ECONOMIC OUTLOOK
REGIONS
April 2019

They Will. They Won't. They Could. They Might. Should They?

"They" refers to the FOMC, and whether they will, won't, could, might, or should refers to whether the Committee will decide to change the Fed funds rate. Sure, that's a topic that generates a good deal of discussion at any given time, so that it's being discussed at present is not, in and of itself, much of a story. What is a story, however, is the degree to which it is being discussed and the intensity with which it is being discussed. And the even bigger story is that "changing" the Fed funds rate now refers to cutting, not raising, the funds rate, a shift that seemingly happened overnight. Okay, maybe not overnight, but it seems like only a few short months ago that the FOMC was raising the funds rate and signaling further rate hikes were likely. Oh, wait, that was only a few short months ago – December 19, 2018 to be precise.

Those calling for cuts in the Fed funds rate are doing so on the grounds that rate cuts are needed to help fend off recession. You can divide this broad group into two camps, those who fear a recession is close at hand and those who see a recession further off but feel the FOMC must act preemptively. Those in the broader rate cut camp can make a compelling argument, at least on the surface. Global economic growth has clearly slowed, the recent U.S. economic data have for the most part alternated between good, listless, and downright scary, and the spread between yields on 10-year U.S. Treasury notes and 3-month U.S. Treasury bills went negative, which is generally seen as the most reliable yield curve signal of recession. Though this inversion lasted for only a few days in late-March, the spread remains uncomfortably narrow.

Thus far, FOMC members are pushing back on calls for Fed funds rate cuts, arguing that it is much too soon for such a move. That does not, however, mean the FOMC hasn't shifted their view of the appropriate path of the funds rate. Indeed, at their March meeting, the FOMC issued an updated "dot plot" that implies no rate hikes in 2019 and a single 25-basis point hike in 2020, and also signaled an earlier end to the run-off of the Fed's balance sheet than anyone had anticipated. Relative to their December policy stance, that's not a dovish pivot on the part of the FOMC, that's the mother of all dovish pivots.

It is understandable that those genuinely concerned about the U.S. economy slipping into recession are calling for cuts in the Fed funds rate. What is perhaps harder to understand is why the FOMC would have made such a pivot from their policy stance of December 2018 despite their outlook for the economy being little changed. For instance, the FOMC's December 2018 economic projections show a median 2019 real GDP growth forecast of 2.0 percent (on a Q4/Q4 basis), whereas the median forecast in the March 2019 projections is 1.9 percent, with only modest changes in the median forecasts for inflation and the unemployment rate.

The way we've explained the FOMC's pivot, which includes a very consistent message of "patience" in public statements by FOMC members, is that the FOMC has adopted a risk management approach to conducting monetary policy. In other words, though their baseline outlook for the U.S. economy has not materially changed, they recognize that the downside risks to that baseline outlook have increased. As such, the evolution of the economic data will determine not only when, but also in what direction, the FOMC makes its next move on the Fed funds rate. As Fed Chairman Powell put it in his press conference following the March FOMC meeting, "the data that we're seeing are not currently sending a signal that suggests moving in either direction" – a point he made four different times in that press conference. Chairman Powell also stated that "it's a great time for us to be patient," thanks largely to what remain muted inflation pressures.

It's good that the FOMC has the latitude to remain patient, because it may be a while before the economic data tell a coherent story on where the economy is, let alone offer meaningful clues as to where the economy is heading. As alluded to earlier, the U.S. economic data have been all over the map, and it isn't just a case of different data series sending different signals, it's also a case of the same data series sending signals that vary sharply from one month to the next. Anyone who has followed the monthly retail sales reports can appreciate this, but the same patterns have been seen in the data on nonfarm employment, residential construction, foreign trade, and business investment spending.

The economic data are not the only source of mixed signals on the U.S. economy of late. An uncomfortably flat yield curve that is only a bad data point or a worrisome headline away from inverting is not sending a very uplifting message on the prospects for economic growth over coming quarters. By comparison, the stock market seems almost giddy over the prospects for economic growth over coming quarters. For equities, Q1 2019 was the best quarter in nearly a decade, with the S&P 500 up by 13 percent, making up most of the roughly 14 percent decline seen during Q4 2018. Still, over time the bond market has had the better track record as an economic prognosticator, which accounts for why the shape of the yield curve has been the center of so much attention from analysts and the media. Going back to 1969, each of the past seven recessions has been preceded by an inversion of yields on 10-year and 3-month Treasuries, so it is only natural that alarm bells began to ring in March when another such inversion occurred (two days after the FOMC meeting, to be specific). And though this inversion was short-lived, the 10-3 spread remains uncomfortably narrow, as noted above.

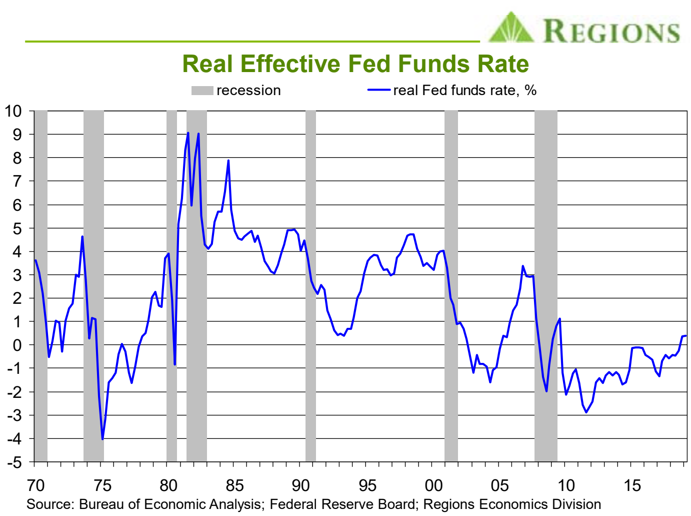
As for us, through all of the twists and turns in the economic data and the financial markets, our baseline economic outlook has not materially changed. Our forecast has for some time anticipated that robust growth in 2018 would be followed by decelerating growth in 2019. Or, to repeat a point we've made on several

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

occasions, there is a difference between slowing growth and the end of growth, and our view remains that we are seeing the former and not the latter. We do, however, see the downside risks to our baseline forecast as having risen, and in that sense we think the FOMC acting as a risk manager is the proper way to interpret their recent policy pivot.

About the only thing that seems clear at this point is that the U.S. economy is slowing. What is less clear, of course, is why the economy is slowing and to what extent the economy will slow. Part of the problem is that the economic data don't move in straight lines, and this is just as true when growth is accelerating as it is when growth is decelerating. So, during times in which the economy is slowing, the difference between what can be a noisy deceleration in growth and an economy heading toward recession is often not readily clear. As such, how market participants interpret shifts in the economy, which at present is a shift into a slower growth rate, will clearly impact the behavior of asset prices.

The FOMC, however, can attach a different interpretation to the same shifts in the economic data, leading to a disconnect between how market participants and central bankers see the economy and, by extension, what each group perceives to be the proper policy response. We think this helps explain a good deal of what we've seen over the past few months. To be sure, pronounced moves in asset prices can help shape how the FOMC perceives shifts in the economic data, particularly given that the behavior of asset prices can have implications for the real economy. This may be one reason the FOMC can seemingly never completely free itself of the perception that it bends to the will of the markets.



To help frame not only the debate over where the FOMC should go from here but also the debate over whether the FOMC has already gone too far, we find it useful to look at the real, or, inflation adjusted, effective Fed funds rate. This is shown in the above chart, and we'll note that we use the PCE deflator as our measure of inflation in calculating the real funds rate – different measures of inflation will yield different values of the real funds rate, but the patterns will be similar to the ones shown above.

After having been negative since Q3 2009, the real effective Fed funds rate turned positive in Q4 2018, standing at 0.35 percent, and as of Q1 2019, the real funds rate stood at 0.40 percent. So, monetary policy is clearly less accommodative, and rightfully so, than it has been over recent years, but whether that means monetary policy is "tight," or "too tight," is really what the present debate over monetary policy comes down to.

The answer may seem obvious if one is simply looking at the above chart and comparing current and past values of the real effective funds rate. Keep in mind, however, that the basis on which the stance of monetary policy is assessed (i.e., accommodative, neutral, or restrictive) varies over time along with fundamental drivers of economic growth such as productivity growth and labor force growth. That productivity growth and labor force growth have been so low over recent years means the real effective funds rate at which monetary policy tips from accommodative to restrictive is in turn much lower than has historically been the case.

This is a point that is seemingly lost on those who argue that the FOMC should push the Fed funds rate higher so that they will have more room to cut the funds rate when the economy does slip into recession. Those who make this argument often point out that the Fed funds rate will be lower when the next recession comes than has historically been the case, and therefore conclude the FOMC will have "less ammunition" with which to "fight" the next recession, which is true. At least the first part. Going back over the past seven recessions, the average value of the real Fed funds rate in the first quarter of recession was 3.92 percent. This, however, is skewed higher by including the 1981 recession, when the real funds rate stood at 9.06 in the first quarter of recession. But, throw this one observation out, and there is still a large gap between the current value of the real funds rate and what would be a historical average of 3.08 percent.

Using historical markers to argue that at present the FOMC should push the funds rate higher in order to have more ammunition with which to fight the next recession is tantamount to arguing that the FOMC should take measures that will, if not ensure a recession, then at least make a recession more likely, so that it will be better prepared to fight a recession. To be clear, we're not saying we're happy that the "neutral" level of the real Fed funds rate is as low as it is, but we at least understand why it is as low as it is. Indeed, we think it's a pretty depressing commentary on some of the key fundamental drivers of economic growth.

The broader point, however, is that there are reasons why it is fitting to be having a debate over whether monetary policy has become restrictive even though the real Fed funds rate is only now getting reacquainted with positive territory. Our own view is that at present the "neutral" real funds rate is no higher than 0.75 percent; based on the most recent dot plot, the range of estimates of FOMC members is between 0.50 and 1.50 percent, with a median estimate of 0.75 percent. So, with the real effective funds rate closing in on what most FOMC members would consider to be its neutral value, if the current rate hike cycle is not at its end, it is very close to its end.

The above discussion is predicated on inflation being at the FOMC's 2.0 percent target rate but, after having risen to that mark in mid-2018, inflation has since gone in the other direction. Using the core PCE deflator as our measure, inflation was running at a 1.8 percent rate as of January (the latest available data). The path of inflation will be a key determinant of whether, when, and in what direction,

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

the FOMC next changes the Fed funds rate. Should inflation again change course and begin to accelerate, that will push the real funds rate lower, effectively making monetary policy more accommodative. FOMC members who see this as inappropriate for an economy at or closing in on "full employment" could argue for further Fed funds rate hikes on this basis.

It is interesting to note that as the FOMC began raising the funds rate back in December 2015, monetary policy actually became more, not less, accommodative (refer back to the chart of the real Fed funds rate). This is because inflation began to accelerate and was rising faster than the funds rate, thus pushing the real funds rate lower. Monetary policy became less accommodative in 2017, as the FOMC raised the funds rate further and inflation eased. The difference between now and 2015-16, however, is that there was still a high degree of slack in the economy when the FOMC first started raising the funds rate, so that a falling real Fed funds rate was not as concerning to the FOMC then as it may be at present.

At present, there are at least some Committee members who would likely be uncomfortable with monetary policy becoming more accommodative (in the form of a falling real funds rate) and, as such, would likely want to push the nominal Fed funds rate higher should inflation speed up again. Conversely, should inflation continue to decelerate while the FOMC leaves the nominal Fed funds rate unchanged, the real funds rate would rise further, effectively tightening monetary policy. This, it could be argued, would be grounds for the FOMC cutting the nominal funds rate.

Either way, it will be some time before there is a clear trend in inflation – at least core inflation, since energy prices will likely continue to push headline higher over coming months – which means the FOMC will likely remain on hold for the next several months. If, as we and most others, including the FOMC, expect, real GDP growth settles back at around a 2.0 percent pace, it is more than reasonable to think that we've seen the last funds rate hike of this cycle. So, in this sense, those who believe the next move in the Fed funds rate will be a rate cut would be correct, but that cut would likely come much later than they expect or believe is appropriate.

It should also be pointed out that, though it tends to dominate the discussion, the Fed funds rate is only one component of the overall financial conditions which ultimately drive economic activity. After all, the Fed funds rate is an overnight interest rate in the market for bank reserves, while individuals and corporations of varying risk profiles borrow in various forms for much longer periods from a wide range of lenders – banks, non-bank lenders, domestic, foreign. Additionally, corporations can raise funds via stock issuance. As such, it is quite possible that while monetary policy is becoming more (less) accommodative, overall financial conditions are becoming less (more) accommodative and, as such, carry more weight in determining the direction and pace of activity in the broader economy than does a change in the Fed funds rate.

Broad measures of overall financial conditions include the Goldman Sachs *Financial Conditions Index* (GSFCI) and the Federal Reserve Bank of Chicago's *National Financial Conditions Index* (NFCI). The NFCI is broader, incorporating data on equity prices, corporate credit spreads, the exchange value of the U.S. dollar, commercial bank lending standards on commercial, consumer, and real estate (residential and commercial) loans, and various indicators of commercial and consumer loan performance. While movements in equity prices, particularly as drastic as those seen in late-2018, can dominate overall measures of financial conditions, they are far from being the only relevant determinant.

In the aftermath of the December 2018 FOMC meeting, equity prices swooned and credit spreads widened, which pushed the GSFCI up to the point that it indicated financial conditions were a drag on growth. While the NFCI indicated overall financial conditions were still accommodative, they were far less so than had been the case for quite some time, and the directional change clearly matters. Either way, overall financial conditions became materially less accommodative, if not slightly restrictive, in late-2018, which contributed to the economy slowing in early-2019.

This is where things get a bit tricky – while the Fed funds rate carries a relatively small weight in measures of overall financial conditions, the actions (and the words, for that matter) of the FOMC can have an outsized impact on other components, a point often overlooked by those who minimize the significance of the funds rate in "the grand scheme of things," as it were. To be sure, it often seems as though there is a tendency for analysts and market participants to extrapolate the most recent FOMC action out to some sort of terminal abyss, but the next funds rate hike will probably not be the one that brings about the end of the world. Note that we did say probably not . . .

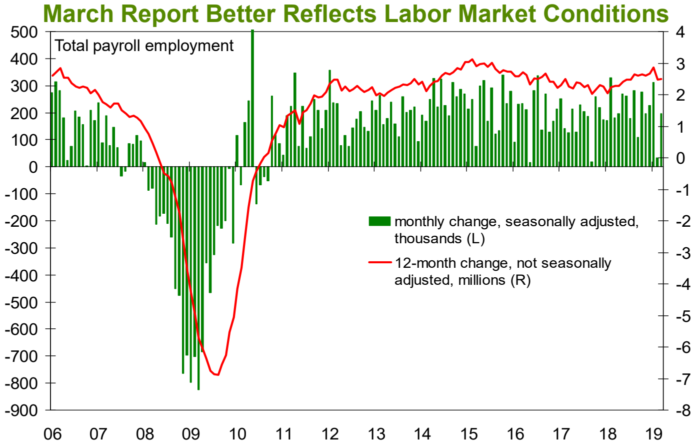
While this no doubt helps account for why the FOMC makes such considerable efforts to communicate its views on the economy and what it sees as the likely path of policy, there is simply no way the FOMC can control how what they say and do will be perceived, and how that in turn impacts the paths of asset prices and overall financial conditions. So, in this sense, the FOMC clearly must pay attention to the markets and the various factors that shape overall financial conditions. This makes it interesting that while many FOMC members, most recently Cleveland Fed President Mester and Philadelphia Fed President Harker, have pushed back on calls for rate cuts and cautioned that the FOMC may not be quite finished raising the funds rate in this cycle, many market participants attach a zero probability to further rate hikes. In other words, as much as we'd all like to forget December 2018, at least in terms of the performance of the financial markets, there may be a repeat performance looming in the not-too-distant future.

No Madness In The March Employment Report

Amidst elevated fears of recession and the ongoing debate over the proper course of monetary policy, the March employment report could hardly have come at a better time. Total nonfarm employment increased by 196,000 jobs, job growth remained notably broad based, the unemployment rate held at 3.8 percent, and the broader U6 measure held at 7.3 percent. True, labor force participation did dip in March, but this largely reflects lower participation amongst those in the 65-and-older age cohort. The March employment rate was solid, not spectacular, but should at least assuage fears that the U.S. economy is fumbling towards recession. Excepting of course the "sure, but employment is a lagging indicator" crowd. Really, you can't stop that crowd, you can only hope to contain them.

Unlike the January and February reports, the March employment report was largely free of the sampling issues, weather effects, and seasonal adjustment noise that beset the prior two reports. These factors contributed to reported increases of 304,000 jobs in January (revised to 312,000) and 20,000 jobs in February (revised to 33,000) but, as we noted upon the release of each report, neither was representative of the health of the labor market. Still, a headline job growth number suggesting the labor market had stalled in February only added to fears that the economy was in danger of slipping into recession.

March Report Better Reflects Labor Market Conditions



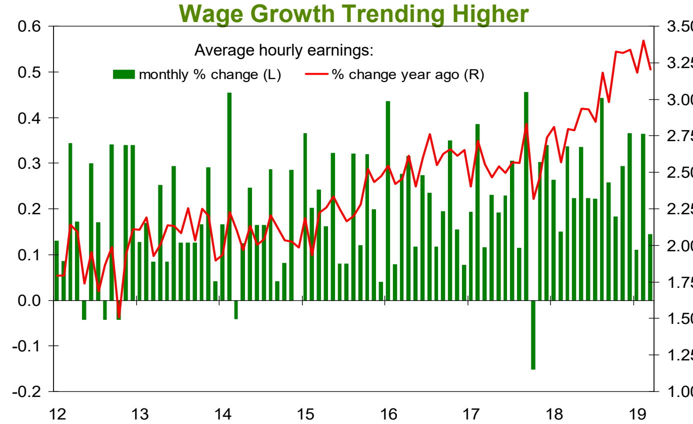
Source: Bureau of Labor Statistics; Regions Economics Division

So, in that sense, the March employment report is a much more reliable gauge of the health of the labor market. At 77.6 percent, the response to the BLS's March establishment survey is above the average March response rate over the past several years. This contrasts with the January and February response rates, both of which were below-average for these months over the past several years. A lower response rate in any given month leaves more space for the BLS to fill with their internal estimates, thus leaving the initial estimate of job growth prone to sizeable revision.

The March employment report was also largely free of weather related noise. The numbers of people not at work at all or at work only part-time due to weather were much lower this March than had been the case in March of recent years. Contrast this to February, when the number of workers impacted by weather (i.e., either not at work at all or at work only part-time) was higher than in any February since 2014. This not only held down the headline job growth number, but it also contributed to a decline in the average length of the workweek.

What many failed to account for, however, is that weather effects in January also helped hold down measured February job growth. Though lost in the fury of the polar vortex that struck later in the month, weather during the middle of January, coinciding with the BLS's establishment survey period, was atypically mild. This was reflected in the seasonally adjusted data showing outsized job gains in weather sensitive industries such as construction, retail trade, and leisure & hospitality services, some of which came at the expense of February job growth. In other words, the estimate of February job growth got it coming and going in terms of being held down by weather related issues. So, while a shockingly small headline February job growth number may have fit into the recession is coming narrative, the not seasonally adjusted data told a different, not to mention far less ominous, story.

Uneven Monthly Gains Still Leave Wage Growth Trending Higher



Source: Bureau of Labor Statistics; Regions Economics Division

Wage growth did disappoint in March, with a monthly increase of 0.1 percent yielding a year-on-year increase of 3.2 percent, down from a cycle-high 3.4 percent increase in February. But, as we show above, the monthly earnings data are quite volatile (if this chart doesn't convince you to ignore the month-to-month noise and focus on the trends, nothing will). Of far more relevance is that the trend rate of wage growth continues to accelerate, which we expect to remain the case over coming months. This puts a floor under growth in personal income and consumer spending.

While the March employment report tells us the labor market remains quite healthy, there were a couple of data points that caught our eye and which will merit further attention over coming months. First, manufacturing employment fell by 6,000 jobs in March, thanks in large part to job losses in motor vehicle manufacturing. Motor vehicle sales are drifting lower, which has contributed to rising inventories, and this will clearly have an impact on output and employment in this industry group. If this seems at odds with strong unit motor vehicle sales in March, the not seasonally adjusted data show abnormally weak sales in February and abnormally strong sales in March, which tells us that the weather issues that held down February job growth impacted other areas of the economy, and likely more segments of retail sales than just motor vehicles. The broader point here is that if motor vehicle sales continue to drift lower as we expect, this could be a source of downward pressure on payrolls in this industry group. Second, though there has been some noise in the data of late, retail trade payrolls have fallen by a net 32,000 jobs over the past two months. It is highly unlikely, however, that the data have picked up all of the job losses resulting from store closings that occurred through the end of March. As such, retail trade payrolls will drop even further, which is likely to be seen in the April data.

On the whole, however, the labor market remains quite healthy. With all apologies to the "sure, but employment is a lagging indicator" crowd, it is hard to envision the economy slipping into recession with job and wage growth as solid they now are.

ECONOMIC OUTLOOK

REGIONS

April 2019

Q3 '18 (a)	Q4 '18 (a)	Q1 '19 (f)	Q2 '19 (f)	Q3 '19 (f)	Q4 '19 (f)	Q1 '20 (f)	Q2 '20 (f)		2016 (a)	2017 (a)	2018 (f)	2019 (f)	2020 (f)
3.4	2.2	2.2	2.0	2.1	1.9	1.9	1.7	Real GDP[1]	1.6	2.2	2.9	2.4	1.8
3.5	2.5	0.6	3.4	2.8	2.5	2.4	2.2	Real Personal Consumption[1]	2.7	2.5	2.6	2.4	2.4
								Real Business Fixed Investment:					
4.3	8.3	4.1	4.3	5.7	4.4	4.3	3.6	Equipment, Software, & IP[1]	2.1	5.5	7.5	5.3	4.0
-3.4	-3.9	-0.6	2.3	1.9	1.5	2.2	2.2	Structures[1]	-5.0	4.6	5.0	0.2	1.9
-3.6	-4.7	0.8	-0.1	2.5	0.1	1.2	2.3	Real Residential Fixed Investment[1]	6.5	3.3	-0.3	-0.9	1.4
2.6	-0.4	2.3	3.1	0.8	-0.1	-0.5	-0.6	Real Government Expenditures[1]	1.4	-0.1	1.5	1.6	-0.1
-949.7	-955.7	-934.8	-942.4	-954.0	-966.9	-975.8	-988.7	Real Net Exports[2]	-786.2	-858.7	-912.2	-949.5	-992.8
877	828	878	877	885	898	914	929	Single Family Housing Starts, ths. of units[3]	785	852	873	885	930
357	357	348	350	350	348	343	338	Multi-Family Housing Starts, ths. of units[3]	393	356	377	349	333
16.9	17.5	16.9	16.9	16.7	16.6	16.5	16.5	Vehicle Sales, millions of units[3]	17.5	17.1	17.2	16.8	16.4
3.8	3.8	3.9	3.8	3.7	3.7	3.6	3.5	Unemployment Rate, %[4]	4.9	4.4	3.9	3.7	3.6
1.7	1.8	1.8	1.6	1.5	1.3	1.2	1.2	Non-Farm Employment[5]	1.8	1.6	1.7	1.5	1.1
2.6	4.3	2.6	1.2	1.9	1.8	2.2	1.5	Real Disposable Personal Income[1]	1.7	2.6	2.9	2.5	1.7
2.4	2.2	2.1	1.9	2.2	2.5	2.7	2.6	GDP Price Index[5]	1.1	1.9	2.3	2.2	2.5
2.2	1.9	1.5	1.7	2.0	2.2	2.5	2.4	PCE Deflator[5]	1.1	1.8	2.0	1.8	2.4
2.6	2.2	1.7	1.8	1.8	2.0	2.2	2.1	Consumer Price Index[5]	1.3	2.1	2.4	1.8	2.0
2.0	1.9	1.8	1.8	2.0	2.1	2.2	2.2	Core PCE Deflator[5]	1.7	1.6	1.9	1.9	2.2
2.2	2.2	2.1	2.1	2.2	2.2	2.2	2.2	Core Consumer Price Index[5]	2.2	1.8	2.1	2.2	2.2
1.89	2.16	2.38	2.38	2.38	2.38	2.38	2.38	Fed Funds Target Rate Range Mid-Point, %[4]	0.39	0.98	1.78	2.38	2.38
2.92	3.04	2.65	2.55	2.60	2.65	2.70	2.70	10-Year Treasury Note Yield, %[4]	1.84	2.33	2.91	2.61	2.70
4.57	4.78	4.37	4.27	4.31	4.41	4.47	4.47	30-Year Fixed Mortgage, %[4]	3.65	3.99	4.54	4.34	4.47
-2.5	-2.6	-2.4	-2.5	-2.7	-2.7	-2.8	-2.8	Current Account, % of GDP	-2.3	-2.3	-2.4	-2.6	-2.9

a = actual; f = forecast; p = preliminary

Notes:
1 - annualized percentage change
2 - chained 2012 $ 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