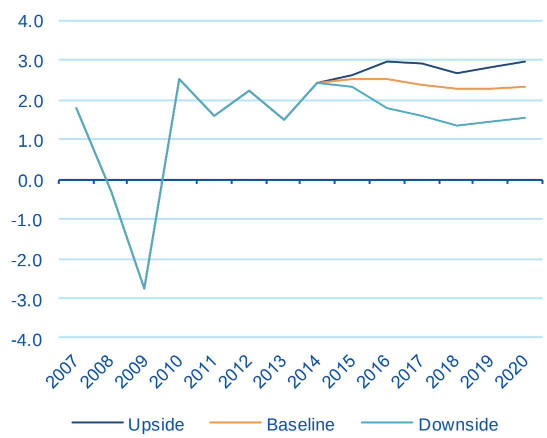
2 U.S. Economy Shifting into a "New Normal" Growth Cycle

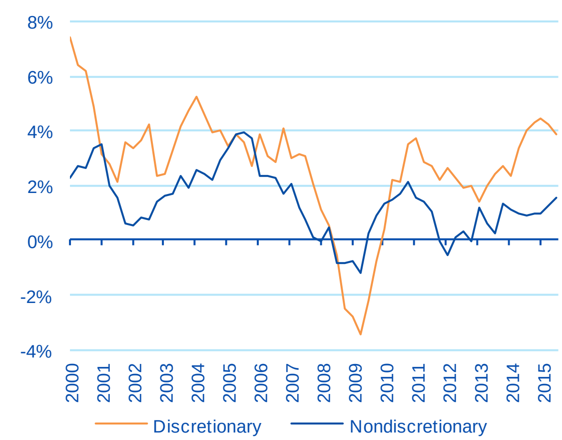
The U.S. economy is chugging along in its seventh year of recovery, yet there are few signs of significant acceleration in the coming years. Short-term optimism slowly faded as third quarter economic reports fell short of expectations. Weaker underlying fundamentals are laying the groundwork for GDP growth to stabilize at lower levels, realizing a "new normal" economic cycle that no longer seems destined for above 3.0% growth anytime soon. Threats of a more pronounced global slowdown have materialized but remain contained for the time being, still limiting upward potential for domestic growth in the foreseeable future. The current low inflation environment is posing problems for the Fed's first federal funds rate hike, increasing uncertainty regarding the timing of liftoff and the future path of interest rates even though there is a strong desire to begin normalization by the end of this year. Despite these risks to growth, domestic consumption continues to shine, putting the focus on the consumer sector to drive growth into 2016.

Figure 7
Real GDP Growth Forecasts (QoQ SAAR % Change)



Source: BEA and BBVA Research

Figure 8
Real Consumer Spending: Discretionary and Nondiscretionary (YoY % Change)

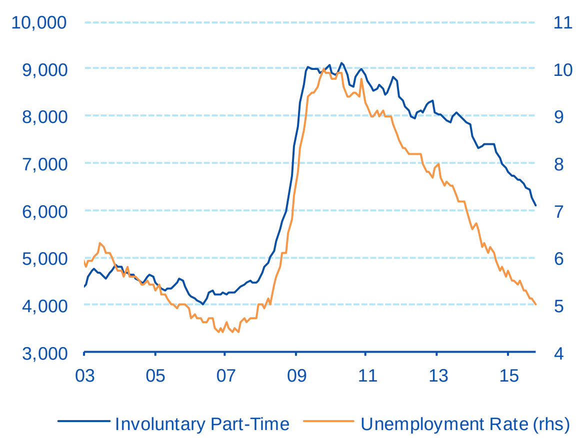


Source: BEA and BBVA Research

Consumption has remained the key driver of economic growth in the U.S., holding at a healthy pace despite the fact that consumers are seeing very little increase in wages. Consumer confidence remains strong on the back of stronger household finances and the end of deleveraging. The household debt-to-income ratio has stabilized at a 36-year low, suggesting that consumers are financially ready to start taking on more debt. However, there has been a downward shift in real nondiscretionary consumer spending (i.e. food, clothing, energy, and housing) compared to pre-recession trends. Discretionary spending (on things other than the above "necessities") has fully bounced back from the crisis, confirming consumers' willingness to loosen their purse strings. Although interest rates are expected to increase in the coming years, the upward pace will be very gradual and therefore we do not expect it to have a major impact on consumers' ability to borrow. Furthermore, the current low inflationary environment is extremely favorable for consumers. Thus, we expect consumer spending to remain the shining star of the U.S. economy over the coming year as it continues to grow at a robust pace.

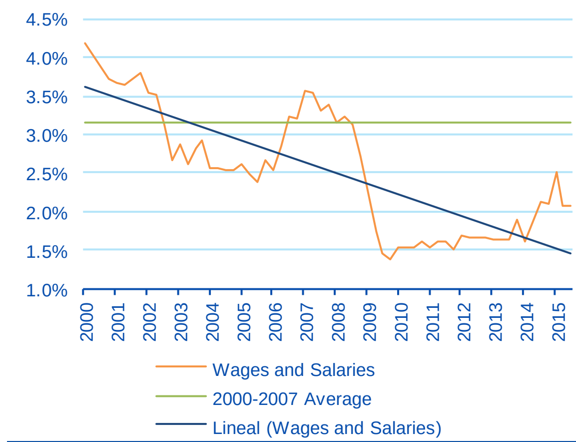
The labor market has seen its fair share of improvement throughout the past year despite the recent bout of weaker-than-expected job growth in August and September. Below average job growth is not abnormal in short spurts, and October's rebound reassured us that the two-month lull was just a fluke. Still, the falling participation rate, low wage growth, and elevated involuntary part-time employment continue to weigh on the outlook. Although the unemployment rate is quickly nearing the long-term natural level, there still appears to be some slack left in the labor market. Looking forward, we expect that hiring will continue along at a healthy pace above 200K per month alongside continued declines in unemployment, and stronger wage growth will eventually follow.

Figure 9
Involuntary Part-Time Employment & Unemployment Rate (NSA 3MMA Thousands & %)



Source: BLS and BBVA Research

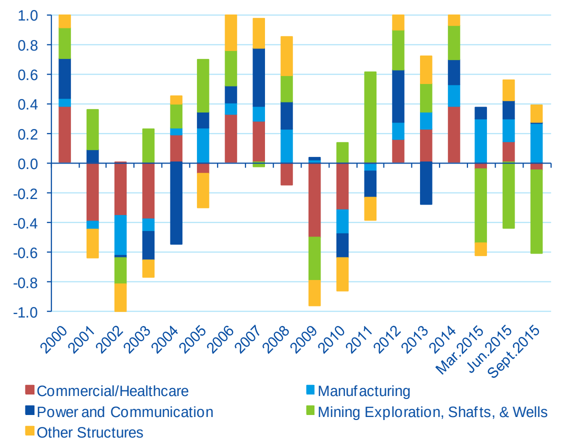
Figure 10
Nominal Wage Growth (YoY % Change)



Source: BLS and BBVA Research

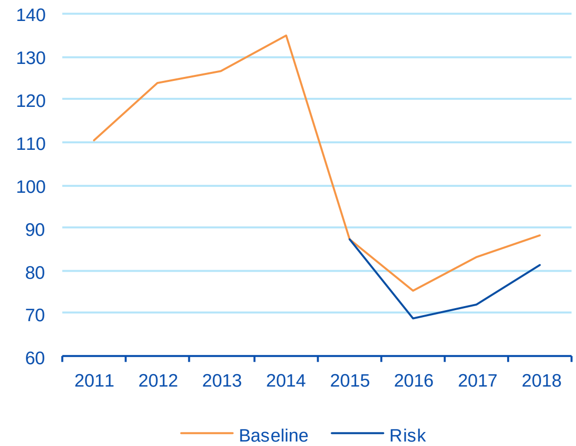
While private consumption remains the key support of domestic growth, private nonresidential fixed investment is expected to remain relatively subdued throughout the next year. The pace of growth is likely to hold slightly lower than in previous expansionary periods given the structural damage from the crisis as well as lingering uncertainty in the global economy. Businesses remain hesitant to significantly expand their workforce and ramp up production due to a variety of unknowns, including the speed at which interest rates will rise and the full extent of weak global demand. Furthermore, the prolonged period of low oil prices limits the upside for investment in the energy sector. Lower investment in oil and gas structures will continue to be a burden and could drag down GDP growth by another 10 basis points between 4Q15 and 1Q16, on top of the 45% decline already seen since 4Q14.

Figure 11
Real Private Investment in Structures (Contributions to QoQ SAAR GDP Growth, pp)



Source: BEA and BBVA Research

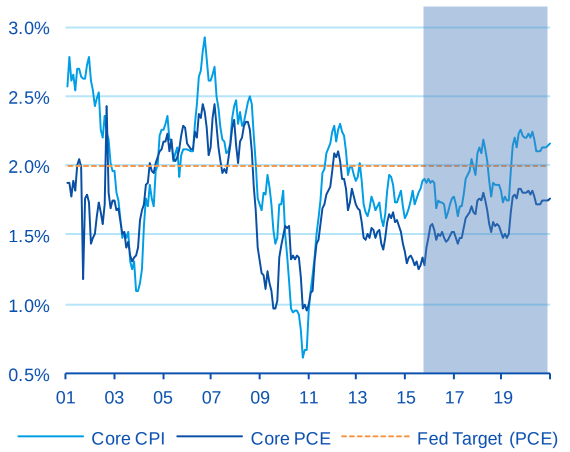
Figure 12
Real Private Investment in Mining Exploration, Shafts and Wells (SAAR $Bn)



Source: BEA and BBVA Research

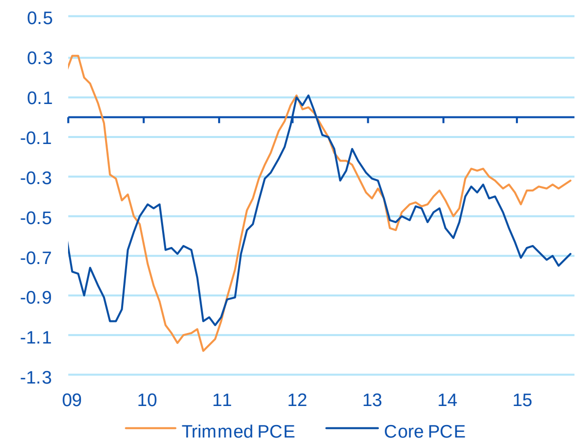
Subdued inflationary pressures are expected to extend into 2016 as low oil and commodity prices limit significant upward momentum. However, headline inflation should be reaching the end of the energy price decline considering that prices have mostly stabilized at these low levels, so we should expect to see an impact on headline inflation in the coming months as the base effect for year-over-year growth works in our favor, pushing inflation back into positive territory. On the downside, we will continue to see a drag on import prices, with the strong USD and weak global demand translating into lower prices for nonpetroleum related goods imports. Although core inflation has not declined, some pass-through from the headline level has materialized, and most of the upward pressure on core inflation stems from rising shelter prices. Therefore, with little movement in core ex-shelter inflation, and a lack of strong wage growth potential, inflation is unlikely to reach the Fed's target until 2017 or later. It is important to remember that the Fed tends to lean more toward the PCE price index as its preferred indicator because it is more comprehensive and has flexible weights that can change as consumers shift from some goods and services to others. However, it is released later than CPI every month and therefore does not always get the attention it deserves. Trends between the two indices are almost identical, except for the fact that CPI on average tends to run roughly 0.5 percentage points higher, though the gap has been growing throughout the past year. The slower pickup in core PCE inflation is limiting the Fed's ability to move forward with their policy normalization strategy, as most members of the FOMC are still not "reasonably confident" that inflation will move toward their target in the mid-term.

Figure 13
Core CPI and PCE Inflation Forecasts (YoY % Change)



Source: BLS, BEA, and BBVA Research

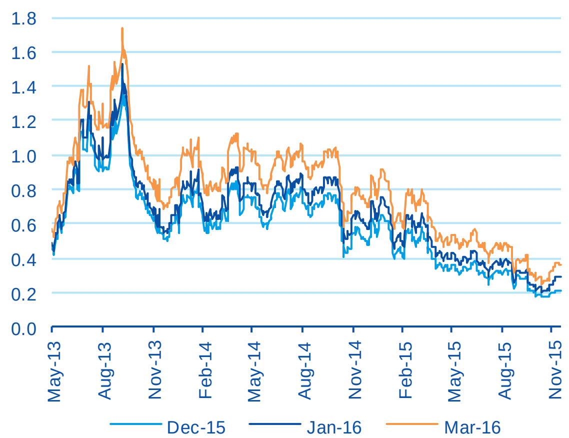
Figure 14
FOMC Target Inflation Gap (Actual inflation – long run FOMC PCE forecast, pp)



Source: FRB, BEA, and BBVA Research

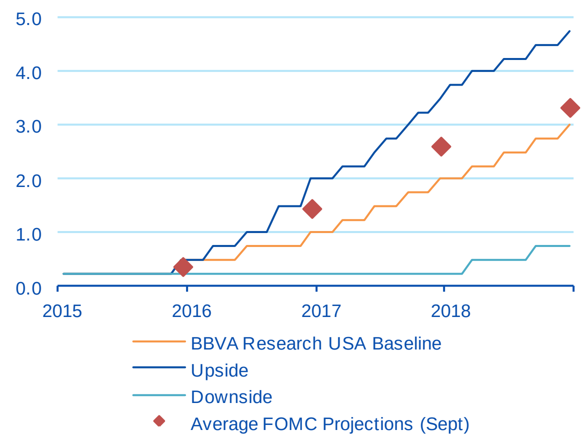
The latest FOMC meeting statement was surprisingly hawkish, yet there are strong dovish undertones still lingering within the Committee. Individual views within the FOMC are becoming more divided as members battle employment and inflation goals as well as ongoing threats from the global economy. Delaying the first hike to 1Q16 remains a possibility depending on how heavily members weigh domestic vs global data, though this scenario is less probable than a few months ago. The rebound in October's job growth as well as Congress' two-year budget agreement both negate some of the concerns raised at the September meeting. With this in mind, markets are now pricing in a rate hike by the end of this year, with federal funds futures pointing to a 65% chance of an increase at the December 16th meeting (compared to just 36% prior to the October meeting). Despite these differences in opinion on the timing of the first hike, there is an underlying agreement that the future pace of interest rate increases will be gradual, with more emphasis on the overall path in an attempt to control reaction to the first hike. The data-dependent strategy will live on indefinitely, and the FOMC will continue to monitor a variety of economic and financial reports. The Fed's meeting-by-meeting approach will continue even after the first rate hike, with two to three increases likely to occur in 2016. In general, we continue to expect a December liftoff and a very gradual pace of monetary policy tightening as the Fed tries to avoid introducing any sudden shocks to the financial system.

Figure 15
Federal Funds Rate Futures (%)



Source: Bloomberg and BBVA Research

Figure 16
Federal Funds Rate Forecasts (%)



Source: FRB and BBVA Research

Downside risks to the U.S. economy mostly stem from a more pronounced global spillover. A faster-than-expected slowdown in China is at the forefront of global concerns, particularly after the Chinese stock market crumble in late summer that sent shockwaves through global financial markets. This also adds pressure to the outlook for other emerging markets at a time when U.S. exposure is on the rise. Other global risks include ongoing geopolitical threats, deflation and/or recession in Europe, and increased financial market volatility. The global impact appears to be having a more prolonged impact on domestic activity, particularly when it comes to export-oriented industries, and this will likely heighten internal risks if the spillover intensifies. Thus, domestic risks are heavily intertwined with weakness from abroad and include steep disinflation, rapid USD appreciation, financial overheating, and further delays in the Fed's policy normalization plan. Fiscal uncertainty and more severe shocks to regional economics (i.e. Texas) are also important risks to keep on the radar. At the same time, upside risks to the U.S. economy would come from stronger-than-expected domestic consumption and investment despite any spillover from the weak global economy. A stronger pickup in inflation would encourage the Fed to increase rates at a faster pace, translating to a more optimistic outlook for the U.S. economy.

Box 1. Long-Term Growth: Three Perspectives Behind the Low Growth Environment

Economic growth in the U.S. has shifted to a lower gear ever since the Great Recession, suffering from structural damages that are preventing us from returning to pre-crisis norms. Despite many positive aspects of the recovery thus far, there are reasons to believe that the economy is no longer destined to accelerate above the 3% pace that was so typical before 2007. A downshift in productivity biases long-term growth to the downside, and this has influenced our revised outlook for the mid and long run. Our models confirm lower potential growth and a lower non-accelerating inflation rate of unemployment (NAIRU), allowing the output gap to narrow with lower realized growth rates.

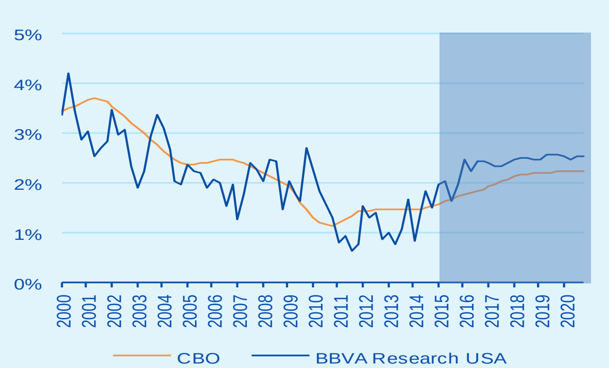
Three independent academic perspectives shed light on this “new normal” low-growth environment

Diminished Long-Run Potential: The U.S. economy has undergone significant transformation throughout the past century as globalization and various industrial and technological breakthroughs boosted productivity. The question is whether there is still room for additional progress of those magnitudes. Potential growth began to decline back in 2004 and has since recovered less than halfway back to the historical peak near 3.6%. Our estimates suggest that potential growth now holds at 2.0%, with aging demographics and stagnant population growth adding to the constraints on productivity. Reforms to help combat these limitations include increased investment in education, addressing inequality, and creating more sustainable public services.

Persistent Output Gap (“Secular Stagnation”): There are rising concerns that the U.S. is facing a period of secular stagnation, a cycle in which economic growth comes to a standstill. The lack of significant investment in infrastructure and education alongside excess savings and demand shortages could slow economic activity to a halt. This also becomes particularly relevant with the current highly accommodative stance of monetary policy, which under the secular stagnation assumption with low inflation and at the zero-lower bound, would be ineffective in combating slow growth.

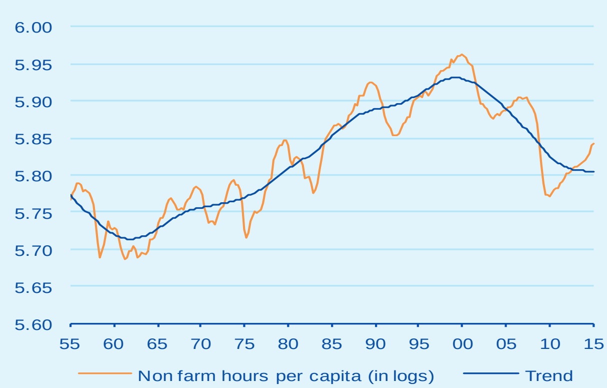
Supply-Side Damage: The Great Recession was different than any crisis before it, most notably because of the significant structural damage and subsequent lengthy recovery period. It may be the case that this is a one-off event, impacting the labor market and the private economy in such a way that it completely slows the path of economic prosperity. The decline in labor force participation adds to other demographic challenges and ultimately limits potential growth. Serious reforms are needed to boost the workforce via educational training and increased work incentives.

Figure 17
Real Potential GDP Growth (YoY % Change)



Source: CBO and BBVA Research

Figure 18
Labor Productivity (Hours)



Source: BLS and BBVA Research

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