August 1, 2018

ECONOMIC REPORT

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NO CHANGE IN FED FUNDS RATE, BUT FOMC SET TO HIKE IN SEPTEMBER; WAGE GROWTH IS ACCELERATING

SUMMARY

- The FOMC kept the fed funds rate unchanged in a range of 1.75 to 2.00 percent. The statement indicates that a rate increase is likely at the FOMC's next meeting, in late September.
- The FOMC remains upbeat about the economy.
- Worker compensation rose 0.6 percent in the second quarter, according to the employment cost index, with wages up 0.5 percent. The tighter labor market is leading businesses to raise pay.
- The ISM manufacturing index fell in July, but still indicates solid growth in the industry.
- Construction spending fell 1.1 percent in June, with a large drop in public spending. Still, spending was up 6.1 percent from one year earlier.
- Private-sector employment increased by 219,000 in July, according to the ADP national employment report.
- PNC expects job growth of 180,000 in July when the BLS releases the monthly jobs report on August 3. The unemployment rate likely fell in July to 3.9 percent.

As widely expected the Federal Open Market Committee held the federal funds rate steady on August 1, in a range between 1.75 to 2.00 percent. The decision was unanimous. The FOMC had raised the fed funds rate at its previous meeting, in mid-June. In its August 1 statement the FOMC said that it "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 language is unchanged from the June 13 statement. The FOMC has increased the range for the fed funds rate by a quarter of a percentage point at every other meeting since late 2017, and the language in the statement and recent speeches from Fed officials point to a quarter point increase at the FOMC's next meeting, on September 25 and 26.

The August 1 statement was quite positive on current economic conditions, saying that "economic activity has been rising at a strong rate;" in June, it was rising at a "solid rate." The August statement noted that "household spending and business investment have grown strongly"; in the previous statement household spending was said to have "picked up." The most recent statement also said that inflation "remain[s] near 2 percent," while in June inflation had "moved close to 2 percent."

The August 1 statement again said that risks to the outlook are "roughly balanced." There was no explicit mention of concerns about the impact of trade disputes on the U.S. economy, although the minutes from the previous meeting and the most recent Beige Book both prominently mentioned potential downside risks from trade.

According to the FOMC statement monetary policy "remains accommodative, thereby supporting strong labor market conditions and a sustained return to 2 percent inflation." The minutes twice note that the FOMC's 2 percent inflation objective is "symmetric," meaning that the FOMC is willing to temporarily tolerate inflation somewhat above 2 percent (measured using the personal consumption expenditures price index), given that inflation has been below the objective for most of the past six years.

The FOMC will continue to gradually raise the federal funds rate through the rest of 2018 and in 2019. PNC's baseline

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forecast is for the FOMC to raise the fed funds rate at its next meeting, on September 26; this would be the third increase in 2018. PNC then expects the FOMC to raise the rate by a quarter of a percentage point in both March and June of 2019, bringing it to a range of 2.50 to 2.75 percent by the middle of next year. The final increase in this tightening cycle will come in September 2019, with the FOMC raising the rate to a level (not range) of 2.75 percent. This is somewhat slower than the path of rate hikes implied by the latest Summary of Economic Projections (the "dot plot") released at the FOMC's mid-June meeting. The dot plot indicated two more rate hikes this year, with the fed funds rate moving to above 3 percent in 2019, before settling in at slightly below 3 percent over the longer run.

Total worker compensation, as measured by the employment cost index, rose 0.6 percent in the second quarter; wages were up 0.5 percent while benefit costs rose 0.9 percent. The ECI controls for industry and occupation, so it is a better measure of wage and compensation growth for an individual worker than the average hourly earnings measure from the monthly jobs report.

Compensation growth slowed somewhat in the second quarter from the first, but worker pay is increasing. Wages and salaries for private-sector workers were up 2.9 percent in the second quarter from one year earlier, the fastest pace since the Great Recession (see Chart 1). With the unemployment rate set to move lower into 2019 wage growth will further accelerate, allowing households to increase their spending, but also raising concerns about faster inflation.

The ISM manufacturing index fell to 58.1 percent in July from 60.2 percent in June; a reading of above 50 indicates expansion in manufacturing. Three of the five major components used to calculate the overall index fell in July: production, new orders and supplier deliveries. Two rose over the month: inventories and employment. All five were comfortably above 50.

The export new orders subindex fell for the fourth time in five months; it was at 55.3 percent in July, down from 62.8 percent in February. Trade disruptions are likely weighing on export orders (see Chart 2). Primary metals was the only manufacturing industry, out of 18 total, to report contraction

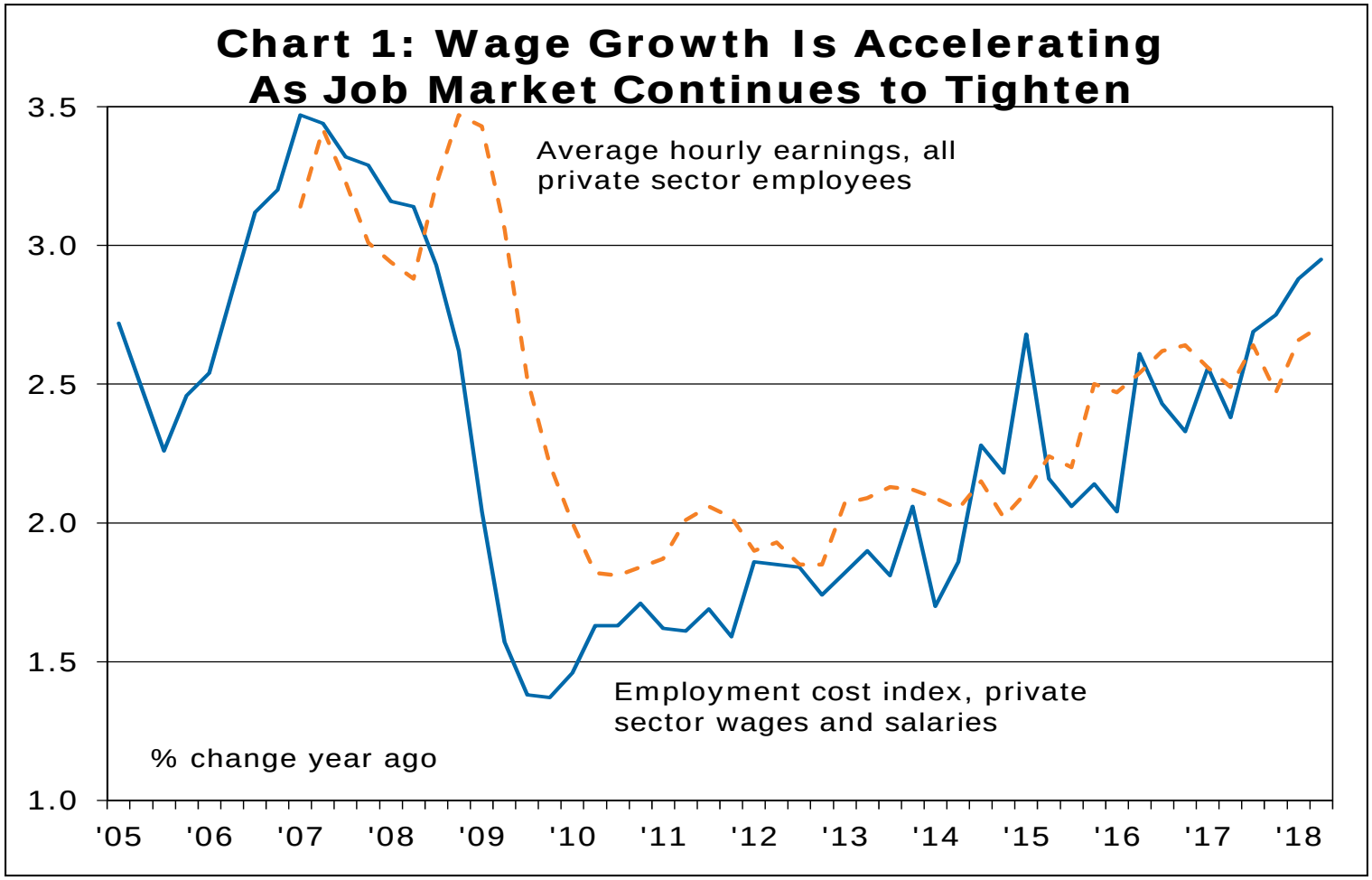

Chart source: Bureau of Labor Statistics

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in July; U.S. trading partners have enacted retaliatory tariffs on U.S. steel and aluminum exports.

Construction spending fell 1.1 percent in June from May, the biggest decline in more than one year. Public spending fell 3.5 percent, but there were also declines in private residential spending (down 0.5 percent) and nonresidential spending (down 0.3 percent).

Although spending was down for the month, it was up 6.1 percent in June from one year earlier, with solid increases for all three major components (public, private residential and private nonresidential). The drivers for construction spending are good: rising household incomes, good corporate profitability, higher commercial rents, increasing federal spending, and rising revenues for state and local governments.

Private-sector employment rose by 219,000 in July, based on records from payroll-processing firm ADP. This was the biggest gain in the ADP report since February. Job growth was solid across industries and firm sizes over the month.

PNC expects job growth of 180,000 in July when the Bureau of Labor Statistics releases the government's official employment report on Friday, August 3. After big gains in May (244,000) and June (211,000), job growth is set to ease somewhat, but the U.S. economy is still adding around 200,000 jobs per month in 2018. The unemployment rate, which rose to 4.0 percent in June from 3.8 percent in May, is likely to decline to 3.9 percent in July. The June increase was because of a surge of more than 600,000 job seekers into the labor market; labor force growth was likely significantly slower in July. The unemployment rate will continue to fall in the near term, to around 3.5 percent in early 2019.

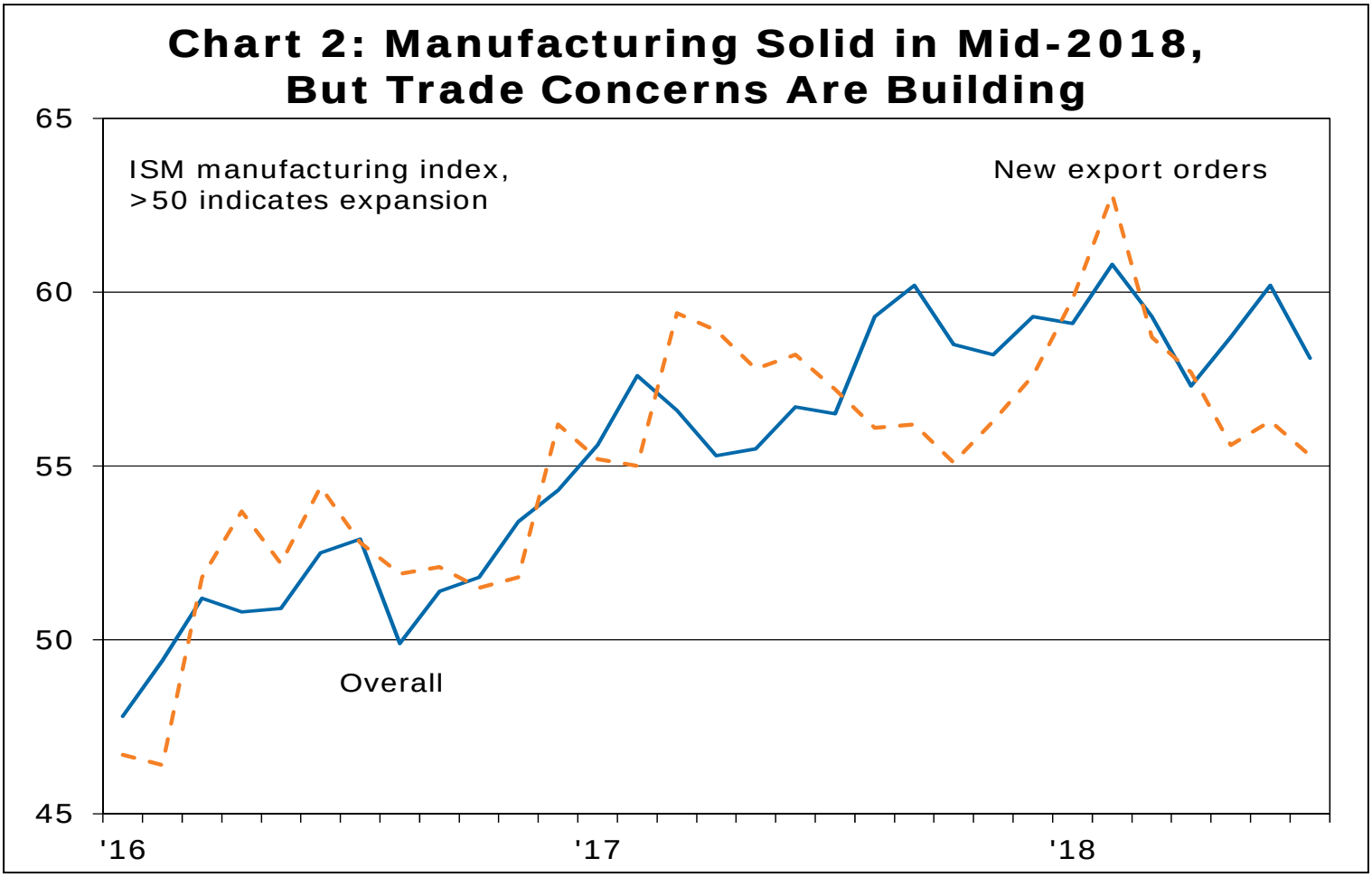

Chart source: Institute for Supply Management

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