Economic Watch

U.S.

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Economic Analysis

U.S.

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Monthly US Outlook

Economic Recovery at a Standstill, Growth Outlook Revised

- **Economic recovery will be weaker than previously expected**
- **Inflation will remain within Fed's comfort zone**
- **Weak growth and downside risks favor a more dovish monetary policy**

The economic recovery has been at a standstill and the latest indicators suggest little improvement over the last month. With mounting fears of recession, activity and confidence levels imply more persistent and long-lasting effects of the financial crisis. In general, we expect that growth will pick up in 2H11 and 2012. However, the depressed housing sector, weak labor market, ongoing deleveraging process, and financial volatility will limit the recovery. We also believe that the current downside risks facing the US economy will outweigh any potential upside.

Much of the concern regarding the economic recovery relates to the discouraging employment situation. Sluggish demand and uncertainty have contributed to a more pessimistic business outlook and companies have become more hesitant to hire additional workers (see our Economic Watch released on Sept 7th). The unemployment rate remains high, with most of the weakness coming from layoffs in the government sector and sluggish residential activity. Construction jobs have suffered as the housing market struggles to incite demand for new homes. For the next year, we expect labor market growth to remain low, in line with the slower-than-expected economic recovery. Furthermore, we expect the unemployment rate to be higher than previously forecasted.

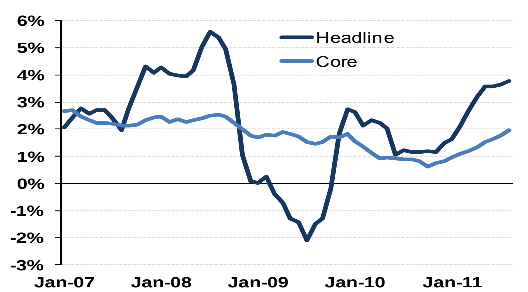
Deflationary risks have declined considerably as the consumer price index has come in higher-than-expected for two consecutive months. Despite increasing shelter prices that have pushed core inflation higher, oil prices have started to decline due to weak economic prospects. A combination of weak economic activity and stabilizing commodity prices will help contain headline inflation pressures and we expect that core inflation will remain within the Fed's comfort zone. Overall, we expect low and stable inflation rates throughout the forecast horizon.

Accordingly, the Fed has explicitly committed to keeping interest rates low through mid-2013 and recently announced that it plans to lengthen the average maturity of its balance sheet by selling $400bn of shorter-term Treasury holdings and purchasing the same amount of longer-term maturity Treasury securities (dubbed "Operation Twist"). The Fed will also reinvest principal from maturing securities into agency mortgages instead of its previous policy of reinvestment into Treasuries (see our Fed Watch brief released on Sept 21st). Moreover, the latest FOMC statement and Fed governors' speeches present a less optimistic view on the US economy for the next few years. Given these circumstances, we expect later rate hikes than suggested in our previous baseline scenario. Weak growth and downside risks favor a more dovish Fed and the latest trends suggest a flatter yield curve. In addition, elevated risk perception and flight to safety support Treasuries, with no alternatives worldwide. Therefore, for the long-term, we expect that downward pressures will keep rates lower than usual for an economic recovery. Furthermore, the Fed could implement further stimulus if downside risks increase further. While the "Operation Twist" strategy is slated to last 9 months, the Fed could act sooner if weak economic activity continues.

Overall, we estimate a higher probability of recession now for the US economy given increasing downside risks, such as political brinkmanship, deeper contagion from the European sovereign debt crisis, and further deleveraging. Although these may weigh on the recovery in the coming months, our current baseline scenario does not assume that the U.S. economy will fall back into recession.

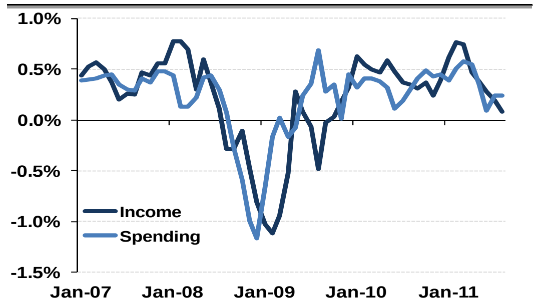
Economic Indicators

Graph 1
Consumer Price Index
(YOY% NSA, 1982-84=100)



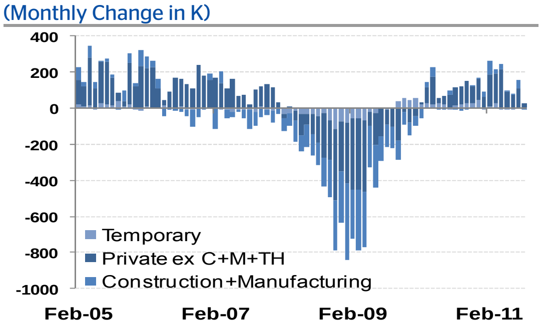
Source: BLS

Graph 2
Personal Income and Expenditures
(3MMA, MoM%)



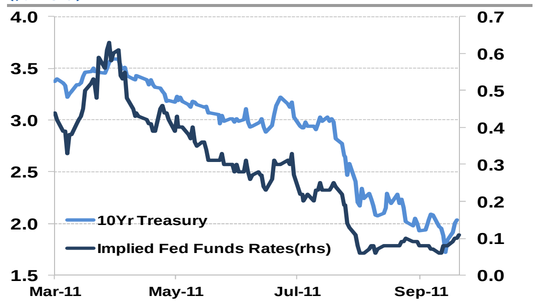
Source: BEA

Graph 3
Private Nonfarm Payrolls
(Monthly Change in K)



Source: Haver Analytics & BBVA Research

Graph 4
12 Month Implied Fed Funds Rate & 10 Yr Treasury
(%Yield)



Source: Haver Analytics

Table 1
Forecasts (BOLD=FORECASTS)

	3Q2010	4Q2010	1Q2011	2Q2011	2011	2012	2013
Real GDP (% SAAR)							
GDP	2.5	2.3	0.4	1.3	**1.6**	**2.3**	**2.2**
Real GDP (Contribution, pp)							
PCE	2.6	3.6	2.1	0.7	**2.1**	**1.9**	**2.0**
Gross Investment	9.2	-7.1	3.8	6.4	**5.0**	**7.9**	**6.3**
Non Residential	11.3	8.7	2.1	10.3	**8.5**	**9.2**	**7.0**
Residential	-27.7	2.5	-2.4	4.2	**-1.6**	**4.0**	**2.0**
Exports	10.0	7.8	7.9	3.6	**6.7**	**6.5**	**6.8**
Imports	12.3	-2.3	8.3	1.4	**5.5**	**6.6**	**6.8**
Government	1.0	-2.8	-5.9	-0.9	**-1.8**	**0.5**	**0.9**
Unemployment rate (%)	9.6	9.6	8.9	9.1	**9.0**	**8.9**	**8.4**
Average Montly Nonfarm Payroll(k)	-46	139	166	97	**108.5**	**147.5**	**170.0**
CPI							
CPI (YoY%)	1.2%	1.3%	2.1%	3.4%	**2.9**	**2.2**	**2.3**
Core CPI (YoY%)	0.9%	0.7%	1.1%	1.5%	**1.6**	**1.7**	**1.8**
Fiscal balance (% GDP)	-	-	-	-	**-9.5**	**-6.9**	**-4.6**
Current Account (bop, % GDP)	-3.3	-3.0	-3.2	-3.2	**-3.4**	**-3.5**	**-3.5**
Fed target rate (%)	0.25	0.25	0.25	0.25	**0.25**	**0.25**	**1.00**
S&P Case & Shiller Index	135.7	130.9	125.6	130.1	**128.2**	**127.7**	**128.9**
10Yr Treasury (% Yield)	2.8	2.9	3.5	3.2	**2.2**	**2.8**	**3.2**
US Dollar/ Euro	1.29	1.36	1.37	1.44	**1.39**	**1.34**	**1.36**
Oil Prices(dpb)	76.7	86.6	104.8	117.6	**111.1**	**94.0**	**102.5**

Source: BBVA Research

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