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Economics Group

Interest Rate Weekly

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Notes on the Fed's Exit Strategy, Part II

In our second installment on the Fed's exit strategy we focus on the timeline behind the normalization of monetary policy, including the latest details of expected FOMC operations to raise interest rates next year.

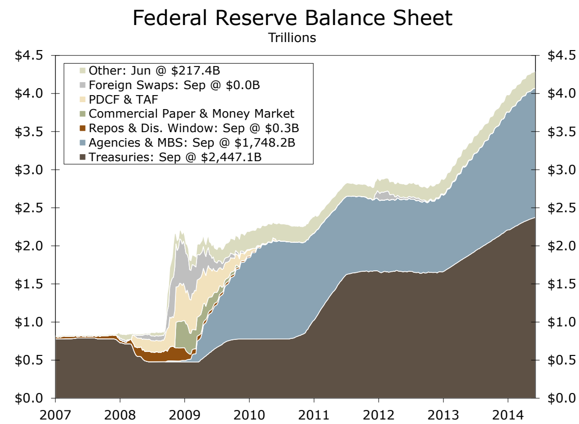
The Anything But Normal Policy Normalization Timeline

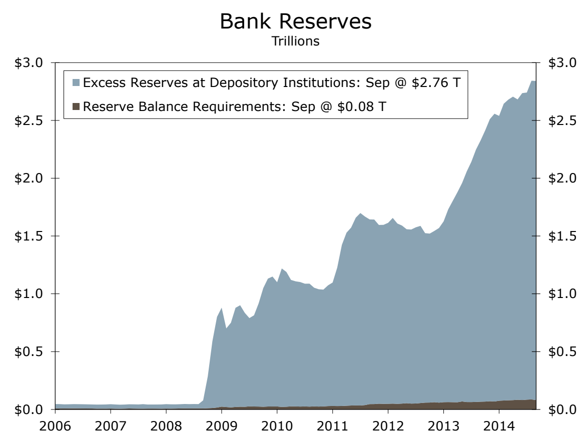
When the Fed begins the process of monetary policy normalization, in our view in June of next year, it will take a number of steps to ensure control over short-term interest rates. First, when the FOMC determines the appropriate time to raise the fed funds target rate, it will use the interest on excess reserves that banks hold at the Fed as the primary mechanism to control short-term interest rates. However, as we have pointed out in Part I of this series, there are concerns given the size of the Fed's balance sheet that there may not be as much control over short-term rates. Thus the Fed introduced the Reverse Repo Facility in order to allow it to effectively pay interest on excess reserves to non-bank institutions, therefore exerting greater control over short-term interest rates since these institutions would not want to lend at a rate below what the Fed would pay them. In addition to describing the use of the Overnight Reverse Repo Facility, the Fed established maximum limits on the reverse repo program to ensure that the facility does not become a destination to invest cash short-term in the event of market unrest.

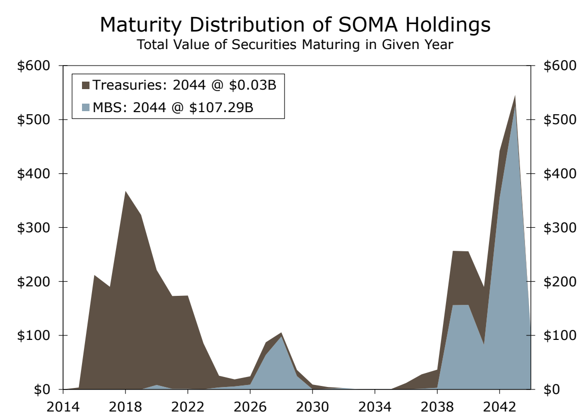
What the Fed Will Not Do

After raising the fed funds target rate, the next issue is how to deal with the size of the Fed's balance sheet. The Fed's plan indicates that securities holdings will be reduced by ceasing to reinvest repayments of principal on the securities held. This phasing out of reinvestments will take place after the first fed funds rate hike and will be dependent on economic conditions. The plans indicated that the Fed does not anticipate selling agency mortgage-backed securities as part of the normalization process. Thus, the primary way in which the Fed's balance sheet will be reduced over a number of years will be through holding these securities to maturity.

A look at the maturity distribution of the Fed's assets indicates the bulk of the Fed's Treasury holdings will mature within the next 10 years, while most of the MBS holdings will not mature until sometime after 2042, prepayment risk aside. This suggests that the size of the balance sheet will remain large for quite some time. Furthermore, there are implications for the Fed deciding not to sell MBS, as Richmond Fed President Jeffrey Lacker pointed out following the announcement. Lacker argues that the Fed's MBS holdings may put downward pressure on mortgage rates, a view we agree with, compared to holding an equivalent amount of Treasury securities. Thus, mortgage rates would be lower relative to other types of credit. In light of this announcement from the Fed, last week we downwardly revised our conventional mortgage rate outlook to reflect somewhat lower mortgage rates resulting from the Fed's plan not to sell MBS.







Source: Federal Reserve Bank of New York, 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	0.38	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	4.39	4.41	4.52	4.74	4.87	5.12	5.38
3 Month Bill	0.05	0.04	0.06	0.21	0.23	0.55	0.89	1.07	1.30	1.80	2.30	2.80
6 Month Bill	0.07	0.07	0.08	0.37	0.54	0.83	1.01	1.19	1.40	1.90	2.42	2.92
1 Year Bill	0.13	0.11	0.13	0.45	0.63	0.92	1.10	1.29	1.51	2.00	2.53	3.03
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	2.75	2.98	3.12	3.59	3.96
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	3.98
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 26, 2014

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

	2014	2015	2016
Change in Real Gross Domestic Product			
Wells Fargo	2.1	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 26, 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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