

Economic Outlook

United States

Fourth Quarter 2013
Economic Analysis

- Slow global growth on the back of policy risks in the U.S., Europe, and China
- Fiscal and monetary concerns in the U.S. overshadow growth prospects
- Minor changes to U.S. forecasts for the short-term, but expectations stable farther out in the horizon

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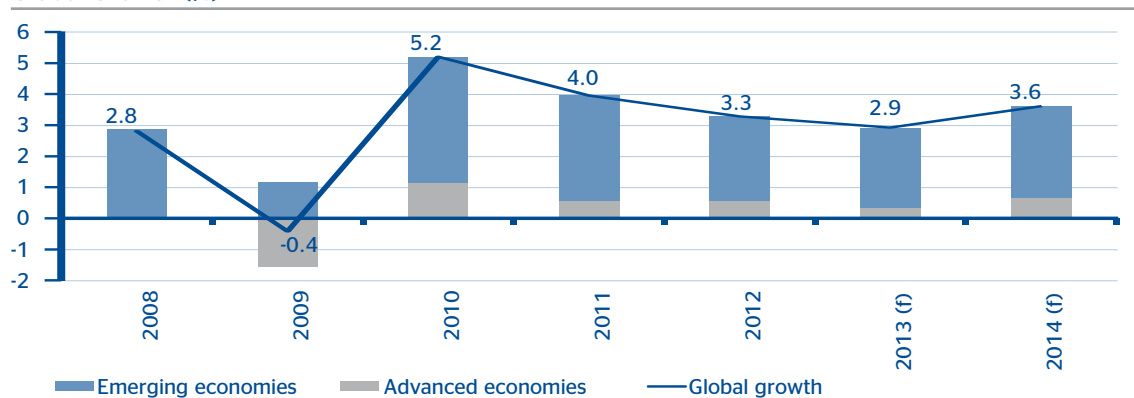
1. Global Outlook

A Slow Global Recovery with Downward Risks

The economic cycle is improving, above all in advanced economies, yet it is still far from a strong recovery. Two general features have characterized the global economic environment in the past quarter: financial markets and policy uncertainty. First, business confidence indicators and the reduced volatility of financial markets have continued to reflect the low probability of tail risk events that could be disruptive to the global outlook. With this in mind, the economic recovery looks to be on the upswing and there is less risk of it derailing. However, some events (i.e., the U.S. government shutdown and the tightening of global financial conditions due to the expected end of highly accommodative monetary policy) have had the opposite effect, contributing to a more feeble global recovery within a one or two-year horizon. Overall, we have revised down our expected growth forecast for the global economy by 0.2pp in both 2013 and 2014 to 2.9% and 3.6%, respectively. The revision of 2013 growth is due to weaker-than-expected figures recorded in the U.S. (prior to the advance 3Q13 GDP report) and the slowdown in parts of developing Asia. Emerging markets are mostly behind the downward revision for 2014 (except for China, where we maintain our forecasts from last quarter), although they will continue to be the biggest contributors to global growth (Chart 1). The higher rate of global growth in 2014 is backed by overall economic acceleration in all geographical areas, except for Asia, where growth is expected to increase at the same rate as in 2013. Particularly worth noting is the improvement expected in the Eurozone after two years of recession, and the significant acceleration in Latin America after a brief dip in 2013.

Chart 1

Global Growth (%)



Source: BBVA Research & IMF

Volatility and financial tensions have eased at a global level, particularly regarding emerging markets in Asia and Latin America, which are also affected by major capital flight. The first signs that the Fed would eventually end its monetary expansion program (with all the reservations and steadiness adopted) led to a major depreciation of emerging market currencies, as well as major capital flight. These financial tensions coincided with doubts about the performance of these economies during a slowdown that was becoming more evident. The severity of capital flight and the depreciation of currencies following expectations of imminent tapering raised fears of a “sudden stop” of emerging market funding and then a steep fall in economic activity. However, the sell-off process has been gradually losing intensity, and levels are far from the severity of capital outflows observed after the collapse of Lehman Brothers. At the same time, emerging markets show some indications of a recovery in confidence, after a check in the middle of the year. In any event, tapering will ultimately change the global scenario of liquidity injections that favored indiscriminate flows to emerging markets. The impact of tapering, once it is effectively

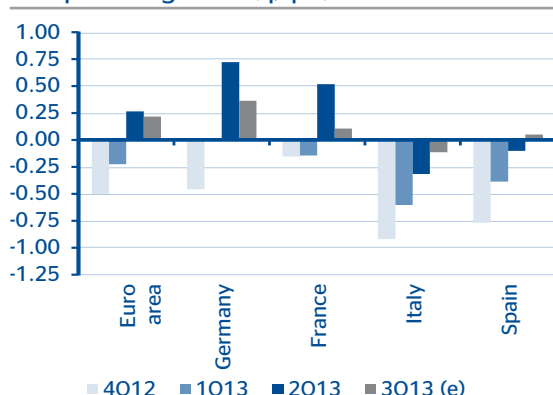
underway, will probably be a greater discrimination in flows toward emerging markets according to the individual fundamentals of each country (i.e., current-account deficit, foreign-currency debt levels, greater or lesser maturity of short-term debt, etc.). While we await this drawback in stimulus from the Fed, the extra time reduces the risk of a sudden fall in economic activity, at least in the short term.

In China, the doubts at the start of the year on the possibility of a sharp adjustment in its economy have also dissipated for the time being. Over the year, China's economy has maintained a high rate of growth, and the most recent data for the third quarter suggest a pickup in GDP. The better-than-expected figures in 2013 have influenced a slight upward revision to the annual growth outlook from 7.6% to 7.7%. Even so, doubts remain on the sustainability of growth in the medium and long term, as the recent upturn in growth has been the result of an improvement in foreign demand, but also of one-off measures of tax policy and public spending with a renewed use of credit. This suggests that vulnerabilities (i.e., intensive credit use, banking sector liberalization, regional finance, and opening of the services sector) are still not being fully addressed. The appropriate management of these aspects must ensure a steady transition involving a re-balancing of growth weighted more toward domestic demand and household consumption.

The perception on Europe has improved and the most extreme risks have dissipated. Our forecasts have been confirmed and the Eurozone emerged from the recession with 0.3% growth in the second quarter of 2013, after six quarters of contraction. Recent economic data suggest that the trend will continue in the third quarter, when the Eurozone will likely once again record a few tenths of a percentage point of positive growth. The reading of the data is positive in two respects. First, the recent upturn is based not only on foreign demand, but also on an improvement in domestic demand. Second, the improvement in activity is not only boosted by countries within the center of Europe (with Germany recording strong growth, but also France surprising to the upside recently), but also extends to the periphery (with Spain and Portugal emerging from recession, and Italy reducing its rate of decline), contributing (together with the progress made to improve governance and the reforms) to eliminate the systemic risks characterizing previous quarters. The recovery has been supported by reduced financial tensions in the area as well as a relaxation (de facto) of the more short-term targets of fiscal consolidation, implicitly tolerated by the European authorities. In general, we maintain our forecasts for Europe's GDP at -0.4% in 2013 and 1.1% in 2014. The weak recovery is consistent with the deleveraging process underway in the private sector in some economies in the area and the financial fragmentation that is still in place, which affects the capacity of bank credit supply. Monetary policy will continue to be loose, offsetting in part the continued negative effect on growth of fiscal policy. Additionally, the ECB has shown itself prepared to act if necessary, either with a new round of long-term liquidity for the banks, or even with another rate cut (which cannot be ruled out). At the same time, the next few months will be decisive in progress toward a banking union, with the entry into operation of a single supervisor (the ECB) and the definition of the mechanisms for bank resolution, the model for implementing which is still under discussion.

Chart 2

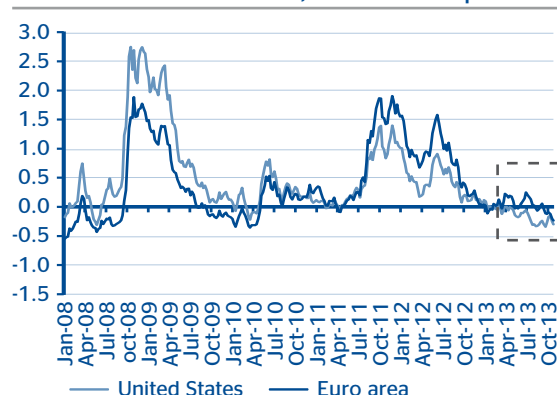
Europe: GDP growth (q/q %)



Source: BBVA Research & Haver Analytics

Chart 3

Financial Stress Indicator, U.S. and Europe



Source: BBVA Research

The risks to the moderate recovery scenario are lower compared to the previous quarter but are still biased to the downside. First, there remains the possibility of a “disorderly exit” from the Fed’s QE, which could generate an excessive increase in interest rates (in the U.S. and in other countries), not as a result of improved growth prospects or higher inflation, but due to uncertainty regarding the planned exit strategy. Financial conditions that are too tight for the rest of the world could terminate a global recovery if it is not especially dynamic, as it is particularly in the Eurozone. In addition, it is also worth noting as a risk the resolution of the fiscal questions in the U.S., the budget and the debt ceiling, which have now been postponed until the first quarter of 2014. The negotiations that the parties have to carry out until then are a potential source of uncertainty and may lead to an additional drag if the fiscal drain increases.

Second, it is worth identifying as a risk factor the possible adjustment in growth in China and in other emerging markets. This could be the result of idiosyncratic factors, but also of dilemmas to which domestic policies have to address in a more acute global financial environment. Although the differences between economies are relevant, an interruption in the recovery underway is not to be expected unless there are financial scenarios that are as adverse as those registered between the end of 2008 and 2009.

Lastly, the resurgence of the euro crisis is a globally relevant risk. The authorities have to support the positive perception of the markets with decisive progress to strengthen the monetary union (in particular, the banking union). However, some peripheral countries are lacking political consensus to check the necessary reforms, and negotiations on the programs in Portugal and Greece may be a source of uncertainty. In addition, work is soon to begin on the review of bank balance sheets and the stress test to risk scenarios needed for the implementation of the single banking supervisor. Finally, as has been shown by past experience, disagreements on the definition of policies that strengthen the euro area (in this case, bank resolution mechanisms) may produce tensions and volatility in the financial markets.

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

2. U.S. Outlook

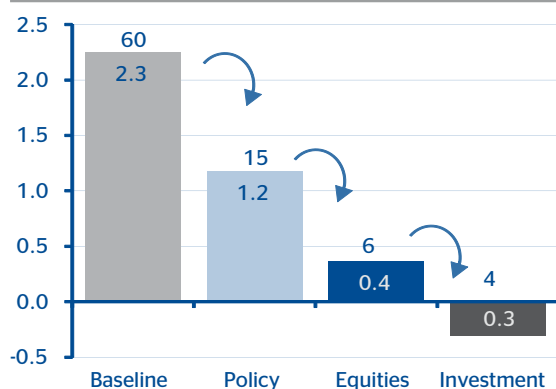
Temporary Headwinds Dampening Short-Term Expectations

The second half of 2013 has not turned out quite like we had expected a few months back. Transitioning from a relatively strong 2Q13, it seemed that economic activity was setting the stage for a brighter picture in 2H13. On the surface, this is exactly what happened: the advance estimate for 3Q13 real GDP growth came in at 2.8% on a QoQ seasonally-adjusted annualized basis, the fastest pace in four quarters. However, the underlying details tell a different story, in particular one dominated by waves of fiscal and monetary policy uncertainty, which could be constraining the recovery of nonresidential private investment.

The government shutdown has been the biggest headline thus far in 2013, with the 16-day impasse casting a gloomy cloud over the U.S. economy. While we do expect only a small impact to real GDP growth in 4Q13 (-0.2%), the repercussions are long-lasting. Congress agreed to a temporary fix, funding the government through January 15th and raising the debt ceiling through February 7th. Unfortunately, this pushes the fiscal risk further into 2014, where negotiations are not expected to play out any differently. Although the impact from policy uncertainty has been limited when it comes to equities and investment, the economy remains vulnerable and therefore susceptible to further downside risk. On a brighter note, the ongoing sequester has had less of an impact on growth than originally expected, and the U.S. is slowly moving toward short-term fiscal stability.

Chart 4

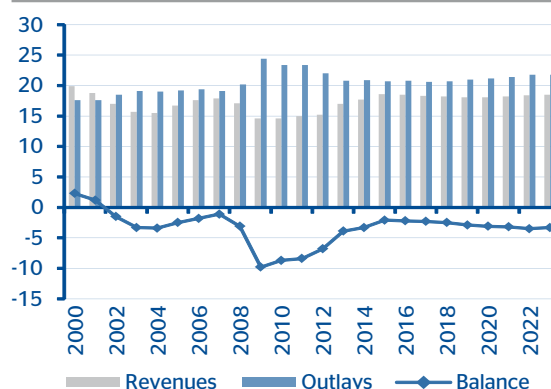
Risks to 2014 GDP Growth (% change and probability)



Source: BBVA Research

Chart 5

Fiscal Balance (% of GDP)



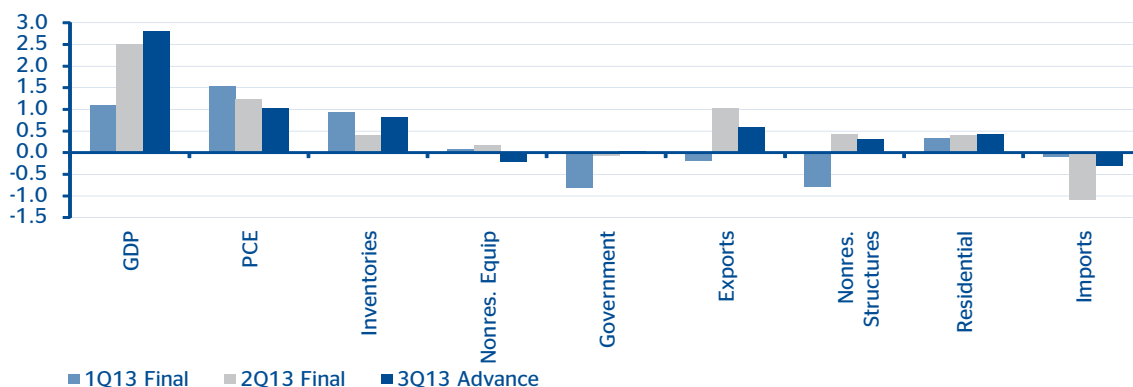
Source: BEA & BBVA Research

Aside from the direct impact of furloughing workers and closing down national parks and museums, the government shutdown also made it difficult to assess current economic trends, as various data releases were delayed. The postponed GDP report for 3Q13 was a positive surprise given that early indications of private consumption and investment weren't too encouraging. Following an average 1.8% growth in 1H13 (1.1% in 1Q13 and 2.5% in 2Q13), real GDP growth in the third quarter beat expectations at 2.8%. Most of this gain was due to continued strength in domestic investment, with residential holding steady just above 14% growth and nonresidential structures only slightly slower than 2Q13 at 12.3%. However, personal consumption growth decelerated to 1.5% from 1.8% in the second quarter. In addition, inventories, which increased at their fastest pace since 1Q12, added almost one full percentage point to GDP growth. A repeat of this trend in the fourth quarter is unlikely. Export and import growth also slowed in 3Q13, though the contribution from net exports was positive for the first time in three quarters on the back of ongoing declines in petroleum and products, which dropped to their lowest level since

1997, and slower imports of consumer goods (other than autos). Leading up to the imminent shutdown in October, government spending increased a mere 0.2% SAAR for the first time since 3Q12. On average, we expect growth to hold above 2.0% for 2H13, and we maintain our annual forecast at 1.6% for 2013.

Chart 6

Contributions to Real GDP Growth (SAAR Percentage Points)

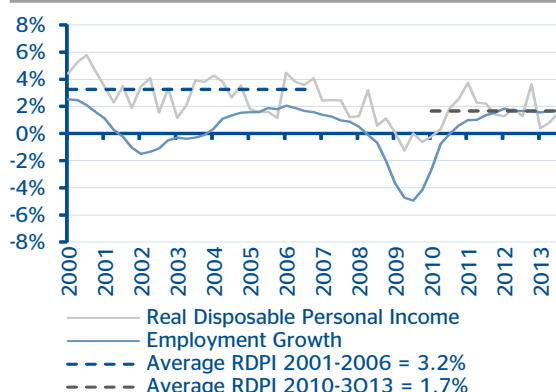


Source: BEA & BBVA Research

Taking a closer look at consumption, it is clear that individuals are still hesitant to spend. Real personal consumption growth has stabilized on a YoY basis near 2.0%, about on par with the pre-recession pace. However, the pace of disposable personal income growth, which fuels consumption, has averaged only half that compared to the 2001-2006 period. To fill the gap, consumers have relied on their savings, financial wealth gains and consumer credit. While this is not necessarily positive nor negative, a sustainable expansion of private consumption requires strong job and wage growth. However, while employment growth has recovered from the crisis, it shows no signs of significant acceleration. Meanwhile, real average weekly earnings increased 0.5% year-on-year in the third quarter, which was even weaker than the 0.8% gain in the previous period. This mainly reflects stagnant productivity growth, which averaged a modest 0.2% growth rate in 1H13, significantly lower than the 2.6% pace in the last decade. The deleveraging process has also slowed, with the debt-to-income ratio hitting a recovery low and pointing towards stronger household balance sheets in the coming years. Still, consumer confidence remains very low compared to the pre-crisis period, and therefore we expect that consumption growth will remain relatively flat throughout the next few years.

Chart 7

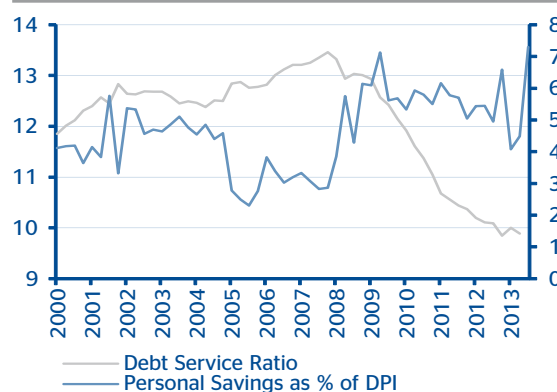
Employment and Real Disposable Personal Income Growth (YoY % Change)



Source: BLS, BEA, & BBVA Research

Chart 8

Debt-to-Income and Savings Rate (% of GDP)

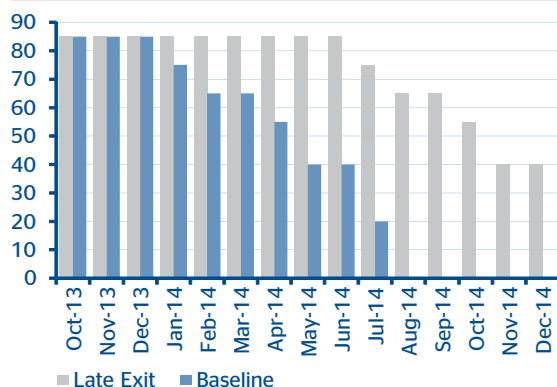


Source: BEA & BBVA Research

Congress has not been the only hiccup in Washington during the past few months. The Federal Reserve had been hinting at QE3 tapering for some time, with market reactions somewhat askew following Chairman Bernanke's press conference back in June. While many expected the first tapering announcement to come in September, including ourselves, the Fed held off on reducing asset purchases as they remained concerned over fiscal uncertainty and limited improvements in economic data. When the government shutdown led only to kicking the can further down the road, it seemed unlikely that the Fed would initiate tapering in 2013. While the latest data do suggest an improvement underway (i.e., the acceleration in GDP and employment growth), it is unclear whether the underlying trends are enough to convince the Fed to taper. Furthermore, inflation remains very low and has failed to pick up along with the economic recovery as expected. These trends ultimately support the continuation of QE3 at least for the time being. With Bernanke's term over in January, it is possible that he may want to start the tapering process as his last hurrah. However, as the strategy remains heavily data dependent, one discouraging economic report –particularly the next nonfarm payroll release– could turn the tables yet again. The good news is that Janet Yellen will be taking on the role as Fed Chair, at the least assuring continuity of the current monetary policy course set out by Bernanke which has held on the conservative side, accurately avoiding to fall captive to the fears spelled out by the inflation hawks. In addition, this strengthens the credibility of the Fed's forward guidance given that Yellen is a strong proponent of tying interest rate movements to certain economic thresholds. The Fed will need to decide what to do regarding their forward policy guidance. Currently, the threshold for the unemployment rate stands at 6.5%; however, this is not far from the current rate. Thus, if the Fed wants to guarantee that market expectations do not discount a rate hike before 2015, it may need to lower this threshold. Ultimately, our baseline scenario for the Fed Funds Rate remains unchanged, with the first rate hike expected no earlier than 2015.

Chart 9

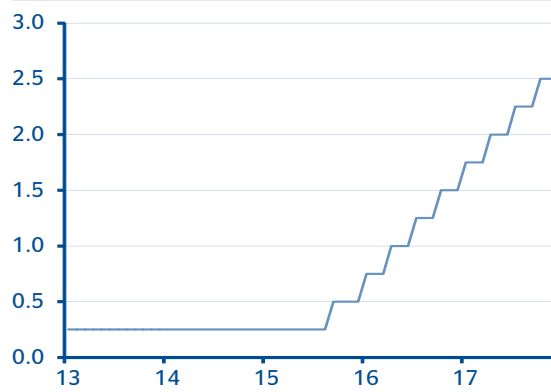
LSAP Scale-Down Path (USD Billion, monthly average)



Source: BBVA Research

Chart 10

Baseline Federal Funds Rate Forecast (%)



Source: BBVA Research

Despite all that has transpired throughout the past few months, our risk scenario remains unchanged. Domestically, fiscal concerns are heightened for the short-term but should dwindle as the next year progresses. A fiscal deal which continues to kick the can down the road but that funds the government for a few more months appears to be a positive step given current circumstances. On the monetary policy side, uncertainty regarding the Fed's tapering of QE3 leaves room for costly consequences of a growing balance sheet as well as a disorderly exit that disrupts markets. Fairly seldom interest rates move in an orderly manner when market expectations swing abruptly. If market participants are focused on a short-term outlook where there are two options –taper vs. no taper– then interest rates are likely to move briskly. A related concern is labor market weakness, but more on the structural side given the extent of long-term unemployment as well as continued declines in labor force participation. Globally, the risk of deterioration in Europe and emerging markets –particularly China– remains relevant. Nevertheless, it is important to point out that improving the confidence among households and businesses and the reduction in financial market stress depend on the appropriate implementation and coordination of various economic policies in the U.S. and abroad (particularly Europe and China).

3. Economic Forecasts

Table 1

	4Q12	1Q13	2Q13	3Q13	2011	2012	2013	2014	2015	2016
Real GDP (% SAAR)	0.1	1.1	2.5	2.8	1.8	2.8	1.6	2.3	2.5	2.8
Real GDP (Contribution, pp)										
PCE	1.1	1.5	1.2	1.0	1.7	1.5	1.2	1.1	1.2	1.2
Gross Investment	-0.4	0.7	1.4	1.5	0.7	1.4	0.7	1.0	0.9	1.1
Non Residential	1.1	-0.6	0.6	0.2	0.8	0.9	0.3	0.6	0.8	0.9
Residential	0.5	0.3	0.4	0.4	0.0	0.3	0.4	0.3	0.3	0.3
Exports	0.2	-0.2	1.0	0.6	0.9	0.5	0.3	0.7	0.9	0.8
Imports	0.5	-0.1	-1.1	-0.3	-0.8	-0.4	0.2	0.5	0.5	0.3
Government	-1.3	-0.8	-0.1	0.0	-0.7	-0.2	-0.4	0.0	0.0	0.0
Unemployment Rate (% average)	7.8	7.7	7.6	7.3	8.9	8.1	7.5	7.0	6.4	5.9
Average Monthly Nonfarm Payroll (K)	209	207	182	163	175	183	186	201	226	243
CPI (YoY %)	1.9	1.7	1.4	1.6	3.1	2.1	1.7	2.2	2.4	2.4
Core CPI (YoY %)	1.9	1.9	1.7	1.7	1.7	2.1	1.8	2.0	2.1	2.3
Fiscal Balance (% GDP)	-	-	-	-	-8.7	-6.8	-4.0	-3.4	-2.2	-2.4
Current Account (bop, % GDP)	-2.5	-2.5	-2.4	-	-3.0	-3.0	-2.7	-3.1	-2.9	-2.7
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 %)	7.30	10.11	10.01	-	-4.36	2.76	11.96	9.25	6.86	5.78
10-Yr Treasury (% Yield, eop)	1.72	1.96	2.30	2.81	1.98	1.72	3.00	3.35	3.64	4.03
U.S. Dollar / Euro (eop)	1.31	1.30	1.32	1.34	1.32	1.31	1.30	1.30	1.38	1.36
Brent Oil Prices (dps, average)	110.3	112.6	102.7	110.3	111.3	111.7	108.5	112.9	117.2	120.2

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

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