January 2, 2018

GLOBAL ECONOMIC HIGHLIGHTS

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TAX CUT TO BOOST GROWTH AND DEFICIT, LITTLE EFFECT ON EXCHANGE RATES; KEY US EXPORT MARKETS SLOWING

UNITED STATES: PNC Economics forecasts for real GDP growth to accelerate to 2.7 percent in 2018 from 2.3 percent in 2017 on a boost from the Tax Cuts and Jobs Act (TCJA), which becomes effective January 1. The TCJA's corporate and personal income tax cuts will add to final sales, but higher inventories at the end of 2017 will limit the need for production in 2018, which is what counts for GDP. In addition, some of the demand generated by the tax cuts will be spent on imports, which do not add to GDP. Finally, and independent of the tax cuts, growth is slowing in the US's largest export markets Canada and Mexico, a potential headwind to net exports and real GDP growth in 2018 (see below). The tax cuts are partially funded by eliminating or reducing exemptions (i.e. offsetting tax increases), and by imposing a one-time tax on the foreign assets of US companies. After that, the US government will cease taxing foreign profits of US companies in a shift to a "territorial taxation" system. The rest of the tax cut is not funded, so it will increase the federal deficit by roughly one-half of a percentage point of GDP in 2018 and 1.25 percentage points in 2019. These estimates may prove high if the tax cut generates more growth than expected, or low if taxpayers use provisions in the TCJA to lower their tax burdens more than expected. The tax cut is unlikely to affect trend GDP growth after 2018 and 2019. Rising public borrowing in an economy that is at full employment reinforces our forecast that US long-term interest rates will rise in 2018. Repatriation of foreign earnings should not move exchange rates, since many of the foreign exchange transactions related to earnings repatriation have already occurred. Many US companies that will repatriate earnings have already converted them to US dollars in their foreign accounts or hedged their value using derivatives to prevent exchange rate movements from affecting budgets.

CANADA: PNC Economics forecasts that the December jobs report will show Canadian household employment up 24,000 from November and the unemployment rate unchanged at 5.9 percent, the lowest since February 2008. If so, December's monthly gain in employment would be a moderation from the 31,300 average of the first 11 months of 2017, consistent with moderation in other recent labor market and output data. Average weekly earnings rose 3.1 percent on the year in October, faster than inflation, and the average workweek rose to 32.8 hours from 32.6 hours in October 2016, but payroll employment fell 22,000, or 0.1 percent, in October from September and its year-ago growth rate slowed to 2.1 percent from September's 2.4 percent. New claims for employment insurance grew 6.1 percent from a year earlier in October; claims fell from a year earlier in every month of the first half of 2017, but rose from a year earlier (signaling a weaker job market) in the four months reported so far for the second half of 2017. Canada's monthly GDP index slowed from 4.6 percent year-ago growth in May to 3.3 percent in September and 3.4 percent in October. After a resurgence of energy sector activity and investment earlier in 2017, growth is moderating, and the housing sector is a headwind to real GDP; job gains will likely slow somewhat in 2018 after slower GDP growth in late 2017. Headline and core CPI inflation firmed in November: Headline CPI was 2.1 percent in year-ago terms, up from 1.4 percent in October, and two of the Bank of Canada's three measures of core inflation increased: CPI-median rose to 1.9 percent from 1.7 percent and CPI-trim to 1.8 percent from 1.5 percent (CPI-common was 1.5 percent, down from 1.6 percent in October). In month over month terms, headline CPI rose 0.5 percent on a 1.5 percent increase in transportation prices (gas prices rose from October). Financial markets price in roughly a fifty-fifty chance of a rate hike at the Bank of Canada's January 17 interest rate decision; if the December's jobs report is as strong as our forecast, the

Bank of Canada will likely raise the overnight rate target to 1.25 percent from its current 1.0 percent in January. This would be their third 25 basis point rate hike since July 2017, another reason why Canadian real GDP growth will moderate in 2018 after an above-trend 2017.

MEXICO: The Mexican unemployment rate rose to 3.5 percent in November from 3.4 percent in October and 3.3 percent in September. The unemployment rate's increase follows a sequential decline in Mexican GDP in the third quarter: The monthly GDP index fell a cumulative 0.5 percent between June and September, and its year-over-year rate of growth slowed from 2.2 percent in June to 0.9 percent in September. Mexico's economy is slowing on lagged effects of consumer energy price liberalization in January 2017, the blow to consumer and business sentiment from the Trump effect, and chronic production declines at the state-owned oil company Pemex. As in Canada, tighter monetary policy also plays a role: The Bank of Mexico raised its policy rate 150 basis points to 7.25 percent in 2017, meaning Mexico will have the highest inflation-adjusted interest rates of any major economy in 2018. NAFTA uncertainties continue to be the biggest risk to the Mexican economic outlook. Continuity on US-Mexican trade policy seems most likely: The US government will probably try to avoid disrupting the business models of companies that have developed integrated supply chains and open trade across the NAFTA markets, including those in agribusiness, aerospace, auto, retail, and diversified manufacturing. The next largest risk to the outlook is Mexico's July 1 general election, which seems less likely to deliver policy continuity after the ruling PRI party's treasurer was arrested in December on allegations of channeling public money to political campaigns. If the election's outcome scares financial markets, the Bank of Mexico could be forced to raise interest rates even further to defend the currency, compounding headwinds to Mexican growth.

JAPAN: As expected, the Bank of Japan held its monetary stance unchanged at its final decision of 2017 on December 21. They held their short-term policy rate and target for the 10 year government yield unchanged at negative 0.1 percent and "around zero" percent, respectively, and continue to buy exchange traded funds and real estate investment trusts at annual rates of ¥6 trillion yen and ¥90 billion yen, respectively. The BoJ will be able to keep the 10 year bond yield at its target with fewer purchases in 2018 since it now owns about 40 percent of all bonds outstanding, so government bond purchases will likely slow in 2018, but the key instrument of its QE policy – the long-term interest rate target – will stay unchanged. PNC Economics forecasts that the Bank of Japan will maintain an unchanged policy stance throughout 2018: Their forward guidance is that they will "continue expanding the monetary base until the year-on-year rate of increase in the observed CPI (all items less fresh food) exceeded 2 percent and stayed above the target in a stable manner." This objective is far in the future: Headline CPI inflation was 0.6 percent in year-over-year terms in November, and the Bank of Japan's measures of core inflation between 0.2 percent and 0.6 percent. The Tankan business sentiment survey for the fourth quarter of 2017 showed the average expectation for CPI inflation five years in the future is just 1.3 percent, and shorter-term inflation expectations are even lower. Only small nonmanufacturing businesses expect inflation to reach the BoJ's target in five years. These businesses have limited scope to raise output per worker, and are under the most pressure to pass on higher wage costs to customers, explaining why they expect more inflation than other Japanese businesses.

EUROZONE: European politics provided fewer upsets for financial markets in 2017 than feared, but the currency area's political unity will face several more tests in 2018. Separatist parties won a majority in Catalan regional elections on December 20, a reaction against the Government of Spain's crackdown on the October 1 Catalan referendum on independence. The European Commission is moving toward penalizing the Polish government for alleged violations of the EU's rule of law framework. Since taking control of the government in October 2015, Poland's right-wing populist Law and Order Party enacted a series of measures reducing judicial independence, an alleged violation of EU rules. The European Commission has recommended that the European Parliament penalize Poland; EU parliamentarians must weigh the rule of EU law against Polish sovereignty. On March 4, Italy will hold a general election that could bring Euroskeptic or anti-austerity parties into government or set up another showdown between a national government and the EU. Finally, European financial markets could face a repricing of interest rate expectations if the term premium on medium-term interest rates normalizes: Medium-term interbank interest rates and the German government bond yield price in lower ECB policy rates over the next two years than expected by PNC Economics' or consensus forecasts.

UNITED KINGDOM: Prime Minister Theresa May's government met a new setback December 20 when First Secretary of State and Minister Damian Green resigned after lying about improper use of a government computer. His resignation follows those of the Defense Minister and of the Secretary of State for International Development, who both resigned in November. The Tory government's instability could complicate its negotiations with the EU in pursuit of a trade deal. The Bank of England's *Agents' Summary of Business Conditions* survey for November reaffirmed our view that the British economy weakened in late 2017: Output and turnover fell in the retail, construction, and domestically-oriented manufacturing industries, partially offset by stronger activity for export-oriented manufacturers. Employment intentions weakened, while labor shortages intensified; this is a sign that growth is weakening and that fewer workers are coming to the UK from the rest of the EU. Investment intentions were weak in both the manufacturing and services sectors and little changed from October.

BRAZIL: The Central Bank of Brazil's monthly proxy for real GDP, the IBC-Br index, rose 0.3 percent in October from September and 2.3 percent from a year earlier, up from 1.5 percent year-ago growth in September. Benchmark consumer price inflation was 2.9 percent in year-ago terms through mid-December, up slightly from 2.8 percent in November.

CHINA: The December Central Economic Work Conference's communique announced plans for economic policy continuity in 2018. China's policymakers pledged a neutral monetary policy and proactive fiscal policy, unchanged from 2017, continued efforts to deleverage and hold credit growth to a "reasonable rate," and a transition "from high speed growth to high quality growth." Regarding exchange rate policy, the conference reaffirmed a goal to "maintain the basic stability of the yuan exchange rate within a reasonable range," unchanged language on exchange rate management. If the dollar strengthens against most currencies in 2018, China's government would likely guide the yuan weaker against the dollar as well; a resumption of capital outflows could also be a catalyst for yuan depreciation, but this risk seems lower after early 2017's tightening of controls on capital outflows from China. The Work Conference statement also encouraged lower-level government officials to control financial sector risks, and to "effectively strengthen management of local government debt" – reaffirming standing orders.

AUSTRALIA: The minutes of the Reserve Bank of Australia's December 5 monetary policy committee meeting reaffirm PNC Economics' expectation that the RBA waits to raise interest rates until late 2018. The RBA noted that wage growth was "stable at a low rate," and only expected to increase "gradually" despite the unemployment rate reaching the lowest since 2013. The RBA continues to see risks to consumption spending from high household indebtedness and housing prices, but expects the economic expansion to continue on the back of non-resource sector investment.

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