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ECONOMIC REPORT

Stuart Hoffman
Chief Economist
Gus Faucher
Senior Economist
William Adams
Senior Economist
Kurt Rankin
Economist
Mekael Teshome
Economist

THE PNC FINANCIAL SERVICES GROUP | Three PNC Plaza | 225 Fifth Avenue | Pittsburgh, PA 15222-2724

BERNANKE EMPHASIZES RATE HIKES NOT IMMINENT; DROP IN HOUSING STARTS MORE BAD NEWS FOR Q2 GROWTH

SUMMARY

- In his testimony before a House committee today, Fed Chairman Bernanke again stated that any increase in the Fed funds rate is likely to come well after the central bank ends its asset purchases under quantitative easing.
- Bernanke also restated a tentative schedule for the Fed to reduce its asset purchases starting later this year.
- In the Q&A session Bernanke noted the economic benefits of the Fed's current very aggressive monetary policy.
- Housing starts fell in June, contrary to expectations for an increase. Starts were down significantly in the second quarter from the first, another indication that GDP growth in the second quarter was subpar.
- Despite the drop in housing starts in June homebuilding will strengthen in the second half of 2013, and residential construction will remain an important growth driver.

Federal Reserve Chairman Ben Bernanke testified on Wednesday before the House Financial Services Committee. In his prepared remarks Bernanke reaffirmed his recent statements on monetary policy. In terms of quantitative easing—Fed purchases of long-term Treasury bonds and mortgage-backed securities designed to put downward pressure on long-term interest rates—Bernanke said that if the economy continues to improve as projected, the Fed will start to reduce its current $85 billion per month of purchases later this year, and then wrap them up by the middle of next year. This conforms with recent statements. However, Bernanke again said that the path of purchases could change depending on economic conditions. And Bernanke said that "if financial conditions—which have tightened recently—were judged to be insufficiently accommodative to allow us to attain our mandated objectives, the current pace of purchases could be maintained for longer." That is, if long-term rates, including mortgage rates, move high enough so that they appear to be choking off the recovery, the Fed would hold off on reducing its asset purchases.

Bernanke also discussed the conditions under which the Federal Open Market Committee would raise the Federal funds rate. As he said last week in a Q&A session, he emphasized that the Fed would not automatically raise the Fed funds rate once the unemployment rate falls below 6.5 percent or inflation one to two years out looks set to rise above 2.5 percent. Bernanke said "that the specific numbers for unemployment and inflation in the guidance are thresholds, not triggers. Reaching one of the thresholds would not automatically result in an increase in the federal funds rate target; rather, it would lead the Committee to consider whether the outlook for the labor market, inflation and the broader economy justified such an increase." Bernanke went on to say that if the unemployment rate were falling because of a lower labor force participation rate, the FOMC would likely not raise the Fed funds rate once the unemployment rate fell below 6.5 percent. Similarly, he said that "the Committee would be unlikely to raise the funds rate if inflation remained persistently below our longer-run objective" of 2 percent inflation, measured using the personal consumption expenditures price index.

Today's statement is designed to reassure markets that the Fed remains concerned about economic growth, and in particular the slow pace of the labor market recovery. Bernanke's reassurances last week that the Fed was going to be cautious in raising short-term interest rates buoyed equity and fixed income markets, and both stock and bond prices are up again this morning, with the yield on the 10-year Treasury bond falling below 2.50 percent.

In his question and answer session following his prepared testimony Bernanke was asked about the benefits of the Fed's current very aggressive monetary policy. Bernanke noted that two of the sectors that are leading growth, housing and

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autos, are very interest rate sensitive, and he attributed their improvements in large part to Fed policy and very low interest rates.

PNC expects that the Fed will begin to reduce its asset purchases later this year, likely following the FOMC's mid-September meeting, when Bernanke will be giving a press conference. The purchases are likely to wrap up in the middle of 2014. The unemployment rate will fall below 6.5 percent in early 2015, but PNC does not expect the FOMC to increase the Fed funds rate from its current near-zero level until the second half of 2015.

Housing starts unexpectedly fell 10 percent in June, to 836,000 at a seasonally-adjusted annualized pace, from 928,000 in May (revised up from 914,000). For the second quarter as a whole starts were down 31 percent at an annual rate from the first quarter, another indication that second quarter GDP growth was quite soft. There is significant downside risk to PNC's forecast for 1.8 percent annualized real GDP growth in the second quarter.

Single-family starts fell less than 1 percent (not annualized) from May to June, while more volatile multifamily starts were down 26 percent. Multifamily starts have been especially volatile recently, and some of the first quarter strength, and subsequent second quarter decline, could be due to seasonal adjustment problems. More encouragingly, single-family housing permits rose 0.6 percent in June, although multifamily permits fell 21 percent.

Despite the weak June housing starts numbers, residential construction is turning around (see Chart). The National Association of Home Builders' housing market index rose in July to its highest level since January 2006, and single-family permits have risen for three straight months. High affordability (despite recent increases in mortgage rates), an improving labor market, pent-up demand, and easing credit will continue to support new home sales and residential construction through the rest of 2013 and into 2014. Housing will remain an important driver of near-term economic growth.

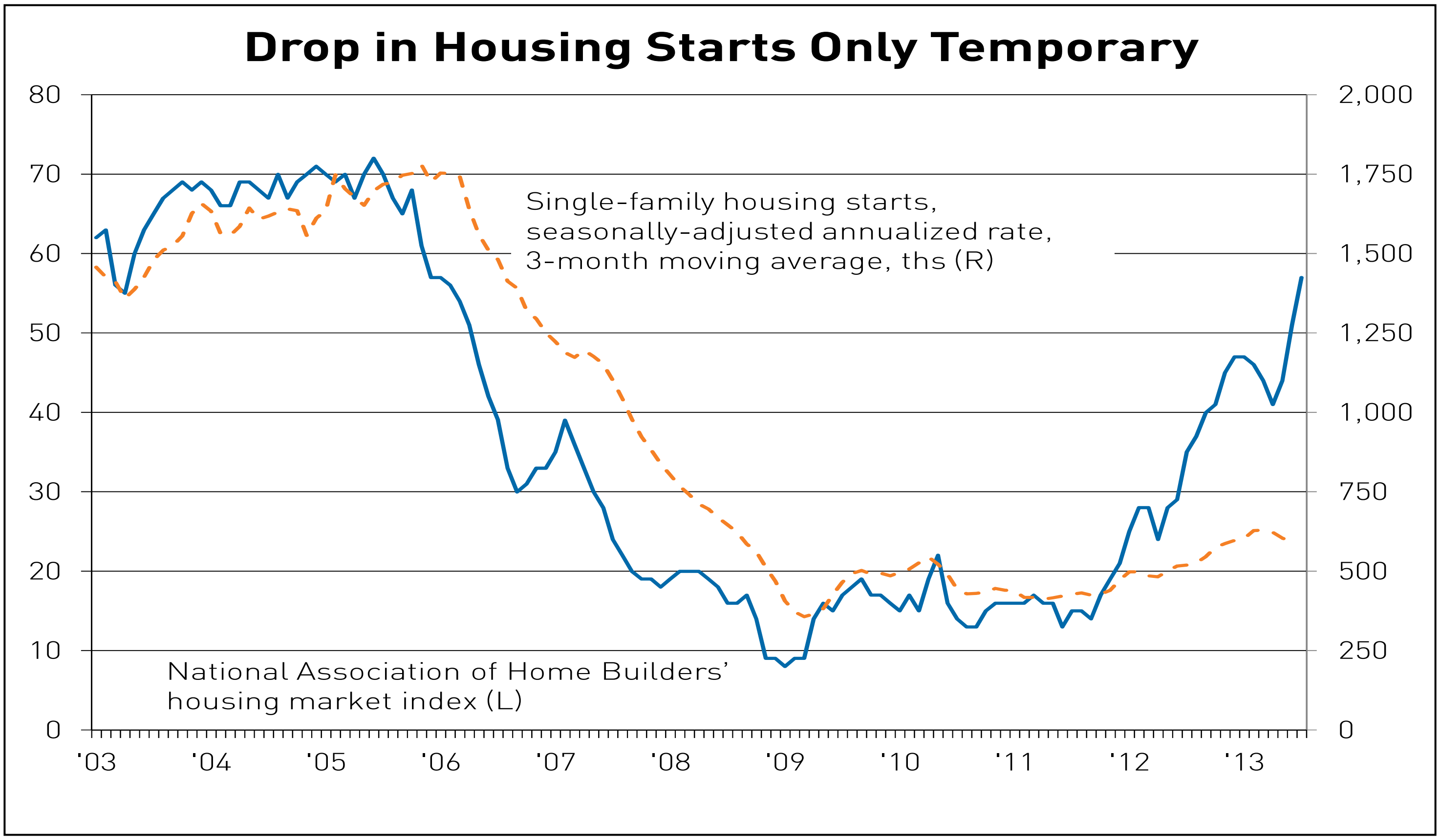

Chart source: NAHB, Census

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