Economic Watch

US

Houston, June 8, 2012
Economic Analysis

US
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Monthly US Outlook

Weak Macroeconomic Data Preventing a Stronger Recovery

- Downward revision to 1Q12 GDP growth and weakening labor market conditions limiting economic optimism
- Increased uncertainty regarding financial stability in Europe and a Greek exit highlight the potential for second round effects
- Data released throughout the intermeeting period suggest a higher probability of more Fed action

The latest economic news have been somewhat discouraging, increasing uncertainty about the strength of the recovery in the coming months. Real GDP growth in 1Q12 was revised down to 1.9% QoQ annualized on a seasonally-adjusted basis from the first estimate of 2.2%, consistent with market expectations. The revision reflected a downward revision to personal consumption expenditures (PCE), marking a slightly smaller contribution of 1.9pp. However, modest increases in business confidence and continued expansion in manufacturing activity suggest reasonable GDP growth in 2Q12. We expect that growth will average around 2.3-2.4% QoQ SAAR during the second and third quarters, on average.

Nonresidential investment (NRI), which increased 9.7% on average in the previous two years, lost its momentum in 1Q12 by increasing only 1.9% SAAR. The main reason behind this slowdown is the decline in structures. Within structures, commercial, healthcare, and oil & gas well drilling and exploration were the main drags. The significant drop in natural gas prices could be the reason for the declines in exploration in the last two quarters. However, natural gas prices have increased from $1.83 to $2.40 (a 30% increase) since mid-April, a trend that would positively affect fixed investment in the sector. The government sector contributed -0.8pp to real GDP growth in 1Q12 and we expect this trend to continue throughout the year.

On the production side, industrial output does not show any slowdown in the current quarter. In the first quarter, industrial production increased only 0.2% MoM on average but soared 1.0% in April. Within industrial production, business equipment rose 1.5% and mining jumped 4.6%, indicating no signs of a slowdown. The ISM Manufacturing index declined slightly to 53.5 in May but new orders, a leading indicator for future economic growth, jumped to the highest level since April 2011. The ISM Services Index also increased slightly to 53.7 in the same period while new orders rose 2 points to 55.5. Of the four main sub-indices, only the employment index declined. In addition, real PCE in April increased 0.27% MoM, the second highest increase since September 2011. All these trends point to modest economic growth in 2Q12. However, recent developments in Europe and increasing fiscal uncertainty could jeopardize the sustainability of the recovery.

The most recent employment report for May reflected worse-than-expected labor market conditions for 2Q12. Nonfarm payrolls increased by only 69K, following downward revisions to both March (from 154K to 143K) and April (from 115K to 77K). The private sector added 82K jobs for the month, slightly less than April's gain of 87K, with most of the hiring concentrated in service providing industries (+97K) such as transportation and warehousing (+36K), education and health services (+46K), and wholesale trade (+16K). Construction payrolls fell for the fourth consecutive month by 28K, while employment in professional and business services was almost unchanged. Government payrolls declined by 13K, marking the biggest drop since November 2011

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As a consequence of the slowing employment gains in recent months, the unemployment rate increased by 0.1pp to 8.2% in May. The participation rate increased by 0.2pp to 63.8% and offset its decline in the previous month. The number of individuals unemployed for 27 weeks or more increased by 300K after declining for seven consecutive months. The data also indicate a rise in the number of workers employed part time for economic reasons. These "involuntary part-time workers" likely had difficulty finding a full-time job to match their skill set or were working part time because their hours had been cut back. All these details suggest that structural unemployment is still a concern. In general, May's employment report reflects slower job growth in 2Q12 compared to in 1Q12 when nonfarm payrolls increased by an average of 226K per month. Weak April and May payrolls could be due to the warmer-than-usual winter weather which may have shifted some of the usual spring gains to the earlier months. Therefore, June and July payroll data will be important to understand the real trend. We expect that payroll growth will gain momentum in 3Q11 but that labor market conditions will remain weak.

Another factor weighing on economic activity in the U.S. relates to the uncertain situation in Europe. The most recent developments have stemmed from the potential for a Greek exit from the Eurozone. The probability of a "Grexit" has increased as a result of the country's political stalemate following the May elections. The latest Bloomberg Global Survey indicates that almost 60% of the 1,253 respondents expect at least one country to leave the Euro by year end. Given the very fragmented political landscape in Greece, the risk of another divided parliament after the next election (June 17th) lingers. Against this backdrop, European authorities maintain their view that Greece must fulfill the agreed upon conditionality to remain in the Eurozone, with the possibility of an exit now openly recognized by officials. Consequently, the liquidity risk of the banking system in Greece has increased, with acceleration in deposit outflows. Furthermore, financial markets are also worried about Spain's financial condition. The fact that Spanish banks, particularly saving banks ("cajas"), may need between $49.4bn and $126bn, combined with high fiscal deficits in regional governments, will increase the severity of the problem.

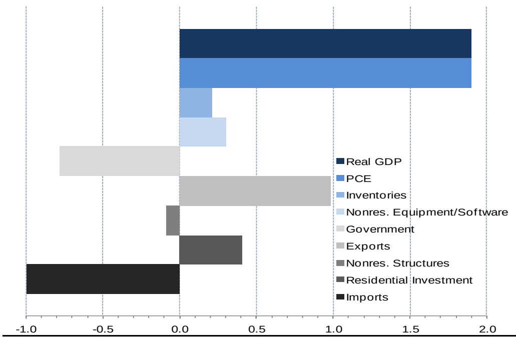
Contagion from deterioration in Europe is a concern in the U.S., with markets becoming more and more pessimistic about the future of the euro. Uncertain financial conditions in the region have caused some spillover in U.S. equity markets rather than in more traditional channels like international trade. The crisis continues to punish foreign banks and investors fly to safe instruments which push long-term rates lower. The 10-year Treasury securities yield declined below 1.5% on June 1st due to developments in Europe and eased somewhat with the improvement in the expectations. If risk aversion elevates again, yields could drop even further. While a break-up of the euro may cause a large economic crisis in Europe, the impact in the U.S. will be less severe. It is important to note that the impact can vary depending on European officials' responses, and we remain cautious in the near term as we await further developments. European Union officials will gather on June 28-29 to discuss possible strategies to ease the financial situation, particularly in Spain and Greece.

The latest FOMC statement and minutes had noted a slightly more centrist committee with lower probability of quantitative easing, though the data released throughout the intermeeting period may influence more immediate action. Leading up to the next meeting in June, markets are discussing whether the Fed will implement additional accommodative monetary policies as well as how Congress should handle the fiscal cliff and debt ceiling issues in order to revive economic activity in the short-term. The probability of extending Operation Twist, which expires this month, has increased significantly and QE remains an option, depending on whether the weak trends continue throughout the next few months. We believe that an extension of OT would have a small impact on the rates and economic activity but could be a tailwind to financial markets since the policy action would indicate that the Fed is ready to act whenever it is needed. Ultimately, the Fed stands ready to act if financial turmoil endangers the recovery.

In general, the latest data are moving in the opposite direction than what the Fed would like to see. Weak labor market indicators, contagion from the European sovereign debt crisis, the recent drop in consumer confidence, and the downward revision to 1Q12 economic growth could signal that the US economy is losing momentum. There are no signs of inflationary pressures in regards to the PCE deflator for April and average workweek hours for May. The sharp decline in oil prices created a downward bias for our headline inflation forecast which assumes Brent oil prices above $120pb in the next six months. In addition, current trends in medical care and shelter prices continue to present an upward bias for the core figure. Similar trends in the coming months could urge the Fed to act, but with 10-year rates at all-time lows, there will be difficulties in stimulating matters further unless the Fed gets creative.

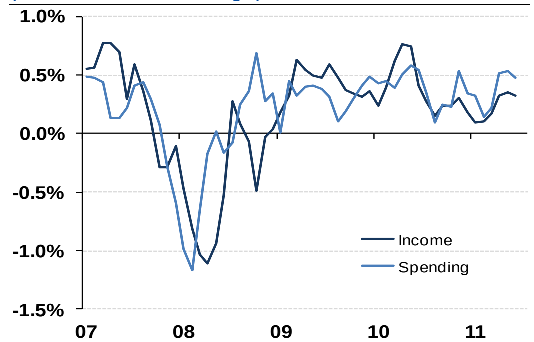
Economic Indicators

Graph 1
Contributions to Real GDP Growth
(1Q12 Advance, SAAR Percentage Points)



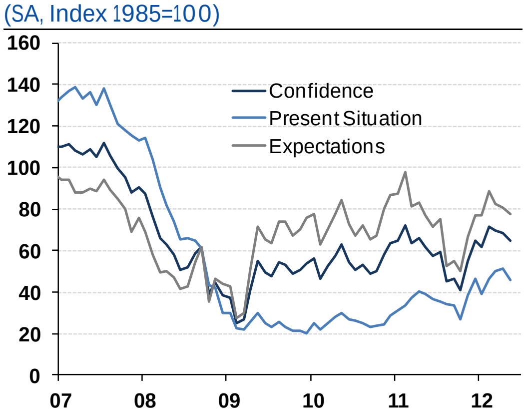
Source: BEA and BBVA Research

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



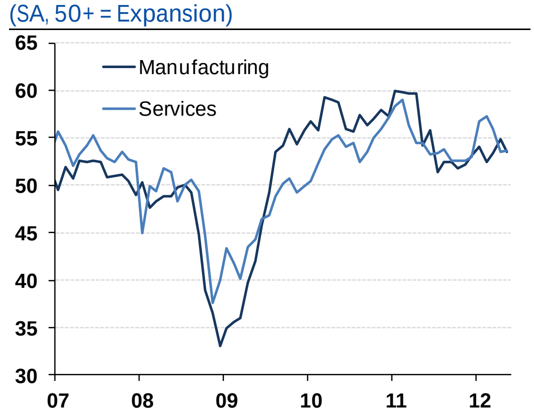
Source: BEA and BBVA Research

Graph 3
Consumer Confidence
(SA, Index 1985=100)



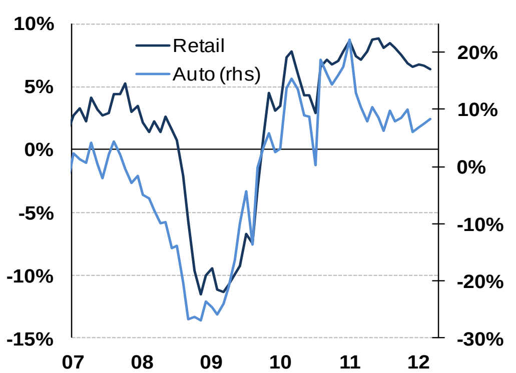
Source: Conference Board and BBVA Research

Graph 4
ISM Indices
(SA, 50+ = Expansion)



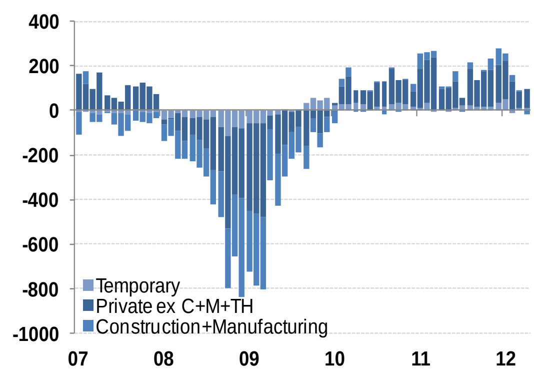
Source: ISM and BBVA Research

Graph 5
Retail and Atuto Sales
(YoY % Change)



Source: US Census Bureau and BBVA Research

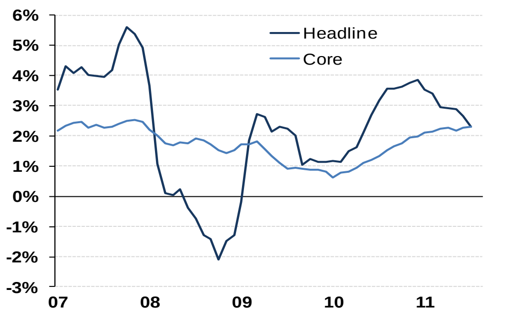
Graph 6
Private Nonfarm Payrolls
(Monthly Change in K)



Source: BLS and BBVA Research

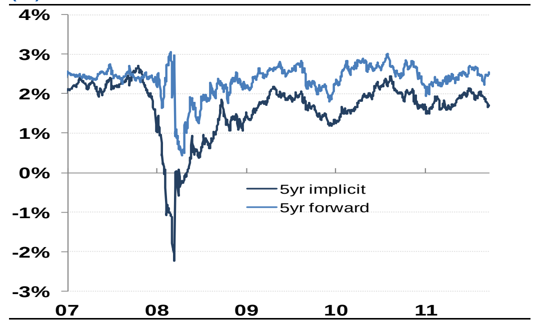
Economic Indicators

Graph 7
Consumer Price Index
(NSA, YoY % Change, 1982-84=100)



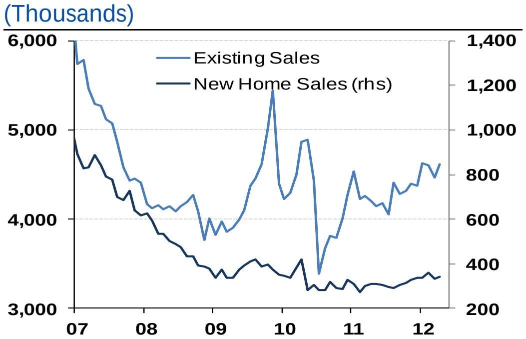
Source: BLS and BBVA Research

Graph 8
Inflation Expectations
(%)



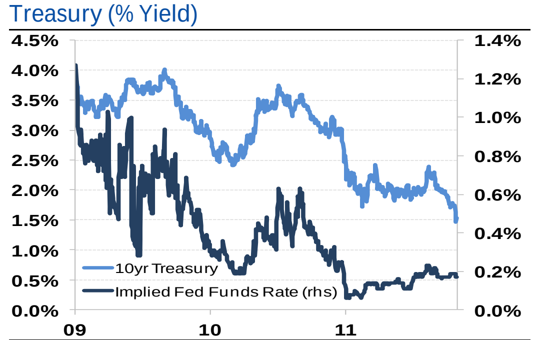
Source: Federal Reserve Board and BBVA Research

Graph 9
New and Existing Home Sales
(Thousands)



Source: US Census Bureau, NAR, and BBVA Research

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



Source: Federal Reserve Board and BBVA Research

Table 1
Forecasts (**BOLD=FORECASTS**)

	3Q11	4Q11	1Q12	2011	2012	2013
Real GDP (% SAAR)	1.8	3.0	1.9	1.7	**2.3**	**2.2**
Real GDP (Contribution, pp)						
PCE	1.2	1.5	1.9	1.5	**1.5**	**1.5**
Gross Investment	0.2	2.6	0.8	0.6	**1.2**	**0.8**
Non Residential	1.5	0.5	0.2	0.8	**0.8**	**0.8**
Residential	0.0	0.3	0.4	0.0	**0.3**	**0.2**
Exports	0.6	0.4	1.0	0.9	**0.8**	**0.9**
Imports	-0.2	-0.6	-1.1	-0.8	**-0.7**	**-1.0**
Government	0.0	-0.8	-0.8	-0.4	**-0.4**	**0.0**
Unemployment Rate (%)	9.1	8.7	8.3	9.0	**8.2**	**7.8**
Average Monthly Nonfarm Payroll (K)	128	164	226	153	**165**	**203**
CPI (YoY %)	3.8	3.3	2.8	3.2	**2.5**	**2.2**
Core CPI (YoY %)	1.9	2.2	2.2	1.7	**1.9**	**1.8**
Fiscal Balance (% GDP)	-	-	-	-8.7	**-7.6**	**-5.0**
Current Account (bop, % GDP)	-2.8	-3.2	-	-3.2	**-3.1**	**-3.3**
Fed Target Rate (%, eop)	0.25	0.25	0.25	0.25	**0.25**	**0.25**
S&P Case-Shiller Index	131.0	125.9	123.3	128.2	**124.8**	**124.2**
10-Yr Treasury (% Yield, eop)	2.0	2.0	2.2	2.0	**2.2**	**2.7**
U.S. Dollar / Euro (eop)	1.38	1.31	1.32	1.31	**1.25**	**1.31**
Oil Prices (dpb, average)	114.8	112.0	121.4	113.5	**120.4**	**106.6**

Source: BBVA Research