



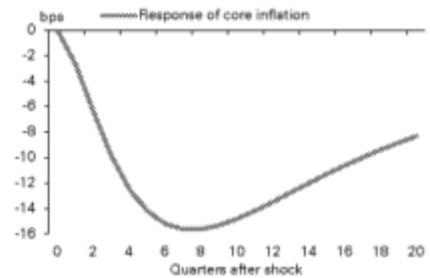
The impact of the trade-weighted dollar on inflation is much more benign than the impact on growth. According to our FRB/US simulations, the recent dollar appreciation would subtract between one- and two-tenths from core PCE inflation over the next couple of years. This may not seem like much, but core inflation has been running significantly below the Fed's 2% target for the past three years. For inflation to rise toward that level, either dollar strength will have to reverse, or services prices will have to rise further, thereby offsetting the effect of the former on goods prices. Given our expectation of a further significant decline in the unemployment rate, services prices, which are dominated by the cost of labor and housing rents, should increase further. Since services account for roughly two-thirds of the core PCE deflator and goods the remaining one-third, acceleration in services prices could offset the deflationary impact of the strong dollar on goods prices. Our forecast assumes that services inflation will continue to accelerate, thus allowing policymakers to proceed with interest rate hikes, but at a very gradual pace relative to prior monetary tightening cycles. Inflation is expected to only gradually return to its 2% target over the next couple of years.

The estimates of the FRB/US model are broadly consistent with our estimates of the impact of the appreciation of the dollar on the contribution of net exports in the GDP accounts. Traditionally, changes in the trade-weighted dollar tend to impact net exports with a lag of approximately two years. When the dollar strengthens, net exports tend to weaken as US export prices become less competitive in the global marketplace and imported goods become relatively cheaper. In the process, domestic production and employment could suffer.

The manufacturing sector is most acutely impacted by the strength of the dollar. However, this weakness is being exacerbated by the excessive inventory building in the first three quarters of the year, which has left inventories elevated relative to demand. Hence, de-stocking is likely contributing to the slowdown in manufacturing output as well. While the inventory unwind should prove temporary, the lagged impact from the dollar will likely prevent a meaningful recovery in the manufacturing sector, which is in contraction territory. It is noteworthy that the manufacturing ISM is highly correlated with real GDP growth, even though the manufacturing sector accounts for only 12% of total economic output.

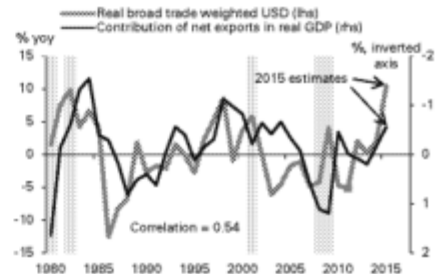
Watching the dot plot. The appreciation of the dollar is a key reason why the Fed trimmed its growth and inflation forecasts this year. A stronger dollar has the same effect on growth and inflation as monetary tightening. Therefore, dollar strength will likely continue to be a meaningful headwind to rate hikes in 2016 and 2017, and possibly beyond. The Figure 8 below shows the FOMC's "dot plot" versus our forecasts and the latest futures market pricing. While the fixed income market is nearly fully pricing a December rate hike, financial market participants expect a much shallower trajectory for the fed funds rate than what the Fed is currently projecting. If the Fed does not reduce its longer-term forecasts of the fed funds rate, the ongoing divergence between what investors are expecting and the Fed is predicting could cause financial market turbulence. Our own estimates of the path of interest rates are between those of the financial markets and monetary policymakers.

Figure 4: According to the FRB/US model, dollar appreciation would result in a modest drag on inflation



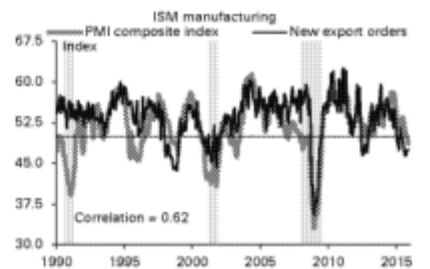
Source: FRB, Deutsche Bank Research

Figure 5: The expected drag from net exports due to dollar appreciation is meaningful



Source: FRB, BEA, Haver Analytics LP, Deutsche Bank Research

Figure 6: The manufacturing ISM and the new export orders series are both in contraction territory



Source: ISM, Haver Analytics LP, Deutsche Bank Research

¹ Fed Vice Chair Fischer cited similar effects in a Jackson Hole speech earlier this year.