SUMMARY

- In her speech at an economic policy conference, Fed Chair Yellen said that the case for an increase in the fed funds rate has strengthened in recent months.
- Yellen noted the improvement in the labor market, and said that she expected inflation to pick up over the next few years.
- Yellen did not provide an indication as to when the next increase in the fed funds rate will come.
- PNC expects that the next increase in the fed funds rate will come at the FOMC’s December meeting.
- GDP growth in the second quarter was revised slightly lower, to 1.1 percent. Growth should be stronger in the third quarter.
- Durable goods orders rose 4.4 percent in July, with solid details.

In a speech at the Kansas City Fed’s annual Jackson Hole economic policy conference, Federal Reserve Chair Janet Yellen indicated that an increase in the federal funds rate is likely in the near term. In particular, Yellen said that “in light of the continued solid performance of the labor market and our outlook for economic activity and inflation, I believe the case for an increase in the federal funds rate has strengthened in recent months.” She reiterated that the fed funds rate path remains dependent on incoming data: “our decisions always depend on the degree to which incoming data continues to confirm the Committee’s outlook.”

Yellen also highlighted the high degree of uncertainty in the current economic environment, saying that “our ability to predict how the federal funds rate will evolve over time is quite limited because monetary policy will need to respond to whatever disturbances may buffet the economy.” She noted the high range of uncertainty surrounding Federal Open Market Committee forecasts for the federal funds rate.

Yellen’s view of current economic conditions was mixed. She noted that “while economic growth has not been rapid, it has been sufficient to generate further improvement in the labor market,” and cited improvement across a variety of labor market measures. She said that inflation should rise to the FOMC’s 2 percent target “over the next few years.”

Yellen said the long-run value of the federal funds rate now appears to be 3 percent, down from 7 percent between 1965 and 2000. However, she also said that this lower level of the funds rate should not hamper the Fed’s ability to fight recessions, citing forward guidance and quantitative easing as alternative tools. She noted that this applies even now, with the fed funds rate very low, in a range between 0.25 and 0.50 percent.

Yellen discussed other monetary policy tools that the Fed might want to consider during future recessions. In particular, she cited purchasing a broader range of assets in quantitative easing, raising the inflation target (currently 2 percent), or targeting a price level or nominal GDP. However, she also said that “the FOMC is not actively considering these additional tools and policy frameworks,” merely researching them. She also did not mention negative interest rates.

Yellen’s speech has strengthened the case for PNC’s forecast for an increase in the federal funds rate at the FOMC’s December meeting. She suggested that an increase in the funds rate would be appropriate in the near term, but is not imminent. The FOMC’s next meeting is on September 20 and 21. Data between now and then are unlikely to shift the
The following meeting is on November 1 and 2, just a week before the presidential election; the FOMC is unlikely to move that close to the election. The meeting after that is on December 13 and 14. By that point third quarter GDP should show a pickup in growth, the labor market will have continued to improve, and inflation should have stabilized and perhaps be moving toward the Fed’s 2 percent target. All of that should make the FOMC confident in raising the fed funds rate.

The market reaction has apparently changed over the course of the day. After starting the day up stocks finished slightly down. Interest rates rose on expectations of a Fed rate increase sooner rather than later. The yield on the 10-year Treasury jumped after the initial release of the speech, then declined, then rose again; it ended the day at 1.62 percent, up more than 4 basis points. The 2-year Treasury yield ended up 5 basis points on the day at 0.85 percent. The dollar has strengthened about 0.8 percent on the day against a range of currencies.

Financial market expectations for a rate increase jumped following Yellen’s speech. The fed funds futures market is pricing in a 36 percent probability of a fed funds rate increase at the FOMC’s September meeting, up from 21 percent yesterday. The probability of at least one increase by December is now about 61 percent, up from 52 percent yesterday.

Growth in real gross domestic product in the second quarter was revised down slightly in the second estimate, to 1.1 percent at an annual rate, from 1.2 percent in the advance estimate. The small downward revision to GDP came from downward revisions to state and local government spending and private inventories, and an upward revision to imports (higher imports reduce GDP). These were somewhat offset by upward revisions to business fixed investment and consumer spending. The small downward revision matched the consensus expectation.

Real GDP was up 1.2 percent in the second quarter from one year earlier (unchanged from the advance estimate), the slowest pace since the second quarter of 2013 (see Chart 1). Growth over the past three quarters has been quite soft, just 0.9 percent annualized.

Much of the softness in the economy in the second quarter came from a decline in inventories. Real final sales of domestic product, which is GDP minus the change in inventories, and measures demand for U.S.-produced goods and services, rose a solid 2.4 percent at an annual rate. Thus inventories subtracted 1.3 percentage points from growth in the second quarter. Consumer spending was very strong in the second quarter, up 4.4 percent per annum adjusted for inflation, adding 2.9 percentage points to growth. Fixed investment was a drag, with declines in spending on residential construction, commercial construction, and business equipment. Government spending was also down for the quarter, subtracting from growth. Trade was a small positive for growth in the quarter, with exports increasing more than imports.

This release provided the first read on second quarter real growth.

![Chart 1: Slower Growth Since Late 2014](chartsource: Bureau of Economic Analysis)
gross domestic income, an alternative measure of the size of the economy that measures income going to households and business; it rose just 0.2 percent at an annualized rate. Real GDI rose 0.8 percent in the first quarter, revised down from 0.9 percent. Real GDI was up 1.2 percent in the second quarter from one year earlier.

Corporate profits fell $24.1 billion in the second quarter from the first (not adjusted for inflation), or 1.2 percent (not annualized). Profits for domestic industries fell $51.0 billion, including a decline of $58.2 billion for nonfinancial corporations. Profits from abroad rose $26.9 billion in the second quarter. Profits were down 4.9 percent from one year earlier (see Chart 2).

The second quarter GDP report was disappointing, but growth should bounce back in the third quarter. Inventories were a major drag on growth in the second quarter, but now that businesses have better aligned inventories with demand, that should lift and inventories will add to growth in the near term. Consumer spending was a big positive for growth in the second quarter, and although it cannot maintain that same torrid pace it will continue to lead the economy. The fundamentals for consumer spending are solid: more jobs, accelerating wage growth, low interest rates, excellent household balance sheets, and rising household wealth. Housing will also add to growth; homebuilding subtracted from growth in the second quarter, but that was an anomaly and stronger housing demand should boost activity in the near term. Business investment was soft, in part because of a massive downturn in investment in energy production. But with energy prices stabilizing that drag should lift. Trade will be a drag in the near term due to soft global growth, the strong U.S. dollar, and increased consumer purchases of foreign goods.

New orders for durable goods rose 4.4 percent in July, better than the consensus expectation for an increase of 3.5 percent. Much of the increase came from aircraft orders, which were up 90 percent over the month. But core capital goods orders—nondefense capital goods orders excluding aircraft, and a proxy for business investment—were up a solid 1.6 percent, the biggest increase since January. Shipments of durable goods rose 0.2 percent in July, with core capital goods shipments down 0.5 percent.

Business investment was a negative for economic growth in the second quarter, but should be a positive in the near term. Energy companies in particular cut back on investment as the big plunge in prices made many projects uneconomical. But with a stabilization in energy prices, this drag should fade. The strong dollar has also weighed on durable goods orders, but with the stabilization in the dollar this year that drag should also lift.

Chart 2: Corporate Profits Have Recovered From Recession, But Flat Over the Past Two Years

Corporate profits, annualized, $ tril

Chart source: Bureau of Economic Analysis

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