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ECONOMIC REPORT

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SLOWING INFLATION NOT LIKELY TO DETER FED; MIXED SUMMER DATA ON CONSUMER AND INDUSTRIAL SECTORS

SUMMARY

- The consumer price index was flat in June, with inflation held down by a drop in energy prices. Core inflation was soft over the month.
- Despite recent softer readings, inflation will pick up in the second half of this year with a tight labor market. Stronger inflation will lead the Federal Reserve to gradually raise interest rates.
- Retail sales fell 0.2 percent in June, in part because of falling prices.
- Industrial production rose 0.4 percent in June, with manufacturing output up over the month. Manufacturing will grow modestly through 2017 and into 2018.
- Consumer sentiment fell in July as Republicans have had difficulty in implementing their policy agenda.
- Consumer fundamentals are still solid, and will push the economy forward into 2018.

The consumer price index was flat in June, below the consensus expectation of a 0.1 percent increase. Energy prices fell 1.6 percent, holding down overall inflation. Core inflation, excluding food and energy, was 0.1 percent over the month.

Year-over-year overall inflation was 1.6 percent in June, down from 1.9 percent in May and its recent high of 2.8 percent in February. Core inflation was 1.7 percent year-over-year in June, unchanged from May and down from 2.3 percent in January.

The recent drop in energy prices and year-over-year comparisons overstate the slowing in broad inflation. In particular, core inflation has stabilized over the past few months, after it slowed in the early spring due to the transitory factors that Federal Reserve Chair Yellen has mentioned in recent speeches; these include price declines for cell phone plans and pharmaceuticals. PNC Economics expects inflation to pick up in the second half of 2017 as the tight labor market boosts wage pressures (see Chart 1). The Job Openings and Labor Turnover Survey for May also supports this view, as layoffs are very low and workers are voluntarily leaving their jobs in search of better opportunities. This will force firms to offer higher wages to retain and attract talent.

The current slow pace of inflation bears watching, but in a few months it should be apparent that it is gradually moving back toward the Federal Open Market Committee's 2 percent inflation goal (the FOMC uses another inflation measure, the personal consumption expenditures price index). Given this, the FOMC will likely announce at its mid-September meeting its plan to begin reducing the Federal Reserve's balance sheet at the beginning of October, which will put modest upward pressure on long-term interest rates. PNC also expects the FOMC to raise the federal funds rate a quarter of a percentage point at the end of this year, to a range of 1.25 to 1.50 percent, with three additional rate increases likely in 2018.

Industrial production rose 0.4 percent in June, besting the consensus expectation of a 0.3 percent increase. This followed a modest 0.1 percent rise in May, revised up from no change. On a year-over-year basis industrial production was up 2.0 percent in June, the fastest pace since January 2015 (see Chart 2).

With increases in high-tech and auto-related production manufacturing output rose 0.2 percent in June, after falling 0.4 percent in May. Mining output rose 1.6 percent for the month following a strong 1.9 percent increase in May as the industry continues to rebound from a steep contraction from 2014 to 2016. Utilities output was flat in June after it rose 0.8 percent

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in May; it can be volatile depending on the weather.

The industrial sector continues to slowly recover from a mild downturn that lasted from the end of 2014 to the middle of 2016. The plunge in energy prices and the strengthening of the dollar over this period weighed on mining and manufacturing. But after falling by nearly one-fifth, mining output has risen 9 percent since the fall as energy prices have stabilized. Manufacturing output, which was basically flat from late 2014 to mid-2016, has risen 1.7 percent since August.

The industrial sector is not likely to add much to growth in 2017, but at least it is not subtracting from growth as it did for much of the past few years. PNC expects continued modest improvement in manufacturing through the rest of this year and into 2018 as consumer spending grows, energy production increases and the global economy expands.

Retail sales fell 0.2 percent in June, against the consensus expectation for a 0.1 percent increase. This followed a 0.1 percent decline in May, revised up from the previously reported 0.3 percent drop.

Falling energy and food prices contributed to much of the decline, with sales at gasoline stations down 1.3 percent and at grocery stores down 0.4 percent. Retail sales excluding autos were down 0.2 percent, and sales excluding autos and gasoline were down 0.1 percent. Control sales—sales excluding autos, restaurants, gasoline and building materials, and which go into consumer spending in GDP—were down 0.1 percent in June before inflation.

Restaurant sales fell 0.6 percent over the month. Other segments were better, however, with sales up for furniture (0.1 percent), electronics (0.1 percent), building materials (0.5 percent), drug stores (0.3 percent), and even general

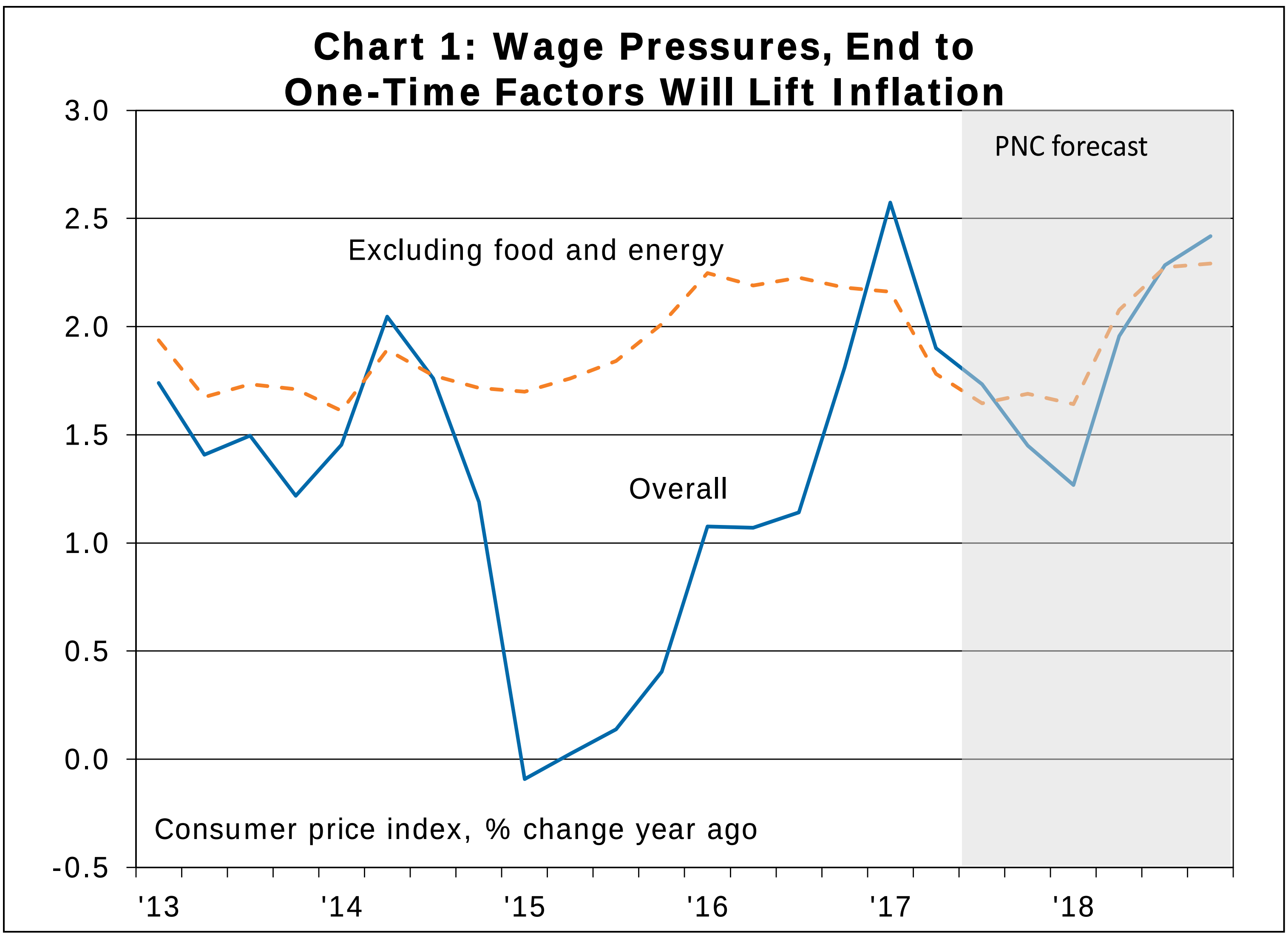

Chart sources: Bureau of Labor Statistics, PNC

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merchandise stores (0.4 percent). Nonstore (online) sales were up 0.4 percent in June.

The June retail sales report, although disappointing, was not as bad as the headline number would suggest. Much of the softness came from lower prices. The fundamentals for consumers in mid-2017 are still good. The economy is adding jobs at a pace that exceeds growth of the working-age population. Wages are rising, albeit slowly. And low energy prices, low interest rates and rising household wealth, from higher stock prices and home values, will all support consumer spending through the rest of this year and into next.

The preliminary University of Michigan consumer sentiment index fell to 93.1 in early July from 95.1 in June and 97.1 in May. This was below the consensus expectation for small decline to 95.0, and the second sizeable drop since the November elections. Consumers were slightly more upbeat about current conditions, but expectations for future economic conditions fell for a second straight month.

Consumer sentiment has moderated after surging after the November elections. Uncertainty about tax cuts, changes to the healthcare system and increased infrastructure spending, and ongoing questions about the Trump administration are weighing on consumer expectations.

Yet even with July's drop in sentiment, it remains well above its pre-election level. Consumer fundamentals are solid, keeping households generally upbeat despite political ups and downs.

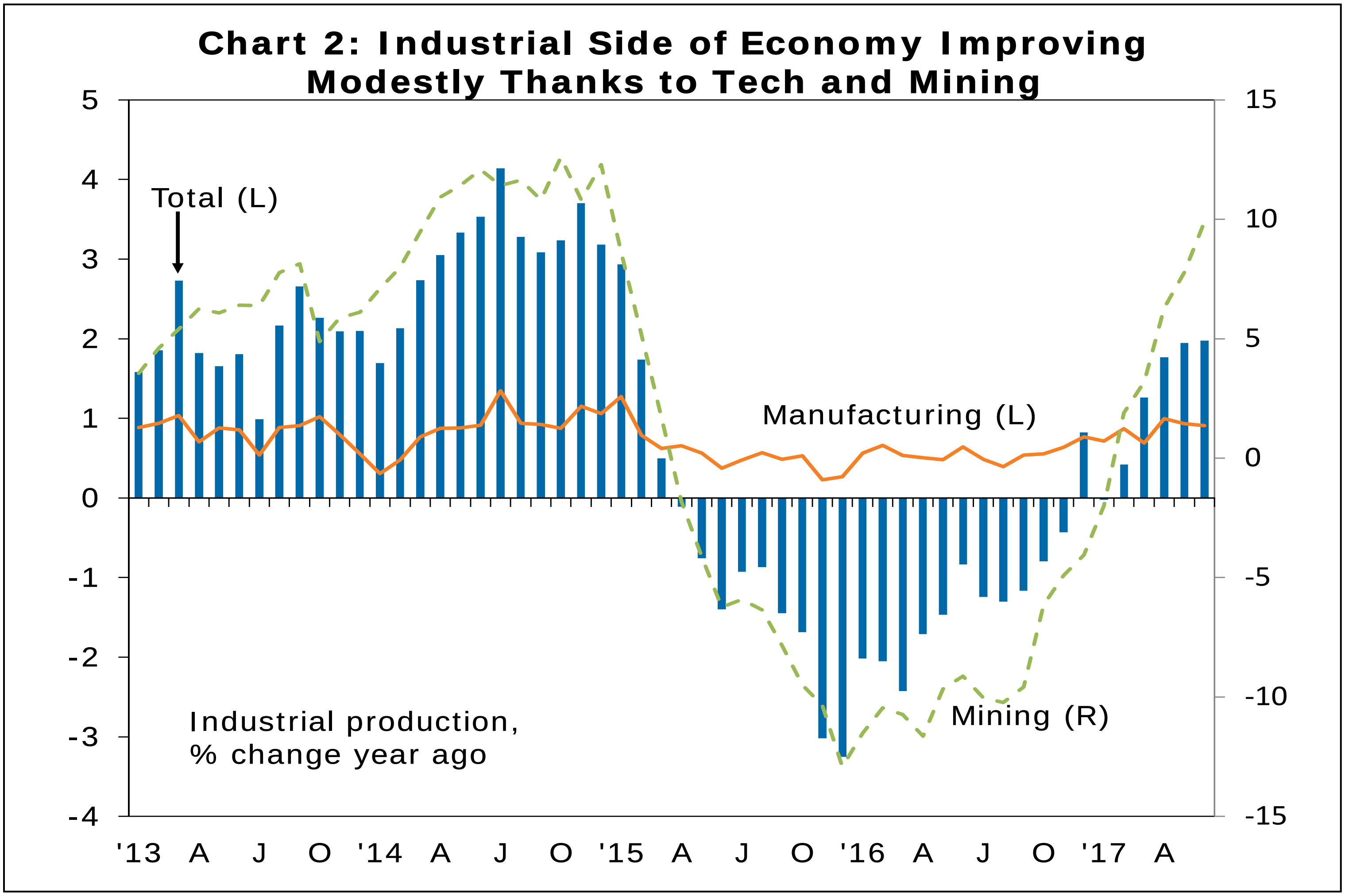

Chart source: Federal Reserve

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