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Economics Group

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

Federal Deficits Expected to Grow Along with Higher Rates

The federal budget deficit continued to edge downward in fiscal year 2014 that ended last month. However, recent projections show that higher interest rates and outlay growth will change this story in 2016.

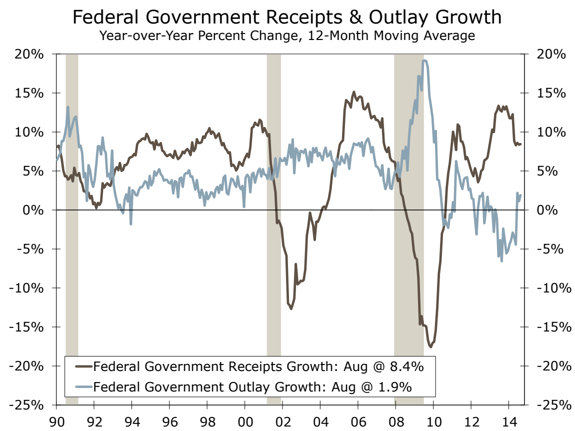
Deficits Continue to Moderate, For Now

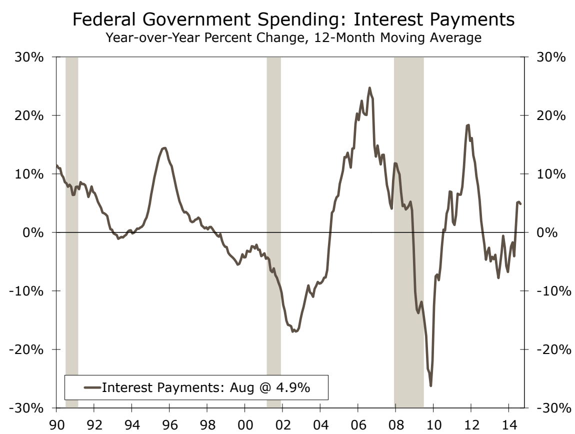
September's end marked the conclusion of federal fiscal year 2014, which once again saw a decline in the federal budget deficit for the third year in a row. While the official numbers have yet to be released by the Department of the Treasury, we estimate that the deficit came in around $575 billion for the fiscal year. Even as the size of the annual deficit has come down, the nation continues to add to the stock of debt. Smaller deficits translate into less borrowing, but new debt issuance is still needed. The reduction in deficits has coincided with budget cuts, known as budget sequestration, and somewhat better economic growth that has helped to support stronger revenue growth (top graph). Low interest rates have also helped keep annual budget deficits in check. Interest expenses as a share of the federal budget have declined to 6.4 percent in fiscal year 2013 from 8.5 percent in 2008. Over the next two years, however, the story is likely to change.

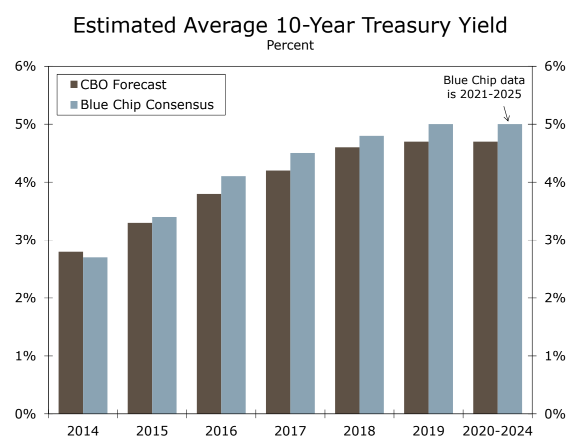
Higher Rates, Higher Interest Expenses

The first major change on the federal budget horizon is that the era of deficit reduction is set to come to an end in 2016. The current federal fiscal year (2015) that began this month is estimated by the Congressional Budget Office to conclude with a slightly smaller $469 billion deficit. In 2016, the CBO estimates that the deficit will once again begin to grow, climbing to $556 billion. Besides the continued growth in outlays, the expected rise in interest rates will result in increased borrowing costs. Even with only modest increases in short-term interest rates, the year-over-year rise in interest expenses is already materializing (middle graph). The CBO estimates that interest expenses will rise from 1.3 percent of GDP this year to 1.5 percent of GDP by fiscal year 2016.

In our view, the CBO's estimates for the federal interest expenses over the next two years are slightly understated for at least two reasons. First, relative to the current CBO baseline projections, deficits will be slightly higher due to the likely extension of several tax credits that were allowed to expire beginning this year and the use of continuing resolutions to keep the government funded. Second, we expect that interest rates over the next two years will rise modestly but at a faster pace than the CBO is currently projecting. As can be seen in the bottom graph, the Blue Chip Consensus forecast for the 10-year treasury beyond 2014 is consistently higher over the forecast horizon. On net, when looking at the federal budget picture over the next two years, we expect the deficit to come down this fiscal year before climbing again in fiscal year 2016. Interest expenses will begin to play a much more dominate role in the federal budget especially as we continue to add to the stock of debt through new Treasury issuance. All of these factors set up growing fiscal pressures in the later part of this decade.







Source: U.S. Department of the Treasury, Congressional Budget Office, Blue Chip and Wells Fargo Securities, LLC

Wells Fargo U.S. Interest Rate Forecast

	Actual 2014 1Q	2014 2Q	2014 3Q	Forecast 2014 4Q	2015 1Q	2015 2Q	2015 3Q	2015 4Q	2016 1Q	2016 2Q	2016 3Q	2016 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	0.24	0.30	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	4.12	4.26	4.31	4.44	4.46	4.62	4.84	5.07	5.32	5.58
3 Month Bill	0.05	0.04	0.02	0.10	0.18	0.55	0.80	1.05	1.30	1.80	2.30	2.80
6 Month Bill	0.07	0.07	0.03	0.15	0.23	0.60	0.85	1.10	1.35	1.85	2.35	2.85
1 Year Bill	0.13	0.11	0.13	0.20	0.28	0.65	0.90	1.15	1.40	1.90	2.40	2.90
2 Year Note	0.44	0.47	0.58	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	1.78	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	2.52	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	3.21	3.48	3.50	3.63	3.66	3.81	3.98	4.12	4.41	4.68

Forecast as of: October 8, 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	2.7	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	1.6	2.0	2.1
FOMC	1.5 to 1.7	1.6 to 1.9	1.8 to 2.0

Forecast as of: October 8, 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

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 Viloria, 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

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