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Are The Biggest Risks Hiding On Corporate Balance Sheets?

Though the current expansion became the longest U.S. economic expansion on record as of July, it hasn't really had much chance to celebrate. Then again, it hasn't really had much reason to celebrate. Amidst the ongoing, and escalating, trade dispute between the U.S. and China, lingering uncertainty over the broader course of trade policy, depressed business sentiment, fading business investment, and an inverted yield curve, there are growing concerns that the end of the expansion is close at hand. Those concerns only intensified when the August read on the ISM Manufacturing Index showed the headline index had fallen below 50.0 percent, indicating that the U.S. manufacturing sector has joined many of its global counterparts in a contraction that shows no signs of letting up any time soon.

The contraction in the factory sector and diminished trade flows have taken a toll on freight markets (we first discussed this in our June *Outlook*), with growing idle capacity and declining shipping rates. Up until now, however, U.S. consumers seem relatively unaffected, with ongoing job and wage growth underpinning growth in personal income and, in turn, consumer spending. At the same time, the housing market continues to muddle along, even if supply constraints are blunting the beneficial effects of lower mortgage interest rates, while rising government spending is also providing some support for GDP growth.

As such, while the fallout from the U.S.-China trade dispute, including weakening capital spending, will act as a meaningful drag on growth, this is unlikely to be sufficient to tip the U.S. economy into recession. That said, with a slower run rate, the economy becomes more vulnerable to adverse shocks, particularly given what at present is a very limited scope for response from either monetary policy or fiscal policy. Should business confidence erode to the point that firms begin to shed workers, then what of late has been the key pillar of support for the economy, i.e., consumer spending, would crumble, likely bringing about the end of the expansion. While not our baseline case, we nonetheless think it would be unwise to dismiss such a scenario out of hand.

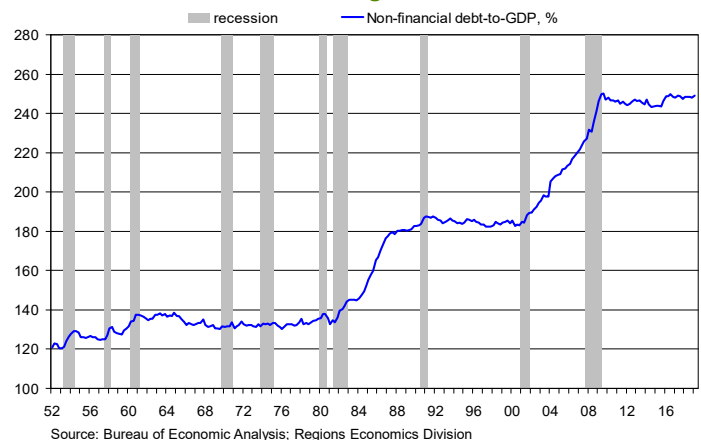
Of course, we may be biased, as this transmission mechanism, i.e., businesses pulling back on capital spending and hiring, with the latter leading to a decline in consumer spending, has been the core of the recession scenario we have been modeling for over a year now. We've used this internally as a means of anticipating where the next recession would emanate from and what it might look like, in terms of duration and severity. The difference, however, is that rather than trade disputes being the trigger, our scenario has been premised on a balance sheet recession originating in the non-financial corporate sector of the economy. And, though at present trade is front and center in terms of downside risks, we continue

to see a balance sheet recession as a nontrivial risk. Consider it the legacy of a decade of ultra-aggressive monetary policy that has fostered what, at least to us, is an uncomfortable degree of leverage in the non-financial corporate sector.

On top of policy rates being held at extraordinarily low levels for a prolonged period, central bank asset purchases have suppressed yields on longer-term assets, leading yield-seeking investors to take on more and more risk. One manifestation of this has been a compression of credit spreads, raising the question of whether risk is being properly priced. At the same time, growth in the level of debt in the non-financial corporate sector has led some to question whether a marked and sustained slowdown in profit growth could trigger financial stress in this sector that could pose a risk to the broader economy. Count us as being in this camp, though to be sure there are plenty who see this scenario as highly unlikely.

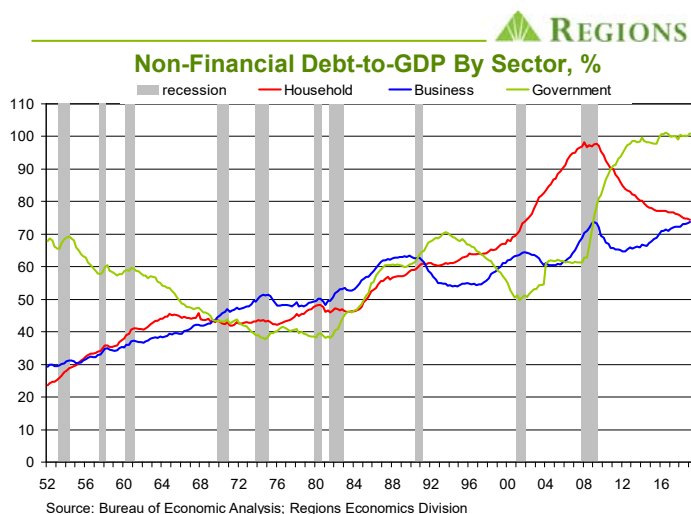


Is Stable Ratio Masking Risks In The Details?



Indeed, when the topic of debt comes up, the reactions tend to be all over the map, with "no worries" and "impending doom" at the extremes and varying degrees of concern, often isolated on a specific sector – household, government – somewhere in between. Those who are unconcerned often point to what has been a notably stable aggregate debt-to-GDP ratio over the course of the current expansion, as we show in the above chart. The chart shows the ratio of aggregate non-financial debt – total debt in the household, non-financial business, and government sectors – as a percentage of nominal GDP, using data from the Federal Reserve's quarterly "Flow of Funds" reports (the latest being Q1 2019). As of Q1 2019, the ratio of total non-financial debt to nominal GDP stood at 249.20 percent, only slightly above the ratio of 247.86 percent as of Q1 2010. In other words, aggregate non-financial debt and nominal GDP have grown by roughly the same degree in the post-recession years. In that sense, one can argue that while the overall level of debt in the economy has grown, the higher level of debt has not imposed a greater burden on the economy.

Our focus here, however, is not the burden of the debt but the potential risks posed by the debt, a discussion which requires us to break the aggregate level of non-financial debt down into its component parts. We do so in the following chart, which shows the debt-to-GDP ratio for the household, non-financial business, and government sectors. Note that the non-financial business sector is a broad sector which includes the non-financial corporate sector, and the broad government sector includes governments on all levels. Also, when we discuss household debt, rather than the debt-to-GDP ratio, we typically use the ratio of household debt to disposable personal income excluding transfer payments, and while the debt-to-income ratio is higher than is the debt-to-GDP ratio, the patterns in each series over time are virtually identical, with both ratios declining sharply in the post-recession years.



Despite the sharp decline in the household debt-to-GDP ratio, each quarterly data release triggers a new round of “new record level of household debt” dramatics, which can most charitably be described as a headline in search of a story. We’ve discussed this in detail on many occasions, including our analysis of the New York Fed’s quarterly reports on household debt, and the bottom line is that household debt poses nowhere near the same risk to the broader economy as was the case leading up to the 2007-09 recession. This is particularly true of mortgage debt, which accounts for over two-thirds of total household debt. In terms of our discussion here, the declining household debt-to-GDP ratio has largely offset rising ratios in the government and non-financial business sectors, keeping the total debt-to-GDP ratio fairly stable.

The ratio of non-financial business debt to nominal GDP has been rising over the past several years, standing at an all-time high of 73.84 percent as of Q1 2019. Rather than the broad sector, many focus on the non-financial corporate sector, which accounts for almost two-thirds of total debt in the broader non-financial business sector; as of Q1 2019 the ratio of non-financial corporate debt to nominal GDP stood at an all-time high of 46.98 percent. Whether couched in terms of the broad non-financial business sector or the narrower non-financial corporate sector, our point here is the same. With mounting pressure on corporate profits, debt service payments become more burdensome, and the risk, at least in our view, is that these burdens at some point become so onerous that businesses pull back on capital spending and hiring.

If such a retrenchment were to become sufficiently broad based across the business sector, it is not hard to envision it tipping the economy into recession via the channel we described earlier, i.e., materially weaker labor market conditions leading to declining consumer spending and, in turn, a contraction in real GDP. To the extent corporations would also pull back on dividend payments to help alleviate stress from debt service obligations, that would introduce another channel through which the broader economy is impacted.

To be sure, we’re not saying we think such a balance sheet recession is close at hand. The recent softening in profits aside, margins remain fairly elevated relative to historical norms and the ratio of interest payments to corporate profits, just under one-third at present, remains fairly low. In past cycles, this ratio has tended to rise significantly as the economy has neared recession. And, sure, it kind of feels like interest rates will never rise again, which would seem to render our concerns moot. In all honesty, when we first began contemplating such a scenario, which was long before we began modeling it, rising interest rates were the trigger for mounting debt service burdens (seems kind of far-fetched at this point in time, no?). Keep in mind, however, that while low interest rates may hold down debt service payments, if the pool of funds out of which those payments are made – profits – begins to dry up, you can still end up in the same place, i.e., firms facing increasingly onerous debt service burdens.

So, while we don’t think this scenario is likely in the near term, it does seem as though we’re heading in that direction. After all, in the BEA’s recent annual revisions to the GDP data, prior estimates of corporate profits were revised significantly lower. As we discussed in last month’s *Outlook*, we have some issues with how these estimates are made, but subsequent to the release of the revised GDP data, the BLS released revised data showing that unit labor costs had risen much more rapidly than had previously been estimated. Faster growth in labor costs is a source of stress on corporate profits. At the same time, decelerating economic growth puts downward pressure on top-line revenue growth. Indeed, even assuming a fairly benign outcome to current trade disputes, our baseline forecast has real GDP growth slowing steadily over the next few years, reflecting slowing growth in nominal GDP, which in turn implies steadily slowing top-line revenue.

In other words, business debt service burdens can become a problem for the broader economy even in the absence of a spike in interest rates. As noted above, we’re not at this point yet, but if our forecast of steadily slowing economic growth is on or even close to the mark, it could be that as we get to 2021 and beyond, interest coverage ratios rise to the point that the scenario we’ve described above begins to play out. Note that a bad outcome to current trade disputes and materially higher interest rates loom as downside risks that would speed up interest coverage stresses.

If for some reason risk aversion began to rise, wider corporate credit spreads could intensify interest coverage stresses. It is worth considering this in light of the share of corporate debt rated BBB, i.e., the lowest rating at which corporate debt is considered investment grade. Most estimates we’ve seen put the share of total corporate debt accounted for by BBB-rated debt at around 60 percent, considerably higher than has been seen in past cycles. Signs of growing financial stress in the corporate sector, or at least

in this segment of the corporate sector, could lead to ratings downgrades, pushing at least some portion of debt now rated BBB down below investment grade. This could in turn cause significant disruption in the high-yield segment of the market that would almost surely be felt in the broader economy.

As noted earlier, we don't see a balance sheet recession as being likely any time soon. Perhaps one reason why many dismiss this scenario out of hand is that at present corporate debt doesn't necessarily stand out as a glaring imbalance with the potential to tip the economy into recession. While that may be true, we liken this to a slow-moving train. That it takes a long time doesn't mean even the slowest moving train won't ultimately get to where it is going. Outside of random adverse shocks, which of course are not predictable, we have for some time now pointed to corporate balance sheets as the most likely breeding ground for the next recession. Time will tell, but at the least it is worth keeping a close watch on corporate credit conditions over coming quarters, particularly as a material and sustained re-acceleration in corporate profit growth seems unlikely.

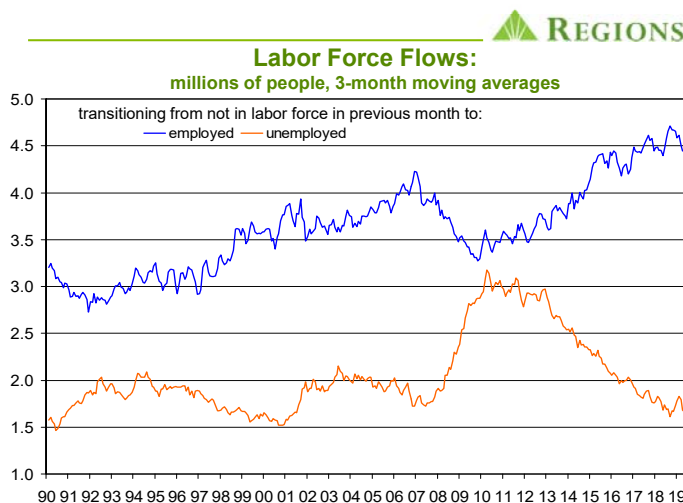
Supply Isn't The Issue In The Labor Market

Job growth was disappointingly weak in August, with total nonfarm employment increasing by just 130,000 jobs, considerably below expectations. Moreover, August's headline job growth number was flattered by advance hiring for the 2020 Census, which accounted for 25,000 jobs of the total increase of 130,000 jobs. Private sector payrolls rose by a paltry 96,000 jobs in August, marking the third time this year the monthly increase in private sector payrolls slipped below the 100,000 jobs mark. To be sure, in any given year the initial estimate of August job growth tends to be on the light side – over the 2009-2018 period, the initial estimate of August job growth was revised higher by an average of 59,000 jobs between the first and third estimates. But, as the response rate to the BLS's establishment survey was well above average for the month of August, it seems likely that any upward revision to this year's initial estimate of August job growth will fall well short of the average revision seen over the prior decade.

Clearly, the pace of job growth has slowed this year. Based on the not seasonally adjusted data, private sector payrolls have risen by a total of 1.945 million jobs over the past twelve months, the lowest such total in almost two years. That job growth has been decelerating does not come as a total surprise. After all, following real GDP growth of 2.9 percent in 2018, which matched 2015 as the fastest full-year growth during the current expansion, it was almost universally expected that growth would slow in 2019. That was even before the effects of trade policy, slowing global growth, and flagging business sentiment here and abroad became obvious drags on U.S. real GDP growth. As such, the deceleration in job growth thus far in 2019 has been more pronounced than we and most other analysts expected at the start of the year.

Yet, despite considerable evidence to the contrary, the "firms can't find qualified workers to hire" chorus carries on. And on. And on. To be fair, one has to examine the details beneath the headline numbers in order to see the considerable evidence to the contrary which, apparently, can be quite taxing. It's almost as if a sub-4.0

percent unemployment is all of the evidence needed to conclude firms are running out of workers to hire, despite, once again, considerable evidence that there is, and has for some time been, much more slack remaining in the labor market than is implied by the unemployment rate. Others point to data from the monthly Job Openings and Labor Turnover Survey (JOLTS), which for the past 16 months have shown the number of open jobs is greater than the number of unemployed people. On the surface, this would suggest firms cannot find enough workers, but this simplistic view fails to account for the beneath the surface dynamics of the labor market.



We routinely cite the data on labor force flows, which track month-to-month flows of people moving into and out of the labor force and also flows of people within the labor force, i.e., moving from unemployed to employed, or vice versa. The blue line in the above chart shows the number of people who transition from not being in the labor force in one month to being employed in the next month, while the orange line shows the number of people who transition from not being in the labor force in one month to being unemployed in the next month. As seen in the chart, even using a three-month moving average, the data are quite volatile, but the trends in the series could not be more clear.

Over the past 34 months an average of 4.55 million people per month have transitioned from being not in the labor force in one month to being employed in the next month, and over the past 12 months the number has been well above that longer-term average. Even allowing for growth in the labor force over time, this is still a large number, and one that illustrates our point about there being more slack in the labor market than is implied by the "headline" unemployment rate.

We have for some time argued that the severe cyclical decline in labor force participation tied to the 2007-09 recession has not been fully reversed, even if the longer-term structural decline has further to run. More specifically, we've pointed to the 25-to-54 year-old age cohort, i.e., the "prime working age population," as a segment of the labor force in which the participation rate has room to the upside. Though the monthly data can be jumpy, the participation rate amongst this age cohort rose to 82.6 percent in August, matching this January as the highest rate since 2009, but which still leaves it shy of rates seen prior to the last recession.

So, while inflows into the labor force cannot continue indefinitely at the pace illustrated in the above chart, we do think they have further to run. To be sure, one also has to account for exits from the labor force – the number of people transitioning from being employed in one month to being not in the labor force in the next month has also been rising, and will likely continue to do so. But, on net, inflows into the labor force continue to run well ahead of outflows from the labor force, and simply comparing the number of open jobs to the number of unemployed fails to account for this dynamic. It is as though those who make this comparison do not account for the fact that in order to be counted as unemployed, one has to actually be in the labor force. Our broader point remains the same, which is that inadequate labor supply is not the reason why the pace of job growth has slowed.

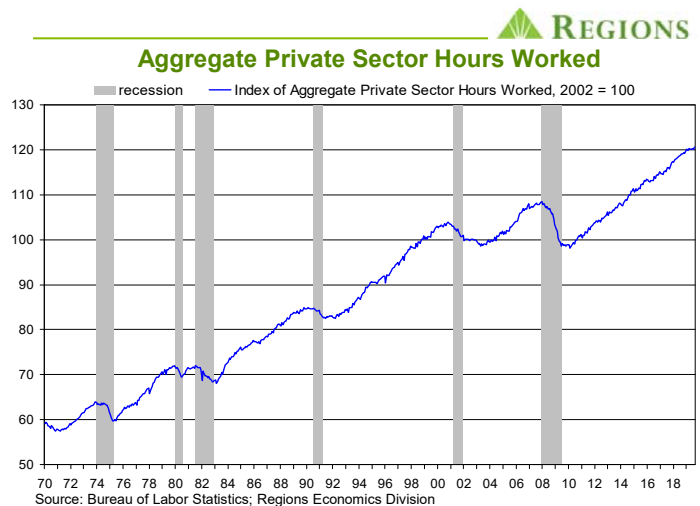
And, as a side point, while the data on labor force flows come from the household survey and the data on average hourly earnings come from the establishment survey, we can make what we think is a reasonable connection between the two data series. To the extent that a growing share of new hires have been accounted for by new entrants into the labor force or people who have been out of the labor force for some period of time, that has likely acted as a persistent drag on wage growth. It figures that new entrants into the labor force and re-entrants who have been out of the labor force for some time have less bargaining power in terms of their going-on wage rate. It is, however, reasonable to think that as the labor market continues to tighten, the bargaining power of those transitioning into the ranks of the employed increases. Even so, we'd still argue that over the past few years this has been an underappreciated reason for why it has taken so long for growth in average hourly earnings to firm up.

We can also look at the deceleration in the rate of job growth from the demand side of the labor market. Again, as the jobless rate approached and then fell below 4.0 percent, it became more and more common for people to argue we were at "full employment," and we've consistently taken the other side of that argument. Aside from the data on labor force flows, we've also pointed to the length of the average workweek to support our contention. More specifically, we've noted that the length of the workweek has been, and remains, shorter than would be the case were the labor market truly operating at full employment, and we've referred to this as an underappreciated form of labor market slack.

Though it is common to simply point to the number of people working as a gauge of the demand for labor, the other component of total labor input is the number of hours being worked by each worker in each time period. In other words, aggregate hours worked is the proper measure of firms' collective demand for labor. This is a topic we've discussed often, and we discussed it in detail in the April 2018 edition of our *Outlook*, when we referred to aggregate private sector hours worked as the one indicator of turns in the business cycle we would track if we were only allowed to track a single indicator. As the following chart illustrates, aggregate private sector hours worked has an excellent track record, acting as no worse than a coincident indicator and often acting as a leading indicator of recession. This is one reason we and other analysts have expressed concern over recent months as growth in this series has flattened out.

What is often overlooked is that changing the number of workers is a blunt tool and one not quickly, or cheaply, reversed, so before

firms utilize this tool they want to be sure business conditions warrant such changes. As such, when firms begin to see softening (firming) demand, the first step is not to start cutting (adding) people but instead to cut back on (increase) the number of hours being worked by their current workers. Altering the number of hours worked basically buys firms time to get a better sense of where business conditions are heading, and is something that can be easily reversed if need be. As such, in the context of a recession indicator, aggregate hours worked will turn before the level of employment turns.



Relative to where they were in late-2018/early-2019, aggregate hours worked in manufacturing, transportation & warehousing, and wholesale trade have fallen, as is also the case in mining and natural resources. The first three industry groups are no doubt been impacted by the fallout from trade disputes and lingering uncertainty over the ultimate course of trade policy, while more recently lower energy prices have taken a toll on hours worked in mining and natural resources. Thus far, firms in these sectors have mainly managed down hours worked rather than actual job counts. For instance, manufacturing payrolls have risen by 44,000 jobs in 2019, but average weekly hours have begun to fall, which leaves aggregate hours worked in the manufacturing sector below where they were as 2018 came to a close. But, if weakness in these sectors persists, it is only a matter of time before shorter workweeks give way to job cuts as a means for firms to pull back on total labor input. Indeed, the August data show a 4,500 jobs decline in employment in the truck transportation industry group, and further job losses here seem likely, but these job losses were led by cuts in average weekly hours worked in prior months.

Thus far, aggregate hours worked continue to rise in sectors such as finance, education & health services, and business services. This reflects both steady or longer average workweeks and rising job counts, suggesting only limited fallout from the weakness in the industrial and transportation sectors, but this clearly bears watching over coming months. Our broader point, however, is that shorter workweeks in some sectors of the economy were a clear and early sign of softening demand for labor. This is why we put so much emphasis on aggregate private sector hours worked as a key metric to monitor over coming months, and why we continue to argue that the demand side, not the supply side, of the labor market is the source of slowing job growth over recent months.

ECONOMIC OUTLOOK



Q1 '19 (a)	Q2 '19 (p)	Q3 '19 (f)	Q4 '19 (f)	Q1 '20 (f)	Q2 '20 (f)	Q3 '20 (f)	Q4 '20 (f)		2016 (a)	2017 (a)	2018 (a)	2019 (f)	2020 (f)
3.1	2.0	2.0	1.9	2.0	1.7	1.5	1.7	Real GDP ¹	1.6	2.4	2.9	2.3	1.8
1.1	4.7	3.8	2.4	1.9	1.9	1.8	1.8	Real Personal Consumption ¹	2.7	2.6	3.0	2.7	2.4
								Real Business Fixed Investment:					
4.4	2.0	1.4	2.0	2.4	1.6	1.4	1.2	Equipment, Software, & IP ¹	2.4	4.3	7.0	4.3	1.8
4.0	-9.4	-5.6	-3.5	-1.1	-0.6	-0.2	-0.4	Structures ¹	-5.0	4.7	4.1	-3.2	-2.4
-1.0	-2.9	1.7	1.2	2.4	1.9	2.5	2.1	Real Residential Fixed Investment ¹	6.5	3.5	-1.5	-2.2	1.7
2.9	4.5	0.8	1.8	1.6	1.7	1.6	0.6	Real Government Expenditures ¹	1.8	0.7	1.7	2.1	1.7
-944.0	-982.5	-991.5	-988.1	-996.1	-1,005.5	-1,017.3	-1,012.3	Real Net Exports ²	-783.7	-849.7	-920.0	-976.5	-1,007.8
864	847	875	883	893	902	906	908	Single Family Housing Starts, ths. of units ³	786	852	873	867	902
349	411	353	357	353	349	343	340	Multi-Family Housing Starts, ths. of units ³	392	357	377	368	346
16.8	17.0	16.9	16.8	16.6	16.5	16.4	16.2	Vehicle Sales, millions of units ³	17.5	17.1	17.2	16.9	16.4
3.9	3.6	3.7	3.6	3.6	3.5	3.5	3.6	Unemployment Rate, % ⁴	4.9	4.4	3.9	3.7	3.5
1.8	1.6	1.4	1.2	1.1	1.1	0.9	0.8	Non-Farm Employment ⁵	1.8	1.6	1.7	1.5	1.0
4.5	2.5	2.6	2.0	1.7	1.8	1.2	1.4	Real Disposable Personal Income ¹	1.8	2.9	4.0	3.1	1.8
1.9	1.7	1.9	2.1	2.6	2.5	2.4	2.2	GDP Price Deflator ⁵	1.0	1.9	2.4	1.9	2.4
1.4	1.4	1.4	1.6	2.2	2.1	2.2	2.2	PCE Deflator ⁵	1.0	1.8	2.1	1.5	2.2
1.6	1.8	1.8	1.8	2.0	1.8	1.8	1.9	Consumer Price Index ⁵	1.3	2.1	2.4	1.7	1.9
1.6	1.5	1.7	1.8	2.1	2.2	2.2	2.2	Core PCE Deflator ⁵	1.6	1.6	1.9	1.7	2.2
2.1	2.1	2.3	2.2	2.3	2.4	2.2	2.3	Core Consumer Price Index ⁵	2.2	1.8	2.1	2.2	2.3
2.38	2.38	2.17	1.82	1.63	1.63	1.63	1.63	Fed Funds Target Rate Range Mid-Point, % ⁴	0.39	0.97	1.78	2.18	1.63
2.65	2.33	1.74	1.53	1.52	1.50	1.48	1.50	10-Year Treasury Note Yield, % ⁴	1.84	2.33	2.91	2.06	1.50
4.37	4.01	3.62	3.43	3.42	3.42	3.40	3.40	30-Year Fixed Mortgage, % ⁴	3.65	3.99	4.54	3.86	3.41
-2.5	-2.5	-2.7	-2.7	-2.8	-2.8	-2.9	-3.0	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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