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GLOBAL ECONOMIC HIGHLIGHTS

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THE FED IS READY TO SHRINK ITS BALANCE SHEET SOON, AND A TAPER OF THE ECB'S QE PROGRAM DRAWS NEARER

UNITED STATES: The minutes from the Federal Open Market Committee's meeting on July 25 and 26 indicate that the FOMC is ready to start reducing the size of the Fed's balance sheet soon. According to the minutes, while "several participants were prepared to announce a starting date for the program at the current meeting, most preferred to defer that decision until an upcoming meeting." Shrinking its balance sheet will put modest upward pressure on longer-term interest rates, which the FOMC members emphasized would "contribute only modestly to the reduction in policy accommodation." One of the concerns about the path of monetary policy is the outlook for inflation, which has slowed in recent months. According to the minutes, "many participants noted that much of the recent decline in inflation had probably reflected idiosyncratic factors…most participants indicated that they expected inflation to pick up over the next couple of years." In addition, most participants expected a tighter labor market to eventually push wages and inflation higher. In fact, "a few participants expressed concerns about the possibility of substantially overshooting full employment," causing wage growth to accelerate and inflation to exceed the Fed's target. Others, however, cited a lack of wage pressures in arguing that this risk was small. Overall, the minutes indicate some uncertainty about the near-term path of the federal funds rate. Some participants suggested holding off on further increases, citing the slowing in inflation in the first half of 2017 and arguing that the FOMC can afford to be patient. Others are worried about moving beyond full employment, and some about too-loose monetary policy leading to instability in financial markets. On balance, the minutes are consistent with PNC's outlook for monetary policy. At its next meeting, on September 19 and 20, the FOMC is likely to announce that it will begin reducing the size of the Federal Reserve's balance sheet on October 1. The Fed will let small amounts of maturing long-term Treasuries and mortgage-backed securities roll off the balance sheet, gradually increasing those amounts over the next year. The next increase in the fed funds rate is likely to come at the FOMC's December 12-13 meeting. Waiting until December would allow the FOMC to judge how the balance sheet reduction process is going, how financial markets are responding to it, and give inflation time to pick up. Fed Chair Janet Yellen could provide further detail about the FOMC's plans at her speech in Jackson Hole at 10am Eastern time on Friday, August 25.

EUROZONE: Financial markets also will listen closely to ECB President Mario Draghi's speech at Jackson Hole Friday August 25 at 3 pm in US Eastern timezones, a few hours after Chair Yellen's, for signs of how the ECB will taper its quantitative easing program in 2018. The "account" (minutes) from the ECB's July 19 and 20 Governing Council meeting released last week show that they want to avoid changes to monetary policy which would cause additional appreciation of the euro or excessive "tightening" of financial conditions, like a large increase in long-term government bond yields. Since the exchange rate was $1.15-$1.16 dollars per euro on July 19 and 20 and is $1.18 today, and since 10-year government bond yields in July were a little above the levels assumed in the ECB's latest macroeconomic forecasts, the ECB Governing Council probably wants to avoid surprising financial markets with hawkish statements over the next few months. Economic growth continues above trend: The Markit manufacturing PMI rose to 58.1 in the August flash release from 56.5 in July, while the services PMI dipped to a seven-month low of 54.9 from 55.4.

CANADA: Retail sales grew 0.1 percent in June from May and jumped 7.3 percent from a year earlier. In inflation-adjusted or real terms, retail sales in June grew 0.5 percent from May and 7.8 percent from June

2016. Sales at motor vehicle and parts dealers fell 1.4 percent on the month, a correction after strong growth in late 2016 and early 2017, but were still up 9.6 percent on the year. Sales excluding motor vehicle and parts dealers and gasoline stations grew a strong 1.1 percent in monthly terms and 6.6 percent in year-ago terms. Canadian consumer spending is sustaining the economic expansion. Canada saw excellent job growth in the first half of 2017, with growth in both hiring into full-time positions and in manufacturing sector jobs, both of which will boost incomes. Better incomes are now helping consumer spending pick up too. The ongoing correction in Canadian housing is a vulnerability for consumer spending and the economy more broadly: Home sales fell 2.1 percent in July from June and were down a cumulative 15.3 percent from their recent peak in March, the month before Ontario enacted its “Fair Housing Plan” tax on foreign housing purchases. Tighter Chinese government restrictions on capital outflows are also a headwind to Canada’s housing market. But so far, the housing correction has not translated into a broader economic drag, in part because prices have not followed transactions lower: The Canadian MLS® home price index rose 12.9 percent in year-over-year terms in July, and the 0.3 percent year-ago decline in average sales prices reflects fewer sales in the expensive Greater Toronto and Vancouver markets rather than an outright decline in home values. June’s strong retail sales report is another reason why the Bank of Canada is likely to raise its policy interest rate 0.25 percentage points to 1.0 percent at its October 25 monetary policy decision. The Bank of Canada is following the Federal Reserve as the second of the major advanced-economy central banks to begin normalizing interest rates.

UNITED KINGDOM: The British government published new position papers on Brexit this week, proposing continued status quo exports of British goods to EU markets after Brexit and of EU imports into the UK; the EU has stated that they do not plan to discuss trade arrangements with the UK before settling political issues related to Brexit are settled, including the size of the UK’s “exit bill” payment to Brussels for leaving the union, the status of UK nationals in the EU and vice versa, and the land border between Northern Ireland and the Republic of Ireland. The EU will most likely stonewall British demands for immediate discussion of trade arrangements to demonstrate to other EU members that it does not give the UK better terms than it does to other members. Household finances are deteriorating but the labor market is strong: The IHS Markit Household Finance Index reported inflation outpaced pay growth in August, a blow to discretionary spending power. By contrast, the Markit/REC Report on Jobs reports July saw the fastest growth in permanent job placements in 27 months and wage growth was its fastest in 20 months due to strong labor demand and a tightening labor market.

JAPAN: Real GDP grew 4.0 percent annualized in the second quarter of 2017 from the first. Domestic demand fueled the strong quarterly increase: Household consumption added two percentage points to the annualized quarterly increase and private nonresidential investment 1.5 percentage points. Trade was a drag on growth in the quarter, since exports fell and imports grew; import growth is confirmation of strong domestic demand. From a year earlier, seasonally-adjusted real GDP grew 2.1 percent in the second quarter, faster than the first quarter’s 1.4 percent year-ago increase and matching growth in the United States. Despite solid real GDP growth that handily outpaces Japan’s 0.5-1.0 percent trend rate, the economy is far from generating enough inflationary pressure to raise CPI inflation to the Bank of Japan’s two percent target: The Bank of Japan’s measures of core inflation are between 0.0 and 0.3 percent, global oil prices have risen little in 2017, and the yen’s recent strength against the dollar lowers the yen-denominated prices of imported goods and by extension inflation. The Bank of Japan is likely to wait until both headline and core inflation rise above two percent before tapering its quantitative easing program. The BoJ’s also seems likely to continue buying equities at their current pace through the end of 2018 at least.

AUSTRALIA: July’s labor market indicators point to slow and steady improvement in the job market. Total employment rose by 27,900 between June and July, more than the 14,000 consensus expectation. June’s job gains were revised up as well. The unemployment rate fell by 0.1 percentage point to 5.6 percent in July even as the participation rate ticked up to 65.1 percent in July from 65.0 percent in June. This is the highest participation rate since January 2016 and indicates job seekers are increasingly confident in their employment prospects. The downside to the June figures was that full-time jobs fell by 20,300 while part-time employment rose by 48,200. Nevertheless, labor market data have been much better in 2017 than they were in 2016. Job growth has averaged 28,900 per month so far this year compared with an average gain of just 8,800 per month in 2016. Moreover, even after June’s decline, full-time employment gains in 2017 have outnumbered part-time positions by more than three-to-one. In light of these data, the Reserve Bank of Australia will likely keep its target cash rate at 1.50 percent until the second half of 2018. While the shift in job growth toward full-time positions is encouraging, it has not been strong enough to cause wages to accelerate materially.

CHINA: July's monthly indicators report steady economic growth and financial conditions. Aggregate growth of debt financing to the nonfinancial sector ticked up slightly to 13.0 percent in year-ago terms in July from 12.5 percent in June; equity financing grew 20.1 percent, little changed from June's 21.7 percent increase. Value added of industry grew 6.4 percent in July, down from 7.6 percent in June; the trend in 2017 has been growth of about 6.75 percent, up from about 6.25 percent in the second half of 2016. Cumulative investment in fixed assets slowed to 8.3 percent in the seven months through July from 8.6 percent in the six months through June, and retail sales slowed to 10.4 percent in year-ago terms in July from 11.0 percent in June.

BRAZIL: Inflation in mid-August was 2.7 percent in year-ago terms, unchanged from July's reading. Slower inflation is creating room for less tight monetary policy and a revival of private investment and consumption, as described in our in-depth Brazil Update released last week.

MEXICO: Real GDP grew 2.3 percent annualized in the second quarter of 2017, down from 2.7 percent growth in the first quarter and 2.9 percent growth in the fourth quarter of 2016. From a year earlier, real GDP grew 3.0 percent in the second quarter, up from 2.6 percent in the first. By industry, a 7.4 percent annualized drop in volatile primary output (agriculture/livestock/fishing/logging) was behind much of the quarterly slowdown in GDP growth. Secondary or industrial activity grew a scant 0.1 percent annualized in the second quarter after 0.6 percent in the first, with ongoing weakness in construction and mining output and a small correction in manufacturing after strong growth in the prior three quarters. Tertiary or services output grew 3.3 percent in annualized quarterly terms, or 4.1 percent from a year earlier. In current prices, annualized Mexican GDP was 20.77 trillion pesos or $1.2 trillion US dollars, about 6 percent of the US economy's $19.2 trillion in the second quarter. Mexico's monthly real GDP index grew 0.5 percent in June from May, with primary activity up 4.4 percent, secondary activity up 0.1 percent, and tertiary activity up 0.4 percent. From a year earlier, the monthly index grew 2.4 percent in June, with primary up 2.2 percent, secondary unchanged, and tertiary up 3.9 percent.

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