



ECONOMIC REPORT

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TRADE, CONSTRUCTION SPENDING, AUTO SALES AND BEIGE BOOK POINT TO CONTINUED MODERATE GROWTH

SUMMARY

- The trade deficit widened as expected in July, but so far trade is neutral for growth in the third quarter.
- Construction spending increased 0.6 percent in July with gains in private residential and nonresidential building.
- Auto sales rose to 16.1 million units in August, the best pace in almost six years.
- The Federal Reserve's Beige Book reported modest to moderate growth in mid-summer, with expansion in all regions and most industries.
- The ISM manufacturing index rose unexpectedly in August, and continues to indicate expansion.
- Recent data indicate solid but unexceptional economic growth in the third quarter.

The trade deficit widened in July to \$39.1 billion, from \$34.5 billion in June (revised from \$34.2 billion); the trade deficit in May was \$43.7 billion. Exports fell by 0.6 percent in July, while imports rose 1.6 percent. About one-quarter of the increase in the trade deficit in July came from petroleum as oil prices increased over the month. There was a more than 3 percent increase in auto imports in July as vehicle sales remained strong. The trade deficit for goods, adjusted for inflation, also widened in July.

The increase in the trade deficit in July was expected, after it narrowed much more than expected in June. Even with the increase, the July trade deficit was close to the second quarter average, and so right now trade is roughly neutral for growth in the third quarter. Exports will increase in the near term with the recession in Europe coming to an end and growth in Asia set to reaccelerate. But imports are also rising as consumers gradually increase their spending. Trade will be neutral for growth in the second half of this year, and then positive for growth in 2014 as the global expansion picks up.

Construction spending rose 0.6 percent in July after no gain in June (revised up from a 0.6 percent decline). Private residential spending increased 0.9 percent in July, and private non-residential spending was up 0.6 percent. Public construction spending fell 0.3 percent in July. On a year-ago basis private residential spending was up 17 percent in July as homebuilding rebounds from the housing bust. Private non-residential spending was up a much more modest 2 percent as the recovery in commercial construction remains muted. And public construction spending was down almost 4 percent in July from one year earlier as a result of budget cuts, particularly at the Federal level (see Chart 1).

Private construction spending will continue to increase in the near term, with housing leading the way in 2013. Despite rising mortgage rates demand for new homes continues to increase, thanks to pent-up demand, good affordability, job growth, and easing lending standards. Commercial construction is expanding, but slowly, as there is still a good deal of empty space on the market, particularly office space. Non-residential building will gradually improve through the rest of this year and in 2014 as job gains lead to more absorption of excess supply. Public construction spending will continue to decline, however, with the emphasis on deficit reduction on the Federal level, although improving budget outlooks for state and local governments will provide some offset.

Vehicle sales were 16.1 million units at a seasonally-adjusted annualized rate, up from 15.8 million in July. This was the best month for auto sales since November 2007, before the start of the Great Recession (see Chart 2). Although overall

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consumer spending growth remains disappointing, households are boosting their purchases of cars and trucks. There is significant pent-up demand for vehicles after households put off purchases in recent years because of economic uncertainty; with the improvement in the job market consumers are now more willing to buy a new vehicle. Low interest rates and slightly laxer lending standards for auto loans are also supporting sales. The pickup in homebuilding is also boosting purchases of light trucks used in construction.

Sales will continue at their current pace of around 16 million units over the next year. Increased domestic vehicle production is supporting job and income growth, especially in the Midwest and Southeast.

The Federal Reserve's Beige Book reported "modest to moderate" economic growth from early July to late August.

All twelve Fed districts reported economic expansion, with eight reporting moderate growth.

Consumer spending increased in mid-summer, especially on vehicles and housing-related items. There was also an improvement in travel and tourism. There was modest growth in manufacturing in the period covered by the Beige Book, especially for autos and homebuilding materials, although there was some weakness tied to Federal spending cuts. Services spending by businesses also increased.

The housing market recovery continued, with stronger sales and limited supply pushing up prices. Homebuilding also continued to strengthen nationally. Conditions were also improving for commercial real estate, but at a slower pace, with better demand for office space. The Beige Book reported that financial market conditions were essentially

Chart 1: Homebuilding Accounting for Most Construction Growth

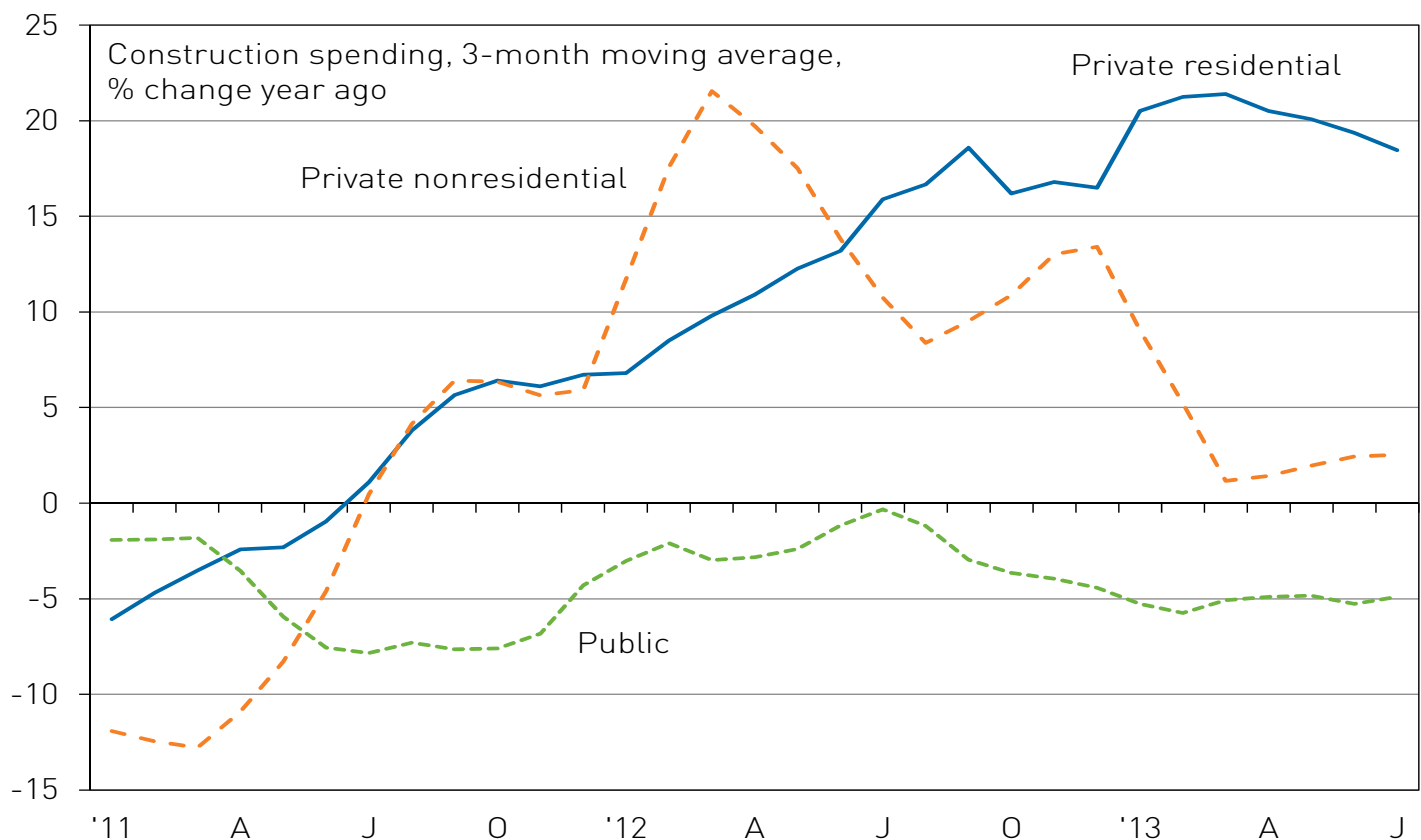


Chart source: Census Bureau

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flat, with little change in lending standards but improved credit quality. Energy production remained a bright spot, but agricultural activity was generally weak due to poor weather.

The labor market continued its slow improvement in the middle of the summer, with stronger demand for information technology workers and modest growth in manufacturing employment. Wage pressures remained modest.

The ISM manufacturing index rose in August to 55.7 percent, from 55.4 percent in July, against expectations for a small decline. The index is comfortably above the 50 level that indicates expansion in manufacturing. There was a big jump in the new orders component, although the production component fell slightly. The employment component also declined in August. These three components were above 50 for the month, along with supplier deliveries; inventories

was the only component used in calculating the index below 50 in August, although it did increase over the month. Other details were generally positive.

Of the 18 manufacturing industries covered in the survey 15 reported expansion in August. Growth was strongest for textile mills and wood products, which are both benefiting from the improving housing market.

After slower growth in early 2013 manufacturing appears to be reaccelerating. Business investment has improved after some weakness in late 2012 and early 2013 tied to uncertainty about Federal tax and spending policies. Exports were also a drag with recession in Europe. Vehicles and the housing market are also boosting manufacturing. After leading growth earlier in the recovery, manufacturing is now expanding at roughly the same rate as the overall economy.

Chart 2: Vehicle Sales Back to Pre-Recession Levels

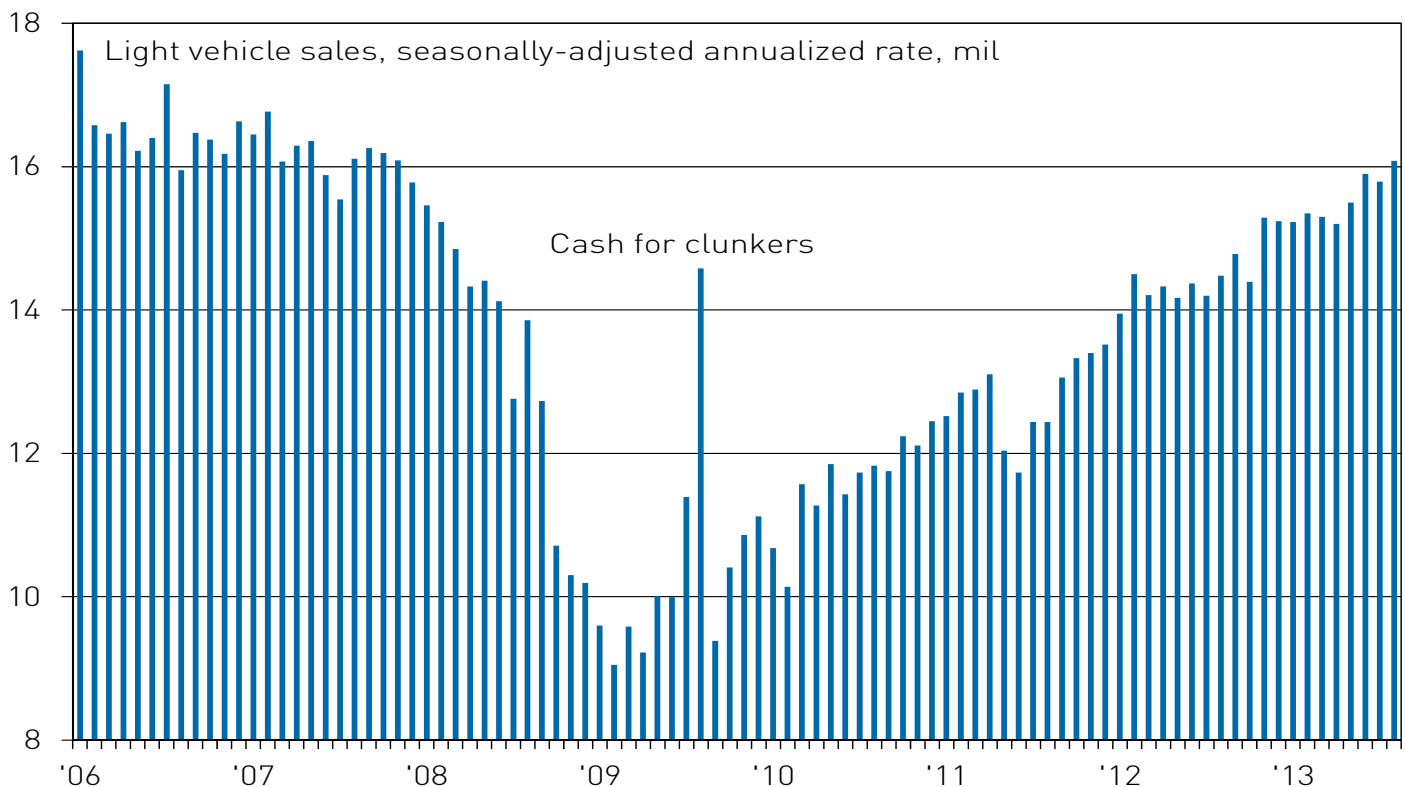


Chart source: AutoData

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