September 24, 2014

Economics Group

Interest Rate Weekly

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A Long and Awkward Road Back to Normal

The Fed once again laid out its plan for bringing monetary policy back to normal. The critical questions now involve the timing and execution of policy adjustments, as well as what ultimately constitutes "normal."

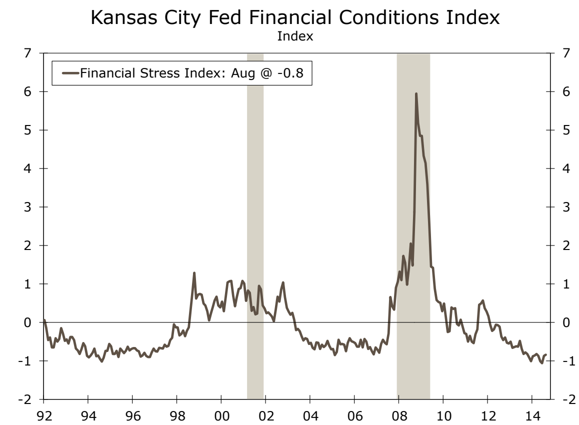
T-Minus A Still Considerable Period Till Lift-Off

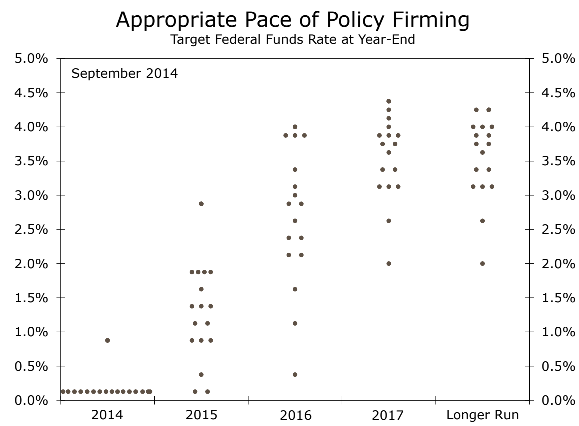
There had been some thought that the FOMC would replace the calendar guidance with some sort of data-specific targets at the September FOMC meeting because they could explain the changes at the press conference following the meeting. Such a change, however, would have run the risk of rocking the boat, just as it was about to dock. The wind down of QE has gone remarkably well, with economic growth gaining momentum, the stock market bounding higher and no repeat of the Spring 2013 Taper Tantrum. Why risk all this progress when virtually every credible scenario still has the Fed waiting at least six months before raising the federal funds rate?

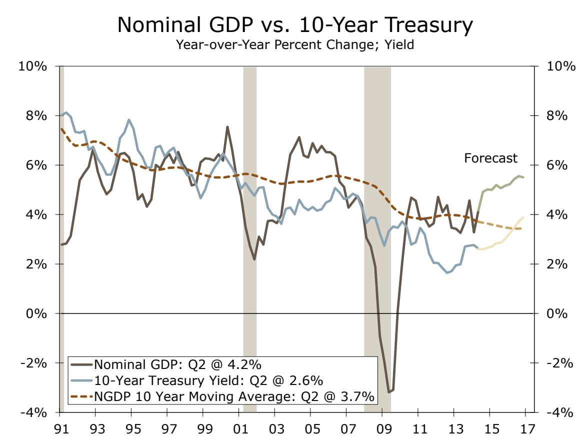
How the Fed dealt with the considerable time language is instructive because it provides hints as to how future policy changes will be enacted. The Fed has provided a map of how it intends to normalize monetary policy. The plan calls for raising the federal funds rate and other short-term interest rates to "more normal levels" and reducing the Federal Reserve's securities holdings. Accomplishing this without roiling the financial markets or upending the economic recovery will require a great deal of finesse. The Fed needs to provide clear and credible guidance about its expectations for economic growth, inflation and interest rates. This makes for a pretty straightforward projection on short-term interest rates. Our forecast for the federal funds rate closely follows the mid-point of the FOMC's forecast and we expect lift-off to occur in June 2015.

Once the Fed begins to hike interest rates, we expect it to move even more gradually than it did in the 2004-2006 period, when it hiked the federal funds rate a quarter of a percentage point at each FOMC meeting, raising the federal funds rate from 1.00 percent to 5.25 percent, beginning in June 2004. Our forecast has the federal funds rate ending 2015 at 1.00 percent and ending 2016 at 2.75 percent, which is slightly below the mid-point of the Fed's dot map. The justification for maintaining an easier policy for an even longer period of time today is primarily based on the low inflation and excess slack that is still present in the economy, even though the overall unemployment rate has fallen to 6.1 percent.

Long-term interest rates will likely rise a little faster than short-term rates, at least during the early part of the normalization process. Normally the yield on the 10-year Treasury is above or roughly even with the 10-year moving average of nominal GDP. Times have been anything but normal since the late 1990s, however, as the Fed has worked to combat financial crises, the bursting of the dotcom bubble, the 9/11 attacks, and the Great Recession and its aftermath. Now, with U.S. economic growth back on track and the Federal Reserve winding down their bond purchases, long-term Treasury yields should gradually grind higher and exceed nominal GDP toward the end of 2016.







Source: U.S. Department of the Commerce, 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	0.25	0.38	0.75	1.00	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	4.62	4.84	5.07	5.32	5.48
3 Month Bill	0.05	0.04	0.06	0.10	0.28	0.65	0.87	1.10	1.21	1.78	2.27	2.78
6 Month Bill	0.07	0.07	0.08	0.15	0.32	0.68	0.92	1.16	1.29	1.87	2.37	2.88
1 Year Bill	0.13	0.11	0.13	0.20	0.36	0.72	0.98	1.23	1.48	1.97	2.47	2.98
2 Year Note	0.44	0.47	0.57	0.86	0.97	1.42	1.48	2.09	2.18	2.41	2.91	3.31
5 Year Note	1.73	1.62	1.81	2.05	2.16	2.51	2.57	2.98	3.04	3.12	3.39	3.51
10 Year Note	2.73	2.53	2.59	2.66	2.71	2.84	2.86	3.02	3.24	3.47	3.72	3.88
30 Year Bond	3.56	3.34	3.37	3.48	3.50	3.63	3.66	3.81	3.98	4.12	4.41	4.68

Forecast as of: September 19, 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	2.0 to 2.2	2.6 to 3.0	2.6 to 2.9
Unemployment Rate			
Wells Fargo	5.9	5.5	5.3
FOMC	5.9 to 6.0	5.4 to 5.6	5.1 to 5.4
PCE Inflation			
Wells Fargo	1.7	2.0	2.2
FOMC	1.5 to 1.7	1.6 to 1.9	1.8 to 2.0

Forecast as of: September 19, 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: September 17, 2014

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