

Economic Watch

US

Houston, October 5, 2012
Economic Analysis

Monthly US Outlook QE3 Sets the Stage for the Recovery in 4Q12 and Beyond

US
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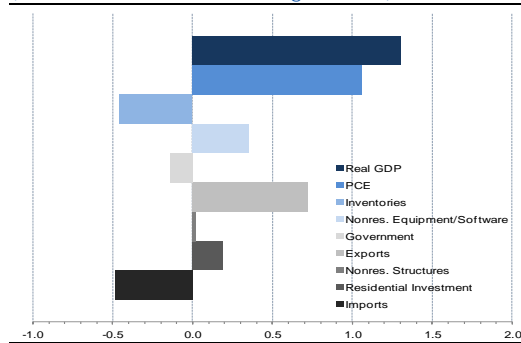
The economic mood is mixed as the end of 2012 quickly approaches. Despite the downward shift in GDP growth for 2Q12 (from 1.7% to 1.3%), we are still on track to reach our baseline scenario of 2.1% growth for the year. The outlook for GDP growth in 3Q12 is not so encouraging given weak production data and only a modest boost in consumer spending, so we could see growth just as slow as in the second quarter. August was an extremely weak month for output, with particular weakness in manufacturing, but we are beginning to see a more positive shift in business demand as we move into 4Q12. Even still, we expect real GDP growth to average near 1.4% for the third and fourth quarters. On the bright side, the employment report for September noted a significant boost in job growth for 3Q12 compared to 2Q12. Nonfarm payrolls increased a modest 114K, but revisions to the previous months were significant and enough to bring down the unemployment rate from 8.1% to 7.8%. The underlying factors were stronger than we have seen in past reports, in particular reflecting an increase in the labor force for the first time in three months. However, there is still the possibility that the unemployment rate will increase as people continue to enter or re-enter the labor force, particularly if payroll growth does not accelerate significantly. We expect that payroll growth will continue at a similar pace throughout the next few quarters, but there are no signs to suggest a significant boost in the numbers above 200K anytime soon.

Although recent macroeconomic data were not a dead giveaway for QE3, the Fed decided to move forward with additional easing in order to stimulate the economy. As expected, this round of quantitative easing will be slightly different than the previous two rounds, with plans to purchase \$40bn per month of mortgage-backed securities (MBS) on an open-ended basis (i.e. until we see substantial improvement in labor market conditions given that inflation is under control). The impact of QE3 is not expected to be significant, but in general the policy tool pushes long-term yields and inflation expectations higher, while lowering short-term yields and mortgage rates. The FOMC also decided to continue Operation Twist as scheduled through the end of the year. Overall, both policy accommodations will increase long-term securities holdings by about \$85bn per month until the end of 2012. In addition, the FOMC announced an extension of their policy guidance. The committee expects that "exceptionally low levels for the federal funds rate are likely to be warranted at least through mid-2015" rather than late-2014 as announced in the previous meeting. Ultimately, Bernanke made it clear the Fed's highly accommodative stance will be appropriate even as economic growth picks up. The FOMC is committed to promoting a stronger recovery and will be careful not to prematurely tighten monetary policy in order to give some time for the economy to show steady growth.

The FOMC announced a more positive outlook for 2013, not only reflecting the implications of further easing but also an improved outlook for Europe and for equity prices (as noted in the meeting minutes). However, while QE3 aims to contain downside risks, it cannot completely eliminate policy uncertainty and fragile expectations. The fiscal cliff is an unresolved issue that can significantly curb economic activity in 2013, but it will not be addressed in Congress until after the elections next month. Economic uncertainty will remain high throughout 4Q12 and for some time after until the recovery becomes more self-sustaining.

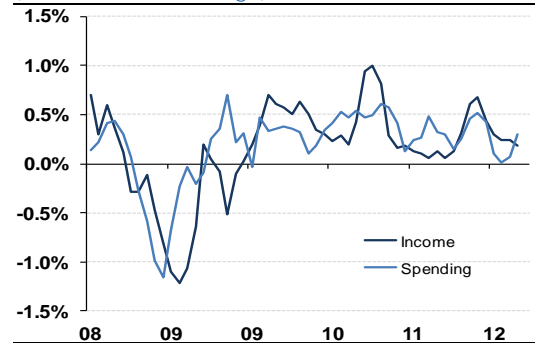
Economic Indicators

Graph 1
Contributions to Real GDP Growth
(2Q12 Final, SAAR Percentage Points)



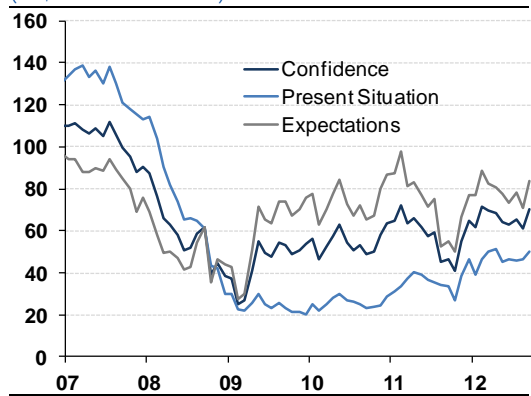
Source: BEA and BBVA Research

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



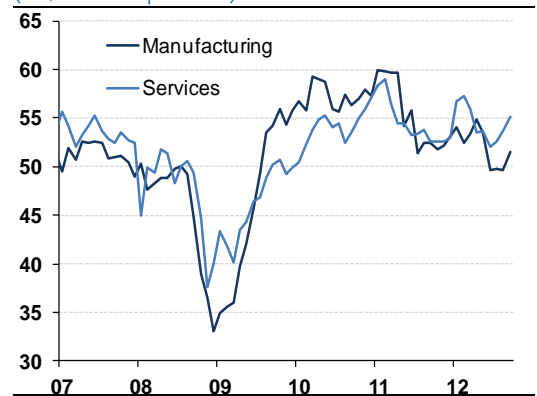
Source: BEA and BBVA Research

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



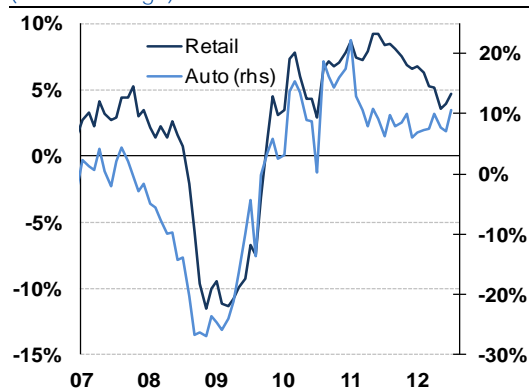
Source: Conference Board and BBVA Research

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



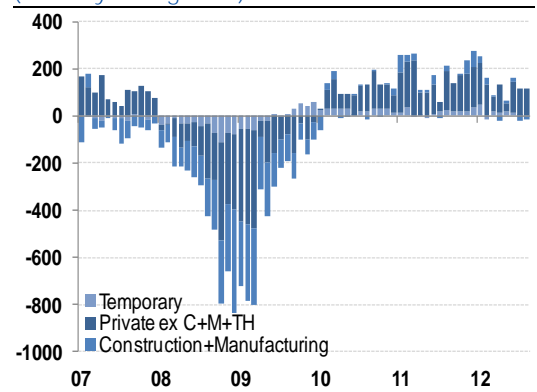
Source: ISM and BBVA Research

Graph 5
Retail and Auto Sales
(YoY % Change)



Source: US Census Bureau and BBVA Research

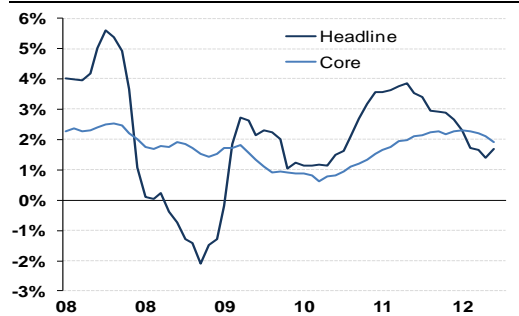
Graph 6
Private Nonfarm Payrolls
(Monthly Change in K)



Source: BLS and BBVA Research

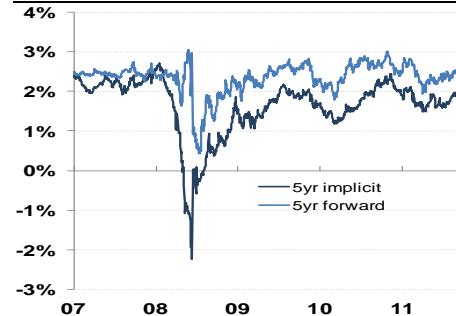
Economic Indicators

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



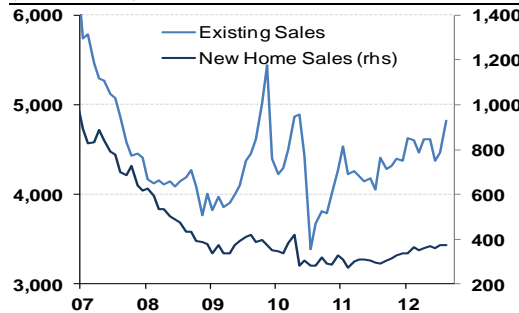
Source: BLS and BBVA Research

Graph 8
Inflation Expectations
(%)



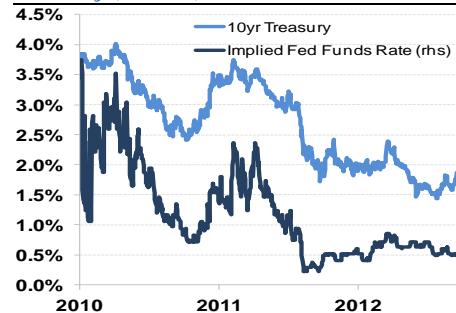
Source: Federal Reserve Board and BBVA Research

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)

| | 4Q11 | 1Q12 | 2Q12 | 2011 | 2012 | 2013 | 2014 | 2015 |
|-------------------------------------|-------|-------|-------|-------|-------|-------|-------|-------|
| Real GDP (% SAAR) | 4.1 | 2.0 | 1.3 | 1.8 | 2.1 | 1.8 | 2.3 | 2.5 |
| Real GDP (Contribution, pp) | | | | | | | | |
| PCE | 1.5 | 1.7 | 1.1 | 1.8 | 1.3 | 1.2 | 1.4 | 1.5 |
| Gross Investment | 3.7 | 0.8 | 0.1 | 0.6 | 1.3 | 0.7 | 0.9 | 0.9 |
| Non Residential | 0.9 | 0.7 | 0.4 | 0.8 | 0.9 | 0.6 | 0.8 | 0.9 |
| Residential | 0.3 | 0.4 | 0.2 | 0.0 | 0.3 | 0.2 | 0.2 | 0.2 |
| Exports | 0.2 | 0.6 | 0.7 | 0.9 | 0.5 | 0.7 | 1.0 | 1.1 |
| Imports | -0.9 | -0.5 | -0.5 | -0.8 | -0.6 | -0.8 | -1.2 | -1.3 |
| Government | -0.4 | -0.6 | -0.1 | -0.7 | -0.4 | 0.0 | 0.1 | 0.1 |
| Unemployment Rate (%) | 8.7 | 8.3 | 8.2 | 9.0 | 8.2 | 8.1 | 7.6 | 7.0 |
| Average Monthly Nonfarm Payroll (K) | 164 | 226 | 67 | 153 | 142 | 137 | 170 | 195 |
| CPI (YoY %) | 3.3 | 2.8 | 1.9 | 3.2 | 2.0 | 1.9 | 2.3 | 2.5 |
| Core CPI (YoY %) | 2.2 | 2.2 | 2.3 | 1.7 | 2.1 | 1.8 | 1.9 | 2.1 |
| Fiscal Balance (% GDP) | - | - | - | -8.7 | -7.7 | -5.0 | -3.2 | -2.8 |
| Current Account (bop, % GDP) | -3.1 | -3.5 | -3.0 | -3.1 | -3.0 | -3.1 | -3.5 | -3.7 |
| Fed Target Rate (% eop) | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.75 |
| S&P Case-Shiller Index (YoY %) | -3.9 | -1.9 | -0.8 | -4.4 | 0.7 | 3.3 | 3.3 | 3.2 |
| 10-Yr Treasury (% Yield, eop) | 2.0 | 2.2 | 1.6 | 2.0 | 1.9 | 2.6 | 3.0 | 3.3 |
| U.S. Dollar / Euro (eop) | 1.31 | 1.32 | 1.25 | 1.31 | 1.25 | 1.31 | 1.31 | 1.32 |
| Oil Prices (dcb, average) | 112.0 | 121.4 | 111.6 | 113.5 | 113.9 | 106.1 | 110.2 | 118.3 |

Source: BBVA Research

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