubts about the effects of China's economic adjustment on global trading channels and financing, external imbalances, renewed flare-ups of geopolitical tension, and the constraints faced by the authorities in managing the economic slowdown without compromising financial stability are growing. In those cases where the cumulative depreciation of the currency is more intense and lasting, rates of inflation are starting to pick up and to diverge from the levels set by their central banks as monetary policy targets. The change of regime in the pricing of the yuan constitutes, without doubt, an additional depreciation factor for most emerging currencies, in an environment of lower external demand in which a significant deterioration in the terms of trade may exacerbate the correction of domestic demand.

The dilemma faced by emerging market central banks is heightened by the risks entailed by the accumulation of debt by the business sector over the past decade and, with greater intensity, from 2007. The abundant liquidity in the capital markets and the reduction of financial costs were triggers for the private sectors of quite a few emerging countries to increase the recourse to debt, in many cases denominated in foreign currency. An increase in financial costs (and corporate credit spreads have come under significant stress in the past few months), in a context of lower revenues and falling business profitability, may jeopardize debt servicing and lead to a sharp reduction in capital expenditure, raising credit risk and endangering the stability of the banking system and the country's external creditworthiness.

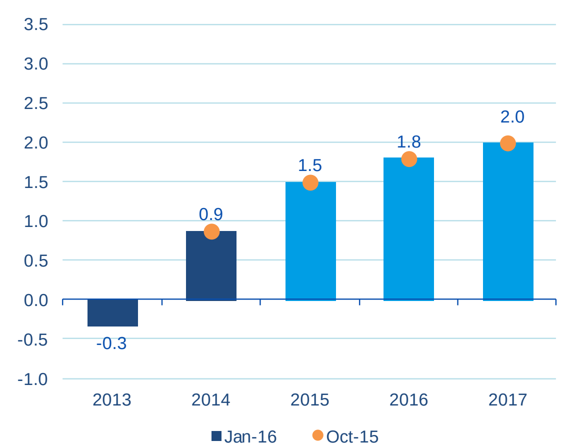
In this regard, the approach to monetary policy adopted by the developed economies' central banks will continue to be of decisive importance. The start of the process of normalization of interest rates by the U.S. Federal Reserve in December 2015 has not led to any substantial increase in financial volatility, thanks to the Fed's repeated assurances that the process will be a gradual one. The majority of Latin American central banks matched the measure, increasing their reference interest rates in similar or greater proportions, since it was in their economies that the effect of currency depreciation on consumer prices was being felt most. In Europe and emerging Asia, management of monetary policy was characterized by stable rates (in consonance with the strengthening of the stimulus measures by the ECB) or even rate reductions, as in China and India.

Figure 5
China, economic growth (% YoY)



Source: BBVA Research

Figure 6
Eurozone, economic growth (% YoY)



Source: BBVA Research

The recent correction in inflation figures in the developed countries in response to falling oil prices and the renewed fall in medium-term price expectations may once again change how their central banks react; in the case of the Fed, delaying the next rate hike; for the ECB and the Bank of Japan, making their monetary strategy even more accommodative. Following the temporary extension of the bond-buying program and the cut in its deposit facility rate to -0.3% in December, at the beginning of this year the ECB hinted at its readiness to continue stimulating price recovery. The Bank of Japan has decided to follow the lead of its European counterpart in penalizing the holding of liquidity positions, taking reference rates into negative territory. With average inflation rates in the world's four biggest economies (U.S., Eurozone, Japan, and China) below 1% since mid-2014, monetary policy in the developed countries will continue to be highly accommodative, even more so than was being forecast in mid-2015.

However, with this price containment taking place within a context of weak growth in demand, persistently high indebtedness, and reference interest rates firmly anchored to the bottom, close to zero in Europe and Japan, the margin for monetary policy to reactivate growth and dispel doubts about the effects of the adjustment in emerging markets is very limited. This is particularly so when the downturn in emerging market activity is due not just to cyclical factors but also to a secular decline in key sources of revenue such as the export of commodities.

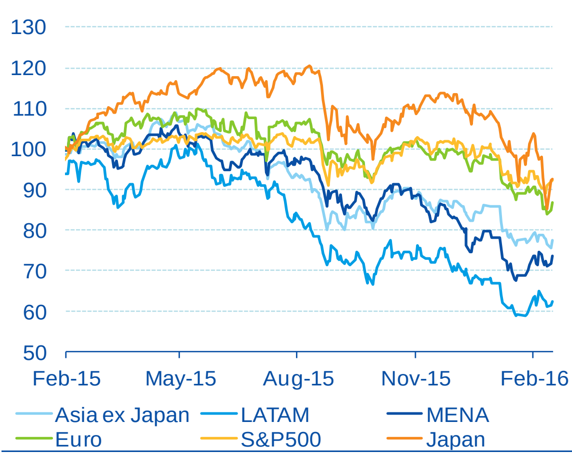
All the same, the world economy faces limited growth in 2016 (3.2%), similar to that of 2015, and with a balance of risks showing a negative bias concentrated in the emerging bloc. How China's economy evolves, both as regards to the degree of slowdown in activity and how the authorities manage the financial imbalances that exist, will continue to have a significant influence on capital flows and commodity prices in general, not just oil. The level of corporate indebtedness in those emerging countries most vulnerable to the circumstances described constitutes an additional source of instability, in a context of lower profits and higher funding costs (high risk premia). Allied to this, geopolitical tensions in certain parts of the world and the risk of a scenario of low growth and low inflation in the major developed economies complete the outlook for the world economy in 2016.

(Note: for a more in-depth analysis of Europe and the emerging markets, see our latest Global Outlook).

2 U.S. Economy Powering Through Despite Dreary Start to 2016

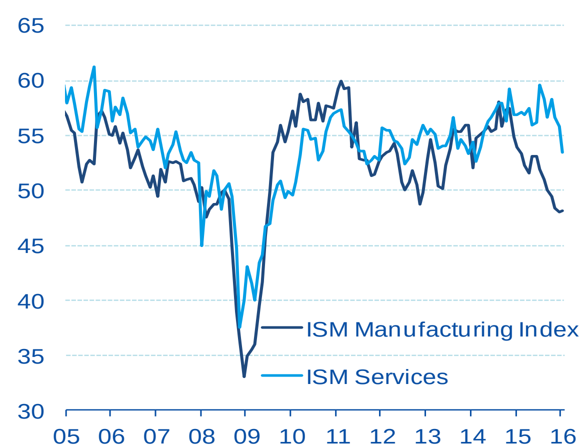
The U.S. economy is expected to maintain a moderate pace of expansion throughout the coming year, around 2.5%, as strong personal consumption helps offset weakness in other areas. Subdued inflationary pressures will continue for some time, providing a favorable environment for domestic consumers but at the same time putting pressure on the Fed's plans for their policy normalization strategy. With the first federal funds rate hike behind us, we are now facing additional monetary policy uncertainty as the FOMC attempts to assess the impact of higher rates on real economic activity. Fed communication will be a key component, particularly as we wade through the murky waters of a vulnerable global economy. Risks to growth remain tilted to the downside, in large part stemming from abroad as the strong USD and weak external demand weigh heavily on U.S. net exports and export-oriented industries such as manufacturing.

Figure 7
Global Equities (Index)



Source: Bloomberg & BBVA Research

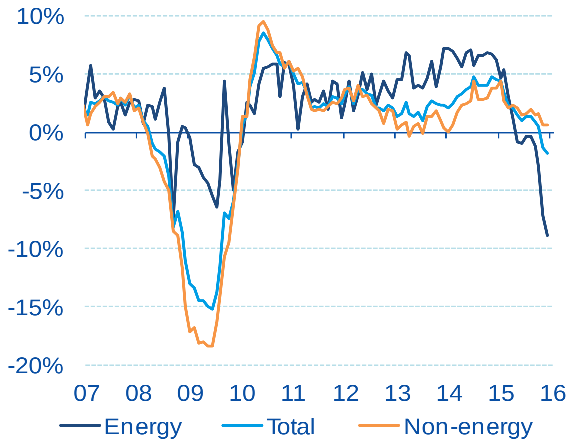
Figure 8
ISM Manufacturing and Services Indices



Source: ISM & BBVA Research

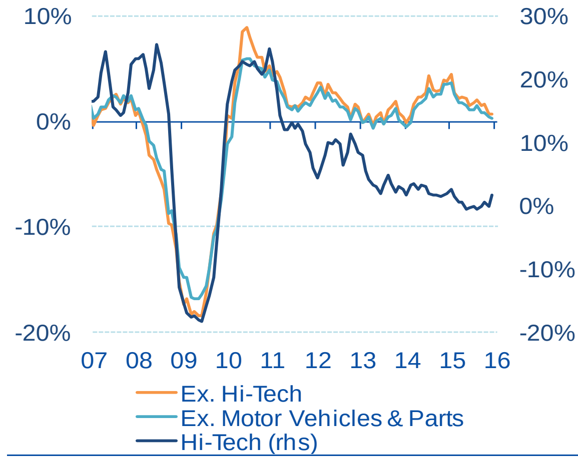
Recent economic data are pointing to signs of a slowdown in growth, at least for the first quarter, when the typical seasonal factors are also at play. Household spending has remained positive but is not quite as strong as we would expect to see in an environment of persistently low inflation, especially now when the domestic economy is so heavily dependent on private consumption. Nonresidential and inventory investment have slowed considerably and are expected to remain weak at least throughout the first part of this year, dragged down by structures (i.e. mining exploration, shafts, and wells) and uncertainty in future demand, respectively. Talk of an impending recession has intensified, with many pointing to weakness in industrial production and manufacturing as a sign of negative growth on the horizon. However, the latest declines in industrial production have been led (not surprisingly) primarily by the energy sector, with non-energy components still moving along at a healthy pace. In particular, high-tech output (i.e. computers, semiconductors, communications equipment, etc) has far surpassed its pre-recession and historical peak. Furthermore, auto production has been very strong, not only driving overall output but also contributing to gains in consumption as well. In fact, auto production helped boost total industrial production in January at the fastest monthly pace since November 2014, with manufacturing on the rise for the first time in three months. The growing gap between manufacturing and services activity has caused concerns that the first might eventually have a negative impact on the latter, but even this small turnaround helps fend off those fears for the time being.

Figure 9
Industrial Production: Energy vs Non-Energy (YoY % Change)



Source: FRB & BBVA Research

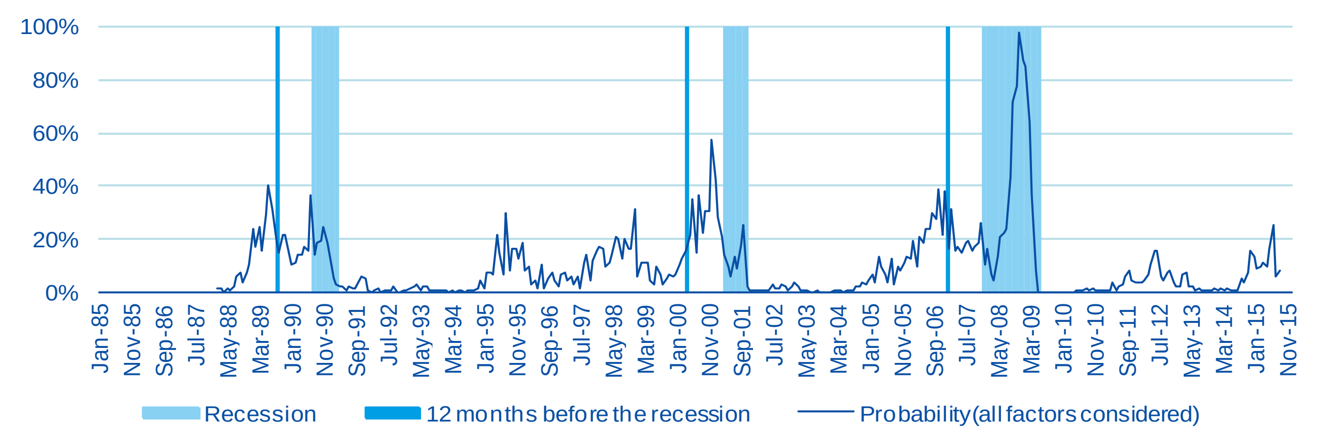
Figure 10
Non-Energy Industrial Production



Source: FRB & BBVA Research

Regardless, there has clearly been a rise in global financial turmoil throughout the past few months that is triggering recessionary concerns. Sharp drops in U.S. equities and increased market volatility have dominated, stemming from concerns on China and other widespread weakness throughout the global economy. Oil prices have fallen below $30/barrel amid continued strength in the USD, and 10-year Treasury yields have hit a 3-year low. None of this bodes well for the global economic outlook. However, it is important to remember that financial volatility comes and goes in the short-term and eventually becomes a story of the past (as was the case back in September 2015). When it comes to measuring the chance of recession, broad-based models still point to a low probability. Modelling at-risk sectors (i.e. manufacturing), corporate spreads, and P/E ratios increases the probability of recession, but all in all it remains relatively low below 20%. We expect that financial conditions will shake off this turmoil in the coming months as economic data slowly improve throughout the second quarter.

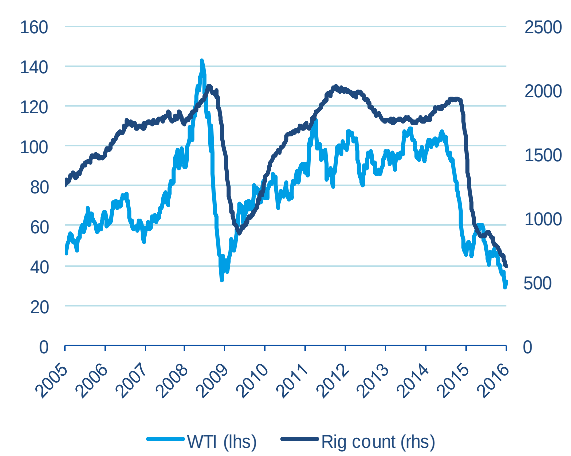
Figure 11
BBVA Research USA Probability of Recession in 12 Months (%)



Source: BBVA Research

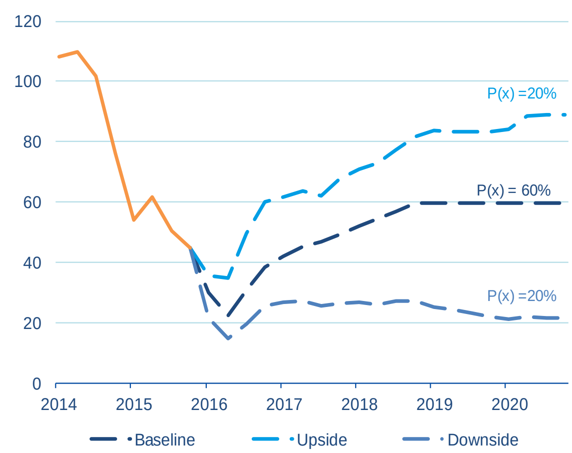
Oil prices are obviously a key factor to monitor in this scenario. Investment in the energy sector will remain subdued following a 35% drop in 2015 – the largest annual decline since 1986. However, we continue to expect a positive impact on consumption via savings at the gas pump, with gasoline prices down 47% since June 2014 and saving the average American consumer approximately $1,000 over the past year and a half. Our estimates suggest that a 10% drop in oil prices may increase real GDP growth by 0.1%. Assuming that consumers actually spend these savings elsewhere, we could see a potential 0.4% boost to growth through the end of 2016 (on aggregate since mid-2014). This would imply around a 0.1% impact on 2016 alone. However, it doesn't appear that consumers are spending all of this extra disposable income, with the personal savings rate at a recovery high of 5.5%. Furthermore, we expect that consumers have become a bit more price sensitive, so a modest increase in gasoline prices may limit their willingness to spend more, even if prices are still relatively low. Current market conditions suggest further oil price declines at least throughout the first half of this year, and there remains high uncertainty from an economic slowdown, financial volatility, and policy responses. However, as oversupply shrinks, we are likely to see a gradual rebound in prices. Even still, structural trends point to a lower oil price equilibrium in the mid- to long-run, stabilizing around $60/barrel. For a more detailed outlook on oil prices, see our latest publication.

Figure 12
U.S. Active Rig Count and WTI Price (Units and $/bbl)



Source: Haver Analytics & BBVA Research

Figure 13
Crude Oil Price Scenarios (Brent, $/bbl)

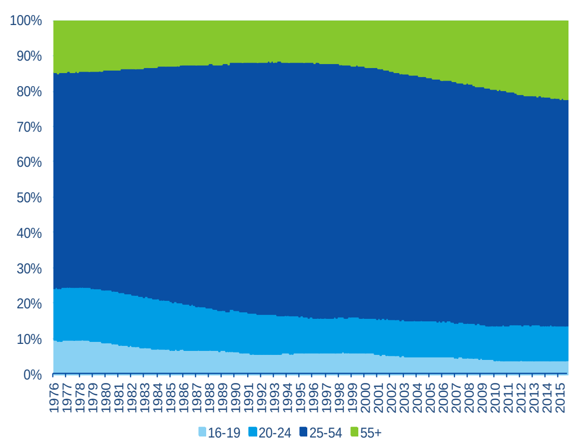


Source: Haver Analytics & BBVA Research

Consequently, inflation remains subdued, particularly at the headline level. Even with favorable YoY comparisons, we expect headline CPI inflation to reach only 1.3% on average in 2016, accelerating to 2.0% in 2017 as oil prices slowly increase. Inflation expectations have fallen to seven-year lows, suggesting that there may still be some room left for a pass-through to core inflation, which is expected to hold below the Fed's target for the next few years.

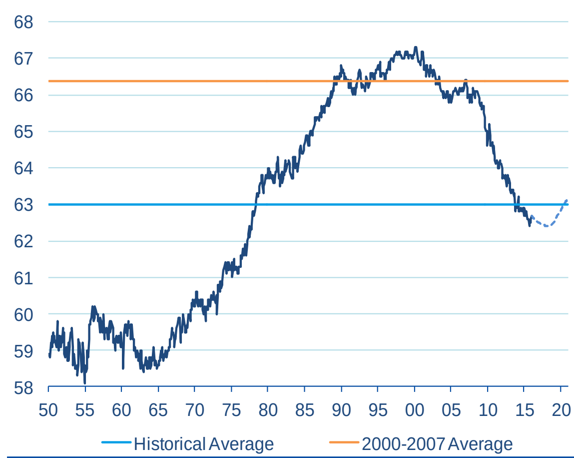
The labor market has shown strong improvements throughout the past few years, with the unemployment rate falling at a faster-than-expected pace as job growth accelerated to a +200K per month average in both 2014 and 2015. In 4Q15, nonfarm payroll growth averaged 279K per month, and the unemployment rate dropped below the 5.0% threshold to start 2016. However, there are some concerns still lingering despite the fact that we are back at (or close to) full employment. Wage growth has yet to show significant acceleration and will be a key focus for the labor market throughout the coming year. Many people are still working part-time for economic reasons or have left the labor force but would be willing to come back if the job (and price) were right. The participation rate is holding near thirty-year lows in large part due to post-crisis structural challenges and an aging population. Although the baby boomers are retiring, the share of workers 55 and older in the labor force has increased, suggesting that many are delaying retirement. Therefore, there is still a large pool of this older generation left to retire in the next few years, ultimately putting further downward pressure on the labor force participation rate. However, growing confidence in the labor market and an increase in job availability should help encourage those marginally attached workers to jump back into the labor force and offset some of the demographic decline. This plays into the assumption that labor force participation is at the very least stabilizing at low levels, and may even tick up intermittently throughout the year. Ultimately, this will limit the speed at which the unemployment rate continues to decline in 2016 as more people reenter the workforce and begin looking for jobs once again.

Figure 14
Labor Force Participation by Age (%)



Source: BLS & BBVA Research

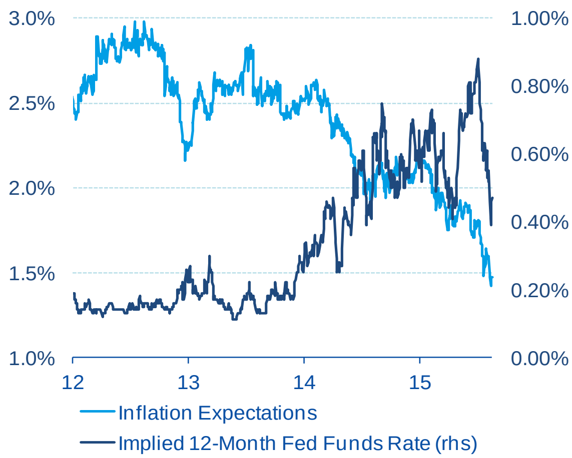
Figure 15
Labor Force Participation Rate (%)



Source: BLS & BBVA Research

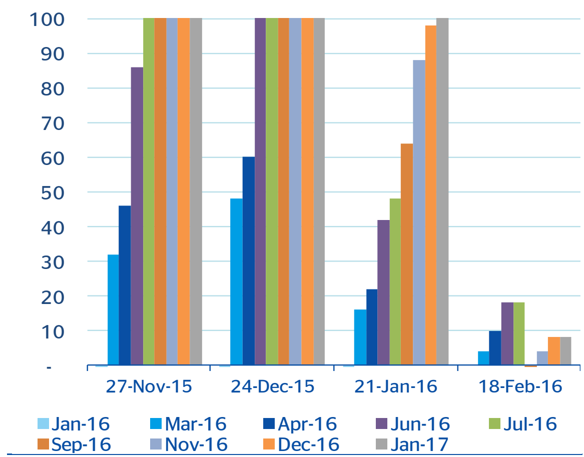
The Federal Reserve has finally moved forward in its gradual process toward policy normalization, announcing in December 2015 to increase the target range for the federal funds rate to 0.25-0.50%. However, it is likely that uncertainty will linger even after this initial increase as the Committee takes each additional rate hike on a meeting-by-meeting basis. Now that the target range is 25 basis points higher, the Fed needs to assess how markets react and whether the economy can handle such a change. This will take time, and the Fed will hold tight to their data-dependent strategy, monitoring incoming economic data to confirm that the move is playing out as expected. There will be particular focus on inflation, with many FOMC members still concerned about the lack of upward inflationary pressure materializing in the economy. In order to move forward with liftoff, members want to be certain that the statement and any future communication emphasized “the potential need to accelerate or slow the pace of normalization as the economic outlook evolved.” They also wanted to make sure it was clear that they are not committing to a specific pace or size of adjustments with the understanding that the future path of interest rates could become flatter/steeper if economic activity strayed negatively/positively from their outlook. The problem is that the latest FOMC projections from December suggest four rate increases in 2016, though at this point there is very little chance the Fed will increase again in March. Our expectations are for only two increases this year, considering the time needed to assess the impact from each rate move as well as the slow and uncertain start to 2016. Market expectations have also declined sharply in the past month, from just one to no rates increases this year. Renewed volatility in global financial markets has the potential to spook FOMC members again (as was the case in September), and we have already seen some of this come up in meeting discussions (see the latest FOMC meeting minutes). The FOMC will really need to focus on their communication in order to maintain a smooth policy normalization strategy going forward.

Figure 16
12M Implied Fed Funds Rate & Inflation Expectations (%)



Source: FRB, CME, & BBVA Research

Figure 17
Fed Funds Futures Implied Probabilities (2nd 25bp increase, %)



Source: Bloomberg & BBVA Research

Overall, we do not expect to see the next rate hike until 2Q16, with another in December to close out the year at 1.0%. This year will also be interesting because the Fed will seriously begin discussions on implementing other monetary policy tools in order to reduce the size of their balance sheet. This will warrant a trial-and-error process as the Fed evaluates the efficacy of each tool and whether they need to introduce new tools or change existing ones already in place.

Fiscal policy is also playing an important role in the outlook, this time relieving some of the drag on economic growth for this year with the Bipartisan Act of 2015. Congress agreed to suspend the debt limit until March 2017 and also increased the discretionary spending caps established by the Budget Control Act of 2011. In total, $80bn in budget caps across defense and non-defense spending were lifted – $50bn for FY2016 and $30bn for FY2017. Estimated outlays under this new budget will add about 0.15-0.2% to real GDP growth over the next two years, relative to the pre-budget scenario. This reduced drag from government spending will help offset the other components that may be weighing on growth for the year.

Also, 2016 is an election year and the presidential race is heating up. There is certainly no clear leader yet, but a lot can change in the nine months left to go before the official vote. Although we will know the individual party nominees by the end of the July, there is still a lot of uncertainty about the candidates vying to run this country. The Republican party stands to benefit from growing national security concerns and economic policy uncertainty.

Given the current state of the global economy, risks to the outlook are tilted to the downside. Most notably, the strong USD and weak global demand are the ongoing risks to growth, both of which could force the Fed to halt, or even take a step backwards, in their monetary policy plans. Falling oil prices obviously pose a risk to energy-dependent states like Texas, where we now expect to see a modest recession for 2016 (link?). On the bright side, continued declines in oil prices could lead to a potential upside surprise for domestic consumption, promoting widespread economic confidence.

3 Economic Forecasts

Table 1

	2Q14	3Q14	4Q14	1Q15	2Q15	3Q15	4Q15	2012	2013	2014	2015	**2016**	**2017**	**2018**	**2019**	**2020**
Real GDP (% SAAR)	4.6	4.3	2.1	0.6	3.9	2.0	0.7	2.2	1.5	2.4	2.4	**2.5**	**2.4**	**2.3**	**2.3**	**2.3**
Real GDP (Contribution, pp)																
PCE	2.6	2.3	2.9	1.2	2.4	2.0	1.5	1.0	1.2	1.8	2.1	**2.1**	**1.8**	**1.7**	**1.8**	**1.8**
Gross Investment	2.0	1.2	0.4	1.4	0.9	-0.1	-0.4	1.5	0.7	0.9	0.8	**0.5**	**1.1**	**1.0**	**1.1**	**1.2**
Non Residential	0.6	1.1	0.1	0.2	0.5	0.3	-0.2	1.1	0.4	0.8	0.4	**0.6**	**0.8**	**0.8**	**0.9**	**1.0**
Residential	0.3	0.1	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.1	0.3	**0.4**	**0.3**	**0.2**	**0.2**	**0.2**
Exports	1.3	0.2	0.7	-0.8	0.6	0.1	-0.3	0.5	0.4	0.5	0.2	**0.0**	**0.2**	**0.5**	**0.5**	**0.6**
Imports	-1.5	0.2	-1.6	-1.1	-0.5	-0.4	-0.2	-0.4	-0.2	-0.6	-0.8	**-0.6**	**-0.9**	**-1.0**	**-1.1**	**-1.1**
Government	0.2	0.3	-0.3	0.0	0.5	0.3	0.1	-0.4	-0.6	-0.1	0.1	**0.3**	**0.1**	**0.1**	**0.0**	**-0.1**
Unemployment Rate (%, average)	6.2	6.1	5.7	5.6	5.4	5.2	5.0	8.1	7.4	6.2	5.3	**4.8**	**4.6**	**4.5**	**4.5**	**4.6**
Average Monthly Nonfarm Payroll (K)	276	245	274	190	251	192	279	179	193	251	228	**205**	**245**	**265**	**283**	**281**
CPI (YoY %)	2.1	1.8	1.2	-0.1	0.0	0.1	0.4	2.1	1.5	1.6	0.1	**1.3**	**2.0**	**2.0**	**2.1**	**2.2**
Core CPI (YoY %)	1.9	1.8	1.7	1.7	1.8	1.8	2.0	2.1	1.8	1.7	1.8	**2.0**	**2.0**	**2.1**	**2.1**	**2.2**
Fiscal Balance (% GDP)	-	-	-	-	-	-	-	-6.8	-4.1	-2.8	**-2.6**	**-3.1**	**-3.0**	**-3.0**	**-3.6**	**-3.8**
Current Account (bop, % GDP)	-2.1	-2.2	-2.3	-2.7	-2.5	-2.8	-	-2.8	-2.3	-2.9	**-2.6**	**-3.0**	**-3.2**	**-3.2**	**-3.3**	**-3.3**
Fed Target Rate (%, eop)	0.25	0.25	0.25	0.25	0.25	0.25	0.50	0.25	0.25	0.25	0.50	**1.00**	**2.00**	**3.00**	**3.50**	**3.50**
Core Logic House Price Index (YoY %)	8.06	6.21	5.51	4.72	4.89	4.86	5.51	3.84	10.91	7.69	4.99	**5.37**	**2.45**	**2.43**	**1.10**	**1.18**
10-Yr Treasury (% Yield, eop)	2.60	2.53	2.21	2.04	2.36	2.17	2.24	1.72	2.90	2.21	2.24	**2.32**	**2.88**	**3.67**	**4.39**	**4.56**
U.S. Dollar / Euro (eop)	1.36	1.29	1.23	1.08	1.12	1.12	1.09	1.31	1.37	1.23	1.09	**1.11**	**1.16**	**1.20**	**1.20**	**1.20**
Brent Oil Prices (dpb, average)	109.7	101.8	76.4	53.9	61.7	50.2	43.6	111.7	108.6	99.0	52.4	**30.0**	**45.7**	**55.7**	**59.6**	**59.6**

Source: BBVA Research & Haver Analytics

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This report has been produced by the BBVA Research U.S. Unit:

Chief Economist
Nathaniel Karp
+1 713 881 0663
nathaniel.karp@bbva.com

Kim Fraser Chase
kim.fraser@bbva.com

Boyd Nash-Stacey
boyd.stacey@bbva.com

Shushanik Papanyan
shushanik.papanyan@bbva.com

Amanda Augustine
amanda.augustine@bbva.com

Filip Blazheski
filip.blazheski@bbva.com

Kan Chen
kan.chen@bbva.com

Marcial Nava
marcial.nava@bbva.com

Art & Lay out:
Fernando Tamayo

BBVA Research

Group Chief Economist
Jorge Sicilia Serrano

Developed Economies Area
Rafael Doménech
r.domenech@bbva.com

U.S.
Nathaniel Karp
nathaniel.karp@bbva.com

Spain
Miguel Cardoso
Miguel.cardoso@bbva.com

Europe
Miguel Jiménez
mjimenezg@bbva.com

Emerging Markets Area

Cross-Country Emerging Markets Analysis
Alvaro Ortiz
alvaro.ortiz@bbva.com

Asia
Le Xia
le.xia@bbva.com

Mexico
Carlos Serrano
carlos.serranoh@bbva.com

LATAM Coordination
Juan Manuel Ruiz
juan.ruiz@bbva.com

Argentina
Gloria Sorensen
gsorensen@bbva.com

Chile
Jorge Selaive
jselaive@bbva.com

Colombia
Juana Téllez
juana.tellez@bbva.com

Peru
Hugo Perea
hperea@bbva.com

Venezuela
Julio Pineda
juliocesar.pineda@bbva.com

Financial Systems and Regulation Area
Santiago Fernández de Lis
sfernandezdelis@bbva.com

Financial Systems
Ana Rubio
arubiog@bbva.com

Financial Inclusion
David Tuesta
david.tuesta@bbva.com

Regulation and Public Policy
María Abascal
maria.abascal@bbva.com

Recovery and Resolution Strategy

Digital Regulation
Alvaro Martin

Global Areas

Economic Scenarios
Julián Cubero
juan.cubero@bbva.com

Financial Scenarios
Sonsoles Castillo
s.castillo@bbva.com

Innovation & Processes
Oscar de las Peñas
oscar.delaspenas@bbva.com

Contact details:

BBVA Research USA
2200 Post Oak Blvd.
Houston, TX 77025
United States.
Email: researchusa@bbva.com
www.bbvaresearch.com
www.bbvacompass.com/compass/research/
twitter.com/BBVAResearchUSA