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The Details Have Changed, The Big Picture Not So Much . . .

It's August, which means the dog days are here (unless of course you're *Florence + The Machine*, in which case the dog days are over). Things just tend to move a bit slower in August, and even the big news doesn't seem so big as people are intent on clinging to the last weeks of summer. And, sure, we'll admit it, at this time of the year, it is often difficult for us to come up with anything that seems even remotely as interesting as the beach as we try to fill these four pages. Ah, but this year we've lucked out which, in turn, means that you too have lucked out. It does mean that, right?

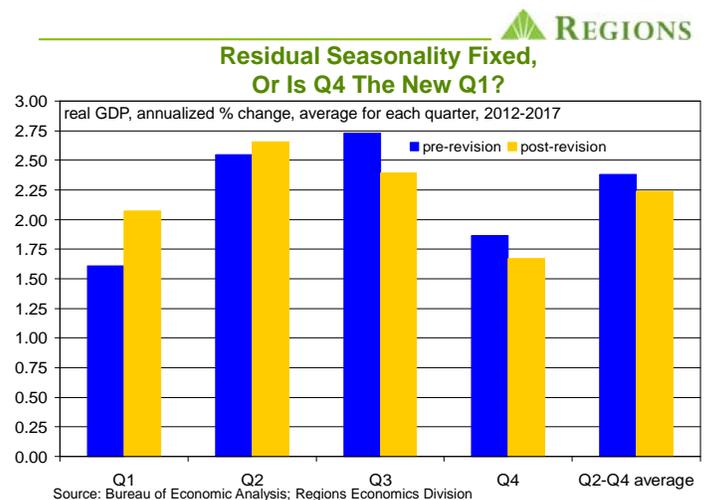
The Bureau of Economic Analysis (BEA) has come through for us, having just released their comprehensive revisions to the *National Income and Product Accounts (NIPA)* data from which GDP is estimated. That's right, not just revisions, but comprehensive revisions, such that the entire history of the GDP data was subject to revision, with some methodological changes thrown in for, well, for good measure. All of the sudden, the end of summer just got way more interesting, and our problem has at once gone from how to fill four pages to how to stop at just four pages.

On the whole, while there were some changes in quarterly growth patterns, the revised GDP data do not change the broader view of the U.S. economy – average quarterly real GDP growth from Q3 2009 (the start of the current expansion) through Q1 2018 is still just 2.2 percent. That said, there are some notable changes in the details of the GDP data, even if those changes can only be fully appreciated by those in our line of work. For instance, the BEA has addressed the issue of residual seasonality in the GDP data, which over the past two decades has tended to bias measured real GDP growth in the first quarter of any given year lower so that, on average, Q1 growth has lagged growth in the remaining quarters.

For instance, over the 2012-2017 period Q1 real GDP growth averaged 1.61 percent prior to the revisions, with growth over the remaining three quarters averaging 2.38 percent. To be sure, economic activity tends to slow during the winter months, as winter weather takes a toll on economic activity ranging from construction to tourism. Additionally, there are distinct seasonal patterns in government spending that can skew measures of economic activity. The purpose of seasonal adjustment, however, is to correct for these seasonal swings in economic activity and offer a clearer view of the underlying trends. Easier said than done, however, as has long been apparent in the GDP data. The term "residual seasonality" refers to the presence of seasonal patterns in data that have already been seasonally adjusted.

The BEA has been working to correct this issue for the past three years, and the revised data show the outcome of those efforts. Sure enough, the revised GDP data now peg average Q1 growth

over the 2012-2017 period at 2.07 percent. The flip side of this, however, is that growth over the remaining three quarters is now reported to be slower, with average growth of 2.24 percent. And, as seen in the following chart, one is tempted to ask if we've merely swapped the quarter in which residual seasonality is most pronounced from Q1 to Q4.

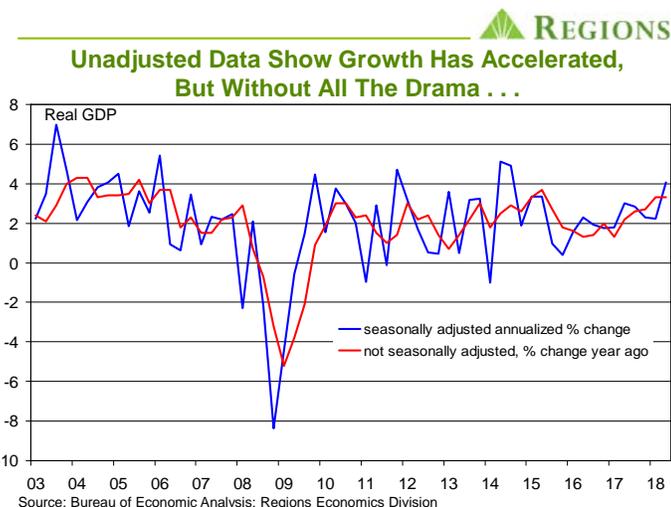


The revised GDP data show average Q4 real GDP growth of 1.67 percent over the 2012-2017 period, down from the pre-revision average of 1.87 percent, and well below growth in the other three quarters. Still, the BEA has expressed confidence that they have solved the problem of residual seasonality; we're not so sure. Answering that question, however, will be easier going forward than has been the case in the past as the BEA now publishes the raw, or, not seasonally adjusted, data for GDP and its components (with history dating back to 2002). Having the raw data will allow for more meaningful testing as to whether, or to what extent, seasonal patterns have been properly accounted for in the data reported on a seasonally adjusted and annualized basis.

Sure, we get that you are probably not as wildly excited by this as we are, but that's okay, as long as the ultimate outcome is having a more accurate portrayal of GDP growth. Along those lines, even aside from the issue of residual seasonality, we think the not seasonally adjusted data offer a better view of the underlying trend rate of GDP growth. This will come as no surprise to those who regularly read our updates of the high frequency data releases, in which we routinely stress the value of examining trends in the unadjusted data. Those readers will also know of our particular disdain for the practice of reporting data on a seasonally adjusted and annualized basis, as is the case with the GDP data.

Our view is that reporting the data on this basis exaggerates quarter-to-quarter (or, in other data series, month-to-month) changes, which can easily make economic activity look far more

volatile than is actually the case. Which of course leads to further annoyance, at least for us, when those commenting on the data feel compelled to come up with a narrative to explain volatility that doesn't actually exist. Take the most recent GDP data – real GDP is reported to have grown at annualized rates of 2.2 percent in Q1 2018 and 4.1 percent (pending revision) in Q2 2018. Again, these rates are based on seasonally adjusted data, and it is more than reasonable to ask whether an \$18 trillion (in real terms) economy really swung so sharply from one quarter to the next. This is the most recent, but far from the only, instance in which one can find drastic swings in reported growth from one quarter to the next.



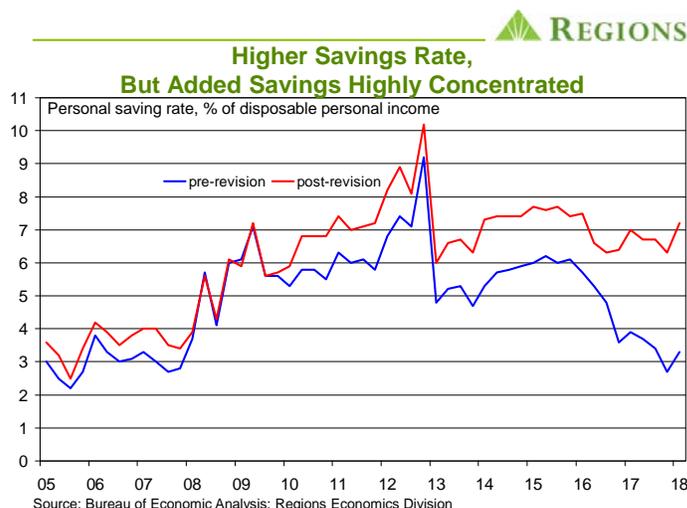
The above chart helps illustrate our point. The blue line shows real GDP growth on a seasonally adjusted and annualized basis, i.e., how the data are typically reported (and reacted to), and the red line shows the year-on-year percentage change in not seasonally adjusted GDP, using the just-released data from the BEA. Clearly, no matter how you measure it, real GDP growth has accelerated, but note the absence of sharp quarter-to-quarter swings in the series based on the not seasonally adjusted data. We'd argue that this is a more apt portrayal of the economy's trend rate of growth.

In contrast to the swings in real GDP growth reported on a seasonally adjusted annualized basis, year-on-year growth in not seasonally adjusted real GDP was 3.3 percent in each of the first two quarters of 2018 which, with the exception of Q2 2015, is the fastest growth in the life of the current expansion. Which also kind of answers our earlier question as to whether an \$18 trillion economy performed as differently in the first two quarters of this year as implied by the seasonally adjusted annualized growth rate. It remains to be seen whether, or to what extent, the unadjusted GDP data become part of the tool kits of analysts and the media. Admittedly, a relatively short history may diminish the appeal of the unadjusted data for some but, either way, we find the new data series to be a highly useful addition.

More Saving, But By Whom?

The introduction of the series on not seasonally adjusted GDP data largely escaped notice in accounts of the BEA's comprehensive revisions. In contrast, one element of the revisions that garnered considerable attention is the dramatic change in the personal saving rate. With good reason, we'd add – prior to the revisions,

the personal saving rate for Q1 2018 was reported to be 3.3 percent, but the revised data put the saving rate at 7.2 percent. Indeed, as seen in the following chart, the personal saving rate is now shown to be considerably higher going all the way back to 2010 than had previously been reported. A revision of this magnitude certainly changes what we all thought we knew about the financial condition of U.S. consumers.

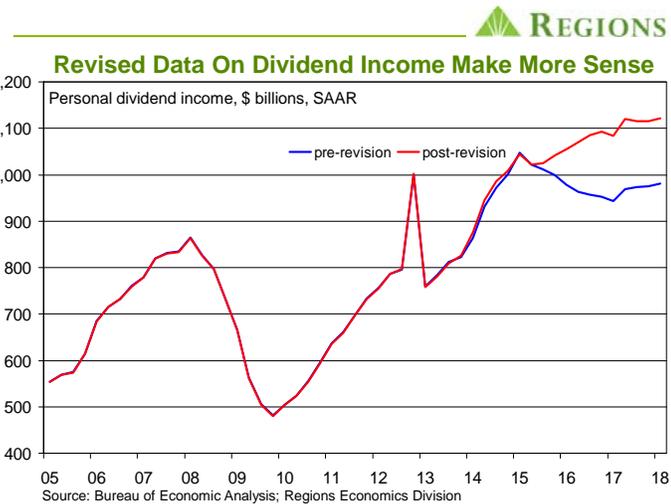
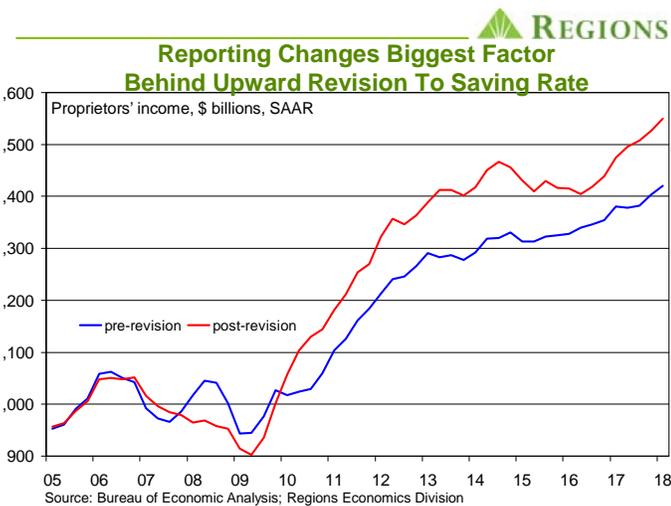


Unless of course it doesn't. Sure, many have spun the revised data into a new, decidedly more upbeat narrative on U.S. consumers, arguing that with such a large cushion of savings underneath them, consumers have the capacity to significantly ramp up the pace of their spending, which will surely extend the life of the current expansion. Which for us is simply yet another illustration of a point we make frequently – knowing what the number is does one little good without knowing why the number is what it is.

In other words, it is important to know why the saving rate has been revised higher before trying to explain what the higher saving rate actually means. Yes, the revised NIPA data show considerably more saving in the household sector than had previously been reported, but we'd argue that the higher saving rate says little, if anything, about the financial wherewithal of the vast majority of U.S. households. The saving rate is basically the difference between disposable (or, after-tax) personal income and personal spending, with a few other adjustments. As such, revisions to the saving rate can be the result of revisions to disposable personal income or to personal spending, or some combination of the two.

As to the most recent revisions, a slight downward revision to growth in consumer spending played a modest role, but the upward revision in the saving rate is almost entirely accounted for by upward revisions to two components of personal income – nonfarm proprietors' income and dividend income. The distribution of each of these components of total personal income is much more highly concentrated than is the distribution of income from wage and salary earnings, which for most households is far and away the largest single component of personal income. This goes to our point that the upward revisions to the saving rate, even though mostly due to an upward revision to personal income, have little bearing on the financial condition of the vast majority of U.S. households, contrary to many accounts we've seen.

The following two charts help put the revisions to the saving rate in proper context. The first chart shows proprietors' income (or, basically the net income of small business owners) before and after the revisions to the NIPA data. The revised data show that, beginning in 2010, proprietors' income grew at a significantly faster pace than had previously been reported (this faster growth was concentrated in the non-farm proprietors' category). The explanation offered by the BEA is that the difference mainly reflects reporting issues involving small business owners either underreporting income or misreporting income. Once corrected for, proprietors' income is shown to be much higher than had previously been reported and, as proprietors' income is a component of personal income, this is far and away the largest single factor behind the upward revision to the saving rate.



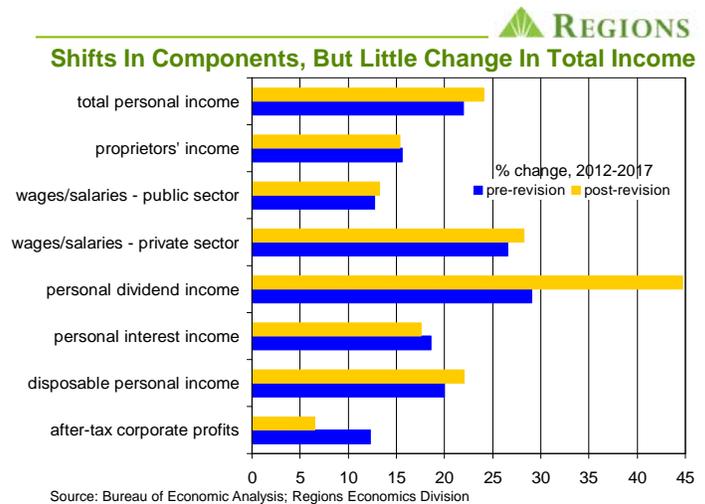
A significant upward revision to dividend income is the second largest factor in the upward revision to the saving rate, though the effects here are concentrated in the 2015-2017 period. Prior to the recent revisions, the personal income data showed a steady decline in personal dividend income beginning in March 2015 and persisting into early-2017. Aside from being greatly annoyed by this reported decline routinely wreaking havoc on our forecasts of monthly personal income, we had a hard time reconciling it with

what we observed in the equity markets and in the behavior of corporate profits. In other words, it never made any sense to us.

As it turns out, however, the revisions to the NIPA data resolve (even if perhaps only until the next comprehensive revision) this inconsistency, showing dividend income steadily rising over this two-year period. As the reported decline in dividend income contributed to the decline in the saving rate that began in late-2015 prior to the revisions, the upward revision to dividend income helps account for the upward revision to the saving rate.

Again, our point here is that income derived from these two sources is more concentrated amongst a smaller swath of U.S. households than is the case for wage and salary earnings. As such, that the saving rate has been revised higher, and significantly so, doesn't materially alter the financial situation of most households. It is important to keep in mind that, regardless of whether or not it was adequately captured in the data, this is income that was available all along to those who had earned it, which accounts for why there wasn't a corresponding upward revision to consumer spending in the BEA's comprehensive revisions. Also keep in mind that the empirical evidence shows the marginal propensity to consume (or, how much of an extra dollar of income will be spent) for higher-income households to be significantly smaller than that for lower-income households, so it makes sense that the revisions to income stemming from these two sources would be manifested in a higher saving rate.

Hopefully, the above discussion helps point to the folly of drawing sweeping conclusions based on changes in a "headline" number, in this case the personal saving rate, without knowing the sources of that change. This is not to dismiss the significance of a higher saving rate (after all, saving is the pool out of which investment outlays are financed), but instead simply to note that the implications for the consumer sector of the U.S. economy are far less pronounced than implied by the change in the saving rate.



For the sake of completeness, the above chart shows reported growth in the main components of personal income over the 2012-2017 period before and after the comprehensive revisions to the NIPA data. We also show the same for corporate profits – it could be that some of what had been classified as corporate profits was shifted into proprietors' income, though the BEA did not address

this point. And, if the slight downward revision in the growth of proprietors' income shown in the above chart seems at odds with the earlier discussion, like many things in life it's a matter of timing. Growth in proprietors' income over the 2010-2013 period is now shown to be significantly faster than had previously been reported, so that the level of proprietors' income was ultimately also significantly higher. In the chart immediately above, the time frame for comparison is 2012-2017, which is simply the period we concentrated on in our analysis of the revisions to the GDP data.

In another illustration that the revisions to the NIPA data do not necessarily mean what one might think, recent growth in business investment spending was revised higher, which at first we took to be a positive sign. After all, we have for years been bemoaning the weakness of business investment spending over the life of the current expansion, and the revised data would seem to allay at least some of our concerns. But, over half of the upward revision to growth in real business investment spending reflects revisions to the relevant price deflators, as opposed to greater quantities of capital equipment having been purchased. In other words, prices of capital equipment did not rise by as much as had previously been estimated, meaning that when measured in real, or, inflation adjusted, terms, growth in capital outlays is shown to be faster. Which, sadly, doesn't buy us the faster productivity growth needed for the economy to grow at a faster rate on a sustained basis.

There are other interesting elements of the revisions to the NIPA data – no, really, there are – and there are still segments of the data we have yet to work through. We do so, and quite happily, so you don't have to. And, who knows, there may be an outcry amongst our readers for a comprehensive quarter-by-quarter summary of the revisions to the NIPA data going all the way back to 1929, in which case . . . forget it, even we have our limits.

"Strong" Is The (FOMC's) Word. . .

As expected, the FOMC left the Fed funds rate target range unchanged at their meeting which concluded on August 1. In their post-meeting statement, however, the Committee teed up a September rate hike with the use of the word "strong" (or a derivative thereof) six times to characterize the labor market and the broader economy. We'd find it hard to argue with that characterization, even if the headline numbers on some of the latest data releases seem to suggest otherwise.

For instance, total nonfarm employment rose by "only" 157,000 jobs in July, well below expectations of an increase of 190,000 jobs. That "miss" on July job growth, however, must be put in the context of sharp upward revisions to job growth over the previous two months. Prior estimates of job growth in May and June were revised higher by a net 59,000 jobs over the two-month period.

On the whole, the July employment report is more noise than signal. For instance, local government payrolls are reported to have fallen by 20,000 jobs in July, with 13,900 of these job losses coming in education. This is nothing more than noise reflecting the difficulty of seasonally adjusting the data for this segment given that the timing of the school year changes from year to year.

Additionally, the closing of remaining *Toys R Us* stores took 31,800 jobs out of retail trade in July, which says more about the changing nature of retail trade than about the underlying health of the U.S.

economy. The bottom line is that even with the "miss" in July, monthly job growth has averaged 201,000 jobs over the past 12 months (not seasonally adjusted), roughly double the number needed to absorb growth in the labor force.

A beneath-the-headline trend we have been highlighting for some time continued in July, as over 4.8 million people transitioned from not in the labor force in June to employed in July. This number has averaged over 4.5 million over the past 21 months, which is a high number by historical standards, even when scaled to the size of the labor force. To be sure, you must also account for those who leave the labor force each month, but, on net, inflows into the labor force, the vast majority of whom are employed upon entry, continue to significantly outpace outflows from the labor force.

This goes to our point that there is still significant unabsorbed slack in the labor market, more so than implied by the headline, or, U3, unemployment rate, which fell to 3.9 percent in July. The broader U6 measure, which also accounts for underemployment, fell to 7.5 percent in July, the lowest since May 2001, on a sharp decline in the number of those working part-time for economic reasons. This goes to another point we've frequently made, which is that firms still have ample capacity to add to total labor input by upping average weekly hours of current workers, as the length of the average workweek remains shorter than it would were firms facing widespread labor supply constraints.

Both the ISM Manufacturing Index and the ISM Non-Manufacturing Index fell in July, the latter to an 11-month low. In each case, however, the underlying details are more robust than implied by the headline index. Firms in both broad sectors continue to report solid growth in demand, but also report intensifying transportation bottlenecks and rising input costs. Still, even having fallen in July, the ISM indexes remain firmly in expansionary territory, where we expect them to stay over coming quarters.

Our view, supported by the ISM data, is that the demand side of the economy remains solid, which is to be expected given robust job growth and the high degree of fiscal stimulus coursing through the economy. For us, the ISM's gauges of new orders will be the canaries in the coal mine in terms of assessing demand growth, but at present, our main concerns are on the supply side of the economy. Certain industry groups, mainly construction and transportation & warehousing, are facing pressing labor supply constraints. Firms, both manufacturing and non-manufacturing, are facing backlogs of unfilled orders that continue to grow, even if at a slightly slower pace of late. Tariffs are contributing to higher input costs and causing firms to rethink production schedules. The danger is that these supply side pressures will lead to intensifying inflation pressures, which in turn would impact the pace at which the FOMC raises the Fed funds rate.

Still, while acknowledging the downside risks, we expect real GDP growth of around 3.0 percent over the back half of 2018. Our view is that the economy's underlying momentum combined with the high degree of fiscal stimulus will more than offset any potential disruptions from trade policy over the remainder of this year. Our worries are more concentrated on the supply side of the economy, which we see as more of an issue for 2019 than for 2018. For now, our outlook is consistent with the FOMC remaining on a path of gradual Fed funds rate hikes, with 25-basis point hikes coming at both the September and December FOMC meetings.

ECONOMIC OUTLOOK



August 2018

| Q1 '18 (a) | Q2 '18 (p) | Q3 '18 (f) | Q4 '18 (f) | Q1 '19 (f) | Q2 '19 (f) | Q3 '19 (f) | Q4 '19 (f) | | 2016 (a) | 2017 (a) | 2018 (f) | 2019 (f) | 2020 (f) |
|------------|------------|------------|------------|------------|------------|------------|------------|---|----------|----------|----------|----------|----------|
| 2.2 | 4.1 | 3.4 | 2.8 | 2.4 | 2.1 | 1.8 | 1.5 | Real GDP ¹ | 1.6 | 2.2 | 2.9 | 2.5 | 1.4 |
| 0.5 | 4.0 | 3.2 | 2.8 | 2.5 | 2.2 | 2.1 | 2.1 | Real Personal Consumption ¹ | 2.7 | 2.5 | 2.6 | 2.6 | 2.1 |
| | | | | | | | | Business Fixed Investment: | | | | | |
| 10.8 | 5.6 | 5.2 | 4.5 | 4.7 | 4.1 | 3.0 | 2.6 | Equipment, Software, & IP ¹ | 2.1 | 5.5 | 7.1 | 4.3 | 2.1 |
| 13.9 | 13.3 | 5.1 | 5.2 | 3.9 | 3.2 | 1.8 | 0.7 | Structures ¹ | -5.0 | 4.6 | 6.5 | 4.2 | 0.4 |
| -3.4 | -1.1 | 2.8 | 0.3 | 1.0 | 2.9 | 1.8 | 1.1 | Residential Fixed Investment ¹ | 6.5 | 3.3 | 0.9 | 1.4 | 1.1 |
| 1.5 | 2.1 | 1.2 | 1.7 | 0.9 | 1.2 | 0.6 | -0.5 | Government Expenditures ¹ | 1.4 | -0.1 | 1.4 | 1.1 | -0.5 |
| -902.4 | -849.9 | -896.9 | -910.2 | -925.0 | -936.6 | -946.7 | -953.3 | Net Exports ² | -786.2 | -858.7 | -889.9 | -940.4 | -983.4 |
| 1.317 | 1.262 | 1.275 | 1.282 | 1.291 | 1.296 | 1.302 | 1.302 | Housing Starts, millions of units ³ | 1.177 | 1.208 | 1.284 | 1.298 | 1.312 |
| 17.1 | 17.2 | 16.9 | 16.9 | 16.8 | 16.7 | 16.6 | 16.5 | Vehicle Sales, millions of units ³ | 17.5 | 17.1 | 17.0 | 16.7 | 16.2 |
| 4.1 | 3.9 | 3.9 | 3.8 | 3.7 | 3.7 | 3.6 | 3.6 | Unemployment Rate, % ⁴ | 4.9 | 4.4 | 3.9 | 3.6 | 3.6 |
| 1.5 | 1.6 | 1.7 | 1.6 | 1.5 | 1.3 | 1.1 | 1.0 | Non-Farm Employment ⁵ | 1.8 | 1.6 | 1.6 | 1.2 | 0.8 |
| 4.4 | 2.6 | 1.9 | 2.4 | 2.5 | 2.0 | 2.3 | 2.1 | Real Disposable Personal Income ¹ | 1.7 | 2.6 | 2.8 | 2.3 | 2.0 |
| 2.0 | 2.5 | 2.6 | 2.5 | 2.6 | 2.5 | 2.5 | 2.5 | GDP Price Index ⁵ | 1.1 | 1.9 | 2.4 | 2.5 | 2.2 |
| 1.9 | 2.2 | 2.3 | 2.1 | 2.1 | 2.1 | 2.1 | 2.2 | PCE Deflator ⁵ | 1.1 | 1.8 | 2.1 | 2.1 | 2.1 |
| 2.3 | 2.6 | 2.7 | 2.4 | 2.0 | 2.1 | 2.0 | 2.0 | Consumer Price Index ⁵ | 1.3 | 2.1 | 2.5 | 2.0 | 2.0 |
| 1.7 | 1.9 | 2.1 | 2.1 | 2.1 | 2.1 | 2.1 | 2.2 | Core PCE Deflator ⁵ | 1.7 | 1.6 | 1.9 | 2.1 | 2.2 |
| 1.9 | 2.2 | 2.3 | 2.3 | 2.2 | 2.3 | 2.4 | 2.4 | Core Consumer Price Index ⁵ | 2.2 | 1.8 | 2.2 | 2.3 | 2.4 |
| 1.41 | 1.68 | 1.90 | 2.17 | 2.42 | 2.67 | 2.88 | 2.88 | Fed Funds Target Rate Range Mid-Point, % ⁴ | 0.39 | 0.97 | 1.79 | 2.71 | 2.88 |
| 2.76 | 2.92 | 2.97 | 3.05 | 3.10 | 3.20 | 3.40 | 3.45 | 10-Year Treasury Note Yield, % ⁴ | 1.84 | 2.33 | 2.93 | 3.29 | 3.49 |
| 4.28 | 4.54 | 4.65 | 4.73 | 4.78 | 4.88 | 5.08 | 5.13 | 30-Year Fixed Mortgage, % ⁴ | 3.65 | 3.99 | 4.55 | 4.97 | 5.17 |
| -2.5 | -2.2 | -2.3 | -2.4 | -2.4 | -2.5 | -2.7 | -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

Regions Financial Corporation, 1900 5th Avenue North, 17th Floor, Birmingham, Alabama 35203

Richard F. Moody
Chief Economist

Greg McAtee
Senior Economist