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ECONOMIC REPORT

Gus Faucher
Chief Economist

Stuart Hoffman
Senior Economic Advisor

William Adams
Senior Economist

Kurt Rankin
Economist

Abbey Omodunbi
Economist

THE PNC FINANCIAL SERVICES GROUP | The Tower at PNC Plaza | 300 Fifth Avenue | Pittsburgh, PA 15222-2401

REAL GDP UP 2.1 PERCENT IN Q2, BEATS EXPECTATIONS; CONSUMER SPENDING KEEPS ECONOMY SOLID IN MID-2019

SUMMARY

- Real GDP increased 2.1 percent in the second quarter. Growth slowed from the first quarter, but the second-quarter details were better than the headline number suggested.
- Consumer spending growth rebounded from a soft first quarter, although trade and inventories were major drags in the second quarter.
- Economic fundamentals are solid in mid-2019, but U.S. growth is expected to slow through the rest of 2019 and into 2020 due to less fiscal stimulus, slower labor force growth, and weaker global economic growth.
- PNC expects the FOMC to cut the fed funds rate by a quarter of a percentage point at the end of July, with another rate cut in October.

Real GDP increased 2.1 percent at an annual rate in the second quarter, according to the advance estimate from the Bureau of Economic Analysis. This was better than the 1.9 percent consensus expectation. Growth in the first quarter was 3.1 percent. On a year-ago basis real GDP growth was 2.3 percent in the second quarter, down from 2.7 percent in the first quarter, and from above 3 percent in mid-2018 (see chart).

Consumer spending rose a large 4.3 percent annualized in the second quarter, after a soft gain of 1.1 percent in the first quarter; this was the biggest jump in consumer spending since the fourth quarter of 2014. Consumer spending added 2.85 percentage points to GDP growth in the second quarter. Fixed business investment fell 0.6 percent annualized in the second quarter, the first decline since the beginning of 2016, subtracting a little less than 0.1 percentage point from overall growth in the quarter. There was a drop of more than 10 percent annualized in business investment in structures in the second quarter, likely tied to a decline in investment in energy infrastructure. Investment in residential structures, which is homebuilding and renovations, fell 1.5 percent in the second quarter, subtracting 0.06 percentage point from growth.

Inventories and trade were the major drags in the second quarter, after being big positives for growth in the first quarter. Inventories subtracted almost 0.9 percentage point from growth in the second quarter, after adding to growth in the previous three quarters. Businesses cut back on inventory accumulation heading into the middle of 2019, concerned about having too much stock on hand. Trade subtracted 0.65 percentage point to growth in the second quarter, just about offsetting the first quarter's 0.73 percentage point addition to growth. Exports fell more than 5 percent annualized in the second quarter, accounting for most of the drag from trade, as slower global growth and trade tensions pushed down exports. Imports were up very slightly in the second quarter. Government was another big economic positive in the second quarter, adding 0.85 percentage point to growth. The federal government accounted for 0.5 percentage point of that, with state and local government adding 0.35 percentage point.

Inflation accelerated in the second quarter. The personal consumption expenditures price index, the Federal Reserve's preferred inflation gauge, rose 2.3 percent annualized in the second quarter, up from 0.8 percent in the first quarter. Core inflation, excluding food and energy, was 1.8 percent in the second quarter, up from 1.1 percent in the first. Still, on a year-ago basis both measures were well below the Federal Reserve's 2 percent objective. The GDP price index was up 2.2 percent in the second quarter, an acceleration from 0.8 percent inflation in the first.

Although overall economic growth was slower in the second quarter of 2019 compared to the first, the details were still good. Inventories and trade boosted growth in the first quarter, but those lifts were unsustainable. Consumer spending



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growth was soft in the first quarter, but bounced back even better than expected in the second quarter. With the labor market strong in mid-2019, good job and wage growth will push household incomes higher at least into 2020. With consumer spending accounting for about two-thirds of the U.S. economy, that means the current expansion, already the longest in U.S. history, will continue.

However, soft business investment in the second quarter is a concern. Some of that was tied to a downturn in investment in energy production as commodity prices fell. It could also be that business are holding back on capital spending because of trade tensions and associated uncertainty. Also, even with the new budget deal that Congress is in the midst of passing, government spending is unlikely to continue to increase at its recent rapid pace.

Still, the U.S. economy, which has been growing steadily if unspectacularly for more than 10 years, will continue to expand at least through the rest of 2019 and into 2020. Growth will slow, however, due to less fiscal stimulus as the

impact of the 2017 tax cuts fades, slower labor force growth, and weaker global economic growth.

Risks to the outlook are weighed to the downside. A further slowdown in overseas economies and escalating trade tensions are the biggest downside risks right now to the U.S. economy. However, with the Federal Open Market Committee set to cut the fed funds rate by a quarter of a percentage point on July 31, and again in October, lower borrowing costs should mitigate against any potential negative shocks. Low inflation gives the FOMC the leeway to cut rates to help offset any downside risks.

This report also included annual historical revisions to GDP. GDP growth was revised up slightly in 2017, and revised down slightly in 2018, but the general picture is about the same: moderate but unremarkable growth throughout the current expansion. With the revisions, it now appears that growth peaked in mid-2018, and has been gradually slowing since then.

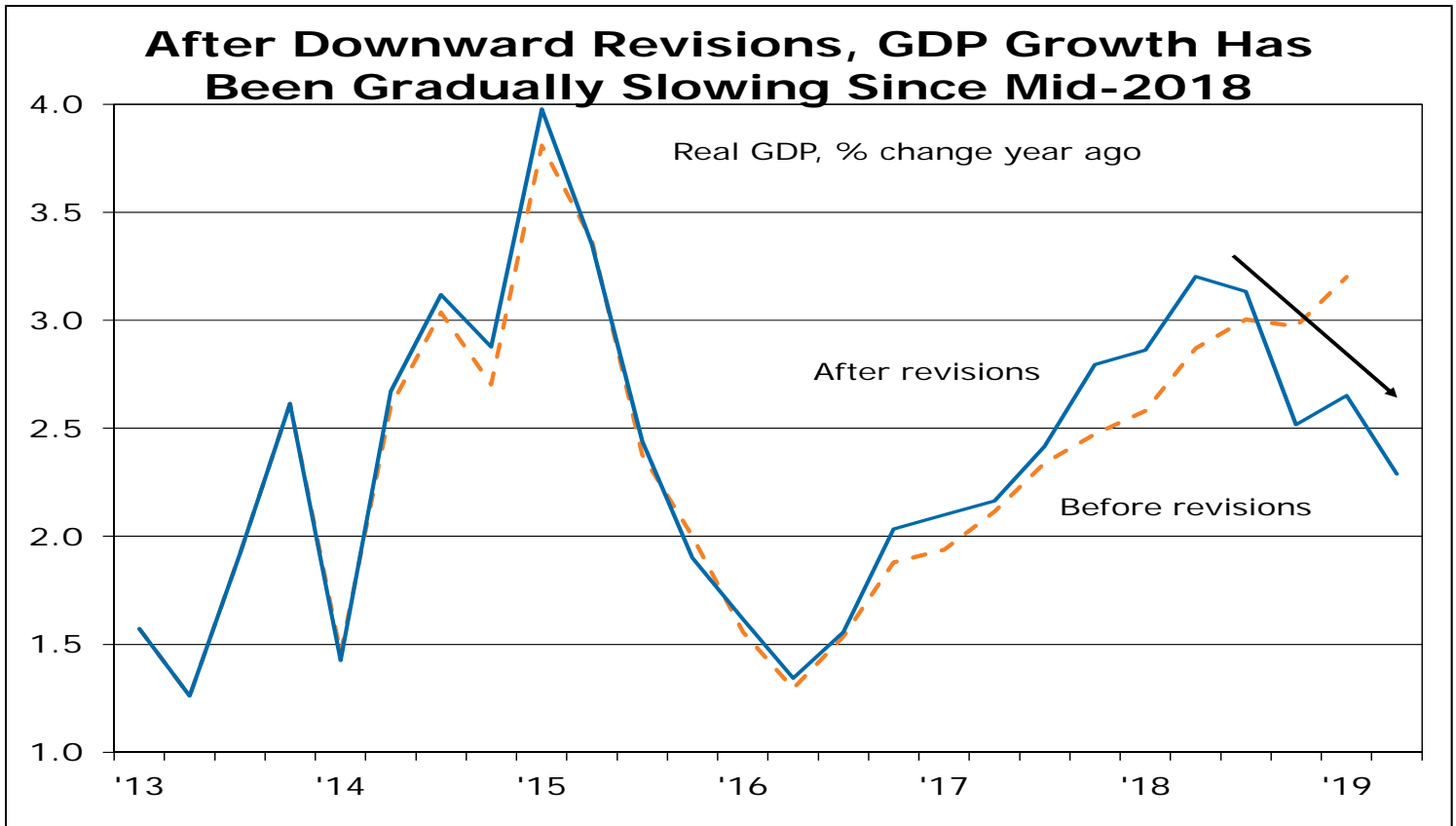


Chart source: Bureau of Economic Analysis

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