February 06, 2015

U.S. Outlook

SCOTT ANDERSON, Ph.D | Chief Economist | 415.765.8020
www.bankofthewest.com

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Date	Indicator	For	Estimate	Consensus*	Previous Period
09-February -2015	Labor Market Conditions Index	JAN	N/A	N/A	6.1
09-February -2015	Mortgage Foreclosures	Q4	N/A	N/A	2.39%
09-February -2015	Mortgage Delinquencies	Q4	N/A	N/A	5.85%
10-February -2015	NFIB Small Business Optimism	JAN	101.5	101.1	100.4
10-February -2015	Wholesale Inventories MoM	DEC	0.3%	0.1%	0.8%
10-February -2015	JOLTS Job Openings	DEC	N/A	N/A	4,972
11-February -2015	Monthly Budget Statement	JAN	N/A	-$2.1B	$1.87B
12-February -2015	Retail Sales Advance MoM	JAN	0.2%	-0.3%	-0.9%
12-February -2015	Retail Sales Ex Auto MoM	JAN	0.2%	-0.3%	-1.0%
12-February -2015	Initial Jobless Claims	02/07	287K	285K	278K
12-February -2015	Business Inventories	DEC	0.2%	0.2%	0.2%
13-February -2015	Import Price Index MoM	JAN	-2.0%	-3.4%	-2.5%
13-February -2015	Univ. of Michigan Sentiment Index- Preliminary	FEB	97.3	98.0	98.1

*Consensus from Bloomberg

U.S. Deflation Not the End of the World

Doomsday newspaper articles are being written about deflation these days. Most look across the pond toward Europe and extrapolate that the United States is next in line to suffer from stagnant growth and declining prices. While we are forecasting deflation in both Europe and the U.S. this year, we see a far different economic and monetary policy outcome for the United States. The doomsday articles muddle the economic theory on deflation and make no distinction about the causes or transmission mechanism across countries.

Central bankers and economic textbooks have sounded warnings about deflation's potential dampening effects on aggregate demand. Simplistically the thinking goes, if prices are falling and one believes prices will continue falling tomorrow and the next day and the next day after that, it would make economic sense to delay consuming and investing as long as possible in order to get the cheaper prices in the future.

The macroeconomic problem crystalizes when the vast majority of consumers and businesses start behaving in this manner. Aggregate spending plunges and the economy goes into a deep funk or outright recession. The problem is compounded if consumers or businesses are carrying a high debt load, since their real debt rises over time as prices fall, adding to the downward pressure on future spending. It takes aggressive monetary policy to change expectations about prices and right the sinking ship and stabilize aggregate demand.

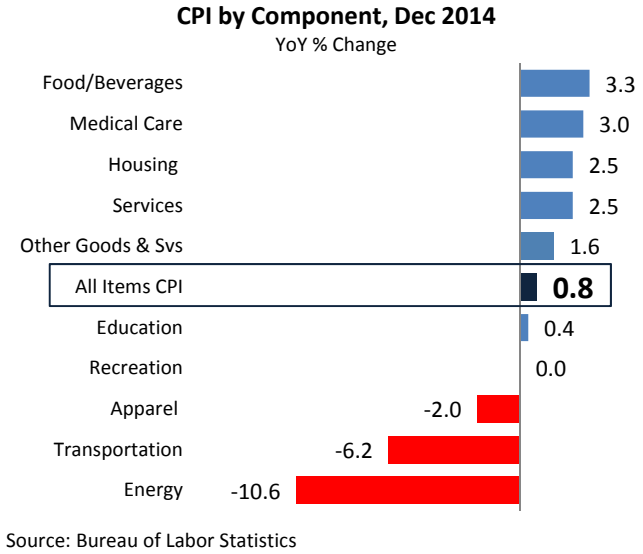
The key ingredient in this theory is the **expectations component** – consumers and business must **believe** that deflation will continue for a very long-time, if not indefinitely, to get them to switch their spending behavior. If the deflation proves temporary or is seen as temporary, the behavior of consumers and businesses could end up being quite different -- falling on the other end of the spectrum. The price declines may be seen as temporary one-off sale prices that won't last forever – so act today! The same thing applies to credit markets. Interest rates are back near record lows thanks to low inflation and loose monetary policy. If you don't think such rates will last forever, it makes economic sense to borrow today for that new car or home you were thinking about buying over the next few years. Next year, the cost of financing could be higher, raising the effective price for that item.

While Europe may be in the former camp, high levels of labor market slack (Eurozone unemployment remains stuck around 11.4 percent) and little or no prospect for robust growth could lead to entrenched declines in inflation expectations, making deflation there a real

macroeconomic threat that must be countered by more aggressive monetary policy.

Here in the United States, the outcome is likely to be quite different and should elicit a very different response from the Federal Reserve. First, the deflationary pressures are mainly coming for only a handful of sectors: energy, transportation, and apparel. Combined, these sectors make up about 30 percent of the weight in the overall CPI index.

U.S. Deflation Concentrated in Only a Few Sectors



The impact of the drop in oil prices on core-inflation is likely to be far less severe than the headline declines. While market inflation expectations have sagged noticeably, the measures of inflation and GDP growth expectations coming from economists through surveys like the Survey of Professional Forecasters, which I participate in, and consumer surveys like the University of Michigan's show a far more stable path ahead.

Finally – and this is probably the most important point – the U.S. labor market is in a far different place right now than Europe's. With the U.S. unemployment rate at 5.7 percent in January, and the economy just ending 52 consecutive months of positive net job creation, there is a far smaller probability that U.S. nominal wage growth will follow headline consumer inflation lower. Many economists, including the Fed, use models of inflation that are based on an expectations-augmented Phillips curve framework. The Phillips curve shows the relationship between inflation and the unemployment rate. When the unemployment rate falls below the natural or full-employment level of unemployment, wage and price pressures tend to build. If the unemployment rate rises above the natural rate, inflation pressures tend to fall. Europe and America are currently at far different points along the Phillips curve in my view.

Indeed, in the United States, the latest reading of the Employment Cost Index shows some tantalizing clues that nominal wage growth is firming. The nation's ECI index held at 2.2 percent year-on-year in the fourth quarter matching the fastest pace of 12-month growth in this expansion. The metro area measures of the ECI are even more telling. Nine out of 15 major metro areas across the country had a higher rate of private wage growth over the 12 months ending in December 2014 than they did in the 12 months ending in December 2013. Robust wage gains are occurring in high-tech driven metros with low unemployment rates like the Bay Area (+4.9%) and Boston (+3.5%). Nationally, private sector wages were up a more modest 2.2% over the past 12 months through December. Wage growth slowed from the pace a year ago in Dallas, Houston, Washington DC, Chicago, and Detroit. But Dallas and Houston were coming off of outsized increases in 2013, and wage growth there remained healthy year-on-year through December.

If further U.S. labor market improvement is realized this year as we expect, don't rule out a 5.0 percent unemployment rate in the U.S. before the end of the year. Consumers could be in for a real wage growth windfall. Declining prices will only bolster real wage gains. Economists know it takes real wage gains to boost real consumer spending power.

The evidence garnered so far suggests U.S. consumers and businesses are behaving just as we would expect given a temporary drop in prices with stable inflation expectations and solid growth prospects. Consumer confidence has jumped, reaching new expansion highs in just the last few months. Business borrowing jumped higher in December, and mortgage applications increased strongly in January. Those betting the Fed will delay their liftoff date into 2016 due to deflation may be seriously misreading the economic tea leaves.

In short, both Europe and the United States are likely to fall into deflation this year, but for the U.S. the economic and monetary signal this creates is likely to be far different than the one seen in Europe, exacerbating the economic and policy divide that is already clearly visible to the discerning eye.

Major Economic Indicators

	History				Forecast								Yr/Yr % chg or Annual Avg.			
Economic Data	**2014.1**	**2014.2**	**2014.3**	**2014.4**	**2015.1**	**2015.2**	**2015.3**	**2015.4**	**2016.1**	**2016.2**	**2016.3**	**2016.4**	**2013**	**2014**	**2015**	**2016**
Real GDP*	-2.1	4.6	5.0	2.6	2.4	2.7	2.9	3.0	2.5	2.8	2.6	2.7	2.2	2.4	3.1	2.8
Personal Consumption Expenditures*	1.2	2.5	3.2	4.3	3.4	3.4	3.5	3.4	3.1	3.1	2.9	2.8	2.4	2.5	3.5	3.2
Non-residential Fixed Investment*	1.6	9.7	8.9	1.9	4.3	5.0	5.0	5.0	4.7	4.6	4.6	4.2	3.0	6.1	5.0	4.8
Private Housing Starts (000s units)	925	985	1,030	1,075	1,090	1,100	1,121	1,143	1,165	1,180	1,240	1,260	930	1,004	1,114	1,211
Vehicle Sales (mill. Units, annualized)	15.6	16.5	16.7	16.8	17.0	17.1	17.2	17.2	17.2	17.2	17.3	17.3	15.5	16.4	17.2	17.2
Industrial Production*	3.9	5.7	4.1	5.6	3.5	3.3	3.3	3.2	3.4	3.4	3.4	3.4	2.9	4.3	4.0	3.4
Nonfarm Payroll Employment (mil.)	137.8	138.5	139.2	140.1	140.8	141.5	142.1	142.8	143.5	144.1	144.8	145.4	136.4	138.9	141.8	144.4
Unemployment rate	6.7	6.2	6.1	5.7	5.5	5.4	5.3	5.2	5.2	5.1	5.0	5.0	7.4	6.2	5.4	5.1
Consumer Price Index* (percent)	1.9	3.0	1.1	-1.2	-3.5	1.7	1.9	1.9	1.9	1.9	2.0	2.1	1.5	1.6	-0.1	1.9
"Core" CPI* (percent)	1.6	2.5	1.3	1.4	1.2	1.5	1.5	1.6	1.7	1.7	1.8	1.8	1.8	1.7	1.5	1.7
PPI (finished goods)* (percent)	3.9	3.9	0.8	-5.6	-4.7	0.3	1.0	1.1	1.3	1.3	1.4	1.4	1.2	1.9	-1.7	1.2
Trade Weighted Dollar (Fed BOG, major)	76.9	76.4	77.5	82.2	88.0	89.5	90.4	90.7	91.0	91.8	92.5	92.4	76.1	78.3	89.7	91.9
Crude Oil Prices -WTI ($ per barrel)	99	103	98	76	49	52	54	56	64	65	66	67	98	94	53	66

*Quarterly Data Percent Change At Annual Rate; Annual Data Year-on-Year % Chg, or Annual Average.

	History				Forecast								Annual Average			
Financial Data	**2014.1**	**2014.2**	**2014.3**	**2014.4**	**2015.1**	**2015.2**	**2015.3**	**2015.4**	**2016.1**	**2016.2**	**2016.3**	**2016.4**	**2013**	**2014**	**2015**	**2016**
S & P 500	1,835	1,900	1,976	2,009									1,644			
Dow Jones Industrial Average	16,177	16,604	16,954	17,345									15,010			
Federal Funds Rate (effective)	0.07	0.09	0.09	0.08	0.12	0.18	0.43	0.70	1.12	1.37	1.62	1.95	0.11	0.08	0.36	1.52
Treasury-3 Month Bills (yield)	0.05	0.03	0.03	0.02	0.02	0.10	0.33	0.60	1.08	1.32	1.57	1.90	0.06	0.03	0.26	1.47
Treasury-2 Year Notes (yield)	0.37	0.42	0.52	0.52	0.52	0.65	0.93	1.13	1.60	1.90	2.15	2.48	0.31	0.45	0.81	2.03
Treasury-5 Year Notes (yield)	1.60	1.66	1.70	1.57	1.37	1.58	1.79	2.07	2.54	2.74	2.99	3.12	1.17	1.63	1.70	2.85
Treasury-10 Year Notes (yield)	2.77	2.62	2.50	2.27	1.90	2.15	2.36	2.51	2.71	2.84	2.95	3.18	2.35	2.54	2.23	2.92
Treasury-30 Year Notes (yield)	3.68	3.44	3.27	2.97	2.50	2.63	2.80	2.90	3.11	3.22	3.40	3.48	3.44	3.34	2.71	3.30
Prime Rate	3.25	3.25	3.25	3.25	3.25	3.25	3.43	3.70	4.12	4.37	4.62	4.95	3.25	3.25	3.41	4.52
Libor 3-Mo. U.S. Dollar	0.26	0.25	0.24	0.23	0.25	0.26	0.46	0.78	1.19	1.45	1.68	2.03	0.28	0.25	0.44	1.59
Mortgage-30 Year (yield)	4.36	4.23	4.14	4.03	3.71	3.97	4.21	4.35	4.52	4.65	4.76	4.99	3.98	4.19	4.06	4.73
BAA Corporate (yield)	5.12	4.82	4.74	4.74	4.45	4.48	4.66	4.82	5.05	5.20	5.32	5.55	5.10	4.86	4.60	5.28

Source: Bank of the West Economics, Bloomberg, Federal Reserve