ECONOMIC UPDATE

August 27, 2020

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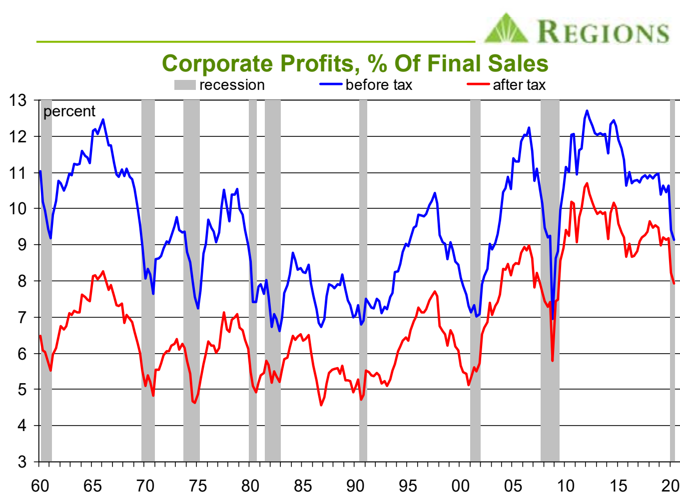
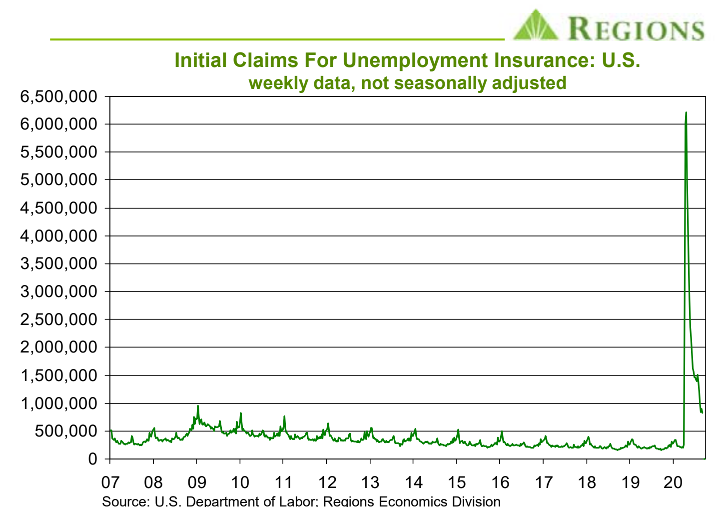
Real GDP: Revised and more complete source data show real GDP contracted at an annualized rate of 31.7 percent in Q2 2020, slightly smaller than the BEA's initial estimate of a 32.9 percent (annualized) contraction. The contractions in consumer spending, business fixed investment, and residential fixed investment are slightly smaller than initially estimated; growth in total government spending is slightly faster than initially estimated, and the trade deficit narrowed by more than initially estimated. In the big picture, the revisions to the initial estimate of Q2 GDP amount to little more than tinkering around the edges. Though there is no way of making the Q2 GDP data look better, reporting the magnitude of the contraction in terms of the annualized percentage change exaggerates the extent of the damage done by the COVID-19 virus and the efforts to stem its spread. The not seasonally adjusted data avoid this issue; on a not seasonally adjusted basis, real GDP declined by 6.47 percent between Q1 2020 and Q2 2020, a bit less harsh than the 6.97 percent decline BEA initially reported, though this still leaves the level of real GDP 11.8 percent below the level as of Q4 2020.



One new element of the Q2 GDP data in today's release is the initial estimate of corporate profits – the measure of corporate profits in the NIPA is much broader than the measure reported for the S&P 500 and, as such, is our preferred measure. On a before-tax basis, corporate profits fell by 11.15 percent in Q2 following a decline of 11.95 percent in Q1, which leaves before-tax profits down 20.1 percent year-on-year. After-tax corporate profits declined by 11.8 percent in Q2 following a decline of 10.98 percent in Q1, which leaves after-tax profits down 19.86 percent year-on-year. The chart to the side shows profit margins, corporate profits as a percentage of final sales (GDP less inventories), are at their lowest point since the early phases of the recovery from the 2007-09 recession. While Q2 may mark the trough for corporate profits, the rebound in profits figures to be highly uneven across the broad industry groups.

It should be noted that the manner in which BEA is accounting for loans taken out under the Paycheck Protection Program (PPP) mitigated the reported decline in corporate profits in Q2, and this is also the case for small business profits, which are largely captured in the nonfarm proprietors' category of the personal income data. PPP loans that ultimately are forgiven are booked as income in the NIPA data, which added $215.6 billion to nonfarm proprietors' income and added $397.3 billion to corporate profits (these are annualized rates) in Q2. There will be an additional boost in the Q3 data, but the payback will come in the Q4 data as the PPP "grants" run off the books. As reported, nonfarm proprietors' income declined by 10.73 percent in Q2, leaving it down 7.48 percent year-on-year. All in all, with the path ahead for the U.S. economy looking more and more bumpy, we should expect the same for corporate profits, more so for small businesses than for larger corporations, but the NIPA data for each category will be nosier than usual over the next two quarters.

Initial jobless claims: Initial claims for Unemployment Insurance fell to 1.006 million in the week ending August 22 from 1.104 million in the week ending August 15. Continuing claims, a measure of the number of people drawing benefits, fell to 14.535 million in the week ending August 15 from 14.758 million in the week ending August 7 (data on continuing claims come with a one-week lag from the data on initial claims). As we pointed out back in March when we saw the initial surge in claims, we see the seasonally adjusted data as being inherently unreliable, as the seasonal adjustment process simply isn't geared to account for changes of the magnitude we've seen over the past several months. The not seasonally adjusted data show 821,591 initial claims were filed during the week ending August 22, down from 889,549 in the week ending August 15. As seen in the chart to the side, claims have fallen sharply from the peak of 6.211 million in the week ending April 4, but at the same time reman almost four times higher than what had been the run rate prior to the

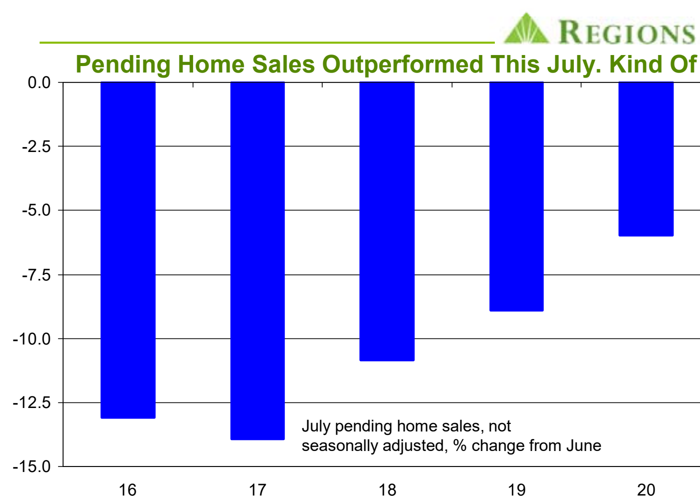


Regions Financial Corporation, 1900 5th Avenue North, 17th Floor, Birmingham, Alabama 35203
Richard F. Moody, Chief Economist • 205.264.7545 • richard.moody@regions.com

pandemic. This is perhaps the most concerning element of the nascent economic recovery, i.e., that large numbers of people continue to be laid off, and speaks to a halting and uneven recovery in the broader economy. It should also be noted that while continuing claims are down sharply from their peak – 13.910 million in the week ending August 15 from 22.761 million in the week ending May 9 (not seasonally adjusted) – there are a few potential explanations. One is that those who had been drawing Unemployment Insurance (UI) benefits have found a new job or have been called back to their old job and, as such, are no longer drawing benefits. But, to the extent that such workers were called back under the PPP, that does not necessarily mean they were actually working, only that they were put back on the payroll and, as such, they could be at risk of being laid off again as PPP funds are exhausted. Additionally, it could be that those amongst the first to file for UI benefits back in March are exhausting their regular UI benefits, thus dropping out of the data on continuing claims, but have migrated to extended benefits under one of the pandemic-related plans included in the CARES Act. Indeed, the number of people included in the Pandemic Emergency Unemployment Compensation program, which provides up to 13 additional weeks of UI benefits, rose by 119,000 in the week ending August 8, the latest week for which data are reported. Benefits paid under pandemic-related programs are not included in the regular claims data, so these numbers will clearly bear watching in the weeks ahead.

July Pending Home Sales: The housing market has been one notable bright spot in the U.S. economy over the past few months. Existing home sales rose to an annualized rate of 5.860 million units in July, while new home sales rose to an annualized rate of 901,000 units, in each case the highest monthly sales rate since December 2006. Sure, the obvious explanation is that mortgage interest rates hovering at or near record lows are fueling, as some have put it, a "housing boom." It could just be us, and it could just be too soon, but, honestly, we shudder every time we hear the term "housing boom." Still, our objections to what we are seeing in the housing market being characterized as a "boom" come on a more fundamental level, more specifically, questions about how long demand for home purchases can hold up in the absence of a more tangible recovery in the labor market and how much further upside room there is for sales given notably lean inventories of homes, new and existing, for sale. In our analysis of the data on July existing home sales, we pointed to today's release of the data on July pending home sales as an early marker of whether, or to what extent July's sales momentum could be sustained – pending homes reflect signed sales contracts and typically lead closings by 30-45 days, with existing home sales booked at closing. As such, the data on pending home sales offer an early look at August existing home sales.

At first glance, it would seem the data on July pending home sales should put our concerns to rest. The NAR's index of pending home sales rose to 122.1 in July, the highest level since 2005, and providing more fuel to the housing boom narrative. As we pointed out in our note on July existing home sales, however, the real story would be told by the not seasonally adjusted data. We are moving into the seasonally weak time of the year, any given year, for home sales, and pending home sales typically decline in the month of July. So what matters is how unadjusted pending home sales fared this July relative to a normal July and, as our chart to the side shows, the answer is "better." The unadjusted index of pending home sales fell by 5.97 percent in July, but this is much smaller than the declines seen in July of a "typical year." But, as the seasonal adjustment factors are geared towards a much larger decline, the increase reported in the seasonally adjusted data is exaggerated. This foray into the not seasonally adjusted data is nothing new for us; our long-time readers by now know our view that, when it comes to residential construction and home sales, the only data that matter are the not seasonally adjusted data. The bottom line here is that, yes, pending home sales were better in July than is typically the case, and, yes, this does in part reflect the effects of low mortgage interest rates. What hasn't changed, however, is the inventory situation, which we still maintain is acting to cap the upside for existing home sales and, though to a much lesser extent, new home sales. But, with still-sturdy demand and still-lean inventories, something has to give, and that something is price. House price appreciation has remained robust, and thus raises the possibility that affordability may become an issue even in the absence of a meaningful increase in mortgage interest rates. Regardless of whether, or to what extent, demand for home purchases holds up, there is a limit to how much upside room there is for home sales unless and until there is meaningful progress on the inventory front.



Jackson Hole: Federal Reserve Chairman Powell addressed the Jackson Hole conference this morning. As widely expected, Chairman Powell unveiled a shift in FOMC strategy under which the Committee will target 2.0 percent inflation over time, i.e., seeking an average inflation rate of 2.0 percent over time, though no specific time horizon was laid out. Again, that decision was widely expected. What is striking, however, is the shift in language regarding "full employment" – whereas the former policy stance addressed going "beyond full employment" the new policy stance addresses "shortfalls" from full employment. Rather than being concerned that the economy moving beyond full employment would spark inflation pressures (whatever the merits of that concern), the implicit assumption is that the economy will remain below full employment for the five-year duration of this new policy framework. Aside from any change in the approach to targeting inflation, this alone suggests the FOMC will not be changing the Fed funds rate target range any time soon.

Regions Financial Corporation, 1900 5th Avenue North, 17th Floor, Birmingham, Alabama 35203
Richard F. Moody, Chief Economist • 205.264.7545 • richard.moody@regions.com