March 13, 2019

ECONOMIC REPORT

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INFLATION SLOWED IN FEBRUARY; RETAIL SALES, HOUSING STARTS SOMEWHAT BETTER IN JANUARY

SUMMARY

- The consumer price index rose 0.2 percent in February, with core prices up 0.1 percent. Inflation slowed on a year-over-year basis.
- Retail sales rose a modest 0.2 percent in January, but December's big decline was revised down further, to a huge 1.6 percent drop.
- Housing starts rose in January to their highest level since September, with an especially big gain for single-family starts.
- With recent mixed data, low inflation gives the Federal Reserve room to be patient with monetary policy. PNC does not expect an increase in the federal funds rate until the second half of 2019.

The consumer price index increased 0.2 percent in February, matching the consensus. Overall inflation was zero in each of the three previous months as there were steep drops in energy prices from November to January, offsetting increases in other prices. But energy prices rose 0.4 percent in February, pushing overall inflation higher. Core prices, excluding volatile food and energy prices, were up 0.1 percent in February, below the consensus expectation of a 0.2 percent increase. Core inflation slowed in February from 0.2 percent each month from September to January.

On a year-ago basis overall inflation (with seasonal adjustment) held steady at 1.5 percent in February. Core inflation slowed from 2.2 percent in January to 2.1 percent in February (see Chart 1). Although inflation has slowed in recent months, it should move gradually higher in the spring and summer. Higher energy prices will push up overall inflation, and rising wages will lead businesses to raise prices in an effort to maintain profit margins.

Retail sales rose 0.2 percent in January, slightly better than the consensus expectation for a 0.1 percent increase. Sales dropped a huge 1.6 percent in December, revised even lower from the initially reported 1.2 percent decline. December was the biggest monthly drop since September 2009, after the expiration of "cash for clunkers," a federal incentive program for new car buyers.

January details were better than the headline number. Sales excluding autos and parts were up 0.9 percent in January, and sales excluding autos and gasoline were up 1.2 percent. Gasoline sales were down 2.0 percent because of lower fuel prices, and sales of autos and parts were down 2.4 percent. Control sales—sales excluding food service, autos, gasoline, and building supplies, and which go into nominal consumer spending in GDP—were up a solid 1.1 percent in January, making back about one-half of December's 2.3 percent decline.

On a year-ago basis total retail sales were up 2.3 percent in January. This is up from 1.6 percent in December, but down from 4.0 percent in November, and 6+ percent growth in mid-2018 (see Chart 2). Sales excluding autos were up 2.8 percent in January from a year earlier, compared to a 1.5 percent increase in December. Year-ago sales excluding autos and gasoline were up 3.7 percent in January, stronger than 1.7 percent growth in December. Control sales were up 3.3 percent year-over-year in January, a rebound from 1.1 percent growth in December, but down from better than 4 percent in the fall of 2018, and around 5 percent in the middle of last year.

Consumer spending rebounded in January, even with some households likely restraining their spending because of the partial federal government shutdown. However, December's steep decline was revised even lower, with the biggest drop

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in almost a decade. December's decline does not appear to be related to data problems from the government shutdown. Retail sales are likely to increase again in February as federal workers received back pay after the shutdown ended in late January.

December's large decline in retail spending is concerning, because there was no obvious cause. It may be that the big drop in stock prices at the end of 2018 spooked consumers. Consumer spending will continue to increase this year, but growth will slow over the course of 2019 as drivers turn less positive. Job growth was very weak in February at just 20,000 for the month, and although job growth will rebound, it will likely be slower than it was in 2018 as the tight labor market limits job gains going forward. Tax refunds this year were initially delayed by the government shutdown, and have been smaller than in previous years because of changes to withholding in the wake of the 2017 cut in personal income taxes. Higher interest rates will also take a toll on consumer spending this year, particularly for big-ticket items like cars and trucks, appliances, housing-related materials, and vacations.

Still, consumer spending will continue to increase in 2019, just at a slower pace than in recent years. Strong wage growth because of the tight labor market, rising home prices, and the recovery in stock prices in early 2019 are positives for near-term household spending. With rising consumer incomes and spending the U.S. economic expansion will continue in 2019, and by the middle of this year will become the longest expansion in U.S. history.

Housing starts rose a strong 19 percent in January to 1.23 million at a seasonally-adjusted annualized rate, the best number since September. Single-family starts jumped 25 percent to 926,000, the best month since May of last year. Multifamily starts rose 2 percent, to 533,000. Residential construction permits also rose in January, up 1.4 percent for the month, suggesting an increase in starts over the next few months.

Starts had weakened since the spring of 2018, in large part because of higher mortgage rates. A decline in rates over the past few months should contribute to gains in homebuilding, and PNC expects residential construction to

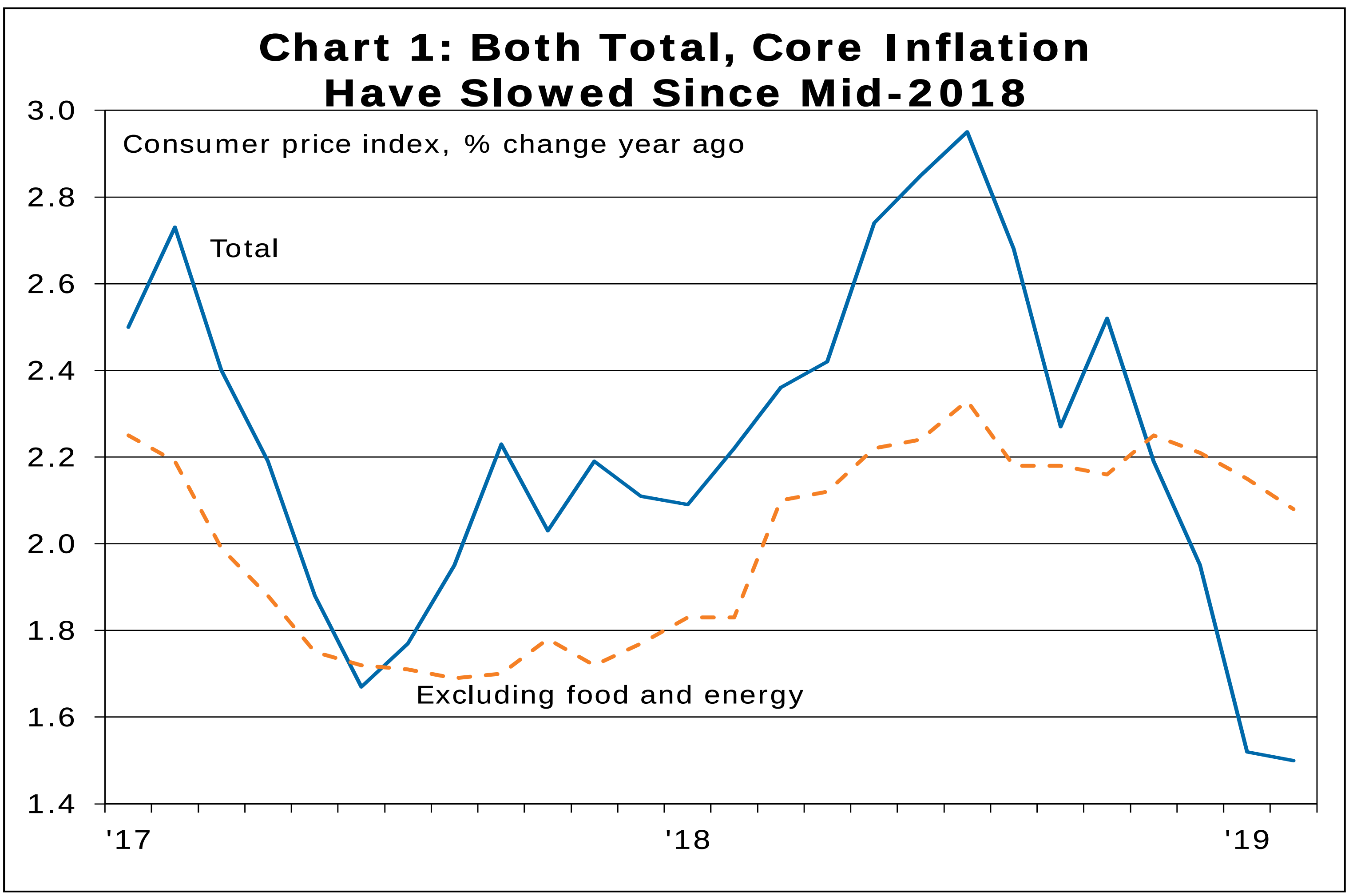

Chart source: Bureau of Labor Statistics

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provide a modest boost to overall U.S. economic growth in 2019.

The Federal Reserve has set a symmetric inflation objective of 2.0 percent using the personal consumption expenditures price index, which tends to run a touch below the CPI. In December overall PCE price inflation was 1.7 percent on a year-ago basis, while core inflation was 1.9 percent. (The January PCE inflation report has been delayed because of the partial government shutdown earlier this year.)

The slowing in CPI inflation suggests that PCE inflation has moved even further below the Fed's 2 percent objective in early 2019. Because of this, the Federal Open Market Committee is in no hurry to raise interest rates. With a lot of uncertainty surrounding the US economy right now—the stock market decline in late 2018, ongoing trade talks with China, the partial government shutdown earlier this year, Brexit, the big drop in retail sales in December, the weak February jobs report, softness in the housing market—the FOMC can take a wait-and-see approach. PNC expects no change in the fed funds rate, the Fed's key policy rate, at the next FOMC meeting on March 19 and 20. The fed funds rate is currently in a range between 2.25 and 2.50 percent.

By the middle of 2019 it should be apparent that the US economy, and in particular the labor market, remain in good shape. At that point inflation will have picked up somewhat. PNC expects one increase in the fed funds rate this year, at the FOMC's September meeting. That would take the fed funds rate to a range of 2.50 to 2.75 percent, close to its neutral level, where it neither adds to nor subtracts from economic growth.

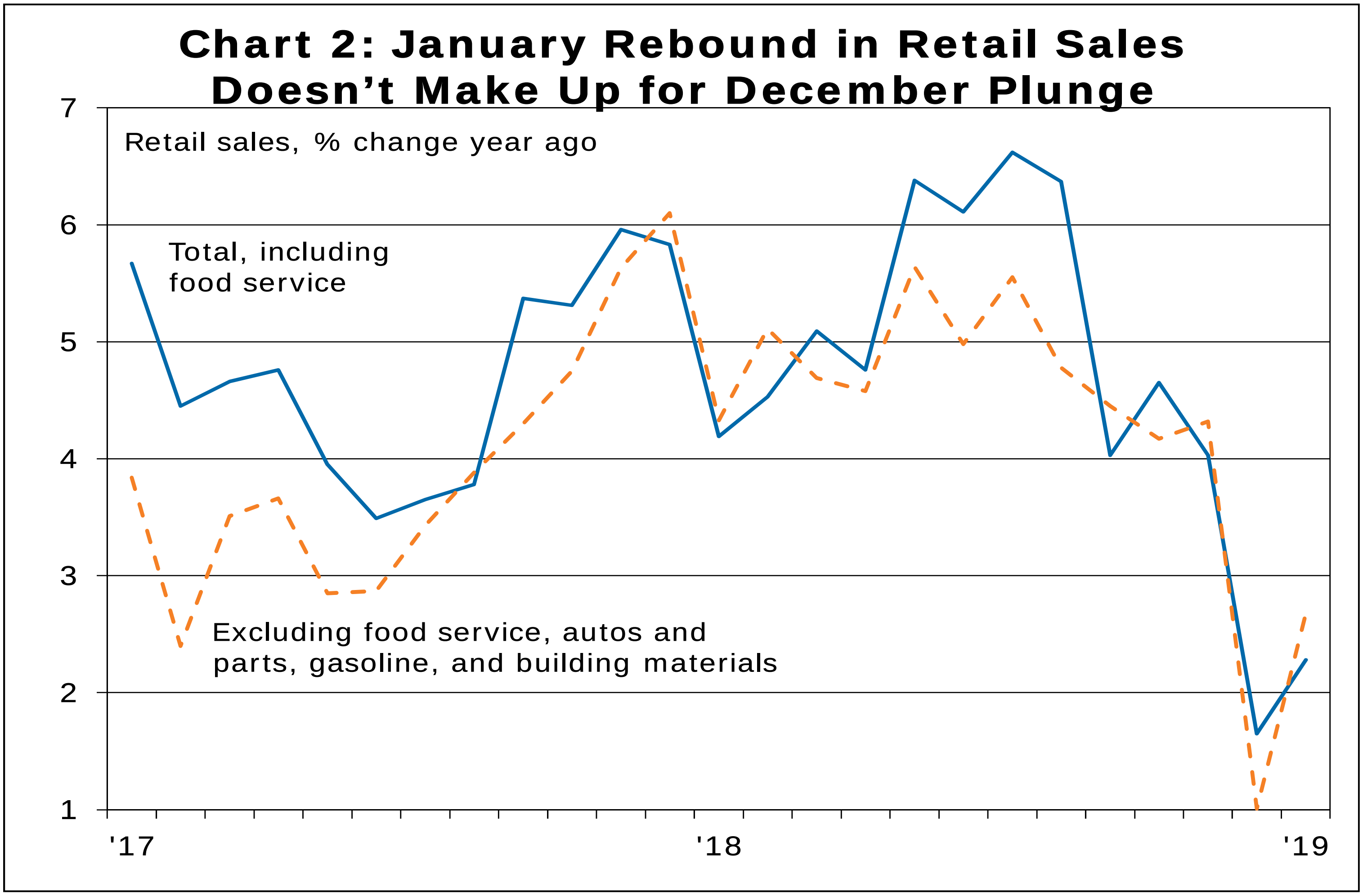

Chart source: Census Bureau

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