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Catch A Falling U.S. Dollar

Well, we didn't expect much out of the U.S. dollar in 2017 but we expected more than this. After heading into 2017 riding high on a wave of positive sentiment towards the U.S. economy and somewhat pedestrian expectations for global economic growth, the U.S. dollar has not lived up to the hype and sentiment has turned somewhat negative. As such, the main question concerning the U.S. dollar has gone from "how much higher?" to "how much lower?" Our answer to the former was "not a lot" but there could be considerably more downside left for the U.S. dollar over coming quarters, as we will discuss below.

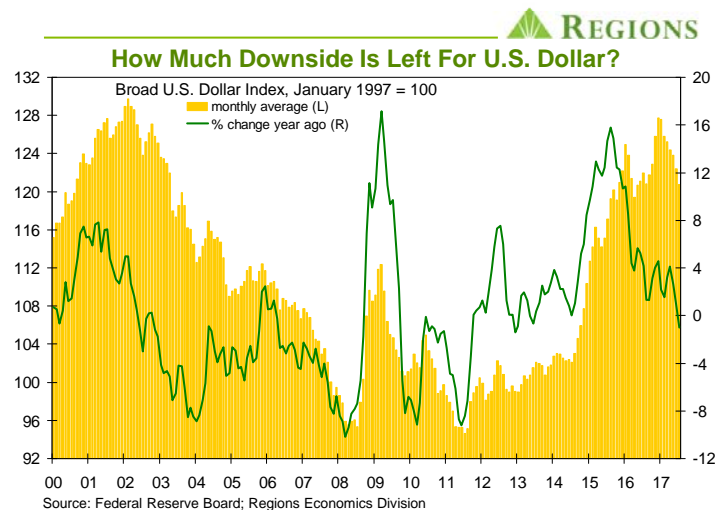
In our annual economic outlook piece (see the January 2017 *Monthly Economic Outlook*), we offered a below consensus call on the U.S. dollar. If that sounded familiar to our long-term readers, that's because our 2017 outlook for the dollar was pretty much the same as our 2016 outlook, which was pretty much the same as our 2015 outlook. A common theme amongst many market participants heading into each of the past three years has been that a growing degree of divergence in monetary policy amongst the Fed and foreign central banks would support steady appreciation of the U.S. dollar.

The FOMC contributed, even if unintentionally, to this view by messaging an aggressive course of Fed funds rate hikes in the "dot plot" released in conjunction with their regular economic forecasts. Specifically, the December 2014 and December 2015 editions of the dot plot each implied four 25-basis point hikes in the mid-point of the Fed funds rate target range over the course of the following year. This helped push the exchange value of the U.S. dollar higher and supported these higher values of the dollar, at least initially, in each year. While the December 2016 dot plot implied only three quarter-point funds rate hikes, the U.S. dollar got an added kick from the November 2016 elections, which raised expectations of policy fueled accelerations in growth and inflation that would cause the FOMC to be more aggressive in raising the funds rate.

As we discussed in our annual economic outlooks for 2015 and 2016, we thought there was more policy divergence priced in the dollar than would actually be seen over the course of the year, hence our below consensus calls on the exchange value of the U.S. dollar. That was also our premise in our 2017 outlook, but heading into this year we also thought many forecasts for the path of the U.S. dollar incorporated more divergence in economic growth rates than would actually be the case this year. This reflected our view that expectations for the U.S. economy were too high and those for the rest of the world were too low.

That said, we have still been surprised by the rapid decline in the exchange value of the U.S. dollar thus far in 2017. The Fed's Broad Dollar Index ended 2016 just 1.6 percent below its all-time record high, and our 2017 forecast was that the post-election euphoria

would be sufficient to push the index to a new record high early in the year but that this would not be sustained. While we got the "not sustained" part right, the index didn't really make a run at a new record high. Instead, the index hit its high for 2017, at least to date, on January 3 and has been drifting lower ever since.



Indeed, as seen in the above chart, the Broad Dollar Index has not only been declining on a month-to-month basis during 2017, but the daily index value has been down year-on-year every day since July 6. It's worth noting that while we focus on the Broad Dollar Index, just about any measure of the exchange value of the dollar, whether relative to a basket of currencies or individual major currencies, has exhibited similar patterns. So, what happened? Well, while you could just chalk this up as yet another illustration of how, when the consensus is so aligned with so much conviction, you should run the other way, there are actually a number of more fundamental factors behind the downturn of the U.S. dollar.

One factor is that reality has set in. In other words, post-election expectations of U.S. economic growth and inflation were simply too high, at least on the part of those who thought Republican control of the White House and Congress would quickly result in sweeping changes in fiscal and regulatory policy that would put the U.S. economy on a much faster growth path. Those expectations have been deflated, though perhaps not completely, by the lack of meaningful movement on matters such as health care and tax reform while over the first half of 2017 the U.S. economy grew at roughly the same 2.1 percent pace that has prevailed since the end of the 2007-09 recession.

At the same time, global economic growth has clearly improved, most notably in the Euro Zone, which is in line with our premise that global growth differentials would narrow, not widen, this year. One implication of improving global growth is that foreign central banks may feel they have the latitude to start pulling back on the

degree of monetary accommodation they have been providing. For instance, it is widely expected that at some point this fall the European Central Bank (ECB) will announce that while they will extend their asset purchases into 2018, the rate at which they will purchase assets will be scaled down. This gets us back to our point that there is likely to be less divergence in monetary policy this year than had widely been assumed heading into 2017.

And, along those lines, the recent deceleration in inflation means that 2017 could be yet another year in which the FOMC delivers fewer Fed funds rate hikes than they had messaged heading into the year. Recent months have seen both headline and core inflation move further away from, rather than closer to, the FOMC's target, calling into question whether or not there will be a third 25-basis point funds rate hike in 2017. There is at present considerable debate, both within and outside of the FOMC, as to whether the deceleration in inflation is transitory or structural, and the timing of the next funds rate hike will be highly dependent upon how that debate is resolved. At present, however, market participants attach only about a fifty percent chance of another funds rate hike in 2017, and this too has contributed to the recent weakness in the U.S. dollar.

To be sure, the deceleration in inflation of late is not strictly a U.S. story but is instead a global story. So, to the extent it gives the FOMC pause, it will likely do the same for foreign central banks. That does not, however, preclude there being a lesser degree of policy divergence between the Fed and global central banks over coming quarters. And, in the end, the factors we have outlined above have aligned to lessen the allure of U.S. dollar denominated assets after several years in which dollar denominated assets were pretty much the only game in town. This has been a key factor behind the turn in sentiment against the U.S. dollar.

It is valid to point to the FOMC's intent to begin the process of paring down the Fed's balance sheet "relatively soon" as a factor that could stem the dollar's slide. We don't, however, think this will prove very impactful, at least not if the process of normalizing the Fed's balance sheet does, as the FOMC intends, turn out to be policy equivalent of "watching paint dry." Granted, this is uncharted territory, but the FOMC has repeatedly emphasized their intent for this to be a very gradual process that will not have a meaningful impact on market interest rates. To the extent that is the case, balance sheet normalization won't do much to prop up the U.S. dollar, particularly to the extent risk assets denominated in other currencies become increasingly attractive to global investors.

This is one reason why we don't rule out a much deeper decline for the U.S. dollar over coming quarters. Consider the chart of the Broad Dollar Index shown on the prior page. To the extent that anticipated degrees of growth differentials and monetary policy divergence were the main factors behind the increased exchange value of the U.S. dollar from late-2014 through 2016, one could make a plausible case the Broad Dollar Index has considerably more room to run to the downside, particularly if the FOMC slows the pace of Fed funds rate hikes.

Still, one should also never underestimate the speed with which currency values can change course in response to economic and/or political shocks. In other words, any event that would lead to

higher degree of risk aversion and in turn increase demand for U.S. dollar denominated assets would lead to a stronger dollar. In the absence of such a shock, however, it is worth considering some of the implications of a weaker U.S. dollar. For instance, a weaker U.S. dollar makes goods imported into the U.S. more expensive for U.S. consumers to purchase. Given the extent to which goods consumed in the U.S. are produced abroad, this could provide support for a faster rate of inflation in the U.S. As we routinely note in our monthly write ups of the CPI data, prices for core consumer goods (i.e., goods excluding food and energy) have long acted as a material drag on core inflation, and indeed have fallen on a year-on-year basis in 51 of the past 52 months.

As we discussed in our July *Outlook*, however, the combination of considerable idle industrial capacity on a global basis and structural changes in how (as opposed to how much) consumers spend have left both producers and sellers of goods with strikingly little pricing power. This in turn means that a weaker U.S. dollar would likely lead to the U.S. "importing" less inflation from the rest of the world than would have been the case in the past. At the same time, however, a weaker U.S. dollar would help fuel faster growth in U.S. exports of goods as they become relatively cheaper in global markets. We will note that any such "price effects" tend to be dominated by "income effects," so, in other words, the faster pace of global economic growth will do much, much more to fuel growth in U.S. exports than will a depreciating U.S. dollar, though many analysts fail to make this distinction.

A weaker U.S. dollar will also help support growth in corporate profits for larger multi-national corporations with exposure to the rest of the world. More localized U.S. manufacturers and domestic service providers, however, won't see any such benefit from a weaker U.S. dollar. To some extent, this boost to profit growth from a weaker U.S. dollar has been a catalyst behind recent increases in U.S. equity prices. Enjoy those capital gains, however, as these improved foreign profits won't be coming back to you in the form of higher dividend payments unless and until the ridiculous 35 percent tax rate on repatriated foreign earnings is lowered or, preferably, eliminated entirely. In other words, in the absence of meaningful corporate tax reform, a weaker U.S. dollar will support faster growth in profits from foreign operations, but those profits will most likely just be added to the hoards of cash being parked abroad by many U.S. corporations.

It is also worth noting that a weaker U.S. dollar does not guarantee improved corporate profits – it matters of course why the dollar is falling. For instance, should the U.S. be seen as intentionally trying to talk down the value of the dollar to spark faster growth in U.S. exports, or should the U.S. pursue restrictive trade policies that would lead to retaliation on the part of trading partners, the U.S. dollar would surely weaken as would corporate profits. As in so many other instances, no matter where it is you decide you want to go, how you try to get there matters just as much, if not more.

A weaker U.S. dollar could be somewhat worrisome for the FOMC in that it will contribute to further easing in overall financial conditions. This is a topic that clearly has the Committee's attention, in that looser financial conditions can potentially contribute to asset price imbalances that, ultimately, won't end well. This puts the FOMC in somewhat of a bind, as they must balance these concerns against concerns that moving too quickly

in normalizing the Fed funds rate could destabilize the economy. And, foreign central banks won't likely be too thrilled with further declines in the exchange value of the U.S. dollar, given stronger home currencies would make it harder for them to hit their inflation objectives while also acting as a drag on export growth. To this point, if indeed the ECB does announce that they will begin scaling down the rate of their asset purchases, look for ECB President Draghi to insert the word "gradual" into his remarks as many times as it is humanly possible to do so – "Super Mario" may give way to "Super Gradual Mario."

You very seldom hear anyone complain about the lack of volatility in currency markets, for the simple reason is that volatility is seldom lacking from these markets. Sentiment can turn in an instant on any number of factors, some of which actually are tied to the underlying economic fundamentals. For instance, a revival of prospects for meaningful corporate tax reform in the U.S. would likely launch the U.S. dollar on a steep upward trajectory. With that in mind, we're hesitant to extrapolate the recent declines in the exchange value of the U.S. dollar too far out. But, to the extent that global economic growth is less dependent on the U.S. than has been the case over the past several years and given that global central banks are moving, even if at a seemingly glacial pace, towards less divergent monetary policy stances relative to the FOMC, it could be that the decline in the exchange value of the U.S. dollar has much further to run.

U.S. Consumers On Solid Footing Or Shaky Ground?

Frankly, we don't know. But, at least we know that we don't know. Which of course is better than not knowing that we don't know. But, then again, not knowing what we don't know allows us to fill up four or five pages each month, whereas if we knew everything we don't know we'd never . . . Oh, forget it.

In any event, along with their initial estimate of Q2 GDP the BEA released the results of their annual benchmark revisions to the recent historical data, in this case the Q1 2014-Q1 2017 period. For the most part, the revisions were pretty much of a wash, at least in the sense that the post-revision data show average annualized quarterly real GDP growth of 2.1 percent since the end of the 2007-09 recession, the same as the pre-revision data.

There is, however, one striking element of the revised data that certainly warrants attention. The revised data show the personal saving rate to be significantly lower than had been reported in the data prior to the benchmark revisions, mainly due to what is also a significant downward revision to growth in disposable personal income. That is primarily due to a downward revision to aggregate wage and salary earnings, which in the revised data are reported to have grown at a significantly slower pace in 2016 than had been reported prior to the revisions.

The most significant revisions to wage and salary earnings, personal income, and personal saving are limited to the data for 2016. That of course makes them no less puzzling, but it does suggest consumers came into 2017 on less solid footing than had previously been thought to be the case. Before offering any thoughts on what this means going forward, it may help to look

backward to help identify the factors behind these revisions. Keep in mind that wage and salary earnings account for over half of total personal income, so it makes sense that revisions to this series in turn impacted overall income growth and the saving rate.

Wage and salary earnings are a function of the number of people working, the number of hours they work, and what they earn for each hour they work. The most complete and reliable source of data on these metrics is the Quarterly Census of Employment and Wages (QCEW). The QCEW data are derived from state Unemployment Insurance tax returns, which virtually all employers are required to file. The QCEW data are the foundation of many downstream data series, including the nonfarm employment data produced by the BLS and the personal income data produced by the BEA.

As with so many things in life, however, it's a matter of timing. In other words, while many downstream data series incorporate the data from the QCEW, they don't all do so at the same time or with the same frequency. The BEA incorporates the QCEW into their various income series as they become available. For instance, the revised data on personal income issued by the BEA in late-July incorporate the QCEW data through Q1 2017 into the component measuring wage and salary earnings. Prior to last month's revisions of the GDP data, the BEA had reported aggregate wage and salary earnings grew by 3.92 percent in 2016, the revised data show growth of only 2.88 percent.

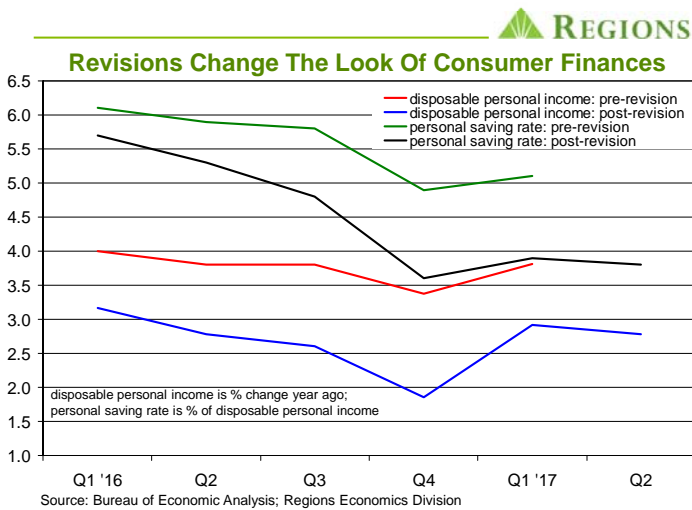
At this point, however, those keeping score at home (admit it, you are) may be wondering how this can be when the data on nonfarm employment show average monthly job growth of 187,000 jobs in 2016. The disconnect stems from the fact that the BLS data on nonfarm employment are, at present, still benchmarked to the Q1 2016 (specifically, March 2016) QCEW data. The BLS updates its "reference month" only once a year – in any given year March of the prior year is the reference month. One implication is the BLS cannot fully account for either new firms that have come into existence or existing firms that have gone out of business until it benchmarks its establishment survey to the QCEW data.

That the BEA data on wage and salary earnings were revised down to such a degree strongly suggests that when the BLS releases its next round of benchmark revisions (the preliminary estimate is due with the August employment report on September 6) job growth for 2016 will be revised lower, as could also be the case with hours worked and average hourly earnings. As to why that would be the case, firms entering/exiting the landscape is unlikely to be the main explanation, or even a significant part. One possible culprit is the weather. Yes, we're going there. Hey, we haven't blamed anything on the weather in at least a few hours, so it's due.

In all seriousness, 2016 was marked by a number of significant weather events, including harsh winter storms, flooding, Florida's first hurricane in 11 years, and wild fires. These events touched many parts of the U.S. throughout the year, but it is possible that the nonfarm employment data did not adequately capture the full effects. There were several months in 2016 in which response rates to the BLS establishment survey were well below the average for those months, meaning the BLS would have had to rely on its own estimates to produce the monthly employment reports. Any errors stemming from such estimates won't be fully accounted for until the benchmark revisions are completed. And, data from the

household survey show significant numbers of people were either not at work or only worked part-time due to inclement weather for months in which this is not typically the case. As such, it very well could be the case that overestimates of hours worked, not the number of people working, led to initial estimates of wage and salary earnings being too high.

Again, we don't know this to be the case, we're just trying to fill in what is now a large gap between the data on employment and earnings. In any event, the BLS's annual benchmark revisions will fill in the blanks, but, to get back to our initial point, the revised data available now show U.S. consumers in a less flattering financial light, with personal income growth and the personal saving rate both noticeably lower in 2016 than previously reported.



The above chart shows growth in disposable personal income and the personal saving rate prior to and after the BEA's benchmark revisions. Note that the personal saving rate in Q4 2015 is reported as 6.1 percent in both the pre-revision and post-revision data, so, in other words, 2016 started out on equal footing in the two series (the levels of both consumer spending and disposable personal income in Q4 2015 are shown to be higher in the revised data, but the saving rate is the same). Aside from growth in personal income being revised lower for 2016, growth in total personal spending was revised higher (from 3.90 percent to 4.06 percent), which also contributed to the downward revision in the saving rate for 2016.

As to what all of this means, there are any number of interpretations. While we're having trouble settling on any single one of them, other analysts have taken the revised data and run with it. For instance, we've heard more than one point to the newly reported path of the saving rate as a sign of distress amongst consumers. In the face of slower income growth they've had to dip into their savings in order to maintain the same level of consumption, leaving them increasingly vulnerable to some sort of financial shock or an adverse economic event such as the loss of a job or an involuntary reduction in hours worked. Others have pointed to the increased use of revolving credit over recent quarters as a sign of distress stemming from slower income growth and less saving. We've also heard some claim the revised data on income and saving "validate" what has been a string of less than inspiring headline prints on the monthly retail sales reports.

Though not convinced, we won't just dismiss the first two points. To be sure, consumers typically resort to either increased use of debt or paring down savings as a means of consumption smoothing when faced with transitory income shocks, but neither of these is a long-term solution. In other words, if the income shock proves to be lasting, then ultimately spending will have to be reduced. Thus far, however, there are no signs in the data to suggest consumers are doing so. And, no, the monthly retail sales reports do not constitute such evidence. By this point we're pretty much out of patience with anyone who either simply won't or just doesn't know they should account for falling prices of consumer goods before making any assessment of consumer spending.

The Q2 GDP data show consumer spending bounced back from a fairly weak Q1, particularly consumer spending on goods (again, adjusted for inflation), and growth in aggregate wage and salary earnings remains fairly stable, albeit still short of the rate that would be seen were the economy at full employment. At the same time, consumer confidence remains elevated and continued low interest rates mean consumers are still comfortably able to make monthly debt service payments. While it is true recent months have seen rising delinquency rates on credit card debt, those rates remain below longer-term norms and the increase off of cyclical troughs appears, at least so far, to be mainly a function of rising delinquencies amongst subprime borrowers.

Going forward, there are several factors that will shape the paths of income growth, consumer spending, and household saving. For instance, virtually no one disagrees that ongoing improvement in labor market conditions will lead to faster growth in average hourly earnings and longer workweeks, both of which will result in faster growth in aggregate labor earnings. The disagreement comes on just when that will happen; we think that is further away than do some other analysts, but we don't doubt it will ultimately happen.

In the interim, consumers will have to decide how comfortable they are with a smaller savings buffer. Should they feel the need to build that buffer up, growth in consumer spending will be slower than would otherwise be the case. We do worry that should interest rates rise to any meaningful degree, a still-high level of household debt would quickly become a heavier burden for many households, leading to broader increases in delinquencies and diminished consumer spending. And, we won't inject record levels of household net worth into this discussion, as we think it to be not very relevant. First and foremost because of the distribution issues that must be accounted for. Additionally, even leaving aside distribution issues, to the extent rising equity prices are fueling rising household net worth, our work and that of others puts a very low estimate on the size of any wealth effect associated with rising equity prices. To the extent rising housing equity is contributing to rising net worth, thus far consumers have shown little inclination to tap that equity to finance current consumption, perhaps recalling how that worked out last time around.

To be sure, the revised data on income and saving are unsettling, and they certainly have us reconsidering our view on the health of the U.S. consumer. Then again, certainty is one luxury we've never afforded ourselves when it comes to interpreting any of the economic data. Our sense is that U.S. consumers are still on firm financial footing, but if nothing else the recent data revisions are a reminder that there are plenty of downside risks lurking.

ECONOMIC OUTLOOK



August 2017

Q1 '17 (a)	Q2 '17 (p)	Q3 '17 (f)	Q4 '17 (f)	Q1 '18 (f)	Q2 '18 (f)	Q3 '18 (f)	Q4 '18 (f)		2016 (a)	2017 (f)	2018 (f)	2019 (f)
1.2	2.6	2.4	2.2	2.2	2.1	2.2	2.0	Real GDP ¹	1.5	2.0	2.2	1.8
1.9	2.8	2.2	2.0	2.3	2.2	2.3	2.1	Real Personal Consumption ¹	2.7	2.5	2.2	2.0
								Business Fixed Investment:				
5.0	5.4	3.3	2.5	2.4	2.2	2.2	2.2	Equipment, Software, & IP ¹	0.3	3.3	2.6	1.9
14.8	4.9	3.8	3.8	2.3	1.4	1.6	2.1	Structures ¹	-4.1	6.5	2.7	1.6
11.1	-6.8	2.0	3.4	5.9	7.6	8.1	8.1	Residential Fixed Investment ¹	5.5	2.2	4.8	7.4
-0.6	0.7	0.4	0.3	0.6	0.9	0.8	0.8	Government Expenditures ¹	0.8	0.1	0.6	0.7
-622.2	-614.9	-618.4	-620.4	-624.9	-629.6	-634.6	-640.9	Net Exports ²	-586.3	-619.0	-632.5	-664.0
1.238	1.164	1.194	1.209	1.231	1.259	1.293	1.318	Housing Starts, millions of units ³	1.177	1.201	1.275	1.390
17.1	16.8	16.6	16.4	16.3	16.2	16.2	16.2	Vehicle Sales, millions of units ³	17.5	16.7	16.2	16.0
4.7	4.4	4.3	4.3	4.3	4.3	4.2	4.2	Unemployment Rate, % ⁴	4.9	4.4	4.2	4.2
1.6	1.6	1.5	1.4	1.3	1.2	1.1	1.0	Non-Farm Employment ⁵	1.8	1.5	1.1	0.9
2.0	1.6	1.8	1.7	1.7	2.0	2.0	2.0	GDP Price Index ⁵	1.3	1.8	1.9	2.1
2.0	1.6	1.5	1.5	1.5	2.0	2.1	2.1	PCE Deflator ⁵	1.2	1.7	1.9	2.2
2.6	1.9	1.8	1.6	1.3	2.0	2.2	2.2	Consumer Price Index ⁵	1.3	2.0	1.9	2.2
1.8	1.5	1.5	1.6	1.6	1.8	1.9	2.0	Core PCE Deflator ⁵	1.8	1.6	1.8	2.1
2.2	1.8	1.7	1.7	1.6	2.0	2.2	2.3	Core Consumer Price Index ⁵	2.2	1.8	2.1	2.3
0.67	0.92	1.13	1.18	1.41	1.67	1.89	2.13	Fed Funds Target Rate, % ⁴	0.39	0.97	1.77	2.27
2.44	2.26	2.45	2.50	2.60	2.70	2.80	2.85	10-Year Treasury Note Yield, % ⁴	1.84	2.41	2.74	2.98
4.17	3.98	3.99	4.11	4.26	4.42	4.61	4.72	30-Year Fixed Mortgage, % ⁴	3.65	4.07	4.50	4.89
-2.5	-2.5	-2.6	-2.7	-2.6	-2.7	-2.8	-2.8	Current Account, % of GDP	-2.4	-2.6	-2.7	-2.9

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