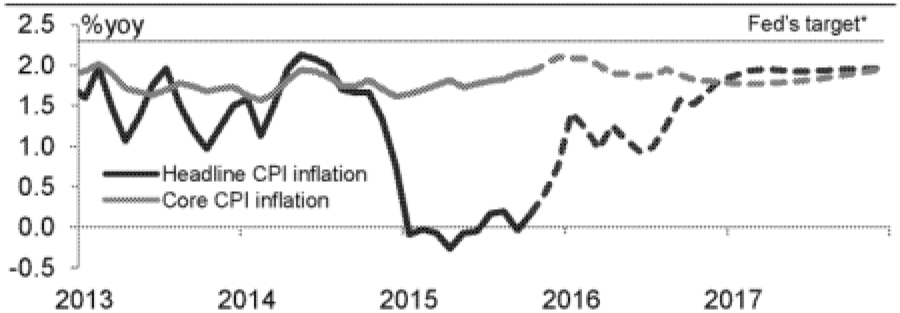
Although inflation is well below the Fed's objective, it is expected to rise ahead

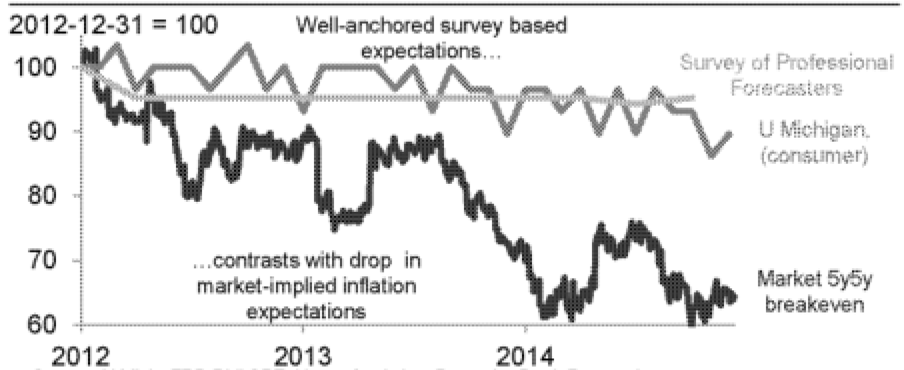
- Inflation still well below 2% target: **headline inflation near 0%; core inflation 40-70bp below target**
- Weakness due primarily to forces Fed describes as temporary (e.g., USD surge, oil price drop)
- **Inflation outlook is more important than current data**
  - Monetary policy acts with a lag: Fed thinks it takes 12-18 months for policy to have full effect
  - Fed must be reasonably confident inflation will return to target to hike – but doesn't need to wait for inflation to rise
- **Key inputs into this assessment include**
  - Outlook for growth / labour market (positive)
  - Inflation expectations (positive)
  - Import price inflation / dollar (negative)
- Core inflation unlikely to rise significantly next year
  - Strong dollar should continue to weigh on inflation next year
  - Falling commodity prices may be more persistent than Fed believes
- **But** we and the Fed see inflation nearing 2% target over next 2 years, as temporary factors dissipate and labour market continues to tighten

Inflation is expected to rebound from current low levels and approach the Fed's target*



Note (*): The Fed officially targets 2% for headline PCE inflation. This is roughly equivalent to 2.3% for headline CPI inflation, given that CPI inflation tends to run a few tenths about PCE.
Source: BLS, Haver Analytics, Deutsche Bank Research

Well-anchored survey measures of inflation expectations more important to Fed than sharp drop in market measures



Source: U Mich, FRB Phil SPF, Haver Analytics, Deutsche Bank Research