Global Economic Highlights

March 20, 2023

Fed To Balance Financial Stability and Price Stability Risks This Week; ECB Raises Policy Rates

UNITED STATES: The Federal Reserve's March 21 and 22 Federal Open Market Committee (FOMC) meeting is a highly anticipated one. With the recent bank failures and increased volatility in financial markets, central bankers are faced with a tough decision between financial stability and price stability. Economic data since the last meeting on January 30 to February 1 has surprised to the upside. Inflation is slowing, but not quickly enough for the Federal Reserve. In isolation, high inflation in February, along with the strong jobs report, would point to at least a 25-basis-point increase in the federal funds rate when the Federal Open Market Committee meets this week, and perhaps a 50-basis-point increase. But the FOMC may turn more cautious with the recent collapses of Silicon Valley and Signature banks. PNC's expectation is that the FOMC raises the fed funds rate by 25 basis points this week, but there is a possibility that the FOMC keeps the rate unchanged, or even cuts it. The FOMC will update its Summary of Economic Projections aka dot plot at the meeting this week. The last dot plot released in December 2022 showed a terminal federal funds rate of 5.1% which is equivalent to a target range of 5% to 5.25%. With the recent turmoil in the banking sector, Fed officials will likely forecast a lower terminal rate.

What was a tricky task for the Fed, raising rates by enough to cool off inflation, but not by too much as to push the economy into recession, has gotten even more difficult with the recent bank failures. The big increase in interest rates over the past year is exposing stresses in the financial system. PNC expects that the cumulative impact of Fed monetary tightening will push the U.S. economy into a mild recession starting in the second half of this year. That, in turn, will lead to a significant slowing in inflation in late 2023 and in 2024, pushing it back to the FOMC's 2% objective by the middle of next year.

The consumer price index rose 0.4% in February from January, according to the Bureau of Labor Statistics, matching the consensus expectation. This followed a 0.5% increase in January. On a year-ago basis overall CPI inflation (not seasonally adjusted) was 6.0% in February, down from 6.4% in January and a cyclical peak of 9.1% in June. The core CPI, excluding food and energy prices, rose a big 0.5% in February, up from 0.4% increases in December and January. Year-over-year core CPI inflation (not seasonally adjusted) was 5.5% in February, down from 5.6% in January and a cyclical peak of 6.6% in September. Inflation remains concentrated in services. Services prices, excluding energy, increased 0.6% in February, including a 0.8% increase for shelter (primarily housing). Food prices rose 0.4%, with grocery store inflation slowing. Energy prices were down 0.8%, with big drops for heating oil and natural gas, but an increase in gasoline prices. Used car prices fell almost 3% over the month, even as new car prices were up slightly.

Retail sales fell 0.4% in February from January. The details were somewhat better; sales excluding autos were down 0.1%, and sales excluding autos and gasoline were flat over the month. Sales growth was mixed across segments. January's huge increase was revised even higher, to a 3.2% gain, from the initially reported 3.0% increase. And the decline in sales in December was revised to a 0.8% drop, from a 1.1% fall. Control sales—sales excluding food services, autos, gasoline, and building materials, and which go into nominal consumer spending in GDP—rose a solid 0.5% in February, after increasing 2.5% in January. Although retail sales were down in February, they are still up from late 2022. Several factors are driving continued strong nominal consumer spending, in particular the very strong job market, price increases, and the high level of household saving. These are offsetting the drags from a shift in consumer spending away

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from goods toward services, higher interest rates, prices that are increasing more rapidly than wages, and a loss of household wealth from falling home values and stock prices. Retail sales are set to decline later this year as the U.S. economy enters recession and a deteriorating labor market pushes households to cut back.

Industrial production was flat in February from January, with manufacturing output up 0.1%. Over the past year industrial production has fallen 0.2%, with manufacturing output down 1.0%. Higher interest rates and a shift in consumer spending from goods to services is weighing on the industrial sector. Industrial production is set to fall further in the near term as the drag from higher interest rates works its way through the economy. Higher rates will weigh on production of durable consumer goods, like autos; business investment goods; and building materials as construction contracts. The overall capacity utilization rate was unchanged in February, from January at 78.0%. The manufacturing capacity utilization rate fell slightly to 77.6% in February, from 77.7% in January. With the capacity utilization rate below 80%, supply chain problems easing, and demand slowing, goods will be deflationary in the near term.

Housing starts rose 13.8% in February to a rate of 1.450 million annualized units from an upwardly-revised 1.321 million in January. This was well above the consensus expectations for a 0.1% increase to a rate of 1.310 million units. Single-family starts rose 1.1% on the month to 830,000, from 821,000 in January. Multi-family starts jumped 24.0% to a rate of 620,000 in February, from 500,000 in January. Multifamily starts tend to be more volatile than single-family starts. Residential construction permits, a leading economic indicator, jumped 13.8% to 1.524 million, from 1.339 million in January. Single-family permits rose 7.6% on the month, while multi-family permits rose 21.1%. The backlog of new construction remains near historical highs. The number of projects authorized but not started is near the highest level since 1974. Privately-owned housing completions came in at 1.557 million in February, a 12.2% increase from 1.388 million units in January. Starts and permits rose well above expectation in February mainly driven by the multi-family segments. In a separate report released last week, homebuilder confidence as measured by the NAHB Market Index increased 2 points from 42 in February to 44 in March. However, the index remains below 50 which indicates poor conditions for homebuilders. The recent bank failures add uncertainty to the U.S. economic outlook and will likely cause the Fed to rethink its policy path when the FOMC meets this week.

Sentiment surveys showed mixed results last week. U.S. consumer sentiment unexpectedly fell in March after rising for three straight months, according to the University of Michigan's preliminary Consumer Sentiment Index report. March's decline was worse than consensus expectations for a flat reading. Small business confidence as measured by the National Federation of Independent Business (NFIB) Small Business optimism index improved for the second straight month. The index remains well below the pre-pandemic level.

EUROZONE: The Governing Council of the European Central Bank (ECB) delivered no surprises at its March 16 meeting and increased the three key interest rates by 50 basis points. With the March 16 decision, the interest rate on the main refinancing operations, marginal lending facility, and the deposit facility will be increased to 3.50%, 3.75% and 3.00% respectively, with effect from March 22. Central bankers acknowledged the increased financial stability risks in the U.S. and eurozone. The accompanying press release noted that "The Governing Council is monitoring current market tensions closely and stands ready to respond as necessary to preserve price stability and financial stability in the euro area."

Inflation in the eurozone is higher than in the U.S. and the ECB will continue its hiking cycle after the Fed pauses. The final release of the February consumer price index (CPI) inflation report showed that headline inflation declined slightly to 8.6% in February, from 8.5% in January. Core CPI inflation which excludes energy, food, alcohol and tobacco was unchanged at 5.6%. Goods inflation fell in February to 11.1% from 11.7% in January, while services inflation rose to an all-time high of 4.8% in February, from 4.4% in January.

Industrial production rose 0.7% in January, better than the consensus expectation for a 0.3% increase, and following a downwardly-revised 1.3% decline in December. Manufacturing output rose 0.8% on the month while mining and quarrying output fell 7.4%. With the increase in January, industrial output in the eurozone is 3.8% above the pre-pandemic level.

UNITED KINGDOM: Payroll growth accelerated to 98,000 in February from a downwardly-revised 42,000 in January. The unemployment rate remained unchanged at 3.7% in the three months to January from the preceding three-month period. Yearly wage growth (average weekly earnings) fell to 5.7% in the three months to January from 6.0% in the preceding three-month period. Like in the U.S., the labor market in the U.K. is very tight. Payroll employment is 3.6% above the pre-pandemic level while the labor force participation rate is over a full percentage point below the pre-pandemic rate. Headline CPI inflation in January was 10.1% while core CPI inflation (excluding energy, food, and alcohol) was 5.8%, both well above the Bank of England's 2% target. With a tight labor market and high inflation, PNC expects the Bank of England to raise its Bank Rate by 25 basis points when it meets on March 23.

At the Spring Budget Statement in the Commons last week, the U.K.'s chancellor of the Exchequer, Jeremy Hunt stated that the U.K. economy is no longer expected to enter a recession this year, according to projections from the Office for Budget Responsibility. Hunt also stated that the current government support for consumer energy bills will be extended for three months; the end date was extended from March 31 to June 30, 2023.

JAPAN: Japan's trade deficit narrowed sharply in February according to data from Japan's Ministry of Finance. The trade deficit narrowed to ¥897.7 billion ($6.8 billion) from a downwardly-revised ¥3.5 trillion ($26.5 billion). Exports grew 6.5% in February from a year ago, following a 3.5% increase in January. Imports growth slowed to 8.3% from 17.5% in January.

Industrial production fell sharply in January according to the final release from Japan's Ministry of Economy, Trade and Industry. Industrial output fell 5.3% in January from December mainly driven by big declines in production machinery. On a year-ago basis, industrial output fell 3.1% in January.

BRAZIL: PNC expects the Central Bank of Brazil (BCB) to hold the Selic policy rate at 13.75% when central bankers meet at the March 21 to 22 meeting.

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