June 20, 2017

ECONOMIC REPORT

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INDUSTRIAL SECTOR FLAT IN MAY ON LOWER AUTO PRODUCTION; HOMEBUILDING TAKES A BREATHER

SUMMARY

- Industrial production was flat in May, following a big increase in April, with manufacturing production down 0.4 percent for the month.
- Housing starts and permits both declined in May from April, and have been flat in 2017.
- The National Association of Homebuilders housing market index slipped in June. Housing demand remains strong but supply is constrained.
- Initial claims for unemployment insurance fell by 8,000 in the week ending June 10, to a very low 237,000. The 4-week moving average of claims ticked up slightly.
- Consumer sentiment declined in May, although it remains high.

Industrial production was flat in May from the month earlier, but this followed a big 1.1 percent gain in April (revised up from 1.0 percent). There was a downward revision to industrial production growth in March (to 0.1 percent from 0.4 percent), and an upward revision to February (to a 0.3 percent increase from 0.2 percent).

Manufacturing production fell 0.4 percent in May, following a 1.1 percent increase in April. A 1.0 percent drop in output of autos and parts led manufacturing lower in May, although that decline followed a more than 4 percent jump in April. Mining production rose 1.6 percent in May, and utilities output rose 0.4 percent.

The overall capacity utilization rate fell slightly to 76.6 percent in May, from 76.7 percent in April. The manufacturing rate fell to 75.5 percent from 75.8 percent over the month, while the mining rate rose to 84.3 percent from 83.2 percent and the utilities rate rose to 76.6 percent from 76.3 percent.

Although industrial production was unchanged from April to May, the general trend is higher. Production was up 2.2 percent in May from a year earlier. Industrial output fell 4 percent from late 2014 to early 2016 as a strengthening dollar and a plunge in energy prices weighed on the industrial sector, including a steep 18 percent drop in mining production. But now that energy prices have largely stabilized, and so has the dollar, the industrial side of the economy has come back a bit. In particular, mining production has increased by 9 percent over the past eight months. Stronger demand from the mining industry, an end to the strengthening of the dollar, and demand from consumers and businesses have supported manufacturing.

The capacity utilization rate is also rising, but it remains low on a historical basis. Pricing pressures generally start to accelerate when the utilization rate hits 80 percent, and so the current low rate is restraining inflation.

PNC is forecasting industrial production to grow 1.5 percent this year, after a decline of 1.7 percent in 2016. Growth should then accelerate to 2.5 percent in 2018. There is also upside potential for the industrial sector over the next few years if Congress and the Trump administration can work together to pass a large infrastructure spending package.

Initial claims for unemployment insurance fell by 8,000 in the week ending June 10 to 237,000. Claims for the prior week were unrevised. The four-week moving average, which smooths out some of the volatility, ticked up by 1,000 to 243,000.

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Although the May jobs report had disappointed, the claims data show that the labor market is not softening. The U.S. economy added just 138,000 workers in May, below the average pace of 187,000 jobs per month in 2016. But firms are not laying off workers. Claims are at their lowest level since 1973, and as measured as a share of the labor force are at their lowest ever (see Chart 1). And there were a record 6.044 million job openings in the U.S. in April, according to the latest Job Openings and Labor Turnover Survey. Employers are having difficulty finding the right workers, leading them to hang on to their employees.

PNC expects the labor market to continue to tighten through the remainder of 2017, with the economy hitting full employment later this year. Average monthly job growth will slow to around 130,000 in 2017, but this will be more from a lack of available workers than weaker demand.

Housing starts fell 5.5 percent in May from April, to 1.092 million units at a seasonally-adjusted annualized rate, the third consecutive monthly decline. March and April starts were revised lower as well. Single-family starts fell 3.9 percent in May, to 794,000. Permits also fell for a third straight month in May, down 4.9 percent to 1.168 million. Multifamily and single-family permits fell 4.9 percent and 1.9 percent, respectively.

The softer housing data are concerning. After expanding from 2011 to 2016, starts and permits have both been down in 2017 (see Chart 2). Residential building contributed to economic growth over the past few years and if it is indeed slowing, that would weigh on the economic expansion. Nevertheless, it is too soon to declare an end to housing's recovery from the Great Recession. Demand for housing is generally sturdy, thanks to job gains, wage growth, and better access to mortgage credit. Millennial adults, who had been sidelined for much of the recovery from the Great Recession, are increasingly participating in the housing market as the job market improves. This adds upside potential for home sales and housing starts.

The constraints on the housing sector are coming from the supply side. A shortage of construction workers is weighing on the construction industry, and in some parts of the country, particularly the West and Northeast, short supply of land to build on is also a factor. It could also be that the

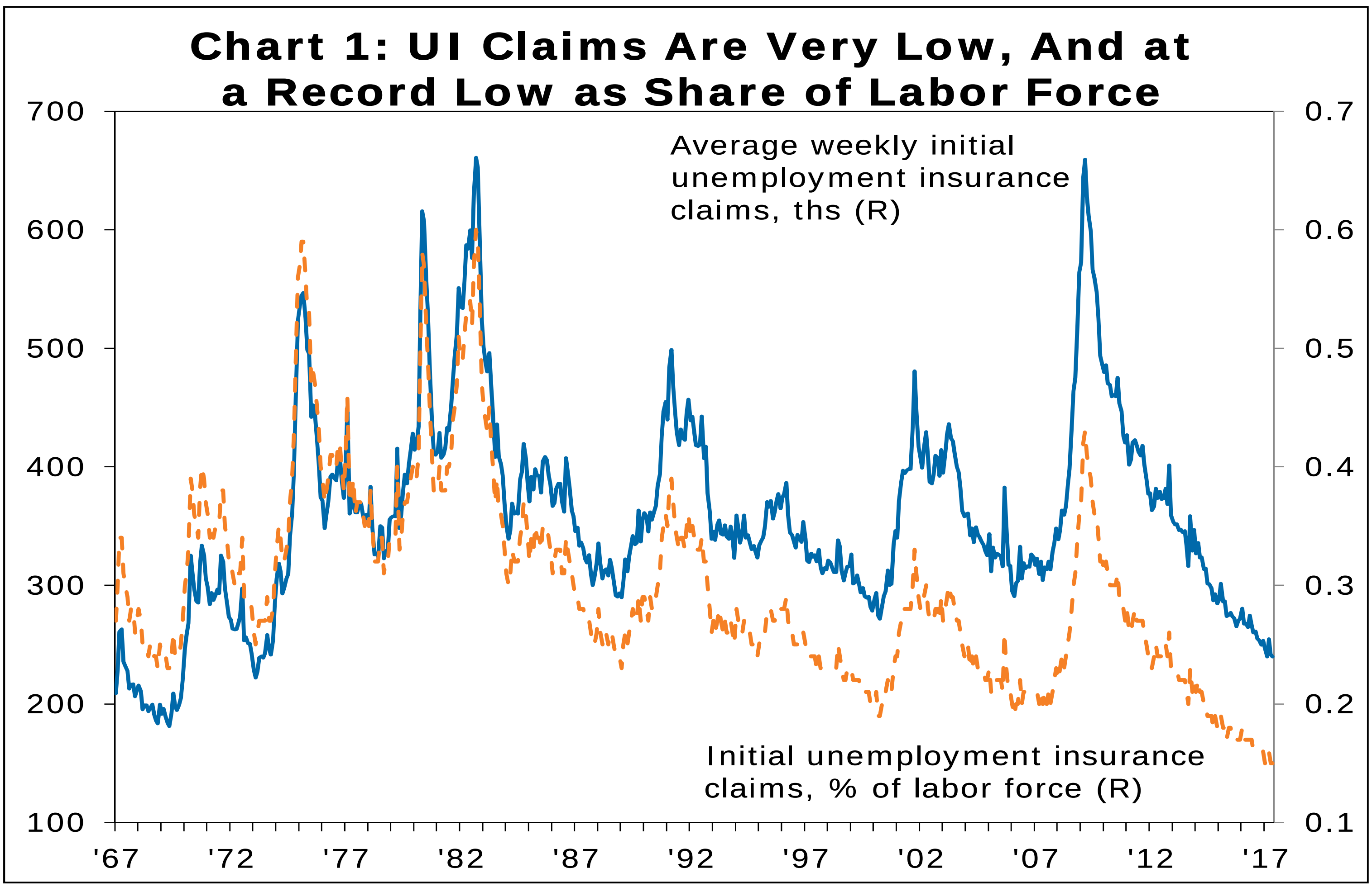

Chart sources: Employment and Training Administration, Bureau of Labor Statistics

INDUSTRIAL SECTOR FLAT IN MAY ON LOWER AUTO PRODUCTION; HOMEBUILDING TAKES A BREATHER

increase in mortgage rates since the summer of 2016 has been a drag on purchases of new homes.

PNC expects single-family housing starts to increase 8.4 percent in 2017 and 4.4 percent in 2018, given further improvement in housing demand. But risks to the outlook for homebuilding are to the downside.

Homebuilder confidence weakened a bit in June, according to the National Association of Homebuilders. The housing market index slipped to 67 in June from 69 in May as all three components—current sales, expected sales and buyer traffic—declined. Still, the index, and all three components, are well above the 50 level that indicates expansion. Confidence fell slightly in the Northeast, Southeast and West in June, but rose in the Midwest. The Northeast was the only region where the index was below the neutral 50 mark.

The University of Michigan consumer sentiment index fell to 94.5 in early June from 97.1 in May, its first sizeable drop since the November elections. Both the present conditions and expectations components fell during the month as expectations for business conditions and the labor market retreated. Consumers were more favorable about purchasing homes and automobiles but were less optimistic about purchasing major household items.

Consumer sentiment is taking a breather from the euphoria that ensued after the November elections. Uncertainty about promised tax cuts, healthcare reforms and infrastructure spending, and the political drama surrounding the Trump administration are weighing on consumer sentiment.

Yet even with the June drop, sentiment remains high. Excluding the months after the elections, sentiment is at its highest since May 2016. Key elements of the economy are in good shape: the job market is improving, wage are increasing and asset prices are rising. Despite the hiccups, consumers will likely remain relatively confident and spending will continue to support economic growth during the remainder of 2017.

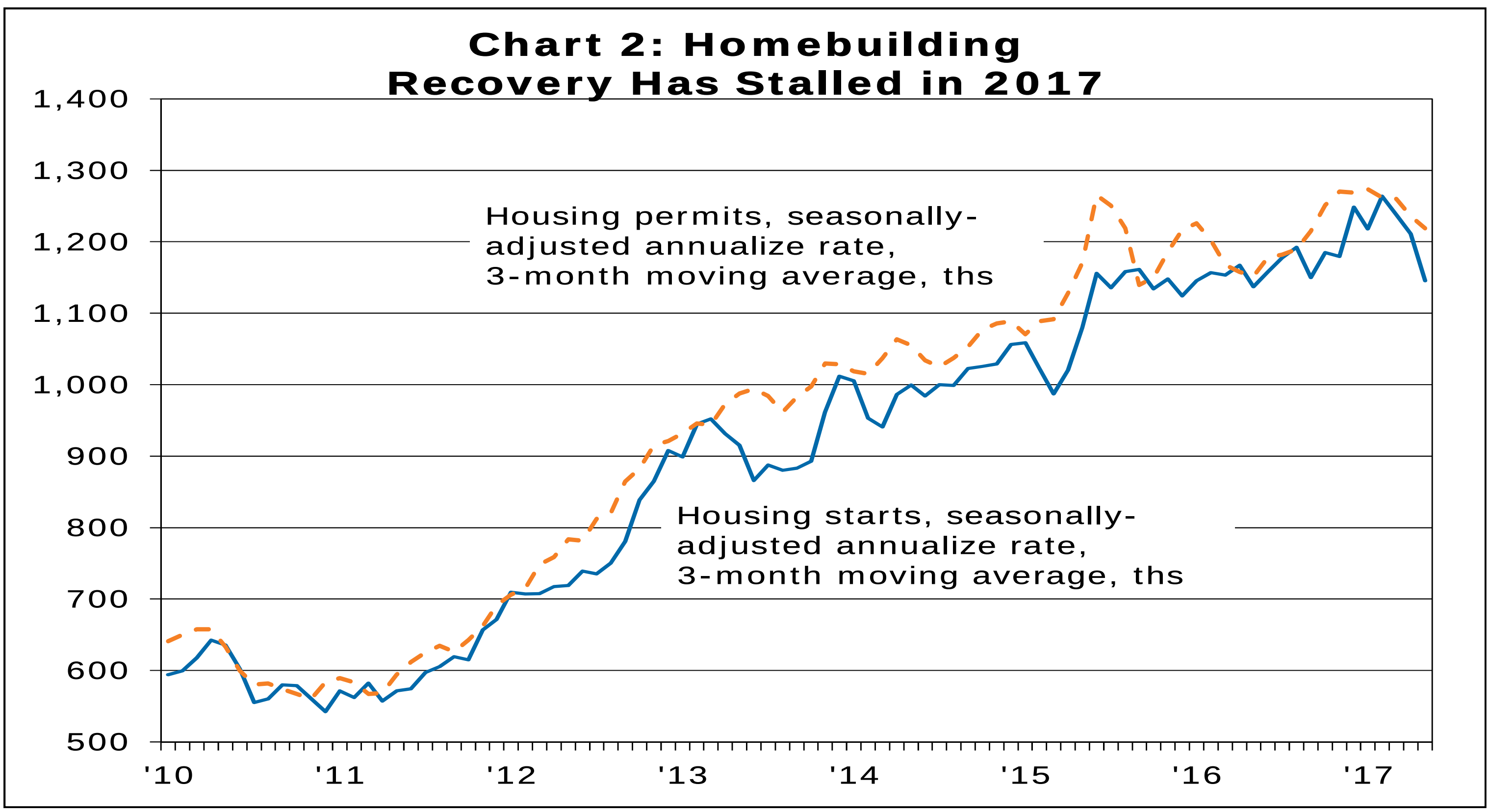

Chart source: Census Bureau

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