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ECONOMIC REPORT

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SOLID JULY JOBS REPORT OVERSHADOWED BY CHINA TRADE WAR; RISKS MOVE FURTHER TO THE DOWNSIDE

SUMMARY

- The U.S. economy added 164,000 jobs in July, close to expectations. Job growth has slowed in 2019, but is still solid.
- The unemployment rate held steady at 3.7 percent, while wage growth picked up slightly.
- The trade deficit was little changed in June, but the details were not good, as both exports and imports fell.
- With President Trump's recent decision to impose additional tariffs on goods imports from China, the two nations are now in a trade war that will weigh on U.S. economic growth. Risks to the outlook are heavily weighted to the downside.
- Because of the new tariffs, PNC now expects a fed funds rate cut in September.

Job growth was once again solid in July, with a gain of 164,000, close to the consensus of 162,000. However, job growth was revised lower in May (to 62,000 from 72,000) and June (to 193,000 from 224,000), for a combined downward revision of 41,000. Job growth has averaged 140,000 over the past three months, and 165,000 per month for all of 2019, down from 223,000 per month last year (see Chart 1). The private sector added 148,000 jobs in July, while government employment was up by 16,000.

The unemployment rate held steady at 3.7 percent in July. Outside of a 3.6 percent rate in April and May, this is the lowest the unemployment rate has been in 49 years. The details underlying the unemployment rate were positive. Employment in the household survey (different from the survey of employers) rose by 283,000, while the labor force increased by 370,000 over the month. The labor force participation rate rose by 0.1 percentage point to 63.0 percent in July. While the increase in the labor force is a sign of confidence in the labor market, the labor force participation rate is still down significantly from around 66 percent before the Great Recession. The broader U-6 unemployment rate (unemployed, underemployed and too discouraged to look for a job) fell to 7.0 percent in July from 7.2 percent in June; this is the lowest U-6 rate since December 2000.

Job growth was solid across most industries in July, but generally weaker than in June. Goods-producing industries added 15,000 jobs over the month, down from a gain of 29,000 in June. Manufacturing employment rose by 16,000 in July, although June growth was revised down to 12,000 from 17,000. Construction employment rose by 4,000 in July, after an increase of 18,000 in June. Employment in private service-providing industries rose by 133,000 in July, down from an increase of 150,000 in June. Eds and meds added 66,000 jobs in July, with professional/business services employment up by 38,000. Employment in financial activities was up by 18,000 in July, while employment in leisure/hospitality services rose by 10,000. Retail trade employment fell by 4,000 in July, the sixth straight monthly decline (down by 67,000 total over that period); the increasing prevalence of online sales continues to weigh on traditional brick-and-mortar retailing. Employment in information industries fell by 10,000 in July. Government employment rose by 16,000 in July; local governments added 14,000 jobs over the month, with federal government employment up by 2,000, and state government employment unchanged.

Wage growth remains solid with the tight labor market, but has not accelerated in 2019. Average hourly earnings rose 0.3 percent in July, after a 0.3 percent increase in June (revised higher from 0.2 percent). Year-over-year growth in wages was 3.2 percent in July, up from 3.1 percent in May and June, but down from a cyclical peak of 3.4 percent in February (distorted in part by the end of the government shutdown). Wage growth remains well above the pace of inflation.

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The average workweek fell 0.1 hour in July to 34.3 hours; it has been between 34.3 and 34.5 hours for more than five years. However, there was a large 0.3 hour drop in the average manufacturing workweek to 40.4 hours; this is the shortest average workweek in the industry since late 2011, and is consistent with other indicators of a slowing in manufacturing growth (see Chart 2). However, manufacturing hours can be volatile, particularly in the summer around plant retoolings, and so manufacturing hours could quickly rebound. With more jobs, an increase in wages, and a shorter workweek, aggregate weekly earnings were down less than 0.1 percent in July. As a result real consumer income likely fell slightly over the month, with the consumer price index set to increase 0.1 percent in July (to be released on August 13).

Job growth is slowing from its pace of 223,000 per month last year to around 150,000 for all of this year, as the tighter labor market constrains hiring. The unemployment rate is likely to move down a bit over the next few months and end 2019 at around 3.6 percent. Wage growth will pick up somewhat in the second half of 2019 as businesses find it more and more difficult to attract qualified workers.

The U.S. trade deficit narrowed slightly in June, to $55.2 billion, from a deficit of $55.3 billion in May (revised from $55.5 billion). Exports fell by 2.1 percent in June to $206.3 billion, while imports fell by 1.7 percent to $261.5 billion. In the first six months of 2019 the trade deficit was $316 billion, almost 8 percent larger compared to the same period last year. Imports are up 1.5 percent so far in 2019, while exports are up less than 0.1 percent.

Despite tariffs that the Trump administration placed on imports from China earlier this year, the U.S. continues to purchase more from abroad as domestic consumer demand remains solid. At the same time U.S. exports are essentially flat due to slower global economic growth, the strong U.S. dollar, and retaliatory actions by U.S. trading partners.

Both exports and imports are likely to slow further assuming the U.S. implements new tariffs on goods imports from China. Earlier this year President Trump put a 25 percent tariff on $250 billion of Chinese-made goods; in early August he announced a 10 percent tariff on the remaining $300 billion of Chinese goods exports to the U.S., to take effect on September 1. These tariffs are intended to pressure China to agree to a trade deal to reduce the nation's bilateral trade surplus with the U.S., which was $379 billion in 2018. That included a U.S. trade deficit in goods with China of $419 billion, and a U.S. services surplus of $40 billion.

Compared to the previous round, the new U.S. tariffs will hit more consumer goods. This will raise prices for households, boosting inflation and weighing on consumer spending on other goods and services. The new tariffs will

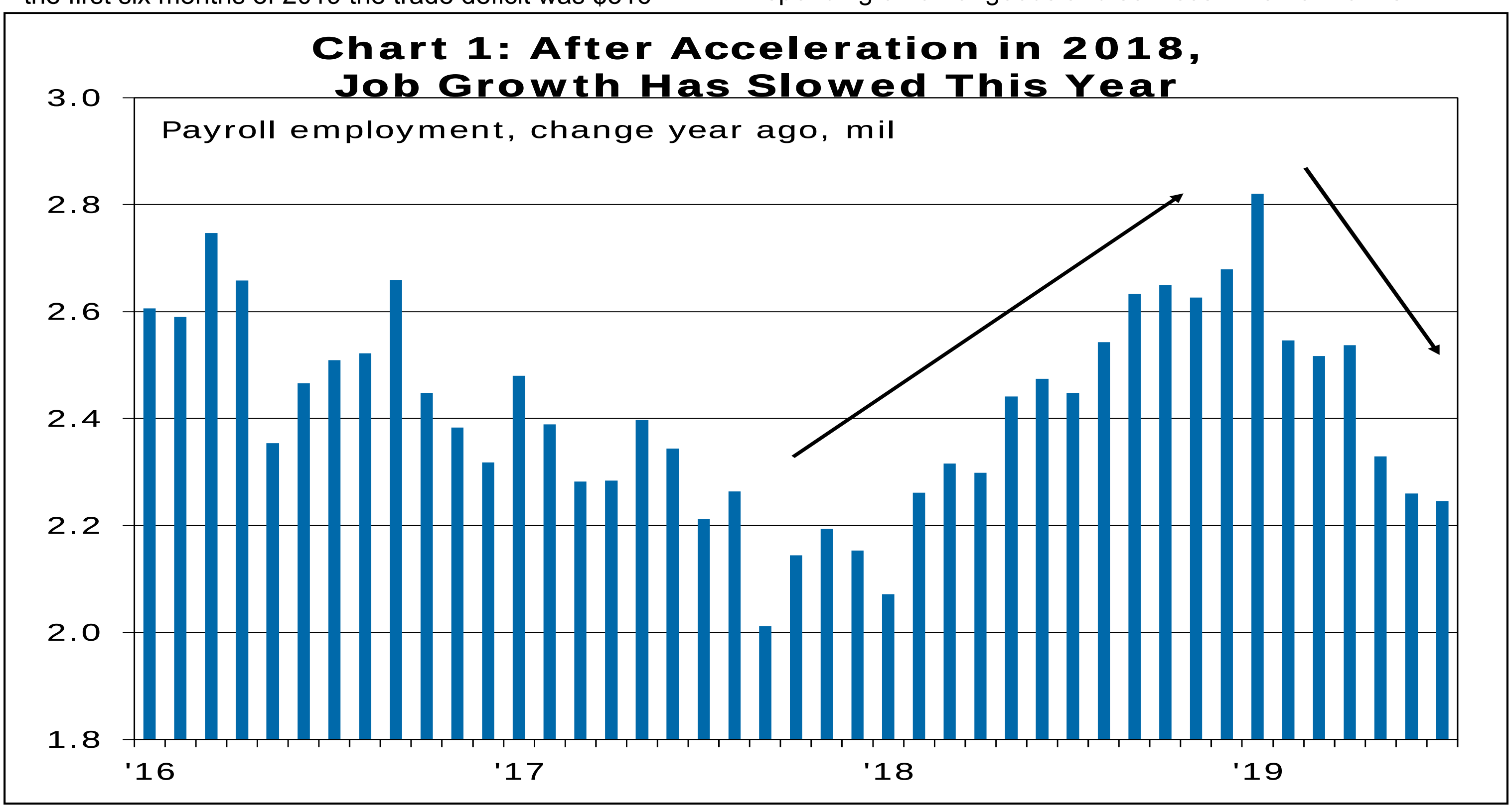

Chart source: Bureau of Labor Statistics

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also disrupt manufacturing supply chains. And increased uncertainty could causes businesses to turn more cautious with hiring and investment. In addition, China is likely to respond by increasing its tariffs on U.S. imports and imposing non-tariff barriers. China has already allowed its currency to depreciate, which will make exports to the U.S. less expensive, partially offsetting the impact of the new tariffs. The weaker yuan will also make U.S. exports to China more expensive. The immediate stock market response to the tariffs and devaluation has been negative, with the S&P 500 down more than 5 percent in the first few days after the president announced the new tariffs.

Assuming the tariffs go into effect on September 1, the net effect will be slower economic growth in the U.S., China, and the world. PNC's August forecast will reflect this. PNC has already changed its fed funds forecast as a result of the announced tariffs; the baseline for August now assumes another 0.25 percentage point reduction in the fed funds rate at the Federal Open Market Committee's next meeting, in mid-September; the previous baseline did not have this rate cut coming until October. The FOMC has already cut the fed funds rate once this year, on July 31.

With the new tariffs, risks to the U.S. economic outlook have moved even further to the downside. PNC expects negotiations with China to drag on into late 2020, and a resolution could take even longer than expected. The economic hit from a trade war could be larger than expected, even if the FOMC cuts interest rates to help offset the damage. A trade war could lead to much slower global economic growth, which could become a significant drag on the U.S. economy.

The proposed tariffs could do significant damage to a U.S. economy that is in good shape in mid-2019. The current expansion is now more than ten years old, setting the record for the longest ever. Outside of trade, economic fundamentals are generally solid. In particular, decent job gains and good wage growth will push household spending higher in 2019; consumer spending accounts for two-thirds of the U.S. economy. The tax cuts passed at the end of 2017 and federal spending increases are also supporting growth in 2019, although those boosts will fade in 2020.

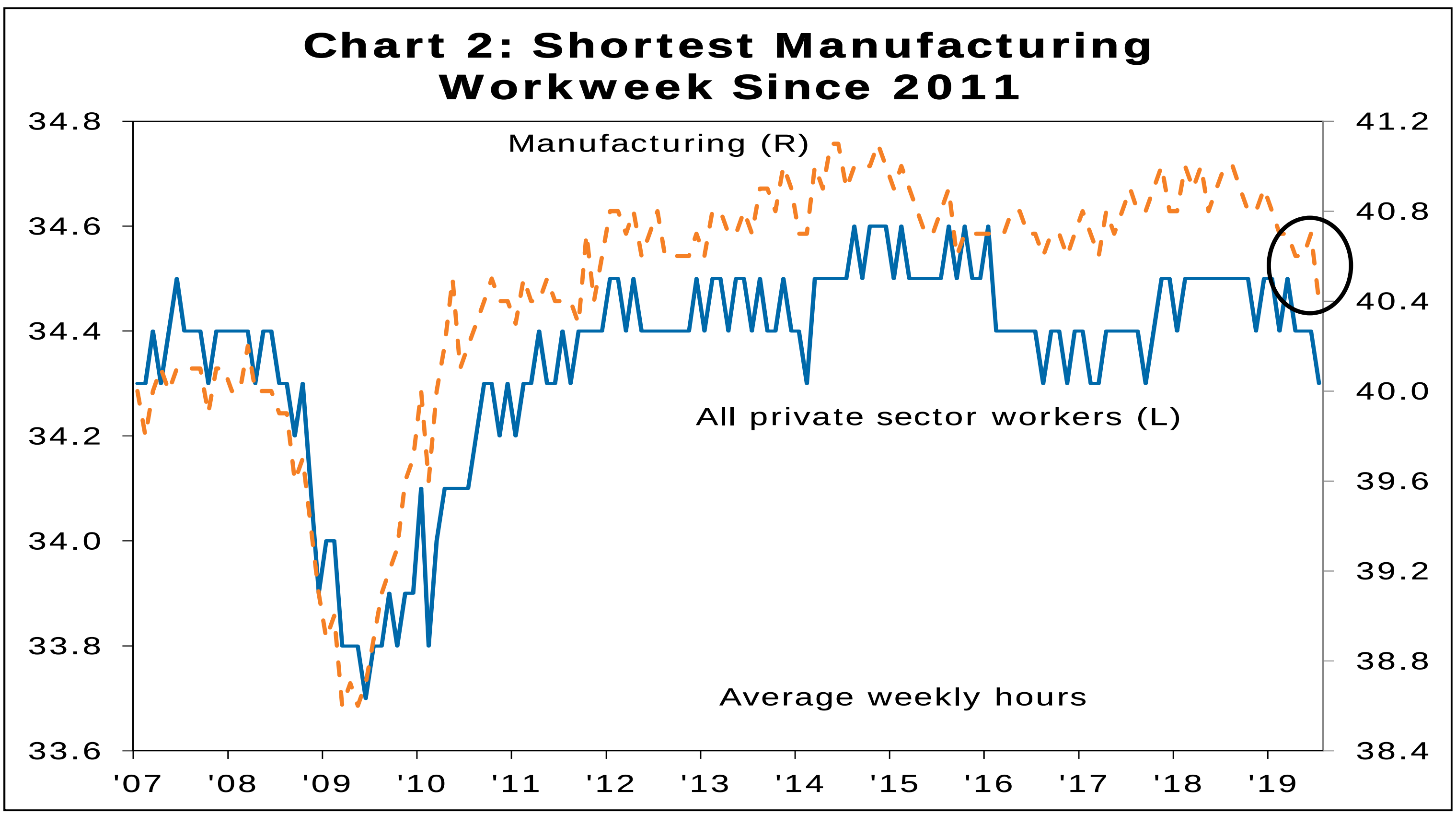

Chart source: Bureau of Labor Statistics

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