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Economic Watch

United States

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Economic Analysis

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2014 Regional Outlook

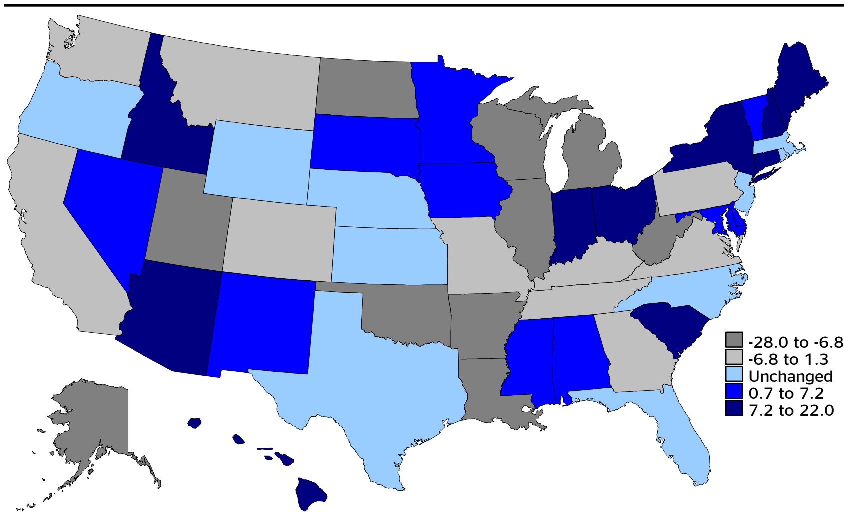
West Coast and Resource Growth Bias to Ease in 2014

- 2014 will be the first year of regional growth convergence in seven years, thereby allowing the recovery to reach the most Americans since 2006
- Quality and type of reserves will drive growth in natural resource dependent states
- Structural factors underlie persistent weakness in regional labor markets

Throughout 2013, labor markets were slow to recover due to rebalancing across emerging and developed markets, and consumer deleverage and fiscal and sovereign uncertainty in the U.S. and Europe. In addition, incongruous fiscal and monetary policies contributed to weaker growth, heightened uncertainty and drove risk appetites and run-up in asset price and fixed income markets. Permanent reductions in government employment and the temporary cuts associated with the government shutdown added to the overall level of economic uncertainty, which contributes to the downside risks to employment growth and investment. We anticipate that the direct impact of the government shutdown on 4Q13 GDP could be as much as 20bp.

However, signs of lesser partisanship and confirmation of tapering by the Fed could allow headwinds that underlie our forecast of 1.7%YoY growth in 2013 to abate. In 2014, stronger business and consumer confidence, higher household net worth, a lower drag from fiscal policy, a surge in housing prices that boost construction activity and credit growth will support stronger regional growth. Our baseline is for 2014 to be the first year of growth convergence in seven years, thereby allowing the recovery to reach the most Americans since 2006.

Chart 1
2H13 Revisions to 2014 Year-over-Year Real GDP Growth (bp)



Source: BBVA Research, BEA & Haver Analytics

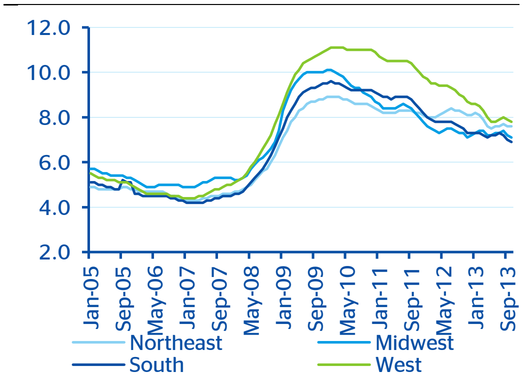
Structural shift biggest risks to labor market recovery

More persistent declines in labor force participation, slow job creation rates and weak employment growth amidst three years of unprecedented monetary policy stimulus suggest that mainly structural factors rather than cyclical frictions underlie the hysteresis in the labor market. Still, increased market clarity and more certain labor market conditions should ease economic hardships in east and gulf coast, which have been slow to recover.

Moderate growth and uncertainty has left some states no better off in terms of unemployment. For example, Texas, which has led the recovery and created seven out of ten jobs since 2005, has experienced a slowed decline in its unemployment rate. In fact, Texas' unemployment rate has not declined below December 2012 rates (6.2%), due to high population growth. Other states, which had been slow to bounce back in the recovery such as New Jersey, Pennsylvania and Indiana, and without strong population growth, experienced precipitous declines of 1.1pp, 0.4pp and 0.8pp in their respective unemployment rates. Although all of the aforementioned states have seen job growth trend positively in 2013, declines of 1.3pp, 0.8pp and 0.7pp in their labor force participation rates suggests that labor market conditions may not be as auspicious as would be indicated by the unemployment rate declines. In other words, high population growth needs proportionally higher employment growth to achieve a similar decline in unemployment. For example, between 2009 and 2013, Houston created 60% more jobs than Detroit, and still both metros have a similar number of people unemployed. This can be explained looking at the labor force which in the case of Houston increased 8.1% while Detroit's declined 2.4% in the same period.

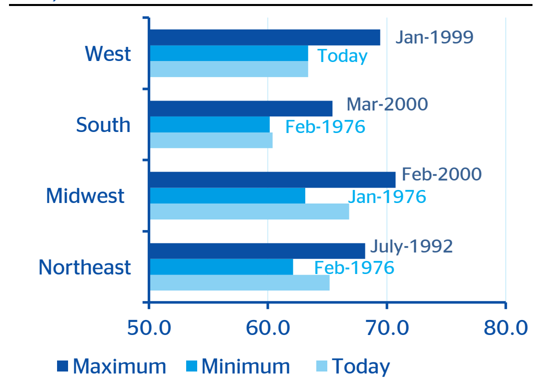
In fact, 43 states had falling labor force participation rates from a year ago and 24 states currently have the lowest labor force participation rates since the 1980s confirms our misgivings about the strength of the labor market recovery (see our latest brief on labor force participation). As a result, our expectations are for continued declines in unemployment rate, albeit at a slower rate. This reflects the exit of baby boomers from the labor force and the drop in prime-age workers labor force participation.

Chart 2
Regional Unemployment Rates (%)



Source: BBVA Research & Haver Analytics

Chart 3
Regional Labor Force Participation (Jan-1976 to Oct-2013)



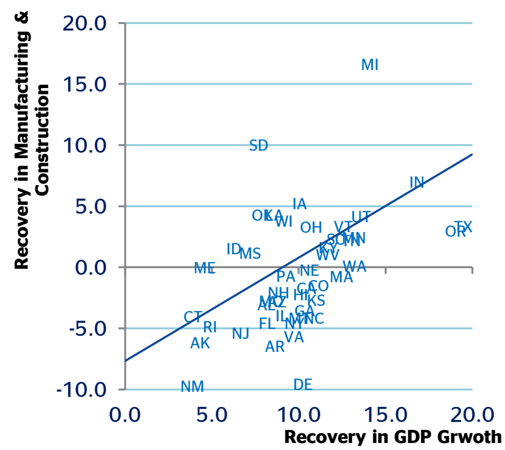
Source: BBVA Research & Haver Analytics

Structural shifts that occurred in the 1970s and more competitive global wages have weighed on domestic manufacturing. Relative to the peak in manufacturing employment in 1979, employment has declined 38% and now accounts for less than 9% of the labor market. Without gains in manufacturing and construction employment, which are sectors that can quickly and endogenously create a sizeable amount of new direct and indirect jobs in all states, the pace of regional employment growth will remain slow and risk a downward shift in economic potential. The rebalancing between durables and non-durables consumption also suggests states with high concentrations of heavy manufacturing such as Indiana, Michigan, Wisconsin, Ohio and Illinois will benefit the most.

Moreover, while the construction sector contributed positively to total employment in 39 states, only three states have construction employment levels higher than before the crisis— North Dakota, Louisiana and Alaska— mainly driven by large energy projects. In contrast, Nevada's construction employment remains 58.6% lower than pre-crisis levels and similar to 1994. Thus, while positive, construction employment is still far from fully recovered and will depend on employment and income growth in other high valued-added sectors.

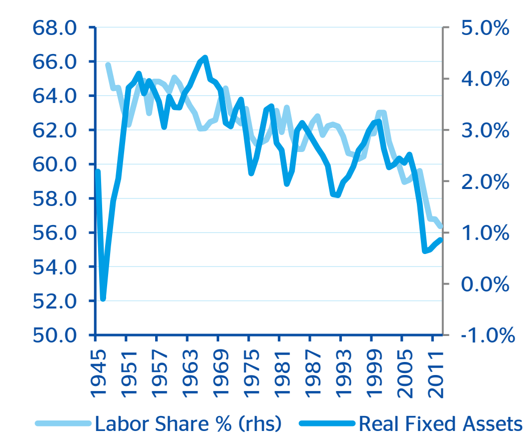
Furthermore, capital accumulation slowed considerably over the recession and despite gains in productivity, firms are returning less real economic profits to the labor force. Specifically, the rate of growth in the real net stock of private assets slowed to its lowest rate of growth since 1945. Moreover, labor share, which is a measure of labor compensation as a share of total output, is at its lowest post-war era rate (55.8%), down from 62.7% in 2000. Upside potential for overall job creation will remain low, assuming net fixed capital accumulation remains weak. If policymakers were to reduce political histrionics and deliver far-reaching agreements, the incentives for firms to commit to long-term investments and hiring decisions would rise.

Chart 4
GDP, Construction & Manufacturing Employment (cumulative growth from trough)



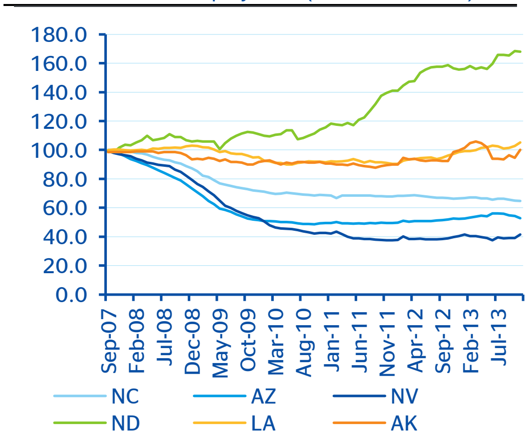
Source: BBVA Research, BLS & Haver Analytics
*Some states excluded due to scaling

Chart 5
Net appreciation in Fixed Assets & Labor Share (YoY% & %)



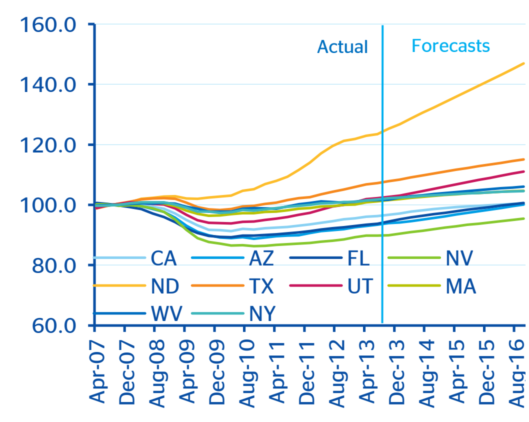
Source BBVA Research, BEA, BLS & Haver Analytics

Chart 6
State Construction Employment (Index, 2007=100)



Source: BBVA Research, BLS & Haver Analytics

Chart 7
Nonfarm Payroll Employment Index w/ Forecasts (Index, 2007=100)

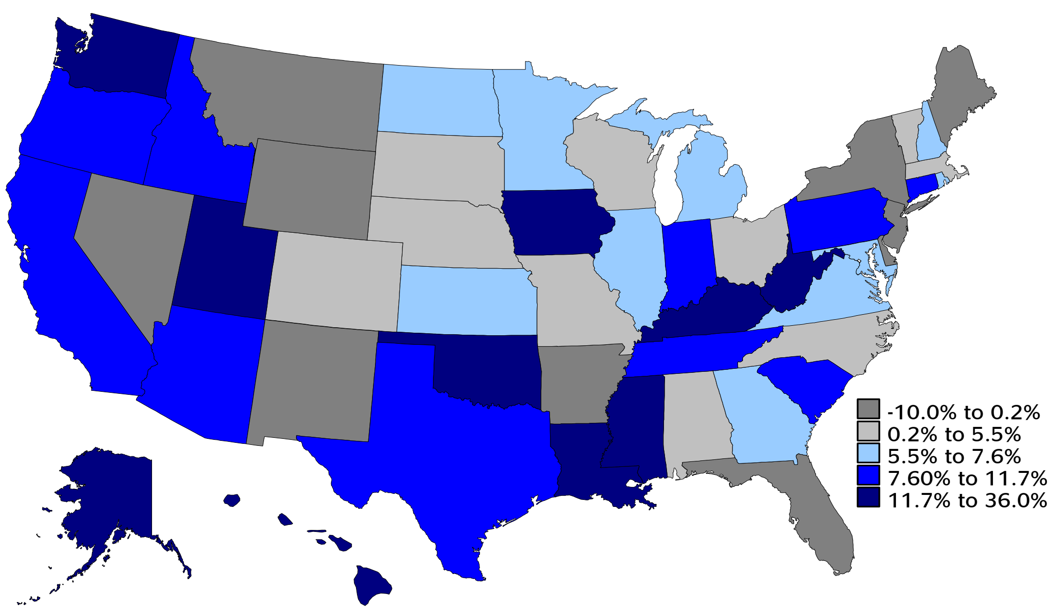


Source: Haver & BBVA Research, BLS & Haver Analytics

Persistent regional heterogeneity and oversupply of low-skilled labor and undersupply of high-skilled workers continue to suggest that the recovery is still fragile. States such as North Dakota, Texas, Utah and Oregon with the fastest growing industries continue to grow at or above potential. However, all of the aforementioned states have seen disproportionate gains in professional and business services and high-skilled mining or manufacturing. However, today, employment growth has slowed in these sectors, and began to shift to lower valued-added service sectors. Moreover, a shortage of science, technology, engineering and math (STEM) trained professionals, which underlies a growing skills mismatch for STEM professionals, continues to lead to lower labor market turnover. As a result, growth in other service based employment and construction could be biased to the downside as high-income occupations become less abundant.

Northeast to benefit from growth in Europe

Chart 8
2014 Exports Year-over-Year Growth



Source: BBVA Research, Census & Haver Analytics

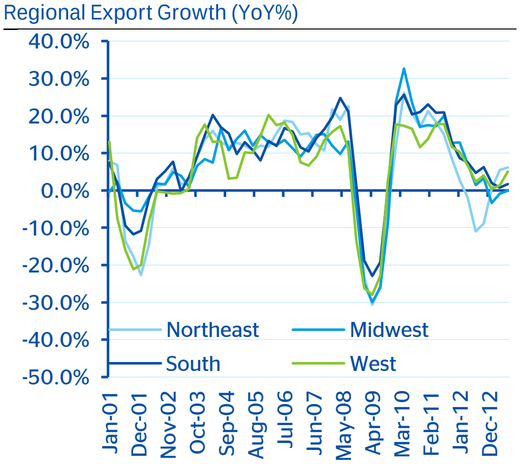
In the Northeast, which has lagged in the recovery, increased exports, underpinned by growth in Europe, should boost the recovery and lead to a higher rate of convergence amongst states. In total, Europe accounts for approximately 32%, 23%, 30% and 26% of exports for Massachusetts, New York, New Jersey and Pennsylvania respectively whereas exports to Europe for states that have led the recovery such as Texas, Washington and Oregon account for 11%, 13% and 10% respectively. Given that Europe is expected to grow in 2014, our baseline is for growth to accelerate to 3.0% in Massachusetts, 1.9% in New Jersey, 1.4% in New York and 1.9% in Pennsylvania. Moreover, we expect GDP growth of 1.7%, 1.8% and 1.7% for Alabama, Kentucky and New Hampshire, respectively.

States such as Louisiana, West Virginia, Indiana and North Dakota that have higher dependencies to emerging market and North American growth saw exports tilt to the downside and recover more slowly in 2013 than other states; a trend likely to persist in 2014. Continued efforts by Bank of Canada to cool consumer credit growth will also weigh on exports to Canada. In terms of emerging markets, our 2014 growth expectations are lower than three months ago and as a result, we revised downward export growth for the South and West. For the Great

Lakes and Plains, despite having a relatively diversified export markets, slower sales abroad lowers our GDP growth expectations to 1.9% and 3.1%, respectively.

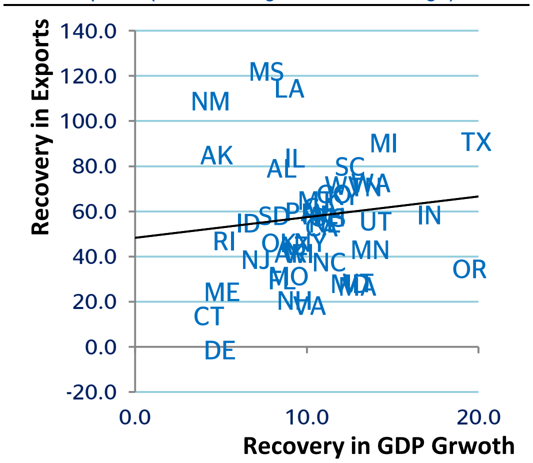
While real exports of goods account for less than ten percent of annual real U.S. GDP growth, stronger export growth has been a driver of the manufacturing rebound and economic recovery in states such as Texas and Oregon. Despite its declining share of the labor force and decreasing global competitiveness, higher manufacturing activity underpinned high economic growth in many states. In fact, Oregon, Utah and Indiana which grew 3.9%, 3.4% and 3.3% respectively, rank in the top ten in terms of the share of economic activity attributable to manufacturing sector. Going forward, however, exposure to Asia and Canada will likely impact economic growth less positively. As a result, we expect growth in 2014 of 3.3% in Oregon, 4.1% in Utah and 1.7% in Indiana.

Chart 9
Regional Export Growth (YoY%)



Source: BBVA Research, Census & Haver Analytics

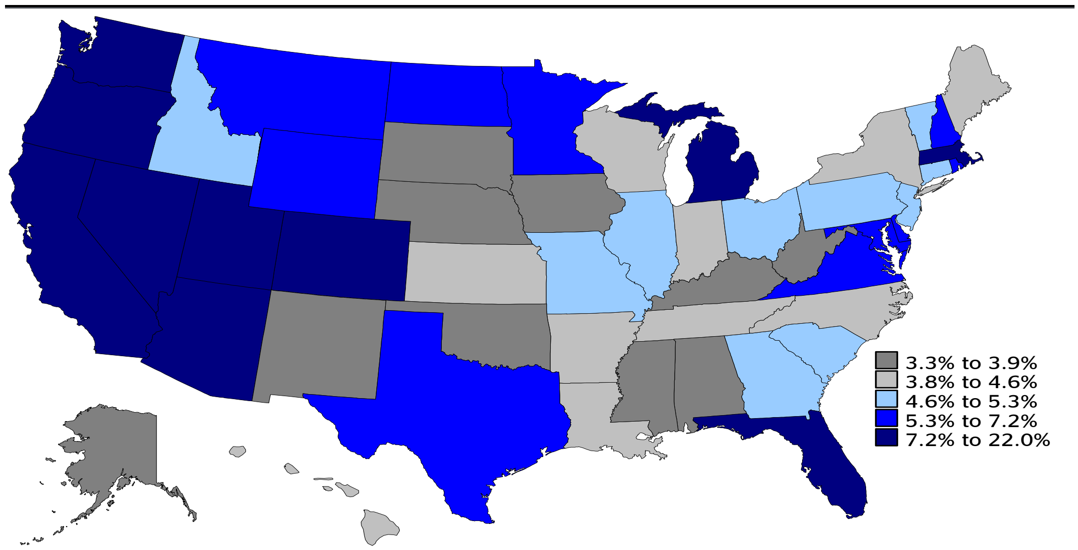
Chart 10
GDP & Exports (cumulative growth from trough)



Source: BBVA Research, BEA, Census & Haver Analytics

Despite headwinds, upside still high for housing

Chart 11
2014 FHFA Home Price Growth Year-over-Year Growth



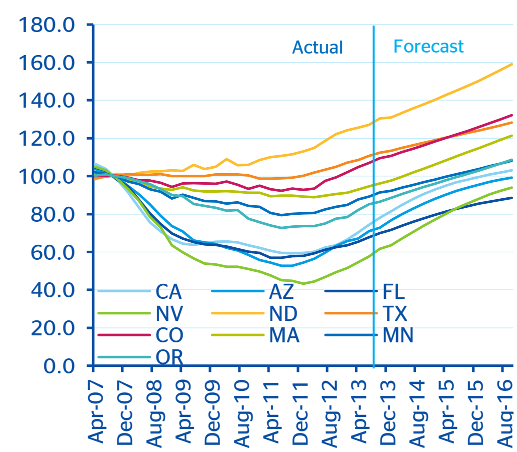
Source: BBVA Research, FHFA & Haver Analytics

Fragility in residential real estate markets, and the fact that only 15 states have exceeded pre-recession home price levels, suggests continued but slower improvements in construction activity 2014. As a result of stronger labor market expectations, low household leverage, low interest rates and higher household net worth, home prices increased significantly in 2013. In fact, Arizona, California, Nevada and Florida home prices increased 11%, 17%, 19% and 10% YTD. Stronger home price growth has aided in the recovery of many states.

While many structural improvements underlie the increase in home prices, a portion of the appreciation can be explained by governmental assistance programs such as Housing Affordable Refinance Program (HARP) and accommodative monetary policy. Thus, on net, we expect house price appreciation to moderate in 2014. On the one hand, higher interest rates, lower refinancing activity and higher supply of distressed properties will limit price gains. However, faster income growth, more lenient lending standards, and improved consumer sentiment will buoy house prices.

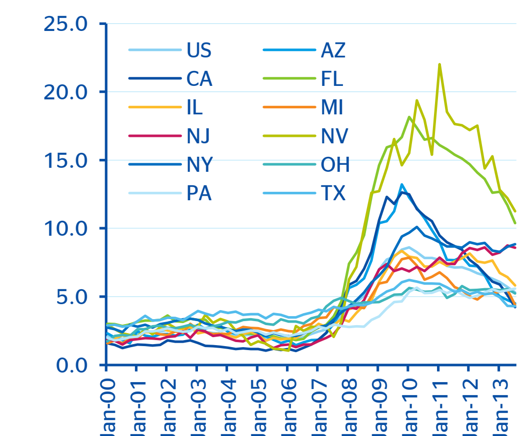
As a result of home price appreciation, 45 out of the 50 states experienced double-digit building permit growth in 2013. We expect positive but slower growth in 48 out of the 50 states in 2014. Economic growth in Georgia, Minnesota and Pennsylvania will benefit from the higher residential investment and thus are expected to accelerate to 3.4%, 3.6% and 1.9%. For states such as Rhode Island, Oklahoma and New Mexico where building permit activity is slowing, GDP growth is likely to trend below the U.S. average at 1.1%, 1.5% and 2.2%, respectively.

Chart 12
FHFA Home Price Index w/ Forecasts (Re-indexed, 2007=100)



Source: BBVA Research, FHFA & Haver Analytics

Chart 13
State Delinquency Rates (%)



Source: BBVA Research, FRBNY & Haver Analytics

Although residential real estate secured credit remains well below pre-recession levels, regional credit activity is stabilizing and lower consumer leverage should realign economic fundamentals and credit growth. Therefore, we expect areas such as Texas, California, Utah and North Dakota which are forecasted to grow above 3.0% to experience the highest growth in total credit in 2014. Moreover, given that these states also have strong housing market conditions and improving construction sectors, growth in real estate secured credit should also expand above the national average. Rising property values in these states, greater access to credit and lower economic uncertainty could also incentivize consumers to begin to increase leverage and extract equity –HELOANs and HELOCs- from homes that are now above water.

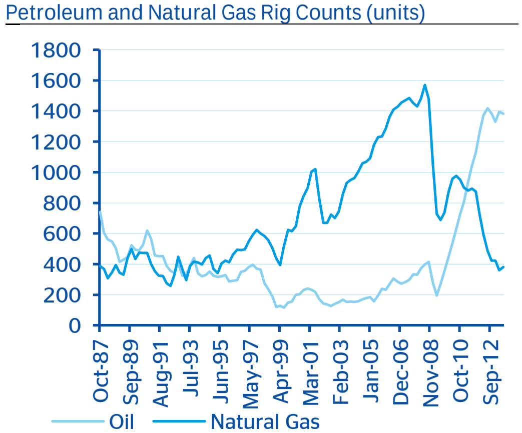
On the other hand, states that rely heavily on global growth and have lagged in the recovery could see more cautions borrowing and lending of non-revolving credit. Depressed property values in states such as New Mexico where home prices only recently returned to positive year-over-year growth, will likely see continued underperformance in credit growth, but still sufficient to boost GDP growth to 2.1% in 2014.

In terms of auto lending, the ubiquitous run-up in auto related finance in nearly all states has started to slow and is likely to continue to trend below post-crisis levels in 2014. The pace of the recovery in consumer expectations and labor markets, and greater political certainty will determine the growth in revolving consumer credit. A faster recovery in Europe, less severe rebalancing across emerging and developed markets, and continued income growth elevate the likelihood that consumers increase leveraged-based consumption. Assuming global growth remains positive, and given that non-revolving credit displays a high degree of homogeneity, growth in revolving credit should occur evenly across most states by 2H14.

Quality and type of natural resources underlie our expectations for growth

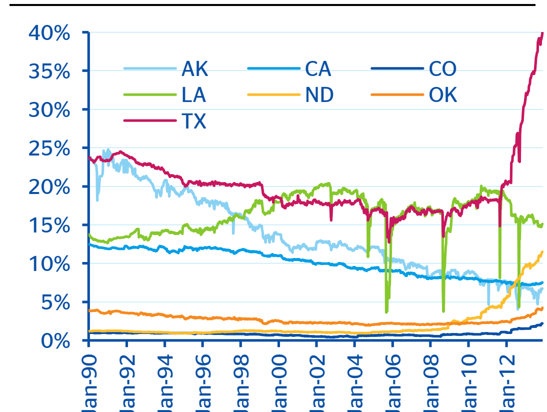
While oil and gas exploration remains an integral aspect of some states economic growth, declining exploration activity, slower-than-expected price growth and insufficient infrastructure weigh on our outlook for these states in 2014. As the result of infrastructure deficits and slower price growth, the number of rig counts, which had increased by double digits for 12 consecutive quarters declined in 3Q13. Moreover the rig count in the most active drilling areas, Texas and North Dakota, has contracted for four consecutive quarters in spite of the fact that both states experienced the highest growth in share of U.S. crude oil production. Depressed natural gas prices render an acceptable return for only a fraction of shale gas-only projects such as the Haynesville formation, whereas mixed formations remain attractive due to high oil prices. As a result, the number of gas based rigs has dropped precipitously by 276% from 2011 and 365% from the pre-crisis peak. Thus, regional heterogeneity could emerge in 2014 between natural resource rich states with petroleum based reserves and those with natural gas based reserves.

Chart 14
Petroleum and Natural Gas Rig Counts (units)



Source: BBVA Research , Baker Hughes & Haver Analytics

Chart 15
State Share of U.S. Crude Oil Production

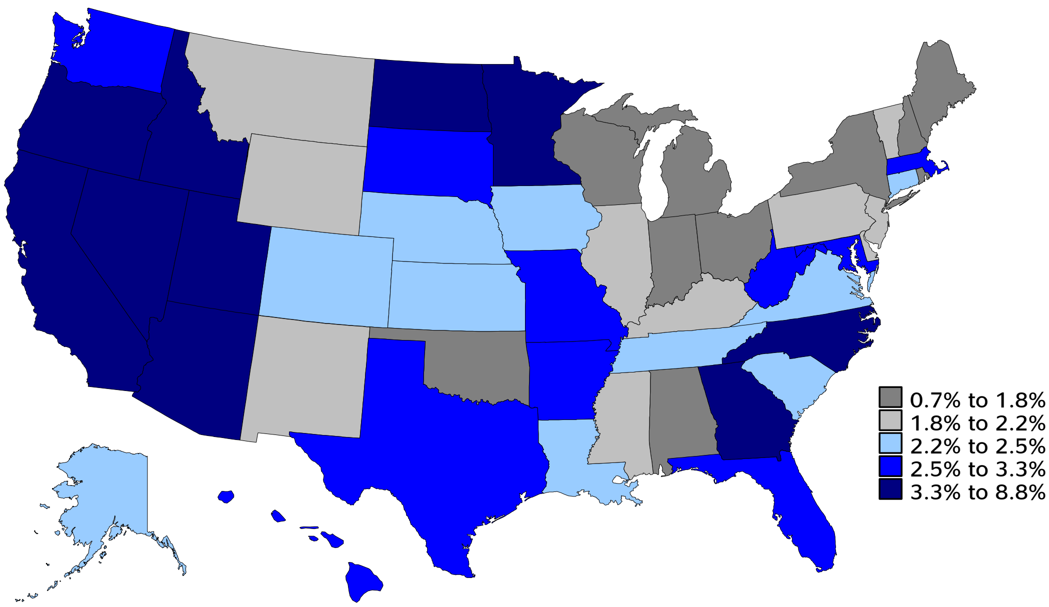


Source: BBVA Research, Oil & Gas Journal & Haver Analytics

Also weighing on the natural gas rich states is insufficient physical infrastructure and regulatory delays associated with switching LNG import terminals to export terminals or building new ones. Given we expect excess supply of natural gas in 2014 prices are unlikely to edge up significantly, thus limiting activity in states with higher concentrations of gas reserves. We forecast GDP growth of 2.5%, 2.0% and 2.3% in Colorado, Wyoming and Louisiana, respectively. Conversely, Texas has increased its share of U.S. crude oil production from 18% in January 2011 to 40% today and as a result we expect growth of 3.1% in 2014. North Dakota, which accounts for 13% of total U.S. share and is now the third largest oil producer at 13%, is expected to grow by 8.8% in 2014, as it benefits from stronger demand for petroleum-based products.

Bottom Line:

Chart 16
2014 State GDP Growth Year-over-Year Growth



Source: BBVA Research, BEA and Haver Analytics

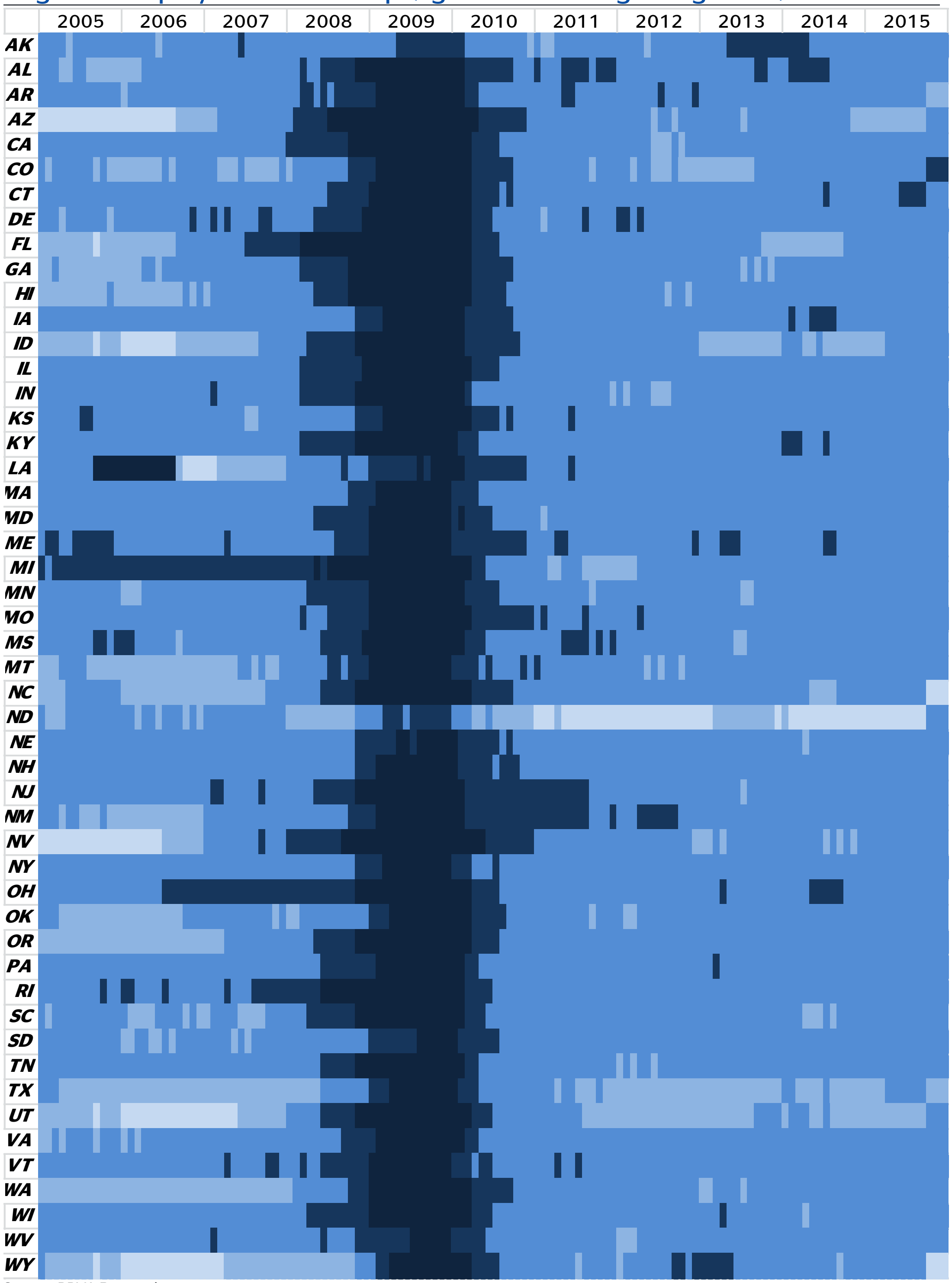
In 2013, regional growth has been on par with the U.S.; moderate growth with downside risks stemming from political uncertainty. However, 2014 will mark the first year of regional growth convergence in seven years. Although the GDP growth rate in Eastern states will be lower than in the rest of the nation, higher foreign demand and sturdier consumer confidence will boost manufacturing output, while stronger impetus in consumer credit markets will support the real estate sector. These trends will benefit the East Coast disproportionally more than the West Coast. Moreover, regional heterogeneity that arose between natural resource rich states and those with higher manufacturing is likely to decline in 2014 as exploration activity slows.

For 2014, we expect GDP growth in 25 states to exceed the U.S. average of 2.3%. We also foresee faster growth in North Dakota, Oregon, Utah and Idaho, and weaker growth in Maine, Michigan and Rhode Island. Although downside risks remain elevated, the balance of risks is improving.

Regional Heat Maps by Indicator

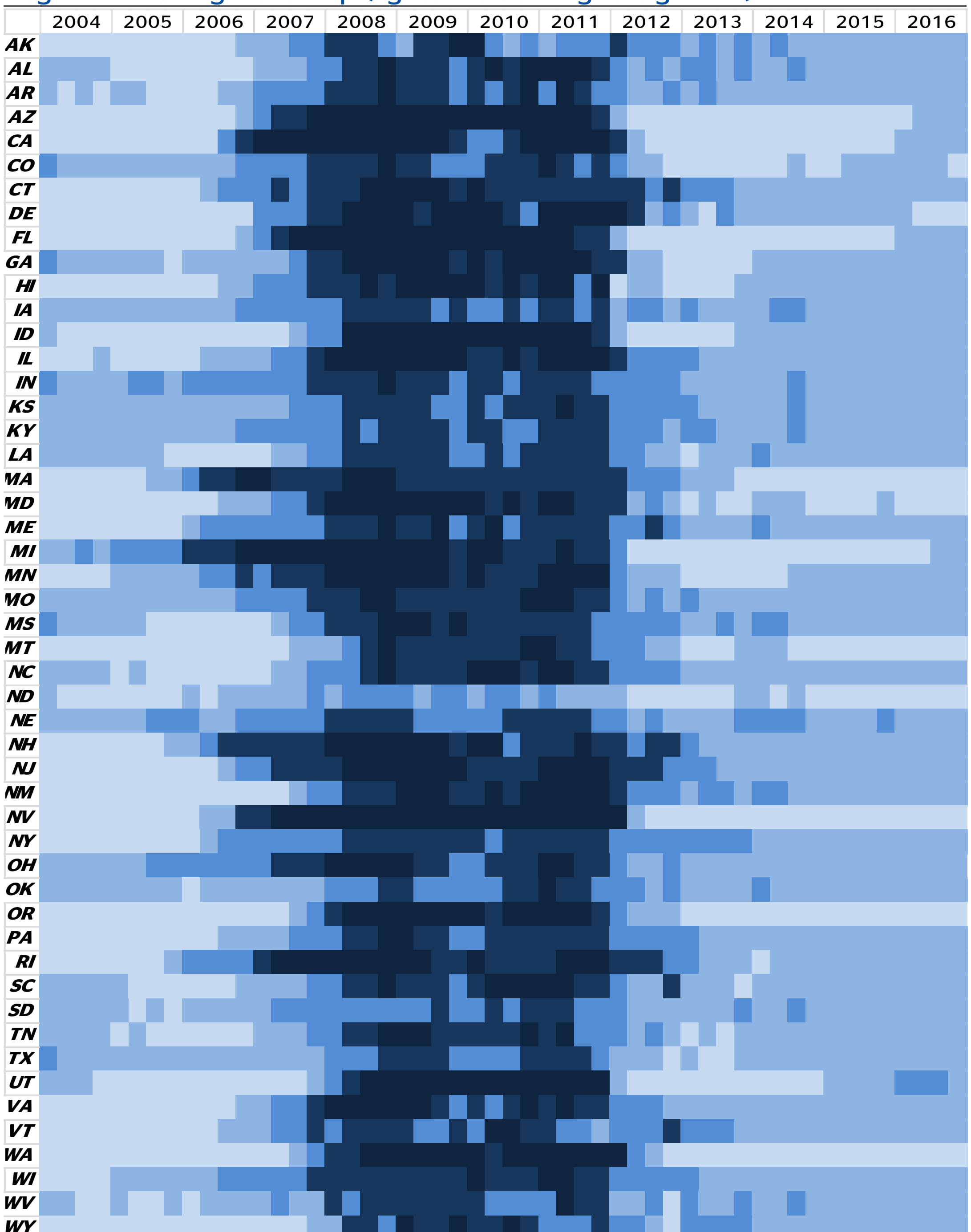
Map 1

Regional Employment Heat Map (lightest blue= highest growth)



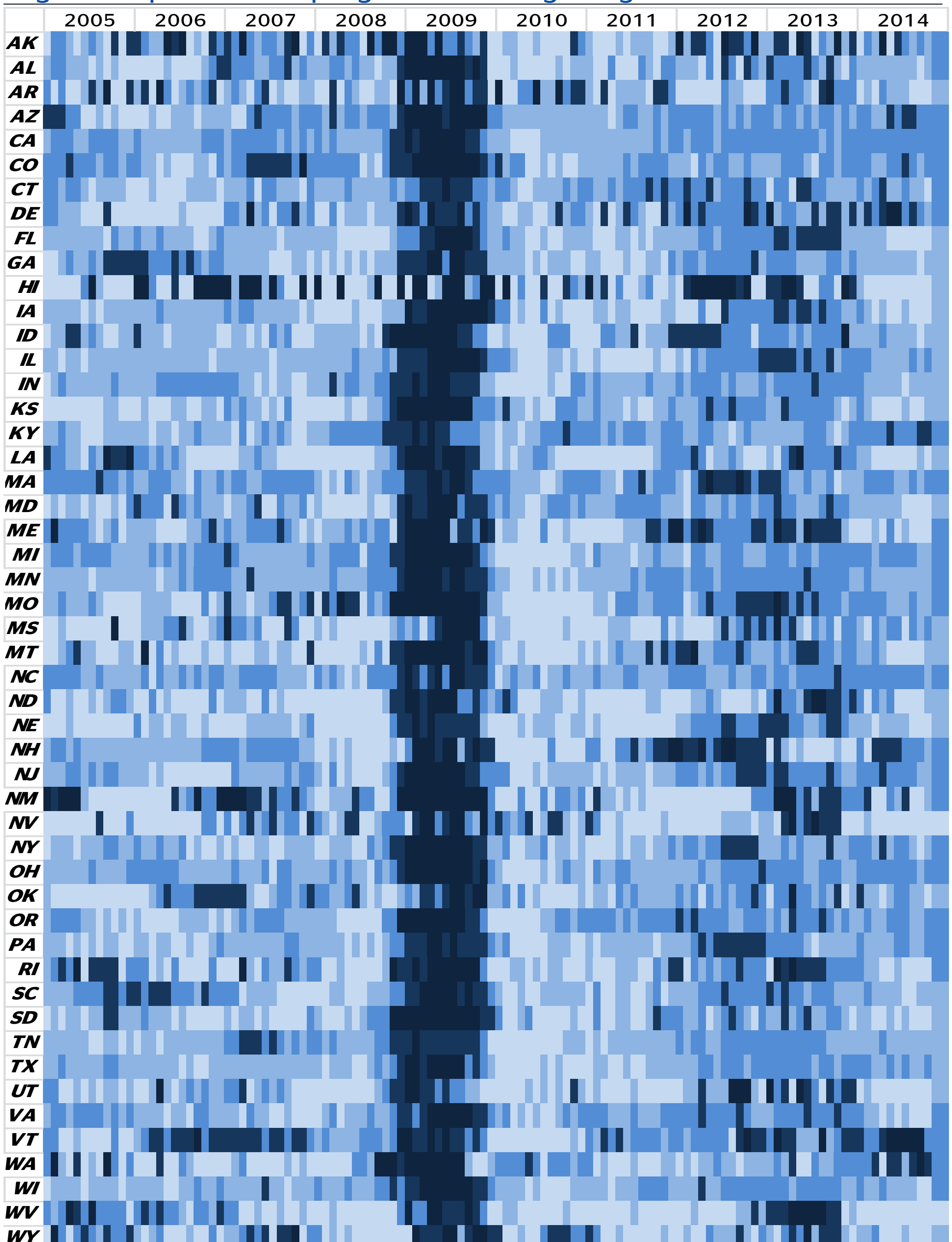
Source: BBVA Research
* Forecasts from 4Q13 onwards

Map 2
Regional Housing Heat Map (lightest blue= highest growth)



Source: BBVA Research
*Forecasts from 3Q13 onwards

Map 3
Regional Export Heat Map (lightest blue= highest growth)



Source: BBVA Research
* Forecasts from 4Q13 onwards