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ECONOMIC REPORT

Stuart Hoffman
Chief Economist

Gus Faucher
Deputy Chief Economist

William Adams
Senior Economist

Kurt Rankin
Economist

Mekael Teshome
Economist

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

INTEREST RATE NORMALIZATION UNDERWAY WITH FED FUNDS RATE HIKE; INFLATION, RETAIL SALES ON TRACK

SUMMARY

- The FOMC, as expected, raised the federal funds rate by one-quarter of a percentage point.
- The statement emphasized that inflation is set to stabilize near the FOMC's 2 percent target.
- Short-term interest rates will gradually increase over the next few years.
- The consumer price index rose 0.1 percent in February, with core prices up 0.2 percent. Inflation is gradually picking up.
- Retail sales rose 0.1 percent in February. The fundamentals for consumer spending are solid.

As expected, the Federal Open Market Committee raised the federal funds rate by one-quarter of a percentage point, to a range of 0.75 to 1.00 percent. After keeping the fed funds rate in a range of 0.00 to 0.25 percent from late 2008 to late 2015, and then holding it steady in a range of 0.25 to 0.50 percent for a year, the FOMC has now raised the rate at two of its past three meetings. After a decade of highly expansionary monetary policy, normalization is now underway.

The major difference between the current statement, and the previous one, from February 1, is that the FOMC is now more confident about higher inflation. There are three changes from the previous statement related to inflation, all making the point that inflation is now close the FOMC's 2 percent target, and that it should remain there.

There was also a notable change to the sentence dealing with the expected path of the fed funds rate. The current statements says that "the Committee expects that economic conditions will evolve in a manner that will warrant gradual increases in the federal funds rate"; previously, the statement said that "conditions will evolve in a manner that will warrant **only** gradual increases" (emphasis added). The removal of "only" does not indicate a change in the outlook for monetary policy, but buys the FOMC some flexibility to increase the fed funds rate a bit more rapidly if economic conditions change.

The section of the statement on current economic conditions is somewhat more positive than the previous statement. In particular, the statement notes that "business fixed investment appears to have firmed somewhat."

Minneapolis Fed President Kashkari voted against the statement, preferring to keep the funds rate at 0.50 to 0.75 percent.

The FOMC also released its Summary of Economic Projections. The median forecast for the fed funds rate is for another two 25 basis points increases this year; the total of three for 2017 is the same as the median in the previous projections, from December 14. The median projection is then for another three fed funds rate increases in 2018, and then a few increases in 2019, taking the rate to its long-run projected value of 3.0 percent.

The economic projections are little changed from December, with only the median inflation projection for 2017 bumped up a bit. In particular, the median real GDP forecast for 2017 is 2.1 percent, unchanged from December; it does not appear that FOMC participants are incorporating fiscal stimulus from the Trump administration into its forecasts.

The latest FOMC statement and Summary of Economic Projections do not change the outlook for monetary policy. The increase in the fed funds rate was widely telegraphed in speeches by Chair Yellen and other FOMC members, and thus did not come as a surprise. The statement was broadly similar to the February 1 statement, and does not indicate any

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substantive change to the outlook for monetary policy. Similarly, there were few differences in the Summary of Economic Projections compared to the previous one.

Given current economic conditions, including an improving labor market and inflation that is headed toward the FOMC's 2 percent objective, PNC expects the FOMC to raise the fed funds rate in June and December this year, each time by one-quarter of a percentage point, which would bring it to a range of 1.25 to 1.50 percent at the end of 2017. The forecast is then for another three rate increases in 2018, which would bring it to a range of 2.00 to 2.25 percent at the end of next year. PNC expects the funds rate to reach its long-run value of 2.50 percent in mid-2019; this is below the FOMC's median projection for a median long-run funds rate of 3.0 percent.

Stock prices rose after the FOMC announcement, and interest rates fell, with the yield on the 10-year Treasury bond fall from 2.57 percent to 2.50 percent in the wake of the FOMC's announcement. The U.S. dollar weakened against a basket of global currencies, and the price of a barrel of West Texas Intermediate crude rose by about 60 cents to close at around $49.

The consumer price index rose 0.1 percent in February, in line with PNC's forecast and slightly higher than the consensus expectation for no increase. Core prices, excluding food and energy, rose 0.2 percent, matching the PNC forecast. Food prices were up 0.2 percent in February, while energy prices fell 1.0 percent, including a 3.0 percent drop in gasoline prices.

On a year-ago basis the overall CPI rose 2.7 percent in February, the fastest pace in five years. Overall inflation has picked up after energy prices reached a trough in early 2016. Core inflation was 2.2 percent year-over-year in February, down from 2.3 percent in January. But core inflation has gradually accelerated over the past few years as wage growth has picked up, higher energy prices have passed through to prices more broadly, and improving demand has given firms more pricing power (see Chart 1). This is one of the factors that led the FOMC to raise the federal funds rate, although its 2 percent inflation target is based on the personal consumption expenditures price index, a different measure that tends to show a bit slower inflation than the CPI.

Overall inflation will likely slow in March as energy prices have moved lower over the month, but broader inflationary pressures will continue to build. An improving economy, in particular a tighter labor market, will put upward pressure on inflation throughout 2017. PNC is forecasting overall CPI inflation of 2.5 percent in 2017, up from 1.3 percent last

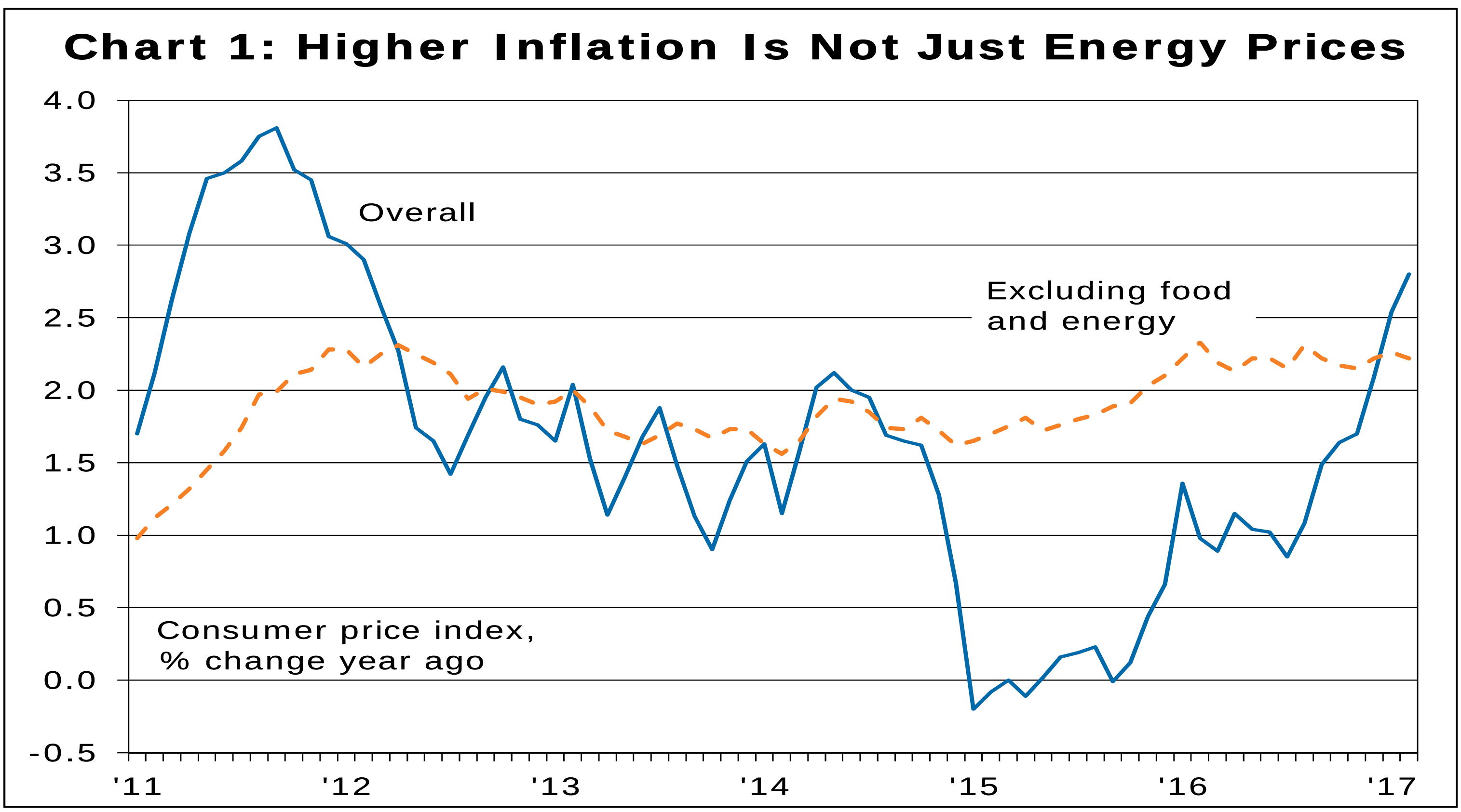

Chart source: Bureau of Labor Statistics

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year and 0.1 percent in 2015, when energy prices were quickly falling. Higher energy prices are responsible for much of the acceleration in inflation. But core inflation is also slowly picking up; it will be 2.3 percent this year, up from 2.2 percent last year and 1.8 percent in 2015.

Retail sales rose 0.1 percent in February, matching the consensus expectation and slightly above PNC's forecast of no change. Sales excluding autos were up 0.2 percent, as were sales excluding autos and gasoline. Autos and parts sales fell 0.2 percent, and sales at gasoline stations were down 0.6 percent as gas prices dropped over the month. Control sales—which exclude food service, autos, gasoline, and building materials, and which go into nominal consumer spending in GDP—rose 0.1 percent in February.

Overall retail sales were revised higher for January, to 0.6 percent from 0.4 percent. Control sales growth in January was revised up to 0.9 percent from 0.6 percent, good news for first quarter GDP.

On a year-ago basis retail sales were up 5.6 percent in February, down from 6.0 percent in January, but still near the fastest pace in a few years. Part of that is from higher gasoline prices over the past year, but even excluding gasoline, retail sales are increasing at a steady clip (see Chart 2).

A small drop in unit auto sales and lower gasoline prices in February restrained growth in retail sales over the month. In addition, later-than-usual processing of income tax refunds may have dampened consumer spending. However, the IRS has now caught up to last year's pace, and so spending could get a bump up in March.

Consumers are in good shape. There are more jobs and wages are increasing with the tighter labor market. Household wealth is up with rising house prices and near-record stock prices. Interest rates, although rising, are still low on an historical basis. Consumer spending will continue to lead overall economic growth in 2017, and personal income tax cuts could provide an additional boost later this year and in 2018.

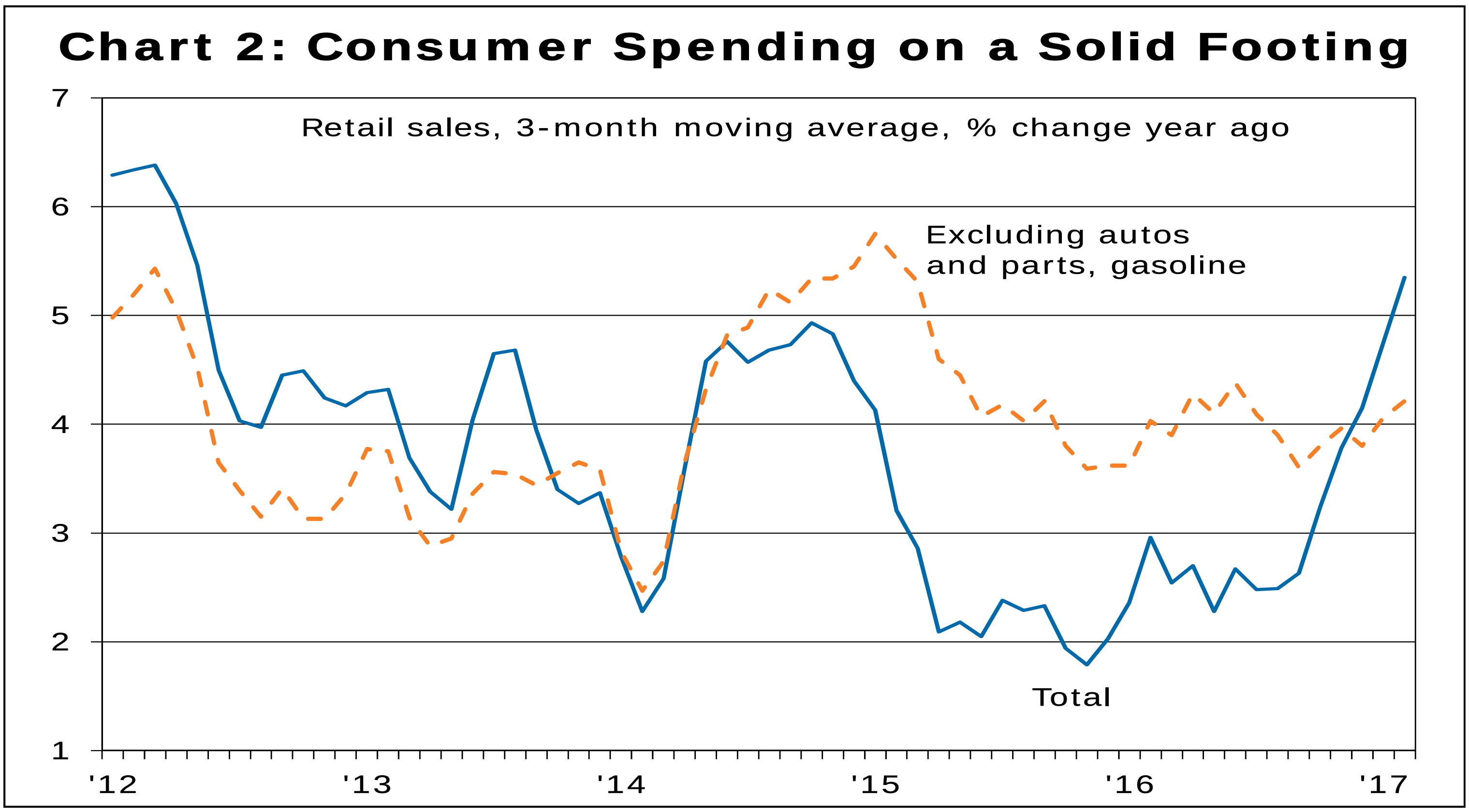

Chart source: Census Bureau

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