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ECONOMIC REPORT

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SLOWER JOB GROWTH IN JULY NOT A CONCERN AS LABOR MARKET IN GREAT SHAPE; UNEMPLOYMENT RATE FALLS

SUMMARY

- The U.S. economy added 159,000 jobs in July, slower than the recent pace, but there were large upward revisions to job growth in May and June.
- The unemployment rate fell slightly in July to 3.9 percent, and remains near a decades-long low.
- Wage growth in July was 0.3 percent; with the U.S. economy at full employment wage growth will accelerate into 2019.
- The excellent labor market supports an increase in the fed funds rate at the FOMC's next meeting, in late September.
- The U.S. trade deficit widened in June. Trade is a major downside risk to the outlook.

The U.S. economy added 157,000 jobs in July, below PNC's forecast of 180,000 and the consensus expectation for an increase of 190,000. The private sector added 170,000 jobs over the month, with government employment down by 13,000. There were big upward revisions to job growth in the previous two months. June job growth was revised up by 35,000 to 248,000, while May growth was revised up by 24,000 to 268,000, for a combined upward revision over the two months of 59,000. Job growth over the past three months averaged 224,000, and the U.S. economy has added an average of 215,000 jobs per month so far in 2018, well above last year's pace of 182,000.

After rising 0.2 percentage point in June the unemployment rate fell 0.1 percentage point in July to 3.9 percent; except for May, this is the lowest the unemployment rate has been since the end of 2000. The unemployment rate fell as the number of people employed in the household survey (different from the survey of employers) rose by 389,000 in July; household job growth has averaged 278,000 per month so far this year (see Chart 1). After a huge gain of 601,000 in June labor force growth slowed to 105,000 in July, and the labor force participation rate (share of adults either working or looking for work) held steady at 62.9 percent; since the beginning of 2016 the labor force participation rate has been in a narrow range between 62.6 and 63.0 percent. The broader U-6 unemployment rate (unemployed, underemployed and too discouraged to look for a job) fell 0.3 percentage point in July to a new cyclical low of 7.5 percent; it has not been this low since the spring of 2001.

Job growth was good in most private industries in July. Goods-producing industries added 52,000 jobs over the month, including 37,000 in manufacturing and 19,000 in construction; trade concerns do not appear to be weighing on manufacturing, at least so far. Private service-providing industries added 118,000 jobs in July, down from 182,000 in June. Retail employment bounced back, adding 7,000 jobs in July after falling by 20,000 in June, despite the recent liquidation of Toys R Us. Professional/business services added 51,000 jobs in July, including 28,000 in temporary services. There were employment gains of 40,000 in leisure/hospitality services and 22,000 in education and healthcare, but a loss of 5,000 in financial activities. Federal government employment rose by 2,000 in June, but state and local government employment fell by 13,000; this may be due to seasonal adjustment issues around the end of the school year.

Average hourly earnings rose 0.3 percent in July, up from 0.1 percent growth in May (revised slightly lower). Year-over-year growth in wages was 2.7 percent in July, unchanged from June. Slowly but surely the tighter job market is leading to stronger wage growth, as businesses raise pay to retain their current workers and attract new ones (see Chart 2).

The average workweek was 34.5 hours in July, down from 34.6 hours in June. With more jobs, a slightly shorter

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workweek, and moderate wage growth, aggregate weekly earnings were down less than 0.1 percent in July; as a result real consumer income was down slightly over the month with the consumer price index likely up 0.1 percent for the month (to be released on August 10).

Although job growth slowed in July there were big upward revisions to job growth in May and June, and the labor market is in excellent shape in the middle of 2018. Job growth is averaging around 215,000 per month this year, far above the pace needed to reduce labor market slack, and wage growth is gradually picking up. After an increase in June the unemployment rate fell in July. PNC expects job growth of close to 200,000 per month in 2018, slightly above last year's pace; it will slow in the second half of this year compared to the first as businesses find it more and more difficult to hire. Stimulus from the recent corporate and personal income tax cuts, as well as increased federal spending, will boost the economy and labor market in 2018 and into 2019. Wage growth will accelerate this year as employers compete for workers; PNC's spring 2018 survey of small and medium-sized businesses found that one-half of firms expect to raise compensation over the next six months. However, a trade war that would lead to a slowing in the job market is becoming a much more plausible downside risk as the U.S. and its trading partners implement tit-for-tat tariffs; after the Trump administration recently announced that is considering additional new tariffs on imports from China, China responded by announcing new tariffs on $60 billion of U.S. exports. One potential upside risk for job growth is higher wages bringing more people into the job market.

The solid July jobs report, and more importantly the excellent labor market, support an increase in the federal funds rate at the Federal Open Market Committee's late September meeting, by one-quarter of a percentage point to a range of 2.00 to 2.25 percent. Core inflation (excluding food and energy) was 1.9 percent in June, just below the FOMC's 2 percent objective, and the tight job market is raising concerns that building wage pressures could lead to higher inflation. The FOMC will try to let some of the steam off the economy, concerned that letting the labor market run too hot could push inflation well past the 2 percent objective. On the morning of August 6 the fed funds futures market has priced in a 94 percent probability of a rate increase at the FOMC's meeting on September 25 and 26.

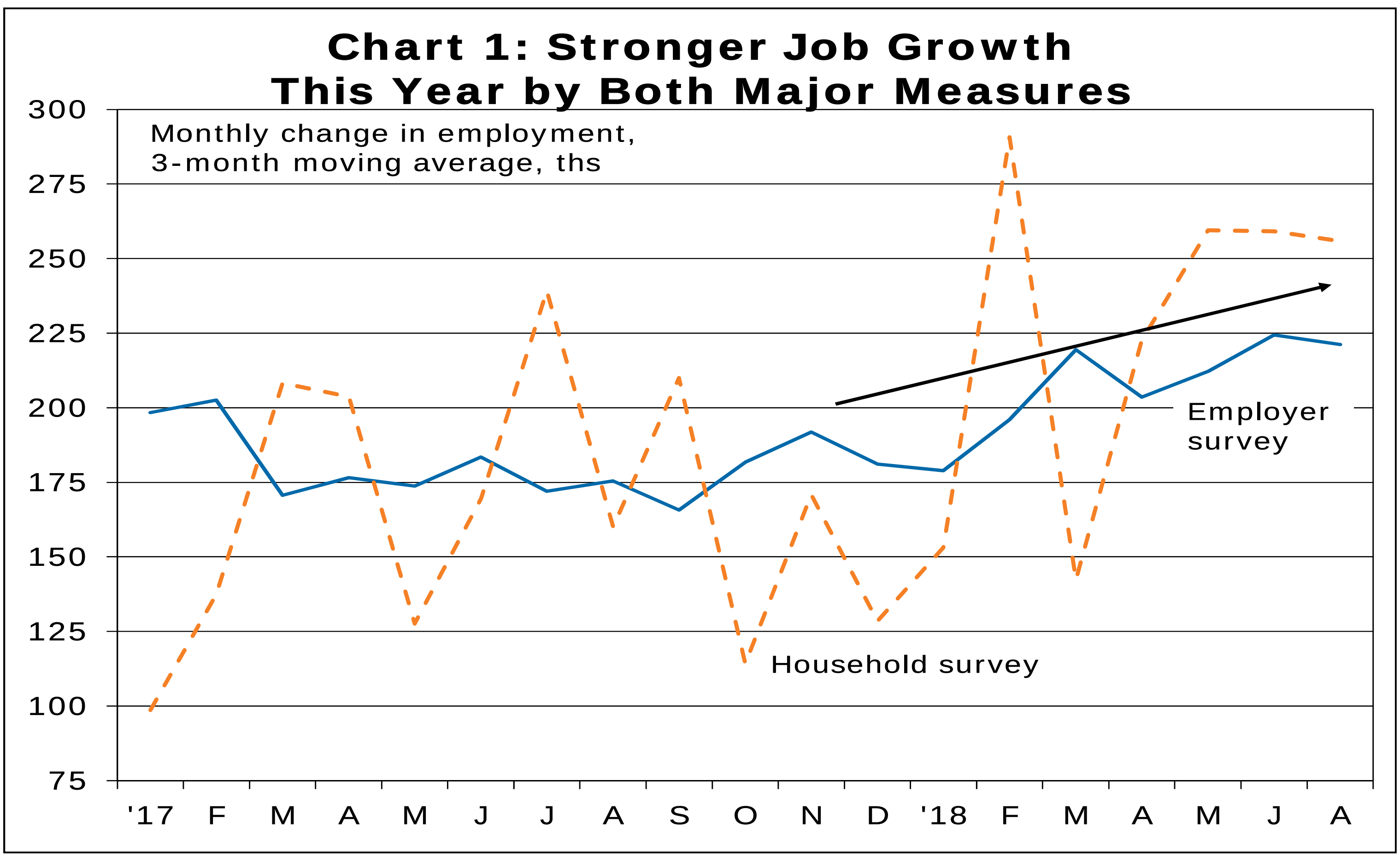

Chart source: Bureau of Labor Statistics

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The current economic expansion, which began in June 2009, is now in its ninth year, making it the second-longest in U.S. economic history. With the job market in great shape right now the expansion has a decent shot of becoming the longest ever; the current longest expansion lasted 120 months, from 1991 to 2001.

The U.S. trade deficit widened in June to $46.3 billion, from $43.2 billion in May (adjusted for seasonal variation but not for inflation). Exports fell 0.7 percent over the month to $213.8 billion, while imports rose 0.8 percent to $260.2 billion. The U.S. trade deficit in goods increased in June, while the surplus in services was unchanged.

After narrowing for three straight months, the U.S. trade deficit widened in June. Trade was a positive for U.S. economic growth in the second quarter; according to the advance estimate of GDP, a narrowing in the trade deficit accounted for 1.1 percentage points of the total 4.1 percent annualized growth in the quarter. One reason the trade deficit fell in the second quarter is that importers stocked up on U.S.-grown soybeans ahead of Chinese tariffs, but that will reverse in the third quarter. Trade will be a negative for growth in the second half of this year and into 2019 as the U.S. trade deficit is set to widen in the near term. Assuming that trade tensions ease exports will increase thanks to global economic growth, but imports will increase more quickly as U.S. consumers and businesses buy more from abroad as domestic demand grows. A stronger U.S. dollar in 2018 will also contribute to a larger trade deficit.

An escalating trade war would weigh on both imports and exports as the U.S. and its trading partners impose tariffs on one another. And the dollar would likely strengthen more in a trade war, which would further encourage imports and discourage exports. PNC's baseline forecast is for a lot of rhetoric on trade, but little concrete action. But as recent actions by the U.S. and China demonstrate, the risk of an all-out trade war that would weigh significantly on U.S. and global economic growth is real and rising.

Chart 2: Uneven Progress, But With Tighter Labor Market Wage Growth Is Accelerating

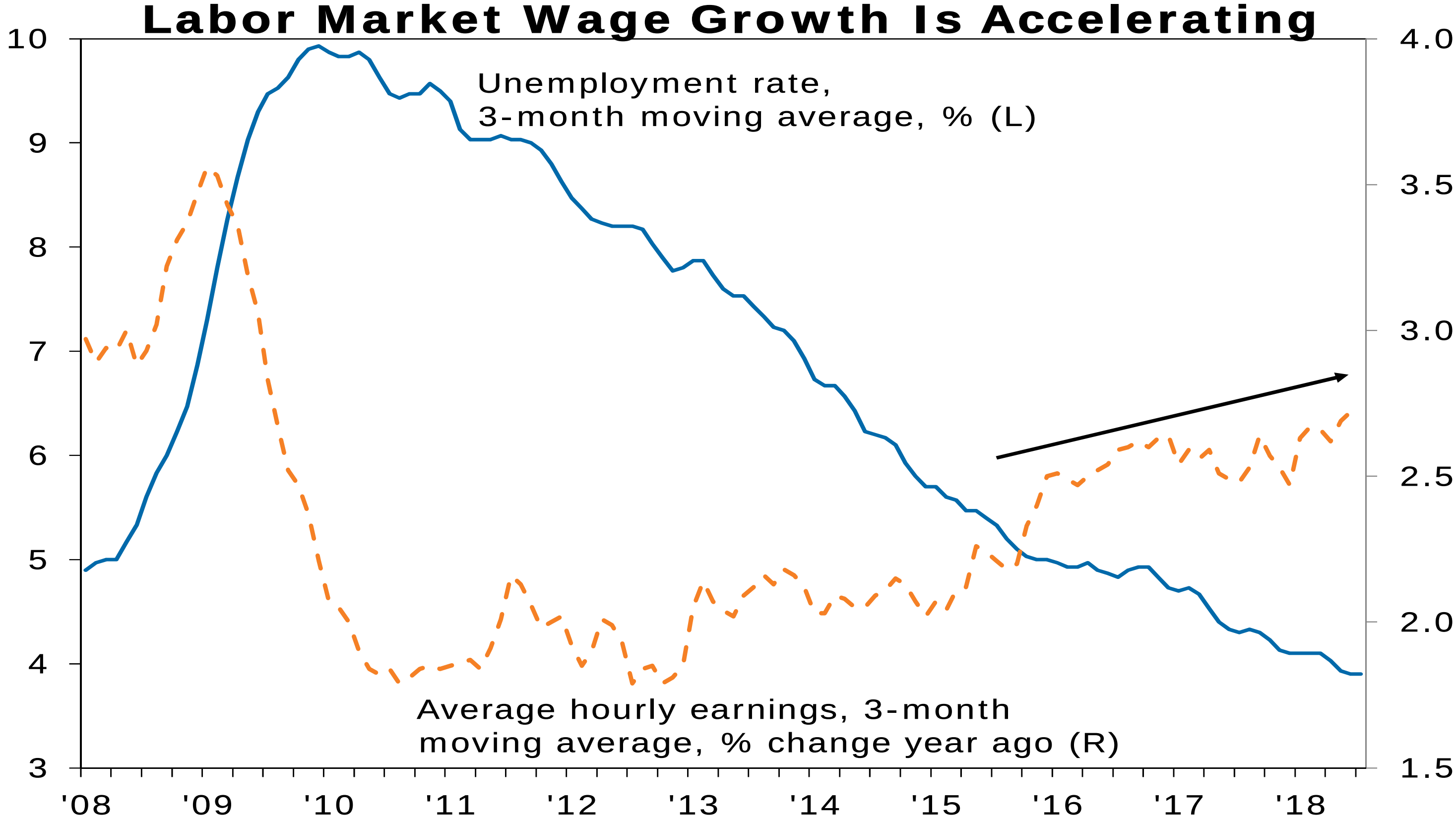

Chart source: Bureau of Labor Statistics

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