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ECONOMIC REPORT

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DISAPPOINTING MAY JOBS REPORT, BUT FOMC STILL SET TO INCREASE FED FUNDS RATE

SUMMARY

- The May employment report was disappointing, with just 138,000 jobs added over the month. Seasonal factors may have weighed on job growth.
- The unemployment rate fell to 4.3 percent in May, its lowest in 16 years.
- Wage growth was also disappointing, with average hourly earnings up 2.5 percent from one year earlier.
- The U.S. trade deficit widened more than expected in April.
- Productivity growth was revised higher in the first quarter, to no change, although it remains weak over the longer run.
- The FOMC is expected to raise the federal funds rate on June 14.

The May jobs report was disappointing. The US economy added just 138,000 jobs in May, compared to PNC's forecast for a gain of 150,000 and the consensus expectation of 185,000. The private sector added 147,000 jobs in May, while government jobs fell by 9,000. There were also big downward revisions to job growth in April (to 174,000 from 211,000) and March (to 50,000 from 79,000), for a total net downward revision of 66,000. Job growth has averaged 121,000 over the past three months, a noticeable slowing from the pace of 187,000 per month for all of last year (see Chart 1). Seasonal factors may have weighed on job growth in May; the reference week used in the survey of employers was earlier in the month than usual, so it may have missed some of the students normally added to summer payrolls.

The unemployment rate fell to 4.3 percent in May, down from 4.4 percent in April and 4.8 percent in January; the last time the unemployment rate was this low was May 2001. However, the decline in the unemployment rate was not all good news. The number of people who reported having jobs in the household survey (different from the survey of employers) fell by 233,000, while the number of people in the labor force dropped by 429,000. The labor force participation rate dipped 0.2 percentage point to 62.7 percent; it remains well below its pre-recession level and has moved in the wrong direction over the past few months. The number of unemployed fell by 195,000 in May. The broader U-6 unemployment rate (unemployed, underemployed and too discouraged to look for a job) fell to 8.4 percent in May from 8.6 percent in April and 9.4 percent in January, and is at its lowest since late 2007.

Job growth was mixed across industries in May. Mining and logging employment rose by 6,000 in May, the seventh straight monthly increase, but it is still down by almost one-quarter from its peak in the fall of 2014. Construction job growth was 11,000 in May. Manufacturing jobs fell by 1,000 in May, after five straight monthly increases. Private service-providing industries added 131,000 jobs in May. This included gains of 38,000 in professional/business services (including 13,000 in temporary services), 47,000 in education and healthcare, 31,000 in leisure/hospitality services, and 11,000 in financial activities. Retail trade employment fell by 6,000 in May and April was revised from a job gain to a loss; there were also big drops in February and March. Traditional retailers remain under pressure from online sales. Employment was down 2,000 in information services in May. Local government jobs fell by 9,000 and state government jobs by 8,000 in May, while federal government employment was up by 8,000.

Wage growth was also disappointing. Average hourly earnings rose 0.2 percent in May, but just 0.152 percent before rounding. Wage growth in April was revised lower, to 0.2 percent from 0.3 percent. Average hourly earnings were up 2.5 percent in May from one year earlier, which is soft given that the expansion is now 8 years old and the unemployment rate has been below 5 percent for a year. The average workweek was unchanged at 34.4 hours. With 138,000 new payroll

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workers and a flat average workweek total hours worked rose 0.1 percent in May, and with moderate wage growth aggregate weekly earnings were up 0.2 percent.

The jobs report for May was subpar. Not only was the headline number soft at 138,000, although some of that may have been due to seasonal factors, but the details were also disappointing. There were big downward revisions to job growth in March and April and wage growth was mediocre. Even the decline in the unemployment rate was not all good news; it fell because of fewer people looking for work. It could be that job growth is slowing as the tight labor market makes it more difficult for firms to find workers, and the weaker pace of job growth over the past few months may persist throughout this year and into next year.

The U.S. trade deficit, unadjusted for inflation, widened more than expected in April, to $47.6 billion, from $45.3 billion in March (revised wider from a deficit of $43.7 billion). Exports fell slightly, by 0.3 percent to $191.0 billion, while imports rose by 0.8 percent to $238.6 billion. The goods deficit rose to $68.4 billion over the month from $66.1 billion, while the surplus in services was unchanged at $20.8 billion. Adjusted for inflation the goods trade deficit rose to $63.5 billion (in 2009 dollars) in April from $60.7 billion in March.

Trade will be a negative for U.S. economic growth through the rest of this year, although the drag will gradually fade. With the U.S. doing better than most other economies, imports will continue to increase, while export growth will be slower. A somewhat weaker U.S. dollar over the past few months will offset some of that, providing a boost to exports and restraining import growth somewhat.

Nonfarm business productivity growth in the first quarter was revised higher, to flat from an annualized decline of 0.6 percent in the preliminary estimate. The upward revision came primarily from an upward revision to GDP in the

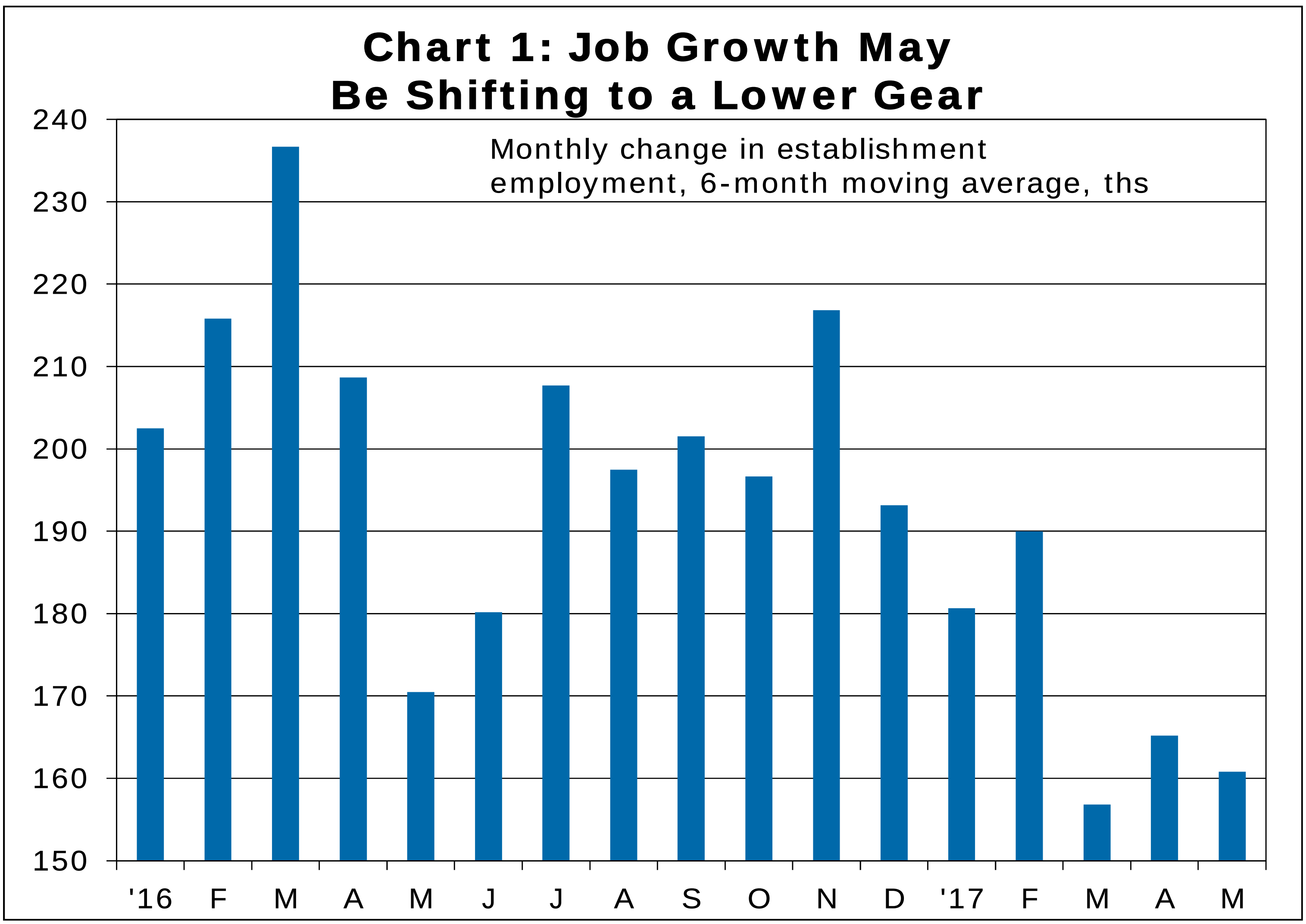

Chart source: Federal Reserve

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quarter. With compensation growth of 2.2 percent in the first quarter, unit labor costs rose 2.2 percent, revised down from a 3.0 percent increase. There was also a big downward revision to unit labor costs in the fourth quarter of 2016, which is good news for business profits.

Although productivity growth was revised higher in the first quarter, it is still soft, and has been for more than a decade. From 1996 to 2005 annual productivity growth averaged almost 3 percent; since then it has averaged just over 1 percent (see Chart 2). Some of this was fallout from the Great Recession, but the slowdown preceded it. Because of this, growth in Americans' standard of living has also slowed, contributing to the unsettled political environment. Boosting productivity growth will be key if President Trump is to succeed in office.

The Federal Open Market Committee will raise the federal funds rate by a quarter of a percentage point, to a range of 1.00 to 1.25 percent, in its policy statement on June 14. After keeping the funds rate at essentially zero from 2009 to the end of 2015, and then raising it once in late 2015, the FOMC is now raising the rate more consistently as the labor market approaches full employment. With the very low unemployment rate, recent softer readings on inflation will not deter the FOMC. PNC expects one more fed funds rate increase this year, likely at the FOMC's December meeting, with another three 25 basis point rate increases in 2018.

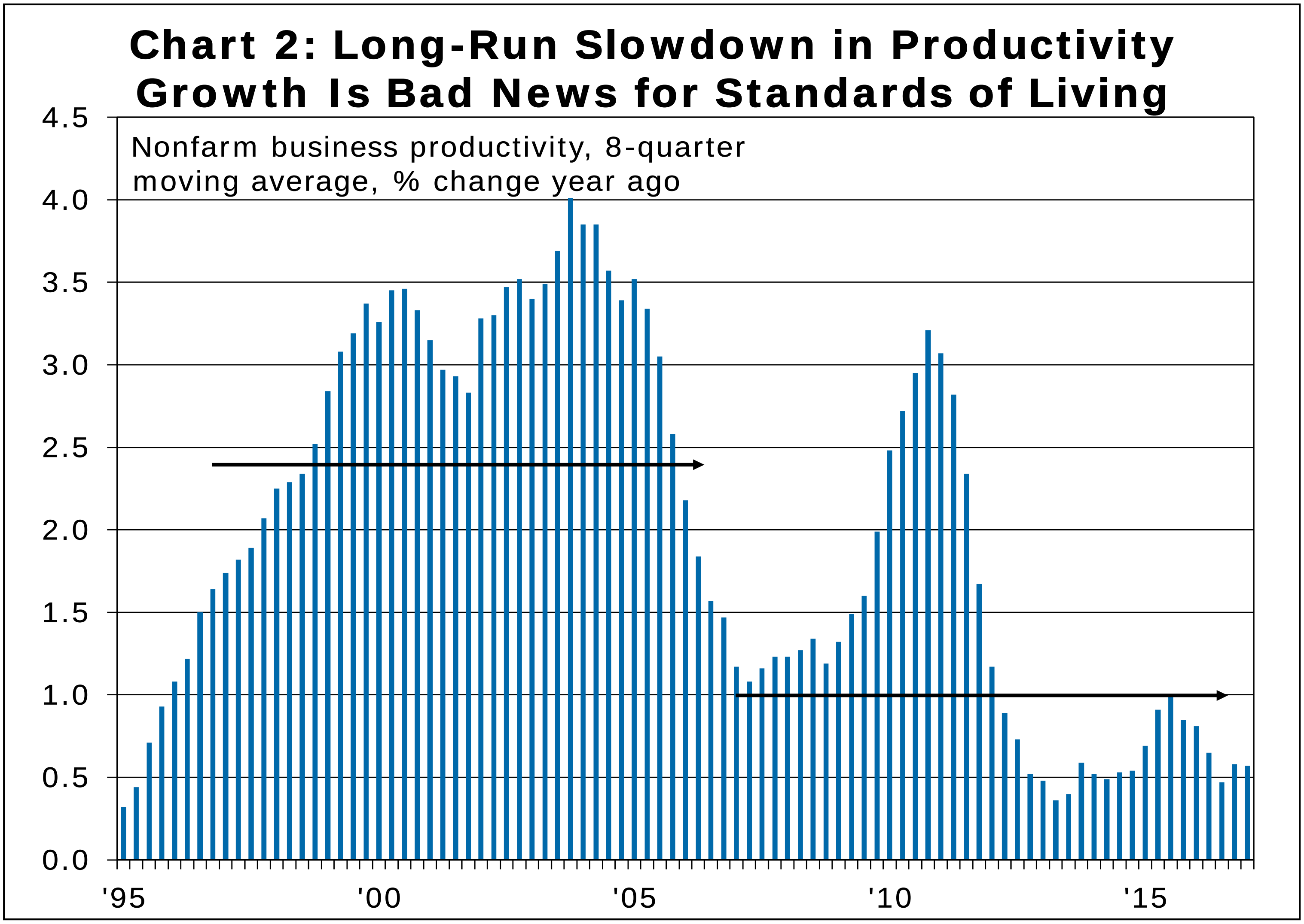

Chart source: Bureau of Labor Statistics

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