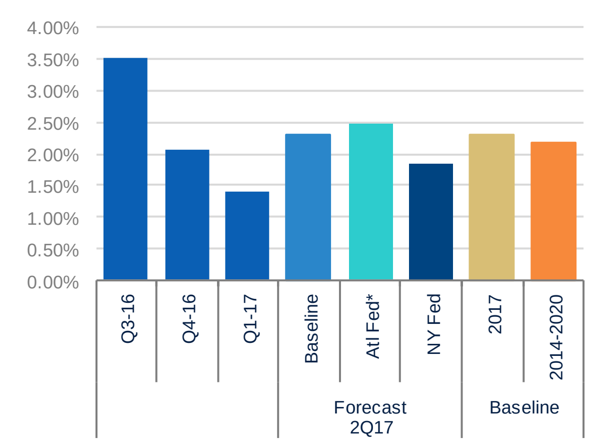
4. U.S. economic outlook

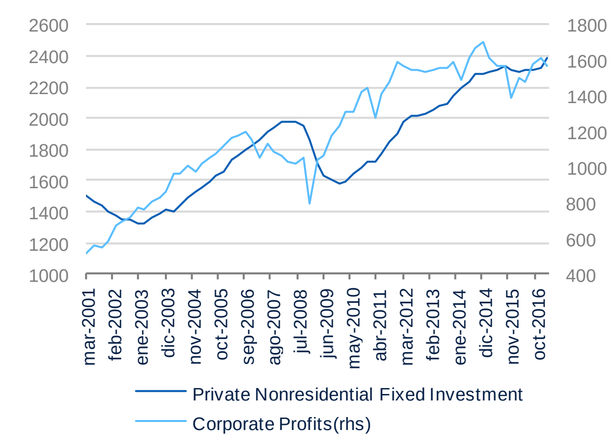
Given the weak first quarter and lack of progress on fiscal policy, we have revised down our baseline forecasts for U.S. GDP growth to 2.1% for 2017 and 2.2% in 2018 from 2.3% and 2.4%, respectively. This projection is consistent with our long-run estimates for potential GDP and a subtle rebalancing between consumption and investment this year. This year stronger global growth should support the recovery in exports while previous gains in oil prices are likely to continue to support increased investment in the Oil & Gas sector. Although there is still time for the GOP to deliver comprehensive tax and healthcare reform the lack of progress to date and inability to pass even partisan reforms suggests that the upside to growth is lower than it was heading into the year. As a result, market, consumer and business expectations, which have been historically high, will have to adjust to an environment characterized by moderate growth, tighter financial conditions and unresponsive policymakers.

Figure 4.1 Real GDP forecasts (annualized, %)



Source BBVA Research, FRB NY & FRB Atlanta

Figure 4.2 Corporate profits and private fixed nonresidential investment ($bn)

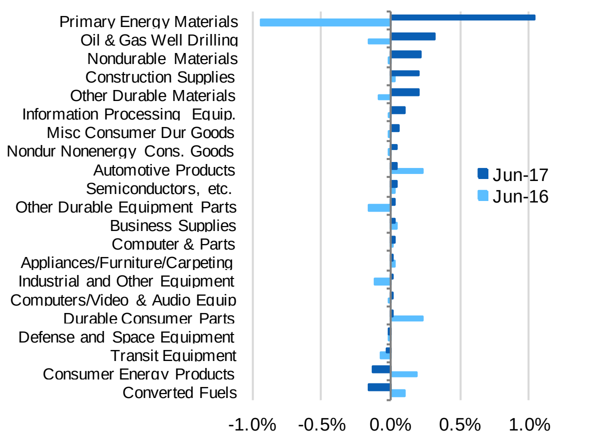


Source BBVA Research & BEA

In the first quarter 2017, private fixed investment posted the strongest year-on-year growth in six years. Although oil prices remain well below pre-2015 averages, at around $45 per barrel current prices have recovered enough to reestablish investment in mining exploration equipment; first quarter estimates for investment in mining structures was 55% higher than the previous quarter. Moreover, transportation and other equipment posted positive year-on-year growth for the first time in six and eight quarters, respectively. There also appears that the sector will carry this momentum in the 2H17, as industrial production in the Oil & Gas sector increased 108% year-over-year in June. Stronger global demand and a recovering mining sector have offset weak domestic auto demand, leading to a rebound in manufacturing activity. While residential investment has slowed somewhat, we expect investment in single-family homes to continue to grow positively, in response to supply shortages, favorable credit conditions and affordability for most buyers.

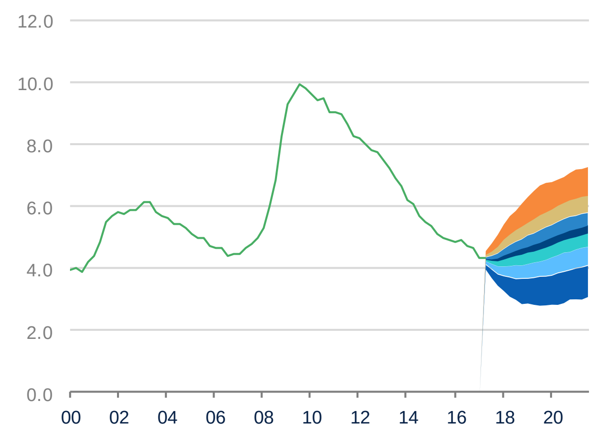
While the pace of growth in retail sector has decelerated in 2Q17, conditions remain suitable for moderate consumption growth for the remainder of the year. A large portion of the drag on consumption has been slower auto demand. Rising interest rates and tighter credit standards have created headwinds for the auto sector that are likely to persist throughout the remainder of the year. That said, labor market conditions are strong and interest rates remain low by historical standards. Consumer credit excluding auto loans also continues to expand at a healthy pace, which will buoy household spending. As such, we expect real personal consumption to grow 2.1% year-over-year, down from 2.7% in 2016.

Figure 4.3 Industrial production by sector (Contribution, pp)



Source BBVA Research & BEA

Figure 4.4 Unemployment rate forecasts (%)



Source BBVA Research

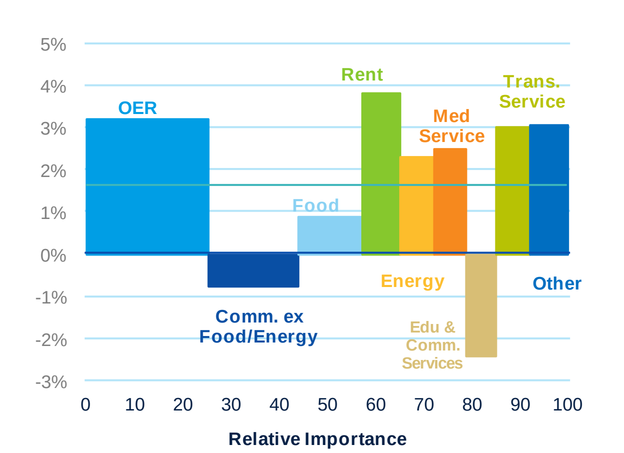
In terms of the labor market, there is evidence that cyclical recovery is nearing its end. In fact, in June, the unemployment stood at 4.4%, representing the lowest level since 2007. Moreover, an additional 60bp drop in the unemployment rate would bring the rate to its lowest level in nearly 50 years. Furthermore, nonfarm payrolls, despite growing faster than market expectations in June, are trending at a rate consistent with our baseline scenario of 180K jobs per month; this pace remains sufficient to bring down the unemployment rate when considering demographics changes and labor force participation. Other measures of labor market utilization such as the Beveridge Curve, persons marginally attached to the labor force, discouraged workers, and persons employed part-time for economic reasons also suggest conditions are normalizing. With this in mind, we expect employment growth to decelerate and the unemployment rate to steadily decline to 3.9% by mid-2018. This would represent a nontrivial undershooting of the unemployment gap.

Despite signs that the economy is at full employment wage pressures have been muted. In fact, this inconsistency has raised doubts that the relationship between the tightness of the labor market and wages is broken or has been altered by the crisis. While part of the low real wage regime is likely a reflection of low-levels of productivity growth in the post-crisis period, nominal wages should be growing at a faster pace. Notwithstanding an unexpected shock to productivity or return to a pre-crisis Phillips Curve implies that wage growth will remain low.

In addition to the lack of wage pressures, disinflationary trends in a handful core consumer prices categories and lower inflation expectations support our downward revision to inflation, which we expect to trend below the committees target of 2.0% over the medium-term. The reflationary sentiment that prevailed following President Trump's election has faded as 5-yr forward inflation expectations have remained consistently below 2.0% since May. Diminishing pressures from previous gains in energy prices and the absence of increases in core prices excluding shelter and medical commodities has pushed headline CPI in June down to 1.7% year-over-year from 2.8% in February. Core consumer prices excluding shelter grew only 0.6% year-over-year, which is the slowest pace since 2003. Similarly, core PCE grew 1.4% year-over-year in May, which is down from 1.8% in January.

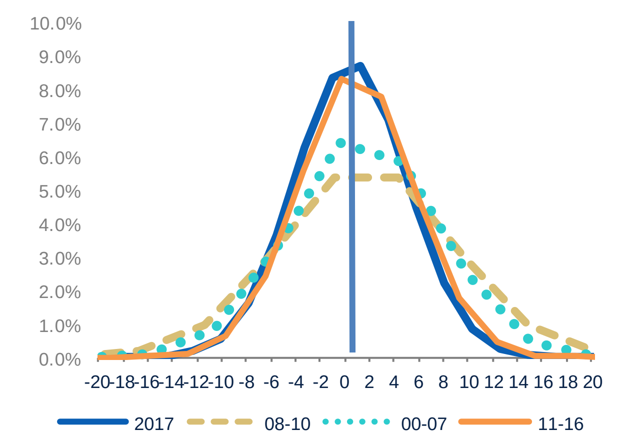
Idiosyncratic explanations for recent inflationary headwinds, which gained traction in 2Q17 after Fed's Chairwoman Yellen highlighted the drop in mobile phone contract prices and physicians services as examples, fails to address the persistently low inflation that has prevailed since prior to 2011. In the last five years, two single items –rent of primary residence and owners' equivalent rent- account for more than 50% of the increase in core CPI. In fact, the distribution of price changes for over 160 unique consumer price categories has shifted downward. Specifically, the average year-over-year change per category shifted from 1.5% in 2000-2007 to 0.9% in 2011-2016 to 0.5% in 2017. Inflationary pressures were also less volatile and more symmetric during this period. Moreover, 12-month inflation for education services has reached a record low and prices for electronic commodities such as televisions, wireless telephones, major household appliances, and computers have been declining for more than 15 years, so expecting a quick reversal of course is misguided. However, while there are no evidence of widespread deflationary pressures these persistent headwinds will create challenges for the Fed, as maintaining a symmetric goal of 2% may be difficult based on the current strategy, which has failed to lift prices above 2% for a prolonged period.

Figure 4.5 Contribution to consumer prices



Source BBVA Research & BLS

Figure 4.6 CPI inflation distribution* (YoY, %)



* 169 unique categories
Source BBVA Research & BLS

In terms of monetary policy, we anticipate that the next major shift in policy accommodation will be the Fed's announcement of the start of its balance sheet normalization, which we expect to occur at the FOMC's September 19th-20th meeting; implementation will likely begin in October, followed by a 25bp rate increase in December. Our baseline also assumes two additional 25bp rate increases in 2018 and 2019. Currently, the biggest sources of uncertainty is inflation, which continues to trend well below the FOMC's target, and equilibrium real interest rates, which by some estimates are close to zero. If inflation continues to trend persistently below the committee's target and expectations on equilibrium real interest rates remain low there is a chance that the current tightening cycle could be put on pause sooner than implied by the committee's projections (Summary of Economic Projections) and thus allow labor market to undershoot full employment for a longer period.

For fiscal policy, although our less upbeat outlook at the start of the year remains fundamentally unchanged, for most market participants it continues to dampen, as the prolonged process of repealing and replacing healthcare has delayed and shifted attention away from policies that could boost growth such as tax reform and infrastructure spending. Moreover, Congress now has to increase the debt ceiling, which after exhausting all extraordinary measures, is projected to occur in mid-October and adopt a budget resolution prior to fiscal year 2018. Failing to increase the debt ceiling or prioritizing Treasury payments would put at risk the U.S. untarnished credit rating.

Meanwhile, since bi-partisan comprehensive tax reform is close to impossible, Republicans will try to approve a budget resolution in both the House and Senate to use reconciliation to pass tax reform with a simple majority in the Senate and bypass a filibuster. However, the first hurdle is having tax policy wonks, deficit hawks and defense hawks inside the GOP agreeing on where spending cuts will be implemented and the level of deficits that are acceptable. Through reconciliation, savings can only take place through mandatory spending, which includes Medicare, Medicaid and other welfare programs. If the president remains committed to keep Medicare untouched, tax cuts would probably be back-loaded with high economic growth expectations or financed through higher deficits.

While indications are that, the White House remains committed to infrastructure investment it at best ranks third in terms of priorities behind tax reform and healthcare. As a result, we are not incorporating fiscal expansion in 2017 outlook. In 2018, our baseline continues to assume a moderate impact from fiscal policy albeit at a reduced rate, particularly since tax reform will be mostly about cuts rather than a complete overhaul to the tax code.

Nevertheless, the uncertainties around our scenario are also growing and tilting to the downside given the lack of clear direction from the administration. To the upside, a quick turnaround in Congress and compromise from the White House on tax reform or infrastructure spending could have an immediate impact on expectations while also boosting demand over medium-run. This would likely imply moderately higher growth over the next four years. Furthermore, the downside risks from damaging restrictions on trade flows and immigration appear to have come down. Conversely, further delays on tax reform and infrastructure spending could erode the confidence of the private sector. This combined with cyclical headwinds and tighter financial conditions could push growth well below 2.0%. Given that the economy is nearing its cyclical peak and trending close to our estimates for potential GDP, means that notwithstanding an about-face from Congress and White House that leads to timely and effective policymaking, growth will continue at its current pace, at or slightly below 2.0%.

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