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ECONOMIC REPORT

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GREAT AUGUST JOBS REPORT, WITH STRONGEST WAGE GROWTH IN NINE YEARS; TRADE TO WEIGH ON ECONOMY

SUMMARY

- The U.S. economy added 201,000 jobs in August, with the unemployment rate steady at 3.9 percent.
- Wage growth in August was 2.9 percent from one year earlier, the fastest pace since 2009.
- The labor market is in excellent shape in the second half of 2018.
- The U.S. trade deficit widened in July. Trade will be a drag on the economy in the third quarter.
- The ISM manufacturing index rose in August, but a potential trade war remains a downside risk for the industry.
- The FOMC will raise the federal funds rate at its next meeting, at the end of September.

The U.S. economy added 201,000 jobs in July, very close to PNC's forecast of 200,000 and above the consensus expectation for an increase of 190,000. Especially notable was the fastest year-over-year wage growth in more than nine years. The private sector added 204,000 jobs over the month, with government employment down by 3,000. There were downward revisions to job growth in the previous two months of a combined 50,000. July job growth was revised down by 10,000 to 147,000, while June growth was revised down by 40,000 to 208,000. Job growth over the past three months has averaged 185,000, and the U.S. economy has added an average of 207,000 jobs per month so far in 2018, well above last year's pace of 182,000.

The unemployment rate was 3.9 percent for a second straight month in August. Except for May, this is the lowest the unemployment rate has been since the end of 2000. The unemployment rate held steady as the number of people employed in the household survey (different from the survey of employers) fell by 423,000 in August, and the number of people in the labor force (either working or looking for work) fell by 469,000. The labor force participation rate fell from 62.9 percent in August to 62.7 percent in July; since the beginning of 2016 the labor force participation rate has been in a narrow range between 62.6 and 63.0 percent. The declines in household employment and the labor force in August are not a concern; these series are volatile from month-to-month, and both have been trending higher this year. The broader U-6 unemployment rate (unemployed, underemployed and too discouraged to look for a job) fell 0.1 percentage point in August to a new cyclical low of 7.4 percent; it has not been this low since the spring of 2001.

Job growth was good in most private industries in August. Goods-producing industries added 26,000 jobs over the month, with an increase of 23,000 in construction but job losses of 3,000 in manufacturing, including 5,000 in auto manufacturing. There are big swings in auto manufacturing employment in the summer as factories retool, and the seasonal adjustment process may have overstated the weakness over the month. Private service-providing industries added 178,000 jobs in August, up from 117,000 in July. Professional/business services added 53,000 jobs in August, including 10,000 in temporary services; job gains were also 53,000 in education/healthcare. There were employment gains of 20,000 in transportation and warehousing and 11,000 in financial activities. Retail employment fell by 6,000 over the month. Federal government employment was flat in August and state and local government employment fell by 3,000.

There was very good news on wages. Average hourly earnings rose 0.4 percent in August, up from 0.3 percent growth in July. More importantly year-over-year growth in wages was 2.9 percent in August, the best pace since mid-2009, when the labor market was imploding from the Great Recession (see Chart 1). 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.

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The average workweek was 34.5 hours in August, unchanged from July. With more jobs, a steady workweek, and good wage growth, aggregate weekly earnings were up 0.4 percent in August; as a result real consumer income was likely up 0.2 percent over the month with the consumer price index likely up 0.2 percent (to be released on September 13).

The labor market is in excellent shape in the second half of 2018. Job growth picked back up in August after a slowing in July, and a long-awaited acceleration in wage growth finally appears to be taking hold as the job market tightens. Job growth is averaging around 207,000 per month this year, far above the pace needed to reduce labor market slack, and the unemployment rate is below 4 percent and set to move lower. PNC expects job growth of close to 200,000 per month in 2018, slightly above last year's pace; it will slow a bit through the rest of this year 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 into 2019. Wage growth will continue to accelerate as employers compete for workers. 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. One potential upside risk for job growth is higher wages bringing more people into the job market.

The U.S. trade deficit (not adjusted for inflation) widened to $50.1 billion in July, from $45.7 billion in June. This was the biggest monthly trade deficit since February. Exports fell 1.0 percent to $211.1 billion, while imports rose 0.9 percent to $261.2 billion.

Trade will weigh on U.S. economic growth in the third quarter. Trade was a positive for the growth in the second quarter, adding 1.2 percentage points to annualized real GDP growth, with a big increase in exports and a small decline in imports. But that will reverse in the third quarter (see Chart 2). Much of the increase in exports came from larger Chinese purchases of U.S. soybeans ahead of higher tariffs imposed by the Chinese government. U.S. imports will rise in the third quarter as consumers and businesses purchase more from abroad. With President Trump getting set to announce tariffs on another $200

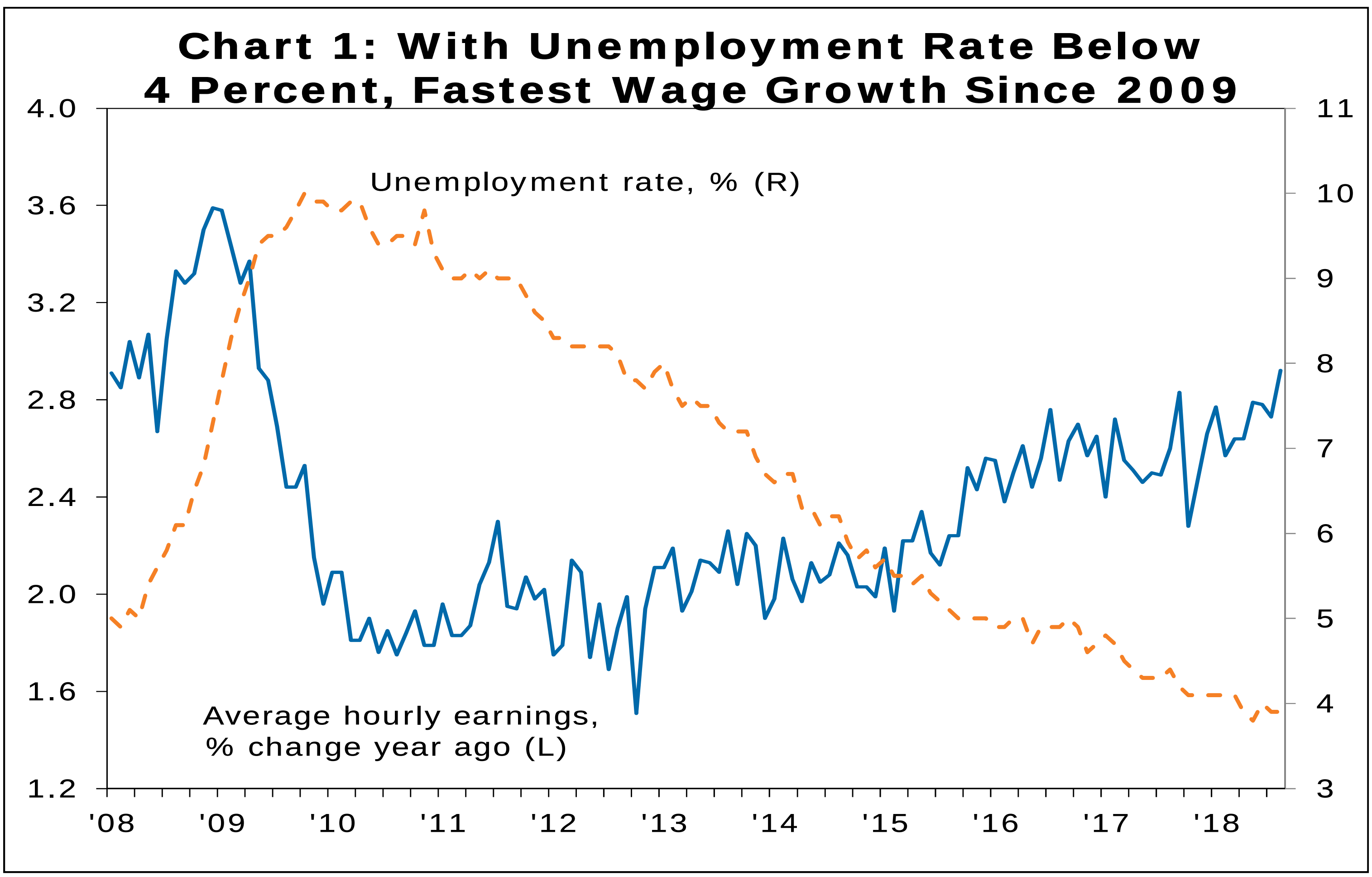

Chart source: Bureau of Labor Statistics

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billion of Chinese imports, a trade war is a becoming more of a downside risk to the economy at the end of 2018.

The ISM manufacturing index jumped to 61.3 in August from 58.1 in July; a reading of above 50 indicates expansion in manufacturing. This was the highest value of the index since 2004. All five of the components used to calculate the headline index improved in August. Production, new orders and supplier deliveries were all above 60, with employment and inventories above 55. The very strong ISM reading for August is one reason to discount the decline in manufacturing jobs over the month. So far trade tensions do not appear to have harmed U.S. manufacturers, but that could change if the U.S. and its trading partners impose more import barriers.

The solid August jobs report, other economic data, and most importantly the excellent labor market all support a one-quarter of a percentage point increase in the federal funds rate at the Federal Open Market Committee's next meeting on September 25 and 26, to a range of 2.00 to 2.25 percent. Core inflation (excluding food and energy) was right at the FOMC's 2 percent objective in July, 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. As of September 7 the fed funds futures market is pricing in almost 100 percent probability of a rate increase at this month's FOMC meeting.

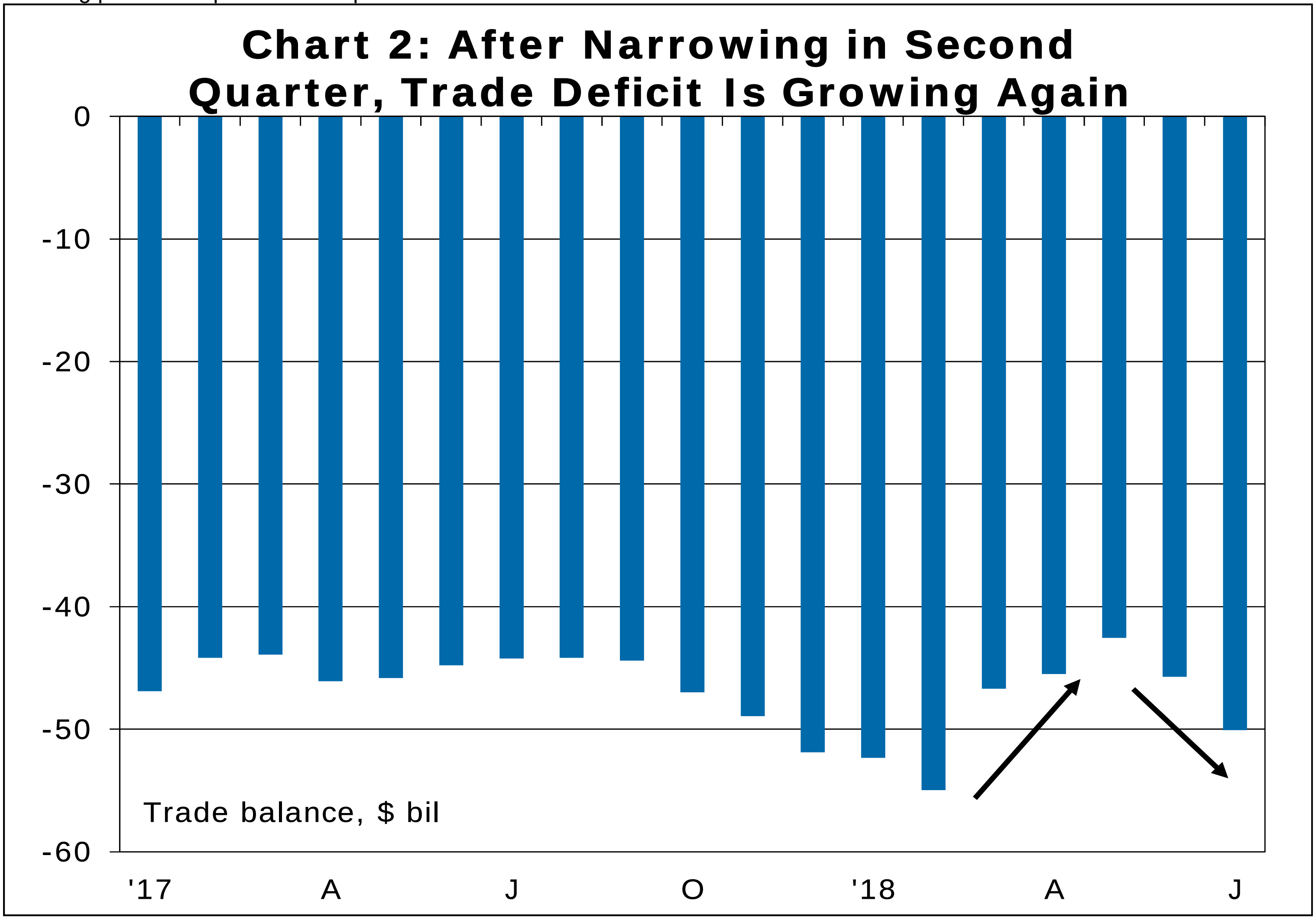

Chart source: Bureau of Economic Analysis/Census Bureau

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