FFTW Weekly Commentary
FOR PROFESSIONAL INVESTORS

US Growth and Inflation Outlook

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Key takeaways

- US economic momentum is now ever more reliant on domestic consumption, which has been supported by solid gains in both employment and household sector net wealth.
- Our forecasts indicate headline inflation should gradually normalize towards the Federal Open Market Committee (FOMC) Consumer Price Indexes (CPI) inflation target of 2.4% by early 2017. However, there are many risks to this forecast.
- Treasury yields should not rise dramatically. We would be surprised to see US 10-year Treasury yields rise above 2.00% in the next six months.

Full commentary

Moderate US Growth Driven by Household Sector
GDP in the first half of 2016 grew by only around 1.1% annualized. The headline numbers can be deceptive, as a slowdown in inventory accumulation detracted meaningfully from the overall GDP numbers – which means that final domestic demand remained relatively firm. However non-residential investment continued to slow, such that it is no longer contributing meaningfully to GDP growth. This picture of slowing non-residential investment is corroborated by business confidence surveys that show a loss of momentum, which is perhaps unsurprising given the ongoing decline in year-over-year profit growth.

US economic momentum is now ever more reliant on domestic consumption, which has been supported by solid gains in both employment and household sector net wealth. The six-month average for monthly employment gains has declined since February by around 60,000 jobs to 169,000 new jobs per month. This is still a solid pace of employment growth. We expect it to slow towards 100,000 per month in coming quarters.

Given the resilience of the labor market so far, the softening of the most recent sales numbers and residential investment activity is worrying. The primary driver of the US economy right now is the household sector. Although households are not overly levered and the cost of credit is low, access to credit is restricted, and consumption is vulnerable to a softening labor market or volatility in financial markets.

US Inflation to Pick-up – But Downside Risks Remain
Inflation prospects look healthier. In late 2015 the FOMC described many of the factors holding back inflation as transitory because of the decline in energy prices and the strength of the USD. The USD has been reasonably stable for months and energy prices rebounded modestly, allowing base effects to work through the data.

Although personal consumption expenditures (PCE) inflation remains below the FOMC's 2.0% objective, a number of measures of underlying, or 'core', inflation continues to gently firm. As of August, year-over-year core PCE was running at 1.70%, trimmed mean PCE at 1.7%, core CPI at 2.3% and sticky CPI at 2.7%. These numbers do not (in our view) allow the FOMC to yet declare victory on its inflation mandate.

Digging into the details of the inflation data shows large divergences between sectors. Shelter service inflation has been strong for some time, but arguably reflects a shortfall of housing inventory due to weak construction activity, limited mortgage financing availability and changes in household preferences on renting versus owning. Goods prices, meanwhile, remain soft as a result of USD strength and declines in internationally-traded commodities prices, and continue to detract from overall inflation.

The best gauge of domestically-generated inflation is the non-shelter services category, which should be most impacted by unit labor costs, which are in turn largely driven by wage pressures. This category has clearly firmed in 2016. Non-shelter services costs - comprising mostly of education, medical care, transport and recreation services - were growing at 2.6% in August 2016, versus a pace of 1.8% year-over-year in March 2016 and 1.13% in May 2015. We need to see this trend continue to offset the deflationary impact of weak core goods prices, and support inflation expectations.

Our forecasts indicate headline inflation should gradually normalize towards the FOMC's inflation target by early 2017. However, there are many risks to this forecast including: strengthening of the USD, drop in commodity prices, international shocks, below trend US growth such that spare capacity is not further reduced, survey and market-based inflation expectations do not reverse their recent softening trend and disinflationary pressures from abroad.

Expect Range Bound US Treasury Yields
Treasury yields should not rise dramatically. We would be surprised to see US 10-year Treasury yields rise above 2.00% in the next six months, although an unexpected presidential election result could raise term premia and steepen the yield curve. Our baseline scenario for the next six months is that yields remain low given negative net supply of sovereign bonds and central bank financial repression. FOMC policy rate hikes would likely appreciate the USD, short-circuiting any rise in yields.

For additional information please refer to the [Inflation-Linked Bond Outlook]

This week's market developments

Tuesday, October 11
- Japan Machine Orders growth decreased to -2.2% m.o.m. (s.a.) for August

Wednesday, October 12
- Eurozone Industrial Production growth increased to 1.6% m.o.m. (s.a.) for August

Thursday, October 13
- Japan Tertiary Industry Index growth decreased to 0.0% m.o.m. (s.a) for August
- Japan PPI growth increased to -3.2% y.o.y. for September

Friday, October 14
- US Retail Sales Advance growth increased to 0.6% m.o.m. (s.a.) for September
- US PPI Final Demand growth increased to 0.3% m.o.m. (s.a.) for September
- University of Michigan Sentiment Index (prelim estimate) decreased to 87.9 for October

Source: Bloomberg, as of end October 17, 2016

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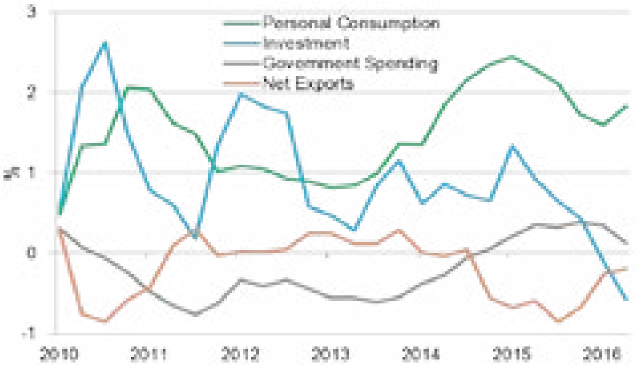
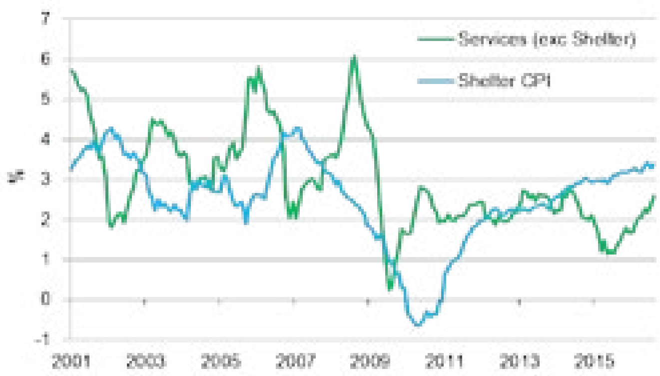
Chart of the Week
Contributions to GDP Growth (4Q Moving Average)



Source: Federal Reserve Bank of St. Louis, as of June 30, 2016

Chart of the Week
Core Inflation and Services & Shelter CPI



Source: Bloomberg, as of end August 31, 2016

Central Bank Watch

	Last move	Date of move	Current policy rate	Implied 3m rate on March 2016 Interest Rates Futures Contract	Next meeting
Fed	+25 basis points	December 16, 2015	0.25 % - 0.50 %	0.50 %	November 2, 2016
ECB	-5 basis points	March 10, 2016	0.00%	-0.18 %	October 20, 2016
BoJ	-20 basis points	February 16, 2016	-0.10 % - 0.00%	0.05 %	November 1, 2016
BoE	-25 basis points	August 4, 2016	0.25 %	0.40 %	November 3, 2016

Source: Bloomberg, as of end October 11, 2016

Next week's market developments

Monday, October 17
- Eurozone CPI growth is expected to increase to 0.4% m.o.m. (s.a.) for September
- US Industrial Production growth is expected to increase to 0.1% m.o.m. (s.a.) for September
- US Capacity Utilization is expected to decrease to 75.6% (s.a.) for September

Tuesday, October 18
- UK CPI growth is expected to decrease to 0.1% m.o.m. (s.a.) for September
- UK PPI Output growth is expected to increase to 0.2% m.o.m. for September
- US CPI growth is expected to increase to 0.3% m.o.m. (s.a.) for September

Wednesday, October 19
- Japan All Industry Activity Index growth is expected to decrease to 0.2% m.o.m. (s.a.) for August
- US Housing Starts are expected to increase to 1,175,000 for September

Thursday, October 20
- US Existing Home Sales are expected to increase to 5,350,000 for September
- US Leading Index growth is expected to increase to 0.2% m.o.m. for September

Friday, October 21
- Eurozone Consumer Confidence (advance estimate) is expected to decrease to -8.0 for October

Source: Bloomberg, as of end October 17, 2016

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