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Have It Your Way

The report on Q1 GDP is the perfect economic data release. That has nothing to do with the better than expected headline number – real GDP grew at an annualized rate of 3.2 percent in Q1, easily topping our forecast of 2.8 percent growth and the consensus forecast of 2.2 percent growth. No, what makes the report on Q1 GDP the perfect economic data release is that it has something in it for everyone. Well, at least everyone with an opinion and a platform through which to share that opinion. Those with an interest in pointing out how good things are can run with that 3.2 percent growth print to support their narrative. At the same time, those with an interest in pointing out how bad things are can run with some of the details beneath that headline growth print to support their narrative.

It isn't often you see the exact same data being used to support the exact opposite points of view which, if you're in to that sort of thing, is what makes the report on Q1 GDP the perfect release. As for us, rather than finding a way to make the data say what we want it to say, the fun, not to mention the challenge, of any given data release is trying to figure out what the data are trying to tell us. After all, it is not now nor has it ever been our job to be bullish or bearish or optimistic or pessimistic. So, remarkably enough, what the report on Q1 GDP is telling us is that the U.S. economy remains on firm footing, with growth neither as strong as implied by the headline growth print nor as weak as implied by some of the details beneath that headline.

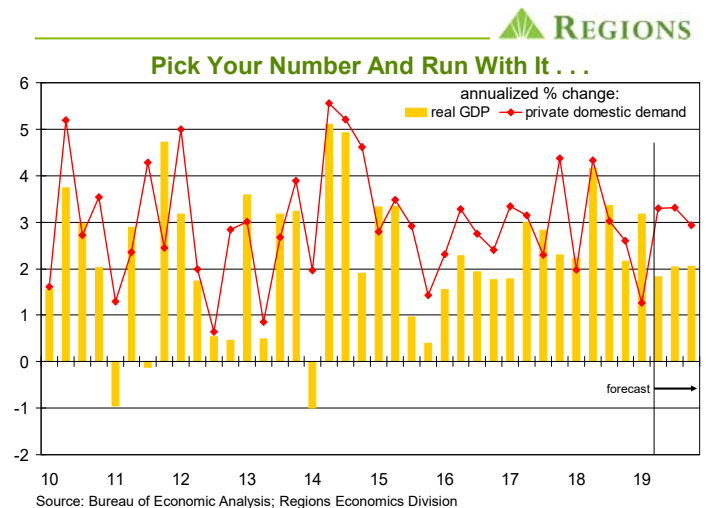
Q1 real GDP growth was flattered by a sizable increase in nonfarm business inventories, which added 0.65 percentage points to top-line real GDP growth. This marks the third consecutive quarter with a significant increase in business inventories, and while these inventory builds add to real GDP growth in the quarter in which they occur, there is always payback somewhere down the line. By definition, the net contribution of inventories to real GDP growth over time is zero, after all, and we think inventories will be a material drag on current quarter growth, taking more than a percentage point off of Q2 real GDP growth.

Trade was an even bigger driver of Q1 real GDP growth, with a significant narrowing of the U.S. trade deficit adding 1.03 percentage points to top-line growth. Trade flows, however, have been somewhat distorted over recent quarters as firms, both domestic and foreign, pulled orders and shipments forward as a hedge against further deterioration in the trade environment in the form of higher tariff rates applied to a broader range of goods. Note that this helps account for the build in business inventories over the back half of 2018.

But, as with the build in inventories, the reduction in the U.S. trade deficit seen in Q1 will not be sustained, and our forecast anticipates a wider trade deficit will be a drag on current quarter

real GDP growth. So, between the contributions from inventories and trade, there was a powerful boost to Q1 real GDP growth from factors that will not be repeated in Q2, setting the stage for a materially slower pace of real GDP growth. This is why we say the economy's underlying growth rate is not as strong as implied by the headline growth print on the report on Q1 GDP.

By their nature, inventories and trade are inherently volatile, and it is not uncommon for this volatility to cause sharp swings in measured real GDP growth from one quarter to the next. That GDP growth is reported on an annualized basis only magnifies these quarter-to-quarter swings. Though to a lesser degree, government spending (which added 0.41 percentage points to Q1 real GDP growth) also tends to be volatile. As such, it is common to focus on private domestic demand, or, combined household and business spending, as a better indicator of the underlying health of the U.S. economy. To be sure, the diagnosis as of Q1 2019 was not good, as real private domestic demand grew at an annualized rate of just 1.3 percent, the slowest pace of growth since Q2 2013.



The meager growth in private domestic demand in Q1 is simply a continuation of a rather ominous looking trend, with growth having decelerated in three consecutive quarters, as seen in the above chart. It was on this basis that some observers argued that the lofty Q1 headline growth print was masking an economy losing momentum at a rather rapid pace, as the "sugar high" of fiscal stimulus that propped up growth in 2018 was fading fast. There is no question that fiscal stimulus will not be as supportive of growth in 2019 as was the case in 2018, but our view is that the slowdown in growth of private domestic demand in Q1 is not only overstated, but will reverse, rather significantly, in the Q2 data. We illustrate this by including our forecasts of real GDP growth and real private domestic demand growth over the remaining quarters of 2019 in the above chart. As shown, we expect growth in private domestic demand to be meaningfully faster than was the case in Q1 even

as inventories and trade act as drags on top-line real GDP growth in Q2 and, albeit to a lesser degree, in Q3.

Growth in real consumer spending was notably soft in Q1, with annualized growth of just 1.2 percent, which was the main culprit behind the sharp slowdown in private domestic demand growth. In part, this reflects a deceleration in the pace of motor vehicle sales, with real consumer spending on motor vehicles contracting at an annualized rate of 18.4 percent in Q1. More significantly, recall that control retail sales, a direct input into the GDP data on consumer spending, are reported to have fallen by 2.2 percent in December 2018, amidst the partial government shutdown and the meltdown in the financial markets. This pushed the level of real consumer spending in December 2018 well below the Q4 average, setting a flimsy base under Q1 growth in consumer spending.

Keep in mind, however, that control retail sales rebounded smartly in Q1 2019, ending with a sizable increase in March that left the level of real consumer spending easily above the Q1 average and thus built a much firmer base for Q2 growth in consumer spending. For instance, our forecast anticipates real consumer spending will grow at an annualized rate of 3.4 percent in Q2. Admittedly, we have little Q2 data to go on at this point and our forecast may be a bit on the ambitious side but, either way, current quarter growth in real consumer spending should be significantly stronger than was Q1 growth.

There is a very simple reason for why we spend so much time examining patterns in the data, such as the base effects described above, which is that these patterns matter. It is mind boggling that some observers are willing to take each number that comes along in isolation, as though it has nothing to do with either the numbers that have come before it or the numbers that will come after it. Then again, it is much easier, not to mention much faster, for someone to take any given number and attach any conclusion to it that they want. This was the case with one observer who jumped on Q1's weak growth in consumer spending as a sign that the U.S. economy is "far from healthy" as consumers "continue to struggle." Come on, man, really – you can't do better than that?

While we have few worries about U.S. consumers at present, there is ample room for debate over the paths of residential and business fixed investment – the remaining components of private domestic demand – over coming quarters. There is no arguing that the housing market ended 2018 on a weak note, as a jump in mortgage interest rates compounded the hit to affordability inflicted by a prolonged period of rapid house price appreciation, with a dip in consumer confidence also helping push many prospective buyers to the sidelines.

That weakness carried into the early phases of 2019, and what was cold and wet weather in February and March made matters worse. As such, real residential fixed investment contracted at an annualized rate of 2.82 percent in Q1, which took 0.11 percentage points off of top-line real GDP growth. Still, with significantly lower mortgage interest rates having sparked a jump in applications for purchase mortgage loans (thus far in 2019 purchase mortgage loan applications are running 11 percent ahead of their Q4 2018 average), pending home sales having risen smartly in Q1, and March having been the strongest month for new home sales since July 2007 (though one has to look at the not seasonally adjusted

data to know that), there is every reason to expect residential fixed investment to flip from being a drag on to a driver of top-line real GDP growth. While Q2 is looking like a toss-up at present, we do expect to see this flip over the final two quarters of 2019. This is not to say that we expect the housing market to come roaring back, but we nonetheless expect housing to make at least a modest contribution to real GDP growth over the back half of 2019.

That leaves, at least to us, the path of business fixed investment as the biggest question mark looming over the U.S. economy over the next several quarters. And, as it turns out, the performance of business fixed investment is seen by many as a referendum on the merits, or lack thereof, of the 2017 tax bill. This is not entirely unfair, given some of the claims made in support of the tax bill, but it is unfortunate in that it reinforces the recency bias that drives far too much of the discussion of the economic data, which goes to our earlier point about taking each number in isolation.

Lost in the argument, however, is that growth in business investment in equipment and machinery picked up significantly in Q1 2017, i.e., well before there was a 2017 tax bill. That faster growth persisted through 2017 and most of 2018 but, as with the housing market, business spending on equipment and machinery softened in late-2018. That softness carried into early 2019, with real business spending on equipment and machinery growing at an annualized rate of just 0.2 percent in Q1 2019, thus neither adding to nor taking away from top-line real GDP growth. What has gone largely unnoticed, however, in all of the talk, or argument, over business investment is that business spending on intellectual property products (which mainly consists of spending on software and R&D) has continued to post solid growth. In Q1, real business spending on intellectual property products grew at an annualized rate of 8.6 percent, which added 0.39 percentage points to top-line real GDP growth. Again, there was a meaningful acceleration in growth of this form of business investment long before there was a 2017 tax bill.

Our view on business investment has not changed. After having significantly underinvested over much of the current expansion, firms had little choice but to step up capital outlays, particularly given that what had become an aged capital stock was weighing on worker efficiency. At the same time, as the labor market continued to tighten and labor costs began to grow at a faster pace, firms had greater incentive to engage in spending that would spark faster labor productivity growth. This turn was well underway before the 2017 tax bill was signed into law, and while we thought the provision allowing for the immediate expensing of capital outlays would be a useful support for business investment, we never bought into the "investment boom" argument.

By late-2018, however, a sharp slowdown in global economic growth, considerable uncertainty over the course of trade policy, and what had become materially tighter financial conditions contributed to the pronounced slowdown in business spending on equipment and machinery. The recent monthly data on orders for core capital goods suggest that the Q2 GDP data will show firmer growth in business spending on equipment and machinery – our forecast anticipates annualized growth of around 2.0 percent in Q2 and an average pace of around 4.8 percent over the second half of 2019, while at the same time our forecast anticipates better than 6.0 percent growth in real outlays on intellectual property

products over the final three quarters of 2019. Again, our forecast may prove too ambitious but, either way, growth in business investment should be better over the remainder of 2019 than was the case in Q1. Anyone with the time and inclination to argue over what this does or does not prove about the merits of the 2017 tax bill is of course free to do so. Aside from the impact on current GDP growth, our interest in business investment centers on the implications for labor productivity growth in subsequent quarters.

The above discussion offers a broad outline of what we expect for the U.S. economy over the remainder of 2019. To the extent our outlook is on or near the mark, the result will be rather pedestrian looking headline real GDP growth on top of more robust growth in private domestic demand. So, in other words, the quarterly reports on GDP won't settle any arguments, though they will change the terms of the arguments, such that those who jumped on the Q1 headline growth number (underlying details) as proof of how good (bad) things are will have to point to the underlying details (headline growth number) to make their case. That's way too confusing, so, as always, we'll do our best to tune out the noise.

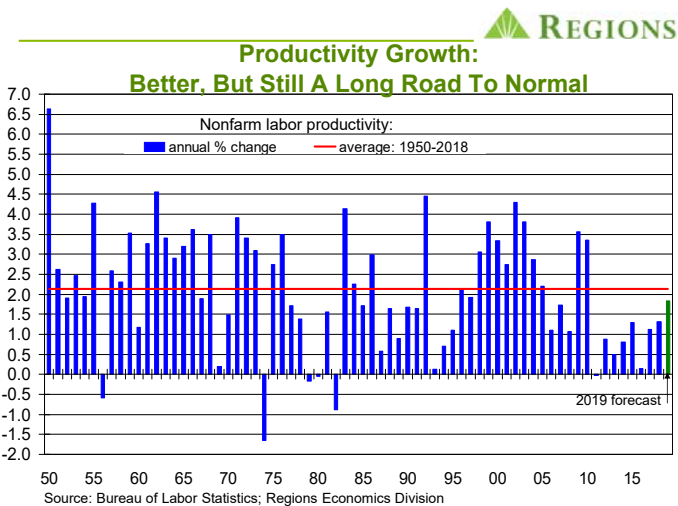
U.S. Economy Moving Into The Fast Lane?

One reason there is so much focus on business fixed investment is that this is one of the key determinants of the rate of labor productivity growth. The rate of labor productivity growth and the rate of labor force growth are key determinants of the rate at which the economy can grow on a sustained basis without fueling inflation pressures. Additionally, the rate of labor productivity growth is a key driver of the rate at which workers' wages grow over time, and productivity growth enables firms to pay higher wages while preserving profit margins. All of this has implications for the path of monetary policy.

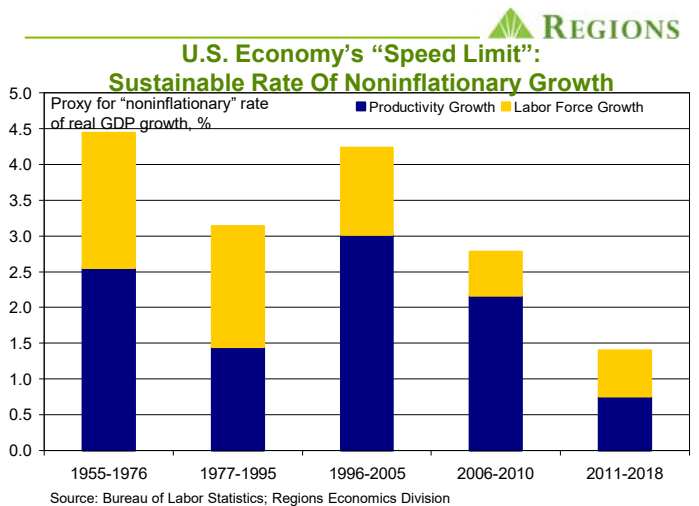
productivity growth are inherently volatile and productivity growth can swing sharply from one quarter to the next. It is for this reason that we focus on the trend rate of productivity growth, which we measure with the 8-quarter moving average of the quarterly rates. As of Q1 2019, the trend rate of productivity growth stood at 1.74 percent, the highest since Q2 2011, and the trend rate has been pushing steadily higher over the past several quarters.

So, there is reason to be encouraged by the recent data on productivity growth, just not as much reason as is implied by the Q1 growth number. Our forecast anticipates full-year 2019 labor productivity growth of 1.8 percent which, while far above average annual growth during the current expansion, is nonetheless still well below the historical average of 2.1 percent. To some extent, that productivity growth has been so anemic over much of the current expansion simply reflects the extent to which firms have substituted labor for capital, which is something we've discussed on many occasions. In a slow-growth environment in which they had access to an ample supply of relatively low-cost labor, firms had little incentive to expand their capital stocks, and growth in aggregate hours worked more than compensated for what were meager gains in productivity. Again, though, as the expansion endured and labor became less readily available and more costly, the incentive set facing firms changed, and it has become more and more important for firms to enhance labor productivity.

This will become increasingly important in the years ahead as demographic trends suggest labor force will be much lower than has historically been the case. Keep in mind that this is a global issue rather than being an issue specific to the U.S. This brings us back to the importance of business investment spending. Larger and more modern capital stocks will enhance labor productivity, and faster growth in R&D spending has historically tended to lead faster productivity growth. All of which takes time, however, which is why is important that the better growth in business investment seen over the past several quarters be sustained.



This helps explain why many are encouraged by the recent data on productivity growth. As the above chart shows, however, there is a limit as to just how encouraged anyone should be, at least for now. Nonfarm labor productivity grew at an annualized rate of 3.6 percent in Q1 2019, besting our above-consensus forecast of 3.0 percent growth. As we routinely point out, however, the data on



We've found the above chart to be a useful way of illustrating the importance of productivity growth. Well, okay, we've also found it to be a useful way to torment a particular colleague of ours, who greets each appearance of this chart with an exasperated roll of the eyes followed by "what, again with your little speed limit chart." Never gets old. We don't think he hates our little chart as

much as he hates the message contained in our little chart, though we can't be entirely sure of this.

Either way, we think it's worth making a few points about the above chart. First, we use the term "speed limit" to denote the rate at which the economy can grow on a sustained basis without sparking inflation pressures. Though it is far more commonly used, we steadfastly refuse to use the term "potential" in this context. While the rates of labor force and productivity growth are key determinants of an economy's speed limit, they are not the only determinants. Regulatory, trade, tax, and monetary policies also play a role, particularly to the extent they impact the rate of capital formation, the rate of labor force participation, and the rate of business formation. Over time, there have been periods in which we've felt the policy mix was weighing on economic growth, leaving the economy with untapped potential, as it were.

Also, the time periods shown in our chart are not based on set time frames, such as decades, but rather on turns in the cycles of productivity growth. This is useful in that it illustrates that productivity growth ebbs and flows over time, which is one reason we refuse to accept the argument that the U.S. economy is forever stuck in the slow lane because the best days of productivity growth are in the past. What we've learned over time is that shifts in productivity growth are almost impossible to forecast, at least for us. We don't know of anyone who anticipated the extent and the duration of the "productivity miracle," or, the ten-year period from 1996 through 2005 during which productivity growth averaged 3.0 percent per year, a run not seen before or since. This isn't to say we're due for a similar run any time soon, but as we look at some of the technological advances and innovations taking place in the world, we can't help thinking that at least some of these will enhance labor productivity. That we can't forecast when, and to what extent, this will happen doesn't mean we think it won't happen. Instead, we simply do not have a formal basis on which to incorporate such changes into our forecasting models.

Finally, while the current expansion has been frustratingly slow, average real GDP growth has nonetheless topped the speed limit implied in our chart, which begs the question of where's the inflation. Sure, that question comes up quite often these days, but in this context it helps to recall that as long as there is idle capacity in the labor market and/or the industrial sector of any economy, growth can exceed the speed limit implied by the rates of labor force and productivity growth, which helps account for why inflation has been so mild over the past several years. As that slack is pared down, however, inflation becomes more of a concern, which makes it imperative that the increasing rate of productivity seen over the past several quarters be sustained. While that is a question that will only be answered over time, we're nowhere near being ready to rule that out.

The Curious Case Of The Disappearing Labor Force

While some have pointed to a sub-4.0 percent unemployment rate as evidence that all of the slack has been wrung out of the labor market, we've been steadfast in our view that there is more slack remaining in the labor market than has been implied by the unemployment rate. This view has in turn shaped our forecasts for

growth in hourly earnings, where we've consistently been below consensus forecasts in recent years. We've relied on the monthly data on labor force flows, which tracks the labor force status of the same individuals over successive months, to guide our view on the degree of slack remaining in the labor market.

The number of people transitioning from being not in the labor force in one month to being employed the next month had risen steadily over the course of the current expansion and, at better than 4.5 million per month over the 2017-18 period, was extraordinarily high even allowing for growth in the labor force. What has gotten our attention, however, is that thus far in 2019 the rate of inflows into the labor force has slowed sharply, which helps account for why the size of the total labor force has fallen in each month of 2019 thus far, culminating in April's unexpectedly large decline in the unemployment rate. Sure, at 3.6 percent, the jobless rate sits at a 49-year low, but the reality is that it fell for the wrong reason in April, i.e., a sizable decline in the labor force.

This is a puzzling development which, if sustained, would temper any increase in the economy's speed limit resulting from faster labor productivity growth. Note that labor force participation amongst the 25-to-54 year-old age cohort, commonly referred to as the "prime working age population," is reported to have risen thus far in 2019 for both males and females. For that matter, the total labor force participation rate in 2019 is modestly higher than the 2018 average, yet the total labor force is reported to have contracted. Predictably, the reported decline in the labor force has been pure gold for those in the "everything is terrible" camp.

As we are inclined to do, we've done some digging into the data, starting with the data on the civilian noninstitutional population, which is the subset of total population from which the labor force is estimated. The data show an oddly sharp slowdown in the rate of growth of the total noninstitutional population in 2019 and an outright decline within the 25-to-54 year-old age group. The data for 2017, a year in which measured labor force growth slowed sharply, show the same pattern which, to us, is a strong sign of data issues. BLS has in the past suggested that the data from the Current Population Survey from which the labor force data are drawn get less reliable the further we get from each decennial Census. This was a pattern seen in the year prior to the 2010 Census, i.e., the establishment survey showing steadily rising nonfarm employment while the household survey showed declines in the labor force and in household employment.

We're not in the habit of reflexively blaming the data when a given data series doesn't evolve as we expect it to. Okay, fine, the retail sales data richly deserve every bit of contempt we have for them. Other than that, our approach is always to do as much digging as it takes to understand why the data are behaving as they do. In this case, however, that digging suggests that the reported decline in the labor force thus far in 2019 is more of a data issue than it is a meaningful shift in the economic fundamentals. Though not perfect, the establishment survey is a more consistent, and a more reliable, gauge of job growth. One reason this matters is that many make inferences about wage growth, and in turn broader inflation, on the basis of the measured unemployment rate. That can lead analysts, and policy makers, down a bad path, and if we're correct in questioning the quality of the household survey data in 2019, the risks of policy mistakes are even greater.

ECONOMIC OUTLOOK



Q4 '18 (a)	Q1 '19 (p)	Q2 '19 (f)	Q3 '19 (f)	Q4 '19 (f)	Q1 '20 (f)	Q2 '20 (f)	Q3 '20 (f)		2016 (a)	2017 (a)	2018 (a)	2019 (f)	2020 (f)
2.2	3.2	1.8	2.0	2.1	1.9	1.7	1.5	Real GDP ¹	1.6	2.2	2.9	2.6	1.8
2.5	1.2	3.4	3.0	2.7	2.4	2.0	2.1	Real Personal Consumption ¹	2.7	2.5	2.6	2.6	2.4
								Real Business Fixed Investment:					
8.3	3.7	4.0	5.5	5.1	4.2	3.5	2.7	Equipment, Software, & IP ¹	2.1	5.5	7.5	5.2	4.1
-3.9	-0.8	2.5	2.6	2.4	2.5	2.4	1.3	Structures ¹	-5.0	4.6	5.0	0.4	2.2
-4.7	-2.8	-1.1	1.9	1.5	1.4	2.1	1.7	Real Residential Fixed Investment ¹	6.5	3.3	-0.3	-2.0	1.5
-0.4	2.4	4.9	1.1	-0.2	-0.3	-0.3	-0.4	Real Government Expenditures ¹	1.4	-0.1	1.5	2.0	0.2
-955.7	-899.3	-924.4	-943.9	-963.2	-977.0	-984.6	-999.7	Real Net Exports ²	-786.2	-858.7	-912.2	-932.7	-990.3
828	849	862	876	894	906	920	929	Single Family Housing Starts, ths. of units ³	785	852	873	870	921
357	344	354	355	353	349	344	336	Multi-Family Housing Starts, ths. of units ³	393	356	377	352	339
17.5	16.8	16.5	16.6	16.5	16.4	16.3	16.3	Vehicle Sales, millions of units ³	17.5	17.1	17.2	16.6	16.3
3.8	3.9	3.6	3.6	3.5	3.5	3.4	3.4	Unemployment Rate, % ⁴	4.9	4.4	3.9	3.6	3.5
1.8	1.8	1.7	1.5	1.4	1.2	1.2	1.0	Non-Farm Employment ⁵	1.8	1.6	1.7	1.6	1.0
4.3	2.4	1.4	1.8	2.1	2.1	1.6	1.4	Real Disposable Personal Income ¹	1.7	2.6	2.9	2.4	1.8
2.2	1.8	1.7	1.9	2.2	2.6	2.6	2.5	GDP Price Index ⁵	1.1	1.9	2.3	1.9	2.5
1.9	1.4	1.5	1.7	1.9	2.3	2.3	2.2	PCE Deflator ⁵	1.1	1.8	2.0	1.6	2.3
2.2	1.6	2.0	2.0	2.1	2.4	2.0	1.9	Consumer Price Index ⁵	1.3	2.1	2.4	1.9	2.0
1.9	1.7	1.7	1.9	2.0	2.2	2.2	2.1	Core PCE Deflator ⁵	1.7	1.6	1.9	1.8	2.2
2.2	2.1	2.1	2.1	2.2	2.2	2.2	2.2	Core Consumer Price Index ⁵	2.2	1.8	2.1	2.1	2.2
2.16	2.38	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
3.04	2.65	2.55	2.60	2.65	2.70	2.70	2.70	10-Year Treasury Note Yield, % ⁴	1.84	2.33	2.91	2.61	2.70
4.78	4.37	4.18	4.25	4.32	4.42	4.43	4.44	30-Year Fixed Mortgage, % ⁴	3.65	3.99	4.54	4.28	4.43
-2.6	-2.4	-2.5	-2.7	-2.7	-2.8	-2.8	-2.9	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

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