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ECONOMIC REPORT

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FED FUNDS RATE HIKE, WITH SMALLER FED BALANCE SHEET TO COME; INFLATION SLOWED AGAIN IN MAY

SUMMARY

- The FOMC raised the fed funds rate by 0.25 percentage point to a range of 1.00 to 1.25 percent. The committee expects to start shrinking the Fed's balance sheet "this year."
- The FOMC's policy statement reflects a more upbeat view on the economy, although policymakers are a bit more concerned about low inflation.
- PNC expects the FOMC to start reducing the Fed's balance sheet in September and then raise the fed funds rate in December.
- Nominal retail sales fell 0.3 percent in May, below expectations; lower gasoline prices were a drag. The fundamentals for consumer spending remain solid, however.
- The CPI fell 0.1 percent in May, pulled lower by a big drop in energy prices. Both overall and core CPI inflation moderated in May on a year-ago basis.

As expected, the Federal Open Market Committee raised the federal funds rate by a quarter of a percentage point to a range of 1.00 to 1.25 percent. After keeping the fed funds rate near zero from 2009 to late 2015, the FOMC has now raised it three times since December 2016.

In its statement, the FOMC announced that it will start to reduce the size of the Federal Reserve's balance sheet "this year," assuming the economic expansion continues. The central bank's balance sheet increased from less than a trillion dollars in 2008 to about $4.5 trillion by 2014 as the Fed created money electronically and used the funds to buy long-term Treasuries, mortgage-backed securities, and Fannie Mae and Freddie Mac debt in a successful effort to push down long-term interest rates and support economic growth. Now that the economic expansion is firmly in place, the Fed feels comfortable gradually reducing the size of its balance sheet. Until now the Fed has been reinvesting all of the principal payments it has been receiving on these securities. When the balance sheet reduction process starts, the Fed will not reinvest some of the principal, starting with a cap on the amount not reinvested of $10 billion per month ($6 billion of Treasuries and $4 billion of MBS and agency debt), with the cap gradually rising over one year to $50 billion per month ($30 billion in Treasuries and $20 billion MBS and agency debt). This will allow these securities to gradually run off the balance sheet, putting modest upward pressure on interest rates.

The FOMC was a bit more concerned about inflation in this statement compared to the previous one, from May 3. The current statement added a section saying that "inflation on a 12-month basis is expected to remain somewhat below 2 percent [the FOMC's inflation target] in the near term." Another new section said that "the Committee is monitoring inflation developments closely," stronger language than in the previous statement.

Regarding economic conditions, the statement was generally more upbeat than the May 3 statement, with no reference to soft GDP growth in the first quarter. However, the current statement did note that "job gains have moderated."

According to the Summary of Economic Projections released along with the statement, FOMC participants expect one more 25 basis point increase in the federal funds rate this year, three rate increases next year, and three in 2019. This is similar to the expected path from the last set of projections, released in mid-March.

The FOMC statement was about as expected. The committee raised the fed funds rate by one-quarter of a percentage

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point and announced some information on reducing the size of the central bank's balance sheet. The near-term expected path for the fed funds rate looks similar to the previously expected path. The FOMC, rightfully so, expressed a little more uncertainty that inflation would return to its 2 percent target. Yet a return to 2 percent inflation is still the most likely outcome given that the unemployment rate was 4.3 percent in May and that the labor market is close to, if not at, full employment.

PNC expects the FOMC to start reducing the size of the Fed's balance sheet in September. Given that the process could create uncertainty and volatility in financial markets, the FOMC is likely to hold off on increasing the fed funds rate until December. That would bring the total number of rate increases in all of 2017 up to 3. PNC expects another three fed funds rate hikes in 2018, with the rate ending up at its long-run level of 2.5 percent in 2019. This is somewhat below the FOMC's median projection of a long-run fed funds rate of 3.00 percent.

Retail sales in May were disappointing, although the fundamentals for consumer spending remain solid. Nominal retail sales fell 0.3 percent for the month, against expectations for a 0.1 percent increase. Sales excluding autos fell 0.3 percent and sales excluding autos and gasoline were flat. Control sales—sales excluding restaurants, autos, gasoline and building materials, and which go into nominal GDP—were also flat in May. Some of the softness in the headline numbers were due to lower gasoline prices, as sales at gas stations dropped 2.4 percent over the month. But sales also declined in a number of other categories, including electronics and appliances, general merchandise, and sporting goods and hobbies. Some of this is due to the continuing movement toward online sales, as sales at nonstore retailers rose 0.8 percent in May.

There were some positives from the report, however. There were upward revisions to control sales in April, to 0.6 percent from 0.2 percent, and in March, to 0.8 percent in March from 0.7 percent. This bodes well for second quarter growth because control sales feed directly into consumer spending in GDP. In addition inflation-adjusted total consumption, including services, has risen 3.4 percent at an annual rate so far in the second quarter, up sharply from the first quarter's 0.6 percent pace. And weak first quarter consumer spending growth will likely be revised higher to above 1 percent based on a recently reported big upward revision in consumer spending on services, particularly

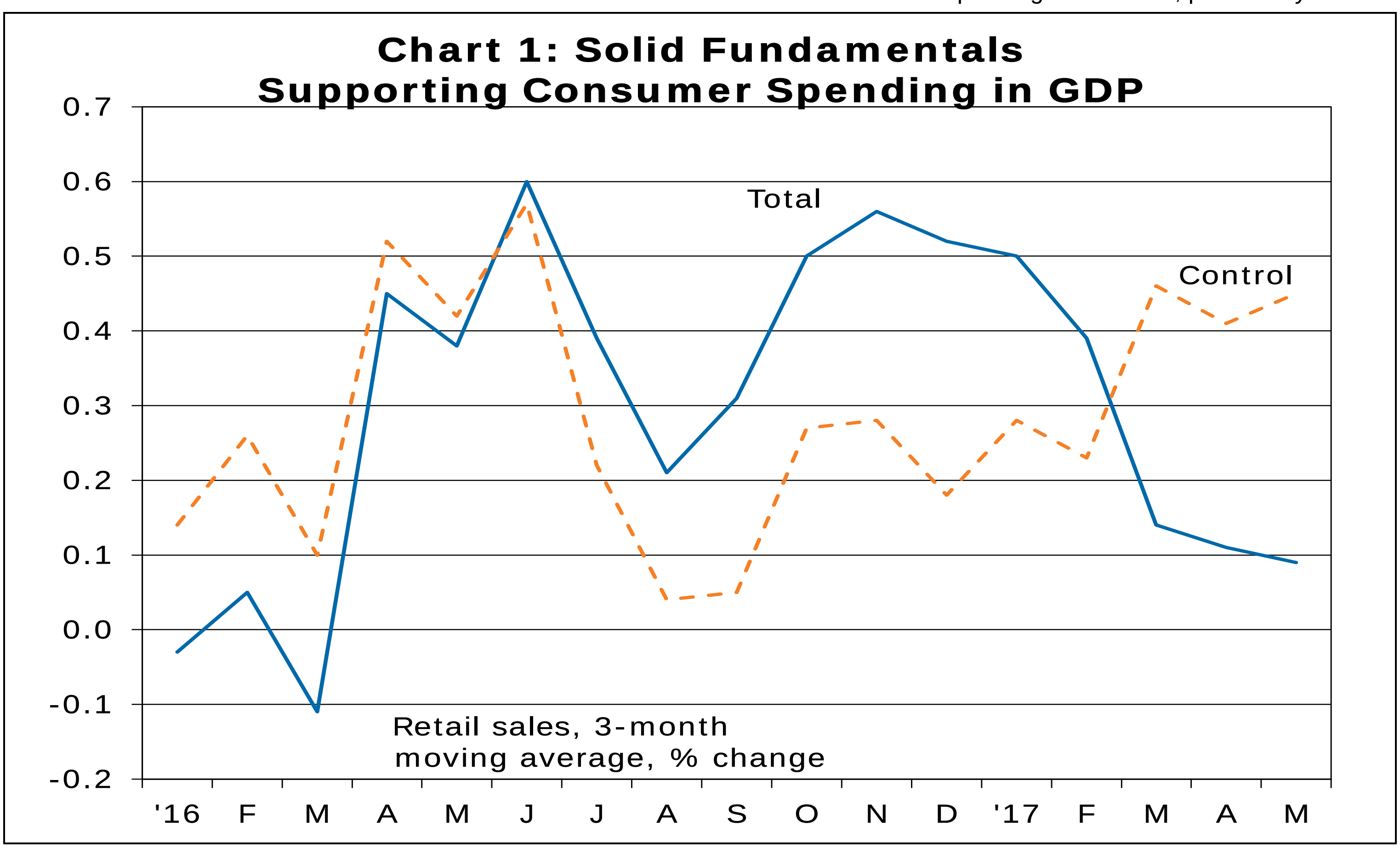

Chart source: Census Bureau

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health services.

Even more importantly, the fundamentals for consumers remain solid. More jobs, rising wages, low inflation, rising home sales, and low interest rates will continue to push consumer spending up in 2017. If Congress is able to pass personal income tax cuts this year, that would provide another boost to consumers.

The consumer price index fell 0.1 percent in May, pulled lower by a 2.7 percent drop in energy prices over the month, including a 6.4 percent drop in gasoline prices. The consensus expectation was for no change. The core index, excluding food and energy prices, rose a modest 0.1 percent in May. The overall CPI rose 0.2 percent in April while the core index rose 0.1 percent.

On a year-over-year basis both the overall and core CPIs slowed in May. The overall index was up 1.9 percent in May from one year earlier, down from 2.0 percent in April and 2.8 percent in February. Falling energy prices over the last few months are contributing to the slowing in overall inflation. Core inflation was 1.7 percent year-over-year in May, down from 1.9 percent in April and 2.3 percent in February. Some of the slowing is coming from the pass-through of lower energy prices into prices of other goods; pharmaceutical prices have also fallen this year. And some of the slowing is from new unlimited data cell phone plans, which constitute an improvement in service and thus a lower price.

But inflation is set to accelerate given the tight labor market. Businesses will raise wages as it becomes more and more difficult to hire, and in turn raise prices for consumer goods and services. PNC is forecasting overall CPI inflation of 2.3 percent in both 2017 and 2018, up from 1.3 percent last year (Chart 2). Core CPI inflation will be 2.1 percent this year and 2.2 percent next year, close to last year's 2.2 percent pace.

Chart 2: Inflation to Pick Up Despite Temporary Slowing

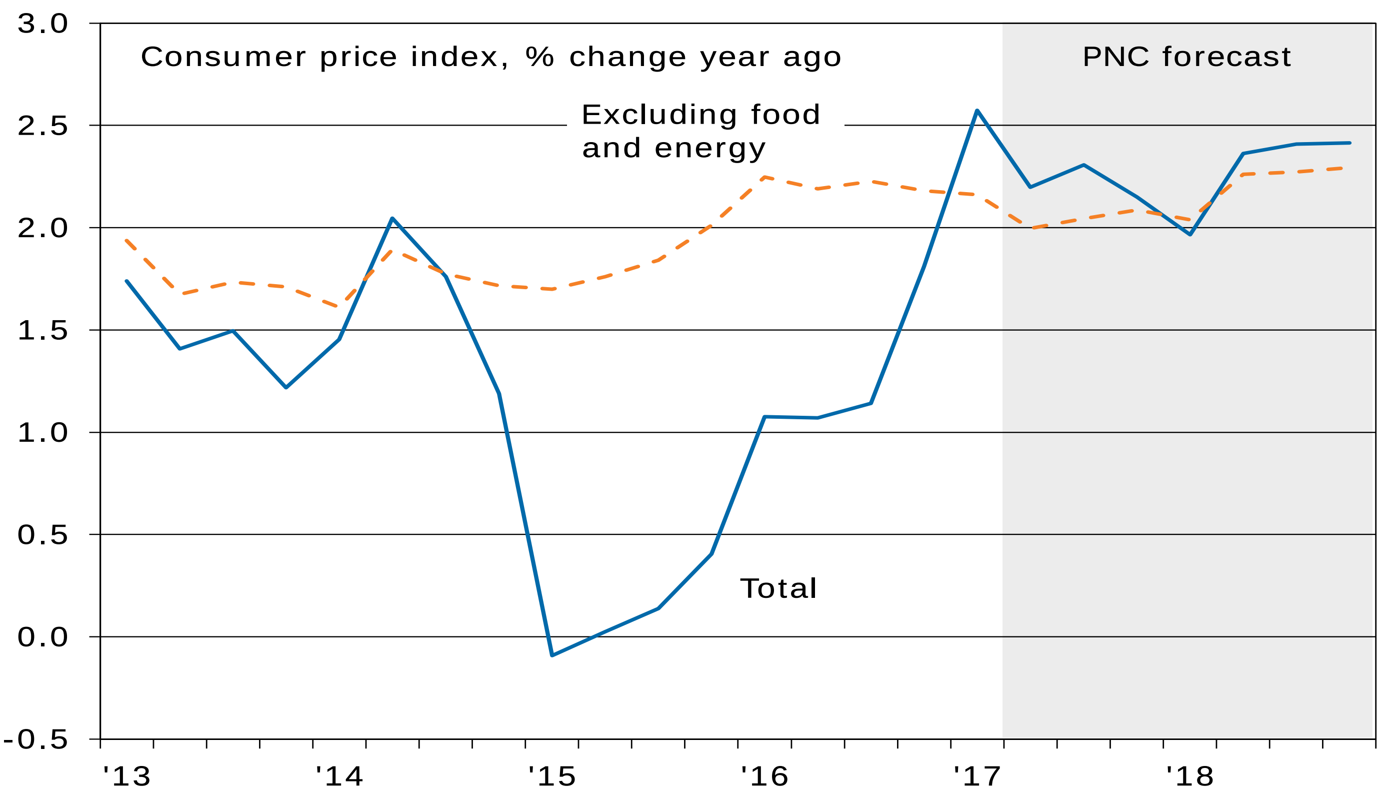

Chart sources: Bureau of Labor Statistics, PNC

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