ECONOMIC OUTLOOK
REGIONS
October 2019

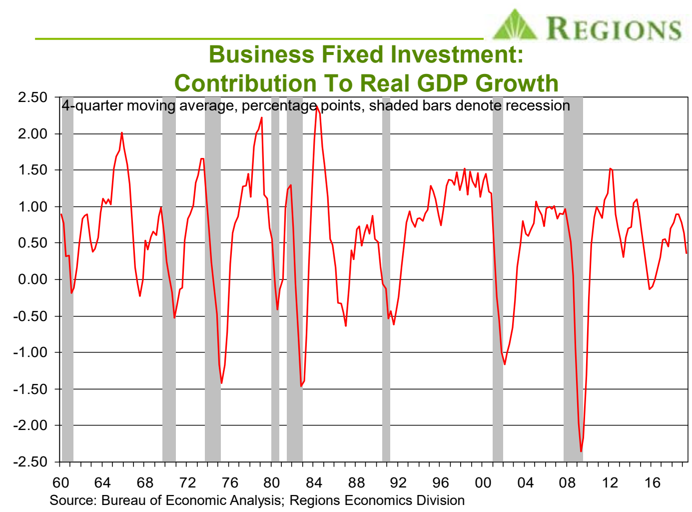
Slumping Business Investment Hurts Now And Later

Heading into 2019, our baseline forecast anticipated real GDP growth of around 2.5 percent, with consumer spending doing most of the heavy lifting and key support from business investment spending. As we make the turn into the homestretch of 2019, our expectations for full-year 2019 real GDP growth have been scaled down. While growth in consumer spending is at present closely tracking our January forecast, business investment spending is fading fast, ending a run of solid growth that began back in 2017, which will leave growth in business investment spending for 2019 as a whole well short of our January forecast. Indeed, in their past three post-meeting policy statements, the FOMC has called out the weakness in business investment spending.

Our outlook for business investment spending was premised on businesses having to compensate for persistent underinvestment in equipment and machinery over much of the current expansion, while at the same time we felt that steadily tightening labor market conditions would make it critical for firms to upgrade their capital stocks as a means of driving faster growth in labor productivity. As we have discussed before, the 2017 tax bill was not a significant factor in our outlook. After all, business investment began to strengthen before the tax bill was formulated and even longer before the tax bill took effect in 2018. We did, however, think that the provision allowing for immediate expensing of capital spending would give firms greater incentive to play catch-up.

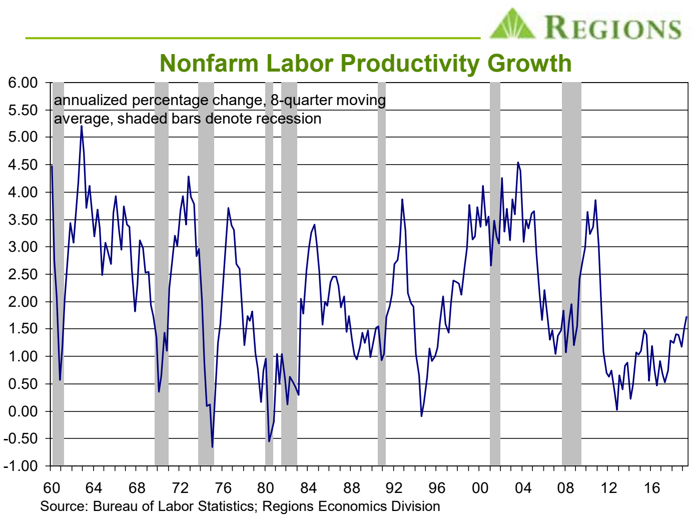
So, while we never envisioned an investment boom along the lines of that seen during the 1990s, we did expect business investment to be notably stronger than had been the case over most of the current expansion. For a time, it looked as though our forecast would play out, but at this point there seems little chance of that happening. Business sentiment, here and abroad, has sagged under the weight of trade disputes and lingering uncertainty over the course of trade policy. Trade disputes have taken a toll on global economic growth, as has the failure of policy makers throughout Asia and Europe to address structural issues that for far too long have acted as material drags on growth. Obviously, such an environment is hardly conducive to business investment. Moreover, though still somewhat elevated relative to historical norms, corporate profit margins are narrowing, and to the extent this continues as top-line growth slows, it poses an additional headwind to growth in business investment spending.

The weakness in investment spending is apparent in the monthly data on orders for core capital goods. While it is shipments that feed into the GDP data, orders lead shipments, and the two most recent monthly reports show core capital goods orders declining sequentially and year-on-year. Though the data for September are not yet available, shipments of core capital goods were on course to have declined in Q3. This sets the stage for a decline in business fixed investment in the Q3 GDP data, which would be the second consecutive quarterly decline. This is notable given that, outside of recessions or their immediate aftermath, it is rare to see back-to-back declines in business fixed investment. Going back to 1960, there are only three instances of back-to-back quarterly declines in business fixed investment outside of recessionary periods – the most recent of which was Q4 2015-Q1 2016. So, if our expectation of a decline in Q3 proves to be correct, it would not mean the economy is in, or will soon be in, recession, but it certainly would be a warning sign that would be foolish to ignore.



The above chart shows the contribution of business fixed investment to top-line real GDP growth. We use a four-quarter moving average to counter the high degree of volatility in the data, which in our chart masks the decline in business fixed investment in Q2. As the chart indicates, business fixed investment has been highly uneven over the course of the current expansion. In the early phases of the expansion, heavy investment in the energy sector was the main driver of overall growth in business fixed investment. The most recent period of accelerating growth was more broad based, with investment in equipment and machinery and intellectual property products making significant contributions. That momentum, however, has faded, and weakness in business fixed investment is apparent in categories ranging from industrial equipment to transportation equipment to outlays for research and development. The tailing off of spending on intellectual property products is notable, as stronger spending in this category is typically associated with improving labor productivity growth.

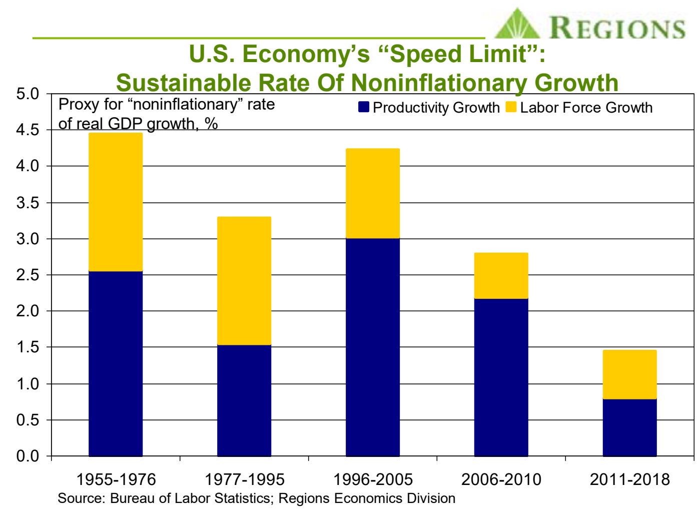
Amidst flagging business sentiment, slowing economic growth, and narrowing corporate profit margins, it seems likely that the recent weakness in business fixed investment will persist, if not intensify, over coming quarters. The risk is that, should firms feel compelled to continue cutting back on capital spending, they at some point will also feel compelled to begin cutting down on labor input, whether via cutbacks in hours or cutbacks in head counts. Either way, slower growth, or outright declines, in labor earnings would in turn lead to weakness in consumer spending, thus introducing a channel through which what starts as a decline in business investment could ultimately put the expansion at risk.



Aside from the impact on current GDP growth, should business investment continue to slide, it puts at risk the recent improvement in the rate of labor productivity growth. As our longer-term readers well know, productivity growth is a topic we discuss frequently, though over much of the current expansion the discussion hasn't been all that positive. We've argued that what has been anemic growth in labor productivity over much of the current expansion is the result of underinvestment on the part of businesses. But, as seen in the above chart, the trend rate of labor productivity growth (which we measure by the 8-quarter moving average of the quarterly growth rates) has clearly improved over recent quarters, hitting an eight-year high in Q2 2019.

We've argued that what had been a long run of solid growth of business investment in research and development, which accounts for roughly half of all spending in the broader intellectual property products category, ultimately led to a faster pace of growth in labor productivity. Growth in research and development outlays has slowed, though not to the extent seen in other components of business investment, but should this continue, or should we begin to see outright declines in research and development outlays, it is difficult to see how the recent improvement in labor productivity growth could be sustained.

That gets us back to the economy's "speed limit," or, the rate at which the economy can grow on a sustained basis without fueling inflation pressures. Sure, we know what you're thinking, all roads lead back to our discussion of the economy's speed limit. While that isn't exactly the case, it is a topic we touch on every chance we get given its significance. In short, the two key drivers of any economy's speed limit are the rate of labor force growth and the rate of productivity growth. Most recently, we discussed this in the context of productivity growth in the May edition of our *Outlook* and in the context of demographics in the June edition. For now, we'll simply note that if the recent weakness in business investment persists to the point where the improvement in the rate of labor productivity growth fades, that would effectively keep the U.S. economy stuck in the slow lane for some time to come. As can be seen in the following chart, the combination of anemic labor productivity growth and slower labor force growth in the post-recession years has basically relegated the economy to the slow lane and, given that the demographic trends are going in the wrong direction, the only plausible way out is a meaningful and sustained increase in the rate of labor productivity growth.



Clearly, there is a lot riding on whether, or when, business investment breaks out of its current malaise. Unfortunately, the leading indicators of business investment suggest things are likely to get worse before they get better. And, for anyone thinking the solution is further Fed funds rate cuts, we'll simply note that neither the price nor the availability of credit is an impediment to business investment spending, nor have they been for quite some time. As we've noted before, the next commercial client who tells us that another funds rate cut will give them the confidence they need to embark on large-scale capital investment will be the first commercial client to tell us that. Our view is that a benign resolution of trade disputes is a necessary, but likely not sufficient, condition for business confidence to bounce back to the point that capital spending picks back up. We'll leave it for each reader to assess how likely they see such an outcome as being.

Housing Won't Be The Hero, But It Won't Be The Villain Either

As business investment fades amidst rising fears of recession, some are turning a hopeful eye to . . . the housing market. If nothing else, you at least have to appreciate the irony of that, right? In all honesty, we can understand if you feel more than a bit unsettled by people pinning their hopes on the housing market to take up the slack for declining business investment. After all, fixed residential investment has declined in six consecutive quarters and in eight of the past nine quarters, thus acting as a persistent drag on real GDP growth. As such, it may seem that, as far as inspiration goes, talk of the housing market stepping up to keep the economy from slipping into recession is more along the lines of Bluto rallying the crew at Delta House than of Knute Rockne exhorting the team to go out and win one for the Gipper.

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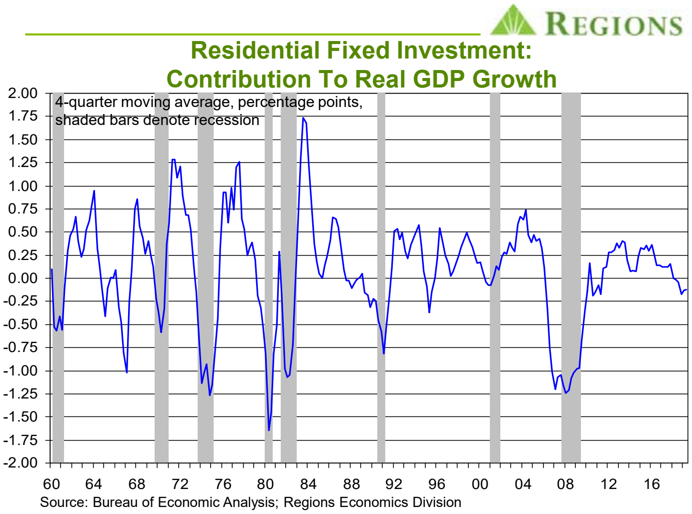
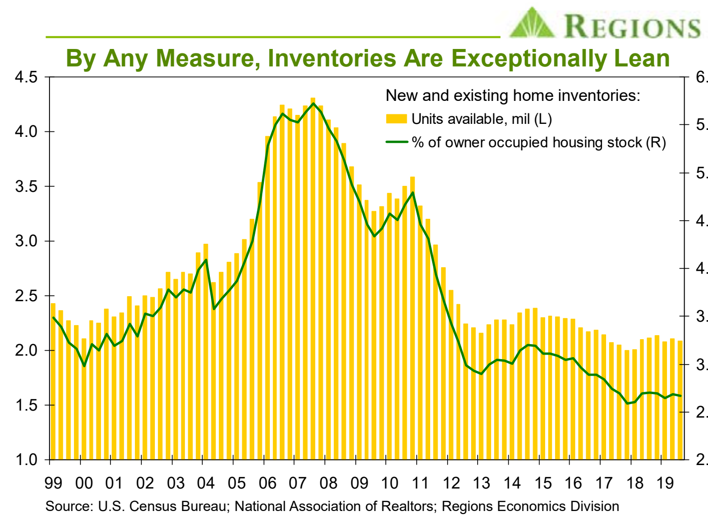
Or not. The housing market has clearly perked up in recent months, aided by lower mortgage interest rates and a slowing pace of house price appreciation. Sales of new and existing homes jumped in August (the latest available data point), as did permits for and construction starts of single family homes. All of which is in stark contrast to the rout in housing market activity over the final months of 2018 that carried into the early months of 2019. Mortgage rates hit a multi-year high in mid-November, which amplified the cumulative impact of a prolonged period of robust house price appreciation, thus triggering an affordability shock that sent sales and construction of single family homes reeling.



The turnabout in housing market activity over recent months is a welcome development, and our forecast anticipates that, starting in the Q3 data, residential fixed investment will flip from being a drag on real GDP growth to making a positive contribution to real GDP growth. That contribution, however, will be modest, and while it may fill in the gap from the decline we expect in business fixed investment, it is unlikely to do much more. Still, while housing may not ride to the economy's rescue, it is also the case that if the economy is intent on slipping into recession, it will get no help from the housing market this time around.

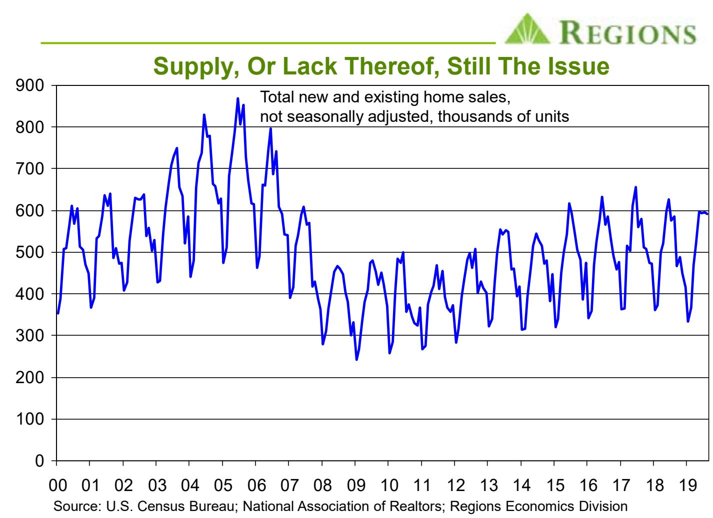
Our longer-term readers may find it odd that we seem to be downplaying what has been a decidedly better tone of housing market data. After all, for much of the past couple of years we've come to the defense of the housing market time and time again as the latest "housing is done" story lines popped up. Which has been quite often. The reality, however, is that our view of the housing market has barely budged over the past several years. Our view has been that the issues in the housing market have been on the supply side, not the demand side, of the market.

The only time our faith in the demand side of the market has been put to the test was when the affordability shock hit, but that demand has snapped back smartly as mortgage interest rates have fallen does not surprise us. Through September, applications for purchase mortgage loans are up 11.1 percent over their Q4 2018 average and ended September up 10 percent year-on-year. Lower mortgage interest rates and a slower pace of house price appreciation have greatly improved affordability with solid income growth, healthy household balance sheets, and still-elevated consumer confidence underpinning growth in demand. In other words, prospective buyers have both the willingness and the wherewithal to purchase homes.



What they don't have, however, is an ample supply to choose from, at least in many if not most markets. The chart above shows the number of new and existing homes available for sale, which in early-2018 fell to the lowest point in the life of the data. While inventories have risen a bit since then, they are still notably lean. This can also be seen by scaling the number of homes available for sale to the size of the owner occupied housing stock, which we show with the green line in the chart above.

In the wake of continued strength of applications for purchase mortgage loans and the jump in new and existing home sales in August, we've heard some analysts proclaim that housing has "turned a corner." Our reply to that is that you can turn a corner, but if all you're doing is walking around the block, you eventually end up in the exact same spot. That same spot, for the housing market, is limited inventories capping the upside for home sales.

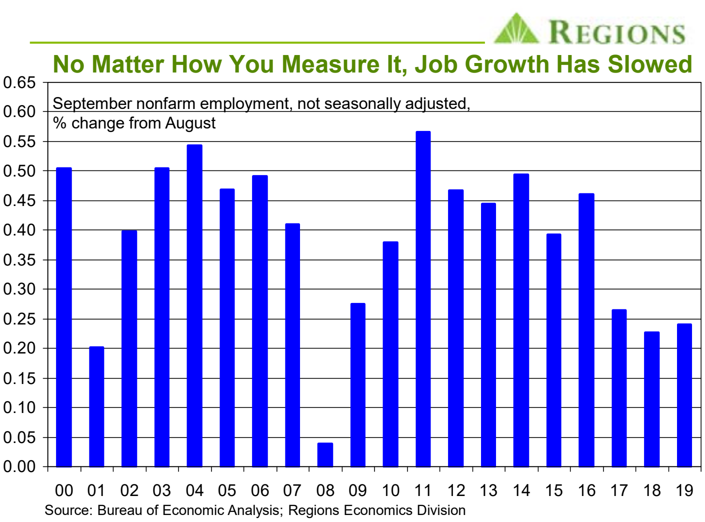


One way to see this is to look at the raw, or, not seasonally adjusted data on home sales, which we show in the above chart. Our regular readers know that we base our analysis of the housing market on the unadjusted data, as opposed to the seasonally adjusted and annualized basis on which the data are reported. As the above chart shows, despite lower mortgage interest rates and improved affordability, this year's seasonal top in combined new and existing home sales will be the lowest of any year since 2014. Sure, the year is not quite over, but we are in the time of the year during which typical seasonal patterns see home sales tapering off, not picking up. So, while sales could surprise us to the upside, it is nonetheless highly unlikely that the 2019 peak will be higher than those of the past four years.

Again, our view is that this is strictly a supply side, not a demand side, issue, which is why our base case for housing has not changed, i.e., steady, but very slow, increases in single family construction and sales. In terms of the impact on GDP, new home construction has the largest impact on GDP, existing home sales impact the GDP data only through brokers' commissions on sales, which in the grand scheme of GDP, is a very small share. Purchases of home furnishings and appliances associated with home purchases also make a contribution to GDP growth but, again, to the extent we are correct in our view that lean inventories are a binding constraint on home sales, the size of this contribution will also be capped. To be clear, we are not dismissing the notion that housing will contribute to GDP growth over coming quarters, we're merely pointing out that expectations need to be tempered. Then again, with our outlook for middling GDP growth over coming quarters, any contribution to growth will be a meaningful one.

September Employment Report

Coming on the heels of two surprisingly weak reports from the ISM, the September employment report didn't need to be great, it just needed to not be terrible. Happily, it cleared that low bar. Total nonfarm employment rose by 136,000 jobs in September, with prior estimates of job growth in July and August revised higher by a net 45,000 jobs for the two-month period. The pace of job growth has slowed over recent months, in conjunction with a narrowing in the breadth of hiring across private sector industry groups. That said, the pace of job growth remains more than sufficient to absorb new entrants into the labor force.



It will come as no surprise that we use the not seasonally adjusted data to illustrate the extent to which job growth has slowed. The above chart shows the percentage change in total nonfarm employment between August and September for each year back to 2000. September job growth in both 2017 and 2018 was held down by hurricanes, and 2001 and 2008 were recession years. So, compared to a "normal" September, hiring this September was notably weak. Indeed, aside from the four years impacted by hurricanes or recessions, this year saw the smallest September increase in nonfarm employment (the percentage increase from August) of any September in the past 30 years.

Payrolls in manufacturing fell by 2,000 jobs in September, dragged down by the loss of 4,100 jobs amongst motor vehicle producers. Keep in mind that the effects of the GM strike did not appear in the September data, as the strike began after the establishment survey week ended; if the strike is still on it will be seen in the October data, and will spread to the GM suppliers who have cut jobs due to the lull in demand for parts and accessories. The list of headwinds facing the manufacturing sector is lengthy – trade disputes, slower global economic growth, elevated inventories, Boeing's issues, and a strong U.S. dollar. As such, it is no surprise that employment and output in the factory sector are declining.

What is often overlooked, however, is the spillover into other sectors of the economy. For instance, truck transportation payrolls have declined by 9,600 jobs over the past three months, and payrolls in rail transportation and water transportation have also turned lower. Less manufacturing output and diminished trade flows mean fewer goods being transported, and to the extent that there is more pain to come in the factory sector, these segments of the transportation sector will also suffer. It is worth noting that those segments of the broad transportation sector more closely aligned with consumer spending – such as delivery services and warehousing operations, continue to add jobs, but these job gains are simply countering ongoing job losses in retail trade.

Still, elsewhere in the employment data, while there are signs of a slower pace of job growth, it is hard to find signs that the economy is on the verge of slipping into recession. To some extent, the slower pace of job growth is not, or at least should not be, surprising given what coming into this year were almost universal expectations of a slower pace of real GDP growth. If anything, it is 2018 that is the outlier, as the spurt in real GDP growth largely due to fiscal stimulus and a more favorable regulatory climate acted as an accelerant to job growth. As the boost from fiscal stimulus faded this year, it follows that real GDP growth as well as job growth would slow. The surprising part is the extent to which growth has slowed, largely due to uncertainty over trade policy. The question all of us are trying to answer is whether, or to what extent, the weakness seen thus far in manufacturing and parts of the transportation sector will spill over into the broader economy.

For now, the unemployment rate sits at 3.5 percent, a 50-year low, and jobless rates across many segments of the labor force are at or near all-time lows. Though average hourly earnings were flat in September, this is largely due to the survey week ending prior to the 15th of the month, which biases measured wage growth lower in such months. More significantly, wage growth amongst production and non-supervisory workers has run at a 3.5 percent pace (year-on-year) over the past three months, which is an 11-year high. A still-solid labor market is fueling income growth and supporting consumer confidence, the two keys to sustaining consumer spending. This, along with steady growth in federal government spending and, yes, some support from housing, should help the economy endure weakness in the industrial sector.

ECONOMIC OUTLOOK

REGIONS

October 2019

Q1 '19 (a)	Q2 '19 (a)	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	1.9	1.8	2.0	1.7	1.5	1.6	Real GDP[1]	1.6	2.4	2.9	2.3	1.8
1.1	4.6	3.3	2.6	2.0	2.0	1.9	1.8	Real Personal Consumption[1]	2.7	2.6	3.0	2.7	2.4
4.4	-1.0	-1.1	0.9	1.4	1.3	1.5	1.6	Real Business Fixed Investment[1]	0.7	4.4	6.4	2.4	0.9
-0.1	0.8	-0.1	0.9	0.2	0.8	1.3	1.4	Equipment[1]	-1.3	4.7	6.8	2.1	0.7
10.8	3.6	2.4	3.1	3.5	3.4	3.3	3.2	Intellectual Property and Software[1]	7.9	3.7	7.4	7.2	3.2
4.0	-11.1	-9.6	-3.3	0.6	-1.7	-1.3	-1.0	Structures[1]	-5.0	4.7	4.1	-4.0	-3.0
-1.0	-3.0	0.5	2.7	2.5	0.7	0.8	0.8	Real Residential Fixed Investment[1]	6.5	3.5	-1.5	-2.2	1.3
2.9	4.8	1.0	1.3	1.8	1.2	1.5	0.5	Real Government Expenditures[1]	1.8	0.7	1.7	2.2	1.5
-944.0	-980.7	-993.8	-1,005.5	-1,000.8	-1,010.5	-1,024.6	-1,021.5	Real Net Exports[2]	-783.7	-849.7	-920.0	-981.0	-1,014.4
864	847	893	898	903	908	909	907	Single Family Housing Starts, ths. of units[3]	786	852	873	875	907
349	409	381	369	362	358	354	346	Multi-Family Housing Starts, ths. of units[3]	392	357	377	377	355
16.8	17.0	17.0	16.8	16.7	16.5	16.4	16.3	Vehicle Sales, millions of units[3]	17.5	17.1	17.2	16.9	16.5
3.9	3.6	3.6	3.5	3.4	3.3	3.4	3.5	Unemployment Rate, %[4]	4.9	4.4	3.9	3.7	3.4
1.8	1.6	1.4	1.3	1.1	1.2	1.0	0.8	Non-Farm Employment[5]	1.8	1.6	1.7	1.5	1.0
4.5	2.4	2.4	2.1	2.0	2.0	1.5	1.5	Real Disposable Personal Income[1]	1.8	2.9	4.0	3.1	2.0
1.9	1.7	1.9	2.1	2.5	2.4	2.3	2.1	GDP Price Deflator[5]	1.0	1.9	2.4	1.9	2.3
1.4	1.4	1.5	1.6	2.1	2.0	2.1	2.1	PCE Deflator[5]	1.0	1.8	2.1	1.5	2.1
1.6	1.8	1.8	1.8	2.1	1.8	1.8	1.9	Consumer Price Index[5]	1.3	2.1	2.4	1.8	1.9
1.6	1.6	1.7	1.8	2.2	2.2	2.2	2.1	Core PCE Deflator[5]	1.6	1.6	1.9	1.7	2.2
2.1	2.1	2.3	2.4	2.5	2.6	2.4	2.3	Core Consumer Price Index[5]	2.2	1.8	2.1	2.2	2.4
2.38	2.38	2.18	1.82	1.63	1.63	1.63	1.63	Fed Funds Target Rate Range Mid-Point, %[4]	0.39	0.97	1.78	2.19	1.63
2.65	2.33	1.80	1.59	1.61	1.60	1.60	1.60	10-Year Treasury Note Yield, %[4]	1.84	2.33	2.91	2.09	1.60
4.37	4.01	3.66	3.57	3.58	3.56	3.54	3.53	30-Year Fixed Mortgage, %[4]	3.65	3.99	4.54	3.90	3.56
-2.6	-2.4	-2.5	-2.6	-2.7	-2.8	-2.9	-2.9	Current Account, % of GDP	-2.3	-2.3	-2.4	-2.5	-2.8

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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