ECONOMIC OUTLOOK

REGIONS

December 2018

This Economic Outlook may include opinions, forecasts, projections, estimates, assumptions, and speculations (the "Contents") based on currently available information which is believed to be reliable and on past, current and projected economic, political, and other conditions. There is no guarantee as to the accuracy or completeness of the Contents of this Economic Outlook. The Contents of this Economic Outlook reflect judgments made at this time and are subject to change without notice, and the information and opinions herein are for general information use only. Regions specifically disclaims all warranties, express or implied, with respect to the use of or reliance on the Contents of this Economic Outlook or with respect to any results arising therefrom. The Contents of this Economic Outlook shall in no way be construed as a recommendation or advice with respect to the taking of any action or the making of any economic, financial, or other plan or decision.

Business Investment Running Out Of Steam?

The BEA's second estimate shows real GDP grew at an annualized rate of 3.5 percent in Q3, matching the first estimate. Though the top-line growth number was unchanged, there were some notable revisions to the underlying details. The revisions we were the most interested in were those pertaining to business fixed investment. Recall that the BEA's first estimate showed real business fixed investment grew at an annualized rate of just 0.8 percent in Q3, a sharp and sudden slowdown from annualized growth of 11.5 percent in Q1 and 8.7 percent in Q2. After having posted double-digit growth in each of the first two quarters of 2018, real business spending on structures was reported to have declined markedly in Q3. As this is a highly volatile category, the reported decline in Q3 was more disappointing than alarming. Of more consequence was that real business spending on equipment and machinery was said to have grown at an annualized rate of just 0.4 percent in Q3, far below average growth of 8.6 percent over the prior six quarters.

In the wake of the initial report on Q3 GDP, some were quick to pounce on the weak print on business investment spending as "proof" that the "sugar high" had worn off and that the 2017 tax bill was "a flop" in that it had failed to spark the much touted surge in business investment spending that would sustain a faster pace of economic growth over coming years. This simply illustrates the difference between trying to understand what the data are saying and trying to make the data say what you want it to say. While we prefer the former approach, there is, sadly, no shortage of those preferring the latter approach. But, you know, whatever works.

In our analysis of the first estimate of Q3 GDP, we noted the weak print on business investment was at odds with the monthly data on core capital goods orders and shipments, and said that it was best to wait and see what the revised GDP data had to say before drawing conclusions about the health of business investment. As if by magic coincidence, the revised data said that real business fixed investment grew at an annualized rate of 2.5 percent in Q3, with annualized growth in business investment in equipment and machinery of 3.5 percent, neither great by any means, but by no means as tepid as first reported. If we cared enough to bother, upon the release of the revised Q3 GDP data we would have scoured the internet, looking for retractions from those who used the initial estimate to bury the 2017 tax bill. We don't, so we didn't, but if we had, we likely would have found . . . not a single word.

In any event, we think this – business investment, that is – is a topic worth addressing for reasons that go beyond the effect on top-line real GDP growth. Indeed, over the past few years we have devoted considerable attention to patterns in business investment, in large measure because we've argued that what has been weak capital spending over much of the current cycle is the main culprit behind what has been anemic labor productivity growth. At the same time, however, growth in business investment picked up considerably beginning in Q1 2017, i.e., before there was a 2017 tax bill (which cleared Congress in December 2017). That faster growth, however, went largely unnoticed, which led us to refer to it as the most underreported story of 2017.

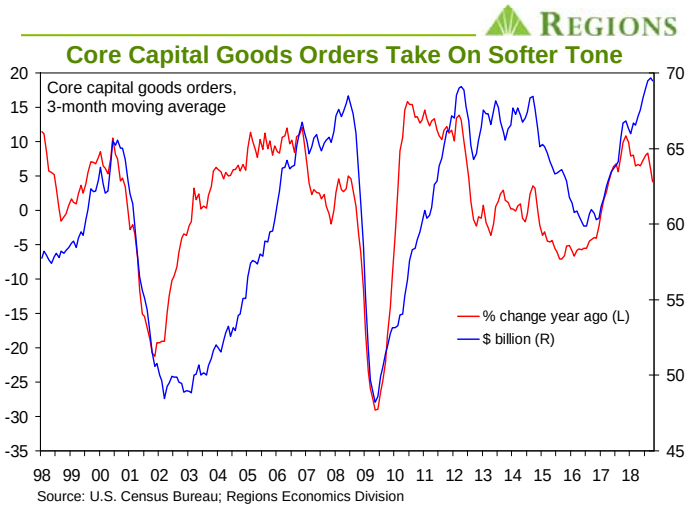
To us, the behavior of business investment over the current economic expansion has simply reflected businesses responding to the set of incentives facing them at various stages of the cycle. We've discussed this on many occasions, so we'll just offer the short version here. In what was clearly going to be a slow and uneven recovery from the 2007-09 recession, firms simply had little incentive to invest in additional capital given that: a)they were sitting on considerable idle capacity; and b)they had access to an abundant pool of readily available and relatively cheap labor. Firms responded by basically substituting labor for capital, which enabled them to meet what was, generally, tepid growth in demand. While firms to some degree kept up with replacement investment, there was simply little incentive for them to expand their capital stocks. One implication of this labor-for-capital substitution was an anemic trend rate of labor productivity growth, as growth in (real) output barely outpaced growth in aggregate hours worked.

As the expansion endured, the incentive set facing firms evolved. Steadily tightening labor market conditions meant labor became increasingly less plentiful and more costly, while a prolonged period of underinvestment had left firms with an increasingly aged and inefficient capital stock. In other words, the labor-capital math had flipped to the point that firms were incented to invest in capital to a much greater degree than had been the case earlier in the expansion. And, increased confidence in the economic outlook in the wake of the 2016 election added even more incentive for firms to step up capital spending. These were, at least in our view, key drivers of the marked acceleration in growth of business fixed investment that began in Q1 2017.

Still, though not nearly to the extent implied by the initial estimate of Q3 GDP, growth in business investment did slow in Q3, and the monthly data show core capital goods orders and shipments have softened of late. As such, it is more than fair to ask where business investment spending goes from here. At present, there are two factors acting as drags on growth in business investment. First, capital spending in the energy sector is highly sensitive to the outlook for energy prices, so to the extent the recent declines in crude oil prices are not expected to reverse, at least to any meaningful degree, this will hold down capital spending. This will be far more evident in the data on business spending on structures, of which the energy sector accounts for a much higher share than in spending on equipment and machinery.

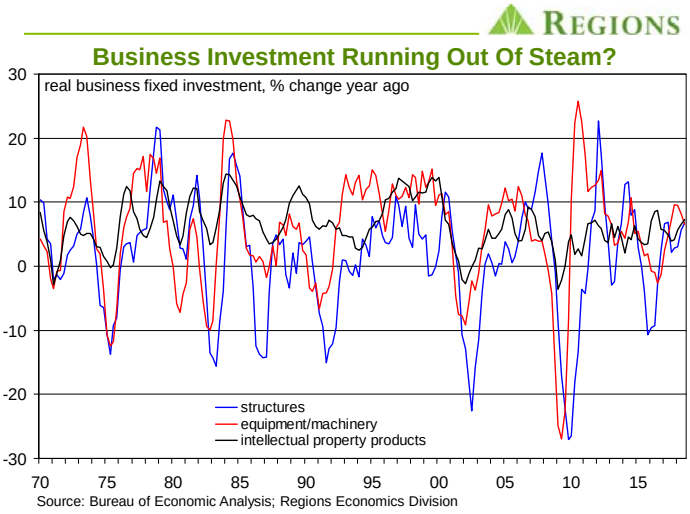
A second factor that is likely weighing on growth in business investment is uncertainty over trade policy, or, more specifically,

the extent to which tariffs will become more punitive and more widespread – geographically and across classes of goods. In the most recent round of corporate earnings calls, trade policy was cited as a headwind and a source of uncertainty for companies across a broad swath of industry groups, much more so than was the case with interest rates. Additionally, the monthly *Institute for Supply Management* (ISM) surveys, covering both manufacturing and non-manufacturing activity, show firms across a wide range of industry groups pointing to tariffs as a source of uncertainty. And, sure, we know the only thing that is ever certain is that nothing is ever certain, but policy uncertainty can, and does, get in the way of firms making decisions on hiring, investment, and, in the case of trade policy, the configuration of supply pipelines.



Though growth has slowed of late, core capital goods orders are still on course to post another solid increase in 2018, up 6.2 percent on a year-to-date basis through October. This follows a 6.7 percent increase in 2017, with the growth in 2017 and 2018 in stark contrast to the average annual 1.0 percent decline seen over the 2012 through 2016 period. And, while it is popular to dismiss the rise and fall of core capital goods orders as reflecting nothing more than the twists and turns of the energy sector, the data tell us otherwise. Mining/oil & gas field equipment has accounted for between two and four percent of core capital goods orders over the past few years, and has accounted for a similar share of business investment in equipment and machinery as measured in the GDP data. The details of the data show growth in core capital goods orders over the past two years has been broad based; the only two components posting year-to-date declines in 2018 are household appliances and electric lighting equipment, and it is worth noting the former category has been subject to tariffs that have resulted in significant price increases for consumers.

Orders for core capital goods ultimately become, excluding of course any cancelled orders, shipments of core capital goods, and these shipments flow into the GDP data on business investment in equipment and machinery. This, however, is only one component of the broader business fixed investment category reported in the GDP data, which also includes business investment spending on structures and on intellectual property products. It is important to account for each of these components when assessing the data on business fixed investment and when forming conclusions on the outlook for capital spending going forward.

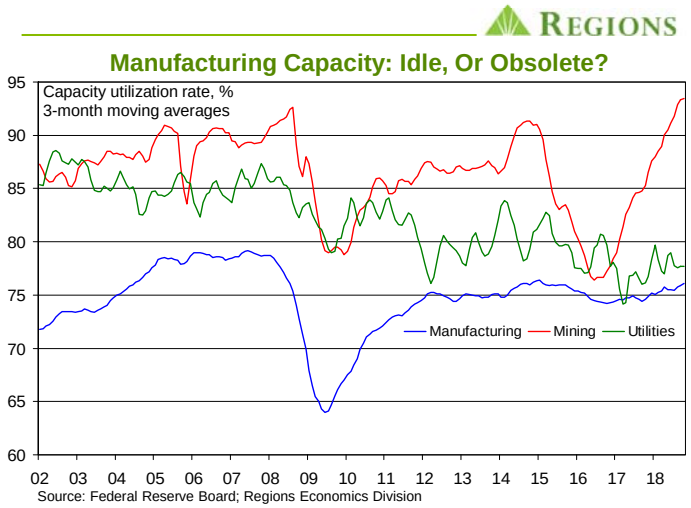


The above chart shows year-on-year growth for each of the three components of business fixed investment spending, on an inflation adjusted basis, as reported in the GDP data. As seen in the chart, growth in real spending on equipment and machinery has slowed, in line with the higher frequency data on core capital goods orders and shipments. Still, on a year-on-year basis, real investment in equipment and machinery was up 6.6 percent, real investment in business structures was up 6.8 percent, and investment in intellectual property products was up 7.3 percent in Q3. Hardly a picture of business investment falling off a cliff.

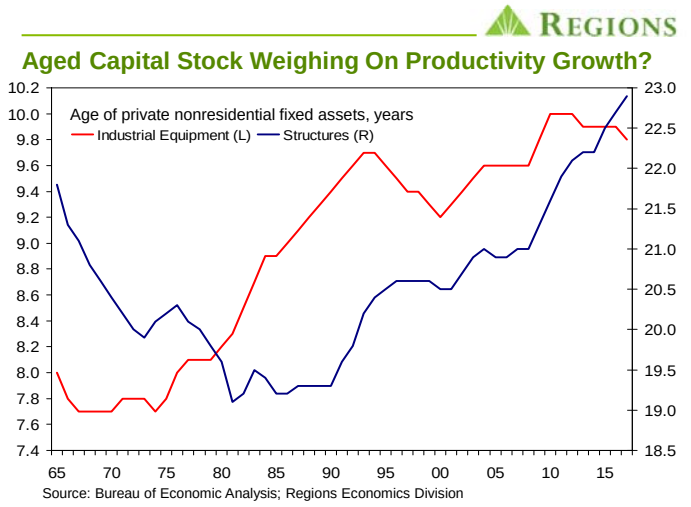
To be sure, there is room for confusion stemming from the manner in which the GDP data are reported. For instance, real spending on business structures fell at an annualized rate of 1.7 percent in Q3 (a much smaller decline than initially reported) after having grown at annualized rates of 13.9 percent in Q1 and 14.5 percent in Q2, numbers quite at odds with what is shown in the above chart. This, as our regular readers well know, is why we have little use for annualized changes – taking quarter-to-quarter changes and annualizing them can yield some eye-catching "growth" numbers, particularly on a small base, that actually tell us little, if anything, about what is actually going on in the economy. Sure, on an annual basis the changes are the same, but drawing conclusions on changes in the data from one time period to the next on this basis can be misleading.

In any event, there is reason, at least to us, to think the slowdown in growth of business investment over the past few months is a pause in, rather than the beginning of the end of, growth. One thing that strikes us in the monthly data on industrial production is that the capacity utilization rate in the manufacturing sector has not moved much since 2012, even in the midst of what for the past 27 months has been solid and broad based growth in the factory sector as reported in the ISM data on manufacturing. Though the capacity utilization rate has risen over the past year, it has been a modest and uneven increase, and leaves the capacity utilization rate at 76.2 percent as of October (the last observation available at this writing). While it is true that rapid growth in business outlays on machinery and equipment since early-2017

will have checked upward pressure on the utilization rate, it still seems odd that the utilization rate has not risen further.



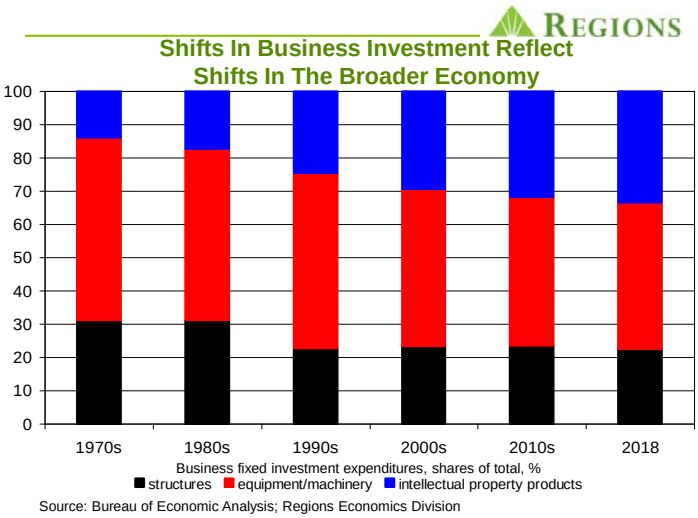
The above chart shows capacity utilization rates for the three broad sectors reported in the data on industrial production (we show three-month moving averages to smooth out the volatility in the data). At first glance, the chart would suggest there is ample spare capacity in the manufacturing sector, which would in turn suggest firms, at least in the aggregate, have little need to invest to expand their capital stocks. In sharp contrast is the capacity utilization rate of 92.7 percent in the mining sector as of October, which suggests firms in the energy sector have considerable incentive to undertake additional capital spending, at least to the extent oil prices are not expected to continue falling.



Returning our attention to the manufacturing sector, we wonder whether there is truly as much idle capacity as is implied by the capacity utilization rate. It could be that, rather than being idle, a good portion of the capital stock in the manufacturing sector is simply obsolete, i.e., capital that is still on the books, and as such accounted for in the capacity utilization rate, but simply not viable from an age/efficiency standpoint. This is where we think the age of the capital stock may come into play; as seen in the above chart, the capital stock is old relative to historical standards.

To the extent we are correct on this point, there are several implications. Perhaps most significantly, if the capital stock is older and less efficient, it will be a drag on growth in labor productivity. As labor market conditions continue to tighten, it becomes more imperative for firms to make their existing workforces more efficient which, with an older and less efficient capital stock, in turn means firms must step up capital investment.

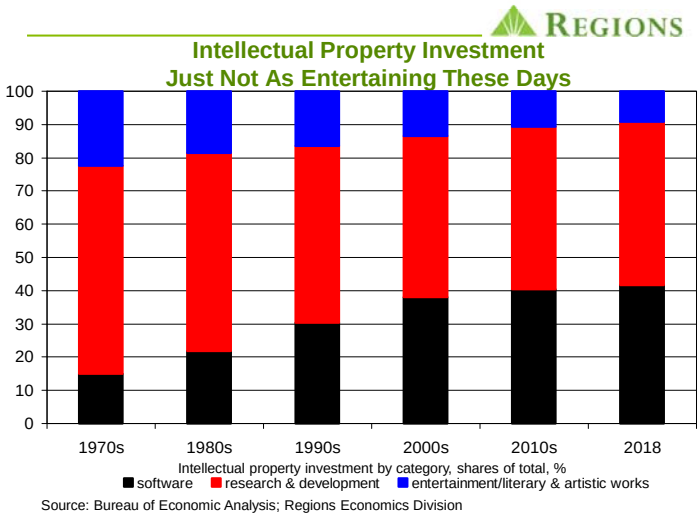
It is also important to note that investment in plant and equipment is not the only channel through which business investment impacts labor productivity. As we noted earlier, business fixed investment is broken down into three main components – equipment and machinery, structures, and intellectual property products. Though the latter category goes largely unnoticed, it is actually an increasingly critical component of business investment spending, as illustrated in the following chart.



The chart above shows the shares of business fixed investment accounted for by each of the three broad components over the past several decades. For instance, during the 1970s, spending on structures accounted for 31.23 percent of total business fixed investment, spending on equipment and machinery accounted for 55.01 percent, and spending on intellectual property products accounted for 13.76 percent. Through Q3, spending on structures accounted for 22.65 percent of total business fixed investment, spending on equipment and machinery accounted for 43.94 percent, and spending on intellectual property products accounted for 33.41 percent in 2018. The shifts in these shares simply reflect the structural shifts in the U.S. economy over this same time frame, most notably the extent to which technology has become more and more imbedded across the different sectors of the economy, including manufacturing. And, to our earlier point, over the past several years energy's share of private business spending on structures has varied widely, between 25 and 65 percent, which, again, is where the effects of energy are most apparent in the data on business investment spending.

As for intellectual property products, this broad category is the aggregation of three components – computer software, research and development, and original entertainment/artistic/literary works (you know, like what you are reading now {okay, fine, bad example}). Whether that third component has anything to do with economic growth or labor productivity is another debate for

another day, but there is little doubt that business spending on software can enhance worker productivity. The same is true of business outlays on research and development, though the link is less straightforward and takes longer to develop. It is these latter two components that account for the bulk business investment in intellectual property products, as illustrated in the following chart.



Again, the shifts in the shares seen in the above chart simply reflect shifts in the broader economy, and through Q3 spending on software accounted for 41.59 percent of total business spending on intellectual property products in 2018, with research and development accounting for 49.24 percent and entertainment and literary/artistic works accounting for 9.16 percent. As such, no discussion of business investment is complete unless it accounts for spending in these categories. Most discussions do not, at least in part due to there being a lack of the kind of timely, higher frequency data available for other forms of investment.

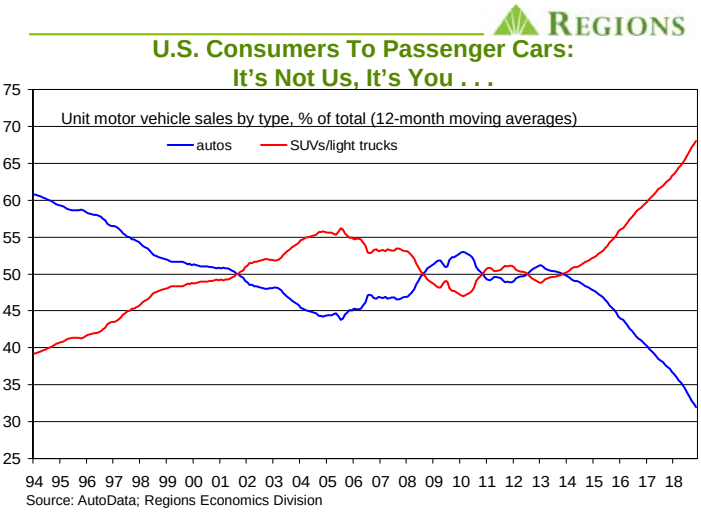
If anything, business spending on software and on research and development figures to be increasingly critical, both in the near term and over the longer-term. Steadily tightening labor market conditions over the near term will make it more critical that businesses eke out efficiency gains, many of which will come via applications of new technology/software. Over the longer term, with less than inspiring demographic trends holding down growth in the labor force, increased efficiency and increased automation are likely to be increasingly important themes, and this will be reflected in patterns in business investment spending.

In short, we can point to a number of factors that should sustain growth in business investment spending over coming quarters, even if that growth does not match the average annualized growth of 8.6 percent seen over the Q1 2017-Q2 2018 period. Our view of the role of the 2017 tax bill has not changed. We never thought of the tax bill as being the catalyst for a "boom" in business investment spending, but instead thought it a factor which would add to the incentives that had already prompted firms to step up the pace of capital spending and which may help extend the cycle.

Our view all along has been that a sustained period of faster growth in business investment spending was necessary for there to be a meaningful and sustained acceleration in labor productivity growth. This, in turn, would allow for faster wage growth which would not impinge on corporate profit margins. While there has been a gentle acceleration in productivity growth over recent quarters, that needs to be sustained over coming quarters for there to be an appreciable increase in the economy's "speed limit," i.e., its capacity to grow at a faster pace for a sustained period without sparking inflation pressures. Our view is that, while there are many who seem to have already crafted their own end to it, the story on business investment has yet to be written.

U.S. Consumers Breaking Up With Passenger Cars . . .

One of life's harsher truths is that when someone tells you "it's not you, it's me," it really is you. Get told that enough times, you figure it out. Having long ago figured that out, we can at least appreciate the honest manner in which U.S. consumers are breaking up with passenger cars, effectively saying "it's not us, it's you." The reality is that, while this break-up has been in progress for some time, it is only recently coming into sharper focus. Both Ford and General Motors have announced plans to discontinue production of many lines of the smaller, more fuel efficient passenger cars that have fallen out of favor with U.S. consumers, as shown below.



The share of unit motor vehicle sales accounted for by SUVs/light trucks has been steadily increasing over recent years and hit 70 percent in November. What have been low interest rates, friendlier loan terms, and, for the most part, low gasoline prices have played a role in sustaining this shift. With SUVs/light trucks themselves more fuel efficient, higher retail gasoline prices would have less of an impact on the mix of sales now than in the past. Thus far, higher interest rates haven't made a dent in SUV/truck sales, but it remains to be seen how high rates can go before that changes given much higher sticker prices on SUVs/light trucks. Additionally, we think that motor vehicle sales are past their cycle high, which in and of itself shouldn't have a large impact on the sales mix. But, to the extent motor vehicle sales decline during the next recession, whenever that comes, it is fair to ask whether consumers will still be so enamored with larger, pricier SUVs/light trucks. That they will have fewer alternatives, at least amongst vehicles made by domestic producers, may mean any decline in motor vehicle sales is more severe than would have otherwise been the case. At some point, consumers and producers may be re-thinking this break-up.

ECONOMIC OUTLOOK

REGIONS

December 2018

Q2 '18 (a)	Q3 '18 (a)	Q4 '18 (f)	Q1 '19 (f)	Q2 '19 (f)	Q3 '19 (f)	Q4 '19 (f)	Q1 '20 (f)		2016 (a)	2017 (a)	2018 (f)	2019 (f)	2020 (f)
4.2	3.5	2.8	2.2	2.5	2.4	2.0	1.6	Real GDP[1]	1.6	2.2	2.9	2.6	1.7
3.8	3.6	3.4	3.0	2.7	2.3	2.3	2.1	Real Personal Consumption[1]	2.7	2.5	2.7	3.0	2.1
								Business Fixed Investment:					
7.0	3.8	6.5	5.1	4.6	3.8	3.3	2.6	Equipment, Software, & IP[1]	2.1	5.5	7.3	5.0	2.8
14.5	-1.7	4.6	-0.7	0.2	0.5	0.9	1.4	Structures[1]	-5.0	4.6	5.8	1.5	1.2
-1.3	-2.6	-2.4	0.0	-0.4	1.4	2.1	2.9	Residential Fixed Investment[1]	6.5	3.3	0.0	-0.6	2.4
2.5	2.6	1.4	1.5	1.6	0.9	0.3	-0.2	Government Expenditures[1]	1.4	-0.1	1.6	1.6	0.0
-841.0	-945.8	-950.1	-928.0	-938.6	-952.0	-962.4	-974.9	Net Exports[2]	-786.2	-858.7	-909.8	-945.2	-999.4
1.261	1.225	1.220	1.230	1.238	1.251	1.269	1.284	Housing Starts, millions of units[3]	1.177	1.208	1.256	1.247	1.303
17.2	16.9	17.3	17.0	16.8	16.6	16.6	16.6	Vehicle Sales, millions of units[3]	17.5	17.1	17.1	16.8	16.4
3.9	3.8	3.7	3.6	3.6	3.5	3.5	3.5	Unemployment Rate, %[4]	4.9	4.4	3.9	3.6	3.5
1.6	1.7	1.7	1.6	1.4	1.3	1.1	1.0	Non-Farm Employment[5]	1.8	1.6	1.6	1.4	0.9
1.8	2.4	2.7	3.2	2.1	2.2	2.1	2.2	Real Disposable Personal Income[1]	1.7	2.6	2.7	2.5	1.9
2.5	2.4	2.4	2.6	2.4	2.6	2.5	2.4	GDP Price Index[5]	1.1	1.9	2.3	2.5	2.3
2.2	2.2	1.9	1.6	1.7	1.9	2.0	2.2	PCE Deflator[5]	1.1	1.8	2.0	1.8	2.3
2.6	2.6	2.2	1.5	1.7	1.7	1.8	2.1	Consumer Price Index[5]	1.3	2.1	2.4	1.7	2.1
1.9	2.0	1.8	1.8	1.8	1.9	2.1	2.1	Core PCE Deflator[5]	1.7	1.6	1.9	1.9	2.2
2.2	2.2	2.2	2.0	2.1	2.1	2.2	2.3	Core Consumer Price Index[5]	2.2	1.8	2.1	2.1	2.3
1.68	1.89	2.16	2.43	2.66	2.88	2.88	2.88	Fed Funds Target Rate Range Mid-Point, %[4]	0.39	0.98	1.78	2.71	2.88
2.92	2.92	3.06	3.00	3.10	3.20	3.30	3.30	10-Year Treasury Note Yield, %[4]	1.84	2.33	2.92	3.15	3.28
4.54	4.57	4.71	4.69	4.77	4.89	5.00	5.01	30-Year Fixed Mortgage, %[4]	3.65	3.99	4.53	4.84	5.01
-2.0	-2.3	-2.4	-2.4	-2.5	-2.7	-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