ECONOMIC OUTLOOK
REGIONS
July 2023

A Funny Thing Happened On The Way To The Recession. Or Did It?

For more than a year now, forecasts of recession have been much more the rule than the exception. With the FOMC moving aggressively to combat inflation and suggesting they were willing to accept recession as the price to be paid for pushing inflation lower, many expected significantly higher interest rates to be the catalyst that triggered the downturn. With higher interest rates, a prolonged period of elevated inflation, and dwindling levels of excess savings, consumers were seen as coming under increasing financial stress, which would in turn sap consumer spending. A dimming outlook for growth and profits and higher financing costs were expected to drag down business investment, and higher mortgage interest rates were expected to send the housing market reeling. All of which was widely expected to culminate in recession, although those who were forecasting recession almost universally predicted a "brief and mild" recession.

That the much anticipated recession didn't appear in 2022 did not dissuade most of those calling for recession, but instead prompted them to push back their recession ETA – it's still coming, just later than they had thought. Recession forecasts got a second wind this March, as a few high profile bank failures sparked talk of a "banking crisis" that would prompt a credit crunch. That would surely tip the economy into recession, with many apparently not having noticed banks had, per the Fed's quarterly survey of bank lending officers, been raising lending standards on and seeing falling demand for business and consumer loans for most of 2022.

Either way, the economy having been more resilient than many were, in mid-March, expecting to be the case has led many, if not most, calling for recession to push the timing back even further, with early-2024 now being a more common start time. Of course, if you keep pushing the starting time further and further out into the future, then eventually you'll be right. After all, one thing we can say with absolute certainty is that the U.S. economy will slip into recession, as that is simply part of the normal cyclical pattern of economic activity. What we do not know, nor does anyone else for that matter, is when exactly that will be.

To be sure, we can offer an array of plausible paths for the U.S. economy that would have a recession starting at times ranging from 2H 2023 to several years down the road. As for our base case, we remain in a relatively uncrowded camp, not having had recession as our base case at any time since the FOMC went on its rate-raising rampage, nor does our baseline forecast have a recession beginning either later this year or in 2024. Then again, as we've consistently noted over the past several months, were you to compare our baseline forecast with the "brief and mild" recession still being widely predicted, you'd be hard-pressed to tell a difference given that our baseline forecast has for some time anticipated listless real GDP growth and a rising unemployment rate (reflecting significantly slower job growth) over coming quarters. Where we differ more materially with those recession forecasts is the seemingly high degree of confidence many seem to have in the "brief and mild" part of their recession calls. After all, once the recession horse is out of the barn, it tends to resemble an unruly mustang more than a sedate show pony, the obvious exception being the, well, brief and mild recession of 2001.

Regardless of whether or not one's base case includes recession, one thing no forecast being made at present should include is a high degree of confidence. Okay, we shouldn't speak for others, but we find it hard to have much, if any, confidence in forecasts, ours or anyone else's, these days. That is in no small part because we don't have much confidence in the data that feed into our forecasting models. One reason is that we continue to see evidence of considerable seasonal adjustment noise in much of the top-tier economic data. As we've frequently noted, what had long been fairly regular seasonal patterns in economic activity were disrupted by the pandemic and in many cases have yet to re-emerge. While there have been efforts to update seasonal factors to account for these changes in patterns of economic activity, we still detect considerable noise in the data. Sure, the easiest solution is to simply ignore the not seasonally adjusted data, as many seem to do, but we've always seen the trends in the unadjusted data as the truest gauge of underlying economic activity.

Another issue we've often discussed is how response rates to many various survey-based data series have plummeted since the onset of the pandemic and remain low enough to cast doubt over the reliability of the data. For instance, the response rate to the Job Openings and Labor Turnover Survey, a/k/a JOLTS, has hovered around thirty percent for some time now which, coupled with a much smaller sample size than that used to produce the monthly estimates of nonfarm employment, hours, and earnings, has led to considerable volatility in the monthly JOLTS data. This has also contributed to what are often sizable revisions to initial estimates of job openings, hires, and quits, to the point that we put little stock in the monthly data points, though we do think the trends in the data are a more useful signal.

We see the combination of seasonal adjustment noise and depressed survey response rates as contributing to what has been a notable degree of volatility in the month-to-month data. While that isn't necessarily an obstacle for those content to simply craft a narrative around whatever headline number comes atop a given economic data release in a given month, it makes it considerably more difficult to get a reliable read on the true underlying trends in the economy for those inclined to do so. That task is made even harder by what have been some pronounced divergences in performance across different segments of the economy. On a very broad level, the Institute for Supply Management's (ISM) monthly surveys of the manufacturing and services sectors illustrate that

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

point, with the ISM Manufacturing Index signaling contraction in the manufacturing sector in each of the past eight months while the ISM Non-Manufacturing Index shows continued growth in the services sector. Even within the manufacturing sector, however, there are clear divergences amongst individual industry groups. For instance, producers of transportation equipment continue to see growth in demand as they play catch-up from a prolonged period of supply chain disruptions.

The labor market is another example of diverging fortunes across different sectors of the economy. While remaining robust, job growth has become increasingly concentrated amongst a smaller group of industries as hiring in manufacturing, wholesale trade, retail trade, transportation/warehousing, finance, and information services has softened considerably over recent months. Moreover, even as nonfarm payrolls have continued to expand at a rapid clip, growth in aggregate private sector hours worked has slowed to a crawl, June's increase notwithstanding. This suggests firms are to some degree engaging in labor hoarding, bracing for a period of weaker/declining demand but yet still eager to take on qualified workers when they can find them in anticipation of future growth in demand. That said, if that demand either does not materialize or takes longer than anticipated to do so, it could be that letting workers go becomes a more feasible alternative for firms. To our earlier point, enough firms changing course on labor retention to a great enough degree could be one channel through which a brief and mild recession turns into something much less benign.

These divergences across industry groups have given rise to the term "rolling recession" which, unfortunately, has become an increasingly trendy way to seemingly reconcile these uneven performances across different industries with the absence of recession in the broader economy. Unfortunate in the sense that we have no idea what the term "rolling recession" actually means. Really, people can't even agree on the definition of recession in the context of the broader economy, and as far as we know there is no clear and generally accepted threshold beyond which an individual industry is considered to be "in recession." Sure, we can all see the monthly data on employment, hours, earnings, and output on an industry by industry basis, but these metrics do not always move in the same direction at the same time. This has been the case over the past several months in manufacturing despite the factory sector generally considered to have been "in recession" over this time. Even were all of these metrics showing declines at the same time in a given industry, does it really add anything to declare that industry to be in recession?

There have, over recent quarters, also been divergences in the two broadest measures of the economy – Gross Domestic Product (GDP) and Gross Domestic Income (GDI). In principle, the two measures are simply different approaches to measuring the same thing, i.e., the value of all final goods and services produced in a given period of time. GDP is measured on the basis of expenditures on these final goods and services, while GDI is measured on the basis of income earned in the production of these final goods and services. While the two series tend to track closely over time, as would be expected, they do at times diverge, as has been the case over the past two quarters when real GDI has contracted while real GDP has continued to grow. Historically, when the two series have diverged, revisions to real GDP have tended to be in the direction of GDI, not the other way around. This is somewhat disconcerting given the questions surrounding the current state of the U.S. economy and concerns that a recession is lurking around the corner. Indeed, the minutes to the June FOMC meeting refer to a discussion amongst Committee members of the divergence of real GDP and real GDI and what that may suggest about real GDP.

The contraction in real GDI over the past two quarters is largely a function of declining corporate profits as personal income has expanded at a healthy clip, with real disposable (after-tax) personal income rising at an annual rate of 8.5 percent in Q1. Tempting as it may be to discount the declines in real GDI on the grounds that declining corporate profits don't have big implications for the broader economy, history suggests otherwise. A look at past cycles shows corporate profits have tended to begin declining prior to the economy slipping into recession, which is one reason real GDI has tended to begin declining prior to real GDP beginning to do so. Think about it this way – if declining profits lead firms to pull in the reins on capital spending and, ultimately, staffing, those cuts in business investment and employment can help drag the economy into recession. If, as we expect, profit margins compress further over coming quarters, that would seem to up the odds of a downturn in the broader economy.

One caveat is that on September 28 the BEA will release its annual comprehensive revisions to the data from the National Economic Accounts, which include the data that are the basis for GDP and GDI, and this year the revisions to the GDI data will stretch all the way back to 1979. As such, the profiles of both real GDP and real GDI may look quite different two-plus months from now than they do today. On the basis of the data at our disposal today, however, we'd caution against dismissing the contractions in real GDI seen over the past two quarters, particularly given the weakening trend in aggregate hours worked in recent months and our suspicion, which we discuss in the next segment, that the BLS's estimates of nonfarm employment have for some time been overstated, perhaps substantially. If so, one implication would be that growth in personal income will have also been overstated over the same span as growth in labor earnings would be lower than reported.

There is, at least to us, precious little clarity across the various economic data series at present, which itself may be a signal of a turning point in the business cycle. To be sure, there are some supports that could sustain growth, however modest, and keep the economy from slipping into recession. Overall household financial conditions remain fairly strong, as we discussed in detail in last month's *Outlook*. A preponderance of fixed rate debt on household balance sheets has been an important, if somewhat overlooked, buffer against higher interest rates. Corporate balance sheets, particularly amongst investment-grade corporations, also remain strong. While higher mortgage interest rates have greatly impacted construction and sales of new single family homes, both have nonetheless begun to rebound. Sure, that rebound can hardly be described as vigorous, but it is at least lively enough that we expect residential fixed investment to have made a modest contribution to Q2 real GDP growth after having acted as a drag in each quarter since Q2 2021, though it remains to be seen whether the nascent rebound in single family construction and sales will survive the latest upturn in mortgage interest rates. Though clearly cooling, the labor market remains tight, and while we expect further cooling, what form that takes will have material implications elsewhere in the economy. In other words, it matters whether subsiding demand for labor leads to further, and more pronounced, declines in job vacancies, fewer opportunities for job switching, and further cuts in hours worked, or whether subsiding demand for labor leads to significant increases in layoffs. While we expect the former, the latter cannot be ruled out.

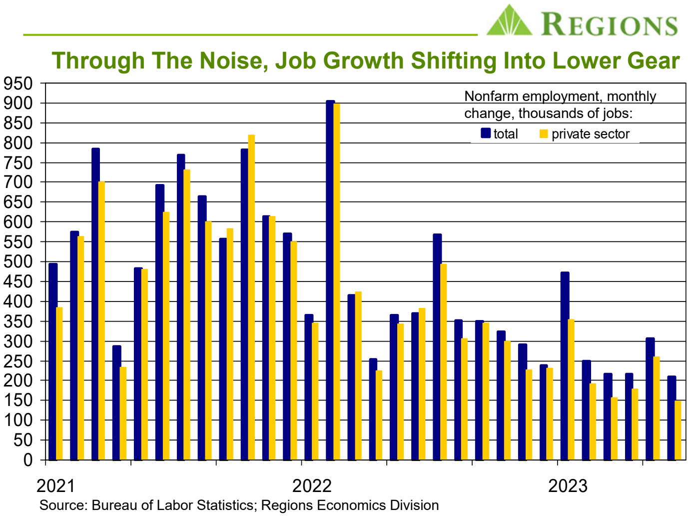
Either way, the economy seems set to slow further in the months ahead, regardless of whether or not that culminates in recession. As we often point out, however, at a growth rate as low as what we expect over coming quarters, there is little, if any, margin for error, as a growth rate this low leaves the economy with little capacity to absorb adverse shocks. This could be the difference between the economy avoiding or falling into recession. Lurking as a wild card is the FOMC, which seems intent on at least one more 25-basis point increase in the Fed funds rate, which we expect them to deliver at this month's meeting.

While there may be little clarity elsewhere in the economy, there is no denying that inflation remains much too high for the FOMC's comfort. What the FOMC can, will, or should do about that, however, is open for debate. Our sense is that the economic landscape will look different, perhaps meaningfully so given the pending benchmark revisions to the data on nonfarm employment, hours, and earnings, by time the FOMC meets in September. One potential problem, however, is that the revised data on GDP and GDI do not come out until the week following the September FOMC meeting, meaning that Committee members won't have a full sense of how different the economic landscape looks. Either way, by the time the September FOMC meeting rolls around, it could be that further funds rate hikes are much harder to justify. Still, given how murky the view of the U.S. economy is at present, September seems an awful long way away.

Cracks Starting To Emerge In The Labor Market?

Though on the surface the labor market still appears to be solid, there are some cracks beginning to emerge beneath the surface. Whether those cracks will remain manageable obstacles that can be navigated around or will morph into a sinkhole large enough to swallow up the labor market and, in turn, take a bite out of the broader economy, remains to be seen. Though the former seems more likely, the latter cannot be ruled out, as our discussion in the prior section hopefully helps illustrate.

Total nonfarm employment rose by 209,000 jobs in June, falling short of the consensus forecast for the first time in fourteen months, with private sector payrolls up by 149,000 jobs and public sector payrolls up by 60,000 jobs. The reported increase in public sector payrolls, however, should be discounted due to seasonal adjustment noise in the education segment of state and local government. Education payrolls fell by 564,400 jobs in June on a not seasonally adjusted basis, but on a percentage change basis this is smaller than the typical June decline, such that seasonally adjusted education payrolls rose by 36,700 jobs. Aside from the distortions brought on by the pandemic, June's increase in private sector payrolls was the smallest since December 2019. As the following chart shows, through the bumps in the monthly data, the pace of job growth has clearly slowed over the past several months. This deceleration, however, is neither surprising nor concerning, as it reflects job growth slowing from a pace that was by no means sustainable, and we expect further deceleration in the pace of job growth in the months ahead.



Though the slowing pace of job growth does not constitute one of the cracks in the labor market we referred to above, the narrowing base of job growth is concerning. As noted in the prior section, job growth has become increasingly concentrated amongst a smaller group of industries as hiring in manufacturing, wholesale trade, retail trade, transportation/warehousing, finance, and information services has softened considerably over recent months. The one-month hiring diffusion index, a measure of the breadth of job growth across private sector industry groups, fell to 58.0 percent in June, leaving it in the lower end of the range that had prevailed prior to the pandemic. More so than the level, it is the direction of the diffusion index that is concerning, and further declines in the months ahead, i.e., job growth becoming even more concentrated amongst a smaller group of industries, would be a worrying sign for the staying power of this expansion. We have long referred to the one-month hiring diffusion index as our favorite beneath the headlines indicator in the monthly employment reports, in no small part due to its record in signaling turns in the business cycle.

Another worrisome pattern we've highlighted (lowlighted?) over recent months is the weakening trend in aggregate private sector hours worked. As discussed in the prior section, this could be a sign of firms engaging in labor hoarding. More broadly, however, changes in aggregate hours worked are a much more reliable guide to changes in aggregate output than are changes in the level of employment. To that point, aggregate private sector hours worked increased at an annual rate of just 0.17 percent in Q2, significantly slower than the 2.34 percent annual rate posted in Q1. To be sure, one much also factor labor productivity into the equation to get a sense of the change in real GDP, but, given how weak and uneven labor productivity growth has been over the past several quarters, it probably wouldn't be wise to be banking on a productivity miracle to sustain real GDP growth. Reflecting patterns in job growth, aggregate hours worked declined in Q2 in manufacturing (amongst both durable goods and non-durable goods producers), retail trade, information services, leisure and hospitality services, and transportation/warehousing. Again, to the extent firms are engaging in labor hoarding, without a rebound in demand or at least the prospects of a rebound, at some point labor hoarding no longer makes sense for firms, and it is at that point (which obviously need not come at the same time across industry groups) that the pace of layoffs will start to rapidly increase.

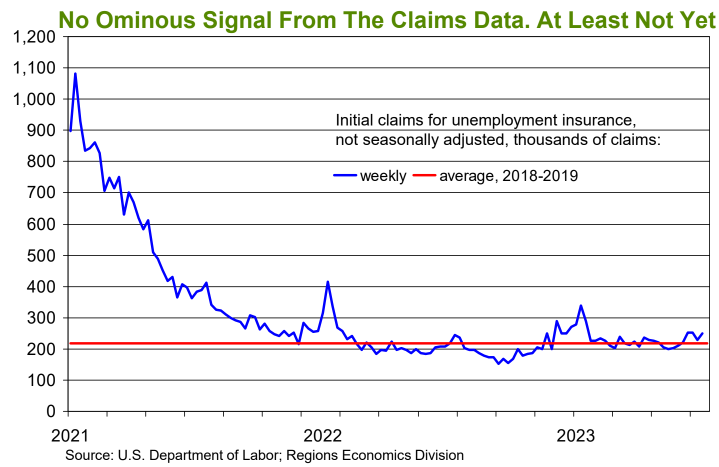
Though it is too soon to know if this is simply a reflection of the high degree of volatility in the household survey (from which the unemployment rate is estimated) or the start of a more persistent and concerning trend, the number of people working part-time for economic reasons increased sharply in June, rising by 425,000 persons. This is a notably large increase, even allowing for the inherent volatility in the household survey data, and merits notice in that it was primarily driven by those working part-time due to slack business conditions. That would be consistent with our premise that the underlying pace of economic activity is slowing, as also suggested by the weakening trend in aggregate hours worked, and should this number continue to increase in the months ahead that would be a clear sign of a slowing economy.

Beneath these beneath-the-surface cracks in the labor market, we have questions about the reliability of the data from the BLS's establishment survey used to produce estimates of employment, hours, and earnings. In addition to the seasonal adjustment noise that we think continues to plague much of the economic data, the response rates to the monthly establishment survey have been notably low. At 54.7 percent, the response rate to the May survey was egregiously low, as this was not only far below the average response rate for all months but was the lowest May response rate since 2001. Moreover, the secondary response rate to the May establishment survey was also below average, and these low response rates are why we still don't have much faith in reported May job growth even as the initial estimate of a gain of 339,000 jobs was revised down to a gain of 306,000 jobs. Lower response rates mean the BLS must rely more heavily on its own estimates, including the "birth-death" model intended to account for the arrivals of new firms and the exits of existing firms, to fill in the gaps. The birth-death model has, over the past several months, accounted for an above-average share of measured job growth.

We also suspect that, as noted earlier, the BLS's estimates of nonfarm employment have been meaningfully overstated over the past several months. Our suspicion will be either confirmed or debunked on August 23, when the BLS releases a preliminary estimate of the annual benchmark revision to the establishment survey data, including nonfarm employment, hours, and earnings. This is based on our analysis of data from the Quarterly Census of Employment and Wages (QCEW), drawn from data on the payroll tax returns that nearly all firms have to file. Each year the BLS benchmarks its establishment survey data to the universe of payroll tax returns, resulting in a level-change in their estimate of nonfarm employment as of the month of March. Our sense is that the looming benchmark revisions will yield a significant reduction in the estimated level of employment as of March 2023, which will be the new reference month for the establishment surveys, and there will likely be changes in measured monthly job growth.

While the full results of the annual benchmark revision process will not be revealed until February 2024, next month we'll get the BLS's estimate of the magnitude and direction of the revision to total nonfarm employment. If we are correct in expecting a substantial downward revision, that would in turn give us a weaker profile in aggregate hours worked and also would lead to a downward revision in aggregate labor earnings, the largest single component of total personal income. As we noted earlier, between the looming revisions to the data on GDP, GDI, and nonfarm employment, hours, and earnings, how we perceive the economy at the end of September could be quite different than how we perceive it today.

It should be noted, however, that even if we are correct on these points and labor market conditions are not as strong as they now appear, that is not the same as saying the labor market will be made to look weak. Though trending downward, the number of job vacancies remains easily above pre-pandemic levels and remains much higher than the combined number of unemployed persons and those not in the labor force who want a job. At 3.6 percent as of June, the unemployment rate remains notably low. Moreover, while there have been a number of high-profile layoff announcements across a few industry groups, such as information services, the absolute number of layoffs remains low.



This is best seen in the not seasonally adjusted data, as we've found the seasonally adjusted data to be biased higher over the past several months. Using the unadjusted data, the chart above shows weekly claims for unemployment insurance benefits relative to average weekly filings over the two years prior to the pandemic (shown by the red line). There are clear seasonal patterns in the data, with claims rising sharply in the first few and final few weeks of any given year and also tending to rise in mid-summer. Both of those patterns are seen in the data thus far for 2023, and thus far initial claims have not deviated much from that pre-pandemic average. The same pattern is evident in the data on continuing claims for unemployment insurance, which measures the number of people actually drawing benefits, suggesting that those who are losing jobs are able to find new ones in fairly short order.

Note that the data on claims are independent from the establishment survey data on nonfarm employment. This goes to our point that even if job growth has been meaningfully overstated over the past several months. That's not the same as saying the labor market is really weak but that weakness is being masked by faulty data, which we are by no means arguing is the case. That said, slower growth in nonfarm employment and hours worked would be more in line with signs that the pace of economic activity is slowing as we've expected would be the case. The question now, however, is how much further that slowdown will progress.

Richard F. Moody, Chief Economist • 205.264.7545 • richard.moody@regions.com

ECONOMIC OUTLOOK

REGIONS

July 2023

Q4 '22 (a)	Q1 '23 (a)	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	2.0	1.3	0.9	0.6	0.9	1.2	1.4	Real GDP[1]	-2.8	5.9	2.1	1.7	1.0
1.0	4.2	0.9	0.9	0.8	1.1	1.1	1.0	Real Personal Consumption[1]	-3.0	8.3	2.7	2.0	1.0
4.0	0.6	3.6	2.1	1.1	1.5	2.0	2.9	Real Business Fixed Investment[1]	-4.9	6.4	3.9	2.7	2.0
-3.5	-8.9	0.5	-1.4	-2.9	-1.5	-0.8	1.2	Equipment[1]	-10.5	10.3	4.3	-2.1	-0.9
6.2	3.1	4.3	4.2	4.2	4.1	4.8	4.8	Intellectual Property and Software[1]	4.8	9.7	8.8	4.9	4.4
15.8	15.8	10.0	5.3	3.0	2.0	1.2	1.6	Structures[1]	-10.1	-6.4	-6.6	8.0	2.8
-25.1	-4.0	0.3	2.7	4.2	3.6	3.8	5.2	Real Residential Fixed Investment[1]	7.2	10.7	-10.6	-10.6	3.7
3.8	5.0	2.7	2.1	2.3	1.5	0.9	0.6	Real Government Expenditures[1]	2.6	0.6	-0.6	3.2	1.5
-1,238.6	-1,208.4	-1,245.4	-1,271.2	-1,296.5	-1,312.8	-1,321.2	-1,324.0	Real Net Exports[2]	-922.6	-1,233.4	-1,356.7	-1,255.4	-1,325.1
850	834	912	906	917	926	938	947	Single Family Housing Starts, ths. of units[3]	1,003	1,132	1,004	892	942
556	552	545	500	478	460	444	433	Multi-Family Housing Starts, ths. of units[3]	394	474	547	519	440
7.0	3.1	-0.3	-2.2	-3.8	-4.8	-4.0	-0.9	CoreLogic House Price Index[5]	6.7	15.6	13.5	-0.8	-2.1
14.3	15.3	15.6	15.4	15.3	15.5	15.5	15.7	Vehicle Sales, millions of units[3]	14.5	14.9	13.8	15.4	15.6
3.6	3.5	3.6	3.6	3.8	4.0	4.1	4.2	Unemployment Rate, %[4]	8.1	5.4	3.6	3.6	4.1
3.4	2.9	2.6	2.0	1.6	1.1	0.7	0.5	Non-Farm Employment[5]	-5.8	2.9	4.3	2.3	0.7
2.5	8.5	2.3	2.5	1.4	2.3	1.8	2.0	Real Disposable Personal Income[1]	6.2	1.9	-6.2	3.7	2.0
6.4	5.3	3.8	3.4	3.1	2.7	2.5	2.3	GDP Price Deflator[5]	1.3	4.5	7.0	3.9	2.4
5.7	4.9	3.7	3.4	3.1	2.7	2.6	2.3	PCE Deflator[5]	1.1	4.0	6.3	3.8	2.4
7.1	5.8	4.1	3.4	3.1	2.8	2.6	2.4	Consumer Price Index[5]	1.3	4.7	8.0	4.1	2.5
4.8	4.6	4.5	4.1	3.6	2.9	2.4	2.1	Core PCE Deflator[5]	1.3	3.5	5.0	4.2	2.4
6.0	5.6	5.3	4.6	4.1	3.5	2.8	2.5	Core Consumer Price Index[5]	1.7	3.6	6.1	4.9	2.8
3.71	4.56	5.03	5.13	5.13	5.13	4.82	4.46	Fed Funds Target Rate Range Mid-Point, %[4]	0.42	0.13	1.73	4.96	4.63
3.83	3.65	3.59	3.92	3.83	3.70	3.52	3.46	10-Year Treasury Note Yield, %[4]	0.89	1.44	2.95	3.75	3.50
6.66	6.37	6.51	6.83	6.73	6.48	6.17	5.95	30-Year Fixed Mortgage, %[4]	3.12	2.96	5.34	6.61	6.06
-3.3	-3.3	-3.6	-3.4	-3.4	-3.3	-3.2	-3.2	Current Account, % of GDP	-2.8	-3.6	-3.8	-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

Regions Financial Corporation, 1900 5th Avenue North, 17th Floor, Birmingham, Alabama 35203

Richard F. Moody
Chief Economist

Greg McAtee
Senior Economist