BBVA | RESEARCH

Economic Outlook

United States

First Quarter 2014
Economic Analysis

- The global economic cycle is improving and we now have clarity on some economic policy uncertainties
- Compromise in Congress and the Fed's start to QE3 tapering have reduced fiscal and monetary policy uncertainty in the U.S.
- Positive revisions to 2014 GDP, with risks shifted to the upside in the coming years

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Closing Date: February 13, 2014

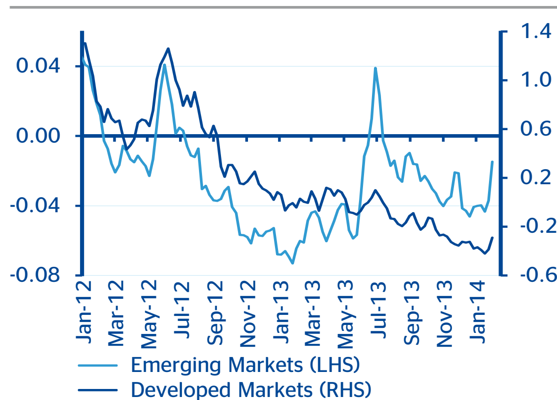
1. Global Outlook

More Growth in Sight and with More Balanced Risks

The global economic cycle strengthened during the latter months of 2013, driven primarily by acceleration in developed economies. Global GDP accelerated to 1.0% QoQ, leaving behind the moderation with its roots in 2012 and a low at the beginning of 2013, when growth was barely 0.5%. A pick-up in the U.S. was a major factor in this global improvement, but the Eurozone also made some progress, seeing moderate growth after the recession ended in mid-2013. In emerging markets, the situation is more diverse, but some of them (i.e., China) are posting relatively stable rates of growth. Improvements in the global outlook are also the result of economic policy news, as this has helped to reduce financial tensions and overall uncertainty worldwide (Chart 1). In the U.S., both fiscal and monetary policy took steps forward, with Congress agreeing on a two-year budget and the Federal Reserve initiating the tapering process at the beginning of 2014. In Europe, further steps have been taken towards the construction of a banking union, which together with the ECB's determination to keep risks under control, should eliminate the hobble represented by financial fragmentation. Still, the overall outlook would be clearer if it were not for the effect that the tapering is having on financial markets in emerging markets, which could ultimately impact economic growth on a global scale.

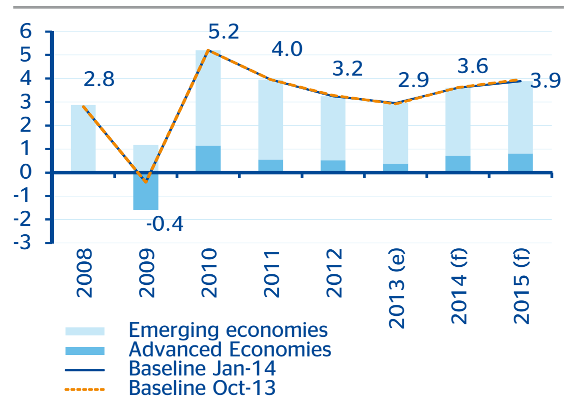
Altogether, our assessment of the global scenario is better than it was three months ago. Our projections now suggest that global GDP growth, which in 2013 had decelerated to 2.9%, will increase 3.6% and 3.9% in 2014 and 2015, respectively (Chart 2). While our overall outlook is more optimistic, these figures are mostly the same as our forecasts three months ago due to the offset between growth expectations in different regions: to the upside in the U.S. and to the downside in some emerging economies, with no significant change to eurozone forecasts for 2014. In spite of the expected acceleration in growth, we still see some downside risks to our forecasts. These risks are a long way from having the systemic nature that they had in the past, but some recent events such as the fall in asset prices and currency depreciation in emerging markets have made themselves felt.

Chart 1
BBVA Research Financial Tensions Index



Source: BBVA Research

Chart 2
Global Economic Growth (%)

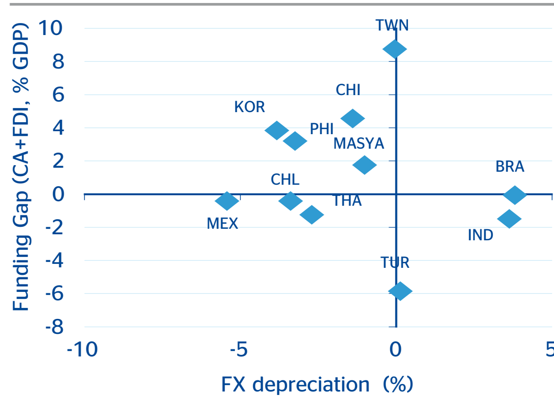


Source: BBVA Research & IMF

The change of direction in U.S. monetary policy has, as usual, a global impact. Emerging economies are being subjected to capital outflows and currency depreciation, intensified in some cases by domestic events that have increased uncertainty regarding the management of their respective local economic policies. Even so, the intensity of the non-resident capital outflows is no worse than on previous occasions when expectations have changed regarding the start of Fed tapering. In addition, there continues to be

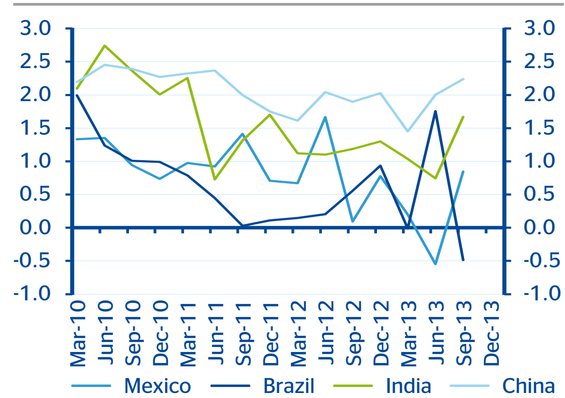
a differentiation between economies depending on their fundamentals: higher external deficits and more dependence on short-term and foreign-currency funding are associated with greater vulnerability to capital outflows and currency depreciation (Chart 3). The recent tensions have not changed our growth forecasts for emerging markets as a whole, but they do represent a significant downside risk. This risk is higher in the economies that are financially more integrated in global portfolio indexes and that have the above-mentioned vulnerabilities: Turkey, Brazil, Indonesia and India, in particular. The monetary tightening being introduced by some of these countries to control currency depreciation and inflation expectations will inevitably have a negative impact on growth in these markets. All in all, the diversity within emerging markets means that our outlook remains favorable for some parts of South America, such as the Andean economies, as well as emerging Asia and Mexico. In the case of Mexico, we have even improved our outlook for growth in 2014 to 3.4%, driven by the cyclical momentum of the U.S. economy (Chart 4).

Chart 3
Exchange-rate Depreciation (%) and External Funding Gap (CA + FDI, % GDP)



Source: BBVA Research & Haver Analytics

Chart 4
Emerging Markets Economic Growth (SA, QoQ %)



Source: BBVA Research

Growth in China remains at around 7.5%, but the vulnerabilities are more evident. The fourth quarter was a clear example of the duality of China as both a support for the global economy and a potential risk factor. The uncertainty at the beginning of the year regarding the sustainability of China's growth and the possibility of a hard landing dissipated temporarily. The economy recovered in the second half of 2013 and has since maintained a healthy tone, although some of the more recent data on confidence and manufacturing activity are once again below market expectations.

Fundamental changes in Chinese economic policy have also been announced. At the Third Plenum of the Chinese Communist Party, the authorities reiterated their commitment to maintaining high rates of growth, while at the same time proposing measures that will strengthen the role of the market in allocating resources and a rebalancing from a model of investment and exports towards increasing household consumption. These announcements should be valued as steps in the right direction, but their effectiveness will depend on execution, and they are not without risk. For example, with regards to the financial sector, authorities are continuing to demonstrate their commitment to tackle the current vulnerabilities fundamentally linked to the rapid growth of credit. This is being reflected in liquidity tensions in the interbank market which are above all affecting the so-called shadow banking sector. However, the authorities have not managed to moderate the rate of credit growth, and a continuation of these tensions could have unwelcome effects on the stability of the system.

In any case, our 2014 and 2015 forecasts for China's economy remain unchanged at 7.6%, based on our confidence in the authorities' scope and ability to take action. All in all, the risk of a hard landing would be particularly damaging given the size of the economy and its importance for world trade.

The gradual recovery in the eurozone continues, with the support of the ECB and with banking union in its sights. After starting 2013 in recession, the region managed to sustain moderate expansion throughout the second half of the year, in line with our forecast. Thus, if our expectations are confirmed, the fourth quarter data will indicate YoY growth of 0.4%, which although only slight, is its best since the end of 2011. The driver of this slight improvement is the prospect of an increasing role played by domestic demand, although the engine of European growth in 2013 and 2014 was, and will continue to be, the export sector. The factors supporting the moderate recovery in the eurozone are: i) the recovery of external demand; ii) sustained improvement in financial conditions, favored by the ECB's determination of, and commitment to, an expansive monetary policy; and finally, iii) the steps taken towards a banking union, which should reduce the financial fragmentation that is hampering the role of monetary policy in the region as a whole. In any case, we cannot rule out periods of instability as we approach events that could alter the panorama of progress for a banking union and of strengthening the monetary union in Europe in general. The events to watch in this context include the European Parliamentary elections as well as news on the conditions and results of the stress test and asset quality review of the banking sector.

All in all, we reiterate our forecast for eurozone GDP growth at 1.1% in 2014 and 1.9% in 2015. However, given our projection of continued cyclical weakness, we are also maintaining as a risk event to our forecast horizon a scenario of significant deflation, though we assign a low probability to this risk.

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

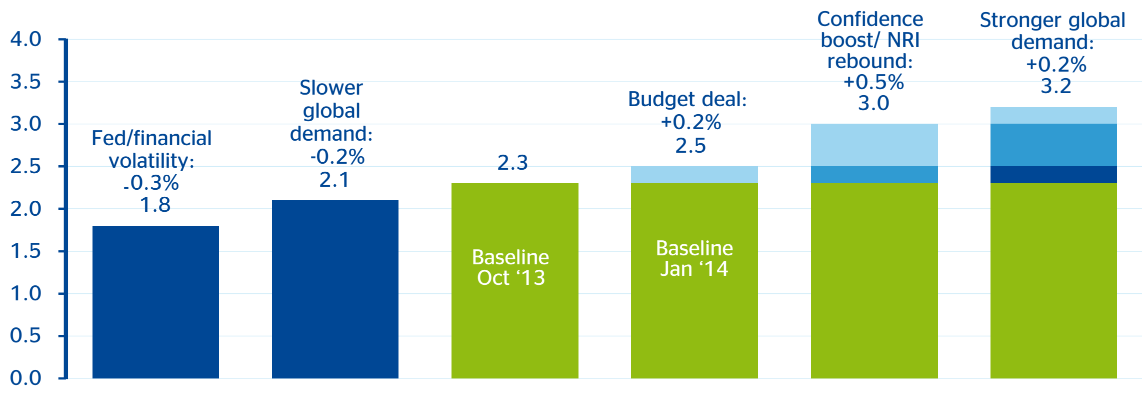
2. U.S. Outlook

Winter Pains a Small Glitch in an Otherwise Strengthening Economy

Economic activity has been moving along relatively smoothly into 2014, but the system is not without its glitches. Despite better-than-expected data throughout the latter part of 2013, the most recent indicators are a good reminder of why we remain careful not to jump to conclusions when it comes to the overall strength of the recovery. Job growth, housing, and manufacturing activity have slowed substantially from the robust growth set forth in 3Q13 and early 4Q13. Consumer confidence and consumption have held up so far, but most of that reflects the usual trends seen during the holidays, and it is unclear whether personal spending momentum has carried over into 2014. Even still, we have managed to overcome some of the major obstacles that had prevented a more optimistic outlook, with the two-year budget agreement and debt-ceiling deal in Congress as well as the Fed's start to tapering alleviating some of the risks from fiscal and monetary policy uncertainty.

Despite some minor hiccups in the data, risks to GDP growth have certainly shifted to the upside, particularly in the short-term. With the initial estimate for 4Q13 growth coming in at 3.2% on a QoQ seasonally-adjusted annualized basis, annual growth for 2013 hit a higher-than-expected 1.9%. Personal consumption was a strong contributor, as were inventories and net exports. Private investment was led by nonresidential equipment, as residential activity took a cold turn downward as the polar vortex hit hard across the nation. However, we expect that this housing slowdown will be only temporary, particularly as home prices continue to rise and household deleveraging comes to an end. For 2014, we expect to see continued recovery in the residential market and a return to positive growth contributions in the years to come (see U.S. Housing Outlook). Meanwhile, reduced fiscal uncertainty is likely to boost capital spending and hiring.

Chart 5
Risks to GDP Growth in 2014 (YoY % Change)



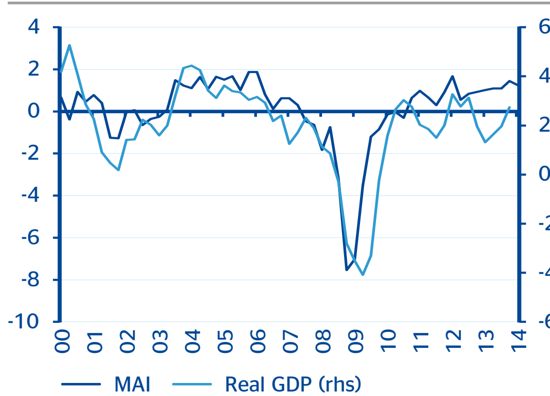
Source: BBVA Research

These latest developments in the short-term fiscal situation suggest a smaller drag on economic growth for 2014, and thus, we have revised up our GDP forecast from 2.3% to 2.5% for the year (Chart 5). Our internal activity indices based on short-term data suggest a slight quarterly deceleration moving into 1Q14 (Chart 6), but overall the pace of growth for 2014 is shaping up to be one of the strongest of the recovery thus far. Upside risk potential has definitely improved throughout the past few quarters, not solely because of fiscal progress but also related gains in confidence and nonresidential investment. A faster-than-expected global recovery could also spillover in the form of increased demand for U.S. exports. If these upside scenarios come to fruition, we could see average growth in 2014 surpass 3.0%, marking the first such occurrence since 2005. While these upside scenarios seem more plausible now

compared to six months ago, major contributors to growth are still running below comparable pace from prior expansions. On the flipside, a slowing or reversal in the global economy's forward momentum (i.e. increased financial volatility abroad or a sharp slowdown in emerging markets) could have an impact on growth in the U.S., but only to the extent of a few percentage points depending on the severity of the situation. Domestically, the biggest downside risk would involve any financial market disruption and increased volatility related to a disorderly Fed exit. However, given the latest trends in monetary policy accommodation, we assign a low probability to this risk event.

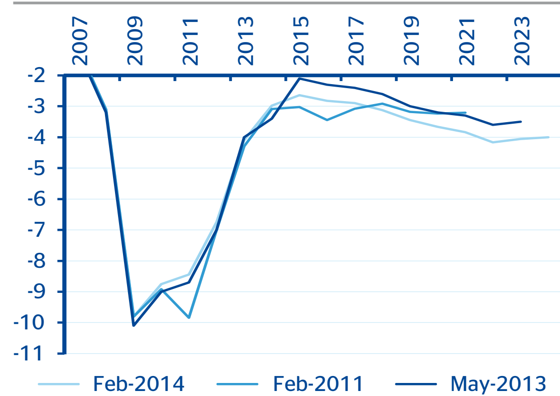
Longer-term concerns are still relevant, mostly as they relate to fiscal stability in the U.S. and abroad. Given the austerity measures already in place for the coming years, we do expect to see modest improvements. The Congressional Budget Office (CBO) just recently released the updated budget outlook for fiscal years 2014-2024, with the 2014 deficit projected to be the lowest since 2007 (Chart 7). However, debt held by the public is expected to reach 74% of GDP, the highest since 1950. High debt-to-GDP ratios limit the ability of fiscal policy to respond to potential future negative shocks. In the short run, the outlook continues to look upbeat as the economy finally appears to be consistently expanding at a steady clip; however, continued lack of progress in addressing longer-term budgetary challenges has the potential to curb economic activity in the near term (see U.S. Budget Outlook).

Chart 6
BBVA Research Monthly Activity Index and Real GDP Growth (4Q % Change)



Source: BEA & BBVA Research

Chart 7
Government Budget Balance (% of GDP)

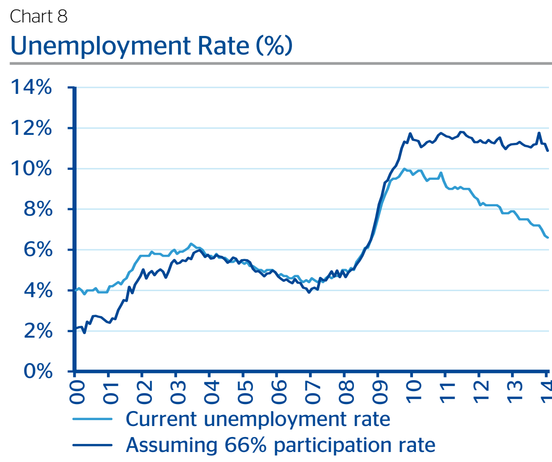


Source: CBO & BBVA Research

Labor market trends have definitely been at the forefront of the economic outlook in recent years, and now even more so as it relates to monetary policy accommodation. Job growth has definitely accelerated since the recession, and employment levels are approaching the pre-recession peak. However, we have yet to see a steady pace of hiring in the short term, with nonfarm payroll growth jumping above 200K for a few months at a time, but then falling back to a much slower and disappointing pace. In December and January, nonfarm payrolls increased only 75K and 113K, respectively, compared to a +200K average during the prior months in 2013. Some of this can be attributed to the extremely cold weather threatening most of the U.S. as well as other temporary factors, although it remains to be seen the true strength of the labor market as a whole. Various employment indicators suggest that hiring remains extremely soft compared to recent gains in job openings, and the number of long-term unemployed remains elevated – both of which are supportive of increasing structural unemployment concerns. Furthermore, labor force participation continues to disappoint, hovering near 30-year lows. Recent declines in participation have played a major role in the faster-than-expected declines in the unemployment rate, although in January, participation ticked up slightly while unemployment fell to a recovery low of 6.6%. If the participation rate had held steady at the pre-crisis (2000-2007) average near 66.0%, the unemployment rate would still be well-above 10.0%, assuming consistent employment, population, and demographic trends (Chart 8).

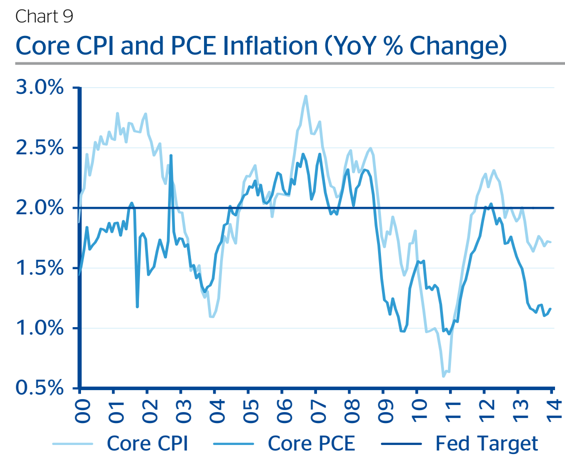
This is certainly a concern moving forward, but we do expect that with increasing job and income prospects, more people will come back into the labor force looking for work. This should put upward pressure on the unemployment rate temporarily, assuming that employment growth continues along at a gradual pace. For 2014, we expect the unemployment rate to average 6.7%, with employment growth holding steady near 1.7% annually. Ongoing expansion of aggregate demand will boost job creation that could average 200K per month in 2014. However, if labor force participation continues to decline, we could see a much lower unemployment rate by the end of the year, even if employment growth disappoints to the downside.

Chart 8
Unemployment Rate (%)



Source: BLS & BBVA Research

Chart 9
Core CPI and PCE Inflation (YoY % Change)



Source: BLS & BBVA Research

Balancing out improvement in the labor market has been unusually low inflation, a concern rising within the Federal Reserve and among other policymakers (Chart 9). This prolonged period of low inflation reflects elevated slack in the labor market and downward price pressures on imported goods, as well as a more permanent shift alongside technological advancements that have reduced the costs for many goods and services. Although wage growth is expected to remain subdued throughout 2014, consumers have benefited from low inflation and the resulting increase in purchasing power. This has helped move consumption along, and we expect that accelerating economic growth will gradually exert upward pressures on prices. Furthermore, long-term inflation expectations remain well anchored, thus limiting both upside and downside risks. For the next few years, we expect core inflation to approach the Fed's 2.0% target, with headline CPI averaging 2.3% in 2014 and 2.4% in 2015.

With lingering concerns related to both unemployment and inflation, the Fed will remain extremely cautious in adjusting their monetary policy stance throughout the coming year. Tapering of asset purchases has officially begun, and we expect that the process will continue in "measured steps" of around $10bn per month, split evenly between MBS and Treasuries, with QE3 finally coming to an end in 4Q14. It is important to note that the Fed has been successful in de-linking the decision to taper asset purchases from the decision to begin hiking interest rates. Janet Yellen, the new Chair, is expected to uphold consistency in the Fed's strategy as laid out by Bernanke throughout the past few years. Overall, the biggest challenge for the Fed is to assure a smooth transition in implementing an exit strategy, and there is some uncertainty related to the eventual normalization process. However, with the slow tapering process taking us through most of 2014, the downside Fed-related risks for this year are limited. Our baseline scenario assumes that the first federal funds rate hike will occur in 3Q15, with short-term rates expected to follow the policy rate path. However, as the Fed continues to normalize monetary conditions, we anticipate an upward trend in long-term interest rates, driven primarily by a higher term-premium and the real interest component, and to a lesser extent by higher inflation expectations. In our baseline scenario, the 10-year Treasury yield averages 3.2% in 2014 and slowly rises to 3.8% by the end of 2015. As the Fed's exit strategy is not immune to unexpected domestic and global events, we maintain our expectations for very cautious and calculated monetary policy changes in the years to come.

3. Economic Forecasts

Table 1

	2Q13	3Q13	4Q13	1Q14	2012	2013	2014	2015	2016	2017
Real GDP (% SAAR)	2.5	4.1	3.2	1.6	2.8	1.9	**2.5**	**2.5**	**2.8**	**2.8**
Real GDP (Contribution, pp)										
PCE	1.2	1.4	2.3	1.0	1.5	1.4	**1.2**	**1.2**	**1.3**	**1.2**
Gross Investment	1.4	2.6	0.6	0.2	1.4	0.8	**0.9**	**0.8**	**1.0**	**1.1**
Non Residential	0.6	0.6	0.5	0.6	0.9	0.3	**0.6**	**0.9**	**0.9**	**0.9**
Residential	0.4	0.3	-0.3	0.2	0.3	0.3	**0.1**	**0.3**	**0.2**	**0.3**
Exports	1.0	0.5	1.5	0.7	0.5	0.4	**0.9**	**1.0**	**0.8**	**0.9**
Imports	-1.1	-0.4	-0.2	0.6	-0.4	-0.2	**0.5**	**0.5**	**0.3**	**0.4**
Government	-0.1	0.1	-0.9	0.0	-0.2	-0.4	**-0.2**	**0.0**	**0.0**	**0.0**
Unemployment Rate (%, average)	7.5	7.2	7.0	6.7	8.1	7.4	**6.7**	**6.2**	**5.7**	**5.2**
Average Monthly Nonfarm Payroll (K)	201	172	195	171	186	194	**197**	**226**	**245**	**273**
CPI (YoY %)	1.4	1.6	1.2	1.9	2.1	1.5	**2.3**	**2.4**	**2.4**	**2.5**
Core CPI (YoY %)	1.7	1.7	1.7	1.9	2.1	1.8	**2.0**	**2.3**	**2.4**	**2.5**
Fiscal Balance (% GDP)	-	-	-	-	-6.8	-4.2	**-3.4**	**-2.2**	**-2.4**	**-2.5**
Current Account (bop, % GDP)	-2.3	-2.3	-	-	-3.0	**-2.5**	**-2.5**	**-2.1**	**-1.9**	**-1.3**
Fed Target Rate (%, eop)	0.25	0.25	0.25	0.25	0.25	0.25	**0.25**	**0.50**	**1.50**	**2.50**
S&P Case-Shiller Index (YoY %)	9.88	11.19	11.32	9.68	2.81	10.60	**8.78**	**6.20**	**4.62**	**3.78**
10-Yr Treasury (% Yield, eop)	2.30	2.81	2.90	2.94	1.72	2.90	**3.50**	**3.80**	**4.10**	**4.34**
U.S. Dollar / Euro (eop)	1.32	1.34	1.37	1.31	1.31	1.37	**1.30**	**1.38**	**1.36**	**1.36**
Brent Oil Prices (dpb, average)	102.7	110.3	109.3	109.4	111.7	108.7	**112.8**	**117.2**	**120.2**	**124.2**

Source: BBVA Research & Haver Analytics

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