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## *It's What You Don't Know That You Don't Know That Gets You . . .*

Well, that didn't take long, did it? In our January *Outlook*, in which we presented our baseline 2020 economic forecast, we noted that we felt a sense of unease over our outlook. It wasn't just that our baseline 2020 forecast – real GDP growth of around 2.0 percent with mild inflation and the FOMC on hold for the duration – was right in line with consensus expectations, which in and of itself always makes us nervous. It was more along the lines that the paths of economic growth, inflation, (global) central bank policy, and interest rates that we and many others envisioned for 2020 seemed too benign. In stark contrast to how 2019 started, with many analysts (though not us) and market participants on recession watch, 2020 started off with what we felt was an odd sense of calm, if not outright complacency. This got us to fretting about what it was that we were missing, to the point that the title of our January *Outlook* was "What's Wrong With This Picture?"

As we do each time we present a forecast, in our January *Outlook* we discussed what we saw as the main risks, both upside and downside, to our baseline forecast, and concluded that the balance of risks to our forecast was tilted slightly to the downside. At the same time, however, we noted that any assessment of forecast risks reflects only the known unknowns, which isn't what keeps us up at night. What keeps us up at night is worrying about what we don't know that we don't know, which is something you typically only find out the hard way. So, while we felt that our 2020 outlook seemed too calm and quiet to actually play out, we couldn't necessarily put our finger on what might go wrong.

As if on cue, the coronavirus has materialized, rather quickly, and now looms as a meaningful threat to global economic growth, and the U.S. economy is by no means immune. The virus comes at a time when the U.S. economy is just starting to feel the effects of Boeing halting production of its 737 Max in January. The coronavirus and Boeing's production halt illustrate our point about the difference between the known unknowns and what you don't know that you don't know. We did, after all, point to Boeing's production halt in our January *Outlook* as a downside risk to growth, even if we did not know how long the shutdown would persist and could not precisely quantify the impact on real GDP growth in 2020 (i.e., the known unknown). In contrast, the coronavirus seemingly came out of the blue to pose a material threat to global growth (i.e., the unknown unknown).

Boeing halting production of the 737 Max will cast a long shadow over the manufacturing sector that seems likely to persist beyond this year's first quarter. Though saying so may seem at odds with the January print on the ISM Manufacturing Index, which saw the headline index push above the 50.0 percent break between contraction and expansion for the first time since July, that is not

necessarily the case. Recall that the ISM's index is a diffusion index based on the number of industry groups (of the 18 included in the ISM survey) reporting growth/contraction. As such, weakness in one industry group, in this case transportation equipment, need not drag the headline index lower. In contrast, other series that pertain to manufacturing are either weighted measures (industrial production) or aggregated dollar volumes (core capital goods orders) in which the significant drop in aircraft production and the impact on downstream suppliers will likely be more visible.

Our take on the January ISM Manufacturing Index was that the push back above the 50.0 percent mark reflected the recent stabilization, if not modest improvement, in the broader manufacturing sector, hints of which are apparent in the data on global manufacturing activity. Any such improvement, however, is threatened by the coronavirus, the effects of which are not reflected to any meaningful degree in the data for the month of January. The coronavirus is disrupting global supply chains and trade flows, suppressing travel and tourism activity, contributing to fluctuations in commodity prices and asset prices, and leading to increased uncertainty for businesses, all of which could result in damaging hits to business and consumer confidence.

The economic effects of the coronavirus will likely begin to make themselves known in the data for the month of February, and Q1 growth, domestic and global, will almost surely be adversely impacted, though the extent to which this will be the case cannot at this point be quantified. Nor can the effects of Boeing shutting down 737 Max production, though at least in this case we can make some plausible estimates, which we and many others peg as around a one-half of one percentage point hit to Q1 real GDP growth. What is striking, at least to us, is how sanguine many analysts and market participants are about prospects for U.S. and global growth in light of Boeing's issues and the coronavirus.

Indeed, most economic forecasts that we've seen are discounting any lasting effects of Boeing's issues and the coronavirus. While over time that may be correct, the question, at least to us, is how long is "over time"? For instance, while Boeing's production halt will be a drag on manufacturing activity and GDP growth for as long as it persists, when production resumes there will be an offsetting bounce in manufacturing activity and GDP growth. While to us the timing and extent of any such bounce remains unknown at this point, many analysts simply assume a full offset over 2H 2020, leaving little, if any, impact on their forecast of full-year 2020 real GDP growth. Similarly, many are assuming that once the coronavirus is contained and activity returns to normal, any losses in economic activity in the interim will be fully made up. In terms of market participants, after fears of the economic impacts of the coronavirus drove the Dow Jones Industrial Average down by over 600 points (a 2.1 percent decline) on February 3, that loss was more than made up for over the subsequent three days, suggesting confidence that the coronavirus will not derail the global economy.

To be sure, making any forecast involves making assumptions, and while there's no way around that, one does have control over the assumptions they make. We have always been on the conservative side in this sense, and while at times this has greatly annoyed some seeking quick and definitive answers to complex questions which can only be answered slowly over time, we will always be on the conservative side in this sense. As such, while we have factored in the drag from production of the 737 Max being halted, we have not factored in any offsetting lift to growth when production resumes – we simply have no basis on which to do so at present. Along those same lines, at present we do not have a plausible basis on which to quantify the economic impacts of the coronavirus, either the likely drag to near-term growth or any subsequent payback to growth when the virus abates.

So, while we all have to live with the assumptions we make (which, come to think of it, holds true not only for forecasting but also for life in general), it strikes us that many are being too complacent by simply discounting the potential severity and duration of these “transitory” disruptions to economic growth. And, aside from what the implications are for any forecast of 2020 real GDP growth, this gets us back to the broader point we had in mind when we started this discussion. Which is that an economy with a slow trend rate of growth has considerably less capacity to absorb shocks than is true of an economy with a faster trend rate of growth.

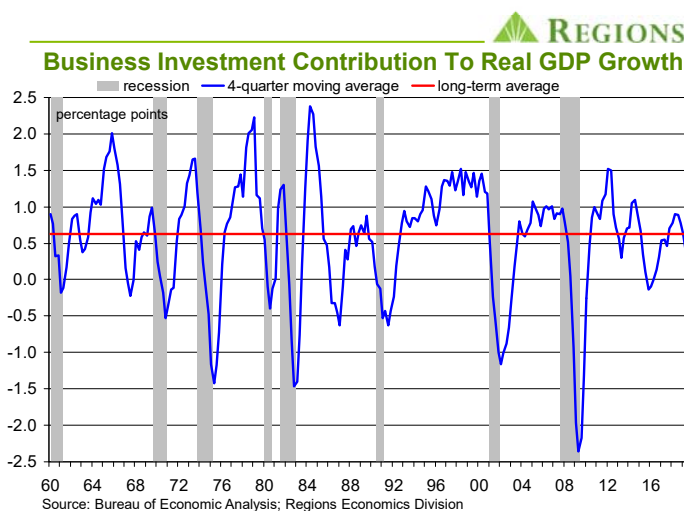
With real GDP growth trending around 2.0 percent, little capacity for additional fiscal or monetary stimulus, and some sectors already heavily in debt, it is reasonable to ask how much shock absorbing capacity remains in the U.S. economy. It strikes us that many seem to assume the end of the current expansion will be precipitated by a severe adverse shock. But, while waiting for “the big one” to hit, one could easily overlook the cumulative effects of a series of smaller shocks, none of which in isolation would be sufficient to drive the economy into recession though, collectively, they could.

Consider it, as *Wall Street Journal* columnist Holman Jenkins put it, a recession of incidents. In other words, start with Boeing's production disruption, add in the coronavirus, and you have a potentially significant hit to overall growth. By no means are we saying these two factors will combine to cause a recession. Our point is simply that, given the U.S. economy's slow run rate, absorbing these shocks leaves less capacity for dealing with whatever incident may come along next, even if we cannot at this moment define what that incident may be or when it may come along, neither of which justifies dismissing out of hand the possibility of a recession of incidents. After all, maintaining an inventory of risks captures only the risks you are aware of at any point in time, which is not the same as capturing every risk. This is, at least to us, a distinction that very much matters.

### *More Stress On Capital Spending?*

Regardless of what the final tally turns out to be, it seems very likely that one segment of the economy that will suffer the most from the collective effects of Boeing's production disruption and the coronavirus will be business capital spending. Already wobbling by year-end 2019 thanks to listless global economic growth and the fallout from trade disputes, capital spending is likely to remain weak over the early phases of 2020. To the point

that while our baseline forecast anticipated growth in real business fixed investment of only about 1.0 percent for 2020, that forecast may prove to have been too ambitious. Though this is a topic to which we frequently return, we nonetheless think it worth offering a few thoughts on capital spending here, including what, to us, is one encouraging, yet mostly overlooked, detail in the data.

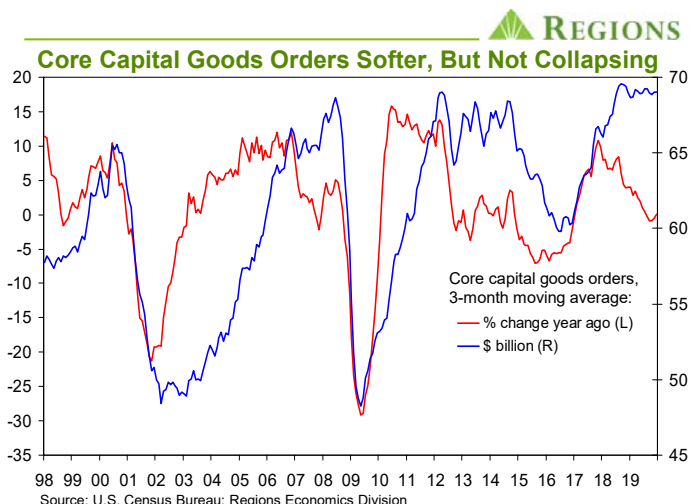


To be sure, the word “encouraging” and the above chart do not belong anywhere near each other. As seen in the chart, capital spending has offered increasingly less support to top-line real GDP growth over the past several quarters, and has actually been a drag on top-line growth in each of the past three quarters. Three straight quarterly contractions in real business fixed investment is something rarely seen outside of recessionary periods, yet that is what we saw over the final three quarters of 2019. Business spending on structures has been particularly weak, declining at a double-digit annualized rate over the final three quarters of 2019. In part, this reflects weakness in spending in the energy sector, which also contributed to the declines in real business investment in equipment and machinery over the second half of 2019.

That business investment in aircraft has declined significantly is of no surprise in light of the issues with the 737 Max, and though a relatively small share of overall business investment in machinery and equipment, the magnitude of these declines has been such that the aggregate business investment number has been impacted. As a side note, while the plunge in shipments over 2H 2019 was a drag on business investment, the offset in the GDP data was higher inventories, as Boeing continued to produce the 737 Max through year-end. With the halt in production, there will be a sharp drop in inventories in Q1, which accounts for much of the drag we expect on Q1 real GDP growth stemming from Boeing.

Still, it is not all about energy and aircraft, as business investment has softened across a range of the components of the broader structures and equipment categories. That said, one thing in the data on investment in equipment and machinery that is striking is the declines to date have been fairly modest in magnitude. This may come as a surprise given what for some time has been a considerable volume of talk of depressed business sentiment and uncertainty over trade weighing on business investment. For instance, the monthly data on core capital goods orders, an early indicator of business investment as measured in the GDP data,

show spending on core capital goods took on a softer tone during 2019 but by no means collapsed, as shown in the chart below.



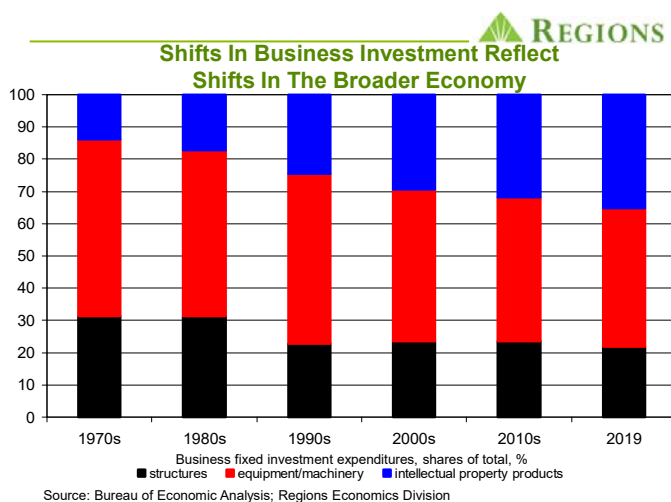
Keep in mind that the core capital goods category captures orders for business durable goods excluding defense capital goods and nondefense aircraft, meaning core capital goods orders are less vulnerable to Boeing’s production issues. The data do tend to be very volatile on a month-to-month basis, which is why we show a three-month moving average in the above chart. As the chart shows, however, core capital goods orders have been surprisingly stable, particularly in light of the weak global economic growth and lingering uncertainty over trade policy that prevailed for most of 2019. This suggests that, rather than being in full-fledged retreat, businesses are in more of a holding pattern when it comes to spending on equipment and machinery. That the declines in this category in the GDP data have been modest supports this view, and points to weak spending on structures as the primary culprit behind the weakness in overall business investment.

Obviously, this could change. Businesses have had a lot thrown their way over recent quarters – from trade to tepid global growth to the impacts of Boeing and now the coronavirus. One could argue the easing of trade tensions has removed what had been a persistent weight on business confidence, but we’d argue the “phase one” trade deal between the U.S. and China alleviates, but does not eliminate, the ill effects of trade tensions. And, to our point in the previous section, while none of the factors cited above may in and of itself be sufficient to trigger a more pronounced decline in business investment, the cumulative effects may, particularly if there are added stressors in the months ahead.

As for that encouraging detail in the data we mentioned above, no, we haven’t forgotten about that. Thus far, we’ve touched on two of the three main components of business fixed investment as reported in the GDP data – structures and equipment/machinery. The third component is investment in intellectual property products which, despite having taken on increasing importance over the past several years, tends to get relatively little attention in discussions of business investment spending. That may be in part due to the fact that, while we get monthly observations on the other two components of business investment, the only consistent data we get on intellectual property investment comes in the quarterly reports on GDP. Additionally, there is not always a

lot of clarity around the meaning of the term “intellectual property products,” and some components, such as the value of original entertainment/artistic/literary works, may or may not actually have anything to do with business investment spending. But, the data show spending on computer software and research and development accounts for over 90 percent of spending on intellectual property products as measured in the GDP data.

As the two other components of business investment have fallen on hard times over the past few quarters, real business spending on intellectual property products has been on an enviable roll, expanding for 19 consecutive quarters with average annualized growth of 6.3 percent. One reason we put a great deal of emphasis on this form of business investment is that we see such spending as leading changes in the rate of labor productivity growth. We’d argue that it is no mere coincidence that, in the midst of the run of steady growth in investment in intellectual property products, the trend rate of growth in labor productivity has perked up considerably over the past several quarters.



As the above chart illustrates, investment in intellectual property products has taken on increasing significance over recent decades. The preliminary GDP data show spending on intellectual property products accounted for 35.2 percent of total business investment in 2019, more than double its share during the 1970s and 1980s. This of course mirrors the shifts in the broader economy over the same time period. We sometimes refer to business spending on structures and equipment/machinery as “old school” business investment and spending on intellectual property products as “new age” business investment. While that may be an oversimplification, it goes to our point about shifting patterns in business investment reflecting the structural shifts in the U.S. economy over time.

We think it significant that growth in spending on intellectual property products did not waver over the course of 2019 as other forms of business investment faltered, and our forecast anticipates continued strong growth in 2020. One reason we expect this will be the case is that, with increasingly tight labor market conditions and faster wage growth, firms will place an increasing premium on productivity growth. Much to our point about core capital goods orders softening but not being anywhere near collapsing, that we are still seeing solid growth in spending on intellectual property products as a sign that businesses are not bracing for the end of

the expansion, despite the hurdles that have been thrown in the economy’s path over recent quarters. To be sure, this could change, but at present there are no indications of that happening.

We had low expectations for business investment coming in to 2020, but our expectations for the individual components varied sharply. Sure, the year is still early and there is considerable uncertainty around domestic and global growth, but nothing we’ve seen so far has led us to materially alter what was already a fairly uninspiring forecast. We continue to see business investment as the main wild card in our 2020 forecast.

### Labor Market Keeps Rolling On

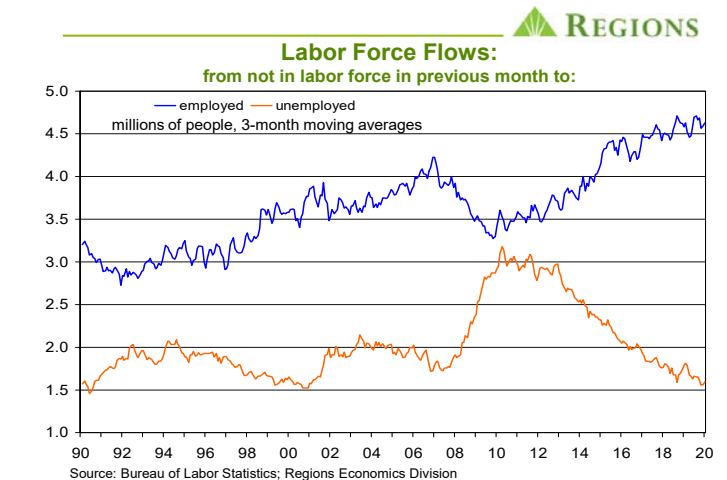
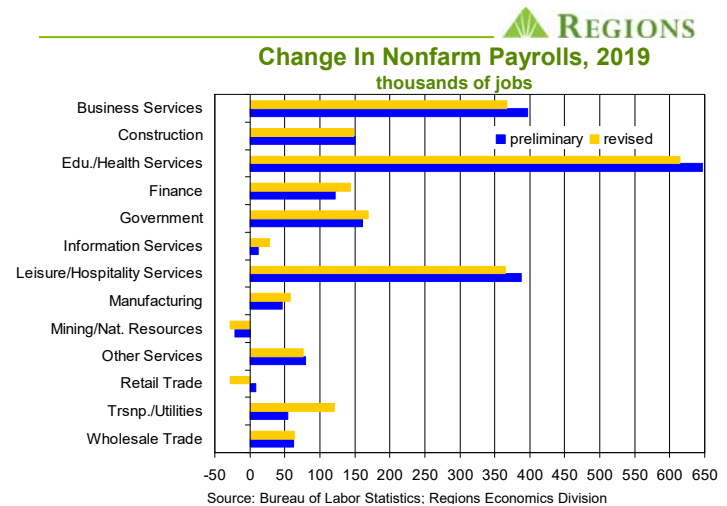
Total nonfarm employment rose by 225,000 jobs in January, handily beating expectations. To be sure, that number comes with a big assist from Mother Nature, as atypically warm weather led to fewer seasonal layoffs in weather-sensitive industries, most notably construction and leisure and hospitality services. The seasonal adjustment process basically overcompensated for these smaller than normal declines, yielding implausibly large gains in the seasonally adjusted data. We estimate that weather effects boosted seasonally adjusted January job growth by roughly 70,000 jobs, for which there will be payback in the February data. This is the same pattern we saw last year – after an outsized increase in private sector payrolls in January 2019, led by these two sectors, private sector payrolls actually declined in February, again led by these two sectors. That total nonfarm employment rose by 1,000 jobs in February 2019 reflected an increase in public sector payrolls, thus salvaging, even if just barely, the economy’s streak of monthly job gains, a streak that now stands at 112 months.

These weather-related distortions may raise the question of whether atypically warm winter weather is becoming typical, but that’s another discussion for another day. In terms of what they say about the labor market and the broader economy, they’re nothing more than meaningless noise. What does matter is that the underlying trend rate of job growth remains more than sufficient to keep the unemployment rate flat to slightly lower. Just as significantly, job growth remains notably broad based across private sector industry groups, a sign that the current expansion has longer to run, even if it does so at a slightly slower pace.

The January employment data incorporate the annual benchmark revisions to the data from the BLS’s establishment survey, from which estimates of nonfarm employment, hours worked, and hourly earnings are drawn. This year’s benchmark revisions show job growth was slower over the past few years than had been previously estimated. For instance, while preliminary estimates pegged 2019 job growth at 2.108 million jobs, the revised data show an increase of 2.096 million jobs, though the downward revision to 2018 job growth was larger. Even so, 2019 marks the ninth consecutive year in which job growth topped the 2.0 million mark. While we think that streak will end in 2020, the slower pace of job growth our forecast anticipates is consistent with the slower pace of overall economic growth we expect and, as noted above, will still be sufficient to push the jobless rate slightly lower.

The revised data on job growth by industry resolve what we thought were anomalies in the data over the course of 2019. For instance, while the preliminary data showed a modest increase in retail trade payrolls in 2019, the revised data show retail trade payrolls fell by 28,700 jobs. At the same time, however, job growth

in transportation/utilities, which includes warehousing and delivery operations, was revised materially higher – the revised data show an increase of 120,800 jobs compared to the initial estimate of 54,700 jobs. Also, restaurant hiring struck us as oddly strong during 2019 – the downward revisions in this component affirm our suspicion and more than account for the downward revision in job growth in leisure and hospitality services.



In addition to the duration, pace, and breadth of job growth, we continue to be struck by the pace at which people are flowing into the labor market, either new entrants or reentrants. This is a pattern we have been highlighting for years, as we think it deserves more attention than it has received, particularly in response to the persistent but unfounded claim that firms are “running out of workers” to hire. Be that as it may, more than 4.8 million people who were not in the labor force in December became employed in January, the most on record. While this pace, or even this trend, cannot go on indefinitely, we do think it has further to go, particularly given that the participation rate amongst the 25-to-54 year-old age cohort remains below historical norms, which to us is a sign that there is more slack in the labor market than implied by the jobless rate. As we’ve noted, these inflows are weighing on the pace of wage growth, though that drag will ease over time. For now, however, these steady inflows into the labor force are a prime, even if unappreciated, support for job growth.

# ECONOMIC OUTLOOK



February 2020

Q3 '19 (a)	Q4 '19 (p)	Q1 '20 (f)	Q2 '20 (f)	Q3 '20 (f)	Q4 '20 (f)	Q1 '21 (f)	Q2 '21 (f)		2017 (a)	2018 (a)	2019 (p)	2020 (f)	2021 (f)
2.1	2.1	1.4	2.2	1.8	2.0	1.8	1.6	Real GDP <sup>1</sup>	2.4	2.9	2.3	1.9	1.8
3.1	1.8	2.5	2.4	2.3	2.1	2.0	1.8	Real Personal Consumption <sup>1</sup>	2.6	3.0	2.6	2.5	2.0
-2.3	-1.5	1.3	2.1	2.2	2.2	2.5	2.4	Real Business Fixed Investment <sup>1</sup>	4.4	6.4	2.1	0.5	2.3
-3.8	-2.9	1.4	1.4	0.5	0.9	1.8	2.0	Equipment <sup>1</sup>	4.7	6.8	1.4	-0.3	1.6
4.7	5.9	5.1	4.8	4.7	4.4	4.0	3.7	Intellectual Property and Software <sup>1</sup>	3.7	7.4	7.7	5.0	4.1
-9.9	-10.1	-6.4	-1.8	1.4	0.9	0.9	0.7	Structures <sup>1</sup>	4.7	4.1	-4.4	-5.7	0.6
4.6	5.8	7.8	5.5	-0.2	-0.7	-0.4	-0.8	Real Residential Fixed Investment <sup>1</sup>	3.5	-1.5	-1.5	4.3	-0.2
1.7	2.7	2.0	1.9	1.9	0.7	1.4	1.2	Real Government Expenditures <sup>1</sup>	0.7	1.7	2.3	2.2	1.2
-990.1	-902.0	-967.8	-992.7	-1,005.4	-1,009.8	-1,020.5	-1,028.1	Real Net Exports <sup>2</sup>	-849.7	-920.0	-954.2	-993.9	-1,032.0
894	973	952	955	955	959	961	961	Single Family Housing Starts, ths. of units <sup>3</sup>	852	873	894	955	960
388	468	420	401	390	379	372	367	Multi-Family Housing Starts, ths. of units <sup>3</sup>	357	377	404	398	367
17.0	16.7	16.8	16.7	16.6	16.6	16.5	16.4	Vehicle Sales, millions of units <sup>3</sup>	17.1	17.2	16.9	16.7	16.3
3.6	3.5	3.5	3.4	3.4	3.5	3.5	3.5	Unemployment Rate, % <sup>4</sup>	4.3	3.9	3.7	3.5	3.5
1.3	1.4	1.4	1.6	1.3	1.0	0.8	0.5	Non-Farm Employment <sup>5</sup>	1.6	1.6	1.4	1.3	0.6
2.9	1.5	2.7	2.5	2.0	1.8	2.4	1.8	Real Disposable Personal Income <sup>1</sup>	2.9	4.0	3.0	2.3	2.0
1.7	1.6	1.8	1.6	1.6	1.7	1.8	1.8	GDP Price Deflator <sup>5</sup>	1.9	2.4	1.8	1.7	1.8
1.4	1.5	1.7	1.5	1.6	1.7	1.8	1.9	PCE Deflator <sup>5</sup>	1.8	2.1	1.4	1.6	1.8
1.8	2.0	2.3	2.0	2.0	1.8	1.9	2.0	Consumer Price Index <sup>5</sup>	2.1	2.4	1.8	2.0	1.9
1.7	1.6	1.8	1.9	1.8	2.0	2.0	2.0	Core PCE Deflator <sup>5</sup>	1.6	1.9	1.6	1.9	2.0
2.3	2.3	2.3	2.4	2.3	2.3	2.3	2.3	Core Consumer Price Index <sup>5</sup>	1.8	2.1	2.2	2.3	2.3
2.18	1.71	1.63	1.63	1.63	1.58	1.38	1.38	Fed Funds Target Rate Range Mid-Point, % <sup>4</sup>	0.97	1.78	2.16	1.61	1.38
1.80	1.79	1.71	1.79	1.80	1.74	1.65	1.62	10-Year Treasury Note Yield, % <sup>4</sup>	2.33	2.91	2.14	1.76	1.63
3.66	3.70	3.60	3.68	3.71	3.65	3.57	3.54	30-Year Fixed Mortgage, % <sup>4</sup>	3.99	4.54	3.94	3.66	3.55
-2.3	-2.3	-2.4	-2.6	-2.7	-2.7	-2.8	-2.8	Current Account, % of GDP	-2.3	-2.4	-2.3	-2.6	-2.9

a = actual; f = forecast; p = preliminary

- Notes: 1 - annualized percentage change      4 - quarterly average  
 2 - chained 2012 \$ billions                      5 - year-over-year percentage change  
 3 - annualized rate

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