July 29, 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

EUROPEAN CENTRAL BANK AND BANK OF JAPAN REINFORCE EXPECTATIONS FOR EASING IN SEPTEMBER

EUROZONE: Matching PNC's forecast and consensus, the European Central Bank held its policy stance unchanged at its July 25 decision and signaled they will intensify stimulus at the next decision September 12. The Governing Council changed their forward guidance on interest rates to say they expect "interest rates to remain at their present **or lower levels**" (our emphasis) through at least the first half of 2020, and as long as necessary to achieve their inflation aim. The new phrase "or lower" points to a cut to the benchmark deposit rate, probably to -0.50 percent from -0.40 percent currently. The Governing Council also set up a committee to research "mitigating measures, such as the design of a tiered system for reserve remuneration." The ECB probably will exempt some of Eurozone commercial banks' excess cash from the negative deposit rate in September, boosting their net interest margins, profitability, and ability to grow loans and fund economic growth.

In addition, the Governing Council tasked a committee of representatives from member state central banks with examining "options for the size and composition of potential new net asset purchases." Could asset purchases broaden to include stocks as well as bonds as in Japan? President Draghi was tight-lipped at the July 25 press conference, saying the decision is "in the hands of the committee." With negative interest rates highly controversial, especially in Germany, the case for broadening asset purchases to riskier assets rather than making interest rates even more negative is compelling. The Bank of Japan already uses this tool, setting a clear precedent. But the details would be trickier in the Eurozone. German critics of QE sued the ECB over bond purchases, arguing they exceed the central bank's mandate, and could challenge purchases of stocks as well. And the ECB may struggle to allocate stock purchases equally among Eurozone member states as their current practice requires: The ECB's QE program attempts to allocate purchases across economies by their weight in the ECB's capital stock, which in turn mirrors their shares in Eurozone GDP, in part to fend off accusations that QE is a handout to Eurozone economies with large deficits and higher interest rates. There will very likely be a restart of QE in September, probably with €30 billion euros per month in asset purchases, the same pace as in the first three quarters of 2018. All of the assets eligible in prior rounds of QE will stay eligible in this round: National government bonds, regional and local government bonds, and commercial bank and corporate bonds. An expansion to equities is possible, but the ECB has not publicly commented on it, a sign that the policy tool is controversial within the Governing Council. QE will likely last at least through June 2020, with a taper possible in the second quarter of 2020 if growth and inflation firm. The ECB deposit rate will likely stay at its post-cut level (again, PNC forecasts -0.50 percent) through year-end 2020 or longer.

The September expansion of quantitative easing is a response both to weakening growth and to inflation's persistent undershoot of the ECB's target. President Draghi stated in the press conference that "the outlook is getting worse and worse, in manufacturing especially" – his gloomiest comments on the economic outlook in years. Data justify this: The IHS Markit manufacturing PMI for Germany fell to the weakest since 2012 in the July flash release, and the Ifo German Business Climate Index was the weakest since 2013 in July. Both headline and core consumer inflation have trended between one and one and a quarter percent for the last year, and have averaged around those levels throughout President Draghi's term, which started in 2011 and will end in October. The ECB's policymakers have become increasingly convinced that the reasons for weak inflation since the global financial crisis are persistent ones: The Eurozone is a developed economy with an aging population, weak population growth, and large pension spending; these are the same characteristics that make inflation persistently weak in Japan.

The ECB also tasked a committee with designing an inflation target that is more symmetric, as President Draghi advocated in a speech at the ECB's annual policy conference in Sintra on June 19 (the ECB's version of the Fed's Jackson Hole conference).

UNITED STATES: Real GDP growth slowed to 2.1 percent at an annual rate in the second quarter from 3.1 percent in the first, but was still a bit better than the 1.9 percent consensus forecast. On a year-ago basis real GDP grew 2.3 percent, down from 2.7 percent in the first quarter and better than three percent in mid-2018. As expected, inventories and trade were major drags on growth in the second quarter, and business investment fell. Strong consumer spending was a tailwind with spending on autos and other durable goods bouncing back after weakness in the first quarter; federal government spending also was a boost, as the government caught up on expenditures delayed by the late-2018 to early-2019 shutdown.

Inventories subtracted almost 0.9 percentage point from growth in the second quarter, after adding to growth for the previous three quarters. Trade subtracted 0.65 percentage point from growth, basically reversing the 0.73 percentage point contribution to first quarter growth; exports fell more than 5 percent annualized due to trade uncertainties, contracting foreign manufacturing, and the strong dollar, while imports edged higher. Business investment fell: Investment in nonresidential structures dropped more than 10 percent annualized, partly due to weaker investment in energy infrastructure – the number of oil drilling rigs active in the US averaged 5.4 percent lower in the second quarter than the first. But investment in manufacturing structures also fell, and seems unlikely to rebound in the third quarter: The Markit manufacturing PMI (purchasing managers' index) fell to 50.0 in the flash estimate for July and was the weakest since September 2009. Business fixed investment's share of gross domestic product shrank to 13.6 percent in the second quarter from 13.7 percent in the first; its expansion-to-date peak was 13.8 percent in the fourth quarter of 2014. Residential investment fell 1.5 percent annualized, a sixth consecutive quarterly decline, and was down a cumulative 5.0 percent from its peak in the fourth quarter of 2017.

Other details of the GDP report were encouraging. Final sales of domestic product, which is GDP minus inventories and measures demand for goods and services produced in the US, rose 3.0 percent in the second quarter, up from 2.6 percent in the first. Growth of gross domestic income in the first quarter was revised up substantially to 3.2 percent from 1.0 percent reported previously; this reinforces the first quarter's strong jobs data to show the economy was solid in early 2019 despite the government shutdown. This report also included annual historical revisions to GDP. GDP growth was revised up slightly in 2017, and revised down slightly in 2018, but the general picture is about the same: moderate but unspectacular growth throughout the current expansion.

Other data releases were consistent with a slower but still growing US economy at mid-year. Existing home sales fell 1.7 percent in June from May, with May's sales level revised up a partially offsetting 0.3 percent. Existing home sales rose 5.8 percent annualized in the second quarter after 5.0 percent growth in the first, but were still down 2.2 percent from a year earlier in June after the large decline in the second half of 2018. New home sales rose 7.0 percent in June from May and 4.5 percent from a year earlier, but the second quarter's total was still down 4.9 percent from the first quarter's expansion to date peak of 669,000 annualized units. Goods exports fell 2.7 percent in June from May and imports 2.2 percent, according to the advance report on US trade in goods; exports fell 3.7 percent from a year earlier, while imports rose 0.2 percent. Exports of consumer goods fell 10.9 percent on the month, while imports of consumer goods fell 1.7 percent; exports and imports of autos also fell, by 4.0 percent and 1.9 percent, respectively. The Federal Open Market Committee is set to cut the fed funds rate by a quarter of a percentage point July 31 and again in October, lowering borrowing costs and mitigating against downside risks from tariffs and trade friction.

JAPAN: After the ECB held policy unchanged July 25 but signaled easing in September, PNC forecasts for the BoJ to follow suit at its July 30 monetary policy decision. The BoJ will likely signal a cut to its short-term policy rate, which they will probably lower from its current -0.10 percent to -0.20 percent, and an expansion of purchases of exchange-traded funds, increasing from ¥6 trillion yen annually (roughly 1 percent of the

Tokyo Stock Exchange capitalization) to ¥10 trillion annually. Japanese inflation is trending at 0.2 to 0.6 percent as measured by the Bank of Japan's three measures of underlying inflation, well below the BoJ's 2.0 percent target, and growth is weakening too: On top of headwinds from the global manufacturing slump and trade policy uncertainty, Japanese growth will take another hit in October when the government raises the value added tax; Japan experienced a moderate recession after its last value added tax hike in 2014.

CHINA: US Trade Representative Robert Lighthizer and Treasury Secretary Steven Mnuchin will represent the United States in the next round of trade talks on Tuesday, July 30. Both sides seem to be hoping for concessions from the other to advance the negotiation. Gross profits of industrial enterprises fell 2.4 percent in the first six months of 2019 from a year earlier, a little worse than their 2.3 percent year-to-date decline in the year through May. While this indicator is of secondary importance to industrial production, which improved in June, its incremental deterioration is a discouraging sign that Chinese growth may not have stabilized after all in June.

CANADA: Solid payroll data confirms the strength of Canada's labor market, but an overhang of wholesale inventories points to a slowdown in business activity at mid-year. Average weekly earnings rose 1.1 percent in May from April and 3.4 percent from a year earlier, the fastest increase since February 2018; the increase came despite a 0.3 percent year-over-year decrease in average weekly hours, implying that hourly earnings rose a robust 3.7 percent on the year. Payroll employment rose a solid 2.1 percent from a year earlier. Wholesale sales fell 1.8 percent by value and 1.9 percent by volume in May from April, reflecting a 5.2 percent decline in motor vehicle sales; the inventory to sales ratio rose to the highest since October 1995.

UNITED KINGDOM: The Confederation of British Industry's quarterly Optimism Index fell to the weakest since July 2016, immediately after the Brexit referendum, in the July 2019 release, confirming an elevated risk of recession at mid-year 2019.

MEXICO: The Global Indicator of Economic Activity, the Mexican statistical agency's measure of monthly GDP, was unchanged in May from April and down 0.3 percent from May 2018, as industrial activity fell 2.1 percent on the month and 3.1 percent on the year. Agricultural activity grew 0.7 percent on the month and a modest 0.6 percent on the year, and services 0.8 percent on the month and 1.1 percent on the year. Sluggish economic growth, moderate inflation, and interest rate cuts expected from the Federal Reserve make the Bank of Mexico also likely to cut its policy interest rate near-term; financial markets prices in 1.31 percentage points of cuts to the benchmark interbank target rate, currently 8.25 percent, over the next twelve months.

BRAZIL: The benchmark IPCA measure of inflation slowed to 3.3 percent in mid-July from 3.8 percent in June, matching economists' consensus forecast of 3.3 percent. The Central Bank of Brazil's weekly survey of professional forecasters showed the median estimate for real GDP growth in 2019 was 0.8 percent in the July 19th survey, up marginally from the prior week (unchanged after rounding). This increase snapped a run of 20 consecutive weekly downgrades to the Brazilian growth outlook. Brazil's economy added 48,436 jobs in June according to the Ministry of Economy, the largest June increase since 2013.

Visit http://www.pnc.com/economicreports to view the full listing of economic reports published by PNC's economists.