December 24, 2018

GLOBAL ECONOMIC HIGHLIGHTS

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GLOBAL MONETARY POLICY TIGHTER BUT FISCAL STIMULUS CONTINUES; BREXIT ENDGAME NEARS; ECB ENDS QE

UNITED STATES: Matching PNC's forecast and market consensus, the Federal Reserve raised the Federal Funds target 0.25 percentage point to a range of 2.25 to 2.50 percent at their December 19 Open Market Committee meeting. They modified the forward guidance on interest rates to call for "**some** further gradual increases" (our emphasis added) in the policy rate from "further gradual increases" (no quantity specified) in the prior statement. This is confirmation that the Fed expects to end its rate hike cycle within the next year or two. The Summary of Economic Projections a.k.a. "dot plot" showed the balance of opinion among members of the Fed's interest rate setting committee has shifted toward fewer rate hikes in 2019 and 2020. The median expectation for rate hikes – half of members support the same number or more, the other half the same number or less – through year-end 2019 fell to two 0.25 percentage point increases from three in the prior SEP released in September 2018. The median FOMC member also reduced the level they expect to set their policy interest rate at year-end 2020 and 2021 to 3.1 percent from 3.4 percent in September. The median forecast for real GDP growth in 2019 also fell, to 2.3 percent from 2.5 percent in the September SEP, as did the median forecasts for PCE inflation and PCE inflation excluding food and energy, to 1.9 percent and 2.0 percent, respectively, both 0.1 percentage point lower than the September SEP. The median forecast for interest rates by year-end 2019 in the Fed's December SEP matches PNC's forecast for two 0.25 percentage point federal funds rate hikes next year, which we forecast for June and September. This means that the Fed's pattern of raising interest rates roughly every quarter, which it followed from late 2017 through the end of 2018, will pause between December 2018 and June 2019, giving the Fed time to confirm that the US economy, while slowing, is not weakening more than expected. While US monetary policy has tightened, ongoing fiscal stimulus will support growth for much of 2019, offsetting downside risks from trade friction and other policy uncertainties. This matches the global outlook for 2019: Outside of the US, the UK, Italy, France, and China have announced fiscal stimulus plans to support growth and prolong the global expansion.

UNITED KINGDOM: As expected, the Bank of England held its policy bank rate unchanged at 0.75 percent at its December 20 monetary policy decision, and emphasized that the outlook for monetary policy depends on whether the British government opts for a Hard Brexit, Soft Brexit, or No Brexit. The BoE's forecasters expect fiscal stimulus announced by the government in October 2018 to add an average of about 0.1 percentage point to real GDP growth per year in 2019 and 2020. The BoE decision followed Prime Minister Theresa May's December 17 directive to the government to begin contingency planning for a Hard Brexit at the end of March 2019 – in less than 100 days. The Bank of England forecasts a Hard Brexit would cause an economic downturn more severe than the US Great Recession and substantial financial turbulence. Prime Minister May also announced that the vote on the Withdrawal Agreement would begin January 14 – she delayed the vote December 10 when it became obvious Parliament would vote the agreement down. To reiterate our long-held position, a Hard Brexit seems very unlikely, since it would almost certainly cause the ruling Tory party to lose power for a long time. Political parties very rarely enact policies they know will cause them to lose power. Parliament also seems unlikely to ratify the very unpopular Withdrawal Agreement, which imposes all sorts of costs and constraints on the UK which pro-Brexit advocates insist should not be required. A second referendum or extension of the Brexit negotiating period still seem like the most likely outcomes. In the meantime, the British economy is weakening and is at risk of a recession in early 2019 as businesses and households delay spending, hiring, and investment decisions. The Bank of

England's business conditions survey the *Agents' Summary of Business Conditions* confirmed the economy was already weakening when survey data was collected between mid-October and late November: Retail sales, hiring intentions, and business investment plans all deteriorated from the third quarter.

EUROZONE: As expected, the European Central Bank at its December 13 Governing Council meeting confirmed its quantitative easing program would end at year-end 2018. Like the Federal Reserve, the ECB modestly downgraded its forecasts for both real GDP growth and HICP inflation in 2019 in its December forecasts, reducing the outlook for both by 0.1 percentage point to 1.7 percent and 1.6 percent, respectively, and holding unchanged projections for subsequent years. At the press conference following the decision, President Draghi remarked of 2018's disappointing economic growth that "it's just weaker, and it's not one-off, it's been weaker for a while now." The ECB Governing Council also noted a deterioration of the risks to the growth outlook, stemming from "geopolitical factors, the threat of protectionism, vulnerabilities in emerging markets, and financial market volatility." On the other hand, an important downside risk to the Eurozone was contained December 18 when the European Commission accepted Italy's proposal for a fiscal stimulus plan that, while less expansionary than the budget deficit of 2.4 percent of GDP the Italian government had previously proposed, will still increase the deficit, to 2.04 percent of GDP in 2019 from 1.8 percent in 2018. A larger deficit is a tailwind to Italian growth prospects. France too is proposing fiscal stimulus in 2019 in the form of tax cuts, a minimum wage hike, and raises for public employees in response to populist protests in early December against tax hikes targeting middle class and lower income groups.

CANADA: The real estate correction continues: home sales fell 2.3 percent in November from October and 12.6 percent from a year earlier, new listings fell 3.3 percent on the month, the MLS® HPI rose 2.0 percent from a year earlier, and the national average sale price fell 2.9 percent. Housing has become a significant headwind to Canadian growth, but other parts of the economy are holding up so far. Payroll employment, released at a long lag to the more closely followed household survey, rose a robust 2.3 percent from a year earlier in October, and average weekly earnings rose 2.5 percent despite a 0.3 percent year over year drop in average hours worked. Canadian interest rate markets price in less than 50-50 odds of a rate hike through year-end 2019, but with average hourly earnings outpacing trend inflation in October and the unemployment rate at its lowest since comparable data began in 1976, the Bank of Canada seems likely to raise its policy rate 0.25 percentage points to 1.00 percent at its April 2019 decision to hedge against labor bottlenecks causing the economy to overheat.

CHINA: Economic data were weak through November, but monetary and fiscal policies will provide more support to growth in 2019 and trade tensions with the United States may be easing. Retail sales growth slowed to 8.1 percent in year over year terms in November from 8.6 percent in October and was the slowest since May 2003, when quarantines related to the deadly SARS virus disrupted the Chinese economy. Falling auto sales are behind the weak headline number: Passenger car sales fell 11.7 percent from a year earlier according to the China Association of Auto Manufacturers, held back by the withdrawal of a rebate on auto purchases and cautious consumer sentiment. Signs of more pro-growth policies are growing: China's state news agency announced December 21 that the Central Economic Work Meeting decided that monetary policy in 2019 will be "stable" and set "appropriately." The statement omitted prior language describing policy as "neutral," implying that the next change in monetary policy is likely incremental easing. The Work Conference also pledged to broaden tax cuts in 2019, i.e. add to fiscal stimulus. Finally, the Chinese government cancelled retaliatory tariffs on US car exports on December 14, a concession ahead of a planned reopening of negotiations with the United States over trade frictions in January.

MEXICO: As expected, the Bank of Mexico followed the Fed by raising their policy rate 0.25 percentage point to 8.25 percent at their December 20 decision. Mexican growth is below potential and inflation set to slow on lower energy prices, so the Bank of Mexico will probably hold its policy rate unchanged through year-end 2019. They may even find room to cut rates and support growth if the government successfully reassures financing markets that Mexico's policy environment will be stable and predictable. The government made a first step toward regaining market confidence on December 19 when it reached an agreement with bond holders to buy back $1.8 billion dollars of the $6 billion in bonds issued to finance construction of a new airport for Mexico City, which president Andres Manuel Lopez Obrador cancelled in late October.

BRAZIL: As expected, the Central Bank of Brazil held its benchmark Selic rate unchanged at 6.5 percent at its December 12 monetary policy decision. Financial markets price in roughly 50-50 odds of a rate hike by mid-2019, but if the Brazilian government enacts pension reforms or otherwise acts to narrow the fiscal deficit, the central bank could cut interest rates. Also as expected, Brazil's economy was soft in October with the central bank's proxy for real GDP growth the IBC-Br index unchanged on the month; the IBC-Br's growth slowed to 1.8 percent in year-over-year terms from 2.2 percent in September. Growth will pick up going forward with the uncertainty of the October 28 election out of the way. In an early sign of improving growth prospects, a Datafolha poll showed economic optimism in December reached its highest level since 1997.