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Lofty Expectations Clash With Down To Earth Data

As of this month the current economic expansion became the second-longest expansion on record. The flip side of that, however, is that the current expansion is also the slowest on record. But, as we noted in last month's *Outlook*, a significant dose of fiscal stimulus figures to boost growth this year and next, to the point that we, like many other analysts, expect real GDP growth for 2018 as a whole to come in right around 3.0 percent.

Talk about bad timing. The most recent batch of top-tier economic data seems to suggest 2018 real GDP growth will fall well short of those lofty expectations and will instead be more in line with the rather pedestrian pace of growth seen over the life of the current expansion. Or not – the operative word in the previous sentence being "seems." Sure, the headline numbers on recent reports on job growth, wage growth, productivity growth, capital spending, and even Q1 GDP don't exactly paint a picture of a robustly growing economy, yet neither our assessment of current economic conditions nor our growth outlook have changed much.

No, this isn't a case of us whistling past the graveyard or us being bound and determined to bend the economic data to conform to how we know the world to be. Trust us, one thing we know from over two decades in the fun-filled and fast-paced world of economics is that the economic data are open to interpretation, offering ample opportunity for people to pick and choose the specific numbers, or the specific interpretations of those numbers, that fit whatever narrative they're pushing. For instance, there are some who have been on recession watch since July 2009, a/k/a the first month of the current expansion. If nothing else, we give them credit for their perseverance, though in a persistently slow-growth world they've never been too far from a soft data point that could back their story. Their payoff, of course, is that when the next recession does come, they'll be able to proudly, and, sure, correctly, lay claim to being the first to call it, so there's that.

In any event, as our regular readers well know, we have little use for "analysis by headline," or, simply taking the headline numbers on any given data release in any given month and spinning a narrative of the economy around those headline numbers. Instead, we do our best to adhere to what we think is the most important, not to mention the most basic, tenet of economic analysis, which is looking at the details beneath the headline numbers of any given data release and putting those details in the context of the underlying trends in the data. The simple reality is that underlying trends cannot be seen in headline numbers, and an economy as large and as complex as the U.S. economy doesn't change as often, and surely not as dramatically, as the month-to-month headline numbers on the data releases would suggest.

For instance, take the BEA's initial estimate of Q1 GDP, which was released in late-April. After averaging better than 3.0 percent over the last three quarters of 2017, real GDP growth slowed to a 2.3 percent annualized rate in Q1. Inflation adjusted consumer spending grew at its slowest pace since Q2 2013, which was rich fodder for those clinging to the "what's wrong with U.S. consumers?" narrative, even if clinging to that narrative requires one to ignore that Q4 2017 saw the fastest pace of growth in inflation adjusted consumer spending since Q4 2014. The broader point here is that for the past two decades the GDP data for the first quarter of any given year have been plagued by residual seasonality, and without allowing for that one cannot put the BEA's estimate of 2.3 percent growth in any sort of context. One simple way to do so is to look at real GDP growth on a year-on-year basis, rather than on the seasonally adjusted annualized basis on which growth is reported. Real GDP was up 2.9 percent year-on-year in Q1, the fastest such growth since Q2 2015.

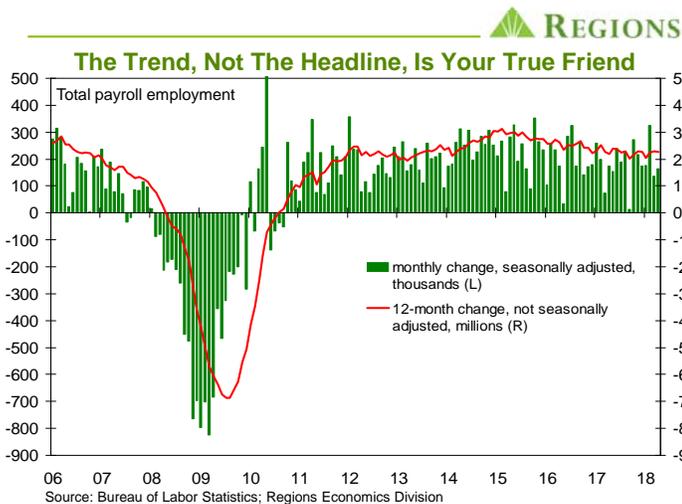
We could also point to the BLS's monthly employment report, widely seen as the most important data release in any given month. Yet, for as much importance is attached to it, and for as much media attention is devoted to it, the monthly employment report is a prime example of how easily analysis by headline can steer one wrong. Granted, the monthly employment reports typically run around 40 pages, 40 pages full of tables full of numbers, that is, meaning that those with full, productive, and interesting lives cannot be reasonably expected to sift through all of those numbers and ponder what they all mean.

Which is of course why there are economists. Even so, the employment data are prone to the same month-to-month volatility seen in pretty much every data series, which in turn means the employment data are subject to the same seasonal adjustment noise seen in pretty much every data series. And, each data series has its own special quirks that don't lend themselves to short and simple analysis/interpretation. For instance, measured job growth is sensitive to, yes, the weather, and also to the number of weeks between the BLS's establishment surveys, while measured growth in hourly earnings is sensitive to whether or not the 15th day of the month falls within or outside of the establishment survey week.

What we've learned from (sometimes painful) experience is that when someone asks our take on a given data report, they don't want to hear all of the ins and outs and quirks of the data (and the words "seasonal adjustment noise" will make eyes glaze over). Instead, they mainly want to know if it's "good" or "bad" or "what does it mean for the Fed?" But, while "it depends" is pretty much always the correct answer for any question anyone ever asks an economist, that is not typically regarded as a satisfactory answer.

By now, if nothing else is clear to you, it is probably clear why no one wants to talk to an economist at a cocktail party. It is hopefully clear why we place so little weight on the headline number atop

any given data release and so much weight on the details beneath the headline number. For instance, the following chart is one we use each month in our write-up of the employment report, and by showing both the “headline” monthly job growth number (shown with the green bars) as well as the 12-month change in not seasonally adjusted employment (shown with the red line), it illustrates our point about analysis by headline.



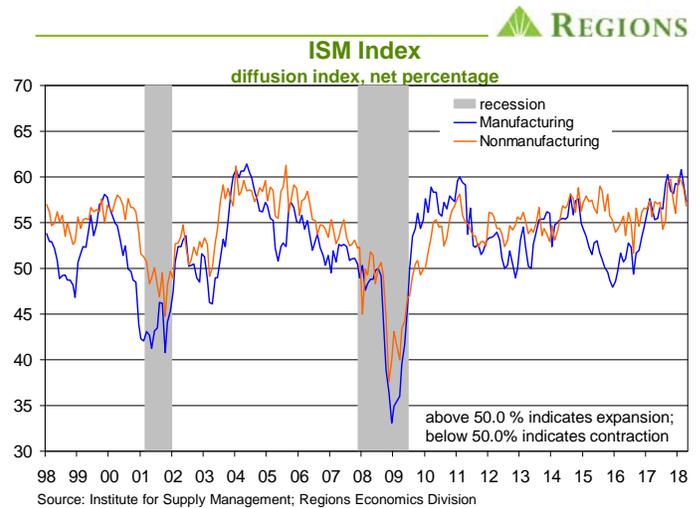
As is seen in the chart, there is considerable variance in measured job growth from one month to the next but, as noted above, it simply isn't the case that the narrative of the large and complex U.S. economy changes by anything close to that same degree from one month to the next. Our preference is to focus on the trend rate of job growth which, as seen in the above chart, has been notably stable over recent months. The not seasonally adjusted data show that over the past 12 months the U.S. economy has added an average of 189,000 jobs per month, an average that has barely budged over the past year-and-a-half.

Admittedly, many find the regular monthly screaming matches on financial talk TV over the meaning of the rise and fall of the green bars to be more interesting but, at least to us, the stable red line tells the more relevant story. We could illustrate the same point with any number of economic data series. Whether it's job growth, productivity growth, capital spending, residential construction, or consumer spending, in each case we see the underlying trends as being healthier than implied by the recent headline numbers, though this is not to say there is not room for further improvement. And, while by no means do we claim to always be correct in our interpretation of the trends in the economic data, we do remain comfortable with our assessment of current economic conditions and our outlook for growth over coming quarters.

You Need Not Take Our Word . . .

Over the years, one of our favorite data sets has been the monthly survey data from the Institute for Supply Management (ISM). Each month the ISM surveys 18 industry groups in the manufacturing sector to compile the *ISM Manufacturing Index* and surveys 18 industry groups in other sectors of the economy to compile the *ISM Nonmanufacturing Index*. The headline index in each case is a diffusion index, with 50.0 percent the break between contraction

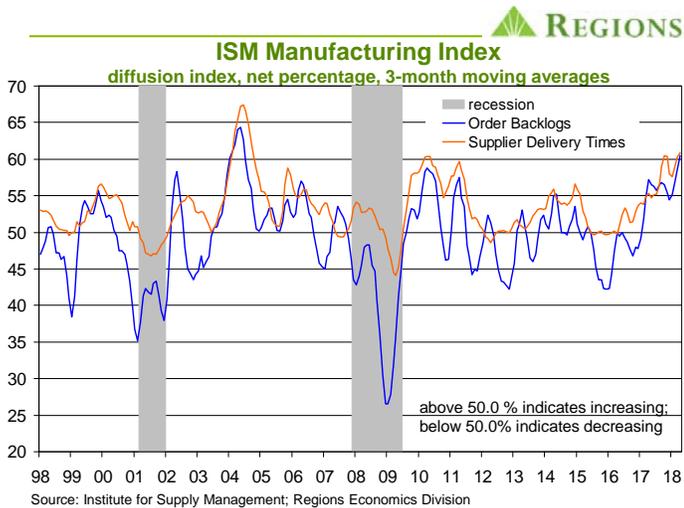
and expansion, but it will come as no surprise when we say we find the details beneath the headline index numbers to be much more useful. Indeed, we have long relied on the ISM data to be a valuable check on our assessment of current economic conditions.



Though off of their recent, and perhaps cyclical, highs, both the manufacturing and nonmanufacturing indexes remain comfortably above that 50.0 break between contraction and expansion. Still, some have fretted that the headline indexes have both declined in each of the past two months. This is where looking at the various sub-indexes that go into the headline index is of use. For instance, in April 17 of the 18 manufacturing industry groups reported growth (with one reporting no change in the level of activity) and all 18 of the nonmanufacturing industry groups reported growth. It is also interesting to note that in September 2016, when the *ISM Manufacturing Index* began its current 20-month (and counting) run of readings above 50.0 percent, only seven of the 18 industry groups reported growth, but that number has steadily risen over the intervening months, a sign of an increasingly broad based expansion in the factory sector. *The ISM Nonmanufacturing Index* has topped the 50.0 percent threshold for 99 consecutive months.

One of our favorite elements of the ISM's monthly releases is that they include a section in which the ISM relays comments from survey respondents pertaining to what they see in their industry (industries are identified, individuals are not). Over the past several months there have been some common themes in those comments that reinforce our comfort with our assessment of current conditions. One such theme is that firms, in both the manufacturing and nonmanufacturing sectors, are having trouble keeping pace with growth in demand. The data affirm the comments, as the sub-index in each survey that gauges backlogs of unfilled orders has consistently indicated growing backlogs over the past several months. In other words, firms are booking orders at a faster pace than they are able to fill orders. As long as firms are confident that growth in new orders will be sustained, they at some point have to either expand their capital stocks, take on more labor, or find ways to make current workforces more productive, though most likely it will be some combination these alternatives. That industrial capacity utilization rates have been trending higher over the past several months points to stronger capital spending over coming quarters.

In April, 16 of the 18 manufacturing industry groups reported larger backlogs of unfilled orders than was the case in March, a number that has gotten progressively larger since the headline index has been in expansionary territory. But, just as producers of goods and services are having trouble keeping pace with growth in demand, so too are their suppliers. This is seen in the sub-index that gauges supplier delivery times, shown in the chart below with the sub-index measuring order backlogs (we use 3-month moving averages to rid the data of some of the month-to-month volatility).



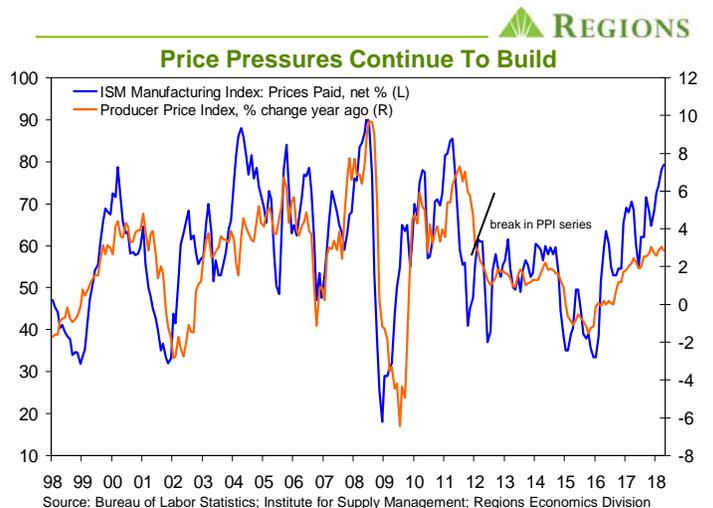
To our earlier point about firms having to find ways to better keep pace with growth in demand, many respondents in both surveys point to difficulty in finding labor. This is consistent with an argument we've made often over the past several months, i.e., a dwindling pool of labor, along with faster growth in the cost of that labor, will push firms towards more investment in equipment and machinery, reversing the labor-for-capital substitution that has prevailed over much of the current economic expansion.

Comments from survey respondents also show that just as policy giveth, so too does policy taketh away. Comments from some respondents tout the beneficial effects of the 2017 tax bill which, as a reminder, included provisions lowering the statutory corporate income tax rate, allowing for the immediate expensing of capital investment, and making it less costly to repatriate foreign profits. While respondents taking a favorable view of these provisions isn't exactly a surprise, it should (but probably won't) give pause to those dismissing the possibility that the tax bill will ultimately be beneficial to both firms and to labor simply because large-scale impacts weren't evident in the first few months after the tax bill was signed into law. Some things do indeed take time.

What has been apparent in much shorter order is the fallout from tariffs, those already implemented and those potentially to be implemented down the road. In the April survey, respondents across a number of manufacturing and nonmanufacturing industry groups pointed to adverse effects from tariffs/tariff talk. These effects range from higher steel prices to uncertainty over the ability to procure sufficient quantities in the future. Respondents from mining, construction, machinery manufacturing, fabricated metal products, and miscellaneous manufacturing voiced such concerns in the April survey, and one response from the finance industry noted uncertainty over the outlook for trade "has folks

nervous" which, while we have no way of knowing if this is the case, could easily be a lender feeling the effects of that uncertainty in the form of prospective C&I lending activity being put on hold. To be perfectly clear, we are not offering any kind of political commentary on either the tax bill or trade, as this is neither the time nor the place for that. It is far more relevant to know how these policy measures are impacting actual business activity, which is a key benefit of the ISM surveys.

Another common theme amongst survey respondents of late has been a growing shortage of transportation capacity and rising transportation costs, particularly transportation by truck. This likely reflects both capacity constraints in the trucking industry and regulations aimed at limiting driving times, but the broader point is that slower delivery times in part reflect growing transportation bottlenecks. Worth watching over coming months is how higher fuel costs impact shipping costs and whether, or to what extent, these higher costs are passed on to downstream firms/consumers.



As it is, price pressures have been building for some time now in both the manufacturing and nonmanufacturing sectors of the economy. This is to be expected with both suppliers and producers stretching to keep pace with growth in demand, and is seen in the ISM's sub-indexes measuring prices paid for non-labor inputs in both the manufacturing and nonmanufacturing sectors. In the chart above, we show the prices paid sub-index from the *ISM Manufacturing Index* along with the year-on-year percentage change in the Producer Price Index (PPI) published by the BLS. As seen in the chart, movements in the ISM's prices paid sub-index have tended to lead movements in the PPI. It would, however, seem that the PPI should be rising at a faster pace than has been the case over recent months given the steep upward trajectory of the prices paid metric. Then again, just because it hasn't happened yet doesn't mean it won't happen down the line.

Even so, it is an interesting dynamic that prices of raw materials and intermediate inputs are rising at a faster pace than are prices of consumer goods and services which, along with at least some acceleration in the growth of labor costs, is putting pressure on corporate profit margins. It is worth noting that the acceleration in input prices seen in both the ISM data and the PPI data began well before tariffs began to push prices for certain metals higher over the past two months.

To us, this is simply a reflection of faster global economic growth having considerably pared down remaining slack, thus putting upward pressure on prices for materials and commodities. Our view is that slower global growth in Q1 is more transitory than structural, which means upward pressure on input prices will persist at the same time labor costs are poised to rise at a faster pace over coming quarters. Higher prices for both non-labor inputs and for labor could lead firms to test their pricing power in the months ahead. If so, the prolonged period of dormancy of retail (or, consumer) level inflation that has baffled central bankers (and, okay, sure, economists) could come to an end faster than anyone had anticipated at the turn of the year.

This has fueled uncertainty amongst financial market participants as to how rapidly, and how high, the FOMC will raise its Fed funds rate target. It is interesting that against this backdrop the FOMC, following their early-May meeting, noted that their inflation objective was “symmetric,” meaning that they would be willing to tolerate a period of inflation running above their 2.0 percent target rate just as for the majority of the time over recent years inflation has fallen short of this target. But, in central banking as in life in general, tolerance has its limits, though rather than being pre-defined, those limits only become known when they are breached.

While recent measures of consumer level inflation have shown inflation above the FOMC’s 2.0 percent target, the over-the-year comparisons in both the CPI and the PCE Deflator are being biased higher by base effects stemming from last year’s precipitous declines in prices for cell phone service plans. Hence, as are most private sector analysts, the FOMC is somewhat discounting the recent pop in inflation, which could help account for outgoing New York Fed President William Dudley cautioning that it is too soon for the FOMC to “declare victory” in achieving its inflation target.

That said, there are signs that inflation pressures are becoming both more broad based and more intense, even if that is not readily apparent in measures of consumer level inflation. Neither is that apparent in wage growth, which some still cling to as a predictor of inflation pressures in the broader economy. Many analysts, and at least a few FOMC members, still seem wedded to the Phillips Curve even though the Phillips Curve has been divorced from reality for quite some time now.

The ISM data and the PPI data are sending signals that merit more attention than they are getting. To be sure, inflation is a process, not an event. In other words, it takes time for inflation in raw materials and commodities prices, and higher shipping costs for that matter, to translate into higher prices on the retail level. And, at some point growth in labor compensation costs (for which growth in average hourly earnings is a poor proxy, as we discussed at length in our March 2018 *Outlook*) will accelerate further, thus giving firms greater incentive to test their pricing power. Time will tell how successful any such efforts will be. But, that we are even having this discussion is a sign that the U.S. economy has considerably more positive momentum than implied by the headline numbers on several of the economic reports of late.

April Employment Report

After reported increases of 326,000 jobs in February and 103,000 jobs in March (both since revised), neither a true reflection of the

state of the labor market, many had hoped the April data would bring some clarity in that regard. Wow, talk about a rookie mistake, even if many of us who made that mistake aren’t exactly rookies. The BLS’s initial estimate shows nonfarm payrolls rose by 164,000 jobs in April, shy of expectations (our forecast was for a gain of 202,000 jobs). At the same time, average hourly earnings were reported to have risen by just 0.1 percent, and even the decline in the unemployment rate to 3.9 percent, the lowest since December 2000, is not cause for celebration, as the jobless rate was dragged lower by a sizeable decline in the labor force.

All in all, the April employment left us feeling, well, cold. That seems an apt characterization as unusually harsh “winter” weather wreaked havoc on the employment data. For instance, the number of people not at work due to weather was the highest for the month of April in the life of the data that go back to 1977, and a significant number of number of people worked only part-time, rather than full-time as normal, due to weather in April. These weather effects are visible in the not seasonally adjusted data; reported job growth in weather sensitive industries such as construction and leisure & hospitality services was less robust than is typical for the month of April.

We did not anticipate weather effects being this strong in April, which contributed to our miss on our forecasts for both job growth and average weekly hours. But, this is simply noise and weather effects alter the timing of hiring, not the level of hiring, hence the “soft” April job growth number tells us nothing about momentum in hiring. Particularly when, as noted above, the not seasonally adjusted data tell us that over the past 12 months nonfarm employment has risen by an average of 189,000 jobs per month.

The average hourly earnings figure for April is also of little use as a signal of underlying labor market conditions. A curious calendar quirk likely contributed to the measly gain in average hourly earnings in April, as the 15th of the month fell outside the reference week for the establishment survey. Such an occurrence has tended to bias growth in average hourly earnings lower and we have no reason to think April was any different. The bad news is that, if anything, the initial estimate of hourly earnings in April overstates the case – to the extent salaried workers had their hours shortened by weather, that will have biased measured average hourly earnings higher. The other bad news here is that the May earnings data will likely not show much improvement, as the 15th of May also falls outside of the reference week.

That the hourly earnings figure was distorted by noise didn’t stop the usual suspects from spinning the usual narratives around it, however. Our favorite was hearing how the lack of wage growth in April means the FOMC does not have to “panic” and begin raising the Fed funds rate at a faster pace, which narrowly beat out hearing how meager wage growth in April “proves” the tax cut is not working as firms still refuse to pay their workers more. Wow, sometimes it really does make our heads hurt. Badly.

There are many factors, such as anemic productivity growth, that have weighed on wage growth over the past several years. But, just as the trend rate of productivity growth is improving, albeit at a frustratingly slow pace, so too is the trend rate of wage growth. Once again, though, underlying trends simply cannot be seen in headline numbers, no matter how hard one looks.

ECONOMIC OUTLOOK

Q4 '17 (a)	Q1 '18 (p)	Q2 '18 (f)	Q3 '18 (f)	Q4 '18 (f)	Q1 '19 (f)	Q2 '19 (f)	Q3 '19 (f)		2016 (a)	2017 (f)	2018 (f)	2019 (f)
2.9	2.3	3.3	3.0	2.9	2.4	2.1	1.9	Real GDP ¹	1.5	2.3	2.9	2.5
4.0	1.1	2.3	2.4	2.3	2.2	2.1	2.0	Real Personal Consumption ¹	2.7	2.8	2.4	2.2
								Business Fixed Investment:				
7.1	4.3	6.3	6.1	5.0	4.6	4.3	3.6	Equipment, Software, & IP ¹	0.3	4.4	6.1	4.7
6.3	12.3	4.4	4.9	3.9	3.3	2.2	1.6	Structures ¹	-4.1	5.6	5.3	3.1
12.8	0.0	5.4	2.2	4.9	5.0	5.5	4.9	Residential Fixed Investment ¹	5.5	1.8	2.8	4.7
3.0	1.2	1.9	2.3	3.2	1.8	1.1	1.1	Government Expenditures ¹	0.8	0.1	1.8	1.8
-653.9	-645.9	-645.2	-646.1	-647.5	-651.7	-660.7	-673.2	Net Exports ²	-586.3	-621.8	-646.2	-665.9
1.256	1.318	1.285	1.288	1.301	1.317	1.339	1.359	Housing Starts, millions of units ³	1.177	1.208	1.298	1.347
17.7	17.1	16.9	16.8	16.7	16.6	16.5	16.4	Vehicle Sales, millions of units ³	17.5	17.2	16.9	16.5
4.1	4.1	4.0	3.9	3.8	3.8	3.7	3.7	Unemployment Rate, % ⁴	4.9	4.4	3.9	3.7
1.5	1.5	1.6	1.5	1.4	1.2	1.1	1.1	Non-Farm Employment ⁵	1.8	1.6	1.5	1.1
1.1	3.4	2.5	2.8	2.8	2.9	2.2	2.5	Real Disposable Personal Income ¹	1.4	1.2	2.3	2.6
1.9	1.9	2.1	2.1	2.0	2.0	2.0	2.0	GDP Price Index ⁵	1.3	1.8	2.0	2.0
1.7	1.8	2.4	2.5	2.3	2.1	2.0	1.9	PCE Deflator ⁵	1.2	1.7	2.2	2.0
2.1	2.3	3.0	3.0	2.7	2.3	2.1	2.1	Consumer Price Index ⁵	1.3	2.1	2.7	2.1
1.5	1.7	2.0	2.2	2.2	2.1	2.1	2.1	Core PCE Deflator ⁵	1.8	1.5	2.0	2.1
1.7	1.9	2.3	2.5	2.5	2.4	2.4	2.4	Core Consumer Price Index ⁵	2.2	1.8	2.3	2.4
1.18	1.41	1.67	1.90	2.13	2.17	2.42	2.63	Fed Funds Target Rate, % ⁴	0.39	0.98	1.78	2.46
2.37	2.76	2.83	2.93	3.03	3.10	3.15	3.20	10-Year Treasury Note Yield, % ⁴	1.84	2.33	2.89	3.18
3.92	4.28	4.40	4.53	4.67	4.75	4.78	4.87	30-Year Fixed Mortgage, % ⁴	3.65	3.99	4.47	4.83
-2.6	-2.5	-2.5	-2.6	-2.8	-2.7	-2.8	-3.0	Current Account, % of GDP	-2.4	-2.3	-2.6	-2.8

a = actual; f = forecast; p = preliminary

- Notes:
- 1 - annualized percentage change
 - 2 - chained 2009 \$ billions
 - 3 - annualized rate
 - 4 - quarterly average
 - 5 - year-over-year percentage change