ECONOMIC OUTLOOK

REGIONS

August 2019

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The More Things Change, The More They Don't . . .

As they do each year, in late-July the Bureau of Economic Analysis (BEA) released their revised data on the National Income and Product Accounts (NIPA), from which are drawn estimates of GDP and all of the underlying components. The annual NIPA revisions incorporate revised source data and, when applicable, introduce methodological changes in the estimation of the underlying components of GDP. About every five years, the annual revisions are "comprehensive" revisions, meaning that the entire history of the GDP data is re-estimated and, for the real (i.e., inflation adjusted) GDP data, a new base year is adopted. As last year was a comprehensive revision, this year's revision covered only the five years of historical data from Q1 2014 through Q1 2019.

Ahead of the release of the revised NIPA data, we noted that while there would likely be changes in the quarterly growth patterns, we did not expect any meaningful changes to the overall trajectory of real GDP growth over the past five years. That turned out to be the case; the revised data show average annualized real GDP growth of 2.466 percent over the Q1 2014-Q1 2019 period, compared to the average annualized growth of 2.448 percent reported prior to the revisions (in the spirit of Cliff Clavin, we show three digits after the decimal point to accommodate those with a deep-rooted need to quibble). The revised data put average annualized real GDP growth over the life of the current expansion, which began in Q3 2009, at 2.331 percent, compared to the 2.322 percent growth reported prior to the revisions.

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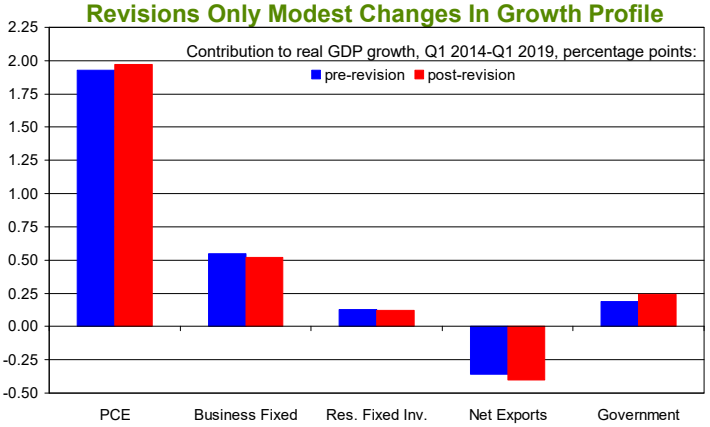
Revisions Only Modest Changes In Growth Profile



Source: Bureau of Economic Analysis; Regions Economics Division

So, anyone who had hoped the BEA's annual revisions would make the current expansion look better (i.e., faster) is pretty much out of luck. For that matter, the growth profile of the current expansion doesn't look all that different than it did prior to the revisions to the NIPA data. The chart above shows the contribution to top-line real GDP growth from the main components over the Q1 2014 through Q1 2019 period. As seen in the chart, consumer spending and government spending each made slightly larger contributions to top-line real GDP growth than had previously been reported, while fixed investment, both business and residential, contributed less and trade was a larger drag on growth than had previously been reported. Over any appreciable length of time, the contribution from the change in inventories will, by definition, be zero, which is why inventories do not appear in our chart.

Still, while the big picture may not look all that different, there are some changes in the underlying details of the revised GDP data that merit consideration. For instance, for the second year in a row, the revisions to the GDP data show the personal saving rate to be significantly higher than had previously been reported. As illustrated in the chart below, the personal saving rate over the Q2 2017 through Q1 2019 period is now shown to be much higher than had previously been reported, culminating in a savings rate of 8.50 percent in Q1 2019. While the saving rate fell to 8.10 percent in Q2 2019, the revised data nonetheless show consumers have a much larger financial cushion beneath them than had previously been thought to be the case.

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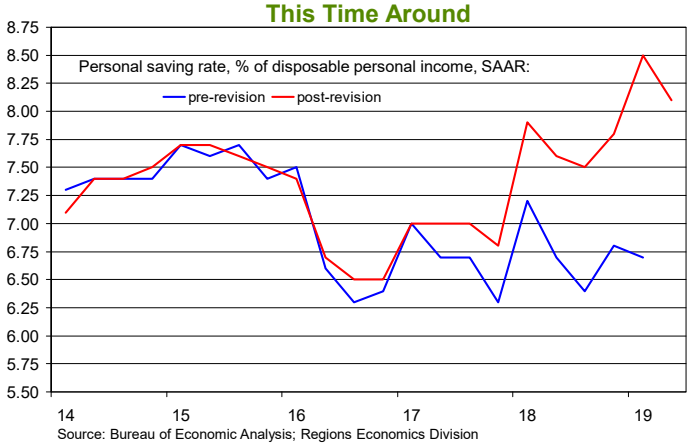
Higher Saving Rate More Broadly Distributed This Time Around



Source: Bureau of Economic Analysis; Regions Economics Division

To be sure, personal saving as defined by the BEA can be difficult to measure, and this series is frequently revised. That said, as was the case last year, this year's upward revision to personal saving is surprisingly large. There is, however, one significant difference between this year's revision and last year's revision to personal saving. In the 2018 revisions, the higher saving rate was largely a function of upward revisions to two components of personal income – nonfarm proprietors' income (a proxy for small business profits) and dividend income. As such, 2018's upward revision to personal saving was highly concentrated amongst a relatively small share of U.S. households, as we discussed in detail in our

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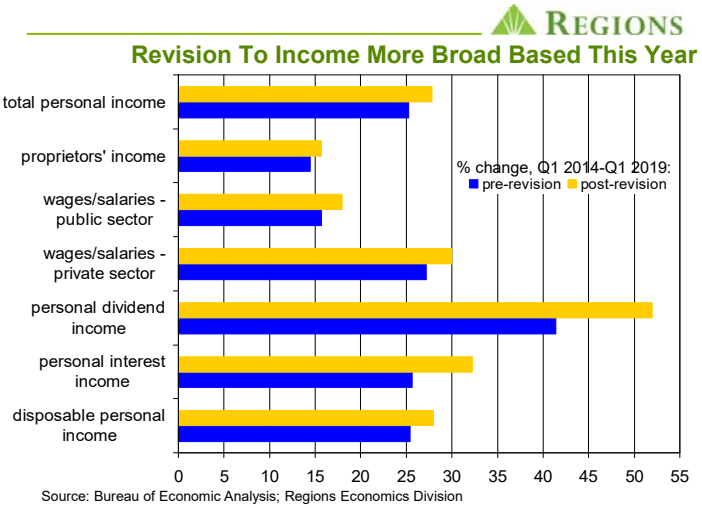
August 2018 *Outlook*. That is an important distinction in terms of what the higher saving rate actually means for the typical household, and which accounts for why we see this year's revision to be more meaningful than we saw last year's revision as being.

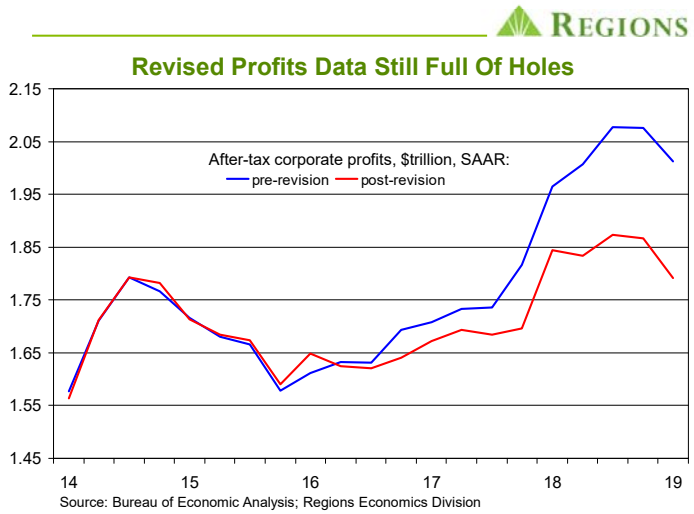


The 2019 NIPA revisions show an upward revision to personal income that is much more broad based across the components, as illustrated in the chart above. Each of the main components of personal income is now shown to have grown faster over the Q1 2014 through Q1 2019 period than had previously been reported. Again, this suggests that the upward revision to personal saving was spread across a wider swath of U.S. households than was the case with the 2018 revision to personal saving.

Perhaps a more significant factor behind this year's upward revision to personal saving is the 2017 tax bill, which led to lower personal income tax rates for most households beginning in 2018. Indeed, the revised data show the divergence in the reported saving rates widens sharply at the start of 2018 (as our prior chart of the saving rate shows). It should be noted that while the magnitude of upward revision to disposable personal income over the Q1 2014 through Q1 2019 period may not seem large (refer to the above chart), it is telling that virtually all of the upward revision comes from Q1 2018 onward. Full-year 2018 growth in disposable (or, after-tax) personal income is significantly faster in the revised data than had been previously reported, and this accounts for the bulk of the upward revision to personal saving.

Lower individual taxes raised disposable personal income which, despite a modest upward revision to consumer spending, fueled a boost in personal savings. Rather than being a one-off boost, however, the revised data show the personal saving rate pushed higher through Q1 2019 before settling back to a still-elevated 8.10 percent as of June, according to the monthly data. Our question at this point is whether or not the higher saving rate now being reported will survive future revisions, though we'll have to wait at least a year to know. But, if the higher saving rate is real, rather than simply a statistical mirage, it does alter our perceptions about consumers' ability to financially withstand an economic downturn, whenever that may occur (yes, it's still a matter of when, not if).

Much like the revised data on personal saving can help change the narrative of the financial health of U.S. consumers, the revised data on corporate profits may help change the narrative of the financial health of U.S. corporations. The difference, however, is that the change suggested by the revised data on corporate profits is not exactly a change any of us wants to embrace. The 2019 NIPA revisions show materially weaker growth in corporate profits over the Q1 2014 through Q1 2019 period than had previously been reported, with growth of after-tax profits revised from 19.80 percent to 6.65 percent. The following chart illustrates the change.



Before-tax corporate profits are now reported to have contracted by 0.28 percent in 2017, followed by growth of 3.42 percent growth in 2018. Originally, pre-tax profits were reported to have risen by 3.16 percent in 2017 and by 7.79 percent in 2018. The entire downward revision is accounted for by domestic profits, as profits from global operations were revised higher for each year. Financial sector profits bore the brunt of the downward revision to 2017 profits, while the nonfinancial sector absorbed the bulk of the downward revision to 2018 profits. Nondurable manufacturing and wholesale trade were the only industry groups to escape downward revision to prior estimates of 2018 profits.

As with the data on personal income and saving, the effects of the 2017 tax bill are apparent in the data on corporate profits. The revised NIPA data show after-tax corporate profits rose by 3.22 percent in 2017 and by 9.98 percent in 2018, though these too reflect downward revisions from the originally reported increases of 6.48 percent and 16.18 percent, respectively. Still, as the chart above illustrates, a significantly lower statutory corporate tax rate in 2018 provided a healthy boost to after-tax profits. Just not as healthy of a boost as had been reported.

If, at first glance, the above chart seriously upset your equilibrium, then you know exactly how we felt when we saw the revised data on corporate profits. Some analysts were quick to attribute the downward revision to slower revenue growth and higher labor costs than had previously been reported which, at least on the surface, sounds plausible. But, while there is something, perhaps much, to be said for sounding plausible, that explanation does not square with other elements of the data. First of all, final sales of domestic product, which we use as a proxy for top-line corporate revenue, were revised modestly higher, not lower. Second, while wage and salary earnings were revised higher, as we discussed above, that upward revision does not come close to matching the

downward revision to corporate profits. Third, a glance back at our chart on the revisions to the components of personal income shows a sharp upward revision to dividend income, which is quite the opposite of what you'd expect in light of the sharp downward revision to corporate profits. Fourth, nonfarm proprietors' income, again, a proxy for small business profits, was revised higher over the Q1 2017 through Q1 2019 period, which coincides with the bulk of the downward revision to corporate profits. One would think that small business owners would be more susceptible higher input costs than are large corporations, if higher input costs were a significant driver of the downward revision to corporate profits.

Our view is that the revisions to the data on corporate profits are more of a methodology issue than an economic issue. For anyone who is really, really, really, really interested, the BEA's handbook of methodology has a chapter devoted to the estimation of corporate profits. For everyone else, we'll just hit some of the main points here, and if the thought of that is too much, we'll start with our conclusion, which is that there is far less to these revisions than meets the eye. Our guess is that a year from now the data on corporate profits will look much different than they do today.

In the NIPA data, corporate profits represent profits from current production. The NIPA definition of profits is more closely aligned with profits as reported on a tax accounting basis than with profits as reported on a financial accounting basis (the basis on which profits are reported to stockholders and regulatory bodies). As such, the main source data for the BEA's estimates of corporate profits come from the IRS publication *Statistics of Income: Corporation Income Tax Returns*. These data, however, come with a lengthy lag – it takes about two years for the IRS to publish a preliminary estimate and about three years for them to publish the final estimate of tax statistics for the year to which they refer. In the interim, the BEA extrapolates the latest available year of IRS data, relying heavily on the Census Bureau's *Quarterly Financial Report* and BEA tabulations of corporate earnings reports.

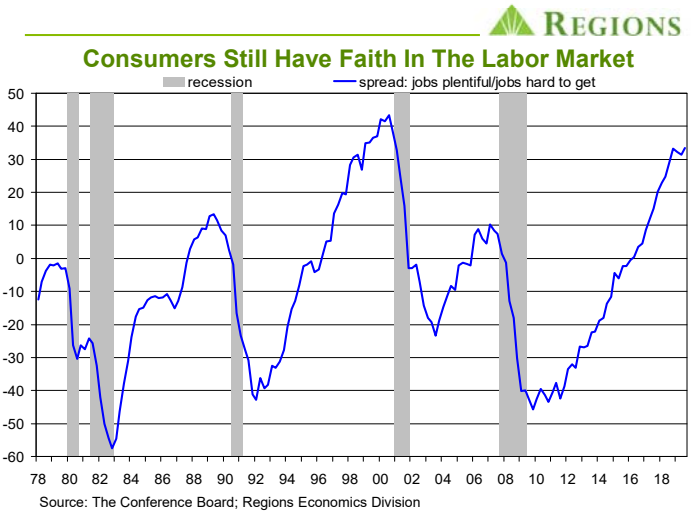
The bottom line, no pun intended, is that the latest year for which final IRS data are available is 2016. This year's NIPA revisions incorporate preliminary 2017 data, which are subject to change by this time next year, and estimates for 2018 and 2019 will be based on extrapolations from various sources. All of which is a rather roundabout way of us saying that, while the chart on the prior page showing the revisions to the data on corporate profits is not a good look, we don't find it very, if at all, informative in terms of what it might say about actual economic activity.

Corporate profits are an important topic, and the behavior of profit margins has material implications across the economy. Which makes the lack of timely, reliable data on corporate profits from the NIPA accounts that much more frustrating. This isn't to say the data on personal income, spending, and saving are flawless – they're not. But, those series have a firmer foundation under them and are far more timely than the data on corporate profits. This illustrates the importance of understanding the methodology behind the data. Those who simply accept the data as they are, without understanding how they are produced, run the risk of drawing faulty conclusions. This is one reason why we are hesitant to try to back-fill an economic story around the revised data on corporate profits, no matter how eye catching the revisions appear to be or how plausible our story would sound.

No Ominous Message From The Unemployment Rate . . . Yet

Between the current expansion now being the longest U.S. economic expansion on record, the softening of the manufacturing sector over recent months, and a pronounced slowdown in global economic growth, more and more people are wondering if the U.S. economy is on the verge of slipping into recession. At least that's our sense, based on the number of times we have been asked that over the past several weeks. Our answer has not varied – we do not think a recession is at hand, though the downside risks to our baseline outlook have clearly become more pronounced. That often leads to a follow-up question, along the lines of how will we know if the economy is in recession. After all, the National Bureau of Economic Research's Business Cycle Dating Committee, almost universally accepted as the arbiter of turns in the business cycle, takes a very deliberative approach to declaring the beginnings and ends of recessions. For instance, while the 2007-09 recession was determined to have begun in December 2007 and to have ended in June 2009, the announcements of those dates occurred in December 2008 and September 2010, respectively.

We fully understand, and have no quarrel whatsoever with, the Committee's deliberative approach to calling turns in the business cycle. That said, as a practical matter, when it comes to the question of whether or not the economy is in recession, business owners, investors, and policy makers need a more timely answer than the Business Cycle Dating Committee generally delivers. Like most other analysts, over the years we've come up with a set of what we believe to be fairly reliable indicators of turns in the business cycle, and rather than relying on any single indicator, we rely on the collective behavior of our group of indicators to inform our calls on turns in the business cycle.

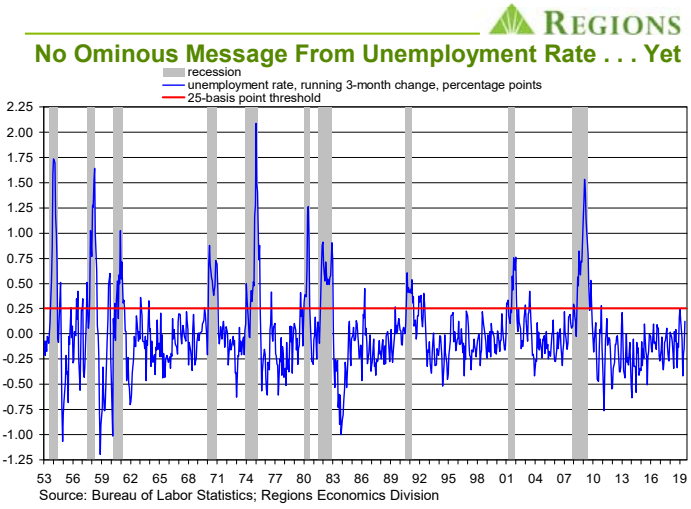


We won't go through our go-to list of indicators in detail here but, with the unemployment rate currently sitting at 3.7 percent, it seems fitting to focus on two of our go-to indicators that are actually very closely related. The first of these comes from the *Conference Board's* monthly survey of consumer confidence. As part of the broad-ranging survey, consumers are asked about their perceptions of labor market conditions, including whether they see

jobs as being "plentiful" or as being "hard to get." On a month-to-month basis, changes in the spread between the percentage of those who see jobs as plentiful and the percentage who see jobs as hard to get has long been a reliable indicator of changes in the unemployment rate – this is one indicator we look to each month when we produce our forecast of the jobless rate. As the above chart shows, the plentiful/hard to get spread is also a prescient indicator of turns in the business cycle. Ahead of each of the past five recessions, which is as far back as this series goes, the spread has peaked and turned lower prior to the start of the recession.

As of the July data, the latest available, 46.2 percent of survey respondents saw jobs as plentiful, while 12.8 percent saw jobs as hard to get. This put the spread between the two at 33.4 percent of survey respondents, just off the post-recession high of 34.2 percent in November 2018, which was the largest spread since January 2001. Clearly, consumers still feel good about the labor market, as they should given that the unemployment rate stands just off of a 49-year low and accelerating wage growth is touching workers across all skill levels.

Yet, when the unemployment rate fell to 3.6 percent in April, there were some who right away went on recession watch, while others waited until June, when the jobless rate rose to 3.7 percent, before going on recession watch. In each case, however, the premise is that the unemployment rate always reaches a trough and then begins rising ahead of a recession. That of course assumes that 3.6 marks the low-point for the unemployment rate during this cycle, an assessment with which we do not agree as we see further downside room for the jobless rate. Either way, like any other data series, the unemployment rate can change from one month to the next without signaling any change in the underlying health of the economy, and when used as an indicator of turns in the business cycle there is no consistency in terms of lead time from one cycle to the next.



That said, changes in the unemployment rate can be a useful and timely indicator of changes in the broader economy. Specifically, if the unemployment rises by more than 25 basis points in a three-month period, a recession typically follows, as illustrated in the above chart. Each of the past ten recessions has come with such a change in the unemployment rate. To be sure, there have been some "false positives," i.e., instances in which a cumulative 3-month increase of at least 25 basis points in the jobless rate has not been associated with a recession but, as the chart shows, there have been relatively few such instances, particularly over the past three decades. As of July, the cumulative 3-month increase in the unemployment rate was 13 basis points.

In tandem, the Conference Board's data on consumer perceptions of labor market conditions and the running 3-month change in the unemployment rate offer a reliable signal of turns in the business cycle, and there is a good reason for that. Consumers' perceptions of overall economic conditions are heavily influenced by labor market conditions, particularly how secure they feel in their job and how they assess their own prospects for earnings growth. Should they begin to feel less secure about their job and income prospects, they are likely to pull in the reins on spending, and should that happen on a large scale across U.S. households, the economy can easily tip into recession.

In other words, perceptions (i.e., consumers' perceptions of labor market conditions) really can become reality (i.e., an economic slowdown if not outright recession). To be sure, consumers' perceptions of labor market conditions can be swayed by events in the broader economy, such as the sharp pullback in equity prices during Q4 2018. It could be, however, that unless they have a direct connection to such events, consumers won't react, either emotionally or economically, to nearly the same degree as they would if they were to feel less secure about their own job.

It is also worth pointing out that even with an exceptionally low starting point, such as the current jobless rate of 3.7 percent, a rising unemployment rate can begin to dent consumers' confidence in the broader economy. The 1969-70 recession and the 2001 recession both came off of unemployment rates below 4.0 percent. In other words, while it is not uncommon for people to think a recession could not begin with a jobless rate or 3.7 percent, or even lower, the reality is that there is no magical threshold for the jobless rate below which a recession cannot occur. We would also add that as the jobless rate associated with "full employment" has drifted lower, it should be expected that the unemployment rate at the beginning of the next recession will be lower than those associated with most past cycles.

It is noteworthy that, amidst volatility in the financial markets and rising worries about the toll being exacted by trade disputes, consumer confidence and consumers' assessments of labor market conditions remain elevated. As such, these two indicators are sending a strong signal that the current expansion has longer to run. At least for now. This could change, and could do so relatively quickly should the prospects for a benign resolution of the U.S.-China trade dispute continue to deteriorate. The same is true of the other indicators we track. Our view remains that the current expansion has more life in it but at the same time the downside risks to growth have clearly become more pronounced. This makes it all the more important to have a set of reliable and timely indicators to track for signs that the business cycle is set to turn.

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Q1 '19 (a)	Q2 '19 (a)	Q3 '19 (f)	Q4 '19 (f)	Q1 '20 (f)	Q2 '20 (f)	Q3 '20 (f)	Q4 '20 (f)		2016 (a)	2017 (a)	2018 (a)	2019 (f)	2020 (f)
3.1	2.1	1.8	2.0	2.1	2.1	1.9	2.0	Real GDP[1]	1.6	2.4	2.9	2.3	2.0
1.1	4.3	2.5	2.3	2.1	2.1	2.1	2.1	Real Personal Consumption[1]	2.7	2.6	3.0	2.5	2.3
								Real Business Fixed Investment:					
4.4	2.4	3.6	4.0	4.3	4.2	3.4	3.1	Equipment, Software, & IP[1]	2.4	4.3	7.0	4.8	3.8
4.0	-10.6	-1.6	0.9	1.3	1.2	2.0	0.7	Structures[1]	-5.0	4.7	4.1	-2.6	0.1
-1.0	-1.5	1.5	-0.6	1.7	2.3	2.6	2.1	Real Residential Fixed Investment[1]	6.5	3.5	-1.5	-2.0	1.3
2.9	5.0	1.2	1.6	1.5	1.6	1.5	0.4	Real Government Expenditures[1]	1.8	0.7	1.7	2.2	1.6
-944.0	-978.7	-980.9	-988.3	-997.1	-1,006.7	-1,024.2	-1,023.5	Real Net Exports[2]	-783.7	-849.7	-920.0	-973.0	-1,012.9
864	842	860	873	887	900	911	912	Single Family Housing Starts, ths. of units[3]	786	852	873	860	902
349	420	355	347	342	337	332	330	Multi-Family Housing Starts, ths. of units[3]	392	357	377	368	335
16.8	17.1	16.9	16.7	16.6	16.6	16.5	16.4	Vehicle Sales, millions of units[3]	17.5	17.1	17.2	16.9	16.5
3.9	3.6	3.7	3.6	3.6	3.4	3.5	3.5	Unemployment Rate, %[4]	4.9	4.4	3.9	3.7	3.5
1.8	1.6	1.5	1.3	1.1	1.2	1.0	0.9	Non-Farm Employment[5]	1.8	1.6	1.7	1.5	1.1
4.4	2.5	0.8	2.0	1.8	1.8	1.5	1.4	Real Disposable Personal Income[1]	1.8	2.9	4.0	2.9	1.7
1.9	1.7	1.9	2.1	2.5	2.4	2.2	2.0	GDP Price Deflator[5]	1.0	1.9	2.4	1.9	2.3
1.4	1.4	1.5	1.7	2.2	2.0	2.0	2.0	PCE Deflator[5]	1.0	1.8	2.1	1.5	2.0
1.6	1.8	1.5	1.5	1.7	1.4	1.6	1.7	Consumer Price Index[5]	1.3	2.1	2.4	1.6	1.6
1.6	1.5	1.7	1.8	2.0	2.0	2.0	2.0	Core PCE Deflator[5]	1.6	1.6	1.9	1.7	2.0
2.1	2.1	1.9	1.8	1.7	1.7	1.8	1.9	Core Consumer Price Index[5]	2.2	1.8	2.1	2.0	1.8
2.38	2.38	2.21	2.07	1.88	1.88	1.88	1.88	Fed Funds Target Rate Range Mid-Point, %[4]	0.39	0.97	1.78	2.26	1.88
2.65	2.33	1.89	1.81	1.80	1.76	1.74	1.74	10-Year Treasury Note Yield, %[4]	1.84	2.33	2.91	2.17	1.76
4.37	4.01	3.70	3.58	3.57	3.56	3.54	3.53	30-Year Fixed Mortgage, %[4]	3.65	3.99	4.54	3.92	3.55
-2.5	-2.5	-2.7	-2.7	-2.8	-2.8	-2.9	-3.0	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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