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GLOBAL ECONOMIC HIGHLIGHTS

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CHINA OPENS TAPS FOR CREDIT GROWTH; FAR-RIGHT LEADS IN BRAZIL'S ELECTION; BANK OF MEXICO ON HOLD

CHINA: The People's Bank of China cut the reserve requirement ratio for commercial banks by 1 percentage point on October 7, creating room for banks to add another ¥750 billion yuan in loans (≈$110 billion US dollars or 0.9 percent of China's GDP). This loosening of credit policy followed the announcement that foreign reserve assets fell $22.7 billion US dollars to $3.087 trillion in September and were the lowest since July 2017. Capital outflows drain liquidity from the banking system, but the reserve requirement ratio cut offsets them and allows banks to keep credit growing. The yuan depreciated to 6.93 per US dollar, the weakest since January 2017, after the PBoC's policy change, which increased the divergence between the tightening Federal Reserve and loosening monetary policy in China. PNC forecasts for the yuan's weakness to be temporary, and for the currency to average stronger in 2019 than its current level as US growth momentum moderates, the US trade deficit widens, and the dollar depreciates against most foreign currencies. However, we also expect China's currency to experience wider fluctuations in 2019 than in 2018 as the government continues to transition toward a freely floating exchange rate.

BRAZIL: The Brazilian real recovered to below 3.8 per US dollar on October 8, the strongest since August, after far-right candidate Jair Bolsonaro won a larger than expected 46 percent plurality of the first round vote in Brazil's presidential election on October 7, increasing the odds that he wins the runoff on October 28. Bolsonaro is likely to support fiscal austerity and other right-leaning economic policies intended to support growth (although details are limited). His positions are a sharp contrast with those of the second runner-up Fernando Haddad of the Worker's Party, who won 29 percent of the vote, and who would probably oppose deficit cuts. Bolsonaro, like Mexico's anti-establishment president Andres Manuel Lopez-Obrador, has won support by campaigning as an anti-corruption outsider (from the far right, unlike the leftist Lopez-Obrador).

MEXICO: Matching PNC's forecast, the Bank of Mexico held its policy rate unchanged at 7.75 percent at its October 4 decision and broke with the Federal Reserve, who had raised interest rates at their most recent decision September 26. Prior to the October decision, the Bank of Mexico had been keeping pace with the Fed's rate hikes into mid-2018 to maintain a stable premium of Mexican interest rates above comparable US rates. But the USMCA trade agreement reached on October 1 removes the largest potential catalyst for peso exchange rate volatility, allowing the Bank of Mexico to shift its focus toward domestic conditions. PNC forecasts for the peso to appreciate into 2019 as the Bank of Mexico cuts interest rates to more neutral levels, pushing Mexican bond prices higher as their yields fall, and attracting inflows of foreign capital.

EUROZONE: Italian stock prices continue to fall and bond yields to rise following defiant statements on October 8 by the country's Deputy Prime Minister, that the anti-establishment government will not be cowed by either EU leaders or financial markets. The yield on Italian 10-year government bond reached the highest in four and a half years on Deputy Prime Minister Matteo Salvini's comments, which echo those made by anti-establishment Greek leaders in their 2015 standoff with the EU. While the tone is concerning, actions matter more than words, and the Italian government's steps toward compromise with the European Union during the week of October 1 were noteworthy: Italy changed its budget plan to target a fiscal deficit of 2.2 percent of GDP in 2020 and 2.0 percent in 2021, down from the 2.4 percent they originally proposed; however, the government is maintaining its 2019 deficit target unchanged at 2.4 percent, and bases its smaller deficit projections in subsequent years on excessively optimistic GDP growth forecasts. The European

Commission wants Italy to target a smaller deficit to reduce its sovereign debt, currently about 130 percent of GDP, to below the EU's Stability and Growth Pact limit of 120 percent, but is trying to avoid further inflaming financial turmoil or populist sentiment. For the Eurozone as a whole, the labor market continues to improve and inflation is stable. HICP inflation was 2.1 percent in year over year terms in September; it has been between 1.9 percent and 2.1 percent since May as food and energy prices rose. Core HICP excluding energy, food, alcohol and tobacco was 0.9 percent, also within its recent range. The unemployment rate fell to 8.1 percent in August from 8.2 percent in July and was the lowest since April 2008.

UNITED STATES: The US economy added just 134,000 jobs in September, the weakest job growth since September 2017. Hurricane Florence likely weighed on job growth in September 2018, just as Hurricanes Harvey and Irma weighed on job growth in September 2017. There was a huge 87,000 cumulative upward revision to job growth in August and July. Job growth has averaged 208,000 per month so far in 2018, up considerably from 182,000 per month last year. The unemployment rate fell 0.2 percentage point in September to 3.7 percent; this is the lowest the unemployment rate has been since 1969. Job growth increased in the household survey (different from the survey of employers) by a large 420,000 in September, while the labor force grew by 150,000. With the tight labor market wages continue to increase. Average hourly earnings rose 0.3 percent over the month, and were up 2.8 percent from one year earlier. This is a bit slower than the 2.9 percent year-over-year wage growth in August, but competition for workers is pushing up pay, consistent with the findings from PNC's semiannual small business survey, released in October. The labor market is in excellent shape heading into the end of 2018, perhaps the best it has been in 50 years. Job growth was a bit softer in September, but some of that was from Hurricane Florence, and it should bounce back through the rest of 2018 and into 2019. Job growth is set to slow next year as an inability to find workers weighs on hiring. The unemployment rate may increase slightly in the near term, but will remain below 4 percent through the rest of 2018 and reach 3.5 percent by early 2019. Job gains and wage growth will power increases in consumer incomes and spending; this should be an excellent holiday season. The September jobs report does not change the outlook for interest rates. The Federal Open Market Committee will raise the federal funds rate at their meeting in mid-December in an attempt to make sure that an overheating job market does not lead to inflation consistently above the FOMC's 2 percent objective. The FOMC will continue to gradually raise the fed funds rate in 2019 as the job market continues to tighten.

CANADA: Employment rose a strong 63,300 in September, more than reversing August's 51,600 decline, and the unemployment rate dipped to 5.9 percent from 6.0 percent and was close to the lowest since comparable data began in 1976. Canadian unemployment is measured by a different definition than US unemployment, so Canada's unemployment rate is not directly comparable to the 3.7 percent US one. Part-time employment surged 80,200 from August, while full-time employment fell 16,900. However, the recent trend is the opposite. Full-time employment rose 224,000 or 1.5 percent from a year earlier in September while part-time employment was basically unchanged. The month's shift to part-time employment was largely concentrated in workers ages 15-24, so some of the shift might be residual seasonality from the start of the school year. Positively, employment of employees grew 98,200 on the month, with 44,900 of the gain in goods-producing sectors, of which the largest gains were in construction, up 28,000, and agriculture, up 9,300. Employment of self-employed Canadians fell on both the month and the year. Average hourly wages rose a cool 2.4 percent from a year earlier. The Bank of Canada has repeatedly noted that wage growth is slower than would be expected given the low unemployment rate. Combined with the USMCA trade deal, September's solid jobs report flashes a green light for the Bank of Canada to raise its policy rate another 0.25 percentage point to 1.75 percent at its October 24 monetary policy decision. After October, Canada's housing downturn and high household indebtedness will be headwinds to growth, and spillover from rising US interest rates will add to Canadian mortgage costs even if the Bank of Canada goes slow. For these reasons, we expect the Bank of Canada's next rate hike after October to be in April 2019, and for the BoC to go slower than the Fed in raising interest rates in the rest of 2019. This will cause the Canadian dollar to depreciate against the US dollar, in our view.

UNITED KINGDOM: Prime Minister Theresa May came out swinging against opponents in her address to the Conservative Party congress on October 3. She drew a contrast between her approach to Brexit, which she said would “back” business, with that of her Conservative party rival Boris Johnson, who was infamously quoted in the British press for using a different four-letter word to dismiss business concerns about Brexit’s costs. She also attacked Labour party leader Jeremy Corbyn’s proposal to transfer a tenth of ownership of businesses with over 250 employees to their workers, and also announced plans to increase social spending to court moderate voters. PM May could call a snap election before year-end to attempt to consolidate her ruling coalition before the end of the Brexit negotiation; the Conservatives are short of a majority in parliament and need the support of the Northern Irish Democratic Unionist Party to control the government. PM May likely lacks votes to approve her Brexit plan (which is essentially customs union membership) due to opposition from Conservative Brexit hardliners and Labour, which decided in late September to vote against any plan she proposes.

JAPAN: Recent data do not point to a turning point in Japanese monetary policy in the near future. The Tankan business sentiment survey showed sentiment in large enterprises down to 19 in September from 21 in June, sentiment for medium-sized enterprises down to 15 from 20, and small enterprise sentiment unchanged. Growth in average cash earnings slowed further in August to 0.9 percent in year over year terms from 1.6 percent in July and 3.3 percent in June, which had been the fastest since 1997 – June’s strong cash earnings growth was due to a spike in bonus payments.

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