BBVA | RESEARCH

United States Economic Outlook

2nd QUARTER 2016 | U.S. UNIT

01
Low and fragile global growth, dependent on developments in China

02
Despite a rocky start to 2016, underlying fundamentals are indicative of moderate economic growth in the U.S.

03
Strength in the labor market, fading downward pressures on inflation, and reduced volatility in global financial markets support another rate increase in the near future

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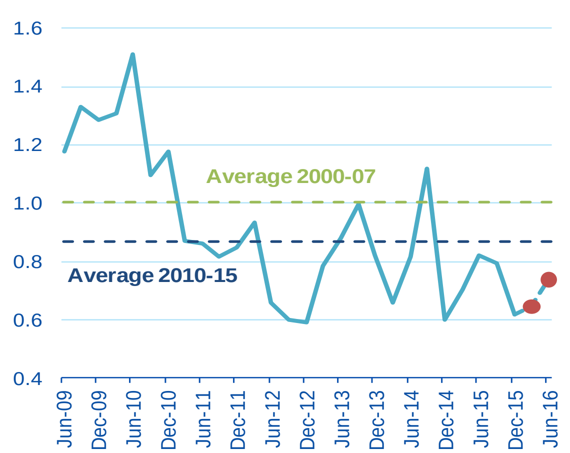
Closing Date: May 27, 2016

1 Low and Fragile Global Economic Growth

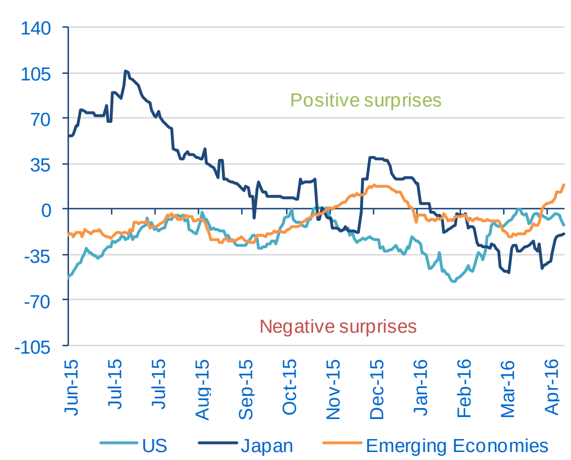
The outlook for the global economic scenario has brightened over the last three months, as the downward adjustment in world growth and the slump of financial markets has stalled. However, the brighter global scenario is fragile and limited in scope. It does not involve fundamental changes in the factors that have caused an environment of low growth with exposure to many different sources of uncertainty. The health of the global economy is dependent in large part on how the Chinese economy evolves, the resolution of hot spots of instability around Europe (geopolitics, "Brexit", payment of the Greek debt) and a possible slow-down in the U.S. The Fed has warned of downside risks, confirming the weakness of the present recovery, and the fact that the ECB, the Bank of Japan, and the Bank of China are applying or are going to apply expansionary measures underlines how precarious growth is and the difficulty in achieving price stability.

Figure 1
World GDP, % q/q. Q1 and Q2 forecasts 2016 based on BBVA-GAIN



Source: BBVA Research

Figure 2
Economic Surprise Index (CESI)



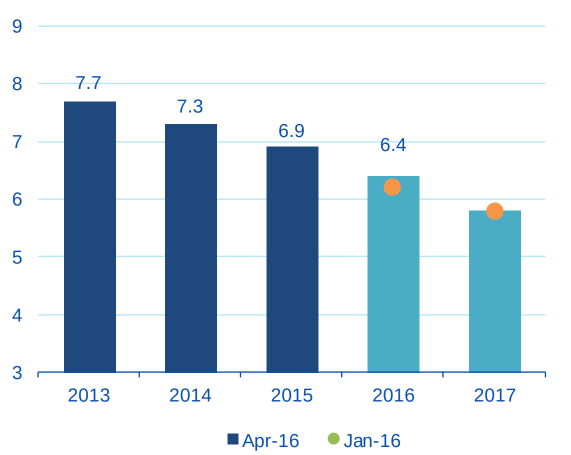
Source: BBVA Research and Haver

Global growth in the first part of 2016 will be between 2.6% and 3.0% YoY, which is more positive than the 2.5% YoY in 4Q15, but falls short of the average 3.2% for the 2011-15 period or the 4% of the decade up to 2008. For our forecast to be correct, bearing in mind the progressive slow-down in China and the weakness in the activity cycle in the major emerging countries, it will be necessary to witness a substantial improvement in economic growth in the US and Japan, two developed economies where industrial production and export of goods have seen year-on-year falls as a result of the adjustment in the energy sector and the accumulated appreciation of the dollar, on the one hand, and lower Asian demand and the revaluation of the yen on the other. Resilience in the production of services in the developed block, which in recent months has lost steam due to the manufacturing adjustment, is also a necessary condition.

The sharp increase in financial volatility observed between December 2015 and February 2016, as well as responding to the actual deceleration of global activity, threatened to accentuate it if it continued at the same intensity and translated into a contraction of demand decisions. Since then, financial tensions, as well as the probability of the occurrence of a stress scenario on a global scale, have subsided. The better-than-expected balance of economic indicators from China, lower downward pressure on the value of the yuan, the recovery of raw material prices, and the moderation of expectations on interest rate rises by the Federal Reserve have been determining factors.

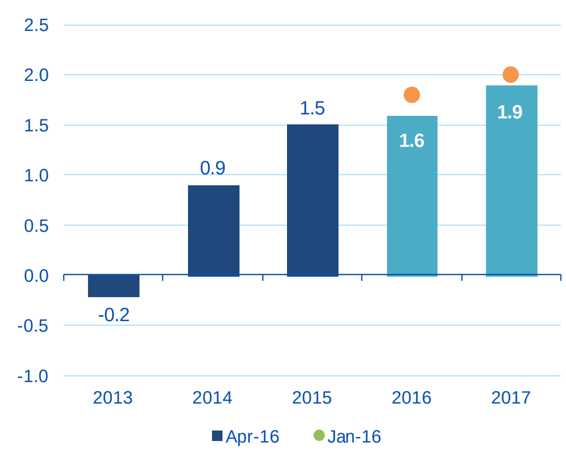
The strengthening of stimulus policies, both monetary and fiscal, by the Chinese authorities has contributed to ease the effects of the readjustment in the manufacturing sector on aggregate production and, consequently on the country's trade flows with the rest of the world. In the short term, the implementation of counter-cyclical measures may facilitate a more gradual slow-down of the economy than expected; nevertheless if it is accompanied by a delay in the correction of fundamental imbalances such as high leverage in the corporate sector or excess installed capacity in some industries and construction, the financial vulnerability of China in the face of shocks like the one seen in the summer of 2015 would increase and, with it, its destabilizing potential on the rest of the world.

Figure 3
China: GDP (annual change, %)



Source: BBVA Research and Haver

Figure 4
Eurozone: GDP (annual change, %)

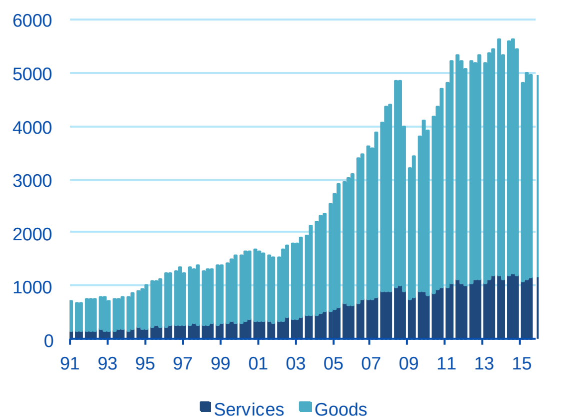


Source: BBVA Research y Haver

Economic outlook is also fragile because now there are a greater number of events of uncertainty which are significant enough to affect growth in this "new normal" period following the 2008-09 global crisis and the 2010-11 European sovereign debt crisis. This is because of two new developments which spell greater uncertainty in the economic panorama. First, the extensive use of non-conventional monetary policies (quantitative easing and interest rate anchoring), which can affect correct assessment of risks by economic agents, decoupling it from economic fundamentals and triggering volatility. Two, the more diverse sources of potential risks, as we have emerging economies with an increasing degree of financial integration and which are in turn undergoing adjustment due to the changes under way in China.

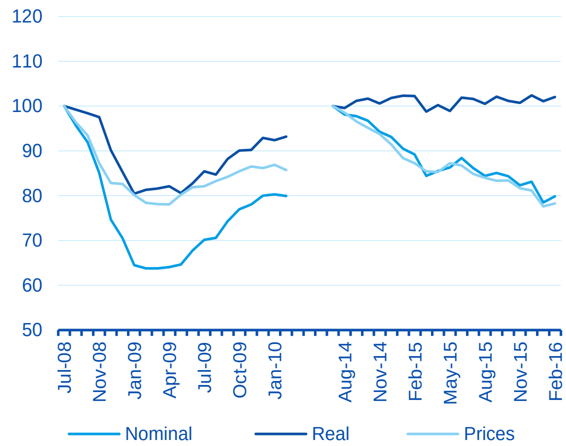
Another reason for caution is the deceleration in global trade, where the growth in goods and services is at its lowest levels since the collapse at the end of 2008. The current dynamic of trade differs from that seen in 2008. At that time, the decline of nearly 40% in the level of world exports took place in just two quarters, with trade credit being practically cut off in an environment in which worldwide financial activity and real activity was at a standstill, especially in developed countries, as well as a strong appreciation of the dollar, which also contributed to the decline in nominal levels of exports and imports. After the adjustment came a sudden and intense recovery, with massive liquidity-boosting measures on the part of central banks, support for commercial banking, and fiscal expansion. At present, with four quarters of near stagnation through December 2015, we don't see signs of immediate recovery.

Figure 5
World exports of goods and services (*)



(*) Quarterly levels expressed in US$ billions.
Source: IMF

Figure 6
World exports of goods (*)



(*) Index July 2008 and August 2014 = 100.
Source: Netherlands Bureau for Economic Policy Analysis

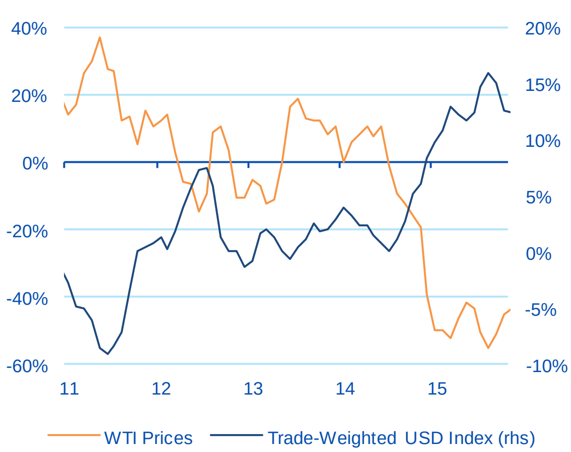
In short, the strength of the economic global economy will continue to be shaped by financial markets which have to cope with a great variety of potential risks against the background of different economic forces consistent with anemic growth.

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

2 Healthy Underlying Fundamentals Supporting Moderate U.S. Economic Growth

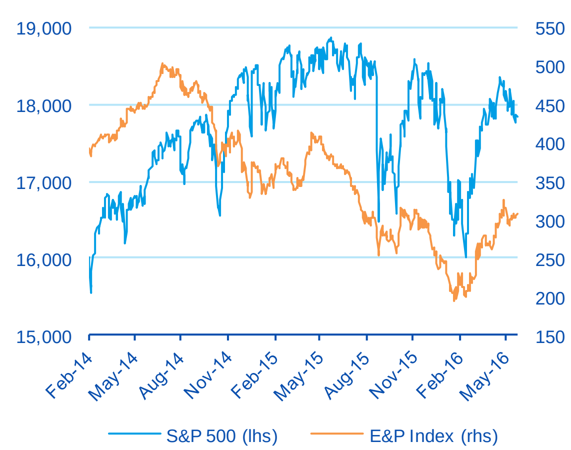
The U.S. economy has had a rocky start to 2016, with 1Q16 real GDP growth falling to a 0.5% QoQ SAAR pace – the slowest in two years. Personal consumption, which has been the key factor driving domestic growth, disappointed to the downside despite the favorable spending environment of low oil prices. Nonresidential fixed investment fell for the second quarter in a row on account of another strong decline in structures for mining exploration, shafts, and wells, down a massive 86% as a result of curtailed investment due to low oil and gas prices. The stabilization of oil prices between $40 and $50 per barrel suggests a softer drag on growth in the coming quarters, though the lagged impact suggests prolonged weakness in energy investment for the remainder of this year. The downward pressures on net exports will also fade at least in 2Q16 given the recent depreciation of the USD back toward 3Q15 levels.

Figure 7
WTI Prices and USD Index (YoY % Change)



Source: EIA, FRB, & BBVA Research

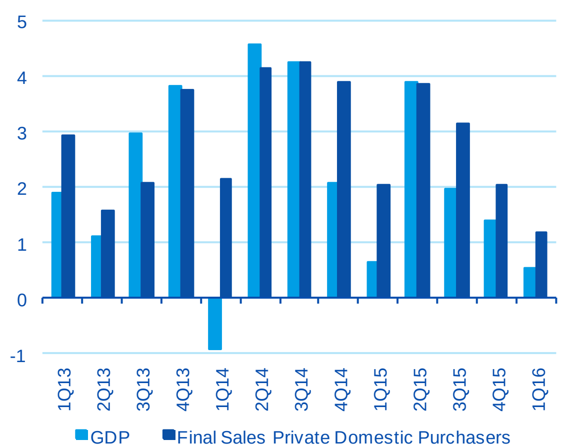
Figure 8
Market Cap ($Bn)



Source: Haver Analytics & BBVA Research

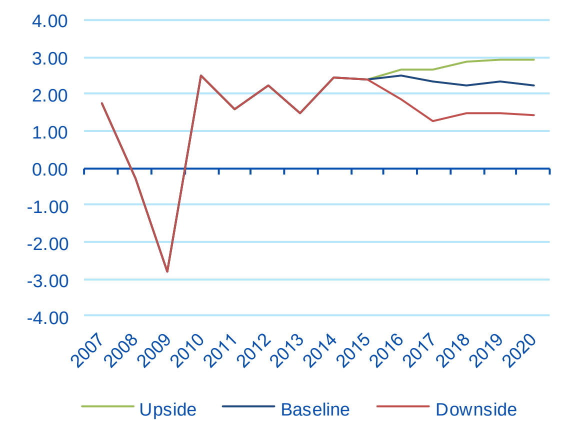
While we continue to expect domestic consumption to lead growth in the next few years, the more prolonged issues stemming from slow global demand and lagging investment in the energy sector will remain risk factors to monitor. We expect that growth will remain volatile on a quarterly basis, particularly with many seasonality issues still lingering for first quarter figures. Residual seasonality remains an issue, with 1Q numbers showing more weakness compared to other quarters. Overall, we maintain our expectations for growth to stay near 2.5% in 2016, assuming a healthy rebound in 2Q16 and beyond. However, there is a slight downward bias to this figure depending on how strong the rebound is throughout the rest of the year, with heightened global uncertainty still playing a major role. Once we get through the uncertainties of this year, growth should stabilize just above 2%. GDP is expected to average around 2.3% in 2017-2020.

Figure 9
Real GDP Growth and Final Sales (QoQ SAAR % Change)



Source: BEA & BBVA Research

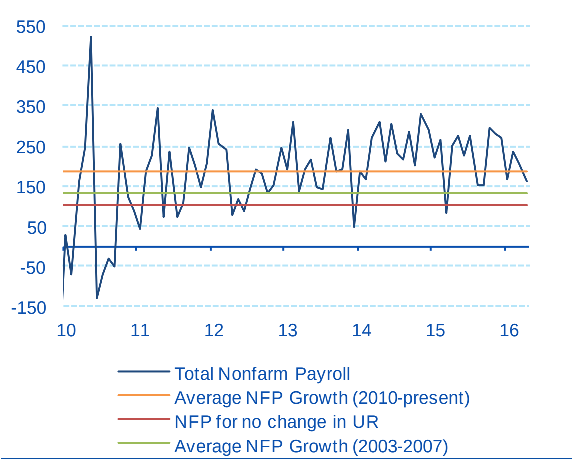
Figure 10
Real GDP Growth Forecasts (QoQ SAAR % Change)



Source: BEA & BBVA Research

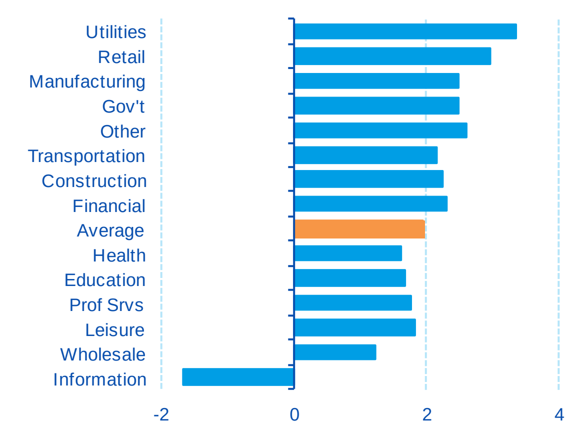
There has been a growing disconnect between GDP growth and the labor market, with the latter showing more significant strength and providing a clearer picture of the economic cycle. In 1Q16, job growth held above the 200K average while the unemployment rate remained at 5.0%. Recent gains in the labor force participation rate suggest growing confidence and an increase in job availability, ultimately slowing the pace of unemployment declines compared to the faster trend of the past few years. Although the unemployment rate has quickly approached its natural level, the fact that there are still so many out of the labor force that are willing to work highlights the concern that there is some slack left in the labor market, and serves as a good explanation for why wage pressures have yet to pick up significantly.

Figure 11
Nonfarm Payroll Growth (MoM Change in Thousands)



Source: BLS & BBVA Research

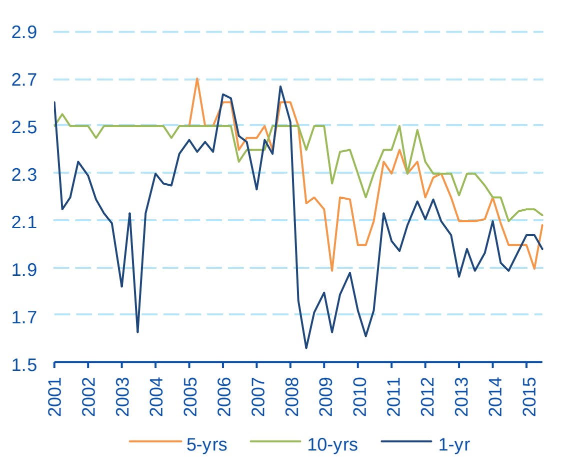
Figure 12
Employment Cost Index by Sector (SA, Dec-05=100)



Source: BLS & BBVA Research

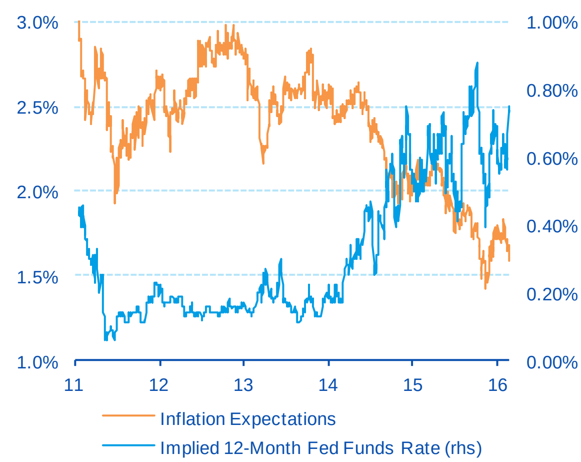
On the inflation front, the recent turnaround in oil prices has lifted expectations. Core inflation has gradually approached the Fed's 2% target—hitting its highest rate in three years—and inflation expectations have started to climb back from hitting seven-year lows in February. Although inflation will continue to run below target for the foreseeable future, downward pressures are fading. This should provide some comfort to the most dovish FOMC members in moving forward with at least one additional 25 basis point rate hike in 2016.

Figure 13
Survey-Based Inflation Expectations (%)



Source: FRB & BBVA Research

Figure 14
12-Month Implied Federal Funds Rate & Inflation Expectations (%)

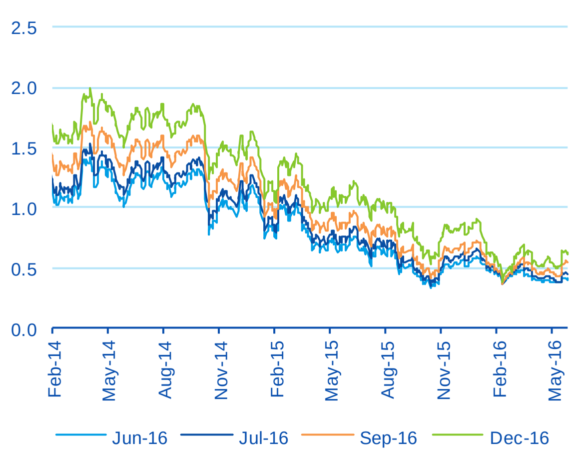


Source: FRB & BBVA Research

If the Fed intends to stick closely to their data-dependent strategy as promised, we should see another rate hike in the near future. The strength of the labor market, fading downward pressures on inflation, and reduced volatility in global financial markets support the continuation of the Fed's gradual monetary policy normalization process. Rising oil prices have boosted market sentiment, and easing actions from other central banks have helped maintain expectations for modest global growth in the coming year. Although the outlook remains uncertain, it seems that conditions are better primed for a rate hike in the next few months.

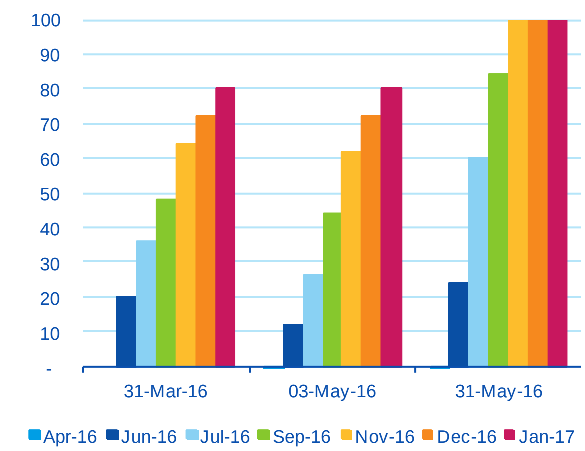
Federal funds rate futures have indicated a growing probability of a rate increase at the June meeting, from close to zero back before the April meeting to around 30% in recent weeks. The minutes from April's FOMC meeting served as another step forward in the quest towards a June rate hike, adding to the bout of seemingly hawkish Fedspeak in mid-May. Still, expectations can change at the drop of a dime depending on how strongly upcoming communication signals such action, but only if FOMC members are willing to commit to signaling a June increase – which does seem to be the case. With expectations where they are now, the most dovish Fed members may still be hesitant to make any surprising moves.

Figure 15
Federal Funds Rate Futures (%)



Source: Bloomberg & BBVA Research

Figure 16
Fed Funds Futures Implied Probabilities (2nd 25bp increase, %)



Source: Bloomberg & BBVA Research

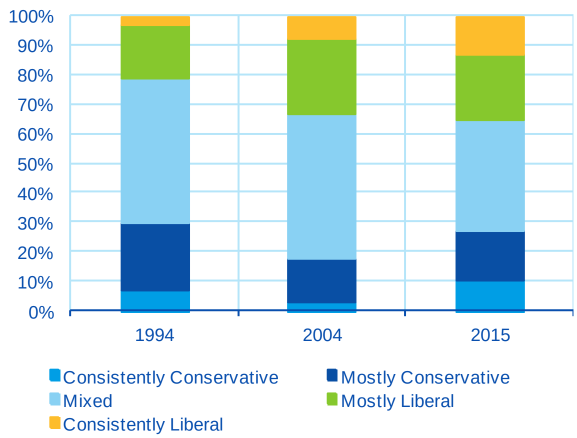
The timing may never be perfect, but conditions are certainly improving and it seems that any impact from the first rate hike has already been absorbed into the real economy. Some Fed officials may argue to continue delaying the second rate hike in order to wait for further improvement in financial stability even with stronger employment and higher inflation. While we continue to expect another increase in the near future, we cannot completely rule out the possibility that the FOMC could get cold feet and feel forced to rethink their strategy of higher rates in 2016, particularly if economic conditions do not evolve in line with their projections set forth at the time of liftoff. The risk is that if they don't move again in June, we may not see another move until at least December, if not later.

After months of contentious campaigning by both parties there appears to be growing consensus that the 2016 presidential election will be between two polarizing figures in Hillary Clinton and Donald Trump. In terms of the general election, current polling data seems to suggest that the GOP will be fighting an uphill battle. Model, market-based, and polling data show that Democrats, irrespective of the candidates, have a sizeable lead. Despite the fact that Trump has made headways recently in the general electorate, Hillary maintains a greater than 5pp margin over Trump in the head-to-head contest in various general election polls, and she has an edge in traditional swing states such as Pennsylvania, Florida, North Carolina, Virginia.

In terms of Congress, current data suggest the GOP will maintain its majority in the House albeit with a lower margin. Although not impossible, Democrats would have to win areas that heavily favor the GOP. Ultimately, it remains highly improbable that Democrats will overtake the GOP in the House in this election. However, projections for the Senate suggest that it will come down to elections in 5 states: Nevada, Florida, Ohio, Pennsylvania and New Hampshire.

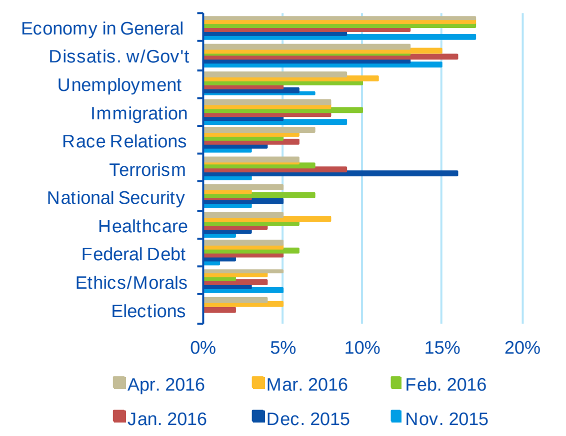
In sum, current projections suggest the most likely outcome is a divided and polarized U.S. government. In this environment, the next president is likely to resort to executive orders. However, this could imply greater policy uncertainty as it usually involves fighting the issue at the Supreme Court. In addition, highly controversial executive orders are more easily reversed when there is a change of party in the White House, and thus they do not do much for long-term business confidence. Regardless of who is elected, challenges for the next administration will include infrastructure, healthcare, immigration, and education, and tax reform.

Figure 17
Public Ideology by Distribution (%)



Source: Pew Research & BBVA Research

Figure 18
Survey of Most Important Problem (%)



Source: Gallup & BBVA Research

Overall, risks to the outlook are tilted to the downside, particularly in 2016 given the weak start to the year. However, factors that were more of a risk in 1Q16 are less dominant now, such as the strong dollar and falling oil prices. Still, weakness in the global economy, heightened uncertainty, and ongoing financial market volatility pose risks to U.S. growth. All three issues (among others) could force the Fed to delay even further their monetary policy plans, after already having paused since liftoff six months ago. This would send a pessimistic signal to the public, but if they do move ahead with rate rises in the near future, they would be exhibiting a more confident outlook for the U.S. economy.

3 Economic Forecasts

Table 1

	4Q14	1Q15	2Q15	3Q15	4Q15	1Q16	2012	2013	2014	2015	**2016**	**2017**	**2018**	**2019**	**2020**
Real GDP (% SAAR)	2.1	0.6	3.9	2.0	1.4	0.8	2.2	1.5	2.4	2.4	**2.5**	**2.4**	**2.3**	**2.3**	**2.3**
Real GDP (Contribution, pp)															
PCE	2.9	1.2	2.4	2.0	1.7	1.3	1.0	1.2	1.8	2.1	**2.0**	**1.9**	**1.8**	**1.8**	**1.7**
Gross Investment	0.4	1.4	0.9	-0.1	-0.2	-0.5	1.5	0.7	0.9	0.8	**0.4**	**1.0**	**1.1**	**1.2**	**1.2**
Non Residential	0.1	0.2	0.5	0.3	-0.3	-0.8	1.1	0.4	0.8	0.4	**0.2**	**0.7**	**0.7**	**0.9**	**1.0**
Residential	0.3	0.3	0.3	0.3	0.3	0.6	0.3	0.3	0.1	0.3	**0.4**	**0.3**	**0.4**	**0.3**	**0.3**
Exports	0.7	-0.8	0.6	0.1	-0.3	-0.3	0.5	0.4	0.5	0.2	**0.0**	**0.3**	**0.5**	**0.5**	**0.6**
Imports	-1.6	-1.1	-0.5	-0.4	0.1	0.0	-0.4	-0.2	-0.6	-0.8	**-0.3**	**-0.8**	**-1.0**	**-1.1**	**-1.1**
Government	-0.3	0.0	0.5	0.3	0.0	0.2	-0.4	-0.6	-0.1	0.1	**0.3**	**0.1**	**0.0**	**0.0**	**-0.1**
Unemployment Rate (%, average)	5.7	5.6	5.4	5.2	5.0	4.9	8.1	7.4	6.2	5.3	**4.8**	**4.6**	**4.5**	**4.5**	**4.6**
Average Monthly Nonfarm Payroll (K)	274	190	251	192	282	203	179	193	251	229	**204**	**244**	**265**	**283**	**281**
CPI (YoY %)	1.2	-0.1	0.0	0.1	0.4	1.1	2.1	1.5	1.6	0.1	**1.3**	**2.0**	**2.0**	**2.1**	**2.2**
Core CPI (YoY %)	1.7	1.7	1.8	1.8	2.0	2.3	2.1	1.8	1.7	1.8	**2.1**	**2.1**	**2.1**	**2.2**	**2.2**
Fiscal Balance (% GDP)	-	-	-	-	-	-	-6.8	-4.1	-2.8	-2.8	**-3.0**	**-3.0**	**-2.9**	**-2.9**	**-3.0**
Current Account (bop, % GDP)	-2.3	-2.7	-2.5	-2.9	-2.8	-	-2.8	-2.3	-2.9	-2.9	**-2.8**	**-3.0**	**-3.0**	**-3.1**	**-3.1**
Fed Target Rate (%, eop)	0.25	0.25	0.25	0.25	0.50	0.50	0.25	0.25	0.25	0.25	**1.00**	**2.00**	**3.00**	**3.50**	**3.50**
Core Logic House Price Index (YoY %)	5.54	4.76	5.00	5.12	5.36	6.00	3.84	10.89	7.69	5.06	**4.87**	**4.10**	**3.34**	**2.40**	**2.53**
10-Yr Treasury (% Yield, eop)	2.21	2.04	2.36	2.17	2.24	1.89	1.72	2.90	2.21	2.24	**2.27**	**2.79**	**3.69**	**4.42**	**4.61**
U.S. Dollar / Euro (eop)	1.23	1.08	1.12	1.12	1.09	1.11	1.31	1.37	1.23	1.09	**1.12**	**1.16**	**1.20**	**1.20**	**1.20**
Brent Oil Prices (dpb, average)	76.4	53.9	61.7	50.2	43.6	33.7	111.7	108.6	99.0	52.4	**36.8**	**45.7**	**55.7**	**59.6**	**59.6**

Source: BBVA Research & Haver Analytics

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