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ECONOMIC REPORT

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SOFTER SEPTEMBER JOB GROWTH, BUT LOWEST UNEMPLOYMENT RATE SINCE 1969; FED RAISES RATES

SUMMARY

- The US economy added 134,000 jobs in September, the weakest job growth in a year. Hurricane Florence was a drag on the labor market.
- The unemployment rate fell to 3.7 percent in September, the lowest rate since 1969.
- Wage growth was once again solid.
- The labor market will continue to improve into 2019. Job growth and rising wages will support gains in consumer spending.
- The FOMC raised the fed funds rate by one-quarter of a percentage point in late September.
- With the economy continuing to expand and the unemployment rate falling, the FOMC will continue to raise short-term interest rates.

The U.S. economy added 134,000 jobs in September, below PNC's forecast of 160,000 and the consensus expectation for an increase of 185,000. Hurricane Florence weighed on job growth over the month; this was the weakest job growth since September of last year, when Hurricanes Harvey and Irma disrupted the labor market (see Chart 1). The private sector added 121,000 jobs in September, with government employment up by 13,000. There was an enormous upward revision to job growth in August, to 270,000 from 201,000, with a smaller upward revision to July, to 165,000 from 147,000, for a combined upward revision of 87,000. Job growth over the past three months has averaged 190,000, and the US economy has added an average of 208,000 jobs per month so far in 2018, well above last year's pace of 182,000. This pace of job growth is consistent with PNC's fall 2018 survey of small and mid-sized businesses, which found that almost one-third (31 percent) of firms surveyed expect to increase staffing over the next six months.

The unemployment rate fell 0.2 percentage point in September to 3.7 percent; this is the lowest the rate has been since late 1969 (see Chart 2). The number of people employed in the household survey (different from the survey of employers) rose by a large 420,000 in September after falling by 423,000 in August; the number of people in the labor force (either working or looking for work) rose by 150,000, after a decline of 469,000 in August. The labor force participation rate held steady at 62.7 percent in September from August; 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) rose 0.1 percentage point in September to 7.5 percent, but remains near a cyclical low.

Job growth was more mixed across industries in September than it has been in previous months, likely because of Florence. Goods-producing industries added 46,000 jobs over the month, with increases of 23,000 in construction and 18,000 in manufacturing. Private service-providing industries added just 75,000 jobs in September, the weakest number in a year. Professional/business services added 54,000 jobs, including 11,000 in temporary services, with gains of 11,000 in education/healthcare (well below the recent trend), 13,000 in financial activities, and 24,000 in transportation and warehousing. Employment fell by 20,000 in retail trade over the month and by 17,000 in leisure/hospitality services, both likely influenced by Florence. Federal government employment was down by 1,000 in September, but state and local government employment rose by 14,000.

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Average hourly earnings rose 0.3 percent in September, the same pace as in August (revised down from a 0.4 percent increase). Year-over-year growth in wages was 2.8 percent in September (2.753 percent before rounding), down from 2.9 percent in August, which was the best year-over-year pace since mid-2009, when the labor market was imploding from the Great Recession. While year-over-year wage comparisons will be difficult to interpret in the near term because of the impacts of Florence and last year's hurricanes, 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. PNC's small business survey found that 46 percent of firms expect to increase worker compensation in the next six months, the third-highest share since the survey began in 2007.

The labor market is in excellent shape heading into the end of 2018, perhaps the best it has been in 50 years. Job growth was a bit softer in September, but some of that was from Hurricane Florence, and it should bounce back through the rest of 2018 and into 2019. A long-awaited acceleration in wage growth is taking hold as the labor market tightens. Job growth is averaging around 208,000 per month this year, far above the pace needed to reduce labor market slack. The unemployment rate may increase slightly in October, but will remain below 4 percent through the rest of 2018 and reach 3.5 percent by early 2019. PNC expects job growth of close to 200,000 per month in 2018, somewhat above last year's pace; it will slow in 2019 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. Job gains and wage growth will power increases in consumer incomes and spending; this should be an excellent holiday season.

As widely expected, the Federal Open Market Committee raised the federal funds rate by a quarter of a percentage point on September 26, to a range of 2.00 to 2.25 percent. The decision was unanimous. This was the eighth 25 basis point rate increase since the current tightening cycle began in late 2015. The preceding rate increase was on June 13; the FOMC held the rate steady in a range of 1.75 to 2.00 percent on August 1.

The biggest change from the August 1 statement was the removal of a sentence saying that "The stance of monetary policy remains accommodative, thereby supporting strong labor market conditions and a sustained return to 2 percent inflation." The removal of the sentence means that many FOMC members now think that the fed funds rate is close to, if not at, the "neutral" rate where monetary policy neither adds to nor subtracts from growth. As the fed funds rate approaches the neutral rate, FOMC members may be more cautious about pushing the rate higher, concerned about making monetary policy contractionary.

That being said, the statement indicates that further rate

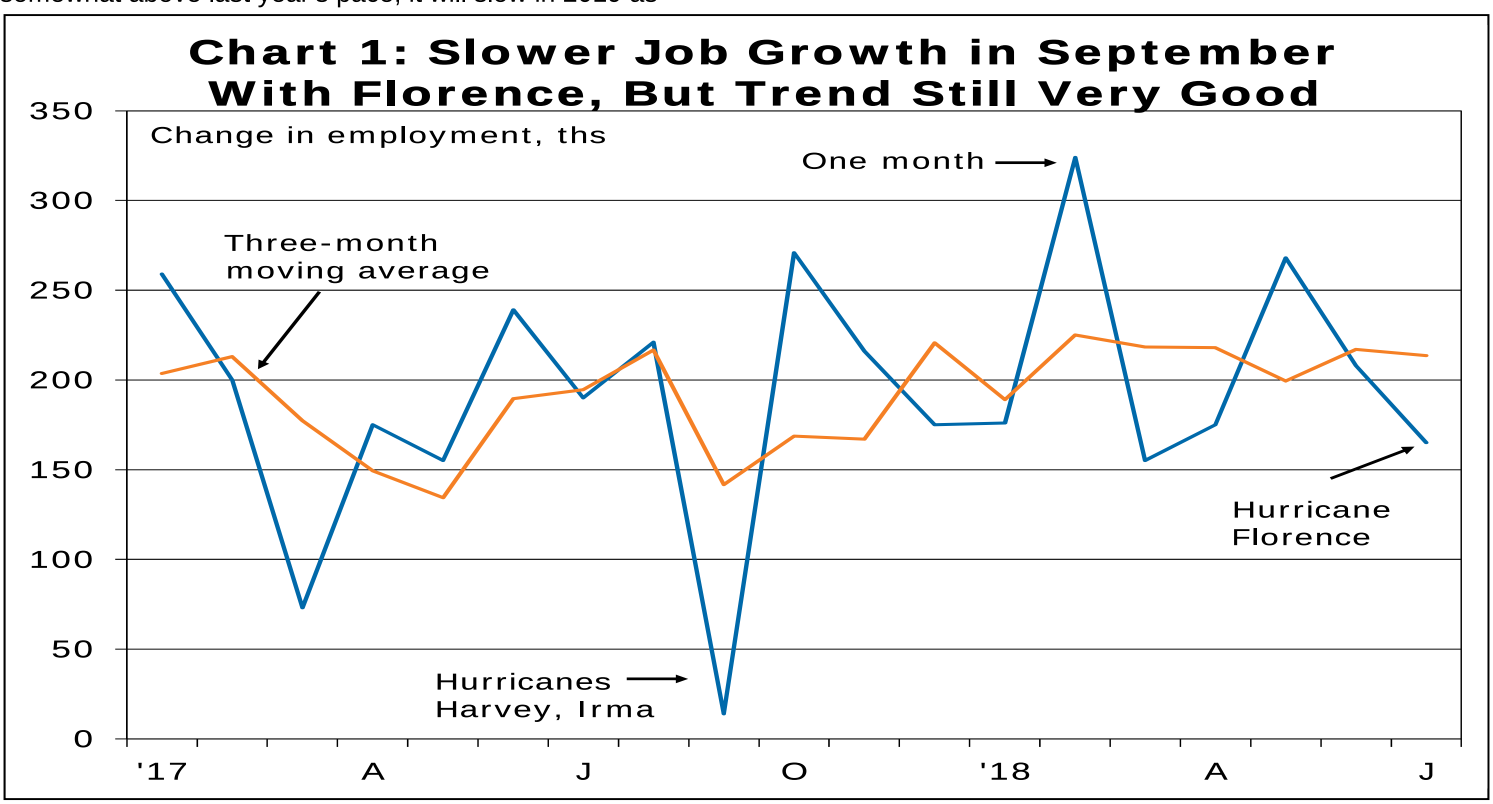

Chart source: Bureau of Labor Statistics

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hikes are coming: “The Committee expects that further gradual increases in the target range for the federal funds rate will be consistent with sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee’s symmetric 2 percent objective over the medium term.”

This meeting also included the release of the Summary of Economic Projections (SEP), or “dot plot,” which shows participants’ expectations for the economy and the fed funds rate; it is released at every other meeting. According to the September 26 dot plot, 12 participants (not necessarily voting members) expect one more increase in the fed funds rate this year, while four expect no change through the end of 2018. The median fed funds rate at the end of 2019 is in a range between 3.00 and 3.25 percent, implying three rate increases next year (assuming one more increase this year). The median rate at the ends of both 2020 and 2021 is in a range between 3.25 and 3.50 percent. The median for the long-run fed funds rate, equivalent to the committee’s estimate of the neutral rate, is 3.00 percent, suggesting that monetary policy may become slightly restrictive over the next few years.

The solid September jobs report, including the drop in the unemployment rate and good wage growth, and more importantly the overall excellent labor market, support the current path of monetary policy. The Federal Open Market Committee has been raising the fed funds rate by one-quarter of a percentage point at every other meeting for the past year; that pattern supports PNC’s forecast for no rate hike at the FOMC’s November 7-8 meeting, but an increase on December 18-19 to a range of 2.25 to 2.50 percent. Core inflation (excluding food and energy) has been right at the FOMC’s 2 percent objective since May, 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. The fed funds futures market is currently pricing in just a 6 percent probability of a rate increase at the FOMC’s November meeting, but an 82 percent probability of at least once increase by the FOMC’s December meeting. PNC expects two more increases in the fed funds rate in 2019, bringing it to a range of 2.75 to 3.00 percent by the fall of next year.

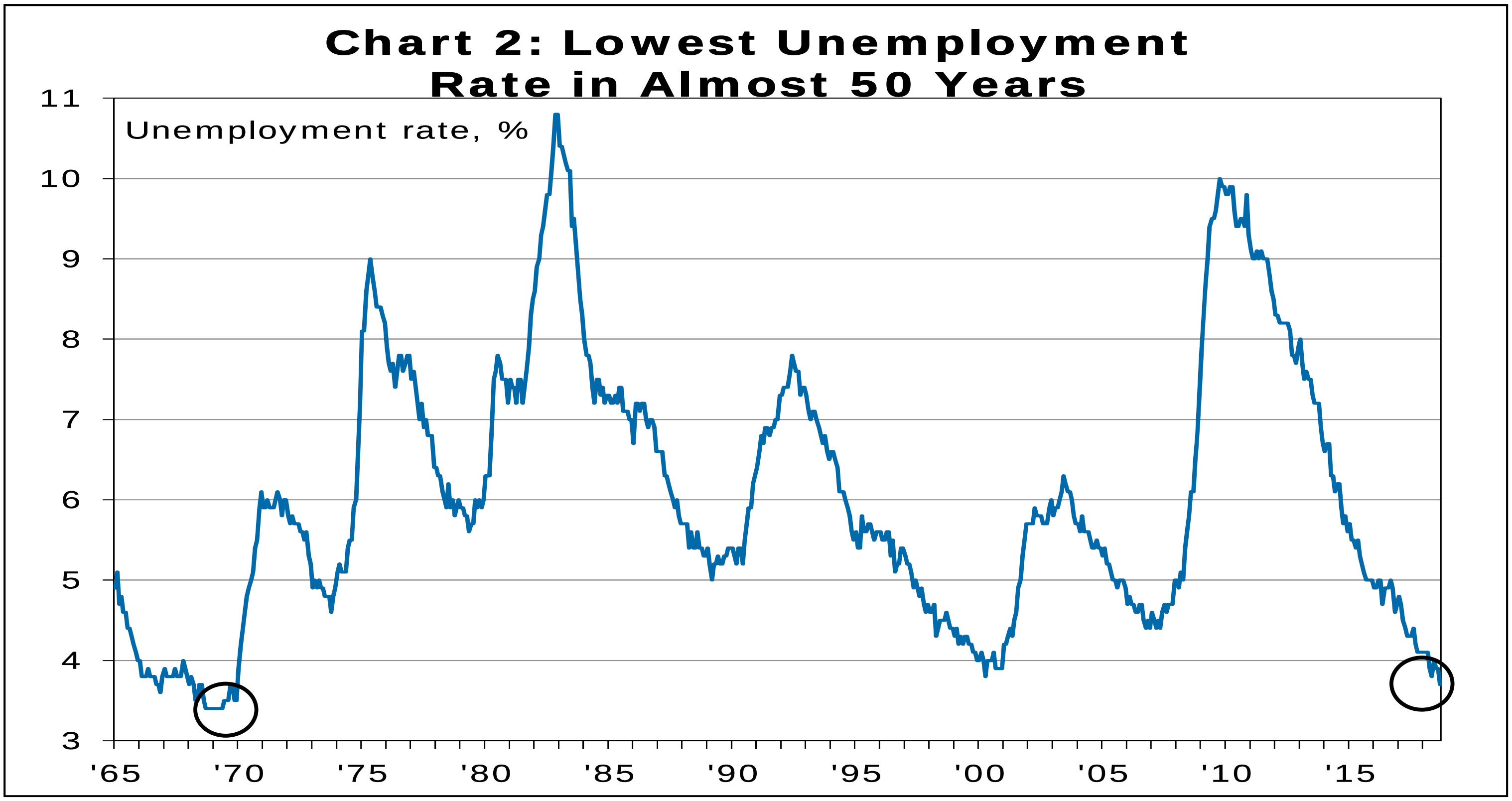

Chart source: Bureau of Labor Statistics

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