ECONOMIC OUTLOOK

REGIONS
July 2022

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This Is It . . . Unless Of Course It Isn't

We've always considered providing context to be an important part of our job, perhaps the most important part. With a constant flow of economic data releases, we think it important to explain not only why the numbers in a given data release are what they are, but also how a given data release connects with other releases and what it all might mean for the path of the economy. Doing so is at times neither easy nor straightforward, particularly when some of the numbers we see don't make a lot of sense to us, and by no means do we claim to always be correct in our interpretation of the data. The main problem in trying to provide context, however, is that so few people do context these days.

To a seemingly increasing degree, context has given way to snappy soundbites and screaming headlines. It's hard, however, to offer much analysis within the confines of character limits while, in an increasingly noisy world, some seem to think that being the loudest and most dramatic is the best way to be heard, which to some extent accounts for those screaming headlines. And, sure, there are plenty of analysts who treat each and every data point as if it exists in isolation and can somehow dictate the path of a $20 trillion (adjusted for inflation, of course) economy. That makes it much simpler to either extrapolate the latest data point out into forever or to dismiss it out of hand, depending on whether or not the latest data point fits in with one's preconceived notion about the direction of the economy. We often find ourselves pointing out that it is not our job to be optimistic or pessimistic, or to be bullish or bearish, as we are often accused of being one or the other of those things when attempting to provide context. It is our job to take as open-minded of an approach to the data as possible and to make/change a call when the data tell us that is warranted, or at least when we interpret the data as sending us such a message.

This seems an appropriate discussion in the, well, context of what has become an almost nonstop barrage of recession calls, with some declaring the U.S. economy to already be in recession (it's not) and others declaring a recession is inevitable (it's not). We do not at present have a recession as our base case, though the economy has clearly slowed under the weight of elevated inflation and higher interest rates and our baseline forecast is, as of July, bruised and battered compared to how it came into 2022. Our forecast anticipates the economy limping along at barely above stall speed over the next several quarters and, with diminishing capacity to absorb additional adverse shocks, it is clear that the probability of recession has increased over recent months.

To be sure, if our July baseline forecast is on or near the mark, an economy limping along at barely above stall speed may not feel all that different than would a brief and mild recession, and anyone losing a job in either setting wouldn't care what it was called. And, regardless of where the economy goes from here, those who are at present struggling to make ends meet in the face of elevated inflation, particularly for food, energy, and shelter, won't sense a distinction between the two potential paths for the economy. Still, we think it worth trying to put the recent economic data, the near-term outlook, and all of the recession chatter in context.

This isn't the first time we've used our *Monthly Economic Outlook* to address growing concern over recession, as we did so in the April 2018 and July 2019 editions. In both of these instances, the combination of economic growth settling back to a fairly anemic trend rate of growth and the length of the expansion (recall the pre-pandemic expansion was the longest U.S. economic expansion on record) triggered fears that the economy was on the verge of slipping into recession. And, on both of these occasions, we laid out our case against that happening. As a side note, in our April 2018 *Outlook* we noted we saw an increasing probability of recession in 2020. That, however, was nothing more than an unhappy coincidence, as our concerns centered around a material fiscal drag and higher interest rates rather than a global pandemic that wasn't on our or anyone else's radar screen at the time.

Still, this time does feel different, in that the concerns are more widespread and, to an increasing degree of late, more justified than was the case on those prior two occasions. With elevated inflation, rising interest rates, signs of a slowing economy, and an increasing number of recession calls, it is not at all surprising that *Google* searches for "recession" have risen sharply, to the point that such searches are far more common now than was the case ahead of the 2007-09 recession. Neither is it surprising that, with real GDP having contracted in Q1 2022 and the Atlanta Fed's GDP tracking estimate pointing to another contraction in Q2, so many people think we're already in a recession and that the July 28 release of the Q2 GDP data will make it official. This stems from two consecutive quarters of declining real GDP being a commonly used definition of recession, although this is not the definition used by the National Bureau of Economic Research (NBER), which has long been the unofficial arbiter of turns in the business cycle.

We'll get back to the NBER's criteria for recession later, but before that think it worth discussing the factors behind the contraction in real GDP in Q1 and possible contraction in Q2. As we noted at the time of the release of the initial estimate of Q1 2022 GDP, which showed real GDP fell at an annualized rate of 1.4 percent (since revised to -1.6 percent), we thought that contraction said more about the quirks of GDP accounting than it did about the state of the U.S. economy. For instance, the U.S. trade deficit ballooned in Q1 as imports of goods into the U.S. rose by eleven percent in March. As we discussed in detail in our May *Outlook*, in the rules of GDP accounting, a wider trade deficit is a deduction from GDP, and the trade deficit widened in Q1 to the extent that it deducted 3.23 percentage points off the quarterly change in real GDP. Moreover, roughly half of all goods imported into the U.S. in Q1

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were industrial supplies and materials or non-automotive capital goods used in the production of finished consumer and capital goods which, despite being treated unfavorably in GDP accounting, result in higher output amongst U.S. producers.

Were domestic producers seeing, or anticipating, a material and sustained drop in demand, that would lead to falling imports of raw/intermediate inputs, which was not the case in Q1, nor was it the case in Q2. At the same time, despite rising, business inventories were treated as a drag on the quarterly change in real GDP in Q1. The drag from inventories will be substantially larger in Q2, to the point that the result may be another decline in real GDP. What may be surprising, however, is that business inventories not only rose in Q1 but the increase in real business inventories in Q1 2022 is the second largest on record, second only to the increase seen in Q4 2021.

This is where GDP accounting comes into play. In the calculation of the rate of GDP growth, it is the change in the change in inventories that matters. As such, even though the increase in real business inventories in Q1 2022 was the second largest on record, it was nonetheless smaller than that seen in Q4 2021 which, under the rules of GDP accounting, resulted in a 0.35 percentage point deduction off the quarterly change in real GDP in Q1. While we do not yet have complete data, business inventories were on pace to rise further in Q2 but, as that increase will be much smaller than that seen in Q1, the deduction from the quarterly change in real GDP could be as large as two percentage points. We'll leave it to each reader to decide for themselves whether the "drag" from inventories over 1H 2022 says more about the underlying health of the U.S. economy or about GDP accounting. Of course, to those who don't do context, that question will be moot.

Either way, the hit from inventories in Q2 could be large enough to result in a second straight quarterly decline in real GDP, and while we do not expect that to be the case, we cannot rule it out. While that would fit the common definition of recession (by the way, two of the past three recessions did not include two straight quarterly declines in real GDP), it is unlikely it would fit the NBER's definition of recession, which is "a significant decline in economic activity that is spread across the economy and lasts more than a few months." The brief recession of 2020 is an obvious exception to the "lasts more than a few months" clause, which illustrates that to some extent NBER is making judgment calls when dating turns in the business cycle. To help them make these calls, NBER focuses on a range of indicators, including real consumer spending, real personal income excluding transfer payments, real business sales, industrial production, and nonfarm and household employment, putting the greatest emphasis on nonfarm employment and real personal income excluding transfer payments.

On the whole, these indicators are not pointing to the economy being in or close to recession. Real consumer spending did decline in May, as growth in nominal spending failed to keep pace with inflation. This in part reflects a sharp decline in motor vehicle sales, which we saw as mainly a (lack of) supply issue, but also in part reflects a pullback in consumer spending on goods, particularly consumer durable goods such as home furnishings, appliances, and electronics. We have for some time been pointing to a rotation in consumer spending patterns, with less emphasis on goods and more emphasis on services. That rotation is underway and is being hastened by softening home sales and spending on discretionary goods being somewhat displaced as higher prices for food, energy, and shelter mean consumers are allocating more of their budgets to necessities. At the same time, services spending, particularly in areas such as travel, recreation, entertainment, and dining out, has been notably strong over recent months, and while we expect growth in services spending to ease after this summer, it should still be sufficient to push total consumer spending higher at a modest pace after adjusting for inflation.

So, as is the case with the broader body of economic data, the main indicators NBER uses in determining turns in the business cycle are signaling decelerating growth rather than contracting real GDP. That is seemingly at odds with the Atlanta Fed's *GDP Now* tool which, as of the July 8 update, is projecting real GDP contracted at an annualized rate of 1.2 percent in Q2. As noted earlier, the *GDP Now* tool has gotten considerable attention over recent weeks, with many pointing to it as evidence that the economy is already in recession. An important distinction that should be, but often is not, be kept in mind is that the Atlanta Fed's tool is a tracking estimate, not a formal forecast.

Tracking estimates such as *GDP Now* feed the most recent observations of the source data used to calculate GDP into a model that mimics the calculation of GDP made by the Bureau of Economic Analysis (BEA). The Atlanta Fed is not the only regional Fed bank with a tracking estimate of GDP. The St. Louis Fed's tracking estimate shows real GDP growing at an annualized rate of 3.9 percent as of its July 8 update, which somehow has largely escaped notice. Still, as of the July 8 updates, the various tracking estimates do not yet have May data for some series and have only limited data for June. As more source data become available, tracking estimates of Q2 GDP will change, perhaps significantly, so citing these tracking estimates as "proof" of recession is somewhat curious, except of course to those living a context-free life.

To that point, the BEA's initial estimate of GDP in any given quarter is based on incomplete source data and, as such, prone to sizable revision in subsequent months when revised and more complete source data become available. The Q1 2022 data are no exception to this general rule, but what does stand out is that what were sizable revisions to the various components of GDP yielded only a modest revision to the estimate of real GDP growth, just two-tenths of a point between the first and third estimates. That could change on July 28, which brings not only the initial estimate of Q2 GDP but also the results of the annual revisions of recent historical data, in this case spanning from Q1 2017 through Q1 2022.

One reason to think that the Q1 2022 data may look, if not better, then at least less bad than what has been reported thus far is that Gross Domestic Income (GDI), an alternative measure of national output, grew at an annualized rate of 1.8 percent in Q1. While GDP is measured on the production side, GDI measures income from wages, profits, interest, and investments. Over time the two series track each other fairly closely, as they should, but they can diverge sharply in any given quarter, as was the case in Q1. There are studies that suggest the initial estimate of GDI is a better indicator of the final estimate of both measures. While that may or may not hold in the revised data to be released on July 28, it could be that perceptions of the state of the U.S. economy over 1H 2022 will be different than they are ahead of the July 28 release.

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Then again, it could be that perceptions of the state of the U.S. economy won't change regardless of what July 28 brings, and that the economy is not now in recession does not mean it can't, or won't, be in the quarters ahead. Clearly, the pace of economic growth has slowed, but that should come as no surprise. While the extent to which the fiscal and monetary policy support provided in 2020 and 2021 boosted demand above where it otherwise would have been is open for debate, our view is that none of this support did anything to change the economy's trend rate of growth which, as always, is a function of the rates of labor force growth and capital formation. As such, we had always expected that by the second half of 2023 real GDP growth would have settled back into its longer-term trend rate, i.e., right around two percent.

Where there is cause for worry, however, is that this "natural slowdown" in growth will be compounded by the effects of higher inflation and higher interest rates. We are already seeing effects of higher interest rates in the housing market, with new single family construction and home sales having slowed. Additionally, higher interest rates have crushed mortgage refinancing as the number of borrowers who can profitably refinance at current rates is vastly smaller than it was a year ago. To the extent consumer spending on goods is being scaled back, in part because demand has been largely sated and in part because higher prices for necessities are weighing on discretionary spending, some retailers are facing undesired increases in inventories and shipping services are seeing demand ease. Firms in technology/information services are scaling back plans for growth to better align with scaled down expectations of overall economic growth, which in some cases incorporates slower global growth.

These are some of the adjustments now underway in the broader economy, each of which has implications for the labor market. For instance, providers of mortgage finance are scaling back head counts as demand slows, some retailers are finding that they hired too aggressively when consumer spending on goods was surging, and providers of transportation/warehousing/distribution services and technology/information services providers are making the same sorts of assessments. In some cases, this entails job cuts, in other cases, it entails scaled-down hiring plans, but the net result is a slower pace of job growth.

There seems to be a tendency, however, to extrapolate a slowing pace of growth into an outright contraction, which is not at all specific to this cycle, as we saw the same thing back in 2018 and 2019 when we addressed rising concerns over recession. To be sure, it is understandable that people are on edge at present given the aggressive policy stance adopted by the FOMC. But, we often point out that starting conditions matter, in terms of the economy's capacity to withstand higher interest rates. For instance, both household and business balance sheets are stronger now than they have been in some time, and both households and businesses are sitting on significant liquidity buffers in the form of elevated cash balances. Obviously, this isn't true of every household or every business, but it is true in the aggregate.

We discussed household liquidity positions in last month's *Outlook*, with data from the Federal Reserve's *Distributional Financial Accounts* showing deposit balances of households across all income and net worth levels remain significantly higher than was the case prior to the pandemic. Some point to a falling personal saving rate as evidence of households struggling to maintain spending under the weight of elevated inflation, but we do not agree with such assessments. We've often noted that we put little stock in the saving rate as a meaningful indicator, as it simply compares spending and income in a given month, thus making no allowance for the existing stock of saving, such as the elevated deposit balances now evident in the household sector. So, while not infinite, households do have more capacity to withstand the effects of elevated inflation. Indeed, one thing that we find striking is that households appear to be quite protective of these liquidity buffers, with deposit balances having thus far been drawn to by quite a bit less than we would have expected. Rather than using these deposit balances to preserve existing spending patterns, many households instead seem to have altered spending patterns to preserve elevated deposit balances. This could be a sign of unease about the future, but we find it interesting nonetheless.

While there are signs of moderately higher layoffs, as seen in the weekly data on initial claims for unemployment insurance benefits, and signs that the demand for labor is easing, again, consider the starting points. Initial jobless claims had been running at levels last seen in the late 1960s, while data from the Job Openings and Labor Turnover Survey (JOLTS) show that despite having fallen, job openings remain above eleven million, equivalent to 1.9 open jobs for each unemployed person and roughly 4.5 million more open jobs than were seen prior to the pandemic. And while the pace of job growth has slowed, what had in the twelve months ending with May been average monthly job gains of 539,000 was never a sustainable pace. Even with demand for labor easing and the pace of job growth slowing, the labor market is not close to being balanced, with labor supply still no match for labor demand. This is one reason we've argued that, even should the economy slip into recession, firms will be hesitant to resort to large-scale layoffs and will instead use other levers, such as changes in hours worked, in response to slowing demand.

We've made the same point about the housing market. We have for years now been discussing how chronically undersupplied the housing market has been, and mortgage interest rates falling to the lowest on record after the onset of the pandemic exacerbated the long-running supply/demand imbalance. Before mortgage rates began to rise earlier this year, housing market conditions over much of the prior two years were, to use a highly technical term, just plain nuts. As such, rather than causing the housing market to collapse, we see higher mortgage rates as leading to more normal housing market conditions. A preponderance of fixed rate mortgages, stronger credit quality of borrowers, and stronger equity positions than at any time since the mid-1980s (based on the *Flow of Funds* data from the Federal Reserve), and a still-undersupplied market will cushion the impact of higher mortgage rates, which should ease concerns over the market collapsing.

We can make the same point more broadly. While we may not know the proper term to describe the U.S. economy over the past two-plus years, we do know that "normal" is not it. There was never any question, or at least should not have been, that conditions would normalize and growth revert to its longer-term trend. Whether we're seeing that or something more sinister has yet to be determined, and we get that people are more on edge, but sentiment has turned surprisingly dour. Indeed, what to us is perhaps the most striking data point seen for quite some time is

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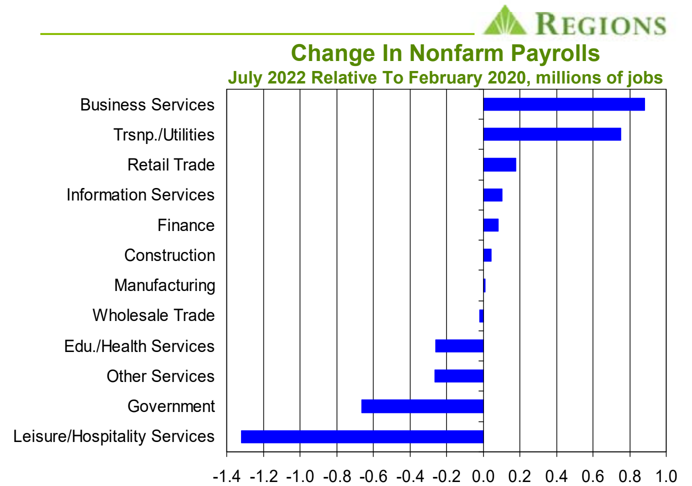
the University of Michigan's *Consumer Sentiment Index* falling to an all-time low of 50.0 percent in June. Consider that the survey dates back to 1952 and think about some of the challenges seen since then, such as double-digit unemployment rates, double-digit inflation, gas shortages, severe recessions, financial crises, and, oh by the way, a global pandemic, and ask yourself if it makes sense for consumers to see present day conditions as worse than ever before. Really, imagine how dour sentiment would be if the unemployment rate were 3.7 percent rather than 3.6 percent . . .

Still, whether or not anyone thinks consumer sentiment being this poor makes sense, you at least have to respect that it is, to the extent that it could influence decisions pertaining to spending, the labor market, and the housing market, to name a few. At the same time, business sentiment is also increasingly fragile, which is not hard to understand in an environment of supply chain and logistics challenges and a prolonged period of rapidly rising input costs. One reason this matters is that business investment has been a support for GDP over recent quarters, and we expect it to remain so. But, flagging business sentiment in the face of an increasingly uncertain macro environment could easily, and quickly, take a toll on business investment. If so, that would not only act as a drag on current growth, but it would also weigh on longer-term growth given that the rate of capital formation is one of the main determinants of any economy's long-term trend rate of growth.

Again, while more than aware of the downside risks, we do not at present have recession as our base case, even if the path of the economy we anticipate over coming quarters may not look or feel all that different. Obviously, our expectations could change over coming months, particularly should the FOMC remain on a course of aggressive Fed funds rate hikes and market interest rates push higher. Indeed, one common element in the recession calls we've seen thus far is the FOMC being more aggressive than we anticipate and than is being priced into market-based measures of the path of the Fed funds rate. Though still above the FOMC's target, core inflation is slowing, but the path of headline inflation remains highly uncertain despite energy and commodity prices having eased of late. At some point, after the Funds rate is at or slightly above its "neutral" level, the FOMC will have to choose between continuing to hike in the face of slowing economic growth and slowing core inflation or pausing despite headline inflation remaining well above their 2.0 percent target rate. We think that choice will be less clear-cut than is implied by what remains a steady chorus of aggressive talk from several FOMC members.

June Employment Report

Total nonfarm payrolls rose by 372,000 jobs in June, easily ahead of expectations, with private sector payrolls up by 381,000 jobs and public sector jobs down by 9,000 jobs. Prior estimates of job growth in April and May were revised down by a net 74,000 jobs for the two-month period, the third consecutive month in which the net revision for the prior two months was to the downside. We see this as a reflection of more complete survey data as the BLS backfills missing responses to the initial rounds of the monthly establishment survey as opposed to being an ominous sign of softening labor market conditions. Hiring remains notably broad based across private sector industry groups, which should help allay concerns around the durability of the expansion. To be sure, the pace of job growth has slowed, but that comes as no surprise. That hiring remains so broad based suggests job growth is settling into a more sustainable pace; were a slowing pace of job growth coming on top of a narrowing base of hiring across private sector industry groups, that would be a much more troubling sign.



As of June, the level of total nonfarm employment was 524,000 jobs below the pre-pandemic peak but, as the above chart shows, results vary sharply across private sector industry groups. Payrolls in leisure and hospitality services remain 1.318 million jobs below their pre-pandemic peak, easily the largest gap of any of the main industry groups. On the flip side, this is the industry group seeing the fastest growth in average hourly earnings and total wage earnings, as firms in leisure and hospitality services continue to struggle to attract and retail workers.

The June employment report is not without blemishes, such as the decline in labor force participation, particularly amongst the 25-to-54 year-old age cohort, often referred to as the prime working age population. With household employment falling along with the labor force, the unemployment rate held at 3.6 percent for a fourth straight month. As the household survey data are inherently volatile from one month to the next, we won't make too much of the decline in participation in June. More broadly, however, labor force participation remains well below pre-pandemic norms, which is one remaining blight on an otherwise strong labor market.

To that point, while the economy is slowing, it still seems that for many firms finding enough people to hire is a far bigger problem than having too many people working. As noted earlier, as of May there were over eleven million open jobs across the U.S. economy, and while that is off recent highs, it is still roughly 4.5 million higher than pre-pandemic openings. While the number of open jobs will likely fall in the months ahead as the economy continues to slow, we're a long way from the labor market being balanced, and that labor force participation remains below pre-pandemic norms makes labor market balance much more difficult to achieve.

That of course won't deter the FOMC from trying to restore more of a balance by quashing demand. As we discussed in our May *Outlook*, we're more than a little skeptical about this approach. It seems somewhat odd to think that firms taking on productive assets is somehow adding to inflation pressures. After all, it isn't as though firms are looking to hire workers so they can pay them to sit around and make no contributions to output and revenue.

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Q4 '21 (a)	Q1 '22 (a)	Q2 '22 (f)	Q3 '22 (f)	Q4 '22 (f)	Q1 '23 (f)	Q2 '23 (f)	Q3 '23 (f)		2019 (a)	2020 (a)	2021 (a)	2022 (f)	2023 (f)
6.9	-1.6	1.1	0.8	1.0	1.1	1.2	1.5	Real GDP[1]	2.3	-3.4	5.7	1.9	1.1
2.5	1.8	1.1	1.1	1.4	1.3	1.0	1.2	Real Personal Consumption[1]	2.2	-3.8	7.9	2.3	1.2
2.9	10.0	5.1	3.3	3.3	3.7	3.1	3.4	Real Business Fixed Investment[1]	4.3	-5.3	7.4	5.3	3.5
2.8	14.1	6.2	2.4	2.3	3.0	2.4	2.7	Equipment[1]	3.3	-8.3	13.1	6.0	2.8
8.9	11.2	8.1	6.8	4.9	4.7	4.5	4.4	Intellectual Property and Software[1]	7.2	2.8	10.0	9.0	5.1
-8.3	-0.9	-6.1	-3.7	1.8	2.5	1.4	2.2	Structures[1]	2.0	-12.5	-8.0	-4.0	0.8
2.2	0.4	-10.8	-5.2	-2.0	-1.2	0.9	1.7	Real Residential Fixed Investment[1]	-0.9	6.8	9.2	-4.1	-1.5
-2.6	-2.9	1.0	-0.3	0.8	1.1	1.7	1.6	Real Government Expenditures[1]	2.2	2.5	0.5	-1.0	1.0
-1,350.1	-1,544.7	-1,455.2	-1,445.9	-1,465.4	-1,473.5	-1,490.9	-1,497.9	Real Net Exports[2]	-905.3	-942.7	-1,284.3	-1,477.8	-1,491.7
1,170	1,187	1,079	1,038	1,048	1,056	1,063	1,072	Single Family Housing Starts, ths. of units[3]	889	1,002	1,131	1,088	1,069
509	533	561	527	522	507	499	490	Multi-Family Housing Starts, ths. of units[3]	402	393	474	536	495
17.5	19.2	19.3	15.8	11.8	7.0	2.5	1.6	CoreLogic House Price Index[5]	3.9	6.2	14.9	16.4	3.2
12.9	14.1	13.4	13.7	14.4	14.7	15.0	15.3	Vehicle Sales, millions of units[3]	17.0	14.5	15.0	13.9	15.1
4.2	3.8	3.6	3.6	3.6	3.7	3.8	3.9	Unemployment Rate, %[4]	3.7	8.1	5.4	3.7	3.8
4.3	4.6	4.4	3.7	2.8	1.8	1.1	0.7	Non-Farm Employment[5]	1.3	-5.8	2.8	3.9	1.0
-4.5	-7.8	-0.5	-0.1	1.1	7.0	2.6	2.8	Real Disposable Personal Income[1]	2.3	6.2	2.3	-5.5	2.9
5.9	6.9	7.1	6.9	6.0	4.8	3.8	3.0	GDP Price Deflator[5]	1.8	1.2	4.1	6.7	3.6
5.5	6.3	6.4	6.4	5.7	4.9	3.9	3.2	PCE Deflator[5]	1.5	1.2	3.9	6.2	3.7
6.7	8.0	8.5	8.5	7.7	6.2	4.4	3.3	Consumer Price Index[5]	1.8	1.2	4.7	8.2	4.1
4.6	5.2	4.8	4.7	4.3	3.9	3.6	3.2	Core PCE Deflator[5]	1.7	1.4	3.3	4.7	3.4
5.0	6.3	6.0	5.9	5.5	4.7	4.0	3.4	Core Consumer Price Index[5]	2.2	1.7	3.6	5.9	3.8
0.13	0.17	0.81	2.22	3.04	3.13	3.13	3.13	Fed Funds Target Rate Range Mid-Point, %[4]	2.16	0.42	0.13	1.56	3.08
1.54	1.94	2.93	3.21	3.42	3.30	3.23	3.24	10-Year Treasury Note Yield, %[4]	2.14	0.89	1.44	2.87	3.24
3.08	3.82	5.27	5.57	5.82	5.71	5.61	5.56	30-Year Fixed Mortgage, %[4]	3.94	3.12	2.96	5.12	5.58
-3.7	-4.8	-3.8	-3.6	-3.6	-3.5	-3.4	-3.3	Current Account, % of GDP	-2.1	-3.0	-3.7	-3.9	-3.3

a = actual; f = forecast; p = preliminary

Notes: 1 - annualized percentage change 2 - chained 2021 $ billions 3 - annualized rate 4 - quarterly average 5 - year-over-year percentage change

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