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ECONOMIC REPORT

Gus Faucher Chief Economist | **Stuart Hoffman** Senior Economic Advisor | **William Adams** Senior Economist | **Kurt Rankin** Economist | **Abbey Omodunbi** Economist

THE PNC FINANCIAL SERVICES GROUP | The Tower at PNC Plaza | 300 Fifth Avenue | Pittsburgh, PA 15222-2401

FED HOLDS RATES STEADY AS EXPECTED; ECONOMIC HIT FROM GOVERNMENT SHUTDOWN WILL FADE

SUMMARY

- As expected, the FOMC held the fed funds rate steady at its meeting in late January.
- PNC expects the FOMC to raise the fed funds rate once in 2019, in September.
- The CBO expects that most of the economic output lost during the recent partial federal government shutdown will be made up in the second quarter.
- Private-sector job growth remained solid in January, according to data from payroll-processing firm ADP.
- Job growth likely slowed in January and the unemployment rate likely rose due to the shutdown, but the fundamentals are good and the labor market should quickly bounce back.

After the conclusion of its meeting on January 29 and 30, the Federal Open Market Committee held the fed funds rate steady in a range between 2.25 to 2.50 percent; it had raised the fed funds rate 25 basis points to that range at its previous meeting, on December 19. The decision was unanimous.

In holding the fed funds rate steady, the FOMC expressed more caution about the outlook. The policy statement said that “In light of global economic and financial developments and muted inflation pressures, the Committee will be patient as it determines what future adjustments to the target range for the federal funds rate may be appropriate to support” the FOMC’s objectives of sustained economic growth, a strong labor market, and inflation close to 2 percent. This is a noticeable change from the language of the December 19 statement, which said that “The Committee judges that some further gradual increases in the target range for the federal funds rate will be consistent with” these objectives. Chair Powell also used “patient” a number of times in his post-meeting press conference on January 30.

Although the January 30 statement was much more dovish than the previous one, the section of the statement commenting on current economic conditions was still quite positive. The statement called economic growth “solid,” although that was a downgrade from “strong” on December 19. The statement said job growth has been “strong,” and was positive about both consumer spending and business investment, using essentially the same language as in December. There was no explicit mention of the partial government shutdown or its economic impact in the statement, although Chair Powell did mention it in his press conference. In addition, the January 30 statement dropped any mention of risks to the outlook; the previous statement called risks “roughly balanced.”

The January 30 FOMC statement had a different tone compared to the one from mid-December. Although the description of current economic conditions was quite positive and largely unchanged, the near-term outlook has gotten cloudier. Global growth is slowing, trade tensions remain high, financial markets have been volatile, and there was a 35-day partial federal government shutdown that weighed on the economy.

The FOMC can afford a wait-and-see approach. US economic fundamentals remain good, and growth will likely be solid in the first half of 2019 thanks to gains in consumer spending and business investment. Any economic impact from the shutdown should be made up quickly in the second quarter. And inflation is near the FOMC’s 2 percent objective and set to move lower, given the big drop in energy prices in recent months. Thus the FOMC has the luxury of time. If it becomes apparent over the next few months that growth remains solid and the labor market is continuing to improve, the FOMC can raise the fed funds rate toward the middle of this year before inflation revs up.

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PNC's baseline forecast is for one fed funds rate hike this year, in September, to a range of 2.50 to 2.75 percent. That would take the fed funds rate to roughly its neutral level, where it is neither adding to nor subtracting from growth.

The FOMC also provided an update on its plans for the Federal Reserve's balance sheet. The central bank greatly expanded its holdings of long-term securities in the wake of the Great Recession to push down long-term interest rates; it has been slowly reducing the size of its balance sheet since 2017 as the economic expansion has continued. The FOMC said that the fed funds rate will remain the primary monetary policy tool, but that the balance sheet remains a viable policy option. The statement also noted that effective monetary policy requires "an ample supply of reserves," suggesting that the balance sheet in the future will be much larger than it was before the Great Recession.

The immediate financial market reaction to the announcement was positive, with stock prices up sharply upon its release. Long-term interest rates fell, although short-term rates were little changed. The US dollar weakened against a basket of currencies.

According to the Congressional Budget Office, the partial government shutdown caused a small hit to economic growth in the fourth quarter of 2018, when the government was shut down for one week, and a larger drag in the first quarter of 2019, when the government was shut down for almost four weeks. Annualized economic growth was lower by about 0.2 percentage point in the fourth quarter, according to the CBO, and by about 0.4 percentage point in the first quarter. The losses came from reduced services provided by federal government workers, reduced federal purchases of goods and services, and temporarily lower demand from the private sector. Thus PNC's January forecast, which was prepared before the extent of the shutdown was known, is too optimistic for the first quarter; the forecast will be updated in February to fully reflect the drag from the shutdown. The CBO then projects that economic growth will rebound to be 1.0 percentage point faster in the second quarter than expected before the shutdown.

Overall, the CBO estimates that the shutdown has resulted in an initial loss of output of $11 billion, but $8 billion of that will be made up in the near term. Thus the permanent loss to the economy will be $3 billion in 2019, or just 0.02 percent of gross domestic product for the year.

The shutdown also delayed the release of some economic data. Some government offices remained open—in particular, the Labor Department continued to report data on jobs, the unemployment rate, initial claims for unemployment insurance, and inflation. But the Commerce Department was closed, delaying releases on retail sales, exports and imports, housing, consumer income and spending, and GDP, and it will take Commerce time to catch up with its regularly scheduled data releases. This will make it more difficult to gauge what is going on in the U.S. economy in early 2019, one reason for the FOMC to be cautious with monetary policy.

Private-sector employers added 213,000 jobs in January, according to data from payroll-processing firm ADP. This was below December's gain of 263,000, but above the 2018 average of 205,000 (see Chart). Service industries accounted for the bulk of job growth in January, but there were solid gains in manufacturing and construction as well.

Initial claims for unemployment insurance rose by 53,000 in in the week ending January 26, to 253,000. This was the highest number of claims since September 2017, in the wake of Hurricanes Harvey and Irma. The increase in claims likely came from the partial government shutdown, as well as seasonal adjustment issues around the Martin Luther King holiday. The claims data do not include federal government employees who file for unemployment, but do include private-sector workers who were laid off as a result of the shutdown. Still, the four-week moving average of claims barely rose at the end of January, and remains near a 50-year low, so with the shutdown over the labor market should quickly rebound.

Before the shutdown ended Congress passed a law ensuring that federal government employees who were furloughed, or who were working without pay because of the shutdown, would receive their back pay once the shutdown ended. Therefore these workers will be counted as employed in the Bureau of Labor Statistics' January jobs report, to be released on February 1, and there should not be a big drop in federal government employment in the January jobs numbers.

However, private-sector employees who were laid off because of the shutdown, such as federal contractors and leisure/hospitality workers laid off because of reduced tourism, will not be counted as employed.

PNC is forecasting total job growth in January of 160,000 in the BLS jobs report, with all of that coming from the private sector; the forecast assumes no change in government employment over the month. However, there is a great deal of uncertainty around this number given the unknown impact of the shutdown.

Federal employees working without pay were counted as employed in the household survey of employment (different from the survey of employers). However, furloughed federal workers were classified as unemployed on temporary layoff. Back-of-the-envelope calculations suggest this would boost the unemployment rate by about 0.2 percentage point relative to no shutdown, before any impact on private-sector workers.

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Private-sector workers who were not working due to the shutdown will also be counted as unemployed on temporary layoff in the household survey; this will also drive the unemployment rate higher in January. The unemployment rate was 3.9 percent in December; PNC is forecasting that the unemployment rose to 4.0 percent in January.

Workers (both public- and private-sector) who had their hours reduced because of the shutdown were counted as employed in the household survey, and thus their change in hours will not affect the unemployment rate. However, they will be counted as underemployed, and the broader U6 rate, which includes underemployed and discouraged workers, as well as the unemployed, is likely to move higher in January as well.

The average workweek likely fell in January because of the shutdown.

Because of the federal government shutdown the January jobs report will be of limited value in gauging the economy in early 2019. But the labor market was solid at the end of 2018, with a big job gain of 312,000 in December, the unemployment rate near a 50-year low, and accelerating wage growth as the tight job market forces businesses to raise pay. As more data become available, including the delayed report on fourth quarter GDP and the February jobs report (to be released on Friday, March 8), it should become clearer that the US economy has weathered the shutdown and the economic expansion is continuing.

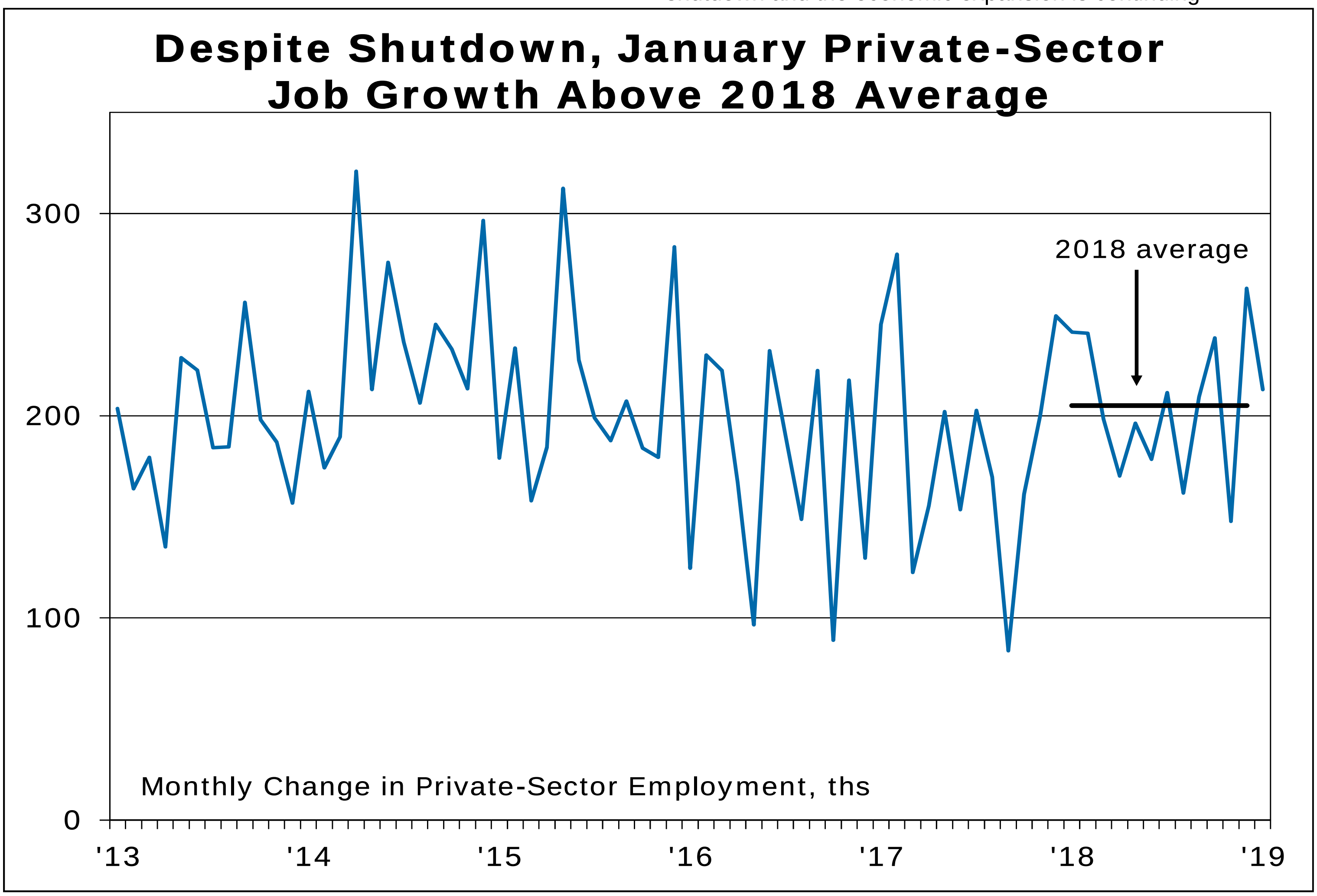

Chart source: ADP

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