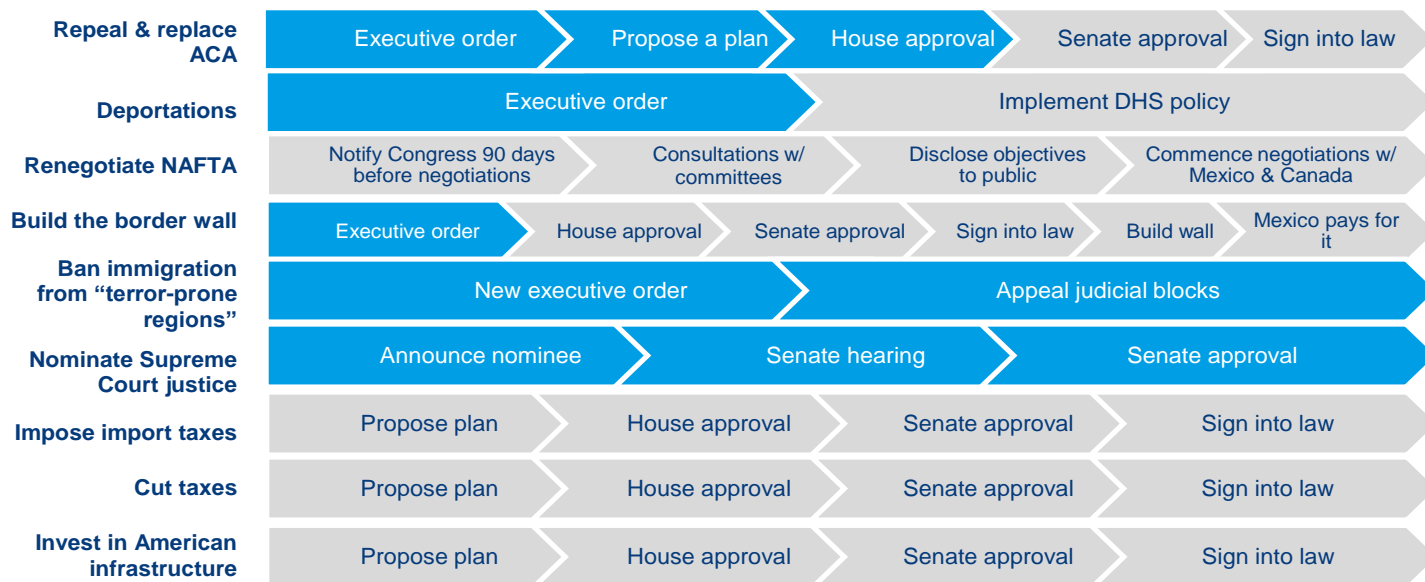


### 3. U.S. investment doing the heavy lifting

While risks remain balanced, the lack of progress on fiscal reform and the fact that the administration has little to hang their hat on in the first 100 days could test market's patience, increasing the risk of vulnerability to external imbalances—geopolitical surprises, commodity price shock or emerging market weakness. Failing to roll back the ACA in a timely manner and deliver a comprehensive tax and regulatory reform has not changed our outlook for 2017, as we expected the administration to experience nontrivial frictions at the beginning. That being said, it seems that the administration is falling short of the lofty expectations of markets which could begin to erode market confidence. In addition, the Fed is signaling an increased willingness to remove accommodation as pressures from an aging cycle build. It also seems clear that consensus has moved away from advocating for fiscal stimulus at a time when economic slack is minimal. With financial vulnerabilities low, despite equity markets likely overpricing the Trump effect, there are growing signs that headwinds to this expansion cycle are growing. A strong profit outlook and a rebound in investment in equipment and housing should alleviate some of these pressures in the short-run.

**Figure 3.1** Administration Timeline



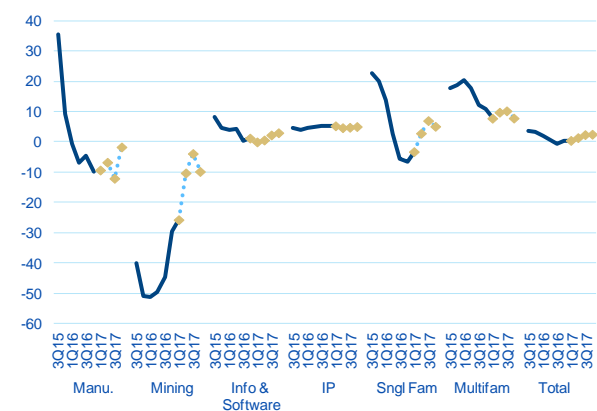
Source: BBVA Research

## Investment to take up the torch in post-crisis cycle

With tailwinds from firmer global growth expectation and moderate and stable oil prices the mining and manufacturing sectors are expanding for the first time since 2015. At current price levels, domestic producers have increased drilling activity in the most profitable and productive areas, particularly in Texas with over 150 wells being added in the Permian and Eagle Ford through March. That being said, utilities have suffered from warm weather conditions in the first quarter, leaving the energy sector on balance unchanged for the year. Manufacturing, machinery, computer electronics and petroleum and coal products have benefited from the cyclical recovery in investment and profits, growing strongly to start the year. The high-tech sector has also recovered to growth rates consistent with those prior to the slowdown, with the rebirth in investment in equipment and software. For autos, the downward surprise in sales in March could be a sign of a broader trend if tighter credit conditions and cooling labor markets continue to dampen demand.

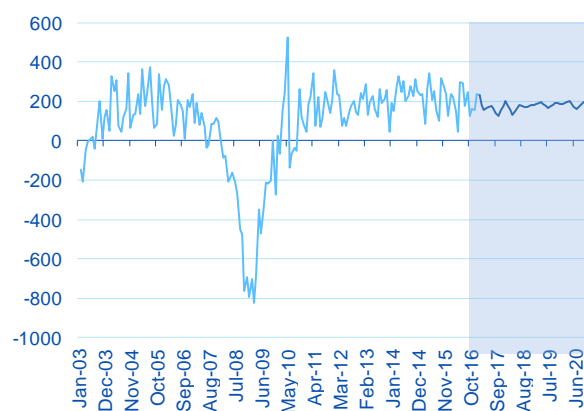
For the labor market, signals have been mixed. In January and February nonfarm payrolls grew by 200K per month, which was above consensus estimates for job gains of around 150-175K jobs. Despite nontrivial deceleration in payroll growth in March to a pace of 98K per month, employment growth for the first quarter remains consistent with our forecast for a moderation in employment gains. In addition, the rate of job openings has remained flat over the last six-months while average weekly hours worked have stagnated, suggesting that despite firms communicating a greater willingness to hire domestically, the commitments are failing to move the needle, as the cycle gets long in the tooth. The aging cycle and headwinds from structural changes in the composition of the labor force underlie the deceleration.

**Figure 3.2** Real Private Fixed Investment  
(Year-over-year %)



Source: BBVA Research & BEA

**Figure 3.3** Monthly Change in Nonfarm Payroll (K per month)



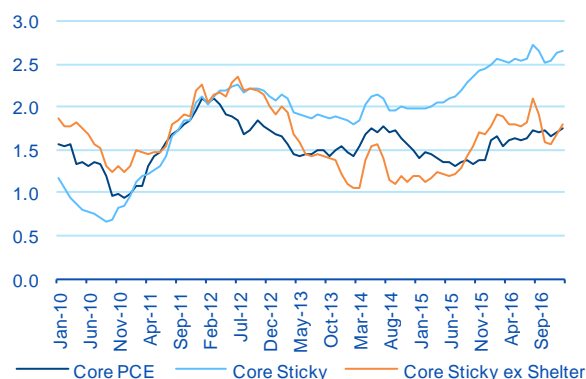
Source: BBVA Research & BLS

Nevertheless, with the unemployment rate at 4.5% and the participation rate edging up in spite of the strong outflows of the retirees, it seems that the labor market is at or even trending below long-term projections of the unemployment rate; this lends significant support to the argument that the labor market is at full employment. If the labor markets continue to grow at its current pace, the estimated 750K-1.2M individuals out of the labor force looking for jobs would be absorbed by the

end of the year. As the remaining slack is absorbed, we expect the pace of job growth to slow to levels more consistent with the growth in the labor force (100-150K) and for the unemployment to remain at levels close to 4.4% over the medium-term. Although there could be some moderate undershooting in the short-run, it appears the Fed is ready to respond to with more aggressive removal of policy accommodation (rates and ceasing principal reinvestment), particularly if inflation surprises to the upside.

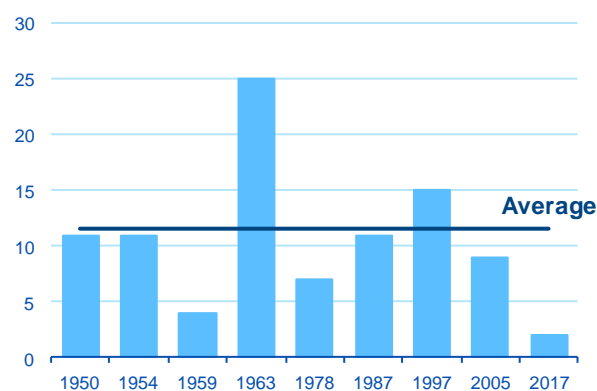
However, the Fed does have some flexibility on how quickly it wants to remove accommodation given that real wages, in spite of the tight labor market, have remained flat over the year. In fact, wages in seven industries — Retail, Education and Health Services, Wholesale Trade and Transportation, Mining, Durable Goods Manufacturing, Wholesale Trade, Finance, Utilities— failed to keep pace with inflation, with wages in the retail sector contracting 1.3% from a year-ago. While tighter labor markets in more technical sectors such as professional and business services and information have led positive real wage growth, these sectors remain only a small fraction of the broader labor market suggesting wages pressures could remain muted despite overall labor market conditions remaining somewhat tight.

**Figure 3.4** Consumer Prices (year-over-year, %)



Source: BBVA Research, FRB & FRB Atlanta

**Figure 3.5** Proximity to next cycle & Output Gap (# of Quarters)



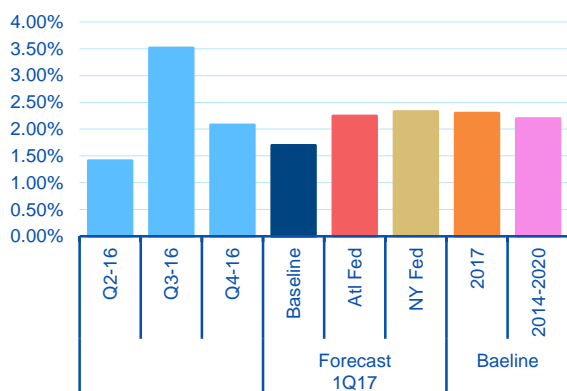
Source: BBVA Research

Furthermore, the pass-through from higher energy prices is eliminating some of the purchasing power gains delivered by the drop in crude oil prices in 2015-1H16. Pressures from rising energy prices will fade over the 2Q17, but the negative contributions from declining auto prices could dampen the inflation outlook and suggests broader weakness. That being said, high inventory levels and weak demand in the auto sector could continue to add to the downside pressures to consumer prices. With little progress on fiscal reform, and moderate inflationary pressures outside of energy and housing, market-based inflation expectations have eased; survey-based measures are also trending lower. Lower import prices from the strong dollar should also add to the downside pressures.

With this in mind, the outlook for the consumers and consumption in 2017 remains strong, although it is likely to disappoint relative to 2016, in which it had been the saving grace in the face of an investment, profits and productivity slump. Although car manufacturers could sacrifice margins by discounting existing inventories to attract customers, lenders are shifting away from the auto sector as delinquencies continue to rise and lenders try to limit their exposure to riskier sub-prime borrowers. Outside of autos, consumption should remain solid, as confidence remains high.

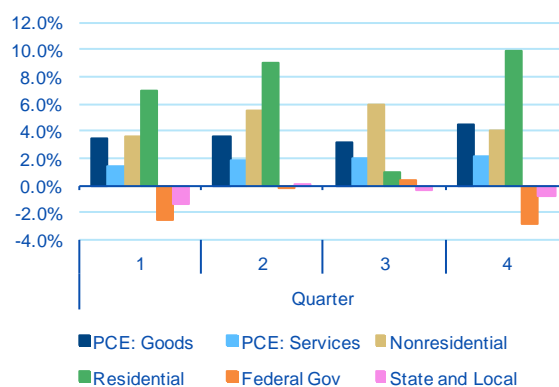
Growth in the first quarter disappointed markets, with consumption falling briskly. While more immediate than expected, the transition from consumption to investment is in line with our baseline. Despite a drawdown in inventories, nonresidential private fixed investment was strong, residential investment improved despite rising interest rates and exports grew due to stronger global growth and trade. Although the slow start to the year may raise concerns over the prospects of reaching 2% by year end there appears to be sufficient capacity left for investment following the slowdown in 2016. In fact, a positive surprise from the mining sector, which grew 19.3% year-over-year suggests that if consumption rebounds in the remaining three quarters growth exceed our baseline of 2.3%.

**Figure 3.6 Real GDP (SAAR, quarter-over-quarter %)**



Source: BBVA Research, BEA, FRB ATL & NY

**Figure 3.7 Average Quarterly Growth (%)**

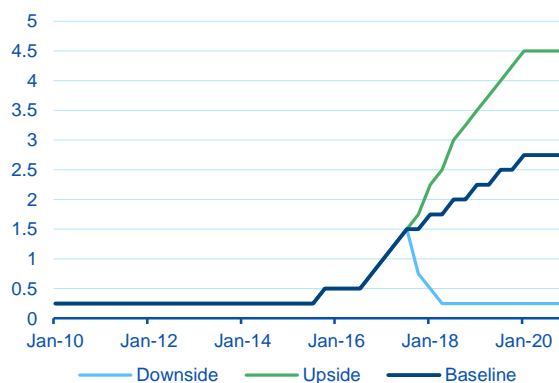


Source: BBVA Research & BEA

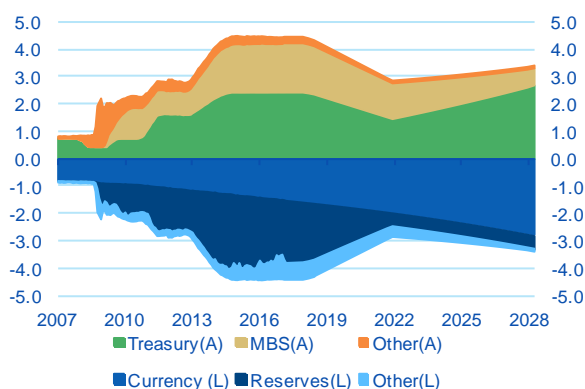
## Fed accelerates removal of accommodation with plans to shrink balance sheet

With conditions ripe for the removal of monetary policy accommodation, the Fed, after resuming policy normalization in December and increasing rates again in March, will continue on a gradual tightening path in 2017 with two additional 25bp rate increases in June and September. The uncertainty around this path is high, as communication in March struck a deliberately more hawkish tone. At the same time, the Fed is steadfast in its commitment to measured normalization. After the series of speeches leading up to the March meeting, along with the statement, the committee's economic outlook and press conference, it seems that with no change to their outlook gradual normalization could imply 3-4 rate increases per year. With this in mind, our bias is to the upside for the remainder of the year, with the possibility of three additional rates hikes this year —June, September and December.

However, the Fed seems ready to deal with the other side of the normalization coin: balance sheet normalization. Today, the Fed's balance has grown to \$4.5Tr in the post-crisis period from less than a trillion prior to the crisis. The bulk of the Fed's assets are treasury securities (\$2.5Trn) —most which have a tenor of longer than 10 years after Maturity Extension Program— and Mortgage Backed Securities (\$1.7tr). On the liabilities side, currency in circulation amounts to \$1.5Tr —twice as large as in 2007- while excess reserves sum \$2.2Tr. Although normalization could take many forms, it will likely imply a gradual ceasing of principal reinvestment that will begin at the end of the year. The rush to wind down the balance sheet is likely a function of the amount of securities maturing over the next two years, which could be as large as \$1.2Trn if pay downs on the Mortgage Backed Securities (MBS) portfolio proceed as expected—around 18bn per month. In addition, purchases of MBS excluding the Federal Reserve, which totaled \$374bn in 2016, have returned to pre-crisis levels. For the Fed to begin the process of normalization risks will have to remain balanced, which is consistent with our baseline scenario of moderate growth and inflation.

**Figure 3.8** Fed Funds Rate Scenarios (%)


Source: BBVA Research

**Figure 3.9** Fed Assets and Liabilities (\$, Trillion)


Source: BBVA Research & FRB

While the minutes seem to close the book on when the reinvestment policy will end, there remains a considerable amount of uncertainty as to the pace, composition and whether the committee would concurrently normalize the balance sheet and increase interest rates. Fears of a rebirth of the Taper Tantrum<sup>1</sup> also reinforced our view that the committee will communicate “to the public well in advance of an actual change”, meaning that the topic will be a focal point of upcoming meetings. Furthermore, a handful of participants will advocate for announcing the FOMC’s “expectations for the size and composition of the Federal Reserve’s assets and liabilities in the longer run.”

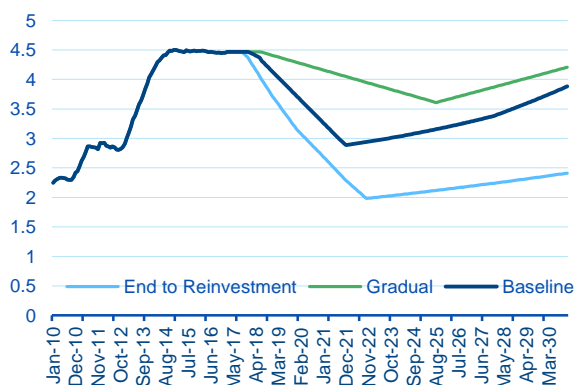
In terms of pace, the trade-off will be between clear communication and financial disruptions. A phased-out approach will likely reduce “the risks of triggering financial market volatility”, but ending the reinvestment policy altogether was viewed “as

1: For more information see <https://research.stlouisfed.org/publications/economic-synopses/2014/01/28/lessons-from-the-taper-tantrum/>

easier to communicate while allowing for somewhat swifter normalization of the size of the balance sheet.” A complete end to the reinvestment policy of Treasury holdings –assuming no changes to the duration of the portfolio, no sales of securities, and no changes to the MBS portfolio- would imply reducing the balance sheet by around \$420 billion by the end of 2018 and an additional \$1.5 trillion by 2022. A phase-out approach combining both Treasuries and MBS securities would result in a reduction of almost \$1.5 trillion by year end 2022. Obviously, the Fed could accelerate the pace as markets adjust or change the duration of the portfolio, which in turn would speed up the normalization process.

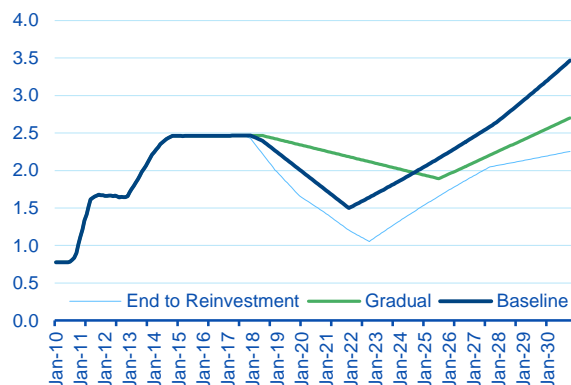
With respect to the composition and mix of reinvestment there seems to be disagreement on which portfolios — Treasuries vs. Mortgage Backed Securities (MBS)— to reduce; although in the long-run it appears that members will prefer a lean and clean portfolio of treasuries. In addition, reducing the size of the MBS portfolio will present additional risks to normalization given that pay-downs of the MBS portfolio are unknown and the factors underlying that pay-down such as home prices, prepayment, government and fiscal policy, and interest rates can fluctuate, altering the timing and size of principal payments. Considerations of housing market stability could also complicate the process, as the Fed remains one of largest purchasers of MBS. In other words, the Fed will try to avoid destabilizing the MBS market so not to disrupt home prices and mortgage lending. Given that the MBS market is back to normal, the Fed can take action without generating these risks.

**Figure 3.10** Balance Sheet: Asset Scenarios (\$, Trillion)



Source: BBVA Research & FRB

**Figure 3.11** Balance Sheet: Treasury Scenarios (\$, Trillion)

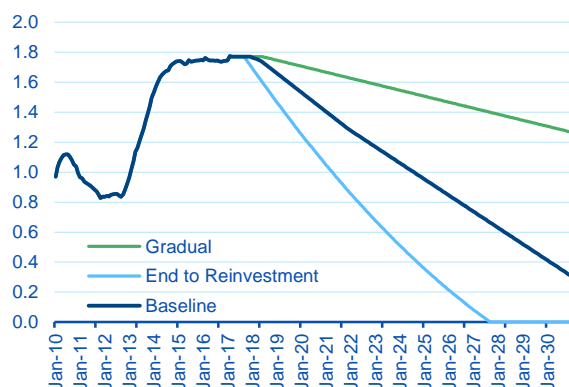


Source: BBVA Research & FRB

Given that a complete or gradual reduction in the balance sheet could push longer-term interest rates up 1-2pp, it is remains unclear whether the Fed would view balance sheet normalization and interest rate policy as mutually exclusive or would act concurrently. Ultimately, however, if economic conditions were deemed stable enough, there is a chance that the committee could increase rates and begin normalization this year, as the minutes stated that later this year that “gradual increases in the federal funds rate would continue and judged that a change to the Committee's reinvestment policy would likely be appropriate.” If recent history is an indicator of how the committee will proceed, the approach will be staggered and slow to allow the committee to assess the impact of the adjustments in its reinvestment policy. This could imply that if the

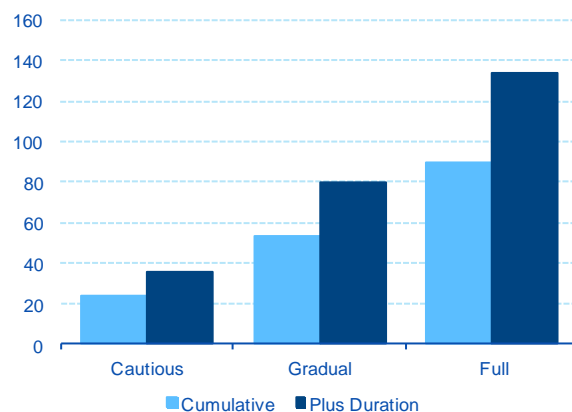
Fed stops reinvestments in December, after two additional rate hikes (June and September 2017), the next rate increase could be pushed back to the second half of 2018, to allow markets to absorb the effects of higher long-term interest rates.

**Figure 3.12** Balance Sheet: MBS Scenarios (\$, Trillion)



Source: BBVA Research & FRB

**Figure 3.13** Balance Sheet: Impact on 10-year Treasury (bp)



Source: BBVA Research

## Administration fails to set policy course in first 100 days

Although tax reform was the key Republican proposal during the election campaign, it now is less clear what type of fiscal package the administration will be able to accomplish. The Treasury, which will be charged with creating a comprehensive strategy, remains largely understaffed with 70% of the 28 political appointees yet to be announced. Even with fully staffed Treasury, it took 10-months to produce the comprehensive plan for the Tax Reform act of 1986, an additional 13 months for it to be proposed in Congress and another nine before its passage. In a best case scenario, this would imply major tax reform would come no sooner than November 2019. In addition, there are important differences between the White House and Congressional plans. The Trump administration has not explicitly endorsed the implementation of a border adjustment tax (BAT) and fiscal conservatives will likely stall any plans that lead to major increases in the debt levels. Taken together, the most likely outcome will be something akin to the Bush tax cuts that reduced rates but were sunset due to the need to be deficit neutral beyond the 10-year budget horizon in order to meet the requirements for reconciliation.

The Trump administration has not yet proposed what they have described as a \$1 trillion infrastructure spending program involving the public and private sectors. Its challenge: to convince Congress to include this spending package as part of fiscal reform. However, details of the plan have yet to be revealed. Although popular among both parties there seems to be challenges remaining, Democrats are less willing to accept the participation of the private sector while budget-conscious Republicans worry about the country's mounting debt.

On trade, President Trump seems to have softened his stance regarding international trade. For instance, he decided not to label China a currency manipulator as he promised through his campaign. The administration actions now seem targeted to

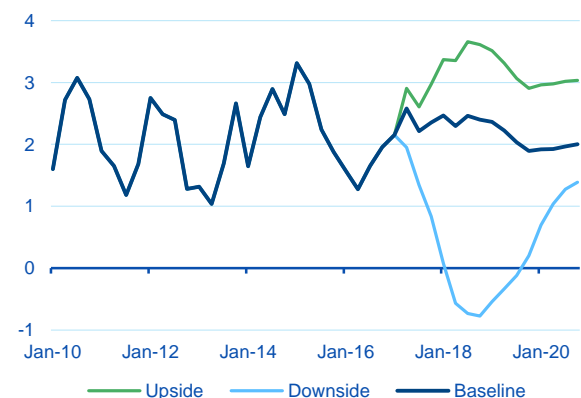


specific sectors like steel and tit-for-tat tariffs. A re-negotiation of NAFTA is still on the table. However, increasing pressure from stakeholders (e.g. agricultural sectors and companies reliant on global value chains) would prevent the administration from taking radical steps, like a complete withdrawal from the treaty.

## Too much optimism, not enough progress

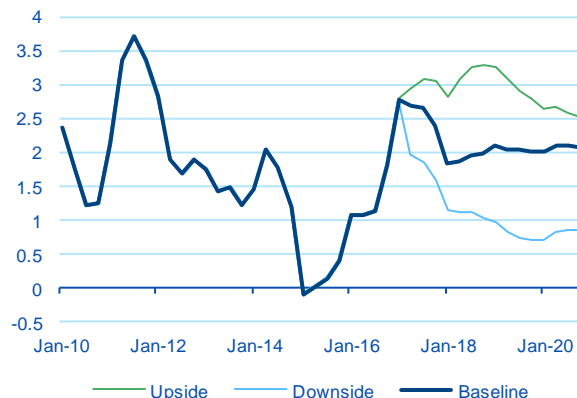
The possibility of Trump meeting market expectations and achieving comprehensive tax reform, or at worst lowering the corporate tax rate before the end of the fiscal year appear remote. With this in mind, the likelihood of reaching growth rates above 3% this year is equally unlikely given the headwinds from demographics, productivity and less accommodative monetary policy. Furthermore, the cyclical recovery in consumption is slowing, and while investment is growing following the commodity induced profit slump, the space for a major investment boom is small notwithstanding a major shift in regulation and policy.

**Figure 3.14** Real GDP Growth (%)



Source: BBVA Research

**Figure 3.15** Headline Consumer Price Index (year-over-year %)



Source: BBVA Research

Despite the post-election euphoria, we remain skeptical that Washington will be able to quickly and effectively deliver on its promises, and we assumed going into the year that the new administration would face growing pains. As such, we are maintaining our outlook for growth to recover to 2.3% in 2017. In 2018, we expect growth to be 2.4% as the cumulative effect of regulatory reform and piecemealed executive actions give a slight boost to expectations. Thereafter, the scenario assumes the demand-side pressures overtake any modest supply-side reforms of the administration bringing growth back to around 2%.

With only minor changes to the fiscal outlook and growth moderating, our expectations are for the inflationary pressures from energy prices and housing to fade throughout the year. This will bring inflation below the 2% target to 1.9% in 2018 from 2.6% in 2017. After the transitory pass-through from energy price gains fades and core prices stabilize we expect headline inflation to trend back to 2.0% over the medium-run.



There still remains a scenario, in which Trump achieves the breadth and magnitude of reforms that he promised heading into office, although the probability remains low due to the lack of tangible evidence that the administration is prepared and has enough political capital to tackle structural reforms. In this scenario, with expansionary fiscal policy and modest regulatory and supply-side reforms growth could surpass 3% in 2018-2020. This scenario would likely imply an unemployment rate that would trend close to historical lows at around 3.9%. Above potential growth and expansionary fiscal policy push inflation above 3.0%.

With little progress domestically and increased geopolitical tensions abroad, the probability of reaching our downside scenario has grown. Although the likelihood remains small, the impact would likely imply a moderate recession given that overall financial imbalances remain largely contained and leverage has declined since the crisis. In this scenario, stagnation-like conditions would produce a disinflationary environment with rising unemployment, reaching 7.0% in 2018.

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