5. Regional Outlook

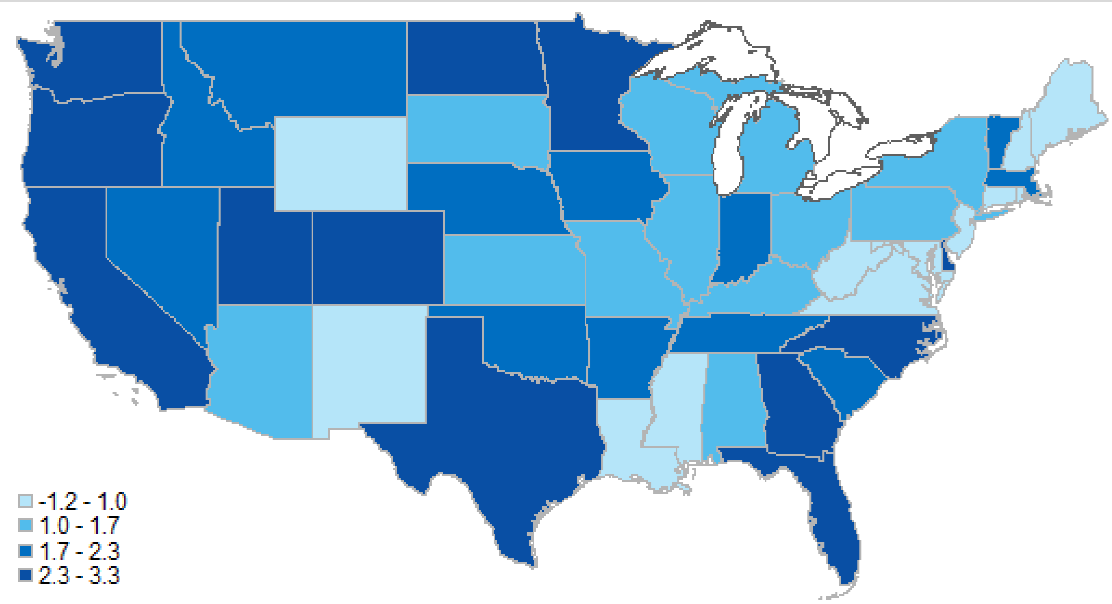
Incoming administration has potential to disrupt state growth balance

The outlook for the U.S. regional economies will to a large degree be determined by three key factors: the depth and duration of the current commodity cycle, the severity of pressures on foreign exchange rates and the extent to which weak global demand persists. The combination of the strong dollar and weak global trade produce inauspicious conditions for states with major links to the global economy while reduced capital expenditures in the mining sector will hit commodity intensive states. At the same time, lower energy prices and the strong dollar will continue to support growth in consumer based economies with high-skilled labor forces like California, Florida, Georgia and Washington.

With labor markets in a majority of states approaching conditions not seen since prior to the crisis and with headwinds abating, there is a chance that 2017 could be a departure from the commodity and consumer-industrial rebalancing of 2015-2016 and be a year of convergence. However, the probability and speed of the convergence will be influenced by the incoming administration’s policies and its success at managing the legislative process. With this in mind, we also highlight both the upside and downside risk profiles of the 50 states.

Figure 5.1

2017-2018 Average State Real GDP Growth Projections, %



Source: BBVA Research

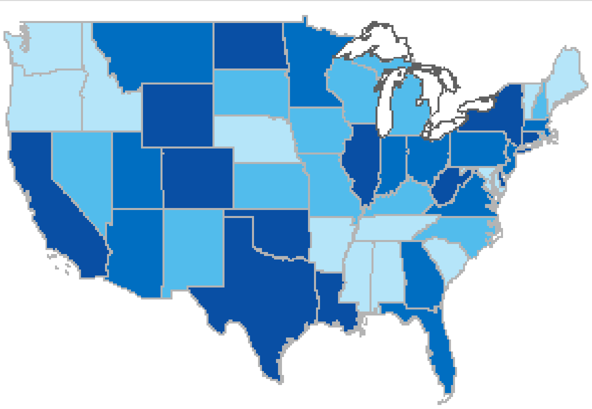
For most states, current economic conditions are the strongest in decades. However, with the change in administrations and the shift to a more conservative agenda, there is the potential for a reshuffling amongst states in terms of the winners and losers. In addition, there is a chance that the incoming administration's agenda produces countervailing winds with policies like tax cuts and deregulation supporting higher growth while policies geared towards protectionism and deportations detract from growth.

In terms of the business sector, conditions are firmly tilted to the upside given the current strength of the economy and the fact that there is a high probability that corporations will excel under the new administration. States that have large infrastructure deficits, heavy military presences and strong ties to the financial and oil sectors will see a boost to growth in the short-run. For commodity-rich states, the key challenges are securing stable and affordable sources of financing, convincing skilled workers to return to the industry and effectively managing a transition from projects with short life-cycles to more complex developments that require more time and resources. These states include Wyoming, Alaska, North Dakota and Colorado — all of which have large mining sectors and potential for higher investment and employment in the transportation and construction sectors.

Meanwhile, the states where defense spending represents a larger share of overall economic activity are likely to benefit the most from the new administration's plan of "peace through strength," which is aimed at rebuilding the military, include Virginia, Hawaii, Alaska and Alabama. A strategy focused on developing new missile defense capabilities, along with defensive and offensive cyber capabilities, would also benefit California, Washington, Texas, Missouri, Ohio and New York, among others.

Figure 5.2

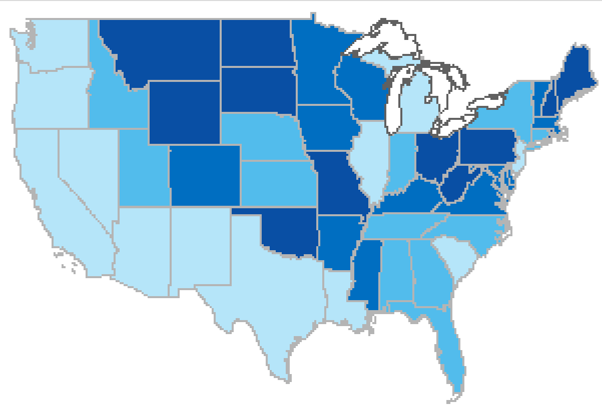
Exposure to Positive Growth Factors*



Source: BBVA Research
*Ranking based on exposure to winning industries and boost to disposable income from federal tax savings; darker shading indicates greater upside

Figure 5.3

Exposure to Negative Growth Factors*



Source: BBVA Research
*Ranking based on export exposure to China and Mexico and dependency on immigrant labor; darker shading indicates lower downside

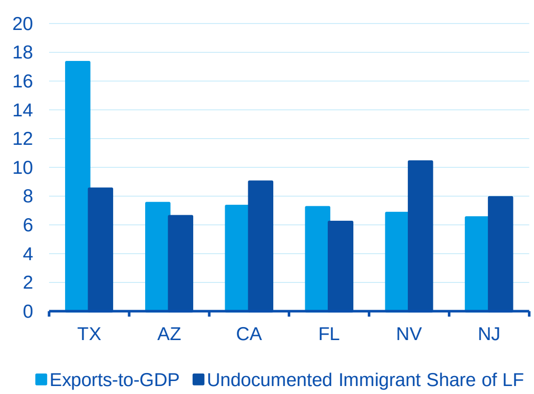
In addition, areas such as Delaware, Connecticut and New York, which have high concentrations of financial activities, should see a positive impact from the administration's policies aimed at generating a new leverage and investment cycle.

Tax cuts could boost annual disposable income by 0.4-0.5%

From the fiscal side, the impact at the state level could be significant, particularly for states with large per capita income and a large portion of income coming from wages. For example, in states with high tax burdens and high incomes, such as Connecticut, Massachusetts, New York and California, the tax cuts could boost annual disposable income by 0.4-0.5% or $400-$500 per worker, assuming a 3.5% reduction in the weighted-average marginal rate. Even in a more moderate scenario, the reduction in taxes would boost disposable income by $190 per year. To put this into perspective, the tax cuts could resemble the gains experienced from the 120 cent drop per gallon in gasoline prices during 2014-2016, which resulted in about a $600 annual boost to personal income. Ultimately, the magnitude of economic impact will depend largely on consumers' propensity to consume in that state, as the windfall gains from low energy prices were in large part diverted to savings rather than consumption. If the tax cuts are perceived as more permanent, the impact on consumption could be much larger.

Figure 5.4

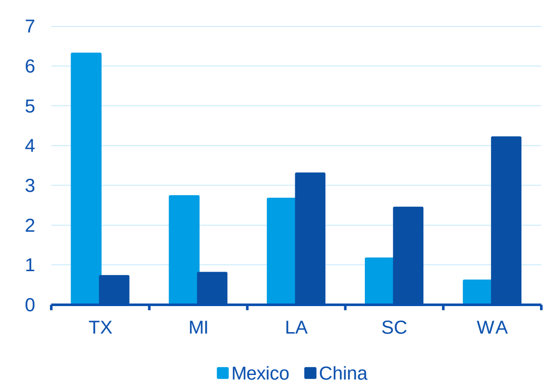
Immigrant Contribution to Labor Force and Export Dependency, % & share



Source: BBVA Research & Pew Research

Figure 5.5

Exports to Mexico & China, % of GDP



Source: BBVA Research & BEA

In terms of downside risks, the most problematic are mass deportations, along with increased protectionism and distortionary trade policy. Any large scale mass deportations would have immediate impact on labor supply, which could lead to shortages, wage pressures, hoarding and/or strong capital outflows. For states like California, Texas and Nevada, which have undocumented immigrant populations that make up around 10% of the labor force, the effects will be nontrivial. In terms of the direct impact, a large scale deportation in these states would lower the level of GDP by around 0.2pp. The direct impact may be seen as small in relative terms, given that undocumented occupations are lower-skilled and are generally substitutes for capital. However, acute or prolonged labor shortages could lead to substantial increases in food prices and services, particularly if incentives to work have to be sufficiently large enough to attract native workers, if it takes time to substitute away from labor to more capital intensive or automated production or if imports are needed to reduce shortages. In addition, an uptick in precautionary savings from fear of deportation could have significant second and third round effects.

Large scale deportation would lower the level of GDP by around 0.2pp

On exports, there is a similar risk that tariffs, border-adjustments or trade wars produce inflationary pressures, or in the worst case, lead to a reduction in trade flows for major exporting states. In an extreme scenario, states such as South Carolina, Kentucky and Michigan, for which exports make up approximately 15% of GDP, could see a large contraction in economic activity. This will obviously depend on the size, direction and industries impacted by the shock.

In a scenario skewed towards isolated or targeted protectionism directed at Mexico and China, the most acute impacts will occur in Louisiana, Texas and Washington, which export 5% to7% of their GDP to these countries combined. Nonetheless, given the lack of details on the new administration's trade policy, it is still unclear what the magnitude of the impact will be. However, as the saying goes, everything is bigger in Texas, even the potential negative impact of protectionism and deportations.

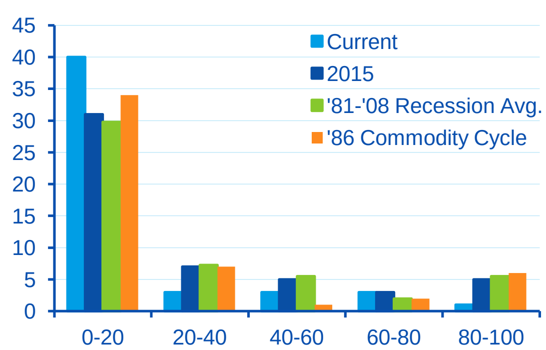
Fundamentals and rebalancing predominant factors in outlook

Given that there is a significant amount of uncertainty still tied to the magnitude, mixture, effectiveness and scope of the administration's economic policies, we believe that secular and structural trends within each state will be the most important factors for growth over the medium-run given that legislation and implementation can take years.

Despite the recessionary conditions building in some major industrial areas, the bulk of the headwinds have diminished. In fact, for states with large exposures to the oil and gas and mining sectors, such as North Dakota, Wyoming, Alaska, Oklahoma and Louisiana, it appears that the worst of the commodity cycle is behind them. As of the 4Q16, these states had lost 60K jobs in the mining sector. However, the quick turnaround in commodity prices appears to have moderated the spillovers into other sectors.

Figure 5.6

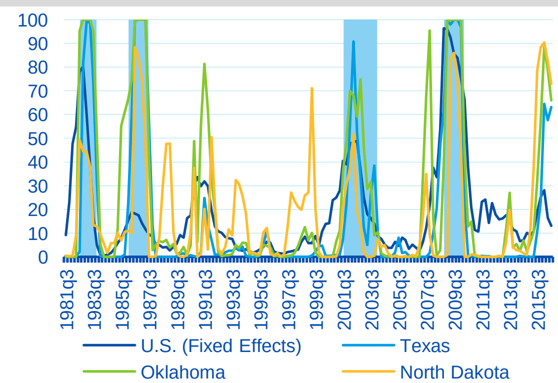
State Probability of Recession, # in quintile



Source: BBVA Research

Figure 5.7

Recession Probability, %



Source: BBVA Research

From a growth perspective, however, these states entered recession around the 1Q16 and remain in recession today, as anticipated. Although there is a risk that oil prices could fall below the current range of 50-60 $/bbl, stronger global growth and commitments from OPEC to pare production should keep prices close to their current levels. With this in mind, our baseline scenario is for these states, excluding Alaska and Wyoming, to grow positively in 2017, and for Alaska and Wyoming to return to positive growth in 2018.

For Texas, the story was nuanced. While its mining sector lost nearly 100K jobs since the end of 2014 and manufacturing employment shrank by 55K jobs due to reduced trade flows and direct impact from lower investment in the mining sector, overall job creation in Texas was positive. Albeit half the rate of growth prior to the oil slump, employment grew by 1.6% in Texas (in line with the U.S. average of 1.7%) while the unemployment rate remained effectively unchanged from the end of 2015.

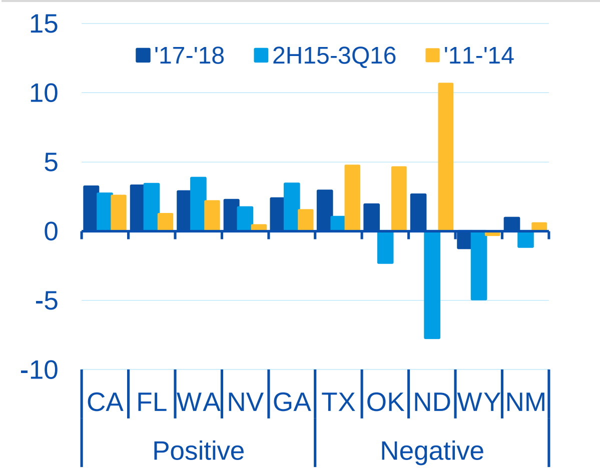
Industry and geographic diversity, along with the comparative advantage of major drilling basins, buoyed Texas's economy in the current slump and should support a bounce out of the current economic malaise in 2017. For instance, active rig counts — while still well below previous peaks — have trended up in the Permian basin and Eagle Ford, whereas in other major drilling areas, such as North Dakota, activity has stagnated. Historically, investment and drilling activity works at a 6 to 9 month lag with respect to prices, suggesting that the bulk of the benefits from the price gains will be realized in 2017. In addition, the non-oil-related major metro areas in Texas that left the commodity cycle unscathed should continue to grow at a pace well above the U.S. average, supporting consumption and investment outside of the energy sector. These factors support our baseline for 2.2% state-level growth in 2017 and 3.6% growth in 2018.

Texas growth will be 2.2% in 2017

Favorable demand-side conditions in regions and states on the winning side of domestic rebalancing will be reinforced by strengthening fundamentals. Consumers in these states are benefiting from stronger balance sheets, higher home prices and strengthening labor markets — trends that will continue in 2017. In fact, we expect growth to be above the U.S. average for states on the West Coast, such as California, Colorado, Washington, Colorado and Utah, and for the Southeastern U.S., in states such as Florida and Georgia.

Figure 5.8

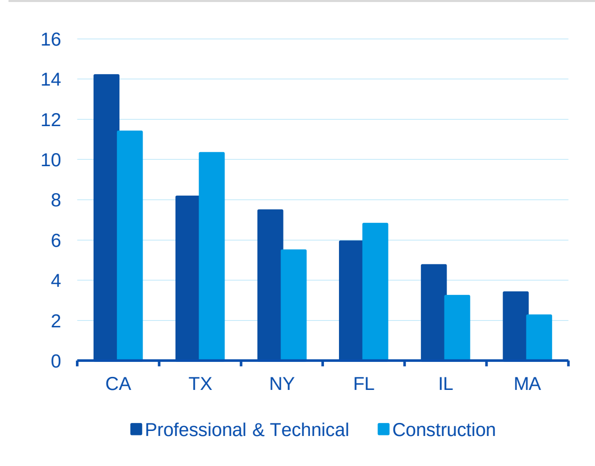
State GDP Growth Rebalancing, annualized %



Source: BBVA Research & BEA

Figure 5.9

Professional and Tech & Construction, share %



Source: BBVA Research & BLS

In the short-run, all of these areas are poised to benefit from higher domestic tourism and construction activity as these states are home to nearly one-third of all leisure and hospitality and construction jobs in the country. However, concentrations of highly technical sectors, such as computer system design, private R&D, architecture, engineering and specialized design, will support ongoing gains in productivity, which will lead to higher potential growth levels and improved living standards. In fact, in these states, there are nearly thirty percent more individuals employed in a technical industry than in construction. California, for example, hosts one-fifth of all individuals working in privately funded R&D. The tilt towards technology related industries will be enormously beneficial, and as a result, we expect average growth over the next four years in California, Washington, Colorado and Utah to be 2.9%, 2.8%, 2.8% and 3.0%, respectively. For Florida and Georgia, our baseline is for growth to be 2.9 and 2.2%, respectively.

For parts of the country that rely on manufacturing and industrial activity, the prospects of lower oil and commodity prices should have implied higher growth and activity. However, lower oil prices, less accommodative monetary policy with respect to other major central banks and weak growth abroad led to significant appreciation in the dollar. These frictions and the impact of a general slowdown in trade in 2016 limited the upside from lower input costs. In fact, traditional manufacturing states, such as Michigan, Ohio and Wisconsin, saw growth moderate over the 2H15 and 1H16 as pressures on manufacturing peaked. Other areas, such as Alabama, Arkansas and Mississippi, were able to weather pressures on the manufacturing sector due to strong domestic demand for autos and other consumer durables. That being said, the pace was slower than the U.S. average.

Going forward, with confidence growing for consumers and corporations, our baseline scenario is for Alabama to grow 1.4% in 2017 and 1.5% in 2018. Similarly, Ohio and Michigan will grow at a pace slightly below the U.S. average at 1.7% and 1.3%, respectively.

Finally, although we don't expect residential construction to be a major driver of growth in 2017, some states will continue to benefit more from a faster expansion in this sector. These include Michigan, Minnesota, Georgia, Kentucky, Utah, Arkansas, Tennessee, Arizona and Florida. As a result, the regional outlook, barring any unforeseen shock to confidence or trust, should be underpinned by widespread prosperity.

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