

## U.S.: Toward a Soft Recession; Doubts About the Strength of the Recovery

### Economic weakness to continue; the risks are lower

Recently, most of the indicators of U.S. activity caused surprise due to an upturn, although within a context of marked weakness in the economy. The absence of strong adjustments in industrial production, employment (not in the unemployment rate), and even in the dynamics of credit to companies and, to a lower extent, to families, are surprising favorably, given the collapse of the real estate sector and the financial crisis. This has translated into a more positive view of the economy than what it was at the beginning of the year, although the real economy continues to weaken, and it is unlikely that this trend will change in the coming months. Our base scenario remains unchanged: economic growth will continue with a downward trend throughout 2008 before picking up slightly in 2009, due more to a reduced drag from residential investment and solid demand abroad than to a recovery in private consumption. Jointly, our most probable scenario is the one to which our timely indicators point: more to a marked slowdown than to a prolonged recession. Nevertheless, the probability that the greater loan restrictions will end up turning into a credit crisis for companies and families cannot be underestimated, and, should this occur, it would have important implications for economic growth and public policies.

### Improvement in the financial markets: is it solid?

In recent weeks, conditions in the international financial markets have improved. The risk perception indicators have distanced themselves from their maximum levels, in particular, in corporate bonds (see graph), and the bonds with an investment grade and speculative grade. At the same time, companies with an investment grade, particularly the financial institutions, have been able to refinance themselves—a necessary action after the loss of capital due to the recognition of losses—and have begun to issue new loan instruments. Thus, a small part of the enormous rise in risk aversion since August 2007 has been reverted. Nevertheless, risk-taking continues to be limited; the inter-bank market continues to show strong tensions and the banks continue to toughen loan standards. This suggests that the aversion to risk continues and that the recent improvement is vulnerable to, for example, bad economic news or to the banks acknowledging greater losses.

The improvement in the financial markets seems to respond to several factors. We believe that these are helping to contain the negative effects of the recession in the real estate sector and the associated financial turbulence: a) Federal Reserve policies—aggressive policies injecting liquidity through monetary relaxation and other less conventional tools, and rescue packages guaranteeing “orderly” bankruptcies (i.e. Bear Stearns); b) availability of capital—on the part of agents outside the banking system, which has allowed for the refinancing of the most important financial institutions; c) the solid financial situation of companies—aggressive adjustments in the current cycle to reduce costs and debt have allowed the firms to continue with their investment projects despite the lower credit availability; and d) international disconnection—the economic performance has remained solid in the rest of the world, which represents an important source of demand, mainly in Asia and Europe.

### Corporate Spreads in the U.S. Basis points



Source: BBVA Bancomer with Federal Reserve data

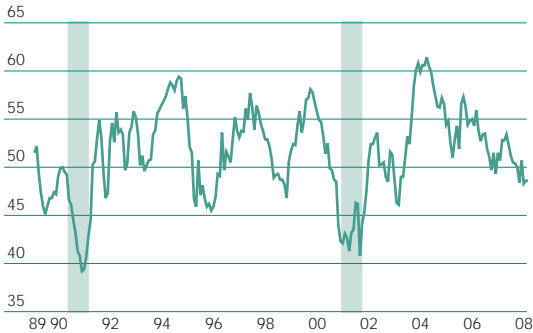
### Performance of the Labor Market in Recession Periods

Non-farm payroll, index, T-12 months = 100, T = start of recession



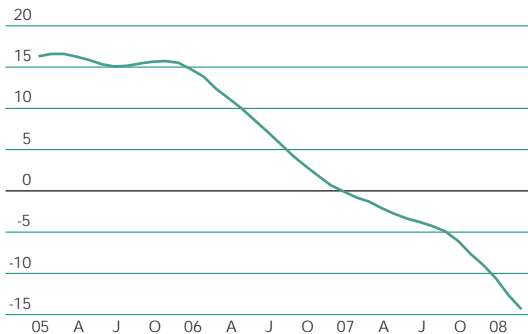
Source: BBVA Bancomer with Bloomberg data

### ISM Index, higher (lower) levels than 50 indicate expansion (contraction)



Note: Shaded areas correspond to recession periods  
Source: BBVA Bancomer with Bloomberg data

### Housing Prices S&P Case-Schiller index for 20 cities, real annual % change



Source: BBVA Bancomer with Bloomberg data

### “Better than expected” timely indicators; the adjustment in the real estate sector continues

In 1Q08, economic growth was weak and stood at 0.9% in the annualized quarter, slightly better than expectations. The most positive news was not that the datum was better than expected but that growth remained positive—some analysts had anticipated a contraction of GDP in the quarter—. Nonetheless, the report points to an evident economic weakness. The contents of the report indicate that private domestic demand contracted. In fact, if we were to eliminate the contribution of net exports and government spending to growth, GDP would have contracted an annualized quarterly 0.3%.<sup>1</sup> Going forward, the accumulation of inventory during the quarter will translate into lower production so as to eliminate inventory surpluses in view of weak domestic demand. There was a sharp slowdown in consumption, which would have contracted had it not been for the services sector. Non-residential investment stopped boosting growth and began to limit it, while residential investment continues to be a burden for expansion. The only positive point was the strength of exports, which continues to offset, although partially, the weakness of domestic demand.

Timely indicators indicate that growth could be very low or even negative in 2Q08 in view of the weakness of the housing market—without any symptoms yet of a slowdown—, and the lower existing available income, in view of the price hikes in food and energy and the weakness in the labor market.

The slowdown in economic activity is being reflected in the labor market. Layoffs continue to rise while new hiring continues to drop. Net job creation in the first five months of the year has decreased by almost 325,000 persons and, given that the hiring of around 125,000 new workers is required to absorb the new incomers to the labor market, the unemployment rate has rallied 5.5%. Nevertheless, it should be noted that there are notable divergences in the performance of the labor market. Job losses in the goods producing sectors and in the construction sector are important, while the services sector is not so weak and the number of workers has remained practically unchanged. If we were to compare the labor market with the previous recession cycle, we should expect greater weakness going forward (see graph). As a reaction to the greater adversities—the drop in families’ net wealth, job losses, greater restriction of credit conditions—, families’ trust has decreased to levels consistent only with previous recession periods and forecast the weakness of consumption going forward.

In turn, industrial activity is stagnant, which is not necessarily bad news when compared to its performance in previous recession or sharp slowdown periods (see graph). The strength of foreign demand and the weakness of the dollar could be the main factors that are allowing for a less abrupt contraction of manufacturing production.

1 Both the consumption of goods, as well as non-residential investment, contracted (although the consumption of services continued to grow). Residential investment continued to strongly reduce growth. Private domestic demand subtracted 0.28 pp from growth, which was offset by a positive contribution of government spending (+0.38 pp), net exports (+0.30 pp), and inventory accumulation (+0.21 pp).

The sector, where in general recent rallying data have not been surprising, is precisely the one that gave rise to a large part of the economic problems. Despite the marked contraction in home construction during 2007 and so far in 2008, the excess of supply on the real estate market has continued to rise. With an upward trend in home foreclosures by the banks, a lower demand by first-time purchasers (in view of more restrictive loan conditions and greater expectations of price drops), excess supply could take a longer time to be absorbed despite the reduction in housing starts and construction permits. The measure most accepted for evaluating excess supply on the market is the vacancy rate—because it includes all homes on sale, notwithstanding whether the owners are builders, individuals or banks—, which reached a historic high in 1Q08. As a result, the housing price drop has accelerated (see graph). In annualized monthly terms, home prices are dropping at a 25% rate. In this sense, an indispensable prerequisite to begin to think of an improvement in the economic situation is the end of the real estate adjustment, and, in this respect, the news has not only been bad but worse than expected, even though the plan announced by Congress could end by helping stability that could start toward the end of 2008 or the beginning of 2009. .

### Outlook: doubts about the strength of the recovery

Timely indicators point to a significant slowdown in the rhythm of economic activity and not to a severe recession. In our central scenario, we expect that the expansion rate will continue to weaken in the second and third quarters before starting to strengthen moderately toward the end of 2008 and during 2009. In the near future, private consumption will receive a boost from US\$100 billion in tax rebates to families, equivalent to 0.9% of GDP or 1.2% of private consumption. Nevertheless, we estimate that the support could have a lower impact to the extent that part of the tax rebate checks will be used to amortize debt, since the current situation of the pillars of consumption is not good. Also, the recent increase in the price of gasoline is reducing families' purchasing power. Families' wealth will continue to decrease (with the housing price drop), by which, very probably, the savings rate will tend to rise—to finance retirement or other future expense, which will not permit solid increases in consumption.

Furthermore, in view of the expected weakness in demand, it will be difficult for companies to accelerate their investment plans and their hiring rate. Finally, more restrictive credit conditions will more perceptibly limit financing to families.

On the investment side, we expect more modest growth in capital within a context of weakness in demand (and lower expected demand), higher costs and a marked decrease in the profit growth rate. Moreover, the adjustment in residential investment has not touched bottom and excess supply in the real estate market—added to the possibility that it will continue to increase—will cause additional drops in housing prices. The contraction of residential investment will continue to be the main dead weight for economic growth in 2008. In contrast, the solid growth rate in exports will continue to partially compensate for the weakness in domestic demand.

### Federal Reserve Economic Projections for the U.S.

Base trend, %, May 2008

	2008	2009	2010
GDP	0.3 – 1.2	2.0 – 2.8	2.6 – 3.1
January projections	1.3 – 2.0	2.1 – 2.7	2.5 – 3.0
Unemployment	5.5 – 5.7	5.2 – 5.7	4.9 – 5.5
January projections	5.2 – 5.3	5.0 – 5.3	4.9 – 5.1
Headline inflation	3.1 – 3.4	1.9 – 2.3	1.8 – 2.0
January projections	2.1 – 2.4	1.7 – 2.0	1.7 – 2.0
Core inflation	2.2 – 2.4	1.9 – 2.1	1.7 – 1.9
January projections	2.0 – 2.2	1.7 – 2.0	1.7 – 1.9

Note: Inflation projections correspond to PCE. GDP and inflation estimates are inter-annual changes in the fourth quarter of each year. The unemployment forecasts are the average of the unemployment rate in the fourth quarter of each year.

Source: BBVA Bancomer with Federal Reserve data

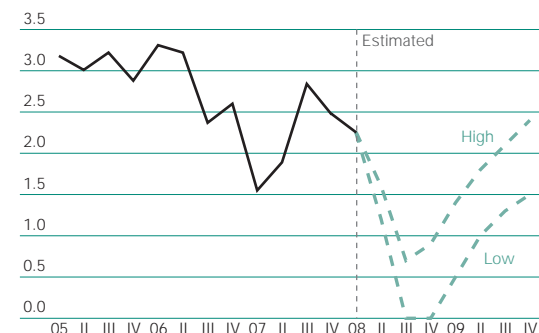
### BBVA Economic Projections for the U.S.

	2007	2008e	2009e
GDP (real annual % change)	2.2	0.8 – 1.4	1.1 – 1.9
Inflation (CPI, annual average)	2.8	3.3 – 4.0	1.5 – 3.6
Core	2.3	2.0 – 2.4	2.0 – 2.9
Federal Funds (eop)	4.25	1.5 – 2.75	1.5 – 4.0
Treasury Note (10-year, eop)	4.62	3.5 – 3.9	3.6 – 4.3
Dollar/Euro*	1.46	1.47 – 1.54	1.39 – 1.48

e estimate  
\* For the dollar/euro forecasts, the highest (lowest) exchange rate corresponds to the lower(highest) GDP scenario

Source: BBVA

### Gross Domestic Product Annual % change



Note: Estimated as of the second quarter 2008

Source: BBVA Bancomer with Bloomberg data

## Core Inflation and Unit Corporate Profits

Annual % change



\* Leading 2 years  
Source: BBVA Bancomer with Bloomberg data

## Core Inflation

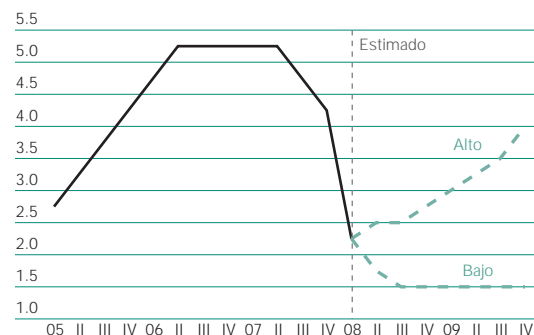
Annual % change



Note: Estimated as of May 2008  
Source: BBVA Bancomer with Bloomberg data

## Federal Funds

%, end of period



Note: Estimated as of the second quarter 2008  
Source: BBVA Bancomer with Bloomberg data

Going forward, risks in economic activity continue to be clearly biased downward and a more negative scenario cannot be ruled out. If within a few months the beginning of the end of housing price drops is not perceived, insolvency topics could generate the need for commercial banks to protect their capital, and, without accompanying capital procurement, they could end up with credit restrictions to companies and families. Also, the greater weakness of the labor market, in the absence of legislative solutions, could translate into a massive increase in the non-payment of real estate loans and home foreclosures by the banks, which would lead to an even more pronounced drop in families' confidence and, therefore, would translate into a greater weakness in domestic demand, in addition to making the rise in loan restrictions more likely. In this sense, there are some doubts as to whether the recovery would be more evident in 2009 (once the tax rebate boost ends).

## We anticipate a period without changes in monetary policy

Within a context of downward risks in economic activity and core inflation with a downward trend (see graphs) in face of lower demand and the lower price power of companies, we expect monetary policy to continue to be expansive, notwithstanding pressure on headline inflation from energy and food. We anticipate that the Federal Reserve will not raise its reference rate until housing prices and the unemployment rate have stopped deteriorating, which we do not foresee happening until the second half of 2009. In our central scenario, we expect that the federal funding rate will remain at 2.0% until 2Q09, at which time the Federal Reserve will begin to raise its reference rate. However, even though it is not our base scenario, currently, a resumption of the lowering of interest rates is more probable than an increase in the near future if the economic outlook deteriorates and a more pronounced period of weakness is envisioned. Once economic activity recovers, the main risk is that pressure in food and energy will continue, and that this can be translated with greater ease into a rise in the medium- and long-term expectations, which, in turn, will contaminate the determination of other prices in the economy, particularly wages. But this is still some months away, despite the current fears of the market.

# United States Indicators and Forecasts

	2007	2008	2009	I'07	II'07	III'07	IV'07	I'08	II'08	III'08	IV'08
<b>Economic Activity</b>											
GDP (real annual % change)	2.2	<b>1.0</b>	<b>1.6</b>	1.5	1.9	2.8	2.5	2.5	<b>1.2</b>	<b>0.1</b>	<b>0.1</b>
Personal consumption expenditures	2.9	<b>0.9</b>	<b>1.3</b>	3.2	2.9	3.0	2.6	1.9	<b>1.3</b>	<b>0.5</b>	<b>-0.1</b>
Gross fixed investment	-2.9	<b>-2.3</b>	<b>1.9</b>	-4.5	-3.3	-2.3	-1.5	-2.4	<b>-2.4</b>	<b>-2.7</b>	<b>-1.8</b>
Non-residential	4.7	<b>3.1</b>	<b>2.6</b>	2.5	4.1	5.1	7.1	6.4	<b>3.8</b>	<b>1.7</b>	<b>0.6</b>
Structures	13.0	<b>7.7</b>	<b>3.8</b>	10.2	12.4	13.8	15.1	13.7	<b>9.5</b>	<b>5.7</b>	<b>2.8</b>
Equipment and software	1.3	<b>1.7</b>	<b>2.4</b>	-0.5	0.7	1.5	3.6	3.3	<b>2.2</b>	<b>0.8</b>	<b>0.5</b>
Residential	-17.0	<b>-20.6</b>	<b>-3.5</b>	-16.5	-16.5	-16.5	-18.6	-20.9	<b>-23.3</b>	<b>-21.1</b>	<b>-16.7</b>
Total exports	8.1	<b>5.3</b>	<b>3.2</b>	6.6	7.1	10.3	8.4	8.8	<b>7.3</b>	<b>3.2</b>	<b>2.1</b>
Total imports	1.9	<b>-0.6</b>	<b>2.6</b>	2.9	2.0	1.7	1.0	-0.6	<b>-0.1</b>	<b>-1.1</b>	<b>-0.6</b>
Government consumption	2.0	<b>2.2</b>	<b>2.7</b>	1.2	1.9	2.7	2.3	2.9	<b>1.8</b>	<b>2.0</b>	<b>2.1</b>
<b>Contribution to Growth (pp)</b>											
Personal consumption expenditures	2.1	<b>0.6</b>	<b>0.9</b>	2.3	2.1	2.1	1.8	1.3	<b>0.9</b>	<b>0.3</b>	<b>-0.1</b>
Private investment	-0.8	<b>-0.4</b>	<b>0.4</b>	-1.1	-1.0	-0.6	-0.6	-0.5	<b>-0.4</b>	<b>-0.7</b>	<b>0.0</b>
Net exports	0.6	<b>0.7</b>	<b>0.0</b>	0.2	0.5	0.9	0.8	1.2	<b>0.9</b>	<b>0.6</b>	<b>0.4</b>
Government consumption	0.4	<b>0.4</b>	<b>0.5</b>	0.2	0.3	0.5	0.4	0.5	<b>0.3</b>	<b>0.3</b>	<b>0.4</b>
<b>Prices and Costs (annual % change, average)</b>											
CPI	2.9	<b>3.7</b>	<b>2.5</b>	2.4	2.7	2.4	4.0	4.1	<b>3.8</b>	<b>3.8</b>	<b>3.2</b>
Core	2.3	<b>2.2</b>	<b>2.4</b>	2.6	2.3	2.2	2.3	2.4	<b>2.3</b>	<b>2.1</b>	<b>2.0</b>
PCE	2.5	<b>3.1</b>	<b>2.2</b>	2.3	2.3	2.1	3.4	3.4	<b>3.1</b>	<b>3.1</b>	<b>2.8</b>
Core	2.1	<b>2.0</b>	<b>2.1</b>	2.4	2.0	1.9	2.1	2.0	<b>2.1</b>	<b>1.9</b>	<b>1.9</b>
GDP deflator	2.7	<b>2.9</b>	<b>2.2</b>	2.9	2.7	2.4	2.6	2.2	<b>3.2</b>	<b>3.3</b>	<b>3.0</b>
Productivity	1.9	<b>1.3</b>	<b>1.4</b>	0.7	1.0	2.9	2.9	3.2	<b>0.7</b>	<b>0.7</b>	<b>0.7</b>
Real compensation per hour	2.1	<b>0.2</b>	<b>1.0</b>	2.4	2.6	3.3	-0.1	-0.7	<b>0.5</b>	<b>0.5</b>	<b>0.5</b>
Unit labor cost	3.1	<b>0.4</b>	<b>1.0</b>	4.3	4.3	2.8	0.9	0.2	<b>0.5</b>	<b>0.5</b>	<b>0.5</b>
<b>Other Indicators</b>											
Industrial production (real annual % change)	1.7	<b>0.4</b>	<b>1.5</b>	1.3	1.5	1.9	2.2	1.7	<b>0.5</b>	<b>-0.2</b>	<b>-0.3</b>
Capacity utilization (%)	81.0	<b>79.5</b>	<b>80.1</b>	80.7	81.0	81.3	81.0	80.6	<b>79.5</b>	<b>78.9</b>	<b>79.0</b>
Light weight vehicle sales (millions, annualized)	16.2	<b>15.2</b>	<b>15.3</b>	16.5	16.1	15.9	16.2	15.2	<b>15.0</b>	<b>15.3</b>	<b>15.3</b>
Housing starts (thousands, annualized)	1,341	<b>770</b>	<b>962</b>	1,453	1,460	1,298	1,151	1,042	<b>811</b>	<b>573</b>	<b>656</b>
Nonfarm payrolls (thousands of new jobs, average)	91	<b>-89</b>	<b>20</b>	109	105	71	80	-80	<b>-67</b>	<b>-100</b>	<b>-110</b>
Unemployment rate (average, %)	4.6	<b>5.1</b>	<b>5.4</b>	4.5	4.5	4.7	4.8	4.9	<b>5.0</b>	<b>5.1</b>	<b>5.2</b>
Personal savings rate	-0.2	<b>0.0</b>	<b>0.0</b>	-0.6	-0.4	-0.1	0.2	-0.3	<b>-0.2</b>	<b>0.1</b>	<b>0.4</b>
Trade balance (US\$ billions)	-706	<b>-671</b>	<b>-718</b>	-177	-179	-174	-177	-179	<b>-157</b>	<b>-162</b>	<b>-173</b>
Current account balance (US\$ billions)	-726	<b>-688</b>	<b>-758</b>	-193	-187	-177	-170	<b>-172</b>	<b>-166</b>	<b>-164</b>	<b>-186</b>
% of GDP	-5.3	<b>-4.8</b>	<b>-5.1</b>	-771.8	-746.4	-706.3	-680.9	<b>-689.1</b>	<b>-664.8</b>	<b>-656.6</b>	<b>-742.9</b>
Fiscal balance (US\$ billions, fiscal year)	-163	<b>-399</b>	<b>-388</b>	—	—	—	—	—	—	—	—
% of GDP	-1.2	<b>-2.8</b>	<b>-2.6</b>	—	—	—	—	—	—	—	—
<b>Financial Markets (eop)</b>											
Fed Funds (%)	4.25	<b>2.00</b>	<b>2.50</b>	5.25	5.25	4.75	4.25	2.25	<b>2.00</b>	<b>2.00</b>	<b>2.00</b>
10-year Treasury Note (%)	4.10	<b>3.89</b>	<b>4.40</b>	4.56	5.10	4.51	4.10	3.48	<b>3.89</b>	<b>3.80</b>	<b>3.89</b>
Dollar/euro	1.46	<b>1.49</b>	<b>1.40</b>	1.32	1.34	1.39	1.46	1.55	<b>1.53</b>	<b>1.54</b>	<b>1.49</b>

eop end of period  
CPI Consumer price index  
PCE Personal consumption expenditures index