February 6, 2020

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

FED HOLDS STEADY; MODERATE GDP GROWTH IN Q4; CORONAVIRUS A DOWNSIDE RISK FOR US GROWTH

SUMMARY

- The FOMC held the fed funds rate unchanged in late January, and did not indicate a direction for its next monetary policy move.
- GDP growth was 2.1 percent in the fourth quarter, and 2.3 percent for all of 2019. U.S. economic growth is moderate entering 2020. PNC is forecasting growth of 1.7 percent for 2020.
- According to the ADP National Employment Report, the U.S. economy added a very strong 291,000 private-sector jobs in January. PNC is forecasting total January job growth of 165,000.
- The coronavirus outbreak is a downside risk for near-term U.S. economic growth.

As expected, on January 29 the Federal Open Market Committee kept the fed funds rate unchanged in a range of 1.50 to 1.75 percent, in a unanimous decision. The statement was about as uneventful as they come. The committee made no change to policy, made only two minor tweaks to the statement, and did not give an indication of where it sees policy heading in the near term. In December the FOMC's last Summary of Economic Projects, or "dot plot," indicated that the committee expects the fed funds rate to remain in its current range throughout 2020; there was nothing in the January 29 statement that indicates anything different.

After cutting the fed funds rate three times in the second half of 2019, from a range of 2.25 to 2.50 percent to a range of 1.50 to 1.75 percent, monetary policy is now on hold. The current fed funds rate is mildly positive for growth. The FOMC cut the fed funds rate in 2019 because of concerns about downside risks to growth and inflation that has been below the Fed's 2 percent objective throughout most of the current expansion. The expectation is that lower interest rates will offset any downside shocks to the U.S. economy from factors like trade and slower global growth, and contribute to wage and prices pressures that will gradually push inflation to 2 percent.

PNC expects the FOMC to keep the fed funds rate in its current range throughout 2020 and 2021. However, given the potential downside risks to the outlook, including the coronavirus, the FOMC is more likely to cut rates in the near term than raise them. Currently, the fed funds futures market is pricing in a 75 percent probability of at least one 25 basis point rate cut by the end of this year, including a 65 percent probability of cumulative rate cuts of 50 basis points or more.

The U.S. economy (real GDP) expanded at a 2.1 percent annualized rate in the fourth quarter of 2019, according to the initial estimate from the Bureau of Economic Analysis. This was the same pace as in the third quarter. For all of 2019, averaged across the four quarters, the U.S. economy grew 2.3 percent, down from 2.9 percent growth in 2018. On a year-over-year basis real GDP growth was also 2.3 percent in the fourth quarter. Growth has slowed since mid-2018, but is still running at a pace allowing for improvement in the labor market (see Chart 1).

Consumer spending growth slowed, but that was inevitable given the strong second and third quarters. Household spending is keeping pace with household incomes, and thus consumers should be able to gradually increase their spending throughout 2020. Given that consumer spending accounts for about two-thirds of U.S. GDP, as long as households do their part the expansion will continue. The fundamentals for consumer spending are excellent at the beginning of 2020: good job gains, solid wage growth, low inflation, low interest rates, strong household balance sheets, and record-high household wealth.

FED HOLDS STEADY; MODERATE GDP GROWTH IN Q4; CORONAVIRUS A DOWNSIDE RISK FOR US GROWTH

Business fixed investment fell for a third straight quarter dragged down by a large 10 percent decline in investment in structures and a smaller but still substantial decline in investment in equipment. Business fixed investment has been falling since the second quarter of 2019 due to a number of drags, including uncertainty surrounding the trade war between the U.S. and China, slower global economic growth, and the problems with the Boeing 737 MAX. However, a turnaround in residential construction, spurred by low mortgage rates and the good job market, offset some of the drag from business investment. Trade was another big positive in the fourth quarter, as exports rose and imports fell.

Growth will be softer in the first half of 2020. A big hit will come from Boeing's decision to suspend production of the 737 MAX. As Boeing has been producing aircraft, but not selling them, it has been adding to inventories; inventory investment will thus take a big plunge in early 2020. Business capital spending will remain soft in the near term. Although some of the uncertainty surrounding the U.S.-China trade relationship has lifted with the Phase One deal, there is still a great deal of uncertainty about China over issues like intellectual property and trade in services. Global economic growth remains soft, and there are also trade tensions between the U.S. and other major trading partners.

PNC is forecasting GDP growth of 1.7 percent for all of 2020, with noticeable weakness in the first half of this year, and then an acceleration in growth in the second half. But given strong consumer fundamentals and expansionary monetary policy, the current expansion, already the longest in U.S. history, should last throughout 2020. However, the coronavirus pandemic is a significant downside risk to cause much slower global growth, or deter U.S. consumer spending, U.S. economic growth would be much weaker.

The private sector added a very strong 291,000 jobs in January, according to the ADP National Employment

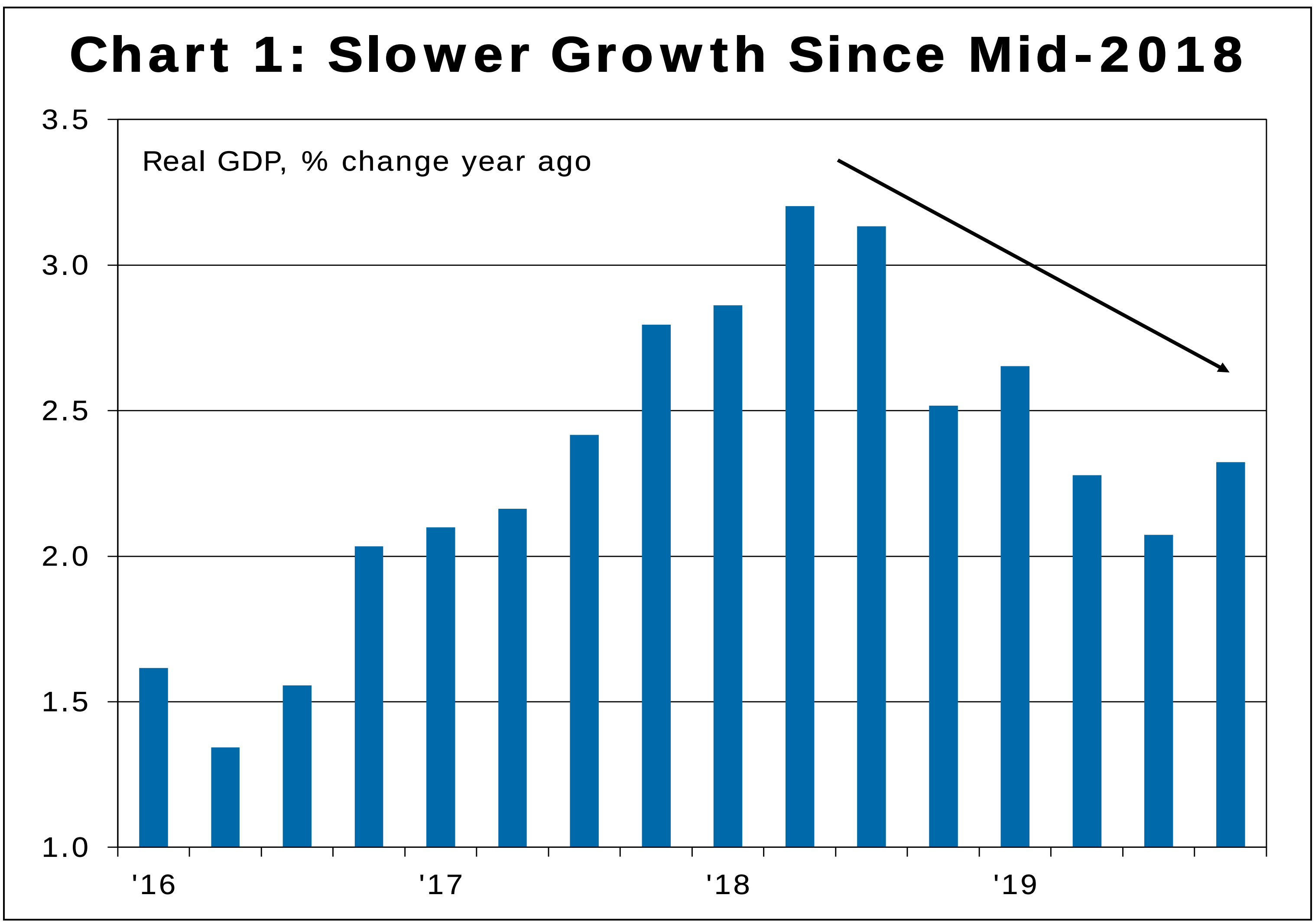

Chart source: Bureau of Economic Analysis

FED HOLDS STEADY; MODERATE GDP GROWTH IN Q4; CORONAVIRUS A DOWNSIDE RISK FOR US GROWTH

Report, based on records from the payroll-processing firm. This was the biggest increase in jobs in the ADP report since May 2015. Job gains were 54,000 in goods-producing industries (primarily manufacturing and construction) and 237,000 in service-providing industries.

The ADP report can be volatile, and is often very different from the official government report from the Bureau of Labor Statistics, which comes out on Friday, February 7. But the huge gain in employment in the ADP report for January adds upside potential to PNC's forecast of 165,000, including 150,000 in the private sector. PNC expects that the unemployment rate held steady at 3.5 percent in January, a 50-year low.

According to the BLS, job growth (private and public) averaged 176,000 per month in 2019 (see Chart 2). However, the January jobs report will include revisions to the 2019 data, and job gains over the course of last year are likely to be revised somewhat lower. Even so, the labor market is in excellent shape.

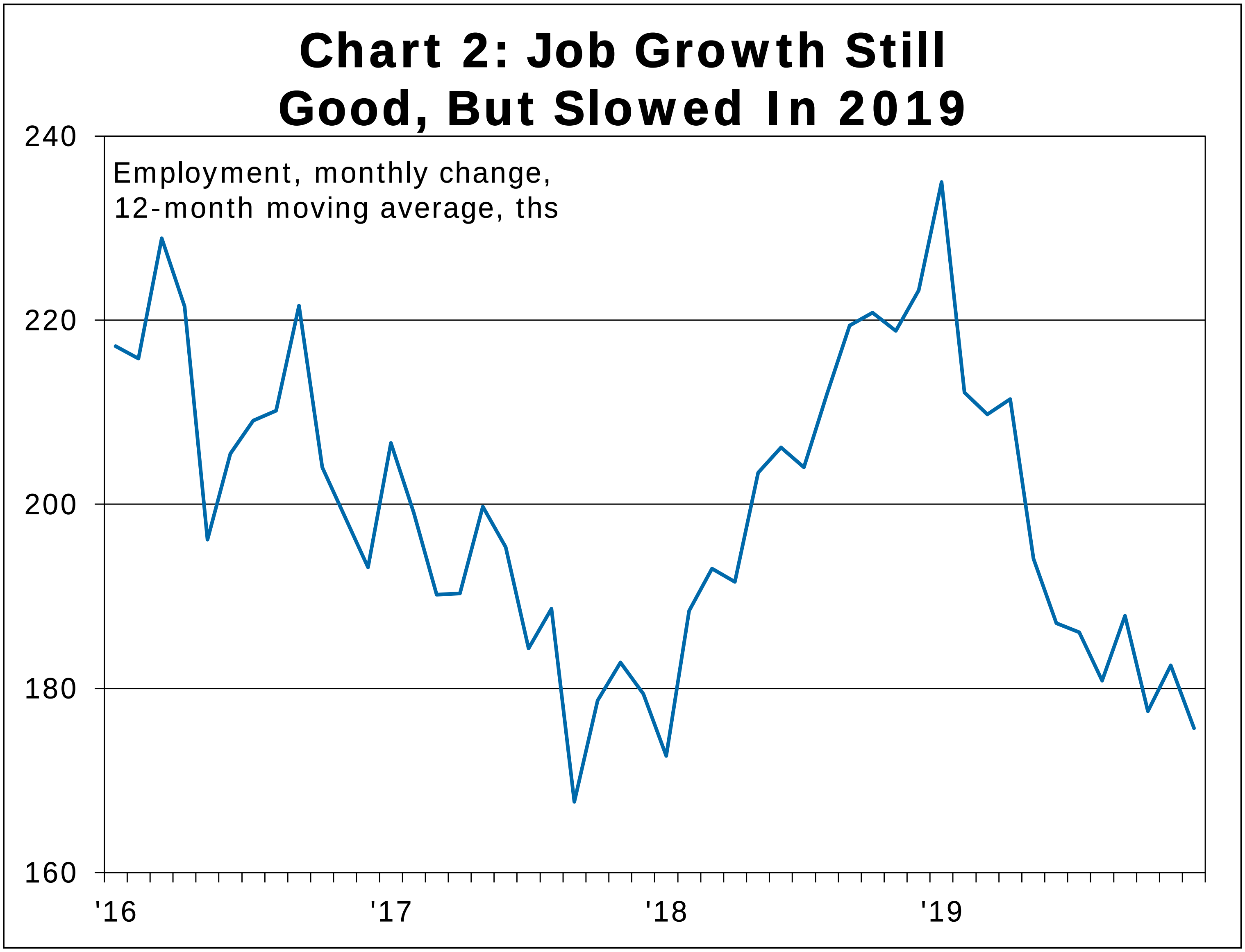

Chart source: Bureau of Labor Statistics

Visit http://www.pnc.com/economicreports to view the full listing of economic reports published by PNC's economists.