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ECONOMIC REPORT

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NO FED FUNDS RATE HIKE, BUT JUNE INCREASE LIKELY; LOWER MARCH TRADE DEFICIT; ISM INDICES DOWN IN APRIL

SUMMARY

- The FOMC held the fed funds rate steady at its most recent meeting, as expected. The committee is set to raise the fed funds rate at its next meeting, in mid-June.
- The U.S. trade deficit narrowed in March, but is set to widen through the rest of 2018.
- The ISM manufacturing and nonmanufacturing indices fell in April, but both remained comfortably above the 50 level that indicates expansion.
- Productivity growth was weaker than expected in the first quarter, and growth in unit labor costs was stronger.
- PNC expects job growth of 175,000 in April, with the unemployment rate falling to 3.9 percent.

As widely expected the Federal Open Market Committee held the fed funds rate steady at the conclusion of its meeting on May 2, in a range of 1.50 to 1.75 percent. The decision was unanimous. The FOMC has been gradually raising the fed funds rate since late 2015 as the economy has steadily improved; the last rate hike was in mid-March.

The biggest change to the FOMC statement announcing the decision was about the inflation outlook. The May 2 statement said that "inflation on a 12-month basis is expected to run near the Committee's symmetric 2 percent objective over the medium term." The previous statement, on March 21, said that inflation is "**expected to move up in coming months** and to stabilize around the Committee's 2 percent objective over the medium term" (emphasis added). Inflation was 2.0 percent in April on a year-ago basis, using the personal consumption expenditures price index; inflation excluding volatile food and energy prices accelerated to 1.9 percent in April. Thus the May 2 FOMC statement noted that inflation is essentially at the committee's goal. The May 2 statement also explicitly referred to a "symmetric" inflation objective; this is to confirm that the FOMC will tolerate inflation temporarily above 2 percent.

The May 2 statement kept language saying that "the Committee expects that economic conditions will evolve in a manner that will warrant further gradual increases in the federal funds rate; the federal funds rate is likely to remain, for some time, below levels that are expected to prevail in the longer run." PNC expects a fed funds rate increase of 0.25 percentage point at the FOMC's next meeting, on June 12 and 13; this would bring the rate to a range of 1.75 to 2.00 percent. This is consistent with recent speeches from Fed officials, and the fed funds futures market has priced in a 100 percent probability of a rate hike at that meeting. PNC expects one further increase in the fed funds rate in 2018, likely at the FOMC's December meeting. This is consistent with the median projection from the FOMC's last Summary of Economic Projections (the "dot plot"), from March, which had three rate hikes for all of 2018. But almost as many FOMC participants expected four increases for all of this year, or one more rate increase than in PNC's forecast.

The U.S. trade deficit narrowed substantially in March, to $49.0 billion, from $57.7 billion in February. The trade deficit widened in part in February because of television rights payments for the Olympics, and so the smaller March deficit reflected a reversal of that. Imports fell 1.8 percent in March from February, while exports rose 2.0 percent. The goods deficit narrowed in March, while the U.S. surplus in services rose. Adjusted for inflation, the U.S. goods trade deficit fell by 10 percent in March from February.

Although the trade deficit narrowed in March, it is likely to expand through the rest of 2018, weighing on U.S. economic growth. U.S. exports are increasing with most of the world's major economies expanding, but imports are rising faster

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as U.S. consumers and businesses buy more from abroad as domestic demand improves.

The ISM manufacturing index dropped more than expected in April, to 57.3, from 59.3 in March and 60.8 in February. A reading of greater than 50 indicates expansion in manufacturing. Four of the five components used to calculate the overall index dropped in April, but all five were comfortably above 50, and new orders were very solid at 61.2. Other details were also good.

The ISM nonmanufacturing index also fell by 2 points in April, to 56.8 from 58.8 in March. This was the third consecutive decline, but the nonmanufacturing index too was well above 50 (see Chart 1). The four major components were all well above 50, although three dropped in April. New orders rose, however, to 60.0. Other details were good.

Although both ISM indices fell in April, they are comfortably in expansionary territory, and new orders were very strong in both. Together the surveys point to above-trend growth in 2018, consistent with PNC's forecast for real GDP growth of 2.8 percent this year, up from 2.3 percent in 2017.

Productivity in the nonfarm business sector rose 0.7 percent at an annual rate in the first quarter, below the consensus expectation of 0.9 percent. This was an acceleration from the 0.3 percent increase in the fourth quarter of last year, but below the 1.3 percent pace for all of 2017. After solid gains in the middle of last year, productivity growth slowed in late 2017 and early 2018. Productivity growth has been disappointing throughout the current economic expansion, and absent an acceleration in productivity growth, economic growth in the United States is likely to remain well below its long-run average (see Chart 2).

Chart 1: Both ISM Indices Down in 2018, But Up From Last Year

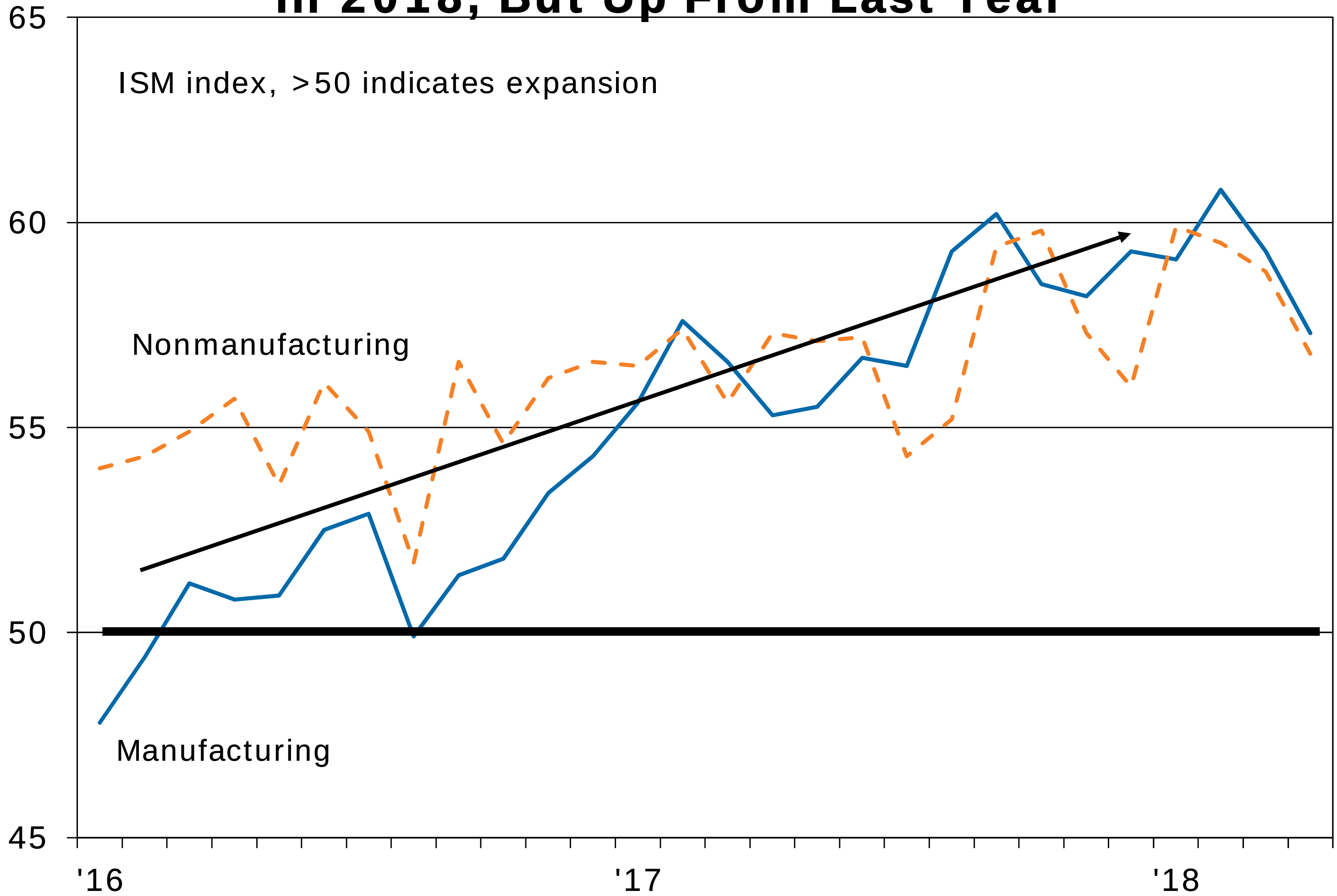

Chart source: Institute for Supply Management

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Compensation per hour rose 3.4 percent annualized in the first quarter as businesses raised pay in an effort to attract workers in a tight labor market. Unit labor costs, which measure the cost of labor taking into account productivity gains, rose 2.7 percent in the first quarter, up from 2.1 percent in the fourth quarter of 2017. Rising unit labor costs are putting upward pressure on inflation.

PNC expects job growth of 175,000 in April, including 170,000 in the private sector, when the Bureau of Labor Statistics releases the monthly employment report on May 4. According to the ADP national employment report, based on data from the payroll-processing firm, private-sector employment was up by 204,000 in April. Job growth averaged 202,000 per month in the first three months of this year, up from 182,000 per month for all of 2017. However, monthly job growth is likely to slow to around 180,000 for all of 2018 as the tight labor market makes it more difficult to hire. PNC is forecasting the unemployment rate to fall to 3.9 percent in April, down from 4.1 percent from October 2017 through March, thanks to solid job growth and weaker labor force growth in April.

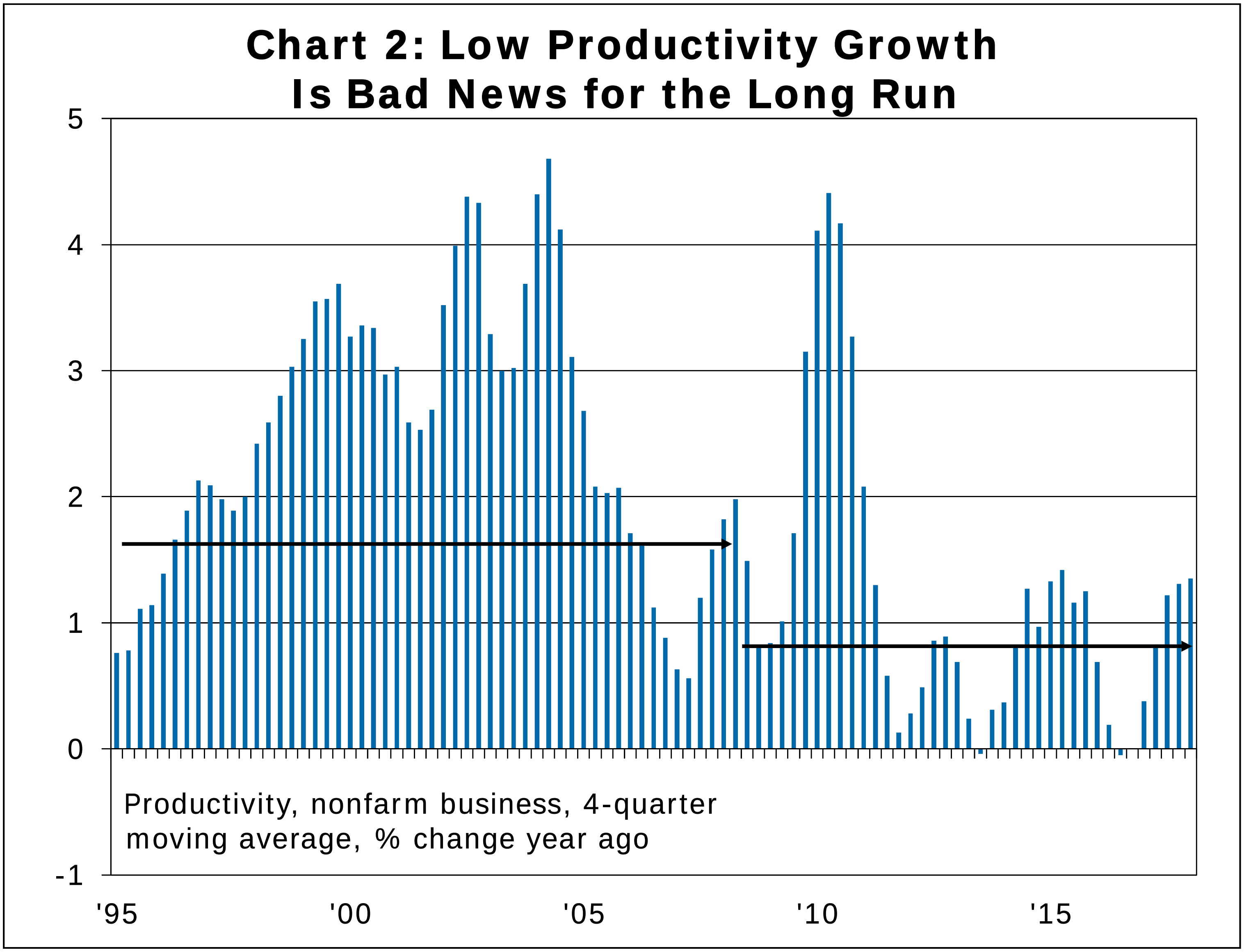

Chart source: Bureau of Labor Statistics

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