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## Racing Back To The Starting Line

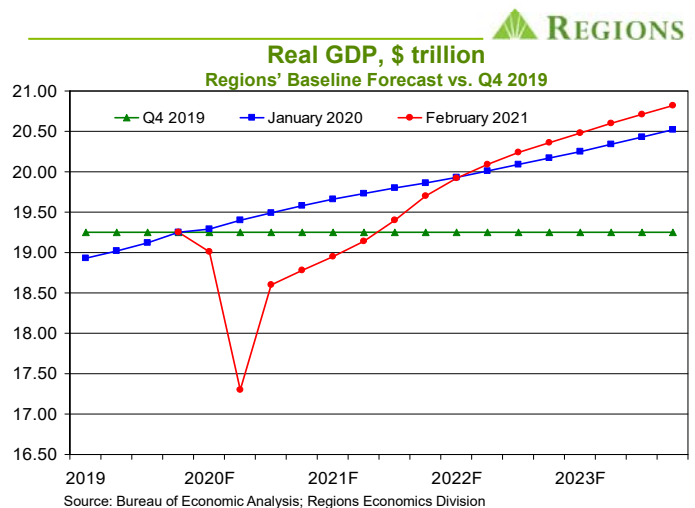
By around the middle of March 2020, it had become clear that the pandemic and the widespread shutdowns imposed to help stem its spread would lead to an epic contraction in real GDP in Q2 2020, one that went far beyond anything seen in the history of the GDP data. Almost as soon as that was clear, the discussion pivoted to what the subsequent recovery would look like. There were constant, and sometimes heated, debates over which letter of the alphabet the recovery would resemble – L, U, V, W – with some even offering up a cool corporate logo as a guide to what the recovery would look like. That these debates were taking place before the actual magnitude of the contraction in real GDP was even known seemed not to have mattered.

To be sure, we were trying to answer the same questions everyone else was trying to answer while attempting to produce plausible forecasts of what the downturn and subsequent recovery would look like. We simply found it hard to have a high degree of confidence in any forecast, ours or those of others, given that the questions that had to be answered on both the public health front and the economic front were impossible to answer in advance. As such, we concluded that the only appropriate letter/shape/symbol with which to characterize the path of the economy was a question mark which, apparently, doesn't make for a strong debating point.

In any event, as we discussed in detail in the April 2020 and May 2020 editions of our *Outlook*, we decided to let the evolution of the economic data speak for itself. Rather than agonizing over what shape the recovery would take on, we thought it would be more useful to lay out two markers against which to gauge the severity of the downturn and the progression of the subsequent recovery. The first marker was the level of real GDP as of Q4 2019, or, the last quarter before the pandemic began to impact the U.S. economy. As do many others, each month upon updating our baseline forecast we note when our forecast would put the level of real GDP back at the level as of Q4 2019. Our forecasts have consistently put the timing in 2H 2021, and our February 2021 baseline forecast has that happening in Q3 2021. Some anticipate that happening sooner than we do, and obviously each forecaster is making their own assumptions about the magnitude of additional fiscal policy support, the efficacy of those fiscal policy measures, and progress on the public health front, each of which will help determine whether the economy hits this marker sooner than, later than, or when we anticipate it will.

Either way, it is important to remember that while the level of real GDP as of Q4 2019 is a clear benchmark against which we can measure the economy's progress, the economy returning to that benchmark is not the same thing as the economy fully recovering from the sharp contraction seen in 1H 2020. This gets us to the second marker we laid out last spring, which goes to the question

of what actually constitutes recovery. Obviously, the meaning of recovery is open to interpretation, so the reality is that there isn't a clear-cut answer to this question. Our point here can perhaps be better illustrated by rephrasing the question, yielding something along the lines of how long will it take us to get to where we would have been had there not been the pandemic?

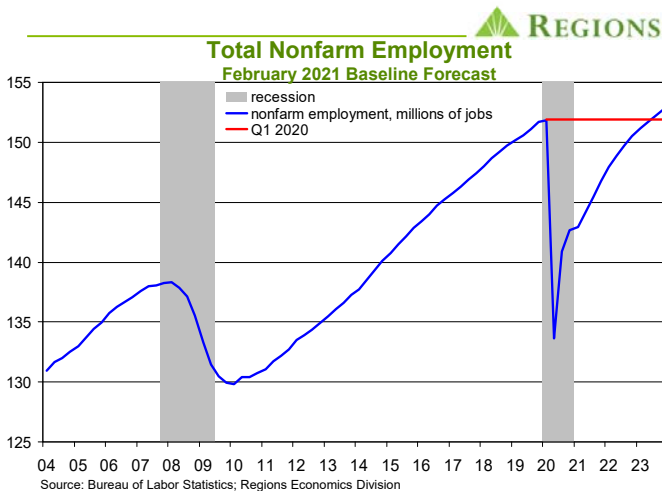


Obviously, that is a question that can never be answered precisely, but which we think is still worth thinking about in the context of defining "recovery." The chart above compares our February 2021 baseline forecast with the baseline forecast we published in our January 2020 *Outlook*, i.e., our annual outlook edition, which reflected our expectations for U.S. economic growth prior to the pandemic taking hold. This is by no means us claiming that our January 2020 forecast is an exact mapping of where the economy would have been had there not been the pandemic, but we think it to be a reasonable measuring stick. There was nothing special about our January 2020 forecast, which anticipated real GDP growth of just under 2.0 percent over the forecast horizon and which was largely in line with the consensus outlook. This goes to our point about it being a reasonable measuring stick.

The broader point here is that even once the level of real GDP has returned to the Q4 2019 level, that doesn't close the book on the economic costs of the pandemic and the efforts to stem its spread. The path of real GDP anticipated in our February 2021 baseline forecast crosses that anticipated in our January 2020 forecast in Q2 2022. While that may prove to be off by a quarter on either side, when all is said and done the pandemic will have in essence robbed the economy of roughly two years' worth of growth.

We are of course mindful that, though immeasurable, the human costs are far more severe and can never be made up for, but our focus here is on the economic costs. While we think it important

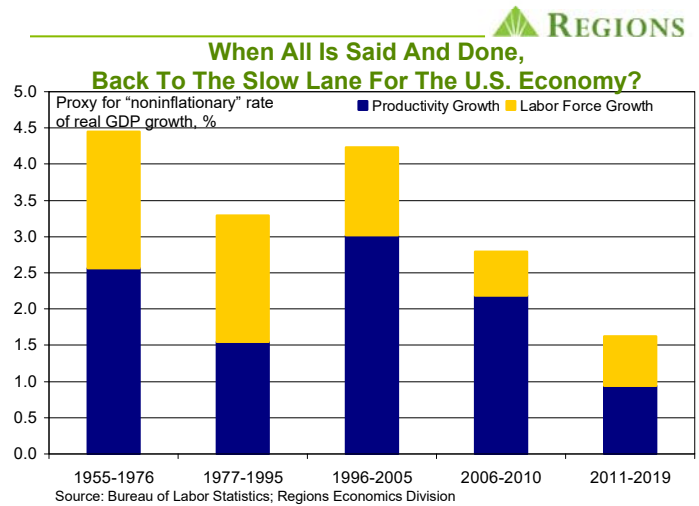
to at least attempt to fully account for the economic costs, it also strikes us that this point is lost amid all of the talk of how much more fiscal “stimulus” there will be, with that word in quotation marks here for a reason. Going back to the passage of the CARES Act in March 2020, we’ve avoided using the term “stimulus” in conjunction with the financial aid being provided to households and businesses, as we’ve seen that aid as more along the lines of filling in a gap, and our chart on the prior page helps illustrate our point. While the discussion of further fiscal policy support almost always seems to turn to the potential impact on GDP growth, the prospect of a transitory burst in real GDP growth seems to deflect attention from the lingering economic costs of the pandemic.



It is fair to ask whether the level of real GDP is the proper measure of the economic costs, and at the very least it seems an incomplete measure. For instance, as of our February baseline forecast, we do not look for the level of total nonfarm employment to return to its pre-pandemic peak until Q2 2023 (on a quarterly average basis). As we discussed in last month’s *Outlook*, one reason we think it will take the labor market longer to catch up is that many small businesses will not have survived the pandemic and the efforts to stem its spread. Another reason is that the experience of the pandemic has likely accelerated the push amongst firms to step up the use of automation, meaning less demand for labor. It is also unclear how long it will take to fully reverse the sharp decline in labor force participation that took place in 2020, and it is possible that some number of those who dropped out of the labor force will never return.

This discussion is not intended to throw cold water on the notion that the U.S. economy will strengthen over the course of 2021. As we discussed in great detail last month, our forecast anticipates the pace of real GDP growth picking up, as does every forecast we’ve seen, even if there are differences across forecasts on the timing and magnitude of the acceleration in growth. The main unknown here is not the size and scope of further fiscal policy measures, but instead is the public health outlook, as has been the case from day one. Instead, the point is that the focus on fiscal policy and the potential impact on real GDP growth makes it easy to lose sight of what will be the lingering economic costs of the pandemic, and even easier to lose sight of the fact that the burst of growth we are likely to see later this year, with or without any

additional fiscal policy measures, won’t last forever.



Admittedly, thinking about longer-term issues right now may seem a bit frivolous. But, the pre-pandemic outlook for labor force growth and productivity growth, the two main drivers of any economy’s sustainable growth rate, didn’t paint a very inspiring picture of longer-term real GDP growth. In this context, there are two questions that seem reasonable to ask. First, will the pandemic have changed the longer-term trends in labor force growth and/or productivity growth? Second, will any of the fiscal policy measures now being considered change either, at least to the extent that will result in a meaningful pick-up in the economy’s sustainable rate of growth? Sure, those may be questions for another day, but nonetheless are questions that await us when we do get back to normal. Whenever that may be.

### *How The Seasonal Adjustment Stole Christmas . . . Wait, What?*

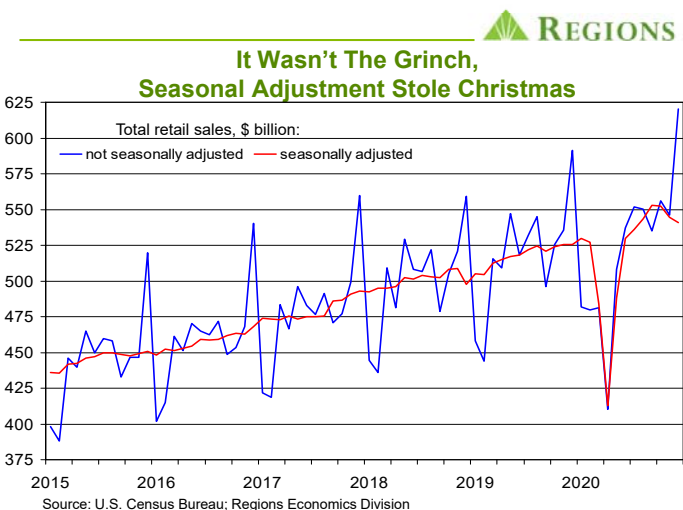
“A complete disaster.” “Dismal.” “Shockingly weak.” On the surface, the report on December retail sales was all of those things. Beneath the surface, however, the report on December retail sales was none of those things. As the general rule seems to be react first, ask questions later, if ever, you can imagine how the report on December retail sales was greeted. To be sure, the headline numbers atop that report – a 0.7 decline in total retail sales and a 1.9 percent decline in control retail sales, a direct input into the GDP data on consumer spending – were a most unwelcome surprise. Beneath the surface, however, December retail sales were nowhere near as dismal as the headline numbers suggested. While it is fair to say that retail sales in December 2020 may have fallen short of what a typical December looks like, there’s a long way between that and the picture that was painted by those reacting to the headline numbers.

We bring this up now for two reasons. One is to put into context where we saw U.S. consumers as 2020 ended, and the other is to yet again reinforce a point that we repeatedly stress cannot be reiterated enough. (Okay, the Department of Redundancy just called, they want their sentence back.) Our point, one that we do indeed make frequently in our coverage of the economic data, is

the importance of examining the raw, or, not seasonally adjusted data and understanding how deviations from “normal” seasonal patterns can, and often do, distort the signal being sent by the seasonally adjusted data. Reacting to the latter without being aware of the former can, and often does, lead one to draw faulty conclusions about the state of the economy. We see the reaction to the report on December retail sales as another instance of this, particularly since many pointed to the report as “proof” that further fiscal policy support, and lots of it, was needed.

Sure, we get it, interpreting one set of numbers in a given economic data release can be confusing enough, so trying to make sense out of another layer of data may seem like a tall task. And, sure, the term “seasonal adjustment” can make one’s eyes glaze over, as it seems like one of those obscure, abstract things only an economist could be into. It is, nonetheless, important, and our view has always been that it’s our job to be able to explain things such as seasonal adjustment in a way that adds to the level of understanding of our readers rather than adding an unwelcome layer of confusion. While we may not always be successful, we at least give it a shot when we think a discussion of seasonal adjustment issues is warranted. Which these days is quite often.

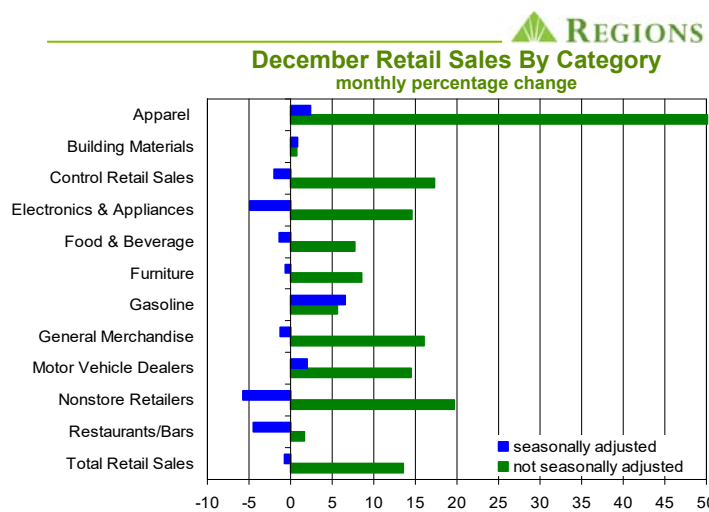
In our April 2020 *Outlook*, we noted that examining the not seasonally adjusted data would be even more important during the pandemic. One reason we thought so is that the seasonal adjustment process is simply not designed to deal with the magnitude of swings in the economic data we anticipated. Additionally, it was clear that what, prior to the pandemic, were well-established seasonal patterns in economic activity would be significantly disrupted by the economy having been effectively shut down and then reopening, which would in turn lead to potentially significant distortions in the seasonally adjusted data.



The chart above shows the monthly level of retail sales on both a not seasonally adjusted basis (blue line) and a seasonally adjusted basis (red line). The chart illustrates both the rationale behind seasonal adjustment and our point about the report on December retail sales. In a typical year, there tend to be spikes in retail sales around specific events, such as Easter, the start of the school year, and the holiday season, with the biggest spike in any year coming in December. Conversely, after the holiday shopping binge, retail

sales tend to decline in January and February. Such seasonal swings are not unique to retail sales, but instead can be observed in almost any economic data series. For instance, construction activity slows considerably in the winter months when, or so we hear, it’s always cold, and then perks up sharply when spring comes, while labor force participation rises (falls) at the end (start) of the school year. The purpose of seasonal adjustment is to smooth out these seasonal swings while, to the extent possible, preserving the underlying trends in the data.

Where things can, and usually do, go off the rails is when these typical seasonal patterns are disrupted. For instance, when it really isn’t cold in the winter, construction activity doesn’t fall off as sharply as it otherwise would. As such, the seasonal adjustment process basically compensates for a larger decline than actually occurred, making the seasonally adjusted data look stronger than is actually the case. In the case of December retail sales, we saw the opposite effect. As can be seen in the prior chart, we did see the typical December spike in retail sales in December 2020. The not seasonally adjusted data show total retail sales rose by 13.5 percent in December, the largest December increase since 2016, with control retail sales (total sales less auto, gasoline, building materials, and restaurant sales) rising by 17.3 percent. As impressive as these increases may seem, the reality is they are smaller than the average December increases of 16.0 percent and 25.6 percent, respectively. Moreover, the seasonal adjustment factor used by the Census Bureau to adjust total retail sales for December was the most punitive of any December since 1993. So, a smaller than average December increase combined with a harsher seasonal adjustment factor added up to the “dismal” headline retail sales numbers.



As the above chart illustrates, each of the main categories for which data are reported saw increases in sales on a not seasonally adjusted basis in December. Again, though, the increases were for the most part smaller than those typically seen in the month of December, hence the broad based declines in seasonally adjusted sales. Most of the reaction to the report, however, was based on the seasonally adjusted data, which we think led to some overly dour assessments of the state of U.S. consumers. We question how anyone could be comfortable offering such assessments without accounting for obvious seasonal adjustment issues.

There are some who argue that had the increase in unadjusted sales not been smaller than is typical for the month of December, the seasonally adjusted data would not have looked so bad, so in essence the unadjusted and adjusted data were telling the same story. Needless to say, we don't agree. Moreover, that it was not difficult to construct a seemingly plausible narrative around the "dismal" December retail sales data may have led some to see no reason to examine the unadjusted data. That narrative pointed to the ongoing surge in COVID-19 cases keeping people away from stores, deteriorating labor market conditions, and the looming expiration of various unemployment insurance benefit programs having all combined to lead consumers to pull back on spending.

As plausible as it may have sounded, that narrative didn't hold up under closer examination. To be sure, those facing a looming cut in cash flow due to lapsing unemployment insurance benefits likely did pull back on, or eliminate, discretionary spending in December. That alone, however, would not have come close to accounting for the December retail sales data. As for the part about physical stores having been largely deserted, that didn't square with the employment data showing that on a not seasonally adjusted basis retail trade payrolls rose by 230,000 jobs after rising by 317,000 jobs in November (both numbers have since been revised higher). We're not experts in retail management, but it would seem odd for stores to have ramped up hiring to accommodate . . . a complete lack of shoppers. Even if you buy the empty stores narrative, the question then becomes how to account for the reported 5.8 percent decline in sales by nonstore retailers. At least when you know that online sales account for roughly 88 percent of sales in this broad category and that by all other accounts online sales surged in December. Moreover, the employment data show a much larger than normal increase in unadjusted payrolls in warehousing/delivery services during Q4 2020, to accommodate increased online shopping. By the way, the unadjusted data show sales by nonstore retailers rose by 19.7 percent in December. And, in a month in which restaurant sales were reported to have fallen by 4.5 percent, is it remotely plausible that grocery store sales would have fallen by 1.7 percent? We think not.

To be sure, it is perfectly reasonable to ask why the increase in not seasonally adjusted sales in December was not as large as is typical for the month of December, and the factors cited above no doubt played a major role. At the same time, the sheer size of the reported decline in retail sales, particularly control retail sales, should lead you to wonder if there isn't more to the story, especially when all other indicators are pointing in the opposite direction. Here's another, and not unrelated, point to keep in mind. When one month brings disruptions in any form of economic activity – construction, retail sales, employment – there will almost surely be payback in the next month. For instance, as the increase in not seasonally adjusted retail sales in December was smaller than is normal for the month, it is very likely that the post-holiday season decline in January sales will be smaller than is typical for the month, meaning that on a seasonally adjusted basis sales will look stronger than is actually the case. Keep that in mind when you're reading accounts of how a second round of Economic Impact Payments (most of which will have been saved, not spent) and the restoration of the various unemployment insurance benefit programs led to a burst of spending in January. This isn't to say those won't have played a part, but even without those factors

January was set up to be a "strong" month for seasonally adjusted retail sales.

Some may wonder why, if the month-to-month swings in the data tend to even out, we should worry about what's going on in the not seasonally adjusted data. And, sure, it would be easier to simply craft a plausible narrative around whatever the seasonally adjusted headline numbers atop the economic data releases are in a given month. The broader point, however, is that the narrative of the economy does not change as quickly and as dramatically as is sometimes implied by the month-to-month swings in the data reported on a seasonally adjusted basis. As we often note, our job isn't to know what the numbers are, our job is to understand, as best we possibly can, why the numbers are what the numbers are. That takes some digging, which we think is well worth the effort.

### *January Employment Report*

Speaking of seasonal adjustment, the January employment report was full of seasonal adjustment noise. But, as this worked in both directions, depending on the industry groups in question, it pretty much cancelled out, meaning the January employment report was lousy on the merits. Total nonfarm employment rose by 49,000 jobs, with private sector payrolls up by 6,000 jobs and public sector payrolls up by 43,000 jobs (an obvious but generous gift from seasonal adjustment). The January data incorporated the annual benchmark revisions to the recent historical data, and the revised data show that when the economy was largely shut down last March and April, total nonfarm employment fell by 22.362 million jobs, more than had previously been estimated. As of January, the level of nonfarm employment stood 9.892 million jobs below the level as of February 2020, the pre-pandemic peak. While the unemployment rate did fall to 6.3 percent in January from 6.7 percent in December, that largely reflects a decline in labor force participation, i.e., the jobless rate fell for the wrong reason.

One of the more troubling aspects of the January employment report is the reversal of what had been broad based private sector hiring in November and December. The one-month hiring diffusion index, a measure of the breadth of hiring across private sector industry groups, fell to 48.1 percent in January from 61.9 percent in December and 64.4 percent in November, meaning that in January more private sector industry groups shed jobs than added jobs. That suggests broader fallout from the surge in COVID-19 cases that began around mid-November and subsequent curbs on activity imposed by many state and local governments. One curious offset, however, was an increase in average weekly hours, with the average workweek rising from 34.7 hours in December to 35.0 hours in January. As such, aggregate private sector hours worked rose by 0.9 percent in January, which provided a powerful boost to growth in aggregate private labor earnings, which jumped by 1.1 percent. Between this increase and the second round of Economic Impact Payments, there will be a massive increase in disposable (or, after-tax) personal income in January.

That the labor market got off to a shaky start in 2021 did not come as a surprise. While we do expect the pace of economic growth, and in turn the pace of hiring, to pick up as the year wears on, the time it will take before the labor market is fully healed will be measured in years, not months.

# ECONOMIC OUTLOOK



February 2021

| Q3 '20 (a) | Q4 '20 (p) | Q1 '21 (f) | Q2 '21 (f) | Q3 '21 (f) | Q4 '21 (f) | Q1 '22 (f) | Q2 '22 (f) |  | 2018 (a) | 2019 (a) | 2020 (p) | 2021 (f) | 2022 (f) |
|------------|------------|------------|------------|------------|------------|------------|------------|--|----------|----------|----------|----------|----------|
| 33.4       | 4.0        | 3.7        | 3.9        | 5.6        | 6.5        | 4.5        | 3.4        | Real GDP <sup>1</sup>                                    | 3.0      | 2.2      | -3.5     | 4.8      | 4.4      |
| 41.0       | 2.5        | 2.1        | 5.9        | 7.3        | 8.2        | 4.9        | 3.4        | Real Personal Consumption <sup>1</sup>                   | 2.7      | 2.4      | -3.9     | 5.3      | 5.1      |
| 22.9       | 13.8       | 6.5        | 6.4        | 5.0        | 4.9        | 4.5        | 4.6        | Real Business Fixed Investment <sup>1</sup>              | 6.9      | 2.9      | -4.0     | 6.8      | 4.8      |
| 68.2       | 24.9       | 13.1       | 7.6        | 3.7        | 2.3        | 2.1        | 2.1        | Equipment <sup>1</sup>                                   | 8.0      | 2.1      | -5.0     | 13.6     | 2.8      |
| 8.4        | 7.5        | 3.9        | 6.4        | 6.9        | 8.0        | 7.0        | 5.6        | Intellectual Property and Software <sup>1</sup>          | 7.8      | 6.4      | 1.5      | 5.2      | 6.5      |
| -17.4      | 3.0        | -5.7       | 2.6        | 4.1        | 5.6        | 5.7        | 9.3        | Structures <sup>1</sup>                                  | 3.7      | -0.6     | -10.5    | -4.6     | 6.6      |
| 63.0       | 33.5       | 12.0       | 3.7        | 3.5        | 0.9        | 0.2        | -0.7       | Real Residential Fixed Investment <sup>1</sup>           | -0.6     | -1.7     | 5.9      | 13.4     | 0.7      |
| -4.8       | -1.2       | 1.3        | -3.8       | 1.0        | 1.9        | 2.9        | 2.3        | Real Government Expenditures <sup>1</sup>                | 1.8      | 2.3      | 1.1      | -0.9     | 1.7      |
| -1,019.0   | -1,121.1   | -1,118.5   | -1,161.4   | -1,178.2   | -1,174.8   | -1,165.1   | -1,162.6   | Real Net Exports <sup>2</sup>                            | -877.7   | -917.6   | -925.8   | -1,158.2 | -1,168.4 |
| 1,037      | 1,237      | 1,249      | 1,229      | 1,208      | 1,199      | 1,193      | 1,186      | Single Family Housing Starts, ths. of units <sup>3</sup> | 872      | 893      | 1,002    | 1,221    | 1,188    |
| 395        | 355        | 360        | 361        | 362        | 367        | 368        | 370        | Multi-Family Housing Starts, ths. of units <sup>3</sup>  | 376      | 403      | 395      | 362      | 373      |
| 15.3       | 16.1       | 16.4       | 16.3       | 16.4       | 16.5       | 16.6       | 16.6       | Vehicle Sales, millions of units <sup>3</sup>            | 17.2     | 17.0     | 14.4     | 16.4     | 16.7     |
| 8.8        | 6.8        | 6.2        | 6.1        | 5.9        | 5.5        | 5.1        | 4.8        | Unemployment Rate, % <sup>4</sup>                        | 3.9      | 3.7      | 8.1      | 5.9      | 4.7      |
| -6.8       | -6.0       | -5.9       | 7.9        | 3.3        | 2.9        | 3.5        | 3.3        | Non-Farm Employment <sup>5</sup>                         | 1.6      | 1.3      | -5.7     | 1.8      | 3.1      |
| -16.3      | -9.5       | 49.0       | -28.4      | -2.7       | -6.3       | 2.4        | 2.4        | Real Disposable Personal Income <sup>1</sup>             | 3.6      | 2.2      | 6.0      | 1.4      | -2.2     |
| 1.2        | 1.3        | 1.2        | 2.2        | 1.8        | 1.9        | 1.9        | 1.9        | GDP Price Deflator <sup>5</sup>                          | 2.4      | 1.8      | 1.2      | 1.8      | 1.8      |
| 1.2        | 1.2        | 1.3        | 2.0        | 1.6        | 1.8        | 1.9        | 2.1        | PCE Deflator <sup>5</sup>                                | 2.1      | 1.5      | 1.2      | 1.7      | 1.9      |
| 1.3        | 1.2        | 1.8        | 3.4        | 2.6        | 2.6        | 2.1        | 1.9        | Consumer Price Index <sup>5</sup>                        | 2.4      | 1.8      | 1.3      | 2.6      | 1.9      |
| 1.4        | 1.4        | 1.5        | 2.1        | 1.8        | 2.0        | 2.1        | 2.1        | Core PCE Deflator <sup>5</sup>                           | 2.0      | 1.7      | 1.4      | 1.9      | 2.1      |
| 1.7        | 1.6        | 1.6        | 2.6        | 2.2        | 2.3        | 2.4        | 2.4        | Core Consumer Price Index <sup>5</sup>                   | 2.1      | 2.2      | 1.7      | 2.2      | 2.4      |
| 0.13       | 0.13       | 0.13       | 0.13       | 0.13       | 0.13       | 0.13       | 0.13       | Fed Funds Target Rate Range Mid-Point, % <sup>4</sup>    | 1.78     | 2.16     | 0.42     | 0.13     | 0.13     |
| 0.65       | 0.86       | 1.13       | 1.24       | 1.33       | 1.39       | 1.46       | 1.51       | 10-Year Treasury Note Yield, % <sup>4</sup>              | 2.91     | 2.14     | 0.89     | 1.27     | 1.55     |
| 2.95       | 2.76       | 2.80       | 2.90       | 2.99       | 3.09       | 3.15       | 3.23       | 30-Year Fixed Mortgage, % <sup>4</sup>                   | 4.54     | 3.94     | 3.12     | 2.95     | 3.29     |
| -3.4       | -2.9       | -3.1       | -3.1       | -3.3       | -3.2       | -3.0       | -3.1       | Current Account, % of GDP                                | -2.2     | -2.2     | -2.9     | -3.2     | -3.1     |

a = actual; f = forecast; p = preliminary

- Notes: 1 - annualized percentage change      4 - quarterly average  
 2 - chained 2012 \$ billions                      5 - year-over-year percentage change  
 3 - annualized rate

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