ECONOMIC OUTLOOK
REGIONS
June 2016

Statistical Noise, Or Something More Ominous?

The shockingly weak May employment report has cast a large, dark shadow over the economic landscape. Total nonfarm payrolls rose by just 38,000 jobs in May, more than 100,000 jobs below the consensus estimate. Even allowing for the impact of striking Verizon workers, which led to a 37,200 job decline in telecommunications payrolls, we're still left with a puzzlingly weak number (those telecommunications jobs will be added back in June with the strike having been settled). Moreover, prior estimates of job growth for March and April were knocked down by a net 59,000 jobs for the two-month period. Even the decline in the unemployment rate to 4.7 percent, the lowest since November 2007, isn't something to celebrate, as it is the result of a sharp decline in the size of the labor force.

As you might imagine, the May employment report left analysts, market participants, and likely more than a few people employed by a certain central bank scrambling for an explanation. Indeed, having done this more years than we'd care to admit and having scoured through the details of more economic releases than we'd care to even try to count, we can think of few, if any, instances in which we've been so confounded by a single data release. Thus far, we've heard and read many explanations, some more plausible than others, while some are, well, let's say delusional – apparently, no matter who you support in the Presidential election, you can spin the May employment report into an argument that your gal or guy is the only one who can fix this. In every such instance, however, we find the fix far more frightening than whatever "this" is. Okay, we won't go any further down that road here. Promise.

The reality is that it will take more time, and more data, in order to put the May employment report in its proper context. Not everyone, however, has the luxury of time. After all, firms have decisions to make, market participants have trades to make, central bankers have policy decisions to make, and, though perhaps nothing more than an occupational hazard, forecasters have forecasts to make. As such, we can point to a few factors behind the May employment report, some fairly benign, others far less so.

For openers, the response rate to the May establishment survey was well below the average for the month of May over recent years. This raises the possibility of sizeable revisions as the BLS backfills the initial May estimate with more complete survey data. Second, as we have discussed over the past few months, there has been a considerable volume of seasonal adjustment noise in the employment data over the course of 2016. That noise was artificially inflating reported seasonally adjusted job gains in Q1 of this year. But, as is always the case when a given data series is impacted by seasonal adjustment noise in one or more months, there will be payback in subsequent months. We believe that, at least to some extent, the weaker job growth numbers seen in April and May reflect such payback. There is evidence of seasonal adjustment noise in construction, retail trade, and, to a lesser degree, leisure & hospitality services.

For instance, in our regular write-ups of the monthly employment reports we have noted that unseasonably warm weather during the winter months caused more construction activity to be pulled forward earlier in the year than is typically the case. One implication is construction payrolls were higher during Q1 than would have otherwise been the case. With seasonal adjustment factors designed to compensate for declines in construction activity and employment during the winter months, the seasonally adjusted data exaggerated the effects of higher than normal winter activity. It followed that, with activity having pulled forward into the winter months, there would be less of a "bounce" in the spring than is typically the case.

So, even though not seasonally adjusted construction payrolls increased by 340,000 jobs in April and May combined, hiring in each month was less than normal. As such, the seasonally adjusted data show a net <u>loss</u> of 20,000 jobs for the two-month period. What gets lost in the shuffle, however, is that the level of construction employment as of May is, after all of the seasonal distortions, pretty much in line with where it would be in a typical year, but it is the (distorted) month-to-month changes in the seasonally adjusted data that capture most of the attention.

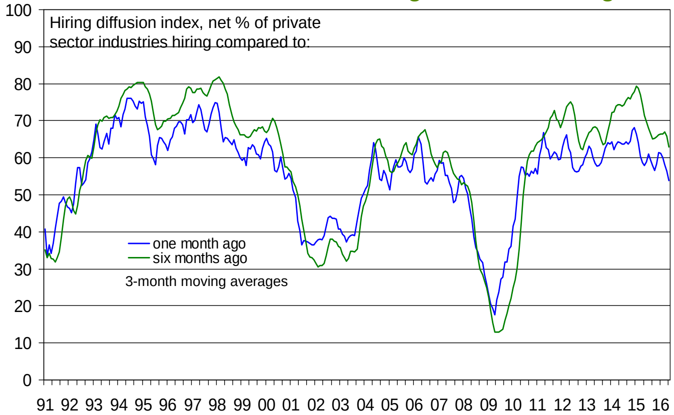
We have no doubt the low response rate to the May establishment survey and seasonal adjustment issues contributed to the weakness apparent in the May employment report. At the same time, however, one would be wise to not totally dismiss the May report as mere statistical noise, as there are other, less benign, signals being sent by the underlying data. For instance, the breadth of hiring across private sector industry groups has significantly narrowed over the past two months. In May, the one-month hiring diffusion index, or, the net percentage of private sector industry groups adding jobs in May, fell to 51.3 percent. This marks the lowest value of the index since February 2010 or, in other words, as private sector employment was only starting to rebound after the sharp contraction during and in the wake of the 2007-09 recession. Similarly, the six-month hiring diffusion index (the net percentage of private sector industry groups hiring relative to six months ago) has also fallen of late and now stands at its lowest level since June 2010.

One caveat we will offer, however, is that the same seasonal adjustment noise we believe to have contributed to the slower pace of job growth reported over the past two months will have also impacted the hiring diffusion index. In other words, to the extent seasonal adjustment noise has artificially repressed

Regions Financial Corporation, 1900 5th Avenue North, 17th Floor, Birmingham, Alabama 35203
Richard F. Moody, Chief Economist • 205.264.7545 • richard.moody@regions.com

reported hiring over the past two months, it will have also led to the readings on the hiring diffusion index being similarly repressed. That said, this is clearly worth watching over coming months, as the hiring diffusion index slipping below 50.0 percent on a sustained basis is, as one would expect, not seen outside of recession. The chart below shows the hiring diffusion index on both a one-month and six-months ago basis and, as seen, the index has been trending in the wrong direction for the past several months now.

Diminished Breadth Of Hiring Worth Watching



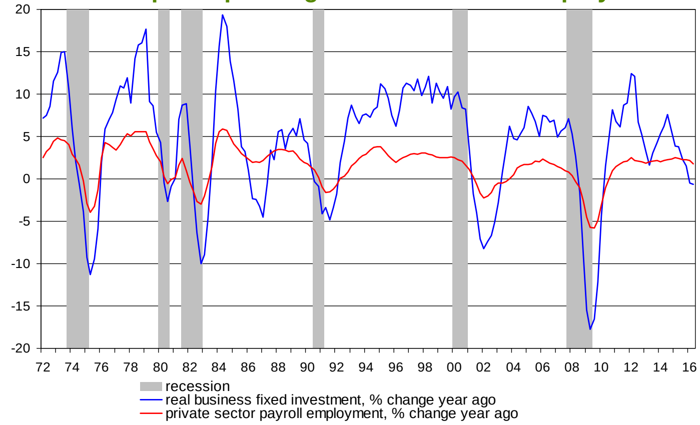
Source: Bureau of Labor Statistics; Regions Economics Division

Another potentially ominous signal from the May employment report is the direction of the revisions to prior estimates of monthly job gains. As noted above, the net revision to prior estimates of job growth in March and April was a negative 59,000 jobs. As a general rule, the direction of revisions tends to be consistent with the direction of the broader economy, and we like to track the rolling 12-month sum of those revisions as an indicator of general trends. What we have seen is that over the past several months the 12-month sum of revisions to estimates of monthly job growth have gone from significantly positive – the 12-month sum stood at over 400,000 jobs, to the upside, at year-end 2014 but has since then steadily fallen, reaching a negative 15,000 jobs as of May. To be sure, this is a small negative and could simply reflect some of the noise we believe to be present in the data. But, should net revisions continue to be negative over coming months that would be a telling, and disturbing, sign for the broader economy.

To the extent these troubling elements of the May employment report reflect something more fundamental, rather than being mere statistical noise, they could be signs of stress in the corporate sector. More specifically, it could be that the sharp deceleration in the rate of job growth is but the logical follow through to what has been steadily weakening business investment spending amidst contracting corporate profit margins. In our April *Monthly Economic Outlook* we presented a detailed discussion of what has to date been a sharp contraction in corporate profit margins and a worrisome, albeit not widely discussed, increase in debt in the nonfinancial corporate sector.

If this were the case, the next step in the progression would be stepped-up layoffs, making the weekly jobless claims numbers worth watching even more closely in the weeks ahead. We've been arguing all along that what to some had been a curiously rapid rate of job growth was simply a reflection of firms, in a slow-revenue growth environment fraught with uncertainty, opting to take on variable costs, i.e., labor, as opposed to fixed costs, i.e., capital, in order to meet demand growth. In this framework, however, barring a faster trend rate of productivity growth (which we see as highly unlikely) the only explanation for such a sharp drop-off in the pace of hiring would be sharply slower demand growth.

Weak Capital Spending A Bad Omen For Employment?

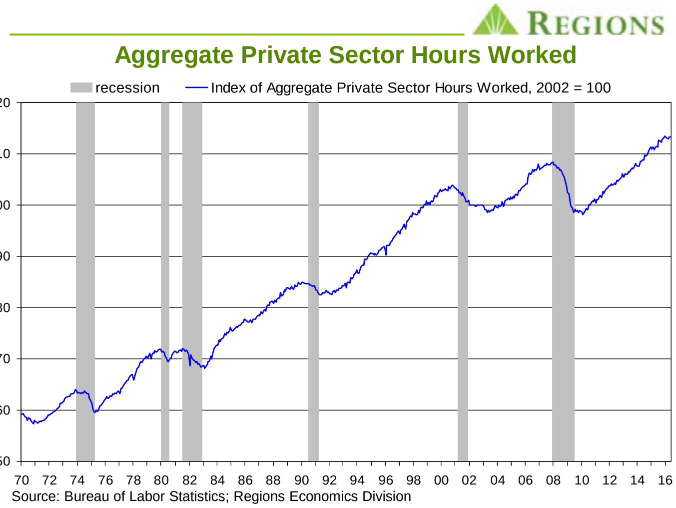


Source: Bureau of Economic Analysis; Bureau of Labor Statistics; Regions Economics Division

As seen in the above chart, there is indeed cause for concern should the recent weakness in business investment spending persist. Historically, sustained over-the-year contractions in real business fixed investment spending have been associated with recession, with the lone exception being the mid-1980s. As we noted in our April *Outlook*, this is also the only time in roughly 60 years of data that a decline in corporate profit margins on the order of the one we're now in the midst of was not followed by a recession. Again, it's early yet to make a definitive call – Q1 2016 was the first quarter in which real business fixed investment fell on an over-the-year basis, but our baseline forecast calls for another such decline in Q2 (we've included our Q2 forecast in the above chart, along with the over-the-year change in private sector payrolls for the first two months of the quarter).

Based on past cycles, it would take a sustained period of firms pulling back on investment spending to a greater extent than has thus far been the case before private sector payrolls began to contract on an over-the-year basis. There would, however, be a telling warning sign along the way to that point – before firms let workers go, at least in large numbers, they have historically been quicker to cut back on the number of hours worked by their existing workers. While the level of employment has indeed historically been a lagging indicator, peaking only after the start of recession and hitting a trough subsequent to the end of recession, aggregate private sector hours worked have been a leading indicator, as is shown in the chart on the following page.

On this basis, there is less cause for concern, as aggregate private sector hours worked did rise, albeit modestly, in May. And, while down marginally from what until now has been the cyclical peak in December 2015, aggregate hours worked have risen in each of the past two months despite the sharply slower pace of job growth. Indeed, as seen in the chart, aggregate hours worked can be bumpy from month-to-month, but there is no evidence as of yet that we have seen a turn towards a sustained decline in aggregate private sector hours worked.



If weakness in demand were to be sufficiently severe and persistent, firms would ultimately follow up scaled back hours by laying off workers. Again, there is nothing to suggest we are at that point – initial claims for Unemployment Insurance have been below 300,000 claims for 65 consecutive weeks now, the longest such streak since the early 1970s. Of course, as with all streaks, this one too will end, but the question is how close we are to that point, a question that takes on more significance in the wake of the weak May employment report.

What Does It All Mean? Ask Us Again In A Few Months . . .

It could be that what we are seeing in the labor market is simply the transition to a more moderate pace of job growth. After all, our baseline forecast all along has had slower real GDP growth this year than last, with a corresponding slowdown in the pace of job growth. Such transitions, however, are not guaranteed to be smooth. Indeed, the day before the release of the May employment report we were quoted in one publication discussing a "gentle slowdown in the pace of job growth" over the course of this year, which, in hindsight, may not necessarily have been the best choice of words. The point remains, however, that we had expected job growth of around 180,000 to 190,000 jobs per month this year compared to last year's monthly average of 229,000 jobs per month.

As we noted above, it will take more time, and more data, to put the May employment report in its proper context. Our sense, however, is that there is no one single explanation but rather a combination of factors are in play. Yes, we do think there has been a high volume of noise in the employment data thus far this year, and indeed this applies to a wide swath of the economic data. At the same time, however, there are some red flags in the underlying details of the employment report, particularly when coupled with the persistent weakness in business investment spending we've been discussing for some time now. In the economic environment of the past several years in which the line between contraction and expansion is much thinner than would be the case with a faster trend rate of growth, one would be foolish to simply brush those red flags aside without at least considering the possibilities they raise.

Like the rest of us, the FOMC will be looking to the incoming data to help put the May employment report in its proper context. But, seriously, talk about bad timing. Weeks of effort to bridge the wide gap in expectations between market participants and the FOMC were basically undone within minutes of the release of the May employment report. Recall that the May 18th release of the minutes to the April FOMC meeting caused quite a stir in the markets, as the minutes conveyed a more hawkish tilt to the FOMC meeting than had been implied by the fairly vanilla post-meeting policy statement. In conjunction with a whole convention's worth of speeches by FOMC members laying out the case for a rate hike at one of the upcoming meetings, this clearly got the markets to take notice.

Prior to the release of the minutes to the April FOMC meeting there were many market participants who saw no changes in the funds rate target range until sometime in 2017. But, on the day before the release of the May employment report, the markets were pricing in a better than 60 percent chance of one 25-basis point hike in the Fed funds rate target range by the conclusion of the July FOMC meeting. That probability fell significantly following the release of the report. While in the days following the May employment report various FOMC members, including Chairwoman Yellen, have noted they still see one or more rate hikes as "likely" being appropriate, most have backed off any hints as to the timing. For instance, in her June 6 speech Dr. Yellen dropped her reference to "coming months" as the likely timing of the next Fed funds rate hike.

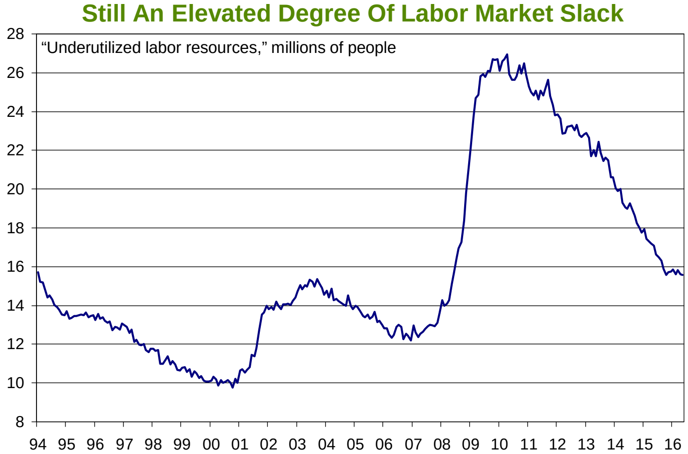
In general, one main premise of those advocating for a hike in the funds rate is that continuous improvement in the labor market has left us at, if not beyond, full employment. If so, at least according to this line of argument, the lack of excess capacity removes a key buffer against inflation pressures, leaving the economy increasingly vulnerable to a significant acceleration in inflation that could stem from a marked acceleration in the rate of wage growth. Given the inherent lags between changes in monetary policy and when those changes actually impact the economy, this means the FOMC must act sooner rather than later in order to fend off these mounting inflation pressures.

Leaving aside our complete lack of patience with the notion that "too much" growth somehow causes inflation, we do not agree with the premise the economy is at, let alone beyond, full employment. We are on record, repeatedly, as arguing that despite what has been a prolonged period of steady improvement in labor market conditions, we are much further from full employment than is implied by the "headline" unemployment rate. Even before the May employment report, we had noted recent months had seen a notable pause in the pace of improvement in labor market conditions. This may of course prove to be nothing more than a transitory pause, but that will take some time to determine. In the interim it hardly suggests a high degree of urgency for the FOMC to pull the trigger on the

Regions Financial Corporation, 1900 5th Avenue North, 17th Floor, Birmingham, Alabama 35203
Richard F. Moody, Chief Economist • 205.264.7545 • richard.moody@regions.com

next Fed funds rate hike. Again, we made this argument before the May employment report, and we'd urge our readers to assess the following discussion as if they'd never seen that report.

Still An Elevated Degree Of Labor Market Slack



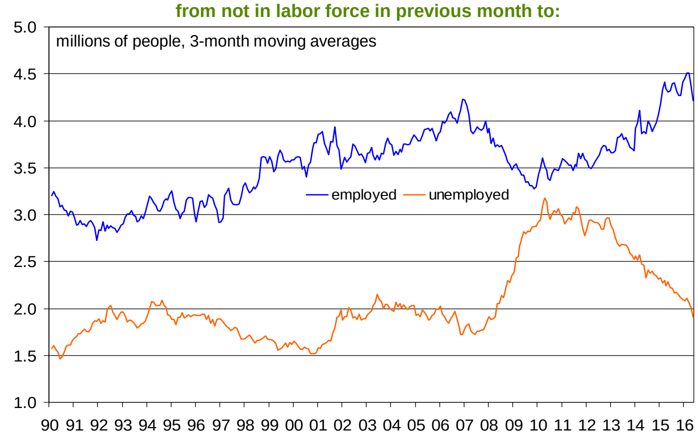
The above chart illustrates our point that, despite a headline unemployment rate of 4.7 percent as of May, there is still an elevated degree of labor market slack. "Underutilized labor resources" refers to the number of people falling into one of the following three groups: 1) those who are unemployed; 2) those who are working part-time for economic reasons (i.e., wanting a full-time job but only able to find part-time work) who, while employed, are nonetheless considered to be underemployed; and 3) those who are marginally attached to the labor force.

As of May, the number of underutilized labor resources stood at 15.6 million people, which is obviously a substantial reduction from the better than 26 million people at the cyclical peak but, at least in our view, still well above the level that would prevail in a healthy labor market. While limitations on the data (some series have a more limited history) make it difficult to determine what is a "normal" size for this group (as a share of the labor force), our estimate is that there are between 2.5 and 3.0 million more people characterized as underutilized labor resources than we would see in a fully healthy labor market. Moreover, our second point, that what had been steady progress in paring down these numbers has basically stalled out, is also apparent in the above chart. While there have been some month-to-month fluctuations, since September 2015 the total number of underutilized labor resources has averaged 15.69 million people.

Some have interpreted the lull in what had been a steady decline in the number of underutilized labor resources as a clear sign the economy has hit full employment, hence making further reductions harder to come by. To us, the more likely cause of this stall is what has been increased labor force participation in recent months – May's drop in the labor force notwithstanding. This is consistent with our argument of a still elevated degree of labor market slack, perhaps more so than we had suspected.

One way of looking at this is in the data on labor force flows, which we present in the following chart. As seen in the chart, the number of those transitioning from not in the labor force in one month to employed in the subsequent month has risen sharply over recent months. While it is true that historically the majority of those transitioning into the labor force enter the labor force as employed, that majority has grown even larger of late. Our view, though not shared by all, is that this inflow has acted as a brake on the pace of wage growth, and will continue to do so.

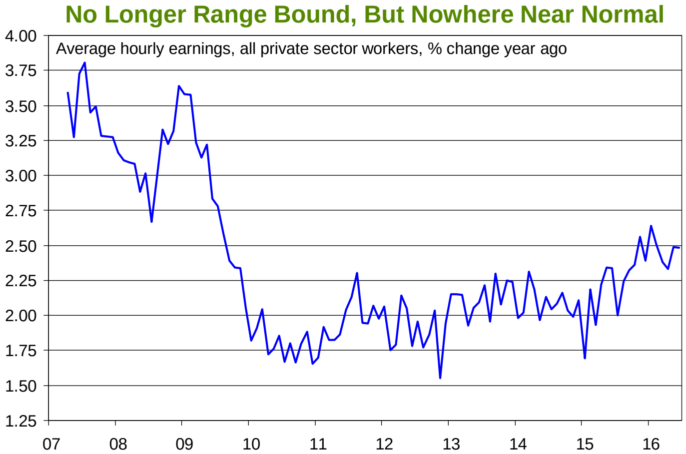
Labor Force Flows:
from not in labor force in previous month to:



For how long is of course an open question. We have argued that what we have seen over the past several months is an unwinding of the cyclical component of the sharp decline in the labor force participation rate following the 2007-09 recession. Thus, even though demographic trends strongly suggest the longer-term trend in the participation rate is down, that does not rule out a period of rising participation as the cyclical portion of the decline is reversed. The main point, however, is to the extent this process continues, it takes pressure off, as opposed to putting pressure on, the FOMC to raise the Fed funds rate further in the near-term.

Many analysts disagree on the grounds that the numbers, i.e., underutilized labor resources, suggest more labor market slack than is actually the case. They argue the distinction between short-term and long-term unemployment matters when assessing the degree of wage pressure in the labor market. While short-term unemployment (those unemployed less than 27 weeks) has fallen back in line with historical norms, long-term unemployment remains significantly higher than the long-term average. These analysts argue that the long-term unemployed, i.e., those out of work 27 weeks or more, are increasingly unlikely to land a job as the duration of their unemployment lengthens and, as such, have little impact on the behavior of wages.

The question, however, is whether or not it is proper to dismiss this group when analyzing the extent of wage pressure. We're not so sure on this point, and, either way, that there has been such an acceleration in the number of those transitioning from not in the labor force in one month to employed in the next month is a signal that firms are not having to stretch so far in order to find qualified workers at prevailing wage rates. This is not to say, however, that there is no upward pressure on wages. But, as seen in the following chart, while wage growth has shown signs of stirring, it nonetheless remains far short of the rate of growth that would be seen in a fully healthy labor market.



After several years of having trended at just over two percent, growth in average hourly earnings has ticked a bit higher in recent months, averaging 2.5 percent. The extent to which this reflects normal supply-demand interactions is unclear thanks to higher minimum wages across parts of the U.S. and some of the larger retail chains upping entry level wages, which in turn has led to some adjustments for longer-tenured employees. But, to the extent these voluntary and mandated wage hikes are a factor in recent wage growth, their effects will ultimately wash out of the data, so we could easily see another prolonged period of range-bound growth in hourly earnings. To the extent faster wage growth reflects supply-demand dynamics, our argument is that what remains an elevated degree of labor market slack renders it unlikely that wage growth will return to a more normal 3.0-to-3.5 percent trend rate any time soon. In our 2016 outlook presented in the January *Monthly Economic Outlook*, we argued wage growth would remain below 3.0 percent until some point in 2017 and thus far see no reason to change that call.

But, even if wage growth accelerates much faster than we expect, what that would imply for inflation pressures in the broader economy is an entirely different matter. Though we often hear the argument that faster wage growth means there will be faster inflation in the broader economy, there is scant empirical support for the existence of such a simple causal relationship. One critical piece of this puzzle, without which one cannot properly discuss the relationship between wage growth and inflation in the broader economy, is productivity growth.

Productivity growth acts as a buffer between wage growth and inflation in the broader economy. In other words, faster productivity growth enables firms to pay higher wages to their workers and not infringe on profit margins without having to raise output prices. Moreover, along with the rate of growth of the labor force, the rate of productivity growth is a key determinant of an economy's noninflationary "speed limit," i.e., the rate at which it can grow without fostering inflation pressures. Unfortunately, however, the trend rate of productivity growth in the current expansion has been, and remains, anemic, which greatly complicates the FOMC's task.

With only anemic productivity growth, rising wage bills have already eaten into firms' profit margins. What remains to be seen is at what point firms will attempt to salvage profit margins by raising output prices, and whether or not any such attempts to raise prices will actually stick. Our view is that providers of services will have more success along these lines than producers of goods, who continue to suffer from what remains considerable excess capacity in the global economy. What is not clear, however, is whether or not those who argue faster wage growth will be followed by faster inflation are implicitly taking the current anemic trend rate of productivity growth into account, in which case they should stipulate as much, or whether they are simply trapped in the belief that faster growth in and of itself causes faster inflation, which is a curious belief to be trapped in.

Either way, that productivity growth is indeed so low means the FOMC must be more attuned to accelerating wage growth, while the lower speed limit for economic growth means the FOMC would have to raise rates sooner than would be the case in an economy with a higher speed limit. This then simply illustrates the importance of being right on the call of whether or not the economy is operating at, or beyond, full employment. While we do not believe this to be the case many, though not all, FOMC members do seem to believe this to be the case. As such, should the next few employment reports suggest the May report was more noise than signal, an increase in the Fed funds rate hike will likely not be too far behind.

Whether that means July or September or later remains to be seen. Even prior to the May employment report, we thought it highly unlikely the FOMC would vote to raise the funds rate at this month's meeting, simply as a matter of prudent risk management. The outcome of the June 23 "Brexit" vote has the potential to significantly disrupt global financial markets. Though getting less attention, political events and uncertainty in Spain and France, along with what is now Act 1,674,229 (we think, admittedly we lost count somewhere down the line) of the ongoing Greek tragi-comedy, could also prove highly disruptive to the financial markets.

Of course, the May employment report made this a moot point. That said, don't think for a minute this renders the June FOMC meeting a nonevent. Quite to the contrary, the June FOMC meeting is worthy of close attention. The meeting will be followed by one of Chairwoman Yellen's regular press conferences and will also see the release of the latest round of FOMC central tendency forecasts, including the updated "dot plot." As such, the June FOMC meeting will go a long way towards signaling whether or not the Committee still sees July as a "live" meeting in terms of the next increase in the Fed funds rate target range.

Clearly, there are many factors for the FOMC to take into account as it deliberates over the path of the Fed funds rate. Prior to the May employment report, the FOMC, at least as a whole, seemed eager to act, and had been somewhat successful in swaying market expectations in the Committee's direction. Should they still be eager to act in the wake of the May employment report, we suspect the FOMC will find it a much tougher sell when it comes to once again moving the markets in their direction.

ECONOMIC OUTLOOK

REGIONS

June 2016

Q4 '15 (a)	Q1 '16 (p)	Q2 '16 (f)	Q3 '16 (f)	Q4 '16 (f)	Q1 '17 (f)	Q2 '17 (f)	Q3 '17 (f)		2014 (a)	2015 (a)	2016 (f)	2017 (f)
1.4	0.8	2.7	1.9	2.1	1.8	2.0	2.1	Real GDP[1]	2.4	2.4	1.8	2.0
2.4	1.9	3.7	2.1	2.2	2.0	2.1	2.1	Real Personal Consumption[1]	2.7	3.1	2.6	2.2
								Business Fixed Investment:				
-1.3	-5.5	1.7	2.9	3.1	2.6	2.7	2.2	Equipment, Software, & IP[1]	5.6	4.1	0.1	2.6
-5.1	-8.9	-3.8	2.7	5.7	5.4	5.1	3.8	Structures[1]	8.1	-1.5	-3.8	4.1
10.1	17.2	8.3	5.5	2.5	7.1	9.1	10.3	Residential Fixed Investment[1]	1.8	8.9	10.1	7.1
0.1	1.2	0.9	1.0	0.6	0.6	0.8	0.8	Government Expenditures[1]	-0.6	0.7	1.0	0.7
-551.9	-561.1	-555.7	-563.5	-561.3	-572.1	-583.5	-597.0	Net Exports[2]	-442.5	-543.4	-560.4	-590.3
1.135	1.147	1.139	1.126	1.148	1.181	1.218	1.268	Housing Starts, millions of units[3]	1.001	1.108	1.140	1.245
17.8	17.1	17.3	16.9	16.8	16.5	16.5	16.4	Vehicle Sales, millions of units[3]	16.4	17.3	17.0	16.4
5.0	4.9	4.8	4.8	4.7	4.7	4.7	4.6	Unemployment Rate, %[4]	6.2	5.3	4.8	4.6
2.0	1.9	1.8	1.6	1.5	1.3	1.3	1.3	Non-Farm Employment[5]	1.9	2.1	1.7	1.3
1.1	1.2	1.1	1.2	1.4	1.8	1.9	1.8	GDP Price Index[5]	1.6	1.0	1.2	1.8
0.5	1.0	1.0	1.4	1.9	2.3	2.3	2.1	PCE Deflator[5]	1.4	0.3	1.3	2.2
0.4	1.1	1.1	1.6	2.0	2.6	2.4	2.1	Consumer Price Index[5]	1.6	0.1	1.4	2.3
1.4	1.7	1.6	1.7	1.9	1.8	1.9	1.9	Core PCE Deflator[5]	1.5	1.3	1.7	1.9
2.0	2.3	2.2	2.3	2.3	2.0	2.0	1.9	Core Consumer Price Index[5]	1.7	1.8	2.2	2.0
0.17	0.38	0.38	0.55	0.67	0.88	0.91	1.16	Fed Funds Target Rate, %[4]	0.13	0.14	0.49	1.08
2.19	1.92	1.86	1.94	2.01	2.22	2.30	2.51	10-Year Treasury Note Yield, %[4]	2.54	2.14	1.93	2.41
3.90	3.74	3.64	3.70	3.75	3.89	3.98	4.15	30-Year Fixed Mortgage, %[4]	4.17	3.85	3.71	4.08
-2.8	-3.0	-2.8	-2.9	-2.9	-3.0	-3.0	-3.1	Current Account, % of GDP	-2.3	-2.7	-2.9	-3.1

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

Regions Financial Corporation, 1900 5th Avenue North, 17th Floor, Birmingham, Alabama 35203

Richard F. Moody
Chief Economist

Greg McAtee
Senior Economist