ECONOMIC OUTLOOK
REGIONS
February 2019

IT'S ALL HORRIBLE

Made you look, didn't we?

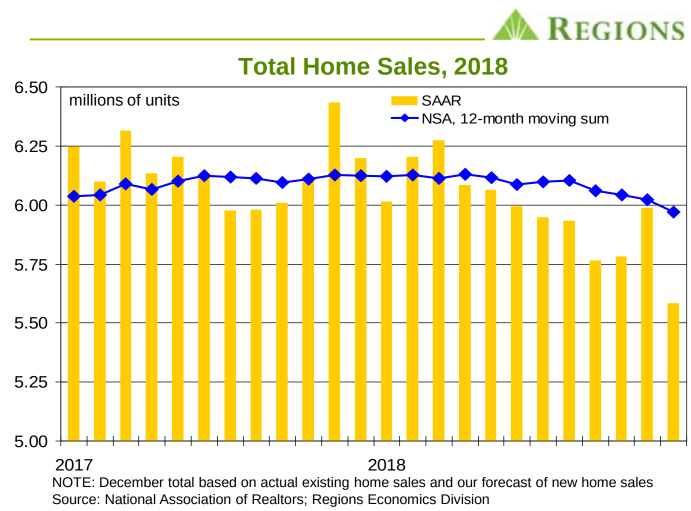
That is the point, right? After all, any reasonably competent child could tell you that the surest way to get attention is to start screaming, and that what you scream isn't nearly as important as how loudly you scream. And, if you think about it, those basic rules never change, it's just that the screaming takes on different forms and takes place in different settings. In the world of print, the screaming often takes place in the headlines, the more dramatic, the better. Of late, a barrage of headlines screaming about the coming economic collapse have captured considerable attention.

At first, most of those headlines sat atop stories in which the basic premise was that the precipitous declines in stock prices seen during Q4 2018 were surefire signs that a recession was right around the corner. What's funny, though not at all in a humorous way, is that while stock prices have bounced back nicely thus far in 2019, those "here comes the economic collapse" headlines keep on coming. Many of these headlines, and the underlying stories, focus on the housing market which, for those of you who haven't been paying attention, is "cratering," "on the verge of collapse," and "dragging the U.S. economy down with it." Goodness.

These "housing is done" stories are nothing new, and this is not the first time we have addressed them. One such story stated that the housing market data "have been dismal," to which our reply was that the only thing dismal about the housing market data has been the reporting on the housing market data. So, to any of our regular readers asking why we're going back down this road, our reply is that we'll stop when they stop, "they" being the "housing is done" stories and the nonsensical headlines that come with them. This recent headline is the latest case in point: "Americans stopped buying homes in 2018, mortgage lenders are getting crushed, and an economic storm could be brewing."

You might think a headline this dramatic, this sweeping, would speak for itself, and that there would be little reason to read the underlying story, assuming anyone still had the will to do so after making it through that headline. But, we simply could not resist, particularly since what followed was no mere story but actual analysis. We know this because it said so – Analysis – right under the headline, and if it's underlined, it has to be true, right? Okay, maybe not. Let's just say that what came beneath the headline is to analysis what our drawings of stick figures are to fine art.

It's hard to even know where to start, but maybe the most obvious starting point is noting that Americans didn't actually stop buying homes in 2018, but instead bought at least 5.927 million homes in 2018, and in no month was the total number of homes purchased zero, as would be consistent with Americans having "stopped buying homes." We say "at least" 5.927 million homes because the data on new home sales in December have yet to be released (the backlog of data releases stemming from the partial government shutdown has yet to be cleared), so assuming Americans didn't actually stop buying new homes in December, that 5.927 million figure will be higher when all is said, done, and released.



To be sure, Americans did buy fewer homes in 2018 than they bought in 2017. There were 5.343 million existing homes sold in the U.S. in 2018, a 3.1 percent decline from the 5.511 million existing homes sold in 2017, while the 584,000 new homes sold year-to-date through November leave sales up 2.8 percent from the same period of 2017. As seen in the above chart (using our forecast of December new home sales in lieu of the actual data), total home sales had been fairly stable from the start of 2017 through Q3 2018 before weakening over the final quarter of 2018, but total home sales will still come in at around 5.970 million units in 2018, a 2.5 percent decline from 6.124 million units in 2017.

Of course, the headline sales numbers make the weakness in home sales in late-2018 look more dramatic than was actually the case. The data on new and existing home sales are reported on a seasonally adjusted and annualized basis, as shown by the gold bars in the above chart. As our regular readers know, we have no use for any data reported on this basis, mainly because annualized changes add volatility to the headline numbers while telling us nothing useful about the underlying trends in the data. When it comes to home sales, we think those trends are best captured by the running 12-month total of not seasonally adjusted sales, which is shown by the blue line in the above chart.

So, sure, home sales did slow over the final months of 2018, but not nearly to the degree implied by the "headline," or, seasonally adjusted and annualized, sales numbers. Unfortunately, it is this measure, not the raw data (i.e., neither seasonally adjusted nor

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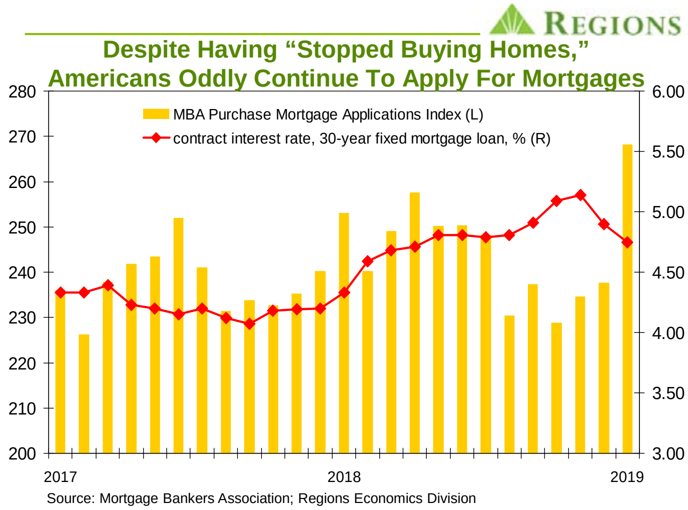
annualized) that people see and which is the basis for most of the "analysis" of the data. But, no matter which measure you prefer, the weakness in home sales seen over the final months of 2018 was not as severe as implied by the "housing is done" stories, nor was it, at least it should not have been, at all surprising.

Our long-held view is that most of the problems in the housing market have been on the supply side, not the demand side, of the market. As we've frequently discussed, inventories of homes for sale, particularly existing homes for sale, remain extraordinarily lean, which is something that will change only gradually, not all at once. We've also noted that lean inventories were fueling a pace of house price appreciation which was out of alignment with income growth, thus acting to erode affordability. While low mortgage interest rates cushioned the blow to affordability, when mortgage interest rates began to rise, particularly as rapidly as they did during Q4 2018, the blow to affordability became more severe, which took a toll on home sales.

Again, this should not have been surprising. For instance, in our write-up of the January 2018 data on new and existing home sales, we stated that "rising mortgage rates pose a threat to an otherwise healthy demand side of the market, not so much at present but if rates continue to rise in conjunction with prices remaining elevated, affordability will suffer, as will sales," and that "if you start with a supply constrained market then add in diminished affordability, it's clear the home sales story won't end well."



Indeed, the home sales story did not end 2018 well, but it's a long, long way from there to the housing market collapsing and dragging the economy down with it. What is even more striking, not to mention maddening, about the most recent round of "housing is done" stories is that the authors of these stories seem not to have noticed that purchase mortgage applications spiked in January 2019 as mortgage interest rates receded from their 2018 highs. This tells us that there is still life left on the demand side of the market, which we have maintained all along, and more life in the housing market than implied by the home sales numbers seen over the final months of 2018.

As for the "mortgage lenders are getting crushed" part of the story, the body of evidence for this contention is the hit to Q4 2018 earnings of two of the largest commercial banks from diminished mortgage originations. Nothing buttresses your analysis and drives home your point like a sweeping generalization, right? With sales volume lower in Q4 2018 than in Q4 2017 and refinancings down due to higher interest rates, it follows that revenue from mortgage originations would be lower in Q4 2018 than in Q4 2017. Even so, offering up two large commercial banks as evidence of mortgage lenders being "crushed" fails to account for the fact that banks in general have for some time been losing market share to nonbank lenders. To be sure, mortgage origination has become a much tougher game, which to some degree reflects margins having been compressed by the presence of the nonbank lenders. Either way, between refinancings and purchases, there were millions of mortgage loans originated in 2018, which tells us that while maybe not crushing it, mortgage lenders are hardly getting crushed.

As for the housing market dragging the broader U.S. economy down with it, we're going to have to go with "no" on this one. Yes, the housing market was ground zero for the 2007-09 recession and the accompanying financial market meltdown, but there are no plausible parallels between the state of the housing market then and the state of the housing market now, the key word here being "plausible." Consider that the current cycle has been characterized by restricted access to mortgage credit thanks to much more stringent underwriting standards that have left early-stage mortgage delinquencies below longer-term norms, too few new homes having been built, and existing home sales having been constrained by notably low inventories (we've discussed each of these factors and their causes in detail on several occasions so won't go back over that ground here). Quite a contrast from the last time around, when we saw record-high levels of new single family home construction facilitated by the virtual abandonment of any and all underwriting standards, which also led to rising mortgage delinquency rates well before the recession began, and liberal extraction of artificially high levels of housing equity used to finance an unsustainably high level of consumer spending.

Simply stated, housing is not even remotely close to being in a position to do anywhere near the same degree of damage to the broader economy as it did during the last cycle. This doesn't mean a sharp contraction in new residential construction – which, by the way, we're not even close to having seen yet, with housing starts up by better than four percent in 2018 – wouldn't be felt in the broader economy. But, neither does it mean such a contraction would once again precipitate a deep and painful recession.

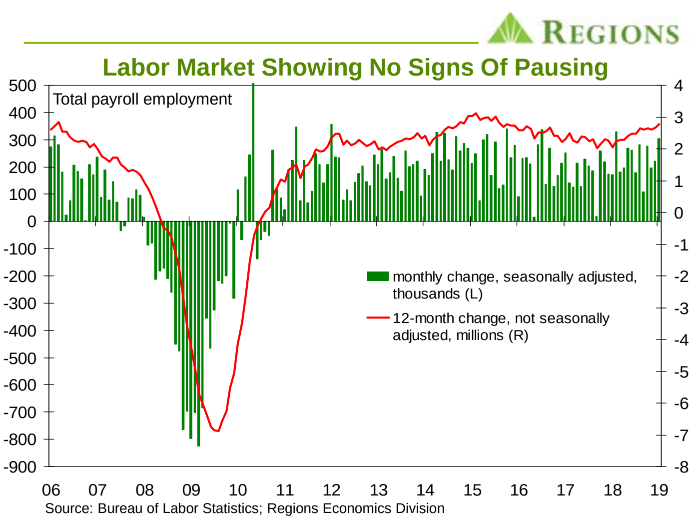
That having been said, housing does still touch a nerve with a large segment of the population. Aside from shoddy analysis and nonsensical headlines, this is a big reason we find the "there goes the housing market and it's taking the broader economy with it" stories so objectionable. Anyone who lived through the last downturn in one of the states in which home values fell by upwards of 50 percent or in which entire neighborhoods were blighted by foreclosure is still, at least to some degree, sensitive to any signs that the housing market is wavering, and the sense of "here we go again" likely isn't limited to this segment of the population. It would be nice if those slapping sensationalized headlines on stories pertaining to the housing market would be mindful of that.

As with any aspect of the economy, there is a wide range of views on how the housing market will fare in 2019. One key determinant of anyone's outlook is whether they see the weakness in home sales in late-2018 as a slowdown that will give way to further growth, even if at only a modest pace, or as the start of a more pronounced and lasting downturn. We see the former as being the case and, as such, have a modestly constructive outlook for the housing market in 2019. The recent decline in mortgage interest rates along with a modestly improving inventory backdrop set up well for the spring selling season, and while we don't look for sales to rocket higher, we do expect them to be noticeably better over the first half of 2019 than was the case in Q4 2018.

Our view, as always, is based on our interpretation of the data, but by no means do we claim to have a flawless record in that regard. Really, even if we were inclined to make such a claim, a more than two-decades long trail of evidence to the contrary would preclude us from doing so. What we have no use for is those who start out with a conclusion then try to mold the data to fit that conclusion, and many of these "housing is done" stories seem to fit that bill. In closing, we'll note that from the latest round of earnings calls, we know many of the large home builders believe continued job growth, accelerating wage growth, a slower pace of price appreciation, and still manageable mortgage interest rates combine to leave further upside room for home sales in 2019.

Labor Market Showing No Signs Of Pausing

The FOMC may be taking a breather, but the labor market is still running at full speed. Total nonfarm employment rose by 304,000 jobs in January, with private sector payrolls up by 296,000 jobs and public sector payrolls up by 8,000 jobs. To be sure, the January employment report is full of noise, and by no means do we believe actual job growth was as strong as the BLS's initial estimate suggests. That said, if there are flaws in the labor market, they're awful hard to find, and we look for broad based job growth and accelerating wage growth to continue over coming months.



Source: Bureau of Labor Statistics; Regions Economics Division

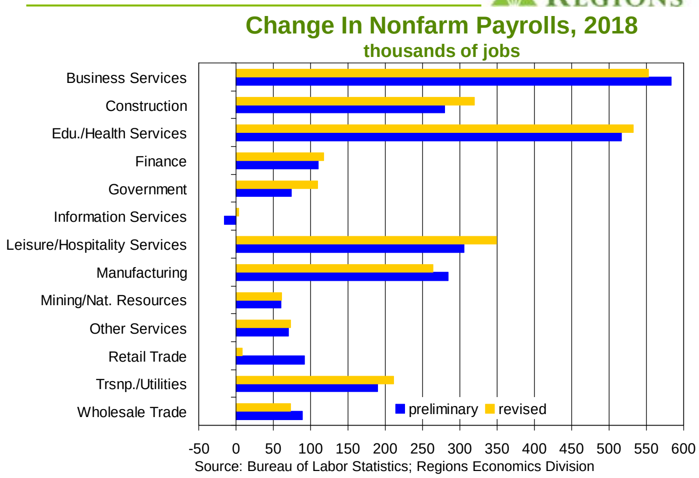
To say there are a lot of moving parts to the January employment report would be a blatant understatement. As such, we think it worth taking some time here to discuss some of these moving parts and how they impacted reported job growth in January. It is worth noting that January marks the 100th consecutive month of growth in nonfarm employment, more than double next longest streak. Our suspicions regarding the initial estimate of January job growth are a matter of degree, not direction. For instance, the response rate to the BLS's January establishment survey was just 60.7 percent, the lowest response rate for the month of January since 2003 and well below the average January response rate of 69.7 percent over the prior 15 years. One way to think about this is that a lower response rate to the establishment survey in any given month leaves the BLS a larger hole to fill with their own estimates, which in turn leaves the initial estimate of headline job growth vulnerable to larger revision. This is the same point we made upon the release of the December employment report. While the BLS's initial estimate put December job growth at 312,000 jobs, the response rate was only 60.0 percent. By January, that response rate had risen to 88.3 percent and that initial estimate of December job growth was revised down to 222,000 jobs.

The January employment report incorporated the BLS's annual benchmark revisions to its estimates of nonfarm employment. In short, each year the BLS benchmarks the sample of firms in its establishment survey to the universe of firms filing Unemployment Insurance tax returns as of March of the prior year. Estimates of nonfarm employment over the prior five years are revised in the annual benchmarking process. So, while part of the revision to the original estimate of December job growth reflects the annual benchmark revision, we'll note that the 90,000 job disparity between the original and revised estimates of December job growth is easily the largest of any month in the five-year period of revised data, which leads us to think the low initial response rate to the December establishment survey was the primary culprit.

Sure, response rates may not be the most riveting topic (really, if you do find it riveting, that's probably a sign that some serious self-examination is in order), and it is a topic that doesn't get much attention, but it is something that can easily distort the initial estimate of job growth in any given month. In other words, don't get too attached to the initial estimate of a gain of 304,000 jobs in January. We also think that weather effects biased the initial estimate of January job growth higher. While by the end of January the polar vortex dominated the weather across much of the U.S., the January survey week (in any month, the survey week is the week containing the 12th day of the month) saw unusually mild weather. As a result, job losses in weather sensitive industries such as construction and leisure & hospitality services this January were smaller than normal for the month, and thus smaller than had been "anticipated" by the seasonal adjustment factors. As such, the reported gain of 52,000 jobs in construction and 74,000 jobs in leisure & hospitality services on a seasonally adjusted basis were overstated, we'd say materially so, which in turn biased the initial estimate of growth in total nonfarm employment higher.

About those benchmark revisions, in terms of the extent of job growth, the revisions were pretty much a non-event. For instance, prior to the revisions, the BLS estimated that over the 2014 through 2018 period the U.S. economy added a net total of 12.887 million jobs, while the revised data show a net gain of 12.894 million jobs. More specifically, for 2018 as a whole the BLS now reports a gain of 2.674 million jobs, a bit higher than the initial estimate of a gain of 2.638 million jobs.

Rather than the magnitude of job growth, the benchmark revisions had a bigger effect on the composition of job growth across the major industry groups. For instance, the original estimate showed retail trade payrolls rose by 91,600 jobs in 2018, but the revised data put 2018 job growth in retail trade at 7,900 jobs. While we thought job growth in retail trade was a bit on the exuberant side as we tracked the data over the course of 2018, even we didn't expect this large of a markdown. In contrast, the revised data show greater hiring in leisure & hospitality services, construction, transportation/warehousing, and government than had originally been reported over the course of 2018.

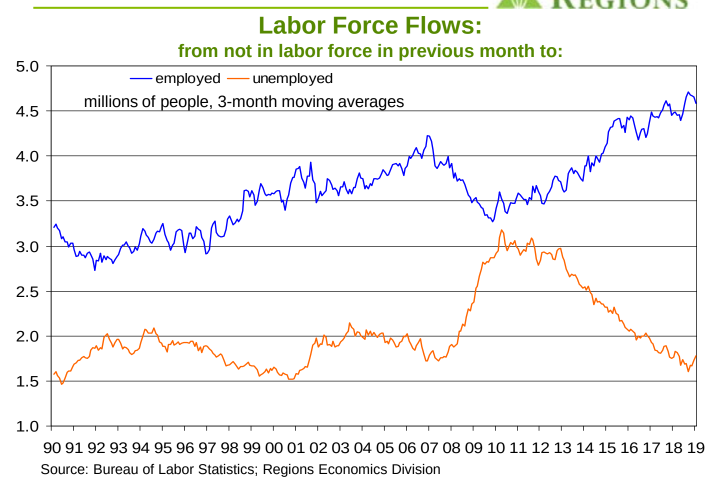


Another factor that impacted the January employment report was the partial government shutdown. There was little direct impact on the establishment survey, as the provision to grant back pay to furloughed government workers meant they were still counted as employed even if not at work or not paid during the survey week. What the BLS could not quantify is the number of private sector contractors who were not at work or not paid during the survey week due to the partial shutdown and, as such, would not have been counted as employed. This held down measured job growth in January, but to the extent these contractors return to work, this will bias measured job growth higher in February.

The partial shutdown had a bigger effect on the household survey, which helps account for the unemployment rate having risen from 3.9 percent in December to 4.0 percent in January. In the household survey, from which the unemployment rate is derived, the BLS relies on individual respondents to correctly classify their labor market status and accepts survey responses as they are given. Furloughed government workers should have classified themselves as "unemployed: on temporary layoff," and while many did, the BLS notes a number of them instead classified themselves as "employed but absent from work." As such, the unemployment rate would have risen further had this latter group properly reported their status. Additionally, it is likely that some furloughed government workers and private sector contractors took part-time work as a means of earning at least some income during the partial shutdown. This would help account for the spike in the number of people working part-time for economic reasons in January, which pushed the broader U6 measure that accounts for both unemployment and underemployment up to 8.1 percent.

These effects on the household survey data amount to nothing more than transitory noise that will fade from the data in February, assuming of course no further shutdowns. Still, we think it worth going through the details of the January employment report because doing so yields a much clearer picture of the state of the labor market than do any of the headline numbers.

Even after accounting for the high volume of noise in the January employment report, our assessment of the labor market is the same – the labor market is rock solid, a term we first used last February and have used continuously ever since. Job growth actually accelerated in 2018, which is extraordinary this deep into an expansion. Job growth also remains broad based across industry groups, which to us is a sign that this expansion has longer to run – one warning sign that an expansion is on its last legs is growth becoming increasingly concentrated amongst a small number of industries. At the same time, wage growth is accelerating; average hourly earnings were up 3.2 percent year-on-year in January, the sixth consecutive month in which year-on-year growth topped 3.0 percent. If that doesn't sound all that impressive, this is the longest such streak since 2008-09.



As is the case with the expansion in the broader economy, now in its tenth year, people are inclined to look at the record run of job growth and ask how much longer it can last. Our answer, if you'll pardon our use of highly technical economist jargon, is "a while." One reason we think so is found in the valuable, yet largely overlooked, data on flows in to and out of the labor force. In 2018, an average of 4.57 million people per month transitioned to being employed after not having been in the labor force in the prior month. This data set is inherently volatile, but the upward trend in this metric is unmistakable, as we show in the above chart. This steady inflow into the ranks of the employed reflects both first-time entrants into the labor force as well as re-entrants. Our view is that part of what we are seeing here is a return to the labor force of those in the "prime working age" population, i.e., those between 25 and 54 years of age. Participation amongst this group fell sharply during and after the 2007-09 recession, and though having increased for some time now, remains below the prior peak. Our view is that the cyclical component of the decline in labor force participation associated with the 2007-09 recession has yet to be fully unwound, meaning there is still upside room for the participation rate. Obviously this cannot continue forever, but we think it has further to run. This is one reason we expect job growth to continue at a healthy rate in 2019, with some further acceleration in wage growth as the year wears on.

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Q3 '18 (a)	Q4 '18 (f)	Q1 '19 (f)	Q2 '19 (f)	Q3 '19 (f)	Q4 '19 (f)	Q1 '20 (f)	Q2 '20 (f)		2016 (a)	2017 (a)	2018 (f)	2019 (f)	2020 (f)
3.4	2.9	1.9	2.5	2.6	2.1	1.8	1.5	Real GDP[1]	1.6	2.2	2.9	2.6	1.9
3.5	3.9	2.6	2.6	2.5	2.4	2.1	2.0	Real Personal Consumption[1]	2.7	2.5	2.7	3.0	2.2
								Real Business Fixed Investment:					
4.3	6.2	5.5	4.8	4.7	4.1	3.1	2.8	Equipment, Software, & IP[1]	2.1	5.5	7.3	5.3	3.3
-3.4	1.8	-1.2	2.8	1.1	1.1	1.5	1.8	Structures[1]	-5.0	4.6	5.4	1.2	1.5
-3.6	-3.0	-0.5	0.0	2.6	1.8	1.7	1.8	Real Residential Fixed Investment[1]	6.5	3.3	-0.2	-0.8	1.6
2.6	1.4	0.9	2.7	1.1	-0.1	-0.6	-0.6	Real Government Expenditures[1]	1.4	-0.1	1.6	1.6	-0.1
-949.7	-960.1	-942.9	-948.7	-956.4	-969.7	-976.7	-985.9	Real Net Exports[2]	-786.2	-858.7	-913.3	-954.4	-989.5
877	847	870	889	905	921	936	947	Single Family Housing Starts, ths. of units[3]	785	852	877	896	948
357	381	362	358	353	350	344	340	Multi-Family Housing Starts, ths. of units[3]	393	356	383	356	334
16.9	17.4	17.1	16.9	16.8	16.8	16.7	16.6	Vehicle Sales, millions of units[3]	17.5	17.1	17.2	16.9	16.5
3.8	3.8	3.9	3.8	3.7	3.6	3.5	3.4	Unemployment Rate, %[4]	4.9	4.4	3.9	3.7	3.5
1.7	1.8	1.8	1.7	1.6	1.4	1.2	1.2	Non-Farm Employment[5]	1.8	1.6	1.7	1.6	1.1
2.4	2.9	2.3	2.0	2.0	2.0	2.0	1.4	Real Disposable Personal Income[1]	1.7	2.6	2.8	2.3	1.8
2.4	2.2	2.4	2.2	2.5	2.6	2.6	2.5	GDP Price Index[5]	1.1	1.9	2.3	2.4	2.5
2.2	1.8	1.7	1.8	2.0	2.2	2.4	2.4	PCE Deflator[5]	1.1	1.8	2.0	1.9	2.4
2.6	2.2	1.5	1.7	1.8	1.9	2.3	2.3	Consumer Price Index[5]	1.3	2.1	2.4	1.7	2.3
2.0	1.9	1.9	1.9	2.1	2.3	2.3	2.3	Core PCE Deflator[5]	1.7	1.6	1.9	2.0	2.3
2.2	2.2	1.9	2.1	2.2	2.3	2.4	2.5	Core Consumer Price Index[5]	2.2	1.8	2.1	2.1	2.5
1.89	2.16	2.38	2.41	2.63	2.63	2.63	2.63	Fed Funds Target Rate Range Mid-Point, %[4]	0.39	0.98	1.78	2.51	2.63
2.92	3.04	2.75	2.85	2.90	2.90	2.90	2.90	10-Year Treasury Note Yield, %[4]	1.84	2.33	2.91	2.85	2.88
4.57	4.79	4.51	4.61	4.66	4.69	4.68	4.68	30-Year Fixed Mortgage, %[4]	3.65	3.99	4.55	4.62	4.66
-2.3	-2.4	-2.4	-2.5	-2.7	-2.7	-2.8	-2.8	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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