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HOUSEHOLD ECONOMIC STRESS INDEX

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More Jobs, Higher Home Values Keep Household Financial Stress Low

SUMMARY

- The PNC U.S. Household Economic Stress Index* increased to 0.8 percentage point in the first quarter of 2016 from 0.3 percentage point in the fourth quarter of 2015. This is still well below the long-term average of about 4.
- Rising inflation, cooling home price appreciation and a steady unemployment rate accounted for the increase.
- Twenty-five out of thirty-four PNC regional markets were at their trend HESI levels in the first quarter of 2016 compared with twenty-six markets a year ago. Nine markets had HESI values better than their respective trend versus eight markets a year ago (a lower HESI value denotes a lower level of stress). No markets were classified as "stressed".
- The HESI will likely tick higher through the remainder of 2016 and 2017 as house price appreciation cools and inflation gradually speeds up.
- PNC Economics forecasts that the HESI will approach its "normal" rate in 2018, as the economy reaches full employment, consumer price inflation increases and house prices rise in line with income and demographic trends.

A stronger labor market, solid home price appreciation and low inflation are keeping financial stress on households low. PNC's U.S. Household Economic Stress Index (HESI)* increased to 0.8 percentage points in the first quarter of 2016 from 0.3 in the fourth quarter of 2015. Though the index level increased slightly, it is still lower than it was in the first quarter of 2015, when it was 1.2. Also, the 0.8 percentage point reading in the first quarter of 2016 was well below the 4 percentage point score we would expect when the economy is growing at its trend rate (Chart 1).The PNC U.S. HESI is designed to measure the amount of stress household budgets are feeling in response to changing macroeconomic conditions.

Low rates of inflation are supporting households' purchasing power. According to the consumer price index, year-over-year inflation was just 1.1 percent in the first quarter of 2016 and was only slightly positive, on average, in 2015. The core PCE price index, which excludes food and energy and is the Federal Reserve's preferred inflation measure, rose by 0.9 percent from a year ago in the first quarter of 2016. This is well below the Fed's 2 percent inflation target. The spectacular collapse of energy prices since 2014 was a significant reason why inflation has been weak. Gasoline prices hit a cycle low in the first quarter of 2016 to become nearly $2 per gallon cheaper than their mid-2014 peak. This big drop in fuel prices provides a massive stimulus to households that acts in a similar way to a tax cut. Every one penny decline in the national average gasoline price that is sustained for a year frees up $1.1 billion dollars that households can either save or spend. This explains, in large part, why consumer spending has been leading economic growth in the past year.

Households are also benefitting from a healing labor market. The jobless rate declined to 4.9 percent in the first quarter of 2016 from 5.0 percent in the fourth quarter of 2015 while the economy created, on average, nearly 175,000 jobs per month in the first half of 2016. Labor force participation edged up in the first three months of the year, signaling that workers are increasingly confident in the labor market's recovery. Other labor market indicators have been encouraging as well. According to JOLTS data, there were close to 5.7 million open positions in the U.S. in the first quarter of 2016, the best quarter for job openings since the early 2000s when the series began. With more employment options available, workers are increasingly leaving their jobs voluntarily in search of other opportunities. Employers for their part are having to increase wages to retain their good employees and to attract the ones they want.

* Household Economic Stress Index = (unemployment rate) + (CPI inflation rate) – (Case-Shiller home price index rate of change). A higher value indicates a higher level of stress.

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Rising home values are easing the pressure on households by increasing the value of their assets (the biggest asset for many people is their home) versus their debts. The national S&P/Case-Shiller home price index rose 5.2 percent from a year ago in the first quarter of 2016, which is about the same pace of appreciation as in the second half of 2015. Housing inventory has been relatively tight, which is lifting home prices. Home price appreciation will likely cool to a more moderate rate over the next year and a half. Though housing is affordable by historic comparisons, the inventory of "bargain" homes is diminishing as home prices rise faster than income. This prices out many young adults who had been sidelined during the economic recovery because of high debt burdens and high rates of unemployment. Though the strengthening job market is improving their financial positions, it will still take several years before many of these potential buyers can transition to home ownership. Also, mortgage rates will likely creep up henceforth as inflation expectations pick up and this will erode affordability somewhat.

Most regional economies across PNC's footprint now have HESI values that are consistent with their long-term averages (Chart 2). After re-indexing the HESI to account for different regional economic structures, nine out of thirty-four market areas had HESI scores better than their trend levels, compared with eight market areas in the first quarter of 2015 (Table 1). A regional HESI value between 96 and 104 points is expected when the regional economy is growing at its trend rate and a lower HESI value denotes a lower level of stress. Twenty-five out of 34 market areas were classified as having HESI levels consistent with their respective long-term trend rate of economic growth in the first quarter of 2016. No markets have been classified as "stressed" since the fourth quarter of 2014. Fifteen markets in PNC's footprint saw their HESI values decline over the year. Markets in Central New Jersey, East Central Florida, Columbus, Northern New Jersey and Toledo experienced some of the sharpest declines with their HESI values dropping by more than 2 points each. Only Mobile, and Southeast Virginia saw large increases in their HESI values. These were primarily due to declines in home prices in those markets.

The U.S. HESI likely remained at 0.8 percentage point in the second quarter of 2016 (Chart 1). The jobless rate held at 4.9 percent between the first and second quarters of 2016. Second quarter consumer price inflation of 0.1 percent on a year-ago basis was marginally faster than in the first quarter. Second quarter 2016 data are not yet available for the national Case-Shiller home price index but it likely increased by 5.1 percent from a year ago, a tick slower than in the first quarter and just enough to offset the change in inflation.

PNC Economics forecasts the economy will continue to grow through the rest of 2016 at a faster rate than in the first half of the year. Major imbalances in housing, the financial system and household finances which led to the Great Recession have been corrected. For the year, real GDP will grow 1.5 percent, compared with 2.6 percent in 2015. Although the economy is expected to grow moderately, the U.S. HESI will likely edge up in the second half of 2016 and end the year close to 2 points. While this index reading is higher than it was in 2015, this should be interpreted as a process of returning to trend rather than an

Chart 1: Though Rising, Financial Stress Remains Low

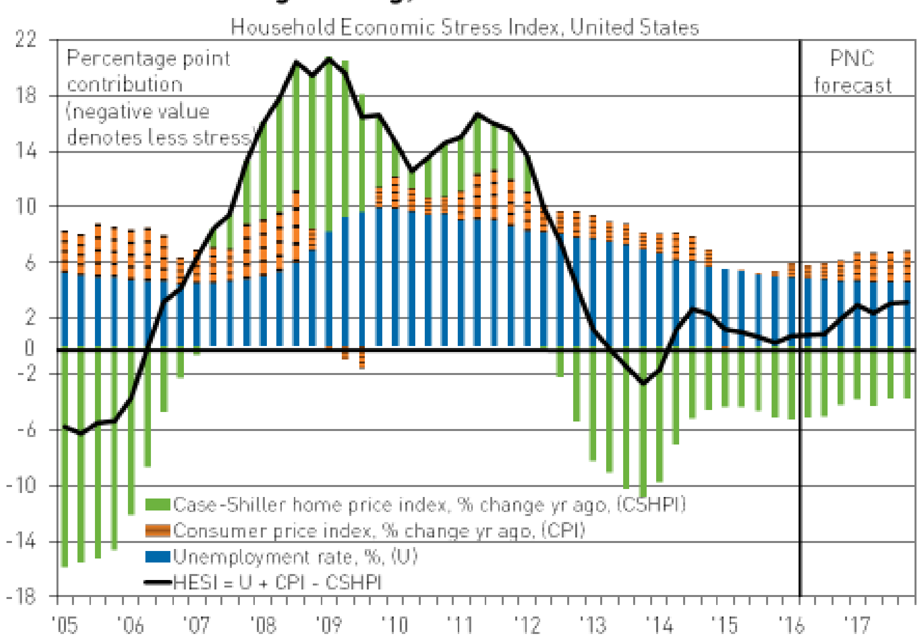

Chart sources: Bureau of Labor Statistics; Fiserv, Inc; Bureau of Census; Moody's Analytics; The PNC Financial Services Group

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increase in household economic stress. During “normal” times, we would expect a HESI index level of about 4.

House price appreciation will decelerate through the remainder of 2016 and 2017, causing the HESI to rise steadily toward its trend level over the course of the next 12 to 18 months. Prices will rise in line with income and demographic trends as the inventory of “cheap” housing diminishes. Despite steady job growth, the unemployment rate will only gradually decrease as labor force growth partially offsets job creation. The unemployment rate is expected to decline to 4.7 percent by the fourth quarter of 2016 and stabilize at 4.6 percent through 2017. Consumer price inflation will also likely edge up over the next few quarters as gasoline prices increase, a tighter labor market supports income growth and aggregate demand, and the pricing power of firms strengthens. Yet CPI inflation is only expected to average 1.1 percent in 2016 and 2.1 percent in 2017.

Chart 2: Financial Conditions Consistent With Long-Run Trend

2016Q1

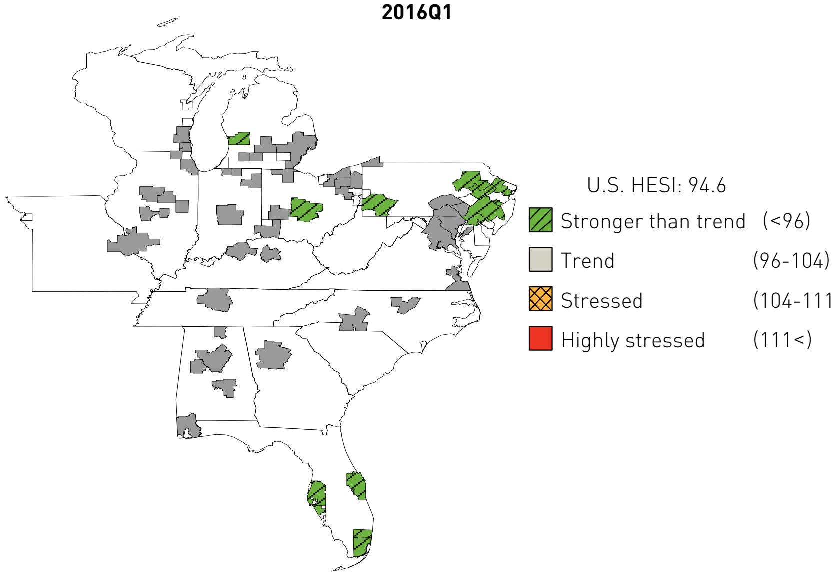

Table 1: Footprint’s Economy Overall Is Stable

Number of markets (out of 34)

	2013Q1	2014Q1	2015Q1	2016Q1
Stronger than trend (<96)	8	12	8	9
Trend (96-104)	20	19	26	25
Stressed (104-111)	6	3	0	0
Highly stressed (111<)	0	0	0	0

Chart sources: Bureau of Labor Statistics; Fiserv, Inc; Bureau of Census; Moody’s Analytics; The PNC Financial Services Group

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