February 4, 2019

GLOBAL ECONOMIC HIGHLIGHTS

Gus Faucher Chief Economist | **Stuart Hoffman** Senior Economic Advisor | **William Adams** Senior Economist | **Kurt Rankin** Economist | **Abbey Omodunbi** Economist

THE PNC FINANCIAL SERVICES GROUP | The Tower at PNC Plaza | 300 Fifth Avenue | Pittsburgh, PA 15222-2401

FED ADOPTS NEUTRAL RATE OUTLOOK, SIGNALS BALANCE SHEET REDUCTIONS ARE NEARING THEIR END

UNITED STATES: As all but assured, the Federal Reserve held the federal funds target unchanged at a range of 2.25 to 2.50 percent at its January 30 Open Market Committee decision, and signaled a dovish shift in the outlook for interest rates and the balance sheet. On interest rates, the policy statement said the Fed "will be patient as it determines what future adjustments" are right for interest rates. The prior statement had said they believe "some further gradual increases" are appropriate. The new word "patience" reaffirms PNC's view that the Fed is ending its practice of raising the funds target once per quarter, the pattern between the fourth quarter of 2017 and the fourth quarter of 2018. And the substitution of "future adjustments" for "gradual increases" in the prior statement means the Fed sees a possibility that the next change in rates could be a cut, not necessarily another hike. Even so, with the unemployment rate below the Fed's estimate of its long-run level and wage growth accelerating, PNC forecasts for the Fed to make one more rate increase in this cycle in September. By then, PNC expects the evidence to be stronger that, while US growth is slowing, it is not giving way to a recession. Regarding the Fed's balance sheet, its policymakers issued a statement separate from the normal monetary policy statement that said they plan to use the federal funds rate as their key policy instrument. However, the balance sheet remains a viable secondary policy tool. The FOMC statement also said that the Committee wants to maintain "an ample supply of reserves" to ensure monetary policy functions smoothly. This means the Fed will maintain a big enough balance sheet to ensure a liquidity "buffer," in Chair Powell's words, between total US bank demand for reserves and the amount the Fed supplies – and the balance sheet will be much larger at the end of balance sheet reductions than it was before unconventional stimulus programs began in 2008. As Chair Powell explained in his January 30 press conference, the Fed tightened bank regulation after the financial crisis and now requires banks to hold much greater quantities of highly liquid assets, like deposits at the Fed and Treasury securities. This substantially increases demand for excess reserves (commercial bank cash deposited at the Fed), and by extension increases the size of the Fed's balance sheet. The Fed has already reduced the balance sheet from $4.5 trillion dollars in mid-2017 to $4.0 trillion in January 2019, and reductions continue at around $50 billion dollars per month. At this rate, the balance sheet would reach the middle of private forecasters' estimates of its steady-state size, $3.5 trillion dollars, by late 2019. However, given uncertainty about how large the balance sheet should be over the longer run, the Fed will probably slow the pace of its balance sheet reductions in the second half of 2019, and end run-off in 2020 or 2021. Recent US economic data surprised to the upside: New home sales rose a strong 16.9 percent in November from October, though they were still down 7.7 percent from a year earlier. The January jobs report showed nonfarm payroll employment up a robust 304,000 from December, though job growth in the prior two months was revised down a net 71,000; even so the three-month moving average of job growth was a very solid 241,000. The unemployment rate rose to 4.0 percent from 3.9 percent as furloughed government workers and contractors were considered unemployed. Average hourly earnings rose a modest 0.1 percent on the month but were still up 3.2 percent on the year; earnings growth continues to be near the strongest since 2009 in year-over-year terms. The labor force participation rate rose to the highest since September 2013. The ISM manufacturing PMI recovered to 56.6 in January from December's 24-month low of 54.3.

CHINA: Manufacturing is weak, but the services sector is a little better. The CFLP manufacturing PMI for China was little changed at 49.5 in January after 49.4 in December, which had been the lowest since

February 2016, and the Caixin general manufacturing PMI (with more coverage of smaller, export-oriented, privately-owned companies) dropped to 48.3 from 49.7 and was the lowest since February 2016. The CFLP nonmanufacturing PMI rose to 54.7 from 53.8. The Trump administration hosted negotiations with senior Chinese economic policymakers the week of January 29, but there was little hard evidence of progress on a trade deal. The US government will most likely extend the negotiations beyond the Trump administration's self-imposed March deadline to allow more time to reach a deal and de-escalate trade tensions.

EUROZONE: HICP inflation slowed to 1.4 percent in year over year terms in January from 1.6 percent in December on lower energy prices, with Eurostat's core inflation indices all 1.1-1.2 percent, little changed on the month. Eurozone real GDP grew 0.2 percent, not annualized, in the fourth quarter from the third according to Eurostat's preliminary flash estimate, a rate of growth that was unchanged from the third quarter; in year over year terms, real GDP growth slowed to 1.2 percent from 1.6 percent in the third quarter. The unemployment rate was unchanged on the month at 7.9 percent in December, matching November for the lowest since October 2008.

JAPAN: The unemployment rate dipped back down to 2.4 percent in December from 2.5 percent in November as fewer Japanese people searched for work and the number of employed persons also fell. Employment fell 270,000 on the month, and the labor force a sharp 510,000; growth of employment slowed to 1.8 percent in year ago terms from 2.4 percent in November, while growth of the labor force slowed from 2.2 percent to 1.5 percent. Japan's slowing job growth reflects a cooler economy, not supply bottlenecks: The Nikkei manufacturing PMI dipped to 50.3 in January from 52.6 in December and was the weakest in 29 months.

UNITED KINGDOM: The Markit/CIPS manufacturing PMI dipped to 52.8 in January from 54.2 in December: The production sub-index was the weakest in two and a half years, and a record share of businesses were adding to inventories to be prepared for potential supply chain disruptions as the end-March deadline for the Brexit negotiation approached. The construction PMI fell to 50.6 from 52.8 and was its weakest in ten months, and the employment sub-index was the weakest in two and a half years. The British economy is at risk of a precautionary recession in the first half of 2019 as businesses delay hiring and investment.

CANADA: PNC forecasts a sharp 75,000 decline in Canadian employment in January, with the unemployment rate rising 0.1 percentage point to 5.7 percent from December and November's multi-decade low of 5.6 percent. Average weekly earnings rose a modest 2.0 percent on the year in November as the average workweek edged lower, and real GDP dipped 0.1 percent from October with weakness widespread across manufacturing, construction, and service sectors. PNC forecasts for the Bank of Canada to next raise its policy interest rate 0.25 percentage point to 2.0 percent at its April interest rate decision, assuming job growth and economic growth stabilize in February and March. But the energy industry is now compounding the headwinds from housing: Alberta's Premier ordered the province's oil producers to curtail production in January, February and March after transportation bottlenecks depressed local oil prices in late 2018. Even with oil prices less low, the curtailments will drag on energy GDP and hiring in the first quarter of 2019.

MEXICO: The Markit manufacturing PMI recovered to 50.9 in January from 49.7 in December, but partly due to bad news: Suppliers' delivery times lifted the index as businesses were hamstrung by gasoline shortages caused by the government's crackdown on theft of gasoline from state-owned pipelines.

BRAZIL: PNC forecasts for the Central Bank of Brazil to hold its benchmark Selic policy rate unchanged at 6.50 percent at its monetary policy decision Wednesday February 6. With unemployment still high, inflation cool by Brazilian standards, and growth slowing since the second half of 2018, the central bank has room to support the economy with record low interest rates. If the government passes fiscal policy reforms and reduces its pension obligations, more rate cuts are possible in late 2019, a potential catalyst for a stronger currency. But political opposition to cutting pensions will delay the reforms, which would help Brazil regain an investment grade sovereign credit rating.