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Okay, And Then What?

According to the initial estimate from the Bureau of Economic Analysis (BEA), real GDP expanded at an annualized rate of 6.4 percent in Q1 2021 which, with one exception, is the fastest quarterly growth rate since Q3 2003. That exception is Q3 2020, when real GDP grew at an annualized rate of 33.1 percent as the economy began to recover from the shutdowns resulting from the pandemic and the efforts to stem its spread. The Q1 2021 data mark the beginning of what should be a run of notably rapid real GDP growth, which we expect will persist through Q4 2021. This run of rapid growth will be driven by further progress on the vaccination front, further reopening of the economy, and what are considerable amounts of cash on household and corporate balance sheets being put to use.

For instance, we estimate that as of March (the latest available data), households were sitting on over \$2.2 trillion of "excess saving," or, the difference between the actual level of saving in the household sector and what the level would have been had saving patterns in place prior to the pandemic held throughout (as we first discussed in our March *Outlook*). While Economic Impact Payments and other fiscal transfers account for a sizable portion of this excess saving, part of it also reflects spending on services having been held down by restrictions on economic activity and changes in consumer behavior during the pandemic. As such, some portion of excess saving can be thought of as "forced saving." Additionally, many households have freed up cash by paring down debt and/or refinancing mortgages, thus lowering monthly debt service burdens.

Between the considerable pool of excess saving, more and more people being vaccinated, and the economy more fully reopening in the months ahead, conditions are in place for there to be a significant burst of spending. To be sure, at this point there are more questions than answers when it comes to how, and how fast, consumers will utilize this pool of excess saving. Moreover, we think it likely the personal saving rate will ultimately settle at a higher rate than was in place (around 7.5 percent) prior to the pandemic. Still, it seems most likely that at least some portion of the excess saving in the household sector will be used to support consumer spending, particularly on services, in the months ahead.

Though there will be ample help from other components, such as business and residential fixed investment, inventory restocking, and government spending, faster growth in consumer spending is expected to be the main support for the robust pace of real GDP growth we and many others are looking for over the next few quarters. Expectations are high, with many forecasts anticipating faster growth than our May baseline forecast calls for. Even aside from the forecast numbers, that expectations are high is obvious from the language many are using to describe how the economy

is performing at present and how it is expected to perform in the quarters ahead. It has become increasingly common to hear the word "boom," as in, economic boom, bandied about in such discussions, though we wouldn't go nearly that far.

However one wishes to characterize it, the next few quarters are likely to bring fairly rapid real GDP growth. Whether or not that growth lives up to the hype remains to be seen, but another, and to us much more relevant, question is what comes after this burst of growth runs its course. In other words, is there anything that we've either seen thus far or expect to see over the next few quarters that suggests the trend rate of real GDP growth in the post-pandemic world will be higher than the average growth rate of 2.3 percent seen over the prior expansion. Sure, we get it, this isn't a question a lot of people want asked, let alone answered, at this point. After all, two things we've come to learn over the many years that we've done this job are: 1) when we're in the midst of a run of growth such as that we expect to see over the next few quarters, many want to extrapolate those growth rates out into, oh, say, forever; and 2) those same people tend to get highly annoyed when we suggest that's unlikely to be the case. Which is kind of why we think this the appropriate time to tackle this question, which we first touched on in our February *Outlook*.

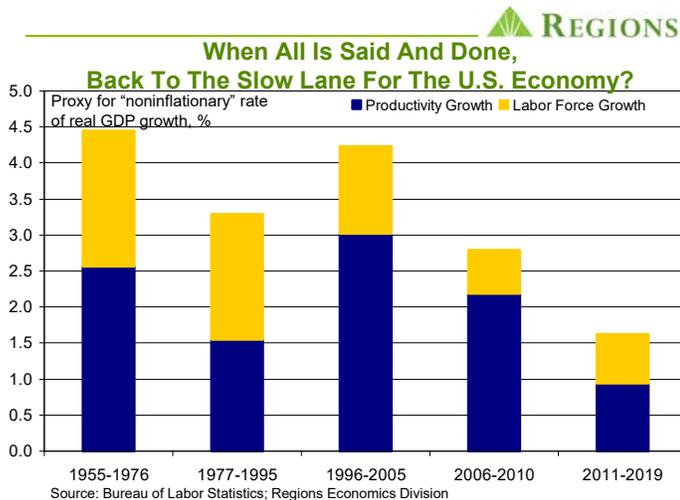
To the extent that, as in the Q1 2021 data, it is consumer spending providing the biggest boost to real GDP growth over the next few quarters, that does nothing to set the stage for a faster sustainable pace of growth. That is a point worth making as there are some who think sustaining the rapid pace of real GDP growth would be as simple as the government engaging in successive rounds of fiscal transfers that would prop up consumption spending. While that may buy us a lot of things, faster sustainable growth isn't one of them. To repeat a point we've made (seemingly) countless times, the economy doesn't grow at a faster rate over time because consumption grows, consumption grows over time because the economy is growing.

That gets us back to another point that will be familiar to our long-time readers, which is that the two main drivers of any economy's sustainable rate of growth are the rate of labor force growth and the rate of productivity growth. So, in terms of what comes after the current run of rapid growth subsides, it seems reasonable to ask the following two questions. First, will the pandemic have triggered changes in the longer-term trends in labor force growth and/or productivity growth, at least to the extent that the net result will be a meaningful pick-up in the economy's sustainable rate of growth? Second, will any of the fiscal policy measures either already enacted or yet to come change either driver?

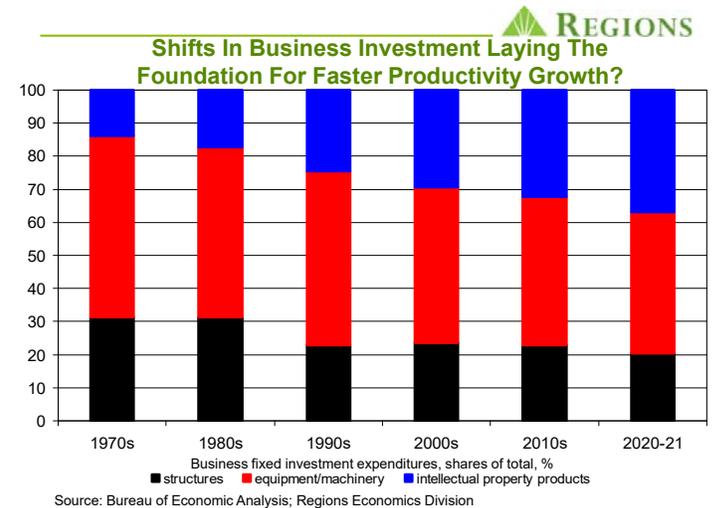
Recall that, prior to the pandemic, the underlying trends in labor force growth and productivity growth weren't all that inspiring, hence the notably slow pace of growth over the prior expansion, which was the longest U.S. economic expansion on record. Over

the course of the pandemic, labor force growth and productivity growth have been on divergent paths, with a sharp decline in labor force participation countered by faster productivity growth. On an annual average basis, the labor force declined by 1.71 percent in 2020 while nonfarm labor productivity increased by 2.62 percent. The pick-up in productivity growth has gotten a good deal of attention, and while the decline in labor force participation has not escaped notice, we seldom hear it discussed in the context of the implications for growth, which is why earlier we stressed that the net change in the two is what matters.

While there has been no let-up in business spending in these areas over the past few quarters, growth in business investment in equipment and machinery has become much broader based, including spending on industrial equipment and transportation equipment. At the same time, business investment in intellectual property products, over 90 percent of which consists of spending on software and research and development, has rebounded smartly after having contracted in Q2 2020, with double-digit annualized growth in each of the past two quarters.



We often use the above chart in our discussions of the roles of labor force growth and productivity growth in determining an economy's sustainable rate of growth over time, which we refer to as an economy's "speed limit." The time periods are delineated in terms of productivity growth cycles which, for better or worse, tend to be prolonged. We've not included the 2020 data in our chart, though it could be that 2020 turns out to be the start of a cycle of faster productivity growth that could potentially increase the U.S. economy's speed limit, subject of course to changing patterns in labor force growth.



To be sure, the profile of business investment spending has been shifting over the past few decades, reflecting shifts in the profile of the broader economy. That the biggest incremental shifts in the share of total business investment accounted for by intellectual property products came in the 1990s and early-2000s coincided with prolonged periods of strong productivity growth is more than mere coincidence. That recent quarters have seen a meaningful increase in intellectual property products' share of overall business investment could be laying the foundation for another period of faster productivity growth, but that could also be true of stepped-up outlays on "traditional" business equipment, which is providing much needed modernization of a good portion of the capital stock.

One encouraging sign for productivity growth is the strength of business investment spending over the past several quarters. Business investment in equipment, machinery, and intellectual property products is the key driver of productivity growth over time. We argued that over the course of the prior expansion, businesses were underinvesting to the point that an aging and inefficient capital stock was acting as a drag on productivity growth and, in turn, broader economic growth. Though business spending on structures remains quite weak, having contracted in each of the past six quarters, business spending on equipment, machinery, and intellectual property products has been notably strong over the past few quarters.

It remains to be seen whether, or to what extent, the strength in business investment over recent quarters will be sustained, but thus far it shows no signs of fading. While we think this period of stronger growth in business investment, particularly investment in intellectual property products, will support faster growth in labor productivity, it will be some time before any definitive conclusions can be reached. There have, however, been some more immediate boosts to productivity growth since the onset of the pandemic. For instance, the significant increase in remote work arrangements is thought to have boosted worker productivity, in large measure because it has eliminated commuting.

To some extent, growth in outlays for business equipment reflects increased spending on computer and communications equipment to facilitate remote working. Indeed, even as real GDP cratered in Q2 2020, business investment in computer and communications equipment grew strongly, with real (or, inflation adjusted) outlays on computer equipment growing at a 29.3 percent rate and outlays on communications equipment growing at a 17.3 percent rate.

Enhanced productivity from remote work arrangements has been facilitated by the increased business spending on computer and communications equipment discussed above. Still, to the extent that a greater incidence of working remotely has enhanced labor productivity, this is more likely to be in the form of a one-off boost than a faster rate of productivity growth on a sustained basis. In other words, once the office-to-remote transition has been made

and the supporting technology is in place, productivity may be higher and may stay at the new higher level, but that is not the same as faster productivity growth on a sustained basis. This is a distinction that we've seldom seen made in discussions of the benefits of remote work arrangements. Moreover, while for many workers there may be no turning back from working remotely, other workers will return, even if not by choice, to office settings, which could push productivity amongst this group down.

Productivity has also gotten a boost over the past year from firms either adapting or more intensively utilizing technology and automation. While this trend had been in place well before the pandemic took hold, the pandemic has accelerated the rate at which such changes are occurring. To the extent greater reliance on technology and automation makes firms less reliant on labor input, measured productivity will be greater, and that we are still in the relatively early phases of this transition suggests we could see a sustained period of faster productivity growth as automation is used more and more intensively.

While any such boost to productivity growth could potentially raise the economy's speed limit, the effects on labor force participation and the utilization of labor resources have to be accounted for in any calculation of the ultimate effects on economic growth. More specifically, it matters whether automation is intended to enhance the productivity of labor or is intended to replace labor. One thing we often hear is that enhanced use of automation will free up labor to focus on higher value-added tasks, which is implicitly assuming the intent is to enhance labor productivity. It is also implicitly assuming that workers displaced from lower value-added tasks have the requisite skill set for performing higher value-added tasks, which may or may not actually be the case. Indeed, for some time prior to the pandemic it had been common to hear firms complain about the inability to find skilled labor. To the extent that more intensive use of technology/automation require higher levels of skills on the part of workers, that could exacerbate the skills mismatches that had been plaguing firms prior to the pandemic.

To the extent workers in lower-skill positions are displaced by the increased use of automation and are unable to find alternative employment, do they remain in the labor force as unemployed or do they drop out of the labor force altogether? If automation leads to people dropping out of the labor force, that is an obvious drag on the rate of labor force growth, thus negating some of the boost in the economy's speed limit from the faster productivity growth. While people remaining in the labor force as unemployed does not necessarily hold down the economy's speed limit, achieving that speed limit is predicated on resources being fully employed, and to the extent they are not, economic growth will fall short of potential. And, we can tie this point into the earlier discussion of more people working remotely. Fewer people commuting implies less utilization of mass transit, while fewer people in office buildings implies less need for building services personnel, and the shops/restaurants that depend on office populations for a good segment of their business would also need fewer workers. What becomes of these displaced workers will have a bearing on the trajectory of economic growth, actual and potential.

Our point isn't that we should do away with technology and force everyone to commute into centralized office buildings where workers are massed together to do their jobs. As we understand

it, that's been tried before – it was called the 1950s. Instead, our point is simply that, while increased automation and remote work arrangements may in fact lead to faster productivity growth, most discussions of these topics completely ignore the implications for employment and labor force participation, but these clearly matter for the path of economic growth.

Finally, there is considerable discussion of the potential effects on productivity growth of the Biden Administration's *Build Back Better* agenda. The proposed \$4.5 trillion of government spending and tax credits focusing on infrastructure (very generously defined) and labor force participation/preparedness could facilitate faster growth in both the labor force and productivity, thus increasing the economy's "speed limit." While not ruling out this possibility, we think it much too soon to quantify any such effects, as there is a long road between proposal and passage of such an ambitious plan. That of course hasn't stopped some from issuing detailed estimates of the impact on employment, productivity growth, and overall economic growth. While passage of some form of the *Build Back Better* agenda is all but assured, when and in what form are anything but, so we'll wait until there is a final bill before trying to quantify the effects.

Some points to consider, however, include the plan coming with a ten-year timeline for the added spending, suggesting that any gains stemming from the plan would also be gradual. Indeed, most estimates – assuming passage of the full plan – assume a boost to real GDP growth of between one and two tenths of a point per year, not a lot in any given year but more substantial over time. Also, part of the plan is to be paid for with tax increases, which are heavily weighted toward increasing taxes on capital. While many argue higher taxes on capital lead to no adverse effects on capital formation, we'd argue the opposite. This matters, given that anything that impedes capital formation in turn holds down the investment that is the key to sustaining/enhancing productivity growth and, as such, weighs on overall economic growth. Couching the argument for higher taxes on capital in terms of reducing income inequality without acknowledging the adverse effects on growth is a questionable tack to take.

We started out by asking what comes after the current run of rapid economic growth has run its course. Sure, there are those who suggest we should just sit back and "enjoy the boom." But whatever you want to call it, this run of rapid growth isn't built to last. While it will take years to know the answer to what comes next, our intent here was to highlight the factors that will determine the answer. As always, it comes down to productivity growth and labor force growth, and much of the discussion we've heard thus far has focused on the former while ignoring the latter, meaning the answer to the "then what?" question isn't as nice and neat as some make it out to be.

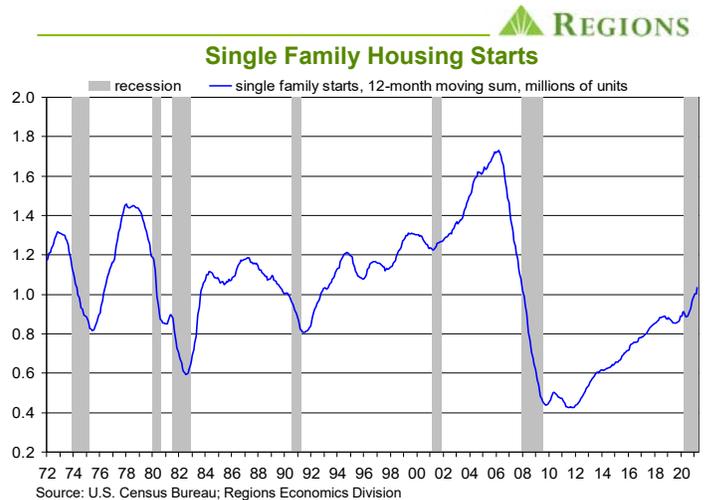
Housing Market: Déjà vu All Over Again?

When it comes to analysis of the economy or the financial markets, perhaps the six most dangerous words in the English language are "this time it really is different." We've in fact counseled that if you ever come across anyone saying those particular words in that particular order, your best option is to turn and run. As fast as you

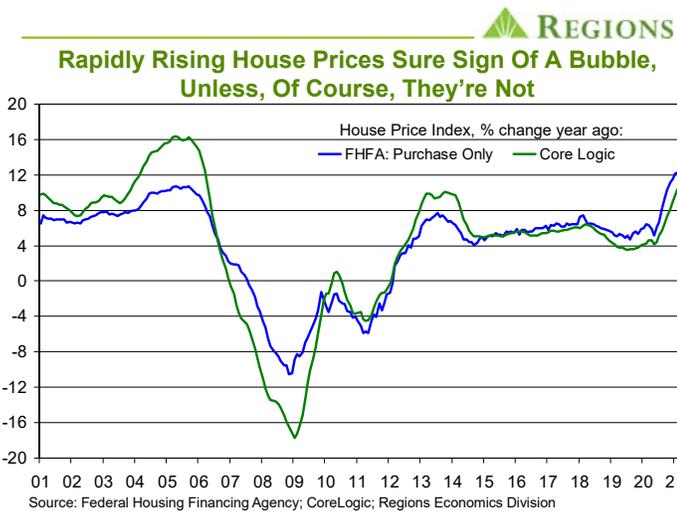
can go. Which is fine advice, except for when this time really is, you know, different. Still, we're loath to go against our own advice, so instead of saying this time it really is different, we'll just say now is not then. Our topic here is the housing market, with "now" being, well, now, and "then" being the years leading up to the 2007-09 recession. Amid the double-digit pace of house price appreciation seen in recent months and the frenzied pace at which houses are flying off the market, more and more people seem convinced that, if there isn't already a bubble in the housing market, then surely one is forming. Indeed, that is perhaps the question we've been asked more frequently than any other of late.

Our reply, boiled down to its most concise form, is "now is not then." Sure, we get why the question comes up. After all, the last time we went through a period of double-digit house price appreciation, things didn't end all that well, and in some ways the housing market still bears the scars left by the subsequent collapse. But, while we understand that the thought of a repeat of that episode makes people nervous, pretty much the only commonality between the housing market now and the housing market then is the double-digit pace of house price appreciation, hence our "now is not then" reply. In what follows, we present a series of charts illustrating our point about the difference between now and then, offering little in the way of commentary and instead letting the charts do most of the talking. Each reader is free to examine the charts and come to their own conclusion as to whether or not there is a housing market bubble.

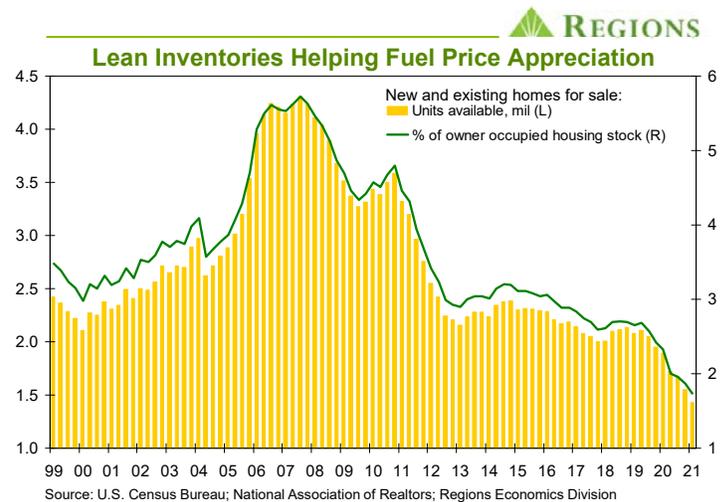
construction has hit that mark, it still leaves the considerable cumulative deficit that has, well, built up, over the past decade.



Over the past several years, inventories of existing homes for sale have fallen considerably, to the point that even prior to the pandemic the market was chronically undersupplied – we literally have been writing on this topic for years. A greater concentration of single family units in the rental market and uncommonly low turnover amongst older homeowners are the primary culprits behind the persistent undersupply of existing homes for sale.

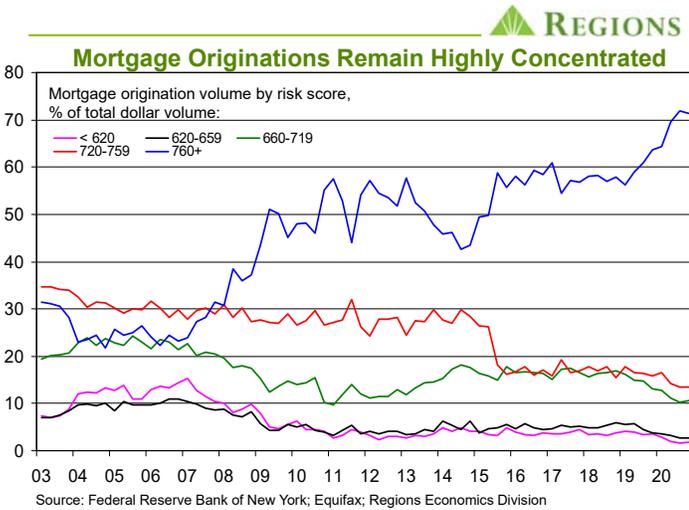


One striking difference between housing market conditions today and in the years leading up to the 2007-09 recession is supply, or, in the case of current conditions, the lack thereof. Single family construction soared to dizzying heights in the prior cycle, topping out with 1.729 million units having been started in the twelve months ending with March 2006, by which time house prices had already begun to decline. What followed was a multi-year decline that did not come to an end 2011, when only 430,000 single family units were started. While single family construction has increased over the past several years, current rates of production (1.033 million units started over the twelve months ending with March 2021) nonetheless remain well below the rate – around 1.25 million units per year – that would accommodate new demand and the replacement of aged units. And, even when new single family

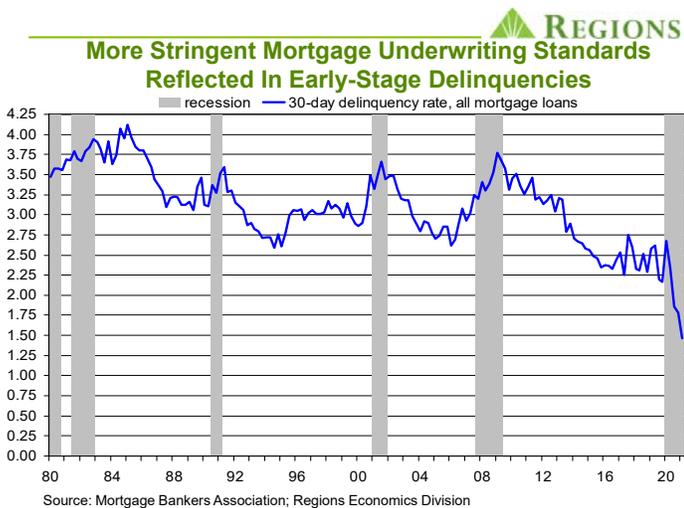


While undersupply has been a lingering issue for years, the degree to which that is the case has clearly intensified over the course of the pandemic. Still, despite the persistent undersupply, the pace of house price appreciation was fairly steady for the several years prior to the pandemic. One reason is that much more stringent mortgage underwriting standards in the years following the 2007-09 recession acted as a governor on the demand side of the market. That made for quite the contrast from the years leading up to the 2007-09 recession, when a seeming lack of lending standards contributed to rapid growth in demand that included borrowers who otherwise would not have qualified for mortgage loans. The years leading up to the 2007-09 recession saw a steady increase in mortgage originations accounted for by borrowers with

credit scores less than 720, an increase that picked up steam after house prices had turned lower and which culminated in Q1 2007, when 48.2 percent of mortgage originations went to borrowers with credit scores of less than 720. In Q4 2020, that share was 15.2 percent, while borrowers with credit scores above 760 accounted for 71.4 percent of mortgage originations.

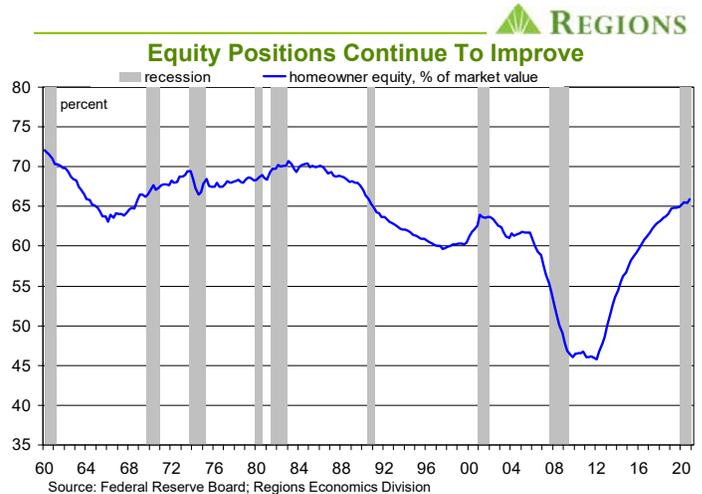


Whether or not this is an equitable or even optimal allocation of mortgage credit is another discussion for another day. What is relevant in this discussion is the actual allocation of mortgage credit over the past several years, how it has differed from the years prior to the 2007-09 recession, and why it matters. One reason it matters is that early-stage mortgage delinquencies, as measured by the 30-day delinquency rate (i.e., loans delinquent by 30-59 days) had been trending lower in the years prior to the pandemic and hit a new all-time low of 1.46 percent in Q1 2021.



In the prior cycle, the 30-day delinquency rate troughed at 2.62 percent in Q1 2006 and began to rise well before the start of the recession (note that there are strong seasonal patterns in the data that are not entirely smoothed out by seasonal adjustment). Since peaking at 3.77 percent in Q1 2009, the 30-day delinquency rate has trended lower, with notable disruptions in Q3 2017 (due to Hurricanes Harvey and Irma) and Q1 2019 (seasonal adjustment

issues). More recently, the 30-day delinquency rate spiked in Q2 2020, reflecting inflows into mortgage forbearance programs as the pandemic took hold (reporting conventions dictate loans in forbearance be reported as delinquent), but has since fallen sharply. This in part reflects loans progressing into later-stage (i.e., 60-day or 90-day) delinquencies and in part reflects loans exiting forbearance and returning to current status.



More stringent underwriting standards over the past several years have contributed to increasingly slower inflows into mortgage distress, and at the same time steadily rising equity positions have helped ensure that fewer and fewer mortgage delinquencies have progressed into foreclosure. Recall that during the prior cycle, lower loan-to-value ratios and cash-out mortgages were pushing on equity positions even before house prices turned lower. When faced with financial distress, many borrowers with little or no equity, let alone those with negative equity, decided it was simply easier to mail their keys to their lenders and walk away. At present the situation is quite the opposite – borrowers with stronger financial profiles and stronger equity positions are less apt to default on their loans and if they do encounter financial distress are more likely to sell their home and walk away with cash. That is a point worth keeping in mind when pondering the fate of the roughly 2.2 million borrowers remaining in mortgage forbearance programs as of April, according to Black Knight. Most of these loans will likely return to current status, but the ones that don't could not possibly trigger a foreclosure crisis such as that seen in the prior cycle, which is another commonly expressed fear.

These are some of the key, but not the only, differences between the current cycle and the prior cycle, going to our point that now is not then. Again, each reader is free to draw their own conclusion as to whether or not there is a housing market bubble. While we do not think double-digit house price appreciation can or will be sustained, that it will end does not mean it will end badly. We look for some relief on the supply side of the market over the back half of this year, and even though some demand was pulled forward into late-2020/early-2021 by low mortgage interest rates, demand is likely to be sustained, particularly with demographic trends favoring homeownership over the next several years. Even a less benign outcome than this will not trigger a multi-year downturn such as that seen last time around. So, again, now is not then.

ECONOMIC OUTLOOK



May 2021

Q4 '20 (a)	Q1 '21 (p)	Q2 '21 (f)	Q3 '21 (f)	Q4 '21 (f)	Q1 '22 (f)	Q2 '22 (f)	Q3 '22 (f)		2018 (a)	2019 (a)	2020 (a)	2021 (f)	2022 (f)
4.3	6.4	7.5	5.5	5.3	3.8	3.3	2.6	Real GDP ¹	3.0	2.2	-3.5	6.1	4.2
2.3	10.7	10.3	4.3	4.5	3.8	3.6	2.6	Real Personal Consumption ¹	2.7	2.4	-3.9	7.6	4.1
13.1	9.9	5.7	5.4	5.7	5.8	5.2	5.4	Real Business Fixed Investment ¹	6.9	2.9	-4.0	7.5	5.5
25.4	16.7	7.9	4.4	3.2	4.3	3.6	3.6	Equipment ¹	8.0	2.1	-5.0	14.8	4.0
10.5	10.1	6.9	8.1	8.3	7.1	5.6	5.3	Intellectual Property and Software ¹	7.8	6.4	1.7	7.5	6.8
-6.2	-4.8	-3.4	2.1	6.8	6.8	8.7	10.9	Structures ¹	3.7	-0.6	-11.0	-7.3	6.6
36.6	10.8	10.5	6.6	5.6	1.5	-2.0	-2.8	Real Residential Fixed Investment ¹	-0.6	-1.7	6.1	15.7	2.0
-0.8	6.3	-5.0	1.0	1.6	2.2	1.3	1.6	Real Government Expenditures ¹	1.8	2.3	1.1	0.2	1.2
-1,122.0	-1,175.5	-1,219.1	-1,231.1	-1,245.7	-1,240.9	-1,240.3	-1,252.5	Real Net Exports ²	-877.7	-917.6	-926.0	-1,217.8	-1,247.3
1,227	1,155	1,230	1,260	1,262	1,250	1,243	1,235	Single Family Housing Starts, ths. of units ³	872	893	1,000	1,227	1,241
357	458	436	417	401	391	389	393	Multi-Family Housing Starts, ths. of units ³	376	403	396	428	393
16.1	16.9	17.5	16.8	16.9	16.9	16.9	16.9	Vehicle Sales, millions of units ³	17.2	17.0	14.4	17.0	16.9
6.8	6.2	5.9	5.5	5.2	4.8	4.6	4.5	Unemployment Rate, % ⁴	3.9	3.7	8.1	5.7	4.6
-6.0	-5.6	8.4	4.1	3.9	4.2	3.6	2.9	Non-Farm Employment ⁵	1.6	1.3	-5.7	2.5	3.2
-10.1	61.3	-29.3	-9.3	-4.4	3.1	2.5	2.7	Real Disposable Personal Income ¹	3.6	2.2	5.8	2.1	-2.6
1.3	1.9	3.3	3.0	3.1	2.6	2.1	1.9	GDP Price Deflator ⁵	2.4	1.8	1.2	2.8	2.1
1.2	1.7	3.2	2.8	2.9	2.5	2.1	2.0	PCE Deflator ⁵	2.1	1.5	1.2	2.6	2.2
1.2	1.9	3.7	3.0	2.7	2.3	1.8	1.9	Consumer Price Index ⁵	2.4	1.8	1.2	2.8	2.0
1.4	1.5	2.4	2.1	2.2	2.2	2.0	2.0	Core PCE Deflator ⁵	2.0	1.7	1.4	2.1	2.1
1.6	1.4	2.4	2.0	2.1	2.4	2.3	2.3	Core Consumer Price Index ⁵	2.1	2.2	1.7	2.0	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, % ⁴	1.78	2.16	0.42	0.13	0.13
0.86	1.32	1.65	1.73	1.85	1.90	2.00	2.06	10-Year Treasury Note Yield, % ⁴	2.91	2.14	0.89	1.64	2.02
2.76	2.88	3.20	3.27	3.32	3.36	3.49	3.57	30-Year Fixed Mortgage, % ⁴	4.54	3.94	3.12	3.17	3.52
-3.5	-3.3	-3.2	-3.3	-3.4	-3.4	-3.3	-3.4	Current Account, % of GDP	-2.2	-2.2	-3.1	-3.3	-3.4

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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