ECONOMIC OUTLOOK

REGIONS

May 2023

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Q1 Real GDP: Better Than The Headline, But Still Not Good

The initial estimate from the Bureau of Economic Analysis (BEA) shows real GDP grew at an annualized rate of 1.1 percent in Q1 2023, well below expectations. As in any given quarter, the BEA's initial estimate of Q1 GDP is based on highly incomplete source data and will be refined as additional data are released and prior estimates are revised. That said, revisions are unlikely to make Q1 growth look all that much better, and could even make it look worse, than the initial headline growth print suggests. That Q1 real GDP growth fell so far short of expectations – our forecast was for annualized growth of 2.3 percent; the consensus forecast was for 2.0 percent growth – was to some evidence of the economy's inexorable march toward the long-awaited but not so eagerly anticipated recession. Others pointed to the 2.9 percent growth (annualized) in real private domestic demand – combined business and household spending – as proof of the economy's resilience. Our view fell somewhere between the two while giving us no grounds on which to change our expectations of somewhat listless real GDP growth over the next few quarters.

There were two main factors behind our forecast miss on Q1 real GDP growth. First, revisions to the retail sales data, released by the Census Bureau after we published our GDP forecast, show retail sales were weaker in Q1 than had previously been reported. For instance, on a nominal basis, control retail sales, a direct input into the GDP data on consumer spending on goods, were originally reported to have grown at an annualized rate of 9.5 percent in Q1, but the revised data knocked that down to 5.5 percent growth, leaving Q1 growth in total consumer spending shy of our forecast. As a side note, the revision to retail sales isn't as drastic as suggested by these annualized growth rates, particularly since the bulk of the revision reflects changes to the seasonal factors used to adjust the raw sales data rather than changes to the raw data.

The main culprit behind our forecast miss on Q1 real GDP growth was that, as treated in GDP accounting, a modest draw in business inventories deducted 2.26 percentage points from top-line real GDP growth. While we expected inventories to be a drag on Q1 real GDP growth, the magnitude of that drag took us by surprise. Adjusted for price changes, total business inventories fell by $1.6 billion (annualized) in Q1, but it is the change in the change in inventories that enters into the calculation of real GDP growth. So, with real business inventories having increased at an annualized rate of $136.5 billion in Q4 2022, the modest drawdown in Q1 2023 became a severe drag on real GDP growth.

This is of course not the first time inventories have wreaked havoc on measured real GDP growth. For instance, real business inventories increased at an annual rate of $110.2 billion in Q2 2022, but as this followed an annualized increase of $214.5 billion in Q1, the largest quarterly increase on record, the change in the change in inventories knocked 1.91 percentage points off top-line real GDP growth, yielding a contraction in real GDP but having said nothing meaningful about the underlying health of the economy.

What is worth noting is that the decline in real business inventories in Q1 followed five consecutive quarters of robust inventory accumulation. Inventories can fall either because firms simply can't keep pace with demand or because expectations of fading demand have led firms to scale back production. Those five quarters of robust inventory growth came as firms were scrambling to rebuild stocks which had been significantly run down by the combination of supply-side impairments and artificially boosted demand. With growth in both consumer and business spending clearly slowing in the early months of 2023, firms likely felt inventories were more or less right-sized. The drag on Q1 growth notwithstanding, the modest drawdown in business inventories left firms in a better position to contend with any further softening in business and consumer spending than would have been the case had there been another sizable build in inventories in Q1.

We and others often note that recessions often serve to remedy imbalances in various components of the economy, such as firms finding themselves with excessive levels of inventories. It is hard to argue that firms are at present sitting on bloated inventory levels that would trigger cuts in both employment and output should demand fade further in the months ahead. If anything, judging by inventory/sales ratios in the manufacturing, wholesale, and retail sectors, inventory levels should actually be higher than they now are, particularly if firms want to hold higher stocks as a hedge against another round of supply chain impairments. This is a point in favor of those who argue that if the economy does slip into recession, that recession is likely to be brief and mild.

While we don't think the Q1 real GDP growth print to be all that meaningful of an indicator of the underlying health of the U.S. economy, neither do we think the reported growth in real private domestic demand (consumer spending, business fixed investment, residential fixed investment) to be all that informative. To be sure, we frequently note that we see private domestic demand to be a more meaningful indicator than top-line real GDP growth, and the 2.9 percent annualized growth in real private domestic demand booked in Q1 is the fastest quarterly growth since Q2 2021. What we find concerning, however, is that much of this growth reflects outsized increases in series such as real consumer spending and core capital goods shipments January. Moreover, those outsized increases reflected little more than friendly seasonal adjustment making the January data look stronger than was actually the case, which was true for almost all of the January economic data.

For instance, on a not seasonally adjusted basis control retail sales, as noted above a direct input into the GDP data on consumer spending on goods, fell by 21.5 percent in January. A large decline

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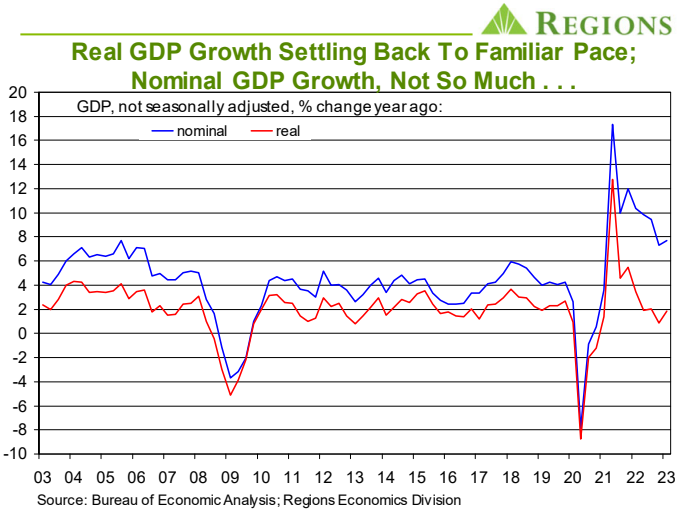
to be sure, but nonetheless much smaller than the typical January decline which, as such, translated into a 1.7 percent increase in control retail sales on a seasonally adjusted basis (these figures reflect the revised retail sales data). This increase more than offset modest declines in both February and March, leaving Q1 control sales easily above Q4 2022 sales even after the sizable downward revision to the initial estimate of Q1 sales.

Along those same lines, the not seasonally adjusted data show unit sales of new motor vehicles fell by 17.1 percent in January, which isn't as terrible as it sounds given that the typical January decline is much larger. As such, the seasonally adjusted data show a spike in unit sales and, in turn, consumer spending on new motor vehicles in January. This easily offset declines in February and March, to the point that the GDP data show that after accounting for price changes consumer outlays on new motor vehicles rose at an annualized rate of 45.3 percent in Q1, adding 1.06 percentage points to top-line real GDP growth. The same pattern is evident in the data on shipments of core capital goods, i.e., a smaller than normal decline in unadjusted shipments in January translating into a large increase in the seasonally adjusted data. In this case, however, an outsized increase in January mitigated the magnitude of the decline in business outlays on equipment and machinery in the Q1 GDP data rather than inflating a reported increase.

There are any number of instances of this exact pattern, and without going through each and every one of them, the broader point should be clear. Much of the growth reported for Q1 reflects nothing more than the January data being flattered by seasonal adjustment to the point that outsized January increases more than offset declines in February and March. While this helped bolster Q1 growth in real private domestic demand, the flip side is that the quarter ended on a soft note, raising the question of just how much momentum the economy took into Q2. This is why we weren't all that comforted by the 2.9 percent annualized growth in real private domestic demand in Q1, and the loss of momentum as Q1 wore on helps account for why we have low expectations for growth in real private domestic demand in Q2.

We'll also point out that, while seasonal adjustment was most kind to the January data, it could be most cruel to the April data. In many data series, the seasonal factors used to adjust the April data are the toughest for any month of the year, meaning that for any series in which the April bounce in activity falls short of historical norms, the seasonally adjusted data will be made to look worse than is actually the case. If so, this will act as a drag on Q2 real GDP growth as it is the seasonally adjusted data points that are pulled into the GDP data. This is something worth keeping in mind as you process the economic data for the month of April, and particularly as you process the reactions to the economic data.

There are two other points about the Q1 GDP data we think worth making. First, while deducting from top-line real GDP growth for the fourth consecutive quarter and the sixth out of the past seven quarters, residential fixed investment could begin contributing to, even if only modestly, growth as soon as this quarter. Though by no means embracing them, home buyers at least seem to have come to terms with mortgage interest rates being where they are, and with extraordinarily lean inventories of existing homes for sale, prospective buyers are increasingly turning to the market for new homes (new home sales enter into the GDP data while existing home sales do not, save for realtor commissions on sales). Many builders saw strong growth in orders in Q1 and new home sales were notably strong in March (genuinely strong, as seen in the not seasonally adjusted data). This should translate into a faster pace of single family starts and sales in Q2 which, if we're correct on this point, may be enough to add to real GDP growth.



Finally, on a not seasonally adjusted basis, real GDP was up by 1.9 percent year-on-year in Q1, with year-on-year growth gravitating around 2.0 percent over the past few quarters. This is in line with the trend rate of real GDP growth that we all came to know but not necessarily love over the course of the prior expansion, as we show in the above chart. While real GDP growth over the past few quarters may look familiar, that is clearly not the case with nominal GDP growth, as shown in the above chart. This of course simply reflects the degree to which rising prices have, well, inflated nominal GDP growth. The not seasonally adjusted data show nominal GDP was up 7.7 percent year-on-year in Q1, up from the 7.3 percent increase seen in Q4 2022. While real GDP growth trended around 2.0 percent over the course of the prior expansion, nominal GDP growth trended around 3.9 percent.

We're a long way from that marker at present and may not be back there for some time to come. That the gap between nominal and real GDP growth is so large is just another way of illustrating how elevated inflation has been over the past several quarters. It could be that the gap between the two, while narrowing further, remains wider than was the case over the prior expansion, another way of saying that the 2.0 percent rate of inflation targeted by the FOMC may no longer be a realistic target. We've argued as much on more than one occasion. While that is another discussion for another day, the yawning gap between nominal and real GDP growth is a striking reminder of how elevated inflation has been and still is.

Faster Wage Growth Sticking Around For A While?

Labor market conditions play a key role in shaping FOMC members' expectations of the path of inflation. While there have been some signs that the labor market is cooling, such as slowing job growth, declining job vacancies, and workers becoming more reluctant to voluntarily quit jobs, the labor market remains tight. To that point,

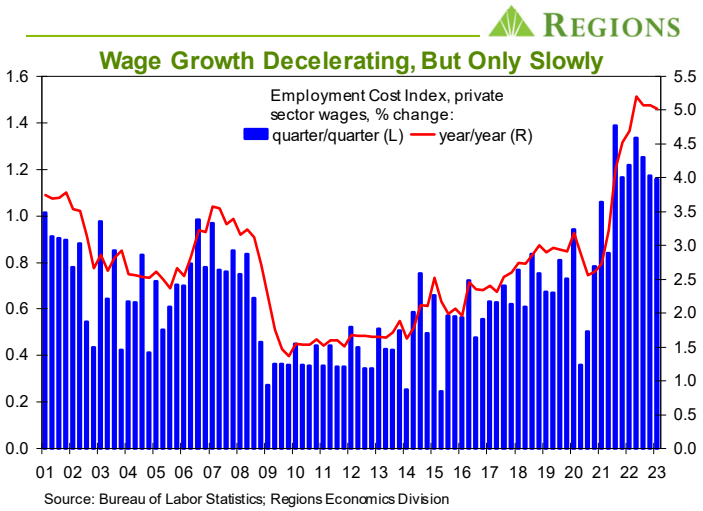
in his press conference following the May FOMC meeting Chair Powell noted that the labor market "remains very tight" even with some signs that labor demand and labor supply are coming back to "better balance."

While some see decelerating growth in average hourly earnings in the past few monthly employment reports as evidence of a cooling labor market, that isn't necessarily the case. The average hourly earnings metric in the monthly employment reports suffers from a mix bias, i.e., it is impacted by the mix of jobs and changes in average hourly earnings are impacted by the mix of jobs added in any given month. That is particularly relevant over the past several months when job growth has been led by industry groups such as education and health services, leisure and hospitality services, and retail trade, all industry groups with average hourly earnings below the overall private sector average. At the same time, payrolls in construction, finance, and information services, all of which boast average hourly earnings well above the overall private sector average, have been either little changed or down.

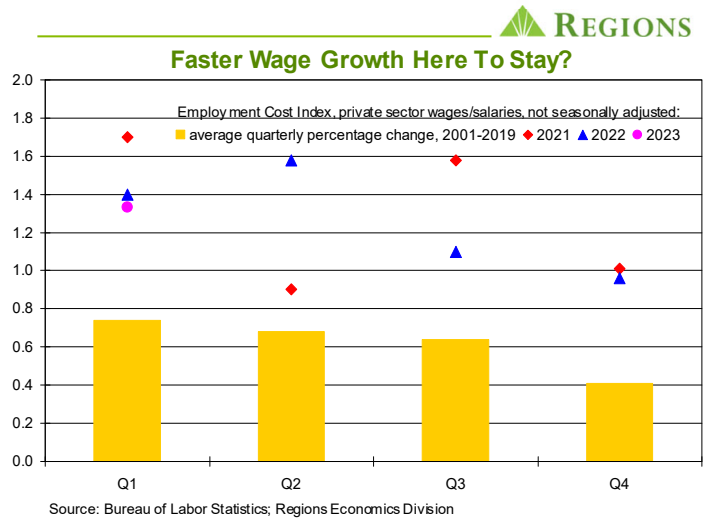
For instance, the three lower-wage industry groups listed above accounted for 54.4 percent of growth in total nonfarm employment in Q1, while the three higher-wage industry groups accounted for 0.9 percent of nonfarm job growth. By comparison, in Q1 2022 these shares were 39.6 percent and 20.0 percent, respectively. This shift in the mix of job growth has impacted year-on-year growth in average hourly earnings. Moreover, it isn't only shifts of jobs across industries that can inject a mix bias into average hourly earnings, as workers moving from higher-wage to/from lower-wage occupations within the same industry group, such as durable and nondurable goods in manufacturing, can have the same effect. Average hourly earnings for all private sector workers were up 4.5 percent year-on-year in Q1, down from 4.9 percent in Q4 2022 and the smallest such increase since Q3 2021.

This mix bias is absent from the Employment Cost Index (ECI), which is designed to account for shifts in the mix of jobs and track changes in compensation costs for the same jobs over time. This is one reason many, including the FOMC, see the ECI as a superior measure of wage growth over time. Moreover, as it also accounts for benefit costs, the ECI is a measure of changes in total labor costs over time. Perhaps one reason the ECI is not more well known is that it comes on a quarterly, as opposed to a monthly, frequency, making it a less timely indicator. That said, while the ECI has shown some modest deceleration in the growth of total labor costs, that mainly reflects some slowing in the growth of benefit costs as the pace of wage growth has yet to let up to any meaningful degree. Indeed, the Q1 data show the total ECI increased by 1.2 percent from Q4 2022, with both wage costs and benefit costs rising by that same amount, with the increase in wage costs exceeding what we and the consensus expected.

On a year-on-year basis, the total ECI was up 4.9 percent in Q1, down from 5.1 percent increases over each of the prior three quarters. Again, though, this mainly reflects growth in benefit costs slowing to 4.5 percent from a 4.9 percent pace while wage costs logged a 5.0 percent over-the-year increase, the fourth consecutive quarter with growth at or above five percent. As noted above, average hourly earnings from the monthly employment reports logged a year-on-year increase of 4.5 percent in Q1 with growth clearly having slowed over the past few quarters. To the extent the reported slowing in growth of average hourly earnings reflects the shifting mix of job growth, that deceleration is sending a misleading signal on labor market conditions.



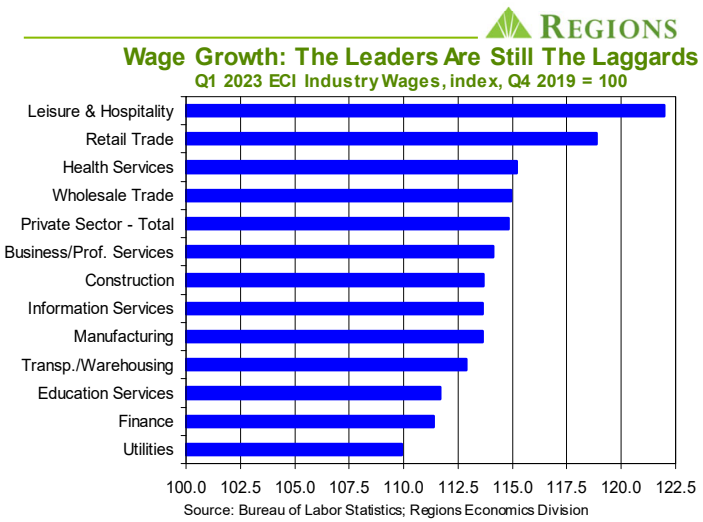
As seen in the chart above, growth in wages as measured by the Employment Cost Index hasn't slowed much over recent quarters. As noted above, there are signs of cooling demand for labor while the rate at which workers are voluntarily quitting jobs has fallen (this is relevant in that job changers have been shown to garner meaningfully larger salary increases than those who stay at the same job), all of which will ultimately be reflected in further deceleration in wage growth. The ECI, however, suggests that will be a longer journey than is implied by the average hourly earnings metric in the monthly employment reports.



One way to see how rapid wage growth has been over the past few years is to use the not seasonally adjusted data – there is a seasonal component to wage growth – to compare wage growth over recent years to historical patterns. The gold bars in the above chart show the long-term average quarterly percentage changes in private sector wages from the ECI, while the colored shapes show the quarterly changes from Q1 2021 through Q1 2023. In each instance, the recent changes have been well above the longer-term average. Note how close the Q1 2023 change (1.33

percent) is to the Q1 2022 change (1.40 percent), which goes to our earlier point of only modest deceleration in wage growth. Of particular note in the Q1 ECI data is the measure of private sector wages excluding incentive-paid occupations. The not seasonally adjusted data show an increase of 1.47 percent in Q1, second only to the 1.61 percent increase in Q1 2022 as the largest quarterly increase on record (this series only dates back to 2006, however) and far above the typical Q1 increase. Q1 2023 was the fifth consecutive quarter with a year-on-year increase of at least 5.0 percent, significantly above the pre-pandemic trend.

Given how tight the labor market remains, it is fair to ask whether wage growth will ever settle back in line with pre-pandemic trends. There is, of course, nothing that says it has to. For instance, faster growth in labor productivity over time would foster faster wage growth without squeezing corporate profit margins. This is not, however, all that comforting in light of what over recent quarters has been a notably weak trend in labor productivity, punctuated by an annualized 2.7 percent decline in Q1 2023. We have expressed skepticism over the productivity data over the past several quarters, but even if we're correct in doubting the data, at best that leaves us with no way of adequately lining up wage growth and productivity growth. It also helps to remember that wage growth had been trending firmly higher in the years prior to the pandemic, with faster wage growth apparent across all of the major industry groups, something that had been sorely lacking in the earlier phases of the pre-pandemic expansion.



To that point, the chart above indexes wages across private sector industry groups, as measured in the ECI, to wages as of Q4 2019. What is striking is the extent to which wage growth in leisure and hospitality services and retail trade has outpaced wage growth in other industry groups, while wage growth in health care has also outpaced growth in the private sector as a whole. In some sense, base effects are at work here, with hourly wages in leisure and hospitality services and retail trade well below the overall private sector average, but the faster wage growth in these industry groups also reflecting firms reaching to attract labor. It is worth noting that payrolls in leisure and hospitality services have yet to return to their pre-pandemic peak despite this notably rapid wage growth. Health care is another industry group in which labor supply constraints are being felt more acutely, helping account for above-average wage growth. Still, even with the faster wage growth in these industry groups since the onset of the pandemic, the level of hourly earnings in leisure and hospitality services and retail trade remains well below the private sector average which, though not to the same degree, is also the case with hourly earnings in health services.

To the extent FOMC members see a strong link between wage growth and inflation, there has to date not been nearly a strong enough deceleration in wage growth to inspire confidence that inflation will settle back at their 2.0 percent target rate any time soon. To be sure, should the economy continue to slow and job vacancies fall more sharply across a wider range of industry groups, job seekers and job switchers will have fewer options, which should translate into more meaningful deceleration in the pace of wage growth. How much further wage growth will slow remains to be seen, particularly to the extent firms will engage in "labor hoarding" even if faced with a brief and mild recession. With the overall labor force participation rate unlikely to rise back to pre-pandemic norms, the floor under wage growth could be higher than many are now anticipating will be the case. Absent a meaningful and sustained improvement in labor productivity, that would spell bad news for profit margins and/or inflation.

April Employment Report

Total nonfarm employment rose by 253,000 jobs in April, handily beating expectations, while the unemployment rate fell to 3.4 percent, matching January as the cycle low. But, and you just knew one of those was coming, beneath the seemingly stellar headline numbers lie some not so stellar details. For starters, prior estimates of job growth in February and March were revised down by a net 149,000 jobs for the two-month period, and unusually large revision in absolute value terms. While our forecast was for payrolls to have risen by 146,000 jobs in April, between the downward revisions and the reported April increase, the level of nonfarm employment is below where our forecast would have put it. So, in that sense, the labor market doesn't look much different than we expected it to look. Still, job growth has become less broadly based over the past three months, and if the breadth of job growth continues to narrow, that would be a worrying sign as to the staying power of this expansion.

The decline in the unemployment rate mostly reflects the size of the labor force having declined by 43,000 persons. An odd, and not all that plausible, detail is that the number of males between the ages of 16 and 24 reported to be in the labor force declined by 343,000 in April, more than accounting for the decline in the total labor force. Of more relevance is that the participation rate amongst the 25-to-54 year-old age cohort, considered the "prime" working age population, rose to 83.3 percent, the highest since March 2008. The flip side of that, however, is that further and sustained increases in participation amongst this key cohort seem unlikely. Also, the number of people involuntarily working part-time due to slack business conditions fell in April, suggesting a more resilient economy than portrayed in what was generally weak data for the month of March.

April's bounce notwithstanding, the trend rate of job growth is clearly slowing amid cooling demand for labor. That does not, however, mean the labor market is on the verge of rolling over.

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REGIONS

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Q4 '22 (a)	Q1 '23 (p)	Q2 '23 (f)	Q3 '23 (f)	Q4 '23 (f)	Q1 '24 (f)	Q2 '24 (f)	Q3 '24 (f)		2020 (a)	2021 (a)	2022 (a)	2023 (f)	2024 (f)
2.6	1.1	1.3	0.8	1.0	1.0	1.2	1.5	Real GDP[1]	-2.8	5.9	2.1	1.5	1.1
1.0	3.7	0.5	1.3	1.0	1.2	1.1	1.3	Real Personal Consumption[1]	-3.0	8.3	2.7	1.8	1.1
4.0	0.7	1.3	0.8	0.4	1.7	2.8	3.2	Real Business Fixed Investment[1]	-4.9	6.4	3.9	2.0	1.8
-3.5	-7.3	-3.2	-3.3	-3.2	-1.2	0.9	2.2	Equipment[1]	-10.5	10.3	4.3	-2.6	-0.9
6.2	3.8	3.7	3.4	3.2	4.0	4.8	4.8	Intellectual Property and Software[1]	4.8	9.7	8.8	4.8	4.0
15.8	11.2	7.1	4.7	2.4	2.6	1.9	1.4	Structures[1]	-10.1	-6.4	-6.6	6.3	2.7
-25.1	-4.2	0.6	2.6	4.6	4.0	3.9	3.1	Real Residential Fixed Investment[1]	7.2	10.7	-10.6	-10.6	3.6
3.8	4.7	2.0	1.2	2.1	1.2	0.7	0.9	Real Government Expenditures[1]	2.6	0.6	-0.6	2.9	1.3
-1,238.6	-1,235.8	-1,245.9	-1,267.6	-1,280.5	-1,298.0	-1,307.8	-1,329.5	Real Net Exports[2]	-922.6	-1,233.4	-1,356.7	-1,257.4	-1,320.8
849	841	856	860	864	870	885	901	Single Family Housing Starts, ths. of units[3]	1,002	1,131	1,007	855	894
549	555	518	494	467	450	436	424	Multi-Family Housing Starts, ths. of units[3]	393	474	547	508	433
6.9	3.1	-2.3	-3.7	-4.0	-4.9	-2.0	0.7	CoreLogic House Price Index[5]	6.7	15.6	13.5	-1.7	-1.2
14.3	15.2	15.4	15.3	15.2	15.4	15.5	15.7	Vehicle Sales, millions of units[3]	14.5	14.9	13.8	15.3	15.6
3.6	3.5	3.4	3.6	3.8	4.0	4.1	4.3	Unemployment Rate, %[4]	8.1	5.4	3.6	3.6	4.2
3.4	2.9	2.5	1.8	1.3	0.7	0.5	0.4	Non-Farm Employment[5]	-5.8	2.9	4.3	2.1	0.5
5.0	8.0	3.1	1.9	2.0	3.2	2.2	2.6	Real Disposable Personal Income[1]	6.2	1.9	-6.1	4.1	2.5
6.4	5.3	3.7	3.4	3.0	2.7	2.6	2.4	GDP Price Deflator[5]	1.3	4.5	7.0	3.8	2.4
5.7	4.9	3.8	3.5	3.2	2.8	2.6	2.3	PCE Deflator[5]	1.1	4.0	6.3	3.8	2.5
7.1	5.8	4.3	3.7	3.4	3.1	2.8	2.5	Consumer Price Index[5]	1.3	4.7	8.0	4.3	2.6
4.8	4.7	4.4	4.0	3.5	2.9	2.5	2.3	Core PCE Deflator[5]	1.3	3.5	5.0	4.1	2.5
6.0	5.6	5.2	4.5	4.0	3.4	2.9	2.6	Core Consumer Price Index[5]	1.7	3.6	6.1	4.8	2.8
3.71	4.56	5.04	5.13	5.13	5.09	4.82	4.44	Fed Funds Target Rate Range Mid-Point, %[4]	0.42	0.13	1.73	4.96	4.62
3.83	3.65	3.43	3.39	3.35	3.26	3.24	3.17	10-Year Treasury Note Yield, %[4]	0.89	1.44	2.95	3.45	3.20
6.66	6.37	6.32	6.29	6.24	6.03	5.86	5.63	30-Year Fixed Mortgage, %[4]	3.12	2.96	5.34	6.30	5.75
-3.2	-3.4	-3.6	-3.4	-3.4	-3.3	-3.2	-3.2	Current Account, % of GDP	-2.9	-3.6	-3.7	-3.5	-3.2

a = actual; f = forecast; p = preliminary

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

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