ECONOMIC OUTLOOK

REGIONS

March 2016

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A MAD World, Or A Mad, Mad, Mad, Mad World?

Back during the days of the Cold War, both the United States and the Soviet Union were armed with enough nuclear weaponry to destroy the world several times over. Yet, the prevailing military and security policy of the day, "Mutual Assured Destruction," or, MAD, held that neither side would be the first to launch an attack, as the other side would respond in kind and the ultimate outcome would be the complete annihilation of both sides.

Recent years have seen mounting worries over global warfare of a different sort, only with currencies the weapon of choice. More specifically, depreciating currencies. Over the past several years central banks around the globe have unleashed what, collectively, has been an unprecedented degree of monetary stimulus. While the need to stimulate domestic demand and avoid deflation is typically offered as justification, what is left unsaid is that along with added monetary accommodation comes a depreciating currency, which in turn should have favorable implications for the balance of trade and support domestic employment and income growth.

While one central bank in isolation pursuing such a policy may "win," when multiple central banks around the globe pursue the same strategy no one really wins. The financial version of MAD would hold that competitive currency devaluations are, in the end, pointless because if every nation tries to devalue its currency none of them actually can, even if those who do move early reap some short-term gains. As such, no one would fire the first shot in a global currency war – sure there are some short-term gains to be had for the early movers, but those gains quickly dissipate as other central banks join the fight. Indeed, anyone with even a passing familiarity with the policy blunders that helped put the "great" in the Great Depression know this to be a classic example of the ultimate futility of currency wars.

Still, as central banks around the globe fall over each other on the way to negative/more negative interest rates and other means of adding further accommodation, there are surely more salvos on the way in what effectively remains an undeclared currency war. While actual wars often beget ironic outcomes, one irony of the currency war is the Federal Reserve – accused by many, including some emerging market central bankers, as firing the first shot in the currency war in the form of the initial round of quantitative easing – is now on the sideline suffering collateral damage.

In other words, even were the FOMC to forego further increases in the Fed funds rate, U.S. monetary policy becomes relatively tighter as foreign central banks become more accommodative, with one consequence being further upward pressure on the U.S. dollar. One implication of a stronger U.S. dollar is that U.S. manufacturers have become less and less competitive in global markets. Perhaps even more significantly, an appreciating dollar has been a prime force behind what have, over the past several months, become tighter overall financial conditions, which has the potential to act as a material drag on U.S. economic growth. It remains to be seen how this impacts the timing and extent of additional increases in the Fed funds rate.

Clearly, global central banks are not buying into the financial version of the MAD doctrine. Looking at global economic policy more broadly, it's hard to fathom what the prevailing doctrine is, or if there even is one. Indeed, global policy more and more reminds us of *It's A Mad, Mad, Mad, Mad World* (it's not old, it's a timeless classic), albeit without any of the humor.

For those not up on their timeless classics, the story opens with a thief on the run crashing his car and five motorists coming to his aid. In his dying moments the thief discloses where he hid a large bundle of cash from an old robbery, but instead of cooperating and sharing the money the five launch into an all-out race to be the first to retrieve the stolen loot, tailed by a corrupt detective who wants the money for himself. After a series of mishaps and chases the corrupt detective has the suitcase containing the money but is trapped by the original five on the fire escape of a condemned office building. When the fire escape buckles, the suitcase pops open and the money rains down on the sidewalk below, scooped up by passing pedestrians while the unlucky six end up in a prison hospital with nothing to show for their troubles.

The past several years have been characterized by persistently slow growth in aggregate demand on a global basis. Yet, policy makers have passed up numerous chances to cooperate on policies to help foster improved global growth. Instead, individual nations have gone off on their own policy paths. In some cases, policy measures taken by one nation are not consistent with those taken in other nations, while in some cases the mix of policy measures within one nation is not even internally consistent. The result is there is little to show for a go it alone approach to policy whereas a cooperative approach would by now likely have yielded material benefits across nations.

The latest chance for cooperation on the global policy front was last month's G20 meeting. Prior to the meeting U.S. Treasury Secretary Jack Lew stated this was not a "moment of crisis" for the global economy. While perhaps not an Alfred E. Neuman "what, me worry?" moment, this should have at least put to rest any thoughts of, you know, actual policy makers taking actual policy measures. Because, really, why take deliberate and thoughtful actions to help fend off a crisis when you can wait until there is an actual crisis then act in haste and take actions just to show you're taking action.

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

Okay, you're right, we're being too harsh and, to give credit where credit is due, the G20 did make a bold and forceful pledge that its members would not engage in competitive currency devaluations. Well, at least not without discussing it ahead of time. Which of course gets us back to monetary policy and to our timeless classic. After all, the climactic scene in *It's A Mad, Mad, Mad, Mad World* in which money is raining down on the sidewalks seems a depressingly fitting analogy at a time when there is increasing talk of "helicopter money" as a means of sparking demand and fending off deflation.

Yes, there are actual, serious discussions taking place as to the viability of simply printing up more money and distributing it as a means of generating economic activity. We would say the helicopter drop is but the next step in a logical progression that started with low interest rates, then went to no interest rates, and now to negative interest rates, but somehow the word "logical" just doesn't seem to fit in this discussion.

By imposing penalties on banks depositing reserves with the central bank, negative interest rates give banks the incentive to make more loans. By imposing penalties on those holding deposits at banks, negative interest rates give businesses and households the incentive to spend. At least in theory. What's missing, however, is any discussion of the demand for loans, the desire to pare down, not add to, debt, and the legitimate desire to save. You know, those same pesky details that have from day one blunted any impact from lower interest rates.

This isn't the first time we've raised these points. Indeed, the title of our September 2007 monthly commentary was "So, Lower Interest Rates Got Us Into This Mess, Now They're Going To Get Us Out???" (we were at a different shop then but just as cynical as we are now). At the time, the Fed funds rate was 5.25 percent and the debate was whether or not the FOMC would begin cutting the funds rate to help prop up the economy. Not only is it hard to imagine the Fed funds rate being that high, but it is also hard to imagine there were those who at the time saw no need for the FOMC to begin cutting the funds rate.

Our position was, yes, there would be rate cuts, but those rate cuts would have no beneficial effects. We argued that what had been a prolonged period of low interest rates resulted in risk being badly underpriced and unsustainable levels of household debt. So, just as more money is never the remedy for problems caused by too much money, lower interest rates are not the remedy for problems caused by interest rates held too low for too long. The reality was there was simply little need and even less desire to borrow in the household and corporate sectors.

Those points are still relevant today, even though the world is a much different place. But, all these years we've been making the exact same point – this isn't about the price of credit. So, just as we had no hopes for low interest rates or no interest rates, we have no hopes for negative interest rates. Unless of course the goal of such a policy is to punish savers and further impair the profitability of the banking system, in which case interest rate policy has all along been a smashing success and, sure, negative interest rates are indeed the next logical step.

That there are people actually thinking about, let alone openly talking about, helicopter drops of money is a sign of how little confidence there is that negative interest rates will actually stimulate demand. The only thing more mind boggling than people actually having this discussion is that anyone thinks helicopter drops (sure, this could take place electronically but it's more entertaining to think about a traditional helicopter drop) would actually accomplish anything. Well, anything other than raising the level of prices as, when all is said and done, there would be no impact on inflation or real output.

And, even before you get to that point, dropping cash down from the sky presumes people would actually spend it. But, when the whole premise would be "hey, things are rotten, here's some cash and we'd really appreciate it if you went out and spent it" it's not hard to imagine people preferring not to spend the cash but instead to pay down debt, or to simply hoard it. Of course, they'd be hoarding that cash somewhere other than their bank, at least those people living in negative interest rate utopias.

You Can't Blame A Central Banker For Trying, Can You?

There has of late been considerable discussion as to whether or not there are limits to monetary policy and, perhaps more importantly, whether or not central bankers understand there are limits to monetary policy. While there are plenty of people not shy about expressing their disdain for central banks and central bankers, we are nowhere near being on board with that. That does not, however, mean we hold out much hope for monetary policy no matter how accommodative it becomes. Our view is that over the past several years central bankers have felt increasingly compelled to fill the void, one can argue a gaping void, left by the absence of meaningful fiscal policy, the lack of badly needed structural reforms, and what has been a less than constructive regulatory climate. There are no doubt many who disagree with this view, some who do so vehemently. But, to put our view in perspective, here is what we wrote a few weeks back in the commentary section of our weekly *Economic Preview* in response to an article bemoaning the loss of confidence in central banks' ability to support the global economy:

"Here is a short list of things central banks were not designed to do, cannot do, and should not be expected to do: fill the void left by fiscal policy makers lacking the wisdom or the will, if not both, to do their jobs; overcome what has become an ad hoc regulatory framework in which regulations are imposed with little or no debate and even less understanding of, if not a wanton disregard for, the economic implications; design and implement structural reforms to enhance economic efficiency; knock down poorly thought out and hastily imposed barriers to trade; and reverse weakening demographic trends. The price of credit is conspicuously absent from the list of issues that are, to different degrees in different countries, holding down global growth. Admittedly, we're no experts but we just can't figure out how low, or even negative, interest rates solve any of these issues, let alone all of them."

In short, we've ended up at a point where far too much is, mostly by default, being asked and expected of monetary policy. Again, this is a global issue, but for now let's just focus on the U.S. and start with fiscal policy. There is considerable scope for

Richard F. Moody, Chief Economist • 205.264.7545 • richard.moody@regions.com

fiscal policy actions that could foster faster economic growth, but a stark political divide pretty much rules out any meaningful changes. A good starting point would be the tax code, which is cumbersome, inefficient, and full of loopholes that can leave wide gaps between statutory and effective tax rates for both firms and individuals. As for the spending side of fiscal policy, good luck trying to have a meaningful discussion there without it turning into yet another mindless repetition of the partisan political platitudes that somehow these days pass for enlightened discourse. In any event, things such as labor force training and badly needed infrastructure repairs are left undone even though they are areas where government spending could be put to good use. The point here is there are ways in which fiscal policy could be used to unleash the economy's true productive capacity which, in turn, would foster faster growth in aggregate demand. The reality is that monetary policy simply cannot, nor should it be expected to, fill the void left by fiscal policy makers who cannot seem to muster up the will to do their job.

As for regulatory policy, think of all of the different ways in which different sectors of the economy have been faced with heavier regulatory burdens over recent years – energy, health care, finance, and transportation, just to name a few. It is simply not plausible to think the higher regulatory burden has not had an adverse impact on the rate of economic growth over the past several years, even if that cannot be adequately quantified. But, if one were able to add up the costs of heavier regulatory burdens across the entire economy, it would no doubt be considerable. This is by no means to say any and all regulation is bad, or bad for the economy, that's another discussion for another day. The point here, however, is the drag on economic growth from a higher regulatory burden is just one more hurdle facing monetary policy makers, but one which monetary policy is not equipped to overcome, nor should it be expected to.

Trade policy is another area where there is considerable room for changes that would help improve economic growth but also one where the politics are simply daunting. In other words, take the political barriers to meaningful trade policy changes in one country and multiply that by the number of prospective partners in a trade deal, and it's a wonder anything ever gets done. Even when deals get done, however, there is still a general inclination to protect domestic industries, even in times of better economic growth. In the slow-growth environment that has prevailed over the past several years, those inclinations only run deeper which, in the end, is a negative for growth. And, at least here in the U.S., the outlook for trade policy is, well, let's just say distressing. No matter who wins the Presidential election, it seems certain free trade will be a loser. Again, though, to the extent this is the case, there is no monetary remedy for higher trade barriers that act as a drag on overall economic growth.

Demographic trends clearly impact the rate of economic growth over time but, unless we seriously do not understand the meaning of the phrase "monetary transmission mechanism," are beyond the scope of monetary policy. As we have often discussed, over time an economy's non-inflationary "speed limit" is determined by the rate of growth in the labor force and the rate of productivity growth. Many nations, however, are in the midst of demographic shifts which are resulting in slower growth in the working age population, and structurally declining labor force participation rates are holding down the economic speed limits of these nations. This includes the U.S., but Japan and much of Western Europe are far more hamstrung by unfavorable demographics. Once again, this is simply not an issue that can be offset by accommodative monetary policy.

These are some of the main factors that are weighing on global economic growth but for which the remedy is not going to be found in monetary policy, no matter how negative interest rates may go or how much currency floats down from the sky. Yet, again as we see it, central banks have nonetheless felt compelled to try to fill the void left by the absence of meaningful policy moves on other fronts. While some argue that seeing the void didn't obligate central banks to jump into the middle of it, we simply do not find that a compelling argument. This isn't to say central bankers haven't reached too high or made missteps along the way, and, sure, we'd argue that dramatic vows to do "whatever it takes" make for better theatre than central banking. There is room for reasonable debate here, but we simply do not believe doing nothing was a viable option for central bankers.

That said, we simply have never seen monetary policy as the appropriate solution for most of the problems confronting the global economy in the aftermath of the deep and painful 2007-09 recession and financial crisis. On top of the factors discussed above, what many analysts have consistently missed is the extent to which impaired balance sheets have weighed on aggregate demand, here and abroad. To be sure, the sectors most impaired by excessive debt vary across economies, but we'd argue that anyone who expected a quick and robust rebound to the recession didn't fully grasp the importance of repairing household, business, and government balance sheets in countries across the globe and how lengthy this process can be.

In the U.S. the household sector was ground zero, too heavy on debt and too light on saving. While low interest rates offer relief in the form of lower monthly debt service ratios, they do not render the level of debt irrelevant. This is a point on which we strongly disagree with analysts who proclaim household deleveraging has run its course. As of Q3 2015 (the latest available data point) the aggregate household debt-to-income ratio stood at 104.4 percent. True, this is down from the cyclical peak of 132.8 percent, but still far higher than what we would consider sustainable. We believe households do consider the level of debt when deciding whether or not to take on additional debt, and we also believe the still-high level of debt has acted as a brake on growth of revolving consumer credit. In terms of this discussion, low interest rates may make taking on more debt less cumbersome on a monthly payment basis, but that doesn't necessarily make taking on more debt more attractive when the level of outstanding debt is already high.

As for the U.S. corporate sector, too much debt wasn't really the issue, but sitting on considerable excess capacity in what has been a slow-growth world nonetheless means low interest rates have little allure. Moreover, our past empirical work on this topic shows a very weak relationship between business investment and interest rates. Still, this does not mean businesses have not taken advantage of low interest rates. They've done so to refinance debt, pay dividends, and retire shares of stock, but none of these things directly effects the rate of economic growth.

This isn't to say that a prolonged period of unprecedented monetary accommodation in the U.S. and abroad, now being manifested in the move to negative interest rates in a growing list of foreign countries, has had no impact. That impact, however, simply isn't what central bankers had in mind when they went all in on monetary accommodation. At least we're fairly sure inflated asset prices, large and volatile capital flows, and the misallocation of credit were not the intended results. One can plausibly argue that at least part of the rocky start to 2016 in the financial markets is market participants coming to terms with the FOMC having taken the first, albeit small, step toward taking back some of that policy accommodation when they raised the Fed funds rate in December 2015. When the FOMC delivers the next funds rate hike, the guess here is we will see another, but not the final, round of asset prices adjusting to a world without support from accommodative monetary policy. Of course, that foreign central banks will likely be moving in the opposite direction will only add to what has so far this year been a high degree of volatility in global financial markets.

We can't but help think part of the problem is that central banks don't see the monetary transmission process as any different in a world of unconventional monetary policy, such as the world we have lived in for the past several years, than it is in a world of conventional monetary policy. In other words, back in the day conventional monetary policy worked through changes in borrowing costs impacting interest sensitive sectors of the economy, such as housing, consumer durables, and, at least to some degree, business investment spending, while trade channels were impacted as currency values adjusted to expected changes in the paths of interest rates. More broadly, asset values would respond in kind to changes in real activity, thus introducing a channel through which wealth effects played a role.

In a world of conventional monetary policy, then, low interest rates were "good" as they stimulated economic activity and supported rising asset values. The thinking behind much of the unconventional monetary policy we have seen for the past several years seems to be if low interest rates are good, then lower interest rates must be better, and negative interest rates will be better still as a means of stimulating economic activity, while wealth effects are expected, ex ante, to play an even more significant role in the transmission process. Unfortunately, this isn't exactly how it has worked in practice.

As discussed above, trying to use low interest rates to stimulate borrowing in already debt heavy economies is pretty much the financial equivalent of drinking from a fire hose. And, sure, asset prices have clearly been boosted to artificially high levels but there are two problems – first, the resulting increases in wealth were fairly concentrated such that any associated gains in consumption have been fairly small, and, second, as noted above investors, and in turn asset prices, will ultimately have to come to terms with the reality that, at some point, central banks will have to recalibrate policy.

In the meantime low interest rates have punished savers, and now negative interest rates will penalize banks for not making new loans. Seriously, if banks had prospective borrowers beating down their doors demanding loans, would anyone have ever even thought about negative interest rates, let alone actually implement them? And, on top of there being little to show for years of unprecedented monetary accommodation, talk of "helicopter money" simply adds insult to injury.

Somehow, rather than inspiring people to rush out and spend, we think it more likely cash giveaways would simply further undermine whatever faith people still have in the value of currency, leading people to look for alternative stores of value. It should tell us something that gold was one of the few assets for which prices were rising during the most turbulent days in the financial markets earlier this year – turbulence which of course led to more and more chatter about further monetary easing.

And, not to close on a down note or anything, but we can't help but be at least a little concerned to see how little impact all of this monetary policy has had in a global economy that is actually growing, albeit slowly and unevenly. It seems only logical to ask, although doing so may be uncomfortable, what central banks would do should this slow growth give way to recession. We'd say we cannot imagine what is left in the monetary policy arsenal, but, in all fairness, we never thought we'd actually see negative interest rates being used as a means of monetary "stimulus" so, hey, what do we know?

In short, central bankers may have started out with the best of intentions and, unlike many of those responsible for other policy areas, have at least tried. But, none of the main impediments to faster global economic growth – too much debt, too little productivity, too much economic inefficiency, unfavorable demographic trends – will be remedied by lower interest rates and/or more money, particularly to the extent "too low for too long" helped sow the seeds of the 2007-09 recession and subsequent anemic recover. And, most worrisome of all, central banks have painted themselves into a corner from which there will be little, if any, means for effective response should tepid global growth give way to recession. Like we said, not to close on a down note or anything . . .

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Q3 '15 (a)	Q4 '15 (p)	Q1 '16 (f)	Q2 '16 (f)	Q3 '16 (f)	Q4 '16 (f)	Q1 '17 (f)	Q2 '17 (f)		2014 (a)	2015 (p)	2016 (f)	2017 (f)
2.0	1.0	1.4	2.8	2.6	2.3	2.0	2.1	Real GDP[1]	2.4	2.4	2.0	2.2
3.0	2.0	3.2	2.7	2.6	2.3	2.0	2.1	Real Personal Consumption[1]	2.7	3.1	2.8	2.2
								Business Fixed Investment:				
5.5	-0.6	3.3	3.5	4.0	3.6	3.1	3.1	Equipment, Software, & IP[1]	5.6	4.1	3.0	3.3
-7.2	-6.6	4.2	2.5	0.9	1.7	2.8	5.5	Structures[1]	8.1	-1.6	-0.1	3.2
8.2	7.9	9.8	10.9	12.8	13.4	9.2	7.1	Residential Fixed Investment[1]	1.8	8.7	10.0	9.7
1.8	-0.1	0.9	0.5	0.4	0.6	0.5	0.6	Government Expenditures[1]	-0.6	0.7	0.8	0.6
-546.1	-556.8	-571.2	-579.7	-591.4	-604.7	-608.3	-613.6	Net Exports[2]	-442.5	-544.7	-586.7	-616.2
1.158	1.130	1.159	1.179	1.216	1.242	1.258	1.279	Housing Starts, millions of units[3]	1.001	1.106	1.199	1.300
17.8	17.8	17.7	17.5	17.3	17.0	16.7	16.5	Vehicle Sales, millions of units[3]	16.4	17.3	17.4	16.5
5.2	5.0	4.9	4.9	4.8	4.7	4.6	4.6	Unemployment Rate, %[4]	6.2	5.3	4.8	4.6
2.0	2.0	1.9	1.9	1.8	1.7	1.5	1.5	Non-Farm Employment[5]	1.9	2.1	1.8	1.4
0.9	1.1	1.5	1.5	1.6	1.9	1.9	1.8	GDP Price Index[5]	1.6	1.0	1.6	1.7
0.3	0.5	1.1	0.9	1.2	1.7	2.1	2.3	PCE Deflator[5]	1.4	0.3	1.2	2.2
0.1	0.4	0.9	0.7	1.0	1.5	2.3	2.5	Consumer Price Index[5]	1.6	0.1	1.0	2.4
1.3	1.4	1.6	1.6	1.6	1.7	1.7	1.8	Core PCE Deflator[5]	1.5	1.3	1.6	1.8
1.8	2.0	2.0	1.8	2.0	1.9	2.0	2.0	Core Consumer Price Index[5]	1.7	1.8	1.9	2.0
0.13	0.17	0.38	0.41	0.66	0.88	0.91	1.16	Fed Funds Target Rate, %[4]	0.13	0.14	0.58	1.28
2.22	2.19	1.90	2.01	2.15	2.30	2.53	2.71	10-Year Treasury Note Yield, %[4]	2.54	2.14	2.09	2.77
3.95	3.90	3.67	3.67	3.78	3.93	4.12	4.30	30-Year Fixed Mortgage, %[4]	4.17	3.85	3.76	4.37
-2.8	-2.8	-2.7	-2.7	-2.8	-2.8	-2.9	-3.0	Current Account, % of GDP	-2.3	-2.7	-2.8	-3.0

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