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GLOBAL ECONOMIC HIGHLIGHTS

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US REAL GDP SLOWS ON TRADE DEFICIT'S DRAG IN THIRD QUARTER; ECB SIGNALS OPTIONS FOR EASING IN 2019

We extend our deepest sympathy to the victims of the white supremacist terrorist attacks in Pittsburgh and Louisville over the weekend, and to their families and communities.

UNITED STATES: US real GDP growth moderated to 3.5 percent in the third quarter of 2018 from 4.2 percent in the second, and was close to both PNC's forecast of 3.4 percent and the consensus of 3.3 percent. As expected, consumer and government spending growth were robust, and businesses ramped up purchases to replenish inventories ran down over the three prior quarters. Also as expected, residential investment fell again, a fifth decline in six quarters, and was a cumulative 2.2 percent below its recent peak in the fourth quarter of 2017. More surprising, nonresidential investment also fell on lower business investment in structures, but this followed double digits annualized growth in the prior two quarters so some giveback is not concerning. Also as expected, the trade deficit widened to its largest since the third quarter of 2008, a large drag on real GDP. The trade deficit's drag on growth was its largest in fact since 1985; imports rose robustly as fiscal stimulus lifted US demand for foreign goods and as importers front-loaded purchases in anticipation of further tariffs, while exports fell due to Chinese retaliatory tariffs. The trade deficit widened despite the Trump administration's aggressive 'buy American, hire American' rhetoric because it is determined by the domestic balance of savings and investment and not by tariffs, or by the exchange rate. Like a household that earns $5,000 a month, spends $6,000, and necessarily must borrow $1,000 from elsewhere, the US spends more on household and government consumption and corporate investment than it generates in national income. The difference is borrowed from abroad and shows up in the GDP accounts as a trade deficit. The US policy stance in 2017 and 2018 has combined low interest rates, which discouraged household savings and encouraged corporate borrowing, and large government deficits; these policies are intended to boost growth and have the side effect of also increasing the need for foreign borrowing. From a year earlier, real GDP grew 3.0 percent in the third quarter, the fastest since the second quarter of 2015. Monthly housing data confirm the weak trends seen in the GDP report: New home sales fell 5.5 percent on the month in September and 13.2 percent on the year, paralleling last week's drop in existing home sales to the lowest since 2015. Housing momentum has faltered on rising mortgage interest rates, which dampen demand, and shortages of construction workers, which constrict supply. Housing activity should return to moderate growth in 2019 as long-term interest rates stabilize, but the sector will contribute less to the expansion going forward than in the immediate recovery from the Great Recession.

EUROZONE: Most of the dialogue during the European Central Bank's October 25 press conference centered on Italy, but President Mario Draghi also acknowledged some weaker than expected recent data, and mentioned discussion within the Governing Council about nonconventional policy options available after quantitative easing ends on December 31. The Governing Council's opening statement, which is a consensus document, repeated their call for cutting debt in heavily indebted member states like Italy: "…rebuilding fiscal buffers… particularly… in countries where government debt is high." President Draghi's key observation on the impasse over Italy's plan for deficit-funded fiscal stimulus was that "I'm still confident that an agreement will be found," and he said in several different ways that the European Council (the EU's executive branch) and not the ECB is in the driver's seat in managing the EU side of the issue. Draghi also emphasized that the EU's approach is to negotiate a solution with Italy, reinforcing our impression that the EU policy elite wants to avoid further inflaming populist sentiment there or adding to financial market

unease. Regarding monetary policy, President Draghi's most noteworthy comment was a mention that during the meeting, "the TLTRO was raised by two speakers, but not in any detail." The TLTRO is the ECB's Targeted Long Term Refinancing Operation, an unconventional monetary policy tool that makes multi-year loans to Eurozone commercial banks at the ECB deposit rate (currently negative, -0.4 percent). When the ECB really dislikes an idea, President Draghi says in the press conference that it was "not discussed" – so TLTRO's mention is a sign that the ECB would consider further unconventional policy in 2019 if Italy's budget impasse or geopolitical tensions spur Eurozone financial turbulence. The threshold for intervention is high, but the ECB is not committed to exiting unconventional monetary policy and, as President Draghi emphasized, has many tools in the toolkit they need to reverse course and restart stimulus. Otherwise, the ECB held the benchmark deposit rate unchanged at -0.4 percent and continues to taper its quantitative easing program as basically assured prior to the meeting. Monthly net asset purchases will continue at €15 billion euros through December, and the ECB "anticipates" ending net purchases at year-end. The Governing Council statement acknowledged that recent economic releases were "somewhat weaker than expected," but attributed the slowdown to temporary country- and sector-specific issues like those of Germany's auto industry, and believes them unlikely to change the outlook. They maintained their view that the risks to the growth outlook are "broadly balanced." Their statement reiterated the claim that "while measures of underlying inflation remain generally muted, they have been increasing from earlier lows." We interpret recent data differently. Most measures of core inflation derived from the euro area's benchmark HICP basket have been stuck around one percent in the last few months' readings. The Governing Council made a Phillips Curve-inspired argument that inflation will rise as unemployment falls and capacity utilization rises, but we are dubious. Central banks in other advanced economies with tight labor markets – including the US, UK, and Japan – have been surprised by how slow labor scarcity raises inflation, and structural changes affecting all advanced economies are likely at work: Aging workforces, an larger share of GDP produced in the service sector, and less wage-setting power in the hands of workers. By implication, the ECB is more likely to be surprised by weaker-than-expected core inflation in 2019 than the opposite. Many Eurozone countries have changed labor market regulations since the onset of the Eurozone fiscal crisis in ways that reduce workers' ability to set wages; the question for the monetary outlook is how large the impact on inflation will be. On balance, PNC's forecast for ECB monetary policy still seems justified: For QE to end at year-end, for no additional unconventional monetary stimulus subsequently, and for a first 0.1 percentage point interest rate hike in the deposit rate to -0.3 percent in June 2019. But if core inflation fails to rise in coming months or if softer growth persists, the ECB's rate hike will be pushed back.

CHINA: In contrast to slowing real GDP growth in the third quarter, industrial profits accelerated: Gross profits of Chinese industry (before netting losses of loss-making firms) grew 14.7 percent in the first nine months of 2018 from a year earlier, up from 13.2 percent in the January to August period. The strongest growth in profits came from heavy industry: Steel, construction material manufacture, oil exploration and refining, and petrochemical manufacture. Faster profit growth in these capital-intensive state-dominated industries reflects both pass-through of higher commodity prices and looser controls on credit growth and investment in the state sector.

UNITED KINGDOM: PNC forecasts for the Bank of England to hold their policy Bank Rate unchanged at their next Monetary Policy Committee meeting Thursday, November 1. Growth of base pay excluding bonuses accelerated to 3.1 percent in year-over-year terms, the fastest since 2009, in the three months through August, but CPI inflation slowed to 2.4 percent in September from 2.7 percent in August on slower increases of food prices. Inflation of trend-following services prices in the CPI basket have been stable near the Bank of England's 2.0 percent target in year over year terms since February. More importantly for the British economic outlook, the government has made no headway in the Brexit negotiations and Prime Minister May faces leadership challenges from both Hard Brexiteers and Brexit skeptics, which prevent her from accepting compromises the EU is offering. Eventually the Prime Minister will run out of time to negotiate with the EU, and the UK will be forced to choose between the compromises of a Brexit deal, a disastrous no-deal Brexit, or status quo EU membership. The last option seems most likely to us.

CANADA: Matching our forecast, the Bank of Canada's October 24 decision raised the overnight rate target from 1.50 percent to 1.75 percent. They unsurprisingly cited the completed NAFTA renegotiation as a catalyst for stronger Canadian business activity in coming months. They also tweaked forward guidance by

removing "gradual" from their characterization of the pace at which they expect to hike interest rates, but still emphasize that they are monitoring spillover from higher interest rates to the most interest rate-sensitive sectors of the economy, housing and highly-indebted consumers. Payroll employment growth slowed from 2.0 percent from a year earlier in July to 1.9 percent in August, paralleling the slowdown in household employment growth during the same month. Household employment subsequently accelerated in September, and has been growing slower than payrolls in recent months. Both data points imply job growth could accelerate in the fourth quarter.

BRAZIL: As anticipated by pre-election polling, far right populist Jair Bolsonaro won the runoff presidential election on October 28. Like the left-leaning populist who won Mexico's July election, Bolsonaro ran against a corrupt political establishment as an iconoclastic outsider. Like the Philippines' populist president Rodrigo Duterte, Bolsonaro positioned himself as a tough-on-crime populist disdainful for institutional checks on power or due process. Like Mexico's president-elect, Bolsonaro did not flesh out a detailed economic agenda prior to the election, but did appoint a lead economic advisor who advocates market-friendly policies. Bolsonaro's opponents fear his most inflammatory comments signal how he will govern and that Brazil could reverse its transition to democracy, which began in 1985. Bolsonaro's supporters hope he will reform dysfunctional institutions, reduce corruption, and improve public safety. The Brazilian real recovered to its strongest since May on the announcement of Bolsonaro's win. Brazil's economic outlook could improve if Bolsonaro can reduce the fiscal deficit and red tape, but rapid policy change is unlikely since political power is divided between Brazil's executive and legislative branches, and the largest political party in congress holds only 11 percent of seats.

MEXICO: Mexicans rejected construction of a new airport for Mexico City in a referendum held October 25 to 28, a $13 billion project which the outgoing presidential administration already approved, begun, and completed roughly 30 percent of construction. The Mexican peso depreciated following the referendum, which creates a number of problems for global investors: Cancelling the airport removes the revenue stream intended to repay the bond issue that financed its construction. Reversing the prior administration's infrastructure plans will discourage investors from participating in future projects that span multiple administrations. A reduced supply of foreign capital for public private partnerships will make it more difficult for Mexico to build the infrastructure necessary for a modern economy, but the Mexican private sector will likely still see solid capital inflows in the coming year with NAFTA-related uncertainties put to rest. CPI inflation edged lower to 4.9 percent in the first half of October from 5.0 percent in September on slower increases of energy and government-set prices. The seasonally-adjusted unemployment rate was unchanged from a month earlier at 3.3 percent in September, and monthly GDP fell 0.1 percent in August from July on a 1.3 percent decline in agricultural output, a 0.5 percent drop in industrial output, and a 0.4 percent increase in services output. The monthly GDP index grew 1.7 percent from a year earlier.

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