U.S. Outlook

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

BANK OF THE WEST | BNP PARIBAS GROUP

Date	Indicator	For	Estimate	Consensus*	Previous Period
24-Aug-2015	Chicago Fed Nat Activity Index	Jul	NA	NA	0.08
25-Aug-2015	FHFA House Price Index MoM	Jun	0.4%	0.4%	0.4%
25-Aug-2015	S&P/CS 20 City MoM SA	Jun	0.22%	0.03%	-0.18%
25-Aug-2015	Markit US Composite PMI	Aug P	NA	NA	55.7
25-Aug-2015	Markit US Services PMI	Aug P	55.2	54.0	55.7
25-Aug-2015	New Home Sales	Jul	507K	511K	482K
25-Aug-2015	Consumer Confidence Index	Aug	94.0	93.0	90.9
25-Aug-2015	Richmond Fed Manufact. Index	Aug	10	9	13
26-Aug-2015	Durable Goods Orders	Jul	-0.5%	-0.4%	3.4%
26-Aug-2015	Durables Ex Transportation	Jul	0.1%	0.2%	0.6%
27-Aug-2015	GDP Annualized QoQ	2Q S	3.3%	3.3%	2.3%
27-Aug-2015	GDP Price Index	2Q S	2.0%	2.0%	2.0%
27-Aug-2015	Initial Jobless Claims	22-Aug	275K	NA	277K
27-Aug-2015	Pending Home Sales MoM	Jul	1.6%	1.5%	-1.8%
27-Aug-2015	Kansas City Fed Manf. Activity	Aug	NA	NA	-7
28-Aug-2015	Personal Income	Jul	0.3%	0.4%	0.4%
28-Aug-2015	Personal Spending	Jul	0.4%	0.4%	0.2%
28-Aug-2015	PCE Deflator MoM	Jul	0.1%	0.1%	0.2%
28-Aug-2015	PCE Core MoM	Jul	0.1%	0.1%	0.1%
28-Aug-2015	U. of Mich. Sentiment	Aug F	93.0	93.2	92.9

*Consensus from Bloomberg

Conflicting Signals from the Fed Minutes

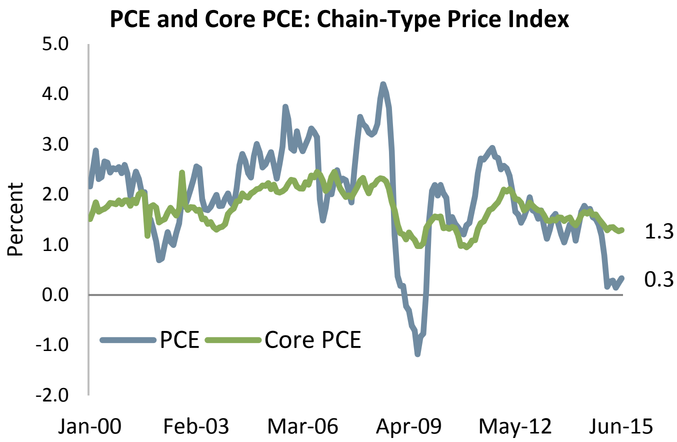
Bond investors, parsing the FOMC minutes from the July meeting, sensed hesitation about the timing of the first interest rate hike from the Fed and have since soundly convinced themselves that a move in September is virtually off the table. The Fed funds futures implied probability of a rate hike in September fell from around 50% prior to the Fed minutes release to 34% on Thursday. But, I still believe the real probability of a September versus a December move is close to 50-50 with a slight nod in favor of a September move.

Expect more volatility in these implied probabilities as the September FOMC meeting approaches. Between now and the September meeting, every FOMC member speech and every economic data point will be given more scrutiny than it deserves. Indeed, there is plenty of opportunity for better U.S. economic data in the weeks ahead to turn investors' minds on a dime again. Bond investors could prove to be as fickle as likely voters in the next Presidential election appear to be this campaign season.

For example, next week we get the second estimate of second quarter GDP. We anticipate a solid upward revision to 3.3% from 2.3%. Consumer spending, structures, residential investment, equipment spending, inventories, and net exports should all see upward revisions from the initial release. Moreover, new home sales, consumer confidence, and personal income and spending all released next week are forecast to show solid monthly gains as well. Even so, the August payroll report released in September will be the weightiest piece of evidence for investors to mull over.

An often cited reason for a delay in the first rate hike is the inability of the Fed to hit its 2.0% inflation target over the last three years and uncertainty it will be able to do so until well after 2017.

PCE Inflation Keeps Falling Short Of The Mark

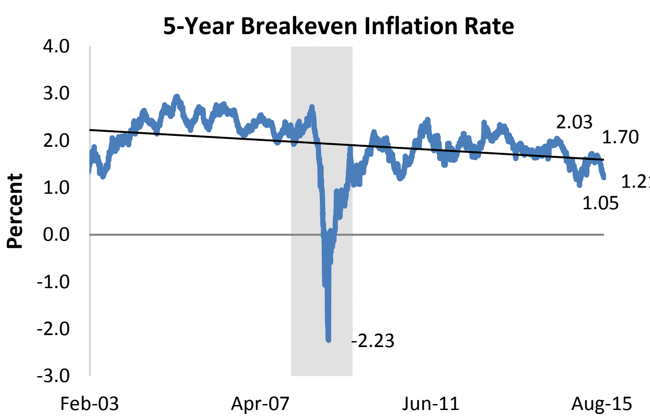


Source: US. Bureau of Economic Analysis/FRED

The June FOMC staff projections, accidently released by the Fed, showed PCE inflation excluding food and energy remaining below the Fed's 2.0% target through 2020. It is doubtful the Fed's inflation forecasts have gained any ground since then, indeed the July minutes noted that the Fed staff cut their GDP growth and inflation forecasts since last meeting. As oil prices have resumed their steep selloff, falling 32% since June to new cyclical lows, near-term inflation is bound to be even lower. This could create an optics problem for a September liftoff.

Intermediate term bond market inflation expectations have sunk along with oil prices, dropping back toward January lows and remain about a half a percentage point lower than a trend line going back to 2003.

5-Year Breakeven's Dropping Back to January Lows



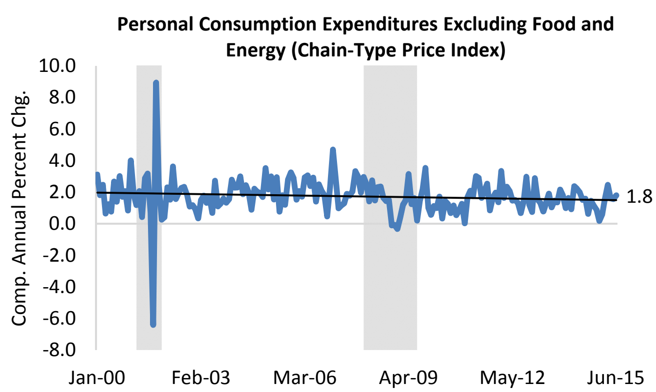
Source: Federal Reserve Bank of St. Louis/FRED

The FOMC statements themselves have said that members need to be "reasonably confident" that inflation will return to its target over the medium-term. Though it is important to note that Chair Yellen herself has said at past FOMC press conferences that this statement does not mean they need to see higher inflation before an initial rate increase, just confidence it will turn higher will be sufficient.

Deep down the Fed believes the Phillips curve relationship between labor market slack and inflation still holds. As the unemployment rate falls below the natural rate, nominal wages will start rising at a faster rate and consumer prices will soon follow. The problem is there is still little hard evidence of wage inflation picking up nationally, or that the link between wages and prices is all that solid. This could imply the natural unemployment rate is even lower than the Fed believes. Certainly, temporary declines in inflation can be expected over the near-term as energy and commodity prices decline and the dollar strengthens.

But let me point out a couple to positive inflation trends that you might not be aware of and seem to fly in the face of all this downbeat focus on the US dollar and declining oil prices. First, since the December low, PCE inflation excluding food and energy on a monthly compound annualized basis has accelerated and even remained above trend since February. So there is evidence of an improving trend even with the Fed's preferred measure of inflation. This could be all the evidence the FOMC needs to start the normalization process. The rebound in overall PCE inflation on an annualized monthly basis has been even stronger. This appears to support the Fed's view that the shortfall in inflation is temporary and once energy prices stabilize, inflation will bounce back.

Core-PCE Inflation Has Been Running Above-Trend Since Feb.



Source: US. Bureau of Economic Analysis/FRED

Conflicting signals from inflation and from the Fed itself ensure a nail bitter at the September FOMC. If I had a vote on the committee, my vote would be to begin liftoff in September despite market volatility –Stay Tuned.

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*	-0.9	4.6	4.3	2.1	0.6	3.3	2.7	2.8	2.7	2.7	2.7	2.7	1.5	2.4	2.5	2.8
Personal Consumption Expenditures*	1.3	3.8	3.5	4.3	1.7	3.2	3.5	3.4	3.1	3.1	2.9	2.8	1.7	2.7	3.2	3.2
Non-residential Fixed Investment*	8.3	4.4	9.0	0.7	1.6	0.9	2.5	5.0	4.7	4.6	4.6	4.1	3.0	6.2	2.7	4.2
Private Housing Starts (000s units)	934	984	1,029	1,055	978	1,144	1,175	1,195	1,220	1,235	1,240	1,260	928	1,001	1,123	1,239
Vehicle Sales (mill. Units, annualized)	15.7	16.5	16.7	16.8	16.6	17.1	17.3	17.2	17.3	17.3	17.2	17.2	15.5	16.4	17.1	17.3
Industrial Production*	3.6	5.7	3.9	4.7	-0.2	-2.0	3.0	3.0	3.2	3.2	3.3	3.3	1.9	3.7	1.9	2.9
Nonfarm Payroll Employment (mil.)	137.8	138.6	139.4	140.2	141.0	141.6	142.3	143.0	143.6	144.3	145.0	145.7	136.4	139.0	142.0	144.7
Unemployment rate	6.6	6.2	6.1	5.7	5.6	5.4	5.2	5.1	5.0	4.9	4.9	4.8	7.4	6.2	5.3	4.9
Consumer Price Index* (percent)	2.1	2.4	1.2	-0.9	-3.1	3.0	2.0	2.0	2.0	2.0	2.0	2.1	1.5	1.6	0.3	2.1
"Core" CPI* (percent)	1.8	2.2	1.4	1.5	1.7	2.5	1.8	1.9	1.9	1.9	2.0	2.0	1.8	1.7	1.8	2.0
PPI (finished goods)* (percent)	4.1	3.5	0.4	-5.1	-11.2	3.6	1.8	1.7	1.7	1.7	1.8	1.8	1.2	1.9	-2.6	1.9
Trade Weighted Dollar (Fed BOG, major)	76.9	76.4	77.5	82.5	89.3	90.0	92.1	92.3	92.4	92.4	93.1	93.0	75.9	78.4	90.9	92.7
Crude Oil Prices -WTI ($ per barrel)	99	103	98	73	48	58	48	52	55	57	59	60	98	93	52	58

*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	2,064	2,102							1,644			
Dow Jones Industrial Average	16,177	16,604	16,954	17,345	17,808	18,004							15,010			
Federal Funds Rate (effective)	0.07	0.09	0.09	0.10	0.11	0.12	0.21	0.38	0.63	0.88	1.13	1.38	0.11	0.08	0.21	1.00
Treasury-3 Month Bills (yield)	0.05	0.03	0.03	0.02	0.02	0.02	0.05	0.24	0.53	0.78	1.03	1.28	0.06	0.03	0.08	0.91
Treasury-2 Year Notes (yield)	0.37	0.42	0.52	0.54	0.60	0.61	0.70	0.94	1.33	1.62	1.87	2.20	0.31	0.45	0.71	1.76
Treasury-5 Year Notes (yield)	1.60	1.66	1.70	1.60	1.46	1.53	1.58	1.80	2.29	2.49	2.74	2.87	1.17	1.63	1.59	2.60
Treasury-10 Year Notes (yield)	2.77	2.62	2.50	2.28	1.97	2.16	2.25	2.45	2.71	2.84	2.95	3.18	2.35	2.54	2.21	2.92
Treasury-30 Year Notes (yield)	3.68	3.44	3.27	2.97	2.55	2.88	3.00	3.15	3.31	3.37	3.50	3.63	3.44	3.34	2.90	3.44
Prime Rate	3.25	3.25	3.25	3.25	3.25	3.25	3.33	3.50	3.75	4.00	4.25	4.50	3.25	3.25	3.33	4.13
Libor 3-Mo. U.S. Dollar	0.26	0.25	0.24	0.25	0.30	0.30	0.32	0.50	0.75	1.00	1.25	1.50	0.28	0.25	0.36	1.13
Mortgage-30 Year (yield)	4.36	4.23	4.14	3.96	3.72	3.82	4.00	4.17	4.52	4.65	4.76	4.99	3.98	4.17	3.93	4.73
BAA Corporate (yield)	5.12	4.82	4.74	4.73	4.50	4.83	5.22	5.30	5.55	5.70	5.82	6.05	5.10	4.86	4.96	5.78

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