

U.S. Economic Outlook

First Quarter 2011

Economic Analysis

- Global growth will decelerate slightly in 2011; rising food and commodity prices present risks
- We have revised our U.S. growth expectations upward; however, the recovery is not yet self-sustaining
- Our new state-level estimates of potential GDP growth indicate softer long-term expansion
- Opportunities will increase for industries that seize upon key market trends
- The financial system reconfigures in the wake of the crisis



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Editorial

Latest economic data indicate that GDP adjusted for inflation reached \$13.4 trillion in 4Q10. This is slightly higher than the peak at the end of 2007, implying a full recovery from the accumulated 4% contraction during the crisis. However, GDP per capita (\$43K) is still 2.4% lower than in the last quarter of 2007. In addition, total employment at 139.2 million is 5% less than November 2007. Meanwhile, measures of labor underutilization indicate that 17% of the labor force is unemployed, working part-time for economic reasons or have abandoned searching for a job. Furthermore, more than 44% of the unemployed have been out of a job for six months or more. These trends suggest that the recovery has been slow and unable to generate sufficient employment to spark a private-led self-sustained recovery. Elevated excess capacity and weak labor markets remain a challenge, and the real estate sector will not make a significant contribution in the near future. While these elements should not derail the economic recovery in 2011, they will not be supportive. Household deleveraging and financial frictions will continue for some time, while municipal debt pressures and rising commodity prices present potential downward risks to this outlook.

Although economic growth will continue to be supported by unprecedented fiscal and monetary stimulus, some bright signs appear on the horizon and suggest a better outcome ahead. In fact, economic expectations for this year have increased by almost one percentage point in the past four months. These revisions reflect three main elements. First, the implementation of further quantitative easing by the Federal Reserve in November increased the appetite for risk and has shifted investment from low risk assets such as Treasuries to higher risk assets such as equities and bonds. Second, additional fiscal stimulus passed by Congress at the end of 2010 will help to partially compensate the contractionary impact of the end of the 2009 American Recovery and Reinvestment Act.

The third element involves a significant upturn in business expectations. According to several measures of business conditions and capital spending plans, business confidence stands at its highest level since 2006. If firms perceive stronger demand and a better operating environment they will be more willing to increase capital spending and hiring, which in turn will boost income and consumption and thereby create a positive feedback loop. Sustained improvement introduces an upward bias to our current growth projection.

Although both monetary and fiscal policies have played a role in the improvement in business expectations, the fast recovery of sales abroad and the reduction in tax and regulatory uncertainty have also contributed to this trend. Reduced political animosity and greater cooperation since the mid-term elections open a window of opportunity for Congress and the Administration to move forward in tackling short and long-term challenges. While it would be irrational to assume structural changes will be undertaken promptly and efficiently, a lower probability of negative outcomes may have had significant effects on business expectations. Considering how low these expectations were a few months ago, small positive steps could have non-linear effects.

Thus, in the coming months, it is paramount that political leaders confront and effectively deal with important challenges such as the fiscal deficit. Leaders must assess entitlement programs, particularly those related to healthcare costs, and make changes to improve their long-term viability. Increasing the efficiency of the tax system can create the right incentives to boost investment and job creation. Measures are also needed to increase the quality of public education, address environmental issues and establish clear energy and immigration policies.

Sincerely,

Nathaniel Karp
BBVA Chief U.S. Economist

Global Outlook

The world will continue on divergent paths, increasing the decoupling between growth and policy

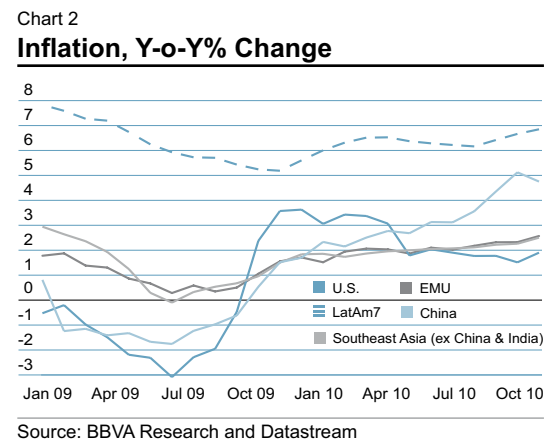
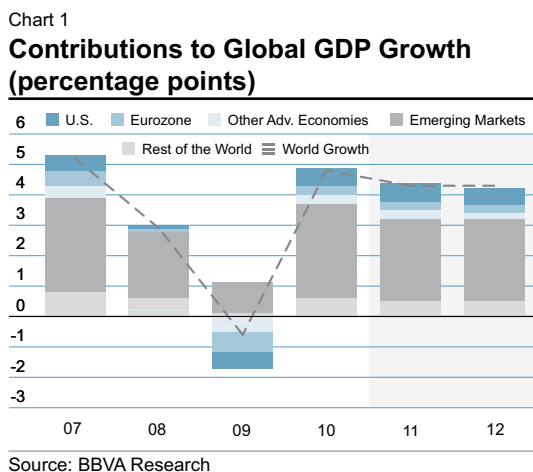
Global growth continues to push forward and raise living standards for millions. After closing 2010 with aggregate growth of 4.8%, the global economy is expected to decelerate slightly to 4.4% in both 2011 and 2012. The global economy ended the year with stronger-than-anticipated growth due in part to a slower-than-expected deceleration in advanced economies. However, the real engine of global dynamism continues to be the emerging world led by Asia and China in particular. (Chart 1) This sustains a scenario where decoupling between emerging and developed economies continues unabated. As we have also highlighted in the past, there is diverging growth between the U.S. and the EMU, as the substantial reduction in the probability of a double dip recession in the U.S. is reinforced. But growth decoupling is also increasingly evident within Europe, between core countries and those in the periphery that have been dragged down by financial market tensions. In fact, even though these tensions worsened during 4Q10, economic activity in the region as a whole has been able to accelerate, thus temporarily revealing a degree of decoupling between the financial sector and the real economy.

These trends offer three important implications for the outlook. First, the divergence between growth in advanced and emerging economies will continue to promote markedly different macroeconomic policies going forward. Monetary policies will continue to be highly accommodative in the U.S. and Europe, fueling a search for yield in emerging markets and commodities. At the same time, signs of overheating are starting to emerge in some countries in Asia and Latin America, pushing authorities to consider tightening monetary policy faster than previously envisioned given nascent inflationary pressures (Chart 2). The resulting incentives for capital inflows into emerging economies will contribute to increased policy dilemmas in both regions, as monetary tightening targets a soft landing while preventing sudden and sharp exchange rate appreciations.

Growth in the major advanced economies has picked up, but fragilities remain

Second, the growth divergence between the U.S. and EMU will continue to put downward pressure on the euro and, perhaps more significantly, will keep drawing market attention to the relative difficulty of the EMU to transcend their high public debt levels. Along with this element, the different size of their central banks' bond-purchase programs and the turmoil surrounding economic governance in Europe explain why markets have not significantly reacted to a further postponement of fiscal consolidation in the U.S. The difference between the markets' punishment of the European fiscal outlook versus the U.S. fiscal outlook could not be starker.

Finally, the increasing decoupling within the EMU will begin to strain the management of the common monetary policy for the region. The debate is already torn between an incipient risk of inflation, especially in core countries, and the need to continue supporting financial stability, especially—but not exclusively—in peripheral economies.



In Europe, institutional and economic reforms will be crucial for solving the financial crisis

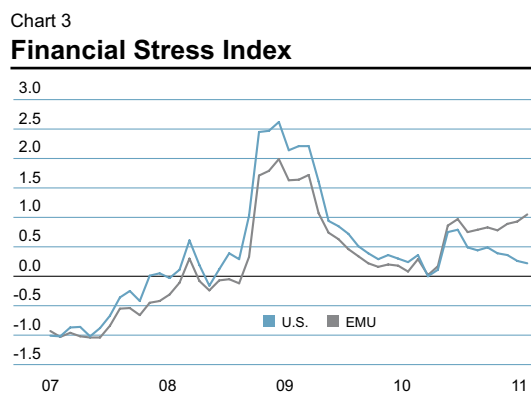
Since October 2010, financial tensions in Europe have surged again (Chart 3), especially in peripheral countries. Concerns about fiscal sustainability and financial sector losses resurfaced again, leading to widening sovereign spreads and funding pressures. However, contrary to the episode in May, financial spillovers to other countries in Europe and outside the EU were more limited.

The increase in financial market tensions was triggered by doubts regarding the ability of European institutions to deal with the sovereign debt crises. Moreover, private investors were spooked by the proposal that they would bear losses on possible restructurings after 2013 and the likelihood that existing debt would need to be trimmed to restore fiscal sustainability.

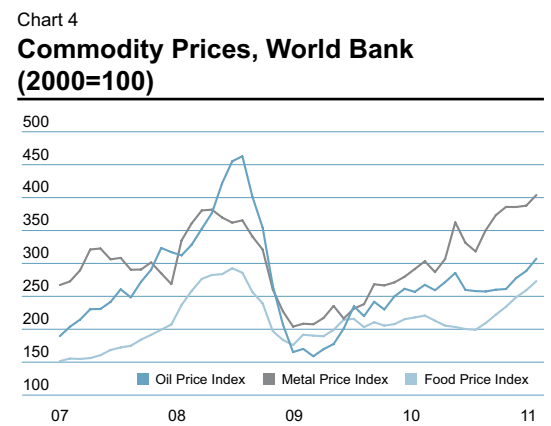
This initial trigger was amplified by doubts about the credibility of stress tests, given the need to support Irish banks shortly after they were deemed adequately capitalized. In addition, concerns about the capacity of some peripheral countries like Portugal and Ireland to fulfill their fiscal deficit targets added a sense of distrust in fiscal consolidation plans elsewhere. These two elements landed on top of doubts about the capacity of European economies to generate enough growth momentum to make their debt burden sustainable.

The evident fragility of this past summer's recovery in financial markets highlights that markets are increasingly focusing on sovereign solvency problems in some countries in addition to liquidity concerns. This stresses the need for a comprehensive solution, both for solving this crisis, as well as establishing a sound crisis prevention and resolution mechanism for the future. For crisis prevention, fiscal coordination needs to be reinforced, providing for shock absorbers for idiosyncratic shocks in individual countries, but also reinforcing surveillance both on the fiscal front and in the macroeconomic dimension (including preventing the build-up of private sector imbalances). For crisis resolution, a clear and transparent mechanism that defines those who will bear losses needs to be put in place in order to avoid excessive market volatility due to uncertainty.

As pointed out above, financial spillovers from this recent episode have been rather limited, including to core countries in Europe. Thus, growth in the EMU as a whole was stronger than anticipated, especially due to very positive outturns in Germany and other core European countries. However, this decoupling between financial tensions in peripheral countries and real economic activity in Europe will not last if a comprehensive governance reform is not agreed to during the European Council in March and if countries do not continue to push economic reforms that increase potential growth.



Source: BBVA Research



Source: BBVA Research and World Bank

Commodity prices will level off, but inflation risks are becoming more relevant in emerging economies

Commodity prices have surged across the board in recent months, reaching all-time highs in the case of some metal prices (Chart 4). This is consistent with a long-term upward trend in commodity prices driven by surging demand from emerging economies, but there are other short-run factors that have contributed to the recent surge. For instance, the rapid increase in food prices in the last several months was due primarily to one-time supply-side factors (weather disturbances), which should wind down during the rest of 2011. Moreover, given ample global liquidity conditions, investors have piled into commodities, increasing their prices across the board.

Looking ahead, we expect commodity prices to level off near current levels. In the case of food prices, this will be the result of normalizing crops in 2011. For metals, elevated inventories will start to weigh on prices. Only in the case of oil do we expect a tight market to continue pushing prices higher in 2011 but easing gradually afterwards. This easing will be helped by a reduction in financial tensions in Europe, which should shift investment flows away from commodities into other assets with more contained risk premiums. Nevertheless, risks are tilted to the upside, as strong demand in Asia will continue to support an upward trend in prices in the medium run.

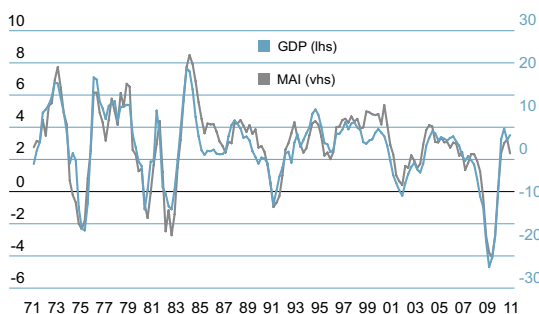
The increase in commodity prices has been responsible, in part, for the increase in inflation observed in emerging economies at the end of 2010 (Chart 2). In particular, the increase in food prices had a direct and important first-round effect on higher inflation in a number of countries—especially Asia—with the risk of feeding into overall inflation. However, going forward, the expected leveling of food prices will mean that this factor should become less important in determining headline inflation. The risk is smaller in developed economies, where food prices have a smaller weight on CPI and ample unused capacity and anchored inflation expectations will keep inflation pressures in check.

More worrisome for emerging economies is the realization that rapid growth and substantial capital flows to Asia and Latin America are starting to generate overheating pressures, not only through inflation but also through rapid credit growth and increasing asset prices. Indeed, we expect Asian economies to continue growing strongly, and while the risk of overheating is more pronounced than several months ago, we believe that authorities will be able to steer them to a soft landing and avoid that risk. Driven by domestic demand and high commodity prices, Latin America is also poised to grow strongly in 2011, converging to potential growth of around 4% in the region. We expect monetary tightening to continue in most countries, and at the same time, especially in Asia, some countries will pursue policies to impose stringent controls to limit capital inflows and credit growth.

U.S. Outlook

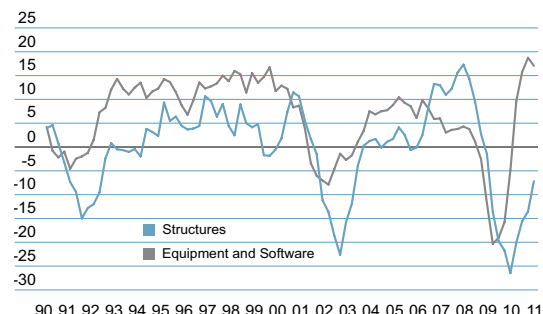
In 4Q10, the U.S. economy grew 2.8% (annualized) according to the Bureau of Economic Analysis (BEA) second estimate. Although the market expected a higher increase of 3.5% (BBVA estimate=3.3%), the components of this growth indicate the economic recovery is gaining momentum. The largest driver was personal consumption which jumped 4.1% in 4Q10 and contributed 2.9pp to GDP growth. However, gross private investment decreased dramatically due to a sharp decline in inventories and a slowdown in nonresidential investment. The change in total inventories dragged GDP growth down 3.7pp. External demand was particularly strong. Exports jumped 9.6% while imports declined 12.4%, and thus net exports contributed a whopping 3.4pp to GDP growth. In total, real GDP grew 2.8% in 2010. Early economic indicators in the first quarter point toward robust growth in 2011.

Chart 5
BBVA U.S. Monthly Activity Index and Real GDP, Y-o-Y % Change



Source: BBVA Research and BEA

Chart 6
Nonresidential Investment, Y-o-Y % Change



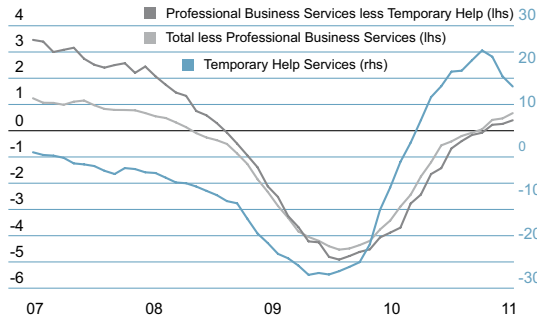
Source: BEA

In December, Congress approved a tax deal worth approximately \$850bn which was larger than anticipated. We expect that the direct impact to GDP growth will be approximately 0.5 percentage points (pp) in 2011 and 0.4 pp in 2012. With new tax incentives and political dynamics after the November elections, businesses and consumers face a less uncertain tax and regulatory environment which is boosting business and consumer expectations. New fiscal stimulus, a second round of monetary easing (QE2) and optimism in the markets could lead to stronger economic activity and a sustained recovery in job creation. Nonetheless, the recovery remains highly dependent on both fiscal and monetary stimulus. A self-sustained, private-led recovery is still in the making.

The main drivers of the economic growth in 2011 will be nonresidential investment and personal consumption expenditures. As for private investment, we expect business spending on equipment and software to remain robust, while investment in nonresidential structures remains weak. The housing sector is still under pressure, and therefore we do not expect residential investment to make a positive contribution to GDP growth. Personal spending will underscore the pace of the recovery given its 70% share of GDP. Recent upward trends in income growth and retail sales and a relative improvement in labor market conditions and consumer optimism are pushing personal spending upward. However, elevated unemployment, reduced housing wealth and tight credit conditions will continue to limit the pace of consumption growth.

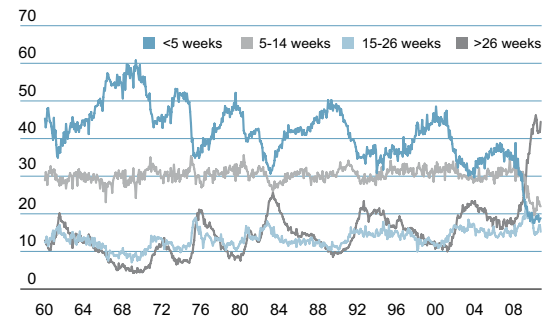
Labor market conditions remain weak. Although the unemployment rate declined to 9.0% in January, total nonfarm payroll only rose 36K. Recent trends in labor markets indicate some improvement in job creation; however, the unemployment rate is expected to remain elevated in 2011 due to an increase in the labor force and the participation rate.

Chart 7
Nonfarm Payrolls, Y-o-Y % Change



Source: BLS

Chart 8
Share of Unemployed, by Duration (Seasonally Adjusted %)



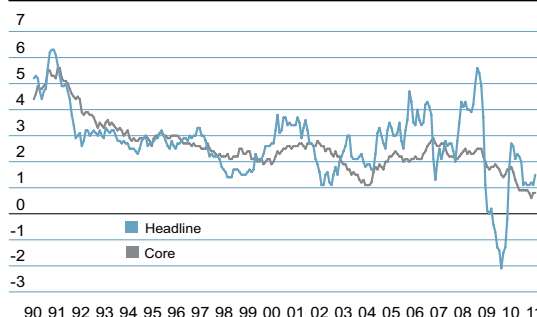
Source: BLS

Inflation remained low in 2010. Consumer prices rose 1.6% while core consumer prices increased 1.0% last year. Excess capacity in the goods market, weak labor market conditions and well-anchored inflation expectations keep both deflationary and inflationary pressures at bay. While commodity prices have appreciated significantly and pushed headline inflation up, compensating disinflationary pressures will limit significant jumps in inflation. We expect core inflation to stay stable in early 2011 and increase slowly thereafter as wage costs and shelter prices exhibit slow appreciation. Similarly, headline inflation is expected to remain lower than 2% in 2011.

There are both downside and upside risks in 2011 that should be considered. The sovereign debt crisis in Europe still poses downside risks to the U.S. recovery; however, these threats are manageable even if the crisis spreads to other European countries. Other downside risks stem from rising commodity prices and a possible double-dip in housing; however, the diversification of the U.S. economy limits the negative impact from these scenarios. On the other hand, there is significant upside potential to growth. Stronger external demand, a further improvement in both business and consumer expectations and a significant appreciation in financial assets will all boost the economy. Although our current baseline scenario assumes 3.0% real GDP growth this year, we strongly believe that the economy could grow at a faster pace.

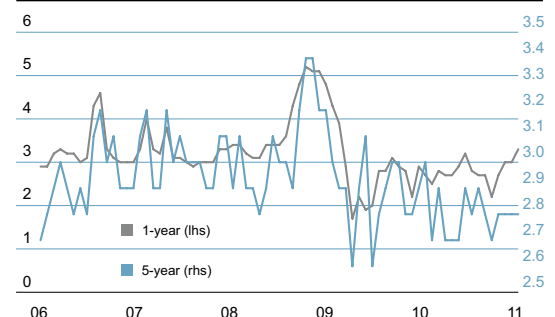
We expect the Fed to continue its implementation of QE2 as planned. While the FOMC is likely to revise up its forecasts at April's meeting, officials remain concerned about the mismatch between GDP growth and the weak labor market. In our baseline scenario, the Fed will maintain a near zero target rate throughout 2011, but we do not expect an additional round of quantitative easing (QE3).

Chart 9
Consumer Prices, Y-o-Y % Change



Source: BLS

Chart 10
Inflation Expectations, Annual %



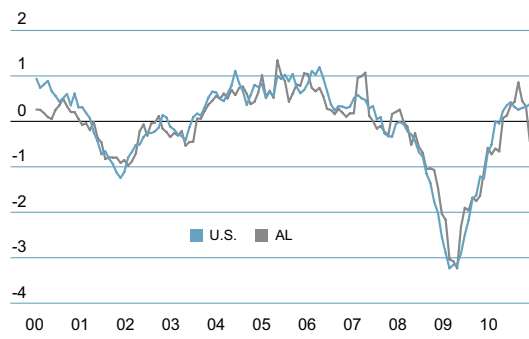
Source: University of Michigan

BBVA Compass Sunbelt Outlook

Alabama's manufacturing industries continue to pull the state forward

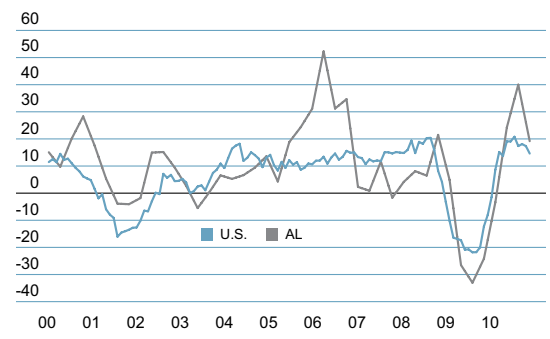
The BBVA Compass State Monthly Activity Index (SMAI) illustrates the quick rise and subsequent pull back of economic growth in Alabama over the past year. The ramp-up of industrial output during the recovery period spilled over to Alabama's production and helped the state satisfy international demand and add to payrolls. In the latter half of the year, however, employment creation lagged, and growth weakened. Nevertheless, our forecasts point to 2.4% growth for 2010, and we expect high productivity firms to continue to add to output this year. For 2011, we expect a solid 2.6% growth in Alabama's GDP.

Chart 11
BBVA Compass SMAI, 3mma



Source: BBVA Research

Chart 12
Total Exports, Y-o-Y % Change

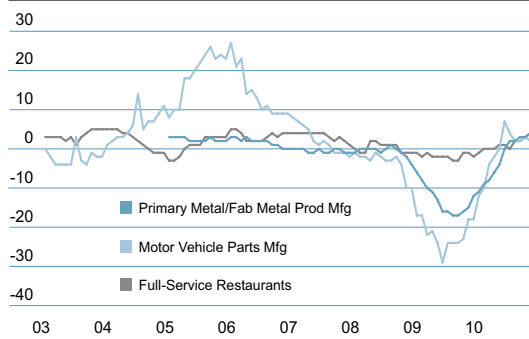


Source: Wisier Trade and Census

Alabama's transportation manufacturing sectors have been expanding over the past 13 years, and they now contribute more than 3% to the state's output. High-productivity firms with flexible manufacturing technology characterize the industry. The presence of these large firms has expanded the state's international links, and even as foreign demand tempers in 2011, we expect domestic auto sales to continue to strengthen. The monthly annualized pace of auto sales has ample room to approach pre-recession levels. Low borrowing costs are also aiding this demand expansion. On a year-over-year (y-o-y) basis, employment in the motor vehicle parts manufacturing industry is poised for positive gains.

Among Alabama's other manufacturing industries, the primary metals and fabricated metal products industries added over 1,000 workers last year as commodity prices rose. As manufacturing hiring continues, these high-productivity industries will boost the state's output. Along with construction, many service industries continue to lag in the recovery, however, job growth in retail trade (including auto dealers) and restaurants reflects stable consumer spending.

Chart 13
Alabama Industry Employment, Y-o-Y % change



Source: BLS/Haver Analytics

Chart 14
State Tax Collections, YTD, Y-o-Y % Change



Source: Census Bureau

On the fiscal front, Alabama's 2010 tax collections were up nearly 9% on a y-o-y basis through the 3rd quarter due primarily to a substantial surge in 3Q income tax revenue. In the 4Q10 U.S. Regional Outlook, we stressed that Alabama's fiscal situation poses minimal concern for markets, and we concluded that a pickup in tax revenue means that government efforts to balance the budget will not drag GDP growth downward in 2011. Certainly, the data reinforces that assessment, and sales tax revenues should only continue to grow.

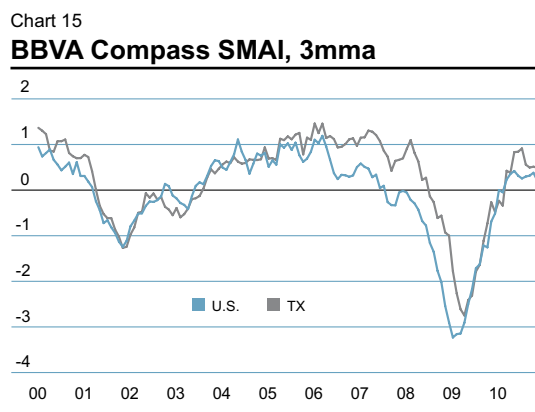
Looking forward, we expect relatively high growth in Alabama this year to generate a rise in per-capita income. North Alabama will lead this growth, as the military, high-tech sectors and auto manufacturers harness their skilled employees. As international demand for skilled labor continues to grow, regions with elevated levels of human capital will benefit from this skill-premium and attract physical capital to boost output. Given the increased openness of Alabama's economy, exports should continue to make a positive contribution to growth in 2011, as emerging market growth will outpace domestic activity.

Texas continues to lead the recovery, and rising oil prices are supporting investment and job creation in the energy industry

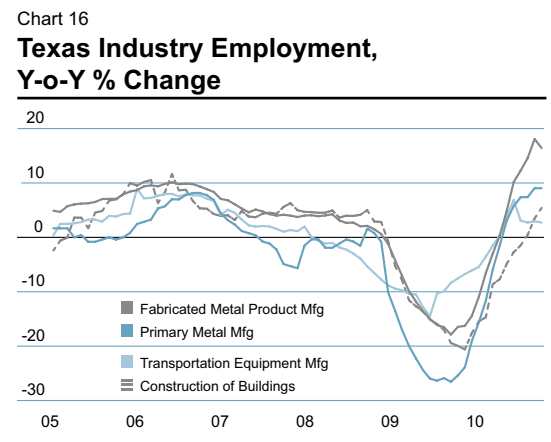
Texas leads the national recovery as we project the addition of over 220,000 jobs in 2010 – nearly 20% of the U.S. total. Along with this job creation, rising domestic and international demand for energy products pushes our estimates of GDP growth to 3.6% in 2010 and 3.7% in 2011.

We expect Texas' manufacturing industries to increase employment further. Employment in the primary metal and fabricated metal products manufacturing sectors has rebounded at near or above double-digit rates. Food manufacturing has also added to payrolls in recent months, as beef prices have risen and both domestic and international appetites have expanded with the recovery. Additionally, aided by NAFTA, Texas' manufacturing industries have formed and strengthened links with Latin America. Thus, as this region expands faster than the U.S., exporting industries will benefit from the sustained international demand.

The energy industry will continue to bolster Texas' economy in the near-term. Upward pressure on oil prices from rising U.S. output and an ever-increasing external demand for energy supports additional capital investment. The oil and gas services industry that surrounds the extraction industry stands to gain from this trend, as extraction may shift from U.S. waters to international destinations due to higher government regulation. A severe positive oil price shock could potentially affect the pace of real GDP growth in Texas (as happened in 2005 and 2008). In this case, production may shift to higher cost wells and domestic demand will drop as consumers adjust to the higher price of gasoline. Additionally, the natural gas market remains subdued due to a persistent excess supply; however, this abundant alternative energy source can provide a boon for Texas' oil and gas companies in the event of coal or oil price spikes. Some power plants may be able to shift their production input to natural gas from coal, and higher oil prices will incentivize the conversion of more vehicles to natural gas.



Source: BBVA Research



Source: BLS

Consistent with the national trend, consumer spending remains stable, although the y-o-y growth of retail sales has moderated to 5%. Thus, job creation in retail trade has lagged many other industries that are less reliant on the domestic market. As we do not expect a sharp rise in consumer spending due to elevated savings rates and further de-leveraging, recovery in the retail trade sector will occur gradually.

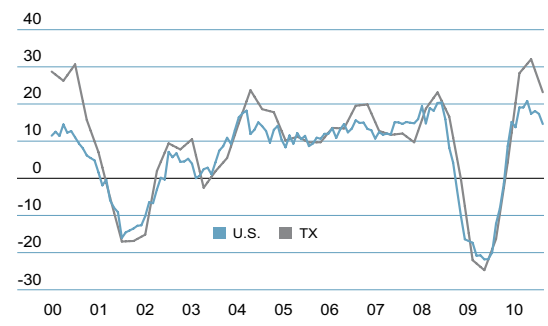
Sustained retail sales are particularly important for the state government's finances, as sales tax revenue is a primary source of funds. Texas has reported a larger than previously anticipated budget deficit heading into 2011 of somewhere between \$25 and \$30 billion. On the positive side, tax revenues were up nearly 5% in the 3rd quarter, and Texas has an ample rainy day fund in excess of \$9 billion. But, this higher estimated shortfall and the combination of spending cuts and/or tax increases add downside risks to GDP growth. Fortunately, slowly increasing home prices and property tax receipts along with the stabilization fund should contain these risks.

Chart 17
State Tax Collections, Y-o-Y % Change



Source: Census Bureau

Chart 18
Total Exports, Y-o-Y % Change

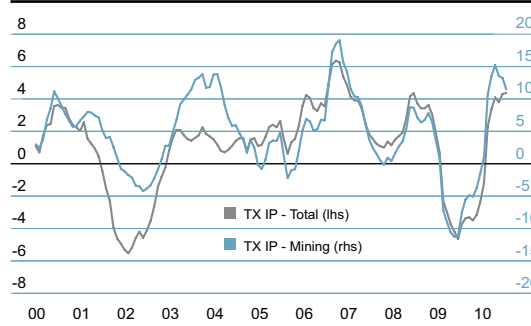


Source: Wisner Trade and Census

Housing prices are expected to appreciate in 2011 as purchase-only price indexes rose slightly above 1% last year. Texas' job creation and higher than average population growth favor household formation and residential investment; already the construction industry is posting y-o-y employment gains. Construction and building permit activity is picking up earlier than other states; however, we expect the commercial real estate market to remain subdued this year.

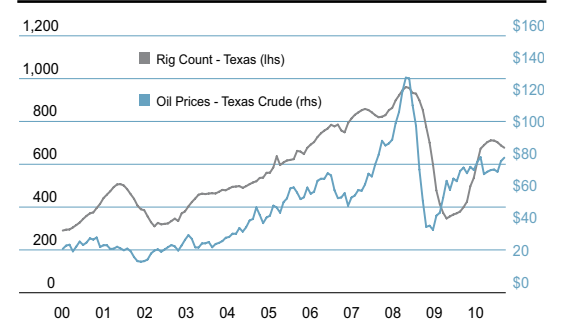
In summary, we are confident that Texas' capital-intensive industries and their complementary high-skill workforce will continue to propel the state forward. Strong foreign demand from the state's trading partners support manufacturing, and services will continue to expand along with the population. Given the favorable demographics, Texas' potential growth is among the top 10 during the next decade.

Chart 19
State Industrial Production, Y-o-Y % Change



Source: Dallas Fed

Chart 20
Texas Rig Count and West Texas Crude Oil Prices



Source: Dallas Fed/Baker-Hughes

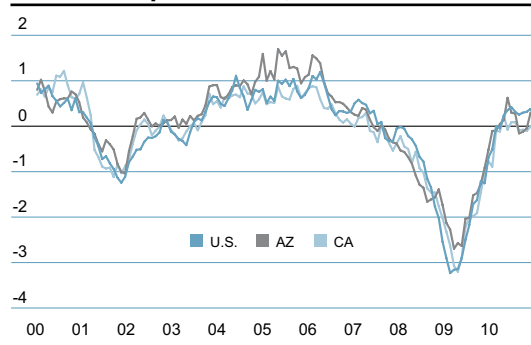
Arizona and California benefit from a recovering residential real-estate market and surging international demand for high-tech products

In Arizona and California, we expect that GDP expanded well above 3% in 2010 and will continue to expand 3.4% in each state in 2011. Particularly in California, a stronger than expected pace of job creation tilts GDP growth to the upside, as labor's contribution increases with the rate of idle labor absorption. Both states experienced a strong boost to their productivity (output per worker) due to an expansion of their highly productive industries during the inventory re-build cycle and in response to external demand. Average working hours per employee increased steadily throughout 2010, which aids growth and partially explains the improved productivity.

In Arizona, the private-sector is leading the recovery, as private employment is up more than 2% in the Phoenix and Flagstaff areas on a y-o-y basis. At the state level, metal ore mining employment is up nearly 9% on a y-o-y basis, and nondurable goods manufacturing (includes food production) is up nearly 4%; retail and wholesale trade, along with warehousing, are all up approximately 3% on a y-o-y basis. Furthermore, professional services, education and healthcare are all exhibiting positive growth. Although 3.4% projected GDP growth in Arizona is higher than the U.S. average, it is well below the 2000-2006 average annual rate of 5.2%. We do not anticipate a return to this high growth rate because most construction labor will remain on the sidelines. Current construction employment is approximately 110,000 below its peak in 2006, and although employment in the building construction sector added 1,600 jobs during 2010, it would take nearly 14 years to return to the pre-recession peak at that rate.

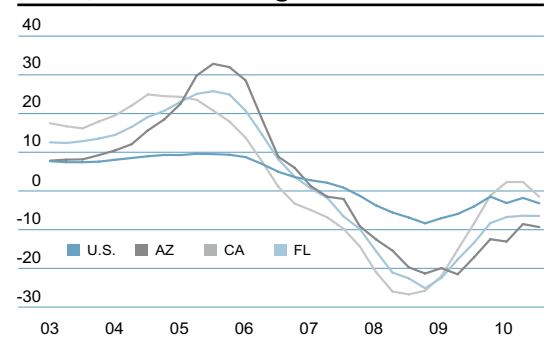
Overall, California has struggled to create jobs and reduce its unemployment rate. Currently, several of California's manufacturing industries lead the expansion: fabricated metal products, computer and electronic products, food manufacturing, heavy machinery and medical equipment. California is home to some of the top firms in each of these highly specialized industries, and they benefit from access to global markets and being on the edge of the technology frontier. California's private service industries will regain employment momentum in 2011, as significant job creation has eluded all but the most highly specialized, such as motion picture and sound recording industries, support activities for water transportation and professional and business services such as computer and software design. In a separate article, we highlight some of these industries as clear winners in the decade ahead as global and technology trends reshape the optimal composition for future growth.

Chart 21
BBVA Compass SMAI, 3mma



Source: BBVA Research

Chart 22
FHFA Purchase Only Housing Price Index, Y-o-Y % Change



Source: FHFA/Haver Analytics

California's projected budget deficit for 2011-2012 is currently above \$25 billion, and Governor Brown has proposed a 50-50 combination of spending cuts and revenue increases to balance the budget. These spending cuts may be a short-term drag on GDP growth this year, as the state reduces services and the workforce. Arizona's budget situation has improved, as a January 2011 report from the state's budget legislative committee states, "The FY 2011 and FY 2012 shortfall estimates have declined since this fall due to an improving economy that has increased revenues and reduced low-income entitlement spending." The governor's office committee projects a nearly \$1.2 billion shortfall in fiscal year 2012 (which begins July 1, 2011),

Florida's expansion has stalled as the real-estate market's recovery is comparatively slow, and export growth has been modest

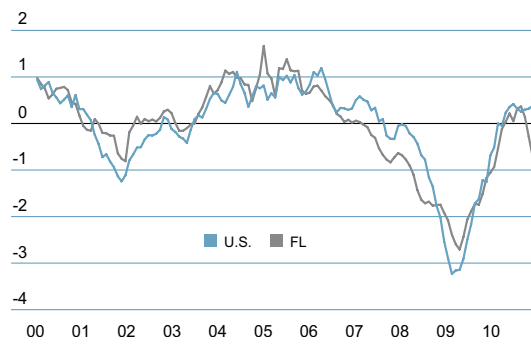
and Governor Brewer has proposed \$1.1 billion in budget reductions. The final agreement (and effect on state growth) in these states depends on the state legislatures and executive action. On the positive side, state tax revenues are modestly positive on a y-o-y basis and consumer spending and income growth should support their pace.

Finally, the housing markets in both California and Arizona suffer from elevated inventory and declining prices; however, in some areas, prices are stabilizing or increasing. Historically low borrowing costs make home purchases attractive. California's coastal cities have seen the highest price increases; however, inland areas and the central valley remain affected by excess supply.

Florida's rebound has slowed dramatically, and thus it begins 2011 with low activity. We estimate GDP growth in 2010 at 2.6%, and an increase of 3.0% in 2011. Productivity accelerated in late 2009 into mid-2010 as average weekly hours worked in private industries climbed from 34.7 in mid-2009 to 36 by mid-2010 before returning to 34.7 by the end of the year. As private employment has not materialized fast enough to compensate for the decline in average hours, the total labor input into production declined and there are few bright prospects.

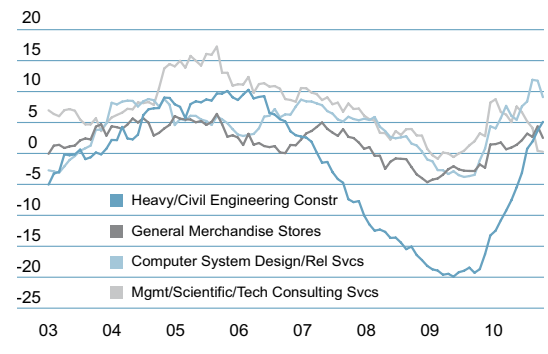
Three notable contributors to job gains include the heavy and civil engineering construction sector, the wholesale durable goods sector and general merchandise retail stores. The computer systems and software design services industry deserves mention, as employment is up nearly 10% on a y-o-y basis. We expect this industry to continue to expand output rapidly. Finally, employment growth in the home health care services industry should continue at approximately 7% on a y-o-y basis. Other bastions of job creation will include the labor intensive healthcare, education and nursing care industries to care for Florida's elderly population. In a sign that tourism is expected to ramp up this year, the amusement, recreation and accommodation industries have also been adding workers.

Chart 23
BBVA Compass SMAI, 3mma



Source: BBVA Research

Chart 24
Florida Industry Employment, NSA, Y-o-Y % Change



Source: BBVA Research

Aside from the aforementioned labor-intensive services and specific manufacturing industries that have significant external ties to foreign markets, private sector employment growth will remain subdued this year. While home prices have stabilized in other markets, they continue their decline, although at a slower pace. Certainly, the excess supply strains a rebound, and thus limits a positive contribution from the residential construction industry during the near-term.

Colorado's recovery appears to be solidifying, while New Mexico lags

Both Colorado and New Mexico have lagged in the recovery, as job creation has remained exceptionally weak. Indeed, we do not expect y-o-y employment gains until early 2011. Since the recovery began in late 2009, energy and manufacturing industries have led the way, as production sped ahead to satisfy foreign demand and re-stock domestic inventories. Our analysis suggests that states with a higher share of goods-producing industries have experienced higher rates of nonfarm job creation during this recovery, as the increase in manufacturing output also spilled over to the local services sectors.

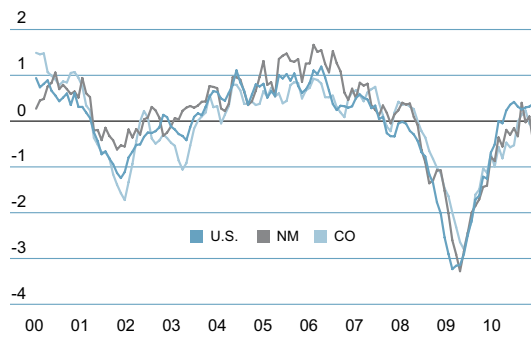
Colorado and New Mexico's shares of employment in goods-producing industries, however, are less than 12% which puts them in the bottom quartile of states. The remainders are employed in private services or government: nationally, the former sector has only recently begun to exhibit y-o-y employment gains. Thus, even though employment has surged ahead in the energy related mining and support services sectors in these two states, and both nondurable and durable goods manufacturing have jumped in New Mexico, their service sectors are struggling to create jobs at a comparable pace.

In the coming years, we expect a sustained rise in demand for computer and electronic products, and thus Colorado's high-tech industries are well-positioned to benefit from this trend. The software design services industry will look to add workers as companies and consumers increasingly interact through mobile operating systems. Thus, we expect Colorado's service industries to recover faster in 2011: already y-o-y employment declines have eased in a cross-section of these services, and retail trade has picked up as personal consumption expenditures have increased. .

New Mexico's private services industries remain anemic. In 2010, New Mexico was one of five states whose y-o-y growth rates in these industries were negative each month. The pace was below Michigan, on par with Nevada and slightly above Rhode Island. Only education and health services show high and stable employment creation above 4%, and modest gains are happening in the leisure and hospitality industries and the federal government – state and local governments are paring their workforce.

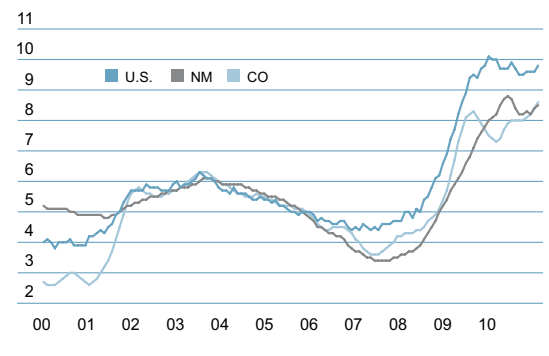
Moving forward, we expect a strong rebound for Colorado with GDP growth approaching 3.8% in 2011, while New Mexico will average 2.8%. Home prices are still declining in both states, and thus residential investment is likely to be weak during the first half of the year.

Chart 25
BBVA Compass SMAI, 3mma



Source: BBVA Research

Chart 26
Unemployment Rate, Seasonally Adjusted (%)



Source: BLS

Industries Poised for Takeoff

As President Obama emphasized in his 2011 State of the Union address, U.S. workers and industries face increasing global competition, and today's investments must ensure that our workforce is prepared to lead the world in tomorrow's innovative industries. He also noted that the leading industries 30 years from now may not exist today, as the explosion of a myriad of new industries related to the Internet was not foreseeable in the past.

Part I: Key Trends Defining International Commerce

During the last two decades, advances in technology and ongoing development in emerging markets have led to increased globalization. Today, a typical manufacturing firm may establish contracts with more than 35 foreign companies to source inputs.¹ Globalization has created an ever-expanding network of businesses and individuals that is re-shaping social, economic and political boundaries. In this environment, we believe that some current industries are best poised to benefit from evolving trends in technology, global growth, government intervention and sustainable design. In the coming years, industries that harness these trends and adapt more rapidly will thrive as they attract capital and produce high returns.

Today, advances in microprocessor technology have reduced the size and expanded the performance and capacity of computer processors, memory chips and digital circuitry. Standardization and manufacturing improvements have enabled the creation of new, highly-specialized, multi-function chips. Thus, a mobile phone today can have more processing ability and consume less power than a desktop personal computer circa 1980.

The Specialization and Maturity of Computer Technology

Along with these developments, a parallel trend continues in network technology. Long ago, engineers recognized the potential benefits of connecting multiple computers together to share information and run programs from remote locations. The standardization of Ethernet technology in the late 70s enabled the proliferation of local area networks and aided the expansion of the Internet into homes. The development in the 1980s and subsequent commercialization of the Internet in the 1990s demanded a high-capacity domestic and international fiber-optic infrastructure for digital communication.

In the late 1990s, as the Internet was beginning to reveal countless benefits of networked computers, the establishment of wireless communication standards firmly supplanted analog with digital wireless transmission. In conjunction with microprocessor advances, wireless transmission and receiving chips exponentially decreased in size and cost, subsequently exploding in demand. Furthermore, these chips can operate across multiple communication standards. At the same time, the bandwidth of these networks has increased, and consequently, in the U.S. and many developed nations, nearly everyone has access to the Internet from anywhere through a combination of wired and wireless technologies.

The maturity of computer and connectivity technology has generated a positive externality for economic growth. Rapid gains in labor productivity (or output per hour) have been achieved as workers are able to communicate and perform formerly time-intensive complex tasks with specialized software and hardware whether in the office or away. Thus, a transformation will continue among end-use technology as both consumers and corporations can leverage the fast, ubiquitous network availability to run specialized applications from a server and store data remotely. This is referred to as cloud computing, and it means that for many tasks, the end-user will be able to use an inexpensive laptop or tablet computer that can access the Internet to run core applications. This trend will fundamentally alter the use of resources at the corporate level, as IT expenditures will shift from maintaining internal corporate networks and individual PCs to ensuring 24/7 availability of data centers and network access. Rather than handle these tasks internally, more companies may look to outside specialists. Small and medium-sized businesses will embrace cloud computing first, as it lowers technology acquisition costs, reduces the need for internal IT expertise and permits them to have access to their applications

1: Bisson, et. al. (2010)

and data from virtually any location on the planet. One risk to this transformation arises from security concerns about third-party access to sensitive data, and the industry will need to address this concern before all companies actively embrace the technology.

Further development and deployment of specialized applications of end-use technology will require skilled computer programmers and software design experts. Businesses will be able to adopt these technologies for both internal purposes to increase productivity and real-time analysis and external purposes to enhance interaction with clients. New end-use technologies are proliferating among consumers and are influencing their preferences and purchasing habits.

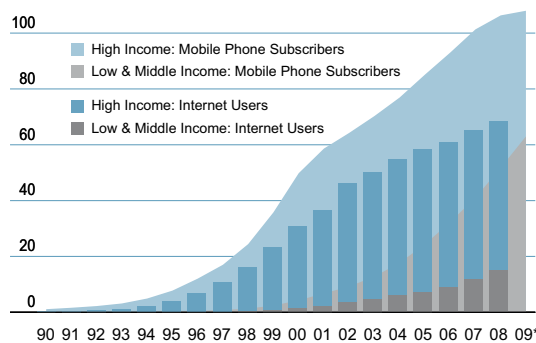
The applications of mature and specialized technologies will only continue to adapt to the changing marketplace and become commercialized at a rapid rate. Demand for these technologies will span the globe, and will not be concentrated in the U.S. or other developed economies. As emerging markets adopt the latest technologies, they will experience similar productivity gains as developed economies in the 1990s at a fraction of the cost.

The Exponential Growth of Emerging Markets

This is the century for emerging markets to industrialize and raise the living standards of billions of people. Over the next decades, emerging markets will lead global growth: urbanization is occurring at a rapid pace and millions of people are entering the middle class each year. This middle class is comprised of predominantly young workers whose incomes and purchasing power are rising. As their incomes surpass subsistence levels, these new consumers will demand a broad range of goods and services. The declining cost of advanced technology means that they will be able to jump to the technological frontier and acquire the latest products. Private companies will thus be willing and able to make the complementary infrastructure investments to support the diffusion of technology.

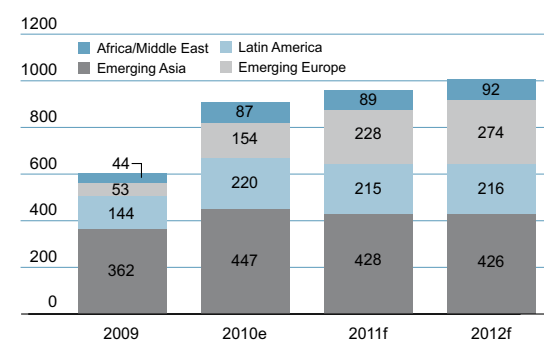
For example, we highlight the number of mobile subscribers in the accompanying chart. As the penetration rate accelerates and phone technology improves, everyone will be carrying a mini-computer in their pocket to interact with the internet. The Wall Street Journal reported in late January that Google cites the high penetration rate of mobile phone subscribers in Malaysia to justify investment to expand there. Similarly, IBM is investing in data centers in China to support a cloud computing infrastructure.

Chart 27
Mobile Phone Subscribers and Internet Users per 100 People, by Countries



Note: 2009 is a BBVA Research projection
Source: World Bank Development Indicators/BBVA Research

Chart 28
Regional Differences in Net Private Capital Flows (\$bn)



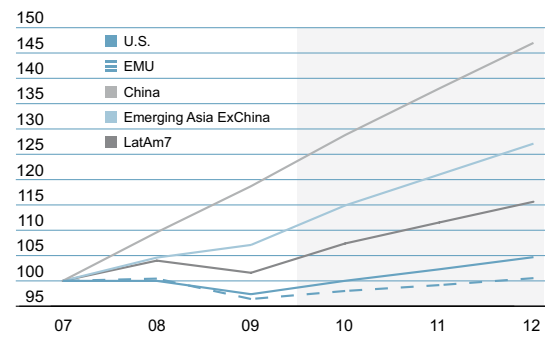
Note: e: estimated, f: forecast
Source: Institute of International Finance and Bloomberg

Along with the adoption of the latest technology, emerging markets will increasingly conduct their own research and development and make significant contributions to world innovation. Therefore, we expect sustained productivity growth over the long term, and their participation in the world economy will accelerate the aforementioned technology trends. Successful countries will shift from being suppliers of low-cost products to providers of tangible and intangible capital.

BBVA Research has developed a new concept called EAGLEs (Emerging and Growth-Leading Economies). In the past, attention has focused on the BRIC economies of Brazil, Russia, India and China. The EAGLEs methodology shifts the focus from the names of the countries and objectively determines a set of countries that will make the highest contributions to global growth. Thus, the set of included countries can change as their performance improves or declines. The list of EAGLEs includes the four BRIC economies, but also adds the six additional countries of Korea, Indonesia, Mexico, Turkey, Egypt and Taiwan.

Chart 29

Global Economic Growth, Index (2007=100)



Source: BBVA Research and Datastream

In terms of the criteria for inclusion, each of these ten countries are expected to contribute more to global GDP growth than the average of the industrialized G7 countries of Canada, France, Germany, Italy, Japan, the United Kingdom and the United States. In other words, the EAGLE countries will be the most relevant in terms of generating new business. The EAGLEs are expected to be responsible for 50% of all global growth in the next 10 years, compared to 14% for the G7. The story does not reflect only the BRIC countries: while they are projected to surge ahead, the other EAGLE countries are responsible for 10% of total world growth.²

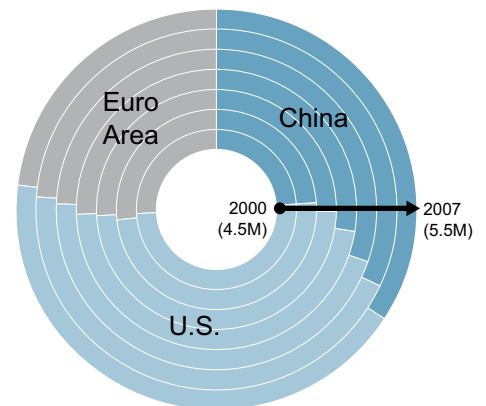
As recent events in Egypt demonstrate, however, even high-potential emerging markets carry additional risks. Substantial income inequality poses a threat to political stability as food prices rise: the vast majority of poor residents may feel excluded from economic progress.

A Focus on Sustainability

This economic expansion will not come without risks to global sustainability. With the rise of China and the other EAGLEs, the demand for energy resources will increase exponentially. The accompanying chart illustrates the change in the shares of energy use between China, the U.S. and Euro-zone. As few as 10 years ago, the U.S. consumed 50% of this three area total while China and the Euro-zone split the remaining 50% equally. By 2007, China's share grew to above 35%, while the U.S. share approached 42%. From 2000-2007, the total energy use of those three areas rose over 22%. While energy use per-capita is declining in Europe and the U.S. due to efficiency gains and the increasing contribution of services to GDP, this statistic accelerated at double digit rates from 2002-2004 in China, and continues to grow more than 5% per year.

Chart 30

Share of Energy Use (Kt of Oil Equivalent, by Region (sum of three areas in parenthesis))



Source: World Bank/Haver Analytics

2: BBVA Research. "Key emerging markets for investors to focus on." Available online: <http://www.bbva.com/KETD/ketd/ing/nav/eagles.jsp>

Competition for natural resources will only increase, and thus commodity prices of oil, coal and eventually natural gas will increase and experience more volatility. These rising commodity prices will push up the costs of production and erode purchasing power if wages cannot keep pace. Additionally, the abundance of oil reserves in the Middle East adds elements of geopolitical risks to the international scene, as events in Tunisia, Libya, Egypt and Saudi Arabia reinforce.

We anticipate that the world's leading economies will aggressively pursue research and development of clean energy alternatives with both public and private investment. Already, in recent years, China has taken the lead in the race to produce the most advanced solar panels. Although much of the initial solar R&D and production was supported with public subsidies in the U.S., more generous Chinese government subsidies have attracted U.S. producers and stimulated competition there.

Furthermore, consumers in developed nations are revealing more favorable attitudes towards environmentally-friendly products. As concerns about sustainability heighten, companies will tout their use of clean energy and resource efficiency to attract consumers and build loyalty. Thus, a company can no longer ignore its environmental impact.

Pervasive Government Regulations and Wealth Transfers

Through regulation, fiscal and monetary policies, governments are escalating their role in market-oriented economies worldwide. In developed economies, as income inequality increases, more people clamor for government transfers and public services. These demands require policymakers to address normative questions that surround the realms of redistribution and fairness rather than positive questions that consider the impacts of new laws on economic growth. In developed countries, excessive regulation distorts the allocation of capital, and thus highly regulated industries may grow slower than their full potential and realize muted returns on capital.

In the U.S., additional regulations permeate essential industries such as energy, healthcare and banking. For example, recent laws have curtailed private investment in doctor-owned healthcare facilities that were previously attracting substantial capital. Looming on the horizon, new energy regulations may change the rules of the road for the utilities, industrial manufacturing, automotive, oil extraction and a host of other industries. Finally, as concerns intensify about pollution, food safety, water scarcity and the depletion of forests and fishing stocks, new environmental regulations tend to emerge. Once the train of government intervention leaves the station, lobbyists, legislators and enforcement agencies rarely stop to re-assess rules or reverse direction.

The Quest for Productivity

In developed countries, demographics present acute challenges for aggregate productivity growth. Compared to developing countries, the workforce in developed countries is older due to their lower birth rates. As a consequence, as current workers retire, the economies will have a lower supply of available young labor. Fast-growing high-tech industries rely on young, educated workers to expand and tap new markets. Manufacturing firms need to train young workers to replace seasoned retirees.

Thus, firms and industries must improve productivity to produce more with fewer available young, educated workers. Industries that incorporate new technology and implement process improvements to increase returns on human capital will see output expand more rapidly. In this context, low-skill labor intensive industries will be at a disadvantage relative to capital-intensive industries that employ complementary high-skill labor.

**Part II: Methodology
of Industry Selection**

To sort industries by their growth potential, we considered several key factors. As a starting point, we used publicly available industry data on Gross Domestic Product (GDP) from the Bureau of Economic Analysis (BEA) through 2009. We combine this data with industry capital stock estimates also from the BEA and industry employment estimates from the Bureau of Labor Statistics (BLS), and perform a growth accounting procedure to decompose the contributions to GDP of labor, capital and total factor productivity (the residual) for 60 industry categories. We assume that output of industry j is produced according to a standard Cobb-Douglas production function where Y is GDP, K is the capital input and L is the labor input. The exponent $(1 - \alpha_j)$ is calibrated to match the industry's share of labor compensation in GDP.

$$Y_j = A_j K_j^{\alpha_j} L_j^{1-\alpha_j} \quad \Delta y_j = \Delta a_j + \alpha_j \Delta k_j + (1 - \alpha_j) \Delta l_j$$

Taking logarithms (represented by lower case letters) and differencing the series allow us to decompose the contributions to GDP growth from capital investment, employment growth and unexplained factors that we refer to as general productivity growth. While the approach has limitations, such as its application to a limited number of aggregated industry categories and its inability to distinguish causes of productivity growth, it provides a first step to narrow the scope of analysis.

With this procedure, we consider the industries that have performed exceptionally well in terms of attracting long-term capital investment, generating productivity and attracting labor. Each of these metrics scores the attractiveness of highly productive and growing industries.

We combine the growth decomposition results with our own outlook for these same industries. We assign each industry a high, medium or low score according to its current and future ability to benefit from influential trends in technology, emerging markets, government intervention and sustainability issues. Finally, a weighted score of these trends and the results of the growth decomposition produce a final rank of industries.

Part III: The Beneficiaries of Key Trends

The results are presented in the accompanying table and categorized by our expected growth potential. Industries toward the left may benefit from ongoing technology trends, but we believe that they will have minimal or negative exposure to global growth. Furthermore, they are less likely to achieve significant process improvements and see an explosion of productivity growth due to lower investments in human capital or excessive regulation. Some industries in this category, however, such as utilities and construction will benefit if government support or private investment flows into infrastructure development. Already, discussions at the 2011 World Economic Forum in Davos indicate that Chinese companies are considering targeted investments in infrastructure and hotels.

Table 1

Full Speed Ahead: A Heat Map of Industry Growth Potential

Potential for Technology Integration	Potential for Technology and Global Integration	Technology, Global and Productivity Growth Potential
Accommodation Services	Agriculture, High Value Added and Capital Intensive	Healthcare Services
Administrative and Support Services	Commercial and Industrial Machinery and Equipment Rental and Leasing	Ambulatory Healthcare
Construction	Educational Services	Hospitals
Insurance Carriers and Related Activities	Food Services and Drinking Places - Chain Establishments	Information Services
Manufacturing	Legal Services	Information and Data Processing
Apparel, Leather and Allied Products	Lessors of Intangible Assets	Motion Picture and Sound Recording Industries
Furniture and Related Products	Mining and Oil and Gas Extraction	Software Publishing Industries
Nonmetallic Mineral Products	Manufacturing	Telecommunications
Textile Mills and Products	Chemical Products	Manufacturing
Wood Products	Fabricated Metal Products	Computer and Electronic Products
Nursing and Residential Care Facilities	Transp. Equipment: Motor Vehicles, Bodies and Trailers, and Parts	Electrical Equipment, Appliances, and Components
Printing and Related Support Activities	Plastics and Rubber Products	Food, Beverage and Tobacco Products
Recreation and Amusement	Primary Metal Products	Industrial Machinery
Social Assistance	Retail Trade	Medical Products
Waste Management and Remediation Services	Transportation - Rail, Truck, Passenger Transit and Support Activities	Petroleum and Coal Products
Utilities		Professional and Business Services
		Architectural and Engineering
		Computer Systems Design and Related
		Internet Advertising and Public Relations
		Management, Scientific, and Technical Consulting
		Support Activities for Mining
		Transportation - Air, Pipeline, and Water
		Warehousing and Storage
		Wholesale Trade

Source: BBVA Research

As we move toward the center of the chart, we believe that these industries have greater potential to benefit from trends in global growth. To the extent that foreign consumers demand our resources and products, these industries will be able to tap new markets or export business models overseas.

On the far right, we highlight the industries in which technology integration and global growth may make particularly high contributions in the mid-term. We believe that many of these industries will be able to achieve substantial productivity improvements in the coming decades as they have significant investments in high-skill labor and will continue to attract educated workers.

Healthcare

The healthcare industry is being shaped by regulation, demographics and technology. Demand for healthcare services is rapidly increasing due to the aging population. This industry continues to generate jobs and positive externalities for local areas, as it attracts a diverse mix of skilled and unskilled workers to well-paying jobs. Within the industry, ambulatory healthcare services, such as outpatient treatment centers and specialized clinics, are expanding to serve patients

at lower costs than hospitals. Technology adoption of electronic records, telemedicine and genomics will enhance the productivity of skilled workers and allow less invasive treatments and remote monitoring. We analyzed the many subsectors of Ambulatory Health Care in our *1Q10 U.S. Regional Watch*.

Hospitals will see increasing mergers with private healthcare companies (both for-profit and non-profit) as many government-owned hospitals are inefficient, outdated and are thus unable to attract capital to invest in technology. We expect more consolidation as local governments sell these assets to larger companies specializing in hospital operation. We presented detailed analysis of hospitals and physician employment relationships in our *2Q10 and 4Q10 U.S. Regional Outlook*.

The rise in healthcare spending and capital investment in hospitals supports medical equipment manufacturers, as the U.S. is an international leader in the production of this specialized equipment. Given the rising cost of medical care in the U.S., equipment manufacturers are able to obtain high prices and enjoy solid margins on advanced equipment. Patients also demand the latest equipment if it allows for less-invasive and more comfortable treatment.

Energy

Rapid growth in emerging markets will continue to drive demand for fossil fuels. This increase in demand will attract investment and accrue returns on capital throughout the energy industry. The prices of energy commodities are expected to increase along with the profits of oil and gas companies. Government regulation in the wake of the 2010 Gulf of Mexico oil spill will continue to affect this industry in the U.S., because many oil reserves are located deep in the ocean and their extraction requires some of the most sophisticated technologies and engineering work in the world. Thus, as exploration increases worldwide, drilling companies will demand these technologies from U.S. suppliers along with the expertise of U.S. oil and gas support services.

While the dynamics of the price of oil are complicated due in part to the OPEC cartel that can adjust supply to support a particular price, any sustained spike in the price of oil will lead consumers to adjust their behavior. A higher price will stimulate new exploration along with infrastructure development to provide alternative fuels such as natural gas. While the price of U.S. natural gas is currently trading very low, new markets will develop domestically and abroad to capitalize on our recently-discovered massive reserves. Already, some Houston companies are assessing the export potential of natural gas which would transform the U.S. into a net exporter of this energy source.

Furthermore, electricity generation will shift from coal-fired power plants to natural gas over the next 20 years, as the U.S. replaces its old coal plants and emerging markets build new, cleaner burning gas fired plants with the latest technology. Along with new investments in nuclear and renewable energy electricity generation, the shift from coal will ease pressures on carbon emissions and global warming.

High Value-Added Manufacturing

Manufacturing industries led the recovery in the U.S. as exports surged and companies needed to restock inventories. The industry's output as a whole continues to grow; however, some segments continue to lose workers due to lower labor costs overseas. Going forward, manufacturing sectors will perform heterogeneously, and the outlook for high-value added manufacturing industries is positive over the next decade.

Computer Technology and Semiconductors, and Electrical Equipment and Components

Manufacturing of computer technology products remains high on the list as global demand for this technology is increasing. This industry is capital intensive and employs a large number of highly-skilled workers. The U.S. is well positioned to meet this demand in large part due to its competitive advantage in innovation. Within this industry there are many sub-industries that will benefit, and others that will lose, because computer technology is subject to disruptive innovations that transform products or services in unexpected ways. As a result, the industry is exposed to a significant degree of volatility. In the semiconductor industry, the firms that are able to produce multi-function chips and low-cost processors will see sales rise. For example, communications semiconductors will be supported by the increasing demand of smart phones,

particularly among the EAGLEs. The adoption of low-cost computers across the world that take advantage of cloud computing technology will demand low-power computer processors.

The coming onslaught of mobile computing devices will demand advances in the related display and battery manufacturing industries. In the computing world, there is a tradeoff between processing speed and power consumption, and in the battery world, there is a tradeoff between capacity and size. Thus, improvements in battery technology will propel the winner to the front of the pack. Display manufacturers will compete to provide the highest resolution at the lowest power consumption. Many of these component products will continue to be manufactured overseas, and competition with foreign companies will intensify.

Advances in networking technology will continue. Improvements in wireless transmission will aid the delivery of high-bandwidth applications such as video. As telecommunications companies work to improve their networks and capacity, they are incrementally extending the reach of high-bandwidth fiber optic cable and converting to optical switches. Because the transmission of all data is digital and indifferent to the network, competition will intensify to improve this network infrastructure and remove bandwidth limitations.

Industrial Machinery

As emerging countries continue their development, the U.S. will maintain its position of supplier of capital goods for domestic and foreign industries. In fact, capital goods are the primary export commodity in the U.S. Agricultural machinery will continue to benefit from increases in food prices and farm revenue. Most of the growth in demand for grains and livestock has come from China. Credit availability is crucial for this market, especially in Europe and North America, which are the largest markets for agricultural machinery. The long-term outlook for construction machinery depends heavily on emerging markets, where the construction industry has not yet matured. Machinery for mining has been favored by elevated metal prices.

Transportation and Warehousing

The transportation and warehousing sectors will continue to be affected by the growth of trade volume and an intensification of international links, as firms must source inputs from across the globe. This sector remains attractive due to the expected growth in transportation worldwide. For example, air traffic will increase in tandem with global GDP. The growth in traffic will have a spillover effect over suppliers of parts, engines and maintenance. A large portion of future orders are likely to come from emerging countries.

As to the warehousing sector, domestically, the rise of on-line shopping will require more distribution points to reduce the necessary transit time for goods. The sector is becoming increasingly de-centralized due to the adoption of more efficient ways to manage inventories. Worldwide, this industry is experiencing a shift towards providing a full range of transport solutions with logistics networks. This industry is gradually adopting technology such as radio-frequency identification systems.

A strengthening warehouse sector supports all forms of the transportation industry from rail to air to water to truck. Although there is currently a glut of supply in the water transportation industry due to new ship purchases over the past few years, global demand for U.S. machinery, food and energy products supports long-term growth. Air transportation will pick up with growth in the U.S., and many current carriers are lean operations after curtailing unprofitable routes during the recession. New long-haul planes, such as the Boeing 787 Dreamliner, will allow carriers to serve more passengers at lower costs once it enters service. Finally, transportation support and passenger transit activities will benefit from government and private investments in domestic infrastructure modernization.

Professional and Business Services

Innovation relies on a constant supply of knowledgeable workers, and professional services industries employ workers with high human capital. Their educated workforce combines with the global and technological trends to generate rapid productivity gains. In the near future, deeper economic integration will require sophisticated professional services. For instance, law firms with expertise in local and foreign legal systems will be highly valued.

Current technology and globalization trends support the computer systems and software design industry, as companies increasingly need specialized applications and web-portals to

Information and Telecommunications

interact with customers. Given the ease of creating these new applications on platforms such as Apple's iOS and Google's Android, the labor cost is low and much of the work can be done domestically. Also, advertising on the internet will continue to be important, and rise of location-based services and targeted advertising is in its infancy. This segment will expand as the sophistication of mobile devices increases.

The telecommunications and information industries stand at the precipice of an upheaval, and they are not quite sure how to proceed. As all information is transmitted digitally today, perfect copies of intellectual content such as music and movies can be sent from one place to another. The music industry is still reeling from the loss of CD sales, but it is finding new ways to attract revenue in the digital world. Now that home network bandwidth is increasing, the same transformation is happening to television and movies.

In the near-term, the transition will upend current business models, as content owners need to receive compensation for their work, distributors want their cut and the consumer wants easy access to desired content on demand. As content is indifferent to the network, movies and television programs can easily be distributed on demand to the consumer through the Internet.

While older generations of Americans still tolerate a constant stream of television content interrupted with advertising, younger generations have more choices, prefer to watch a program from start to finish without the interruptions, and may begin to cut the cord on television service subscriptions. The digital broadcasting of local networks in high-definition and changes in work habits are also affecting consumer preferences.

Consider for a moment the impact on cable companies. They provide both high-speed internet services and content delivery via their network. Via an internet connection, however, content streaming from leading technology companies will increasingly compete with the subscription television business model. These Internet services, however, will only prosper if they can reach mutual agreements with content distributors and owners and deliver desired content.

The roll-out of ever faster wireless networks by wireless companies will pressure the high margins that cable companies currently enjoy as consumers will have an expanded choice of providers. Toward that end, as all transmitted data (whether voice, text, picture or video) is digital, the business models of mobile phone companies will see the next disruption.

Long-term prospects for internet companies remain strong, however, as the rapid growth of advertising spending supports them. There are currently 1.8 billion Internet users worldwide, which reflects a 17% compound annual growth rate since 2006. Global internet penetration has substantial room to grow as it stands at 27%, compared to 76% in the U.S.

Retail Trade

The Internet has allowed companies and consumers to connect to each other across the globe. Today a consumer must consider the tradeoff between taking the time to acquire a product that day from a nearby store or placing an online order and receiving the item within a few days (if not the next day). Currently, internet sales remain well below those of local stores; however, these sales are rising in tandem with the adoption rate of wirelessly-connected Internet-enabled mobile devices. Now, with a mobile phone, consumers can instantly compare prices of products that they see in the store with online sellers.

Thus, the consumer has a new tool that expands her choice set and bargaining power with local retailers. Sellers of consumer electronics, books and other items that are highly substitutable among retailers will face increasing pressure on sales margins as many consumers will choose to make a purchase at the lowest possible price. There is opportunity here also, because a local store can make a counter-offer; however, this strategy involves a paradigm shift in modern retailing.

Agriculture

Not to be left behind, agriculture production in the U.S. has a few particularly bright beacons. Capital intensive, export-oriented agriculture will benefit substantially from the technology and global trends mentioned. This type of production is highly specialized, non-subsidized and focuses primarily on high-value crops such as grapes and nuts. The expansion of the middle class worldwide will boost demand for these products. The state of California is home to some of these producers, along with some of the most efficient packaged food manufacturers that can ramp up output to meet external demand.

Conclusion

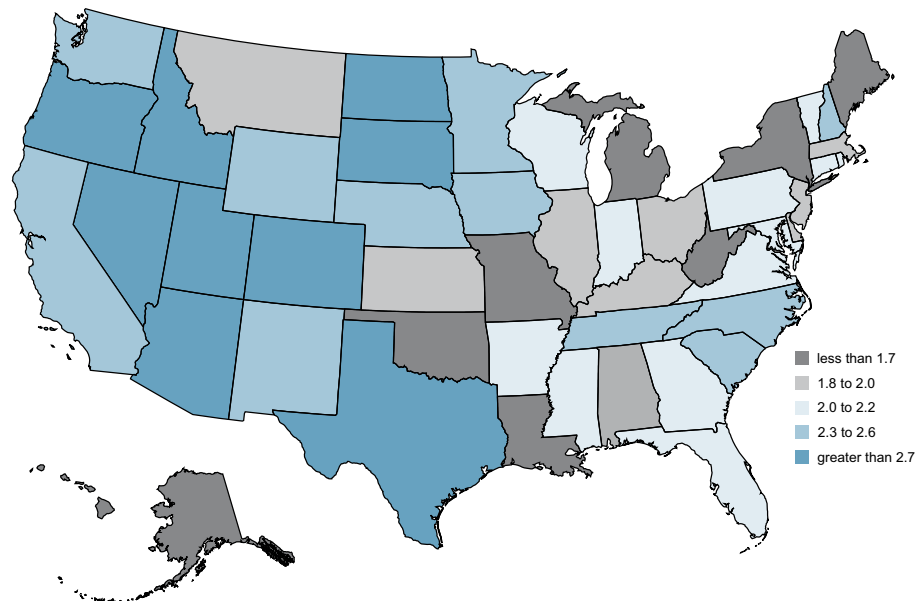
In conclusion, continued technology diffusion, the growth of emerging markets and increasing worldwide demand for energy present unique opportunities and challenges for today's industries. We believe that these trends will create synergies in industries with high levels of human capital to expand output and productivity faster than average. This assessment includes healthcare and professional services. Furthermore, specialized manufacturing industries will gain from the boost in international demand along with segments of transportation. As the U.S. looks to strengthen its domestic infrastructure in the coming decade, related passenger transit, utilities, heavy machinery and civil construction industries will attract capital. Long-term changes to the composition of energy demand look favorable for natural gas, renewable and nuclear technologies as they have lower carbon emissions. Future analysis will delve further into the sub-sectors of these high potential industries to understand the inter-connected links between industries and regions.

State Potential GDP Growth Eases

Over the next decade, state potential GDP growth rates will ease downward as population growth slows, the workforce ages and the labor market recovers from the severe recession. Our estimates project the highest average potential growth in the southern and western U.S., as the population continues to shift to these states and they expand international ties. Furthermore, the estimates point to solid potential growth in the southeast U.S. and the Atlantic coast from Maryland and Virginia over to Tennessee and down to Florida.

Map 1

Potential GDP Growth Estimates, Avg. Annual Rate, by Quintile, 2012-2020 (%)



Source: BBVA Research

Potential GDP reflects an economy's ability to produce goods and services without raising the rate of inflation. For each of the 50 states, we estimate the potential GDP and decompose the growth into the contributions of labor, capital and technological progress. The potential GDP does not represent a forecast: actual GDP can be higher or lower than potential, because the potential represents an expected trend based on the state's industrial composition, past trends and employment projections, capital and productivity growth rates. Our current analysis updates our estimates of state capital stocks with newly revised and available data from the Bureau of Economic Analysis (BEA) and the Bureau of Labor Statistics (BLS).

The recession caused a decline in potential GDP for each of the 50 states, because employment plummeted and the labor market has remained extremely weak. Labor has only seen a mild rebound since the recovery began in mid-2009, and much of the gains have been concentrated in goods-producing industries and labor-intensive service industries such as healthcare and education. To illustrate the fall, consider the change in the un-weighted average of state potential GDP growth rates before, during and after the recession. From 2000-2007, this average was 2.5%, as technological progress contributed 1.2%, labor contributed 0.5% and capital investment contributed 0.8%. From 2008-2011, this average drops to 1.8% as the contribution from labor and capital falls to 0.1% and 0.6%, respectively, and productivity growth eases downward.

After the recession, from 2012-2020, this average increases to 2.2%, as labor’s contribution increases significantly due to the elevated number of unemployed workers who will return to work. During the recession, only more efficient uses of labor and capital (or technological progress) such as an increase in hours worked per employee helps to explain the current rebound of growth near or above 3.0%. Indeed, the average hours worked per employee fell from late 2007 to mid-2009, and has rebounded during the recovery.

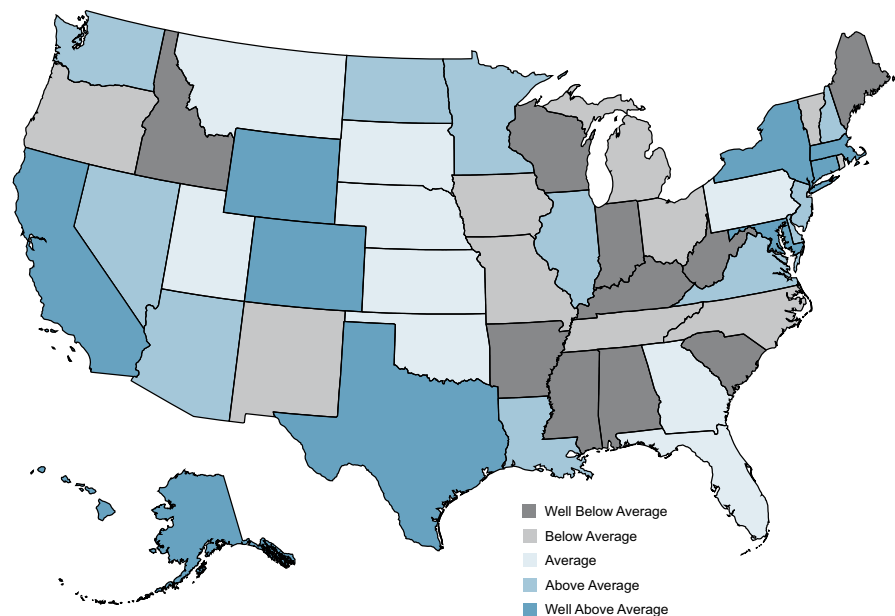
State Capital Stock Estimates

As an integral part of estimating state potential GDP, we updated our estimates of state-level capital stocks according to a previously developed procedure. This procedure weights the national estimate of the industry capital stocks by the share of personal income attributed to that industry in each state, and then we sum across industries to arrive at an estimate of the capital stock. We include both the stocks of private fixed capital and government capital. The technical details are presented in the *3Q09 US Regional Watch*.

From 1994-2009 the highest rates of capital deepening (an increase in capital per capita) occurred in the center of the country, a few states in the northeast, several states on the Atlantic coast and in California and Washington. This pattern reflects the growth of capital-intensive industries in these states, and the associated population changes. If this number is high, then the growth rate of capital outpaced that of population. The deepening suggests areas where GDP per capita has increased significantly as well. During this time period, only Nevada saw its population increase faster than its capital stock, which suggests that much of Nevada’s recent growth stemmed from labor-intensive service industries that absorbed the increase in residents.

Map 2

Growth in Capital Per Capita, 1994-2009 Compound Annual Rate, by Quintile



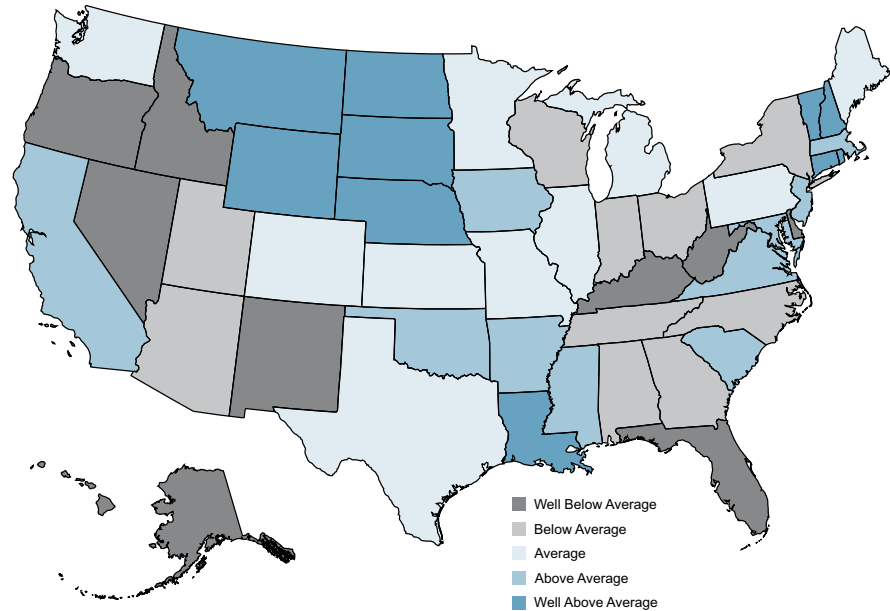
Source: BBVA Research

We assess the potential productivity of a state by looking at its level of capital per capita, as more capital intensive states should pay relatively higher wages and generate wealth. The updated estimation revealed several salient facts: first, between 2007 and 2009, capital per capita actually declined in 13 states, and the stock of capital declined in four of them (Michigan, Nevada, Florida and Idaho). Second, the states with declines, or near zero change in capital per capita, were some of the first to enter the recession and many enjoyed a preceding boom in real-estate. In

these states, any positive growth in capital could not keep up with the growth of the population during this time. Third, the stock of capital increased the most from Texas into the Midwest and in the industrial northeast over this time period. Finally, the 2009 levels of capital per capita are highest in Wyoming, Alaska, Colorado, New York, Hawaii, Connecticut, Maryland, California, Texas and Massachusetts.

Map 3

Capital Stock per Capita, 2009



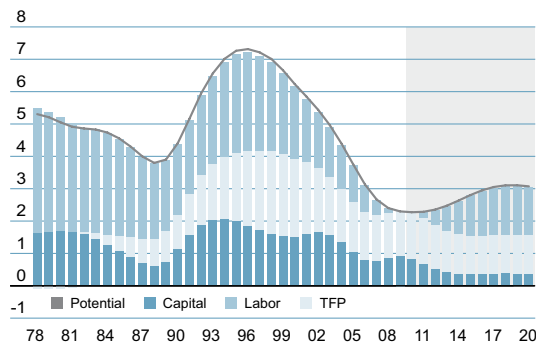
Source: BBVA Research

Assuming the same level of overall productivity, a state with a high level of average capital per capita needs fewer workers to produce the same output as a state with a lower level of capital per capita. Over time, these levels will increase the fastest in states whose industrial composition blends with industry-specific investment. Future analysis will examine this relationship in greater detail, as the current level may mask recent industrial specialization trends. For example, since 2006, the transportation manufacturing sector has expanded fervently in Alabama, and as this industry produces with a higher ratio of capital per worker, capital will grow faster than other states as the industry adds workers. Furthermore, the military's Base Re-Alignment and Closure (BRAC) plan will attract more government capital to north Alabama.

Trends in Potential Growth

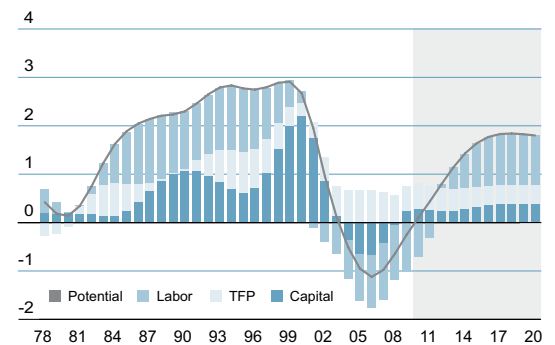
With our updated capital stocks, we estimate the potential growth of state GDPs with the filtered trends of capital, labor and technological progress. The methodology reveals the structural shift that occurred with the recession, as Sunbelt states that had high-potential and actual GDP growth during the late 90s and into the 2000s, such as Arizona and Nevada, exhibit current potential growth well below the rates of the boom years. To the extent that out-of-state residents and immigrants continue to migrate to these states and increase the available labor force, they will continue to grow faster than the U.S. average. Their prospects, however, of near 10% growth are muted due to a decline in capital per capita and elevated unemployment. Furthermore, the construction boom that attracted massive investment and pushed growth ever higher in these states will not be present in the mid-term as the residential and commercial markets must re-equilibrate. The construction sector's contribution to GDP will decline to more sustainable levels of less than 5% from highs above 8%.

Chart 31
Arizona, Potential GDP Growth, %



Source: BBVA Research

Chart 32
Michigan, Potential GDP Growth, %



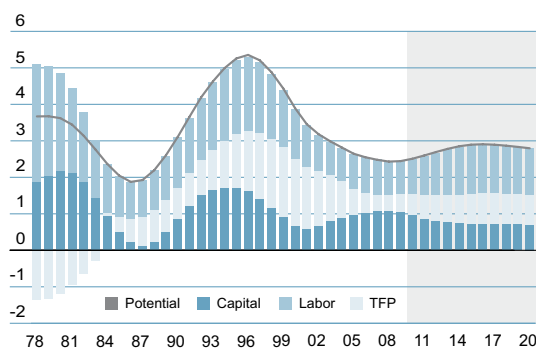
Source: BBVA Research

The methodology also illustrates the structural shifts in the former industrial bellwether states such as Michigan and Ohio. At the beginning of the 21st century, capital and labor began to flow out of these states. In the case of Michigan, the population declined and the state's economy contracted due to this shift. Looking forward, our analysis indicates that potential growth remains below 2%. To approach and exceed this potential, however, the labor force must grow and key industries must create jobs. Economic opportunity may begin to return slowly to Michigan: Detroit is re-inventing itself as small businesses are springing up to serve residents, and local stakeholders are considering dramatic new visions for the vast and vacant urban landscape. Additionally, housing is comparatively affordable. Already, GM has reported selling more cars in China than in the U.S. in 2010; thus, while GM may grow production in China, skilled management, engineering and marketing positions will need to be added to their domestic headquarters operations to support overseas expansion.

Potential Growth Over This Decade

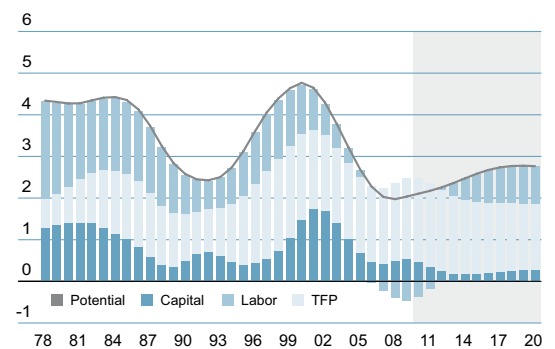
In summary, 16 of the 20 highest potential growth states between 2012-2020 lie west of the Mississippi River, and the remaining four are comprised of Tennessee, The Carolinas and New Hampshire in the eastern half of the U.S. Many of these states will enjoy higher population growth in the coming years, and their concentrations of top-performing industries will continue to attract capital.

Chart 33
Texas, Potential GDP Growth, %



Source: BBVA Research

Chart 34
California, Potential GDP Growth, %



Source: BBVA Research

Future work will consider the skill distribution in these states, as research suggests that a 10% increase in the level of education per worker (as measured by the percentage of the workers with bachelor degrees or higher) leads to a nearly 2% increase in labor productivity. Certainly, the returns to skill will continue to increase in the years ahead, because skilled labor complements the specialized capital that will flow to tomorrow's thriving industries.

Colorado Real Estate

Richard Wobbekind, Executive Director, and Brian Lewandowski, Research Associate, Business Research Division, Leeds School of Business, University of Colorado at Boulder

One vital component to a flourishing real estate market is people. Simply put, growth in jobs translates to more commercial real estate and infrastructure, and growth in population translates to more homes and infrastructure. Colorado continues to be a state with growth potential, which benefits investors taking a long view. However, the Great Recession has wreaked havoc on industry and employment, with reverberating effects on residential and commercial real estate. As the recession loosens the stranglehold it has on consumers and businesses, residents will seek out homes and companies will seek more space for their additional employees. As inventories are consumed, demand for new residential, nonresidential and nonbuilding construction will resume. The following metrics show the Colorado real estate industry is not yet out of the woods, but the situation is stabilizing.

Employment and Population

Aggregate demand for real estate comes from employment and population. The recession hit Colorado employment especially hard, effectively wiping away all employment growth realized over the decade. Based on 2010 year-end numbers released in January from the Colorado Department of Labor and Employment, the state lost nearly 10,000 jobs over the 10-year period. September 2010 marked the beginning of month-over-month (m-o-m) employment growth in the state, and December marked the first y-o-y growth since October 2008. On a related note, the construction industry suffered severe losses over the decade, losing 52,000 jobs over 10 years, with no growth since February 2008 (although losses are narrowing and should turn positive in 1Q11). During this 10-year period of net negative employment growth, the state has added 819,000 residents through in-migration and the natural increase in population. Estimates from the Colorado Demography Office show population increases of 79,100 in 2011 and 81,800 in 2012.

Chart 35

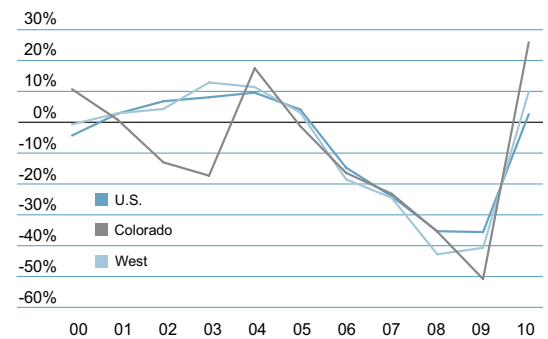
Colorado Population and Employment, Indexed, 2000-2010 (2000=100)



Source: Colorado Demography Office, Colorado Department of Labor and Employment

Chart 36

Building Permits, Units, 2000-2010



Source: U.S. Census Bureau

Production

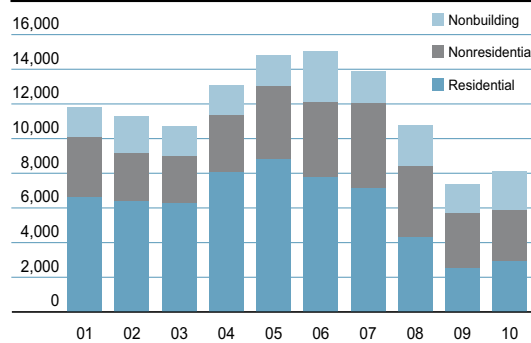
Colorado's production of homes resumed at a faster pace in 2010 than the western region and the nation. Building permits reported by the U.S. Census Bureau for Colorado show a 25.9% increase in units and 28.6% rise in value for 2010 (compared to 9.9% and 11.9% for the west, and 2.6% and 5.9% for the nation). Single-family permits were weak in the west and nationally, with relative strength in multifamily units. Colorado experienced double-digit growth in single-family and multifamily units and valuation in 2010.

The creation of new commercial property collapsed in 2008. Estimates of the value of new nonresidential construction totaled nearly \$3 billion in 2010—7% off 2009 levels and down

39% from the peak recorded in 2007, according to McGraw-Hill Construction. At more than \$2.2 billion, nonbuilding (infrastructure) activity actually improved 32% over 2009, but was down 44% from the 2006 peak.

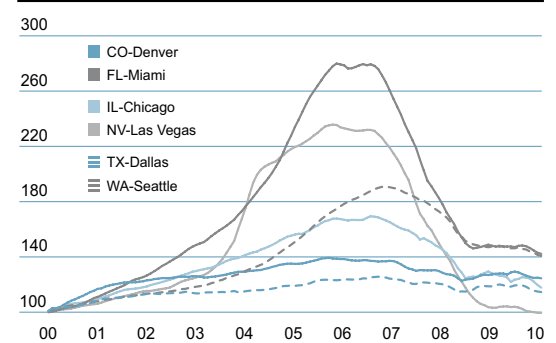
The much noisier monthly data indicate that the situation is improving, with November 2010 numbers up 70% for nonresidential and 124% for nonbuilding, y-o-y.

Chart 37
Colorado Value of Construction, 2001-2010 (\$mn)



Source: U.S. Census Bureau, McGraw-Hill Construction

Chart 38
S&P/Case-Shiller House Price Index (2000=100)



Source: S&P/Case-Shiller

Marketing

Home prices in Colorado were down y-o-y, q-o-q, and m-o-m in three national reporting indices: Federal Housing Finance Agency (FHFA), Zillow and Standard and Poor's Case-Shiller. Prices in the Denver metropolitan statistical area fell by 0.4% in November, according to the S&P/Case-Shiller seasonally adjusted house price index. The Denver index has increased only one month during the past seven, indicating market prices are still volatile. Denver fared worse than the 10- and 20-city composites for the month.

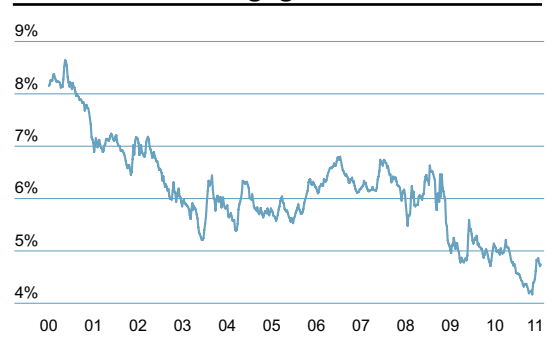
It is often reported that the Colorado housing market did not experience the run up in prices experienced by other cities; therefore, the state will have a softer landing. Supporting this assertion, the Denver MSA has the sixth-lowest appreciation in the 20-city index, and the second-lowest depreciation from the peak (10.6%).

Similarly, the FHFA seasonally adjusted purchase-only quarterly home price index for Colorado was down in 3Q10, by 2.1% from 2Q10, and down 2.9% from 3Q09.

For November 2010, Zillow indicated the Denver MSA was down 1.2% m-o-m, down 4.3% q-o-q, and down 5.2% y-o-y. Zillow reports showed Colorado down 1.3% m-o-m, 3.5% q-o-q, and 6.7% y-o-y, while the United States dropped 0.8%, 2.2% and 5.1%, respectively.

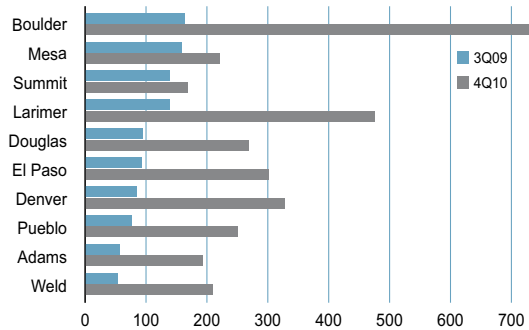
Commercial property metrics show mixed results among property types for the Denver metro region. According to reports from CB Richard Ellis, direct vacancies for offices fell both y-o-y and m-o-m in 4Q10. Industrial property vacancies improved only q-o-q, while retail vacancies increased in Q4. Lease rates increased for retail and industrial, but decreased for office space.

Chart 39
Conventional Mortgage Rates



Federal Reserve, Primary Mortgage Market Survey® data provided by Freddie Mac

Chart 40
Colorado Occupied Units Per Foreclosure



Source: Colorado Division of Housing, 4Q09 and 3Q10 Foreclosure Reports

Table 2

Loan Concentrations (median % of Total Risk-Based Capital)

	3Q10	2Q10	3Q09	2009	2008
Commercial Real Estate	238.5	251.1	282.3	279.4	291.8
Construction & Development	47.2	49.5	65.6	57.8	78.2
Multifamily Residential Real Estate	11.7	12.6	9.6	10.9	9.2
Nonresidential Real Estate	158.3	165.8	170.2	167.2	176.1
Residential Real Estate	151.7	153.3	158.2	165.9	136.4

Source: Federal Deposit Insurance Corporation

Finance

Key interest rates are currently at historically low levels for those who have the credit and down payment to qualify. The Federal Reserve reports weekly conventional mortgage rates of 4.75% in January 2011, down 25 basis points from a year earlier and more than 200 basis points from a decade earlier. Additionally, loans of more than \$400,000 now qualify for FHA lending for single-family units in the Denver-Aurora MSA and over \$700,000 in Colorado’s resort counties.

With home prices deflated and low rates, ample buying opportunities are available for those who have the ability. However, while the Fed released a statement of status quo on January 26, 2011, interest rates and inflation will begin to increase in the next few years. As these interest rates increase, consumers’ home purchasing power decreases, placing downward pressure on prices as more of the monthly payment goes to interest, and less to the principal.

Some banks have had a general aversion to real estate over the past few years. At best, banks have had to increase their reserve to cover possible bad loans, thus tying up capital that could be lent elsewhere; and at worst, poor-performing real estate portfolios have brought down banks.

Many banks have worked to clean their balance sheets by writing down bad loans or by raising capital. FDIC statistics show that commercial real estate loan concentrations as a percent of risk-based capital has been on a steady decline, improving from 282.3 to 238.5 y-o-y, and from 251.1 in 2Q10.

Foreclosures

The foreclosures on the market have become the market in some parts of the state—essentially putting a drag on the market the market inventory of homes. However, according to the Colorado Division of Housing, the rate of foreclosures is improving—there were 294 households per completed foreclosure in 3Q10, compared to 128 households per completed foreclosure in 3Q09. The filings increased in 3Q10 compared to Q2 (327) partly due to the backlog caused by the national moratorium placed on foreclosures.

RealtyTrac puts the Colorado foreclosure rate much lower—1 per every 420 units in December 2010, yet ranking comparatively high to the national rate of 1 per every 501 units (in comparison, Nevada had the highest rate of one in every 84 units).

In conclusion, real estate metrics continue to compete for market direction. Foreclosures and production appear to be stabilizing and prices and mortgage rates continue to be appealing; however, construction employment and prices continue to show destabilization.

Technology Transfer and Wealth Creation

Bruce Kellison, Associate Director, Bureau of Business Research, IC² Institute, The University of Texas at Austin

Commercialization of science and technology can be a key driver of economic growth for a city, region or an entire nation. Through its Global Commercialization Group (GCG), the IC² Institute at The University of Texas at Austin spent three decades experimenting with different approaches to wealth creation through entrepreneurship around science and technology commercialization. From incubating high tech ventures to accelerating the growth of entire high-tech regions, the GCG has developed a unique approach to wealth creation that it has successfully exported to a variety of regions and countries worldwide.

A Model of Development

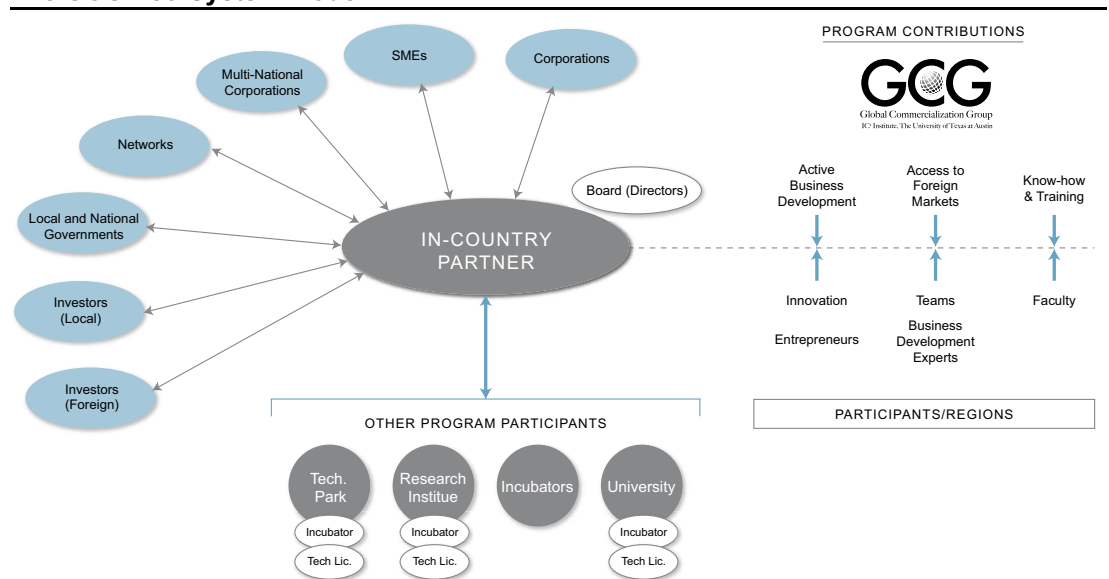
Successful technology commercialization results in the creation of new wealth and new jobs. But the path toward success, for every startup firm, is narrow and dangerous. For U.S.-based high-tech entrepreneurs, even the most promising inventions and scientific discoveries may fail despite their high market potential. For international startups, especially in emerging economies, the hurdles typically are even more daunting.

Researchers and specialists at GCG have absorbed the lessons learned from experiments undertaken at the IC² Institute's Austin Technology Incubator and applied them abroad. GCG teams are committed to influencing the rate of growth and success of regions that have been left behind in the dramatic emergence of "knowledge economies" domestically and internationally.

The illustration below shows the GCG Model. The process usually begins with a regional assessment of science, technology and innovation (STI) capacity, including recommendations for expanding regional STI capacity. Examples of factors examined initially include infrastructure for STI capacity, programs for entrepreneurs, the regulatory and policy climate for entrepreneurs and a region's global STI competitiveness position (export potential, access to capital for STI development and local sources of new innovation). The next step is establishing new programs for technology commercialization, some of which include incubators for startups and training for incubator managers; the creation of technology licensing or transfer offices within local universities or research centers; programs to accelerate established technology businesses in new markets both locally and globally; and the creation of new innovation and education centers.

Chart 41

The GCG Eco-System Model



Source: The Global Commercialization Group, IC² Institute, The University of Texas Austin

From there, the GCG model of technology commercialization extends to business development and becomes increasingly granular. Once commercialization infrastructure is established, the goal is to begin working directly with technologies and entrepreneurs to identify technologies with the greatest potential for commercial success. GCG staff, working through newly established incubators or accelerator programs, assess and screen technologies through the IC² Institute's Quicklook technology assessment methodology, which rates the commercial potential of technologies developed in universities or labs. The process includes competitions among entrepreneurs to select technologies for funding or further development, including the creation of new ventures and/or licensing agreements. One of the strengths of this approach is the primary research in a targeted market that GCG staff conducts for the small- and medium-sized enterprises (SMEs) they assist. Another is the emphasis on training local entrepreneurs, incubator managers and technologists on best practices. The goal after a program is completed is to leave a region with new knowledge about how best to create wealth from technology with locally trained talent.

Program Support

Many of GCG's programs are supported with funds from "offset" clauses in contracts with foreign governments won by U.S. defense companies. Offset programs are designed to return to the purchasing country, in the form of economic development assistance, some of the expenditures it commits to the purchase of military hardware. These offset programs, which typically extend for 2-4 years, promote industrial growth, job creation and new wealth generation for local companies in the purchasing country. GCG has conducted some of its largest technology commercialization and wealth creation programs using offset funds (Poland, Chile and Kuwait are examples).

From Lab to Market: Regional Success Stories

The table below summarizes several success metrics from some of the GCG's most recent programs in a variety of countries. The local economic development benefits for the host country are significant, from technical training in evaluating the market potential of specific technologies, to actual business agreements with global suppliers.

Table 3

Success Metrics for Recent GCG Programs¹

	Technologies Screened (through judging panels or validators)	Technology Market Research Reports (IC ² Quicklook Assessment Methodology)	Technologies Accepted for Business Development in the U.S.	Technologies with U.S. Business Development Results (e.g., customer agreements, joint ventures, strategic investments and equity investments)	Number of Foreign Nationals Trained in the U.S.
Mexico (5-year Program)	906	137	87	79	377
India	1117	129	59	33	240
Hungary	160	55	27	18	67
Poland	448	NA	68	43	65
Korea	196	40	25	15	75
Chile	58	26	8	7	45
TOTAL	2885	387	274	195	869

1: Programs included contained both training and technology business development.

2: Assessments of Polish technologies were done through subject matter experts.

Source: The Global Commercialization Group, IC² Institute, The University of Texas Austin

**Gyeonggi Province,
South Korea**

The summaries of GCG's international partnerships illustrate both the range and depth of its programs and highlight the concrete business development effects of its commercialization programs.

In 2008, GCG began a three-year innovation program in Gyeonggi, the most populous state in South Korea. The first step established The University of Texas-Gyeonggi Innovation Center in the city of Suwon. Since then, hundreds of Gyeonggi innovators applied to have their technologies considered for international business development support through the program. One of the most successful Korean firms working with the GCG in Gyeonggi Province has been Wheel Corp, a Korean company with the technology to make mufflers used in auto air conditioning systems. The GCG staff helped connect Wheel Corp with Visteon, the multinational automotive supplier based in Michigan. Visteon has now submitted a Letter of Interest to Wheel Corp., design work has been completed and the two companies are conducting performance testing and will shortly begin price negotiations. Visteon, which manufactures approximately 4 million automotive A/C systems annually, is intending to have all future automotive A/C designs incorporate Wheel's muffler technology and plans to reduce to two of their current multitude of muffler designs. For Wheel Corp, the benefits of working with GCG have been significant:

- Increased sales revenue of 4.5M USD
- Increased exports from \$165K to \$2.7M USD
- 8.2% increase in profit
- 16 new employees hired
- A 100% increase in unit production

What is more, the GCG program in Gyeonggi may have direct economic development benefits for Texas. Wheel Corp visited Texas in fall 2010 on a site selection trip to establish a manufacturing facility in Texas or Mexico by the end of 2011.

Chile

In concert with the Chilean Economic Development Agency (CORFO), and its Innovation Committee (INNOVA Chile), GCG engaged in an 18-month program to develop an "industry" of technology incubation and business acceleration management. IC² GCG staff and partners assessed and selected Chilean incubators and trained technology business incubator managers, CORFO executive staff, Chilean university faculty and entrepreneurs through seminars, workshops and business development activities. Training topics included technology screening and assessment, technology business development, international commercialization and incubator management. Additionally, the program provided assessments and selection of Chilean technologies and provided international business development of those technologies by matching Chilean enterprises with business opportunities outside Chile. What began as an effort to develop five international cooperative agreements for Chilean firms blossomed into 14 business engagement agreements between Chilean technology enterprises and foreign companies.

India

The Indian Government's Department of Science and Technology (DST) partnered with GCG and used Lockheed Martin offset funds to launch the DST-Lockheed Martin India Innovation Growth Program in 2007. The program's goals are to accelerate innovative Indian technologies into global markets. Each year of the program begins with hundreds of applicants vying to be among the 60 technologies selected for initial evaluation. From these, 30 are selected during a three-day commercialization workshop for in-depth commercialization review using "Quicklook." During each year-long program's second phase, the 30 teams of entrepreneurs are given advanced training in venture formation, venture finance, technology marketing and presentation skills to prepare for the final selection process, during which 15 teams are selected to receive professional business development assistance to commercialize their technologies. The range of technologies is impressive and includes aeronautics, biotechnology, electronics, IT, petrochemicals and agriculture. The India program's emphasis on matching Indian innovators and their technologies with global markets and foreign investors and businesses dovetails nicely with the Indian Government's goal of increasing private sector participation in R&D spending as it tries to raise R&D's share of Indian GDP from one percent to two percent.

TechBA

One of the most unusual but extremely successful of GCG's programs is TechBA, a business accelerator for Mexican companies entering the U.S. market. GCG hosts the program from its offices at UT Austin and runs it in conjunction with the United States-Mexico Foundation for Science (FUMEC), with sponsorship from the Mexican Ministry of Economy.

TechBA-Austin brings senior executives from established Mexican technology businesses to Austin and provides them with office space and support for accelerating their businesses in the U.S. or international markets. Additionally, TechBA-Austin works with companies based in Mexico who are preparing for international expansion. Since 2005, more than 170 companies have received training to help them commercialize their solutions for new markets. Of that group, 60 entered the accelerator and generated more than \$40M in revenue for their companies. Two companies raised investment capital and 15 have developed alliances with U.S. corporations. Merkatum Corporation, a leading developer and provider of multi-biometric identity management systems, received a \$1.0 million project award from the Texas Emerging Technology Fund to expedite the commercialization of innovative web-based, work-flow driven software systems.

IDZ and Loyalty3 are two examples of successful TechBA companies who have entered GCG's program. IDZ's technology is used by military and commercial aerospace clients to automate tool and asset management on military bases, manufacturing facilities and maintenance shops around the world. IDZ is headquartered in Austin, with a manufacturing facility in San Antonio and R&D in Monterrey, Mexico. With the first U.S. implementation at Dyess Air Force base more than a year ago, IDZ is poised to expand its reach across the Department of Defense. Loyalty3 provides award-winning customer loyalty solutions. By combining expertise in marketing, technology and finance, Loyalty3 develops and retains the most profitable consumers with tangible increases in customer satisfaction and spending. Due to early success with restaurants in the U.S., Loyalty3 is now exploring services for major media groups.

The Banking System: Going with a New Flow

The passage of the Dodd-Frank Act altered the funding profile and oversight of U.S. financial firms. Increased oversight is actualized through new authorities given to regulators and a new systemic risk council designed to coordinate regulators and provide early warning. Alterations to the funding profile of banks are operationalized through higher liquidity and capital requirements and, in some cases, activity restrictions or increased disclosure requirements. More specifically, the Dodd-Frank Act will move most derivatives to central clearinghouses. Firms packaging securitized instruments will, in some cases, need to retain some credit risk. Systemically-important firms will be subject to higher capital and liquidity requirements. These regulatory changes will catalyze revisions to prevailing business models at some banks. In addition, the destruction of long intermediation chains by the crisis has rendered demand for certain credit and liquidity transformation activities nonexistent. In this article we explore some of the implications of regulatory changes for financial firms' operating strategies.

Getting Away from Fees and Margins

In the pre-crisis era, the extension of credit products to lower-quality borrowers increased return on equity for the financial system overall, mostly through leverage and consumer fees. However, with the expulsion of products such as subprime mortgages from the banking system, financial institutions will need to turn to technology and cost reductions in order to generate return on equity from mass market customers. Services to the mass market will increasingly turn to the internet and other organizational strategies (purpose-built branches, "asset light" branches, and so forth) in order to keep service provision lean. In some ways, the new fees for checking products are a means for the financial system to retrain the expectation of consumers: the business model is changing and consumer behavior will likely change as well, for example, less reliance on physical check-writing.

Zeroing in on service provision will also aid banks in other demand-driven aspects of the market place. An aging population demographic will create demand for products that allow people to draw-down their wealth as opposed to accumulating wealth. This will also require more annuities, longevity risk management and structured income vehicles. Financial firms that can offer customers solutions to their retirement needs will be in an advantageous position to capitalize on this trend. An additional push will be the increased reliance on the private sector to manage retirement obligations as governments across the world restructure in the wake of high deficits and government debt.

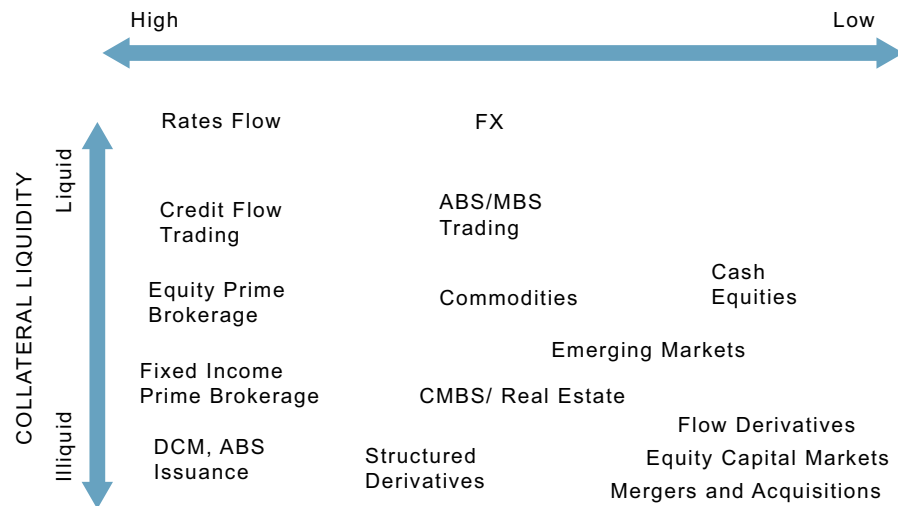
On top of these demand-based changes to business strategy, financial firms must also contend with funding-based changes to business strategy. These are evident in the funding profile of financial institutions. Financial firms may entail different types of sectoral profiles: many firms utilize some combination of banking with wealth management, insurance or flow business.

Two influences are drawing firms towards the perspective of becoming “flow monsters,” or firms that focus on standard financial instruments such as cash equities and bonds, fixed income and foreign exchange trading, and interest rates and commodities trading. First, regulation is driving up capital requirements, and second, customers are less interested in complex products. Conveniently, flow products require relatively little capital compared to complex derivatives and debt instruments. When spreads are high and volatility reigns, flow products tend to become profitable.

Another key factor behind success in the flow products business is scale – this is the “monster” part of the flow monster. As a volume business, scale is generated through large or many customers placing orders for flow products. Scale also generates economies by leveraging investments in information technology, connectivity, and geographical reach for globally-connected clients. These strategy-changing funding pressures are generally causing banks to shrink from unsecured funding source-dependent products such as structured derivatives, prime brokerage, debt capital markets and resecuritizations.

Chart 42

Balance Sheet Capital Consumption



Source: Oliver Wyman

Some new opportunities may arise from regulatory changes as well. Given central clearing of derivatives, costs will decline (but so will margins) and the volume of transactions will likely increase. It is also possible that financial regulation will make the use of derivatives more common than before the crisis: as more transparent, more tightly regulated products that move through established centers netting contracts, new customers will find utility in derivatives that previously did not exist. Additionally, with fewer competitors following the crisis, some financial firms are catapulted into new, more central roles in their respective product lines. Although room to gain new clout is certainly present, overcapacity may exist in certain market segments. This will require consolidation and rationalization to remove excess capacity.

The Parallel Banking System: The Crisis in Perspective

The United States maintains the deepest and most modern financial market in the world. Credit provision outside of the traditional banking system, also called the “shadow” or “parallel” banking system, became larger than the traditional banking system itself. Given the excesses of the years prior to the financial crisis, it is easy to surmise that many of these parallel banking sources will likely never return. It is probably too much to say, however, that commercial banks no longer have any predators from the parallel banking world. In fact, the crisis obscures the reality that some – not all – of the parallel banking system arose because of efficiency gains from specialization in particular financial activities.

For example, independent specialist firms still conduct certain kinds of credit intermediation that are not efficiently-done by commercial banks: origination and securitization of auto and equipment loans and leases, middle-market loans and franchise loans. On the other hand, it is safe to say that standalone subprime mortgage originators are extinct. We can surmise that conservatively-leveraged nonbank financial institutions dependent on a mix of short, medium and long-term funding will remain a viable competitor to traditional banking institutions.

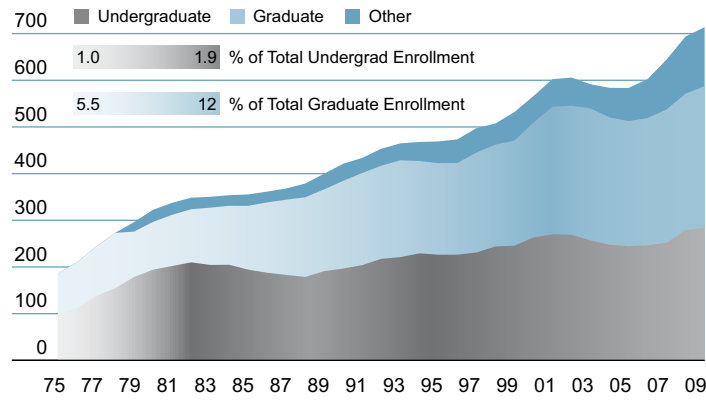
Many forms of parallel financial structures will operate in the future: bank-sponsored multi-seller conduits funding trade and short-term receivables, asset-backed issuance of prime auto loans, securitizations issued by static pools, and so forth. Even asset-backed securities intermediation can be consistent with our new reality if they are conservatively leveraged, dependent on a diverse range of funding sources (asset-backed commercial paper, medium-term notes and bonds) that are used for portfolio of high-quality structured credit assets that are similarly broad in scope. Thus, a parallel banking institution that is reasonably leveraged and maintains variety of funding sources can continue to utilize its specialty in credit intermediation. With a return to more normal monetary policy (an exit from zero interest-rate policies), more attention will be paid to the market-based funding sources of the parallel banking system.

Bottom Line

With the effect of new oversight and capital requirements weighing on the financial industry as a whole, it will not be unusual for firms to revisit their business strategies. As a result of a financial crisis, the focus will likely shift more to low-cost, high-quality service provision and innovation. At the same time, the commercial banking system should not believe that the shadow banking system will never rear its head again. The developments in financial innovation over the past few decades did represent gains to specialization in some segments of the market. Nonetheless, by focusing on innovative solutions for customers' financial needs and by leveraging scale in flow products, financial institutions can unleash their inner flow monster.

Fact Sheet

International Student Enrollment in Higher Education (thousands of persons)



Source: National Center for Educational Statistics and Institute of International Education (IIE) Opendoors Fast Facts 2010

Top 20 U.S. Institutions Hosting International Students, 09/10

(Ordered by approximate percentage of total enrollment)

University	International Enrollment	Approximate % of Total
Columbia - New York	6,833	26
Harvard	4,867	21
USC	7,987	21
Penn	4,522	17
SUNY-Buffalo	4,911	15
NYU	7,276	15
Illinois-Urbana Champaign	7,287	15
Purdue-Main Campus	6,903	15
Boston Univ.	5,172	14
UCLA	5,685	14
Michigan-Ann Arbor	6,095	13
Michigan State	5,358	12
Indiana - Bloomington	4,819	11
Penn State - Univ. Park	4,561	9
Texas - Austin	5,265	9
Texas A&M	4,611	9
Florida - Gainesville	4,920	8
Minnesota - Twin Cities	4,665	8
Ohio State - Columbus	4,796	8
Arizona State	4,483	8

Source: National Center for Educational Statistics and Institute of International Education (IIE) Opendoors Fast Facts 2010

Top Fields of Study of International Students

Field of Study	08/09	09/10	% of Total	% Change
Business and Management	138,565	145,514	21.1	5.0
Engineering	118,980	127,441	18.4	7.1
Physical and Life Sciences	61,699	61,285	8.9	-0.7
Math and Computer Science	56,367	60,780	8.8	7.8
Social Sciences	57,348	59,865	8.7	4.4
Fine and Applied Arts	34,854	35,802	5.2	2.7
Health Professions	35,064	32,111	4.6	-8.4
Intensive English Language	28,524	26,075	3.8	-8.6
Education	18,120	18,299	2.6	1.0
Humanities	19,179	17,985	2.6	-6.2
Agriculture	8,961	10,317	1.5	15.1
Other Fields of Study	73,011	76,743	11.1	5.1
Undeclared	20,944	18,707	2.7	-10.7

Source: National Center for Educational Statistics and Institute of International Education (IIE) Opendoors Fast Facts 2010

International Students in U.S., Top Places of Origin

	08/09	09/10	% of Total, 09/10	% Change
Total	671,616	690,923	100	2.9
China	98,235	127,628	18.5	29.9
India	103,260	104,897	15.2	1.6
South Korea	75,065	72,153	10.4	-3.9
Canada	29,697	28,145	4.1	-5.2
Taiwan	28,065	26,685	3.9	-4.9
Japan	29,264	24,842	3.6	-15.1
Saudi Arabia	12,661	15,810	2.3	24.9
Mexico	14,850	13,450	1.9	-9.4
Vietnam	12,823	13,112	1.9	2.3
Turkey	12,148	12,397	1.8	2.0
Nepal	11,581	11,233	1.6	-3.0
Germany	9,679	9,548	1.4	-1.4
United Kingdom	8,701	8,861	1.3	1.8
Brazil	8,767	8,786	1.3	0.2
Thailand	8,736	8,531	1.2	-2.3
Hong Kong	8,329	8,034	1.2	-3.5
France	7,421	7,716	1.1	4.0
Indonesia	7,509	6,943	1.0	-7.5
Colombia	7,013	6,920	1.0	-1.3
Nigeria	6,256	6,568	1.0	5.0
Malaysia	5,942	6,190	0.9	4.2
Kenya	5,877	5,384	0.8	-8.4
Pakistan	5,298	5,222	0.8	-1.4
Venezuela	4,678	4,958	0.7	6.0
Russia	4,908	4,827	0.7	-1.7

Source: National Center for Educational Statistics and Institute of International Education (IIE) Opendoors Fast Facts 2010

Forecasts (Y-o-Y % change)

	2009	2010	1Q11	2Q11	3Q11	4Q11	2011	2012		2009	2010	1Q11	2Q11	3Q11	4Q11	2011	2012
US									Alabama								
Real GDP	-2.6	2.8	2.3	2.9	3.1	3.6	3.0	2.7	Real GDP	-2.1	2.4	3.3	2.8	2.1	2.2	2.6	2.3
Nonfarm Employment	-4.3	-0.5	1.0	0.8	1.2	1.4	1.1	1.8	Nonfarm Employment	-5.3	-0.9	1.9	1.4	1.8	1.9	1.7	1.2
Nom. Personal Income	-1.7	2.9	3.4	3.8	4.6	5.0	4.2	4.5	Real Personal Income	-1.9	2.1	2.3	2.0	2.1	2.3	2.2	2.2
Home Price Index	-4.7	-2.8	-0.7	-0.6	1.5	2.1	0.6	2.2	Home Price Index	-1.2	-3.8	1.4	1.5	2.7	1.6	1.8	2.5
Home Sales	2.9	-5.4	-1.0	5.1	16.9	0.0	8.3	7.6	Existing Home Sales	-10.8	-0.7	3.6	-9.9	24.9	-0.6	3.3	2.3
Arizona									California								
Real GDP	-3.9	3.5	4.2	3.3	3.0	3.1	3.4	3.3	Real GDP	-2.2	3.2	4.0	3.5	3.1	3.2	3.4	3.2
Nonfarm Employment	-7.2	-1.0	1.3	0.9	1.7	1.8	1.4	1.9	Nonfarm Employment	-6.0	-1.6	0.4	0.4	1.0	1.2	0.7	1.3
Real Personal Income	-3.1	1.4	2.5	2.9	2.7	2.9	2.8	3.4	Real Personal Income	-3.3	1.7	1.4	1.2	1.0	0.9	1.1	1.6
Home Price Index	-18.0	-9.3	-2.3	-1.7	1.8	1.9	-0.1	2.3	Home Price Index	-12.3	0.5	0.9	0.0	1.8	1.2	1.0	2.7
Existing Home Sales	31.4	0.3	5.1	3.3	25.8	4.3	8.9	10.2	Existing Home Sales	15.5	-6.0	0.7	5.4	13.7	2.0	5.2	1.1
Colorado									Florida								
Real GDP	-0.9	2.7	4.1	4.0	3.5	3.6	3.8	3.5	Real GDP	-3.4	2.6	3.8	3.1	2.5	2.6	3.0	2.8
Nonfarm Employment	-4.5	-1.8	0.4	0.9	1.7	2.1	1.3	3.3	Nonfarm Employment	-6.2	-0.5	1.7	1.5	2.0	2.0	1.8	2.0
Real Personal Income	-3.0	1.4	2.4	2.6	2.7	2.9	2.7	3.3	Real Personal Income	-3.2	1.4	2.3	2.4	2.8	2.7	2.6	2.9
Home Price Index	0.0	-0.9	-1.1	-1.7	1.9	2.3	0.3	2.5	Home Price Index	-15.9	-6.1	-2.5	-1.2	1.7	1.7	-0.1	2.3
Existing Home Sales	-9.8	-1.6	2.6	-1.6	32.2	0.0	6.7	1.5	Existing Home Sales	35.8	17.6	18.3	23.0	45.9	9.7	22.6	15.2
New Mexico									Texas								
Real GDP	-2.2	2.4	3.3	2.9	2.5	2.5	2.8	2.4	Real GDP	-1.5	3.6	4.6	3.8	3.1	3.2	3.7	3.4
Nonfarm Employment	-4.0	-1.2	0.6	1.2	1.5	1.4	1.2	2.1	Nonfarm Employment	-2.8	0.4	2.3	1.6	2.1	2.0	2.0	2.8
Real Personal Income	-0.9	3.2	2.7	2.3	2.5	2.6	2.5	2.2	Real Personal Income	-2.2	2.8	3.5	3.7	3.3	3.2	3.4	4.1
Home Price Index	-4.8	-3.0	-2.2	0.5	1.4	1.8	0.3	2.1	Home Price Index	0.1	1.1	2.3	0.8	1.5	2.1	1.7	1.9
Existing Home Sales	-3.0	3.7	1.5	-10.1	39.8	5.3	6.7	4.5	Existing Home Sales	-6.8	-0.4	1.4	-9.1	25.6	-2.0	2.5	2.2

Note: Forecasts in bold

Source: BBVA Research with data from BEA, BLS, NAR, Census and FHFA

Economic Structure

	US	AL	AZ	CA	CO	FL	NM	TX
GDP (2009 \$ Billions)	14,119	1,699	2,564	18,914	2,527	7,370	748	11,447
Population (2010 Thousands)	308,746	4,780	6,392	37,254	5,029	18,801	2,059	25,146
Labor Force (4Q10 Thousands)	153,867	2,130	3,179	18,227	2,663	9,239	957	12,177
Nonfarm Payroll (4Q10 Thousands)	130,019	1,868	2,418	13,884	2,208	7,203	804	10,431
Unemployment Rate (4Q10 %)	9.6	9.0	9.4	12.4	8.6	12.0	8.5	8.2
Total Building Permits, (YTD Jan-Nov 2010)	430468	7758	10212	23431	8757	29591	3809	62184
Change in Building Permits (YTD Jan-Nov Y-o-Y (%))	4.0	-5.4	-12.7	1.4	24.6	15.4	-1.6	-0.2
Home Ownership Rate (2009)	67.4	66.8	68.5	68.4	70.5	70.9	69.1	65.4
Housing Prices (3Q10 Y-o-Y Change (%))	-3.2	-3.5	-9.4	-1.4	-2.9	-6.5	-3.9	1.1
Exports of Goods (3Q10 \$ Billions)	318.7	3.9	3.8	36.1	1.8	13.8	0.4	51.9
Change in Exports (3Q10 Y-o-Y Change (%))	22.0	27.2	11.5	20.9	10.3	18.5	28.8	27.7

Source: BEA, BLS, Census, WiserTrade and FHFA

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