



Interest Rate Weekly

John E. Silvia, Chief Economist
john.silvia@wellsfargo.com • (704) 410-3275
Mark Vitner, Senior Economist
mark.vitner@wellsfargo.com • (704) 410-3277
Michael A. Brown, Economist
michael.a.brown@wellsfargo.com • (704) 410-3278

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.

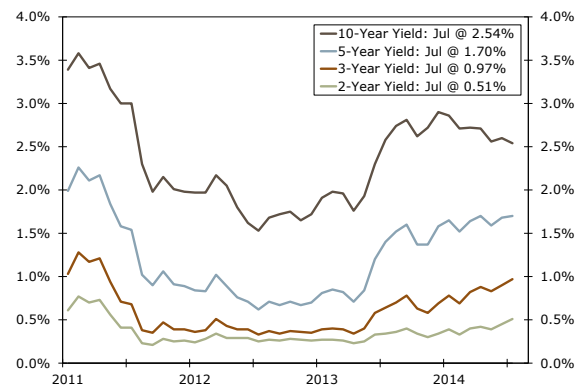
Low Interest Rates Are the New Normal

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.

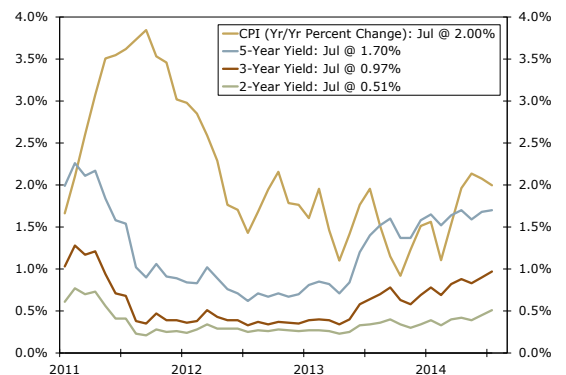
Investors Snap Up Junk Bonds, Junk-Bonds Exodus Accelerates

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.

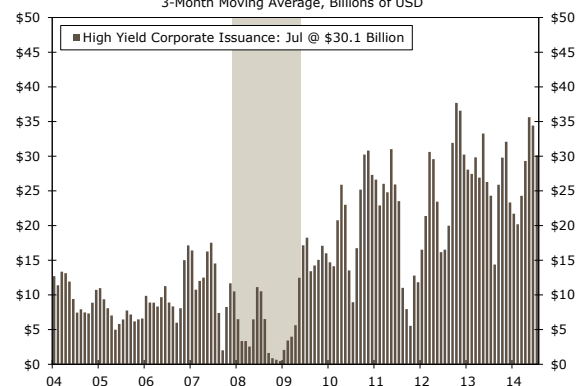
U.S. Treasury Bond Yields



U.S. Treasury Bond Yields and CPI



High Yield Corporate Issuance
3-Month Moving Average, Billions of USD



Wells Fargo Securities, LLC Economics Group

Diane Schumaker-Krieg	Global Head of Research, Economics & Strategy	(704) 410-1801 (212) 214-5070	diane.schumaker@wellsfargo.com
John E. Silvia, Ph.D.	Chief Economist	(704) 410-3275	john.silvia@wellsfargo.com
Mark Vitner	Senior Economist	(704) 410-3277	mark.vitner@wellsfargo.com
Jay H. Bryson, Ph.D.	Global Economist	(704) 410-3274	jay.bryson@wellsfargo.com
Sam Bullard	Senior Economist	(704) 410-3280	sam.bullard@wellsfargo.com
Nick Bennenbroek	Currency Strategist	(212) 214-5636	nicholas.bennenbroek@wellsfargo.com
Eugenio J. Alemán, Ph.D.	Senior Economist	(704) 410-3273	eugenio.j.aleman@wellsfargo.com
Anika R. Khan	Senior Economist	(704) 410-3271	anika.khan@wellsfargo.com
Azhar Iqbal	Econometrician	(704) 410-3270	azhar.iqbal@wellsfargo.com
Tim Quinlan	Economist	(704) 410-3283	tim.quinlan@wellsfargo.com
Eric Viloría, CFA	Currency Strategist	(212) 214-5637	eric.viloria@wellsfargo.com
Sarah Watt House	Economist	(704) 410-3282	sarah.house@wellsfargo.com
Michael A. Brown	Economist	(704) 410-3278	michael.a.brown@wellsfargo.com
Michael T. Wolf	Economist	(704) 410-3286	michael.t.wolf@wellsfargo.com
Zachary Griffiths	Economic Analyst	(704) 410-3284	zachary.griffiths@wellsfargo.com
Mackenzie Miller	Economic Analyst	(704) 410-3358	mackenzie.miller@wellsfargo.com
Erik Nelson	Economic Analyst	(704) 410-3267	erik.f.nelson@wellsfargo.com
Alex Moehring	Economic Analyst	(704) 410-3247	alex.v.moehring@wellsfargo.com
Donna LaFleur	Executive Assistant	(704) 410-3279	donna.lafleur@wellsfargo.com
Cyndi Burris	Senior Admin. Assistant	(704) 410-3272	cyndi.burris@wellsfargo.com

Wells Fargo Securities Economics Group publications are produced by Wells Fargo Securities, LLC, a U.S. broker-dealer registered with the U.S. Securities and Exchange Commission, the Financial Industry Regulatory Authority, and the Securities Investor Protection Corp. Wells Fargo Securities, LLC, distributes these publications directly and through subsidiaries including, but not limited to, Wells Fargo & Company, Wells Fargo Bank N.A., Wells Fargo Advisors, LLC, Wells Fargo Securities International Limited, Wells Fargo Securities Asia Limited and Wells Fargo Securities (Japan) Co. Limited. Wells Fargo Securities, LLC. ("WFS") is registered with the Commodities Futures Trading Commission as a futures commission merchant and is a member in good standing of the National Futures Association. Wells Fargo Bank, N.A. ("WFBNA") is registered with the Commodities Futures Trading Commission as a swap dealer and is a member in good standing of the National Futures Association. WFS and WFBNA are generally engaged in the trading of futures and derivative products, any of which may be discussed within this publication. Wells Fargo Securities, LLC does not compensate its research analysts based on specific investment banking transactions. Wells Fargo Securities, LLC's research analysts receive compensation that is based upon and impacted by the overall profitability and revenue of the firm which includes, but is not limited to investment banking revenue. The information and opinions herein are for general information use only. Wells Fargo Securities, LLC does not guarantee their accuracy or completeness, nor does Wells Fargo Securities, LLC assume any liability for any loss that may result from the reliance by any person upon any such information or opinions. Such information and opinions are subject to change without notice, are for general information only and are not intended as an offer or solicitation with respect to the purchase or sales of any security or as personalized investment advice. Wells Fargo Securities, LLC is a separate legal entity and distinct from affiliated banks and is a wholly owned subsidiary of Wells Fargo & Company © 2014 Wells Fargo Securities, LLC.

Important Information for Non-U.S. Recipients

For recipients in the EEA, this report is distributed by Wells Fargo Securities International Limited ("WFSIL"). WFSIL is a U.K. incorporated investment firm authorized and regulated by the Financial Conduct Authority. The content of this report has been approved by WFSIL a regulated person under the Act. For purposes of the U.K. Financial Conduct Authority's rules, this report constitutes impartial investment research. WFSIL does not deal with retail clients as defined in the Markets in Financial Instruments Directive 2007. The FCA rules made under the Financial Services and Markets Act 2000 for the protection of retail clients will therefore not apply, nor will the Financial Services Compensation Scheme be available. This report is not intended for, and should not be relied upon by, retail clients. This document and any other materials accompanying this document (collectively, the "Materials") are provided for general informational purposes only.

SECURITIES: NOT FDIC-INSURED/NOT BANK-GUARANTEED/MAY LOSE VALUE

WELLS
FARGO

SECURITIES