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Blame It On The Weather?

When explaining away a surprise in the economic data (a/k/a missed forecast), the weather makes the perfect scapegoat. First and foremost, it's always easy to craft a perfectly plausible story around whatever happens to be going on with the weather. For instance, it's: too cold/too hot/too rainy/too dry/too windy (pick one) to: buy clothes/buy a house/buy a car/build a house/build a factory/hire workers/fire workers (pick one). Go ahead, use all of the combinations provided in that last sentence, or add some of your own, and see how many misses, umm, surprises, you can explain away. Even better, the weather never talks back to refute whatever story you've concocted, which really seals the deal for the weather being the perfect scapegoat.

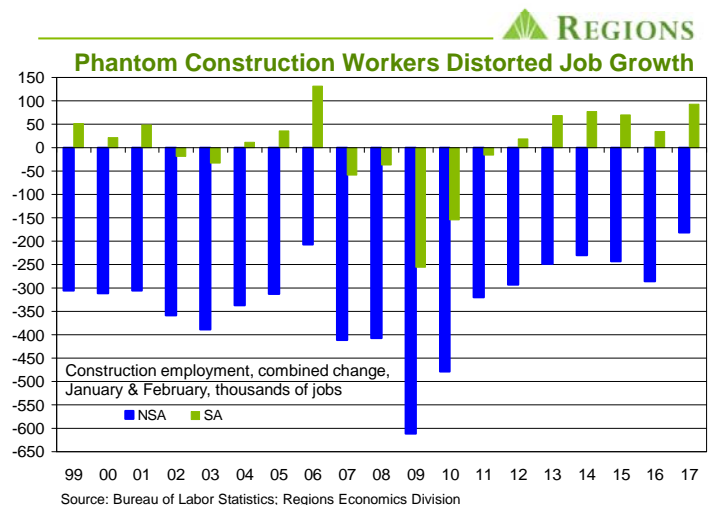
While it sometimes seems as though we economists are always trying to blame something on the weather, we do have at least a passing familiarity with normal seasonal weather patterns. The operative word being "normal." The economic data are, at least in most cases, adjusted to account for normal seasonal patterns in economic activity, many of which are driven by changes in the weather. The problem, in the case of the weather, is that the seasonal adjustments are based on the weather being "normal."

So, that it is cold in the winter, hot in the summer, or wet in the rainy season isn't exactly news, nor would anyone try to pin a surprise move in the data on normal weather patterns. When the weather does become an issue, however, is when it does not conform to normal seasonal patterns. For instance, think back to early 2014 when much harsher than normal winter weather – recall that vast swaths of the South were blanketed in ice for days – caused economic activity to virtually grind to a halt in many parts of the U.S. This was a primary factor in what was a contraction in real GDP in Q1 2014.

We bring this up because the weather is once again wreaking havoc with the economic data. Only this time it's not because this winter's weather was atypically harsh, but instead because it was so atypically mild. This winter's mild weather disrupted normal economic patterns and that has been apparent in the data on employment, residential construction, and consumer spending, just to name a few areas.

Perhaps the most glaring example of how this winter's mild weather has impacted the data is construction. Mild weather gave builders in many parts of the country the opportunity to pull construction activity forward earlier in the year than would have otherwise been the case. Keep in mind that over the past several months an atypically high share of new home sales have been accounted for by units on which construction had not yet started at the signing of the sales contract, and the mild winter weather offered a chance for builders to ease backlogs. Pulling construction forward in turn meant construction payrolls were higher than

would otherwise have been the case. The issue in the employment data is that the seasonal adjustment factors were geared for the normal, i.e., larger, declines that would have been seen in a typical winter. The following chart helps illustrate our point.



The chart shows the combined change in construction for the months of January and February, both not seasonally adjusted (blue bars) and seasonally adjusted (green bars). As seen in the chart, construction payrolls decline in the winter time but this pattern is accounted for in the seasonally adjusted data. So, while this winter saw the typical decline in construction payrolls, the milder winter meant that decline was smaller than normal. We looked at the data going back to 1990, and this year's combined decline of 181,000 jobs is the smallest of any year in this entire period. This translated into the seasonally adjusted data showing an increase of 93,000 construction jobs for the two-month period, which is the third largest such increase since 1990.

This reported boost in construction payrolls fed into the reported headline job gains of better than 200,000 jobs in both January and February. To be sure, we and many other analysts pointed out the distortions in the seasonally adjusted data, but to some extent this was dismissed as "here they go again," i.e., blaming the weather to explain away faster than expected job growth. If nothing else, the reported gains in construction payrolls should have raised a red flag given that for some time now builders have pointed to shortages of labor acting as a drag on construction activity. It would have been highly unlikely that those shortages would suddenly vanish at the start of this year. Moreover, the stepped-up hiring would have only been justified had there been a meaningful acceleration in the pace of construction activity, as opposed to a simple shift in the timing of construction activity. There was, however, no evidence of such a shift in the housing market data despite some shifts in the timing of housing starts.

This was a useful point to remember when setting expectations for the March employment report. After all, when atypical seasonal patterns lead to swings in the seasonally adjusted data in a given month, those swings will be reversed in subsequent months. This was the main reason expectations for the March employment report were fairly low. The March data show construction payrolls rose on a not seasonally adjusted basis, as is typical – 2009 is the only year since 1990 that unadjusted construction payrolls declined in March. But, this year's March increase was smaller than is typically the case. While this makes sense given the net decline for January/February was so small, it yielded an increase of just 6,000 construction jobs in the seasonally adjusted March data.

To be sure, the payback in construction payrolls in the seasonally adjusted data is not the only reason March's headline job growth number – a gain of 98,000 jobs – was even lower than expected. After what was an atypically mild winter, the March reference week (i.e., the week the BLS conducts its establishment survey from which the payroll employment data flow) coincided with, you guessed it, a severe winter storm across much of the Northeast. Maybe the weather can talk back after all?

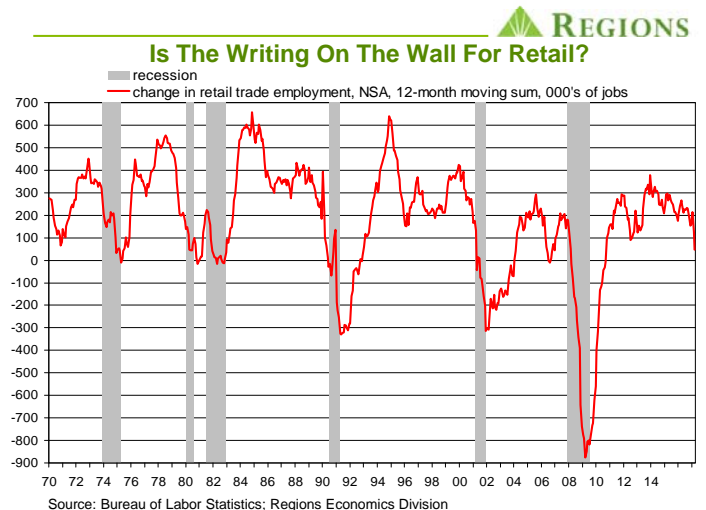
In any event, it is possible the winter storm held down job counts in wholesale trade, transportation, and distribution, all of which were notably soft in March (unlike the household survey and the ADP survey, in the BLS's establishment survey a person must be at work at some point during the survey week to be counted as employed). We'll have a better sense of that when the April report comes out – these sectors should show sizeable job gains in April if it was weather that held down job counts in March. Either way, the bigger effect of the late-winter storm was to hold down hours worked in March – the household data show 3.106 million people worked fewer hours than normal due to harsh weather, far and away the highest number for the month of March on record.

One eye-catching detail in the March report was the reported 30,000 job decline in retail trade payrolls, which was more than entirely accounted for by the reported 35,000 job decline amongst general merchandise retailers. No, we're not even going to try to pin this one on the weather, but it is possible this does reflect seasonal adjustment noise stemming from this year's late (mid-April) Easter. That the timing of Easter varies each year makes it inherently difficult to seasonally adjust data for those segments of the economy, such as retail sales and retail employment, that see stepped-up activity tied to Easter.

We do know that on a not seasonally adjusted basis, retail trade payrolls were up only trivially in March – excluding 2009, this year's March gain was the smallest since 2003. As noted above, this translated into a decline of 30,000 jobs in the seasonally adjusted data. Whether this is simply a timing issue tied to this year's late Easter is a question that can be resolved with the April data; if so, there should be a jump in both unadjusted and adjusted retail trade payrolls in the April data. We're not so sure, however, that this is the entire story here, or even most of the story. The real story may be far less benign and, unfortunately, it may only be in its early chapters.

It is by now a familiar story that the ascendance of online shopping is changing the retail landscape, with one consequence being fewer brick and mortar retail stores. Many retail chains have either

already begun to shutter physical stores or have announced plans to do so. Indeed, announcements by various national chains put the number of store closings in the months ahead at over 3,000, and clearly that means less hiring in the months ahead of those closings before large-scale job cuts as the closings occur.



The chart above shows the running 12-month change in retail trade employment on a not seasonally adjusted basis, which enables us to see the longer-term trends without having to worry about seasonal adjustment issues clouding the view. One thing that stands out in the chart is that the cyclical tops in hiring after the 2001 recession are significantly below the tops in earlier cycles. This corresponds with the rise of online shopping, which is still in its early phases. At the end of the 2001 recession, online sales accounted for just over six percent of total retail sales (or, retail sales excluding motor vehicles, gasoline, building materials, and restaurants), but that share is now just under 17 percent.

That helps account for payrolls in retail trade in March standing only 48,000 jobs higher than was the case a year ago, the smallest such change since September 2010, when the economy was still in the early phases of recovering from the 2007-09 recession. And, as you can see, the over-the-year changes are getting smaller and smaller. The above chart makes an odd backdrop for an economy in which consumer spending has been, and will remain, the main driver of growth. It is, however, hard to imagine a meaningful reversal in the trend shown in the chart, and the increasing prominence of online shopping is only one factor. Rising labor costs biting into already thin margins are likely playing a part in fading retail payrolls. Additionally, shifts in consumer spending patterns have seen spending on services account for a larger share of overall consumer spending, as opposed to spending on goods, which again points to less of a need for physical stores and employees to occupy them.

Whether or not the reported 30,000 decline in retail trade payrolls in the March employment report is a reflection of the seismic shift in the retail landscape remains to be seen. We do think there is a good deal of noise in that March number, but, either way, it got our attention. We think it is worth keeping in mind that retail trade is likely to be a persistent drag on overall job growth over coming

quarters even as consumer spending continues to be a key driver of overall economic growth.

Another hard to ignore detail from the March employment report is the decline in the unemployment rate which, at 4.5 percent, is at its lowest point since May 2007. Perhaps more significantly, at 4.5 percent the unemployment rate now stands below the FOMC's estimate of the "non-accelerating inflation rate of unemployment," or, Nairu. In theory, an unemployment rate persistently below Nairu would result in accelerating wage growth and, in turn, inflation. So, with the unemployment rate now below the FOMC's estimate of Nairu, per the metrics released in conjunction with the March FOMC meeting, the question is how the FOMC will respond.

If Committee members truly believe the economy is at, if not beyond, full employment and the result will be accelerating wage growth and price inflation, they could decide to step up the pace at which they raise the Fed funds rate. Recall the "dot plot" released in conjunction with the March FOMC meeting implied two additional 25-basis point hikes this year beyond the like-sized hike they implemented in March. Alternatively, the FOMC could decide to raise the bar, by lowering their estimate of Nairu, which they could do in the next round of their economic projections that will be released in conjunction with the June FOMC meeting. This isn't out of the question, and indeed estimates of Nairu, the FOMC's or anyone else's, are not set in stone and do vary over time.

For now, though, the FOMC is likely to do nothing, other than to watch and wait. For openers, the household survey data from which the unemployment rate is derived are notoriously volatile. The measure of household employment increased by over 900,000 persons for February and March combined, easily outstripping growth in the labor force over the same period, but it is highly unlikely this pace will be sustained over coming months.

It is also the case that while year-on-year growth in average hourly earnings has picked up, at 2.7 percent that growth is nonetheless well below the rate that would correspond to full employment. Clearly there is going to be a lag between the unemployment rate falling below Nairu and wage growth kicking into a faster gear, but should wage growth continue to accelerate at the halting pace seen to date, the FOMC would be less likely to feel the need to preemptively step up the pace of funds rate hikes.

Our view, which we have expressed on numerous occasions, is that there is considerably more labor market slack than is implied by the headline unemployment rate. That slack takes the form of still elevated numbers of underutilized labor resources (or, those either unemployed, underemployed, or marginally attached to the labor force) and also can be seen in what is a notably short average workweek. Even accounting for any weather related noise that held the average workweek at 34.3 hours in March, the workweek is still well short of where it would be in a labor market that was running hot.

This is, in our view, an overlooked and underappreciated form of labor market slack. But, the short workweek means firms can utilize existing workers more intensively before having to take on additional workers, which in turn helps blunt any upward pressure on wages. And, in the "for what it's worth" category, the whole discussion of wage growth and inflation pressures in the broader economy is only relevant in the context of the trend rate of

productivity growth, even if this is a distinction many analysts consistently fail to make.

At present, with a trend rate of productivity growth below 1.0 percent, there is a stronger link between wage growth and inflation pressures in the broader economy. To the extent productivity growth picks up over coming quarters, which is a possible outcome of a properly designed changes to tax and regulatory policy, then there is more of a buffer between wage growth and price inflation. For now, though, we do not feel there is a compelling case for the FOMC to alter the pace at which they anticipate raising the funds rate on the basis of the 4.5 percent unemployment rate reported in the March data.

FOMC Watching Stock Prices Too?

As if keeping an eye on unemployment, wages, and prices isn't enough, the FOMC seems to also be paying considerable attention to stock prices. And, no, we don't mean in the form of them sitting at their desks all day long running a program that gives them real time updates of stock prices so they can stare at their computer monitors and get second by second calculations of their net worth. Not that we know anyone who does that. Anyway, stock prices, and to a lesser extent prices of risk assets in general, are turning up more often in public comments by FOMC members, and also made an appearance in the minutes to the March FOMC meeting.

According to those minutes, "some participants viewed equity prices as quite high relative to standard valuation measures." The issue isn't whether or not FOMC members feel stock prices are too high, and we don't for a minute believe we're about to get a warning about "irrational exuberance" or anything along those lines. Instead, at least some FOMC members are concerned that rising equity prices may, at some point, trigger behavior that could cause broader economic growth and/or inflation to accelerate, which the FOMC would have to respond to. Moreover, equity prices are one component of various measures of financial conditions, such as the Goldman Sachs Financial Conditions Index or the St. Louis Fed Financial Stress Index. These and other measures show financial conditions easing despite the FOMC having delivered two Fed funds rate hikes in the past four months.

In her post-meeting press conference on March 15, Fed Chairwoman Yellen noted "the higher level of stock prices is one factor that looks like it's likely to somewhat boost consumption spending." The contribution of rising equity prices to the easing in financial conditions was also noted in the minutes to the March FOMC meeting, with an observation that prices of other risk assets had "risen significantly" in recent months. New York Fed President William Dudley – who while at Goldman Sachs was instrumental in developing their Financial Conditions Index – devoted his March 30 speech to a discussion of the implications of financial conditions for monetary policy, in which he noted that "animal spirits in financial markets wax and wane, pushing asset values up or down in a manner that can more than offset the effects of movements in short-term interest rates."

Clearly, the run-up in prices of equities and other risk assets over recent months, which came on top of already sizeable increases for many such assets, has the attention of the FOMC. One potential consequence is that if asset prices continue to rise at rapid rates,

it could lead at least some FOMC members to reevaluate what they consider the appropriate pace of policy firming, i.e., the appropriate pace of Fed funds rate hikes. In other words, some Committee members may conclude subsequent funds rate hikes need to come at a faster pace.

There are two main reasons the FOMC would be concerned over rapid increases in asset prices. One reason is concern over asset price bubbles that will at some point burst, and the bursting of asset price bubbles is clearly disruptive to global financial markets and the broader economy. One has to possess an awfully short memory to not understand why this would be a concern to the FOMC. What is far less clear, however, is what the FOMC can, and should, do if they feel asset price bubbles are forming.

There is little consensus on this issue, either inside or outside the FOMC. Many, us included, would argue that raising interest rates in an attempt to prick any such bubbles would not be an effective policy response; at the very least the magnitude of the increase in interest rates necessary to prick asset price bubbles would have significant adverse effects on the broader economy, including potentially tipping it into recession.

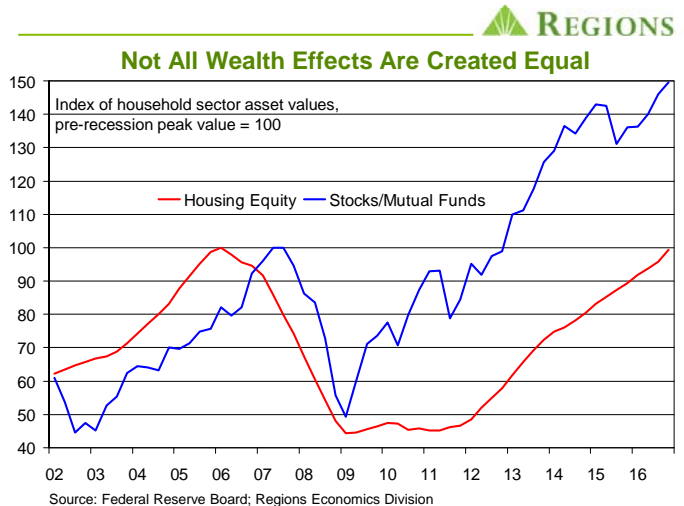
There are other options available to the FOMC, such as using its regulatory tools, including oversight of capital holdings and policies aimed at reducing leverage, and the FOMC could also become far more vocal in expressing their concerns about asset prices and the potential adverse implications of asset price bubbles. The main problem, however, with this line of attack is that in any policy approach that does not involve raising interest rates, the Fed has a very limited reach outside the banking system, with little regulatory capacity to rein in activity amongst non-bank lenders.

We don't, however, believe asset price bubbles are the most immediate concern of the FOMC. Instead, public comments on the topic of asset prices have been more focused on channels through which rising asset prices can feed back to the pace of activity in the broader economy, i.e., the rates of economic growth and inflation. Go back to the above quote from Chairwoman Yellen regarding the impact of stock prices on consumer spending. It is true that many FOMC members express their concerns in terms of broader financial conditions, but rising equity prices have been the key driver of more accommodative financial conditions.

To the extent FOMC members believe that further increases in equity prices will spark faster growth in consumer spending, i.e., the wealth effect, it follows they would be concerned that this faster pace of growth in consumption spending would spark a faster rate of inflation, to which the proper response would be a faster pace of Fed funds rate hikes. It is worth noting that concerns along these lines are more relevant at present than has been the case over the past several years, at least to the extent one believes the economy has absorbed most, if not all, of the significant degree of slack that has been present in the economy since the end of the 2007-09 recession. The implication is there is less capacity for the economy to absorb faster growth in demand and, as such, there will be more of a price response than has been the case over the past several years.

If this is indeed the main concern, we don't see it as nearly as pressing concern as at least some FOMC members seem to. We've discussed the topic of the wealth effect on many occasions,

including our findings that wealth effects from rising equity prices are notably small and not nearly as significant as wealth effects stemming from rising owner equity in residential real estate. One reason is that direct stock holdings are much more concentrated than homeownership, but in general rising housing equity has tended to spark faster spending amongst a wider segment of the economy than have rising stock prices.



There is little empirical evidence that the sustained run-up in equity prices seen in the above chart has spawned meaningful wealth effects. At the same time, housing equity has yet to return to its prior cyclical peak and, even though the Q1 2017 data will almost surely show it has done so, we have yet to observe any meaningful return to housing equity being extracted to finance consumption spending. Additionally, if the FOMC were indeed to shift into a faster pace of rate hikes out of concern over the impact of rising equity prices, that would no doubt curb subsequent growth in housing equity in addition to having other adverse effects on the housing market. Thus far, equity markets have taken the FOMC's rate hikes in stride, probably because the FOMC has stressed that subsequent hikes will come at only a gradual pace. If the FOMC messaged a faster pace of rate hikes, it would likely be disruptive to equity markets, but at some point the FOMC would have to follow through with action, which gets us back to the potential adverse impacts on the broader economy.

It could be that FOMC members are more sensitive to rising equity prices, and by extension further easing in financial conditions, given the possibility that the Administration and Congress will come together on fiscal policy and that, as a result, fiscal policy will be more expansionary. Again, with many FOMC members convinced the economy is closing in on full employment, it is easy to see why this would lead them to be worried about accelerating inflation. We'll go back to a point we've made before, and that is any changes to fiscal, and regulatory, policy should be centered on unleashing what we believe is still a high degree of unused productive capacity, which would basically negate any inflation pressures. If, however, policy changes do nothing but bring a burst in growth of aggregate demand, inflation becomes a more pressing concern. We think that if the FOMC does ultimately shift to a more aggressive course of Fed funds rate hikes, this will be the grounds on which they make that decision, not on the basis of how fast or how high equity prices are rising.

ECONOMIC OUTLOOK



April 2017

Q3 '16 (a)	Q4 '16 (a)	Q1 '17 (f)	Q2 '17 (f)	Q3 '17 (f)	Q4 '17 (f)	Q1 '18 (f)	Q2 '18 (f)		2015 (a)	2016 (a)	2017 (f)	2018 (f)
3.5	2.1	1.1	3.2	2.5	2.5	2.6	2.1	Real GDP ¹	2.6	1.6	2.3	2.4
3.0	3.5	1.0	2.8	2.6	2.7	2.6	2.1	Real Personal Consumption ¹	3.2	2.7	2.6	2.4
								Business Fixed Investment:				
-1.4	1.7	4.1	4.0	3.7	3.4	4.1	3.5	Equipment, Software, & IP ¹	4.0	0.0	2.7	3.6
12.0	-1.9	3.5	2.6	2.2	2.5	2.3	2.9	Structures ¹	-4.4	-2.9	2.7	2.6
-4.1	9.6	9.7	9.3	4.6	5.8	6.4	5.9	Residential Fixed Investment ¹	11.7	4.9	5.8	6.1
0.8	0.2	0.7	0.9	0.4	0.9	0.7	0.8	Government Expenditures ¹	1.8	0.8	0.5	0.8
-522.3	-605.0	-608.7	-608.7	-611.0	-615.1	-620.1	-628.5	Net Exports ²	-540.0	-563.0	-610.9	-633.4
1.145	1.248	1.253	1.233	1.228	1.255	1.275	1.300	Housing Starts, millions of units ³	1.108	1.176	1.242	1.319
17.5	18.0	17.2	17.0	17.0	17.1	17.1	16.8	Vehicle Sales, millions of units ³	17.4	17.5	17.1	16.8
4.9	4.7	4.7	4.6	4.6	4.5	4.5	4.4	Unemployment Rate, % ⁴	5.3	4.9	4.6	4.4
1.8	1.6	1.6	1.6	1.4	1.4	1.3	1.2	Non-Farm Employment ⁵	2.1	1.8	1.5	1.2
1.3	1.6	2.1	2.1	2.2	2.1	1.9	1.9	GDP Price Index ⁵	1.1	1.3	2.1	2.0
1.0	1.4	2.1	2.0	2.1	2.1	1.9	2.0	PCE Deflator ⁵	0.3	1.1	2.1	2.0
1.1	1.8	2.6	2.6	2.7	2.5	2.3	2.3	Consumer Price Index ⁵	0.1	1.3	2.6	2.3
1.7	1.7	1.8	1.9	2.0	2.2	2.1	2.1	Core PCE Deflator ⁵	1.4	1.7	2.0	2.1
2.2	2.2	2.2	2.2	2.3	2.3	2.3	2.3	Core Consumer Price Index ⁵	1.8	2.2	2.2	2.3
0.38	0.42	0.68	0.92	1.15	1.38	1.42	1.67	Fed Funds Target Rate, % ⁴	0.14	0.39	1.03	1.72
1.56	2.13	2.45	2.40	2.50	2.55	2.60	2.70	10-Year Treasury Note Yield, % ⁴	2.14	1.84	2.48	2.75
3.45	3.84	4.17	4.25	4.31	4.40	4.48	4.56	30-Year Fixed Mortgage, % ⁴	3.85	3.65	4.28	4.60
-2.4	-2.4	-2.6	-2.7	-2.9	-3.0	-3.0	-3.2	Current Account, % of GDP	-2.6	-2.6	-2.8	-3.2

a = actual; f = forecast; p = preliminary

- Notes:
- 1 - annualized percentage change
 - 2 - chained 2009 \$ billions
 - 3 - annualized rate
 - 4 - quarterly average
 - 5 - year-over-year percentage change