ECONOMIC UPDATE

REGIONS

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Q3 Real GDP: Growth Slightly Better in Q3, But Still Settling Towards Trend

- The BEA's second estimate puts annualized Q3 real GDP growth at 2.1 percent, compared to the initial estimate of 1.9 percent
- Q3 pre-tax corporate profits were up 0.2 percent from Q2 but down 0.8 percent year-on-year

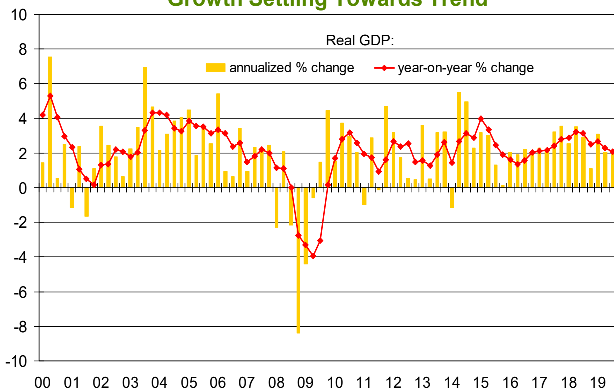
Revised and more complete source data show real GDP grew at an annualized rate of 2.1 percent in Q3, just shy of our above-consensus forecast of 2.2 percent but up from the BEA's initial estimate of 1.9 percent growth. A larger build in nonfarm inventories and a smaller contraction in business fixed investment were the main factors behind the upward revision to top-line growth, while growth in real consumer spending was unchanged relative to the initial estimate. Real gross domestic income, a comprehensive measure of income earned in the production of GDP, grew at an annualized rate of 2.4 percent in Q3. The revised GDP data do not change the narrative of the U.S. economy – really, a two-tenths of a point change in annualized growth in the context of a $19.1 trillion economy would have to be rounded up to even count as a rounding error. That in turn means that the main questions facing the economy today – how long can consumer spending be the main driver of GDP growth, how long will the slump in business investment go on and how much worse will it get, and will the ongoing inventory overhang continue to weigh on growth – have also not changed.

Real consumer spending grew at an annualized rate of 2.9 percent in Q3, matching the BEA's initial estimate, which added 1.97 percentage points to top-line real GDP growth. Real spending on goods advanced at an annualized rate of 5.7 percent, with the revised data showing slightly stronger growth in spending on durable goods and slightly slower growth in spending on nondurable goods. Real spending on services grew at an annualized rate of 1.7 percent. Discretionary spending grew at a solid pace in Q3, which is a sign that consumers continue to shake off the trade concerns that have rattled global businesses. One detail that stands out is that real spending on household furnishings and appliances has turned in solid growth in back-to-back quarters, further evidence that housing market activity has turned higher with help from low mortgage rates.

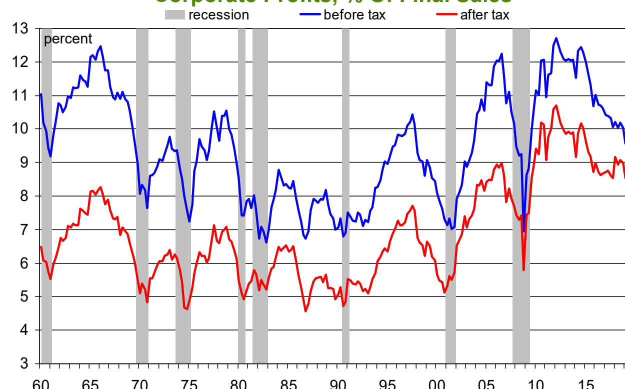
Real business fixed investment contracted at an annualized rate of 2.7 percent in Q3, rather than the 3.0 percent contraction initially reported. That is of little consolation, however, given that a less harsh contraction in business spending on structures than initially reported accounts for the smaller decline in overall business investment. Outlays on intellectual property products grew at an annualized rate of 5.1 percent, down from the 6.6 percent growth initially reported. Real spending on equipment and machinery declined at an annualized rate of 3.8 percent, matching the initial estimate. One concern we have had, indeed, our biggest concern, is that the high frequency data on orders and shipments of core capital goods, which lead the GDP data on business investment, have been notably weak of late, setting up what would be a second straight decline in business outlays on equipment and machinery in the GDP data, something rarely seen outside of recessionary periods. In that sense, today's report showing that core capital goods orders and shipments rose strongly in October helps allay, but does not eliminate, our concerns, as these data can be quite volatile. It should be pointed out that the initial estimate of 5.1 percent (annualized) growth in real residential fixed investment was left intact in the revised data, meaning that residential fixed investment contributed to real GDP growth for the first time since Q4 2017. Our baseline forecast anticipates further, albeit modest, contributions in the quarters ahead.

Before-tax corporate profits rose 0.2 percent on a sequential basis in Q3, but were down 0.8 percent year-on-year. After-tax profits were up 1.3 percent sequentially and up 0.4 percent year-on-year – keep in mind that the over-the-year comparisons for after-tax profits are harder this year, as 2018 benefitted from lower corporate income tax rates. Of greater significance is that profit margins remain under pressure. Not only has top-line revenue growth slowed (nominal GDP growth is a good proxy), but faster growth in labor costs is pressuring margins on the back end. Though after-tax margins remain elevated by historical standards, there is reason to wonder how much longer that will remain the case, and if we are correct on this point it opens up all sorts of questions on factors ranging from hiring to cap-ex to debt service coverage. If we had to pick the one thing that worries us the most about the outlook into and beyond 2020, this is it. For now, though, the economy looks set to continue on along a path of growth around 2.0 percent, with consumer spending the main driver and business investment the biggest question mark.

Growth Settling Towards Trend



Corporate Profits, % Of Final Sales



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