October 22, 2018

GLOBAL ECONOMIC HIGHLIGHTS

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

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

CHINESE REAL GDP GROWTH WEAKEST SINCE 2009; US HOUSING SLOWS; ITALIAN BUDGET; BREXIT IMPASSE

CHINA: Chinese real GDP growth slowed to 6.5 percent in the third quarter of 2018 from 6.7 percent in the second quarter and was the weakest since the first quarter of 2009. GDP marginally undershot the consensus expectation for 6.6 percent growth. Nominal GDP grew a better 9.6 percent in the third quarter, but still slower than the 9.8 percent of the second. Details were mixed and not entirely bad: Industrial production growth slowed to 5.8 percent in September (slowest since 2015) from 6.1 percent in August, while retail sales growth picked up to 9.2 percent and investment in fixed assets to 5.4 percent from 5.3 percent in August (this latter figure reported as the growth of the year to date total relative to the same period a year earlier). The 31-city surveyed unemployment rate was 4.7 percent in September, down from 4.9 percent in August and 4.8 percent in September 2017. China’s unemployment rate has a short history but the indicator is growing in importance as the Statistics Bureau releases more data and potentially more detail. Chinese consumers are tightening their belts in 2018, apparent in September’s 7.1 percent fall in auto sales by value and 11.6 percent drop by units sold from a year earlier. But the labor data, if they’re accurate, suggest the headwind to consumers is weak income growth rather than outright job losses – the Chinese job market is still tight. The third quarter’s weak growth was particularly notable in light of China's record trade surplus with the United States in September, as US importers rushed to bring Chinese goods onshore ahead of possible further escalation of tariffs and as Chinese purchases from the US faltered - either due to retaliatory tariffs, weak Chinese demand, or both. By implication, slowing GDP growth reflects a significant weakening of domestic demand as the government’s deleveraging campaign squeezed credit supply: Aggregate financing growth slowed to 10.6 percent in year over year terms in September from 10.8 percent in August, with equity financing to nonfinancial corporations growing 9.2 percent and debt financing growing 10.6 percent. Equity financing grew the slowest since August 2014, while debt financing and total financing grew the slowest since December 2005. While the third quarter’s slowdown was a little sharper than expected, it was not far out of line from PNC’s most recent China forecast, which predicts real GDP growth averaging 6.5 percent in the second half of 2018 and slowing further to 6.2 percent in 2019. We forecast Chinese credit growth to pick up slightly into 2019 to stabilize real GDP and offset tightening fiscal policy (although fiscal policy could be about to loosen again; an advisor to the central bank said in a statement to Bloomberg that the Chinese government would enact tax cuts of one percent of GDP in 2019). We also forecast for the yuan to appreciate in the next six months and average 6.7 per US dollar in 2019: As Chinese growth slows, so will Chinese imports, and a rise in Chinese net exports (and fall in US net exports as the US economy runs hot) will contribute to a modest recovery of China's currency against the dollar. However, the yuan will experience wider fluctuations in 2019 than in 2018 as the People’s Bank of China gradually transitions the exchange rate toward a free float.

UNITED STATES: Permits for housing construction fell 0.6 percent in September from August and dipped 1.0 percent from a year earlier; housing starts fell 5.3 percent from August and were 3.7 percent above the year ago level. Existing home sales fell 3.4 percent from a month earlier in September, a sixth consecutive monthly decline to the lowest level since 2015. Home inventories were relatively tight at the equivalent of 4.4 months of sales at the September rate. September’s housing data should be taken with a grain of salt, since Hurricane Florence may have depressed housing activity during the month. But the trend in housing activity is one of waning momentum: Mortgage interest rates have risen since the beginning of the year, dampening demand, and construction workers are in short supply, constricting supply. Housing activity should return to moderate growth in 2019 as the rise in long-term interest rates slows, but the sector will contribute less to the expansion going forward than in the immediate recovery from the Great Recession. Job openings reached a new record high of 7.1 million in August (data began in 2000); job openings have exceeded the number of active job seekers (the official unemployed) since March 2018. The minutes of the September 25 and 26 Federal Open Market Committee meeting released October 17 confirmed the Fed's guidance for gradual further interest rate increases. The minutes provided more nuance around Fed Chairman Powell's October 3 comment that the Fed "may go past neutral, but we're a long way from neutral at this point, probably." The minutes show there is no consensus on where interest rates should end the current hiking cycle: "a few" participants want "modestly restrictive" interest rates and that "a number" want to raise interest rates above neutral, but "a couple" oppose a "restrictive" monetary policy absent "signs of an overheating economy and rising inflation." Given Chair Powell's October 3 comments, risks to interest rates in late 2019 and 2020 are to the upside relative to levels currently anticipated by financial markets. The minutes also described how the Fed is monitoring money markets to decide when to slow its balance sheet reductions, and said that "as yet, there were no signs" that the balance sheet reductions were passing through to tighter liquidity in the federal funds market.

EUROZONE: As expected, the European Commission is edging toward a rejection of Italy's proposal for a budget that increases its deficit to fund tax cuts and higher social spending. Moody's downgraded Italy's sovereign credit rating on October 19 in reaction to the budget to Baa3, the lowest investment grade rating. The EU and Italy appear to be negotiating their way to a resolution to the budget dispute and are unlikely to trigger a broader crisis. But the dispute has caused the spread on Italian sovereign bond yields relative to German bond yields to widen on October 18 to the highest since 2013.

UNITED KINGDOM: As expected, the European Council meeting October 17 and 18 failed to deliver progress toward a soft Brexit deal that a majority of British Members of Parliament could endorse. EU negotiators called off the summit with the UK originally scheduled for November after the meeting, due to an impasse over the border between Northern Ireland and the UK – the EU statement emphasized that the bloc would "stay united," meaning that they will not sacrifice Irish demands for freedom of movement into Northern Ireland to reach a deal. An estimated 700,000 people demonstrated in the streets of London on October 21 to advocate a second Brexit referendum. The British press is discussing more openly the possibility of a change in government in coming weeks. If the UK ultimately opts to stay in the EU as seems likely, current data support a faster pace of Bank of England rate hikes than currently anticipated by financial markets. CPI inflation slowed to 2.4 percent in September from 2.6 percent in August and core inflation to 1.9 percent from 2.0 percent, but average wages excluding bonuses accelerated to grow the fastest since 2009 in August on faster pay increases in the public sector.

CANADA: PNC expects for the Bank of Canada to raise the overnight rate target 0.25 percentage point to 1.75 percent at its next monetary policy decision October 24. Recent data have been a little soft – manufacturing sales fell 0.4 percent in August from July by value and 0.3 percent by volume, though they still rose 9.0 percent by value and 3.7 percent by volume from a year earlier. The Canadian auto industry had shutdowns later in the summer than usual in 2018, holding back manufacturing sales. But more important to the outlook, the NAFTA renegotiation is done, and Canadian capex spending will accelerate in business linked to cross-border supply chains in coming months.

BRAZIL: Far right candidate Jair Bolsonaro continues to lead Workers Party candidate Fernando Haddad in polls ahead of the runoff presidential election on October 28. The central bank's monthly proxy for GDP rose 0.5 percent in August from July and 1.9 percent from a year earlier, up from 1.7 percent in July.

Visit http://www.pnc.com/economicreports to view the full listing of economic reports published by PNC's economists.