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ECONOMIC REPORT

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GDP GROWTH ACCELERATES IN Q2; WITH FISCAL STIMULUS, 2018 A GOOD YEAR FOR US ECONOMY

SUMMARY

- Real GDP increased 4.1 percent in the second quarter, the fastest U.S. growth in four years. Details were generally good.
- Fiscal stimulus is supporting stronger economic growth in 2018, but trade tensions are a significant downside risk.
- Personal income and consumer spending both grew at a solid pace in June. An upward revision to the saving rate is good news for household spending growth into 2019.
- Inflation is close to the Federal Reserve's 2 percent goal. The Federal Open Market Committee will hold the fed funds rate steady on August 1.

The U.S. economy grew 4.1 percent at an annualized rate in the second quarter of 2018, according to the advance estimate of real GDP from the Bureau of Economic Analysis. This was an acceleration from 2.2 percent growth in the first quarter, and was the best overall quarter since the second quarter of 2014. The 4.1 percent growth matched the consensus estimate and was just below PNC's forecast of 4.2 percent. On a year-ago basis real GDP was up 2.8 percent in the second quarter, up from 2.6 percent in the first quarter, and 1.6 percent a couple of years ago (see Chart 1).

After a lackluster first quarter, consumer spending (adjusted for inflation) grew 4.0 percent at an annual rate in the second quarter, adding 2.7 percentage points to growth. Private business fixed investment rose a very good 7.3 percent in the second quarter, adding a percentage point to growth, although this was down from 11.5 percent growth in the first quarter. Investment in housing fell for a second straight quarter, although its subtraction from growth was minimal. Net exports were another big contributor, adding 1.1 percentage points to growth, as exports grew more than 9 percent (annualized) in the quarter, with much slower growth in imports. Government purchases grew 2.1 percent, adding 0.4 percentage point to growth in the second quarter.

Inventories fell in the second quarter, subtracting 1 percentage point from growth. Real final sales of domestic product, which measures demand for U.S.-produced goods and services and is GDP minus the change in inventories, rose an excellent 5.1 percent in the second quarter, the best number since 2003.

The U.S. economy expanded at a very good pace in the second quarter, with the strongest real GDP growth in four years. Although some one-time factors supported growth in the second quarter the economy has accelerated over the past few years, and growth in the second half of 2018 will run at a still-solid 3 percent annualized rate.

Consumer spending bounced back in the second quarter after weak growth in the first. Business investment growth was very strong, with a huge contribution from commercial construction, but that will slow somewhat to a more sustainable pace in the second half of the year. Export growth surged in the second quarter as foreign buyers tried to get ahead of possible tariffs on U.S. goods, including soybeans. But inventories, which were a substantial drag on growth in the second quarter, should be a positive in the second half of the year; housing will also be a positive contributor.

The fundamentals for the U.S. economy are good in mid-2018. Consumers are purchasing more goods and services. Business investment will continue to expand as firms use some of their corporate income tax cuts to fund capital spending and they look to make their workers more productive as it becomes even more difficult to hire. Assuming that trade tensions ease, exports should continue to expand, although imports will grow more quickly as U.S. consumers and

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businesses purchase from abroad. Government spending will be a positive for growth into 2019 thanks to a big increase in spending that Congress passed in the spring.

PNC is forecasting real GDP growth of 3.1 percent in 2018 (fourth quarter to fourth quarter), up from 2.5 percent growth in 2017. That would be the best full year for the U.S. economy since 2005. Growth will then slow to 2.4 percent in 2019 and 1.6 percent in 2020 as fiscal stimulus fades and job growth slows with the labor market beyond full employment.

This forecast assumes that trade tensions dissipate and the U.S. and its trading partners do not erect substantial barriers to trade. If the U.S. and its partners do implement substantial tariffs and other trade barriers, U.S. economic growth is likely to be much weaker than this baseline forecast.

This release also included the annual historical revisions to GDP growth. Growth in the first quarter of 2018 was revised somewhat higher to 2.2 percent, from 2.0 percent. Average annual growth of 2.2 percent from 2012 to 2017 was unchanged, although there were minor revision within those years.

Personal income rose 0.4 percent in June, with disposable (after-tax) income also up 0.4 percent. Wages and salaries rose 0.4 percent over the month.

Consumer spending rose 0.4 percent in June. Services spending was up 0.6 percent, while spending on durable goods was flat and spending on nondurable goods fell 0.1 percent.

The personal consumption expenditures price index rose a modest 0.1 percent over the month, and the core index, excluding volatile food and energy prices, also rose 0.1 percent. On a year-ago basis overall inflation was 2.2 percent in June, while core inflation was 1.9 percent. After reaching the Federal Reserve's 2 percent goal in March, core inflation has been 1.9 percent year-over-year from April to June.

With modest inflation, inflation-adjusted (real) after-tax income rose a solid 0.3 percent in June. Real consumer spending was also up 0.3 percent in June.

There were large upward revisions to personal income from 2012 on. In 2017, the level of personal income was revised higher by 2.4 percent compared to pre-revision estimates. Annual growth in inflation-adjusted after-tax income from 2012 to 2017 was revised up to 2.2 percent, from 1.8 percent.

Consumers are in good shape in 2018, especially with the

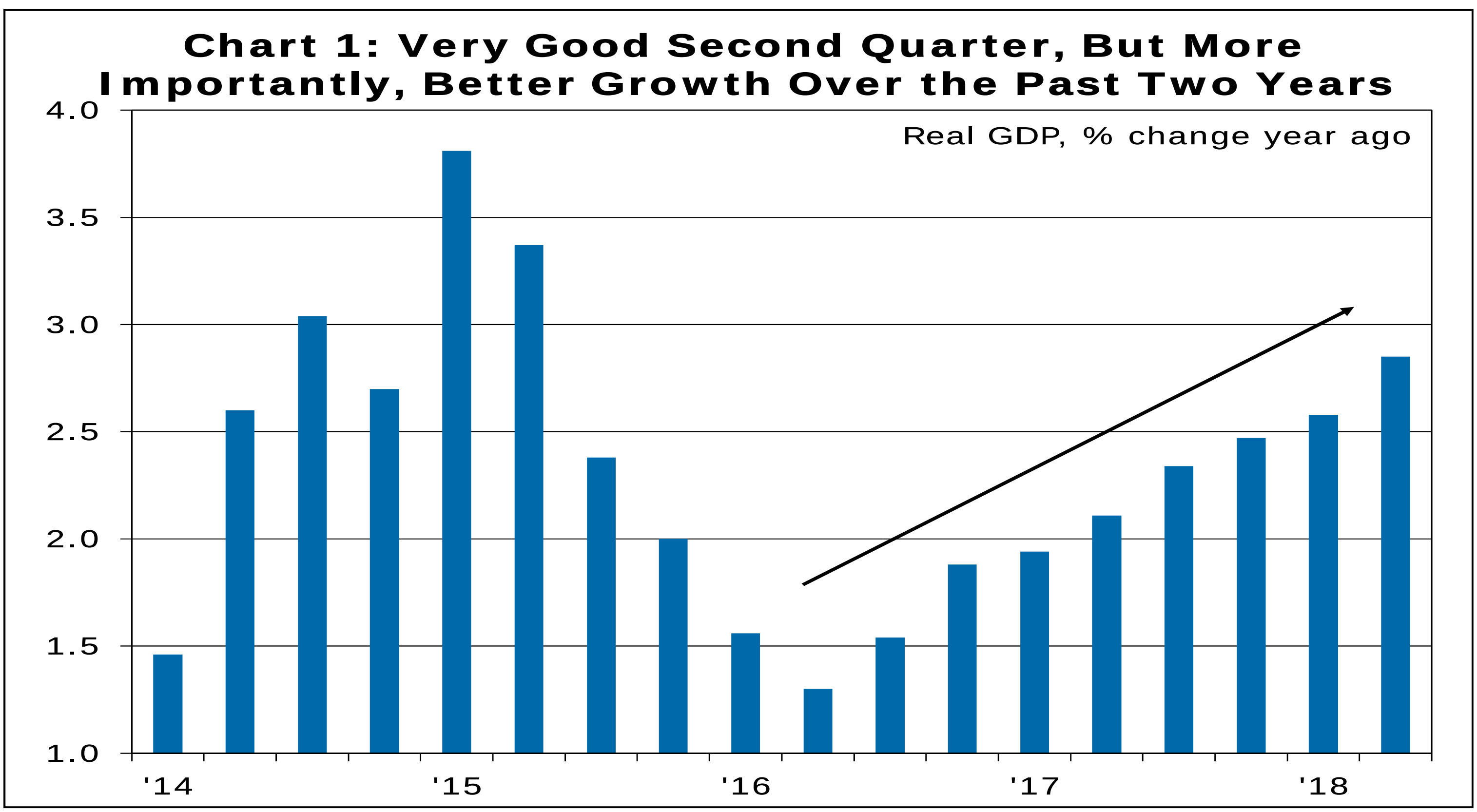

Chart source: Bureau of Economic Analysis

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upward revision to personal income. Incomes are rising thanks to more jobs and higher wages; wage growth should be even stronger in the second half of the year and in early 2019 as the job market tightens, leading businesses to raise pay. Stock-owning households are also benefiting from higher dividends. Personal income tax cuts at the beginning of 2018 are also a positive for household incomes. With after-tax incomes rising consumers can buy more, and consumer spending growth will remain sturdy into 2019, supporting overall economic growth. There are a few negatives for consumer spending in the near term, however, especially higher interest rates and energy prices. And tariffs that would raise prices for imported goods are a big downside risk for household spending.

Something that is no longer a concern is household saving. Before the revised data were released, it appeared that the saving rate had fallen from almost 9 percent in 2012 to around 3.4 percent in 2017, meaning households would need to boost their saving, crimping spending growth. But with the upward revision to personal income over the past five years the saving rate has also been revised higher; the reported rate doubled in 2017 to 6.7 percent (see Chart 2). With the higher saving rate consumers are in good financial shape, and can increase their spending roughly in line with their incomes. The saving rate in June was 6.8 percent, unchanged from May.

Inflation remains near the Federal Open Market Committee's 2 percent goal. But with core inflation below the goal for the past six years, the FOMC would like to make sure that inflation sticks at 2 percent, and would be happy to have inflation run above the goal temporarily. With the unemployment rate at 4.0 percent in June and set to move down to 3.5 percent at the end of the year, wage pressures will build and inflation will pick up somewhat. The FOMC will continue to gradually raise the federal funds rate to prevent the labor market from overheating, while having inflation settle in at around 2 percent over the longer run. The FOMC wraps up its two-day meeting on August 1 and will keep the fed funds rate in its current range of 1.75 to 2.00 percent. PNC expects one more increase in the federal funds rate this year, at the FOMC's September meeting, bringing the rate to a range of 2.00 to 2.25 percent.

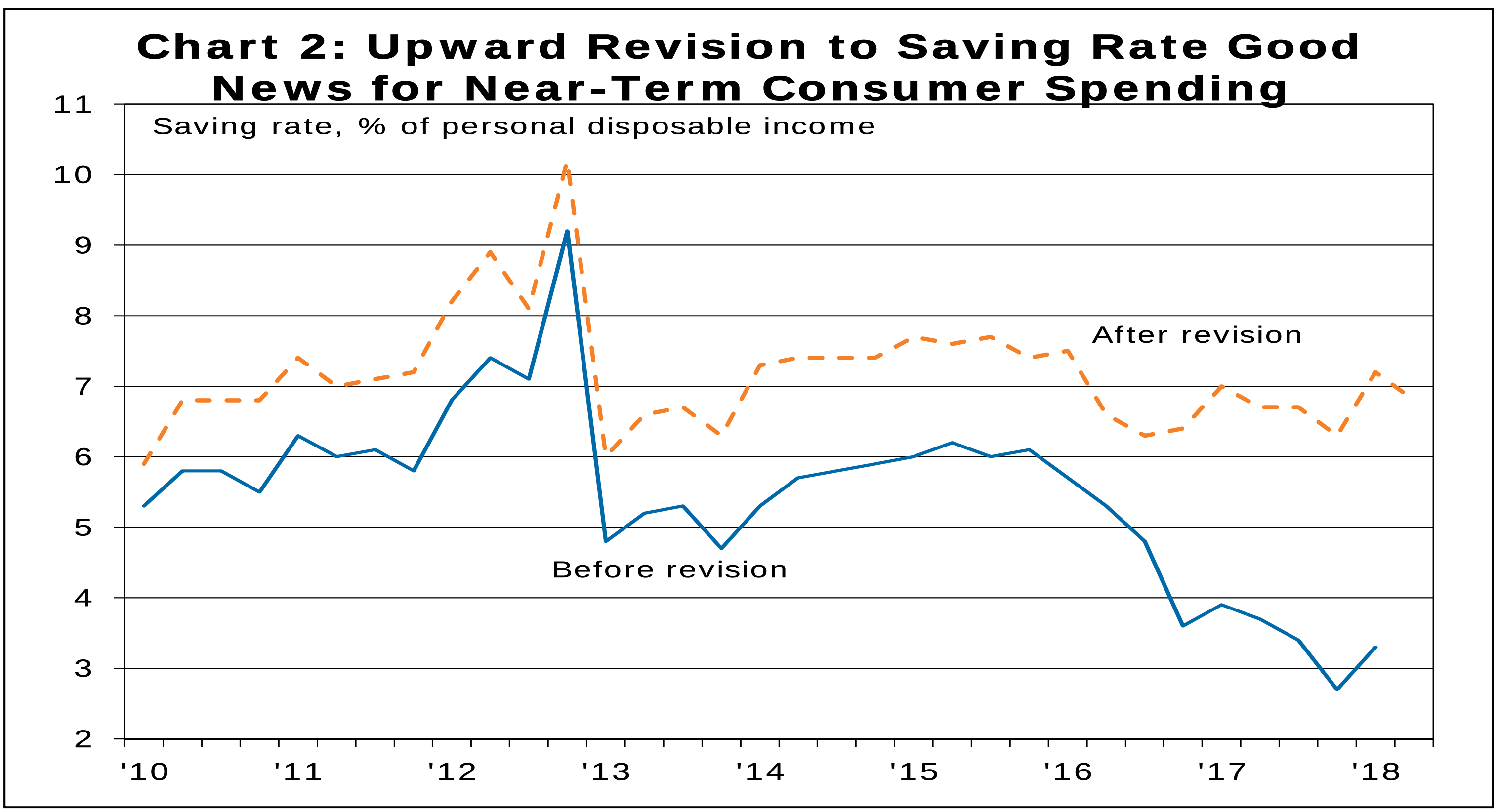

Chart source: Bureau of Economic Analysis

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