U.S. Outlook

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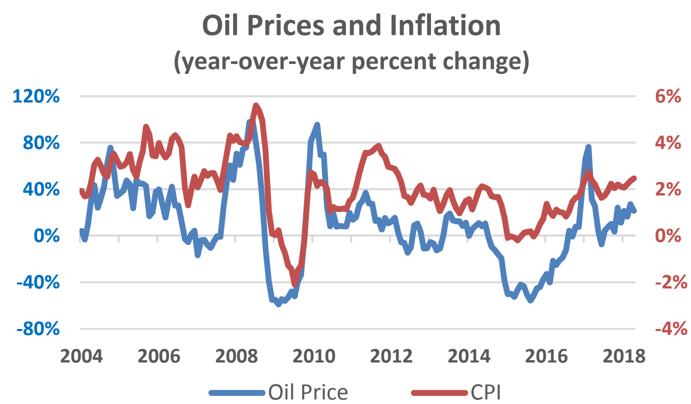
Date	Indicator	For	Estimate	Consensus*	Previous Period
21-May-2018	Chicago Fed Nat Activity Index	Apr	NA	NA	0.1
22-May-2018	Richmond Fed Manufacturing Index	May	10.0	8.0	-3.0
23-May-2018	Markit US Manufacturing PMI	May P	57.1	56.4	56.5
23-May-2018	Markit US Services PMI	May P	54.2	54.8	54.6
23-May-2018	Markit US Composite PMI	May P	NA	NA	54.9
23-May-2018	New Home Sales	Apr	675k	677k	694k
23-May-2018	FOMC Meeting Minutes	May			
24-May-2018	Initial Jobless Claims	19-May	220k	220k	222k
24-May-2018	FHFA House Price Index MoM	Mar	0.6%	0.6%	0.6%
24-May-2018	Existing Home Sales	Apr	5.50m	5.56m	5.60m
24-May-2018	Kansas City Fed Manufacturing Activity	May	20.0	23.0	26.0
25-May-2018	Durable Goods Orders	Apr P	-1.7%	-1.4%	2.6%
25-May-2018	Durables Ex Transportation	Apr P	0.3%	0.5%	0.1%
25-May-2018	U. of Mich. Sentiment	May F	98.8	98.8	98.8

*Consensus from Bloomberg

What Will the Oil Price Spike Do to Consumer Inflation?

The price of oil and inflation are positively – and highly – correlated. In other words, as oil prices increase or decrease, inflation moves in the same direction. This is because oil is a major input in the U.S. economy: It is used for essential activities like the transportation of goods, gasoline for cars, and heating homes. If these costs rise, the increase will ultimately be passed along to the end user in the form of higher consumer prices. The positive relationship between oil prices and inflation is evident in the time period from 2004 to the present, with a significant positive correlation of 0.78.

Oil Prices and Consumer Inflation Are Highly Correlated



Sources: Energy Information Administration, BLS

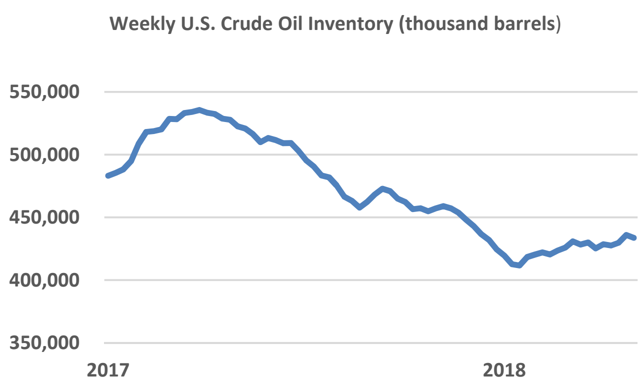
What Drives Global Oil Prices?

We see three primary drivers of oil prices: 1) supply and demand dynamics, 2) the value of the U.S. dollar as oil is priced is dollars, and 3) the risk premium associated with geopolitical tensions. The Federal Reserve estimates that of the 13.1% increase in the price of Brent crude from January 5 to May 11, 7.3 percentage points are the result of changing supply and demand factors, with the remainder coming from changes in the value of the U.S. dollar and the risk premium.

The Outlook for Oil Prices and Inflation

The U.S. withdrawal from the Iran nuclear deal has increased the geopolitical risk premium for oil and stoked additional global oil supply concerns. WTI oil prices have increased about $14.00 per barrel since February to $71.55. Working against these forces is a gradual upswing in U.S. crude oil inventory this year, with a year-to-date increase of about 3%. U.S. producers are increasingly viewed as being the swing producer in the oil market, and fracking technology allows them to increase or decrease output very quickly in response to price movements. As a result, supply and demand are more quickly aligned and large oil price swings have not been as prevalent recently as those witnessed in the past.

U.S. Oil Inventories Are on the Rise

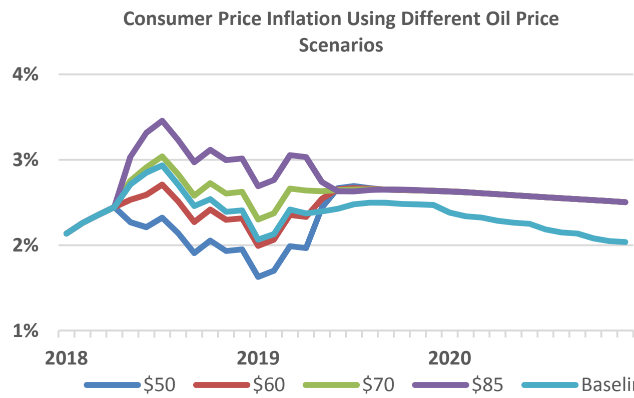


Source: U.S. Energy Information Administration

However, this dynamic that is currently keeping oil supply closely aligned with demand could change abruptly if political tensions boil over in the Middle East. Consequently, we decided to run a number of oil price scenarios through our CPI inflation model to help us gauge the possible impact on future inflation and Fed monetary policy.

In addition to our baseline oil price forecast of $65 and $61 per barrel on average in 2018 and 2019, respectively, an immediate and permanent oil price shock at $50, $60, $70 and $85 was modeled.

An $85 Spike in Oil Could Push Consumer Inflation to 3.5%



Sources: Energy Information Administration, BLS, Bank of the West Economics

What we see is the impact of a spike in oil prices is felt almost immediately at the consumer level, according to our model. In the scenario where WTI oil prices immediately go to $85/barrel in May and stay there, the overall consumer inflation rate jumps to 3.46% by July, 52 basis points above the baseline. Conversely, in the $50 oil price scenario, the year-over-year inflation rate takes far longer to hit its nadir, eventually slipping to 1.63% in January 2019.

In our baseline view, the recent spike in WTI oil prices is likely to be temporary, in part because of the supply-side response from U.S. producers, and a reduction in the geopolitical risk premium. Our forecast has oil peaking for the year at $68 a barrel on average in the current quarter and then declining back to $63 by the end of the year. In this baseline scenario, consumer price inflation peaks in July at 2.94% before dropping back to 2.1% by January 2019. As a result, our baseline forecast still has the Fed raising the fed funds rate only three times this year and once next year, all in 25 basis point increments.

However, if tensions do escalate in the Middle East and there is a sharp and sustained rise in oil prices and inflation, there is a rising possibility for additional rate hikes. In our view, 3% or higher consumer price inflation for a sustained period could not be ignored by the FOMC and would prompt the Fed, at the very least, to consider one additional rate hike this year.

Major Economic Indicators

	History					Forecast							Yr/Yr % chg or Annual Avg.			
Economic Data	**2017.1**	**2017.2**	**2017.3**	**2017.4**	**2018.1**	**2018.2**	**2018.3**	**2018.4**	**2019.1**	**2019.2**	**2019.3**	**2019.4**	**2016**	**2017**	**2018**	**2019**
Real GDP*	1.2	3.1	3.2	2.9	2.3	2.9	2.6	2.6	2.3	2.2	2.1	2.0	1.5	2.3	2.7	2.4
Personal Consumption Expenditures*	1.9	3.3	2.2	4.0	1.1	2.4	2.4	2.4	2.1	2.0	2.0	2.0	2.7	2.8	2.4	2.2
Non-residential Fixed Investment*	7.2	6.7	4.7	6.8	6.1	5.0	5.6	5.7	5.1	5.1	4.4	4.1	-0.6	4.7	5.8	5.2
Private Housing Starts (000s units)	1,238	1,167	1,172	1,256	1,318	1,265	1,275	1,285	1,290	1,298	1,300	1,300	1,176	1,208	1,286	1,297
Vehicle Sales (mill. Units, annualized)	17.1	16.8	17.1	17.7	17.2	17.3	17.0	16.9	16.5	16.5	16.4	16.3	17.5	17.2	17.1	16.4
Industrial Production*	1.0	5.0	-1.5	7.8	4.5	3.9	3.0	2.6	2.2	2.0	1.7	1.5	-1.2	1.6	4.0	2.4
Nonfarm Payroll Employment (mil.)	145.9	146.3	146.9	147.4	148.1	148.6	149.0	149.5	149.9	150.4	150.7	151.1	144.3	146.6	148.8	150.5
Unemployment rate	4.7	4.3	4.3	4.1	4.1	3.9	3.8	3.6	3.8	3.9	4.0	4.1	4.9	4.4	3.9	4.0
Consumer Price Index* (percent)	3.0	0.1	2.1	3.3	3.5	2.2	2.0	2.0	2.0	2.0	2.1	2.1	1.3	2.1	2.6	2.0
"Core" CPI* (percent)	2.2	0.8	1.8	2.2	3.0	2.1	2.1	2.1	2.1	2.1	2.1	2.1	2.2	1.8	2.2	2.1
PPI (finished goods)* (percent)	5.7	1.0	1.4	6.0	2.4	1.8	1.6	1.6	1.6	1.6	1.7	1.7	-1.0	3.2	2.6	1.6
Trade Weighted Dollar (Fed BOG, major)	94.4	93.0	88.3	88.9	86.5	87.3	88.3	88.1	87.8	87.4	86.9	85.8	91.6	91.2	87.6	87.0
Crude Oil Prices -WTI ($ per barrel)	52	48	48	55	63	68	66	63	62	61	61	58	43	51	65	61

*Quarterly Data Percent Change At Annual Rate; Annual Data Year-on-Year % Chg, or Annual Average.

	History					Forecast							Annual Average			
Financial Data	**2017.1**	**2017.2**	**2017.3**	**2017.4**	**2018.1**	**2018.2**	**2018.3**	**2018.4**	**2019.1**	**2019.2**	**2019.3**	**2019.4**	**2016**	**2017**	**2018**	**2019**
S & P 500	2,326	2,398	2,467	2,603	2,733								2,093	2,449		
Dow Jones Industrial Average	20,406	20,994	21,891	23,689	25,127								17,916	21,745		
Federal Funds Rate (effective)	0.70	0.95	1.15	1.20	1.44	1.71	1.88	1.96	2.13	2.38	2.38	2.38	0.39	1.00	1.75	2.32
Treasury-3 Month Bills (yield)	0.61	0.91	1.05	1.23	1.58	1.83	1.98	2.04	2.18	2.41	2.40	2.36	0.32	0.95	1.86	2.34
Treasury-2 Year Notes (yield)	1.24	1.30	1.36	1.69	2.16	2.47	2.59	2.67	2.74	2.90	2.92	2.87	0.84	1.40	2.47	2.86
Treasury-5 Year Notes (yield)	1.95	1.81	1.81	2.07	2.53	2.82	2.93	3.00	3.08	3.15	3.10	3.15	1.34	1.91	2.82	3.12
Treasury-10 Year Notes (yield)	2.45	2.26	2.24	2.37	2.76	2.94	3.05	3.15	3.30	3.53	3.52	3.50	1.84	2.33	2.98	3.46
Treasury-30 Year Notes (yield)	3.05	2.90	2.82	2.82	3.03	3.15	3.28	3.40	3.69	3.85	3.90	3.96	2.60	2.90	3.22	3.85
Prime Rate	3.80	4.05	4.25	4.29	4.52	4.75	4.98	5.06	5.23	5.48	5.48	5.48	3.51	4.10	4.83	5.42
Libor 3-Mo. U.S. Dollar	1.07	1.21	1.31	1.46	1.93	2.35	2.43	2.46	2.50	2.60	2.58	2.56	0.74	1.26	2.29	2.56
Mortgage-30 Year (yield)	4.17	3.98	3.88	3.92	4.28	4.50	4.60	4.73	4.90	5.20	5.21	5.25	3.66	3.99	4.53	5.14
BAA Corporate (yield)	4.66	4.49	4.33	4.27	4.47	4.77	4.99	5.25	5.60	5.80	6.00	6.30	4.71	4.44	4.87	5.93

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