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ECONOMIC REPORT

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FOMC SET TO RAISE RATES IN JUNE WITH MODERATE INFLATION; SMALL DOWNWARD REVISION TO Q1 GROWTH

SUMMARY

- The minutes from the latest FOMC meeting point to a fed funds rate hike in June.
- Inflation is close to the FOMC's 2 percent goal, and the FOMC is willing to let inflation move above 2 percent.
- Consumer spending increased 0.4 percent in April, the second straight month of good growth.
- After-tax income rose a solid 0.4 percent in April.
- Economic growth in the first quarter was revised slightly lower, to 2.2 percent.
- Auto sales slipped in May, but were still solid at 16.9 million.

In their meeting on May 1 and 2, Federal Open Market Committee participants supported further gradual increases in the federal funds rate if the economy continued to evolve as expected. In particular, the minutes from the meeting say that "Most participants judged that if incoming information broadly confirmed their current economic outlook, it would likely soon be appropriate for the Committee to take another step in removing policy accommodation." This points to another fed funds rate hike at the FOMC's next meeting, on June 12 and 13.

Participants expressed some uncertainty about the outlook for inflation. Inflation has moved toward the FOMC's 2 percent goal in 2018. However, after years of inflation below the goal, there were questions about whether inflation would stay at 2 percent, especially given moderate wage growth. Most participants expected inflation to stay at around 2 percent given still-expansionary monetary policy. The minutes emphasized the symmetric nature of the 2 percent goal, meaning that participants would support inflation temporarily above 2 percent. And the minutes said that "It was also noted that a temporary period of inflation modestly above 2 percent would be consistent with the Committee's symmetric inflation objective and could be helpful in anchoring longer-run inflation expectations at a level consistent with that objective," i.e., that at least some participants would like to see inflation stay above the goal temporarily.

The minutes noted discussion of the forward-looking language in the statement. For years FOMC statements have said that the "federal funds rate is likely to remain, for some time, below levels that are expected to prevail in the longer run," and that "the stance of monetary policy remains accommodative." However, some participants called for revisiting this language, noting that with a few more increases the fed funds rate could start to become a drag on economic growth, particularly given uncertainty around its long-run value.

Participants discussed the recent flattening in the yield curve, the difference between long-term and short-term interest rates. Although they agreed that the flattening was explained by economic factors, they also noted that an inverted yield curve, when short-term rates move above long-term rates, often points to a recession, and "several participants thought that it would be important to continue to monitor the slope of the yield curve."

Inflation in April was 0.2 percent on a monthly basis, measured using the Fed's preferred inflation metric, the personal consumption expenditures price index. Core inflation (excluding food and energy prices) was also 0.2 percent. On a year-ago basis overall inflation was 2.0 percent in April, at the FOMC's goal, with core inflation slightly below the goal at 1.8 percent (see Chart 1). With inflation now close to the goal, and the labor market in excellent shape (the unemployment rate fell to an 18-year low in May), the FOMC will continue to gradually raise the fed funds rate; PNC expects the next

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increase to come at the FOMC's June 13 meeting. The fed funds futures market indicates a 91 percent probability of a June 13 rate increase. PNC's baseline forecast then calls for another fed funds rate hike in December, for a total of three in 2018. This is consistent with the FOMC's latest projections, from March; the committee will release new projections in June.

Personal income rose 0.3 percent in April, with wages and salaries up 0.4 percent. After-tax income growth was 0.4 percent over the month. After-tax income was up 3.9 percent in April from one year earlier; income growth has accelerated over the past year thanks to job gains, a pickup in wage growth with the tight job market, and the personal income tax cut enacted at the end of 2017. However, higher inflation has weighed on growth in real after-tax income a bit in early 2018 (see Chart 2).

Consumer spending rose 0.6 percent in April, after a 0.5 percent increase in March. This followed two months of much softer gains. Some of the April increase was due to higher prices for energy, but even after adjusting for inflation spending was up 0.4 percent over the month. On a year-over-year basis consumer spending rose 2.7 percent before inflation in April, close to where it has been for the past few years.

Real GDP growth in the first quarter was 2.2 percent at an annual rate, according to the second estimate from the Bureau of Economic Analysis; this was revised down from a 2.3 percent pace in the advance estimate. There were downward revisions to investment in inventories and consumer spending, somewhat offset by an upward revision to business fixed investment.

Growth was slower in the first quarter compared to the better than 3 percent annualized growth in the previous three quarters, but this does not indicate a slowing in the economy. Some of the apparent softness came from problems the Bureau of Economic Analysis is having with seasonal adjustment. Growth in the first quarter has been consistently weaker than in the other three quarters of the year; since 2000 first-quarter growth has averaged 1.1 percent, compared to 2.2 percent in the other three quarters. On a year-ago basis real GDP growth was 2.8 percent in the first quarter, the fastest pace since the first half of 2015.

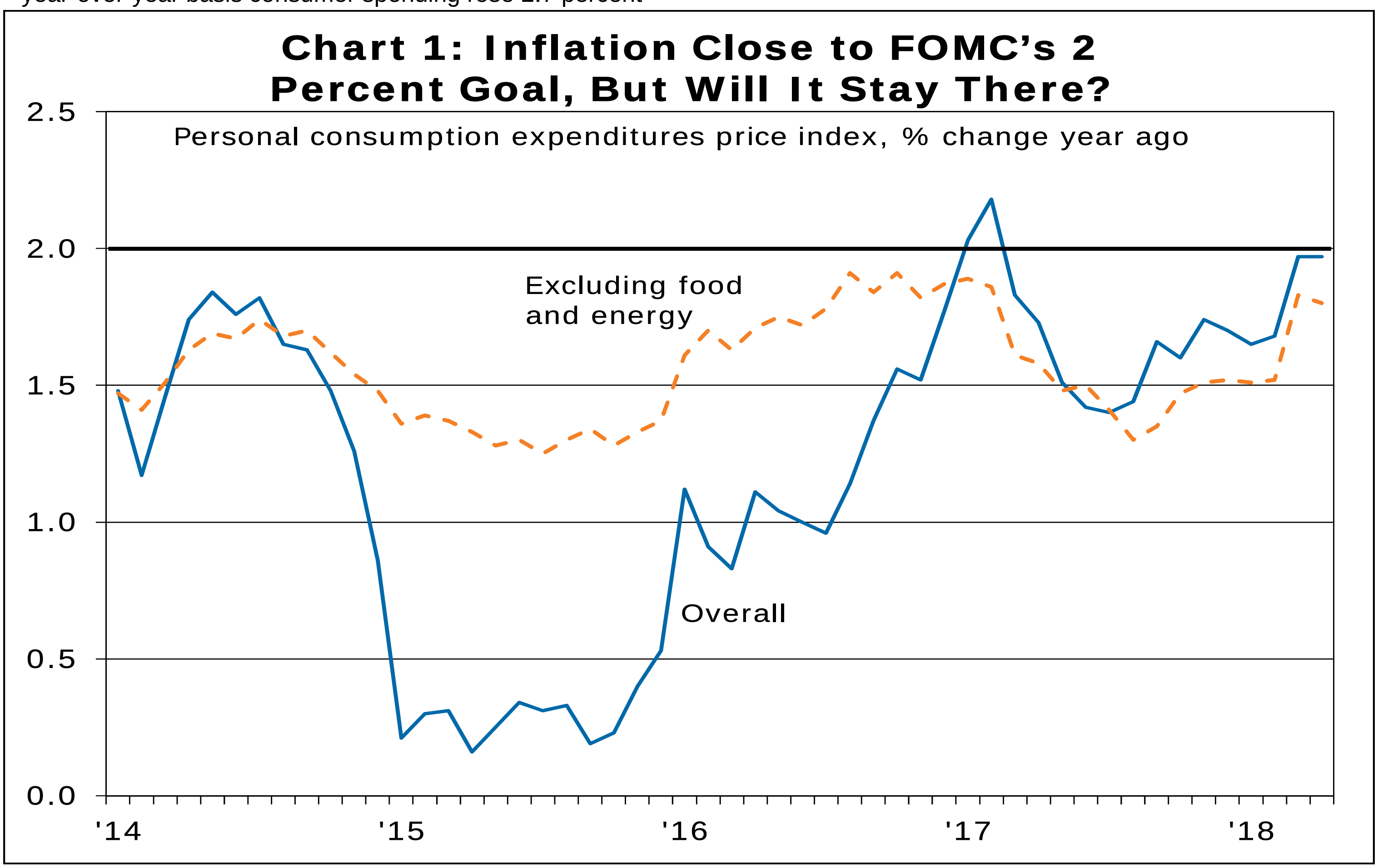

Chart source: Bureau of Economic Analysis

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Corporate profits fell 0.6 percent in the first quarter of 2018 (not annualized), after a 0.1 percent decline in the fourth quarter. All of the decline came from domestic nonfinancial corporations. After-tax profits jumped by 7 percent in the quarter due to the corporate income tax cut passed in late 2017, even as before-tax profits fell.

Real gross domestic income, an alternative measure of the size of the economy based on income going to households and firms, rose 2.8 percent annualized in the first quarter of 2018, and was up 2.1 percent from one year earlier.

PNC is forecasting economic growth of 3.0 percent for all of 2018, up from 2.3 percent last year. This stronger growth will come from an acceleration in business investment, in part because of the corporate income tax cut; continued solid gains in consumer spending; further gradual improvement in the housing market; and greater federal government spending.

Auto sales were 16.91 million at a seasonally-adjusted annualized rate in May according to AutoData, down 1.5 percent from 17.17 million in April. May sales were up 0.7 percent from one year earlier.

Sales jumped to 18.6 million annualized units in September 2017 as consumers needed to replace cars and trucks lost during Hurricanes Harvey and Irma, but have gradually trended lower since. With very strong sales over the past few years there is little need to replace older cars and trucks, and thus vehicle sales are likely to move gradually lower over the next couple of years, despite the good labor market. Higher interest rates on auto loans and higher gasoline prices will also weigh on sales. PNC expects sales of 17.1 million this year and 16.9 million next year, down from 17.2 million last year and 17.5 million in 2015 and 2016.

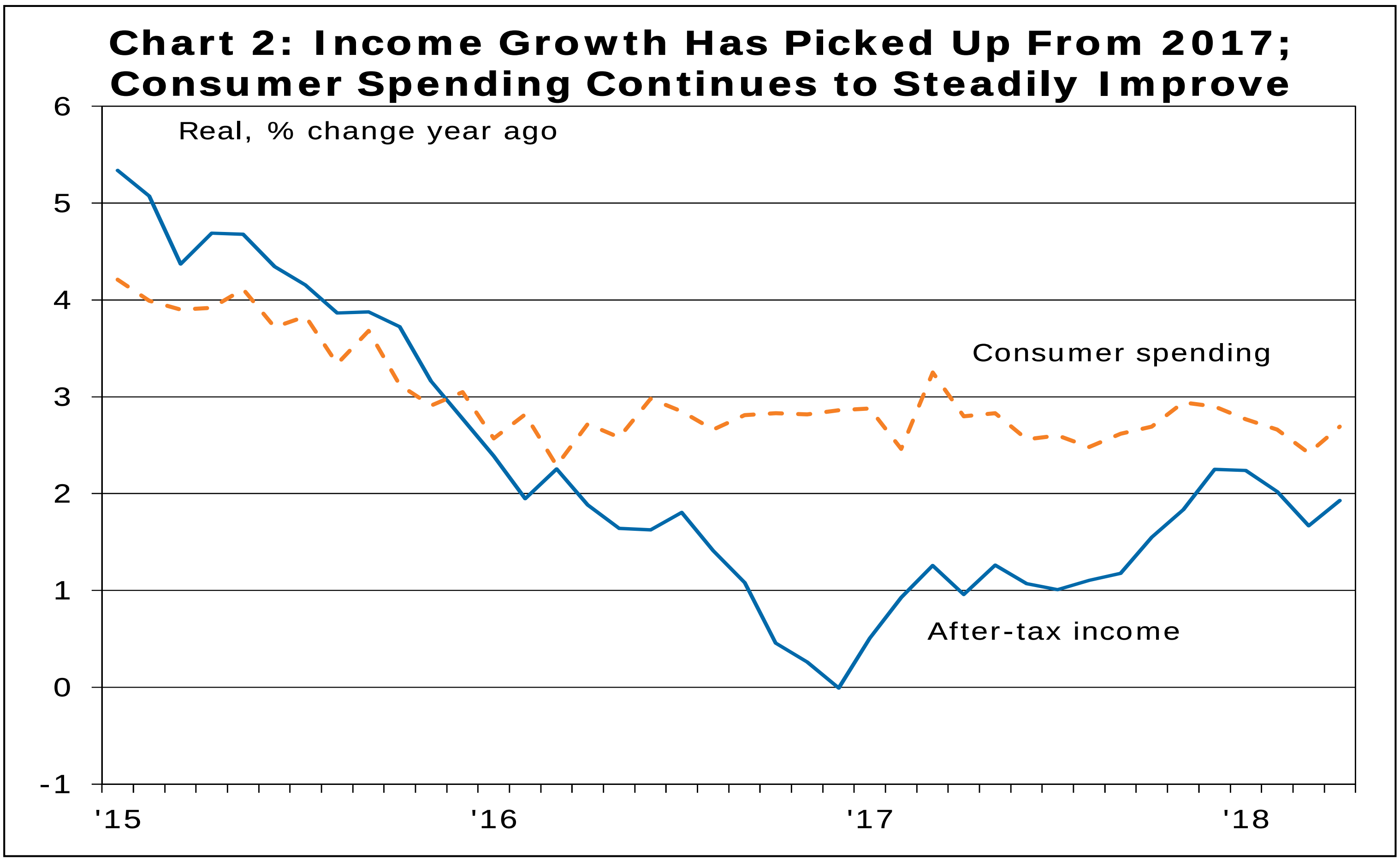

Chart source: Bureau of Economic Analysis

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