March 10, 2010

Economics Group

Special Commentary

John Silvia, Chief Economist
john.silvia@wachovia.com • 704.374.7034
Adam York, Economist
adam.york@wachovia.com • 704.715.9660
Kim Whelan, Economic Analyst
kim.whelan@wachovia.com • 704.715.8457

Treasury Outlook: A Closer Look

During expansions, five-year Treasury rates have historically tracked fairly closely to nominal growth, that is, growth not adjusted for inflation. In the long run, nominal growth and long-term rates tend to converge (Figure 2, page 2). While the correlation between the two is far from perfect, particularly in the short run, nominal growth expectations can provide a general guideline for our rate projections. Given the dismal levels of growth notched during the depth of the recession, our forecast is comparatively quite robust. It follows that rates ought to increase significantly over the same time horizon. Indeed, the 10-year Treasury yield will likely double from the lows of the recession to the end of 2011, due at least in part to much improved economic growth. The path of GDP growth has traversed across an extremely broad swath of territory, which is common when transitioning between economic cycles. Rates have done the same. Extremely low as the flight to safety trade was in play, they have since begun to normalize. In this paper, we will review growth, inflation and market fundamentals to determine what they reveal about future rates.

Growth has returned to the U.S. economy. The recovery in the fourth quarter of 2009 and the first quarter of this year has been stronger than expected, at least on the headline. From the middle of 2009, through the first quarter of this year, we expect that nominal GDP will have risen more than 3.4 percent (4.5 percent annualized). While the composition of growth has been heavily weighted to short-run gains such as a big swing in the inventory cycle, it has been growth nonetheless. Over the next several quarters our expectation is for slower but more organic growth, gradually relying less on inventories and more on real final sales to boost the headline. While growth numbers will likely be weaker than we are accustomed to during expansion, the sustainability of the growth makes it preferable to strong headlines numbers with little tangible improvement underneath. With the economy now in the recovery phase, how will growth affect Treasury rates?

Figure 1

Wells Fargo U.S. Rate Forecast

	Actual				Forecast							
	2009				2010				2011			
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q
Nominal GDP	-4.6	-0.8	2.6	6.3	4.8	3.1	3.3	3.7	4.1	4.5	4.8	4.9
Inflation Indicators (b)												
"Core" PCE Deflator	1.7	1.6	1.3	1.5	1.4	1.2	1.2	1.2	1.5	1.6	1.7	1.8
Consumer Price Index	-0.2	-1.0	-1.6	1.5	2.5	2.4	1.9	1.6	1.7	2.0	2.2	2.4
Quarter-End Interest Rates												
Federal Funds Target Rate	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.50	1.25	2.00	2.75	3.25
3 Month LIBOR	1.19	0.60	0.29	0.25	0.30	0.35	0.55	0.80	1.50	2.35	3.10	3.60
Prime Rate	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.50	4.25	5.00	5.75	6.25
Conventional Mortgage Rate	5.00	5.42	5.06	4.88	5.40	5.70	5.80	5.80	5.80	5.90	6.00	6.10
3 Month Bill	0.21	0.19	0.14	0.06	0.10	0.10	0.30	0.55	1.25	2.10	2.85	3.35
2 Year Note	0.81	1.11	0.95	1.14	1.00	1.20	1.50	1.70	1.90	2.50	3.10	3.60
5 Year Note	1.67	2.54	2.31	2.69	2.40	2.60	2.80	2.90	3.00	3.30	3.60	3.90
10 Year Note	2.71	3.53	3.31	3.85	3.70	3.80	4.00	4.10	4.20	4.30	4.40	4.50
30 Year Bond	3.56	4.32	4.03	4.63	4.60	4.70	4.80	4.90	5.00	5.10	5.20	5.30

Forecast as of: March 10, 2010

Source: Wells Fargo Securities, LLC

The impact of contracting economic activity during the recession clearly had implications on Treasury rates, but the global financial crisis drove the safety trade to extremes. The insatiable demand for Treasuries at the height of the crisis led the four-week and three-month Treasury bills to post negative yields. As risk aversion dissipated and economic collapse was averted, demand slowly seeped into other assets and asset classes. While other systemic issues have arisen over the past year, notably Greece's sovereign debt problems, risk tolerance has grown and the safety trade is not wielding as much influence on rates. That said, should Greece's problems spread or another asset class break down (commercial real estate?), investors are likely to move quickly to U.S. Treasuries once more. The possibility of a renewed period of uncertainty would cause volatility in our rates forecast and remains an important risk factor.

Figure 2

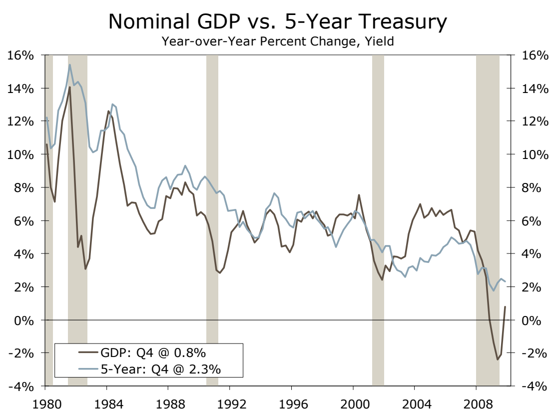
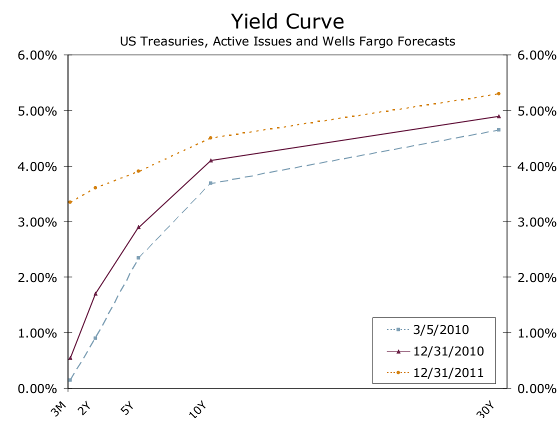


Figure 3



Source: Federal Reserve, U.S. Department of Commerce and Wells Fargo Securities, LLC

Inflation Heading?

Inflation is another fundamental component of risk for which investors demand compensation. It is an even more important factor for Treasuries, where credit risk is negligible, than other asset classes. While growth will likely have a more evident impact on rates in the near term, inflation and expectations for future inflation are also important factors. Fortunately, the mandate of the Federal Reserve, in addition to promoting full employment, is to maintain price stability. We generally think of price stability as slow and steady growth in the price level of about 1-2 percent a year, though the Fed does not officially have a target. For interest rates in the near term, we take into account the direction of consumer prices, producer prices, and the Fed's measure of choice, the core PCE deflator. Over the next few years, we expect relatively slow price increases, with the core PCE deflator moving up 1.3 and 1.7 percent on a year-over-year basis during 2010 and 2011, respectively. While the trend of prices, starting a year ago and continuing through the end of the forecast horizon, is clearly positive, inflation is not quite strong enough to be a key driver of rates at this point. Short-term inflation increases are more evident, while long-run inflation expectations remain anchored. Therefore, we expect Treasury rates to move up most quickly at the short end, with the three-month bill gaining more than 300 basis points (bps) by 2011, while toward the long end, the 10-year note gains less than 100 bps over the same period.

Figure 4

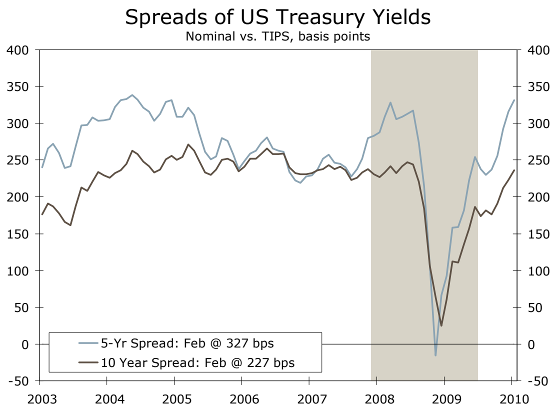
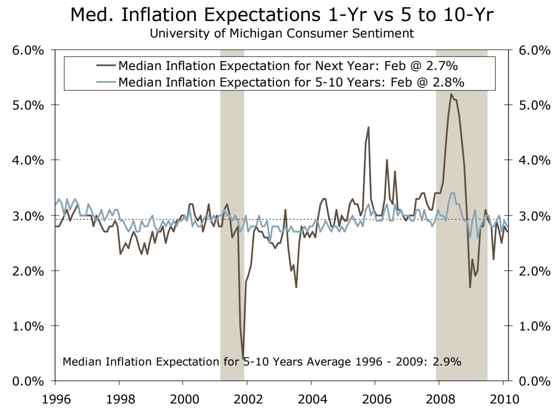


Figure 5



Source: Federal Reserve, Univ. of Michigan and Wells Fargo Securities, LLC

While current inflation measures are important, their influence on expectations of the future price level is vital for setting yields, and thus for informing our Treasury rates forecast, especially for longer-dated securities. The spread between yields on Treasury Inflation Protected Securities, or TIPS, and nominal yields of a similar maturity indicates the amount of inflation for which investors are demanding to be compensated. TIPS are adjusted according to the CPI, thus the inflation premium on nominal securities relative to TIPS is reliant on consumer prices. The CPI showed deflation for a brief period during the recession, but has bounced back to a more normal growth trend and will likely show moderate inflation over the next several years. Consumers, rather than investors, express their inflation expectations in the University of Michigan consumer sentiment survey—while this is softer data, inflation expectations are inherently "soft." We gain a general view of longer-run inflation expectations from Figure 5, which shows that the Federal Reserve has been largely successful in keeping long-run inflation expectations anchored, as the expectation for inflation in 5-10 years has only slightly deviated from its mean of around 3 percent over the history of the data series. Despite these indicators, neither consumers nor investors have proven remarkably adept at estimating future levels of inflation.

Treasury—Supply and Demand

The positive implications of price stability for the populace are evident, but well-anchored inflation expectations are also important in maintaining foreign buyers' demand for U.S. Treasury securities. The rest of the world holds slightly more than half of total Treasury securities outstanding and is integral in financing the nation's debt (Figure 6). Were long-run inflation expectations to become unanchored, foreign buyers could lose their appetite for Treasury securities, making it cost prohibitive to finance the expanding debt load. Fortunately over the next year or two, relative interest rates in the United States and other major economies are likely to favor holding dollar-denominated assets. As interest rates rise in the United States ahead of those abroad, foreign investors are likely to seek out dollar-denominated assets, holding down yields and increasing the value of the dollar. Still, we must be mindful of inflation. Foreign investors will be far more concerned with their real (inflation adjusted) rates of return and the real value of the dollar than with nominal returns or values. Runaway inflation is unlikely and unexpected at this point, but awareness of the potential pitfalls of this outcome is important.

Another risk to interest rates is that the acceleration of issuance coincident to the financial crisis has and is expected to continue. This is also a significant concern for investors and, therefore, has an important implication for rates in the longer run. The 2009 deficit broke the scales at $1.4 trillion and swelled to more than 10 percent of GDP in the fourth quarter. Another equally large deficit is expected for fiscal year 2010 (Figure 7). Treasury securities are generally considered risk-free in terms of default risk, because the full faith and credit of the U.S. government supports their repayment. Still, if the flood of U.S. debt to the marketplace exceeds the market's appetite for those securities, interest rates could ratchet up quickly. [1]

Figure 6

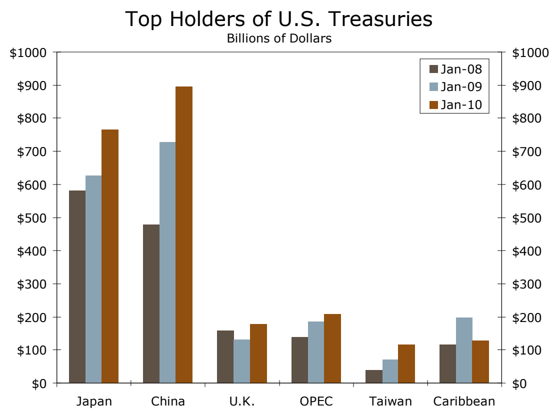
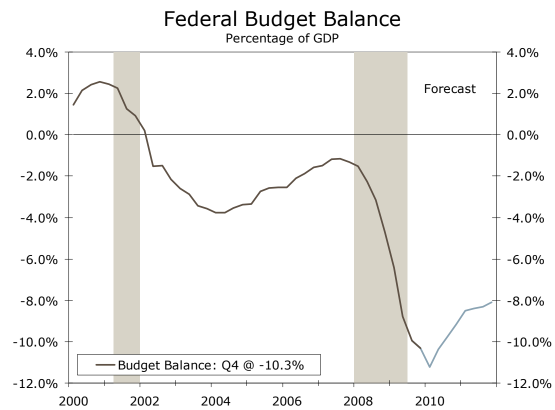


Figure 7



Source: U.S. Dept. of Commerce, U.S. Dept. of the Treasury and Wells Fargo Securities, LLC

Treasuries outstanding value roughly $7.5 trillion, a substantial increase from the $4 trillion levels seen earlier in the decade. The jump is owed in part to the recent ramping up of Treasury issuance to support spending increases concurrent with revenue shortfalls during the latest recession. Even without the recession, however, spending is growing unsustainably thanks to escalating costs of Medicare and Social Security along with an aging and longer-living population. These structural issues are the driving forces of the budget in the long term. To support only the most assured spending, Treasury issuance is likely to continue at a swift pace until at least 2012, a period during which we expect trillion dollar deficits to continue. Beyond 2012, major legislative changes could slow or accelerate the growth of the deficit, but forecasting the passage of such legislation is a fool's errand. The Congressional Budget Office's latest projections of how the deficit will evolve excluding the effects of future legislation point to average annual deficits of more than $600 billion from FY2011–FY2020. Some of the most likely legislative changes like the annual patch of the alternative minimum tax (AMT) or not letting portions of EGTRRA and JGTRRA expire will only make the deficit worse.[2]

In the near term, the Treasury department will likely be working on lengthening the duration of outstanding debt. With short rates expected to be meaningfully higher in future years, there is some desire to issue more longer-dated securities. In November of last year, the Treasury Borrowing Advisory Committee recommended moving the average duration of borrowing from its then level of just over 50 months to 74-90 months. The Treasury Department committed to a slow and gradual change, but increased issuance at the long-end will likely raise concerns about investor appetite for debt. In sum, we expect the supply of Treasuries to continue to be abundant, while the demand side of the equation creates the more pressing concern.

Short Rates and the Yield Curve

While the longer end of the Treasury curve is driven more by fundamentals (e.g., economic growth, inflation and supply), the short-end is more "managed" through monetary policy. The federal funds rate plays a key role in current rates, and many interest rates are influenced by it, at least indirectly. We currently expect the FOMC to begin raising rates late this year, but market rates will likely move higher sooner than this in anticipation of a higher target rate. By the middle of the year, we expect that both three-month bills and three-month LIBOR rates will be moving

---

[1] In fact, past research from the Federal Reserve staff suggests that even an expected increase in the deficit-to-GDP ratio can push up long-term interest rates before deficits actually materialize. See Laubach, Thomas (2003) "New Evidence on the Interest Rate Effects of Budget Deficits and Debt."

[2] The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and The Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) are commonly referred to as the Bush administration tax cuts.

higher. By year-end, both rates are likely to rise above 50 basis points where we expect the target rate will stand. As we move into 2011, a fairly rapid tightening cycle (at least compared to the 2004 cycle) will likely ensue. We would expect this to induce substantial flattening in the Treasury yield curve. However, the Fed is likely to be mindful of the flattening since a steeper yield curve has helped and continues to help financial institutions earn their way out of the recent crisis. Simply letting the yield curve move higher is not an option either as higher long rates will mean higher borrowing costs across debt markets, which would slow the economic recovery unnecessarily. Another potential wildcard for the short end of the curve is the Federal Reserve modifying the interest rate it uses to set policy. There is some concern that, with the amount of excess liquidity in the economy and the sheer size of the Fed's balance sheet, controlling the federal funds rate could prove difficult. The FOMC and the board are likely to actively use their authority to pay interest on excess reserves held at the central bank to influence the rate environment. This could turn into a new temporary or even permanent policy rate if managing the federal funds rate proves too difficult. The exact impact of such a change on private rates is not entirely clear; however, we would expect that as the Fed raises the rate it pays banks for risk free deposits of excess reserves it would push private rates such as LIBOR higher with it, even without a change in the target rate.

Concluding Thoughts

Higher Treasury rates and, consequently, higher private borrowing rates could have a chilling effect on the economic recovery if they come too soon or are too large. If rates rise in line with our current expectations, they will prove to be a modest drag on economic activity into 2011. Among other things, higher rates will hold growth slightly below trend next year and will help contain inflation expectations for the medium to long run. At the same time, a move higher in rates could give dollar denominated assets a relative advantage in global capital markets. If the Federal Reserve pushes short-term rates higher before other central banks, as we currently expect, it should prove modestly positive for the value of the dollar. Relative interest rates will likely favor dollar-dominated assets for the rest of this year and into 2011.

Wells Fargo Securities, LLC Economics Group

Diane Schumaker-Krieg	Global Head of Research & Economics	(704) 715-8437 (212) 214-5070	diane.schumaker@wellsfargo.com
John E. Silvia, Ph.D.	Chief Economist	(704) 374-7034	john.silvia@wellsfargo.com
Mark Vitner	Senior Economist	(704) 383-5635	mark.vitner@wellsfargo.com
Jay Bryson, Ph.D.	Global Economist	(704) 383-3518	jay.bryson@wellsfargo.com
Scott Anderson, Ph.D.	Senior Economist	(612) 667-9281	scott.a.anderson@wellsfargo.com
Eugenio Aleman, Ph.D.	Senior Economist	(612) 667-0168	eugenio.j.aleman@wellsfargo.com
Sam Bullard	Economist	(704) 383-7372	sam.bullard@wellsfargo.com
Anika Khan	Economist	(704) 715-0575	anika.khan@wellsfargo.com
Azhar Iqbal	Econometrician	(704) 383-6805	azhar.iqbal@wellsfargo.com
Adam G. York	Economist	(704) 715-9660	adam.york@wellsfargo.com
Ed Kashmarek	Economist	(612) 667-0479	ed.kashmarek@wellsfargo.com
Tim Quinlan	Economic Analyst	(704) 374-4407	tim.quinlan@wellsfargo.com
Kim Whelan	Economic Analyst	(704) 715-8457	kim.whelan@wellsfargo.com
Yasmine Kamaruddin	Economic Analyst	(704) 374-2992	yasmine.kamaruddin@wellsfargo.com