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ECONOMIC REPORT

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ECONOMY IN GOOD SHAPE AT END OF 2016; FOMC KEEPS RATES UNCHANGED IN EARLY 2017

SUMMARY

- Real GDP increased 1.9 percent in the fourth quarter, slightly weaker than the consensus expectation. Trade was a big drag at the end of the year.
- Although growth slowed from the third quarter, the economy expanded a solid 2.7 percent in the second half of 2016.
- Consumer spending rose 0.5 percent in December, while after-tax income rose 0.3 percent. Consumer spending will lead economic growth in 2017.
- Inflation remained below the Federal Reserve's target in 2016, but is set to gradually accelerate over the next couple of years.
- Private-sector employment rose a very solid 246,000 in January, according to payroll-processing firm ADP. PNC is forecasting job growth of 200,000 in the government employment report for January.
- The FOMC kept the fed funds rate unchanged at its early February meeting. The FOMC will gradually raise interest rates in 2017 and 2018.

The U.S. economy expanded 1.9 percent at an annual rate in the fourth quarter of 2016, according to the advance estimate of real GDP from the Bureau of Economic Analysis. This was below the consensus expectation for a 2.2 percent increase, and followed growth of 3.5 percent in the third quarter. Averaged across all of 2016, inflation-adjusted GDP rose 1.6 percent in 2016 from 2015, the slowest year of economic growth since 2011. A reduction in investment in inventories and a drop in capital spending on energy production were drags in the first half of 2016. But from the fourth quarter of 2015 to the fourth quarter of 2016 real GDP growth was a better 1.9 percent (see Chart 1). Growth in the second half of the year was a solid 2.7 percent annualized, up from 1.1 percent in the first half.

Compared to the third quarter, trade was the big drag. After exports grew 10 percent in the third quarter, thanks in part to a surge in soybeans sent abroad, exports fell 4.3 percent in the fourth quarter. At the same time imports rose a big 8.3 percent in the fourth quarter, as a stronger dollar led consumers and business to buy products from overseas. As a result trade subtracted a huge 1.7 percentage points from annualized growth in the fourth quarter, the biggest drag since 2010.

But demand remained solid. Consumer spending growth slowed somewhat in the fourth quarter, to 2.5 percent at an annual rate from an unsustainable pace of 3.5 percent in the third quarter, but this was still a decent number. Business investment rose a steady if unspectacular 2.4 percent in the fourth quarter, and investment in housing jumped 10.2 percent. Inventories, which had been a drag on growth in 2015 and early 2016, were a big contributor to growth in the second half of the year. Investment in inventories added a large 1.0 percentage point to growth in the fourth quarter, after adding 0.5 percentage point in the third quarter. The pace of inventory investment is set to slow in 2017. Government spending rose 1.2 percent at an annual rate in the fourth quarter, adding 0.2 percentage point to growth.

The U.S. economy was in decent, if unspectacular, shape at the end of 2016. Although the headline number was a bit softer than expected, conditions were generally favorable. Growth was somewhat overstated in the third quarter because of an unsustainably large increase in consumer spending and a temporary boost from trade. Growth slowed when those factors reversed in the fourth quarter. Consumer spending is steadily increasing thanks to job gains and wage growth, and will continue to lead economic growth in 2017, especially if Congress passes big cuts in personal income taxes. Housing

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and business investment will also be a positive for growth this year; corporate tax cuts and regulatory reforms could provide a boost to business capital spending. Trade will be a drag with the stronger dollar. Government could be a positive for growth this year and next if President Trump's proposals for greater investment in infrastructure come to pass.

PNC is forecasting 2.4 percent growth for all of 2017, and 2.7 percent growth for 2018, based on some fiscal stimulus from tax cuts and infrastructure spending and a larger federal budget deficit.

Personal income increased 0.3 percent in December, with after-tax income also up 0.3 percent. This was an acceleration from 0.1 percent growth in both measures in November, revised up from no increase. Wages and salaries were up 0.4 percent in December, thanks to job growth and higher wages.

Consumer spending rose 0.5 percent in December, the biggest increase since September. Durable goods purchases led the increase, up 1.4 percent over the month with very strong auto sales.

The personal consumption expenditures price index rose 0.2 percent in December, while the core PCE price index, excluding volatile food and energy prices, rose 0.1 percent. On a year-ago basis the overall PCE index was up 1.6 percent in December, an acceleration from 1.4 percent inflation in November and a recent low of 0.2 percent in September 2015 (see Chart 2). Core inflation was 1.7 percent year-over-year in December, unchanged from November and down from 1.8 percent in October. Inflation-adjusted after-tax income was up 0.1 percent in December, while real consumer spending was up 0.3 percent.

The private sector added 246,000 jobs in January, according to a report based on records from payroll-processing firm ADP. This was the biggest increase in ADP employment since June 2016. Job gains were broad-based across all firm sizes. Good-producing industries added 46,000 jobs in January, the biggest gain in two years, with increases in construction, manufacturing, and natural resources. Private service-producing industries added 201,000 jobs, including big increases in trade/transportation/utilities, professional/business services, and education/health services.

With the very strong ADP report, PNC has raised its forecast for 200,000 total net jobs added in the U.S. in January, all of them in the private sector, when the Bureau of Labor Statistics releases the government's official report on Friday, February 3. PNC also expects that the unemployment rate held steady in January at 4.7 percent.

The job market is in solid shape entering 2017. Monthly job gains averaged 180,000 last year, about double the pace of underlying growth in the labor force. Thus job market slack continues to decline and the U.S. economy should reach full employment this year. Wage growth is picking up as businesses find it more difficult to hire and raise wages in response. Monthly job growth should average around 180,000 this year as well.

Chart 1: Economy Picked Up at the End of 2016

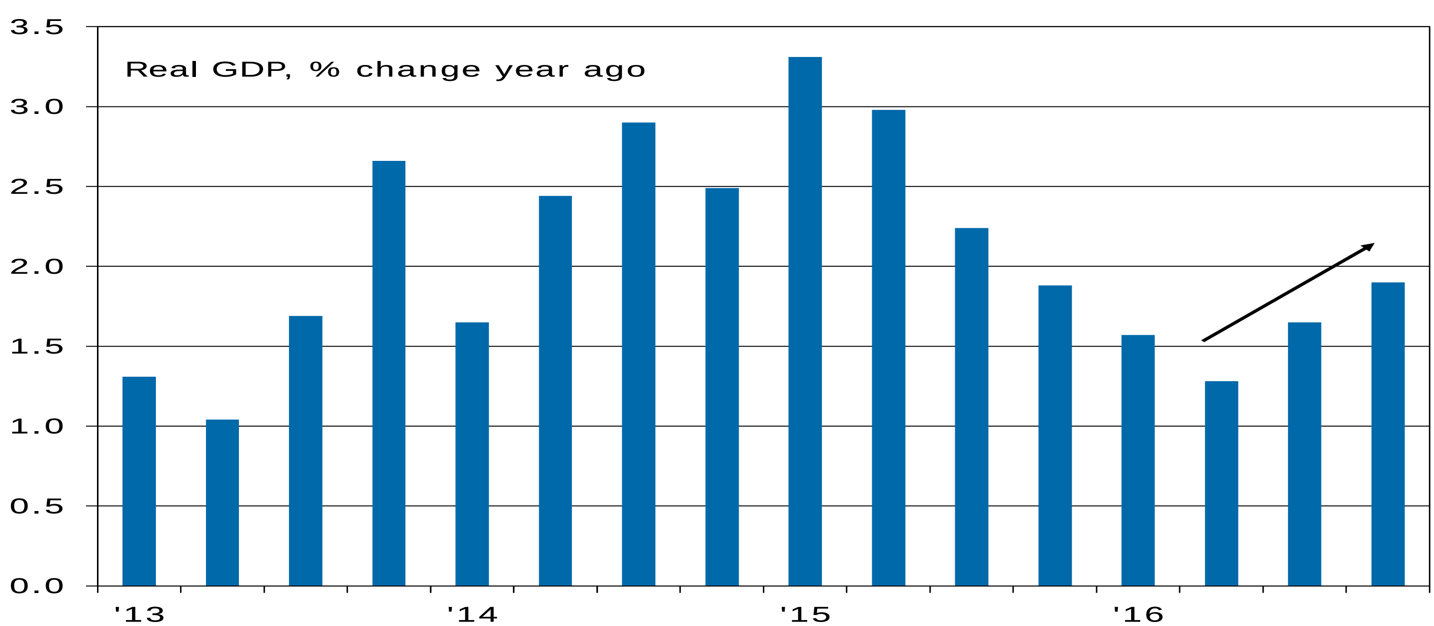

Chart source: Bureau of Economic Analysis

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As expected, the Federal Open Market Committee kept the federal funds rate unchanged in its February 1 policy statement, in a range of 0.50 to 0.75 percent. It raised the target range for the rate in mid-December by 25 basis points. The section of the statement on the outlook for monetary policy was unchanged from December 14. The FOMC expects only "gradual increases" in the fed funds rate, and said that it expects that the rate "is likely to remain, for some time, below levels that are expected to prevail in the longer run."

The FOMC also did not announce any changes to its plans for the Federal Reserve's balance sheet. The central bank's balance sheet expanded greatly in the aftermath of the financial crisis through mid-2014 as the Fed created money and used the funds to purchase long-term Treasuries and mortgage-backed securities to push down long-term interest rates, a process known as quantitative easing. There had been some speculation that the FOMC could use its statement to announce that it was rethinking its plans for the Fed's balance sheet. But the statement once again said that the Fed will continue to roll over maturing securities to purchase new ones, and expects to continue to do so "until normalization of the level of the federal funds rate is well underway."

The description of current economic conditions was positive. The statement noted that "the labor market has continued to strengthen and that economic activity has continued to expand at a moderate pace." The statement also noted that consumer and business confidence have improved in recent months. In the paragraph on the outlook, the statement used language from the prior statement that the labor market should continue to improve and that inflation should rise toward the Fed's 2 percent target in the medium term. However, the statement dropped a couple of sentences that were in the December 14 statement on below-target inflation; this suggests that the committee expects inflation to accelerate, and that low inflation is less of a concern. The statement said that risks to the outlook are roughly balanced.

The February 1 FOMC statement is consistent with PNC's forecast for two 25 basis point increases in the federal funds rate this year and four next year. This is close to the median of the FOMC's last Summary of Economic Projections (the "dot plot"), from the December 2016 meeting, which indicated three rate increases this year and three next year. Given that the labor market is close to full employment and the possibility of fiscal stimulus from the Trump Administration, risks are weighted toward more interest rate increases than called for in the forecast.

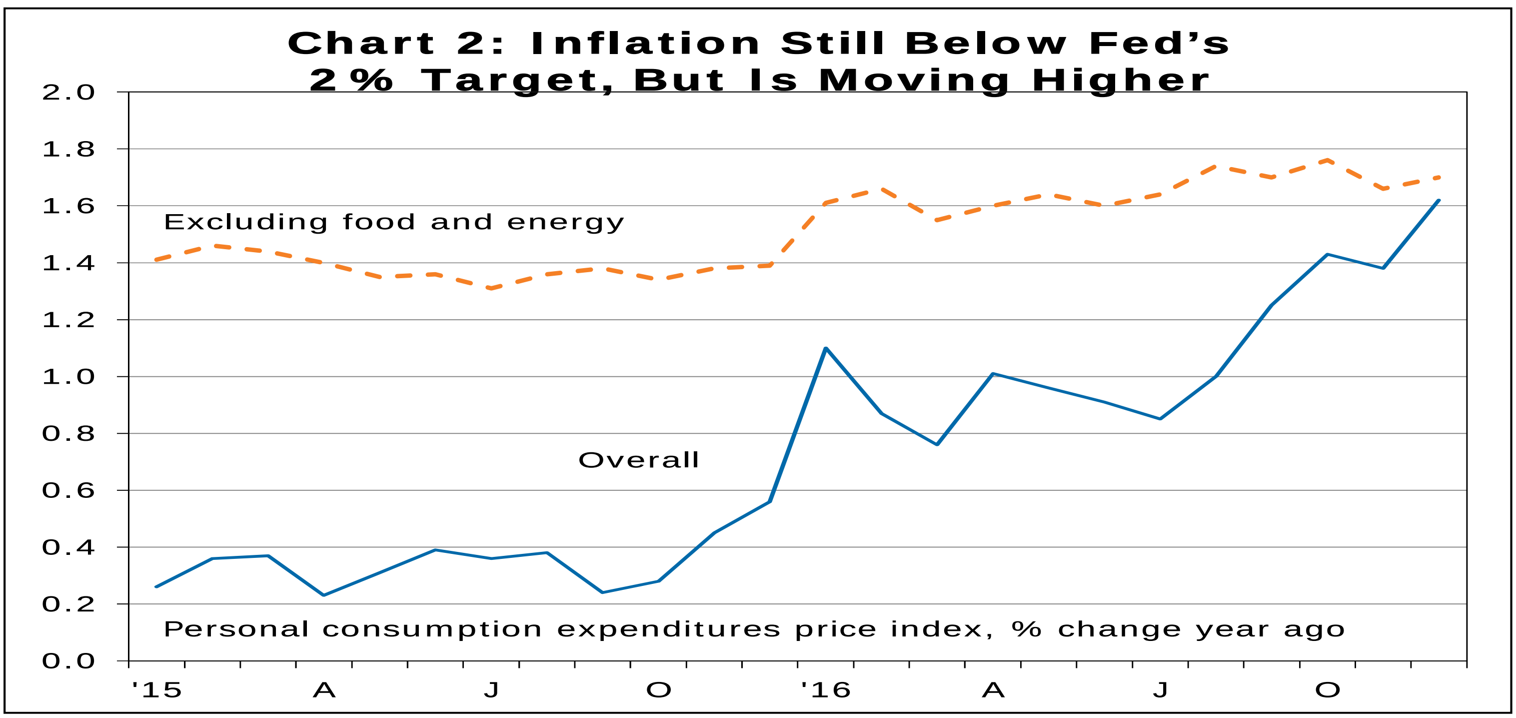

Chart source: Bureau of Economic Analysis

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