September 17, 2014

Economics Group

Interest Rate Weekly

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Declaring Victory at Half-Time: Not So Fast My Friend

Both the 49ers and the Jets would have been happy to declare victory Sunday at half-time but that is not how the game is played. Ditto for those who claimed to have forecasted lower Treasury rates in 2014.

You Can Claim Anything If You're Not Too Specific

Such is the secret of the Delphi Oracle. First, there is the problem of "Treasuries." Claims that Treasury rates have declined immediately run into the problem that rates on the two, three and five year Treasury notes have actually risen year to date (16, 28, and 2 basis points, respectively) and from a year earlier as of the end of last week (Sep. 12th). As illustrated in the top graph, interest rates on short- and intermediate-term Treasuries have risen, and so unless you bought a bullet 10-year portfolio, then interest rates have risen and have taken a bite out of your performance. Commentators on lower rates doubled-down on their bets in July and August by proclaiming that rates could move even lower by the end of the year. In contrast, for the week ending Sep. 12th, active Treasury rates were up for all maturities from the two-year out to the thirty-year. When the facts change it is best to alter your strategy.

Does the Market Accurately Discount the Fed?

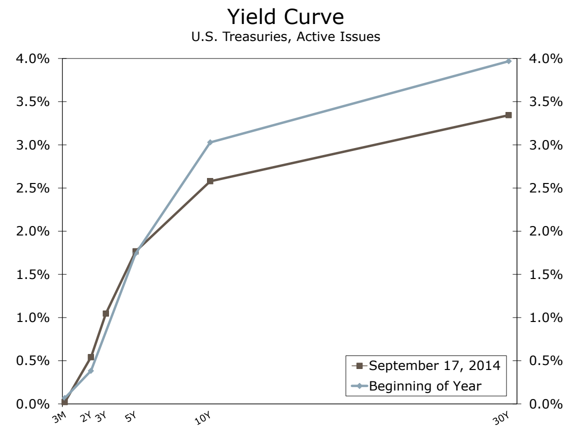
Based upon our most recent history, the answer is no. Consider the middle graph. Looking six months ahead, a time frame suggested by Chair Yellen, it is clear that in 2004, the last example we have of the Fed raising the funds rate after holding it at historic lows for an extended period of time, the market did not discount the Fed move. Why?

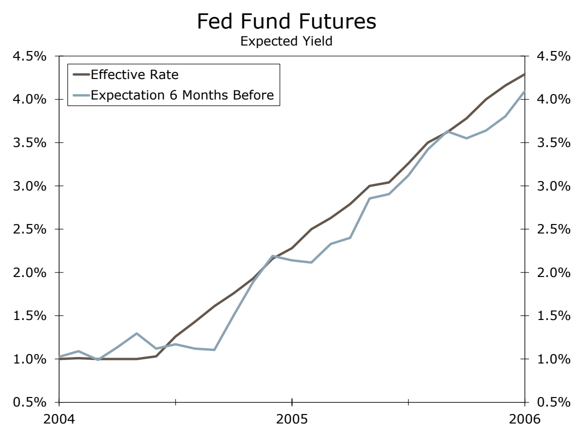
Simple my dear Dr. Watson. The market is efficient in the sense that it discounts all the publicly available information as well as discounting its expectations for the future. However, information and expectations change such that in six months there is often an entirely new set of expectations. The problem is that market information, expectations and actual Fed actions can change in the meantime. The result is that while the market will discount the expected path of the economy and Fed actions, such developments can, and often do change.

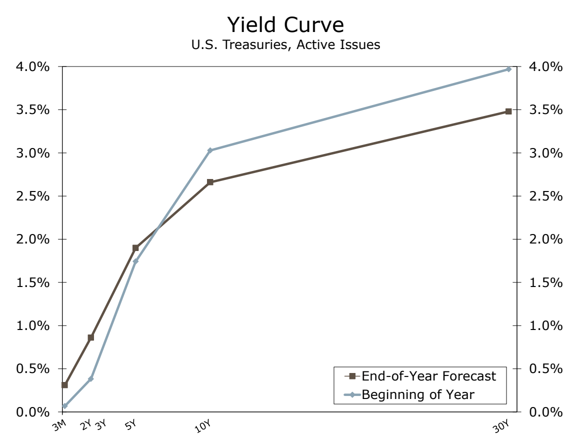
Avoiding Straw Men Masquerading as Wise Men

Too often commentary on interest rates, as well as inflation and economic growth, relies on a straw man to knock down rather than thoughtful analysis. Recent weeks have witnessed an infestation of such commentary. Consider the view that Fed policy may send yields soaring/sharply upward or any similar sentiment. Interest rates do not need to soar to rattle markets and hurt portfolios—how about just a 50 or 100 basis point rise? This is analogous to the debates on whether the economy will boom or go into depression when the real debate is whether growth is 2 or 3 percent.

Consider also the following: it is hard to see U.S. yields rise significantly/dramatically. What does dramatically mean, particularly when we are starting from such low levels? Once again the great lesson is that you can claim anything as long as you are not too specific.







Source: U.S. Department of the Treasury, Federal Reserve Board and Wells Fargo Securities, LLC

Wells Fargo U.S. Interest Rate Forecast

	Actual				Forecast							
	2014				2015				2016			
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q
Quarter End Interest Rates												
Federal Funds Target Rate	0.25	0.25	0.25	0.25	0.25	0.50	0.75	1.00	1.25	1.75	2.25	2.75
3 Month LIBOR	0.23	0.23	0.23	0.36	0.53	0.94	1.02	1.25	1.50	2.00	2.50	3.00
Prime Rate	3.25	3.25	3.25	3.25	3.25	3.50	3.75	4.00	4.25	4.75	5.25	5.75
Conventional Mortgage Rate	4.34	4.16	4.18	4.26	4.31	4.44	4.46	4.49	4.59	4.72	4.86	5.02
3 Month Bill	0.05	0.04	0.06	0.31	0.47	0.84	0.94	0.99	1.32	1.47	1.51	1.56
6 Month Bill	0.07	0.07	0.08	0.37	0.55	0.88	1.06	1.12	1.35	1.49	1.54	1.58
1 Year Bill	0.13	0.11	0.13	0.48	0.64	0.94	1.12	1.16	1.38	1.51	1.56	1.60
2 Year Note	0.44	0.47	0.50	0.86	0.97	1.42	1.48	1.51	1.56	1.85	1.96	1.98
5 Year Note	1.73	1.62	1.61	1.90	1.96	2.09	2.11	2.13	2.20	2.27	2.35	2.44
10 Year Note	2.73	2.53	2.38	2.66	2.71	2.84	2.86	2.89	2.99	3.12	3.26	3.42
30 Year Bond	3.56	3.34	3.17	3.48	3.50	3.62	3.63	3.65	3.77	3.91	4.08	4.29

Forecast as of: September 10, 2014

Wells Fargo U.S. Economic Forecast and FOMC Central Tendency Projections

	2014	2015	2016
Change in Real Gross Domestic Product			
Wells Fargo	1.9	2.9	3.1
FOMC	2.1 to 2.3	3.0 to 3.2	2.5 to 3.0
Unemployment Rate			
Wells Fargo	5.9	5.5	5.3
FOMC	6.0 to 6.1	5.4 to 5.7	5.1 to 5.5
PCE Inflation			
Wells Fargo	1.8	2.1	2.3
FOMC	1.5 to 1.7	1.5 to 2.0	1.6 to 2.0

Forecast as of: September 10, 2014

NOTE: Projections of change in real gross domestic product (GDP) and in inflation are from the fourth quarter of the previous year to the fourth quarter of the year indicated. PCE inflation is the percentage rate of change in the price index for personal consumption expenditures (PCE). Projections for the unemployment rate are for the average civilian unemployment rate in the fourth quarter of the year indicated.

Fed Data as of: June 18, 2014

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