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ECONOMIC REPORT

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SOLID GROWTH AT END OF 2016, WITH GOOD FUNDAMENTALS IN EARLY 2017; INFLATION PICKING UP

SUMMARY

- Real GDP growth in the fourth quarter was revised slightly higher to 2.1 percent. Economic growth in the second half of 2016 was much stronger than in the first half.
- Real gross domestic income rose 1.0 percent in the fourth quarter of 2016.
- Profits rose 0.5 percent in the fourth quarter, held back somewhat by the VW settlement.
- Personal income rose 0.4 percent in February, with after-tax income up 0.3 percent.
- Consumer spending rose 0.1 percent in February.
- Inflation continues to gradually accelerate; this is supporting FOMC rate increases.
- Economic fundamentals remain solid in early 2017.

Real GDP growth in the fourth quarter of 2016 was revised higher in the third estimate, to 2.1 percent at an annual rate, from the 1.9 percent reported in the second estimate (and the advance estimate). This was a slowing from 3.5 percent growth in the third quarter, but that was not surprising given that the pace in the third quarter was unsustainable. The key point is that growth picked up in the second half of 2016, to 2.6 percent at an annual rate, from 1.0 percent in the first half (see Chart 1).

Compared to the second estimate, there were upward revisions to consumer spending and investment in inventories; these were somewhat offset by downward revisions to business fixed investment and exports.

Consumer spending led growth in the fourth quarter, with contributions from inventories, homebuilding, and business fixed investment. Trade was a huge drag, in part due to a surge in soybean exports in the third quarter than reversed in the fourth quarter. Government was neutral for growth in the fourth quarter.

This was the first release on real gross domestic income for the fourth quarter. Real GDI, an alternative measure of the size of the economy based on incomes of households and firms, rose 1.0 percent in the fourth quarter at an annual rate, but this followed a very large increase of 5.0 percent in the third quarter. Real GDPI was up 1.9 percent in the fourth quarter from one year earlier.

This was also the first release on corporate profits for the fourth quarter. They were $2.150 billion at an annual rate, not adjusted for inflation, up 0.5 percent from the third quarter (not annualized). Profits for domestic industries fell in the fourth quarter, but this was more than offset by higher profits from abroad. The settlement between the U.S. subsidiary of automaker Volkswagen and the federal and state governments over emissions tests depressed profits; otherwise they would have risen 1.4 percent. Profits were up 9.3 percent in the fourth quarter from one year earlier, in large part because of smaller losses at energy companies. Profits were stronger in financial services over the year.

Personal income rose a solid 0.4 percent in February, matching the consensus. After-tax income rose 0.3 percent over the month. Wages and salaries were up a strong 0.5 percent in February, due to job growth and higher wages.

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Consumer spending growth was weaker, up 0.1 percent. Spending on durable goods fell 0.1 percent, with spending on nondurable goods flat. Spending on services rose 0.1 percent. A warmer-than-usual winter depressed utilities spending in February, and delays in processing tax refunds this year may also have weighed on spending during the month. With after-tax income up more than spending, the personal saving rate rose to 5.6 percent in February, from 5.4 percent in January.

The personal consumption expenditures price index, the Federal Reserve's preferred inflation measure, was up 0.1 percent in February. The core PCE price index, excluding volatile food and energy prices, rose 0.2 percent over the month. On a year-ago basis overall PCE inflation was 2.1 percent in February; this is the first time overall inflation has been above the Fed's 2 percent target since April 2012 (see Chart 2). Inflation has accelerated from a recent low of 0.2 percent in the fall of 2015 as energy prices have moved higher. Core inflation was 1.8 percent year-over-year in February; with recent revisions to the inflation data, it has been between 1.7 and 1.8 percent for the past half-year, up from 1.3 percent in mid-2015.

Consumer spending will continue to lead economic growth throughout 2017. Spending was a bit soft in February, but that was due primarily to one-time factors, the weather and delayed tax refunds. Those drags should lift, and the fundamentals for spending are solid. Incomes will rise with job gains of around 170,000 per month this year, and wage growth will accelerate as the tighter labor market leads firms to raise pay.

The first quarter of 2017 will look soft, with growth of just 1.1 percent. Some of this softness is due to seasonal adjustment issues that will reverse later in the year. But GDP growth should be 2.3 percent for all of 2017, up from 1.6 percent in 2016, and the U.S. economic expansion will

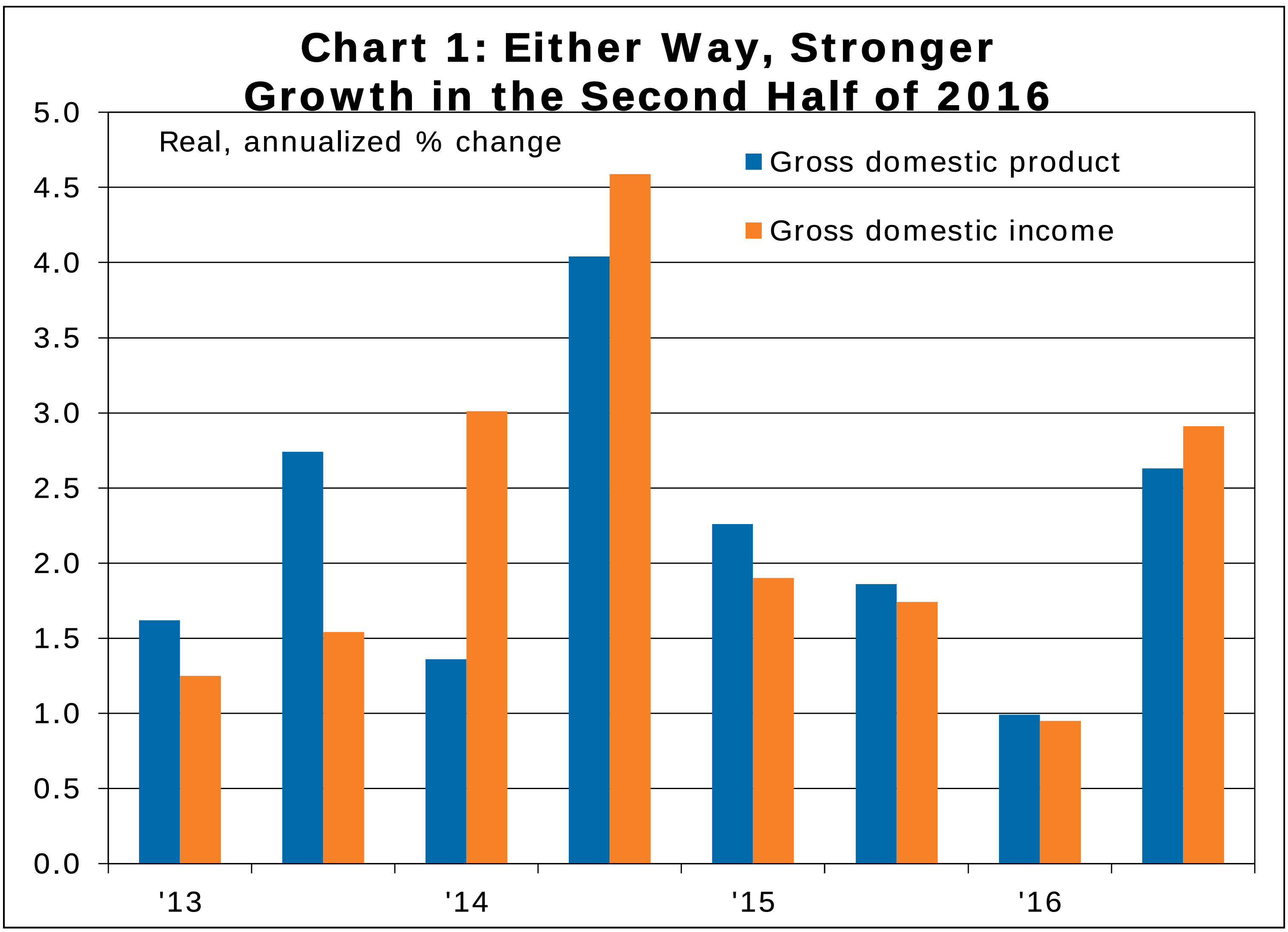

Chart source: Bureau of Economic Analysis

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continue for an eighth straight year. Consumer spending will lead growth thanks to higher incomes from more jobs and rising wages, as well as likely tax cuts, and housing will be another positive for the domestic economy. Trade will be a drag, however, because of the stronger U.S. dollar.

The ongoing slow acceleration in inflation will support further gradual increases in the federal funds rate from the Federal Open Market Committee. Overall inflation in February moved above the Fed's 2 percent target for the first time in almost five years, and core inflation is slowly moving toward the target as well. The 2 percent is a target, not a ceiling, so the FOMC will still be comfortable raising rates only gradually even if inflation temporarily moves a bit above 2 percent.

The FOMC raised the fed funds rate by 0.25 percentage point on March 15, to a range of 0.75 to 1.00 percent. After keeping the rate in a range of 0.00 to 0.25 percent from late 2008 to late 2015, and then holding it steady in a range of 0.25 to 0.50 percent for a year, the FOMC has now raised the rate at two of its last three meetings. After a decade of highly expansionary monetary policy, normalization is now underway. PNC expects two more fed funds rate increases this year, in June and December, consistent with FOMC projections. The pace of rate hikes will be gradual compared to previous tightening cycles.

Chart 2: Inflation Picking Up, Close to Fed's 2% Target

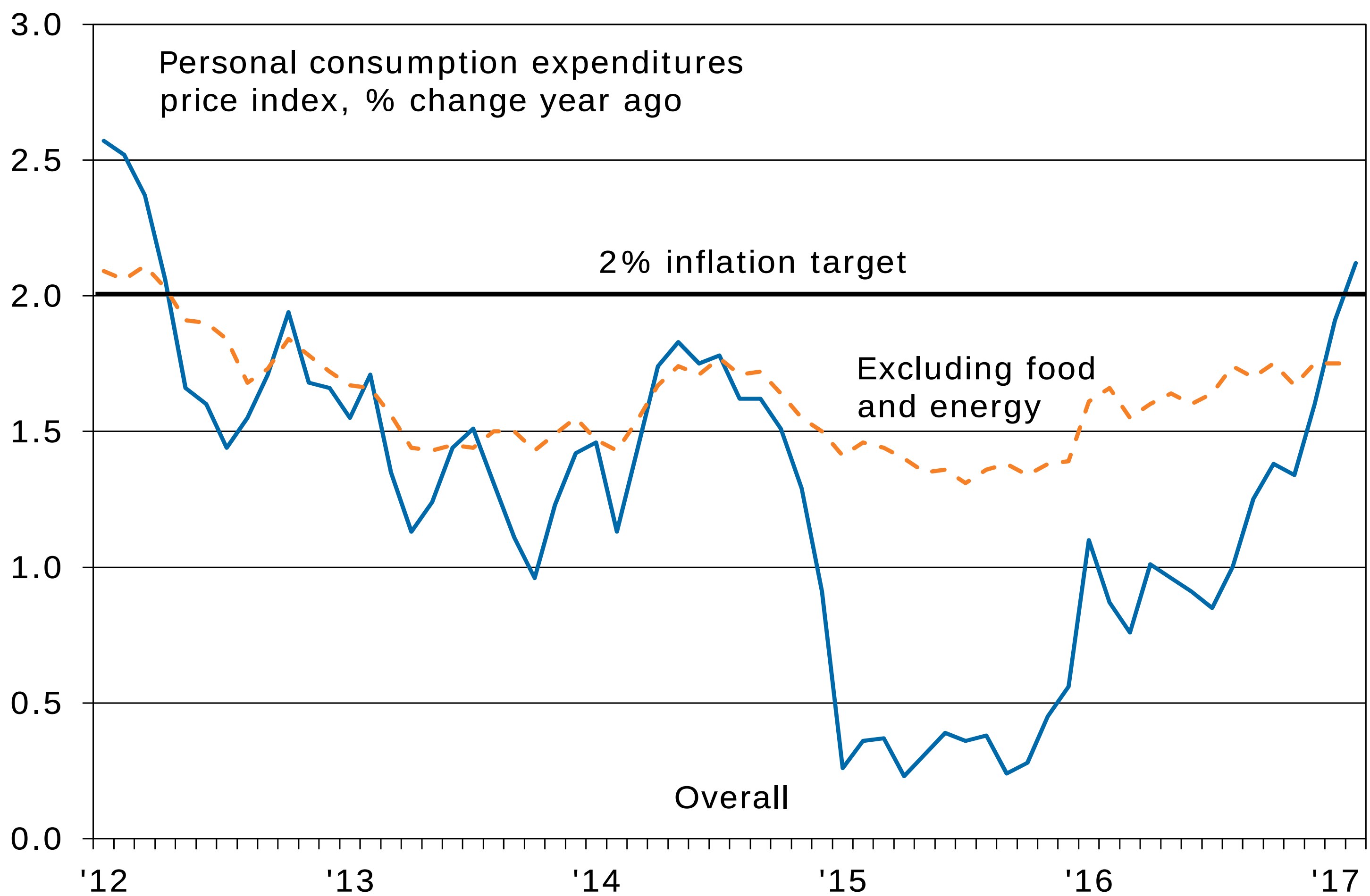

Chart source: Bureau of Economic Analysis

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