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Economics Group

WELLS FARGO SECURITIES

Interest Rate Weekly

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Perspective on Interest Rates: Numbers Not Anecdotes

Commentary should never pass for thoughtful analysis. Recently there has been a stream of unthoughtful commentary that misrepresents the choices for decision makers at this critical time of the credit cycle.

For the Past Two Years, Predicted Rate Increases Have Not Materialized

The problem with the thinking behind this incorrect commentary is what is termed the normalization of deviance. We typically experience this when our car brakes gradually lose effectiveness but we constantly adjust and never realize the deviance until the brakes are adjusted. The Challenger disaster of 1986 is another famous example of this rationalization.

More recently, the rise in adjustable rate mortgage delinquencies, both prime and subprime, was evident by late 2006, see my presentation "Supervisory Challenges at the Mid-cycle of the Economic Expansion Nov. 6, 2006. Note also that this presentation was made long prior to the failure of Bear Stearns in March 2008 and almost two years before Lehman. Overlooking the deviance of mortgage delinquencies then, interest rates over the past two years, and more recently, the rise in inflation on a year-over-year basis, has caused decision makers to ignore trends at their own, their shareholders' and voters' peril.

Contrary to the often repeated anecdotes pronouncing that interest rate increases have not materialized, interest rates have in fact risen for the past two years, as evidenced in the top graph. As of June, the monthly average value of ten-, five-, three- and two-year yields were all higher than their respective values as of July 2013 and July 2012.

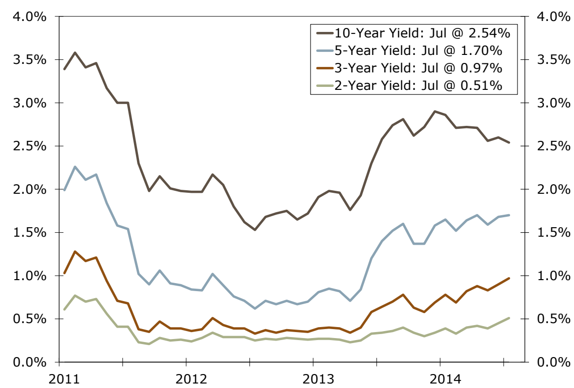
Low Interest Rates Are the New Normal

While it is a bit wonky, whether interest rates are low or high is irrelevant to decision making and economic activity. The direction of change is what motivates economic activity. The focus on whether interest rates are low or high is the problem of the anchoring bias. Here the decision maker is focused on previous benchmarks for interest rates that may not be relevant today. The Fed's decision to significantly expand its balance sheet was driven by its desire to pull Treasury yields well below the prevailing inflation rate and spur risk taking and ultimately stronger economic growth. Even with QE winding down, interest rates remain low relative to current and expected inflation in the US, hence the gradual pull upward.

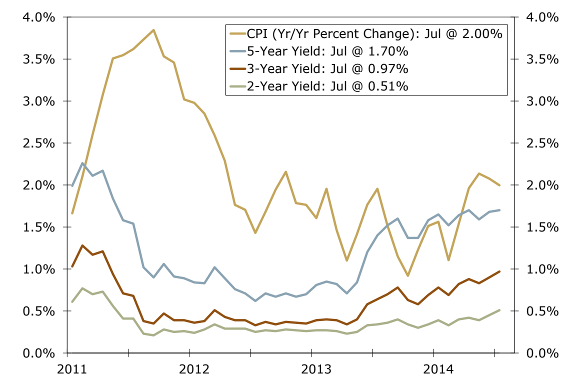
Investors Snap Up Junk Bonds, Junk-Bonds Exodus Accelerates

Two headlines, same newspaper, within the same month. What is a decision maker to think? As evidenced in the bottom graph, there is a strong cyclical pattern to high-yield bond issuance as there is for high grade debt, IPOs and so on. The reality is that for financial markets there is a cycle of risk seeking and risk avoidance that follows the economic cycle. The risk appetite in the markets—for investors and regulators alike—flows with the most recent successes and disasters. Moreover, there are patterns that can be discerned by watching these flows—but that would require thoughtful analysis more than just casual commentary.

U.S. Treasury Bond Yields

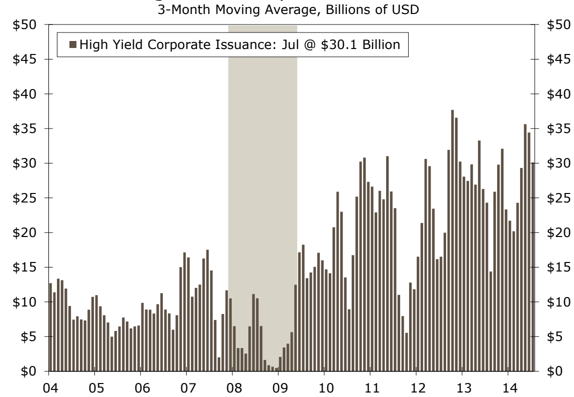


U.S. Treasury Bond Yields and CPI



High Yield Corporate Issuance

3-Month Moving Average, Billions of USD



Source: Bloomberg LP, U.S. Department of the Treasury, U.S. Department of Labor and Wells Fargo Securities, LLC

Wells Fargo Securities, LLC Economics Group

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