ECONOMIC OUTLOOK

REGIONS

March 2015

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.

U.S. Consumers Not Sticking To The Script?

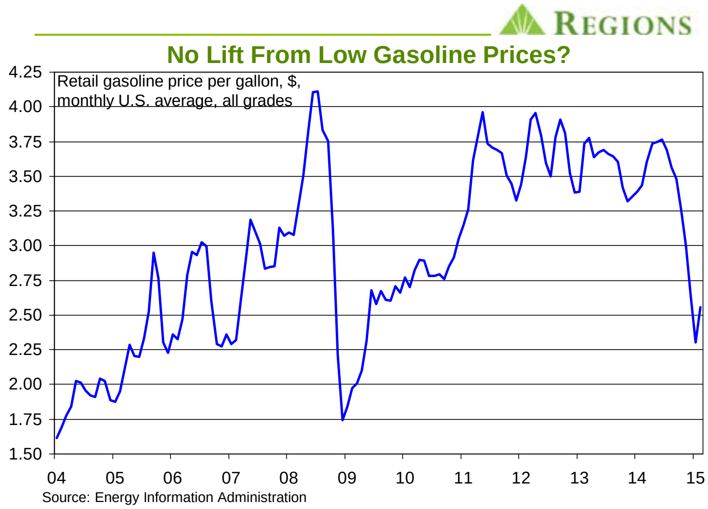
Apparently, the hapless U.S. consumer just can't seem to get it right. For years they were chided for piling up too much debt, spending too much, and saving too little. Now, they're subject to considerable discussion as to why they're saving so much and spending so little, especially given the windfall in the form of savings from lower retail gasoline prices. Instead of running out and spending these savings, they're, well, saving the savings, or at least a sizeable portion of them or, even more out of character, using the extra cash to further pare down debt.

Apparently, U.S. consumers just didn't get the memo instructing them to run out and spend the cash freed up by lower retail gasoline prices. Okay, maybe they got it and just opted to ignore it. Either way, we have been struck by what has been a spate of stories of late wondering what's up with U.S. consumers and why they aren't spending more of those savings from lower gasoline prices. More broadly, however, even before gasoline prices began plummeting in Q4 2014 there had been considerable discussion around the seemingly restrained rate of growth of U.S. consumer spending but, all in all, we find nothing either too surprising or too concerning in consumer spending patterns, even accounting for the fate of the cash freed up by lower gasoline prices.

At least not at present, anyway, though we will admit to having done our fair share, if not more than our fair share, of nagging over rising household debt levels in the years leading up to the 2007-09 recession. But, in the period since the end of the 2007-09 recession consumer spending has progressed pretty much as would have been, or should have been, expected. In our view the two biggest factors governing the rate of growth of consumer spending coming out of the recession were the health, or relative lack thereof, of household balance sheets and the rate of growth of wage and salary earnings, far and away the largest single component of total personal income.

This suggested limited growth in consumer spending for an extended period coming out of the recession, which is what we got. But, it also suggested as household balance sheets improved and the labor market strengthened, the rate of growth of consumer spending should improve, which is what we've seen happen over the past several months. And, yes, we have seen the headline prints on the monthly retail sales reports over the past few months which, for those of you who have not, we'll just say have not been good. It may seem hard to reconcile declines in headline retail sales in both December and January with talk of an improving outlook for consumer spending but the two are not at all inconsistent, as we will discuss below.

In what follows we will take a closer look at recent trends in consumer spending and our outlook for coming quarters, and our focus will be on the longer-term drivers of growth in consumer spending. But, as so much of the focus of late has been the December and January retail sales reports and why significantly lower gasoline prices don't seem to have done much to fuel faster growth in consumer spending, we'll address that before moving on to discuss the underlying fundamentals.



The chart above shows the sharp, and sudden, decline in retail gasoline process seen over the latter stages of 2014. Pump prices peaked in June, at $3.78 per gallon (national average, all grades) and fell to a low of $2.13 per gallon in the week of January 26 2015. Almost as soon as gasoline prices began falling there was talk of the boost this would provide for consumer spending, with most of the talk pointing to the "rule of thumb" that holds each one-cent decline in retail gasoline prices frees up $1 billion of cash for consumers to spend on other goods and services on an annualized basis.

It is perhaps the seemingly endless repetition of this rule of thumb that led to outsized expectations of the impact lower gasoline prices would have on overall consumer spending. After all, simply doing the math on the peak-to-trough decline in retail gasoline prices outlined in the above paragraph implies an additional $165 billion (about 1.4 percent of nominal personal consumption expenditures in 2014) suddenly available to be spent elsewhere. Our more alert readers will notice some really fine print at the end of the rule of thumb stated at the end of the prior paragraph. Yes, this was intentional and what that really fine print says is "on an annualized basis," which is part of the rule of thumb that has tended to either be ignored outright or relegated to "oh, by the way" status either by the analysts reciting this rule of thumb or the media accounts repeating it.

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

Aside from taking issue with this "rule" – we have stated in other venues we think it exaggerates the impact of lower gasoline prices – we will note the significance of the timing aspect. In other words, falling gasoline prices are immediately visible and, while they do free up cash, that cash accrues only gradually over time as opposed to showing up all at once. So, yes, if gasoline prices fall 165 cents per gallon and stay there for a year, at the end of that year there is $165 billion (or whatever the correct number is) of cash available for spending on other goods or services. But, on a week to week basis, the impact is far less apparent and whatever the rate at which consumers accumulate these savings is, they don't do much to spur additional spending, at least in the early stages. If lower prices persist over time, it is reasonable to expect some of the accumulated savings on gasoline to be spent elsewhere in the economy.

Even still, there are other factors that come into play, and one key factor is expectations. Stripped down to its bare essentials, Milton Friedman's *Permanent Income Hypothesis* holds changes in a person's consumption patterns are driven by permanent, not transitory, changes in a person's income. There isn't a corollary that specifically pertains to gasoline prices, of course, but if there was it would hold changes in gasoline prices are unlikely to induce consumers to change their consumption patterns unless the changes in gasoline prices are perceived to be permanent. A quick glance at the above chart of gasoline prices suggests that while, yes, gasoline prices change frequently, and often sharply, those changes tend to ultimately be reversed. As such, it is not unreasonable to posit consumers see the recent declines in gasoline prices as mainly transitory so that at least some of the savings at the pump over recent months may simply have been put aside to cover the higher prices that will surely come later – and the better than 20 percent increase in retail gasoline prices since their January low won't do anything to dispel this notion.

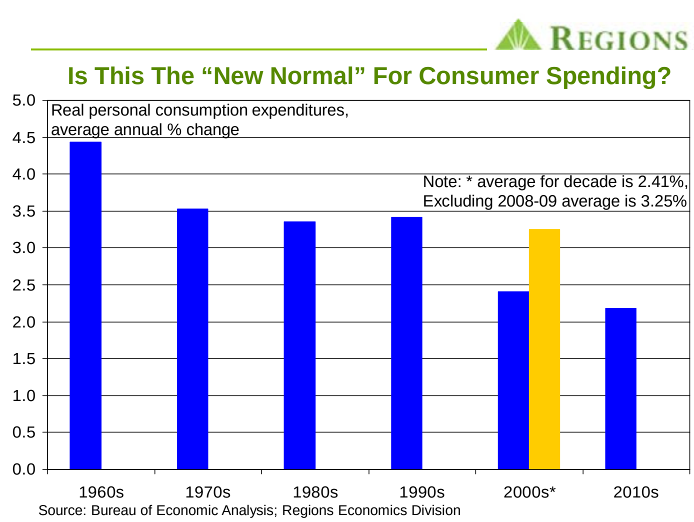
To the extent gasoline prices will rise further – and we are now moving into the months when seasonal patterns suggest higher gasoline prices – but do not return to the highs of last June, there should be some benefit to other forms of consumer spending that will be more apparent over time. This isn't to say, however, lower gasoline prices have not already had an impact on consumer spending. They have, and in a big way, at least in terms of how the retail sales data are reported.

The Census Bureau's monthly report on retail sales presents the data on a nominal basis, i.e., not adjusted for price changes. This is the main factor behind the large declines reported in total retail sales in December and January. As of November 2014 gasoline station sales accounted for over 9 percent of all retail sales (this does not include gas sold at club/warehouse stores, so gasoline's share of total retail sales is even higher) so that when retail gasoline prices fell by 12 percent during the month of December and another 16 percent during the month of January, this acted as a significant drag on total retail sales.

Moreover, there are price effects in other sectors of the economy that are helping hold down reported nominal retail sales. For instance, prices for core goods (goods other than food and energy) have fallen on a month-to-month basis in seven of the past eight months and have declined in a year-over-year basis for 22 consecutive months. Apparel would be one area for which weak pricing has weighed down reported sales volumes. The significance of these price effects can be seen in data from the Bureau of Economic Analysis (BEA), which provides a series on retail sales that parallels that of the Census Bureau, but the BEA reports their series on both a nominal basis and a real (i.e., adjusted for price changes) basis. While nominal retail sales fell by 0.9 percent in December and by 0.8 percent in January, real retail sales were flat in December and up 1.0 percent in January, which paints quite a different picture of consumer spending than that offered up by the nominal headline numbers. And, it is worth recalling retail sales, real and nominal, were strong in both October and November, making December look more like a breather than an all-out retreat on the part of consumers.

It is also worth noting that assessing the state of consumer spending based on the monthly retail sales data means one is doing so on the basis of highly incomplete data. The monthly retail sales reports do not include spending on services, and such spending accounts for roughly two-thirds of consumer spending as reported in the GDP data yet is largely ignored when reported by the BEA in its monthly reports on personal income and spending. In part this is understandable, since this is where we enter the grey area associated with the often repeated but not quite factual assertion that consumer spending accounts for roughly 70 percent of GDP. How that should read is, consumer spending as defined by the BEA accounts for roughly 70 percent of GDP. The difference is that not all of what is characterized by the BEA as consumer spending on services is actually spent – some expenditures are imputed – and not all of what is actually spent is actually spent by consumers – think health care. Those niceties aside, there is nonetheless a good portion of consumer discretionary spending, such as recreation and travel, captured in the data on services spending but not the data on retail sales.

The broader point here is the monthly retail sales data offer only a partial view of consumer spending, particularly when observed on a nominal basis. As such, our discussion from here on will focus on total personal consumption expenditures, or spending on goods and services as reported in the BEA's monthly data on personal income and spending and incorporated into the GDP data. This provides us a better, though not necessarily better looking, basis on which to discuss where consumer spending is, why it is there, and where we see it going from here.

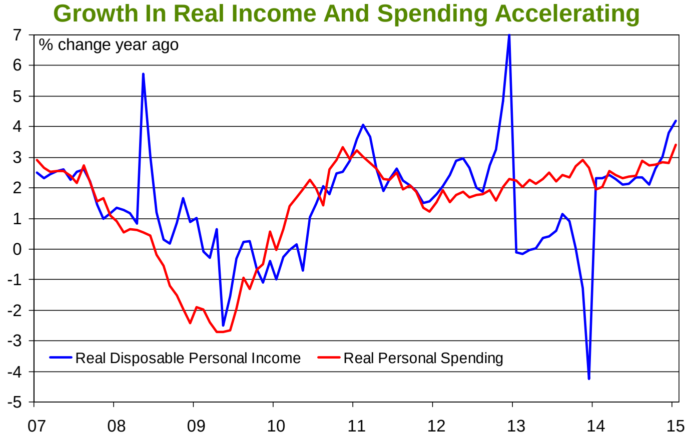


Richard F. Moody, Chief Economist • 205.264.7545 • richard.moody@regions.com

When stacked up against the historical data, as shown in the above chart, it is clear growth in consumer spending in the years since the end of the 2007-09 recession comes up lacking. Since 2010 average annual growth in real personal consumption expenditures (real PCE) has been 2.18 percent, a far cry from the average annual rate of just under 3.5 percent seen from the 1970s through 2007. As a side note, the annual average for the 2000s as a whole is 2.41 percent but, excluding 2008 and 2009 when real PCE declined, the average of 3.25 percent is more "trend like." This isn't to say those two years should be ignored but instead to simply illustrate how things have changed since the 2007-09 recession.

As noted earlier, expecting anything more out of consumer spending coming out of the recession was simply not reasonable given the wretched state of household balance sheets and the severe job losses seen not only during the downturn but over the first several months of recovery (total payroll employment did not begin rising until March 2010). Growth in real PCE has gradually picked up since 2010, with growth of 2.39 percent in 2013 and 2.50 percent in 2014 (4.2 percent, annualized, in Q4), and our expectation is real PCE growth will top 3.0 percent for 2015 as a whole. As seen in the chart below, January 2015 saw growth in both disposable personal income and real PCE accelerate to rates last seen in 2006 (for income, this excludes those months blessed with "stimulus" checks from the federal government and late-2012 when income was pulled forward in anticipation of higher personal tax rates in 2013).

Growth In Real Income And Spending Accelerating



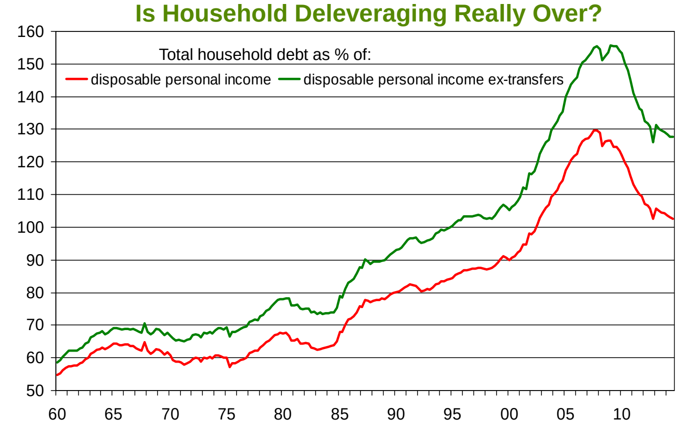
Source: Bureau of Economic Analysis; Regions Economics Division

It would be wrong, however, to attribute January's growth as no more than a one-off spurt due to an abnormally low headline inflation print. One factor in January was a jump in transfer payments, reflecting annual cost of living increases for several federal entitlement programs. More fundamentally, though, nominal income growth has accelerated steadily over recent months as steadily improving labor market conditions have fueled faster growth in private sector wage and salary earnings. On a year-over-year basis, private sector wage and salary earnings have risen by better than five percent for seven consecutive months. At the same time, wage and salary earnings in the government sector are growing at a still-low but improving pace of late, after years of steady job losses and little or no cost of living increases in that sector.

As we routinely point out, it is growth in aggregate wage and salary earnings that is relevant in assessing the outlook for growth in consumer spending, as labor earnings make up far and away the largest single component of personal income. What has been steadily accelerating growth in aggregate wage and salary earnings has been overlooked, to a large degree, in the discussion over what remains sluggish growth in average hourly earnings. It has, to this point, been growth in aggregate hours worked – the product of the number of people working and average weekly hours – that has been the prime source of growth in aggregate wage and salary earnings. As the labor market continues to tighten, however, growth in average hourly earnings – the third component of aggregate wage and salary earnings – will improve and help generate even faster growth in wage and salary earnings which, in turn, will underpin faster growth in disposable personal income. This labor driven growth in real personal income is a more powerful, and lasting, driver of growth in consumer spending than is any growth induced by falling retail gasoline prices.

We expect further gains in wage and salary earnings to underpin faster growth in disposable personal income, which in turn will support more rapid growth in consumer spending. Our premise coming out of the 2007-09 recession was, going forward, growth in consumer spending would be more closely aligned with growth in labor earnings than had been the case in the years leading up to the recession. That said, even though we see labor earnings accelerating further, we do not look for growth in real PCE to settle back into the longer-term trend rate of just under 3.5 percent, at least not for some time to come, as we do not expect debt to play as prominent role in supporting current consumption spending as had been the case prior to the recession.

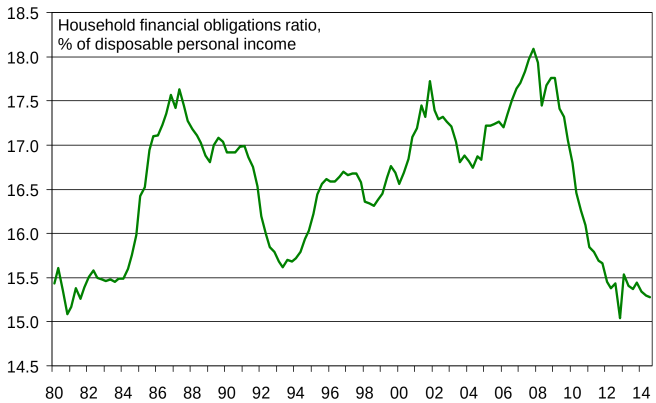
Is Household Deleveraging Really Over?



Source: Bureau of Economic Analysis; Federal Reserve Board; Regions Economics Division

One reason we hold this view can be seen in the above chart, which shows the ratio of total household debt to disposable personal income. We also show the ratio using disposable personal income excluding transfer payments, as we have argued this is a better measure of the income actually available to service debt. Either way, however, there is no denying the ratio has fallen considerably from the peaks reached as the 2007-09 recession was starting. To be sure, much of the decline in the ratio during the recession and in the early stages of the recovery simply reflected lenders writing off bad debt, but as the recovery has progressed and morphed into expansion, we have seen true deleveraging. That said, we think there is still further to go in paring down the debt-to-income ratio. This puts us squarely at odds with others who have proclaimed household deleveraging to have run its course, but we simply cannot fathom how a debt-to-income ratio of 100 percent or even slightly higher can be seen as sustainable over a prolonged period of time.

Low Interest Rates Lightening Monthly Payment Burden



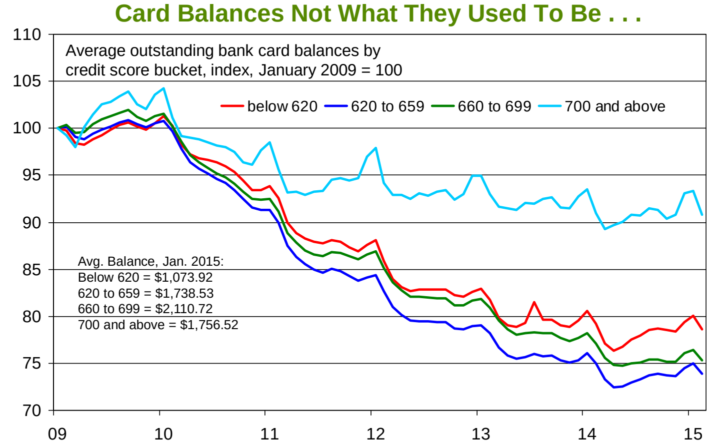
Source: Bureau of Economic Analysis; Federal Reserve Board; Regions Economics Division

For anyone who frets over the level of debt, or, more specifically, the debt-to-income ratio, there seems to be someone on the other side who will argue it isn't the level of debt that matters, rather, it is the ability to service that debt. And, those who hold that view can point to the financial obligations ratio (which starts with the standard debt service ratio and adds other regular obligations such as rent and lease payments) as shown in the above chart. A prolonged period of low interest rates has combined with rising income and lower debt levels to push the household financial obligations ratio to the lowest point on record save for late-2012 when personal income spiked as noted earlier.

One could argue low interest rates and further growth in personal income give households the latitude to take on at least some additional debt and still comfortably meet monthly payment obligations. That argument, however, begins to collapse when interest rates begin to rise to any meaningful degree, a caveat that seems timely with the FOMC preparing to begin the process of normalizing short-term interest rates at some point in 2015. And, while it is widely believed the FOMC will take very measured steps in this process, one cannot rule out the prospect that markets won't be as measured as the FOMC. With expectations of a series of funds rate hikes over coming quarters, market interest rates could rise faster, and farther, than anticipated, to such a degree that the cost of credit and debt service burdens become drags on consumer spending growth.

Those who share our view that the level of the debt-to-income ratio matters, even with the financial obligations ratio as low as it now is, seem to have some company. More than one recent survey shows consumers using some of that cash freed up by lower gasoline prices to pare down debt which, truth be told, we did not expect to see. Overall, consumers remain somewhat restrained when it comes to taking on new debt. What growth we are seeing in household debt is being driven by auto loans and student loans, the former supports current consumption, the latter does not. Mortgage debt, the pillar of growth in household debt in the years leading up to the 2007-09 recession, finally seems to have stopped contracting but seems unlikely to grow with any vigor in the near term, particularly those forms of mortgage debt that allow homeowners to tap into their equity in order to facilitate current consumption.

Card Balances Not What They Used To Be . . .



Source: Equifax; Regions Economics Division

What we have found most interesting over recent years is the behavior of credit card debt. What we had expected, particularly in the leanest post-recession years for the labor market, was increased card utilization to help smooth consumption in the absence of meaningful growth in wage and salary earnings. Instead, card balances have fallen sharply – across all credit score buckets, as shown in the above chart – and have yet to rebound. Note the data shown in the chart are not seasonally adjusted, so the bumps seen each January reflect normal holiday-related increases in balances. But, this year, as in past years, February has seen those seasonal bumps reverse. The broader point, however, is while lenders aggressively cut card limits in the wake of the recession, consumers nonetheless have considerable unused capacity – roughly $2.7 trillion as of Q3 2014 according to FDIC data – to increase card balances but, at least thus far, have resisted any temptation to do so.

So, where does all of this leave us in terms of the outlook for consumer spending? Improving job and income growth, rising household net worth, highly manageable debt service burdens, and low interest rates all suggest conditions are ripe for consumers to step up the pace of spending. And, seasonal increases aside, consumers will see net saving from gasoline prices which, at some point, will add to spending. Yet, even though we expect a faster pace of growth in consumer spending in 2015, we do not expect growth to settle back into the longer-term pre-recession trend rate. We remain worried about what, to us, are still-high levels debt, particularly with higher interest rates looming on the horizon, and wonder to what extent consumers are comfortable adding more debt to facilitate spending.

ECONOMIC OUTLOOK

REGIONS

March 2015

Q3 '14 (a)	Q4 '14 (a)	Q1 '15 (f)	Q2 '15 (f)	Q3 '15 (f)	Q4 '15 (f)	Q1 '16 (f)	Q2 '16 (f)		2013 (a)	2014 (a)	2015 (f)	2016 (f)
5.0	2.2	3.0	3.7	3.3	3.0	3.0	2.8	Real GDP[1]	2.2	2.4	3.4	3.1
3.2	4.2	3.4	4.1	3.6	3.3	2.9	2.8	Real Personal Consumption[1]	2.4	2.5	3.6	3.1
								Business Fixed Investment:				
10.2	4.7	3.5	5.1	6.1	6.6	6.9	7.2	Equipment, Software, & IP[1]	4.1	5.8	5.7	6.7
4.8	5.0	2.4	3.2	5.0	5.7	4.6	5.0	Structures[1]	-0.5	8.1	4.5	4.9
3.3	3.3	19.6	15.0	12.4	14.1	10.7	7.2	Residential Fixed Investment[1]	11.9	1.6	11.6	10.7
4.4	-1.8	1.6	-0.7	-0.6	-1.3	-0.9	-1.2	Government Expenditures[1]	-2.0	-0.2	0.4	-0.9
-431.3	-476.4	-481.5	-490.1	-500.3	-500.3	-493.8	-488.4	Net Exports[2]	-420.5	-453.8	-493.1	-484.3
1.030	1.065	1.069	1.077	1.085	1.094	1.101	1.117	Housing Starts, millions of units[3]	0.930	1.001	1.081	1.135
16.7	16.7	16.6	17.0	17.1	16.9	16.7	16.7	Vehicle Sales, millions of units[3]	15.5	16.4	16.9	16.7
6.1	5.7	5.6	5.4	5.3	5.3	5.2	5.1	Unemployment Rate, %[4]	7.4	6.2	5.4	5.1
2.0	2.1	2.3	2.3	2.2	2.1	2.0	2.0	Non-Farm Employment[5]	1.7	1.9	2.2	1.9
1.6	1.2	0.9	0.8	0.9	1.4	1.9	1.9	GDP Price Index[5]	1.5	1.5	1.0	2.0
1.5	1.1	0.3	0.1	0.3	0.9	1.9	2.0	PCE Deflator[5]	1.2	1.3	0.4	2.0
1.8	1.2	0.0	-0.2	0.0	0.8	2.1	2.4	Consumer Price Index[5]	1.5	1.6	0.2	2.3
1.5	1.4	1.2	1.2	1.2	1.4	1.7	1.8	Core PCE Deflator[5]	1.3	1.4	1.3	1.8
1.8	1.7	1.4	1.3	1.4	1.5	1.9	2.0	Core Consumer Price Index[5]	1.8	1.7	1.4	1.9
0.13	0.13	0.13	0.13	0.29	0.54	0.93	1.17	Fed Funds Target Rate, %[4]	0.13	0.13	0.27	1.34
2.50	2.28	2.00	2.15	2.30	2.50	2.65	2.85	10-Year Treasury Note Yield, %[4]	2.35	2.54	2.24	2.89
4.14	3.97	3.70	3.72	3.85	4.03	4.19	4.38	30-Year Fixed Mortgage, %[4]	3.98	4.17	3.82	4.44
-2.3	-2.2	-2.3	-2.2	-2.3	-2.3	-2.4	-2.4	Current Account, % of GDP	-2.4	-2.3	-2.3	-2.4

a = actual; f = forecast; p = preliminary

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

Constantine Soras
Senior Economist

Greg McAtee
Economist