CHINA GROWS A HAIR FASTER IN THE 4TH QUARTER; ECB POLICY IN CRUISE CONTROL THROUGH YEAR-END 2017

CHINA: Chinese real GDP growth edged up to 6.8 percent in year-ago terms in the first estimate for the fourth quarter of 2016 from 6.7 percent in the third quarter – a touch faster than expected, but no real change in trend. 2016’s full-year real GDP growth was 6.7 percent, a notch slower than 2015's 6.9 percent increase. Stabilizing prices of energy and other commodities lifted Chinese inflation in the fourth quarter and supported 9.9 percent nominal GDP growth, up from 7.8 percent in the third quarter and the fastest since the fourth quarter of 2013. Faster nominal GDP growth will pass through to stronger top-line revenue growth for Chinese businesses in 2017. By major sector, agriculture grew 2.9 percent in real terms in the fourth quarter, industry 6.1 percent (unchanged from the third quarter), and services 8.3 percent, much faster than the 7.6 percent increase of the third quarter. Chinese capital spending growth continues to slow: Investment in fixed assets (a wonky Chinese statistic that systematically overstates the investment component of GDP due to double counting) grew 8.1 percent in 2016, the slowest growth since the year 2000 when China was still struggling out of the post-Asian financial crisis doldrums. Investment by private firms slowed even more sharply, and was up just 3.2 percent 2016 from 2015. Capital spending fell sharply in Chinese mining, down 20.4 percent on the year, and was down in heavy industry too -- investment in ferrous and nonferrous metal industries fell 2.2 percent and 5.8 percent on the year, respectively. By contrast, capital spending grew 4.5 percent in Chinese auto manufacture, and by double digits in light manufacturing industries. The fastest growing share of Chinese fixed investment in 2016 was spending on basic infrastructure, which grew more than 20 percent from 2015. Chinese stimulus spending is prioritizing the basic infrastructure needed to ensure quality of life and public health in Chinese cities -- positive for long-term improvements in standards of living, but less likely to generate high financial returns than the industrial capex which China's economy concentrated spending on ten years ago. A combination of strong real estate sales growth and slower growth in real estate investment helped absorb some of China’s overhang of unsold property in 2016. Real estate developers sold 22.5 percent more floor space in 2016 than in 2015, while new property starts grew a much slower 8.1 percent on the year; the area of land acquired by developers from the government for development fell 3.4 percent from 2015, and unsold inventories fell 3.2 percent. The key risk to the Chinese economy in 2017 and 2018 is the possibility that faster than expected US interest rate increases could intensify Chinese capital outflows and increase stresses on China's financial system. In such a scenario, a free float of the yuan would be China’s most immediate risk to the global outlook. China’s currency is clearly stronger than it would be if a free market's supply and demand determined its value; if it were not, China’s central bank would not have been forced to spend a trillion dollars in foreign reserves between mid-2014 and the end of 2016 propping up its value. If China’s leaders decide to save the rest of their foreign reserves as a cushion against future global financial volatility or in case they someday need to recapitalize their financial system, the yuan could suddenly depreciate by 10-20 percent – a large negative shock to global demand, since China’s real purchasing power for buying both foreign exports and domestically priced goods would fall just as sharply. Such a shock would pull down global prices of industrial and agricultural commodities, stressing commodity-exporting economies in a repeat of the difficult years of 2015 and 2016. But since Chinese financial liabilities are almost all denominated in local currency, a one-off yuan devaluation would help to reduce the overhang of debt which China has accumulated over the last 10 years. In the base case, we expect China to continue to manage its exchange rate in 2017 through a combination of tighter restrictions on cross-border capital flows and a measured spend of foreign reserves, and for the yuan to depreciate to 7.4 per U.S. dollar by the end of 2017 from its current 6.9 per dollar.
**GLOBAL ECONOMIC HIGHLIGHTS**

**EUROZONE:** Matching the commitment made at its December 2016 meeting, the ECB’s Governing Council left its monetary stance unchanged last Thursday: Interest rates will stay at present levels, with the benchmark deposit rate unchanged at negative 0.4 percent; purchases under the asset purchase program will continue at €80 billion euros per month until the end of March 2017, and then at €60 billion euros per month between April and December 2017, “or beyond if necessary, and in any case until the Governing Council sees a sustained adjustment in the path of inflation consistent with its inflation aim.” The ECB signaled that it will wait for faster core inflation and wage growth before normalizing monetary policy, and “will continue to look through changes in HICP inflation if judged to be transient.” Even with the Eurozone economy doing its best since the depths of its sovereign debt crisis, the balance of risks continues to favor historically weak core inflation in the Eurozone in 2017 and 2018. Unemployment is high, growth is slow, and a rapidly aging population puts secular downward pressure on inflation, just like it did in Japan when similar demographic changes took hold there. Barring a major global commodity price shock, the ECB will likely continue to carry out its asset purchases well into 2018, and could leave short-term interest rates in negative territory through the end of President Draghi’s tenure as ECB President in October 2019. The ECB’s dovish January guidance reinforces PNC Economics’ forecast for a divergence between a tightening monetary policy in the United States in 2017 and a stable, highly expansionary monetary stance in the Eurozone, and for the dollar to appreciate to $1.02 per euro by mid-2017 and $1.01 per euro by year-end 2017.

**UNITED STATES:** The US job market continues to tighten. Initial claims for unemployment insurance fell to 234,000 during the week ending January 14, and the four-week moving average fell to 246,750, the lowest since November 1973. As a tight job market gives workers more bargaining power with employers, wage increases will pick up and inflationary pressures build in 2017 and 2018.

**UNITED KINGDOM:** December’s drop in retail sales matched the Bank of England’s forecast that stronger domestic demand in the second half of 2016 is unlikely to be sustained. Retail sales fell 1.3 percent in value terms and 1.9 percent in volume terms in December from November, and rose 5.4 percent by value and 4.3 percent by volume from a year earlier. Retail sales excluding auto fuel fell 1.5 percent by value and 2.0 percent by volume in December from November, and grew 5.1 percent and 4.9 percent in both respective terms from a year earlier. The Bank of England will likely extend its quantitative easing program and leave interest rates unchanged at its February 8 Monetary Policy Committee meeting.

**CANADA:** Moderate retail sales growth in November confirm a stronger Canadian economy in the second half of 2016. Canadian retail sales rose 0.2 percent by value and 0.7 percent by volume in November from October, and were up 3.0 percent and 2.4 percent in both terms, respectively, from a year earlier. Retail sales excluding motor vehicle and parts dealers and gasoline stations rose 0.2 percent on the month and 3.5 percent on the year in November. Motor vehicle and parts dealer sales were softer than headline retail in November, rising just 1.7 percent on the year in the retail report, but Statistics Canada’s separately-reported survey of new motor vehicle sales showed much stronger growth of 17.4 percent in sales by value and 10.3 percent in car units sold during the month of November from a year earlier; the discrepancy suggests consumer spending is stronger than the retail headline. Meanwhile, inflation is not too far beneath the Bank of Canada's target, further evidence that a Canadian interest rate cut is highly unlikely in 2017. The consumer price index rose 0.3 percent in December from November and 1.5 percent from a year earlier, up from November's 1.2 percent year-ago increase on stabilizing energy prices, up 4.0 percent on the year in December. Goods prices rose 0.9 percent on the year in December, while trend-setting services prices rose 2.0 percent. CPI excluding food and energy, the standard definition of core CPI, rose 0.2 percent in monthly seasonally-adjusted terms and 1.8 percent in year-ago terms in December, close to the Bank of Canada's 2.0 percent target. Statistics Canada’s alternative measures of core inflation – CPI-common, CPI-median, and CPI-trim – rose 1.4 percent, 2.0 percent, and 1.6 percent respectively in year-ago terms in December. Like the standard ex-food and energy core inflation measure, these supplemental measures of inflation confirm that trend inflationary pressure in Canada is a little bit less than headline CPI, which is subject to large swings when exchange rates and energy prices change. PNC Economics forecasts that the Bank of Canada’s next move will be a rate hike in the first quarter of 2018.

**JAPAN:** The all-activity index (a monthly proxy for real GDP) grew 0.3 percent in November from October and 1.4 percent from a year earlier. Services activity grew 0.2 percent on the month and 0.9 percent on the
year, industrial activity 1.5 percent on the month and 2.9 percent on the year, and construction fell 2.5 percent on the month while rising 2.8 percent on the year. Economic growth is gaining traction in Japan.

MEXICO: Mexico’s unemployment rate held steady at 3.7 percent in December, but the details were softer than the headline. The labor force participation rate dipped 0.1 percentage points on the month to 59.4 percent from 59.5 percent in November and 59.7 percent in December 2016, and rates of underemployment and informal employment also fell on both the month and the year. Lower underemployment and informal employment may be a leading indicator of broader weakness in Mexico’s job market ahead. Mexican employers can more easily furlough workers classified by the government’s statistical system as underemployed or informally employed than workers with formal employment contracts, so underemployment and informal employment will tend to weaken before the headline employment data at a growth cycle turning point. Mexican consumer prices surged 1.5 percent in the first two weeks of 2017 from the end of 2016 on a 12.7 percent increase in average energy prices as the “gasolinazo” or gas price hike imposed by the government on January 1 came into effect. In year-ago terms, headline inflation accelerated to 4.8 percent in early January, the fastest since September 2012. Mexican consumers will respond to higher gas prices by reining in spending on other categories of goods and services, just as they would to a tax hike. Weaker consumer spending will compound the headwinds to growth from trade-related uncertainties, public spending cuts, and higher interest rates. Mexico’s monthly real GDP index grew a moderate 0.2 percent on the month in November from October, or 2.4 percent from a year earlier, but there is little reason to expect this trend to hold in early 2017. The Mexican economy is likely contracting during the first quarter of 2017 as consumers rein in non-gas spending and as manufacturers delay capital spending plans and add to inventories more cautiously.

AUSTRALIA: Weak but rising inflation and less negative signals from the labor market reaffirm PNC Economics’ forecast that the Reserve Bank of Australia will hold the target cash rate at 1.50 percent throughout 2017. The headline consumer price index rose 1.5 percent from a year earlier in the fourth quarter, compared with an increase of 1.3 percent in the third quarter. Though inflation is currently running below the RBA’s 2-3 percent target range, signs are emerging that inflation is on track to reach the target range by 2018. First, commodity prices are rising and second, CPI inflation of non-tradables (a measure of domestic price pressures) picked up to 2.1 percent from a year ago in the fourth quarter from 1.7 percent in the third quarter. Also, less negative labor market data incentivize the RBA to hold the target cash rate this year. Although the unemployment rate ticked up a tenth of a percentage point for a second month to 5.8 percent in December, job growth is now increasingly leaning on full-time employment, rather than part-time employment as it was in the first three quarters of 2016. This will support wage growth and alleviate the underemployment problem which was worrying policymakers in 2016. All told, the economy is neither strong enough to warrant a rate hike nor weak enough to warrant a cut. Financial markets now place the odds of a rate hike in 2017 at nearly 17 percent, down from a 38 percent chance earlier in January.