August 6, 2018

GLOBAL ECONOMIC HIGHLIGHTS

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

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

US LABOR MARKET IN EXCELLENT SHAPE; CHINA WARNS OF MORE RETALIATION; EUROZONE GROWTH MODERATES

UNITED STATES: Looking past one soft detail, the July jobs report showed the labor market to be in excellent shape in mid-2018. The U.S. economy added 157,000 jobs from June, below PNC's forecast of 180,000 and the consensus of 190,000. But there was a big 59,000 net upward revision to job growth in the prior two months. The US economy has added an average of 215,000 jobs per month so far in 2018, well above 2017's pace of 182,000 per month. After rising 0.2 percentage point in June, the unemployment rate fell 0.1 percentage point in July to 3.9 percent; except for May, this is the lowest since the end of 2000. The labor force participation rate (share of adults either working or looking for work) held steady at 62.9 percent; since the beginning of 2016 the labor force participation rate has been in a narrow range between 62.6 and 63.0 percent. The broader U-6 unemployment rate (unemployed, underemployed and too discouraged to look for a job) fell 0.3 percentage point in July to 7.5 percent, the lowest since the spring of 2001. Average hourly earnings rose 0.3 percent in July, up from 0.1 percent growth in May (revised slightly lower). Year-over-year growth in wages was 2.7 percent in July, unchanged from June. Slowly but surely the tighter job market is leading to stronger wage growth, as businesses raise pay to retain their current workers and attract new ones. Job growth handily exceeds the pace needed to reduce labor market slack. July's jobs report supports an increase in the federal funds rate at the Federal Open Market Committee's late September meeting, by one-quarter of a percentage point to a range of 2.00 to 2.25 percent – the Fed was on hold as expected at their August 1 decision. Core inflation (excluding food and energy) was just below the FOMC's 2 percent objective at 1.9 percent in June, and the tight job market is raising concerns that building wage pressures could lead to higher inflation. The FOMC will try to let some of the steam off the economy in September. Immediately after the July jobs reports' release on August 3, the fed funds futures market priced in a 94 percent probability of a rate increase at the FOMC's September meeting.

CHINA: The Chinese State Council's Customs Tariff Commission announced on August 3 a list of $60 billion in US exports that China would subject to additional tariffs if the US escalates tariffs as they plan. China's announcement was a response to the White House's August 2 announcement that raised the tariff rate planned for $200 billion in Chinese imports to 25 percent from 10 percent; these tariffs would be the US's third round of tariffs aimed at China, if the conflict gets that far. China's latest list of US exports threatened with tariffs includes farm and fishery products, processed foods and beverages, coal, natural gas, and other mined products, chemicals, leather goods, heavy equipment and their components, many types of consumer goods, and medical equipment. China has not yet threatened tariffs on US services exports, which account for about 30 percent of US exports of goods and services to China. The US government enacted 25 percent tariffs on $34 billion in Chinese goods imports on July 6 as part of the US Trade Representative's investigation of Chinese industrial policies related to forced technology transfer, intellectual property, and innovation policies (the Section 301 investigation). The USTR has published a list of an additional $16 billion in goods imports to subject to the 25 percent incremental tariff as part of the Section 301 response, and conducted public hearings on the list on July 24 and 25. In the US policy process, those tariffs are next in line to be implemented. The tariffs on the $200 billion of Chinese imports are still going through the USTR's public comment process, which will run through the end of August, so they could be implemented in September. China said August 3 that they would make the tariffs on $60 billion in US goods exports effective when the US enacts the tariffs on the $200 billion in Chinese imports. The escalating trade skirmish increases downside risks to the US and global economy. Effects of trade frictions are showing up in US economic data: The ISM manufacturing PMI's new export orders index receded to 55.3 in July from 56.3 in June, and was the second weakest since February 2017. Tariffs are a headwind in particular to businesses with large exposures to global demand and global supply chains, as well as farmers, meat processors, and the lumber industry. China's latest round of retaliation targets US goods exports; if the US continues to escalate, Chinese retaliation could expand to target US services exports and the on-shore sales of US subsidiaries. In addition, China has permitted the yuan to depreciate by about 8 percent against the US dollar since the US started announcing tariffs on Chinese imports in the spring. We describe this depreciation as "permitted" because during it, the yuan was weaker in China's off-shore foreign exchange market, which trades relatively freely, than the on-shore foreign exchange market, which is subject to more government control. That implies that market forces were at work. Yuan depreciation offsets some of the effect of US tariffs on Chinese exports, and intensifies the effect of Chinese tariffs on US exports. Other currencies including the euro, yen, and British pound sterling also have weakened against the dollar since the spring, so the yuan's depreciation could be ascribed to market forces instead of retaliation. But the yuan's depreciation is nevertheless another source of tension that could escalate this trade skirmish into a trade war. The People's Bank of China increased the margin requirement for speculative positions in their currency on August 3, curbing further depreciation, for the time being, by increasing the cost of speculation.

EUROZONE: Growth moderated and inflation edged back up toward the ECB's target in the latest data. Real GDP grew 0.3 percent in the second quarter from the first, not annualized, in the first or preliminary flash estimate, and increased 2.1 percent from a year earlier, slower than the 2.5 percent year-ago increase of the first quarter or the 2.8 percent year-ago increase of the fourth quarter of 2017. HICP inflation edged higher, to 2.1 percent in year-over-year terms in July from 2.0 percent in June, and measures of core inflation also accelerated 0.1 percentage points on the month to 1.4 percent for HICP excluding energy, 1.3 percent for HICP excluding energy and unprocessed food, and 1.1 percent for HICP excluding energy, food, alcohol and tobacco, all in year-over-year terms. Headline inflation exceeds the ECB's target, but core inflation still undershoots it meaningfully.

CANADA: PNC forecasts a solid 18,300 increase in Canadian household employment in the July Labor Force Survey's release on August 10, with the unemployment rate edging back down to 5.9 percent from 6.0 percent in June, when a huge jump in the labor force lifted it. We expect wage growth in Canada to remain moderate, giving the Bank of Canada room to wait until January 2019 to next raise the overnight rate target.

UNITED KINGDOM: As expected, the Bank of England raised the bank rate 0.25 percentage points to 0.75 percent on August 2, and signaled that the next rate hike might not be until the first half of 2019. While wage growth is picking up, it is still slow by historical comparison, keeping inflation pressures relatively contained. But rate hikes are coming – many labor market indicators point to the tightest job market in decades, reflecting the plunge in immigration since the Brexit referendum. Employment of nationals of other EU states in the UK fell in year-over-year terms in the first quarter of 2018, down from 15-20 percent growth in 2014 and 2015 and the weakest since 2010. These data support the Bank of England's view that the UK's weak growth still exceeds its even weaker potential output growth.

JAPAN: The Bank of Japan held most components of its monetary stance unchanged at its decision July 31, matching PNC's forecast but a surprise to the market consensus, which expected the BoJ to withdraw monetary stimulus. The targets for short-term and long-term interest rates are unchanged at -0.1 percent and "around zero percent" respectively (in practice, a range of -0.1 percent to 0.1 percent) and purchases of exchange traded funds and real estate investment trusts continue at unchanged paces. The BoJ increased the amount of bank reserves it exempts from the short-term negative interest rate, a measure that supports profits of Japanese commercial banks and responds to criticisms of its unconventional monetary policy as a threat to the functioning of the Japanese financial sector.

MEXICO: The Bank of Mexico held its monetary policy rate unchanged at 7.75 percent at its August 2 decision, matching PNC's forecast and surprising financial markets expectations for a 0.25 percentage point hike. The Bank's policy announcement noted that "since the last monetary policy decision, the Mexican peso appreciated and exhibited lower levels of volatility," reflecting "lesser uncertainty after the country's elections and an improvement in the outlook for the NAFTA renegotiation."

BRAZIL: Matching PNC's forecast, the Central Bank of Brazil held the policy Selic rate unchanged at 6.50 percent at its monetary policy decision on August 1. The Bank's monetary policy statement noted the effects of the late May truckers' strike, but added that "there is evidence of subsequent recovery." The Central Bank foresees a slightly weaker expansion going forward than prior to the strike. The Central Bank expects the inflationary effect of strike-related shortages to be temporary, implying that they will not change monetary policy in response to them. Both the consensus of private forecasters and the Central Bank's own projections foresee inflation around 4.0 percent, the central bank's target, at year-end 2018 and 2019, assuming that the exchange rate holds around 3.7 real per US dollar (considerably weaker than in PNC's forecast) and that the central bank raises the policy rate 1.5 percentage points by year-end 2019 to 8.0 percent. The BCB described risks to inflation as balanced, with upside risks from the possibility that the government does not tighten fiscal policy, and downside risks from high economic slack and the inertial effects of low current inflation. They also said that they would not tighten the policy rate in response to the recent depreciation of the real unless they saw risks that higher import prices would raise core inflation, and right now, they do not. We expect monetary policy to stay on hold through Brazil's October presidential election, and beyond if the next government continues to carry out the unpopular but necessary steps to reduce Brazil's fiscal deficit and bolster financial markets' confidence in Brazilian credit.

INDIA: Matching our forecast and the market consensus, the Reserve Bank of India raised its policy repo rate 0.25 percentage point to 6.50 percent at their August 1 decision. The RBI's monetary policy statement was upbeat on current economic activity, noting robust manufacturing capacity utilization, solid indicators of service sector demand, and an eighth consecutive month of double-digit cement output growth, indicating a robust construction sector. The RBI's survey of household inflation expectations showed a 0.2 percentage point uptick in expectations of inflation on both 3- and 12-month horizons, paralleling households' assessment of current inflation, and the recent uptick in headline CPI and CPI excluding food and fuel. We expect the RBI to again raise the policy repo rate by 0.25 percentage point to 6.75 percent at their next meeting October 5.