Fed and ECB Continue Hiking Cycle as BoJ Adapts Yield Curve Control Policy

UNITED STATES: As expected, the Federal Open Market Committee (FOMC) raised the federal funds rate by 25 basis points on July 26, to a range of 5.25% to 5.50%. The statement noted that additional policy tightening may be appropriate depending on incoming data on inflation and the labor market. Higher interest rates continue to weigh on the US economy, with slower economic growth in recent quarters and softer job growth. Inflation has slowed recently but remains well above the central bank’s 2% objective. Fitch Ratings downgraded US government debt from AAA to AA+, raising alerts for a more sustainable government budget and debt in the long term.

Real GDP increased 2.4% at an annual rate in the second quarter, according to the advance estimate from the Bureau of Economic Analysis. This followed growth of 2.0% in the first quarter. Over the past year real GDP has increased 2.6%, well above the economy’s long-run potential. Consumer spending rose 1.6% in the second quarter, adding 1.1 percentage points to annualized GDP growth.

The overall personal consumption expenditures price index rose 2.6% at an annual rate, the lowest consumer inflation since the first quarter of 2020, near the time the first stimulus check was given out. The core PCE price index, excluding food and energy, increased 3.8% in the second quarter at an annual rate, and PCE inflation in June was 4.1%. This was the slowest core inflation in the past two years, but it remains well above the Federal Reserve’s 2% objective.

Initial claims for unemployment insurance (UI) increased by 6,000 to 227,000 for the week ending July 29 from 221,000 in the previous week, according to data from the U.S. Department of Labor. The four-week moving average of claims, which smooths out some of the weekly volatility fell to 228,250 from 233,750. Continuing claims rose by 21,000 to 1,700,000 in the week ending July 22 from 1,679,000 (revised down from 1,690,000). The four-week moving average of continuing claims fell to 1,712,250 from 1,716,750.

Total nonfarm payroll employment rose by 187,000 in July according to the U.S. Bureau of Labor Statistics. The unemployment rate dropped from 3.6% in June to 3.5% in July. The unemployment rate is near a more than 50-year low. Employment as measured by a survey of households (different from the survey of employers) rose by a solid 268,000 in July. Moreover, employed persons at work part time rose 513,000 in July and employed persons at work full time dropped 245,000.

Construction spending rose 0.5% in June to a seasonally adjusted annual rate of $1.938 trillion, above the revised May estimate of $1.929 trillion, and slightly worse than consensus expectations for a 0.6% increase. On a year-ago basis, the total value of construction put in place was 3.5% higher in June. Total private residential (including home improvements) construction spending was up 0.5% in June from May and up 1.0% on a year-ago basis.

The ISM manufacturing index rose slightly in July, to 46.4% from 46.0% in June, but remained well below the 50% level that indicates expansion in manufacturing. The index has been below 50% for nine straight months. The ISM manufacturing index continues to show contraction in the industry, consistent with other measures such as industrial production. The rapid increase in interest rates over the past couple of years as the Federal Reserve has tightened monetary policy, as well as weaker demand for manufactured goods following very strong demand in the wake of the pandemic, are weighing on the manufacturing industry. Manufacturing is set to contract further in the near term as high interest rates; falling consumer goods spending, particularly on interest-rate sensitive goods like vehicles, appliances,
and home materials; and softer business capital spending are all drags. Manufacturing employment has been flat so far in 2023 and will fall later in the year as the industry continues to contract.

**EUROZONE:** The European Central Bank (ECB) raised its three key policy rates by 25 basis points when central bankers met on July 27. The ECB’s decision was made based on the “assessment of the inflation outlook, the dynamics of underlying inflation, and the strength of monetary policy transmission.” The annual inflation rate in the euro area remains well above ECB’s 2% inflation target, although it has slowed from a peak of 10.6% in Oct 2022 to 5.3% in July 2023. Monthly retail sales growth in the euro area fell to 0.3% in June from 0.6% in May. On a year-over-year basis, retail sales dropped 1.4% in June.

**JAPAN:** The Bank of Japan (BOJ) unexpectedly adjusted its yield curve control policy on July 28. The BOJ will retain the notional cap of 50 basis points as a reference point and allow the 10-year yield for Japanese government bonds to move above 0.5% if it stays below 1.0%. GDP growth in the first quarter of this year came in at 2.7% on an annualized basis, up from 0.4% in the last quarter of 2022. The consensus expectation for second-quarter growth is 3.1%. The consumer confidence index rose to 37.1 in July from 36.2 in June, the eighth consecutive increase since Nov 2022. The unemployment rate declined from 2.6% in May to 2.5% in June, and the labor force participation rate rose from 62.9% to 63.1%.

**CANADA:** Canada’s Ivey Purchasing Managers Index continued to fall in July to 48.6, falling below the critical value of 50 and showing a decrease in purchases in July from June. This is also the first contraction in month-over-month economic activity in 2023 across Canada. The unemployment rate rose to 5.5% in July from 5.2% in June. This was the fourth consecutive increase in the unemployment rate since April 2023. Average hourly earnings in Canada rose by 5% on a year-over-year basis in July, faster than the 3.9% growth in June.

**MEXICO:** Mexico’s economy expanded in the second quarter of 2023 as real GDP grew 3.7% on a year-over-year basis. The manufacturing industry in Mexico expanded at a faster rate and had the “strongest improvements in the health of the sector in over seven years”, according to the S&P Global Mexico Purchasing Managers Index. The headline manufacturing PMI rose in July to 53.1 from 50.9 in June in Mexico.

**CHINA:** According to the National Bureau of Statistics of China, the June manufacturing PMI rose to 49.3% from 49% in May. The manufacturing PMI for small-sized and medium-sized enterprises remained in contraction in July, while the manufacturing PMI for large-sized enterprises was 50.3%, slightly above the critical value at 50, indicating an economic expansion. The nonmanufacturing PMI declined in June to 53.2% to 51.5% in May, the fourth straight decline since March 2023.

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