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ECONOMIC REPORT

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GOOD BUT NOT GREAT GROWTH IN FIRST QUARTER; TIGHT LABOR MARKET PUSHING UP WAGES

SUMMARY

- The U.S. economy grew 2.3 percent in the first quarter of 2018, better than expectations but slower than in previous quarters.
- Details on GDP were mixed.
- The BEA has had troubles with seasonal adjustment, and growth in the first quarter has been weaker than in other quarters for years.
- Private-sector wages grew at their fastest pace in more than a decade in the first quarter, according to the Employment Cost Index. The tight labor market is putting upward pressure on wages.
- The acceleration in labor cost growth supports an increase in the federal funds rate at the FOMC's June meeting.

The U.S. economy expanded 2.3 percent at a seasonally-adjusted annualized rate in the first quarter of 2018. Although this was softer than the average 3 percent growth over the previous three quarters (see Chart 1), it was better than the 2.0 percent consensus and the 1.8 percent forecast from PNC. Real GDP was up 2.9 percent from one year earlier in the first quarter, the biggest year-over-year gain since the second quarter of 2015.

However, the details were a bit weaker than the headline number. Inventories added 0.4 percentage point to growth, after being a big drag in the fourth quarter of 2018. Thus final sales of domestic product, which is GDP minus the change in inventories and measures domestic and foreign demand for goods and services produced in the United States, increased 1.9 percent at an annual rate in the first quarter.

Real personal disposable income rose a very good 3.4 percent annualized in the first quarter, bolstered by personal income tax cuts. However, despite the boost to after-tax incomes from tax cuts, consumer spending rose just 1.1 percent at an annual rate in the first quarter, the smallest gain in almost five years. Some of the weakness came from lower auto sales early in the year, but other components of consumer spending were also soft. Consumer spending added 0.7 percentage point to growth, about one-fourth of its contribution in the fourth quarter of 2017.

Business fixed investment was better, expanding 4.6 percent and adding 0.8 percentage point to growth. There was an especially big increase is commercial construction. Housing investment was unchanged in the first quarter, but this followed a big gain in late 2017 with reconstruction after last year's hurricanes. Trade was a small positive for growth, adding 0.2 percentage point. Exports rose more than imports, so the trade deficit narrowed in the first quarter. Government also added 0.2 percentage point to growth, with contributions from both federal and state and local spending.

The GDP price index rose 2.0 percent at an annual rate in the first quarter. The personal consumption expenditures price index increased 2.7 percent, while the core PCE price index (excluding food and energy) rose 2.5 percent. Both of these are above the Federal Open Market Committee's 2 percent inflation goal, but inflation remains below 2 percent on a year-over-year basis, although it is gradually picking up.

GDP growth was solid in the first quarter, but was a bit softer after taking inventories into account. However, growth in the first quarter has been consistently weaker than in the other three quarters of the year; since 2000 first-quarter growth has averaged 1.1 percent, compared to 2.2 percent in the other three quarters. It appears that the Bureau of Economic

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Analysis has been having difficulty in fully adjusting for seasonal variation in the data.

Putting it all together the first quarter GDP report was good but not great. The current economic expansion is now in its 106th month, according to the National Bureau of Economic Research, putting it in a tie for the second-longest expansion in U.S. history. The expansion will continue through the rest of 2018, and has a shot at lasting a full decade, which would make it the longest U.S. expansion ever. Consumer spending will bounce back as job gains, wage gains, and tax cuts support purchases. Business investment will get a boost from good corporate profits, the corporate income tax cut, and a tight labor market that is encouraging business spending to make workers more productive. Housing will also be a positive as the recovery from the Great Recession continues. Trade will be a negative, despite an expanding global economy, as imports increase more than exports. Government will also add to growth this year as a result of the recent deal in Congress to raise caps on discretionary federal spending.

PNC expects real GDP growth of 2.8 percent in 2018 and 2.9 percent in 2019, averaged across the four quarters of the year. On a year-over-year basis growth will accelerate to above 3 percent in late 2018 and early 2019, before slowing later next year as the impact of fiscal stimulus wears off.

The Employment Cost Index rose 0.8 percent in the first quarter of 2018. The ECI tracks worker compensation, controlling for changes in industry and occupational mixes. Most notably, wages in the private sector rose 1.0 percent in the quarter, the biggest increase since 2007. Public-sector wages rose 0.4 percent in the first quarter. Benefits costs rose 0.7 percent, including a 0.8 percent increase in the private sector.

On a year-over-year basis compensation was up 2.7 percent in the first quarter, the same pace as in the fourth

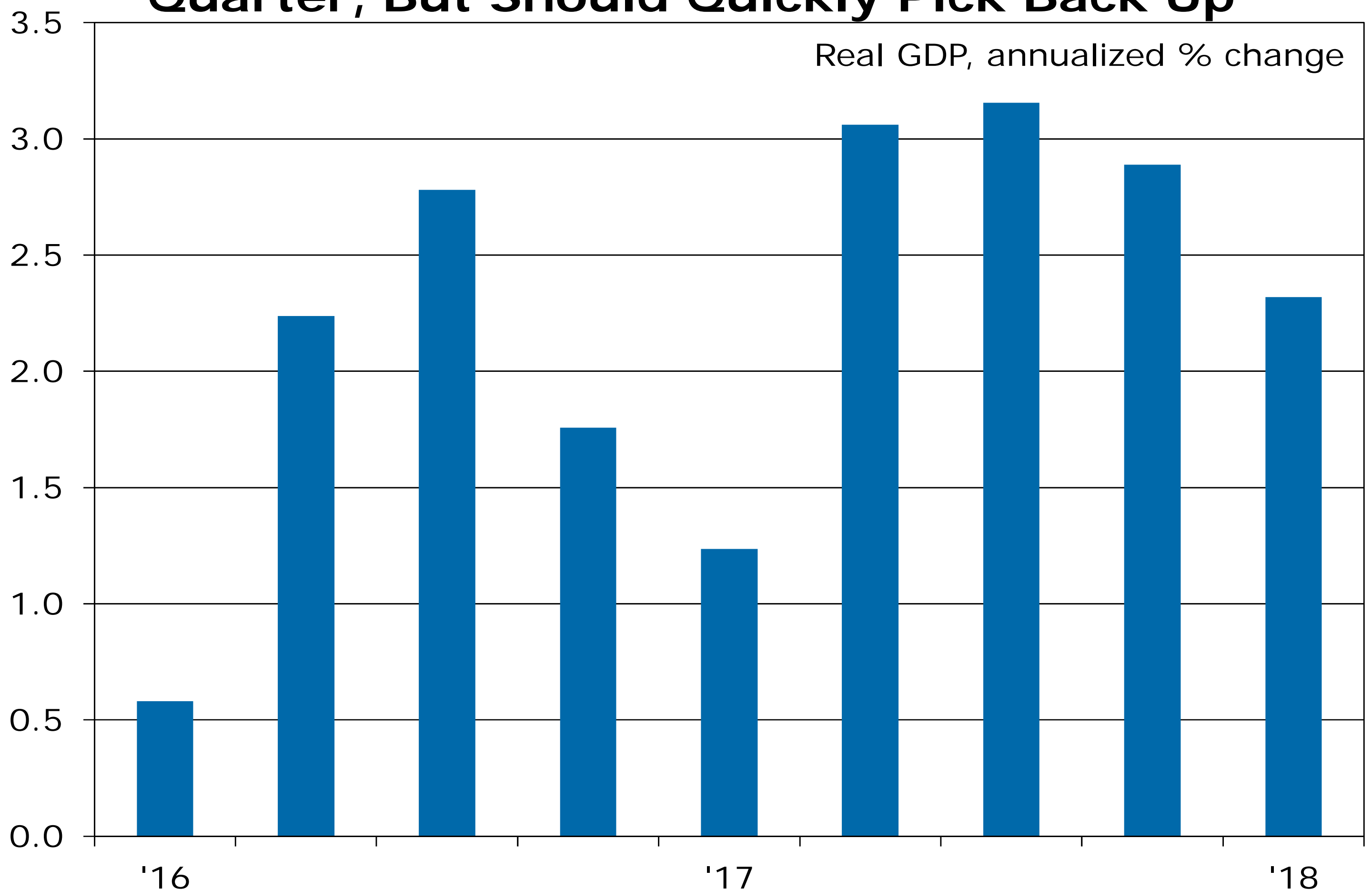

Chart source: Bureau of Economic Analysis

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quarter of 2017. But private-sector wages were up 2.9 percent in the first quarter from one year earlier, the fastest rate of increase since 2008 (see Chart 2).

With the job market continuing to tighten, businesses are raising pay to retain their current workers and attract new ones. This is consistent with PNC's spring small business survey, which found one-half of small and medium-sized businesses expecting to increase worker compensation over the next six months.

The tight labor market and rising wage pressures will lead the Federal Open Market Committee to raise the federal funds rate at its June meeting. Although inflation is below the FOMC's 2 percent goal on a year-ago basis, the committee wants to prevent rising wage pressures from quickly pushing inflation well above 2 percent. At the same time the FOMC wants to encourage a strong labor market that allows workers to enjoy stronger wage growth. The FOMC will continue to gradually push interest rates higher through the rest of 2018 and into 2019. In addition to the June fed funds rate increase, PNC expects another fed funds rate hike in December. But if inflation pressures build more rapidly than expected, the FOMC could raise the fed funds rate three more times this year, in June, September, and December.

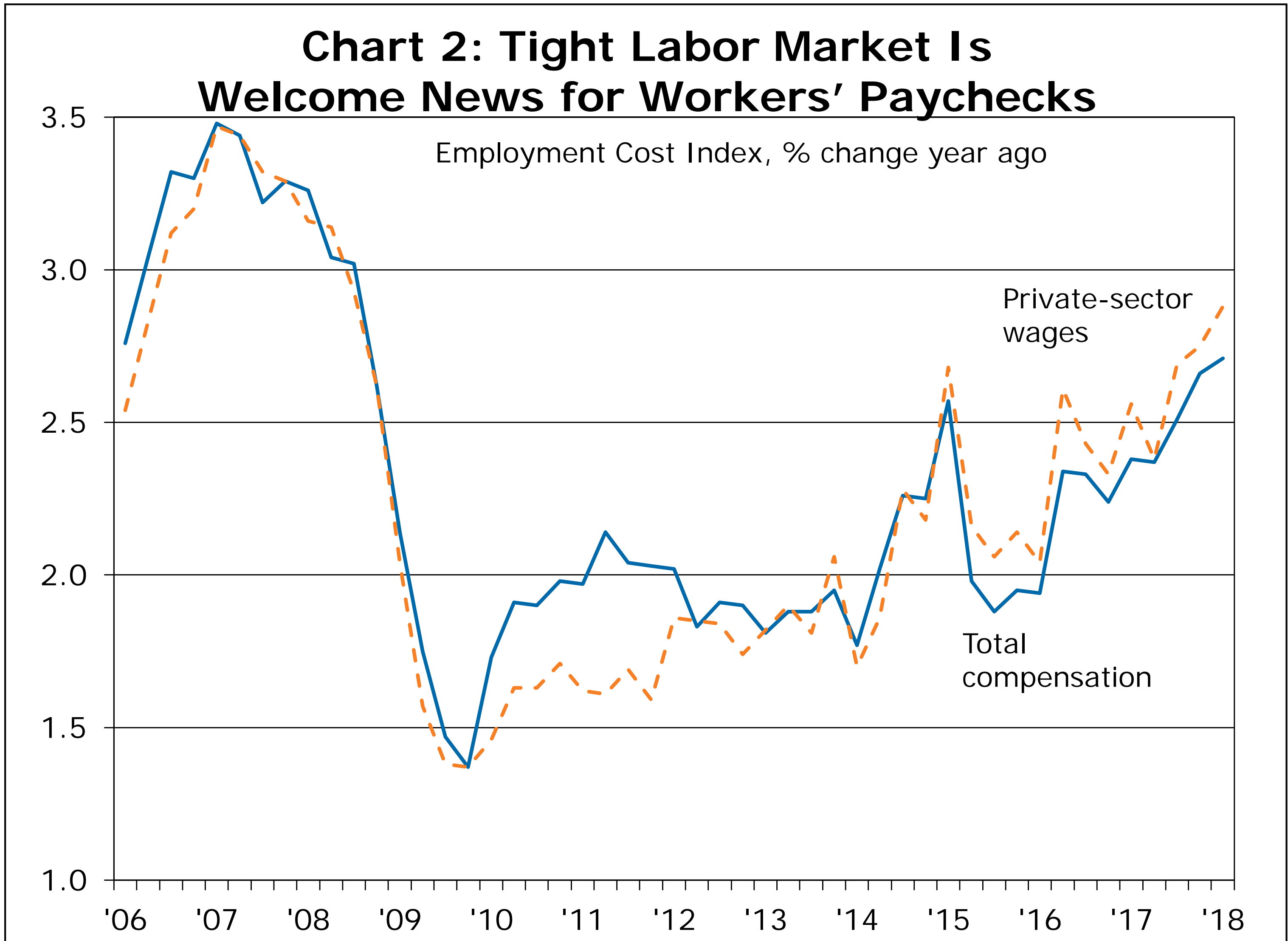

Chart source: Bureau of Labor Statistics

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