ECONOMIC OUTLOOK
REGIONS
June 2020

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Already Faltering Business Investment Takes Another Hit . . .

The BEA's second estimate shows real GDP contracted at an annualized rate of 5.0 percent in Q1 2020. While it wouldn't be entirely accurate to say that this went largely unnoticed despite it being the seventh largest quarterly contraction in real GDP on record, neither would that statement be too far off base. After all, with many forecasters, us included, expecting real GDP to contract at an annualized rate of around 40 percent in Q2, and with those expectations having been formed well ahead of the release of the Q1 data, it's understandable that a "mere" 5.0 percent contraction may not have seemed too noteworthy.

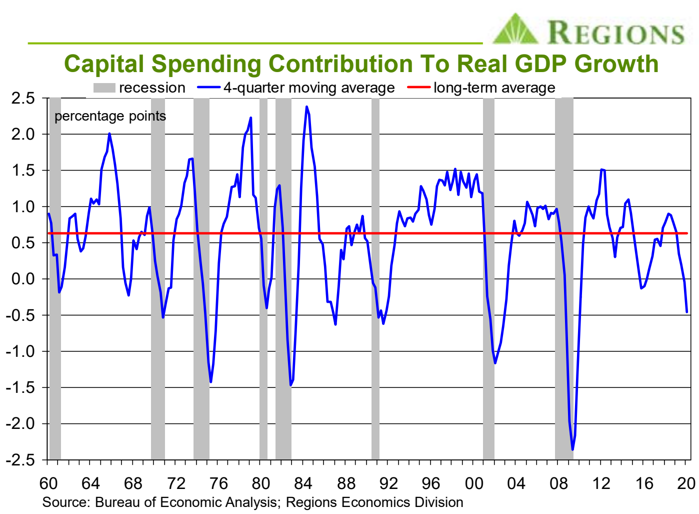
To the extent the Q1 GDP data did get attention, much of it was focused on consumer spending. The BEA's second estimate shows real consumer spending declined at an annualized rate of 6.8 percent in Q1, a bit milder than the initial estimate of a 7.6 percent contraction. As with top-line real GDP, the contraction in consumer spending in Q1 is much less severe than the contraction in Q2 is shaping up to be. The decline in consumer spending goes hand-in-hand with the considerable damage done to the labor market as the most immediate and most visible effects of the COVID-19 virus and the efforts to stem its spread.

Though less visible, the effects on business investment spending are just as, if not more, important. Real business fixed investment declined at an annualized rate of 7.9 percent in Q1 2020, with spending on machinery and equipment falling at an annualized rate of 16.7 percent. Unlike consumer spending, which had been on a run of 40 consecutive quarters of growth, business fixed investment had already been faltering prior to mid-March, when efforts to stem the spread of the COVID-19 virus brought wide swaths of economic activity, in the U.S. and abroad, to a sudden stop. To that point, Q1 2020 marked the fourth straight quarterly contraction in real business fixed investment, and the rate of decline had accelerated over the prior three quarters.

Indeed, faltering business investment spending had been on our radar for some time prior to mid-March, something we most recently discussed in detail in our October 2019 *Outlook*. As was apparent in our January 2020 baseline forecast, we had only modest expectations for business investment in 2020 even before the COVID-19 virus and the efforts to stem its spread began to wreak havoc on the economy. As we discussed in last October's *Outlook*, we viewed the deterioration in business investment over the course of 2019 as the result of flagging business sentiment stemming from global trade tensions, narrowing corporate profit margins, and increasingly widespread expectations that real GDP growth would settle in at around 2.0 percent. Though trade tensions had eased by year-end 2019, the latter two factors would have effectively ruled out anything but modest growth in business investment spending over the course of 2020. It was against that backdrop that the sudden stop in economic activity in mid-March raised the hurdle for business investment spending even higher.

Business investment is a topic we routinely return to, which simply reflects the importance we attach to it. While business investment obviously enters into the calculation of GDP, thus making it worthy of attention, the importance of business investment endures much longer than the headline GDP growth number in any given quarter. Yet, discussions of GDP growth seem to invariably return to consumer spending, on the grounds that "consumer spending accounts for 70 percent of the economy," the correct version of which is that consumer spending, as measured in the GDP data, accounts for roughly 70 percent of GDP.

Either way, that this line is repeated so often apparently lulls many into thinking that propping up consumer spending is the key to sustaining a robust rate of GDP growth over time. This of course misses a fundamental point, which is that it is investment that lays the ground for economic growth over time. The economy does not grow over time because consumption grows. Consumption grows over time as the economy grows, and investment is the key link. We do not know how to put it any more plainly than that.



As to the "here and now," the above chart shows the contribution of business fixed investment to top-line real GDP growth. We show the four-quarter moving average to counter the quarter-to-quarter volatility in the data, but the steady deterioration in business investment over the course of 2019 is readily apparent, as is the sharp drop-off in Q1 2020. A surge in energy-related investment was a primary factor behind what was fairly rapid growth in overall business investment in the early periods of the recovery from the 2007-09 recession. For the most part, however, business investment underperformed over the course of the recently ended expansion. Our basic premise, which we have discussed in detail

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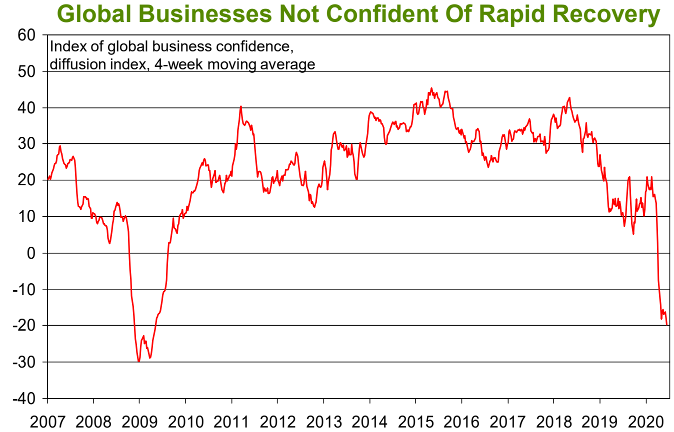
on several occasions, is that an abundance of readily available and relatively cheap labor in a persistently slow growth environment led firms to substitute labor for capital. Though labor became relatively more scarce, we never really reached the tipping point we had anticipated at which shortages of labor and/or the size of the total wage bill would incent firms to begin substituting capital for labor to a meaningful degree. That the sharp acceleration in real GDP in 2018 turned out to be only a brief respite from the middling, i.e., just over 2.0 percent, trend rate of growth that prevailed over the expansion took away one rationale for firms to expand their productive capacity via investment in capital.

Clearly, the short but violent downturn associated with the COVID-19 virus and the efforts to stem its spread and what remains a high degree uncertainty as to what the subsequent recovery will look like have acted to slam the brakes on business investment. Q1 earnings announcements saw many firms report they had slashed their 2020 capital budgets, and details on 2020 and 2021 capital budgets in upcoming Q2 earnings announcements will be a telling sign of how firms expect the recovery to play out. Recall that in comments made during Q1 earnings calls, the overall tone of corporate executives was that the recovery would be slow and gradual, and those comments were made before we had anything close to a full accounting of the damage done to the economy.

Global Businesses Not Confident Of Rapid Recovery

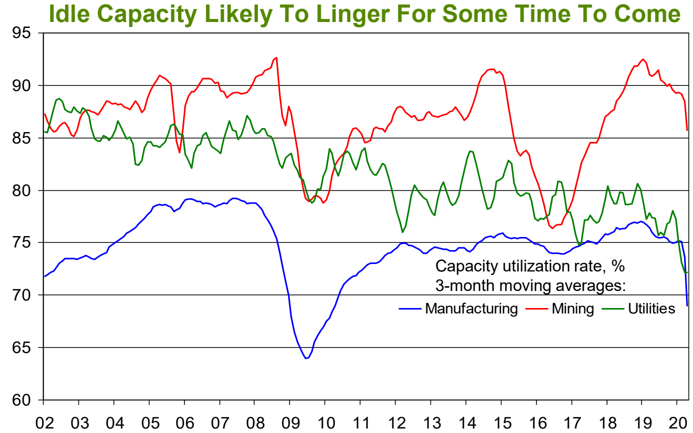


Source: Moody's Analytics; Regions Economics Division

To be sure, expectations vary across industry groups – on either side – but the consensus is for a slow and gradual recovery in the U.S. economy and an even slower recovery in many of the advanced foreign economies. It is unlikely that the overall tone of Q2 earnings announcements will be more upbeat. More broadly, global business sentiment remains significantly depressed, as seen in the above chart. This does not augur for a meaningful rebound in business investment any time soon.

Another factor that could weigh on business investment, at least in the near term, is the degree of idle industrial capacity, most notably in the manufacturing sector. While the following chart shows three-month moving averages to smooth out the month-to-month volatility in the data, the broader point remains the same, i.e., utilization rates this low give firms little incentive to add to existing capital stocks. Obviously, utilization rates will rise as economic activity comes back online, but the rate at which that will happen remains highly uncertain. Moreover, utilization rates within the manufacturing sector had been persistently low over the course of the recently ended expansion. While we have raised the possibility that, based on the age of the capital stock, these persistently low utilization rates reflected obsolete capital still being on the books, we do not think that is the only factor, and if we are correct on this point, the argument that low utilization rates have acted as a drag on business investment still holds. If our view that the rebound will be slow and uneven proves correct, utilization rates will rise at a slow pace, meaning idle capacity could continue to act as a drag on business investment for some time.

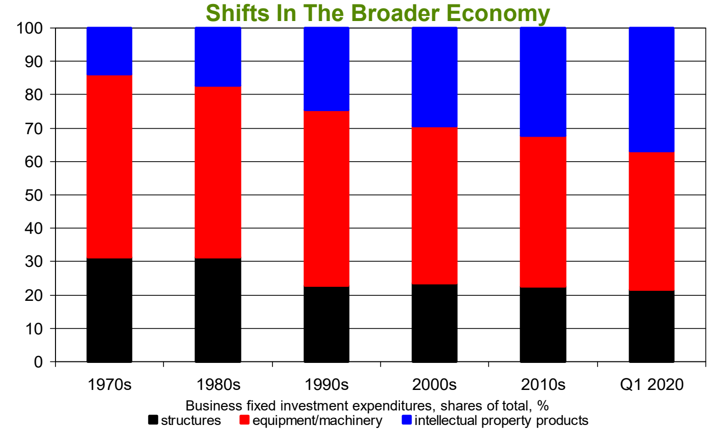
Idle Capacity Likely To Linger For Some Time To Come



Source: Federal Reserve Board; Regions Economics Division

There are also questions as to the rate at which idle capacity in the energy sector will come back online. Though off their recent lows, oil prices remain below what for many domestic producers is the break-even point. This, combined with what for some domestic producers are chronically weak balance sheets, likely spells the end, at least for the time being, of the days of doing whatever it takes to get as much out of the ground as possible. As such, even if less productive sites are shuttered, which could push measured utilization rates higher, new capital investment within the energy sector could remain weak for some time to come.

Shifts In Business Investment Reflect Shifts In The Broader Economy



Source: Bureau of Economic Analysis; Regions Economics Division

In thinking about the outlook for business investment over coming quarters, we think it useful to segregate total business investment

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into the three main components, as we do in the preceding chart. As seen in the chart, the past several decades have witnessed a secular shift in the nature of business investment spending, with intellectual property products accounting for a steadily increasing share of total outlays at the expense of both spending on business structures and on equipment/machinery. The shifts in these shares simply reflect the structural shifts in the U.S. economy over the same time frame, most notably the extent to which technology has become more and more imbedded across the different sectors of the economy, including manufacturing. Though clearly not the catalyst for the changing nature of business investment, the COVID-19 virus will almost surely accelerate the rate at which these changes take place over coming quarters, which is the same point we've made about the effects of the COVID-19 virus on patterns in consumer spending.

For instance, energy-related investment is very prominent in business spending on structures, accounting for just under one-half of all such spending over the recently ended expansion. To the extent that lower prices and/or greater financial discipline continue to prevail over the energy sector, it is unlikely that energy-related investment will be nearly the driver of growth in business investment than had been the case prior to the downturn. This will be most apparent in business outlays on structures.

An even potentially heavier weight on business investment in structures is that, in the wake of the COVID-19 virus and the efforts to stem its spread, firms across a wide array of industry groups could decide they no longer need as much physical space as they previously operated with. This could be office-based firms who, having seen their workers be almost as, if not as, productive working remotely as they had previously been in an office setting, cut back on the amount of office space they lease/own. In and of itself, this would not turn up in the GDP data on business investment in structures, but it would to the extent that the collective weight of such decisions curbs new office construction.

The same argument can be made in retail trade, i.e., firms may decide they need less physical space in the post-virus world. Or, in the case of retail trade, perhaps we should say even less space, as new retail construction has been falling over the past several years. Either way, it is reasonable to expect the rate of decline to pick up over coming quarters if the acceleration in the shift to online shopping persists, as we think it will. One offset would be faster growth in warehouse construction, but in terms of the dollar amounts, this would be unlikely to fully offset a faster decline in new retail construction. More broadly, depending on whether, or for how long, consumer attitudes on traveling or being in the midst of crowded entertainment/recreation/sports venues keep them away from such activities, there could be less new construction in these areas than would otherwise have been the case.

One potential boost to business investment in the wake of the COVID-19 virus could come from firms reconfiguring supply chains and shifting manufacturing activity, with greater emphasis on domestic suppliers and production than has been the case. To the extent this shuffling of the manufacturing deck does occur, it would lead to more investment in structures, equipment, and machinery, lifting overall business investment. While many argue this is a natural extension of trade tensions, which may move from a boil to a simmer but don't really seem to go away, some make the case that it is also a means of insulating the U.S. economy against future pandemic episodes or other disruptions in global economic activity. Still, we remain somewhat skeptical. While firms may indeed think it wise to lessen their exposure to China, that does not necessarily mean they will shift manufacturing activity to the U.S., particularly given what would remain labor cost differentials that lessen the financial attractiveness of such shifts. It could be that production related to medical devices and health care commodities might be pulled into the U.S., but we don't expect to see widespread shifts across manufacturing industries. Either way, any such shifts would take considerable time.

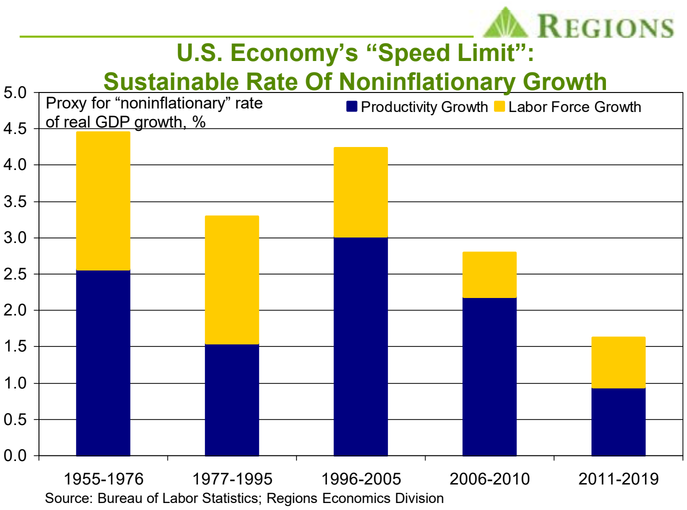
In terms of business investment, if there is one clear beneficiary of the changes triggered by the experience with the COVID-19 virus, it will be business spending on intellectual property products. As noted above, intellectual property products have captured an increasing share of overall business investment over the past several decades, but we think that shift will become even more pronounced going forward. Just as firms across a wide array of industry groups will be reassessing their need for physical space, so too will they be reassessing their need for labor, regardless of where that labor is physically located.

It could be that, in general, firms had become "labor heavy" over the recently-ended expansion, but it could also be that the sudden stop in economic activity in mid-March combined with lasting changes in the nature of how activity is conducted will lead firms to figure out ways to do the same, or more, with less labor. To the extent this turns out to be the case, it would lead to stronger growth in spending on intellectual property products. Keep in mind that this broad category includes not only computer software but also research and development outlays, and a push to enhance labor productivity would lead to stronger spending in both areas.

There have already been shifts towards "contactless" transactions across different forms of activity and an increased emphasis on virtual, as opposed to physical, meetings, and these and other similar shifts are much more likely to intensify than to reverse. To be sure, any move to automation involves outlays on machinery and equipment, but the associated spends on R&D and software will be more enduring. The broader point, however, is that the experience with the COVID-19 virus is likely to intensify the long-running shift of business investment away from what we refer to as "old school" investment (equipment, machinery, and structures) and towards "new age" investment (technology and R&D).

One downside of this is that job losses associated with the COVID-19 virus and efforts to stem its spread have been heavily concentrated amongst lower-skill workers, the last broad group to see a meaningful pick-up in wage growth as the labor market continued to tighten over the recently-ended expansion. A greater push to automation could mean that those in this group will be displaced from the labor market for longer than would have otherwise been the case, if not permanently displaced, unless they are able to invest in upgrading their skill sets.

As is the case with the broader economy, it will take time to identify and to understand the changes in patterns of business investment which are bound to occur over coming quarters. We're not referring to whatever changes there may be in the composition of or the rate of growth of GDP in any given quarter. Instead, we're referring to the much more significant changes in the economy's capacity to expand. For any long-term readers who right now are rolling your eyes and thinking "oh no, here comes the speed limit chart yet again," well, yes, look out below . . .



The rate at which the economy can grow on a sustained basis without sparking inflation pressures – what we refer to as the economy's "speed limit" – is a function of two main drivers: the rate of labor force growth and the rate of productivity growth. We have long argued that underinvestment on the part of firms over the recently ended expansion is a primary cause of what has been an anemic rate of productivity growth. In light of what are, and will remain, less than favorable demographic trends here and abroad, it is critical that the rate of productivity growth improves, which will not happen in the absence of stronger and sustained growth in business investment spending. Any discussions of rising standards of living or faster growth in consumer spending that are not put in the context of business investment and productivity growth are not worth your time or attention.

We concluded our October 2019 discussion of business investment by noting that "there is a lot riding on whether, or when, business investment breaks out of its current malaise" and ended by saying "unfortunately, . . . things are likely to get worse before they get better." And this was well before a global pandemic wreaked havoc on the global economy, thus raising the bar for stronger growth in business investment even higher. Though it gets far less attention than it deserves, the importance of business investment to the health of the economy cannot be overstated. This makes it worth monitoring how business investment fares as the economy climbs out of the deep hole it was thrown into by the COVID-19 virus and the efforts to stem its spread.

May Employment Report

In what may well go down as the greatest forecast miss ever seen this side of "Dewey Defeats Truman," the BLS reported that total nonfarm employment rose by 2.509 million jobs in May. To say that the May employment report was better than expected would not begin to capture the extent to which it humbled those of us in the forecasting game. In the aftermath of the release of the May employment report, some touted it as "proof" that a "V-shaped" recovery is underway. Others pointed to it as validation for the run-up in equity prices over recent weeks. Our view is that the May employment report represents a small step forward on what we still think will be a long road back for the U.S. economy.

The May employment report is starkly at odds with other labor market indicators. The data on initial claims for Unemployment Insurance benefits, the ISM's surveys of the manufacturing and services sectors, and the ADP National Employment Report all pointed to further job losses in May, though not nearly as severe as those seen in April. While by the end of May all states had taken steps to ease restrictions on economic activity, those steps were limited and, in most cases, came after the conclusion of the May establishment survey period. As such, these measures would not have had much impact on the May nonfarm employment data.

Perhaps a more plausible explanation is that firms taking part in the Payroll Protection Program (PPP) brought furloughed workers back on to payrolls, a condition for loans made under the PPP being converted into grants. Keep in mind that these workers would have been paid even if they did not actually work, meaning that BLS would have counted them as employed. This would help account for the seeming disparity between the headline May job growth number and what, for the nation as a whole, were but limited steps to bring economic activity back online.

That May's job gains were highly concentrated amongst industry groups – leisure and hospitality services, education and health services, retail trade – hit the hardest by the restrictions on economic activity points to the PPP having helped lift nonfarm employment in May. If we are correct on this point, it sets up another surprise in the employment data later this summer or in the fall, albeit a decidedly less pleasant surprise than that provided by the May data. As the PPP ends, those firms who have not yet seen, or do not expect to see, demand return to "pre-virus" levels will reassess their staffing needs. This could trigger another round of layoffs which, the second time around, would be permanent.

The May household survey data suggest that the labor market is far from healed. The unemployment rate fell to 13.3 percent, but BLS notes that, in the absence of reporting errors, the May unemployment rate would have printed at roughly 16.3 percent. The broader U6 measure, which accounts for underemployment and those marginally attached to the labor force, stood at 21.2 percent in May. In addition to the 21 million people unemployed in May, over 10.6 million people were involuntarily working part-time rather than full-time – in February, these two groups totaled 10.105 million people. We question how anyone could think fully reversing the damage done to the labor market will be done quickly – we see this as a years-long, not a months-long, process.

Our point here is neither to pick apart the May employment report to find flaws hidden beneath the headline job growth number nor to try to justify a forecast miss of epic proportions. But, there is a difference between knowing what the number is and knowing why the number is what it is. So, while we like surprises, well, good surprises, as much as anyone, we caution against reading too much into the May employment report. Though the worst of the short but violent downturn associated with the COVID-19 virus and the efforts to stem its spread is behind us, the 2.509 million jobs added in May are but a small down payment applied towards making up for the loss of 22.060 million jobs in March and April. That this down payment came earlier than we anticipated doesn't change that broader point.

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Q4 '19 (a)	Q1 '20 (p)	Q2 '20 (f)	Q3 '20 (f)	Q4 '20 (f)	Q1 '21 (f)	Q2 '21 (f)	Q3 '21 (f)		2017 (a)	2018 (a)	2019 (a)	2020 (f)	2021 (f)
2.1	-5.0	-37.9	25.6	9.0	5.6	4.1	3.0	Real GDP[1]	2.4	2.9	2.3	-5.8	4.1
1.8	-6.8	-41.2	41.1	10.1	4.5	3.6	2.9	Real Personal Consumption[1]	2.6	3.0	2.6	-5.5	5.1
-2.4	-7.9	-35.5	-7.7	-2.3	4.8	6.5	8.2	Real Business Fixed Investment[1]	4.4	6.4	2.1	-11.4	-0.5
-4.3	-16.6	-45.0	-10.9	-3.2	4.1	4.8	8.8	Equipment[1]	4.7	6.8	1.3	-16.8	-2.6
2.8	1.0	-19.0	5.1	0.8	7.6	8.6	8.1	Intellectual Property and Software[1]	3.7	7.4	7.5	-1.7	4.3
-7.2	-3.9	-40.1	-24.6	-7.1	-0.3	6.0	6.9	Structures[1]	4.7	4.1	-4.3	-16.2	-6.1
6.5	18.5	-40.8	13.6	4.3	3.9	3.5	4.2	Real Residential Fixed Investment[1]	3.5	-1.5	-1.5	-2.0	1.4
2.5	0.8	1.8	16.2	-1.3	-5.1	-2.0	-0.6	Real Government Expenditures[1]	0.7	1.7	2.3	3.4	0.0
-900.7	-816.0	-864.7	-910.0	-933.8	-948.2	-970.6	-972.9	Real Net Exports[2]	-849.7	-920.0	-953.9	-881.1	-969.0
964	965	730	845	855	862	871	880	Single Family Housing Starts, ths. of units[3]	851	872	893	849	877
469	522	257	321	378	390	403	412	Multi-Family Housing Starts, ths. of units[3]	356	376	403	370	406
16.7	15.0	11.1	12.9	13.6	14.2	14.8	15.0	Vehicle Sales, millions of units[3]	17.1	17.2	16.9	13.2	14.8
3.5	3.8	13.2	9.9	9.1	8.6	7.9	7.4	Unemployment Rate, %[4]	4.3	3.9	3.7	9.0	7.7
1.4	1.3	-11.5	-7.4	-6.6	-5.9	8.3	3.9	Non-Farm Employment[5]	1.6	1.6	1.4	-6.1	2.1
2.1	0.9	31.5	-25.3	-2.5	0.4	1.3	1.9	Real Disposable Personal Income[1]	2.9	4.0	2.9	2.4	-1.7
1.6	1.8	1.6	1.3	1.2	1.1	0.9	1.1	GDP Price Deflator[5]	1.9	2.4	1.7	1.5	1.1
1.4	1.6	0.7	0.6	0.7	0.9	1.6	1.6	PCE Deflator[5]	1.8	2.1	1.4	0.9	1.4
2.0	2.1	0.5	0.9	0.8	1.0	2.3	1.8	Consumer Price Index[5]	2.1	2.4	1.8	1.1	1.7
1.6	1.7	1.2	0.6	0.8	0.8	1.4	1.7	Core PCE Deflator[5]	1.6	1.9	1.6	1.1	1.4
2.3	2.2	1.4	1.1	1.1	1.2	1.9	2.0	Core Consumer Price Index[5]	1.8	2.1	2.2	1.5	1.7
1.71	1.30	0.13	0.13	0.13	0.13	0.13	0.13	Fed Funds Target Rate Range Mid-Point, %[4]	0.97	1.78	2.16	0.42	0.13
1.79	1.38	0.75	0.96	1.13	1.25	1.37	1.46	10-Year Treasury Note Yield, %[4]	2.33	2.91	2.14	1.05	1.40
3.70	3.52	3.30	3.32	3.38	3.41	3.45	3.47	30-Year Fixed Mortgage, %[4]	3.99	4.54	3.94	3.38	3.46
-2.0	-1.6	-1.9	-1.7	-1.8	-2.0	-2.2	-2.2	Current Account, % of GDP	-2.3	-2.4	-2.3	-1.8	-2.2

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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