March 5, 2018

GLOBAL ECONOMIC HIGHLIGHTS

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

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

TARIFF RETALIATION POSES DOWNSIDE RISK TO GROWTH; ITALIAN HUNG PARLIAMENT; JAPANESE TAPER TALK

UNITED STATES: President Trump's intention announced March 1 to impose tariffs on imported steel and aluminum would, if enacted, provoke retaliation from trading partners that would add downside risk to the US real GDP growth outlook for 2019 and 2020. The tariffs would have small direct effects on US inflation or GDP: they would accrue benefits to a small group of metal producers, impose larger but also much more dispersed costs on their customers, and likely have little measurable effect on inflation or output. Tariffs will not affect the US trade deficit, which is caused by US consumption and investment spending exceeding US production. If reducing trade deficits is a US priority, the policy tools to achieve it are tighter fiscal policy (i.e. cut spending or raise taxes) or tighter monetary policy to slow private spending and investment. Tariffs' most meaningful impact on US output and employment would come from trading partners' inevitable retaliation. Canada, the European Union, China, and others have warned that they would tit-for-tat retaliate against US exporters. In the base case, trade frictions will probably not escalate beyond a single round of protectionism. The US imposes tariffs on imports fairly regularly. Before the Trump administration's tariffs on foreign solar panels, washing machines, and now metals, the Obama administration imposed tariffs on Chinese tires, and the administration of George W Bush imposed tariffs on foreign steel. The Obama and Bush tariffs lasted about 3 and 1.5 years, respectively, resulted in limited foreign retaliation, and their effects on the fortunes of protected industries were small relative to that of the domestic business cycle. The last three presidential administrations faced pressure from US businesses who paid higher prices and suffered foreign retaliation after imposing tariffs, and subsequently shifted the focus of trade policy to opening foreign markets for US exports. An escalating trade war like that of the 1930s would pose a much more significant risk to the US outlook, but is a tail risk given the global environment: Outside of the United States, the political-economic forces that fostered a global trade war in the 1930s do not apply. Global growth is strong, unemployment rates have recovered from the great recession, and prices are stable to rising. In Europe, the Brexit quagmire is making populism less appealing, and in the Asia-Pacific, policymakers are focused on implementing the Comprehensive Progressive Trans Pacific Partnership, a trade deal and counterbalance to China that Treasury Secretary Steve Mnuchin is still pushing for the US to re-enter. In the base case, PNC Economics sees the risk of a near-term recession as low, at 10 percent in 2018, 25 percent in 2019, and 35 percent in 2020 as interest rates rise and fiscal policy becomes less expansionary, but higher trade barriers would add to recession risks. Federal Reserve Chairman Jay Powell stated in his initial testimony to Congress February 27 that the Fed should "strike a balance between avoiding an overheated economy and bringing PCE price inflation to 2 percent on a sustained basis." Chairman Powell also stated that despite February's drop in stock prices "financial conditions remain accommodative," another sign that the Fed leans toward a rate hike at the March 21 Open Market Committee meeting.

UNITED KINGDOM: Prime Minister Theresa May in a March 2 speech struggled to contain a new crisis in Northern Ireland caused by the European Union's draft Brexit treaty released February 28. The EU's draft insists that if the UK wishes to maintain an open border between Northern Ireland and the Republic of Ireland (the UK, Ireland, and EU all support it), then the UK must allow Northern Ireland's membership in the EU customs union. If the UK wants to be outside of the customs union, it must create a trade barrier between Northern Ireland and the rest of the UK, anathema to the coalition of Tory and Democratic Unionist

Party (a Northern Irish party) politicians who run the UK's government. Prime Minister May's countered the EU's draft by proposing a "customs partnership," in which Northern Ireland could have an open border with Ireland but would also be able to trade with non-EU economies under customs regulations set by the EU – this proposal is dead on arrival from the EU's perspective, and underscores how far the UK is from a workable vision of its post-Brexit relationship with the EU. The EU has offered the UK a transition period from the official end of the Brexit negotiations in March 2019 until December 2020 in which it can continue to be treated as an EU member while it finds itself. The most likely outcome for this process seems to be eventual British capitulation and continued membership in the EU, or barring that, customs union membership, since only those options would prevent a hard border between Northern Ireland and the Republic of Ireland.

EUROZONE: German politics are stable and Italy's are a mess, again: The German Social Democratic Party voted to again join the center-right Christian Democrats in a grand coalition government over the weekend, removing a source of uncertainty from the European political outlook. By contrast, the Italian election March 4 failed to deliver a majority to any of the three main political groups – the center-right coalition, center-left coalition, or populist Five Star Movement – and probably heralds a return to political paralysis in the Eurozone's most indebted economy. In the near-term, the Eurozone's solid growth momentum and the cyclical improvement of government budgets will probably prevent Italy's political crisis from spurring much in the way of financial market consequences. Growth momentum looks to have peaked: The European Commission's three key sentiment surveys – the consumer confidence indicator, business climate indicator, and the economic sentiment index – all edged lower for a second consecutive month in February from cyclical highs reached in December. HICP inflation slowed to 1.2 percent in year-ago terms in the February flash estimate from 1.3 percent in January. A drop in unprocessed food prices was behind the slowdown in headline inflation, while core measures of HICP were little changed between 1.0 and 1.2 percent. Inflation has still "yet to show convincing signs of a sustained upward trend," the phrase repeated four times in the Account of the ECB's January 24-25 monetary policy decision. The ECB is likely to continue buying sovereign bonds past the September minimum it has so far set for the asset purchase program. But if German Bundesbank President Jens Weidmann – the most hawkish member of the Governing Council – is chosen to replace Mario Draghi as ECB President in November 2019, longer-maturity yields could begin to reflect expectations of tighter monetary policy after Draghi's retirement.

JAPAN: Bank of Japan Governor Haruhiko Kuroda stated March 2 that the BoJ would begin to "consider and debate an exit" from quantitative easing if inflation rises toward their target during the 2019-2020 fiscal year as the BoJ projects. This comment is Japan's closest analogue yet to former Fed Chairman Benjamin Bernanke's speech in May of 2013 preparing financial markets for the beginning of a US taper; echoing how US long-term interest rates rose in 2013 following Chairman Bernanke's speech, Japanese 10-year government bond yields have risen into early 2018 and the yen has appreciated against the dollar. Headline and trend inflation are rising, but still well below the Bank of Japan's 2 percent target. Tokyo's headline CPI (a leading indicator of national CPI) was 1.4 percent in year-ago terms in February, above January's 1.3 percent and the highest since March 2015. The Bank of Japan's measures of core inflation were around a quarter of a percent in year-ago terms in the January release, but Tokyo CPI ex food and energy (the US core definition) jumped to 0.5 percent in year-ago terms from 0.2 percent and was the fastest since May 2016. Japan's job market is tight (the unemployment rate fell to 2.4 percent in January, the lowest since April 1993), but average hourly earnings are still only increasing about 1 percent in year-ago terms. If Japan's trade union confederation wins a large wage increase in March (they are aiming for four percent), that would move the inflation outlook, but in the base case employers will probably argue that the yen's appreciation against the dollar justifies keeping wage increases moderate. In 2019, Japan's government is planning to raise the value added tax from 8 to 10 percent, a new headwind to the economy, and the reverse of the US policy mix. That's another reason for the Bank of Japan to hold the short-term and long-term interest rate targets unchanged throughout 2018, which is PNC Economics' baseline forecast.

CANADA: Real GDP grew 1.7 percent annualized in the fourth quarter of 2017, close to the third quarter's 1.5 percent increase and down from a 4.2 percent average in the first half of the year; for all of 2017, real GDP grew a strong 3.0 percent. PNC Economics forecasts for Canada's February labor force survey to show employment up a modest 2,600 in February after January's 88,000 drop, and for the unemployment rate to hold steady at 5.9 percent. We expect the Bank of Canada to hold the overnight rate target unchanged at

1.25 percent at their March 7 monetary policy decision, and to wait until July to next raise the overnight rate target. In the base case, PNC Economics forecasts for the Bank of Canada to only raise its policy rate once in 2018 as they monitor the housing market's reaction to higher interest rates and tighter mortgage rules, and as they monitor changes in US-Canadian trade policy.

CHINA: The Chinese government again set a goal of real GDP growth of "about 6.5 percent" as a target for 2018 at the March meeting of the Chinese People's Political Consultative Conference and National People's Congress. China's economic institutions continue to implement a "neutral" monetary policy and a "proactive" fiscal policy, and will target a fiscal deficit of 2.6 percent of GDP in 2018, smaller than 2017's target of 3 percent or 2017's realized fiscal deficit of 3.7 percent. Fiscal and monetary policy in China are tightening noticeably.

MEXICO: The Bank of Mexico's February 2018 quarterly Inflation Report maintained unchanged a forecast for real GDP growth between 2.0 and 3.0 percent in 2018 and between 2.2 percent and 3.2 percent in 2019. The bank revised up its forecast for headline and core CPI inflation in 2018, but left the 2019 forecast mostly unchanged. Barring the dissolution of NAFTA or a shock to markets from Mexico's July election, the Bank of Mexico will find room to reduce interest rates to a more neutral stance in the second half of 2018.

BRAZIL: Labor market data continue to improve: The unemployment rate was 12.2 percent in the rolling three months through January, not seasonally-adjusted. In year-ago comparison, the unemployment rate fell 0.4 percentage points in the latest release, more than the 0.2 percentage point year-ago decline in the three months through December. Employment grew 2.1 percent in year-ago terms in the most recent three months, and the employed share of the working-age population rose to 54.2 percent from 53.7 percent a year earlier.

INDIA: Real GDP growth accelerated to 7.2 percent in year-ago terms in the fourth quarter of 2017, the fastest in five quarters, as capital spending recovered from late 2016's demonetization and the mid-2017 implementation of the Goods and Services Tax. Gross value added, the sectoral tally of GDP, grew a slower 6.7 percent in year-ago terms in the fourth quarter, but it too picked up to its fastest in four quarters as activity firmed in manufacturing, construction, and services.

Disclaimer: The material presented is of a general nature and does not constitute the provision of investment or economic advice to any person, or a recommendation to buy or sell any security or adopt any investment strategy. Opinions and forecasts expressed herein are subject to change without notice. Relevant information was obtained from sources deemed reliable. Such information is not guaranteed as to its accuracy. You should seek the advice of an investment professional to tailor a financial plan to your particular needs. © 2018 The PNC Financial Services Group, Inc. All rights reserved.

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