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A "New Normal" For The Labor Market Too?

With the addition of 156,000 net new jobs, September 2016 marked the 72nd consecutive month in which total nonfarm employment increased. This is far and away the longest such streak in the life of the data which date all the way back to 1940, with the July 1986-June 1990 period a distant second at 48 consecutive months. Over the past 72 months, the U.S. economy has added 14.375 million jobs, or an average of 200,000 jobs per month. Yet, despite this run, there is a general sense of dissatisfaction with the overall state of the labor market. It comes as no surprise that both sides have done their best to exploit this lingering unease to their advantage in the Presidential campaign, and even less of a surprise that the level of understanding of the causes and prospective cures on display has on "good" days been highly superficial and on bad days has been nonsensical.

To be sure, there are metrics that support the notion that, to paraphrase from a campaign in the not too distant past, mission not accomplished when it comes to the labor market. For instance, a notably low rate of labor force participation, growth in average hourly earnings still well below normal, and an elevated number of people who, while employed, are nonetheless underemployed. Indeed, we have for some time argued that there is significantly more slack remaining in the labor market than is implied by a headline unemployment rate at or even slightly below 5.0 percent, where it stood in September. There are, however, many analysts, and even some FOMC members, who argue the economy is very close to, if not already at, full employment.

To make this argument one must, whether explicitly or implicitly, hold the position that we are now in the midst of a "new normal" in the labor market. This new normal is characterized by a structurally higher level of, to borrow a term from the FOMC, underutilized labor resources. This term refers to the combined number of people who are either unemployed, underemployed, or marginally attached to the labor force. As seen in the following chart, after hitting a cyclical peak of 26.7 million people in Q4 2009, the number of underutilized labor resources had steadily declined, but thus far in 2016 has basically flat-lined, standing at 15.678 million people as of September. The question going forward, then, is whether there is room for further reduction or whether the labor market is settling into a new normal with a permanently higher number of underutilized labor resources.

This is far more than an academic question. Those who, like us, argue there is room for further reduction in this metric see the current elevated number of underutilized labor market resources as a meaningful drag on wage growth. As such, until this lingering labor market slack has been further pared down, wage growth will remain below the rate that would be seen in a fully healthy labor

Settling In At A New Normal?



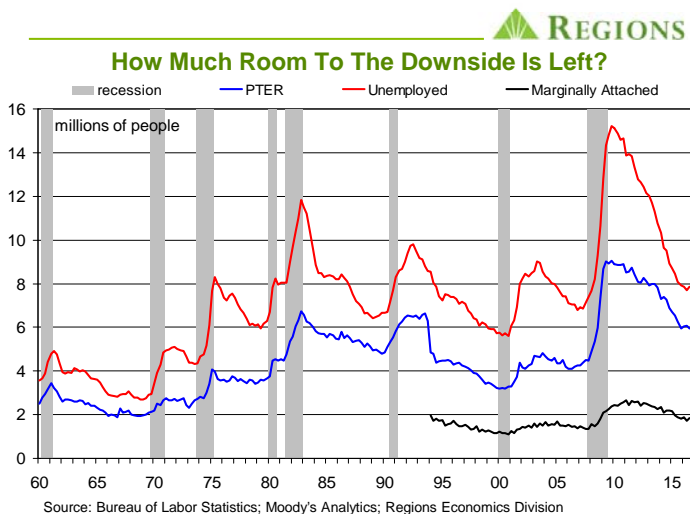
market. The other side of this argument is that, for a variety of reasons, there is little or no room for further reduction in the number of underutilized labor resources, and that the level at which this metric has settled over the past several months reflects a structurally higher "equilibrium" level. The implication is that this pool of underutilized labor resources will have little, if any, impact on wage growth, meaning we are at or near full employment and, in turn, faster wage growth on a sustained basis.

To the extent this is a precursor for an acceleration in inflation in the broader economy, it is clear why we and other analysts, not to mention more than a few central bankers, are trying to get a handle on the degree of slack that remains in the labor market. If we are indeed at or close to full employment, this would suggest faster wage growth which, some argue, will be followed by faster inflation in the broader economy. As such, given the lengthy lags with which changes in monetary policy impact the real economy, this suggests the FOMC should act sooner, rather than later, in order to fend off budding inflation pressures. In other words, the next hike in the Fed funds rate should come sooner, not later.

While we are constantly pointing out that it is incorrect to simply assume faster wage growth leads to faster inflation, there could well be a stronger link now than has been the case in past cycles. That's because the buffer between wage growth and inflation, i.e., the rate of labor productivity growth, is much thinner now than has been the case in past cycles. Without this buffer, firms must either accept further compression in profit margins or attempt to pass along higher labor costs in the form of higher output prices.

To help assess whether there is room for further reduction in the pool of underutilized labor resources, we think it useful to look at the individual components. As seen in the chart below, the number of those unemployed and those working part-time for economic reasons would seem to have much further to go on the downside

before those levels would be seen as consistent with a fully healthy labor market. The same is true, though to a lesser degree, with the number of those marginally attached to the labor force. One problem, though, with trying to gauge “normal” levels of those marginally attached to the labor force is the data on this series does not start until 1994, making it harder to peg the “normal” level and, by extension, how much further room to the downside there is for this metric.



For the other two components there is a much longer history, but gauging “normal” levels is still prone to some degree of subjectivity. For instance, one reason many analysts see little capacity for further reductions in the number of unemployed is that the duration of unemployment remains considerably above historical averages. Over the 1948-2007 period, the average duration of unemployment was 13.5 weeks while the median duration was 7.2 weeks. After peaking at 40.5 weeks in Q3 2011, the average duration has fallen but as of Q3 2016 still stood at 27.7 weeks; the median duration peaked at 23.2 weeks in Q2 2010 but as of Q3 2016 stood at 11.0 weeks.

The cyclical peaks for both average and median duration of unemployment mark the highest readings in the life of the data. In other words, the 2007-09 recession and its aftermath brought unprecedented levels of long-term unemployment, and that sour legacy lingers on for many. To see this more clearly, as of Q3 2016 25.5 percent of those unemployed had been so for 27 weeks or longer. While down from the cyclical peak – and historical high – of 44.9 percent in Q2 2010, this share is nonetheless far above the 12.9 percent average over the 1948-2007 period. Why this matters is that the longer one is unemployed, the lower the probability they will find another job, which could reflect atrophying of skills, lost networking connections, or bias on the part of prospective employers who, rightly or wrongly, tend to extract negative signals from an extended period of unemployment.

If so, then a significant number of those currently unemployed are not likely to be viable job candidates and, as such, are more likely to ultimately exit the labor force than to find a new job. Indeed, the number of the long-term unemployed who exit the labor force each month remains significantly higher than the longer-term average that prevailed prior to the 2007-09 recession. The

implication is that the long-term unemployed have no bearing on the wage setting process as they are highly unlikely to land another full-time, permanent position.

Some analysts argue the same lack of influence on the wage setting process is also true for a significant share of those who are working part-time for economic reasons, but in this case it is a structural change in the economy that is the culprit. The argument is that the Affordable Care Act (ACA) has, in essence, institutionalized part-time employment for a considerable number of employees, with hours intentionally held down by employers to avoid the costs of providing health care coverage. So, while by historical standards it is reasonable to think that, at roughly six million people as of Q3 2016, the number of those working part-time for economic reasons is around 1.5 million above what could be considered normal, those longer-term averages no longer apply. As a result, it is highly unlikely people stuck in this situation will transition to full-time employment, particularly since doing so would require them to change jobs. The bottom line is that this pool of workers will have no bearing on the wage setting process.

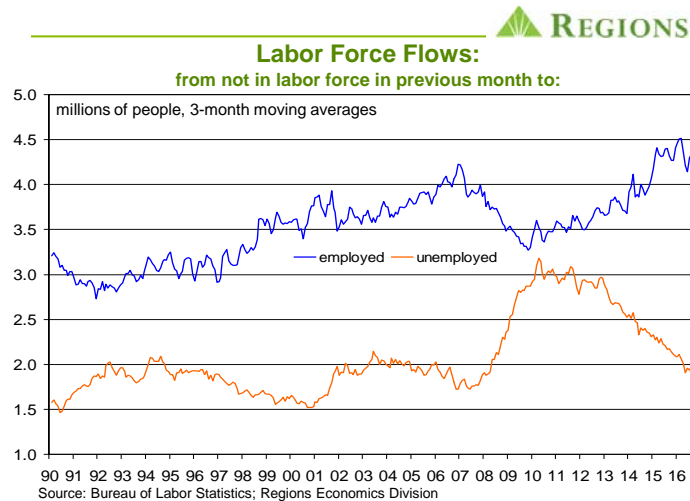
Both of these arguments basically advance the same point – that there is less slack in the labor market than is implied by seemingly still elevated numbers of those either unemployed or working part-time for economic reasons. To the extent this is the case, then we are at or very close to the point where wages will have to be bid higher in order for firms to attract new workers or retain current workers. Again, there are at least some FOMC members who seemingly embrace this view. To the extent they see a causal link between faster wage growth and faster inflation in the broader economy, it would bias them towards raising the Fed funds rate sooner, and perhaps more aggressively, than those who still see an elevated degree of slack that is holding down wage growth.

While we don't totally dismiss these arguments, we nonetheless are not convinced they are correct, at least to the extent believed by those who advance these arguments. Instead, as we noted above, we believe there is considerable capacity for further declines in the number of underutilized labor resources. As for the ACA, its mandated threshold for full-time employment is 30 hours a week, not the more than 34 hours used in the employment data. Our point has always been that the incidence of employers purposely managing down hours is likely confined to industry groups such as retail trade and leisure & hospitality services, in which the average worker works fewer than 34 hours per week. It simply does not seem plausible that firms in other industry groups, particularly with those in which average workweeks are closer to 40 hours, find it feasible to hold down hours to avoid the grasp of the ACA, as doing so would lead to significant hits to productivity if not large-scale exits of disgruntled workers.

If we are correct, then there is still capacity for those now working part-time for economic reasons to transition to full-time work. The rate at which these shifts occur would be mainly a function of how confident firms feel that there will be sufficient demand for them to take on more full-time workers. And, it could be that many part-time workers would be willing to shift to full-time employment at lower wages than they would otherwise settle for, in return for working more hours. In other words, firms could take on greater numbers of full-time workers without necessarily having to offer higher wages, meaning that there is little impact on wage growth

until the number of those working part-time for economic reasons falls closer to what historically would be considered normal levels.

As for long-term unemployment, we do think that to some extent this is an impediment to an individual finding a new job. But, that does not necessarily mean firms are facing a shortage of available labor. Nor does it validate what has become an oddly common refrain amongst some analysts – “there are no more workers to hire.” This is no closer to the mark than the “there are no villas to rent in Tuscany” refrain was back in the day. For instance, the data on labor force flows continue to show high numbers of people moving into the labor force from the sidelines in any given month.

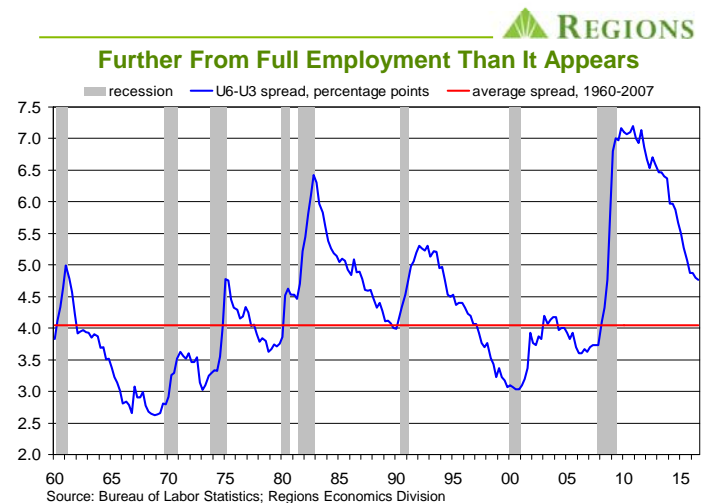


The chart above shows the flow into the labor force of people who in the prior month were not in the labor force (we show 3-month moving averages as the monthly data are highly volatile). It has always been the case that the majority of those who transition from not in the labor force are employed upon entry into the labor force, and that majority has gotten even larger over the past several months. And, while it is true that there are also outflows from the labor force each month, the reality is that net flows, i.e., the difference between inflows and outflows, have not only been positive for some time now but have gotten progressively larger over the past several months.

Our point here is that the body of the labor market data, including data on labor force flows and underutilized labor resources, would seem to suggest we are nowhere near the point where “there are no more workers to hire.” If so, then by extension we are nowhere near the point where we will see meaningfully faster wage growth, at least not to the point where that would raise concerns about accelerating inflation in the broader economy. In our annual outlook for 2016 we noted we did not expect growth in average hourly earnings jump into the 3.0-to-3.5 percent range, typically associated with a fully healthy labor market, by year-end 2016 as some analysts were predicting. Indeed, we stated that growth would be no better than 2.8 percent by Q4 2016, and for Q3 growth was at 2.6 percent.

Where we were wrong, though, was in our forecast, which is proving to be too aggressive, of the rate at which remaining labor market slack would be absorbed in 2016. In 2013, 2014, and 2015 the number of underutilized labor resources fell by at least two

million people, but as we showed above the number of people in this group has barely budged in 2016. A common argument is that skills gaps are holding down the rate of hiring, as those who remain either underemployed or underemployed are lacking in the skills desired by firms. Those who make this argument typically point to the monthly data on job openings and labor turnover (or, the “JOLTS” data) to support this contention. While we don’t doubt there are some industries in which lack of skilled labor is holding down the rate of hiring, we do not believe this issue is as prominent as some claim it to be. For one thing, while reported job openings continue to hover at record highs, this number is biased higher by multiple listings of the same positions on online job sites. Moreover, hiring rates are actually higher now than they were earlier in the year in many industry groups, which goes against the skills shortages argument. Finally, were firms truly intent on hiring but lacking in skilled candidates, we’d likely see more upward pressure on wages than is currently the case.



We’ll use the above chart to summarize our discussion of this issue. Over the 1960-2007 period the average gap between the “headline,” or, U3, unemployment rate and the broader U6 rate which also accounts for those working part-time for economic reasons and those marginally attached to the labor force was 4.05 percentage points (note that the pool we’ve been referring to as underutilized labor resources makes up the numerator in the calculation of the U6 rate). Though the gap has narrowed considerably from the peak of 7.2 percentage points in Q4 2010, it still stands at 4.8 percentage points as of Q3 2016.

While other estimates vary slightly, we peg a U3 rate of 4.5 percent as consistent with “full employment.” This would imply a U6 rate of 8.55 percent if the gap between the two was at its historical average. To get to this point, the pool of underutilized labor resources would have to decline by 1.785 million people from where it was as of September. And, sure, while the U6-U3 gap may be structurally higher, or the U3 rate consistent with full employment may be higher than we think, we’re talking marginal differences, and the bottom line is there is still, after 72 straight months of job growth, a considerable degree of labor market slack yet to be absorbed. In turn, this means it will be some time before wage growth returns to normal. Again, this is a debate that is not only going on amongst private sector analysts, but also within the

FOMC. So, while the FOMC may indeed raise the Fed funds rate at their December meeting, the labor market data offer little basis on which to argue that subsequent rate hikes will, or should, come at anything but a very, very gradual pace.

Households Saving More . . . No, It's Not Cause For Concern

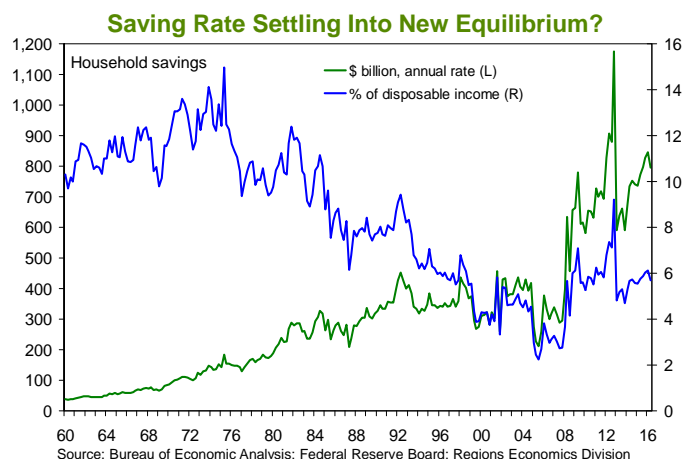
The Federal Reserve recently published the latest update of their Z1 release – *Financial Accounts of the United States*, or, as it is commonly known, the *Flow of Funds*. Trust us, it's really more scintillating than the name may imply; indeed, nothing screams "Friday night fun" like curling up with the latest edition of the *Flow of Funds* release. In any event, the data offer a useful and detailed view of household and corporate balance sheets and credit flows throughout the economy. The latest release is as of Q2 2016.

Our focus here is on the household sector, and the latest data show household net worth reached another record high in Q2 2016, rising to \$89.1 trillion. Since hitting a cyclical low in Q1 2009 household net worth has risen by over \$34.6 trillion. In the early stages of the bounce from the cyclical low, rising stock prices were far and away the main driver of rising net worth, with one implication being gains in net worth were concentrated amongst a relatively small share of U.S. households. Though there have been ups and downs, the value of household stock holdings has continued to rise, and as of Q2 2016 the value of stock holdings was 40 percent higher than its pre-recession peak.

Over the past few years, however, rising home prices have become a key driver of growth in household net worth. As such, gains in net worth were spread amongst a wider swath of U.S. households, as the incidence of homeownership, even after having fallen sharply since the housing market bust, is higher than the incidence of stock ownership, direct or indirect. Still, even having risen sharply since 2013 housing equity remains 5.4 percent below its prior cyclical peak as of Q2 2016.

What is also interesting is that households have also significantly increased their holdings of currency and deposits – checking and saving – in the aftermath of the 2007-09 recession. Though it may perhaps come as a surprise, savings deposits have been the primary vehicle through which households have increased their holdings of liquid assets. For instance, as of Q2 2016 savings deposits accounted for 66.2 percent of the broad M2 money supply, just slightly below the record share of 66.5 percent in Q4 2015. Think about how many times over the past several years, in this era of monetary policy venturing further and further into uncharted territory aimed at holding down interest rates, you've heard the term "search for yield." Now, we're no experts, but as we understand it, if one is searching for yield the last place they would look would be a passbook savings account.

Yet, households continue to add to their savings, held mostly in a highly liquid, albeit not highly earning, form. The causes and implications of this have been topics of considerable discussion, and for some analysts a source of confusion as if saving is some sort of abnormal behavior. Granted, saving may indeed be a foreign concept to anyone who came of age in the years leading up to the 2007-09 recession when households were tanking up on debt, but we're neither confused nor surprised.



It is important to look not at the absolute level of saving but the level of saving in relation to disposable income, i.e., the saving rate. As seen in the above chart, the saving rate has risen quite a bit from the historical low rates that prevailed in the years leading up to the 2007-09 recession, but nonetheless remains far below historical averages. This is a topic we've done considerable empirical work on and have discussed in prior outlooks, so we won't cover all that ground again here. But, our main argument has been that the household saving rate is settling into a new equilibrium between 5.5 and 6.0 percent.

It is useful to think about what has driven the saving rate higher in the post-recession years. Part of it may indeed be heightened risk aversion; it has been common in past cycles for households to up their savings during and after recessions, though granted not to the same extent seen during this cycle. This cycle, however, has a demographic component to it that has not been part of past cycles. In other words, given we are on the verge of what will be a considerable wave of retirements amongst the Baby Boom generation, it is logical to think members of this age cohort will have upped their saving in anticipation of retirement.

It is true, as we noted earlier, that household holdings of stocks have blown through their prior cyclical peak. But, for those nearing retirement, having seen an epic collapse in stock prices may have left them permanently more risk averse than they otherwise would have been. Moreover, with interest rates having been held so low for so long, those targeting a retirement nest egg of a certain size would have had to save much more than had interest rates been moved by, you know, markets rather than by central banks.

In short, we believe higher saving – in the U.S. and globally – is being driven to a considerable degree by demographic factors that are magnified by a prolonged period of artificially low interest rates. We strongly disagree with those who take the increased saving rate as a sign of household distress, and even more so with those who argue higher saving is a drag on the rate of economic growth. Really? In any event, to the extent there is a demographic component to the higher saving rate, it should persist for some time to come, particularly if interest rates remain low. While no one, certainly not us, expects the saving rate to jump back to where it was in earlier decades, neither do we expect it to sink back to pre-recession lows. This is not, however, a bad thing.

ECONOMIC OUTLOOK



REGIONS

October 2016

Q1 '16 (a)	Q2 '16 (a)	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	1.4	2.6	2.5	2.2	2.0	2.1	1.9	Real GDP ¹	2.4	2.6	1.5	2.2
1.6	4.3	2.7	2.7	2.5	2.2	2.2	2.2	Real Personal Consumption ¹	2.9	3.2	2.7	2.6
								Business Fixed Investment:				
-4.5	1.7	0.4	2.2	2.2	2.2	1.8	2.0	Equipment, Software, & IP ¹	4.8	4.0	0.3	1.9
0.1	-2.1	-0.1	2.0	3.0	3.3	2.7	2.5	Structures ¹	10.3	-4.4	-4.0	2.1
7.8	-7.8	-0.2	2.5	4.6	7.2	7.3	8.6	Residential Fixed Investment ¹	3.5	11.7	4.9	3.8
1.6	-1.7	-0.8	1.3	1.5	1.1	1.1	1.0	Government Expenditures ¹	-0.9	1.8	0.7	0.8
-566.2	-558.4	-552.3	-565.5	-577.5	-588.8	-596.0	-602.5	Net Exports ²	-425.7	-540.0	-560.6	-591.2
1.151	1.159	1.168	1.140	1.149	1.167	1.199	1.235	Housing Starts, millions of units ³	1.001	1.108	1.155	1.188
17.3	17.1	17.5	17.0	16.7	16.4	16.2	16.1	Vehicle Sales, millions of units ³	16.5	17.4	17.2	16.3
4.9	4.9	4.9	4.8	4.8	4.7	4.7	4.6	Unemployment Rate, % ⁴	6.2	5.3	4.9	4.7
1.9	1.8	1.7	1.5	1.4	1.4	1.3	1.2	Non-Farm Employment ⁵	1.9	2.1	1.7	1.3
1.2	1.2	1.1	1.2	1.5	1.4	1.6	1.7	GDP Price Index ⁵	1.8	1.1	1.2	1.6
0.9	1.0	0.9	1.3	1.7	1.7	1.9	1.8	PCE Deflator ⁵	1.5	0.3	1.0	1.8
1.1	1.1	1.1	1.4	2.0	1.8	2.0	1.9	Consumer Price Index ⁵	1.6	0.1	1.2	1.9
1.6	1.6	1.6	1.7	1.7	1.7	1.8	1.9	Core PCE Deflator ⁵	1.6	1.4	1.6	1.8
2.3	2.2	2.2	2.1	1.9	1.8	1.8	1.9	Core Consumer Price Index ⁵	1.7	1.8	2.2	1.8
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	1.56	1.75	1.85	1.90	1.95	2.00	10-Year Treasury Note Yield, % ⁴	2.54	2.14	1.75	1.93
3.74	3.59	3.45	3.59	3.71	3.80	3.85	3.87	30-Year Fixed Mortgage, % ⁴	4.17	3.85	3.59	3.81
-2.9	-2.6	-2.7	-2.8	-2.9	-3.0	-3.1	-3.2	Current Account, % of GDP	-2.3	-2.7	-2.8	-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