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ECONOMIC REPORT

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ADP POINTS TO SOLID JOB GAINS IN MAY; CONSUMER SPENDING AND MANUFACTURING EXPANDING

SUMMARY

- According to ADP, private-sector employment rose by 253,000 in May.
- Both personal income and consumer spending rose 0.4 percent in April.
- Prices rose in April after falling in March, but inflation slowed on a year-over-year basis.
- The ISM manufacturing index indicated expansion in the industry for the 14th time in the past 15 months.
- Economic growth was modest to moderate in most of the country in the spring, according to the Beige Book.
- The FOMC is prepared to raise the federal funds rate at its next meeting, according to committee minutes.
- PNC is forecasting job growth of 150,000 in the BLS employment report for May, with the unemployment rate up to 4.5 percent.

Private-sector employment increased by 253,000 in May, according to a report based on records from payroll-processing firm ADP. Job growth was widespread across private industries over the month, with goods-producing industries adding 48,000 jobs, including 37,000 in construction, and service-providing industries adding 205,000, with an especially strong 88,000 in professional/business services.

Personal income rose 0.4 percent in April, according to the Bureau of Economic Analysis. Wages and salaries were up a very strong 0.7 percent with job gains and higher wages, but this was somewhat offset by a decline in business profits and lower interest earnings. After-tax income rose 0.4 percent in April. Consumer spending also rose 0.4 percent over the month. There was a big jump in nominal durable goods spending, up 0.9 percent in April, with nondurable good spending up 0.6 percent (higher gasoline prices) and services spending up 0.3 percent.

The personal consumption expenditures price index rose 0.2 percent in April, with core prices (excluding food and energy) also up 0.2 percent. This followed a decline of 0.2 percent in the overall PCE price index in March, and a drop of 0.1 percent in the core index. On a year-over-year basis overall PCE inflation was 1.7 percent in April, down from 1.9 percent in March and 2.1 percent in February. Core PCE inflation was 1.5 percent in April, down from 1.6 percent in March and 1.8 percent in January and February. Although prices rose in April after falling in March, on a year-over-year basis inflation has slowed over the past few months, moving away from the Federal Reserve’s 2 percent target (see Chart 1). Some of this appears to be from falling prices for cell phone service as carriers offer more unlimited data plans.

After-tax income was up 0.2 percent in April after adjusting inflation, as was consumer spending. Consumer spending will continue to lead economic growth in 2017. Income growth is solid as the US economy adds about 175,000 jobs per month and wages rise with the tighter job market. In turn, income growth is powering gains in consumer spending.

The ISM manufacturing index rose 0.1 percentage point to 54.9 percent in May; a reading of above 50 indicates expansion in the industry. Of the five major components of the index, three improved over the month and two fell, but all were above 50. In particular, new orders jumped 2 points to 59.5 percent, indicating that demand for manufactured goods remains solid. The employment index rose 1.5 points to 53.5 percent, a plus for job growth in May. Anecdotal comments in the

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report noted difficulty in finding skilled workers.

Manufacturing continues to recover from a slowdown in late 2015 and early 2016, and the ISM index has been above 50 in fourteen of the past fifteen months (see Chart 2). Energy production has improved as prices have risen, boosting demand for heavy equipment; the dollar has stopped strengthening; and inventories are under control. Consumer demand is solid, and demand for building materials is benefitting from gains in both residential and commercial construction. Manufacturing will continue to improve throughout 2017 as the overall economy expands. There is the potential for even stronger growth if Congress passes tax cuts and an infrastructure spending program that would boost demand for manufactured goods.

According to the latest Beige Book from the Federal Reserve, growth was “modest or moderate” in most of the twelve Fed districts from early April through late May. Boston and Chicago reported slower growth over the period, with the New York district reporting flat activity.

Consumer spending growth slowed in many districts over this period, with auto sales down and non-auto retail sales flat to up slightly; tourism improved. There was moderate growth in manufacturing activity over the period, and in nonfinancial services as well. Real estate conditions generally improved, with modest to moderate growth in residential and nonresidential construction and sales of existing homes. Tight supply pushed up home prices. There was modest improvement in energy activity.

Job markets continued to tighten, with most districts reporting labor shortages across many occupations and regions. Job growth continued at a “modest to moderate pace,” however. Even with the tight job market, the Beige Book says that there was “little change to the recent trend of modest to moderate wage growth,” although some firms did report paying higher wages for workers who were in particularly short supply. According to the Beige Book “pricing pressures were little changed from the prior report, with most Districts reporting modest increases.” There were higher costs for some inputs, especially for manufacturers and construction firms, but prices fell for some other goods.

The minutes from the Federal Open Market Committee meeting on May 2 and 3 indicate that committee members generally favored an increase in the federal funds rate at their next meeting, on June 13 and 14. The minutes say that if economic conditions continued to improve in line with projections, “it would soon be appropriate for the Committee to take another step in removing some policy accommodation.” The minutes also say that participants generally favored “a continued gradual approach to raising the federal funds rate.”

The minutes also discuss how and when the Fed might reduce the size of its balance sheet. The central bank’s asset holdings ballooned from less than a trillion dollars in early 2009, when the Fed started purchasing long-term Treasuries and mortgage-backed securities in an effort to push down long-term interest rates, to around $4.5 trillion in late 2014, where they have stayed since then. The Fed

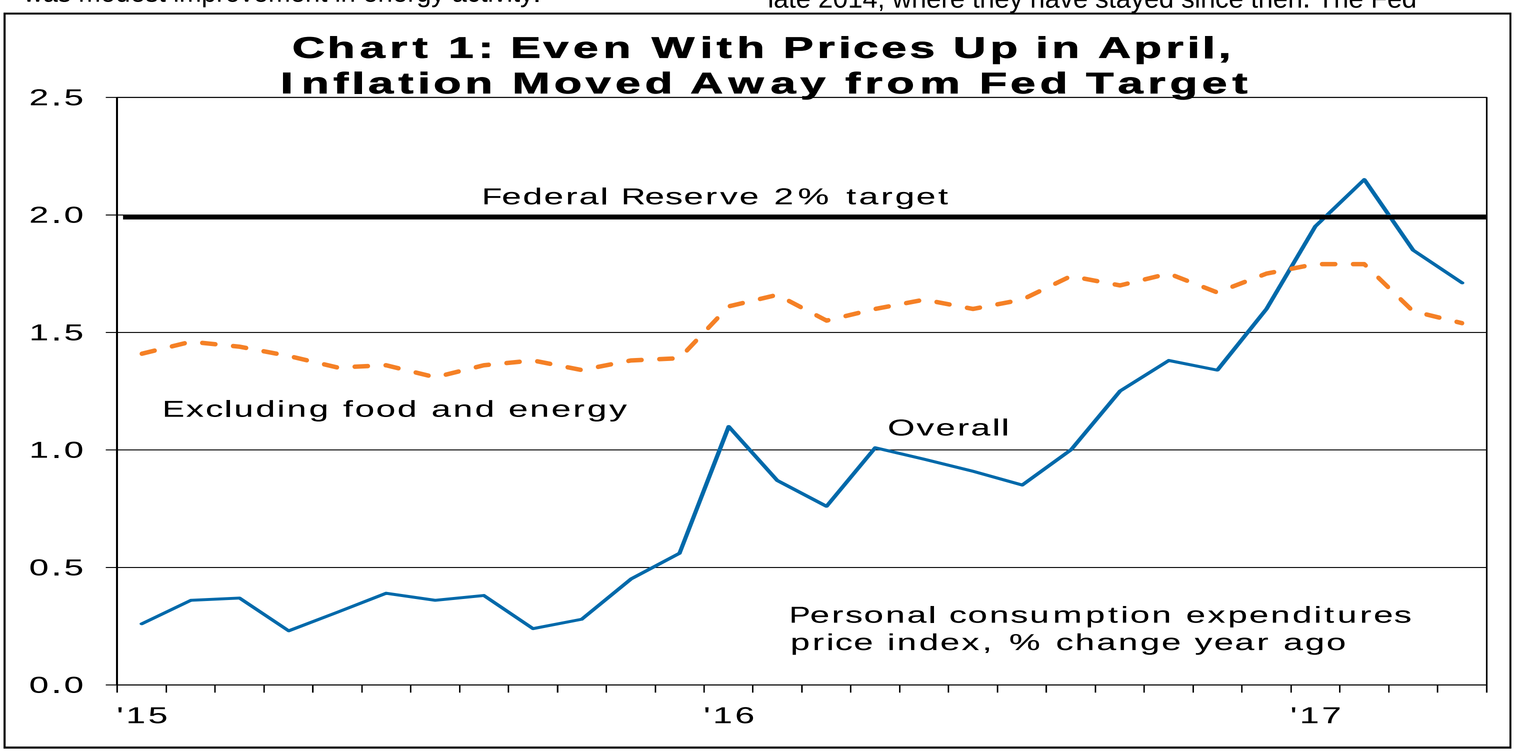

Chart source: Bureau of Economic Analysis

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staff at the meeting discussed a proposal to set gradually increasing caps on the amount of securities to run off each month; this would allow for a predictable decline in the size of the balance sheet, with the pace of decline slowly increasing over time. The minutes say that "it likely would be appropriate to begin reducing the Federal Reserve's securities holdings this year. Policymakers agreed to continue in June their discussion of plans for change to the Committee's reinvestment policy." Given that FOMC members need to fully develop a plan for a change to the reinvestment policy, and then prepare markets, any change is unlikely until late 2017.

FOMC officials were generally positive on the outlook, viewing the slowing in first quarter GDP growth as transitory. They also viewed the recent slowing in inflation as transitory, and expected both overall and core inflation to eventually settle in at around 2 percent, the committee's target. They remained encouraged by the improvement in the labor market.

The minutes are consistent with PNC's forecast, and the latest FOMC projections (from March), for two 25 basis points increases in the federal funds rate this year. The next is set to come at the next FOMC meeting, in mid-June, with one more either in September or, more likely, December. This would bring the fed funds rate to a range of 1.25 to 1.50 percent at the end of 2017. The Fed will start reducing the size of its balance sheet at the end of this year, but the process will be very gradual, not likely to wrap up until the middle of the next decade. This will put modest upward pressure on long-term interest rates.

The very strong May ADP report, as well as the solid May ISM manufacturing report, add upside potential to PNC's forecast for job growth of 150,000 in May, including 140,000 in the private sector, when the Bureau of Labor Statistics releases the government's official jobs report for May on June 2. However, the ADP report missed big in March; ADP's initial read on private-sector employment was 263,000, almost three times greater than the BLS's preliminary report of 89,000. And job growth is likely to slow in May after the BLS reported a gain of 211,000 in April, well above the average over the past year. PNC also expects a slight uptick in the unemployment rate in May, to 4.5 percent, from 4.4 percent in April, its lowest level in more than a decade.

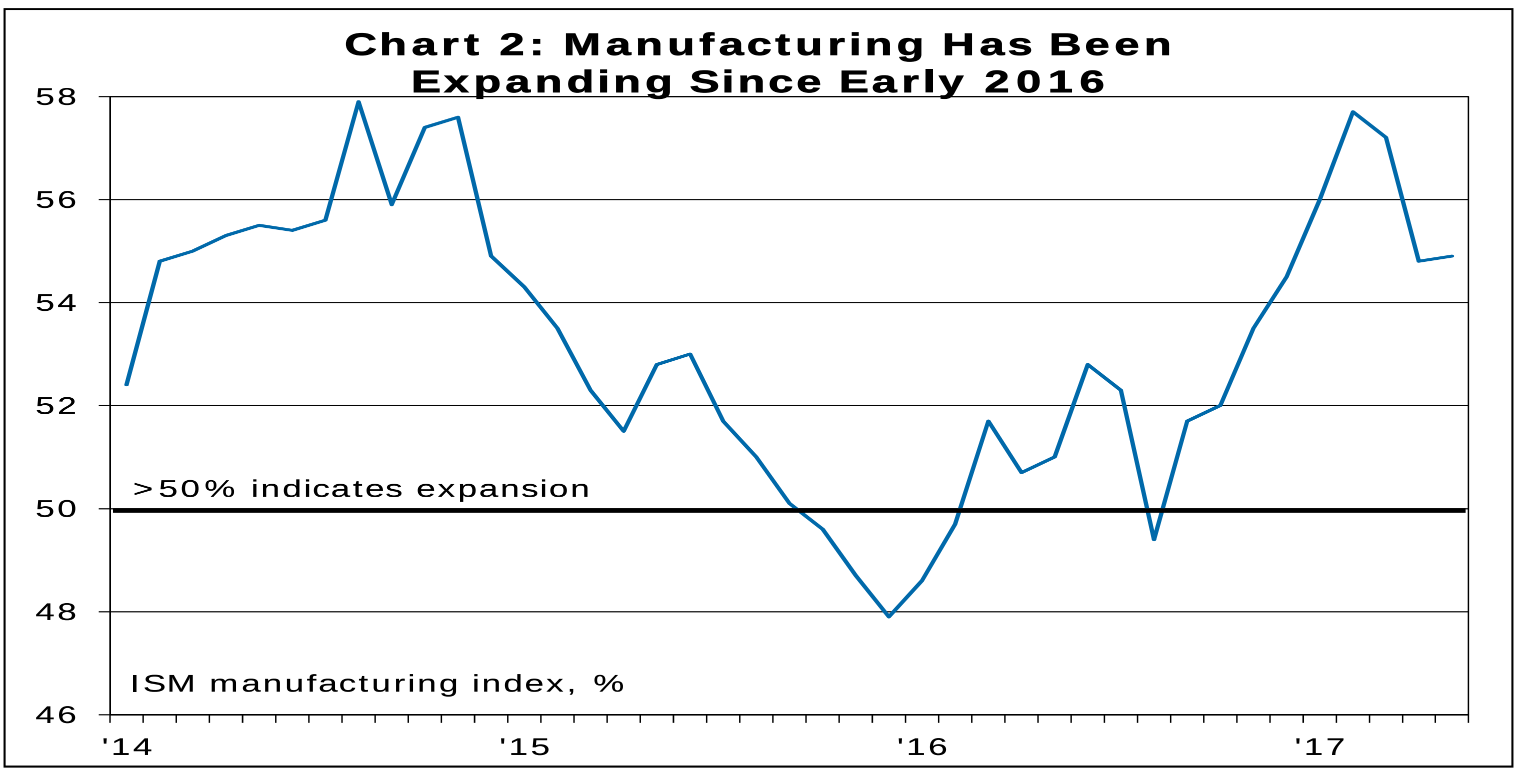

Chart source: Institute for Supply Management

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