RESEARCH

Economic Outlook

United States

Third Quarter 2013

Economic Analysis

- Global outlook revised down slightly as growth in both emerging and advanced economies fails to impress
- Economic activity in the U.S. improving for 2H13 while the Fed prepares for eventual QE3 tapering
- U.S. baseline scenario remains mostly unchanged despite revisions to recent data

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Closing Date: August 12, 2013

1. Global Outlook

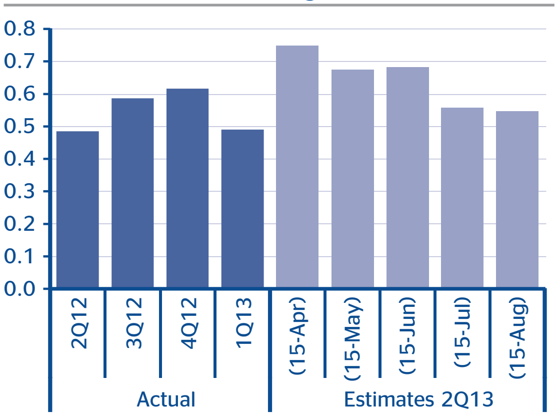
No Growth Improvements Until 2014, Diversified Risks

In recent quarters, macroeconomic data have been less positive than expected, generating major concern in some geographical areas. First, emerging markets are experiencing a sharper slowdown than expected, with the primary focus on more moderate growth in China, which has a global impact beyond Asia (i.e. the South American economies). Second, there has been an unexpected tightening of financial conditions at the global level. This increased stress has basically been the result of market reaction to the communication of the details given by the Federal Reserve of its steady reduction and subsequent reversion of the third round of its quantitative easing program.

On the one hand, growth in advanced economies is sputtering along at a gradual pace. Growth in the U.S., while not dramatic (the economy has not grown above 2% since 3Q12), has been in line with expectations. Europe had a disappointing start to the year, with contraction for the sixth consecutive quarter. However, the most recent data are more favorable and suggest that the euro zone most likely avoided another negative quarter. Meanwhile, Japan experienced an uptick in GDP growth in the first quarter of 2013 and the most recent data suggest that the economy is maintaining its strength, supported by the monetary stimuli and fiscal measures adopted by the new government. Considering these different dynamics across advanced economies, the cyclical behaviors appear to be improving but not enough to boost the outlook too significantly.

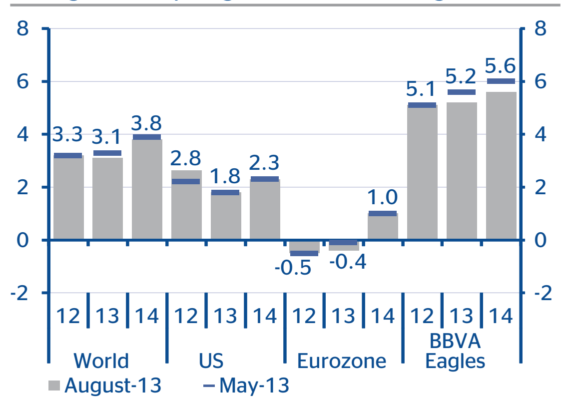
On the other hand, the macroeconomic environment in emerging markets has weakened considerably. In Latin America there is particular concern in Brazil, which appears incapable of a significant upturn from its slump in 2011-2012 and suffers from additional uncertainty related to social tensions. The country's growth model is based primarily on debt-driven consumption (under a framework of extremely limited political reform initiatives) and productive investments, both of which appear to be drying up as of late. In addition, the need for monetary policy to control inflation has led to an increase in interest rates, which will make the recovery harder in the short term. In other Latin American news, Mexico has lost momentum in the first half of 2013 due to lower foreign demand and the impact on public expenditure from the change in government. Ultimately, there has been modest growth in the region compared with its potential capacity.

Chart 1
Growth of global GDP according to the BBVA-GAIN model (QoQ % Change)



Source: BBVA Research

Chart 2
GDP growth by Region (QoQ % Change SAAR)



Source: Haver Analytics & BBVA Research

Meanwhile, two of the major emerging markets in Asia have weakened in recent quarters. Domestic demand, and in particular investment, has weakened in India, with external conditions also becoming less favorable. In China, a steady slowdown has continued, putting downward pressure on growth in other emerging markets, especially those dependent on demand for commodities and those exporting investment goods. The slowdown in China is a result of sluggish external demand, policies aimed at curtailing domestic financial fragilities at the expense of new stimulus measures, and a structural decline in potential growth. In addition, recent data raise doubts about how fast consumption can take over from investment as a driver of medium-term growth as the rebalancing of the economy unfolds.

Overall, the global economic situation is less favorable than it was three months ago, leading us to revise down our global GDP growth outlook to 3.1% in 2013, 0.2 percentage points below our prior forecast. For 2014, we maintain our expectations of continued expansion, in this case at 3.8%, 0.2pp below what we projected three months ago.

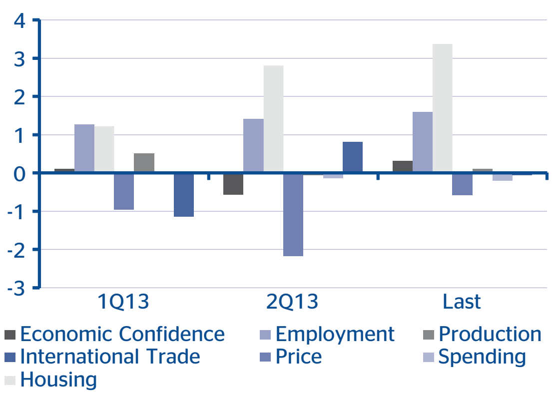
(Note: for a more in-depth analysis of Europe and the emerging markets, see our latest Global Outlook)

2. U.S. Outlook

Economic Activity on the Upswing, but Growth Forecasts Remain Unchanged

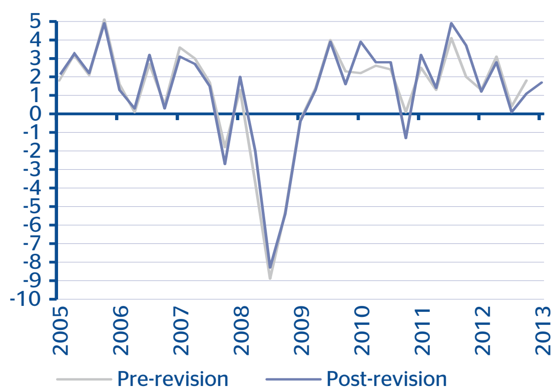
The first half of 2013 has come and gone, and our projections for stronger growth in 2H13 already appear to be materializing. Although real GDP growth for 1H13 turned out to be slower than originally expected, short-term data seem to be suggestive of a more optimistic story moving forward. The manufacturing and services sectors are again showing signs of life, with confidence and demand rising from both the consumer and the business side. Employment growth continues to increase at a steady monthly pace as the unemployment rate gradually declines, although the falling participation rate does not bode well for potential output. Consequently, consumer activity continues to gain momentum in the second half of the year as the economic outlook rallies and household finances improve. Our in-house monthly activity index suggests that housing, employment, and economic confidence remain some of the major drivers of growth. The index points to a significant acceleration in GDP growth for 2Q13.

Chart 3
BBVA U.S. Monthly Activity Index



Source: BBVA Research

Chart 4
Real GDP Growth, Pre- and Post-Annual Revisions (SAAR QoQ % Change)

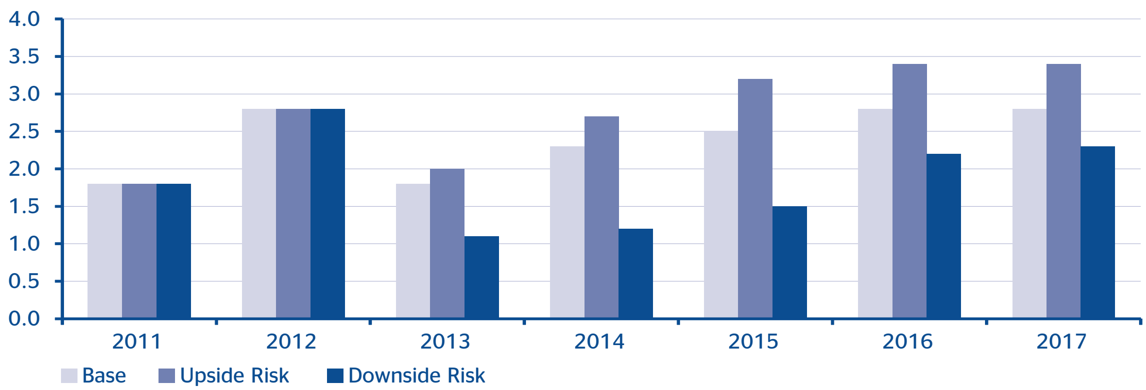


Source: BEA & BBVA Research

In late July, the Bureau of Economic Analysis released its annual revisions to growth, highlighting some significant changes in recent data. First, the recessionary period between 2007 and 2009 was revised upward slightly, hinting at a less severe crisis than previously estimated. Second, growth in 2012 was revised upward from 2.2% to 2.8% on a QoQ seasonally-adjusted annualized basis (SAAR) due to much stronger personal consumption and a lesser drag from government spending (mostly seen in 1Q12). One of the most interesting revisions was related to 1Q13, which was pulled down from 1.8% to 1.1% growth for the quarter. With this revision, 2Q13 GDP growth came in better than expected at 1.7%, though weaker consumer spending and net exports confirm our prior expectations for a relatively fragile economic environment in the second quarter. Overall, this does not change our baseline forecasts – slow growth in 1H13 with expectations for a stronger 2H13, and we maintain our projection for 1.8% annual growth for this year, accelerating above 2.0% in 2014 and beyond.

Despite this downward shift in 1H13, we still see upside potential for growth throughout the next few years. Our upside risk scenario accounts for potential positive surprises in the recovery which include, but are not limited to, stronger labor market dynamics, the implementation of structural reforms (immigration, infrastructure, energy, healthcare, etc) and the potential spillover effects, and a positive productivity shock. When all is said and done, the realization of some (or all) of these upside factors could boost real GDP growth to 2.0% for 2013 and closer to 3.0% for 2014.

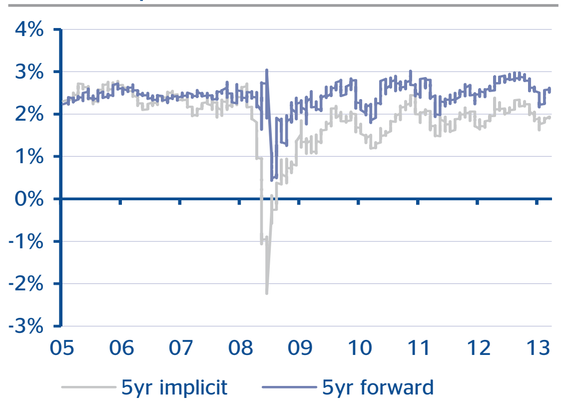
Chart 5
Projections for Real GDP Growth (SAAR QoQ % Change)



Source: BEA & BBVA Research

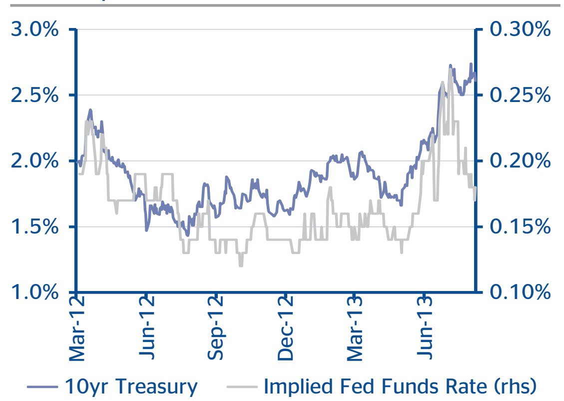
As economic data continue to show improvements, the focus becomes more and more centered on how the Fed will proceed with their monetary policy strategy while keeping in line with the dual mandate for maximum employment and price-stability. Following June's market "overreaction" and subsequent attempt by FOMC members to clean up the mess, expectations are heightened for eventual QE3 tapering. The latest meeting statement from July gave no clearer indication of the Fed's timeline but conveyed the Committee's contentment with current market expectations that appear to be in line with the goals of their policy guidance communication. Ultimately, we maintain our projection for the initial tapering announcement later in 3Q13 with the release of the September 18th meeting statement and Chairman press conference. Furthermore, we expect that this process of reducing monthly asset purchases will continue throughout the first half of next year, with the QE3 program concluding in 2Q14.

Chart 6
Inflation Expectations (%)



Source: FRB & BBVA Research

Chart 7
12-Month Implied Fed Funds Rate & 10-Year Treasury (% Yield)



Source: FRB & BBVA Research

With respect to downside risk factors, it is worth noting that the scenario is no longer dominated by a single risk factor with globally disruptive potential. Domestically, risks are still centered on fiscal policy and the costs of QE3, with lingering concerns related to labor market weakness and tight credit conditions. In regards to QE3, it is possible that we could see a disorderly exit from this monetary policy strategy – somewhat of an extension of the unexpected market movements after June's FOMC announcement and Chairman press conference. If this does occur, and if the rates of risk-free assets rise beyond the Fed's comfort zone, creating high financial volatility, the impact on U.S. and global growth through deteriorating confidence and the effect of negative wealth would not be negligible. On the global stage, risk factors include further deterioration in Europe, geopolitical threats, sharp changes in commodity prices, and a hard landing in emerging markets. China, in particular, is undergoing various reforms to deal with its fragile financial sector, but limiting credit activity could lead to a major slowdown in overall economic growth. The impact would spread beyond China and probably affect the economies dependent on Chinese demand, not only demand in the real economy but also for financial assets of the most developed economies. Finally, the most likely among possible global risk events continues to be a worsening of the crisis in the euro area. The situation is improving gradually, but it is still very vulnerable. The recent political instability in some southern European countries, and the slow pace of the process of constructing a banking union, continue to be elements that could generate financial stress and thus tension in the real economy. Ultimately, our risk scenario for the U.S. remains mostly unchanged from earlier in the year, and we do not expect to fall back into recession even if these risk factors come to light.

3. Economic Forecasts

Table 1

	3Q12	4Q12	1Q13	2Q13	2011	2012	2013	2014	2015	2016
Real GDP (% SAAR)	2.8	0.1	1.1	1.7	1.8	2.8	**1.8**	**2.3**	**2.5**	**2.8**
Real GDP (Contribution, pp)										
PCE	1.2	1.1	1.5	1.2	1.7	1.5	**1.3**	**1.0**	**1.0**	**1.2**
Gross Investment	1.0	-0.4	0.7	1.3	0.7	1.4	**0.7**	**1.0**	**1.0**	**1.1**
Non Residential	0.0	1.1	-0.6	0.6	0.8	0.9	**0.4**	**0.7**	**0.8**	**0.9**
Residential	0.4	0.5	0.3	0.4	0.0	0.3	**0.4**	**0.3**	**0.2**	**0.3**
Exports	0.1	0.2	-0.2	0.7	0.9	0.5	**0.4**	**0.9**	**0.9**	**0.8**
Imports	-0.1	0.5	-0.1	-1.5	-0.8	-0.4	**0.3**	**0.6**	**0.5**	**0.3**
Government	0.7	-1.3	-0.8	-0.1	-0.7	-0.2	**-0.4**	**0.0**	**0.0**	**0.0**
Unemployment Rate (%, average)	8.0	7.8	7.7	7.6	8.9	8.1	**7.6**	**7.0**	**6.4**	**5.9**
Average Monthly Nonfarm Payroll (K)	152	209	207	188	175	183	**186**	**196**	**211**	**230**
CPI (YoY %)	1.7	1.9	1.7	1.4	3.1	2.1	**1.6**	**2.2**	**2.4**	**2.4**
Core CPI (YoY %)	2.0	1.9	1.9	1.7	1.7	2.1	**1.9**	**2.0**	**2.2**	**2.3**
Fiscal Balance (% GDP)	-	-	-	-	-8.3	-6.8	**-4.0**	**-3.4**	**-2.2**	**-2.4**
Current Account (bop, % GDP)	-2.7	-2.6	-2.7	-	-3.0	-2.8	**-2.6**	**-2.8**	**-2.7**	**-2.4**
Fed Target Rate (%, eop)	0.25	0.25	0.25	0.25	0.25	0.25	**0.25**	**0.25**	**0.50**	**1.50**
S&P Case-Shiller Index (YoY %)	3.62	7.31	10.17	-	-4.35	2.78	**11.96**	**9.25**	**6.86**	**5.78**
10-Yr Treasury (% Yield, eop)	1.72	1.72	1.96	2.30	1.98	1.72	**2.90**	**3.28**	**3.64**	**4.03**
U.S. Dollar / Euro (eop)	1.29	1.31	1.30	1.32	1.32	1.31	**1.30**	**1.30**	**1.35**	**1.36**
Brent Oil Prices (dpb, average)	109.7	110.3	112.6	102.7	111.3	111.7	**107.6**	**112.9**	**119.0**	**120.1**

Source: BBVA Research, BEA, BLS, NAR, Census Bureau & FHFA

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This report has been produced by the BBVA Research U.S. unit

Chief Economist
Nathaniel Karp
+1 713 881 0663
nathaniel.karp@bbvacompass.com

Kim Fraser
kim.fraser@bbvacompass.com

Jason Frederick
jason.frederick@bbvacompass.com

Marcial Nava
marcial.nava@bbvacompass.com

Shushanik Papanyan
Shushanik.Papanyan@bbvacompass.com

Boyd Stacey
boyd.stacey@bbvacompass.com

Alejandro Vargas
alejandro.vargas@bbvacompass.com

Art & Lay out:
Fernando Tamayo

BBVA Research

Group Chief Economist
Jorge Sicilia

Developed Economies:
Rafael Doménech
r.domenech@bbva.com

United States
Nathaniel Karp
nathaniel.karp@bbvacompass.com

Spain
Miguel Cardoso
miguel.cardoso@bbva.com

Europe
Miguel Jiménez
mjimenezg@bbva.com

Emerging Economies:
Alicia García-Herrero
alicia.garcia-herrero@bbva.com.hk

Cross-Country Emerging Markets Analysis
Álvaro Ortiz Vidal-Abarca
alvaro.ortiza@bbva.com

Mexico
Carlos Serrano
carlos.serranoh@bbva.com

Asia
Stephen Schwartz
stephen.schwartz@bbva.com.hk

Latam Coordination
Juan Ruiz
juan.ruiz@bbva.com

Argentina
Gloria Sorensen
gsorensen@bbva.com

Chile
Jorge Selaive
jselaive@bbva.com

Colombia
Juana Téllez
juana.tellez@bbva.com

Peru
Hugo Perea
hperea@bbva.com

Venezuela
Oswaldo López
oswaldo_lopez@bbva.com

Financial Systems & Regulation:
Santiago Fernández de Lis
sfernandezdelis@grupobbva.com

Financial Systems
Ana Rubio
arubiog@bbva.com

Pensions
David Tuesta
david.tuesta@bbva.com

Regulation and Public Policy
María Abascal
maria.abascal@bbva.com

Global Areas:

Financial Scenarios
Julián Cubero
juan.cubero@bbva.com

Economic Scenarios
Sonsoles Castillo
s.castillo@bbva.com

Innovation and Process
Clara Barrabés
clara.barrabes@bbva.com

Contact details:

BBVA RESEARCH USA
2200 Post Oak Blvd.
Houston, TX 77025
United States.
Email: researchusa@bbvacompass.com
www.bbvaresearch.com