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ECONOMIC REPORT

Stuart Hoffman Chief Economist

Gus Faucher Senior Economist

William Adams Senior Economist

Kurt Rankin Economist

Mekael Teshome **Economist**

THE PNC FINANCIAL SERVICES GROUP | Three PNC Plaza | 225 Fifth Avenue | Pittsburgh, PA 15222-2724

SERVICE INDUSTRIES CONTINUE TO EXPAND ACCORDING TO ISM NON-MANUFACTURING INDEX

SUMMARY

- The ISM non-manufacturing index fell slightly in October to 54.2 percent, but remains well above the 50 percent level that indicates expansion.
- Forward-looking details were weak, although the employment component rose.
- Service industries will play a more important role in the expansion going forward as manufacturing growth has slowed.
- With both the manufacturing and non-manufacturing ISM indices indicating expansion, moderate economic growth will continue through the end of 2012 and into 2013.

The ISM non-manufacturing index fell from 55.1 percent in September to 54.2 percent in October. This was the first decline in the index since June. A reading greater than 50 is consistent with expansion in the non-manufacturing sector, and the index has been above this threshold for 34 straight months. The October survey was taken before Superstorm Sandy hit.

All four of the major components used in calculating the overall index were above 50 in October. However, three of the components fell over the month, with business activity falling 4.5 percentage points to 55.4, and new orders falling 2.9 percentage points to 54.8. However, the employment component rose 3.8 percentage points in October to 54.9 percent. This confirms the strengthening in the labor market from the October employment report, when non-manufacturing private payrolls rose by 171,000. Four of the remaining five subcategories were below 50 in October, with exports dropping 3 percentage points to 47.5. Recession in Europe and weaker growth in Asia are weighing on U.S. exports.

Thirteen of the 18 industries included in the non-manufacturing index reported expansion in October, with the strongest growth in agriculture and construction. With the homebuilding recovery picking up construction indicators are improving; the industry added 17,000 jobs in October, the largest payroll gains since January. Construction employment will get an additional near-term boost from rebuilding after Superstorm Sandy. Five industries reported contraction in October, including mining and arts, entertainment and recreation.

The ISM manufacturing index, released last week, rose 0.2 percentage point in October to 51.7 percent. Manufacturing continues to expand but at a slower pace as growth in business investment and exports has slowed. Manufacturing had been leading the overall recovery, but as that industry's growth has slowed, non-manufacturing industries are carrying more of the load (see Chart). The ongoing turnaround in homebuilding is driving expansion in construction, and continued gains in consumer spending are also boosting non-manufacturing industries.

Uncertainty over the outlook for taxes and spending will remain a drag in late 2012, and a likely increase in the Social Security payroll tax will weigh on growth in the first half of 2013. A widening trade deficit will also subtract from growth in the near term as the European recession continues and growth in Asia remains soft. Still, gains in consumer spending and homebuilding and a pickup in business investment will be enough to move the recovery forward; clarity on taxes and spending policy after the election will also be a positive. Superstorm Sandy is not expected to significantly reduce nearterm growth, and may provide a boost to the economy in the first half of 2013 as reconstruction gets underway.

PNC's baseline forecast is for real GDP growth of 2.2 percent in 2012 and 2.1 percent in 2013. Monthly job gains will average about 165,000 this year and 170,000 next year. The unemployment rate will average 7.9 percent in the fourth



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quarter of 2012, and fall to 7.5 percent in the fourth quarter of 2013.

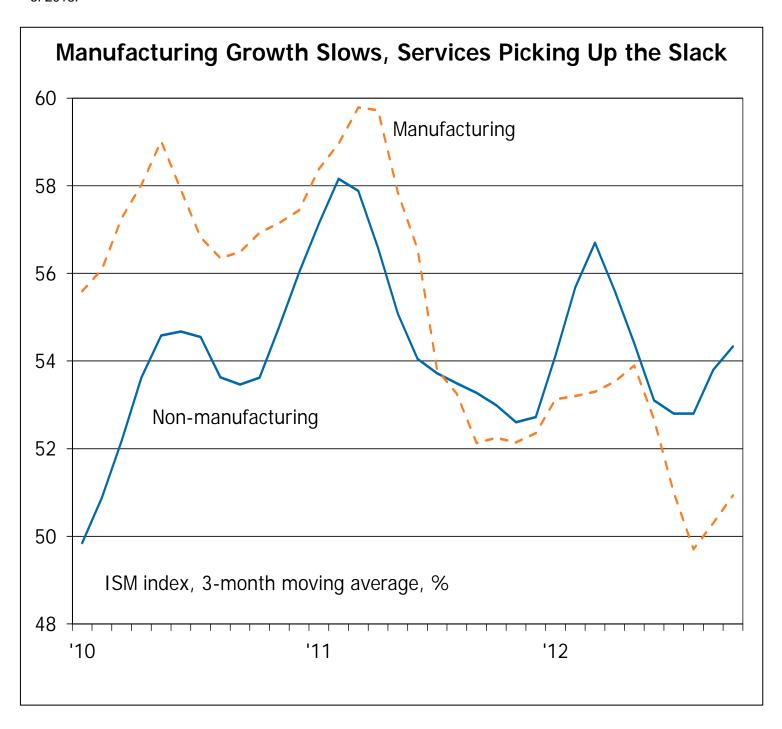


Chart source: ISM

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