ECONOMIC OUTLOOK

REGIONS

August 2016

The ~~Great~~ ~~Good~~ ~~Fair~~ ~~Decent~~ ~~Low~~ No Expectations Economy

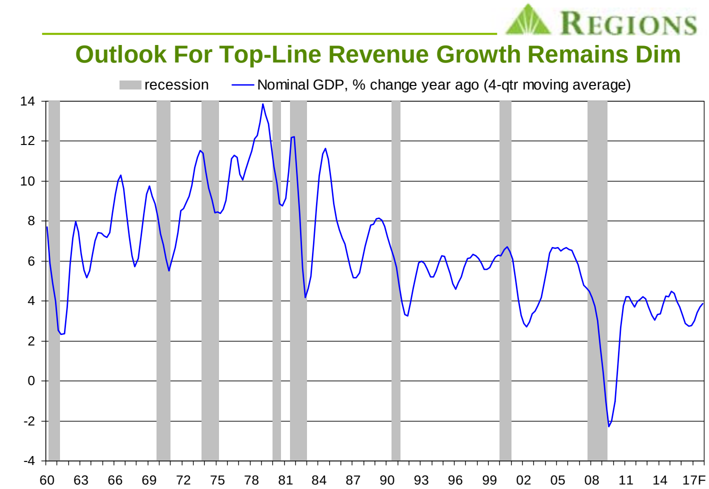
In the policy statement issued after their July meeting, the FOMC took a more upbeat tone on the U.S. economy while noting "the near-term risks to the economic outlook have diminished." The FOMC's statement sparked discussion as to whether the September FOMC meeting was now in play in terms of the timing of the next increase in the Fed funds rate. Two days later, the Bureau of Economic Analysis released their initial estimate of Q2 GDP, showing annualized real GDP growth of just 1.2 percent, significantly below expectations and quickly silencing the talk of a September move by the FOMC. This is a pattern that has become all too familiar over the seven years of the current expansion – whatever you think you know about the U.S. economy, you're only one data release away from being shown to be totally off the mark.

That may be a bit of an overstatement, but it does feel that way at times. The soft headline print notwithstanding, however, we don't feel differently about the U.S. economy after the Q2 GDP report than we did before it. In other words, the parts of the economy we felt good about – consumer spending, housing – we still feel good about, and the parts of the economy we were worried about – business investment spending, trade – we're still worried about. True, real residential fixed investment did decline in Q2 but this is more a reflection of seasonal adjustment noise that made Q1 outlays look far stronger than they actually were, and we continue to see housing as providing support for top-line growth. Our main concern remains persistently weak business investment spending.

Inflation adjusted business fixed investment fell for a third consecutive quarter in Q2, something that is highly unusual during an expansion. To be sure, significant cutbacks in energy related investment have weighed on overall business investment spending over recent quarters. That said, higher frequency data show the weakness in business investment goes beyond energy. This, however, is not a new topic for us – we have for years now been making the argument that underinvestment on the part of businesses has been a characteristic of the current expansion. Indeed, our view is this underinvestment is a primary reason growth in labor productivity has been so anemic over the past several years.

Many attribute weak business investment to "uncertainty," an always popular but not necessarily on the mark explanation for just about any downbeat data point. Whatever its merits as a viable explanation for other economic ills, however, we're not so sure uncertainty is the explanation for what has been persistently weak business investment spending. Our view is that this is far more a reflection of a lack of confidence on the part of businesses than it is a reflection of uncertainty. Some would argue this is a distinction without difference, and a sufficiently high degree of uncertainty can result in a lack of confidence.

To us, though, it is important to distinguish between the two. And not for the obvious reason, i.e., there is always uncertainty. It is of course true that the only time you see certainty is when you're looking in the rearview mirror, and even then given how the economic data are constantly subject to revision, some series several times over, are we ever really sure what happened, let alone why it happened? But, we think a more important point is that term "uncertainty" implies a two-way street, i.e., actual outcomes may differ from expected outcomes, but that could be to the upside or to the downside. At least that used to be the case; over the past several years it seems as though the risks are, if not all to the downside, then at least perceived to be heavily weighted to the downside. When the expected outcome, or, if you like, the baseline case, is the same middling growth we've seen over the past seven years, the risks being skewed to the downside is hardly a call for bold, decisive action. Or, in the context of this discussion, this is hardly an environment in which firms feel compelled to expand/enhance their capital stocks.



Source: Bureau of Economic Analysis; Regions Economics Division

The above chart is one we've used to make this same point in a different context. Using nominal GDP as a proxy for top-line business revenue, the current expansion has seen the slowest sustained revenue growth on record in the life of the data. And, as if to add insult to injury, there does not appear to be a catalyst for a breakout, at least to the upside, on the horizon, though it is not terribly difficult to lay out a number of downside risks. Indeed, each month when we engage in internal discussions of our U.S. macro forecast we provide a statement of what we perceive to be the main risks to our baseline outlook. While there are both upside and downside risks, the list of downside risks is considerably longer, and our assessment of the balance of risks has for some time been slanted to the downside.

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While individual firms are operating under their own forecasts and identifying specific risks to their operations as well as broader macro risks, there is little to suggest the assessment of the overall growth outlook and the balance of risks is much different across a wide swath of the corporate sector than is ours. This would help account for the weakness in business investment spending. When faced with a persistently slow growth environment, firms simply have little incentive to expand their capital stocks. They have had even less incentive over the past several years when slack labor market conditions – an ample supply of available labor at a relatively low cost – have made it feasible for firms to essentially substitute labor for capital. One advantage, at least to firms, of this trade-off is that if the downside risks to the outlook do materialize, it is far easier for firms to rid themselves of excess labor than it is to rid themselves of excess capital. As a side note, this is a story we have been telling for over two years now, but only lately have we noticed a number of analysts and members of the financial media talking up this same story in various forums.

Be that as it may, one could argue that as the labor market tightens and wage bills begin to increase at a faster rate, firms will then have the incentive to take on more capital and less labor. This is true, but only up to a point unless and until the overall growth outlook improves. And, to the extent firms do begin to increase capital outlays, they will more than likely be directed towards productivity enhancing, as opposed to capacity expanding, expenditures. As such, it is likely that, relative to past cycles, the contribution of capital expenditures to overall real GDP growth will remain below average.

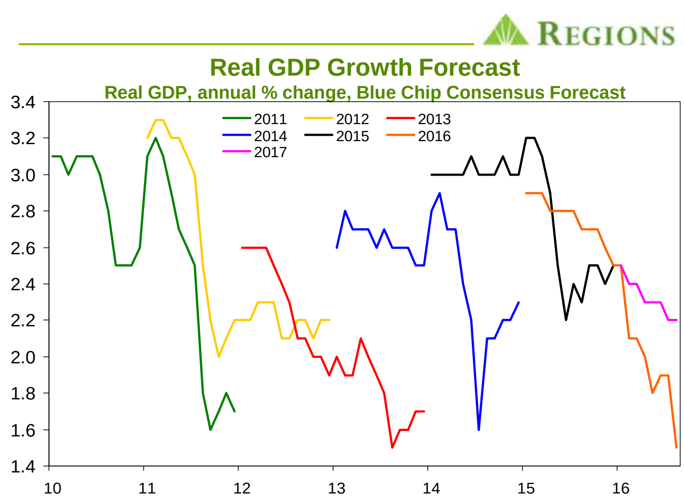
In our view, another manifestation of an overall lack of confidence in growth prospects is how the corporate sector has responded to what has been a prolonged period of extraordinarily low financing costs, courtesy of the central bankers of the world. In general, the corporate sector has not been shy about taking on more debt. As we've discussed in past months, the ratio of nonfinancial corporate debt to GDP has risen significantly over the past few years, and is bumping up against a level that in the past has always preceded recession. The difference is that this time around firms have less to show for that debt, at least in terms of it having contributed to meaningful growth in the economy's productive capacity. Instead, firms have resorted to debt to fund share buybacks, merger and acquisition activity, and dividend payouts. All of which are fine, in and of themselves, but none of them do anything to add to the economy's productive capacity. Had they more confidence in growth prospects, firms would have almost surely found different uses for much of the debt they have taken on.

It is with considerable bemusement that over the past several years we have watched central banks around the globe go to great, not to mention unprecedented, lengths to push interest rates down and hold them there, on the premise that these low rates will stimulate borrowing and, in turn, spur growth in aggregate demand. This of course is predicated on the notion that the price of credit is the issue. It isn't, nor has there been a time since the end of the recession in which it has. Yet, central banks keep at it, the latest example provided by the Bank of England at their early-August meeting. The Bank cut their benchmark policy rate, expanded quantitative easing, and added a term funding program to facilitate lending to households and firms. And, oh by the way, the Bank also slashed their growth forecast for the next two years. Think about that for a minute, if it even takes that long, and see if you can spot the inconsistency here. Now, we're no experts, but, somehow we doubt that the Bank of England slashing its growth outlook is going to put firms in the mood to rush out and take advantage of those low interest rates, at least not to add to their capital stock and expand their productive capacity. One thing that may help, however, is that unlike what we've seen in many countries around the globe over the past several years, fiscal policy makers in England actually seem up to doing their jobs. As such, if they can craft and deliver a fiscal policy package that firms believe will help stimulate growth, those low interest rates just may come in handy after all.

What Can We Say . . . Stuff Happens . . .

Still, even with the prospect of help from fiscal policy, it comes back to the question of confidence. This is of course perfectly understandable given what has been a historically weak expansion here in the U.S. and an even less impressive performance in many other countries. It is almost as though firms have been battered into submission and have come to, however grudgingly, accept this "new normal" paradigm as the way the world will be and have adjusted their behavior accordingly.

The same is seemingly the case with many members of our profession and with many members of the FOMC. It hasn't always been this way since the end of the 2007-09 recession, instead, it's been more of an evolution (or, has it been a devolution?). One way to illustrate this point is to look at how private sector and FOMC forecasts have changed over the past several years, which we do in the following charts.



Source: *Blue Chip Economic Indicators*/Wolters Kluwer

The chart above shows the consensus forecast from the *Blue Chip Economic Indicators* survey for annual real GDP growth for each year from 2011 through 2016. We show how the forecasts evolve over the 24 months for which participants are surveyed for a given calendar year. For instance, January 2010 was the first month in which panelists were asked to provide their 2011 growth forecast (shown in the green line), and then in each month through 2011. In each month of any given year, then, panelists provide a forecast for that calendar year and the following calendar year.

One of the striking features of the above chart is the manner in which in each year since 2011 the forecasts have become more pessimistic as time went on, some of them more quickly than others. It is also interesting to observe, for any given year, the relationship between the current year and coming year forecasts. For instance, over the course of 2011 when forecasts for that year were steadily marked down, so too were the forecasts for 2012. But, when 2012 came, the forecasts for that year did not change much but at the same time the forecasts for 2013 were being marked down. Beginning in 2013, however, a "wait 'till next year" mentality started to take hold – current year forecasts were steadily marked down but the forecasts for the next year were left largely intact. Until of course next year actually showed up, then the same pattern repeated itself. That seems to have changed in 2016, however, as the 2017 forecast has been gradually taken down with the current year forecast.

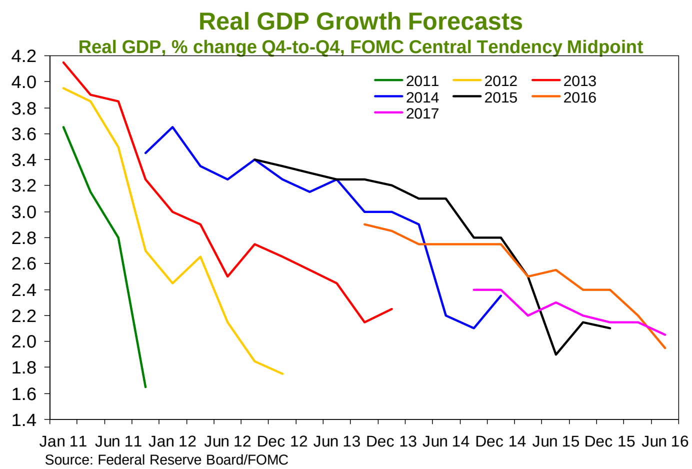
The point here isn't to pass judgement on the forecasts of others. After all, over our career we have steadfastly held to the credo that those who forecast in glass houses should not throw stones, and we do participate in the *Blue Chip* survey. It is also worth keeping in mind that the forecasts shown above were based on the data available at the time while in subsequent years most, if not all, of those data series will have been revised more than once. In at least some cases, the data look quite different today than they did at the time the forecasts based on them were produced. Finally, part of the reason the current year forecasts in any given year were marked down fairly quickly within that year is that the first quarter of recent years has tended to be the weakest of the year in terms of real GDP growth.

For instance, prior to the annual benchmark revisions released late last month, real GDP was shown to have contracted in the first quarters of 2011 and 2014 and to have barely grown in Q1 2015. In part this reflects the issue of residual seasonality, which the BEA is working to correct. Other factors have played a part, such as the abnormally cold winter in 2014 that at times caused economic activity to grind to a halt over a wide swath of the nation while in 2015 the West Coast port strike wreaked havoc on economic activity during the first quarter of the year. A significant inventory correction knocked over a point from top-line real GDP growth in Q1 2016, taking the forecast for full-year growth down with it.

With those caveats out of the way, our main point in showing this chart is to illustrate that, no matter how high the expectations for a given year may have started out, they didn't stay that way for long as those expectations gave way to reality. To be sure, in the early stages of the recovery expectations, at least for many analysts, were simply unrealistically high. There was a segment, a quite vocal segment, touting what would be a "V-shaped" recovery on the premise that deep recessions are always followed by rapid recoveries. That was, in the wake of the 2007-09 recession which was accompanied by a global financial crisis, simply a ridiculous assertion. We said so at the time and have been saying it ever since – and, yes, this is one instance in which we will without reservation or hesitation throw stones.

Still, even though we never took the "V-shaped recovery" premise even remotely seriously, the recovery/expansion has progressed slower than we expected. Our first foray into annual real GDP growth of 3.0 percent or better was our forecast for 2014, and not because we thought the economy healed and off to the races, but simply because we thought it had progressed to the point that the slack that remained in the economy and the labor market could be absorbed at a faster pace. When that frozen first quarter quickly put to rest any hopes of 3.0 percent or better growth for 2014, we for a time thought that would be the case for 2015. It did not take long, however, for it to become clear that would not be the case. We can point to a number of external factors – economic shocks, debt crises, bouts of financial instability, geopolitical tensions, acts of terrorism, and natural disasters – that acted as drags on the domestic and foreign economies. There have also been self-inflicted wounds, most notably the lack of meaningful fiscal policy and a Keystone Cops approach to regulatory policy that, in its totality, has acted as a significant drag on growth.

So, while economic forecasting is a humbling exercise in its own right, it has been even more challenging over the past few years with all of these obstacles strewn across the economy's path. And, for anyone who thinks public sector analysts have had a monopoly on missed forecasts and diminished growth expectations over the past several years, we offer the following chart. As our prior chart did with the *Blue Chip* consensus forecasts, the chart below shows the evolution of FOMC projections for Q4/Q4 real GDP growth over the past several years.



One point about this chart is the FOMC began releasing their central tendency forecasts in early 2011 and while over the past few years they have settled in a regular pattern of releasing the projections in the same four months of each year, in earlier years they were issued less regularly. Even so, the FOMC projections share the pattern of forecasts being consistently marked down as seen in the private sector forecasts. But, one notable difference is that the growth expectations of FOMC members started off higher than did those of the *Blue Chip* panel. We'll make the same point here we made earlier – the projections made by FOMC members were done so on the basis of the data available at the time and the U.S. economy has faced a steady barrage of impediments to growth, some internal, some external.

To the extent these projections formed the judgements of individual Committee members as to the appropriate path of the Fed funds rate target range, it becomes more understandable why over the past several years various FOMC members have in their public comments laid out a far more aggressive path of the Fed funds rate range than has actually been the case. This gets us back to the question of confidence. While many private sector forecasts have been off the mark over the past several years, so too have the forecasts of many of those tasked with setting monetary policy. One could argue that these misses, coupled with a seemingly endless stream of public pronouncements as to the "appropriate" path of monetary policy have exacted a harsher toll on confidence in the corporate sector. Particularly when, regardless of where expectations for growth and for monetary policy started out, growth has ended up right around 2.0 percent (refer back to the chart on Page 1) while, save for a solitary 25-basis point hike last December, the Fed funds rate target range hasn't moved.

On the off chance that anyone interprets this discussion as our implying one can draw a straight line between missed FOMC forecasts and the paucity of business investment spending over the course of the current expansion, we're not. Not even remotely. Our broader point is that a lack of confidence in prospects for economic growth is a primary culprit behind what has been persistent underinvestment from the corporate sector of the U.S. economy over the current expansion. It is fair to argue that the constant downgrading of expectations, in the form of private and public sector forecasts, along with an almost endless stream of chatter surrounding the "appropriate" course of monetary policy, may have inspired a lot of feelings amongst corporate decision makers, but confidence is not likely one of those feelings.

Indeed, that long-term interest rates remain so low both in the U.S. and abroad can be taken as a reflection of the dim view of economic growth prospects taken by financial market participants. So, while many central banks seem to have premised policy moves on low interest rates spurring increased borrowing, it could well be that corporations are extracting the exact opposite message. Again, this would suggest a continued unwillingness on the part of corporations to borrow, at least for the purposes of adding to their existing capital stocks.

Our view is that risk taking can be inspired by confidence or by desperation, and persistently low interest rates are hardly a means by which to inspire confidence. For many individual and institutional investors, the search for yield may well be fostering greater risk taking which, if not yet a reflection of desperation, could easily get to that point if the rate environment does not change. As for corporations, our view is they clearly do not feel confident, certainly not to the point they are willing to take the risk of expanding their productive capacity. And, that they continue to take on workers and to take on low-cost debt is not, at least not to us, a sign of confidence. As we discussed above, taking on labor has been a low cost, and reversible, way for firms to meet what demand growth they are seeing. At the same time, utilizing debt to buy back shares and/or sustain dividend payouts is a low-cost way to increase returns to shareholders.

Neither of these activities, however, is sustainable in perpetuity. For instance, as labor market conditions tighten further, wage bills will rise at a faster rate, which we in fact have seen over recent months. In an environment of diminishing profit margins, this will at some point be reflected in a slower pace of hiring. This is something some analysts don't seem to grasp. But, should we see a meaningful and sustained pullback in hiring and/or steadily rising layoffs over coming quarters, which we feel cannot be ruled out without an improved growth outlook, this in effect would pull the rug out from under consumers. Without growth in labor earnings underpinning growth in total personal income, the prime support for what has been solid growth in consumer spending is taken away. In such a scenario, it is hard to envision the U.S. economy not slipping into recession.

Another factor likely depressing confidence in the corporate sector is the upcoming Presidential election. Aside from the question of how the policy platforms of either candidate would impact economic growth (and our view on this is rather negative), consider much of the campaign rhetoric. Corporations have made for convenient targets, again by both sides if to varying degrees, and castigated for shipping jobs abroad and failing to pay their "fair share" of taxes. For instance, instead of plausibly addressing the set of factors that give firms the incentive to engage in inversions and shift production to foreign shores, there is only talk of punishing firms for engaging in these activities. Moreover, rhetoric on international trade suggests a significantly less free trade environment. Again, the point is it is hard to see how the upcoming election, regardless of the outcome, is going to inspire confidence on the part of firms, particularly if it raises the prospect of yet more years of partisan bickering coupled with policy gridlock that brings no relief on the tax or regulatory fronts.

It is often said that confidence is fleeting. At present, however, confidence seems to be virtually nonexistent, at least in the corporate sector of the U.S. economy. That has taken its toll on business investment spending which, for you fans of irony, clearly diminishes the economy's longer-term growth potential. This is not to say conditions can't, or won't change or that firms won't get their groove back and significantly up their capital outlays to modernize and expand their capital stocks. What we struggle with, however, is a plausible scenario under which these things will happen or what the catalyst would be. Trust us, though, when we say that we're quite open to suggestion and that this is one forecast we'd be happily surprised to have to revise.

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Q1 '16 (a)	Q2 '16 (p)	Q3 '16 (f)	Q4 '16 (f)	Q1 '17 (f)	Q2 '17 (f)	Q3 '17 (f)	Q4 '17 (f)		2014 (a)	2015 (a)	2016 (f)	2017 (f)
0.8	1.2	2.5	2.0	2.2	2.1	2.1	1.9	Real GDP[1]	2.4	2.6	1.5	2.1
1.6	4.2	2.8	1.8	2.2	2.0	2.1	2.0	Real Personal Consumption[1]	2.9	3.2	2.6	2.2
								Business Fixed Investment:				
-4.5	-0.8	0.3	1.3	2.3	2.5	2.2	2.2	Equipment, Software, & IP[1]	4.8	4.0	-0.2	1.7
0.1	-7.9	0.3	4.6	3.9	6.3	3.4	2.8	Structures[1]	10.3	-4.4	-4.9	3.1
7.8	-6.1	4.1	3.9	8.7	9.3	9.4	9.4	Residential Fixed Investment[1]	3.5	11.7	5.9	6.5
1.6	-0.9	1.0	0.7	0.5	0.7	0.7	0.7	Government Expenditures[1]	-0.9	1.8	1.0	0.6
-566.2	-556.3	-573.1	-578.3	-585.5	-590.2	-597.5	-605.1	Net Exports[2]	-425.7	-540.0	-568.5	-594.6
1.151	1.160	1.141	1.180	1.203	1.226	1.257	1.288	Housing Starts, millions of units[3]	1.001	1.108	1.158	1.243
17.2	17.1	17.3	16.9	16.6	16.4	16.3	16.1	Vehicle Sales, millions of units[3]	16.4	17.4	17.1	16.3
4.9	4.9	4.8	4.7	4.7	4.6	4.6	4.6	Unemployment Rate, %[4]	6.2	5.3	4.8	4.6
1.9	1.8	1.7	1.5	1.4	1.4	1.2	1.2	Non-Farm Employment[5]	1.9	2.1	1.7	1.3
1.2	1.2	1.3	1.5	1.8	1.7	1.8	1.7	GDP Price Index[5]	1.8	1.1	1.3	1.8
0.9	0.9	1.2	1.7	2.1	2.1	2.0	1.9	PCE Deflator[5]	1.5	0.3	1.2	2.0
1.1	1.1	1.3	1.8	2.3	2.1	2.0	1.8	Consumer Price Index[5]	1.6	0.1	1.3	2.1
1.6	1.6	1.7	1.8	1.8	1.8	1.8	1.9	Core PCE Deflator[5]	1.6	1.4	1.7	1.8
2.3	2.2	2.2	2.1	1.8	1.7	1.7	1.8	Core Consumer Price Index[5]	1.7	1.8	2.2	1.7
0.38	0.38	0.38	0.42	0.63	0.66	0.88	0.88	Fed Funds Target Rate, %[4]	0.13	0.14	0.39	0.76
1.92	1.75	1.55	1.60	1.65	1.75	1.85	1.90	10-Year Treasury Note Yield, %[4]	2.54	2.14	1.71	1.79
3.76	3.60	3.40	3.42	3.45	3.53	3.61	3.65	30-Year Fixed Mortgage, %[4]	4.18	3.85	3.55	3.56
-3.0	-2.8	-2.9	-2.9	-3.0	-3.0	-3.1	-3.3	Current Account, % of GDP	-2.3	-2.7	-2.9	-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

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