US ECONOMIC OUTLOOK

Q4 2015

CAPITAL ECONOMICS

8th December 2015

Higher inflation is coming

- **Overview –** Although we expect GDP growth to be a moderate 2.5% next year, the big surprise will be how quickly inflation rebounds. With domestic price pressures mounting and this year's deflationary shocks from lower commodity prices and the stronger dollar set to fade, inflation will climb above the Fed's 2% target by mid-2016. Under those circumstances, we believe the Fed will abandon its gradualist philosophy and push the fed funds rate to nearly 2.0% by end-2016 and nearly 3.5% by end-2017. (Pages 3 & 4.)

- **Consumption –** A gradual slowdown in the pace of employment gains combined with rising interest rates next year will usher in a period of softer growth in real consumption. We expect annualised consumption growth to slow from 3.2% this year to 2.7% in 2016 and 2.2% in 2017. (Pages 5 & 6.)

- **Investment –** The growth rate of business investment should accelerate slightly to 3.9% in 2016, from 3.3% this year, but only because the massive drag from the collapse in mining-related investment will fade. (Pages 7 & 8.)

- **External Demand –** Even though we anticipate a much smaller dollar appreciation in 2016, the drag from net trade will persist in 2016, with real exports expanding by a modest 1.8% while real imports increase by 2.8%. (Pages 9 & 10.)

- **Labour Market –** With the labour market now very close to full employment, the big story next year will be a more marked acceleration in wage growth. (Pages 11 & 12.)

- **Prices –** Inflation has remained close to zero for most of this year, but we expect it to climb back to the Fed's 2% target by mid-2016 and then climb well above it in 2017. (Pages 13 & 14.)

- **Monetary & Fiscal Policy –** Rising wage and price inflation will force the Fed to raise the fed funds rate to nearly 2.0% by end-2016 and above 3.0% by end-2017. Fiscal policy will provide a small boost to GDP next year, while the suspension of the debt ceiling until early 2017 has removed the threat of a government shutdown ahead of next year's presidential election. (Pages 15 & 16.)

North America
400 Madison Avenue, Suite 6C
New York
Tel: +1 646 934 6162

2 Bloor Street West, Suite 1740
Toronto
Tel: +1 416 413 0428

Europe
150 Buckingham Palace Road
London
Tel: +44 (0)20 7823 5000

Asia
16 Collyer Quay, Suite 26-03
Singapore
Tel: +65 6595 5190

225 George Street, Suite 29-08
Sydney
Tel: +61 2 9083 6800

Executive Chairman — Roger Bootle (roger.bootle@capitaleconomics.com)
Chief US Economist — Paul Ashworth (paul.ashworth@capitaleconomics.com)
US Economist — Steve Murphy (Stephen.murphy@capitaleconomics.com)

Forecasts

%q/q annualised (unless otherwise stated)	2015				2016				2017				Annual (%y/y)		
	Q1	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f	2015f	2016f	2017f
Demand															
GDP	0.6	3.9	2.1	2.0	2.6	2.6	2.3	2.2	2.0	2.0	2.0	2.0	**2.5**	**2.5**	**2.0**
Consumption	1.7	3.6	3.0	2.5	2.7	2.7	2.5	2.5	2.4	2.2	2.2	2.1	**3.2**	**2.7**	**2.2**
Private Fixed Investment	3.3	5.1	3.4	3.9	3.9	3.7	3.7	3.6	3.5	3.5	3.5	3.5	**4.0**	**3.8**	**3.5**
- Business Investment	1.6	4.1	2.4	4.0	4.0	3.8	3.7	3.6	3.5	3.5	3.5	3.5	**3.3**	**3.9**	**3.5**
- Residential Investment	10.1	9.4	7.3	3.8	3.7	3.5	3.5	3.5	3.5	3.5	3.5	3.5	**8.3**	**3.6**	**3.5**
Government Expenditure	-0.1	2.6	1.7	1.6	2.7	2.7	2.7	2.0	1.0	1.0	1.0	1.0	**0.2**	**2.1**	**1.2**
Domestic Demand	2.5	3.6	2.2	2.1	2.9	2.9	2.7	2.6	2.4	2.3	2.3	2.2	**3.2**	**2.9**	**2.3**
Exports	-6.0	5.1	0.9	-0.3	1.3	1.6	1.8	1.8	1.8	1.8	2.0	2.0	**1.8**	**1.8**	**1.8**
Imports	7.1	3.0	2.1	0.8	2.8	2.8	2.8	2.8	2.5	2.5	2.3	2.2	**5.6**	**2.8**	**2.3**
Labour Market															
Unemployment Rate (%)	5.6	5.4	5.2	5.0	4.9	4.8	4.7	4.7	4.6	4.6	4.5	4.5	**5.3**	**4.8**	**4.5**
Payroll Emp. (Mthly Change, 000s)	259	203	215	200	180	170	170	160	150	150	150	150	**235**	**170**	**150**
Non-Farm Productivity	-1.1	3.5	1.6	0.5	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	**0.5**	**1.0**	**1.0**
Income & Saving															
Real Personal Disposable Income	3.9	1.2	3.5	3.0	2.7	2.5	2.5	2.5	2.4	2.4	2.4	2.4	**3.2**	**2.5**	**2.4**
Average Hourly Earnings (%y/y)	2.2	2.3	2.2	2.3	2.6	3.0	3.2	3.5	3.5	3.7	3.9	4.0	**2.2**	**3.3**	**3.8**
Saving Rate (As a % of Disp. Inc.)	5.2	4.6	4.7	4.9	4.8	4.6	4.5	4.5	4.5	4.6	4.7	4.8	**4.8**	**4.5**	**4.7**
Prices (%y/y)															
Consumer Prices	-0.1	0.0	0.1	0.6	1.9	2.1	2.2	2.4	2.5	2.5	2.6	2.7	**0.2**	**2.1**	**2.6**
Core Consumer Prices[1]	1.7	1.8	1.8	2.0	2.1	2.2	2.4	2.4	2.5	2.6	2.7	2.8	**1.8**	**2.3**	**2.7**
Markets (end period)															
IOER Rate (%)	0.25	0.25	0.25	0.50	0.75	1.00	1.50	2.00	2.50	3.00	3.50	3.50	**0.50**	**2.00**	**3.50**
Fed Funds Rate Target Range (%)	0.0-0.3	0.0-0.3	0.0-0.3	0.3-0.5	0.5-0.8	0.8-1.0	1.3-1.5	1.8-2.0	2.3-2.5	2.8-3.0	3.3-3.5	3.3-3.5	**0.3-0.5**	**1.8-2.0**	**3.3-3.5**
10 Year Treasury Yield (%)	2.0	2.1	2.2	2.5	2.7	2.8	2.9	3.0	3.2	3.4	3.5	3.5	**2.5**	**3.0**	**3.5**
Dollar/Euro	1.08	1.13	1.09	1.05	1.03	1.00	0.98	0.95	0.96	0.98	0.99	1.00	**1.05**	**0.95**	**1.00**
Other															
Current Account (As a % of GDP)	-2.7	-2.5	-2.7	-2.8	-3.0	-3.0	-3.1	-3.2	-3.2	-3.2	-3.2	-3.2	**-2.7**	**-3.1**	**-3.2**
Federal Gov't Bal. (As a % of GDP)	-	-	-	-	-	-	-	-	-	-	-	-	**-2.4**	**-2.4**	**-2.3**

[1] Excluding energy and food.

Overview

When inflation rebounds, interest rates will follow

- Although we expect GDP growth to be a moderate 2.5% next year, we suspect the big surprise will be how quickly inflation rebounds. With domestic price pressures mounting and this year's deflationary shocks from lower commodity prices and the stronger dollar set to fade, we expect inflation to climb above the Fed's 2% target by mid-2016. Under those circumstances, we believe the Fed will abandon its gradualist philosophy and push the fed funds rate up to nearly 2.0% by end-2016 and above 3.0% by end-2017.

- As interest rates rise and act as a bigger constraint on the most rate sensitive spending components such as consumption and business investment, we anticipate that GDP growth will gradually slow to a more modest 2.0% in 2017. (See Chart 1.)

- The dollar's 15% surge over the past 15 months has resulted in a massive divergence between the performance of the export-orientated manufacturing sector and the rest of the economy. That surge is not unprecedented, but it is relatively rare. (See Chart 2.)

- The latest decline in the ISM index hints that the manufacturing sector may have slipped into recession. (See Chart 3.) But the other 88% of the economy is doing fine. Indeed, the strength of domestic demand partly explains why the dollar has risen in the first place.

- The growth rate of final sales to domestic purchasers has been running at 3%. (See Chart 4.) But the slowdown in net exports means that overall GDP growth will be around 2.5% this year, with net external demand subtracting roughly 0.5% points.

- While we anticipate a much more modest increase in the dollar next year, the drag from net exports from the currency appreciation we have already seen will persist for much of 2016 and won't truly fade until 2017. That largely explains why we don't expect GDP growth to accelerate next year.

- The strength of domestic demand has not been universal. (See Chart 5.) It mostly reflects a pick-up in consumption growth. Business investment has been mixed, with the slump in mining-related investment proving to be a big drag. That drag will fade next year, but investment growth is expected to remain muted, as rising labour compensation eats into corporate profit margins. (See Chart 6.)

- While the dollar's impact on real exports will last for some time, the impact on import prices should begin to fade quite soon. At the same time, domestic price pressures are building, with unit labour costs up by 3.0% over the past 12 months. We expect inflation to rebound markedly in the first half of next year. (See Chart 7.)

- If we are right, then the Fed will hike interest rates further than the markets expect. (See Chart 8.) Allowing for our above-consensus inflation forecast, however, it is important to stress that we don't anticipate a bigger than expected increase in *real* interest rates. They should still be below zero at end-2016.

Overview Charts

Chart 1: Real GDP (%q/q Annualised)

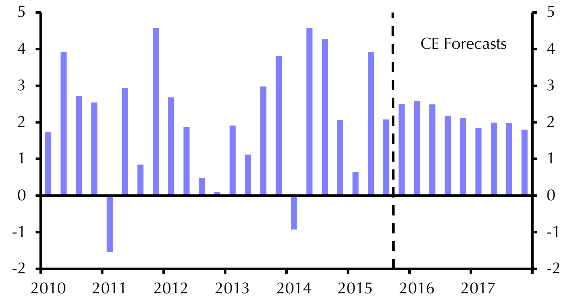


Chart 2: Broad Trade-Weighted Dollar (%y/y)

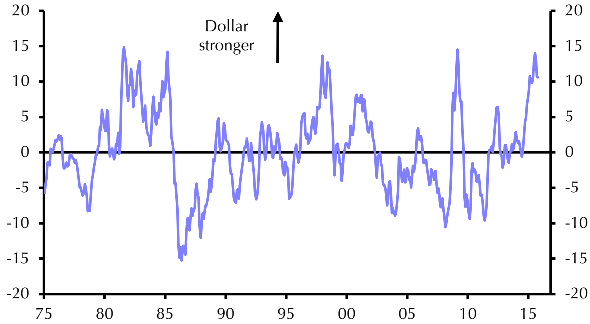


Chart 3: ISM Activity Indices

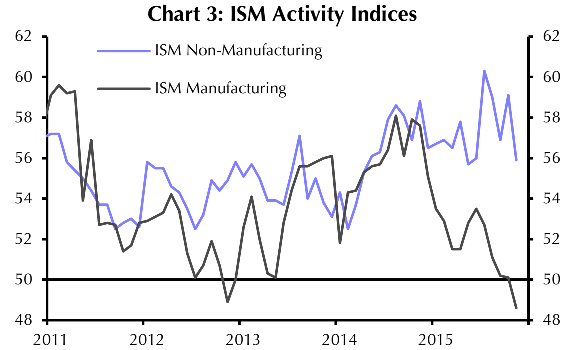


Chart 4: Final Sales to Dom. Purch, Import & Exports (%y/y)

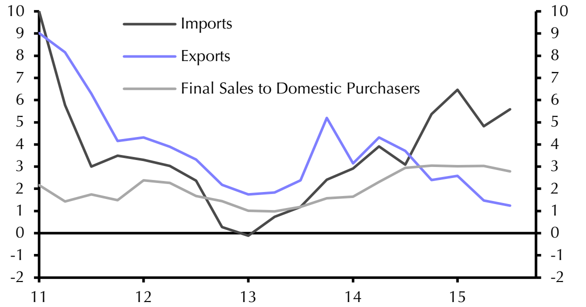


Chart 5: Real Consumption & Business Investment (%y/y)

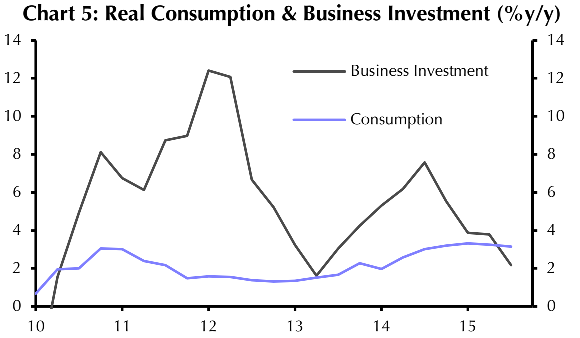


Chart 6: Corp. Profits & Labour Comp'nstn (As a % of GDP)

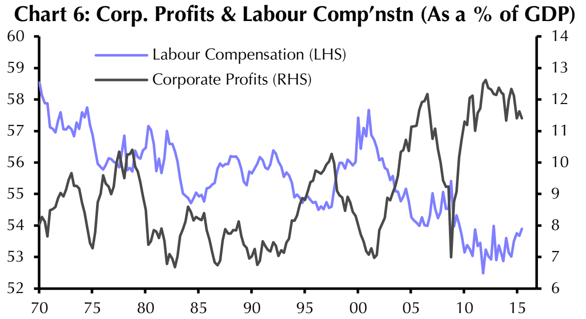


Chart 7: CPI Inflation (%)

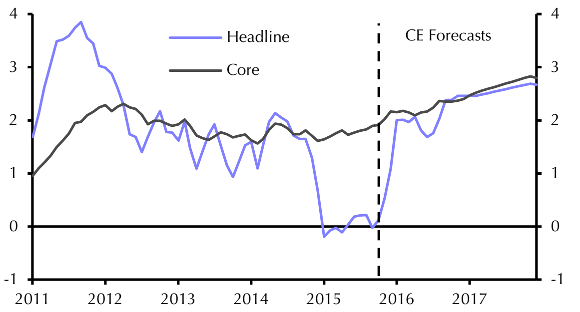
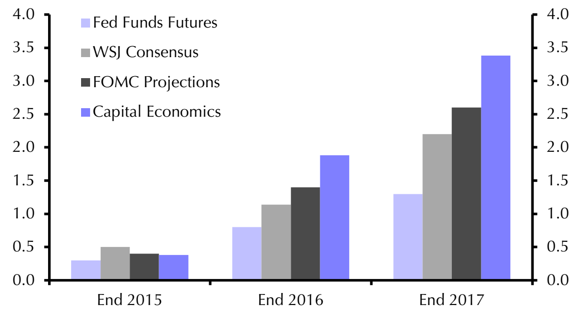


Chart 8: Fed Funds Rate Projections (%)



Sources – Thomson Datastream, Capital Economics, Fed, WSJ

Consumption

Rising interest rates will eventually weigh on spending

- A gradual slowdown in the pace of employment gains combined with rising interest rates next year will usher in a period of softer growth in real consumption. We expect consumption growth to slow from 3.2% this year to 2.7% in 2016 and 2.2% in 2017. (See Chart 1.)

- After a very weak start to the year, which was mainly due to the record cold winter in the Northeast, consumption growth rebounded markedly in the spring. (See Chart 2.) Since then, however, consumption growth has been more mixed.

- The collapse in gasoline prices, which lowered spending on gasoline by roughly $120bn per year, equivalent to 1.1% of consumption, has not provided the boost to real spending that we originally anticipated. (See Chart 3.)

- Lower gasoline prices have, however, triggered a massive surge in motor vehicle sales. Unit sales have been running at more than 18 million annualised for several months now and sales for 2015 as a whole are on track for a record high. (See Chart 4.) Furthermore, that surge has been driven entirely by a rise in more expensive (and less fuel efficient) light trucks, with car sales broadly flat this year.

- Real consumption has also received a big boost from an acceleration in the growth rate of health care spending. (See Chart 5.) The expansion of Medicaid eligibility and the introduction of subsidised insurance plans through the new Obamacare online exchanges has led to a marked decline in the proportion of uninsured Americans and, consequently, a big rise in real health care spending. This is largely a one-off change, however, and we expect health care spending growth to slow again over the next year or two.

- Although real consumption growth has been more mixed in recent months, real income growth has remained robust. (See Chart 6.) Income also took a hit during the winter, since the extreme weather prevented some people from getting to work, but since then income growth has been running at 4% annualised.

- A pick-up in the growth rate of hourly wages should provide an additional boost to real incomes next year, but that needs to be offset against an expected slowdown in employment growth. In addition, rising inflation will also act as a constraint on real incomes. All things considered, we expect real income growth to slow from 3.2% this year, to around 2.5% in both 2016 and 2017.

- Households do have scope to run down their saving rate a little next year, which is why we think consumption growth can still be as strong as 2.7% in 2016. (See Chart 7.)

- Finally, relative to incomes, households are carrying less debt than a decade ago. Accordingly, with interest rates still unusually low, the costs of servicing that debt is very low by past standards. (See Chart 8.) Nevertheless, rising interest rates will inevitably trigger a gradual slowdown in real spending beginning next year, especially in the more rate sensitive areas of consumption, such as durable goods.

Consumption Charts

Chart 1: Real Consumption (%q/q Annualised)

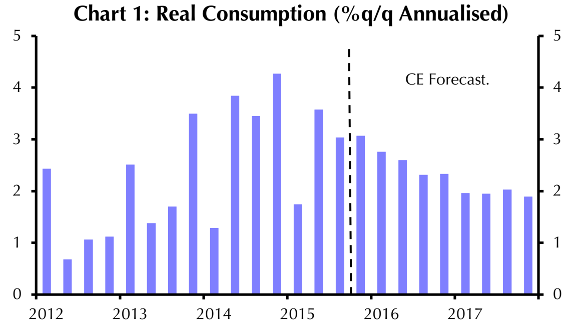


Chart 2: Real Consumption

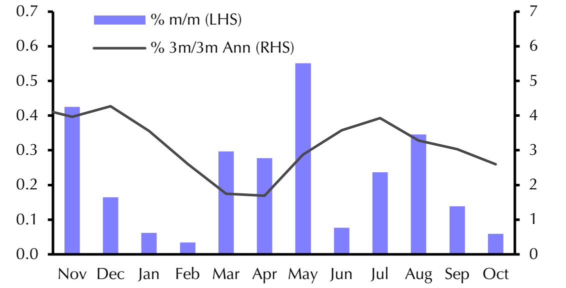


Chart 3: Spending on Gasoline & Gasoline Price

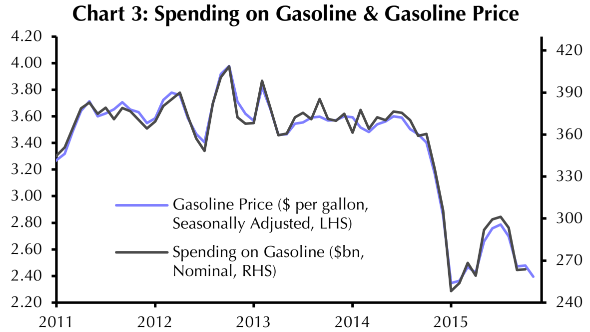


Chart 4: Light Vehicle Sales (Millions, Annualised)

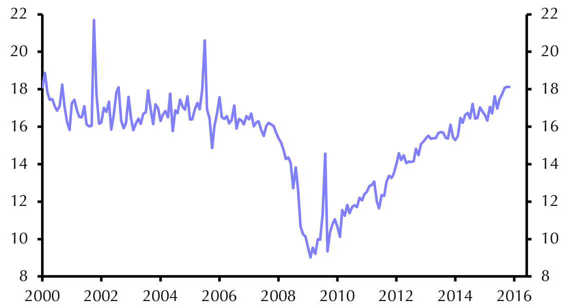


Chart 5: Health Care Spending (%y/y)

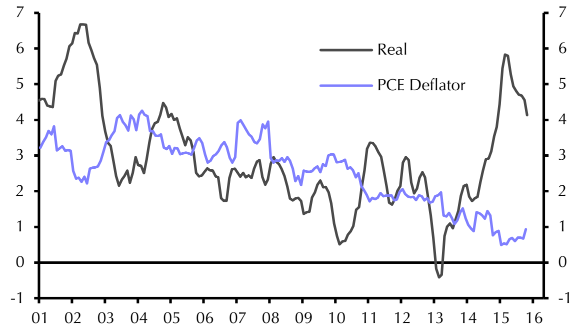


Chart 6: Real Personal Disposable Income

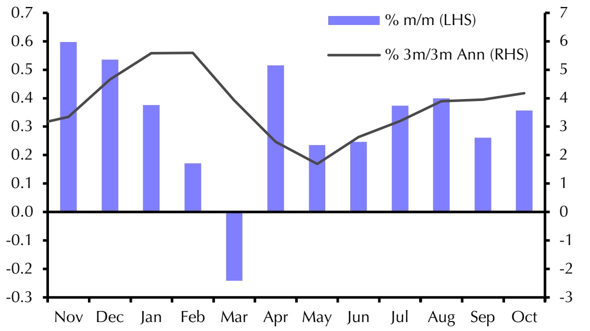


Chart 7: Personal Saving Rate (%)

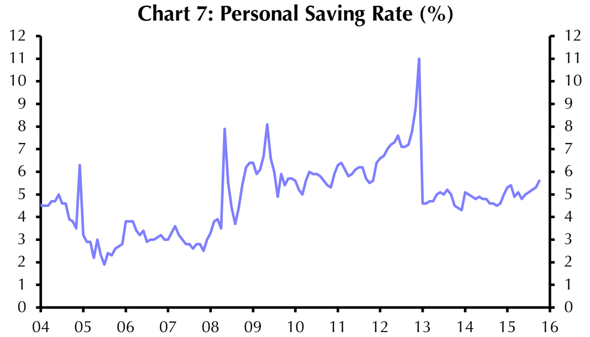
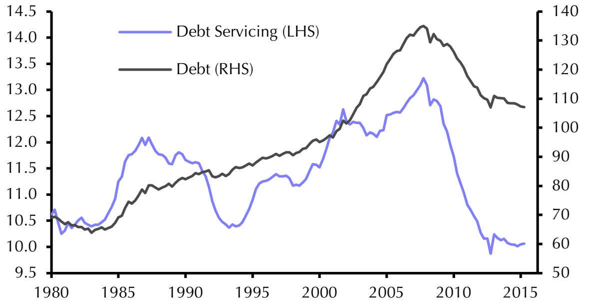


Chart 8: H'hold Debt & Debt Payments (% of Disp. Income)



Sources – Thomson Datastream, Bloomberg, Capital Economics

Investment

Firms struggling with rising borrowing costs and muted profits

- We expect the growth rate of business investment to accelerate slightly to 3.9% in 2016, from 3.3% this year, but only because the massive drag from the collapse in mining-related investment should fade. Otherwise, rising interest rates and the slowdown in corporate profit growth will act as constraints.

- Despite frequent claims to the contrary, business investment is not unusually low. It currently accounts for 12.9% of GDP, which is in line with the long-run average. (See Chart 1.) Overall fixed investment looks muted, but only because residential investment still accounts for a smaller than normal share of GDP.

- Nevertheless, that doesn't necessarily mean that the outlook for business investment is encouraging. For a start, given that interest rates have been near record lows for several years, we would have expected business investment to be well *above* its long-run average. The growth rates of each of the three main components of business investment have also slowed this year. (See Chart 2.)

- Over the past 12 months, non-residential structures investment has contracted slightly, as the slump in crude oil prices triggered a more than 50% drop in mining-related structures investment. The latest downward leg in oil prices has already translated into further declines in fourth-quarter drilling activity and, by extension, mining investment. (See Chart 3.)

- Unless oil prices undergo a further significant decline, however, mining structures investment should stabilise in the first half of next year, albeit at a level that could be close to 70% down on the 2014 peak.

- Unfortunately, the growth rate of business investment in equipment has slowed too. It did enjoy a brief renaissance in the third quarter, but the latest monthly data points to a renewed slowdown in the fourth. (See Chart 4.)

- The problem is that the manufacturing sector, which has seen profits hit hard by the stronger dollar, accounts for roughly one-fifth of the stock of capital equipment in the economy. (See Chart 5.) In recent years, the mining and agricultural sectors, which are now struggling with the slump in commodity prices, were also big buyers of capital equipment.

- With corporate profits stalling and borrowing costs rising quite substantially this year, the growth rate of business investment is likely to remain muted for some time yet. (See Chart 6.)

- Residential investment growth has also disappointed this year. New home sales and housing starts have been moving broadly sideways. (See Chart 7.) We anticipate a muted 3.6% gain in residential investment next year.

- Finally, while the business inventory-to-sales ratio has risen, a lot of the surge at the start of this year was due to the drop in energy prices. Petroleum accounts for a bigger share of inventories compared with sales. (See Chart 8.) Slower inventory accumulation was a drag on third-quarter GDP growth, but we expect it to make a broadly neutral contribution next year.

Investment Charts

Chart 1: Private Fixed Investment (As a % of GDP)

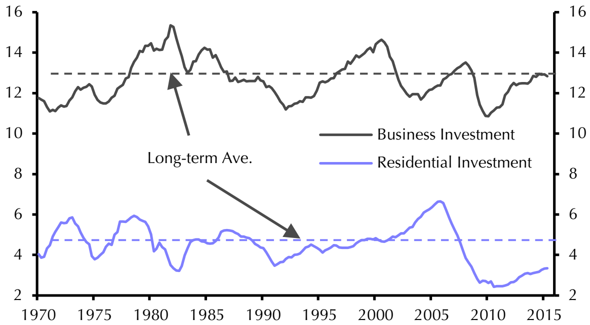


Chart 2: Business Investment (%y/y)

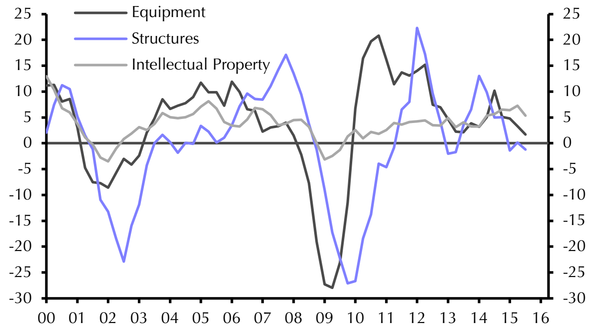


Chart 3: Drilling Rigs & Mining Investment (%q/q Ann.)

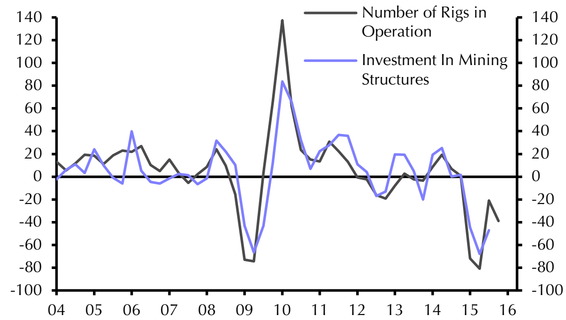


Chart 4: Bus. Equip. Prod'n & Cap. G'ds Ship. (%3m/3m Ann.)

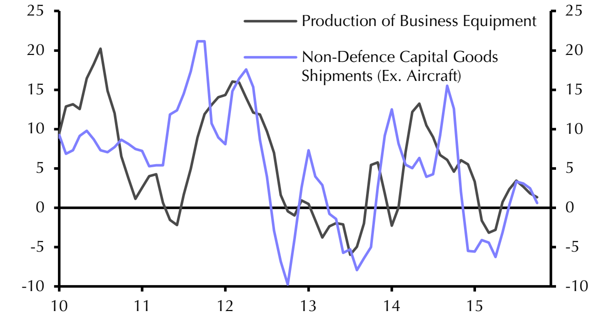


Chart 5: Equipment Assets (As a % of Total)

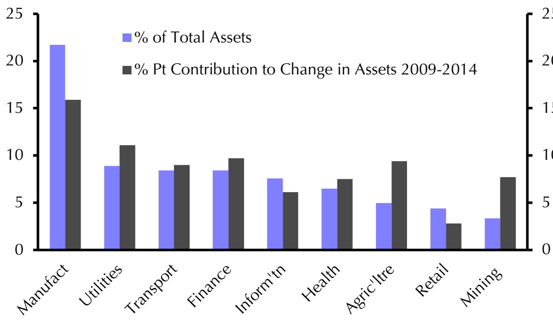


Chart 6: Moody's BAA Corporate Bond Yield (%)

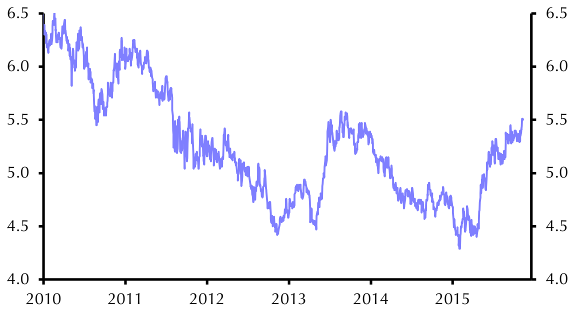


Chart 7: Housing Starts & New Home Sales (000s Annualised)

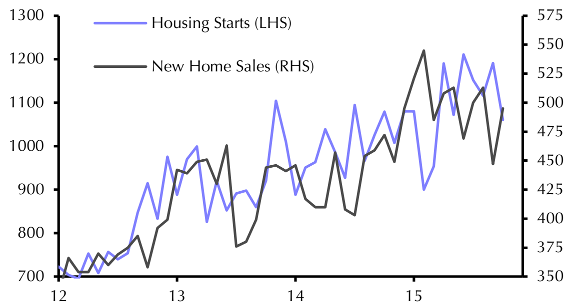
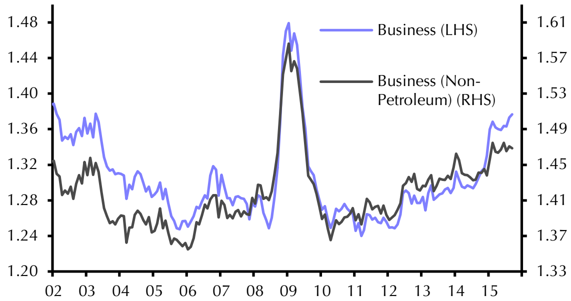


Chart 8: Business Inventory-To-Sales Ratio (%)



Source – Thomson Datastream

External Demand

Exports will remain weak even as dollar's ascent slows

- The 15% surge in the trade-weighted dollar over the past 15 months has hit exports hard and, as a result, net external trade will subtract about 0.5% points from overall GDP growth this year. Even though we anticipate a much smaller dollar appreciation in 2016, we expect the drag from net trade to persist, with real exports expanding by a modest 1.8% while real imports increase by 2.8%.

- The good news is that, even if the Fed raises interest rates more aggressively than the markets currently expect next year, the pace of dollar appreciation should still slow. (See Chart 1.)

- The appreciation in the trade-weighted dollar this year was mainly due to big gains against the euro, Canadian dollar and peso. (See Chart 2.) We expect the dollar to rise sharply against the euro and yen next year, as the ECB and Bank of Japan further loosen monetary policy. But the gains against the Canadian dollar and peso this year were due to the slump in commodity prices, rather than interest rate differentials, which we don't expect to be repeated in 2016.

- The bad news is that even if any further appreciation in the dollar next year is limited, the big rise this year will continue to act as a significant drag on exports for some time. The Fed's own research suggests that the impact can last as long as three years. As Chart 3 shows, real exports stopped expanding late last year and have been treading water ever since.

- Exchange rate shifts tend to have a more modest impact on imports because importers often boost their own margins rather than pass the full savings on to US consumers via lower prices. Real import growth has accelerated a little this year. But, as Chart 4 shows, that acceleration is no more than we would have expected given the corresponding pick-up in the growth rate of total final expenditure (i.e. domestic demand plus exports).

- Above and beyond the dollar's rise, the weakness of global demand has played a secondary role in restraining exports. Nevertheless, for all the fears about a slump in Chinese economic growth, the China PMI is still at a level consistent with a continuing stagnation in US exports to the country rather than an outright contraction. (See Chart 5.)

- US exports to the euro-zone have fared much worse, even though the euro-zone PMI has picked up this year. (See Chart 6.) But this is because the dollar has appreciated by much more against the euro than it has against the Chinese renminbi.

- Although the dollar's rise has hit real export growth, the nominal monthly trade deficit has remained largely unchanged, as plummeting energy prices have reduced the cost of imported oil. (See Chart 7.) In particular, as a result of the slump in oil prices, the US now runs a bilateral trade surplus with OPEC countries. (See Chart 8.) Nevertheless, over the next two years, we expect the nominal trade deficit to widen gradually.

External Demand Charts

Chart 1: Fed Broad Trade-Weighted Dollar Index

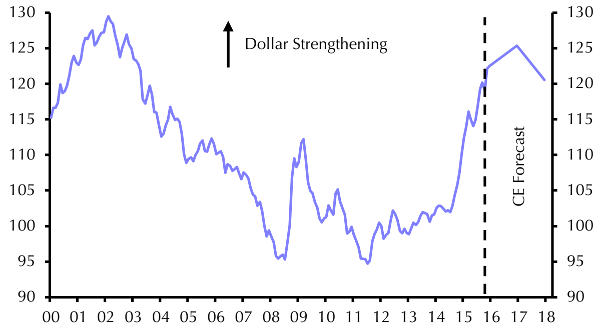


Chart 2: Change in Currency Against the US Dollar (%y/y)

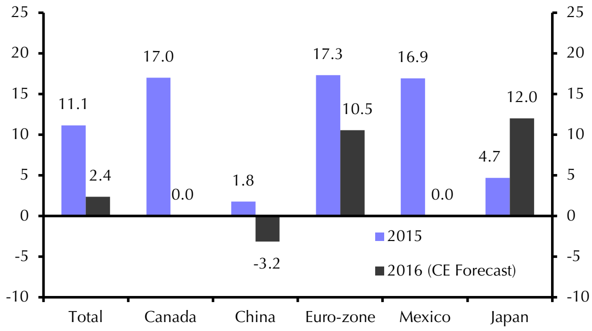


Chart 3: Real Goods Imports & Exports ($bn)

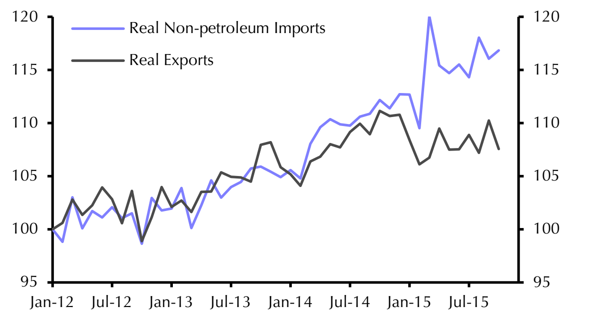


Chart 4: Imports & Total Final Expenditure (%y/y)

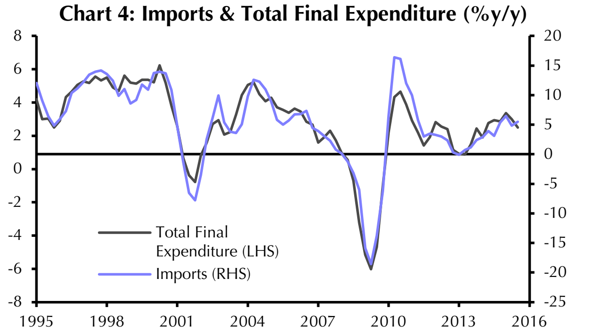


Chart 5: US Exports to China & China PMI

Chart 6: US Exports to Euro-zone & Euro-zone PMI

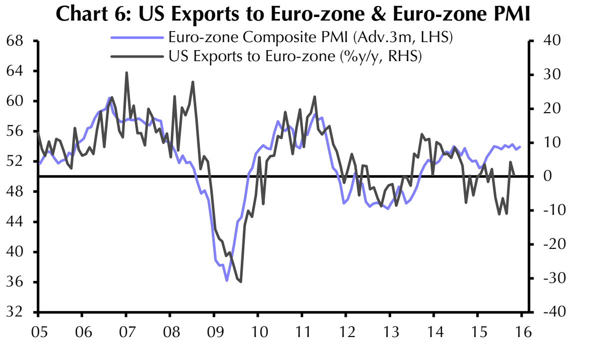


Chart 7: Monthly Trade Balance ($bn)

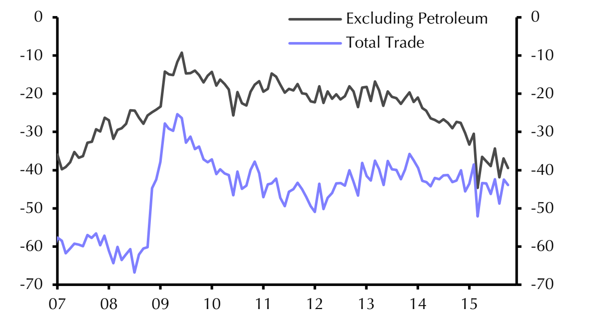
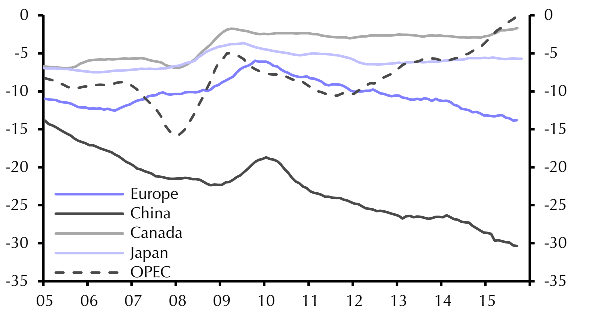


Chart 8: Bilateral Trade Balances ($bn, 12m Ave.)



Sources – Thomson Datastream, Markit

Labour Market

With full employment close, wage growth will finally accelerate

- The average monthly gains in employment will inevitably slow next year but, with the labour market now very close to full employment, the big story next year will be a more marked acceleration in wage growth.

- After peaking at an average of more than 250,000 late last year, payroll employment has been expanding at nearer 200,000 per month recently. (See Chart 1.) With the labour force increasing at an average of less than 100,000 per month, however, even a drop in employment growth to 170,000 a month next year would be consistent with further declines in the unemployment rate.

- The slowdown in employment growth certainly doesn't appear to be due to a drop off in labour demand. The job openings rate remains very close to a record high, easily outstripping the rise in the voluntary job quits rate. (See Chart 2.)

- Instead, the bigger issue now may be the tightness of labour supply. The decline in the unemployment rate to 5.0% suggests that the labour market is now at, or very close to, full employment. (See Chart 3.) Admittedly, other measures, such as the proportion of involuntary part-time workers, suggests that there is still a modest amount of slack left in the labour market. But even on that basis there has been a very big improvement this year.

- Some commentators have suggested that demographic changes mean the long-run equilibrium unemployment rate could now be well below 5%. Following such a severe recession and protracted recovery, however, we suspect that so-called hysteresis effects mean that long-run equilibrium rate is at least as high as it was before 2008. People who are unemployed for an extended period find it much harder to ever return to employment. In effect, the cyclical rise in unemployment becomes a permanent structural increase.

- It is very notable that the short-term unemployment rate is now well below its pre-recession level, whereas the long-term unemployment rate is still well above its pre-recession level. (See Chart 4.) That helps to explain why the pace of hiring has slowed, even as the number of job openings has soared. Prospective employers are struggling to find suitable job candidates.

- Although the drop in the unemployment rate over the past few years has owed as much to a decline in the participation rate as the rebound in employment, we believe that decline is mostly a structural fall rather that a potentially reversible cyclical dip. (See Chart 5.) Our calculations indicate that the aging of the population and rising enrolment in education have played the key roles. (See Chart 6.)

- Admittedly, we haven't yet seen a decisive acceleration in wage growth, but we suspect it is only a matter of time now. (See Chart 7.) The rising proportion of small firms reporting that labour quality is their biggest problem points to a pick-up in hourly wage growth to more than 3.0% by end-2016. (See Chart 8.)

Labour Market Charts

Chart 1: Change in Non-Farm Payrolls (000s)

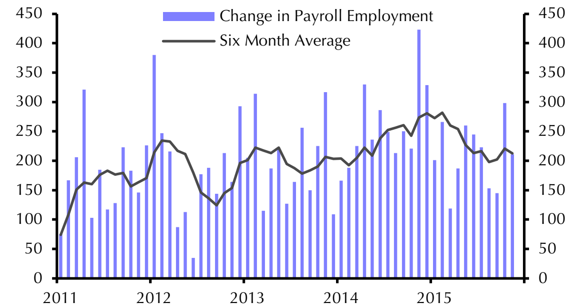


Chart 2: Job Openings & Quit Rates (%)

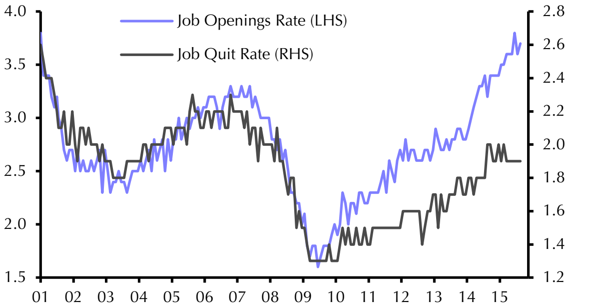


Chart 3: Unemployment & Involuntary Part-Time Rates (%)

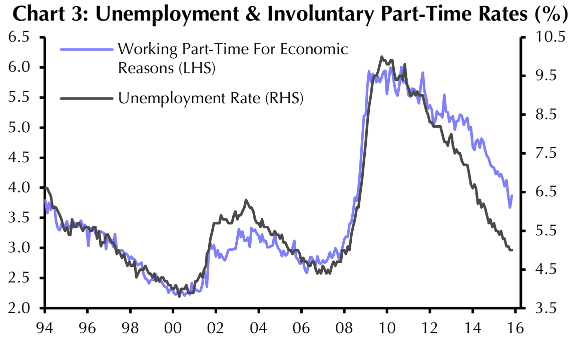


Chart 4: Long- & Short-Term Unemployment Rates (%)

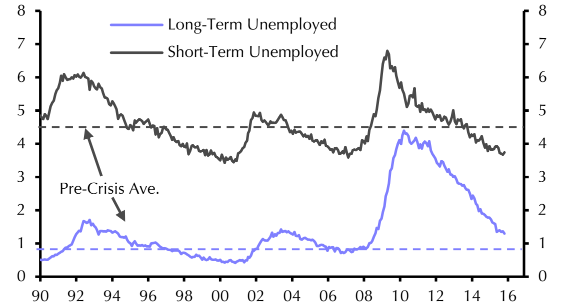


Chart 5: Participation Rate (%)

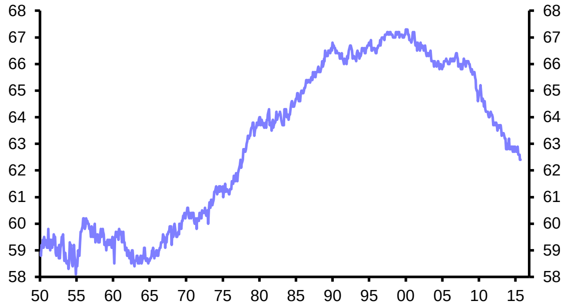


Chart 6: Factors Explaining Drop in Participation Rate (% Pts)

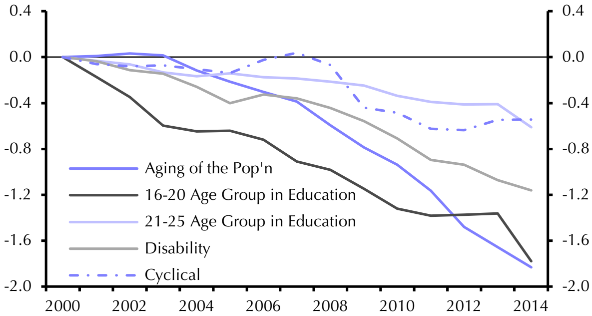


Chart 7: Wages & Earnings (%y/y)

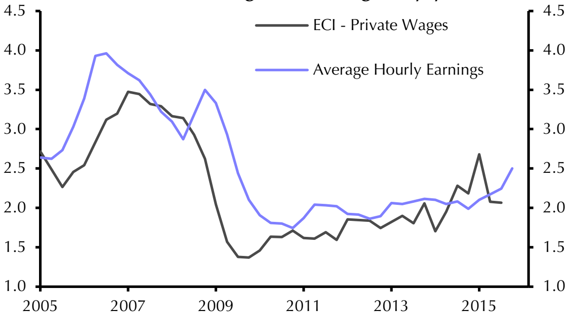
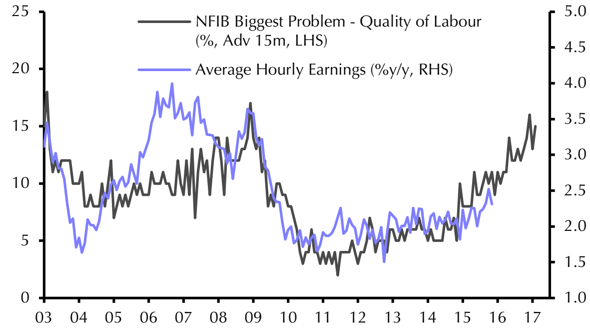


Chart 8: AHE & NFIB Quality of Labour Problem Index



Source – Thomson Datastream

Prices

Rising domestic price pressures point to big rebound in inflation

- Inflation has remained close to zero for most of this year, as the deflationary effects of the slump in commodity prices and the surge in the dollar have dominated. But those effects will fade dramatically next year, while shrinking slack points to a surge in domestic price pressures. The upshot is that we expect inflation to climb back to the Fed's 2% target by mid-2016 and then rise well above it in 2017. (See Chart 1.)

- As Chart 2 shows, the big declines in crude oil and gasoline prices occurred almost a year ago now. If prices remain at current levels, then the annual changes will be back to zero by early next year.

- Although the dollar's surge can be expected to have an ongoing impact on real exports next year, the downward effect on import prices should begin to fade early next year. (See Chart 3.) The rising dollar lowered inflation by up to 0.5% points this year. But if we are right and the increase in the trade-weighted dollar is much smaller next year, then that drag will all but disappear by the second half of 2016.

- The deflationary impact of the dollar's appreciation and the corresponding decline in import prices shows up principally through the decline in core goods prices. (See Chart 4.) Nevertheless, goods prices only account for a quarter of the core CPI index. Services account for the lion's share and, in response to the near-elimination of domestic slack, core services inflation has climbed to a six-year high.

- The biggest input into services costs is labour. Even without a pick-up in hourly wage growth, there has been an acceleration in the growth rate of unit labour costs. (See Chart 5.) As hourly wage growth accelerates next year too, the growth rate of unit labour costs will climb even higher.

- Admittedly, while core CPI inflation is already close to 2%, the Fed's preferred PCE measure still shows core inflation at a markedly below-target 1.3%. (See Chart 6.)

- The increasing divergence between the two core inflation measures this year mainly reflects differences in the inclusion of medical prices. (See Chart 7.) The CPI measure only includes out of pocket expenditures by households, whereas the PCE measure also includes spending through public programmes like Medicare and Medicaid and also spending on behalf of households by private insurers.

- The latter has been dragged down in recent years by cuts to hospital and physician fees for Medicaid and Medicare. But we expect those prices to level out now. More generally, the cuts to these administered prices set by Congress do not reflect any drop off in demand in the private sector. The upshot is that core PCE inflation could rebound even more markedly that core CPI inflation.

- Finally, households' inflation expectations still appear to be well anchored and even breakeven inflation rates have rebounded slightly in recent months. (See Chart 8.)

Prices Charts

Chart 1: CPI Inflation (%)

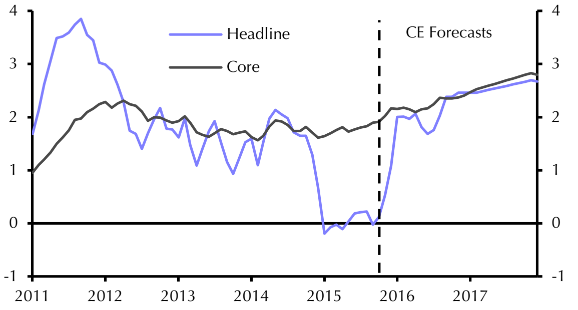


Chart 2: Energy Prices

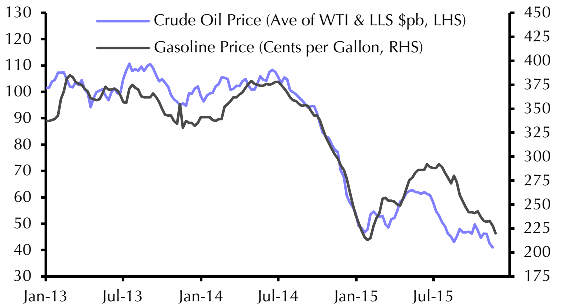


Chart 3: Broad Dollar Index & Import Prices (%y/y)

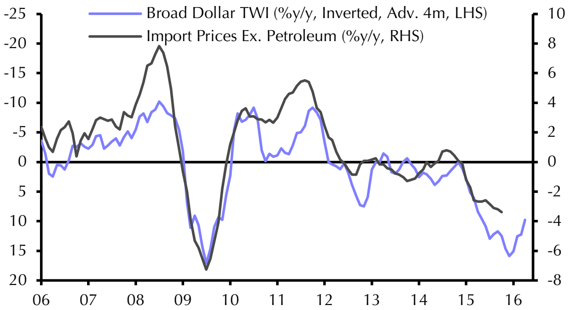


Chart 4: CPI Core Goods & Services (%y/y)

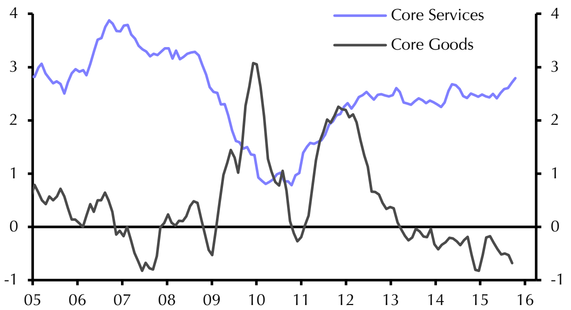


Chart 5: Unit Labour Costs (%y/y)

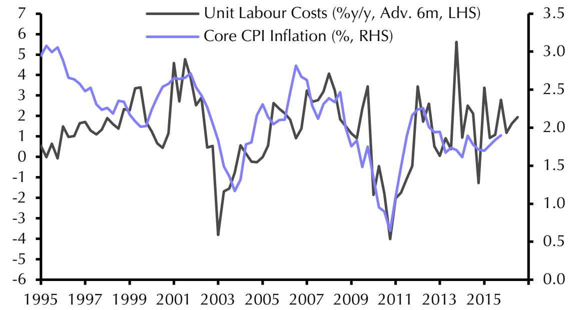


Chart 6: Core Inflation (%)

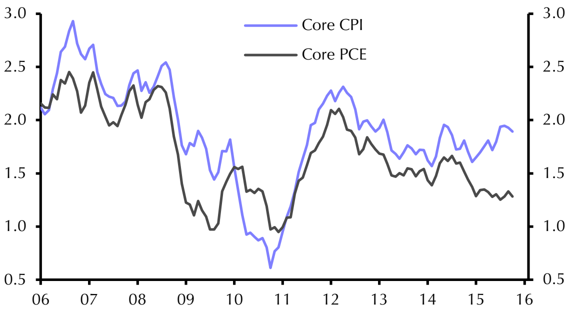


Chart 7: Medical Care Prices (%y/y)

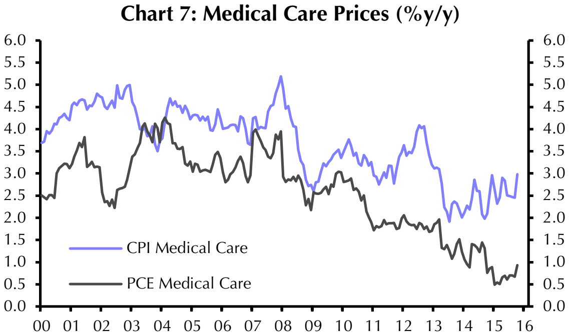
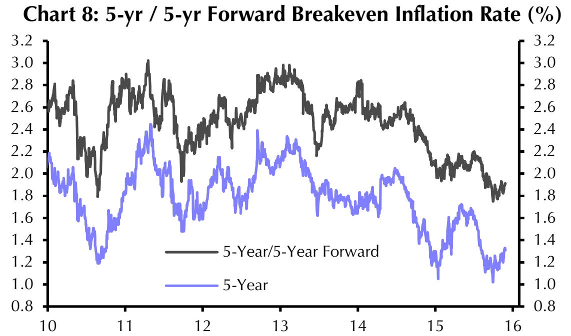


Chart 8: 5-yr / 5-yr Forward Breakeven Inflation Rate (%)



Sources – Thomson Datastream, Capital Economics

Monetary & Fiscal Policy

Fed to abandon gradual pace of hikes once inflation rebounds

- The Fed is widely expected to begin raising the fed funds rate from near-zero at the mid-December FOMC meeting. As far as next year is concerned, markets are taking the Fed at its word that it can subsequently raise rates only very gradually. (See Chart 1.)

- In contrast, we suspect that rising wage and price inflation will force the Fed to abandon its gradualist strategy around the middle of next year. As a result, we expect the fed funds rate to climb to nearly 2.0% by end-2016 and more than 3.0% by end-2017. (See Chart 2.)

- Nevertheless, since we also assume that inflation will climb above the Fed's 2% target next year, our forecasts do not imply a bigger increase in real interest rates. The latter should remain accommodative at below zero in 2016.

- Shorter Treasury yields have risen in response to the signals from the Fed that a rate hike is imminent. But longer-term yields remain well below the peaks reached in late 2013. (See Chart 3.)

- There are legitimate reasons why the neutral fed funds rate is much lower now than it was before the financial crisis in 2008. In particular, the economy's potential growth rate appears to have slowed to 2% or even lower. Nevertheless, a 10-year Treasury yield of barely more than 2% implies the markets think that the real neutral interest could be close to zero now. In contrast, we think it is nearer 1%.

- Once the Fed begins to normalise interest rates, it should be able to fine-tune the effective fed funds rate using its new reverse repo and term deposit facilities, to drain reserve balances when needed. (See Chart 4.) Nevertheless, the slump in the effective rate at the end of each month this year illustrates that keeping the effective rate within the target range will be much harder than it was pre-2008. (See Chart 5.)

- Eventually the Fed will need to consider reducing the size of its asset holdings. We expect it to stop reinvesting the proceeds from maturing securities around mid-2016, although it will be mid-2017 at the earliest before any actual asset sales began.

- Fiscal policy should provide a small boost to GDP growth in 2016. As part of the bipartisan budget deal agreed a month ago, which also suspended the debt ceiling until early 2017, the caps on Federal discretionary spending levels will be loosened next year. Congress has agreed to boost spending by $50bn in fiscal year 2016 and by $30bn in 2017. As a result, we now expect a 2.5% annualised gain in real Federal spending in 2016 and a 0.8% gain in 2017. (See Chart 6.)

- Despite the changes to planned Federal spending, the budget deficit should remain slightly below 2.5% of GDP in both 2016 and 2017. (See Chart 7.) Under current legislation the deficit would begin to widen again in the early 2020s, as the aging population begins to push up the cost of public health care and social security. Even if current legislation wasn't changed, however, the debt burden would remain at around 70% of GDP. (See Chart 8.)

Monetary & Fiscal Policy Charts

Chart 1: Fed Funds Futures Rate Expectations (%)

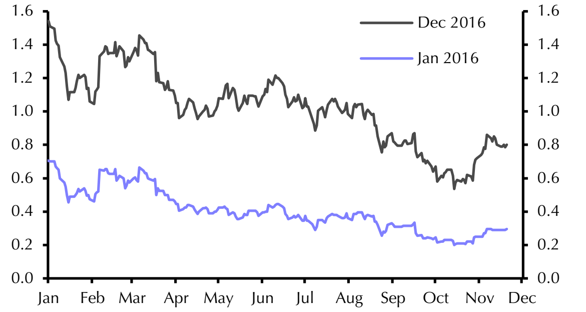


Chart 2: Fed Funds Rate Expectations (%)

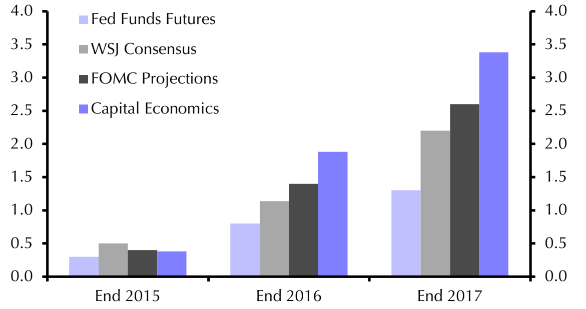


Chart 3: Treasury Yields (%)

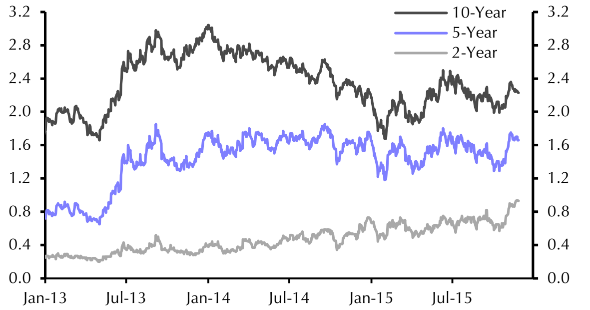


Chart 4: Fed's Assets & Reserve Balances ($bn)

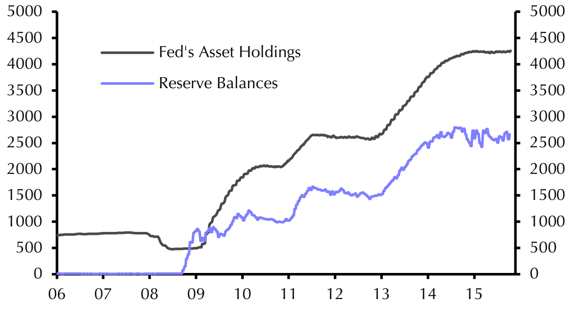


Chart 5: Effective Fed Funds Rate (%)

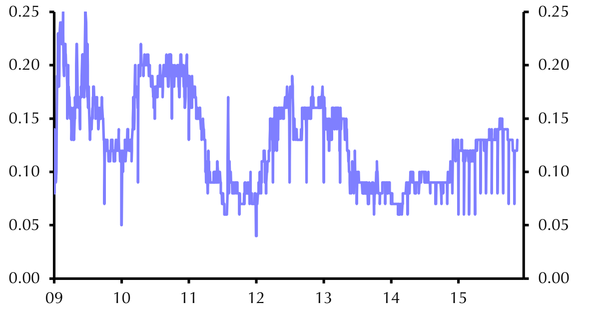


Chart 6: Real Federal Expenditure (%y/y)

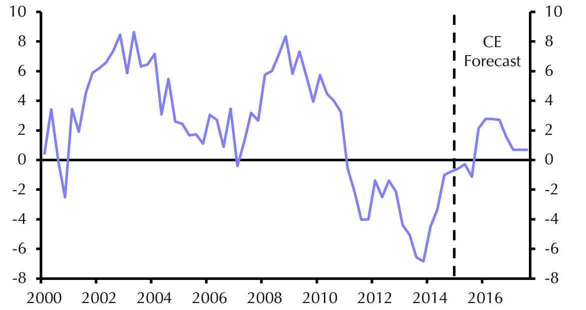


Chart 7: Federal Budget Balance (As a % of GDP)

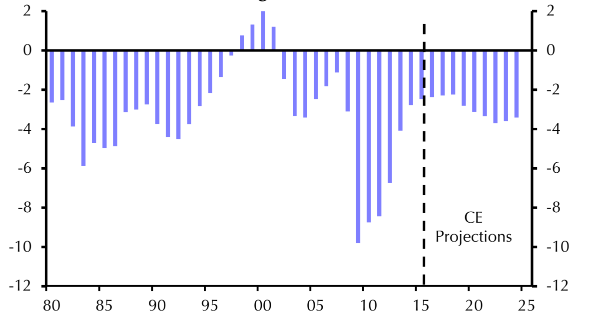
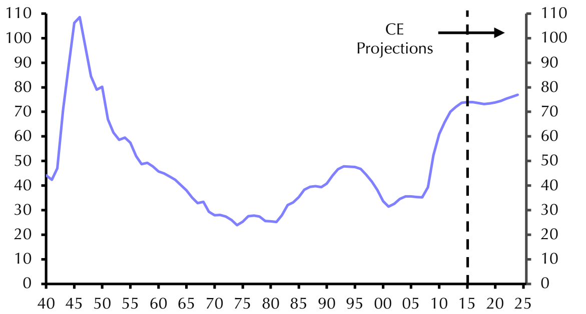


Chart 8: Federal Debt (As a % of GDP)



Sources – Thomson Datastream, CE, WSJ, Bloomberg, CBO