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ECONOMIC REPORT

Gus Faucher Chief Economist | **Stuart Hoffman** Senior Economic Advisor | **William Adams** Senior Economist | **Kurt Rankin** Economist | **Mekael Teshome** Economist

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

REGIONAL ECONOMIES GROWING "MODESTLY"; NON-MANUFACTURING SECTOR IMPROVES, TRADE TO BE A DRAG

SUMMARY

- The Federal Reserve's Beige Book reported "modest to moderate" economic growth in July and August, with improvements in consumer and capital spending.
- The ISM non-manufacturing index rose 1.4 points to 55.3 percent in August, well above the 50 level that indicates expansion. The details were good.
- The trade deficit widened in July as exports fell more than imports. Trade will be a negative for growth into 2018.
- Factory orders fell in July because of volatile civilian aircraft, but details were strong and shipments rose.
- New vehicle sales fell in August to a three-year low, in part because of Hurricane Harvey.

According to the latest Beige Book on regional economic conditions from the Federal Reserve, the economy expanded at a "modest to moderate pace across all twelve Federal Reserve Districts in June and July." Growth was strongest in the New York, Cleveland, Dallas and San Francisco districts. Consumer spending was generally higher, especially for non-auto retail sales and tourism, but auto sales were mixed. Capital spending was up, as was manufacturing production. However, there was widespread concern about a slowdown in auto manufacturing. Construction expanded slightly. There were tight inventories of homes for sale, restraining activity. Loan demand was up modestly from both businesses and consumers. Competition among bank and nonbank lenders increased.

Job growth slowed, to a "slight to a modest rate in most Districts." The labor market was "tight" in most districts, with worker shortages in many industries, especially manufacturing and construction. Hiring was more difficult across all skill levels. Firms in a few districts reported that they had turned down business because of a lack of labor. Despite this, wage pressures were limited and wage growth was "modest to moderate." Wage growth was stronger in the Dallas and San Francisco districts. Prices were up modestly nationwide.

Most of the data in the Beige Book was collected before Hurricane Harvey struck, but there was a great deal of economic disruption from Harvey, although with no firm sense of the longer-run impact. About one-fifth of oil and natural gas production in the Gulf of Mexico was incapacitated by the storm, and fifteen refineries shut down. Freight prices increased in some parts of the country as flows shifted, and alternative ports expected higher traffic.

The most recent Beige Book indicates modest to moderate growth across all of the United States, similar to the pace observed throughout the current economic expansion. Labor markets continue to tighten, but wage and inflationary pressures remain limited. It appears that the impact of Hurricane Harvey so far is limited to the Gulf Coast, with few ripple effects beyond the region.

The Beige Book does not change the outlook for monetary policy. The next move from the Federal Open Market Committee will be an announcement, following its meeting on September 19 and 20, that the Federal Reserve will begin to reduce the size of its balance sheet in October. This will put modest upward pressure on longer-term interest rates. PNC expects the Federal Open Market Committee to next raise the fed funds rate at the end of this year by a quarter of a percentage point, to a range of 1.25 to 1.50 percent. The FOMC will wait until December to gauge the financial market reaction to balance sheet reduction. It will also want to see what impact Hurricanes Harvey and Irma have on the economy.

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The ISM non-manufacturing index rose 1.4 points to 55.3 percent in August, from an 11-month low in July. A reading above 50 indicates expansion in non-manufacturing industries. The index has averaged 56.3 percent so far in 2017, up from 54.9 percent in 2016.

The details were strong, with three of the four components used to calculate the headline index up over the month: employment, new orders, and business activity. Only the supplier deliveries index fell, though it remained above 50. Twelve of the 18 industries covered reported growth in business activity in August.

In addition to the improvement in the ISM non-manufacturing index, the ISM manufacturing index (released last week) jumped in August to its highest level in six years (see Chart 1). Although growth in the third quarter may weaken temporarily from Harvey and Irma, the economy is in good shape and the current expansion will continue into 2018.

The U.S. trade deficit widened to $43.7 billion in July from $43.5 billion in June (revised down slightly from $43.6 billion). Exports fell by $0.6 billion over the month to $194.4 billion, while imports fell by $0.4 billion to $238.1 billion.

The goods deficit rose by less than $0.1 billion in July to $65.3 billion, while the services surplus fell by $0.2 billion to $21.6 billion. Adjusted for inflation, the goods trade deficit increased by $0.8 billion to $61.6 billion.

Trade will be slight negative for U.S. growth in the near term as the trade deficit widens, with imports increasing a bit more quickly than exports. Stronger global economic growth and the depreciation of the U.S. dollar this year are boosting exports from the U.S. However, imports are also increasing as U.S. consumers and businesses purchase more from abroad as the domestic economy continues to expand. One wildcard is Harvey, which has shut down ports along the Gulf Coast in Texas. Those ports are gradually reopening, but the closures are disrupting trade flows, hitting both imports and exports Vehicle imports will get a boost in the near term from replacement of vehicles lost to Harvey.

Orders for manufactured goods fell by 3.3 percent month-over-month in July. However, the details of the report were strong. July’s drop followed a large, 3.2 percent gain in June. Civilian aircraft orders, which are highly volatile, plunged 71 percent in July, but this was after the Paris Air Show lifted orders by 129 percent in June. Durable goods orders excluding transportation goods rose 0.5 percent in July, and orders for nondurable goods were up 0.4 percent. New orders for core capital goods—non-defense capital goods excluding aircraft, and a proxy for business investment—were up 1.0 percent in July. One soft spot in

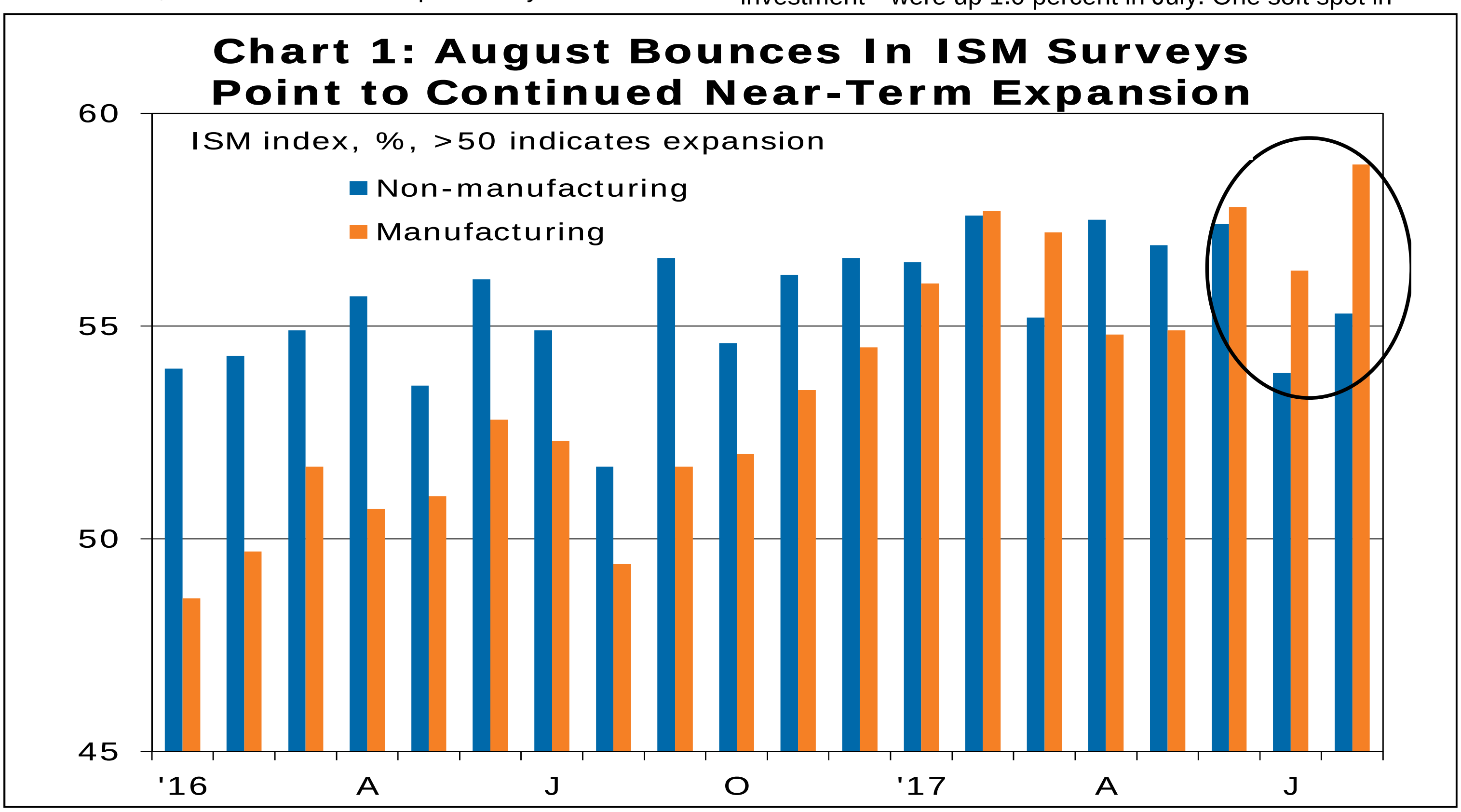

Chart source: Institute for Supply Management

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orders was a 0.9 percent drop for motor vehicles and parts in July, following a flat month in June.

Shipments of manufactured goods rose 0.3 percent in July. Durable goods shipments rose 0.2 percent, and were down 0.3 percent after excluding transportation goods. Nondurable goods shipments rose 0.4 percent over the month. Core capital goods shipments, which go into business investment spending in GDP, rose by a strong 1.2 percent in July, and June was revised upward to 0.6 percent growth from 0.1 percent growth.

Manufacturing is expanding this year. Strong consumer fundamentals, increased construction activity, improving business investment, a growing global economy, and a weaker dollar will support moderate near-term expansion in manufacturing.

In a separate report, new vehicle sales fell 4.2 percent on a monthly basis in August to 16.1 million at a seasonally-adjusted annualized rate, well below the 16.6 million consensus expectation. This was the worst month for vehicle sales since early 2014 (see Chart 2). Some of the weakness came from Hurricane Harvey, with a drop in sales along the Gulf Coast at the end of the month. So far in 2017 unit sales are running at a 16.9 million unit pace, down from a record 17.5 million units in 2016.

Car sales fell 12.0 percent in August from a year earlier, with light truck sales down 2.4 percent. Light trucks (including crossovers, pickups and SUVs) have been selling better than cars since 2014 as gasoline prices have fallen. But larger vehicles are now seeing softer sales. Even with aggressive incentives dealers are struggling to clear their inventories and banks have tightened credit conditions for auto loans to guard against rising delinquencies. In addition, strong sales over the past few years have reduced demand for new vehicles in 2017.

This soft patch in auto sales is likely to pass. Auto sales will bounce back through the rest of this year and into 2018, in part from replacement of vehicles destroyed by Harvey. However, sales during this expansion have likely peaked.

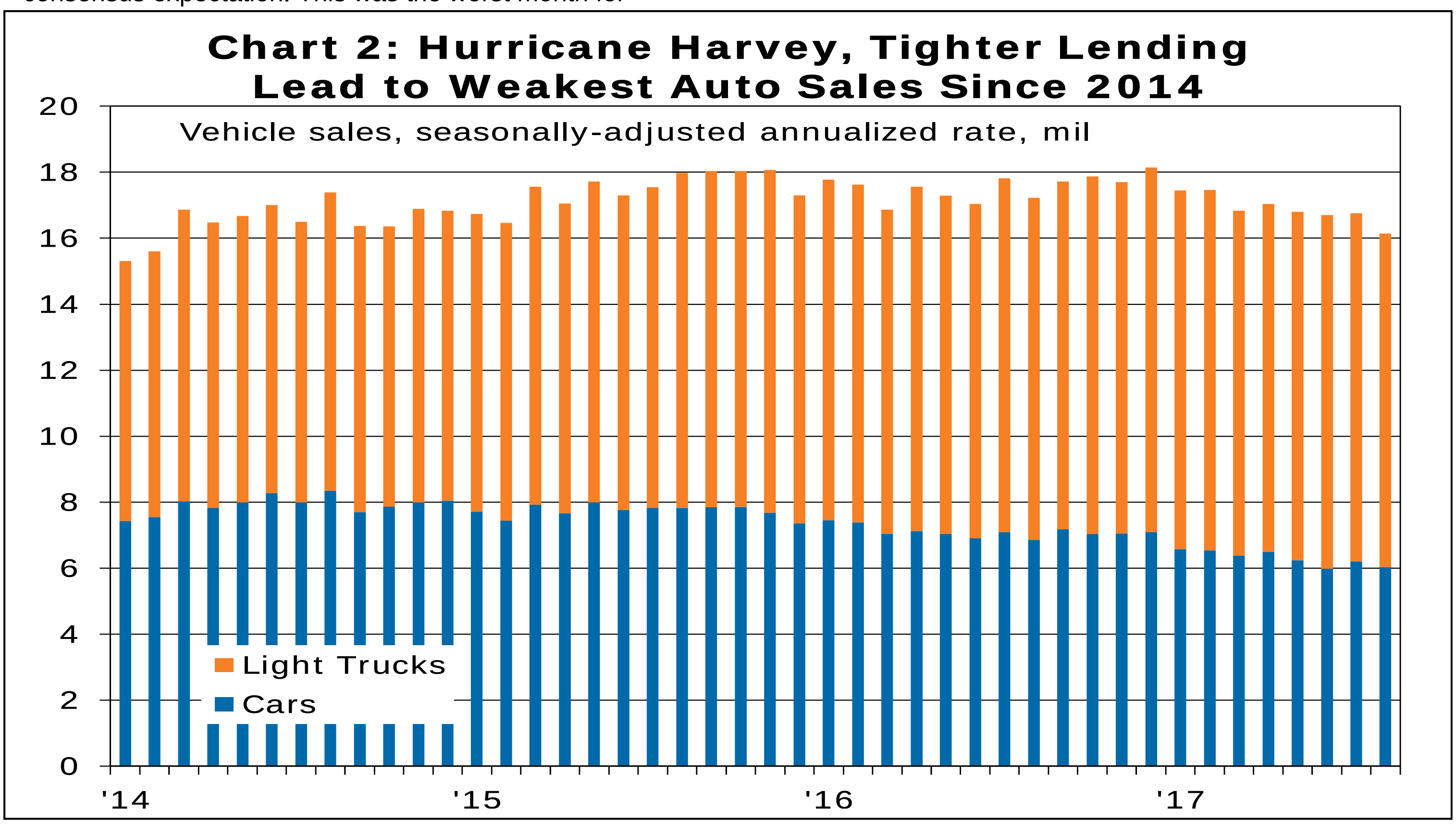

Chart source: AutoData

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