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## Goods Prices: Look Out Below?

Back in a simpler and long-ago time, falling goods prices were the rule rather than the exception. Many retailers built advertising and in-store promotional campaigns around the theme of falling prices, more or less training consumers to watch for falling prices or listen for the sound of falling prices. It wasn't like that whole tree falling in a forest thing given that falling prices in and of themselves don't actually make a sound but, for a certain retailer, certain sounds played in-store were a signal that, somewhere in the store, prices were falling. Okay, sure, it wasn't all that long ago and may or may not have actually been a simpler time, but with the onset of the pandemic the sound of falling prices pretty much turned into the sound of silence.

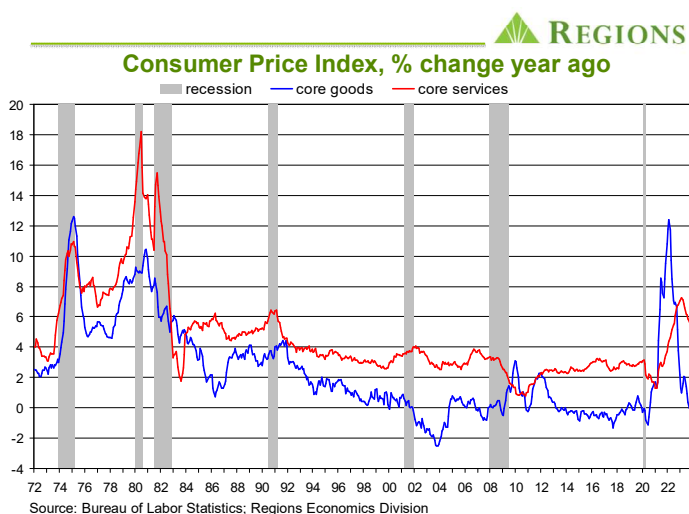
As is by now known all too well by all too many, after some initial declines in the early phases of the pandemic when much of the economy was shuttered, goods prices reversed course and began rising at a rapid pace, reflecting the combination of supply constraints and demand being fueled by generous financial transfers to the household sector at a time when much of the services sector remained under wraps. By early-2022, core goods (i.e., consumer goods excluding food and energy) inflation was running faster than at any time since 1975, but since then has slowed sharply. That we're now wondering whether we're on the verge of another prolonged run of core goods price deflation (core goods prices down on an over-the-year basis) isn't us falling prey to holiday-season nostalgia but is instead a reaction to core goods prices having declined in each of the past five months as measured by the Consumer Price Index (CPI) and in four of the past five months as measured by the PCE Deflator.

shows the over-the-year changes in core goods prices, but in the eighty-four months starting with 2013 and running through 2019 there was not a single instance of the CPI measure of core goods prices rising on a month-to-month basis. While the PCE Deflator's measure of core goods prices did show the odd monthly increase here and there over that span, the broader trend of persistent goods price deflation matched that seen in the CPI data. As seen in the chart, the decades prior to goods price deflation were characterized by persistent goods price disinflation (prices rising at an increasingly slower pace). The long-running weakness in core goods prices can be tied to a few different factors, including production of goods repeatedly migrating to lower-wage countries in what was becoming an increasingly globalized economy, productivity enhancements, and the dominance of the U.S. dollar acting as a weight on prices of imported goods.

The prolonged period of goods price deflation from 2013 through 2019 made it all the more jarring when goods prices began to rise at such a rapid pace in mid-2020. As noted above, rapidly rising core goods prices reflected both supply-side and demand-side factors. With production and transport of goods significantly impaired by global supply chain and logistics bottlenecks, supply constraints were a source of upward pressure on prices. At the same time, with much of the services sector either shuttered or operating at limited capacity, greater shares of consumer spending were funneled away from services and toward goods. This at a time when households were flush with cash thanks to a rash of financial transfers, including three rounds of Economic Impact Payments, extended, and supplemental unemployment insurance benefits, and other forms of transfers/tax credits. Additionally, extraordinarily low interest rates made financing purchases of consumer durable goods much cheaper while mortgage interest rates did double duty, sparking home purchases that triggered related spending and facilitating a wave of refinancing which freed up cash for consumers. Remote work arrangements also spurred spending on home office equipment and furnishings.

These factors conspired to fuel rapidly rising core goods prices. It is fair to note that the CPI measure of core goods prices was significantly impacted by prices of used motor vehicles. Despite carrying a very low weight in the CPI index of core goods prices, the magnitude of increases in used vehicle prices had a meaningful impact on the overall index of core goods prices. That by no means changes the broader narrative; the BLS's measure of core goods prices excluding used motor vehicles exhibits the same patterns seen in the overall measure of core goods prices, just to a lesser extent. By early-2022 the BLS measure of core goods prices excluding used motor vehicles was posting its largest year-on-year increases since 1980.

Just as there were both supply-side and demand-side drivers of rapidly rising core goods prices, there are both supply-side and demand-side factors behind the rapid deceleration in core goods



To our earlier point, in the several years prior to the pandemic we saw persistent, albeit mild, goods price deflation. The chart above

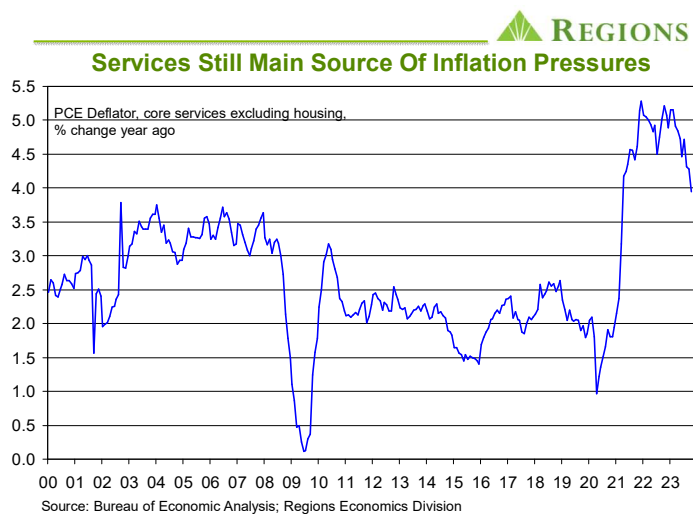
price inflation that could very easily give way to core goods price deflation. Stresses on global supply chain and logistics networks have eased significantly, leaving both production and inventories of consumer goods back on par with pre-pandemic norms. What has become considerable excess shipping capacity has led to sharp declines in shipping rates which, to the extent shipping costs are incorporated into finished goods prices, has also contributed to the softening in goods prices. Fading demand has also helped take the steam out of goods price inflation. In part, that reflects demand for many types of consumer goods being largely sated, particularly as purchases of consumer durable goods such as motor vehicles, furniture, appliances, and electronics, are, at least for most of us, more one-off than recurring in nature, i.e., they may be repeated, but typically over very long intervals. There are some who argue that the consumer durables, particularly electronics, purchased in the early phases of the pandemic are by now bordering on obsolete which, as such, will soon unleash another wave of such purchases. Suffice it to say we're not exactly on board with this argument, particularly given that in many, if not most, cases the cash buffers that supported that first round of purchases have either thinned out or vanished all together.

Another weight on demand for goods is that a prolonged period of elevated inflation combined with thinning financial buffers has led to a rising degree of financial stress for many households, leading them to pare back discretionary spending. It could also be that consumers finally reached a breaking point, even aside from feeling financial stress. During the period in which prices were rising at such rapid rates, we often argued that one reason firms were able to raise prices so aggressively was that being flush with cash made consumers less discerning about price than they had been prior to the pandemic, as though they felt they were playing with house money. That attitude was bound to change at some point, and thinning financial buffers always seemed a logical trigger. More and more firms have offered commentary along these very lines and have adjusted pricing strategies accordingly. Finally, as we and others have been discussing for some time, a shift in consumer spending patterns, away from goods and toward services, has amplified what was already softening demand for goods, thus contributing to slowing core goods price inflation.

This has been apparent in the price data over recent months. As noted above, the CPI measure of core goods prices had fallen in each of the past five months (through October, the November data not yet being available) while the PCE Deflator measure had fallen in four of the past five months. On an over-the-year basis, the CPI showed core goods prices flat as of October while the PCE Deflator showed them up by just 0.3 percent. Assuming the monthly declines persist, it is only a matter of time until the over-the-year changes also fall into negative territory, but ongoing weakness is by no means a given despite supply chain and logistics networks functioning normally. For instance, should the recent declines in market interest rates persist, that would be a support for spending on consumer durable goods, and any firming in demand would translate into some firming in pricing. Should lower mortgage rates lend support to construction and sales of new single family homes, or help ease acute shortages of existing homes for sale, that would in turn support housing-related purchases which, in turn, would be reflected in a firmer pricing environment. The broader point here is that it is too soon to declare that the run of declines in core

goods prices seen over the past several months marks the start of another extended period of core goods price deflation. At the same time, though, it also seems unlikely that we'll see a prolonged period of steadily rising core goods prices.

Obviously, the path of core goods prices matters in the context of the broader question of the path of inflation and, in turn, the path of monetary policy as we move through 2024. As the chart on the prior page illustrates, core services (services excluding energy services) inflation has slowed but yet remains significantly above the pre-pandemic trend rate. This in part is a reflection of the influence of housing costs, in the form of primary rents and owners' equivalent rents, in the measures of prices/inflation. For instance, rents account for over forty percent of the core CPI, and while accounting for a much smaller weight in the core PCE Deflator, that weight is still substantial. In both measures, rents significantly lag movements in market rents and, as such, are still somewhat artificially propping up core services inflation.



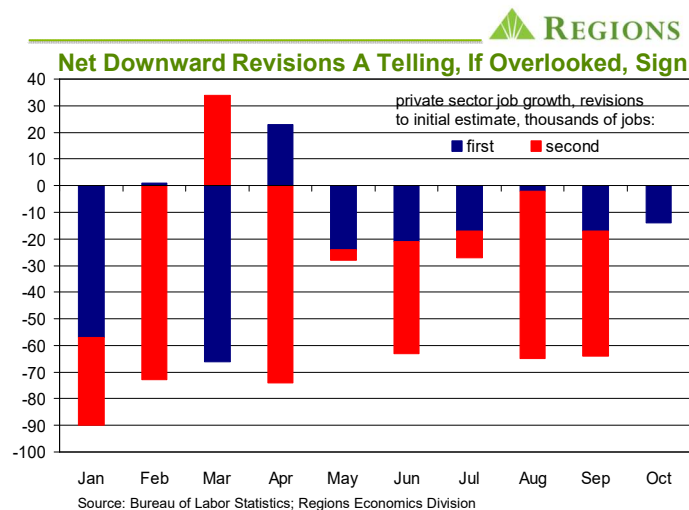
Eliminating rents from the equation, however, leaves core services inflation significantly elevated but nonetheless decelerating. This has become an increasingly important marker for the FOMC as they assess the stance of monetary policy and ponder changes to that stance. While flat-to-lower core goods prices will help pull down overall inflation, the relative weightings of goods and services prices ensures that the focus will remain on core services prices excluding housing. Consumers will of course benefit from a much friendlier goods pricing environment, but it also bears noting that even should we see persistent, modest declines in core goods prices in the months ahead, that will still leave these prices well above where they were prior to the pandemic. So, even if the sound of falling prices once again becomes the soundtrack to in-store shopping, that sound will for many consumers have a most hollow ring to it for some time to come.

## *Getting A Handle On Job Growth Proving To Be Most Difficult*

It often strikes us that in a time in which our ability to process information is greater than has ever been the case, our ability to gather that information is stuck in the stone ages. Sure, it isn't as

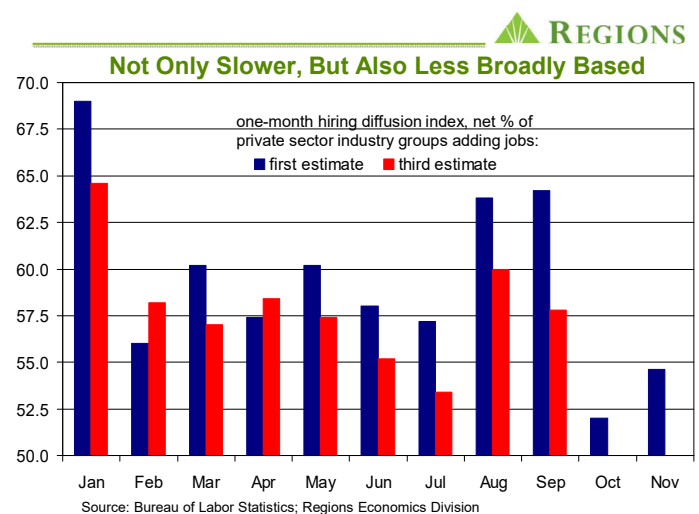
though survey takers in search of economic data are traversing the land in oxen-drawn carts, chiseling responses to survey questions or observations of economic activity onto stone tablets then making their way back to a centralized cave where minions of mathematical wizards are busily tabulating results by etching lines into the walls. Though, now that we say that it may not be all that bad of an alternative to what we now have.

Okay, that may be a bit much, but the reality is that far too often we find ourselves questioning the reliability of the economic data. Those questions have come even more frequently since the onset of the pandemic, and this is not the first time we've discussed this topic in our monthly outlook pieces. Two of the main issues we routinely raise are low response rates to the monthly surveys that serve as the basis of many of the main data series and seasonal adjustment that hasn't adapted to the significant distortions in what used to be typical seasonal patterns in economic activity that arose with the onset of the pandemic. Our discussion here mainly pertains to the first of these issues, in the specific context of the monthly employment reports.



Recall that the initial estimates of nonfarm employment, hours, and earnings in any given month are revised in each of the subsequent two months. While it may seem that the revisions should be free of predictable patterns, it is common that in times in which the economy is growing, particularly when it is growing rapidly, the revisions tend to be to the upside, and that in times in which the economy is slowing, or contracting, the revisions tend to be to the downside. As the chart above shows, thus far in 2023 the revisions to the initial estimates of private sector job growth have been not only sizable but also to the downside. The blue portion of the bar shows the first revision to the initial estimate for each month, while the red portion of the bar shows the second revision, with the net revision reflected by the sum of the two. Note that the second revision to the initial estimate of March job growth was to the upside, but the initial downward revision was meaningfully larger, hence the net revision was negative. The same holds for April – the first revision to the initial estimate of April job growth was positive but the second revision was negative and much larger so that, again, the net revision was negative. While we do not yet have the second revision to the original estimate of October job growth, the first revision shows private

sector payrolls rose by 14,000 fewer jobs than originally estimated. In addition to the direction of the revisions, the magnitude is also noteworthy. Thus far (i.e., through September), the initial estimate of monthly private sector job growth in 2023 has been revised downward by an average of 54,700 jobs between the first and third estimates, equivalent to just over twenty-four percent of the average first estimate. We will note that, while still downward, the average net revision to the initial estimate of growth in total nonfarm employment has been smaller than that to the initial estimate of private sector job growth. This reflects what have been consistent upward revisions to the initial estimates of public sector job growth. To our earlier point, public sector payrolls have been growing rapidly, mostly on the state and local government levels, and the initial estimates of monthly gains have simply not been keeping pace, hence the string of net upward revisions.



It isn't only the initial estimates of job growth that have been prone to meaningful downward revision thus far in 2023. The chart above shows the initial and third estimates of the one-month hiring diffusion index, a measure of the breadth of hiring across private sector industry groups and a metric which we see as an important barometer of the viability of an expansion. Well, at least when we're not questioning the reliability of the data. As indicated in the chart, private sector job growth over the course of 2023 has not only been shown to be slower but, with the exceptions of February and April, has also been shown to have been less broadly based than initially reported. Note that we do not yet have the third estimate of the October value of the hiring diffusion index, and we also show the first estimate for November.

Though not the sole factor, we see persistently low initial response rates to the BLS's monthly establishment survey, on which the estimates of nonfarm employment, hours, and earnings are based, to be the primary culprit behind the sizable downward revisions to the initial estimates of private sector job growth. As we have discussed on prior occasions, initial response rates to the monthly establishment survey have been significantly lower since the onset of the pandemic than was the case over the several years prior. One way to think about it is that the lower the response rate, the larger the gap the BLS must fill in with their own estimates, hence opening up the initial estimates of job growth, average hourly earnings, and average weekly hours to potentially large revisions

in subsequent months as more source data are collected. This is what we have seen over the course of 2023.

What we haven't seen, however, is much discussion of this issue. That could simply indicate that others don't find it to be as much of an issue as we do, if even an issue at all. After all, we do know that the second and third monthly survey response rates are much closer to pre-pandemic norms than are the initial response rates. In other words, by time the BLS produces the third estimates, reads on job growth, hourly earnings, and weekly hours are more reliable. While not dismissing that argument out of hand, we still think this matters. First and foremost, it is the initial estimates that most analysts, market participants, and policy makers are reacting to and using as the basis for assessing how labor market conditions, if not conditions in the broader economy, are changing. You'd think that having a sense of how reliable those initial estimates are would factor into the reactions to them, but that doesn't often seem to be the case.

Of perhaps even more relevance, we think the consistent pattern of large downward revisions to the initial estimates of private sector job growth is an overlooked sign of the extent to which the labor market is cooling, particularly in conjunction with the pattern of downward revisions to estimates of how broadly based job growth is. This matters, to us anyway, in that we have long looked to the hiring diffusion index as an important indicator of the staying power of an expansion, in the sense that the more broadly based job growth is, the more staying power an expansion has. Job growth being increasingly concentrated amongst a smaller base of private sector industry groups, as has been happening over the past several months, is a worrying sign.

To be clear, none of this is intended as an indictment of the professionals at the BLS. After all, they can only work with the data they have, and persistently low initial response rates leave them less to work with when producing initial estimates of monthly job growth. Instead, we offer this discussion as a caveat against taking the initial estimate of any headline number on any data release as gospel and using it to concoct sweeping narratives of the state of the economy or to draw inferences about the potential paths of fiscal or monetary policy. We get it, "come back in two months" isn't exactly a satisfactory assessment of the monthly employment reports. But, we do think that those offering analysis/commentary based on the economic data releases have a duty to recognize and point out potential noise in the data.

### *November Employment Report*

Total nonfarm employment rose by 199,000 jobs in November, with private sector payrolls up by 150,000 jobs and public sector payrolls up by 49,000 jobs. Prior estimates of job growth in September and October were revised down by a net 35,000 jobs for the two-month period, with the net gain in private sector payrolls revised down by 61,000 jobs and the net gain in public sector payrolls revised up by 26,000 jobs, going to the discussion in the prior section. Also to that point, while the 67.0 percent response rate to the November establishment survey was higher than the 2023 average, it is still easily below pre-pandemic norms.

Prior to the release of the November employment report, we pointed to two factors that would have to be accounted for before making any assessment of the data – the return of striking workers

and the potential for significant seasonal adjustment noise stemming from holiday season hiring in warehousing and delivery services and retail trade. With the SAG-AFTRA strike settled, payrolls in the motion pictures and sound recording industries, part of the broader information services industry group, were bolstered by 17,200 jobs, while the resolution of the UAW strike added 30,000 jobs to manufacturing payrolls in November, in each case simply reversing the deduction when the strike started. It should be noted that the return of the striking UAW workers was a support for average hourly earnings, but even with a 0.4 percent increase in November, wage growth continues to slow.

Those in search of a "cleaner" read on private sector job growth in November can simply deduct those 47,200 jobs, they also must account for considerable seasonal adjustment noise. In line with our expectations, 2023 holiday season hiring in warehousing and deliver services and retail trade is shaping up to be weaker than normal. As we discussed in last month's edition, this opens the door for seasonal adjustment issues. While the not seasonally adjusted data show retail trade payrolls rose by 264,000 jobs and payrolls in warehousing and delivery services rose by 146,500 jobs, these are smaller than the typical November increases, such that the seasonally adjusted data show payrolls in these segments declined by 38,000 jobs and 7,800 jobs, respectively. One factor which held down retail hiring in November was the increase in average weekly hours; as we discussed in last month's edition, there was, and remains, ample room for firms to increase hours worked as an alternative to taking on new workers. We'll also note that these seasonal effects will also be present in the December data, albeit to a lesser degree than in the November data.

In that sense, any boost from the return of striking workers was largely negated by seasonal adjustment noise, so the estimate of private sector job growth was about where it should have been. At least for now, as we'll still have to see how the revisions play out (umm, come back in two months?). We will, however, note that while up a bit from October, the one-month hiring diffusion index, at 54.6 percent, is still indicative of the narrowing base of private sector job growth over recent months. To that point, health care and social services payrolls rose by 93,200 jobs, accounting for the bulk of private sector job growth in November. Thus far in 2023, this single category has accounted for 45.2 percent of all private sector job growth, easily more than double the share it accounted for in 2022. This goes to our concern about a steadily narrowing base of private sector job growth.

The labor force is reported to have risen by 532,000 persons while the level of household employment is reported to have risen by 747,000 persons in November. We see these increases as being wholly implausible, instead seeing them more as simply countering what were oddly weak prints in the prior two months. Either way, the unemployment rate stands at 3.7 percent, and while this in part a reflection of the labor force participation rate remaining well below pre-pandemic norms, it is nonetheless indicative of tight labor market conditions.

Though still somewhat tight, it seems clear that labor market conditions are easing. The trend rate of job growth is slowing, and the trend in aggregate hours worked has softened, indicative of cooling demand for labor. While we expect further slowing in job growth to put upward pressure on the unemployment rate, we do not see the labor market as being on the verge of rolling over.

# ECONOMIC OUTLOOK

Q2 '23 (a)	Q3 '23 (p)	Q4 '23 (f)	Q1 '24 (f)	Q2 '24 (f)	Q3 '24 (f)	Q4 '24 (f)	Q1 '25 (f)		2021 (a)	2022 (a)	2023 (f)	2024 (f)	2025 (f)
2.1	5.2	1.2	0.9	0.8	1.3	1.6	2.0	Real GDP <sup>1</sup>	5.8	1.9	2.4	1.6	1.9
0.8	3.6	2.3	1.6	1.5	1.9	2.0	2.1	Real Personal Consumption <sup>1</sup>	8.4	2.5	2.2	2.0	2.1
7.4	1.3	0.6	-0.2	-0.5	0.1	1.2	2.6	Real Business Fixed Investment <sup>1</sup>	5.9	5.2	4.3	0.7	2.2
7.7	-3.5	-1.7	-2.2	-2.1	-0.5	0.6	1.7	Equipment <sup>1</sup>	6.4	5.2	-0.2	-1.3	1.4
2.7	2.8	3.7	4.1	3.9	4.2	4.4	4.7	Intellectual Property and Software <sup>1</sup>	10.4	9.1	4.6	3.8	4.6
16.1	6.9	-1.3	-5.7	-7.0	-8.2	-5.0	-0.5	Structures <sup>1</sup>	-3.2	-2.1	11.8	-2.6	-2.0
-2.2	6.2	-2.6	-5.0	-3.9	0.5	1.4	2.4	Real Residential Fixed Investment <sup>1</sup>	10.7	-9.0	-11.0	-1.7	1.7
3.3	5.5	2.8	3.0	2.0	1.9	0.8	1.4	Real Government Expenditures <sup>1</sup>	-0.3	-0.9	3.9	2.8	1.2
-928.2	-935.4	-943.4	-958.5	-989.3	-1,005.0	-1,022.0	-1,024.0	Real Net Exports <sup>2</sup>	-933.8	-1,051.0	-935.5	-993.7	-1,039.3
930	968	948	922	908	905	911	917	Single Family Housing Starts, ths. of units <sup>3</sup>	1,132	1,004	920	912	929
520	399	399	391	384	385	381	373	Multi-Family Housing Starts, ths. of units <sup>3</sup>	474	547	468	385	369
1.6	4.5	4.6	2.2	-1.3	-3.5	-3.9	-2.1	CoreLogic House Price Index <sup>5</sup>	15.5	13.4	3.6	-1.7	1.1
15.8	15.6	15.2	15.3	15.3	15.5	15.6	15.8	Vehicle Sales, millions of units <sup>3</sup>	14.9	13.8	15.4	15.5	16.0
3.6	3.7	3.8	3.8	4.0	4.1	4.3	4.3	Unemployment Rate, % <sup>4</sup>	5.4	3.6	3.6	4.0	4.3
2.5	2.1	1.8	1.4	1.1	0.8	0.5	0.4	Non-Farm Employment <sup>5</sup>	2.9	4.3	2.3	0.9	0.5
3.3	0.1	2.6	2.8	1.5	1.6	1.9	3.2	Real Disposable Personal Income <sup>1</sup>	3.2	-5.9	4.2	2.0	2.4
3.5	3.3	2.9	2.4	2.5	2.2	2.2	2.2	GDP Price Deflator <sup>5</sup>	4.6	7.1	3.7	2.3	2.2
3.9	3.4	2.9	2.4	2.3	2.2	2.3	2.3	PCE Deflator <sup>5</sup>	4.2	6.5	3.8	2.3	2.3
4.1	3.6	3.2	2.7	2.6	2.4	2.4	2.4	Consumer Price Index <sup>5</sup>	4.7	8.0	4.1	2.5	2.4
4.6	3.9	3.4	2.8	2.5	2.5	2.5	2.4	Core PCE Deflator <sup>5</sup>	3.6	5.2	4.2	2.6	2.4
5.2	4.4	4.0	3.4	2.9	2.9	2.8	2.7	Core Consumer Price Index <sup>5</sup>	3.6	6.1	4.8	3.0	2.7
5.03	5.30	5.38	5.38	5.38	5.21	4.89	4.67	Fed Funds Target Rate Range Mid-Point, % <sup>4</sup>	0.13	1.73	5.07	5.21	4.14
3.59	4.15	4.52	4.32	4.25	4.13	4.14	4.13	10-Year Treasury Note Yield, % <sup>4</sup>	1.44	2.95	3.98	4.21	4.17
6.51	7.04	7.40	7.18	7.09	6.91	6.83	6.70	30-Year Fixed Mortgage, % <sup>4</sup>	2.96	5.34	6.83	7.00	6.60
-3.1	-3.2	-3.3	-3.3	-3.2	-3.1	-3.1	-3.1	Current Account, % of GDP	-3.5	-3.8	-3.4	-3.1	-3.2

a = actual; f = forecast; p = preliminary

Notes: 1 - annualized percentage change 2 - chained 2017 \$ billions 3 - annualized rate 4 - quarterly average 5 - year-over-year percentage change

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