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GLOBAL ECONOMIC HIGHLIGHTS

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FED RELEASES PLAN TO SHRINK BALANCE SHEET LATER THIS YEAR; OIL PRICES FALL ON HIGH INVENTORIES

UNITED STATES: As expected, the Federal Reserve raised the federal funds target range 0.25 percentage points to a range of 1.00 to 1.25 percent at today's Open Market Committee meeting; Minneapolis Fed President Neel Kashkari dissented, preferring to leave the federal funds target unchanged. The Fed also announced its plan to reduce the size of its balance sheet, which it "expects to begin implementing… this year, provided that the economy evolves broadly as anticipated." The Fed will initially reduce its balance sheet by $10 billion per month, split 60-40 between Treasury securities and agency/mortgage-backed securities. In each subsequent quarter, the Fed will increase the monthly roll-off of securities by $10 billion dollars, until the monthly reduction in the balance sheet reaches $50 billion dollars in the fifth quarter of normalization. The Fed does not have a specific number in mind for the steady state size of the balance sheet, and so is unsure when normalization will end. They plan to monitor the effects of balance sheet normalization on the financial system, and expect their balance sheet's steady-state level to be "appreciably below that seen in recent years but larger than before the financial crisis" – a multi-trillion dollar range! In addition, the Fed emphasized today that it could suspend the run-off of its balance sheet or even restart quantitative easing if economic conditions deteriorate and warrant a shift to monetary stimulus. The dot plot of forecasts produced by FOMC members and Federal Reserve Bank presidents revised down the forecast for PCE inflation in 2017, reflecting the recent decline in commodity prices, but also revised down the projection for the unemployment rate to 4.3 percent in 2017 and 4.2 percent in 2018 and 2019, below their 4.5-4.8 percent forecast for the longer-run range of the unemployment rate (itself revised down from a range of 4.7-5.0 percent at the March 2017 round of forecasts). US crude oil production rose 0.1 percent on the week during the week of June 9, and commercial petroleum inventories retreated 0.3 percent after growing 0.6 percent the prior week; petroleum inventories grew 1.2 percent from a year earlier and are within 1.2 percent of an all-time high. WTI crude fell 3.5 percent after the energy statistics' release to just under $45 per barrel. The 10-year government bond yield was little changed intraday at 2.12 percent following the FOMC announcement, and has trended lower since March as financial markets have either rolled back or entirely discounted the likelihood of fiscal stimulus policies. With both inflation and the unemployment rate below the Fed's medium-run targets, and Chair Yellen stating today that balance sheet normalization could begin "relatively soon," PNC Economics forecasts that the Fed will not make a rate hike in September, but will instead announce the beginning of balance sheet normalization, and will wait until December 2017 to next raise the federal funds target range another 0.25 percentage points.

EUROZONE: As expected at its Governing Council meeting last Thursday June 8, the ECB changed its guidance on interest rates to indicate that the next change in policy interest rates will likely be a hike rather than a cut; however, the ECB did not provide guidance on how rapidly it would reduce asset purchases (a.k.a. quantitative easing or QE) in 2018, and continues to expect interest rates to remain unchanged until "well beyond the horizon" of the conclusion of the taper of its QE program. Economic growth is above trend. Employment rose 0.4 percent in seasonally-adjusted terms (not annualized) in the first quarter of 2017, unchanged from the prior quarter. In year-ago terms, employment grew 1.5 percent from a year earlier, up from 1.4 percent in the fourth quarter of 2016 and 1.3 percent in the third. By major economy, employment grew 0.5 percent in Germany, 0.7 percent in Spain, 0.3 percent in Italy, and 0.2 percent in France. From a year earlier, employment in Germany, Spain, Italy and France grew 1.5 percent, 2.4 percent, 1.0 percent, and 0.7 percent, respectively. The smaller economies that had been at the heart of the Eurozone sovereign debt crisis are seeing strong job growth too: Employment rose 1.0 percent on the quarter in Portugal and Greece, and 1.1 percent in Ireland. From a year earlier, employment in the three economies grew 3.3 percent, 1.3 percent, and 3.5 percent, respectively. The sectoral composition of employment growth was mixed for productivity and wages. Employment in industry grew 0.2 percent on the quarter and 0.7 percent on the year, and employment in construction 0.8 percent and 1.4 percent on the quarter and year, respectively. Both lagged aggregate employment, and since productivity and wages in industry tend to exceed those in services, the trend is negative for Eurozone productivity and wage growth. Possibly offsetting this, employment growth in more productive service sectors was faster than for the rest of the economy. Employment in information and communication grew 0.3 percent on the quarter and 2.7 percent on the year, employment in professional and support service activities grew 1.0 percent on the quarter and 2.9 percent on the year. The Eurozone jobs data reinforces the message of recent GDP data: The Eurozone is no longer a crisis economy, and has entered a virtuous cycle of rising employment and income, fueling consumer demand, in turn fueling more business revenue, hiring, and wage growth. If above-trend economic growth continues, the ECB will begin a molasses-slow taper of its asset purchase program in January 2018, reducing monthly purchases by 5-10 billion euros per month, and completing a taper of quantitative easing between July and December, 2018. If the ECB waits “well beyond the horizon” of the conclusion of a taper to make an initial policy rate hike, that hike is unlikely before 2019. And, if the ECB allows a full year to elapse between the conclusion of quantitative easing and an initial hike, following the precedent of the Federal Reserve’s very gradual withdrawal of monetary stimulus in 2014 and 2015, short-term benchmark interest rates in the Eurozone are likely to be negative when ECB President Mario Draghi’s term concludes in October 2019. In the interim, if an electoral upset creates doubt about political support for the European Union or Brexit negotiations increase downside risks to Eurozone growth, the ECB is likely to withdraw stimulus even more slowly than we expect.

CANADA: Canadian household employment surged 55,000 in May, beating the pants off of PNC’s forecast of 11,300 and the consensus estimate of 15,000. The unemployment rate rose 0.1 percentage points to 6.6 percent, matching consensus, on a 0.2 percentage point increase in the labor force participation rate to 65.8 percent - good news that reflects more Canadians looking for work as their view of hiring prospects brightens. Details were glorious. Full-time employment rose even faster than the headline, by 77,000, offsetting a 22,300 decrease in part-time employment. Similarly, more stable jobs held by employees rose 68,500 on the month and offset a 14,000 decline in self-employment. High-wage goods-producing employment rose by a strong 0.6 percent or 23,300 on the month, with a 25,300 surge in manufacturing employment and 2,800 new jobs in resource sectors offsetting slight declines in agriculture, utilities, and construction. Yet even after May’s terrific increase in the quantity and quality of jobs, lingering effects of the 2015-2016 energy downturn are still apparent. Many men who had been working full-time in positions related to energy a few years ago are in part-time positions now: Part-time employment of Canadian men over 25 was up 8.5 percent in year-over-year terms in May, with full-time employment up only 1.2 percent. As a consequence, total hours worked rose a modest 0.7 percent on the year, lagging the 1.8 percent year-ago increase in employment. May’s surge in manufacturing employment follows equally strong growth of Canadian manufacturing output in the first quarter of 2017 and terrific business survey data for the second quarter. The month’s excellent jobs report brings Canada closer to an initial increase in the overnight rate target, which has been on hold at 0.50 percent since July 2015, a message which Deputy Governor of the Bank of Canada Carolyn Wilkins reinforced in a speech Monday. PNC Economics expects an initial Canadian policy rate hike in January 2018, but if the very strong job growth of the first half of 2017 continues in the second half, the Bank of Canada could make a first rate hike in 2017.

JAPAN: Real GDP growth was revised down sharply to 1.0 percent in the second preliminary estimate for the first quarter of 2017 from 2.2 percent in the first estimate. A large downward revision to inventories accounted for half of the drop in real GDP growth, but household consumption and residential investment were also revised down, partially offset by stronger nonresidential investment. We expect the Bank of Japan to leave its monetary stance unchanged at its June decision which will be released overnight Thursday.

UNITED KINGDOM: Prime Minister Theresa May’s decision to call a special election on June 8 backfired. The ruling Tory (Conservative) Party lost 12 parliamentary seats, putting them below the 326 seat majority needed to form a government. They are negotiating a coalition with the Democratic Unionist Party (DUP), a pro-London Northern Irish party whose 10 parliamentary seats would be majority in combination with the Tories. If successful, their coalition government could push the UK toward a more conciliatory position on Brexit. The DUP are likely to insist that Brexit preserves the open border between Northern Ireland and the Republic of Ireland, an EU member state. While this was officially a goal of the Tory government, it would become much more important if its achievement were a precondition of the Tories retaining control of parliament. If so, the UK may ultimately accept the free movement of EU residents into the UK, at least through Northern Ireland's border – the EU does not and will not restrict movement of EU residents into the Republic of Ireland. That could in turn allow the UK to retain the right to export most services to other EU markets after Brexit, a substantial boost to Britain's economic outlook since services exports to the EU comprise about 5 percent of the UK's GDP. The UK's electoral upset throws some sand in the country's Brexit planning gears. But since it was on course for a hard Brexit prior to the election, that may not be such a bad thing. Financial markets price in a bit less than an one in four likelihood of a Bank of England policy rate hike by June 2018, down from around one in three prior to the June 8 election; these and similarly modest shifts in other financial prices due to the UK election have no material implications for the US growth or inflation outlook or for Fed policy.

AUSTRALIA: Consumer confidence dipped to a 14-month low of 96.2 in June from 98.0 in May, according to the Westpac-Melbourne Institute index. The decline was driven by less optimistic expectations for the economy one year ahead and five years ahead. On the positive side, the current conditions sub-index and expectations for family finances one year ahead rose in June. Weaker expectations for the economy were likely due to the weak GDP report that came out during the polling period and the recent cooling in home price appreciation in some cities. At the same time, households may be becoming more upbeat about prospects for personal finances as the labor market adds more full-time jobs. In a separate release, the National Australia Bank's index of business confidence showed firms are more upbeat than households. The NAB's index slipped to +7 in May from +13 in April but the index is still above its long-run average of +6. The separately reported business conditions index slipped marginally to a still high +12 in May from +13 in April. Favorable trading conditions and stable forward orders were important supports to favorable business conditions. Also, profitability fell in May but remained high, and the capacity utilization rate increased to 82.4 percent, the highest level since 2008 according to this measure. Taken together, the business and consumer confidence indices point to moderate growth for the Australian economy in 2017, albeit with more upside potential for business investment than for household spending.

MEXICO: Industrial production fell 0.3 percent in April from March, and was down 0.3 percent on the year. Mexican industrial production has contracted in year-over-year terms for five consecutive months, and in nine of the last 12. April's monthly decline was broad based: Mining output fell 0.9 percent on the month and 9.5 percent on the year, utilities output fell 0.3 percent on the month and 1.2 percent on the year, construction 1.7 percent on the month and 2.6 percent on the year. Manufacturing was a lonely bright spot, with output up 0.6 percent on the month and 5.1 percent on the year, but its strength was not enough to offset the weakness of the rest of Mexican industrial activity. Other recent data were also soft. The monthly index of gross fixed investment fell in month over month terms in two of the three months of the first quarter of 2017, and declined in year-over-year terms in all three months. The monthly index of private domestic consumption fell 0.4 percent on the month in March, the fourth decline in the most recent six months. The peso has appreciated about 20 percent against the US dollar from mid-January to early June, and is 17.9 per dollar today. It's appreciation, more than reversing 2016's fall, coincided with a pullback in long-term US bond yields as financial markets marked down the likelihood of major US tax, stimulus, or trade policy changes. This policy-focused narrative overlooks the last 12 months' shift in the fundamentals underlying the peso-dollar exchange rate in favor of the dollar and against the peso: The US unemployment rate is down to 4.3 percent, the Fed raised interest rates for a third consecutive quarter in June, and – as demonstrated by April's industrial production report – growth momentum in Mexico is lagging. Low oil prices are a drag on energy output, related capital spending, tax revenue, and public infrastructure spending, and hikes in Mexican interest rates since late 2015 are a headwind to consumer credit growth, housing, and construction. If that were not enough, the huge spike in consumer energy prices in January are another major drag on domestic demand. Even if the NAFTA renegotiation is a red herring – a big if – economic fundamentals do not support the peso's rally continuing in the second half of 2017 or 2018.

INDIA: Industrial production slowed to 3.1 percent in year-ago terms in April from 3.8 percent in March, with slower growth in electricity and mining output offsetting a slight pickup in manufacturing. CPI inflation slowed to 2.2 percent in May from 3.0 percent in April, as good harvests pushed food prices down 1.0 percent on the year; core inflation (excluding food and energy) was 4.1 percent in May, the slowest since the current CPI index began in January 2012.

BRAZIL: Consumer inflation measured by the IPCA index slowed to 3.6 percent in May from 4.1 percent in April and was the slowest since May 2007. Slower increases in food prices, which rose 2.4 percent on the year in May after 3.5 percent in April, and a year-over-year 0.4 percent decline in appliance prices (had been up 0.5 percent in April) reflect lagged pass-through of the stronger Brazilian real, raising prices of tradable goods. But services inflation slowed as well in May: Health and personal care costs rose 7.8 percent in year-ago terms, down from 8.9 percent in April, and personal expenses rose 5.3 percent, down from 6.5 percent in April. Slower inflation and in particular slower services inflation will likely keep the Central Bank of Brazil cutting interest rates in the second half of 2017, despite the uncertain outlook for Brazilian pension and other fiscal policy reforms amid the country's political crisis.