

Fed Expected To Pause Hiking Cycle This Week; Eurozone Enters Mild Recession

UNITED STATES: The Federal Open Market Committee (FOMC) is expected to maintain the federal funds rate in its current range of 5.00% to 5.25% at its two-day meeting which ends on June 14. The FOMC statement will likely note that policymakers will continue to assess the lagged effects of the past rate hikes on the U.S. economy but will remain data dependent for the July 25-26 meeting. PNC expects the FOMC to maintain the fed funds rate in its current range of 5.00% to 5.25% through the rest of this year. Inflation, economic growth, and job growth are all slowing as higher interest rates weigh on economic activity. Given that monetary policy is now contractionary, weighing on growth, and a tightening on credit since the banking system problems began is also likely contractionary, the central bank is set to hold off on further increases in the fed funds rate until the outlook becomes clearer.

PNC forecasts for the May Consumer Price Index (CPI) report to be released on June 13, to show consumer prices up 0.1% from May; core CPI excluding food and energy prices likely rose 0.4% in May as new car prices continue to fall. On a year-over-year basis, headline CPI likely decelerated to 4.2% from 4.9% in April. The core CPI will likely decline to 5.3% from 5.5% in April.

The ISM services index in May was just above the 50 threshold that indicates expansion, according to the Institute for Supply Management. The index was at 50.3% in May, down from 51.9% in April. May was the lowest reading for the index since it slipped into contraction for one month in December 2022. The index has fallen in three of the past four months. Although the services sector is still expanding, growth is slowing and is just barely positive. The best news in the ISM services index for May was continued growth in the forward-looking new orders subindex, although the pace of expansion slowed. The ISM manufacturing index was in contraction at 46.9% in May, down from 47.1% in April; it has been in contraction since November 2022. Taken together, the services and manufacturing ISM indices point to slowing and weak, but still positive, growth in mid-2023. The ongoing declines in the two indices are likely to persist, with the U.S. economy set to enter recession around the end of 2023 as the cumulative impact of higher interest rates continues to weigh on activity.

The U.S. trade deficit in goods and services widened sharply in April to a six-month high, according to data from the U.S. Census Bureau. It widened by \$14.0 billion to \$74.6 billion in April from \$60.6 billion in March. This was better than the consensus expectation for a widening to \$75.8 billion. Total exports fell 3.6% in April from the prior month while imports rose 1.5%. Trade was neutral for U.S. economic growth in the prior quarter but will likely be modestly negative for growth in the current quarter as a weak Chinese economy, high inflation and tight financial conditions outside the U.S. weigh on exports, and imports slightly improve with solid U.S. consumer spending and easing global supply-chain networks.

Initial claims for unemployment insurance (UI) increased by a large 28,000 to 261,000 for the week ending June 3 from 233,000 in the previous week. The four-week moving average of claims, which smooths out some of the weekly volatility, increased by 8,000 to 237,000. A new plateau in the initial claims does seem to have formed at close to 235,000. PNC continues to forecast that the FOMC will play “hopscotch” by “hopping, skipping or jumping” over a rate hike at its two-day meeting which ends on June 14. A small rise (0.1%) in the May headline CPI released on June 13 will reinforce the FOMC’s decision to hold tight. U.S. labor markets continue to experience exceptionally tight conditions, but the sustained increase in UI claims and potential further uptrend because of spreading layoff announcements could be the first steps along a path to more balanced labor market conditions.

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EUROZONE: The eurozone economy slid into a mild recession in the first quarter of this year according to new data from the European Statistical Office (Eurostat). Revised data showed that real GDP shrunk by 0.1% in the first quarter of this year, following a contraction of the same magnitude in the fourth quarter of 2022. The decline in output in the first quarter of this year was driven by weaknesses in household and government spending. Inventories were also a drag on GDP, but trade made a positive contribution.

The mild recession is unlikely to stop the European Central Bank (ECB) from raising its policy rates when central bankers meet on June 15. CPI inflation has eased remarkably in the past year but is still more than three times the ECB's target of 2%. PNC Economics expects the ECB to raise its policy rates by 25 basis points at its meeting this week, taking the deposit rate to 3.50%. The ECB will likely raise its policy rates again at its July 27 meeting and hold its deposit rate at 3.75% until the end of the year.

Retail sales were flat in April after declining by 0.4% in March. On a year-over-year basis, retail sales were down 2.6% in April.

CANADA: The Bank of Canada (BoC) unexpectedly increased its overnight rate to 4.75% from 4.50% at its June 7 meeting after maintaining it for two straight meetings. In the accompanying statement, the BoC noted that "Canada's economy was stronger than expected in the first quarter of 2023" and "underlying inflation remains stubbornly high." The Bank also continued its quantitative tightening (QT) policy. The BoC had kept its overnight rate unchanged at 4.50% at its meetings in March and April saying that it needed time to assess whether monetary policy was sufficiently restrictive. The BoC left the door open for further hikes at its June 7 meeting: "We will be evaluating whether the evolution of excess demand, inflation expectations, wage growth and corporate pricing behavior are consistent with achieving the inflation target."

Canada's economy grew stronger than expected in the first quarter of this year driven by solid consumer spending on goods. Preliminary data from Statistics Canada suggest that real gross domestic product (GDP) rose 0.2% in April from March driven by mining, oil and gas, transportation, and real estate. Canada's labor market remains tight despite higher immigration and the unemployment rate rose for the first time this year in May to 5.2%, slightly above the all-time low of 4.9%. Consumer price index (CPI) inflation has eased from the all-time high of 8.1% in June 2022, but at 4.4% in April, is still too strong for the BoC.

Canada's economy lost 17,300 jobs in May after eight straight months of job gains. Job losses in May would be equivalent to 140,494 in the U.S. With the total job losses in May, employment in Canada is 4.6% above the pre-pandemic level. The unemployment rate rose to 5.2% from 5.0% in April. Wage growth slowed as average hourly wages rose 5.1% on a year-over-year basis, down from 5.2% in April. Wage growth remains too hot from the BoC's perspective. Annual growth of hourly wages averaged 2.5% in 2019.

The value of Canadian building permits plunged 18.8% in May, falling to the lowest level since December 2020. The value of building permits is down 5% on a year-to-date basis and down 25% from the all-time high in February 2022. The number of building permits is a leading indicator of construction activity and the decline this year suggests slower activity in the housing market through 2023. With the recent unexpected increase in the overnight rate by the BoC, housing affordability will deteriorate even further, weakening demand.

JAPAN: Real GDP growth in the first quarter of 2023 was revised sharply higher to 2.7% at an annual rate from 1.6% in the preliminary estimate. There were upward revisions to inventories and private capital expenditures. With the growth in the first quarter of this year, real GDP is 1.6% above the pre-pandemic level. The upward revision to inventories suggests

that domestic demand is slowing even as supply chains improve. Looking ahead, growth will likely slow in the current quarter as tighter monetary policy outside Japan weighs on exports.

The Bank of Japan (BoJ) is expected to keep its monetary policy accommodative at its two-day meeting which ends on June 16. Although inflation has worsened since the last meeting (core inflation surged in May to the highest level since April 1982), policy makers will likely continue the BoJ's "wait and see approach" in the near term. The BoJ's monetary policy framework currently includes a negative interest rate policy, yield curve control and quantitative easing. Forward guidance from the April 28 meeting indicated that policymakers would conduct a "broad-perspective review" of monetary policy over 12 to 18 months.

MEXICO: Headline and core inflation slowed in May as the impact of elevated interest rates continues to feed through Mexico's economy. Consumer prices fell by 0.2% in May from April following a flat reading in April. Annual headline inflation, as measured by the consumer price index (CPI), eased to 5.8% in May from 6.3% in April. Core inflation, which excludes volatile food and energy prices, eased to 7.4% in May from 7.7% in April.

CPI inflation has slowed in every month of this year thanks to slower domestic demand, improving global supply chains and a slower growing global economy. The slowing in inflation in recent months is in line with the Bank of Mexico's expectations. At its meeting on May 18, policymakers indicated that they would hold the overnight rate at the current level of 11.25% for "an extended period."

Industrial production rose 0.4% in April from March following a 0.9% decline in March. Industrial production rose 0.7% in April from a year ago following a 1.5% increase in March.

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