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ECONOMIC REPORT

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FOMC RAISES FED FUNDS RATE, WITH MORE TO COME IN 2017; MIXED DATA ON SALES, PRODUCTION, HOUSING

SUMMARY

- The FOMC raised the fed funds rate, to a range of 0.50 to 0.75 percent.
- Fed projections indicate three interest rate increases in 2017, up from two in the previous projections.
- Retail sales rose 0.1 percent in November, but were up solidly from one year earlier.
- Industrial production fell 0.4 percent in November, pulled down by a drop in utilities output.
- Housing starts fell a steep 19 percent in November, somewhat offsetting a 27 percent increase in October.
- Inflation continues to gradually accelerate.

As widely expected, the Federal Open Market Committee raised the federal funds rate by 0.25 percentage point on December 14, to a range of 0.50 to 0.75 percent. The vote was unanimous. This was the first increase in the fed funds rate in a year; before December 2015 it had been in a range of 0 to 0.25 percent since late 2009.

The projections released along with the statement indicate a faster pace of rate increases over the next few years compared to the previous projections, released in September. The median fed funds rate at the end of 2017 is now projected to be 1.4 percent, compared to 1.1 percent in September; the corresponding figures are 2.1 percent and 1.9 percent for 2018, and 2.9 percent and 2.6 percent for 2019. This implies three interest rate increases in 2017, three in 2018, and three in 2019. Although the pace of projected rate increases is now somewhat steeper compared to September, the statement still refers to “gradual increases” in the fed funds rate over the next few years.

The median long-run projection for the fed funds rate is now 3.0 percent, compared to 2.9 percent in the September projections. The unemployment rate is now projected to be slightly lower through 2019 compared to the September projections, in part because of the drop in the unemployment rate in November to 4.6 percent, but the long-run value is the same (4.8 percent). Median forecasts for GDP growth and inflation are little changed.

The most notable change in the FOMC statement from the previous one, on November 2, is the discussion of the labor market. The December 14 statement says that “the stance of monetary policy remains accommodative, thereby supporting some further strengthening in labor market conditions…” The previous statement said that “the stance of monetary policy remains accommodative, thereby supporting further improvement in labor market conditions…” The change in the language suggests that FOMC participants think that the U.S. economy is now very close to full employment.

The statement and the projections indicate that FOMC members are now more confident about an improving labor market and a gradual acceleration in inflation. The higher long-run value for the federal funds rate could be in part because the FOMC expects more fiscal stimulus from the incoming Trump administration, which would support stronger near-term growth and a further tightening in the labor market. However, the statement does not say anything about the expected impact of the change in administration, and the GDP projections do not show higher expected growth.

The statement and projections generally support PNC’s baseline forecast for two increases in the fed funds rate in 2017, and four in 2018, although the timing is slightly different from the FOMC projections. Risks are weighted toward more increases in the fed funds rate than are included in the forecast, rather than fewer. With the potential for fiscal stimulus, above-trend growth over the next couple of years could push up inflation, leading the FOMC to tighten monetary policy

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more quickly than expected.

Retail sales rose 0.1 percent in November from October, below the consensus expectation for a 0.3 percent increase. Sales were up 0.2 percent excluding autos and parts, and also up 0.2 percent excluding autos, parts, and gasoline. Growth in overall retail sales in October was revised down to a 0.6 percent increase, from the initially reported 0.8 percent gain.

On a year-ago basis total retail sales were up 3.8 percent in November, indicating that this will be a good year for holiday sales. Sales were up 3.6 percent excluding autos and parts from one year earlier, and also up 3.8 percent excluding autos, parts, and gasoline. Year-over-year growth was 4.2 percent for total retail sales in October.

Despite slower growth in retail sales in November, and a downward revision to growth in October, consumer spending is increasing solidly, and will continue to lead overall economic growth into 2017. The fundamentals for consumers are good: job growth of about 180,000 per month so far in 2016; rising wages as the job market continues to tighten; low interest rates; low levels of debt; and rising household wealth, thanks to gains in stock prices and home values. PNC is forecasting holiday sales growth of about 3.5 percent in 2016 compared to 2015, with about 2.5 percentage points of that from higher volumes, and 1 percentage point from higher prices. However, gains for traditional retailers will be much weaker due to the increasing reach of online sales.

Industrial production fell 0.4 percent in November, the largest monthly decline since March. However, most of the drop was concentrated in utilities, with production down 4.4 percent over the month with warmer-than-usual weather. Manufacturing production dropped 0.1 percent in November, with mining output up 1.1 percent, the second straight increase; mining production fell 17 percent from late 2014 to mid-2016 as energy prices plunged, before bottoming out.

Despite the decline in overall production in November, the industrial sector is doing better in the second half of 2016. Mining output has stabilized. Manufacturing output has also improved in recent months, although the recent strengthening in the U.S. dollar will be a drag in 2017. The industrial sector will improve in 2017, although its pace of growth will lag that of the larger economy.

Housing starts fell 18.7 percent in November, although that followed an even larger 27.4 percent increase in October.

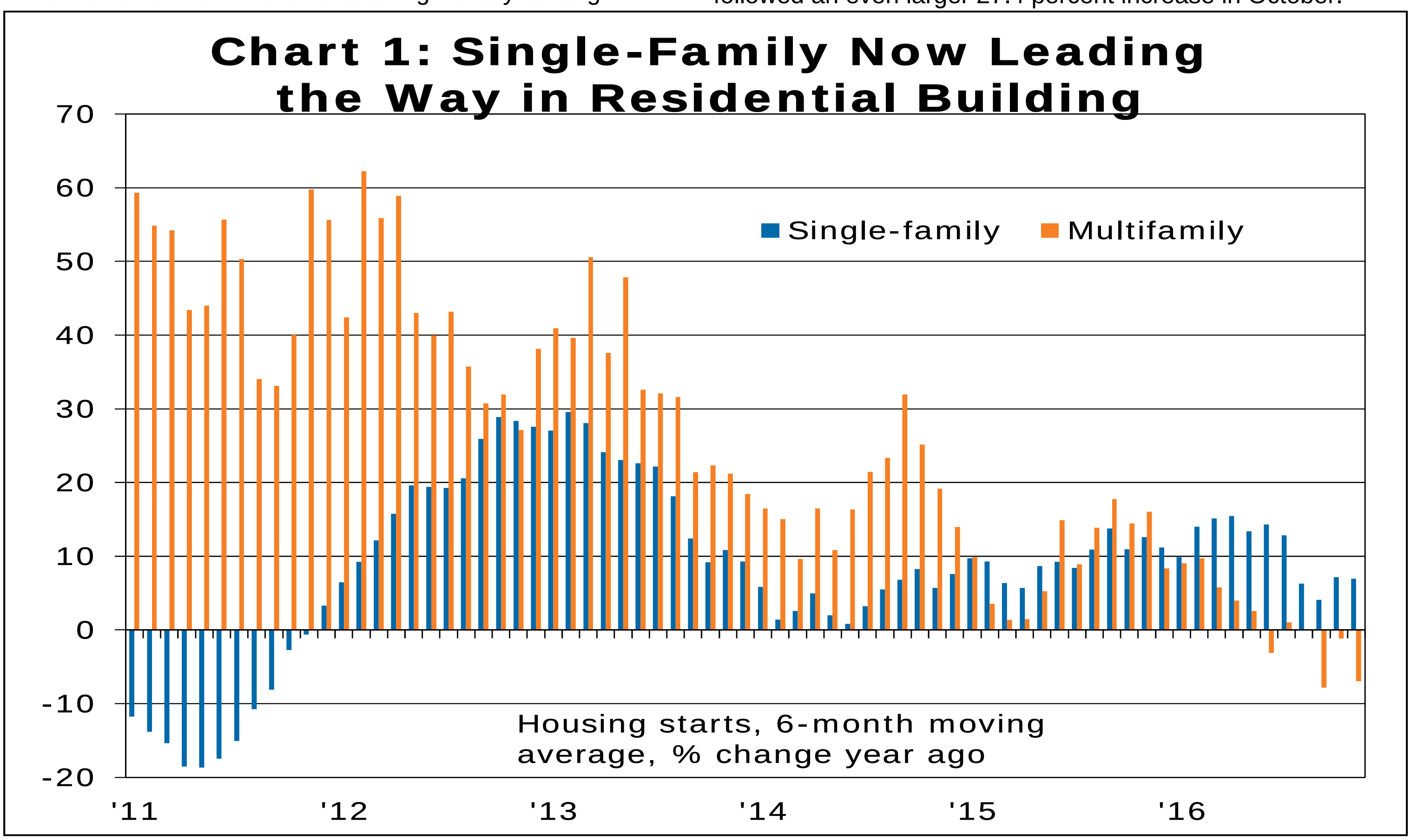

Chart source: Census Bureau

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Single-family starts were down 4.1 percent in November, while more volatile multifamily (apartment and condominium) starts fell 45.1 percent. Housing permits fell 4.7 percent in November, with single-family permits up 0.5 percent but multifamily permits down 13.0 percent.

Although housing starts fell the most since February 2015, the details were better. First, the decline followed an even larger gain in October, so starts were still above their September level. Second, single-family starts, which are more important for the economy, continue their upward trend (see Chart 1). Multifamily building boomed earlier during the recovery, as demand for homeownership diminished in the fallout from the Great Recession. But demand for new single-family homes is steadily improving. The fundamentals are good, with solid job gains, stronger wage growth, low mortgage rates, and pent-up demand. In fact, the biggest constraints are on the supply side: a dearth of skilled construction workers and shortages of developable land in some parts of the country. Higher mortgage rates since the presidential election will slow, but not derail, the homebuilding recovery.

Inflation remained moderate in November. The consumer price index rose 0.2 percent over the month, in line with the consensus. The core CPI, excluding volatile food and energy prices, was also up 0.2 percent. On a year-ago basis overall inflation was 1.7 percent, while core inflation was 2.1 percent.

Overall inflation has moved significantly higher since the summer as energy prices have bottomed out (see Chart 2). This higher inflation was an impetus for the FOMC to raise the federal funds rate. Both overall and core inflation should gradually strengthen throughout 2017, due to higher energy prices, including pass through to non-energy goods and services in the core CPI; stronger wage growth as the job market approaches full employment; and greater pricing power for firms.

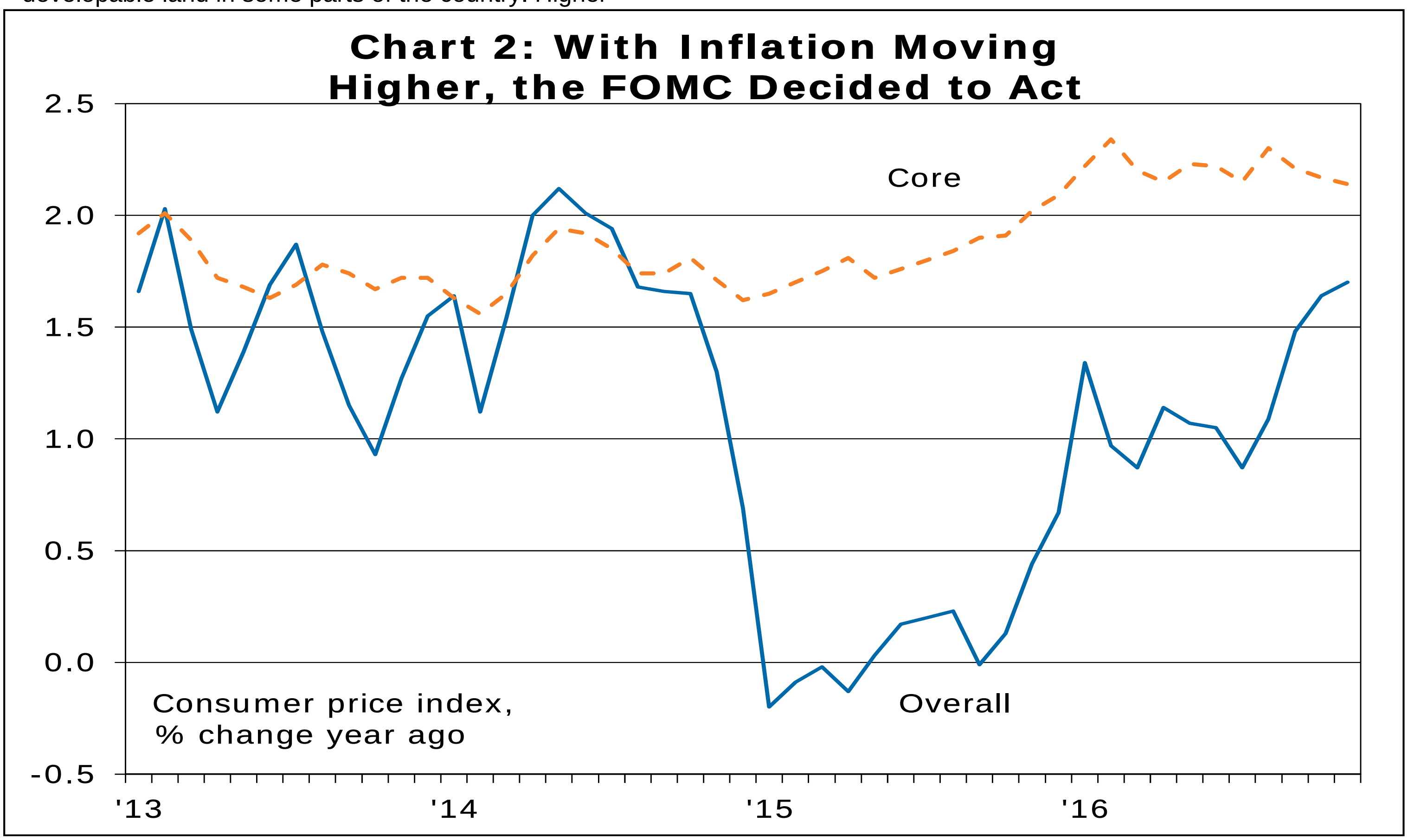

Chart source: Bureau of Labor Statistics

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