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ECONOMIC REPORT

Gus Faucher Chief Economist | **Stuart Hoffman** Senior Economic Advisor | **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

FOMC MINUTES POINT TO DECEMBER RATE HIKE; JOB MARKET IS TIGHT AND INFLATION SET TO INCREASE

SUMMARY

- Participants at the FOMC's September meeting expected a rapid recovery from the recent hurricanes. There was less agreement as to why inflation continues to undershoot the FOMC's 2 percent goal.
- PNC expects an increase in the fed funds rate in December and three more rate hikes in 2018.
- The producer price index rose 0.4 percent in September, boosted by a big increase in gasoline prices.
- Initial claims for unemployment insurance fell by 15,000 to 243,000 in the week ending October 7. Initial claims are falling back to their level prior to Hurricane Harvey.
- The number of job openings fell to 6.08 million in August and the number of hires fell to 5.43 million. Firms are having difficulty filling positions; job growth will slow and wages will rise as a consequence.

According to the minutes from the Federal Open Market Committee meeting on September 19 and 20, participants generally expected a rapid recovery from Hurricanes Harvey, Irma, and Maria. The minutes say that "they expected growth of real GDP in the third quarter to be held down by the severe disruptions caused by the storms but to rebound beginning in the fourth quarter as rebuilding got under way and economic activity in the affected areas resumed. Similarly, employment would be temporarily depressed by the hurricanes, but abstracting from those effects, employment gains were anticipated to remain solid, and the unemployment rate was expected to decline a bit further by year-end." The hurricanes were expected to boost inflation temporarily because of higher prices for gasoline and other goods, but inflation was expected to remain below the FOMC's 2 percent goal in the near term, then move toward the goal over the medium term.

There was a lot of discussion about why inflation has been persistently below the 2 percent target, and its expected path over the next few years. The minutes say that "many participants continued to believe that the cyclical pressures associated with a tightening labor market or an economy operating above its potential were likely to show through to higher inflation over the medium term. In addition, many judged that at least part of the softening in inflation this year was the result of idiosyncratic or one-time factors, and thus, their effects were likely to fade over time." Other factors cited that could be holding down inflation were slower growth in healthcare costs from the Affordable Care Act and technological advances. Some participants noted low global inflation, suggesting that the problems were not isolated to the United States.

The minutes point to another increase in the fed funds rate at the end of 2017. "Many participants thought that another increase in the target range later this year was likely to be warranted if the medium-term outlook remained broadly unchanged. Several others noted that, in light of the uncertainty around their outlook for inflation, their decision on whether to take such a policy action would depend importantly on whether the economic data in coming months increased their confidence that inflation was moving up toward the Committee's objective. A few participants thought that additional increases in the federal funds rate should be deferred until incoming information confirmed that the low readings on inflation this year were not likely to persist and that inflation was clearly on a path" to the 2 percent goal.

The minutes support PNC's forecast for an increase in the fed funds rate at the FOMC's December 12-13 meeting, the next meeting with a Chair Yellen press conference and a release of the Summary of Economic Projections (the "dot plot") showing the expected near-term evolution of the economy and the federal funds rate. The fed funds futures market is

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currently pricing in an 87 percent probability of a rate increase by the end of the year. PNC expects three increases in the fed funds rate in 2018; this is consistent with the last dot plot, from mid-September.

Although the minutes point to a rate increase later this year, there is still a great deal of uncertainty for 2018 and beyond. In addition to questions about inflation, the makeup of the FOMC will be quite different. Randal Quarles has been confirmed by the Senate to fill one of the empty seats on the Fed board, but there are three more empty seats. Thus, President Trump will be naming four members to the board. In addition, Yellen's term as chair ends in early 2018 and the president is likely to replace her. Thus the Federal Reserve board, and monetary policy, could look very different next year.

The producer price index for final demand rose 0.4 percent in September, matching PNC's forecast and the consensus expectation. This followed a 0.2 percent increase in August and a 0.1 percent decline in July. With refinery closures due to Hurricane Harvey, gasoline prices rose 11 percent over the month, contributing to a 0.7 percent increase in final demand goods prices.

Even without the temporary boost from energy prices, producer price inflation broadly gained momentum. Prices for core goods (excluding volatile food and energy prices) for final demand rose 0.3 percent in September, following a 0.2 percent increase in August and a 0.1 percent decline in July. Services prices for final demand rose 0.4 percent in September, following a 0.1 percent increase in August and a 0.2 percent drop in July. Trade prices rose 0.8 percent in September after a flat month in August; transportation and warehousing prices rose 1.0 percent in September.

On a year-ago basis producer prices for final demand rose 2.5 percent in September, from 2.4 percent in August and 2.0 percent increases in both June and July (see Chart 1). Producer prices for final demand excluding food, energy, and trade were up 2.2 percent year-over-year in September, slightly faster than in August and July.

Initial claims for unemployment insurance fell to 243,000 in the week ending October 7, from 258,000 the prior week (revised down from 260,000). Hurricanes Harvey, Irma and Maria have caused volatility in the job market, but claims appear to be normalizing. New filings are trending lower after peaking at 298,000 in the week ending September 2.

Chart 1: Producer Price Inflation Gaining Momentum, Even Excluding Energy Prices

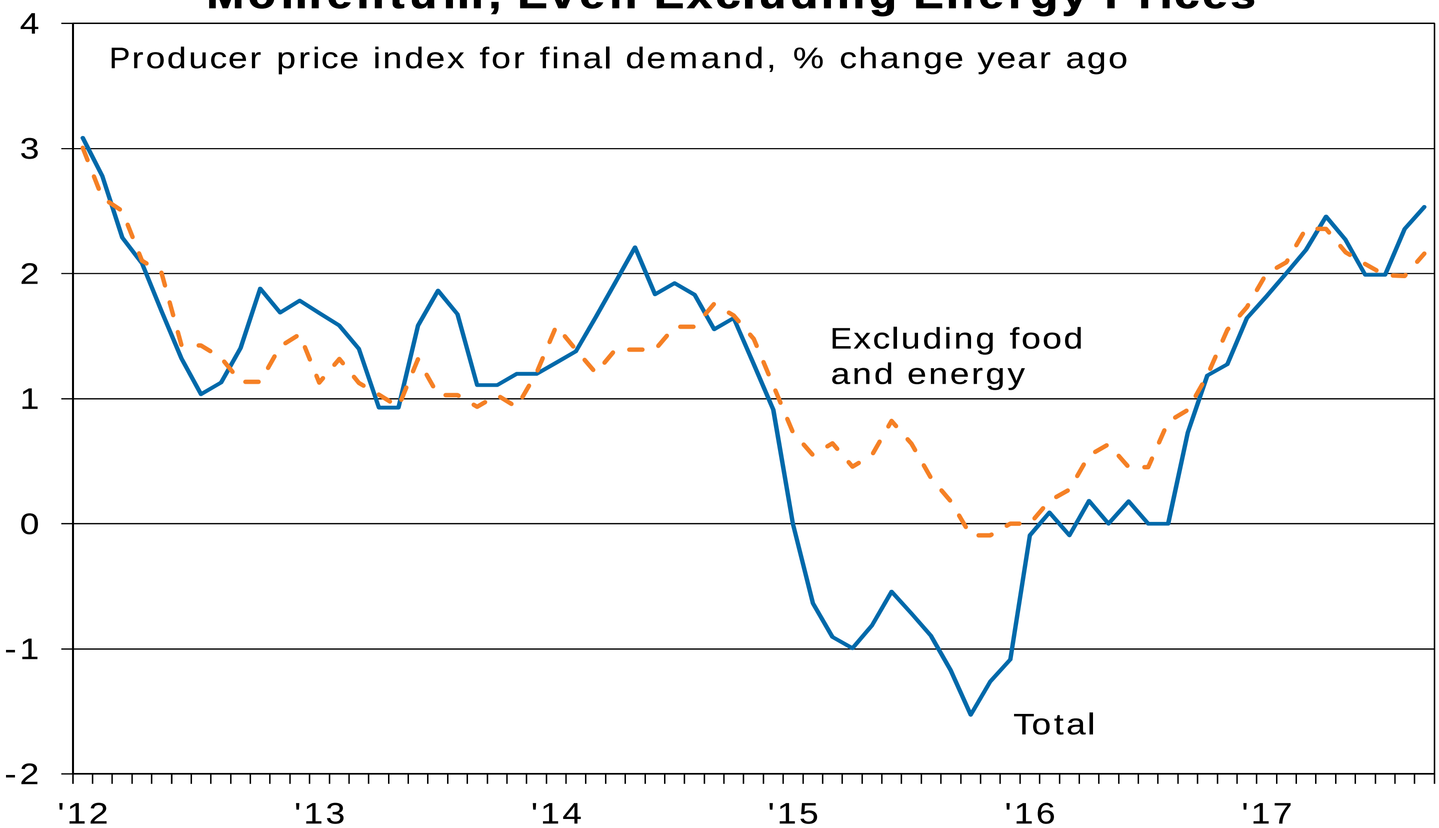

Chart source: Bureau of Labor Statistics

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Initial claims averaged 236,000 per week in August before the storms hit.

The number of job openings fell to 6.08 million in August from 6.14 million in July, according to the Job Openings and Labor Turnover Survey. The job openings rate held steady at a record high of 4.0 percent of total employment for a third straight month. The hiring rate ticked lower to 3.7 percent in August from 3.8 percent in July, while the number of hires declined to 5.43 million in August from 5.52 million in July.

The separations rate and the quits rate both edged down by 0.1 percentage point in August, to 3.6 percent and 2.1 percent, respectively. So far in 2017, both the separations rate and the quits rate have been fluctuating around their pre-Great Recession levels. The layoffs rate held at 1.2 percent for a third month, up from its cyclical low of 1.0 percent in September 2016 but below the 1.4 percent average in the previous economic expansion. At the height of the Great Recession, the layoffs rate peaked at 1.9 percent.

The U.S. labor market is at full employment and employers are having difficulty filling open positions. The consistently higher number of job openings relative to hires attests to the labor market's tightness (see Chart 2). In PNC's fall survey of small and mid-size businesses one in three respondents reported it more difficult to hire qualified workers compared to six months ago.

The tighter job market will lead to faster income growth as firms bid up wages to attract talent. Abstracting from the impact of the hurricanes, PNC expects job growth to average about 170,000 per month this year and 135,000 per month next year, down from 190,000 per month in 2016. The slowing in job growth is from a lack of available workers, not weaker demand for labor.

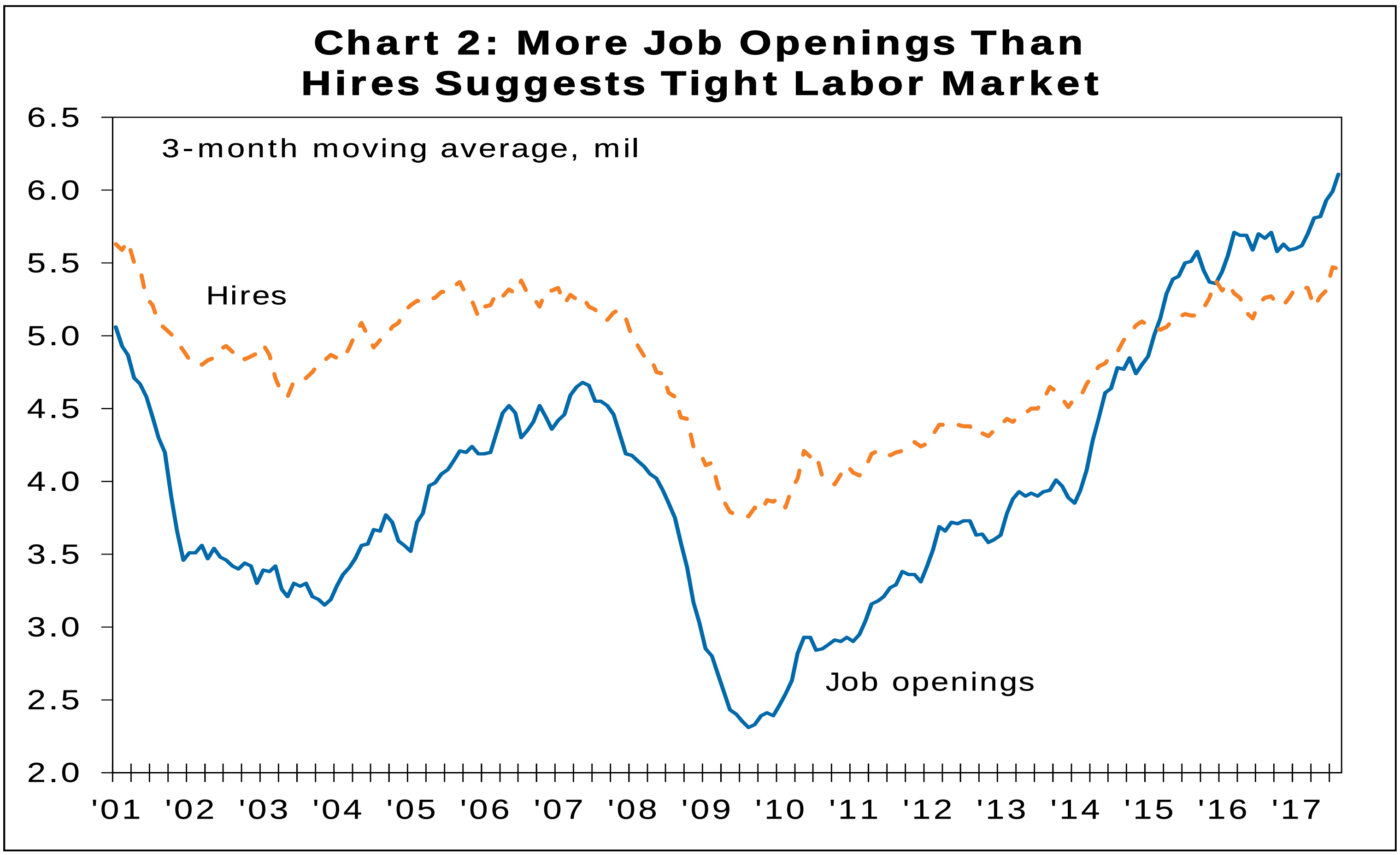

Chart source: Bureau of Labor Statistics

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