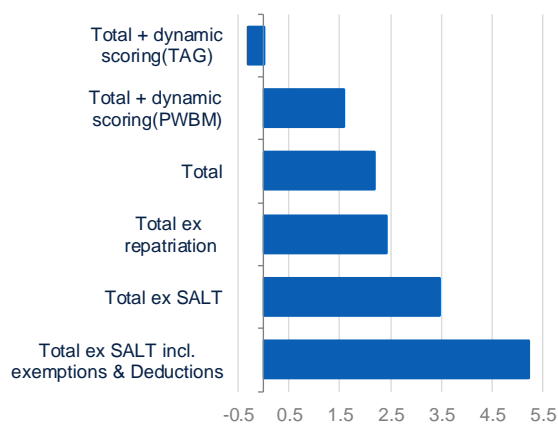


### 3. U.S. on track for moderate growth

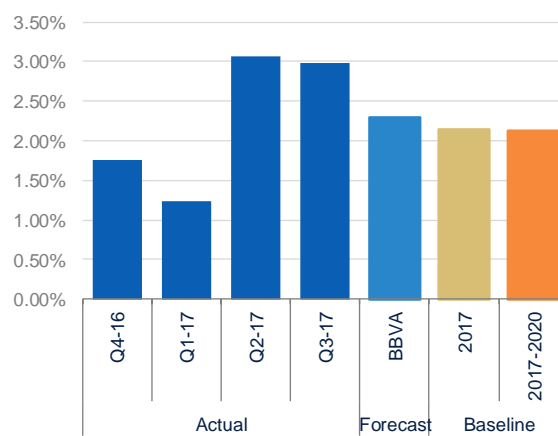
Although the “Unified Tax” framework distributed by the White House and the passage of a budget resolution in Congress reinforces the GOP’s commitment to tax policy, the scant details within the document and lack of consensus are not enough to alter our outlook for moderate growth in 2017 or 2018. Regardless, domestic fundamentals are solid with consumers well positioned after a painful deleverage process, and industrial activity is recovering from the slump in 2016. Financial conditions are also supportive of growth despite the Federal Reserve (Fed) further removing accommodation in 2017: three interest rate increases (one 25bp increase anticipated in December) and the start of balance sheet normalization on October. More broadly, global activity has improved throughout the year with increased growth synchronicity among developed and emerging markets. Notwithstanding any unanticipated rise in geopolitical or economic policy uncertainty, we expect growth to continue to converge with our baseline scenario that assumes growth of 2.1% in 2017 and 2.2% in 2018. However, a strong mid-year upturn in growth has increased the possibility of growth surprising to the upside in 2017.

**Figure 3.1** Static deficit impact of “Unified Framework” proposal, \$trillions



Source: BBVA Research & TPC

**Figure 3.2** GDP growth, %



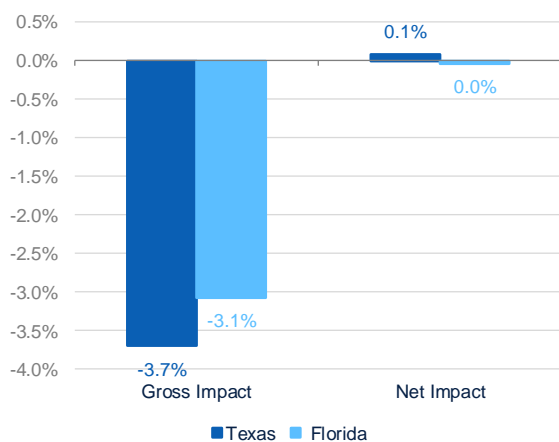
Source: BBVA Research, NY Fed & ATL Fed

While quarterly annualized real GDP growth disappointed in 1Q17, domestic activity rebounded strongly in the 2Q17 and 3Q17, rising to 3.1% and 3.0%, respectively. Fears of demand-side headwinds for the consumer were short-lived, as stronger consumer sentiment indicators finally translated into stronger growth of personal consumption (3.3% and 2.4%). On the supply-side, private nonresidential fixed investment also benefited from the tailwinds of higher business confidence, as investment in information processing equipment expanded at a double-digit pace in both the 2Q17 and 3Q17. Moreover, net exports also contributed positively to domestic growth for the second consecutive quarter due stronger growth abroad and the absence of major frictions from changes to global trade policy. With respect to government activity, aggregate consumption remained weak in the 2Q17 and 3Q17 given a significant drop in investment at the state and local level.

However, accelerated investment in national defense in the 2Q17 and a rebound in national defense consumption expenditures helped counteract the headwinds in other government-related expenditure categories.

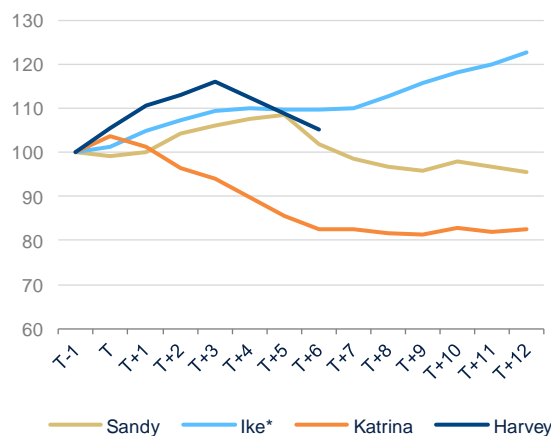
Although evidence suggests that natural disasters have small and transitory net effects on the national economy, Hurricanes Harvey and Irma could add noise to short-term indicators and growth estimates for the third and fourth quarter. That said, preliminary estimates for 3Q17 GDP suggests national growth was largely unaffected by the storms. At the regional-level, we estimate the damage could exceed \$160bn. This includes damage to physical capital and economic losses from short-term flows. That said, notwithstanding the negative surprise in the labor market in September (-33K jobs), national indicators particularly those in the manufacturing and construction sectors have surprised to the upside. In fact, the ISM in September reached its highest level since the pre-crisis period while the monthly pace of auto sales on a seasonally adjusted basis increased by 204K. Ultimately, we expect the labor market to recover quickly in the coming months.

**Figure 3.3** Growth impact from hurricane's Harvey & Irma, pp



Source: BBVA Research

**Figure 3.4** Unemployment insurance claims index, week prior to major hurricane=100



Source: BBVA Research & BLS

Beyond the short-term volatility associated with the storms, labor market conditions continued to improve. In fact, in September, the unemployment rate declined to 4.2% in spite of the frictions created by the storms. Moreover, the participation rate reached its highest level since 2013, which is uplifting given the structural headwinds an aging population poses to labor force participation. Moreover, prime-age participation, which had failed to recover in the post-crisis period, reached its highest level in a decade at 82.0%—between 1990-2010 average prime-age participation was around 83.5%.

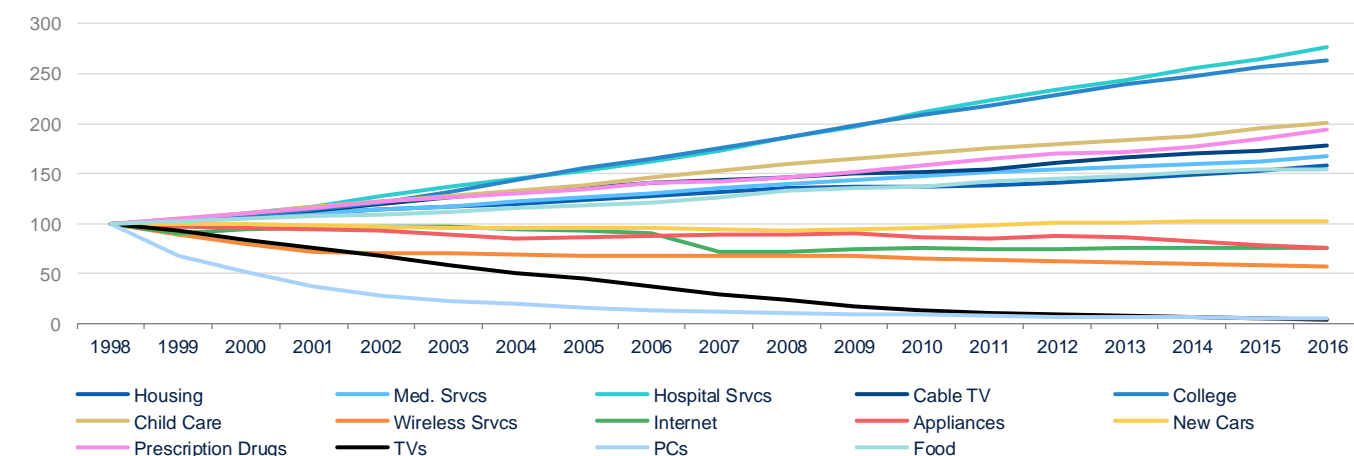
Broader measures of labor market utilization such as the U-6 unemployment rate and the nonemployment rate<sup>1</sup> also suggest the labor market is approaching levels that are consistent with an economy at full employment. Despite the strong cyclical recovery, we continue to expect some frictions to remain given their structural nature. As such, we anticipate

1: Hornstein, A., Mariana Kudlyak and Fabian Lange (2015)

monthly employment growth to average around 140K jobs per month in 2018-2019, which is above the pace needed to absorb new entrants, and the unemployment rate to continue to trend well below consensus estimates of long-run unemployment rates, reaching 4.1% in mid-2018.

Despite tight labor market conditions, expectations of expansionary fiscal policy and depreciation of the U.S. dollar, trend inflation remains below 2.0%. In fact, in August, core inflation for personal consumption expenditures (PCE), the preferred measure of the Fed, decelerated to 1.3% year-over-year—the lowest in two years; market based core PCE decelerated to 1%. In addition, implied inflation expectations, which rose in the post-election euphoria, have declined to levels that represent an undershooting of the Fed's symmetric inflation target for several years.

**Figure 3.5** Consumer price index, 1998=100



Source: BBVA Research & BLS

When looking at the contributions of major components to consumer prices the argument for a quick return to 2% is tenuous. In fact, the idea that the sharp contraction in mobile phone contracts prices explained a majority of the weakness in core prices is unconvincing, as it accounts for roughly 2 percent of consumer prices. In addition, even with less negative contributions over the past quarters, core prices are averaging around 1.7% year-over-year. Conversely, medical care and education have decelerated substantially since 2015, which tend to move without respect to the business cycle. Ultimately, these sectors are also facing regulatory and policy headwinds relating to pricing and service, which reduces the likelihood for a sharp turnaround in the near future.

The factors that explain the common trend have also shifted over time. An analysis of 18 independent components of personal consumer expenditures, prior to 2014 and after, shows that the components that explain a majority of the common trend in inflation have decelerated for services such as health care, recreation, transportation and finance, and contracted for energy commodities and clothing. In fact, if the factor loadings from the estimation after 2014 are applied to historic data, the results suggest that current inflation is slightly above or at trend; if the entire sample is estimated with pre-2014

factor loadings the results show that inflation is below trend and has been since the 1990s. If energy is excluded from the estimation, the results support the conclusion that the post-2014 inflation common trend is close to the average whereas the full sample suggests a significant undershooting of the 2% target of the common inflation trend. As a result, there remains a moderate likelihood of persistent undershooting of the 2% target in 2018 and possibly 2019; a reality some FOMC members have alluded to in recent communications.

**Table 3.1** Inflation components, year-over-year % change

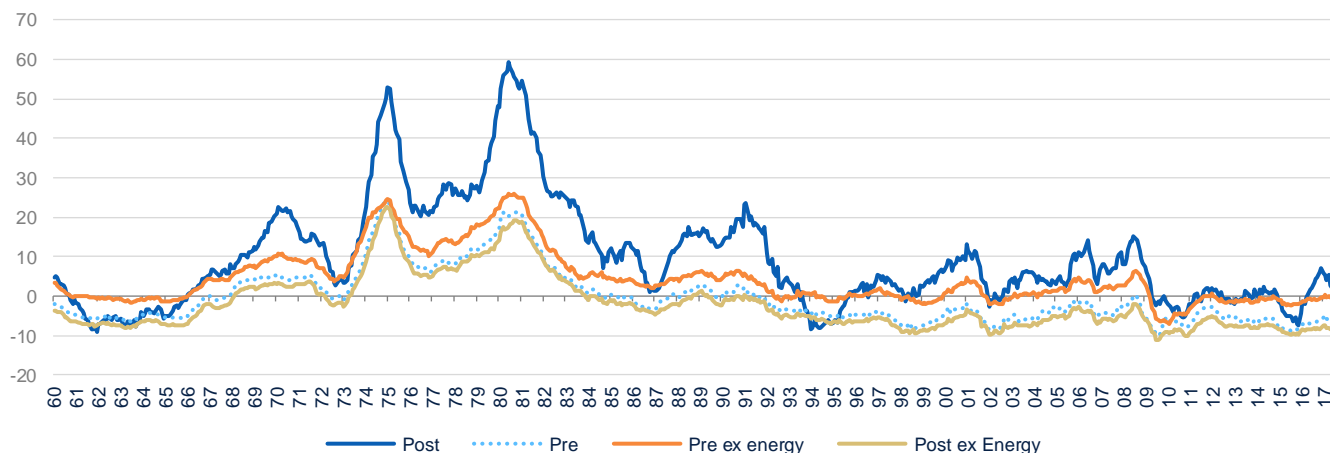
Rank	2014-2017	Average Growth	1960-2017	Average Growth
1	Health Care	1.1	Food Svcs & Accommodations	4.3
2	Housing & Utilities	2.9	Furnishings & Household Equip	1.3
3	Other Durable Gds	-0.7	Recreation Services	3.7
4	Gasoline & Other Energy Gds	-8.9	Transportation Services	4.0
5	Recreation Services	2.1	Other Services	4.1
6	Transportation Services	1.0	Health Care	5.5
7	Clothing & Footwear	-0.4	Other Nondurables	3.5
8	Finance & Insurance	4.6	Housing & Utilities	3.9
9	Electricity and Gas	0.8	Recreational Gds & Vehicles	-1.8
10	alc Bev Purch for Off-Premises Cons	0.6	Other Durable Gds	2.5
11	Other Nondurables	1.4	Electricity and Gas	4.1
12	Final Consumptn Exps of Nonprofit	3.9	Alcohol Off-Premise	2.6
13	Other Services	1.3	Motor Vehicles & Parts	2.3
14	Furnishings & Household Equip	-2.8	Food & Nonalc Bev (Off-Premises)	3.6
15	Food Svcs & Accommodations	2.6	Clothing & Footwear	1.3
16	Recreational Gds & Vehicles	-4.7	Finance & Insurance	3.9
17	Food & Nonalc Bev Purch for Off-Premises Cons	0.4	Final Consumptn Exps of Nonprofit	1.3
18	Motor Vehicles & Parts	-0.5	Gasoline & Other Energy Gds	6.1

Source: BBVA Research

Although, this result is consistent with other empirical studies, there is no guarantee that trend inflation will stay low despite recent evidence of a disinflationary trap.<sup>2</sup> Between 1960-1965— a similar duration to the current disinflationary environment— U.S. core inflation was low and stable at around 1.3% year-over-year. Funding for the Great Society and the Vietnam War, coupled with demand-side concerns at the time led to significant increases in spending and deficits and a substantial rise in inflation, which peaked at 6.25% in 1970 (fiscal shock). After easing in following years, pressures from the White House and President Nixon to ease monetary conditions in the 1970s led to a quadrupling of the money supply with a fairly small or positive output gap, leading to double digit inflation in 1975 and to the stagflation of the 1980s (monetary shock).<sup>3</sup>

While the uncertainty around our inflation scenario has grown with the potential for extreme outcomes from monetary and fiscal policy, our baseline assumes low stable prices with core inflation remaining below the Fed's target for some time. That said, any fiscal expansion or unresponsive monetary policy could tilt the balance quickly to the upside.

2: See for example *Deflating Inflation Expectations: The implications of Inflation's Simple Dynamics* from Cecchetti et al (2017) and *Core and Trend Inflation* by JH Stock (2015)  
3: Other factors that contributed to the period of stagflation such as increase funding for the Vietnam War, the 1972 expansion of social security, the oil embargo and the fall of the Gold Standard.

**Figure 3.6** Common personal consumption expenditure trend, normalized


Source: BBVA Research

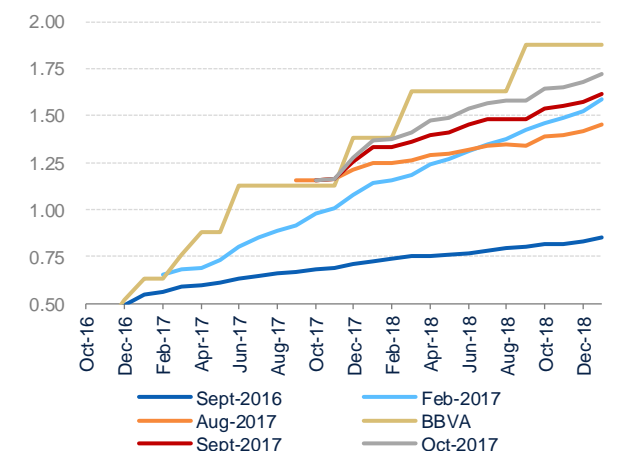
In terms of the monetary policy, we expect the Fed to continue on its normalization path in 2017. This will include ceasing reinvestment of principal payments under the established caps (Balance Sheet Normalization) and one additional 25bp rate increase at the final meeting of the year in December. Following the September meeting, market expectations have realigned with our view of a December hike despite concerns that the Fed may pause to assess the impacts of balance sheet normalization. Nonetheless, a major downward correction in inflation in November or December could give members some reservations about raising rates for a third time in 2017.

Going forward, however, there is a high degree of uncertainty about the path of monetary policy. Chair Yellen's tenure as head of the Fed will expire on February 3, 2018, which opens up the possibility that there could be a new Chairperson in 1Q18. The top candidates to replace Yellen include John Taylor, Kevin Warsh, Jerome Powell, Gary Cohn; other potential, but less likely candidates include Neel Kashkari and Glenn Hubbard. Kevin Warsh, John Taylor and Gary Cohn would be a significant departure from the current monetary policy regime approach of discretion, flexibility and risk management. These candidates would advocate for a rules-based approach, with increased transparency and accountability. Powell, on the other hand, would likely represent a continuation of the status quo albeit with a slightly higher appetite for modest financial deregulation. Moreover, even after the confirmation of Randy Quarles to the board of Governors there are still three remaining vacant seats on the Board of Governors, leaving the possibility that the FOMC could be comprised of a blend of these preferences and approaches.

In terms of the implications for interest rate policy, a shift to a Taylor-like rule would likely imply a much steeper tightening path than implied by the FOMC Summary of Economic Projections. Yet, a rules-based approach coupled with a more accommodative stance towards fiscal policy and the political economy could imply a less aggressive tightening path, assuming actual inflationary pressures remain somewhat contained. That said, we are maintaining our baseline scenario,

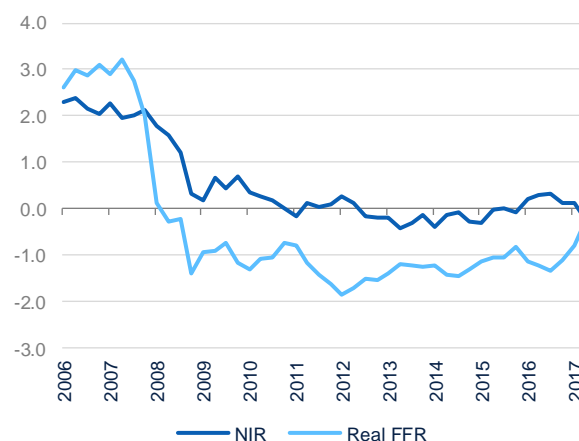
which assumes the Fed will raise rates twice in 2018 and two more times in 2019 despite the growing uncertainty around the future path of monetary policy.

**Figure 3.7** Fed funds projections vs. markets expectations, %



Source: BBVA Research and Bloomberg

**Figure 3.8** Real and neutral interest rates, %



Source: BBVA Research and FRBSF

With respect to fiscal policy, our scenario in 2017 is for the status quo to persist: deadlock. Thereafter, the urgency to deliver tax reform before the mid-term elections will increase the probability of the GOP passing modest fiscal legislation with limited base-broadening, but nontrivial tax cuts. In fact, we currently assume the likelihood of passing tax reform in 2018 is higher than 50%. In terms of the impact from fiscal policy, available details and preliminary third party analysis suggests that, at best, there will only be a slightly positive economic impact in the short-run. Those benefits, however, are eroded in the medium-run due to higher deficits and borrowing costs that tend to distort the way people, and companies work, save and invest. However, if the tax changes include measures that boost investment and efficiency, the economic effects would be larger and potentially even increase potential output.

With the cyclical headwinds of 2016 fading and global growth in lockstep, our outlook beyond 2017 is for the U.S. to continue grow at a moderate pace of around 2%. Similarly, we expect inflation to trend towards 2% target albeit at a slower pace than previously expected. In terms of risk, the fact remains that the U.S. has enjoyed a historically long period of economic prosperity and monetary accommodation is declining, implying slightly higher downside risks from an aging business cycle. In addition, there are potential pitfalls in terms of geopolitical economic policy related risks that could derail the U.S. recovery. Agreeing on the fiscal agenda and nominating a commonsense choice for the Fed Chair will improve the chances of continuing on this stable growth path.

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