

U.S. Outlook

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Date	Indicator	For	Estimate	Consensus*	Previous Period
23-February -2015	Chicago Fed National Activity Index	JAN	NA	NA	-0.05
23-February -2015	Existing Home Sales	JAN	4.92M	4.96M	5.04M
24-February -2015	S&P/Case-Shiller 20 City MoM SA	DEC	0.65%	0.60%	0.74%
24-February -2015	Consumer Confidence Index	FEB	100.7	99.5	102.9
25-February -2015	New Home Sales	JAN	476K	470K	481K
26-February -2015	Consumer Price Index MoM	JAN	-0.6%	-0.6%	-0.4%
26-February -2015	CPI Ex. Food & Energy MoM	JAN	0.1%	0.1%	0.0%
26-February -2015	Durable Goods Orders	JAN	1.9%	1.7%	-3.3%
26-February -2015	Durables Ex. Transportation	JAN	0.6%	0.5%	-0.8%
26-February -2015	Initial Jobless Claims	02/21	285K	NA	283K
26-February -2015	FHFA Home Price Index MoM	DEC	0.6%	0.6%	0.8%
27-February -2015	Real GDP Annualized QoQ- 2 nd Release	Q4	2.0%	2.1%	2.6%
27-February -2015	Chicago Purchasing Managers Index	FEB	58.0	58.0	59.4
27-February -2015	Pending Home Sales MoM	JAN	2.4%	2.2%	-3.7%
27-February -2015	University of Michigan Sentiment- Final	FEB	93.8	94.0	93.6

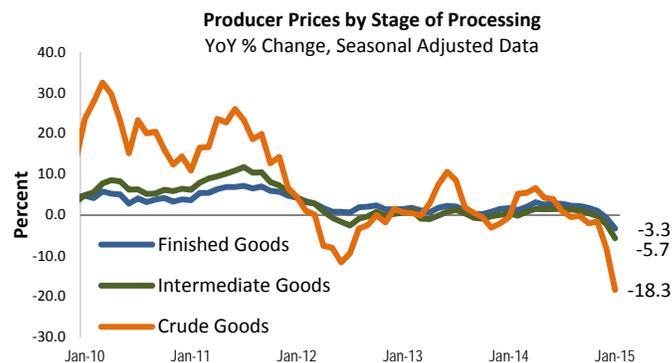
*Consensus from Bloomberg

Deflation Arrives in the United States

We have been advertising it for a while now, but the January price data are finally coming in and the U.S. price deflation is as dramatic as I thought. Producer prices for January dropped 0.8%, twice as fast as the consensus of economists expected, and the year-on-year decline was 3.3%. Outside of the Great Recession of 2009, there was only one time producer prices dropped this much in twelve months in the post-war period and that was 1949.

Looking at producer prices by the stage of production, it is clear that commodity or crude-good prices are driving the declines. Price of crude-good producer prices dropped an eye-popping 18.3 percent from a year ago in January. Intermediate goods inflation was down a not insignificant 5.7 percent. The downdraft from this plunge in early-stage producer prices is likely to continue to exert downward pressure on the finished goods measure in the months ahead.

U.S. Producer Prices Get Slashed

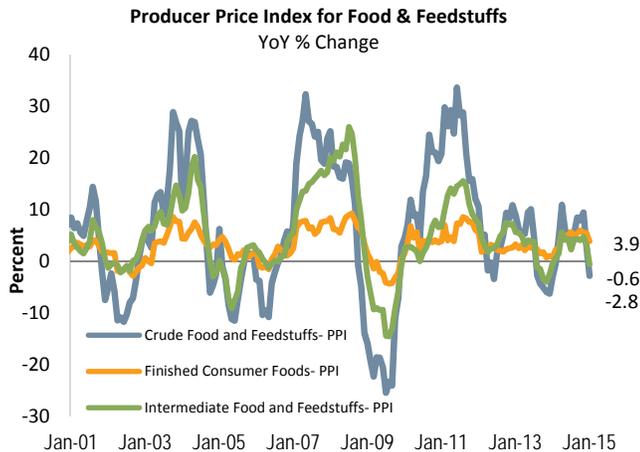


Source: U.S. Bureau of Labor Statistics

Relief may soon arrive at the grocery store, too. The producer price inflation of finished consumer foods slipped to 3.9 percent from over 5.0 percent last month, and deflation is now occurring in intermediate and crude food stuffs as well, suggesting more downward pressure on consumer food prices in the months ahead.

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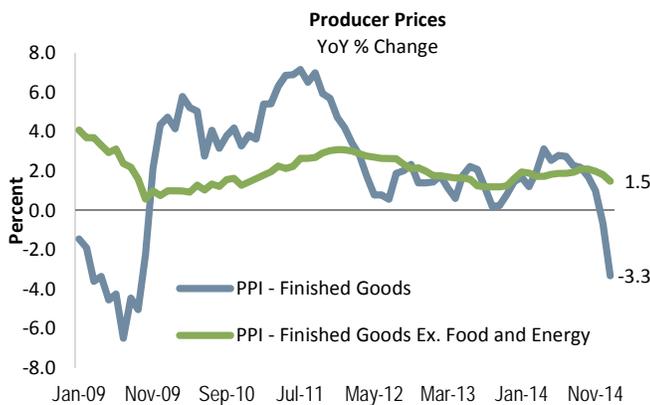
Food Inflation Ebbing As Well



Source: U.S. Bureau of Labor Statistics

Away from the volatile food and energy sectors, producer prices appear much more stable. Even so, core inflation appears to be moving further away from the Federal Reserve’s targeted goals. Seasonal adjusted core producer price inflation has slipped a half a percent in two months to 1.5 percent from a year ago.

Core-Inflation Moving Further From Fed’s Targeted Goals

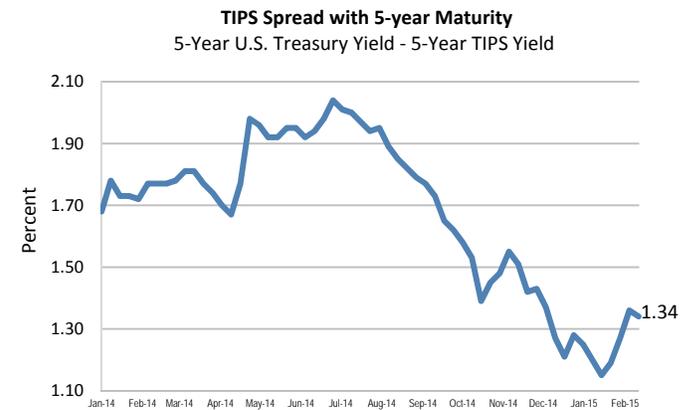


Source: Bureau of Labor Statistics

Still, if crude oil prices can stabilize near \$50 per barrel, the current bout of U.S. deflation could dissipate rather quickly. That doesn’t mean 2.0 percent plus consumer inflation is right around the corner either. The strong dollar will continue to exert downward pressure on import prices that are likely to offset for a time any upward pressure on consumer prices from rising wages. Import prices dropped 2.8 percent last month and are 11.1 percent lower than a year ago.

Market based measures of inflation expectations, while still depressed from normal levels, have already stabilized and moved higher in recent weeks. For example the 5-Yr TIPS spread, a proxy for market inflation expectations over the next five years, improved to 1.34 percent from 1.15 at its January 16 low point. While only a modest improvement, it’s a sign from the markets that the eye-popping deflation readings we are likely to see over the next few months may only be around for a limited time.

Market Inflation Expectations Turn The Corner



Source: Federal Reserve System

We get another dose of price readings next week, this time from the consumer price index. We expect a 0.6 percent decline for January that will push the year-on-year consumer price index into deflation territory for the first time since 2009. The only other periods of U.S. consumer price deflation occurred all the way back in the mid-1950s!

This creates a near-term communication challenge for the FOMC to justify liftoff and the normalization of interest rates. How do you explain to Congress and the American people that you are defending your inflation mandate on the downside when you have missed your inflation target for two years and actual inflation is still moving away from your goals? While you can tell them you have confidence in your inflation forecasts, until the actual inflation figures start turning the corner, I am afraid the communication challenges are nearly insurmountable. While consumer inflation should start turning-the corner by the June FOMC meeting, for now the Fed is content to plan for liftoff and remain in wait and see mode on inflation.

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Major Economic Indicators

Economic Data	History				Forecast								Yr/Yr % chg or Annual Avg.			
	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.

Financial Data	History				Forecast								Annual Average			
	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