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### ECONOMIC REPORT

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### GDI SHOWS BETTER ECONOMY IN Q4 THAN GDP; HOUSE PRICES CONTINUEDTO IMPROVE IN JANUARY

#### SUMMARY

- Real gross domestic product increased 0.4 percent in the fourth quarter of 2012, according to the third estimate, up from 0.1 percent growth in the second estimate. Real gross domestic income growth was better at 2.6 percent in the fourth quarter.
- Durable goods orders rebounded with a 5.7 percent increase in February, although a huge spike in volatile aircraft orders led the gain.
- The S&P/Case-Shiller 10- and 20-city composite house price indices both rose 1.0 percent in January.
- The Conference Board's consumer confidence index dropped sharply in March.
- New home sales fell slightly in February, but homebuilding continues to strengthen.
- Initial unemployment insurance claims rose in the week ending March 23, but are not signaling labor market weakness.

According to the third estimate from the Bureau of Economic Analysis, real GDP grew 0.4 percent at an annual rate in the fourth quarter of 2012, revised up from 0.1 percent growth in the second estimate. There were upward revisions to business fixed investment and exports, somewhat offset by a downward revision to consumer spending. A huge drop in defense spending, reduced investment in inventories, and lower exports caused the weak economic growth in the fourth quarter. Consumer spending, especially on durable goods; business fixed investment; and homebuilding were positives for fourth quarter growth. In the third quarter economic growth was 3.1 percent at an annual rate.

This was the first read on gross domestic income, an alternative measure of the size of the economy based on incomes going to households and firms. GDI, adjusted for inflation, rose 2.6 percent at an annual rate, up from 1.6 percent at an annual rate in the third quarter.

The broadest measure of corporate profits, not adjusted for inflation, rose 2.3 percent (not annualized) in the fourth quarter, to \$2.01 trillion at an annualized rate; this was a record high. Of the \$45.4 billion increase in profits in the fourth quarter, \$24.8 billion came from domestic nonfinancial industries and \$24.1 billion came from the rest of the world. Domestic financial industries lost \$3.5 billion in the quarter.

GDI suggests that the economy at the end of 2012 was not as soft as the GDP numbers alone indicate (see Chart). According to both GDP and GDI, the economy expanded at a 1.5 percent to 2 percent annual pace in the second half of 2012. This is below the economy's potential, but still enough to keep the expansion going.

There were a number of one-time drags on growth in the fourth quarter. Inventories were a big boost to growth in the third quarter, and then a big weight on growth in the fourth quarter. Similarly, defense spending was a big positive in the third quarter, and then a big negative in the fourth quarter, likely because the Defense Department was trying to make purchases ahead of the fiscal cliff. While federal government spending is likely to be a drag on growth in the near term, with the budget cuts from the sequester starting to kick in, the declines will be much smaller than in the fourth quarter, when the drop in defense spending subtracted 1.3 percentage points from growth at an annual rate.



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Growth in the first quarter of 2013 appears to coming in at a roughly 2 percent annual rate. Consumer spending has held up despite higher taxes. The solidifying housing market recovery remains a support to growth. After some slowing at the end of last year, likely due to uncertainty about federal fiscal policy, business investment growth has picked back up in early 2013, and solid profits will support hiring and investment. Trade, however, is likely to remain a near-term drag as Europe struggles to come out of recession. Federal spending cuts from the sequester will also weigh on near-term economic growth. But the economy has enough fundamental strengths to overcome these weights. PNC is forecasting overall GDP growth from the fourth quarter of 2012 to the fourth quarter of 2013 of about 2.1 percent, with growth slightly stronger in the second half of this year as consumers adjust to higher taxes and the impact of the sequester fades somewhat.

Durable goods orders increased 5.7 percent in February, more than offsetting January's 3.8 percent decline. There was a 22 percent increase in transportation orders, led by a 95 percent increase in non-defense aircraft after a very good month for Boeing. Excluding transportation orders were down 0.5 percent in February. Orders of core capital goods--non-defense capital goods excluding aircraft--were down 2.7 percent in February, after a large 6.7 percent increase in January.

Shipments of durable goods were up 1.0 percent in February, with transportation shipments up 1.6 percent. Non-transportation shipments were up 0.7 percent. Shipments of core capital goods were up 1.9 percent in February.

Aircraft have caused volatility in durable goods orders over the past few months, but manufacturing is coming out of its late-2012 lull. Concern about the fiscal cliff weighed on manufacturing at the end of last year, but as the economy has continued to expand manufacturing growth has picked back up. Business investment continues to increase as low financing costs and firms' desire to limit hiring have led to spending on capital goods. Manufacturing will further expand throughout 2013. However, the industry has moved from leading the overall economy early in the recovery to roughly keeping pace with it more recently.

The S&P/Case-Shiller 10- and 20-city house price indices both increased 1.0 percent from December to January on a seasonally-adjusted basis. The 10-city index was up 0.2 percent non-seasonally-adjusted, while the 20-city index was up 0.1 percent. On a year-ago basis the 10-city composite was up 7.3 percent in January, with the 20-city composite up 8.1 percent.

Prices rose in all 20 metro areas from December to January on a seasonally-adjusted basis, with the biggest increases in San Francisco, Phoenix, Atlanta, Tampa and Las Vegas. On a year-ago basis prices were also up for all 20 metro areas, with Phoenix (23.2 percent), San Francisco (17.5 percent) and Las Vegas (15.3 percent) in front. At the back of the pack were New York (up 0.6 percent), Chicago (3.3 percent) and Boston (4.0 percent).

House prices continue to recover from the steep declines during the housing bust. Tight inventories and rising demand are boosting prices. In addition, the share of sales that is distressed (foreclosures and short sales) is falling, supporting prices. Price gains are boosting the overall economy. Consumers are wealthier, making them more willing to spending. Rising prices are also reducing the number of homes that are underwater, supporting bank balance sheets. Price gains will continue throughout 2013 as very high affordability, an improving labor market, and gradually easing access to credit support sales. However, tight inventories could limit the increase in sales this year, while boosting prices.

Sales of new homes fell 4.6 percent in February to 411,000 at an annualized rate, from 431,000 in January. Even with the drop the past three months have been the best for new home sales since the summer of 2009. Tight supplies are restraining sales, although gains in homebuilding will reduce supply constraints later this year. With supply tight the median sale price for a new home was up 2.9 percent in February from one year earlier.

The Conference Board's consumer confidence index fell from 68.0 in February to 59.7 in March, although it remained above its January reading of 58.4. Both the current conditions and expectations components fell in March, with the drop in expectations much larger. The drop in confidence is likely due, at least in part, to concerns about federal spending cuts under the sequester. So far lower confidence in 2013 has yet to translate into lower consumer spending.

Initial unemployment insurance claims jumped sharply to 357,000 in the week ending March 23, up from 341,000 the previous week (revised up from 336,000). This is the first time claims have been above 350,000 since mid-February. The four-week moving average of claims increased slightly, from 341,000 to 344,000.

It is too early to say if the increase in claims over the past two weeks is an indication of a slowing in the labor market. The four-week moving average of claims remains comfortably below 350,000, and claims are still much lower

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than they were during 2012. Claims are highly variable from week-to-week, and the increases over the past two weeks could simply reflect this.

Job growth is holding up in early 2013, with average

monthly job gains in the first two months of the year at around 180,000. PNC is forecast an increase in payroll employment of 200,000 in March when the BLS releases the employment report on April 5, with the unemployment rate holding steady at 7.7 percent.

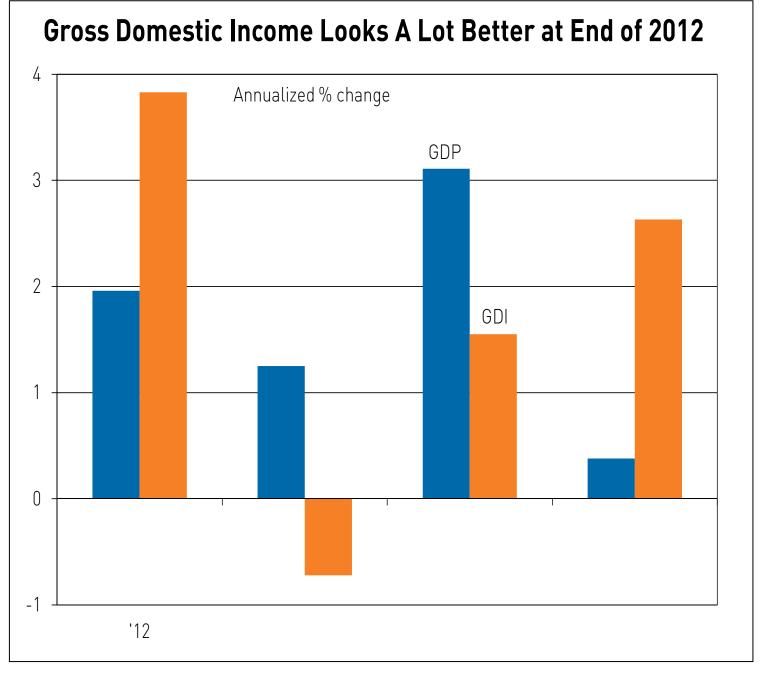


Chart source: BEA

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