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ECONOMIC REPORT

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FED MAY START TRIMMING ITS BALANCE SHEET LATER THIS YEAR; UPSIDE POTENTIAL FOR MARCH JOB GROWTH

SUMMARY

- Minutes from the FOMC's March meeting indicate that the Fed could start to reduce its balance sheet late this year.
- According to the ADP report, the private sector added 263,000 jobs in March.
- Initial claims for unemployment insurance remain near a four-decade low.
- The ISM nonmanufacturing survey fell in March, but still indicates expansion.
- PNC's forecast is for job growth of 160,000 in March in the official government jobs report, but employment gains could beat expectations. The unemployment rate likely fell to 4.6 percent in March.

According to the minutes from the Federal Open Market Committee's meeting on March 14 and 15, the FOMC is looking at options for reducing the size of the Federal Reserve's balance sheet. The central bank's asset holdings jumped from $900 billion in mid-2009 to $4.4 trillion by mid-2014 (see Chart 1). In the aftermath of the financial crisis the Fed purchased huge quantities of long-term Treasuries and mortgage-backed securities in a largely successful effort to push down long-term interest rates (including mortgage rates) and spur borrowing, a process known as quantitative easing.

The minutes say that there is a general consensus that the Fed's balance sheet should be reduced in a "gradual and predictable" way, and that it should be "accomplished primarily by phasing out reinvestments of principal received from these holdings," that is, allowing securities to mature rather than selling them outright. The minutes also say that "a change to the Committee's reinvestment policy would likely be appropriate later this year," and that "participants generally preferred to phase out or cease reinvestments of both Treasury securities and agency MBS."

But beyond that, there was little agreement. To start the process some participants favored "a quantitative threshold or trigger tied to the target range for the federal funds rate," while others favored "a qualitative judgment about economic and financial conditions." There was some discussion about what level of the fed funds rate would be appropriate to start a change to the balance sheet policy, but no agreement. And some participants wanted to end reinvestment cold turkey, while others favored first shifting from full reinvestment to partial reinvestment.

In terms of economic conditions, most participants viewed the economy as "operating at or near maximum employment." There was less consensus about inflation, with some participants thinking that the FOMC had essentially met its inflation target of 2 percent, while others were more skeptical, given "the persistent shortfall of inflation from its [2 percent] objective over the past several years."

The minutes generally support PNC's forecast for two more increases, each of 0.25 percentage point, in the federal funds rate this year. PNC expects those increase to come at the FOMC's June and December meetings; this would take it to a range of 1.25 to 1.50 percent at the end of 2017. Longer-term rates will also move higher as the Fed introduces its plan to gradually reduce its balance sheet, but volatility could pick up given the unprecedented nature of this process. The balance sheet will likely start to shrink sometime late this year or early next, but the entire process will not be over until well into the next decade. Complicating this will be turnover on the Fed's Board of Governors, with Chair Yellen's term expiring in early 2018 and President Trump unlikely to reappoint her.

The private sector added 263,000 jobs in March, based on analysis of records from payroll processing firm ADP; this was

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well above the consensus expectation of 185,000. ADP job growth was 245,000 in February, still solid but revised lower from 298,000. Goods-producing industries added 82,000 jobs in March, including 49,000 jobs in construction and 30,000 in manufacturing, both well above the recent trend. Service-producing industries added 181,000 jobs over the month, with increases in most major industries. Job growth was also broad-based across firm sizes.

Initial claims for unemployment insurance fell by 25,000 in the week ending April 1 to 234,000, the lowest number of claims since late February. The four-week moving average of claims was 250,000, up slightly from a few weeks ago, but still about 10,000 below the average in 2016. Claims remain near their lowest levels in more than four decades, another sign of strength in the labor market.

The Institute of Supply Management's nonmanufacturing index fell to 55.2 percent in March, from 57.6 percent in February. The nonmanufacturing index has been above the 50 percent level that indicates expansion for more than seven straight years (see Chart 2). Three of the four components used to calculate the overall index fell in March, but all four were above 50; both the new orders and business activity indices were solid at 58.9 percent. The employment component slowed to 51.6 percent, from 55.2 percent. Other details were generally solid. The fastest-growing industries in March were utilities, agriculture, and real estate. Only three of the 18 industries covered reported contraction over the month.

PNC is forecasting job growth of 160,000 in March when the Bureau of Labor Statistics releases the government's

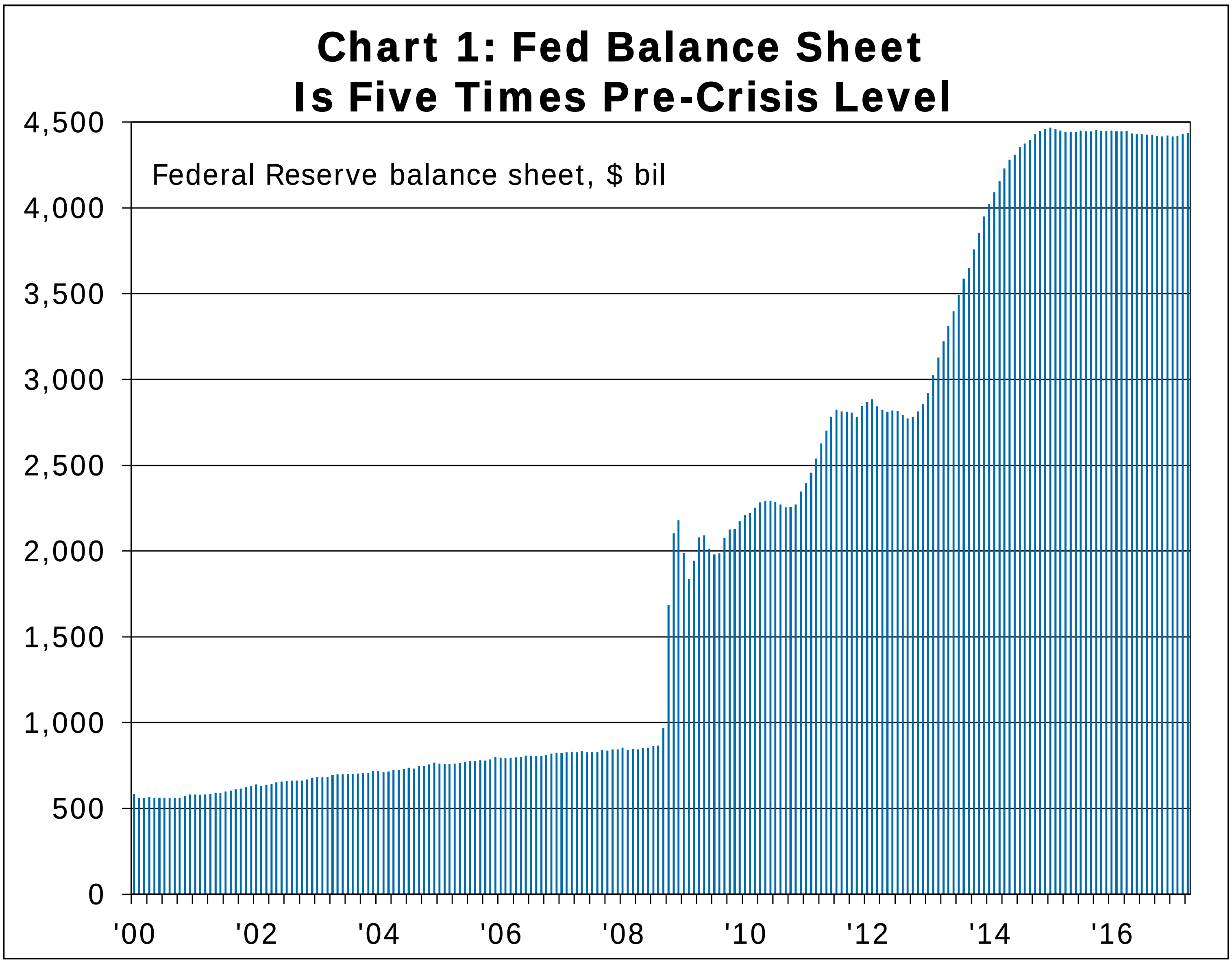

Chart source: Federal Reserve

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official employment report on Friday, April 7. Job growth averaged 237,000 in the first two months of 2017, up from an average of 187,000 in 2016. But much of the strength this year has come in construction, with average monthly growth of 49,000 so far in 2017, compared to 13,000 last year. A warmer-than-usual winter has allowed construction projects to start earlier than normal, but this means that the typical seasonal pickup in hiring that occurs in the spring will be much smaller this year, weighing on overall job growth. Still, the good ADP report does create significant upside potential for job growth in March. The unemployment rate likely fell to 4.6 percent in March, from 4.7 percent in February and 4.8 percent in January. Average wages likely increased 0.3 percent over the month, as a tighter job market is leading businesses to raise pay. More jobs and higher wages are boosting household income, allowing consumers to increase their spending and supporting overall economic growth this year.

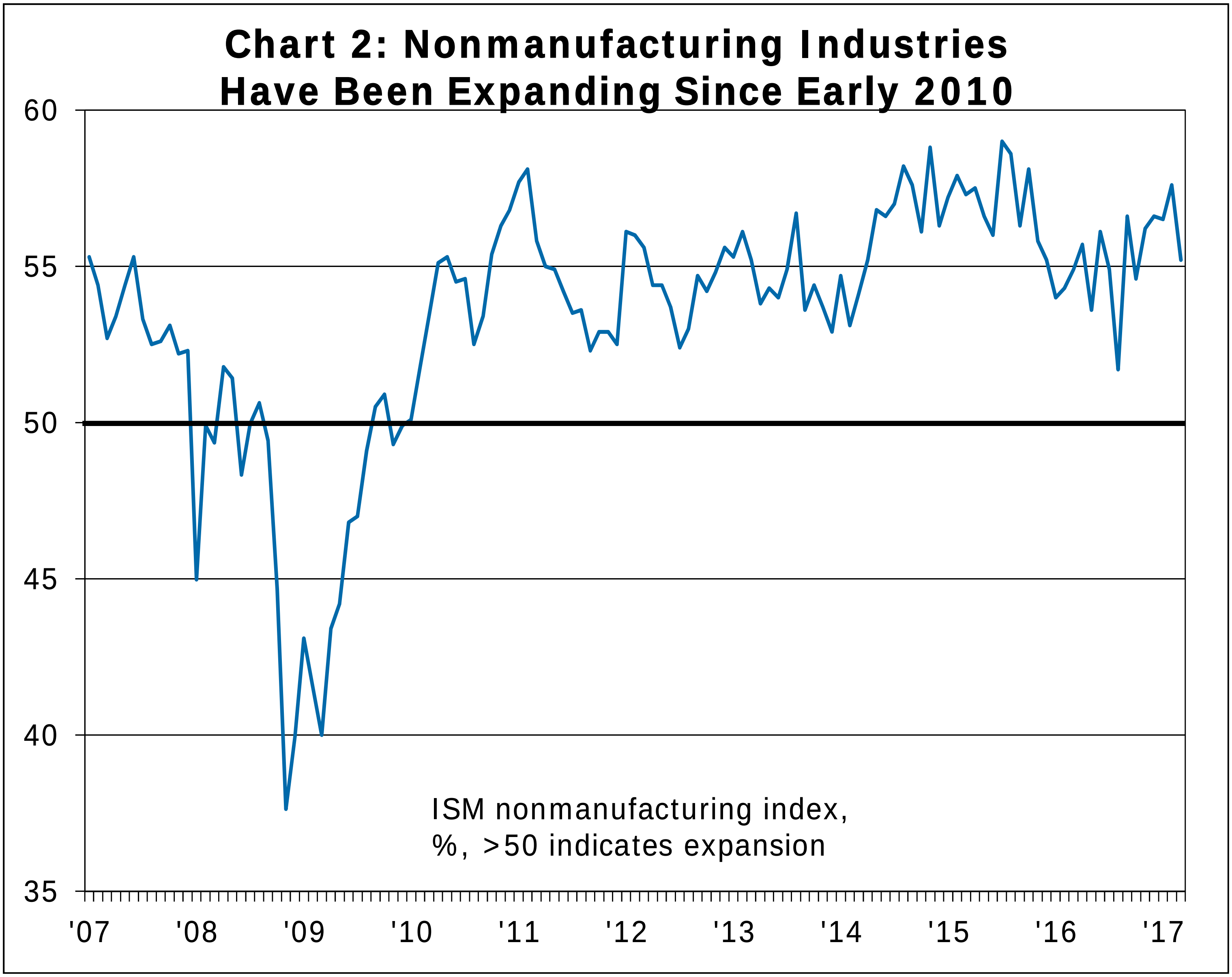

Chart source: Institute for Supply Management

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