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GLOBAL ECONOMIC HIGHLIGHTS

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GLOBAL MONETARY TIGHTENING: FEDERAL RESERVE SET FOR JUNE HIKE; ECB QE TAPER; CANADA MAY HIKE IN JULY

UNITED STATES: PNC Economics forecasts for the Federal Reserve to raise the federal funds target by 0.25 percentage points at their June 13 decision. The fed funds futures market prices in a 91 percent chance of a hike. PNC expects only one additional 0.25 percentage point rate hike in the second half of 2018, in December; financial markets price in roughly 60-40 odds that the Fed will raise the federal funds rate once and not twice in the second half of this year. Private sector productivity rose a modest 0.4 percent annualized in the first quarter of 2018 and was up 1.3 percent from a year earlier, with output up 3.6 percent and hours worked 2.3 percent. Unit labor costs, a measure of inflationary pressures from the wage-price spiral, rose 2.9 percent annualized in the first quarter, and 1.3 percent in year-over-year terms. The recurring and well-documented weakness of real GDP growth in the first quarter of the year probably distorted productivity down and unit labor costs up. The year-over-year comparison, showing modest growth in both productivity and unit labor costs, probably measures the trend more accurately. Trade frictions between the US and major trading partners continue, with President Trump tweeting a withdrawal from the joint statement on economic cooperation following his early departure from the weekend meeting of the G-7, the group of advanced capitalist democracies, after German Chancellor Angela Merkel tweeted a photograph in which she appeared to be scolding him, and after Canadian Prime Minister Justin Trudeau stated in a post-meeting press conference that Canada would retaliate against US tariffs. The Trump administration is trying to use the US's status as the largest national economy as leverage against smaller trading partners (Canada/Mexico/Germany/China/etc) to reach trade deals that are more favorable for the US and less favorable for foreign partners. They, in turn, are responding to US pressure through multilateral organizations like the G-7, where the US only accounts for about half of aggregate GDP, or the G-20, where the US only accounts for a quarter. We expect changes to the US's trade policies currently under discussion to be superficial and do little to boost US growth, and expect them to be reversed in time.

EUROZONE: The European Central Bank's Governing Council may announce a taper of their quantitative easing program at their June 14 meeting. Their chief economist pre-announced that this question is on their agenda in a speech June 6. PNC Economics forecasts for the taper to begin in October 2018 and conclude in March 2019, and for the ECB to raise the deposit rate by 0.1 percentage point in September 2019. Financial markets price in about 0.04 percentage points' increase in the ECB's policy rate over the next 18 months, implying less than 50-50 odds of a 0.10 percentage point rate hike in September 2019.

CANADA: Canada's June jobs report disappointed. Employment fell 7,500 from April, missing consensus expectations for a 17,500 gain. Employment fell 38,000 among workers 25-54, partially offset by a 28,500 increase among workers over age 55. Matching our forecast, the unemployment rate held steady at 5.8 percent, but for a discouraging reason—the labor force shrank 10,900. Employment fell 29,000 in goods-producing industries, with construction down 13,000 and manufacturing 18,300. Despite a decline in high-wage goods-producing jobs, hourly wages rose 3.9 percent on the year, the fastest in six years. Canada's housing downturn slowed growth in the first half of 2018 from 2017's above-trend pace, and this is starting to show up in softer jobs numbers. Even so, faster wage growth will probably convince the Bank of Canada to raise their overnight rate target 0.25 percentage points to 1.50 percent at their July 11 interest rate decision.

UNITED KINGDOM: The European Commission's chief Brexit negotiator Michel Barnier repeated his criticisms of the UK's proposals for economic relations between the UK and EU in a press conference June 8. Barnier said that any UK proposal needs to address three questions: Does it prevent a hard border in Ireland, does it respect the single market and customs union, and does it provide a durable and permanent basis for EU-UK economic relations. The EU does not believe any current British proposals adequately address these questions, adding pressure on Theresa May's beleaguered Tory government.

INDIA: As expected, the Reserve Bank of India raised the policy repo rate 0.25 percentage points to 6.25 percent at its decision June 6. The monetary policy decision noted a pickup in inflation by both headline and core (excluding food and energy) measures, and that households' inflation expectations rose in the RBI's May survey. The statement describes the RBI's policy stance as neutral, but we believe the RBI's next step will likely be another 0.25 percentage point rate hike in the third quarter of 2018.

BRAZIL: The benchmark IPCA measure of consumer inflation picked up to 2.9 percent in year-over-year terms in May from 2.8 percent in April on smaller year-over-year decreases in food prices and faster increases in fuel prices. CPI excluding food and energy rose 3.6 percent on the year, tying March for the slowest since May 2007. A truckers' strike in late May will push inflation higher in the June release, but it is nevertheless encouraging that core inflation was slowing in May. Even so, the concessions made by the government to end the strike – increasing subsidies for truckers – overshadow slower inflation by increasing concerns about Brazil's fiscal policy and sovereign credit rating.

CHINA: China's official foreign reserve assets fell $14.2 billion dollars in May to $3.203 trillion, their lowest since October 2017. US long-term interest rates rose in May – the 10-year Treasury bond yield touched 3.1 percent during the month, its highest since 2011 – drewing capital out of emerging markets. Tighter US financial conditions exacerbated thematic risks to emerging markets, like the plunging Turkish Lira and Argentine peso, Brazil's strikes, Mexican political uncertainty, and global trade war fears. These tensions spilled over to China, and contributed to May's capital outflows. China's foreign reserves rose from $150 billion in the year 2000 to nearly $4 trillion in mid-2014 as the government intervened in the foreign exchange market to keep the yuan weaker than it would have been under a free float. Then from 2014 to 2016, China's foreign reserves fell by nearly a trillion dollars, a sign that yuan had become stronger than market forces would dictate, and a spillover effect of the US dollar's surge between 2014 and 2016. China's managed exchange rate limited the yuan's volatility against the dollar, but at the cost of more yuan appreciation against currencies of other Chinese trading partners. Chinese wage dynamics also contributed to the end of China's trend foreign reserve growth. While Chinese wages are much lower than those in advanced economies, they grow much faster – trend wage growth has been 5-10 percent since China joined the World Trade Organization in 2001. As the wage gap between China and the rest of the world narrows, it causes "real appreciation" of the yuan – faster increases of Chinese prices than prices in the United States or other foreign economies – even though the bilateral exchange rate against the dollar has changed little. Real yuan appreciation dramatically narrowed the competitiveness gap between China and other economies over the first two decades of the 21st century, explaining how the yuan went from very undervalued at 8.28 per dollar in the mid-2000s to near a clearing price between 6 and 7 per dollar in recent years. Chinese foreign reserves rose from January to October 2017 as China's government tightened controls on capital outflows and as the dollar depreciated against most foreign currencies. Since then, China's foreign reserves have trended down. Reserves might increase modestly in June since MSCI added mainland-traded stocks to its emerging markets index June 1, a potential catalyst of capital inflows. But after that, we expect continued increases in US interest rates and the taper of quantitative easing in the Eurozone to spur renewed Chinese capital outflows. The yuan has depreciated modestly from an average of 6.32 in March 2018 to 6.40 per dollar today; PNC's exchange rate forecasts for the second quarter of 2018 see the yuan depreciating a bit more to 6.45 per dollar by the end of June and to 6.50 per dollar by year-end 2018. We expect Chinese real GDP growth to slow somewhat to 6.6 percent in the second quarter of 2018, 6.5 percent the second half of 2018, and 6.2 percent in 2019 as tighter fiscal and monetary policies restrain growth. Despite this, we think China and other emerging market economies still have decent growth prospects in 2018 and 2019.

JAPAN: We forecast no change in the Bank of Japan's monetary stance at its June 14 Policy Board decision, and expect the BoJ to hold its stance unchanged until after the value-added tax hike scheduled for October 2019. The most recent May 22 release of the Bank of Japan's measures of underlying inflation showed the trimmed mean CPI slowing to 0.5 percent in year-over-year terms in April from 0.6-0.8 percent between November 2017 and March 2018, and weighted median CPI and modal CPI stable at 0.1-0.2 percent. The Bank of Japan, like other advanced economy central banks, targets inflation of 2.0 percent – well above current levels.

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