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GLOBAL ECONOMIC HIGHLIGHTS

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NAFTA DEAL ENDS UNCERTAINTY FOR CROSS-BORDER BUSINESSES; ECB GUIDANCE GETS MORE HAWKISH

UNITED STATES: The US reached an agreement with Canada and Mexico to revise the North American Free Trade Agreement on September 30, removing a key source of uncertainty for the North American auto industry and other industries whose supply chains stretch across the three countries. The revised NAFTA – renamed the US-Mexico-Canada Agreement (USMCA) – maintains most of the original agreement's provisions for free trade in manufactured goods. But it does change some provisions to reduce foreign competition in the auto industry. The USMCA mandates that at least 40 percent of the value of freely traded autos be produced in high-wage economies, and that at least 75 percent of the value be produced in the US, Mexico, or Canada. The agreement also maintains countries' "Chapter 19" rights to challenge protectionist limits on their exports, a provision that Canada and Mexico could use to challenge US limits on their exports. It grants US dairy exporters increased access to Canadian markets and allows Canadian poultry producers increased access to US markets. The agreement raises the maximum value of cross-border parcels exempt from tariffs to $100 US dollars in Mexico or $140 Canadian dollars in Canada, effectively opening both markets to cross-border e-commerce. However, it does not end US tariffs on Mexican and Canadian metal exports or those countries' retaliatory tariffs against US exports. Many other chapters of the agreement, like those related to intellectual property-intensive products, mirror the structure of the Trans Pacific Partnership, which the USMCA countries agreed prior to President Trump taking office. The end of NAFTA uncertainty will spur stronger capital spending in the three countries, since many companies with cross-border supply chains delayed spending until the agreement was reached; the deal also spurred sharp appreciations of the Mexican peso and Canadian dollar against the US dollar.

CANADA: Payroll employment grew 2.0 percent from a year earlier in July, down from 2.1 percent in June and the slowest in 13 months. New claims for employment insurance rose 5.1 percent from a year earlier in July – the data are noisy but this is still the largest year-over-year increase since October 2017. PNC forecasts for the October 5 release of the Labor Force Survey to show no change in Canadian household employment in September after August's 52,000 decline, and for the unemployment rate to hold unchanged at 6.0 percent. Canadian economic growth will accelerate in the fourth quarter of 2018 now that NAFTA-related uncertainty is over. After the USMCA deal, PNC is revising our Bank of Canada interest rate forecast to expect a next Canadian policy rate hike at the Bank's October 24 decision, earlier than our prior forecast of a hike in January 2019.

MEXICO: PNC expects the Bank of Mexico to hold its policy interbank rate unchanged at 7.75 percent at its October 4 monetary policy decision, seeing room in the peso's post-USMCA appreciation to near 18.5 per US dollar to use monetary policy to support growth instead of bolstering the value of the exchange rate. Mexico's statistical agency began releasing an experimental monthly index of employment in September, which showed job growth in covered industries up 2.1 percent from a year earlier in July – an acceleration from June's 1.9 percent year-over-year increase. The index covers industries accounting for roughly 90 percent of Mexican employment and may prove a useful complement to the unemployment rate, which was 3.3 percent in July and August after 3.4 percent in June.

EUROZONE: ECB President Mario Draghi sounded much more confident that inflation is accelerating toward the ECB's target in remarks at the European Parliament September 24. He expects a "relatively vigorous pick-up in underlying inflation" over the next two years; the ECB projects that core inflation excluding food and energy will reach 1.8 percent – essentially their target – by 2020. Draghi also remarked that "labor markets are tightening with signs of labor shortages in some countries and sectors." President Draghi's more hawkish tone reinforces our expectation that the ECB will raise its benchmark deposit rate 0.1 percentage point at their June 2019 Governing Council meeting. The Italian budget published September 27 raises the government's fiscal deficit target to 2.4 percent of GDP from the 0.8 percent of GDP target set by the previous government. A larger deficit will fund reductions in personal income taxes and a minimum basic income for the unemployed. Italy's government is run by an alliance of two anti-establishment parties who both favor larger deficits to fund these campaign promises. As expected, Italy's budget pushes the limits of the EU's deficit rules but does not exceed them. The EU's Stability and Growth Pact prohibits deficits that exceed 3 percent of GDP outside of extraordinary circumstances. The Pact also proscribes countries from allowing sovereign debt to exceed 120 percent of GDP, a potential source of friction between the EU and Italy, whose public debt is roughly 130 percent of national GDP (and is also 20 percent of the entire euro area's GDP since Italy is the currency area's largest sovereign borrower). But the EU is not picking a fight over the issue. The EU Commissioner for Economic and Financial Affairs, who manages the review of national budgets, talked down the potential for conflict in a French TV interview September 28. Commissioner Pierre Moscovici said that "it is not in the interest" of the EU to have a crisis over the Italian budget, both because Italy is such a large part of the Eurozone and also because the EU does not want to further inflame populist sentiment there. The yield on the Italian government bond jumped about a quarter percentage point on September 28, and the premium of Italian 10-year bond yields over German bond yields - a financial market measure of the risk that Italian cannot repay its debts – was near the highest since 2013 (which had been reached in August in anticipation of this budget). The FTSE MIB index of Italian stocks fell 3.6 percent on the day. Rather than reflecting the risk of an immediate crisis, which still seems quite unlikely, financial tensions are a recognition that a larger deficit in 2019 will reduce Italy's ability to run a deficit to cushion the blow of the Eurozone's next downturn, whenever it comes. The euro weakened to $1.16 on the news from $1.18 a few days earlier. PNC expects the euro's weakness to be temporary and for the euro to appreciate against the dollar into 2019 as the ECB withdraws monetary stimulus and US economic growth peaks for the cycle.

UNITED KINGDOM: The Labour party declared on September 25 their support for a second Brexit referendum if the UK cannot agree to a deal with the EU that meets Labour's six tests –including the "exact same benefits" as membership in the Single Market and Customs Union – and if Labour cannot force a snap election. Meanwhile, divisions are growing within the Conservative party-led government. Former foreign secretary Boris Johnson published an alternative proposal for Brexit on September 27 in an implied attack on the leadership of Prime Minister Theresa May. Johnson was a rival candidate for Prime Minister before May won the job in 2016, and he resigned from the government in protest against her Brexit plan this year.

JAPAN: Current data do not pressure the Bank of Japan to accelerate its withdrawal of monetary stimulus. The Bank of Japan's measures of underlying inflation held steady in August at a range of 0.1-0.5 percent, and the share of items in the CPI basket with increasing prices edged down slightly to 51.6 percent; at its broadest, 68.8 percent of the CPI basket rose in price in March 2016 reflecting lagged effects of the April 2014 value added tax hike.

CHINA: Growth momentum weakened through September. The government-produced CFLP manufacturing PMI dipped to 50.8 in September from 51.3 in August and was the weakest since February, and the privately produced Caixin general manufacturing PMI fell to 50.0 from 50.6 in August and was the weakest since June 2017. China's Ministry of Finance announced small cuts to import tariffs on September 30 that will become effective November 1, which will reduce China's average tariff rate to 7.5 percent in 2019 from 9.8 percent in 2017 – since tariffs on imports are a tax on domestic buyers of foreign goods, the tax cut will boost domestic Chinese spending power and offset a bit of the drag from US tariffs.

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