U.S. Outlook

October 16, 2015

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
19-Oct-2015	NAHB Housing Market Index	Oct	61	62	62
20-Oct-2015	Housing Starts	Sep	1160k	1140k	1126k
20-Oct-2015	Building Permits	Sep	1170k	1160k	1170k
22-Oct-2015	Chicago Fed Nat Activity Index	Sep	NA	NA	-0.4
22-Oct-2015	Initial Jobless Claims	17-Oct	264K	NA	255K
22-Oct-2015	FHFA House Price Index MoM	Aug	0.4%	0.5%	0.6%
22-Oct-2015	Existing Home Sales	Sep	5.39m	5.35m	5.31m
22-Oct-2015	Leading Index	Sep	0.0%	0.0%	0.1%
22-Oct-2015	Kansas City Fed Manf. Activity	Oct	-10	NA	-8
23-Oct-2015	Markit U.S. Manufacturing PMI - Preliminary	Oct	53.1	53.2	53.1

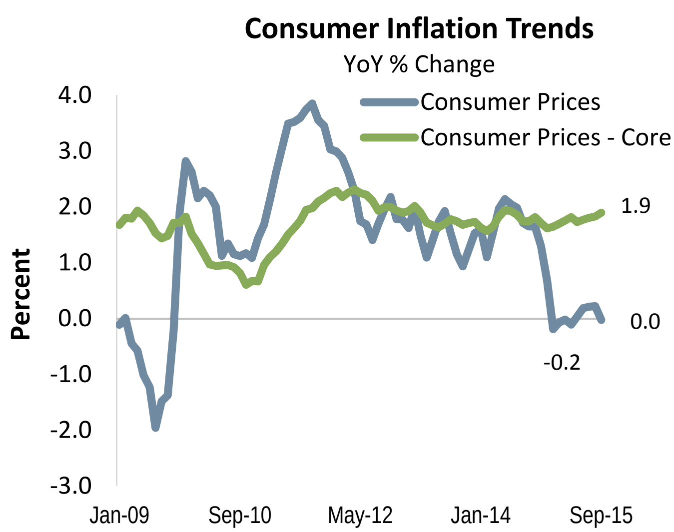
*Consensus from Bloomberg

Core Inflation Holds Firm in the Third Quarter

In your heart you know there is still inflation out there, no matter what the government or Federal Reserve says. Indeed, the September consumer price index release this week held some interesting information about the future path of inflation. While the headline CPI continued to drop last month, the core-CPI inflation picked-up and wasn't as bad as we had been bracing for.

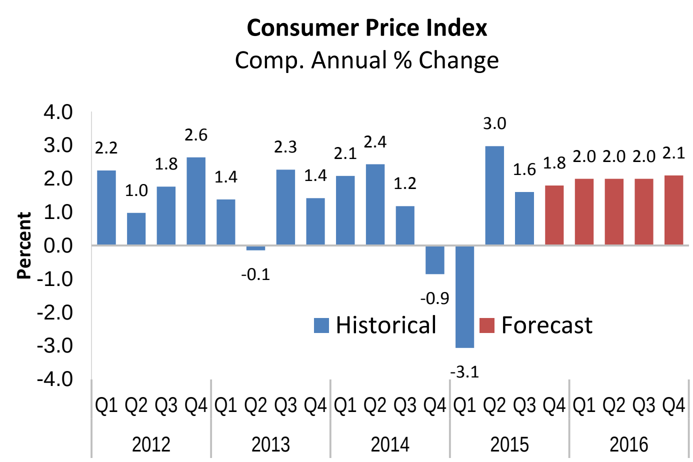
While economic growth headwinds have intensified in recent months and job growth has slowed, the core inflation outlook remains relatively stable in comparison. We forecast rising consumer inflation, both core and headline inflation, in 2016 as the labor market continues to tighten and oil and energy prices bottom-out.

CPI (Ex. Food and Energy) Diverging from Overall Inflation



Source: U.S. Bureau of Labor Statistics

Energy Price Impact on CPI Appears to be Fading



Source: US. Bureau of Labor Statistics; BOTW

I think this latest evidence on consumer prices could give some FOMC members more comfort in their consensus view that the decline in U.S. inflation will in fact prove transitory. The prevailing opinion at the Federal Reserve is that as the labor market continues to tighten the inverse relationship between the unemployment rate and inflation, known as the Phillip's curve, will kick-in. In other words, lower unemployment rates lead to higher inflation.

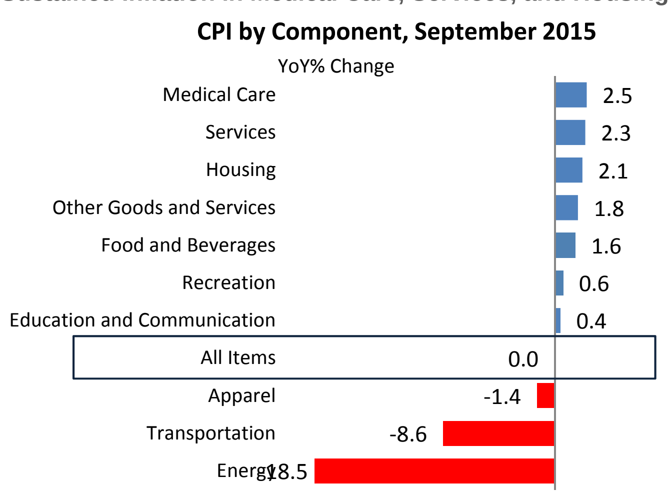
Anecdotal evidence seems to be piling up in the Fed's own Beige Book report for October that the labor market is already tight in many Fed Districts. The report states that "many Districts were having difficulty finding skilled workers, and, in some cases unskilled workers. Scattered labor shortages are being reported in construction, trucking, and information technology. However, significant wage gains are only occurring in information technology, health care, professional services, and some of the skilled trades, in much of the country. But in the New York and San Francisco Districts there are already visible wage pressures among less skilled workers due to minimum wage increases that are having an impact on the retail sector.

In September, gains in housing, services, food, and education prices helped to push the core-inflation rate up a solid 0.2 percent on the month. If gains of this magnitude could be sustained over the next twelve months, core-CPI would increase at a robust rate of 2.4%.

Over the past year rising housing, medical care and service prices have put a pretty stable floor under core-inflation bolstering the case that as global growth stabilizes next year, the most likely path for consumer inflation is higher not lower in 2016.

As the chart below illustrates, consumer inflation over the past year has been driven down by only a handful of categories led by energy, transportation, and apparel prices.

Sustained Inflation in Medical Care, Services, and Housing



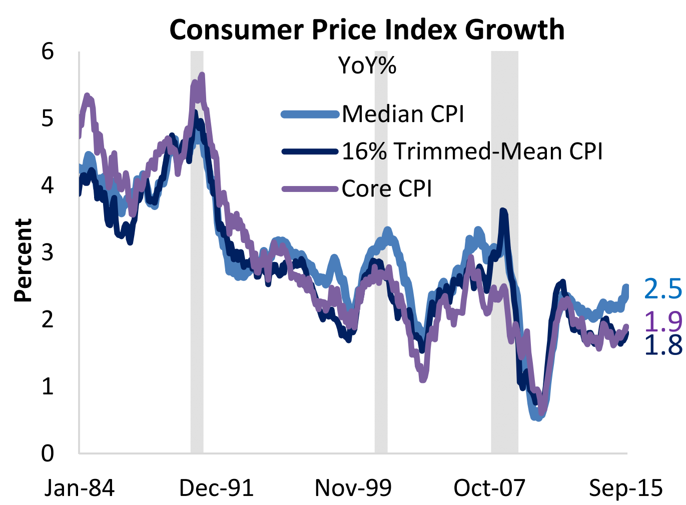
Source: Bureau of Labor Statistics

But what is the true core inflation rate? It might be higher than you think. The Federal Reserve Bank of Cleveland publishes some alternative measures of core-CPI inflation that they say provides a better signal of inflation trends than other measures. The Median Consumer Price Index (CPI) is a measure of core inflation created as a different way to get a "Core CPI" measure, or a better measure of underlying inflation trends. To calculate the Median CPI, the Cleveland Fed analyzes the median price change of the goods and services published by the Bureau of Labor Statistics. The median price change is the price change that's right in the middle of the long list of all of the price changes. This series excludes 49.5% of the CPI components with the highest and lowest one-month price changes from each tail of the price-change distribution resulting in a Median CPI Inflation Estimate.

According to research from the Cleveland Fed, the Median CPI provides a better signal of the inflation trend than either the all-items CPI or the CPI excluding food and energy. This measure is already at 2.5% inflation.

An alternative core-inflation measure is the 16% Trimmed-Mean Consumer Price Index (CPI). The Trimmed-Mean CPI excludes the CPI components that show the most extreme monthly price changes. This series excludes 8% of the CPI components with the highest and lowest one-month price changes from each tail of the price-change distribution resulting in a 16% Trimmed-Mean Inflation Estimate. All three of these core inflation measures are now between 1.8 and 2.5 percent.

What's The True Core Inflation Rate?



Source: Federal Reserve Bank of Cleveland/FRED

Bottom-line, the worst deflation pressure may already be behind us, and the Fed shouldn't tarry too long before raising interest rates if it is going to fulfill its mandate to promote price stability.

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	2013.0	2014	2015	2016
Real GDP*	-0.9	4.6	4.3	2.1	0.6	3.9	1.6	2.5	2.4	2.3	2.5	2.5	1.5	2.4	2.5	2.4
Personal Consumption Expenditures*	1.3	3.8	3.5	4.3	1.7	3.6	3.3	3.2	3.0	3.0	2.9	2.8	1.7	2.7	3.2	3.1
Non-residential Fixed Investment*	8.3	4.4	9.0	0.7	1.6	4.1	6.5	3.8	2.9	2.9	3.3	3.5	3.0	6.2	3.7	3.7
Private Housing Starts (000s units)	934	984	1,029	1,055	978	1,155	1,150	1,164	1,210	1,235	1,240	1,260	928	1,001	1,112	1,236
Vehicle Sales (mill. Units, annualized)	15.7	16.5	16.7	16.8	16.6	17.1	17.8	17.5	17.4	17.3	17.2	17.2	15.5	16.4	17.3	17.3
Industrial Production*	3.6	5.7	3.9	4.7	-0.3	-2.6	2.2	1.9	2.4	1.9	1.9	1.8	1.9	3.7	1.5	1.8
Nonfarm Payroll Employment (mil.)	137.8	138.6	139.4	140.2	141.0	141.6	142.2	142.7	143.3	143.8	144.4	145.0	136.4	139.0	141.9	144.1
Unemployment rate	6.6	6.2	6.1	5.7	5.6	5.4	5.2	5.0	4.9	4.8	4.8	4.7	7.4	6.2	5.3	4.8
Consumer Price Index* (percent)	2.1	2.4	1.2	-0.9	-3.1	3.0	1.6	1.8	2.0	2.0	2.0	2.1	1.5	1.6	0.2	2.0
"Core" CPI* (percent)	1.8	2.2	1.4	1.5	1.7	2.5	1.7	1.5	1.9	1.9	2.0	2.0	1.8	1.7	1.8	1.9
PPI (finished goods)* (percent)	4.1	3.5	0.4	-5.1	-11.2	3.6	0.8	1.7	1.7	1.7	1.8	1.8	1.2	1.9	-2.8	1.7
Trade Weighted Dollar (Fed BOG, major)	76.9	76.4	77.5	82.5	89.3	90.0	91.8	91.5	92.0	92.0	92.5	92.4	75.9	78.4	90.7	92.2
Crude Oil Prices -WTI ($ per barrel)	99	103	98	73	48	58	47	46	52	54	56	56	98	93	50	55

*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	2009	2,064	2102	2027						1,644	1,930		
Dow Jones Industrial Average	16,177	16,604	16,954	17345	17,808	18,004	17,077						15,010	16,770		
Federal Funds Rate (effective)	0.07	0.09	0.09	0.10	0.11	0.12	0.13	0.15	0.38	0.63	0.71	0.96	0.11	0.09	0.13	0.67
Treasury-3 Month Bills (yield)	0.05	0.03	0.03	0.02	0.02	0.02	0.09	0.06	0.32	0.57	0.65	0.90	0.06	0.03	0.05	0.61
Treasury-2 Year Notes (yield)	0.37	0.42	0.52	0.54	0.60	0.61	0.68	0.69	1.07	1.36	1.47	1.73	0.31	0.46	0.65	1.41
Treasury-5 Year Notes (yield)	1.60	1.66	1.70	1.60	1.46	1.53	1.55	1.45	1.89	2.09	2.24	2.37	1.17	1.64	1.50	2.15
Treasury-10 Year Notes (yield)	2.77	2.62	2.50	2.28	1.97	2.16	2.21	2.20	2.47	2.60	2.65	2.88	2.35	2.54	2.14	2.65
Treasury-30 Year Notes (yield)	3.68	3.44	3.27	2.97	2.55	2.88	2.96	2.95	3.13	3.19	3.28	3.41	3.44	3.34	2.84	3.25
Prime Rate	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.31	3.50	3.75	3.83	4.08	3.25	3.25	3.26	3.79
Libor 3-Mo. U.S. Dollar	0.26	0.25	0.24	0.25	0.30	0.30	0.31	0.33	0.57	0.82	0.90	1.15	0.28	0.25	0.31	0.86
Mortgage-30 Year (yield)	4.36	4.23	4.14	3.96	3.72	3.82	3.95	3.98	4.18	4.31	4.36	4.59	3.98	4.17	3.87	4.36
BAA Corporate (yield)	5.12	4.82	4.74	4.73	4.50	4.83	5.24	5.30	5.51	5.66	5.77	6.00	5.10	4.86	4.97	5.74

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