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ECONOMIC REPORT

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MINIMAL IMPACT FROM HARVEY ON NATIONAL GROWTH; ECONOMY AND JOB MARKET REMAIN IN SOLID SHAPE

SUMMARY

- The U.S. economy will take only a small hit from Hurricane Harvey, with most lost output made up over the next few quarters.
- Real GDP growth in the second quarter was revised up to 3.0 percent, from the previous estimate of 2.6 percent.
- Corporate profits rose 1.3 percent in the second quarter, led by domestic nonfinancial corporations.
- Personal income rose 0.4 percent in July, the biggest gain since February. After-tax income rose 0.3 percent.
- Consumer spending increased 0.3 percent in July, with gains for durable goods, nondurable goods and services.
- Job gains and income growth will continue to power consumer spending and overall economic growth into 2018.
- Inflation was modest in July, and it remains well below the Federal Reserve's 2 percent target. However, inflation should gradually pick up over the next year.
- The private sector added 237,000 jobs in August, according to the ADP report.
- PNC expects the BLS to report August job growth of 160,000, with the unemployment rate steady at 4.3 percent.

Despite the devastation in parts of Texas and Louisiana from Hurricane Harvey, the impact on the national economy will be minor. Localized national disasters generally have minimal impact on the overall economy. Houston is the fourth-largest metro area economy in the U.S., but the metro area accounted for less than 3 percent of national GDP in 2015, and just 2 percent of national employment in 2016. While some output will be lost in the wake of the storm, and other smaller metro areas will also see reduced production, most of the difference will be made up in the months ahead. Reconstruction efforts, funded by the federal government and insurance payouts, will add to growth later this year and in 2018. U.S. real GDP may take a slight hit in the third quarter, but that should be made up in subsequent quarters. There could be some drag on consumer spending from higher nationwide gasoline prices because of temporary refinery shutdowns and restricted supply, but given solid consumer fundamentals that will not be a significant weight on household spending.

Real GDP growth in the second quarter of 2017 was revised higher in the second estimate, to 3.0 percent at an annual rate, up from 2.6 percent in the preliminary estimate. There were upward revisions to consumer spending and business fixed investment, although those were somewhat offset by a larger decline in state and local government spending. Growth in the first quarter of the year was 1.2 percent at an annual rate. The economy grew 2.2 percent in the second quarter from one year earlier. Consumer spending, business fixed investment, higher exports, federal spending, and investment in inventories drove second quarter growth. Higher imports were a drag, as were housing investment and state and local government spending.

This was the first estimate on second quarter gross domestic income, another measure of the size of the economy that looks at income going to households and businesses. Adjusted for inflation, gross domestic income rose 2.9 percent annualized in the second quarter, up slightly from 2.7 percent growth in the first quarter. Real gross domestic income was up 2.0 percent in the second quarter from one year earlier.

Corporate profits, unadjusted for inflation, were $2.136 trillion in the second quarter at an annualized rate, up 1.3 percent

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from the first quarter (not annualized). All of the increase in profits came from domestic nonfinancial corporations; domestic financial profits were down, as were profits from overseas. Total profits were up a very good 7.0 percent year-over-year in the second quarter.

Nominal personal income increased 0.4 percent in July, matching the consensus expectation. This was the biggest gain in personal income since February. Wages and salaries were up 0.5 percent for the second straight month, thanks to continued improvement in the labor market. Nominal after-tax income rose 0.3 percent in July, with tax payments up a big 1.3 percent in July from June.

Nominal consumer spending rose 0.3 percent in July, weaker than the consensus expectation for a 0.4 percent increase. Spending growth in June was revised higher to 0.2 percent, from 0.1 percent. Spending rose 0.6 percent over the month for durable goods, 0.5 percent for nondurable goods, and 0.2 percent for services.

The personal consumption expenditures price index, the Federal Open Market Committee's preferred inflation measure, increased 0.1 percent in July from June, the first gain since April. The core PCE price index, excluding volatile food and energy prices, rose 0.1 percent for a third straight month. On a year-ago basis overall PCE inflation was 1.4 percent in July, unchanged from June and down from a recent peak of 2.2 percent in February. Core PCE inflation was also 1.4 percent in July, down from 1.5 percent in May and June and 1.9 percent earlier in the year. Inflation remains well below the FOMC's 2.0 percent goal.

Inflation-adjusted after-tax income was up 0.2 percent in July from June, and up 1.3 percent from a year earlier. Inflation-adjusted spending rose 0.2 percent in July, and was up 2.7 percent year-over-year.

The July report on personal income and spending was mixed. Income growth was solid, although a jump in tax payments that likely will not persist weighed on disposable income growth over the month. However, spending growth was slightly softer, despite Amazon Prime Day. Over the past year spending has grown faster than incomes, and thus the savings rate has fallen. Income growth should pick up in the months ahead thanks to job gains and rising wages from a tightening labor market. This will continue to push up consumer spending and support overall economic expansion.

Core inflation, measured on a year-ago basis, moved further away from the FOMC's 2.0 percent goal, and overall inflation remains well below the goal. One-time factors have held down inflation this year, including new cell phone

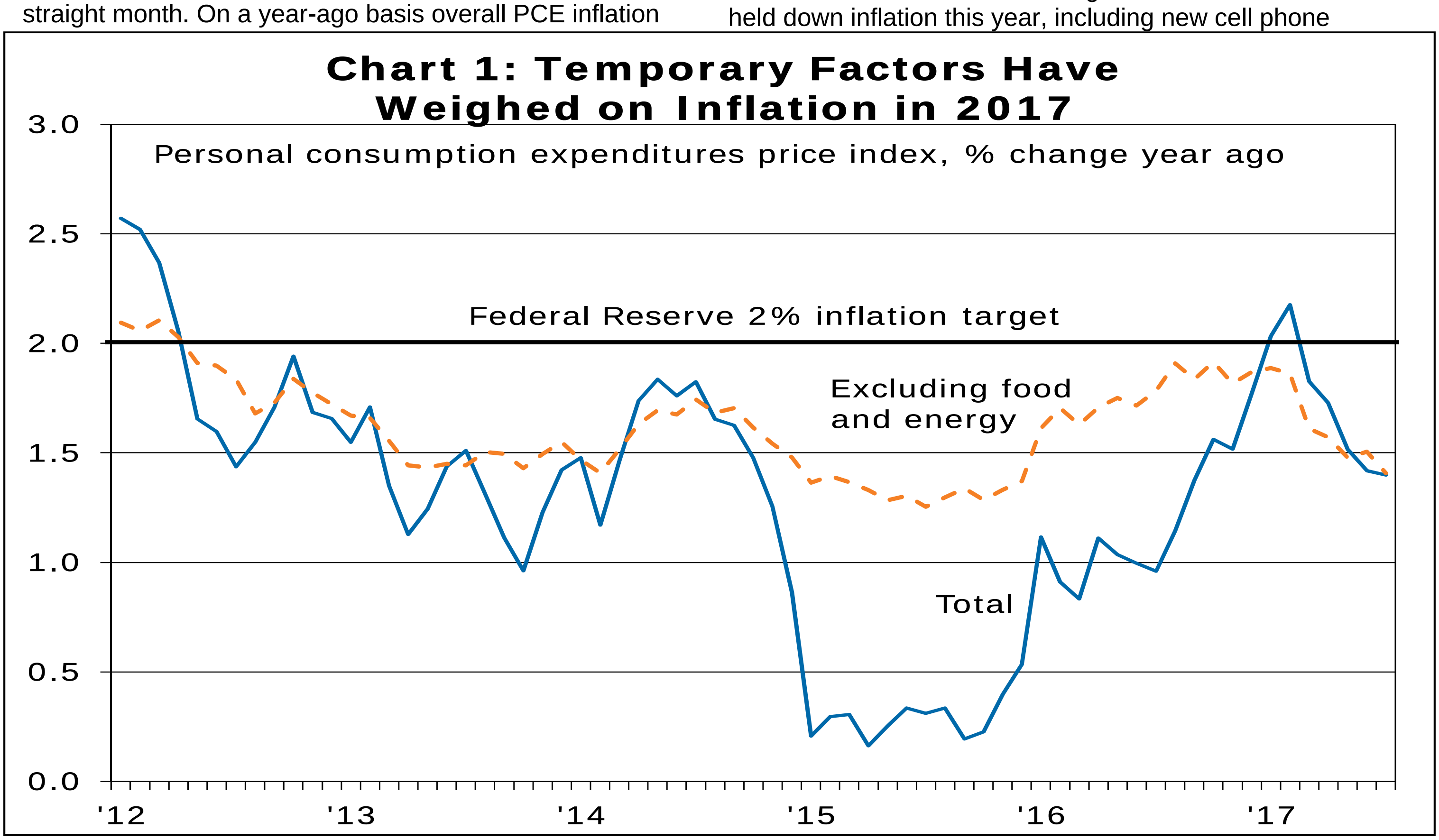

Chart source: Bureau of Economic Analysis

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pricing plans and lower pharmaceutical prices (see Chart 1). These should gradually fade from the data. In addition, inflation will get a boost from higher gasoline prices in the wake of Hurricane Harvey and the tighter job market will eventually push up wages and inflation.

The private sector added 237,000 jobs in August, according to a report based on records from payroll-processing firm ADP. Job growth was broad-based, across all firm sizes and most industries. Once again, service industries led job growth, with a gain of 204,000, including big increases in leisure and hospitality services, education and health services, and professional and business services (see Chart 2). Goods-producing industries added 33,000 jobs in August, with increases in construction and manufacturing, but small job losses in natural resources and mining.

The impact of Harvey on jobs will not show up until the September jobs report, which the Bureau of Labor Statistics will release on September 1. The employment survey for the August report was taken before the storm hit. After good job growth of 209,000 in July and 231,000 in June, PNC is expecting slightly softer job growth of 160,000 in August, with 140,000 jobs added in the private sector. Government employment likely increased 20,000 in August, boosted by hiring for local education. The unemployment rate likely held steady at 4.3 percent.

Employment growth is set to slow in September because of job losses tied to Harvey but should bounce back quickly as reconstruction gets underway; similar patterns were seen after Hurricane Katrina and Superstorm Sandy.

Overall, the U.S. economy and labor market remain in good shape and will easily withstand any temporary drag from Harvey. Solid job growth continues to push consumer incomes higher, powering gains in consumer spending. Businesses are investing, albeit modestly, and the moderate housing recovery continues. Better global growth in 2017 is also a positive for the U.S. economy. PNC is forecasting 2.2 percent real GDP growth for all of 2017, up from 1.5 percent last year. Growth will be slightly stronger in 2018, at 2.6 percent, with support from expected tax cuts and perhaps an increase in infrastructure spending.

Chart 2: Services Leading Private-Sector Job Gains

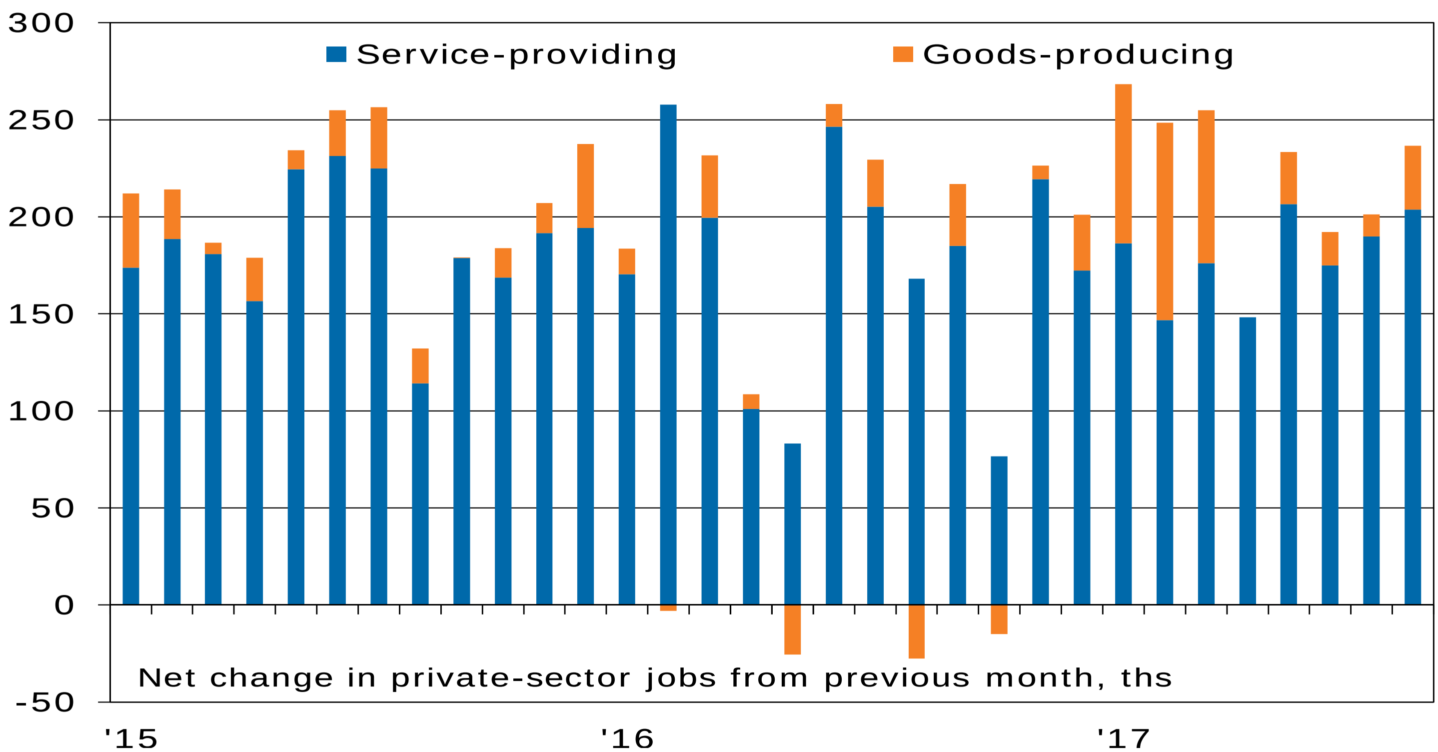

Chart source: ADP

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