July 2018

# NATIONAL ECONOMIC OUTLOOK


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## Executive Summary


**Economy Continues to Expand in Mid-2018, But Trade Remains a Downside Risk**

- The U.S. economy added 213,000 jobs in June, above the consensus expectation for an increase of 195,000. The private sector added 202,000 jobs over the month, with government employment up by 11,000. May job growth was revised up 21,000 to 244,000, while April growth was revised up by 16,000 to 175,000, for a combined upward revision to job growth over the two months of 37,000. The U.S. economy has added an average of 215,000 jobs per month so far in 2018, above last year's pace of 182,000 per month.

- The unemployment rate rose 0.2 percentage point in June to 4.0 percent; this was the first increase in the unemployment rate since August 2017. Outside of April and May, this is the lowest the unemployment rate has been since the end of 2000. The unemployment rate rose for a good reason. More than 600,000 people entered the labor force in June, encouraged by the tight job market. The labor force participation rate (share of adults working or looking for work) rose by 0.2 percentage point over the month to 62.9 percent; since the beginning of 2016 it has been in a narrow range between 62.6 and 63.0 percent. The number of people employed in the household survey (different from the survey of employers) rose by an unspectacular 100,000 in June, but growth has averaged almost 260,000 per month so far this year. Average hourly earnings rose 0.2 percent in June, a slowing from 0.3 percent growth in May. Year-over-year growth in wages was 2.7 percent in June, unchanged from May.

- The U.S. and the European Union reopened negotiations to reduce tariffs on July 25, but disagree on what they are discussing: E.U. President Jean-Claude Juncker said it was "zero tariffs on industrial goods," while President Trump said "zero tariffs on non-auto industrial goods." Even so, both sides are refraining from adding tariffs during the negotiations, including on imported cars. The U.S., Canada, and Mexico resumed NAFTA renegotiations after Mexico's July election. The U.S. imposed 25 percent incremental tariffs on $34 billion of Chinese imports on July 6, and China retaliated with equivalent tariffs on U.S. exports. China's yuan has depreciated 8 percent from its year-to-date peak in April, and the U.S. is pursuing tariffs on hundreds of billions of dollars of other Chinese imports. Further escalation of trade barriers is a major downside risk to U.S. economic growth.


## Baseline U.S. Economic Outlook, Summary Table*

| | 1Q'18p | 2Q'18f | 3Q'18f | 4Q'18f | 1Q'19f | 2Q'19f | 3Q'19f | 4Q'19f | 2017a | 2018f | 2019f | 2020f |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| ***Output & Prices*** | | | | | | | | | | | | |
| Real GDP (*Chained 2009 Billions $*) | 17372 | 17549 | 17684 | 17827 | 17958 | 18075 | 18174 | 18261 | 17096 | 17608 | 18117 | 18445 |
| **Percent Change Annualized** | **2.0** | **4.1** | **3.1** | **3.3** | **3.0** | **2.6** | **2.2** | **1.9** | **2.3** | **3.0** | **2.9** | **1.8** |
| CPI (*1982-84 = 100*) | 249.4 | 251.3 | 252.4 | 253.7 | 255.2 | 256.7 | 258.3 | 259.8 | 245.1 | 251.7 | 257.5 | 263.6 |
| **Percent Change Annualized** | **3.5** | **3.1** | **1.7** | **2.1** | **2.3** | **2.4** | **2.4** | **2.4** | **2.1** | **2.7** | **2.3** | **2.3** |
| ***Labor Markets*** | | | | | | | | | | | | |
| Payroll Jobs (*Millions*) | 148.1 | 148.7 | 149.2 | 149.7 | 150.0 | 150.3 | 150.6 | 150.9 | 146.6 | 148.9 | 150.5 | 151.3 |
| **Percent Change Annualized** | **1.7** | **1.6** | **1.4** | **1.3** | **1.0** | **0.8** | **0.8** | **0.6** | **1.6** | **1.5** | **1.1** | **0.6** |
| Unemployment Rate (*Percent*) | 4.1 | 3.9 | 3.8 | 3.6 | 3.5 | 3.5 | 3.5 | 3.5 | 4.4 | 3.9 | 3.5 | 3.7 |
| ***Interest Rates (Percent)*** | | | | | | | | | | | | |
| Federal Funds | 1.45 | 1.74 | 1.97 | 2.13 | 2.24 | 2.49 | 2.68 | 2.75 | 1.00 | 1.82 | 2.54 | 2.75 |
| Treasury Note, 10-year | 2.76 | 2.92 | 3.00 | 3.07 | 3.13 | 3.18 | 3.16 | 3.12 | 2.33 | 2.94 | 3.15 | 3.10 |

*a = actual      f = forecast      p = preliminary      * Please see the Expanded Table for more forecast series.*

**Chart 1: Yield Curve Has Flattened But Not Inverted in Mid-2018**

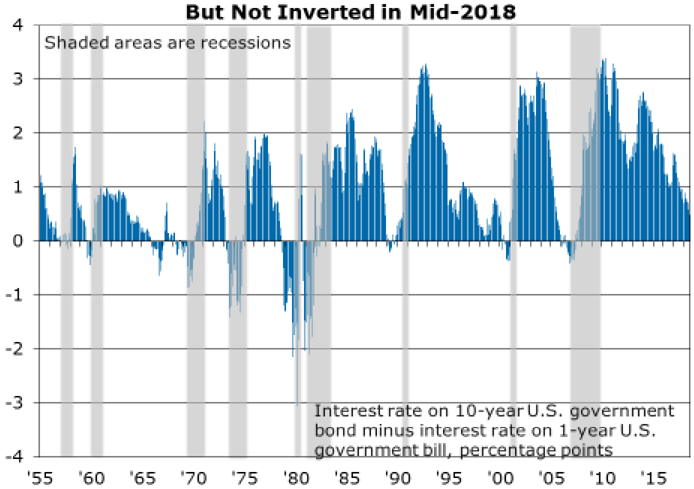
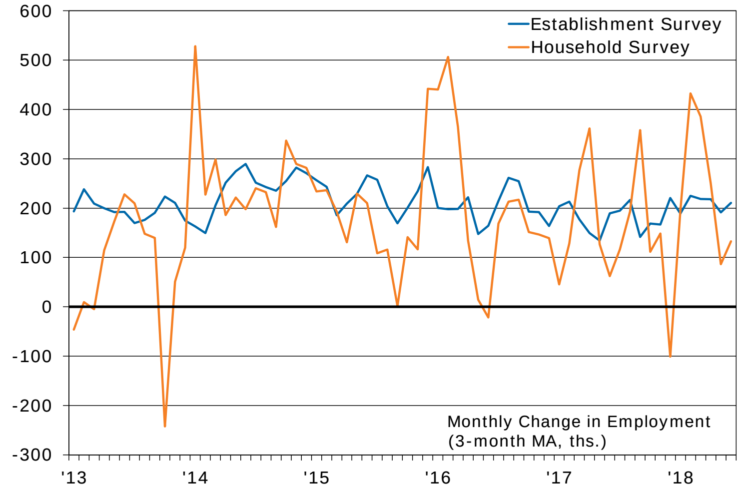



**Chart 2: Another Month of Great Job Growth in June**




## Flattening Yield Curve Bears Watching, But Likely Not Signaling Near-Term Recession

What economists call an inverted yield curve, when short-term interest rates move above long-term interest rates, has traditionally been a signal of coming recession. Right now short-term rates remain below long-term rates, but the yield spread, or difference, has narrowed dramatically over the past several years. This has raised concerns about the potential of a recession in the next year or two. The yield curve may narrow further but is unlikely to invert, and even if it does, that may not be an indication that a recession is coming. But the flattening yield curve certainly bears watching.

Lending for longer periods of time is riskier than lending for shorter periods, for a number of reasons. The lender is less likely to be paid back with a longer loan, and the lender is also exposed to changing economic conditions, such as higher inflation, that makes a fixed interest rate loan less valuable. Because of this interest rates generally increase with the length of the loan. For example, in the United States the interest rate on a 10-year Treasury bond (a 10-year loan to the federal government) is almost always higher than the interest rate on a 1-year Treasury bill (a 1-year loan). But under some conditions short-term interest rates move **above** long-term interest rates, and the yield curve is said to invert. (The difference in interest rates between 10-year and 1-year Treasurys is the one of the most widely cited spreads).

According to research from the San Francisco Fed, since 1955 every recession has been preceded by an inverted yield curve in the previous 6 to 24 months. There has only been one false positive time during that time, when the yield curve inverted but a recession did not follow, in the mid-1960s (see Chart 1). An inverted yield curve occurs when short-term rates are rising quickly, most often because the Federal Reserve is raising short-term interest rates to cool off an economy at risk of overheating. At the same time long-term rates are rising much more slowly, or perhaps even falling, because they reflect longer-term concerns about economic growth. In that respect in an inverted yield curve may signal recession, but does not cause it. But an inverted yield curve may also making lending less profitable, and thus lead banks to pull back on extending credit, contributing to a recession.

The 1-year to 10-year Treasury spread has narrowed from 2.8 percentage points in late 2013 to around 0.5 percentage point in mid-2018 as short-term rates have increased much more than long-term rates, raising concerns that the yield curve could soon invert. PNC's baseline forecast is for the yield curve to narrow somewhat through this year and next as the Fed continues to raise the fed funds rate, but not invert. However, even if the yield curve does invert, that does not mean that a recession is inevitable. There are a number of factors that have brought long-term rates well below their long-run historical averages, including slower expected U.S. and global economic growth; lower expected inflation; and quantitative easing from the Federal Reserve, the European Central Bank, and the Bank of Japan. Thus the yield curve may not be as powerful a predictor of recession in the future as it has been in the past. However, because the yield curve is a forward-looking indicator of recession, economists will not know if its predictive power has declined until well after the next inversion.

The yield curve will likely not invert in the near term, and the U.S. economic expansion should continue at least through mid-2019. Real U.S. GDP growth will accelerate to above 3 percent on a year-over-year basis by late 2018. Business investment and consumer spending will both get boosts from the tax cuts, and the housing market will gradually improve despite higher mortgage rates. A large increase in federal government spending will also be a near-term positive. Assuming no significant disruptions trade will be a slight negative as growth in imports is stronger than growth in exports. Growth will slow in 2019 as fiscal stimulus wears off. Job growth this year will be 190,000, slightly above last year's pace, and the unemployment rate will move lower, to around 3.5 percent by the end of the year. The tighter job market will lead to faster wage growth, providing additional support to consumer spending and offsetting the drag from higher energy prices. The Federal Open Market Committee will raise the federal funds rate one more time this year, in September, to a range of 2.00 to 2.25 percent.

**Chart 3: June Increase in Unemployment Rate Nothing to Worry About**

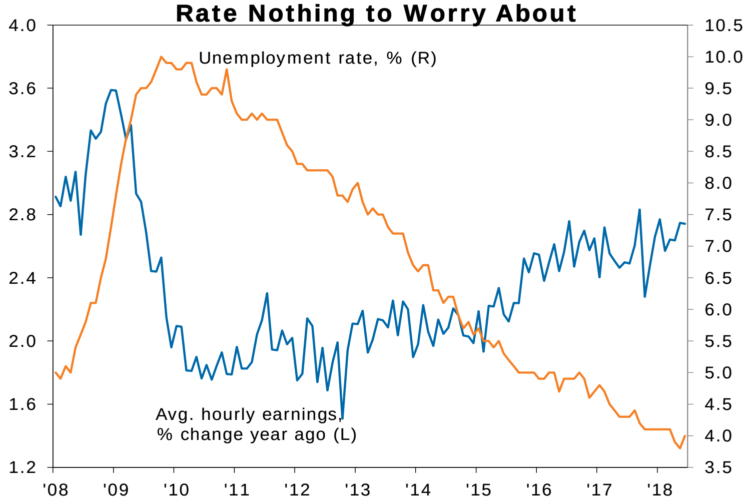



**Chart 4: Rising Utilization Rate Giving Manufacturers More Pricing Power**

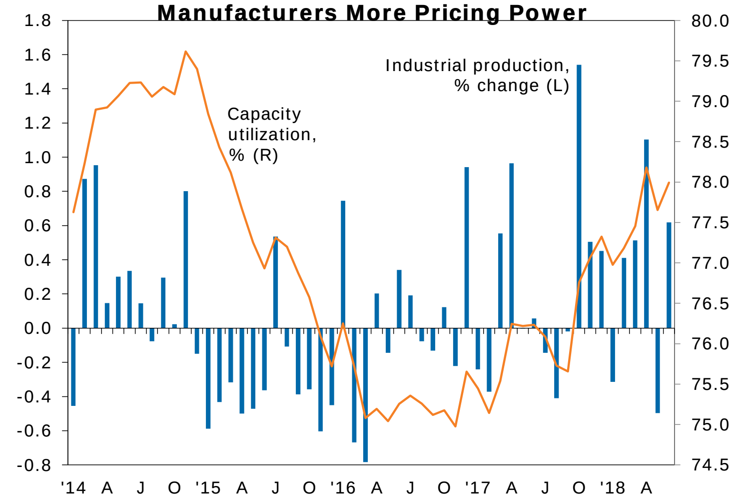



**Chart 5: Manufacturing Job Growth Continues to Accelerate in 2018**

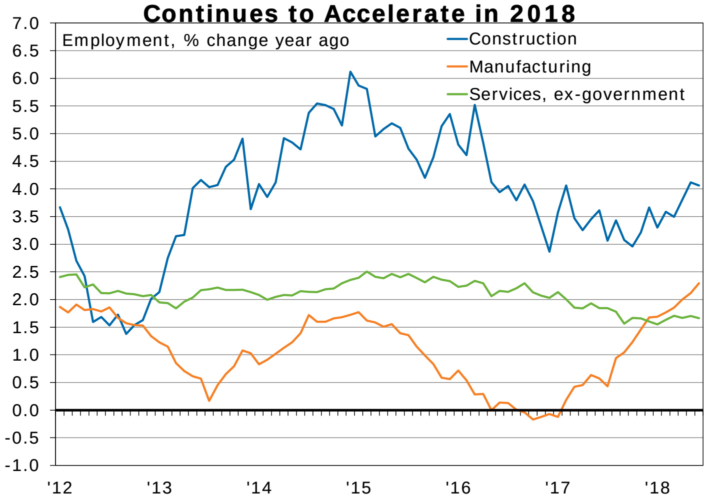



**Chart 6: Housing Affordability Is Falling With Continued Price Gains, Higher Mortgage Rates**

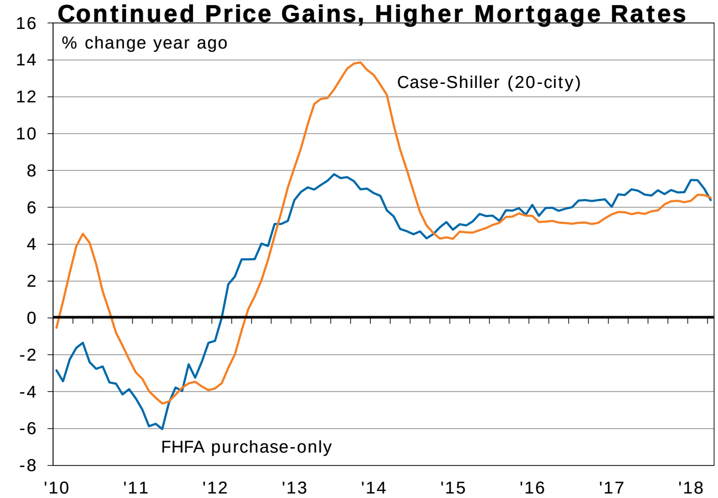



**Chart 7: With More Inventory, Home Sales Set to Pick Up in Second Half of 2018**

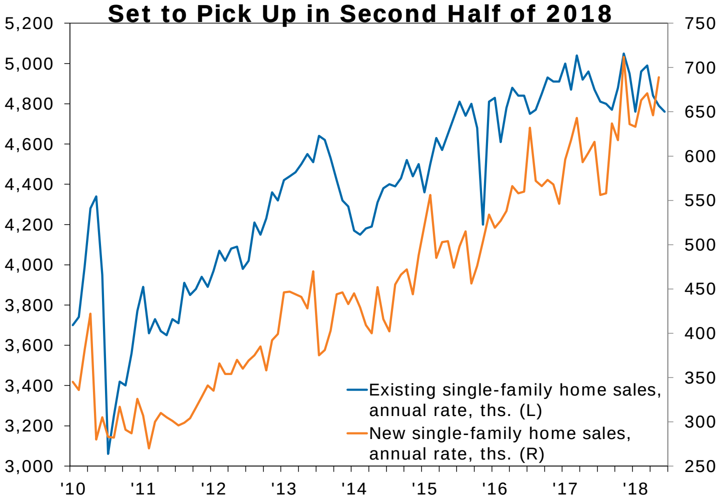
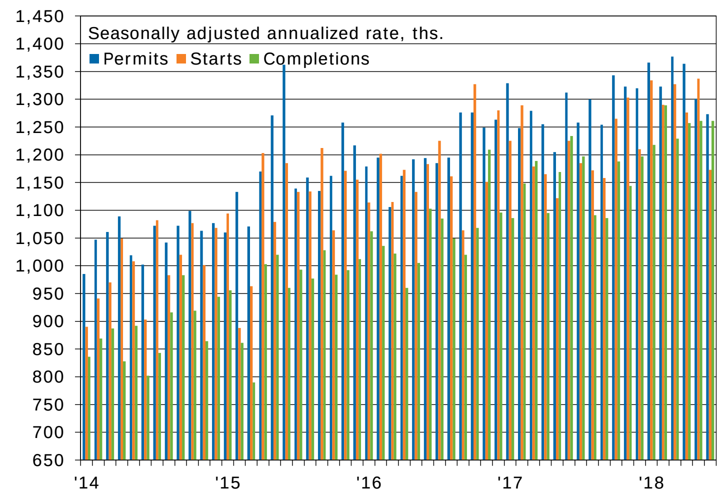



**Chart 8: Lull in Housing Starts Unlikely to Persist**

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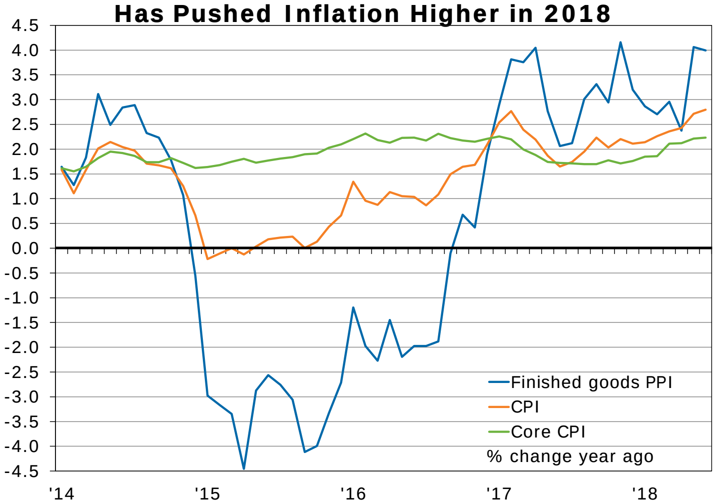
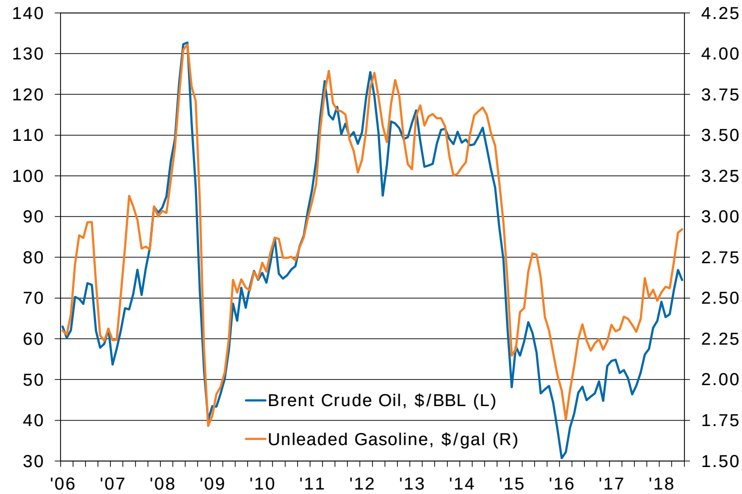
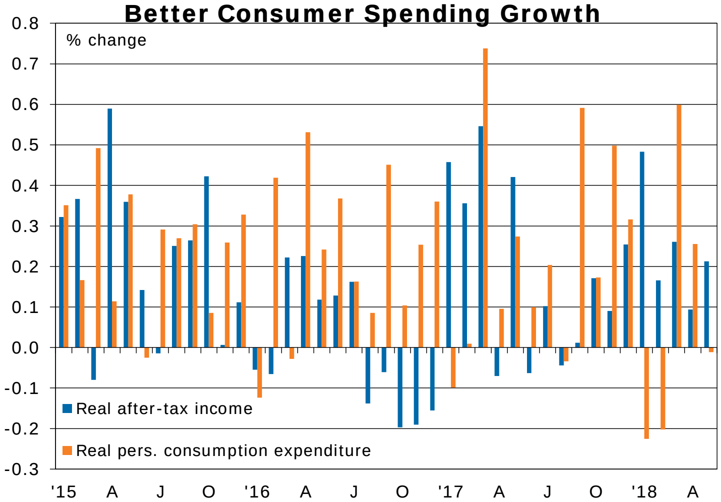
## Chart 9: It Is Not Just Energy That Has Pushed Inflation Higher in 2018



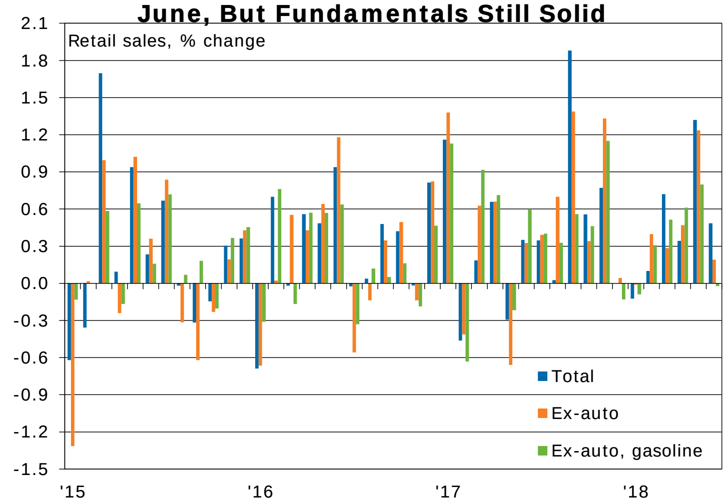

## Chart 10: Gasoline Prices Continue to Increase in 2018



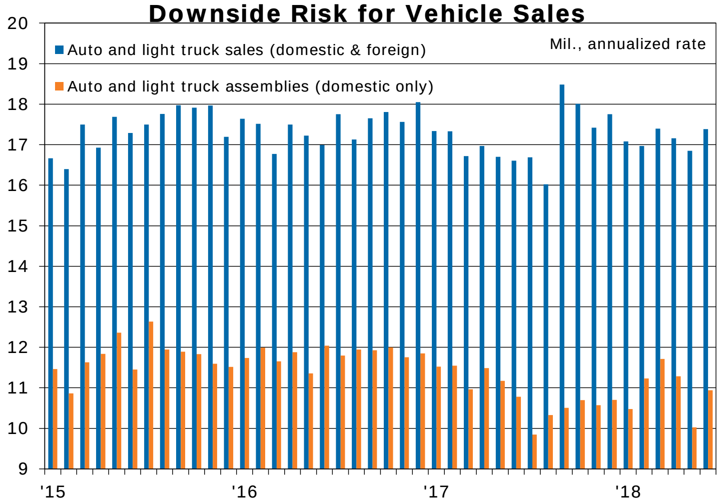

## Chart 11: After Soft First Quarter, Better Consumer Spending Growth



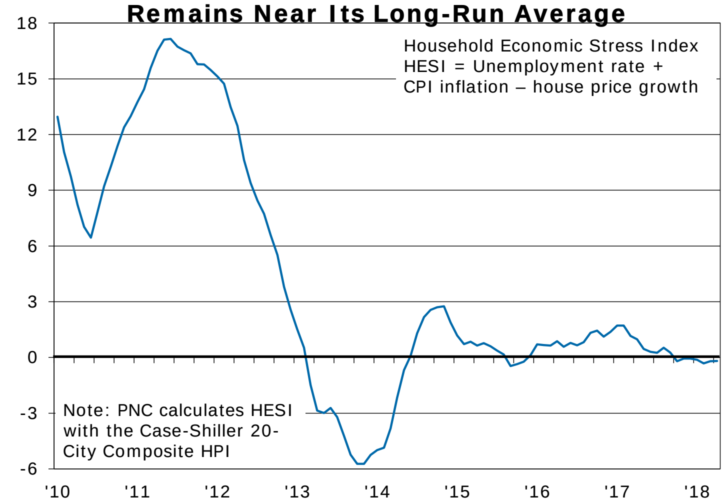

## Chart 12: Weaker Retail Sales in June, But Fundamentals Still Solid




## Chart 13: Potential Tariffs a Big Downside Risk for Vehicle Sales




## Chart 14: Household Economic Stress Remains Near Its Long-Run Average

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**PNC Economics Group**
**July, 2018**

## Baseline U.S. Economic Outlook, Expanded Table

| | 1Q'18p | 2Q'18f | 3Q'18f | 4Q'18f | 1Q'19f | 2Q'19f | 3Q'19f | 4Q'19f | 2017a | 2018f | 2019f | 2020f |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| ***Output*** | | | | | | | | | | | | |
| Nominal GDP (*Billions $*) | 19960 | 20318 | 20558 | 20828 | 21097 | 21356 | 21602 | 21835 | 19391 | 20416 | 21473 | 22371 |
| **Percent Change Annualized** | **4.2** | **7.4** | **4.8** | **5.4** | **5.3** | **5.0** | **4.7** | **4.4** | **4.1** | **5.3** | **5.2** | **4.2** |
| Real GDP (*Chained 2009 Billions $*) | 17372 | 17549 | 17684 | 17827 | 17958 | 18075 | 18174 | 18261 | 17096 | 17608 | 18117 | 18445 |
| **Percent Change Annualized** | **2.0** | **4.1** | **3.1** | **3.3** | **3.0** | **2.6** | **2.2** | **1.9** | **2.3** | **3.0** | **2.9** | **1.8** |
| Pers. Consumption Expenditures | 12061 | 12146 | 12224 | 12298 | 12367 | 12427 | 12486 | 12540 | 11891 | 12182 | 12455 | 12673 |
| **Percent Change Annualized** | **0.9** | **2.9** | **2.6** | **2.5** | **2.3** | **2.0** | **1.9** | **1.8** | **2.8** | **2.5** | **2.2** | **1.7** |
| Nonresidential Fixed Investment | 2425 | 2459 | 2505 | 2549 | 2587 | 2618 | 2645 | 2667 | 2314 | 2484 | 2629 | 2704 |
| **Percent Change Annualized** | **10.4** | **5.7** | **7.6** | **7.3** | **6.1** | **4.9** | **4.1** | **3.4** | **4.7** | **7.4** | **5.8** | **2.8** |
| Residential Investment | 603 | 606 | 609 | 615 | 622 | 628 | 633 | 636 | 598 | 608 | 630 | 645 |
| **Percent Change Annualized** | **-1.1** | **1.6** | **2.4** | **4.2** | **4.6** | **4.0** | **2.8** | **2.3** | **1.8** | **1.8** | **3.6** | **2.4** |
| Change in Private Inventories | 14 | 57 | 59 | 57 | 58 | 63 | 57 | 52 | 15 | 47 | 57 | 42 |
| Net Exports | -657 | -662 | -677 | -691 | -704 | -713 | -717 | -719 | -622 | -672 | -713 | -717 |
| Government Expenditures | 2931 | 2947 | 2970 | 3004 | 3034 | 3056 | 3076 | 3090 | 2903 | 2963 | 3064 | 3103 |
| **Percent Change Annualized** | **1.3** | **2.3** | **3.1** | **4.6** | **4.0** | **3.0** | **2.6** | **1.9** | **0.1** | **2.1** | **3.4** | **1.3** |
| Industrial Prod. Index (*2012 = 100*) | 105.9 | 106.8 | 107.6 | 108.1 | 108.6 | 109.0 | 109.2 | 109.5 | 103.7 | 107.1 | 109.1 | 110.1 |
| **Percent Change Annualized** | **2.4** | **3.3** | **3.1** | **2.1** | **1.7** | **1.3** | **1.1** | **0.9** | **1.6** | **3.3** | **1.9** | **0.9** |
| Capacity Utilization (*Percent*) | 77.2 | 77.7 | 78.0 | 78.1 | 78.4 | 78.6 | 78.6 | 78.7 | 76.1 | 77.7 | 78.6 | 78.8 |
| ***Prices*** | | | | | | | | | | | | |
| CPI (*1982-84 = 100*) | 249.4 | 251.3 | 252.4 | 253.7 | 255.2 | 256.7 | 258.3 | 259.8 | 245.1 | 251.7 | 257.5 | 263.6 |
| **Percent Change Annualized** | **3.5** | **3.1** | **1.7** | **2.1** | **2.3** | **2.4** | **2.4** | **2.4** | **2.1** | **2.7** | **2.3** | **2.3** |
| Core CPI Index (1982-84 = 100) | 255.7 | 257.3 | 258.6 | 260.1 | 261.7 | 263.3 | 264.9 | 266.6 | 252.2 | 258.0 | 264.1 | 270.5 |
| **Percent Change Annualized** | **3.0** | **2.5** | **2.1** | **2.3** | **2.4** | **2.5** | **2.5** | **2.5** | **1.8** | **2.3** | **2.4** | **2.4** |
| PCE Price Index (*2009 = 100*) | 114.2 | 115.1 | 115.5 | 116.0 | 116.6 | 117.3 | 117.9 | 118.6 | 112.7 | 115.2 | 117.6 | 120.2 |
| **Percent Change Annualized** | **2.5** | **3.2** | **1.4** | **2.0** | **2.1** | **2.2** | **2.3** | **2.3** | **1.7** | **2.2** | **2.1** | **2.2** |
| Core PCE Price Index (*2009 = 100*) | 114.4 | 115.0 | 115.6 | 116.3 | 116.9 | 117.6 | 118.3 | 119.0 | 113.1 | 115.3 | 117.9 | 120.6 |
| **Percent Change Annualized** | **2.3** | **2.2** | **2.2** | **2.2** | **2.3** | **2.3** | **2.3** | **2.4** | **1.5** | **2.0** | **2.3** | **2.3** |
| GDP Price Index (*2009 = 100*) | 114.9 | 115.8 | 116.3 | 116.9 | 117.6 | 118.3 | 119.0 | 119.7 | 113.4 | 116.0 | 118.6 | 121.4 |
| **Percent Change Annualized** | **2.2** | **3.2** | **1.7** | **2.1** | **2.3** | **2.4** | **2.5** | **2.5** | **1.8** | **2.3** | **2.3** | **2.4** |
| Crude Oil, WTI (*$/Barrel*) | 62.9 | 68.1 | 71.5 | 71.2 | 72.0 | 72.9 | 73.8 | 74.7 | 50.8 | 68.4 | 73.4 | 75.6 |
| ***Labor Markets*** | | | | | | | | | | | | |
| Payroll Jobs (*Millions*) | 148.1 | 148.7 | 149.2 | 149.7 | 150.0 | 150.3 | 150.6 | 150.9 | 146.6 | 148.9 | 150.5 | 151.3 |
| **Percent Change Annualized** | **1.7** | **1.6** | **1.4** | **1.3** | **1.0** | **0.8** | **0.8** | **0.6** | **1.6** | **1.5** | **1.1** | **0.6** |
| Unemployment Rate (*Percent*) | 4.1 | 3.9 | 3.8 | 3.6 | 3.5 | 3.5 | 3.5 | 3.5 | 4.4 | 3.9 | 3.5 | 3.7 |
| Average Weekly Hours, Prod. Works. | 33.7 | 33.7 | 33.8 | 33.8 | 33.9 | 33.9 | 33.8 | 33.8 | 33.7 | 33.8 | 33.8 | 33.8 |
| ***Personal Income*** | | | | | | | | | | | | |
| Average Hourly Earnings (*$*) | 22.40 | 22.56 | 22.73 | 22.92 | 23.11 | 23.30 | 23.49 | 23.68 | 22.05 | 22.65 | 23.39 | 24.16 |
| **Percent Change Annualized** | **2.8** | **2.9** | **3.2** | **3.3** | **3.4** | **3.4** | **3.3** | **3.3** | **2.3** | **2.7** | **3.3** | **3.3** |
| Real Disp. Income (*2009 Billions $*) | 12940 | 12956 | 13003 | 13044 | 13085 | 13124 | 13157 | 13189 | 12765 | 12986 | 13139 | 13284 |
| **Percent Change Annualized** | **3.6** | **0.5** | **1.5** | **1.3** | **1.3** | **1.2** | **1.0** | **1.0** | **1.2** | **1.7** | **1.2** | **1.1** |
| ***Housing*** | | | | | | | | | | | | |
| Housing Starts (*Ths., Ann. Rate*) | 1317 | 1286 | 1307 | 1334 | 1356 | 1372 | 1380 | 1387 | 1208 | 1311 | 1374 | 1397 |
| Ext. Home Sales (*Ths., Ann Rate*) | 5507 | 5538 | 5626 | 5717 | 5776 | 5811 | 5838 | 5861 | 5536 | 5597 | 5822 | 5905 |
| New SF Home Sales (*Ths., Ann Rate*) | 656 | 641 | 653 | 668 | 680 | 686 | 691 | 694 | 616 | 655 | 688 | 694 |
| Case/Shiller HPI (*Jan. 2000 = 100*) | 199.8 | 202.0 | 204.4 | 206.5 | 208.5 | 210.4 | 212.0 | 213.4 | 191.6 | 203.2 | 211.1 | 216.4 |
| **Percent Change Year Ago** | **6.4** | **6.4** | **6.2** | **5.2** | **4.3** | **4.1** | **3.7** | **3.4** | **5.8** | **6.0** | **3.9** | **2.5** |
| ***Consumer*** | | | | | | | | | | | | |
| Household Economic Stress Index | 0.0 | 0.5 | 0.5 | 1.1 | 1.5 | 1.5 | 2.1 | 2.6 | 0.6 | 0.5 | 1.9 | 3.5 |
| Auto Sales (*Millions*) | 17.1 | 17.1 | 17.2 | 17.2 | 17.1 | 17.0 | 17.0 | 17.0 | 17.2 | 17.2 | 17.0 | 16.8 |
| Consumer Credit (*Billions $*) | 3873 | 3936 | 3997 | 4056 | 4116 | 4173 | 4232 | 4285 | 3756 | 3966 | 4202 | 4402 |
| **Percent Change Annualized** | **4.3** | **6.7** | **6.3** | **6.1** | **6.0** | **5.6** | **5.8** | **5.1** | **5.6** | **5.6** | **5.9** | **4.8** |
| ***Interest Rates (Percent)*** | | | | | | | | | | | | |
| Prime Rate | 4.53 | 4.80 | 5.09 | 5.25 | 5.36 | 5.61 | 5.75 | 5.75 | 4.10 | 4.92 | 5.62 | 5.75 |
| Federal Funds | 1.45 | 1.74 | 1.97 | 2.13 | 2.24 | 2.49 | 2.68 | 2.75 | 1.00 | 1.82 | 2.54 | 2.75 |
| 3-Month Treasury Bill | 1.58 | 1.87 | 1.99 | 2.07 | 2.25 | 2.48 | 2.59 | 2.63 | 0.95 | 1.88 | 2.49 | 2.61 |
| 10-Year Treasury Note | 2.76 | 2.92 | 3.00 | 3.07 | 3.13 | 3.18 | 3.16 | 3.12 | 2.33 | 2.94 | 3.15 | 3.10 |
| 30-Year Fixed Mortgage | 4.27 | 4.55 | 4.65 | 4.73 | 4.78 | 4.83 | 4.81 | 4.77 | 3.99 | 4.55 | 4.80 | 4.75 |

*a = actual    f = forecast    p = preliminary*

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