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ECONOMIC REPORT

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STRONG OCTOBER JOBS REPORT REINFORCES CASE FOR DECEMBER FED RATE HIKE; TRADE DEFICIT NARROWS

SUMMARY

- The U.S. economy added 161,000 jobs in October, with upward revisions to job growth in August and September.
- The unemployment rate fell slightly in October to 4.9 percent, although details from the household survey were mixed.
- The tightening labor market is pushing up wages; average hourly earnings were up 2.8 percent in October from one year earlier, the fastest growth in more than seven years. This is very good news for incomes and consumer spending.
- The strong October jobs report strengthens the case for a December increase in the fed funds rate.
- The U.S. trade deficit narrowed substantially in September, supporting third quarter growth. The trade deficit is set to widen again in the near term, however.
- The U.S. economic expansion is set to continue well into 2017.

October payroll jobs rose by 161,000, slightly below the market consensus of 175,000. **But** there was a 35,000 upward revision to job growth in September to 191,000 (from 156,000), and a 9,000 upward revision to August to 176,000 (from 167,000), for a large combined upward revision of 44,000. Average monthly job growth in 2016, through October, is a solid 181,000, but a slowing from 229,000 in 2015 (see Chart 1). Private-sector employment was up by 142,000 in October, slightly below the ADP figure of 147,000. State and local government jobs were up by 7,000 in October, with Federal government jobs up by 12,000.

The unemployment rate edged back down to 4.9 percent in October, from 5.0 percent in September. The details in the household survey (different from the survey of employers) were mixed. The number of people who reported having jobs in the household survey fell by 43,000 in October, but the monthly average household job gain in the first ten months of 2016 was still a solid 178,000. The unemployment rate fell over the month because the labor force contracted by 195,000 in October, after a combined increase of 1.44 million in June through September, more than offsetting a decline of 820,000 in April and May. The monthly average labor force gain in the first ten months of 2016 was a solid 168,000, a vote of confidence in the job market. The number of unemployed fell by 152,000 in October. The labor force participation rate edged down 0.1 percentage point in October to 62.8 percent; it is up from a cyclical low of 62.4 percent in September 2015, but remains well below its pre-recession level.

One very encouraging note from the household survey is that in October the broader U-6 unemployment rate (unemployed, “under employed” and too discouraged to even look for a job) moved down to 9.5 percent, from 9.7 percent in July through September. This is the lowest U-6 rate since April 2008, and it is down from a peak of 16.9 percent in late 2010. Part-time jobs for economic reasons ("involuntary part-time jobs") fell by 5,000 in October but were up by 128,000 from one year earlier. Voluntary part-time jobs rose by 3,000 in October and were up by 512,000 from a year earlier. Part-time jobs will surely rise in November and December since holiday seasonal hiring is expected to be strong.

The breadth of payroll job growth in October was widespread across private service-providing industries, but mixed in goods-producing ones. Mining jobs fell by 2,000, the twenty-sixth straight monthly decline, but the pace of job losses has slowed over the past several months. Manufacturing jobs fell by 9,000 in October, but construction jobs rose by 11,000. Private service-producing industries added 142,000 jobs in October. This included gains of 43,000 in professional/

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business services (including 6,000 temp jobs), 52,000 in eds and meds, 13,000 in trade/transportation/utilities, 10,000 in leisure/hospitality services, 14,000 in financial activities, and 4,000 in information services.

Perhaps the best news in the report is that average hourly earnings in the private sector jumped by a large 0.4 percent in October and were up by 2.8 percent from one year earlier, the biggest year-over-year increase since June 2009. As the job market gets tighter, firms are responding to tougher competition for workers by raising pay (see Chart 2). This is a big positive for income growth, consumer spending, and the overall economy. Disappointing wage growth up to now has made the Federal Open Market Committee reluctant to increase the federal funds rate.

The average workweek held steady at 34.4 hours in October. Combining 161,000 new workers, a 0.4 percent rise in average hourly wages and a steady average workweek (total hours worked rose by 0.2 percent), workers' earned income rose by a strong 0.7 percent in October. The October CPI was likely up 0.4 percent (reported on November 17) as gasoline prices rose by nearly 7 percent, so workers' real income rose by a solid 0.3 percent for the month. October unit vehicle sales were very strong at an 18.3 million annual rate. Both total and ex-auto retail sales rose solidly for a second month in October, after a consumer spending "pause" in July and August. This is the prelude to a solid holiday sales season, with a gain of 3.0 to 3.5 percent from last year, mostly reflecting strong real sales growth since prices of holiday-type items will be up less than 1 percent.

Taken all together, a decent rise in October payroll jobs with large upward revisions to job growth in September and August, a large increase in average hourly earnings, and a steady average workweek constitute a strong October jobs report, further strengthening the case for an increase in the fed funds rate after the election, at the FOMC's December 13-14 meeting. The fed funds futures market is pricing in a two-thirds probability of a December rate increase, which means the markets are preparing themselves (with help from Fed speakers, and additional improved economic and faster inflation data for October) for a December rate hike. This will give Fed Chair Yellen a green light to go next month.

The "gift" of lower gasoline prices holding down inflation for the past 2½ years is coming to an end. The result is that inflation measured using the Fed's preferred inflation measure, the headline personal consumption expenditures price index, will speed up to near 2 percent by spring 2017, coming closer in line with core (excluding food and energy prices) inflation. The FOMC's target for inflation is 2

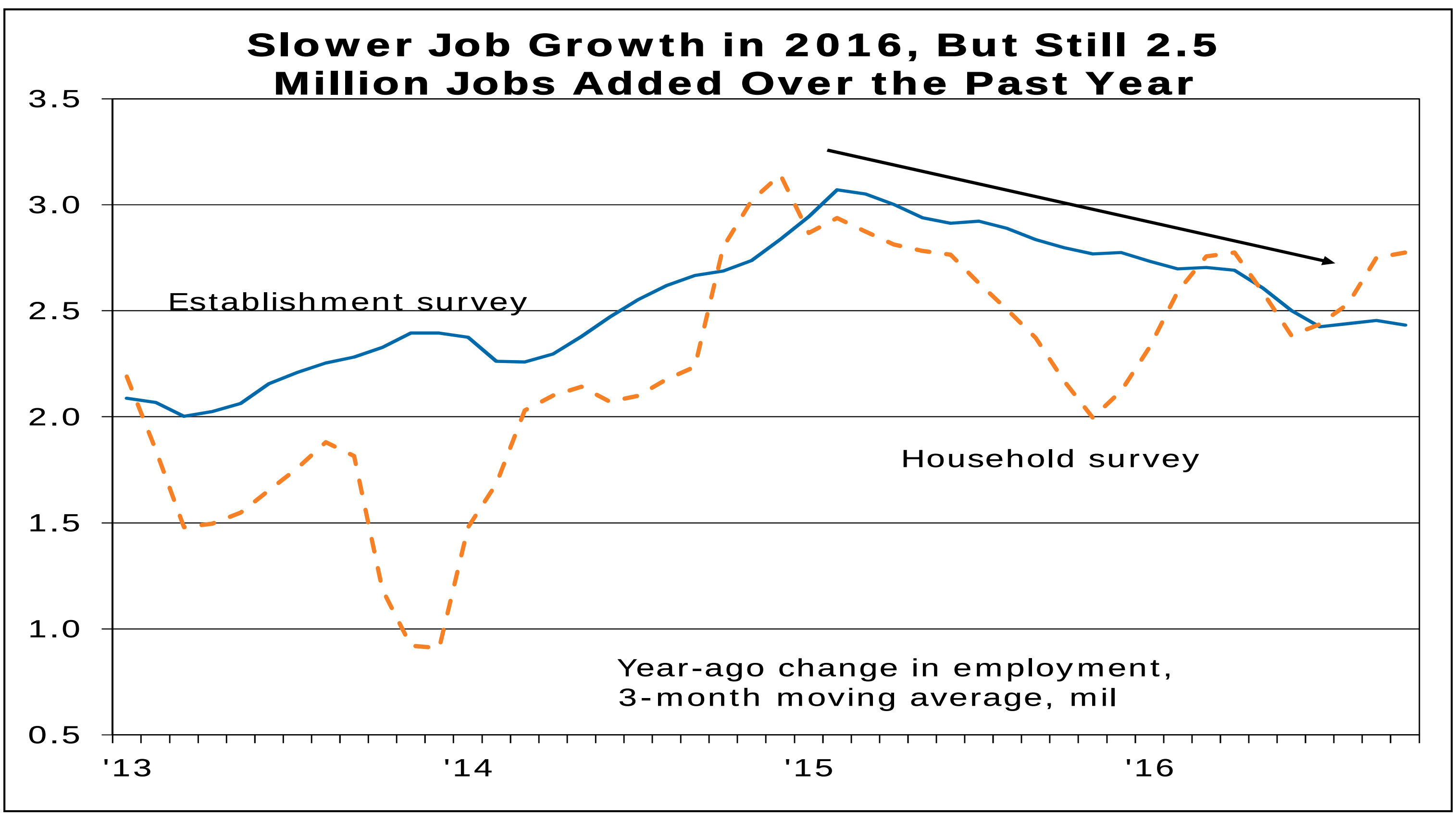

Chart source: Bureau of Labor Statistics

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percent; movement toward this target will bolster the case for another fed funds rate hike in the middle of next year.

The S&P 500 was down 0.2 percent today, with oil prices down about 1 percent to slightly above $44 per barrel; this is a slide of about $7 per barrel over the past two weeks as oil supplies have grown. The 2-year Treasury note rate was down slightly to 0.79 percent, while the 10-year Treasury note rate was down to 1.78 percent, from 1.82 percent. The dollar was slightly weaker against most major currencies.

The U.S. trade deficit fell sharply in September, to $35.4 billion, from $40.5 billion in October. This was the smallest monthly trade deficit since February 2015. Exports rose 0.5 percent over the month to $189.2 billion, while imports fell 1.3 percent to $225.6 billion. TV rights for the Summer Olympics boosted imports in August, and then they fell in September.

Trade provided a big economic boost in the third quarter, adding 0.8 percentage point to overall GDP growth, which was 2.9 percent at an annual rate. A big increase in soybean exports led to a smaller trade deficit in the quarter.

Trade is likely to be a drag on growth in the fourth quarter and in 2017. The boost from soybeans will fade, and solid growth in consumer spending will boost imports. At the same time the strong U.S. dollar and weak global growth will weigh on exports.

Even with the drag from trade, the U.S. economy will remain solid through at least the first half of next year. Consumer spending will continue to lead growth, thanks to job and income gains. Construction will also be a positive, with gains in both residential and commercial building. Business investment will be a small positive for growth. PNC is forecasting real GDP growth of 2.3 percent in the fourth quarter, with growth continuing at that pace next year. Job growth will further slow next year, but more from greater difficulty in finding workers and not weaker demand. After adding about 180,000 jobs per month on average this year, growth will slow to about 160,000 per month in 2017. The unemployment rate will move slightly lower through 2017, toward its long-run value of 4.6 percent.

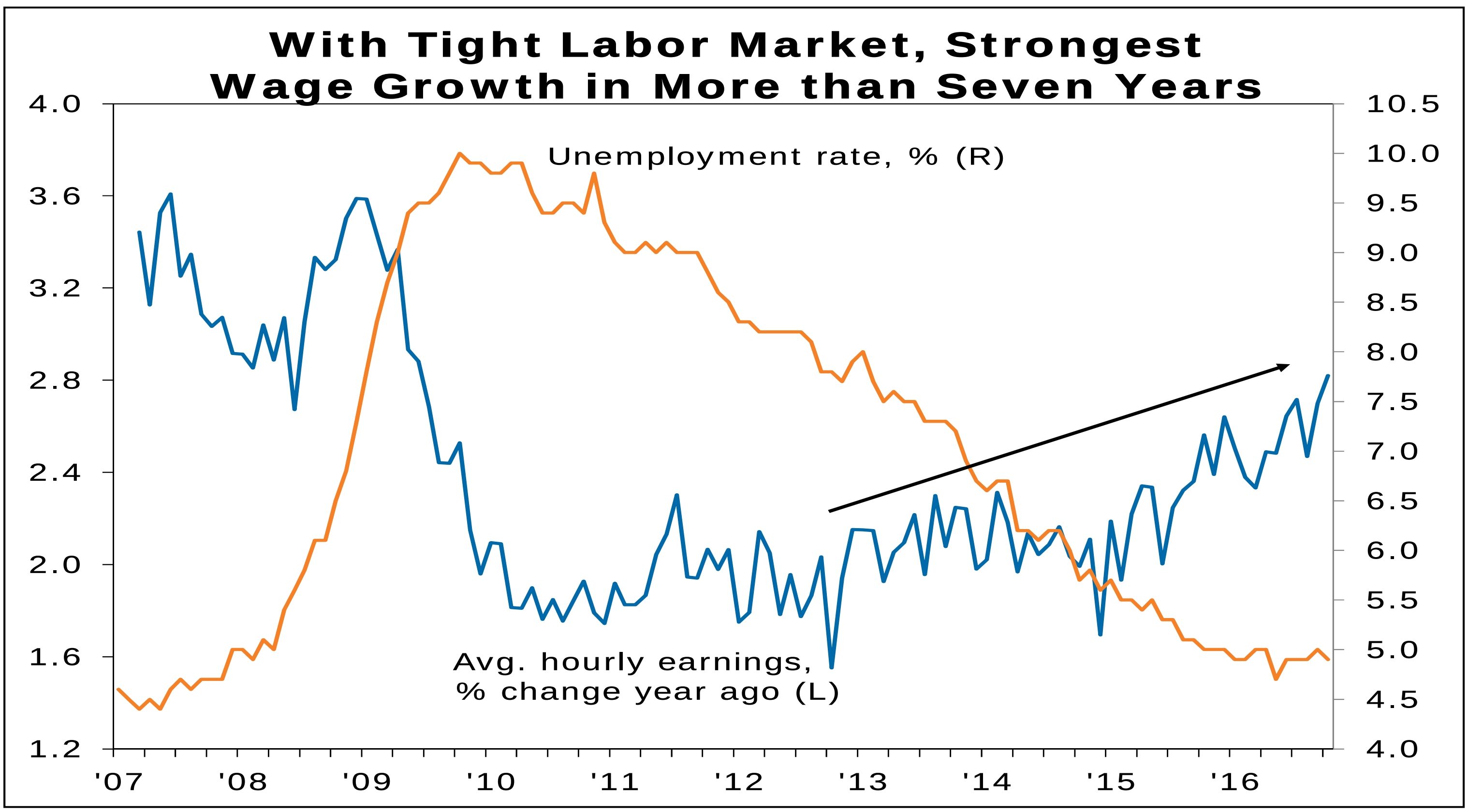

Chart source: Bureau of Labor Statistics

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