



This Economic Outlook may include opinions, forecasts, projections, estimates, assumptions and speculations (the "Contents") based on currently available information which is believed to be reliable and on past, current and projected economic, political and other conditions. There is no guarantee as to the accuracy or completeness of the Contents of this Economic Outlook. The Contents of this Economic Outlook reflect judgments made at this time and are subject to change without notice, and the information and opinions herein are for general information use only. Regions specifically disclaims all warranties, express or implied, with respect to the use of or reliance on the Contents of this Economic Outlook or with respect to any results arising therefrom. The Contents of this Economic Outlook shall in no way be construed as a recommendation or advice with respect to the taking of any action or the making of any economic, financial or other plan or decision.

Is Health Care Making The U.S. Economy Sick?

Sure, that's a bit strong and, in a word, no, health care is not making the U.S. economy sick. But, a glance at the latest round of revisions to the Q1 GDP data at least makes it understandable that one would ask the question. The BEA's third, but not yet final, estimate shows real GDP contracted at an annualized rate of 2.9 percent in Q1, matching the largest quarterly contraction ever recorded when the economy was not in recession (the last such instance was Q2 1981 and a recession began the following quarter). This was a significantly more severe contraction than reported in the BEA's second estimate (1.0 percent, annualized). The primary culprit in the sizeable downward revision was health care, or, more specifically, consumer spending on health care. The short version is the implementation of the Affordable Care Act (ACA) is wreaking havoc on the economic data.

Start with what, in the wake of a seismic shift in the health care landscape, are bound to be structural changes in individual and institutional behavior, add in the lack of timely data that would help to quantify the economic impact of these changes, and top that off with financial market participants who react in real time to the data, or estimates of data, as they come, and it can make for false signals about the economy's direction and an unhealthy degree of volatility in the markets. We saw this in the Q1 2014 GDP data – subject to yet another revision in the BEA's annual benchmark revisions due on July 30 – and could well see the same in the data for Q2 and subsequent quarters.

For some perspective on the potential impact of swings in patterns of expenditures on health care, consider the following chart, which shows household expenditures on health care as a

share of GDP (all data adjusted for inflation). In Q1 2014, such expenditures accounted for 11.4 percent of GDP and in the absence of meaningful changes in the administration of health care services this share would have risen sharply over coming years. The ACA was intended as a framework of structural changes in which access to health care would be expanded, but in a more efficient, cost effective manner. Whether, and to what extent, the ACA will accomplish these dual goals will take years to become clear, but the relevant point for now is the implementation of the ACA is clouding our view of the underlying trends in the U.S. economy.

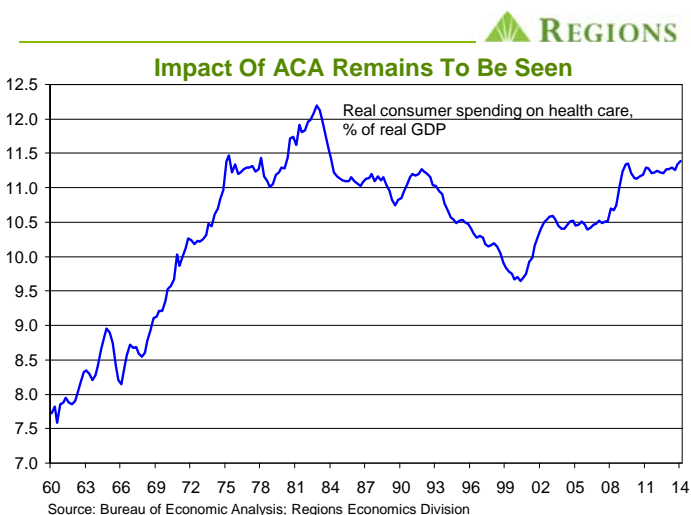
To that point, with consumer outlays on health care accounting for such a large share of GDP, it does not take much to move the needle on top-line growth even when the swings in spending are milder than that seen in Q1. As a means of clarification, as accounted for in the GDP data, household expenditures on health care include all such expenditures regardless of who foots the bill, whether direct payments by individuals, private insurance, or employer sponsored insurance, for example. The issue in Q1 was, as the ACA began to take effect, the BEA was basically flying blind in terms of having hard data with which to work.

In the absence of timely data on health care spending the BEA relied on its own estimate based on extrapolation of data on Medicaid enrollment and spending, and enrollments into the insurance exchanges, amongst other factors, in the first estimate of Q1 real GDP. This methodology yielded an annualized increase in household expenditures on health care of 9.9 percent in Q1, which added 1.1 points to top-line real GDP growth (as seen in the chart on the following page) of 0.1 percent according to the BEA's first estimate. Had it stood, the BEA's estimated 1.1 point contribution to top-line real GDP growth would have been far and away the largest such contribution on record in the life of the data that go back to Q2 1959.

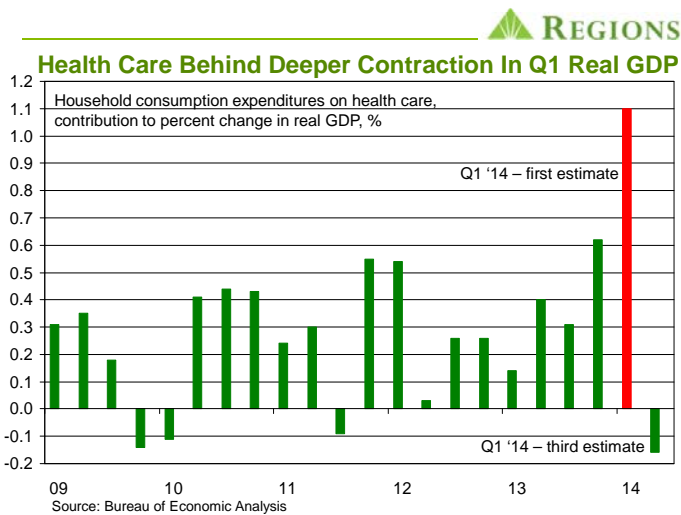
In the BEA's second pass at Q1 GDP, their estimate for annualized growth in health care outlays was trimmed down to 9.1 percent, enough to still add 1.0 points to top-line real GDP growth which by then had turned into a contraction of 1.0 percent (annualized). So, thank goodness for health care, which cushioned the blow inflicted by an unusually harsh winter, a sizeable increase in the U.S. trade deficit (talk about curious numbers in the GDP data), and a brief but violent inventory correction that teamed up to do a number on the economy in Q1. Were it not for the jump in health care spending, the contraction in real GDP would have been far worse than the 1.0 percent reported by the BEA.

Oops.

By the time of their third pass at Q1 real GDP, the BEA had source data on total revenue in the health care industry, courtesy of the *Quarterly Services Survey* (QSS) published by the Census



Bureau. The QSS showed a 2.0 percent decline in total revenue between Q4 2013 and Q1 2014, leading the BEA to bludgeon its estimate for household spending on health care, now reported to have declined at an annualized rate of 1.4 percent. So, instead of cushioning the blow to the economy in Q1, health care added to it, deducting 0.16 points from top-line “growth,” as shown in the chart below.



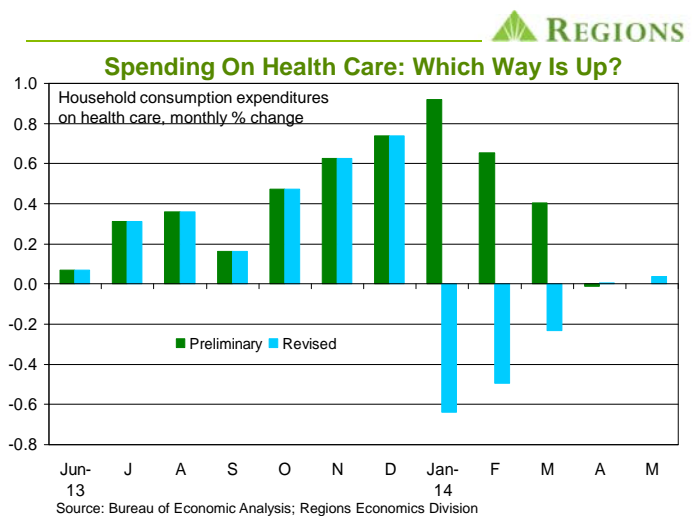
There are a few other notable points to make from the above chart. First, since the 2007-09 recession ended in June 2009, household outlays on health care have fallen in four different quarters. Leaving Q1 2014 aside, it could be that along with their jobs, many people lost their health insurance and with it access to care, which could have contributed to the slower growth in health care spending in Q3 2009 and then the outright declines in such spending in the subsequent two quarters. Prior to Q4 2009, one would have to go all the way back to Q2 1993 to find a quarter in which household outlays on health care declined.

Also worth noting is the sizeable increase in health care outlays in Q4 2013 – the quarter immediately prior to the ACA beginning to take effect. Household outlays on health care rose at an annualized rate of 5.6 percent which, as seen in the chart above, added 0.62 points to top-line real GDP growth. This marks the second largest contribution from health care on record, second only to the 0.76 point contribution in Q1 2002 which reclaimed its rightful place at the top with the revisions to this year’s Q1 estimates. It could very well be the case that, in anticipation of disruptions in/changes to insurance coverage or limitations on service providers, people pulled the consumption of elective health care services forward into Q4 2013. To the extent this was the case, it would have played a hand in the reported decline in health care spending in Q1 2014.

To be clear, the point here is not to pass judgment on the merits of the ACA or to ridicule the BEA for producing such sharply divergent estimates of health care spending – we are firm believers in the maxim those who forecast in glass houses should not throw stones. Instead, our one and only focus here is the impact on the GDP data and the perceptions of, well, the underlying health of the U.S. economy formed at least in part by that very GDP data. And, if Q1 was a case of one and done, in

terms of the potential impact of health care spending, we could have easily found another scintillating means of filling a couple pages of text.

Instead, the way things are shaping up Q2 could bring a reversal of the patterns seen in Q1 – an initial estimate of Q2 real GDP growth on the low side that is ultimately revised higher when the source data on health care revenue from the QSS are incorporated. For instance, the data on personal income and spending that appear in the quarterly GDP reports come from the BEA’s monthly reports. Through May, the BEA is showing virtually no change in consumer outlays on health care, but again thus far these data points reflect estimates made by the BEA. Barring an outsized leap in health care spending in June, such spending will be flat to only modestly higher for Q2 as a whole. The monthly data are shown in the following chart, which also show the sharp downward revisions to the Q1 data.



The data in the above chart notwithstanding, it does make intuitive sense that along with expanded access to health care, be it through more widespread insurance coverage or expanded access to Medicaid, will come higher spending on health care (keep in mind here the point made earlier regarding how health care expenditures are accounted for in the GDP data), and this increase could be sizeable. In short, it seems plausible it is a matter of when, not if, we will see such an increase in spending but, judging from the above chart, that increase will not have come in Q2. Here is where it gets, depending on your perspective, either really fun or really aggravating. The Q2 *Quarterly Services Survey* is due on September 11, roughly two weeks prior to the release of the BEA’s third estimate of Q2 GDP. So, if the QSS shows a jump in health care revenue in Q2, we will almost surely see an upward revision to the expenditures data shown in the chart above, which would in turn add to top-line real GDP growth. Were we to see growth on the order of that initially estimated for Q1, this would push real GDP growth close to 5 percent, annualized, for Q2 when incorporated into our baseline forecast (which now stands at 3.8 percent without a sizeable increase in health care spending).

The other possibility is the profile of health care spending in both Q4 2013 and Q1 2014 will look substantially different upon the

release of the BEA's annual benchmark revisions to the GDP data, set for release on July 30. As this coincides with the first estimate of Q2 GDP, it could also be the initial estimate of health care spending in Q2 will be substantially higher than implied by the data for April and May shown in the chart above.

Either way, when all is said and done, at least to the extent all can ever be said and done in the fun filled and fast paced world of economic data, the trajectory of health care spending starting with Q4 2013 and going forward will almost surely look far different than it does today. It is likely to be some time before we have a clear view of the true path of household expenditures on health care. In the interim, we could see repeated episodes of release and revision, in terms of the data on health care. To be sure, this is the case with every economic data series, but what makes health care so impactful is its size in terms of the overall economy. We do not, nor should we, expect every quarter to see such sharp swings in estimates; the point is the changes need not be so large to have a nontrivial impact on reported GDP growth. This, in turn, could lead to a lot of misplaced angst or, depending on the turns of the data, euphoria in the financial markets as participants react to headline numbers that may or may not offer an accurate assessment of underlying economic conditions, and could also complicate the task of policy makers trying to steer the economy on the proper course.

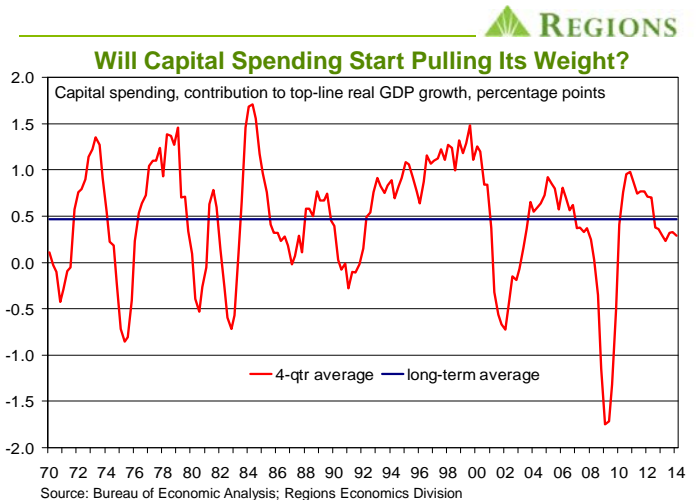
Moreover, even if we assume the BEA had the ability to perfectly measure actual spending on health care, we are only in the early stages of what are potentially landmark changes in the structure of the health care system, changes that will impact consumers, care providers, insurance providers, and businesses. Anyone who, at this point in time, thinks they can accurately project how the various parties will be impacted, let alone how these changes will collectively impact the economy, is either way smarter or way more delusional than are we. Again, the reality is it will take time, potentially a lot of time, until we have clarity on these matters, and in the interim reported changes in the economy's rate of growth could have more to do with the health care system than with the underlying health of the economy.

Now Or Never For Cap-Ex?

Since early Q4 2013 we have consistently pointed to what we saw as an improving tone of the economic data, and we have stuck with our story through the unusually harsh winter and through the unusually harsh revisions to the Q1 GDP data. Whether this is us being foolish, arrogant, stubborn, in denial, or correct – come on, don't rule that out so quickly – remains to be seen. The reality is the Q1 GDP data are the outlier amidst data pointing to a firmer underlying rate of growth. That said, we by no means believe our forecasted rate of Q2 real GDP growth to be sustainable. And while we do expect growth to remain around 3.0 percent through 2015, we do not see that as a sustainable rate of long-term growth.

One element behind our expectation for faster economic growth in the near term is what we expect to be a stepped up pace of capital expenditures. As seen in the chart below, capital spending has not exactly held up its end of the bargain thus far since the end of the 2007-09 recession. For a variety of reasons, we think that will change starting with Q2 2014, and that capital spending

will support a faster pace of top-line real GDP growth, not only over coming quarters via a direct add-on to GDP but perhaps over the longer term should it help revive worker productivity growth, which has fallen on hard times of late.



Business investment in equipment and software has fallen short in terms of its contribution to top-line real GDP growth over the past several quarters. True, such spending made an above-average contribution in the early stages of the recovery, but that was in reaction to the steep and prolonged decline during the recession and capital spending was also swayed by various tax incentives included in efforts to stimulate the economy. That capital spending has been a laggard seems consistent with tales of corporations sitting on large stockpiles of cash but finding few, if any, good uses for that cash. These stories, as we discussed at length in our March 2013 *Outlook*, are somewhat overblown but, nonetheless, the lack of a more meaningful rebound in capital spending has been somewhat of a surprise.

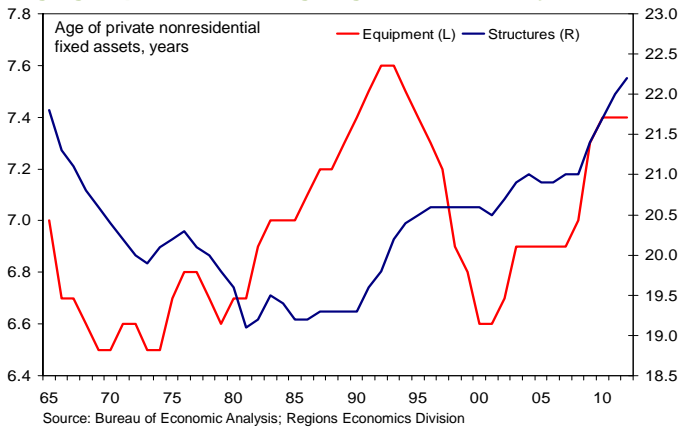
The sluggish rebound in business investment could very well reflect an overall lack of confidence in the prospects for growth, both domestic and global. This would be understandable in the wake of the most severe economic contraction this side of the Great Depression, and while confidence has improved, that is relative to a very low base. One factor that could be inhibiting confidence is the lack of clarity over economic policy and what could be looming doubts as to whether policy makers, again on a global basis, will get it right in terms of weaning the economy off of highly accommodative monetary policy, particularly at a time when fiscal policy makers for the most part remain AWOL.

In such an environment, firms are willing to do the minimum, but not much more, when it comes to capital spending. One way to think of it is to segregate capital spending into three categories: 1) replacement investment; 2) productivity enhancing investment; and 3) capacity enhancing investment (two and three can be lumped together, as improved worker productivity leads to faster growth in output, but we prefer to view them separately). Clearly, replacement investment is needed to simply maintain the current capital stock, while in a revenue constrained environment enhanced productivity can keep a lid on costs, including labor costs. But, unless and until firms feel more confident over prospects for growth, they are certainly not going

to be willing to invest in expanding capacity. Sure, at any point in time there will be specific industries in which expanded capacity makes sense, but in the aggregate it does not appear the corporate sector has been willing to embark on such investment.

Aside from providing less support for top-line real GDP growth, there are other implications of the sluggish recovery in business investment. First, the capital stock has aged more rapidly than otherwise would be the case and while replacement investment can fend off the effects of an aging capital stock, it is by no means an economic fountain of youth, and an older capital stock is by nature a less efficient capital stock. One implication is a less efficient capital stock acts as a drag on worker productivity growth. Additionally, one source of weakness in business investment has been in computer equipment and software, the type of “high tech” investment that helped fuel a surge in worker productivity beginning in the mid-1990s.

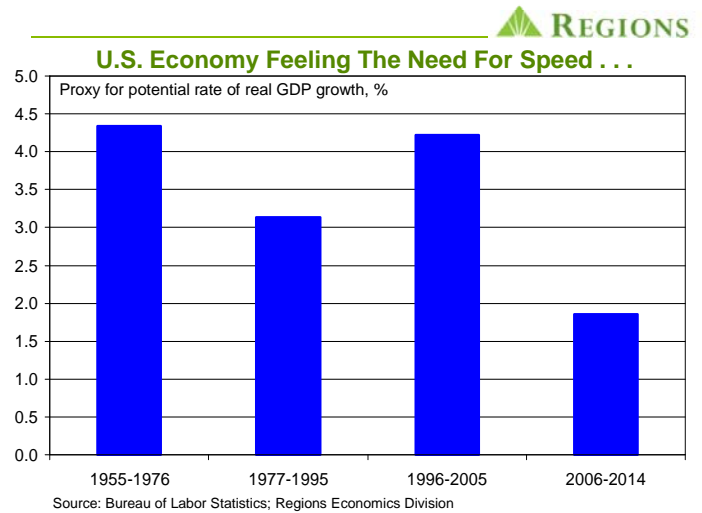
Aging Capital Stock Weighing On Productivity Growth?



As the chart above shows, the average age of the capital stock has risen significantly, though in the case of structures this ageing process began some time ago. More concerning is the rapid advancement in the age of the stock of equipment which, in recent years, has coincided with a significant slowdown in the growth of worker productivity. For instance, over the past eight quarters, annualized growth in worker productivity in the nonfarm business sector has averaged just over 0.2 percent per quarter (this includes our estimate that productivity fell at an annualized rate of almost 6 percent in Q1 following the downward revision to real GDP). Productivity has behaved atypically over the course of this recovery/expansion, as has been the case with business investment.

Granted, there are few things that can kill an otherwise interesting dinner party conversation as turning to the topic of productivity growth, but what it lacks in style it makes up for in substance. One way to think of the significance of productivity growth is to think of what is referred to as an economy’s “speed limit,” or, the rate at which it can grow without igniting inflation pressures. A quick proxy for an economy’s speed limit is the sum of the rate of labor force growth and the rate of productivity growth. As such, for a given rate of labor force growth, a slower rate of productivity growth means a lower speed limit for the economy. Unfortunately, at present the U.S. economy is seeing

not only a significant slowdown in productivity growth but also a pronounced and ongoing slowdown in labor force growth.



As seen in the chart above, the past several years have seen a significant slowdown in the U.S. economy’s speed limit. To some extent this was to be expected as productivity growth could not have been expected to stay at the 3.0 percent average per year that prevailed over the 1996-2005 period, while demographic factors (hey, the capital stock isn’t the only thing getting older) acted as a drag on the rate of labor force growth. What is less clear, at least in recent years, is the extent to which the severe 2007-09 recession introduced a cyclical component on top of these structural factors and at what point that cyclical component will be reversed. We do expect the rate of labor force growth to pick up, particularly as younger adults, now in school, either come back to the labor force or join for the first time.

That said, it could be some time before labor force growth returns to the average annual rate of 1.0 percent that prevailed between 2001 and 2007, meaning one component of potential growth would remain below its longer-run norm for some time to come. This highlights the importance of productivity growth but, at least at present, there is little to suggest productivity growth will fill in the gap, as productivity growth itself is lagging its historical norm. Even were labor force growth to return to 1.0 percent, without a meaningful pick up in the pace of productivity growth the economy would be hard pressed to hit a 2.0 percent rate of potential growth.

Faster productivity growth will also be important to alleviate wage pressures as the labor market tightens. For whatever reason, many associate rising wages with inflation, as though the former automatically cause the latter. The piece they are missing, clearly having not paid attention at the dinner party, is productivity – it is when wage growth exceeds productivity growth that forces firms to choose between raising prices on the goods and services they produce or simply accept slimmer profit margins. With productivity growth low and trending lower, firms will be faced with that choice sooner rather than later.

This also has clear implications for monetary policy. By all accounts there are not a lot of good reasons to remember the 1970s, but there are certain parallels that could prove instructive

for where the economy is today. Specifically, beginning in 1977 the rate of productivity growth slowed sharply, the start of the nearly 20-year period of anemic productivity growth that ended with the tech revolution of the 1990s. (Note – some draw the line of demarcation at 1974, when productivity declined by 1.6 percent, but productivity growth bounced back to 2.7 percent in 1975 and 3.5 percent in 1976, so it was not until 1977 that productivity growth firmly settled into its anemic phase.) During the era of low productivity, the rate of inflation accelerated, culminating with double-digit inflation in 1979, 1980, and 1981, albeit with some help from oil prices. But, the slowdown in productivity growth caught the Fed off guard and the economy got sucked into a classic wage-price spiral (admit it, you covered that in Macro 101 but fell asleep in class that day).

The point here is not that we think we are about to see a return of double-digit inflation, or polyester leisure suits and disco for that matter (though one can always hope), but there is a danger of inflation being kicked started by the combination of a tightening labor market and slow productivity growth. For as much as Chair Yellen and some other FOMC members point to indicators of labor market slack, they nonetheless must be on the watch as they opt to keep the Funds rate so low as a means of helping pare down labor market slack. Persistently overestimating the trend rate of productivity growth has, in the past, led central bankers and private sector forecasters astray in terms of forecasting inflation, and this could potentially happen over coming quarters.

This brings us back to the significance of a meaningful pick up in the rate of growth in business investment spending. There are reasons to be hopeful. First, with the rate of job growth having picked up over recent months, it will be necessary for firms to increase investment to keep the per worker capital stock from falling too low and in turn fostering production inefficiencies (don't worry, we'll spare you a lengthy discourse on the determination of the optimal capital stock per worker).

Second, new orders for core capital goods have been trending higher, despite the inherent month-to-month volatility in the data, and have surpassed their pre-recession high. This tells us that firms have already recognized the need to enhance their capital stocks and have begun to do so. Third, C&I loan growth has accelerated sharply over the course of 2014 and at least some portion of this loan growth is likely coming from small and mid-sized firms, who do not have access to the capital markets, taking loans to finance capital expenditures.

Finally, firms have the capacity, at least in the aggregate, to self-finance a significant portion of capital expenditures, based on the data from the Fed's *Flow of Funds* accounts. What still seems to be lagging, at least to some degree, is confidence in faster and sustained economic growth. In a recovery that has come in fits and starts, confidence is unlikely to come roaring back any time soon, particularly with a high degree of uncertainty on the monetary and fiscal policy fronts. But, even gradually improving business confidence will help foster a more solid rebound in business investment.

There is clearly a lot riding on the course of business capital spending. In addition to contributing to faster top-line real GDP

growth today, stronger growth in business investment will help spur faster productivity growth tomorrow, thereby raising the economy's speed limit and giving the Fed more breathing room. At the same time, a meaningful and sustained rebound in capital spending would be another signal of a self-sustaining expansion, thereby giving the Fed confidence to pare back on monetary policy accommodation, thereby diminishing the downside risk of a policy error. Like we said, there is a lot riding on an improvement in business capital spending, so we will be carefully watching the data in the months ahead to see whether or not our forecast is on track.

ECONOMIC OUTLOOK



July 2014

Q4 '13 (a)	Q1 '14 (a)	Q2 '14 (f)	Q3 '14 (f)	Q4 '14 (f)	Q1 '15 (f)	Q2 '15 (f)	Q3 '15 (f)		2012 (a)	2013 (a)	2014 (f)	2015 (f)
2.6	-2.9	3.8	3.4	3.2	3.0	3.3	3.1	Real GDP ¹	2.8	1.9	1.7	3.2
3.3	1.0	2.4	3.4	3.0	3.0	3.0	2.8	Real Personal Consumption ¹	2.2	2.0	2.3	3.0
								Business Fixed Investment:				
8.1	0.7	8.9	8.5	8.0	7.6	7.4	7.9	Equipment, Software, & IP ⁴	5.9	3.1	5.3	7.9
-1.8	-7.7	3.8	5.1	4.5	5.8	6.1	6.1	Structures ¹	12.7	1.3	1.8	5.4
-7.9	-4.2	8.3	14.9	12.1	13.2	17.1	18.4	Residential Fixed Investment ¹	12.9	12.2	3.5	14.5
-5.2	-0.8	-0.9	-0.3	-1.0	-1.1	-0.6	-0.5	Government Expenditures ¹	-1.0	-2.2	-1.4	-0.8
-382.7	-429.8	-434.1	-434.6	-438.6	-441.5	-442.8	-450.2	Net Exports ²	-430.8	-412.3	-434.3	-448.0
1.025	0.925	1.043	1.066	1.083	1.103	1.171	1.207	Housing Starts, millions of units ³	0.784	0.930	1.029	1.182
15.6	15.6	16.6	16.7	16.8	16.7	16.8	16.9	Vehicle Sales, millions of units ³	14.4	15.5	16.4	16.8
7.0	6.7	6.2	6.1	5.9	5.8	5.6	5.5	Unemployment Rate, % ⁴	8.1	7.4	6.2	5.6
1.8	1.7	1.8	1.9	1.9	2.0	2.0	2.0	Non-Farm Employment ⁵	1.7	1.7	1.8	2.0
1.4	1.3	1.9	2.0	2.1	2.4	2.2	2.1	GDP Price Index ⁵	1.7	1.5	1.8	2.2
1.0	1.1	1.7	1.8	2.1	2.2	2.1	2.0	PCE Deflator ⁵	1.8	1.1	1.7	2.1
1.2	1.4	2.1	2.2	2.4	2.5	2.2	2.1	Consumer Price Index ⁵	2.1	1.5	2.0	2.2
1.2	1.1	1.5	1.7	1.9	2.1	2.0	2.0	Core PCE Deflator ⁵	1.8	1.2	1.6	2.0
1.7	1.6	1.9	2.0	2.1	2.3	2.2	2.2	Core Consumer Price Index ⁵	2.1	1.8	1.9	2.2
0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	Fed Funds Target Rate, % ⁴	0.25	0.25	0.25	0.38
2.75	2.76	2.62	2.80	3.10	3.30	3.40	3.50	10-Year Treasury Note Yield, % ⁴	1.80	2.35	2.82	3.45
4.30	4.36	4.23	4.29	4.51	4.69	4.78	4.86	30-Year Fixed Mortgage, % ⁴	3.66	3.98	4.35	4.82
-2.0	-2.6	-2.5	-2.4	-2.3	-2.3	-2.2	-2.3	Current Account, % of GDP	-2.8	-2.4	-2.5	-2.3

a = actual; f = forecast;

- Notes:
- 1 - annualized percentage change
 - 2 - chained 2009 \$ 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

richard.moody@regions.com

Constantine Soras
Senior Economist

constantine.soras@regions.com

Greg McAtee
Economist

gregory.mcatee@regions.com