Economic Analysis

Economic uncertainty: no relief for faint-hearted

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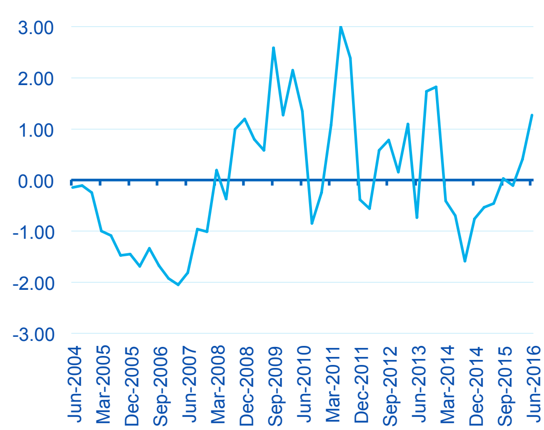
- **Two year highs in uncertainty inauspicious sign for growth in 2016**
- **Lending activity could suffer if banks grow wary of economic outlook**
- **Likelihood of Fed raising rates low amidst geopolitical or policy tumult**

Of late, and for that matter, throughout the post-crisis period, it seems that every week brings a historic event that destabilizes markets and renews economic and policy concerns. The short list includes: the attempted putsch in Turkey, the decision by the UK to exit the EU (Brexit), horrific acts of terror globally, and a presidential race in the U.S. that is set to be a contest of two of the most polarizing characters in history. More concerning are issues—Italian banking instability, tensions in the South China Sea, spillover from the real impact of Brexit—that remain unresolved. While not “black swan” events given the attention they are receiving, in aggregate, they have the potential to exacerbate what is becoming a highly uncertain period. In fact, without incorporating the impacts of these events, our policy uncertainty index, which uses textual analysis of Google news stories as a proxy for uncertainty, shows that uncertainty is at its highest level in two and a half years—during the 2013 government shutdown.

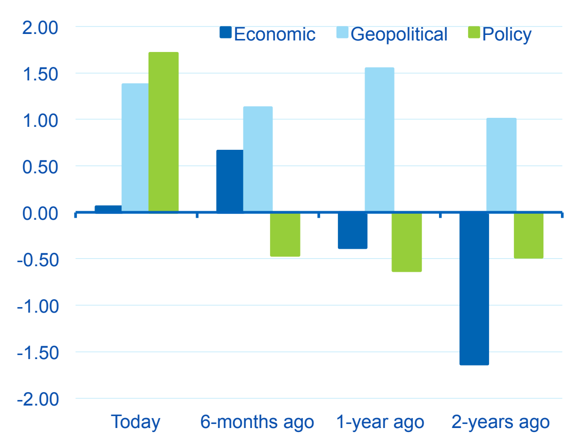
Measuring uncertainty is not an easy or straightforward task, but advances in data aggregation and analysis allow for a more objective, quantifiable measure, as opposed to a survey-based measure which can be subject to multiple biases. For our index, we apportion more than 25 words and phrases amongst three subindexes—policy, economic and geopolitical—to compile an overall measure of uncertainty. The common movements of each index combine to form our overall uncertainty index. Our index tracks closely with major idiosyncratic events such as the 2008 Lehman bankruptcy, the so-called fiscal cliff, the government shutdown in 2013, the debt-ceiling debate, the Ebola crisis and, most recently, the U.K. referendum on E.U. membership.

Chart 1
BBVA Research Uncertainty Index



Source: BBVA Research, using Google trends
*+=above average

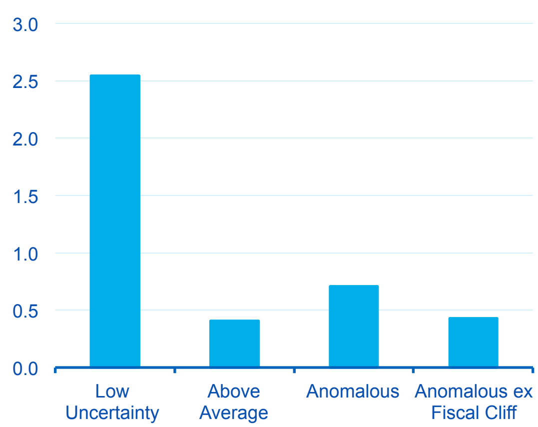
Chart 2
BBVA Research Uncertainty Index Components*



Source: BBVA Research, using Google trends
*+=above average

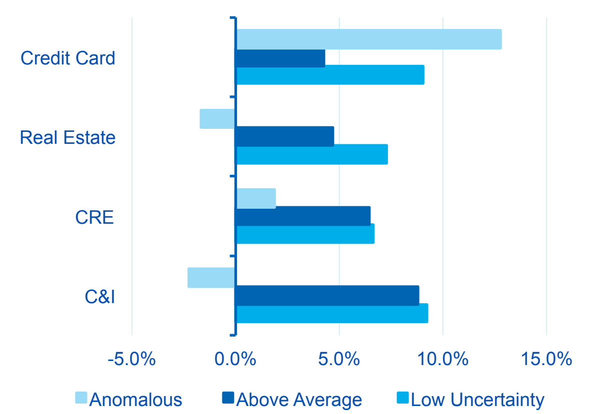
Beyond measuring uncertainty, there is a need to understand the impacts and costs that are associated with high levels of policy or economic uncertainty. Recent research has shown that, for firms, policy uncertainty can increase equity volatility and reduce investment and employment in policy-sensitive sectors like defense, healthcare, finance and infrastructure. Also, at the aggregate level, policy and uncertainty shocks can decrease investment, output, and employment.[1] Uncertainty has also been shown to reduce the probability of a "match" between job seekers and firms and to reduce the willingness of banks to lend.[2] However, when thinking in terms of uncertainty regimes, we find the story is nuanced.

Chart 3
Uncertainty Regimes and GDP



Source: BBVA Research & Haver Analytics

Chart 4
Commercial Loan Growth, year-over-year %



Source: BBVA Research & FDIC

In the context of investment, employment, and wages, we find that, consistent with an environment where firms forego investment and hiring decisions that are inflexible or irreversible, employment and investment trend downwards as uncertainty rises. This trend is consistent with the second quarter's weak employment data and tepid investment. Although, equities have rebounded slightly, most often, equity returns decline with high levels of uncertainty; however, of note, returns are slightly higher in the anomalous periods.

For GDP, the outlook for the second quarter is weighed on by the fact that GDP responds negatively to uncertainty, averaging less than 0.5% year-over-year since 2004. Unlike investment, consumption remains resilient in the face of uncertainty, averaging around 2.5% year-over-year.[3] Likewise, government spending and uncertainty are positively related, which could help to explain the slightly higher rate of growth in anomalous periods of uncertainty. Assuming no major changes in fiscal policy in a lame duck session, our baseline remains for moderate growth in 2H16.[4]

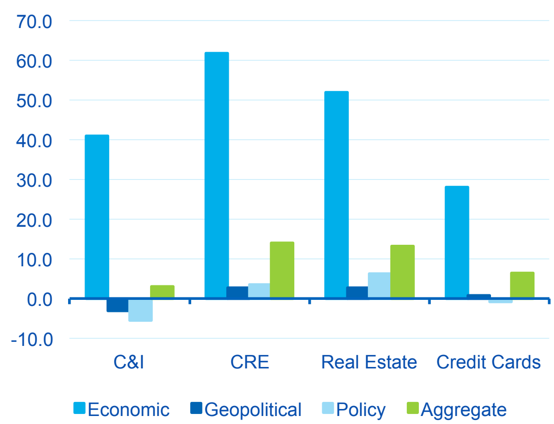
High levels of uncertainty also impacts credit markets, with loan growth contracting in the C&I and residential real estate segments. However, consumer loans actually perform better in high uncertainty environments. In fact, credit cards loans and auto lending decelerate in times of above average uncertainty, but grow at a rate 1pp higher in anomalous times; deep discounting at auto dealerships during recessions, consumption smoothing,

[1] See Baker R. Scott, Nicholas Bloom, and Steven J. Davis. "Measuring Economic Policy Uncertainty". 2016
[2] See Nash-Stacey https://www.bbvaresearch.com/wpcontent/uploads/2016/06/160622_US_EW_RunningOnFumes.pdf
[3] We define "above average" uncertainty any shock above the average but less than or equal to plus 1 standard deviation. "Anomalous" shocks are those greater than 1 standard deviation
[4] Current nowcast estimate is for quarter-over-quarter annualized growth of 1.5%

and the fact that these loans generally carry smaller average balances could explain this idiosyncrasy. This is unwelcome news for markets, as interest margin pressures and stress in the oil and gas sectors have reduced banks' appetite for new loans.

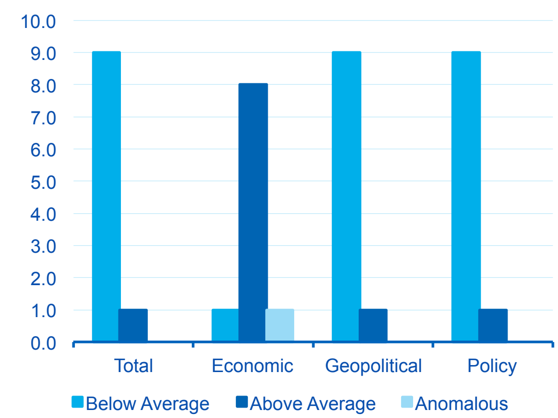
When looking more closely at the supply-side, the willingness of commercial banks to lend declines in times of moderate uncertainty, with standards actually relaxing in anomalous circumstances for the major lending categories—C&I, CRE, residential real estate, and consumer loans. However, how banks respond to various types of uncertainty is starkly contrasted. For example, when economic uncertainty is unusually high, 30-60% of banks report tightening credit standards, whereas in times of geopolitical or policy uncertainty, the largest net increase in the percentage of banks tightening their standards is 14.1% and 13.2% for CRE and residential real estate, respectively. Given that the recent increase in uncertainty has been associated with geopolitics and policy, it is unlikely that the current uptick will derail banks' willingness to lend.

Chart 5
Bank Lending Standards & Anomalous Uncertainty*



Source: BBVA Research & Federal Reserve Board
*positive = net tightening of bank lending standards

Chart 6
Fed Response to Uncertainty (# of rate increases)



Source: BBVA Research, using Google trends

In contrast to banks, the Federal Reserve seems to be unmoved by economic uncertainty, raising rates eight out of 10 times in periods of above average economic uncertainty. However, this unabashed attitude does not carry over into other forms of uncertainty. In fact, contrary to economic uncertainty, the committee appears highly sensitive to policy and geopolitical uncertainty, raising rates only one time under such conditions (December 2015). Moreover, between 2004 and 2Q16, there is only one scenario in which the target federal funds rate has averaged a 25bp increase over the quarter: above average economic uncertainty. This could imply that markets are overreacting to subpar employment figures, seasonality in GDP reports or pessimistic inflation figures. Instead, markets may not be sufficiently discounting the impact that global events such as Brexit, the attempted Turkish coup or the upcoming presidential election will have on the committee's decision to resume policy normalization. This evidence reinforces the idea that rate hikes are unlikely to occur before 4Q16.

Bottom Line

Both domestic and global events that have unfolded in 2Q16 have led to a marked increase in our uncertainty index, which uses textual analysis of Google news stories as a proxy for uncertainty. Given that firms generally forego large and irreversible investment and hiring decisions, it is no surprise that employment and investment were weak in 2Q16. Moreover, average growth in periods with uncertainty similar to current levels is ~0.5% year-over-year, which supports our baseline for moderate growth in 2016. Another concern heading into 2H16 is lending conditions given pressures on interest margins and the lingering effects of low oil prices. However, data suggests that that banks are more sensitive to economic uncertainty, which has receded since December, than policy or geopolitical. That being said, with the exception of December 2015, the Fed has rarely raised rates in times of high policy or geopolitical uncertainty, suggesting the likelihood of the Fed raising rates will remain low until the tumult fades.