October 28, 2016

ECONOMIC REPORT

Stuart Hoffman
Chief Economist

Gus Faucher
Deputy Chief Economist

William Adams
Senior Economist

Kurt Rankin
Economist

Mikael Tahoma
Economist

THE PNC FINANCIAL SERVICES GROUP | the Tower at PNC Plaza | 300 Fifth Avenue | Pittsburgh, PA 15222-2401

GROWTH BOUNCES BACK IN THIRD QUARTER, SUPPORTING CASE FOR DECEMBER FED RATE HIKE

SUMMARY

- Real GDP increased 2.9 percent in the third quarter, the best performance for the U.S. economy in two years.
- A rebound in investment in inventories led to the acceleration of growth in the third quarter.
- Average labor compensation rose 0.6 percent in the third quarter, with wages up 0.5 percent, according to the employment cost index.
- A tighter labor market is slowly pushing up wages.
- The fundamentals for the U.S. economy remains solid, and consumer spending will continue to drive economic growth into 2017.
- The FOMC is likely to raise the fed funds rate at its mid-December meeting.

Real GDP increased 2.9 percent at an annual rate in the third quarter, the largest increase since the third quarter of 2014, according to the advance estimate from the Bureau of Economic Analysis. It was also an acceleration after weak growth of 1.4 percent in the second quarter, and just 1.0 percent annualized over the three previous quarters (see Chart 1). Compared to the second quarter, the acceleration in GDP came from a rebound in investment in inventories, stronger growth in exports, a smaller decline in state and local government spending, and an increase in federal government spending. These were somewhat offset by slower growth in consumer spending and a bigger increase in imports. The consensus was for a 2.5 percent increase.

Consumer spending rose 2.1 percent at an annual rate in the third quarter, adding 1.5 percentage points to annualized growth, but down from 4.3 percent growth in the second quarter. This slowing was expected after the unsustainably strong increase in the second quarter. Business fixed investment rose 1.2 percent annualized in the third quarter, adding 0.2 percentage point to growth in the third quarter, with positive contributions from structures and intellectual property products, but a drag from equipment. The downturn in investment in energy production remained a weight in the third quarter but that drag is nearing an end as crude oil prices stay near $50 per barrel. Residential construction subtracted 0.2 percentage point from growth, the second consecutive decline; a lack of skilled construction workers may be part of the problem. We expect residential construction to rebound in the next two quarters.

Inventories added 0.6 percentage point to growth in the third quarter, after five straight quarters of subtracting from growth. Businesses got ahead of themselves in 2014, leading to too much inventory. A gradual inventory correction more recently has been weighing on growth, but that has likely come to an end. With inventories adding to growth, final sales of domestic product, which is GDP minus the change in inventories and measures demand for U.S.-produced goods and services, rose a moderate 2.3 percent at an annual rate in the third quarter.

Trade added 0.8 percentage point to growth in the third quarter, the biggest positive contribution since the fourth quarter of 2013. Exports rose 10 percent at an annualized rate in the third quarter, while imports rose 2.3 percent (higher imports reduce GDP). The boost from trade will not persist as global economic growth remains soft. Government added 0.1 percentage point to growth in the third quarter, with an increase in federal spending more than offsetting a small decline in state and local spending.

The GDP price index rose 1.5 percent annualized in the third quarter, down from 2.3 percent in the second quarter. The

GROWTH BOUNCES BACK IN THIRD QUARTER, SUPPORTING CASE FOR DECEMBER FED RATE HIKE

personal consumption expenditures price index, the Federal Reserve's preferred inflation measure, rose 1.4 percent at an annual rate in the third quarter, a slowing from 2.0 percent inflation in the second quarter. The core PCE price index, excluding volatile food and energy prices, was up 1.7 percent per annum in the third quarter, and also up 1.7 percent from a year ago. The Federal Reserve has set an inflation target of 2.0 percent using the PCE price index.

Employee compensation rose 0.6 percent in the third quarter, according to the employment cost index from the Bureau of Labor Statistics, which measures worker compensation, controlling for changes in industry and occupational structure. This was the third straight quarter of 0.6 percent growth in compensation, and the increase matched the consensus. Wages rose 0.5 percent, with benefits up 0.7 percent. Total private-sector compensation rose 0.5 percent in the third quarter, with both private-sector wages and benefits up 0.5 percent.

Private-sector wages were up 2.4 percent in the third quarter from one year earlier, down from 2.6 percent growth in the second quarter, but up from 2.0 percent in the first quarter. Total private-sector compensation was up 2.3 percent in the third quarter, and has picked up from 2015 (see Chart 2).

The ECI demonstrates that the tighter job market is slowly pushing wages higher as firms compete for employees. This is good news for workers and for consumer spending. Consumers are leading the U.S. economy now, thanks to job gains and stronger wage growth. Wage growth will continue to accelerate into 2017 as businesses find it more difficult to hire workers as the job market gets tighter.

The U.S. economy is expanding at a moderate pace. Growth over the past year was 1.5 percent, up from 1.3 percent in the second quarter, and should continue to pick up over the next couple of quarters. The drag from the inventory correction is over, and with a stabilization in

Chart 1: Growth Picks Up After Three Soft Quarters

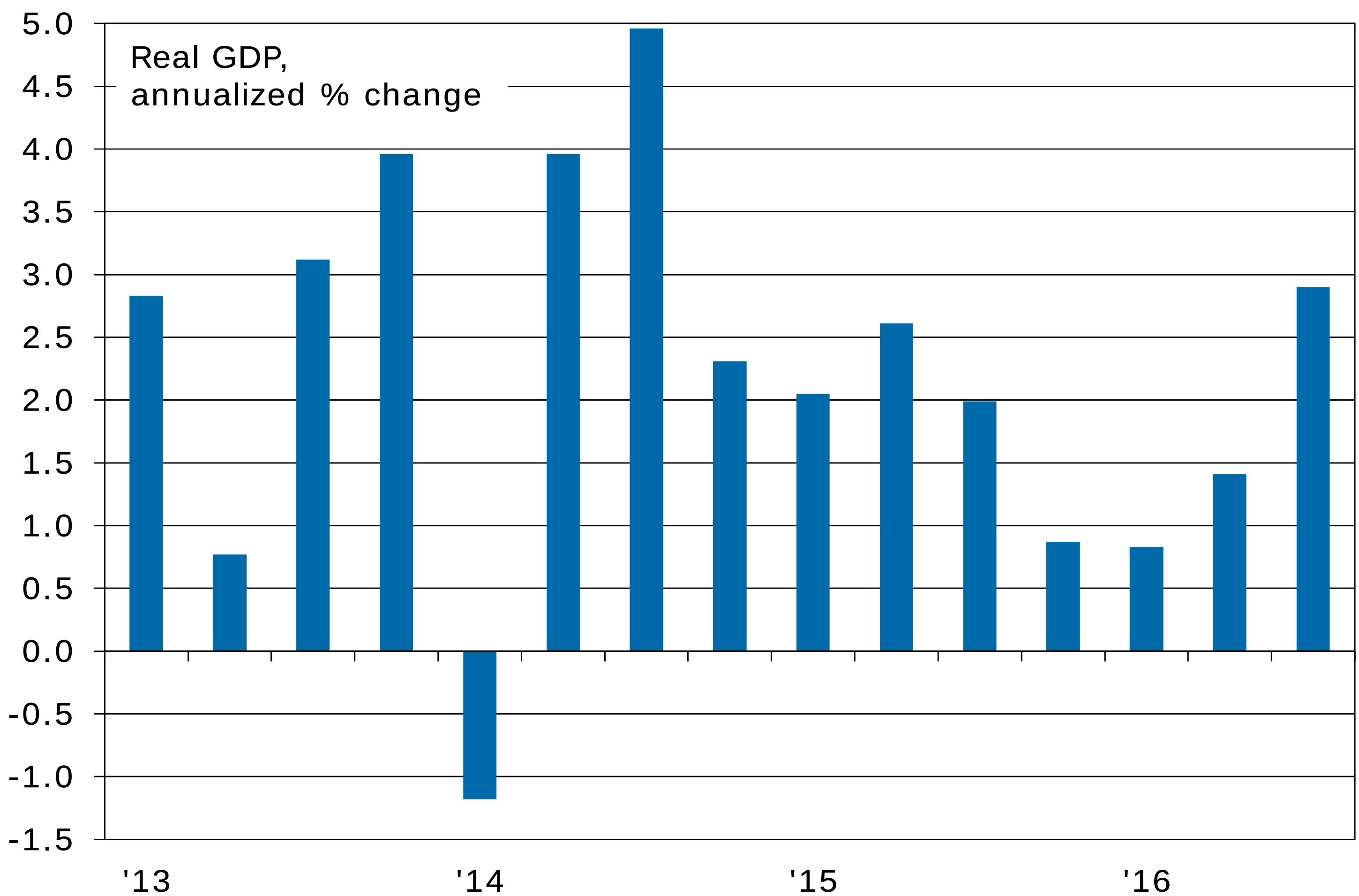

Chart source: Bureau of Economic Analysis

GROWTH BOUNCES BACK IN THIRD QUARTER, SUPPORTING CASE FOR DECEMBER FED RATE HIKE

energy prices, the weight from reduced energy production will also abate. Consumer spending will continue to lead economic growth in the near term, as job and wage gains allow households to boost their purchases. Housing and business investment will also be positives for growth. Trade will be a drag on growth, despite the stabilization in the dollar, because of a weak global economic expansion. PNC is forecasting real GDP growth of 2.3 percent annualized in the fourth quarter of this year, and then 2.3 percent for all of 2017, close to the economy's long-run potential.

The good GDP report and building wage pressures as shown in the ECI reinforce the case for an increase in the federal funds rate before year-end. An increase is unlikely at the Federal Open Market Committee's meeting next Tuesday and Wednesday, just a week before the presidential election. But an acceleration in growth in the third quarter, as well as continued improvement in the labor market and indications of higher inflation, will lead the FOMC to boost the federal funds rate by 0.25 percentage point at its meeting on December 13 and 14, to a range of 0.50 to 0.75 percent.

Chart 2: Tighter Labor Market Is Pushing Up Wages

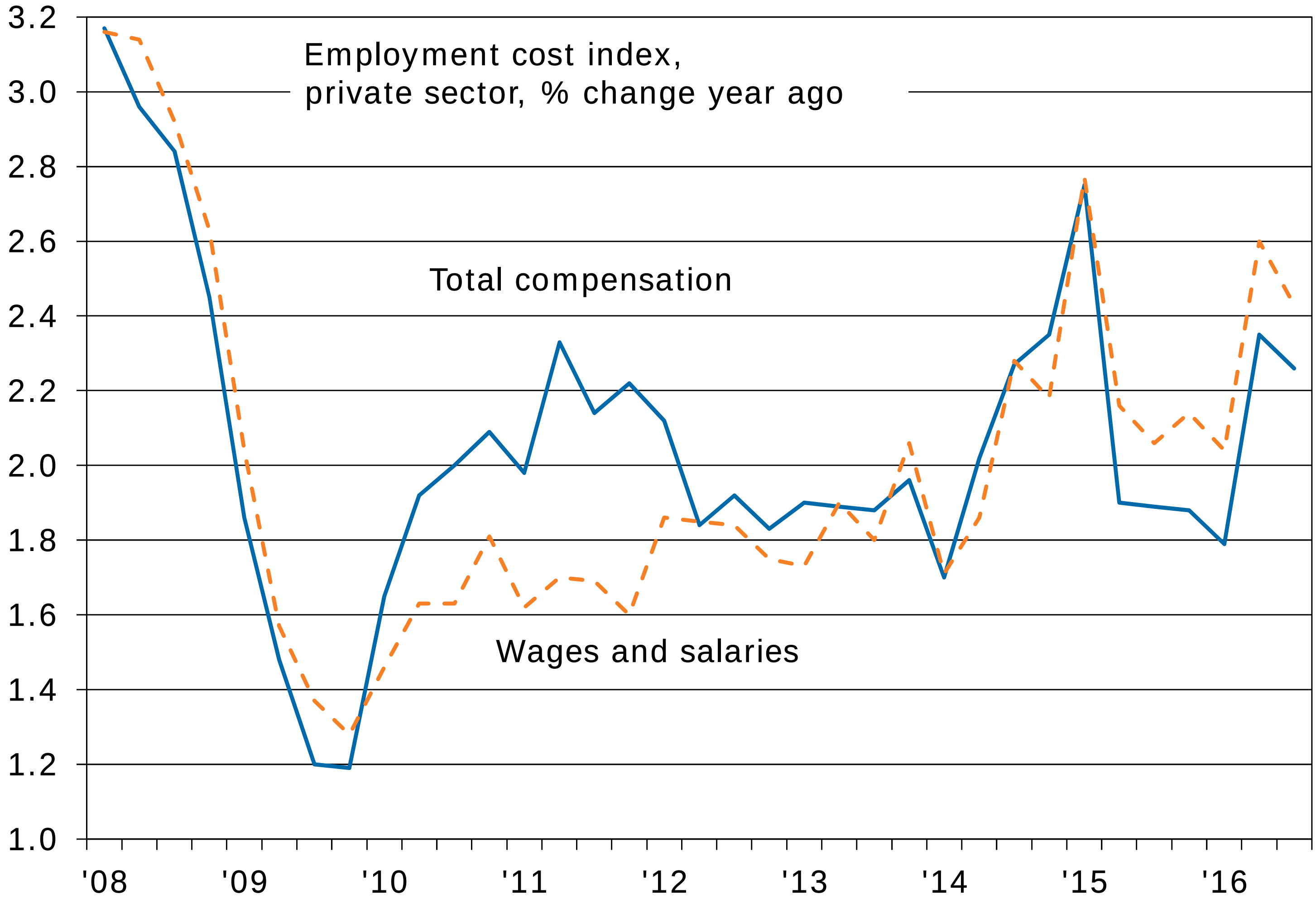

Chart source: Bureau of Labor Statistics

Visit http://www.pnc.com/economicreports to view the full listing of economic reports published by PNC's economists.