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ECONOMIC REPORT

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SILVER LININGS GDP PLAYBOOK. EXCELSIOR!

SUMMARY

- Real GDP fell 0.1 percent at an annual rate in the fourth quarter of 2012, the first contraction in the economy since the second quarter of 2009.
- There were big drags from inventories, defense spending, and trade. The silver linings were solid gains in consumer spending, residential construction and business equipment investment. Excelsior!
- Although the weak GDP report is worrisome, the economic recovery is continuing in the beginning of 2013.
- Private-sector payrolls rose by 192,000 in January, according to the ADP employment report, a decent gain.
- As we expected, the Federal Open Market Committee maintained its aggressive monetary policy.

Real gross domestic product fell 0.1 percent at an annual rate in the fourth quarter of 2012, according to the advance estimate from the Bureau of Economic Analysis. This was the first contraction in the economy since the second quarter of 2009. Growth in the third quarter was 3.1 percent at an annual rate.

On a year-over-year basis, real GDP growth in the fourth quarter was a disappointing 1.5 percent. Averaged over the entire year, the economy expanded 2.2 percent in 2012, after a 1.8 percent increase in 2011.

There were three big drags on real GDP growth in the fourth quarter. After adding 1.1 percentage points to growth in the third quarter, private nonfarm inventories subtracted 1.4 percentage points in the fourth quarter as firms cut their stocks. There was a 22 percent annualized decline in defense spending in the fourth quarter, subtracting 1.3 percentage points from growth. The Defense Department likely pushed spending ahead in the third quarter in response to concerns about potential budget cuts, taking a big chunk out of growth in the fourth quarter. Also, the troop pull-out of Iraq may have given a “peace dividend” to our nation even as it dragged down economic growth, not an all-together bad tradeoff! And exports fell almost 6 percent at an annual rate in the fourth quarter, subtracting 0.8 percentage point from growth. Added together, these three factors reduced growth by a whopping 3.4 percentage points in the fourth quarter (see Chart 1). Superstorm Sandy also likely slowed growth in late 2012, but that temporary drag is impossible to quantify.

On the positive silver linings side, consumer spending rose 2.2 percent annualized in the fourth quarter, adding 1.5 percentage points to growth, with 0.6 percentage point of that from stronger vehicle sales. After falling in the third quarter business fixed investment rose by more than 8 percent in the fourth quarter, adding 0.8 percentage point to growth; all of the gain came in equipment and software, with a small decline in commercial construction spending. And residential construction increased 15 percent in the fourth quarter, adding almost 0.4 percentage point to growth, as the housing rebound maintained its solid momentum.

Inflation was practically non-existent, with the GDP price index up 0.6 percent at an annual rate in the fourth quarter. The personal consumption expenditures consumer price index was up 1.2 percent, and the core PCE price index, excluding food and energy, was up just 0.9 percent. With a contraction in real economic activity and low inflation, nominal GDP was up less than 0.5 percent at an annual rate in the fourth quarter, down dramatically from 5.9 percent growth in the third.

Personal income rose 7.9 percent at an annual rate in the fourth quarter before inflation, the best quarter for income growth since the first quarter of 2011. Companies looked to pay dividends and bonuses ahead of (correctly) expected tax rate increases at the beginning of 2013, pushing income forward. As a result income growth in early 2013 will be soft as a payback. We will get more detail on December income and consumer spending on Thursday morning.

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There could be small revisions to the fourth quarter data, but the best that can be said is that the economy was basically flat at the end of 2012. The drags from inventories and defense spending were one-time factors, but growth in the second half of the year was an anemic 1.5 percent.

This raises concerns about early 2013, given that tax increases and federal budget cuts will weigh on growth in the first half of this year, although the drag from government will be much smaller compared to the fourth quarter. Exports will remain a weight given the ongoing recession in Europe, although growth in Asia does appear to be picking up.

Private-sector job growth in January was 192,000 according to the ADP employment report. This provides support to PNC's forecast for private-sector payroll gains of 185,000 in January, and overall job growth of 175,000, when the Bureau of Labor Statistics releases the official government employment report on Friday (see Chart 2).

The ADP December job gain was revised down from 215,000 to 185,000; according to the BLS, private-sector job growth in December was a similar 168,000.

In January, according to ADP, small businesses (fewer than 50 employees) added 115,000 jobs; medium-sized businesses (50 to 499 employees) added 79,000 jobs; and large businesses dropped 2,000 employees.

Goods-producing industries added 15,000 jobs in January, with job losses of 3,000 in manufacturing and job gains of 15,000 in construction; it could be that the turnaround in homebuilding is finally contributing to job growth. Private service industries added 177,000 jobs over the month, including gains of 33,000 in trade, transportation and utilities; 12,000 in financial activities; and 40,000 in business/professional services.

If confirmed in the BLS report, the private sector started off 2013 on a good note, especially given the tax increases

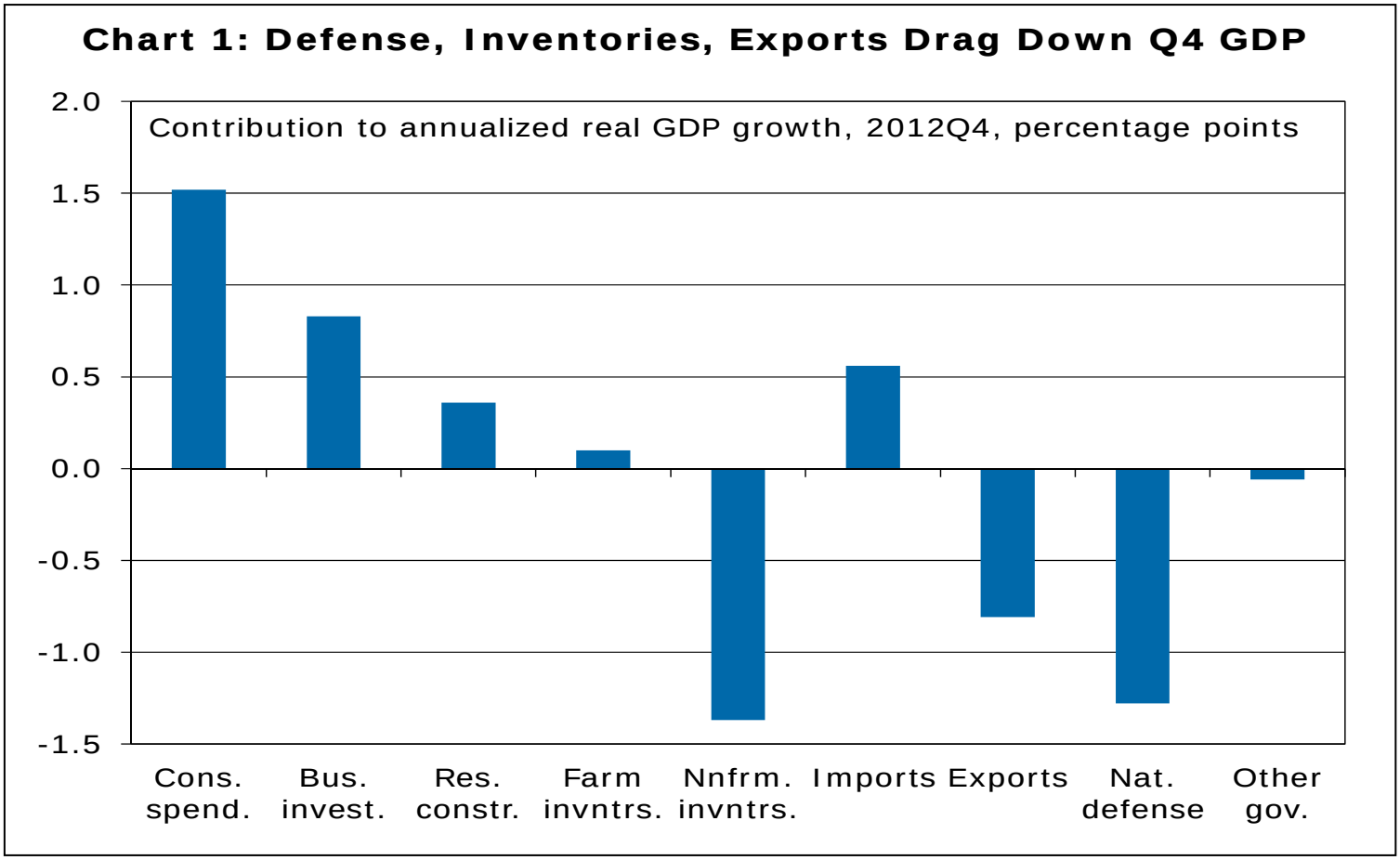

Chart source: BEA

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that are taking effect this year, concern over the debt limit ceiling in the first half of January, and the slight contraction in economic growth in the fourth quarter. However, the drop in employment at large firms provides a note of caution.

The Federal Open Market, as expected, announced no change in monetary policy. The central bank expects to keep the fed funds target rate in the 0 to 0.25 percent range until either the unemployment rate moves below 6.5 percent or inflation one to two years ahead appears ready to move above 2.5 percent. The Fed will also continue to create money electronically, expanding its balance sheet by $85 billion per month and using the proceeds to purchase long-term Treasuries and mortgage-backed securities in an effort to push (keep) down long-term interest rates.

In the section on current economic conditions, the FOMC's statement noted "growth in economic activity paused in recent months," presumably a nod to the fourth quarter GDP report. However, the statement blamed weather and "other transitory factors" for the economic weakness at the end of 2012. The statement also noted that inflation is well below the Fed's 2 percent goal.

In the section on the economic outlook, the statement noted that although "strains in global financial markets have eased somewhat, the Committee continues to see downside risks to the economic outlook."

With the decline in output in the fourth quarter, the economy has less momentum going into 2013 than initially thought, making it vulnerable to external shocks. Real GDP growth in the first half of 2013 is likely to be a bit below 2 percent at an annual rate as consumers adjust to higher taxes and the federal government cuts spending. Growth will pick up in the second half of the year, to above 2.5 percent, as the tax bite fades and the recession in Europe ends. A turnaround in the housing market will be a key support to the economy this year, with homebuilding contributing to growth and higher home prices supporting consumer spending. Low interest rates will continue to boost business investment.

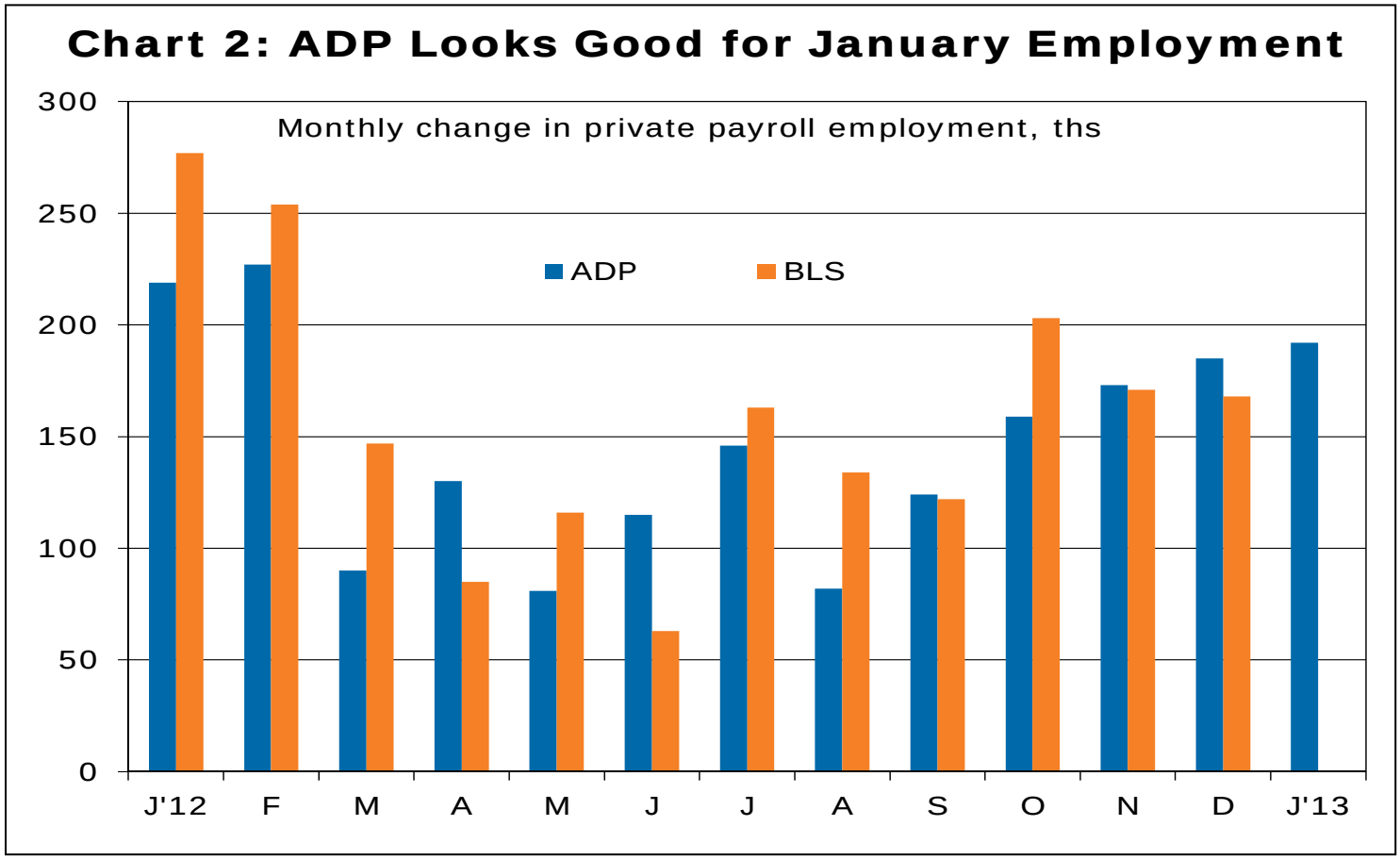

Chart sources: ADP, BLS

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