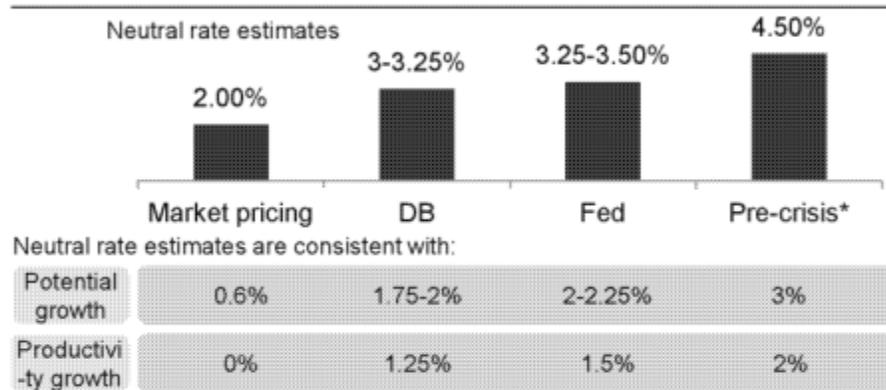


The terminal rate will be lower than in the past but very likely higher than current market expectations



The neutral rate has fallen since the crisis – but the rate implied by market pricing is consistent with a very pessimistic scenario



Source: CBO, Laubach and Williams (2003), FOMC, Deutsche Bank Research Note: (*) Avg. 1995-2005

Several of the reasons for a lower terminal rate have faded

	Reducing terminal rate?	Rationale
Fiscal policy	✘	Fiscal policy has shifted from a significant drag to neutral
Private deleveraging	✘	Deleveraging slowed significantly; credit growth picking up
Mortgage credit conditions	~	Still tight but showing some signs of loosening
Subdued global growth	✔	Global growth, giving less external impulse to US growth
Low potential growth	✔	Still low but should rise modestly as productivity picks up

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- How high the Fed's policy rate eventually rises (i.e., the terminal rate) is closely tied to the neutral rate
 - A higher neutral rate means the Fed has to raise rates more to tighten financial conditions
- Estimates suggest the neutral rate is currently very low due to growth headwinds (e.g., fiscal drag, tight credit, slow global growth), lower potential growth
- Neutral rate should rise as these headwinds fade and potential growth improves...
- ...But estimates suggest that the long-run neutral rate will remain lower than in the past
 - Prior to the crisis the neutral rate was near 4.5%
 - Fed's estimate is currently 3.25-3.50%; we think it is somewhat lower (i.e., 3-3.25%)
- The market pricing of a terminal rate around 2% is consistent with a very pessimistic economic scenario, assuming no rebound in potential growth
- As the market reprices the pace of hikes, it will also have to raise its view on the terminal rate

Note (#): FOMC committee's leadership (Yellen, Fischer and Dudley) likely expect only 3-4 hikes