ECONOMIC OUTLOOK

REGIONS

November 2016

It's The Most Wonderful Time Of The Year. Unless It's Not.

There is just something uplifting about being absorbed in a dignified campaign in which debates on meaningful issues are conducted in an engaging and respectful manner and in which candidates offer plausible solutions so that informed voters can make rational choices that will help shape a nation's future. Or so we hear. As for our Presidential campaign that seemed unending, well, it's over, so there's that, though it will likely be some time before any of us can actually forget it, as much as we may want to. We're guessing we're not alone in wishing for something uplifting to come along to help forget the past several months.

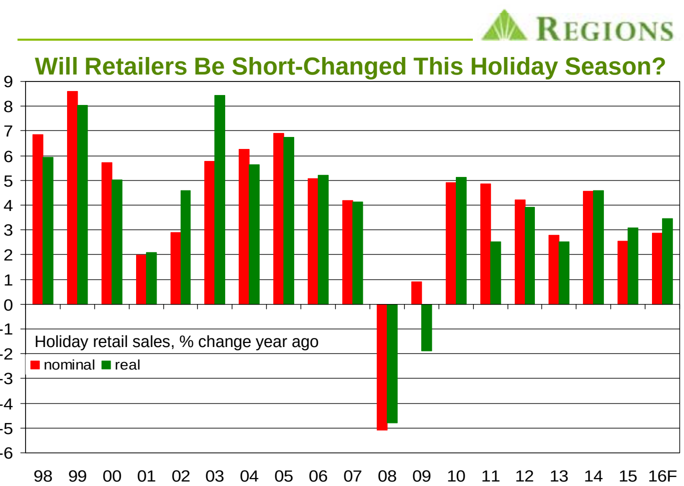
Ah, but of course, the holiday season is now upon us, and what better remedy could there possibly be for whatever post-election ills any of us are feeling. Then again, along with the holiday season comes the holiday shopping season, which itself often seems endless. And, far too often what should be the uplifting meaning of the holiday season is overshadowed by what have become some less than inspiring traditions, such as retailers feeling the need to be open on Thanksgiving and consumers feeling the need to duke it out over the last hot new toy or piece of clothing on the shelf.

Wow, that is so not uplifting. But, on the bright side, we do of course have the day-long *A Christmas Story* marathon to look forward to. Never gets old.

Nonetheless, like it or not, the holiday sales season is upon us, which also means it's time for our annual holiday sales forecast. Yes, it's that time of the year when we take the pulse of the U.S. consumer, apply the collective force of our years of professional experience, extensive research, and sophisticated statistical analysis, and basically guess how much consumers will spend over the holiday sales season. Consider it our contribution to the dubious behavior this time of the year seems to bring out. Bah.

Before proceeding, we'll clarify a couple of points. First, though the holiday sales season seemingly never ends, different people peg the start at different points in time; for instance, the holiday lay-away promotions begin in September. The official start, however, comes when the first person stakes out ground in front of the local *Best Buy* days in advance of Thanksgiving so that they can be the first person through the door to buy cool gadgets and electronics at prices no lower than they could find online. Perhaps the only sadder thing is that, invariably, at least one local television station finds these fine specimens worthy of being interviewed on the local news. Regardless of when it starts, the holiday sales season is officially in full swing when the first punch is thrown in anger in a dispute over the last flat-screen television on the shelf.

Second, as with the timing of the holiday shopping season, the definition of "holiday sales" tends to vary considerably – for a quick empirical test of this just count how many estimates you see each year of sales on "Black Friday" or "Cyber Monday." As has always been our practice, our measure of holiday sales consists of combined November and December retail sales excluding motor vehicle, gasoline, building materials, restaurant, grocery store, and drug store sales – things not typically given as holiday gifts (sure, we see all the ads with neatly gift wrapped cars in driveways, but, really, who does that?).



Source: U.S. Census Bureau; Bureau of Labor Statistics; Regions Economics Division

The short version of our holiday sales forecast is that this holiday season will bring somewhat more cheer to consumers than it will to retailers. Our forecast is for a 2.9 percent increase in holiday sales, only slightly better than the 2.6 percent increase posted in 2015. As seen in the chart above, if our forecast is on or near the mark it would make 2016 another middling year for holiday sales by historical standards. Indeed, barring the 2008 and 2009 holiday sales seasons which were waylaid by the Great Recession, the 2015 holiday sales season was the weakest since 2001, and we are looking for only trivial improvement this holiday season.

Even so, our forecast may prove to be a bit on the ambitious side, though not to the extent as proved to be the case last year. Our forecast of a 3.8 percent increase in 2015 holiday sales turned out to be well off the mark, even allowing for the downside risk we noted when we published our call. Still, while last year's puny increase in holiday sales and our forecast for an equally uninspiring performance this holiday season may seem to feed into the "what's wrong with U.S. consumers?" narrative we've been railing against for some time now, our answer to that question remains the same as it has been all along – not much.

U.S. consumers are on firmer financial footing than has been the case for some time. Consumers have benefitted from ongoing job and income growth, low interest rates, and generally low inflation, which have all helped consumers increase discretionary spending

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and at the same time pare down debt and build up savings. Still, we find ourselves having to explain there is nothing actually wrong with those latter two activities. At the same time, rising asset values have fueled rising household net worth, which stood at a record high as of Q2 2016 (the latest available data point). It is worth noting that recent quarters have seen house price appreciation make greater contributions to growth in net worth, which is significant given that the incidence of homeownership, even at current low rates, is higher than is the incidence of direct stock ownership. In other words, rising net worth is being distributed across a wider swath of households.

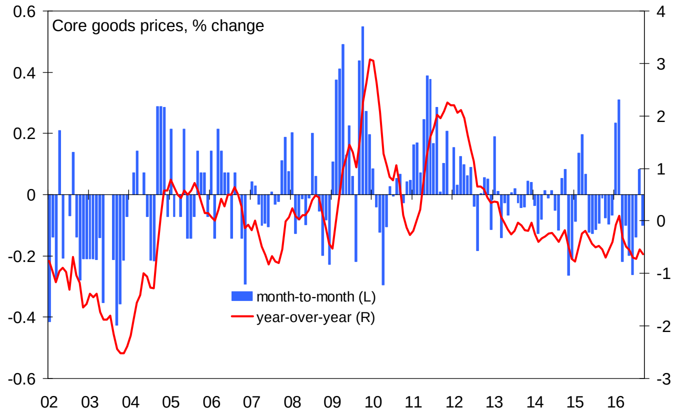
In short, consumers have the wherewithal to shop this holiday season. It is fair, however, to point out that the rate of growth in real disposable personal income has slowed over recent months and is running below the pace seen last year at this time. Also, though it is easily off cyclical lows, consumer confidence remains well below pre-recession levels and has been pretty much range bound over the past several months. This is especially true of the component of the survey which captures expectations of future conditions, which suggests that while consumers have seen meaningful improvements in their financial situation, they harbor doubts as to the extent these better conditions will last. This could be one factor that has led consumers to be more disciplined in their use of credit to finance current consumption spending over the course of this expansion than has been true in the past, particularly in the years leading up to the 2007-09 recession.

On the whole, then, conditions are supportive of growth in holiday sales this season, but that growth is likely to be moderate. But, if we are correct in that assessment, there will be factors other than the financial and emotional state of U.S. consumers in play. For instance, spending on consumer goods accounts for only about one-third of all consumer spending, so that, as we define them, holiday sales account for an even smaller share. So to the extent consumers increase outlays on services such as recreation, travel, and entertainment this holiday season, that won't be captured in any assessment of holiday sales.

Another factor that comes into play with any discussion of consumer spending on goods is pricing. As we note each month in our write-up of the retail sales reports, retail sales are reported in nominal, not real, terms. In other words, they are not adjusted for price changes, and the reality is that prices of consumer goods have been falling, almost across the board, for some time now. This can be seen in our chart on the prior page, in which we show both nominal and real growth in holiday sales. Note that in 2013, 2014, and 2015 growth in real, i.e., adjusted for price changes, holiday sales topped growth in nominal sales, and we expect that to again be the case in 2016. While we expect a 2.9 percent increase in nominal holiday sales, accounting for what we expect to be further goods price deflation yields a 3.5 percent increase in real holiday sales. We use the component for core goods prices from the Consumer Price Index data, shown in the following chart, to deflate nominal sales.

Sellers of consumer goods for the most part simply have no pricing power at their disposal. While goods price deflation is not as pronounced as was the case in 2003, it has been more persistent, making for a challenging environment for retailers. What is compounding the misery for many retailers is that U.S. consumers have become accustomed to holiday discounting by retailers hoping to clear inventories, which comes on top of the falling prices that are captured in the inflation data. Do not, well, discount the significance of this effect during this holiday sales season, as elevated inventory-to-sales ratios across the retail landscape will likely test the resolve of merchants needing to clear out stocks, particularly if the holiday sales season gets off to a slow start. The bottom line is that retail sales measured in nominal terms give a misleadingly weak view of consumer spending.

Core Goods Deflation Hasn't Yet Run Its Course

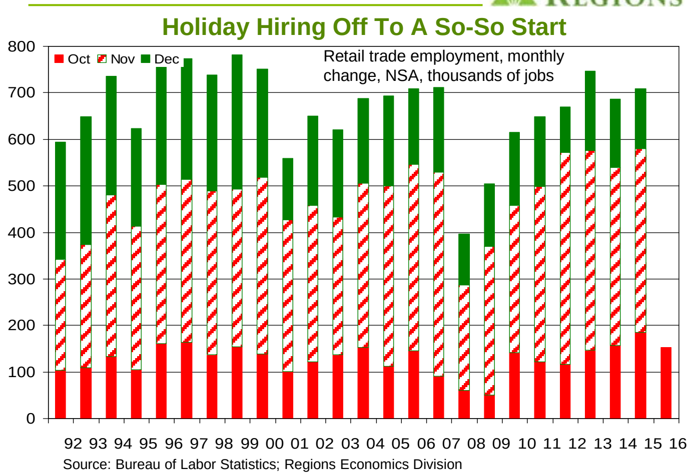


Source: Bureau of Labor Statistics; Regions Economics Division

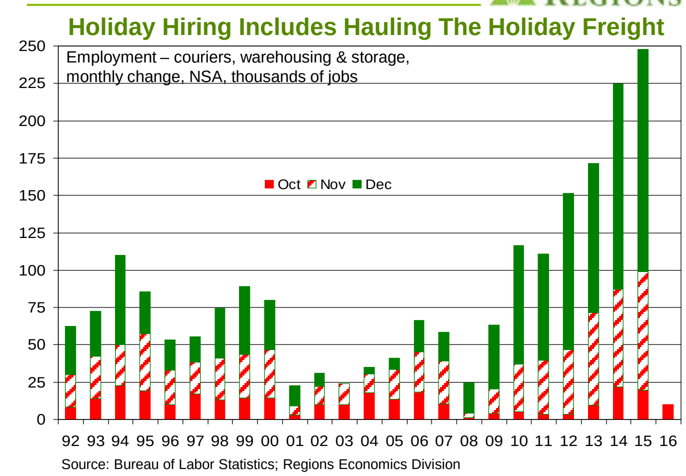
While these price effects can be accounted for so that we can paint a more accurate picture of the strength, or lack thereof, of consumer spending, their impact on retailers' margins can't be brushed aside. Moreover, the lack of pricing power is being compounded by rising labor costs. Though it may seem logical to attribute this to tighter labor market conditions, we think it is more a reflection of higher minimum wages as mandated by law in many parts of the U.S. and of many large national retailers having voluntarily raised entry level wages, increases which tend to ripple up through the ranks. Indeed, the industry level data from the Employment Cost Index, our preferred measure of changes in labor compensation costs, show that since Q1 2015 retail trade has seen faster wage growth than any other industry group.

This is what we mean when we say this holiday season will bring more cheer to consumers than it will to retailers. And, as if things weren't tough enough for brick and mortar retailers thanks to the lack of pricing power and rising labor costs, they are also having to contend with online retailers taking bigger and bigger bites out of sales at physical stores. Indeed, holiday sales by online retailers rose by 11.4 percent in 2015, which was actually smaller than the 13.3 percent increase posted in 2014. This year, we are looking for a 12.3 percent increase in online sales during the holiday season, which for many traditional retailers will be the holiday equivalent of a lump of coal.

While the above discussion may lead you to think the best strategy for brick and mortar retailers to follow this holiday season would be to simply fire all their workers and bar their doors, they seem intent on trying it the usual way, i.e., hiring more workers and trying to find ways to lure people into their stores. As to the hiring part, October is typically the start of holiday hiring in the retail trade industry and, despite it costing them more to do so, retailers have already started their holiday hiring. The chart below shows seasonal holiday hiring (i.e., October through December) in retail trade; to be consistent, we have excluded hiring in those retail categories excluded from our measure of holiday sales. Also, we show not seasonally adjusted data, which is the proper basis on which to compare data for the same months across different years.



After last year saw the strongest October hiring in retail trade in over two decades, this October saw a slower rate of hiring but one that is right in line with historical averages. But, October does not necessarily set the tone for the entire holiday season – note that last year hiring slowed in November and December such that hiring for the holiday season, as a whole, was not terribly strong. There had been talk that this year tighter labor market conditions would force retailers to hire as early as possible to make sure they could reach their holiday hiring goals, but there is little evidence of that in the October data. Again, while November and December will see hiring accelerate, we suspect that low expectations for holiday sales along with higher retail wages will act as drags and that, for the season as a whole, retail hiring will fall short of last year.



You cannot, however, really get a sense of holiday hiring without accounting for online sales. After all, once goods are ordered they have to be transported and delivered to consumers, and to the extent online sales ramp up during the holiday season we must account for activities such as warehousing, distribution, and delivery to get a true sense of holiday hiring. We do this in the preceding chart, and the growing significance of online sales over recent years is readily apparent in the employment data. As with retail hiring, we look at the monthly changes in the not seasonally adjusted data for October, November, and December.

Last year saw the largest increase in holiday hiring in distribution and delivery activities on record and, as seen in the chart, hiring got progressively stronger as the holiday season wore on. Just as with retail hiring, many had argued firms involved in shipping and delivering goods would jump to an early start on holiday hiring this year. But, also as with retail, there is no evidence of this in the October employment data, which show the slowest October hiring since 2013 in these areas. We will note, however, the October data reflect the initial estimate, and given the relatively small size of these industry groups we can expect revisions, potentially large, to these initial estimates. Either way, hiring will surely ramp up in November and December, and when all is said, done, and revised, we won't be surprised to see this year's holiday hiring in shipping and delivery activities top last year's record. Barring of course a record number of fine specimens holding storefront campouts during Thanksgiving week, thereby acting as their own delivery services, which would cut down on the need for actual delivery services to hire workers.

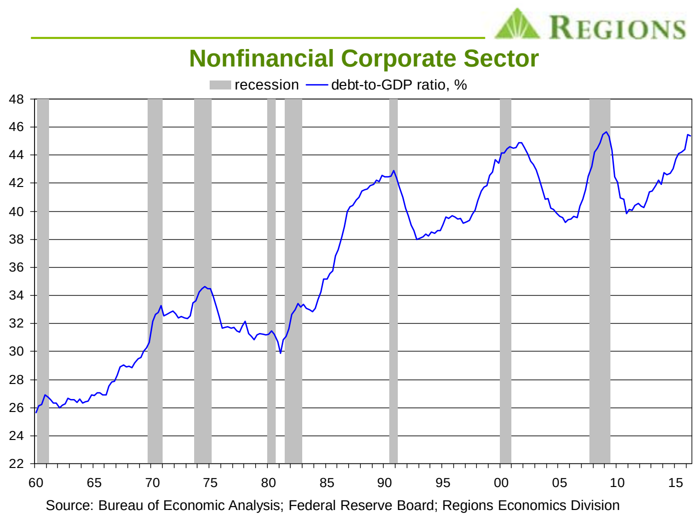
All in all, we think this holiday season will bring more cheer to consumers than to retailers. As has been the case in recent years, price effects will again mean that growth in real (or, adjusted for price changes) sales will be stronger than growth in nominal sales. Although, in what has become not just a holiday tradition but a year-round tradition, many analysts will fail to account for these price effects and crank out the usual "what's wrong with U.S. consumers?" narratives. In any event, we think it will be a tough holiday for brick and mortar retailers, at least those without a viable online presence, who will have to contend with not only weak pricing but also higher labor costs on top of the growing challenge from online sales. Already slimmer margins will come under even more pressure if retailers have to resort to discounting to clear inventories, which we worry are too high.

Still, while we look for holiday sales growth to be better than last year, we don't expect consumers to go all out. In part because spending on services has become a larger piece of the consumer narrative (or, to borrow a commonly used phrase, spending on experiences not on things), but also in part because consumers are, at least in our view, still exercising more financial discipline than was the case prior to the 2007-09 recession. Whether this is the result of hard-learned lessons or whether it is the lack of confidence over prospects for income growth or worries about job stability, building up savings and less reliance on debt remain part of the consumer narrative as well. While this may not bring much cheer to retailers, we don't see it as a bad thing, and it certainly doesn't make us wonder what's wrong with U.S. consumers.

There is, however, one piece of our holiday sales forecast we still haven't worked out. We still don't know which particular toy or piece of clothing will, when there's only one left, incite fights in store aisles. Trust us, it will happen, and it won't be at all inspiring or uplifting. Though, somehow, this year that seems sadly fitting.

Corporate, Not Household, Debt Cause For Concern?

Having for many years written previews of holiday sales, we know that at this time of the year it is not at all unusual to hear warnings about taking on too much debt. Well, sure, we know that because we're typically amongst those tossing out such warnings. So, in that sense, this year isn't any different, but, what is different is that this year our focus is not on the household sector but on the corporate sector of the U.S. economy. As noted in the earlier discussion, households have generally been disciplined in their approach to taking on new debt over the course of this expansion. In contrast, however, there has been an explosion of debt in the nonfinancial corporate sector.



As seen in the above chart, the ratio of nonfinancial corporate debt-to-GDP is hovering just shy of its historical high, at 45.4 percent as of Q2 2016 (the last available data point). The all-time high was seen at the depths of the 2007-09 recession, a time in which falling nominal GDP helped push the ratio higher. During the present expansion, nominal GDP has been rising, albeit at a listless pace, but growth in nonfinancial corporate debt has been much faster. And, with interest rates remaining low and investor interest still high, there is no reason to believe coming quarters won't bring a new record high debt-to-GDP ratio. Whether that prospect should be a source of comfort or a cause for concern, however, is an open debate but we definitely see it as the latter.

To be sure, we aren't the only ones concerned over the growth in nonfinancial corporate debt. In the minutes to the September 2016 FOMC meeting it was noted that some officials "expressed concern that the protracted period of very low interest rates might be encouraging excessive borrowing and increased leverage in the nonfinancial corporate sector." Wow, do ya' think? Okay, that may be a bit harsh on our part, but we'd be curious to know whether this is something that is just now coming on the radar screens of FOMC members or, even worse, whether any of them are actually surprised that a protracted period of artificially low (which is our less diplomatic way of saying "very low") interest rates would have encouraged, you know, excessive borrowing.

Just to be clear, we don't have an issue with debt in and of itself. And, yes, we get that in many instances corporations simply responded to the incentives placed in front of them, in the form of a protracted period of artificially low interest rates, and revitalized their balance sheets by refinancing debt and building liquidity to withstand another financial shock. But, as the long period of low interest rates got longer and longer, more and more corporations took on new debt to finance share buybacks and/or dividend payouts or to finance mergers/acquisitions. Largely absent from the list of things firms did with this new debt is financing capital expenditures to expand their productive capacity.

In other words, one of our main concerns is that corporations will have taken on significant amounts of debt but will have nothing to show for it. Sure, higher dividends may have helped push the prices of issuing firms' stocks higher, and share buybacks will have helped dress up earnings per share. Those, however, are transitory effects and once they have faded the debt will of course still be on corporate books. Meanwhile, the capital stock gets older and older, which acts as a drag on productivity growth and, in turn, on the rate of overall economic growth.

Many argue that with global investors in a yield-hungry world willing to snap up this debt while low interest rates make it highly affordable for firms to service the debt, there is nothing to worry about. Yeah, okay, but this sounds vaguely like an argument we heard in the run-up to the 2007-09 recession, and, as we seem to recall, that didn't end so well. Whether it makes us old school, set in our ways, or just plain clueless as to how the world actually works, we still find plenty of reasons for concern over a significantly higher level of debt that has yielded little, if anything, in return for the real economy.

For instance, this buildup in debt has taken place in what has been a protracted period of restrained top-line revenue growth, which we do not see changing materially over coming quarters. With labor costs rising at a faster rate, even if below longer-term norms, corporate profit margins are coming under increasing pressure, as we have discussed in detail in past *Monthly Outlooks*. There are already signs of deteriorating corporate credit fundamentals, which goes beyond the obvious candidate, i.e., energy. While still relatively low, delinquency rates on commercial bank C&I loans have increased in each of the past six quarters.

With the current expansion getting long in the tooth and interest rates heading higher, albeit gradually, it isn't hard to envision a set of circumstances in which credit losses could spike significantly in a short period of time. And, even if we avoid such a scenario, the high level of debt at some point becomes a constraint on growth for firms looking to take on debt to finance capital spending. To those who argue record cash balances on corporate balance sheets render this a moot point, we'll simply note those balances are highly concentrated amongst a relatively small subset of the corporate sector, while the aggregated data show firms unable to internally finance even the slow growth in capital spending we have seen over the past several quarters. So, while we're not suggesting an imminent crisis, we nonetheless think many analysts are being complacent in dismissing concerns about the level of debt in the corporate sector.

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Q2 '16 (a)	Q3 '16 (p)	Q4 '16 (f)	Q1 '17 (f)	Q2 '17 (f)	Q3 '17 (f)	Q4 '17 (f)	Q4 '17 (f)		2014 (a)	2015 (a)	2016 (f)	2017 (f)
1.4	2.9	1.9	2.3	1.9	2.2	2.0	1.9	Real GDP[1]	2.4	2.6	1.5	2.1
4.3	2.1	2.8	2.2	2.2	2.2	2.2	2.2	Real Personal Consumption[1]	2.9	3.2	2.6	2.5
								Business Fixed Investment:				
1.7	0.0	2.6	2.7	2.4	1.9	1.3	2.0	Equipment, Software, & IP[1]	4.8	4.0	0.3	2.0
-2.1	5.4	1.4	2.7	2.6	2.5	3.0	2.5	Structures[1]	10.3	-4.4	-3.4	2.4
-7.8	-6.2	4.5	6.5	6.5	8.2	8.4	8.6	Residential Fixed Investment[1]	3.5	11.7	4.3	3.9
-1.7	0.5	0.7	1.3	1.0	1.0	0.9	1.0	Government Expenditures[1]	-0.9	1.8	0.8	0.8
-558.4	-522.9	-547.2	-562.1	-579.2	-588.0	-594.3	-602.5	Net Exports[2]	-425.7	-540.0	-548.7	-580.9
1.159	1.138	1.159	1.158	1.173	1.206	1.236	1.235	Housing Starts, millions of units[3]	1.001	1.108	1.152	1.193
17.1	17.5	17.6	16.9	16.5	16.3	16.3	16.1	Vehicle Sales, millions of units[3]	16.5	17.4	17.3	16.5
4.9	4.9	4.8	4.8	4.7	4.7	4.6	4.6	Unemployment Rate, %[4]	6.2	5.3	4.9	4.7
1.8	1.7	1.6	1.4	1.4	1.3	1.2	1.2	Non-Farm Employment[5]	1.9	2.1	1.7	1.3
1.2	1.3	1.5	1.8	1.7	1.7	1.8	1.7	GDP Price Index[5]	1.8	1.1	1.3	1.7
1.0	1.0	1.4	1.9	1.9	2.0	2.0	1.8	PCE Deflator[5]	1.5	0.3	1.1	1.9
1.1	1.1	1.6	2.3	2.2	2.4	2.3	1.9	Consumer Price Index[5]	1.6	0.1	1.2	2.3
1.6	1.7	1.8	1.8	1.8	1.9	2.0	1.9	Core PCE Deflator[5]	1.6	1.4	1.7	1.9
2.2	2.2	2.2	2.1	2.1	2.2	2.2	1.9	Core Consumer Price Index[5]	1.7	1.8	2.2	2.1
0.38	0.38	0.42	0.63	0.66	0.88	0.88	0.88	Fed Funds Target Rate, %[4]	0.13	0.14	0.39	0.76
1.75	1.56	1.81	1.85	1.90	1.95	2.00	2.05	10-Year Treasury Note Yield, %[4]	2.54	2.14	1.76	1.98
3.59	3.45	3.63	3.75	3.82	3.86	3.90	3.94	30-Year Fixed Mortgage, %[4]	4.17	3.85	3.60	3.83
-2.6	-2.7	-2.8	-2.9	-3.0	-3.1	-3.2	-3.4	Current Account, % of GDP	-2.3	-2.7	-2.8	-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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