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Economics Group

Interest Rate Weekly

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A Look Ahead to 2015: A Flatter Yield Curve, Refinancing Risk

2014 has been characterized by a much flatter yield curve with yields on intermediate-term Treasury debt up while longer-duration Treasury yields fell. In 2015, expect the flatter yield curve story to continue.

A Quick Look Back at 2014

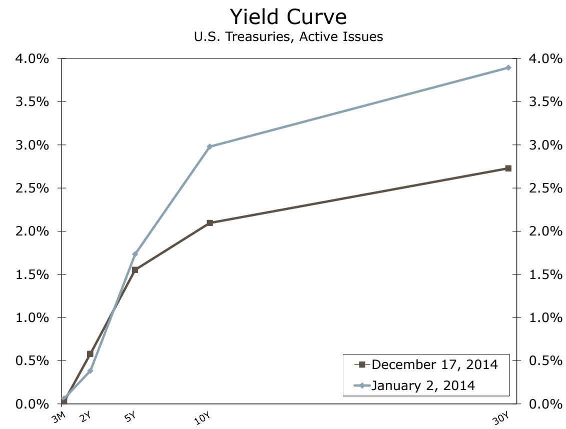
A look back at interest rates over the past year shows the considerable flattening of the yield curve (top graph). Yields on Treasuries with tenor between six months and two years migrated higher throughout the course of the year. The shorter end of the curve did not see much movement. Yields at the long-end of the curve on the other hand migrated lower, resulting in the much flatter yield curve we see today. As we have pointed out throughout the year, the sharp downward migration at the longer end of the yield curve has been tied to the extreme supply and demand imbalance of longer-duration U.S. Treasuries. Supply remains light due to lower net new Treasury issuance while demand remains strong from foreign investors, central banks and domestic firms aiming to meet new capital holding requirements and a flight to safety.

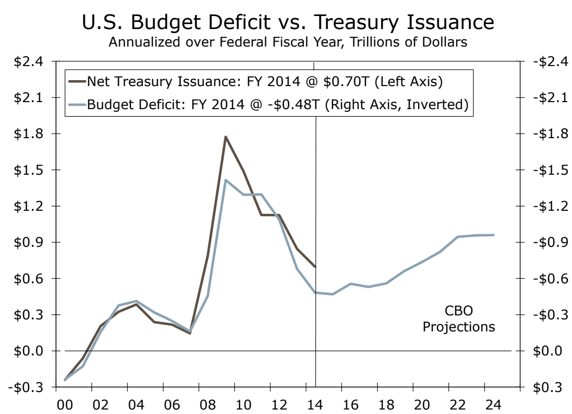
What Should We Expect in 2015?

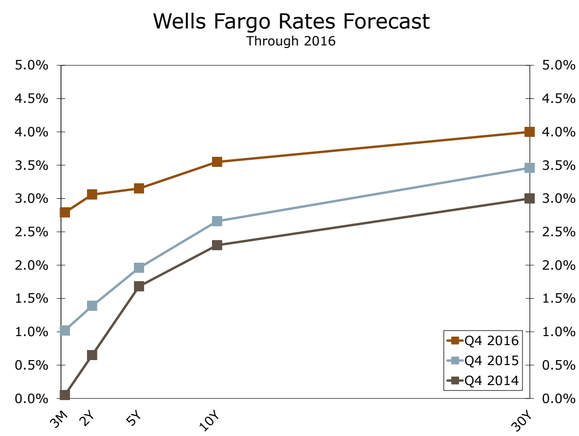
Looking ahead to 2015, our expectation is that the yield curve will continue to flatten, but for different reasons. The tight supply of U.S. Treasuries, particularly at the longer end of the yield curve, will likely continue as the federal budget deficit is expected to shrink again next year (middle graph). Thus, net new Treasury issuance is not likely to be a factor that would have upward pressure on yields in the 10s and 30s. While this year has been characterized by yield curve flattening due to longer yields coming down, the key difference in the coming year will be the upward migration in short-term yields that will result in further yield curve flattening. Our expectation is that shorter-term yields will begin to migrate higher in the first six months of next year as markets begin pricing in the first fed funds rate hike in June. Meanwhile, longer-duration yields will continue to remain well anchored due to the structural changes imposed on the market from new regulations.

Implications of a Flatter Yield Curve

With the yield curve becoming even flatter next year, we look for parts of the yield curve to underprice the potential for future Fed moves (bottom graph). In addition, firms that have been relying on very low short-term borrowing rates to facilitate their operations will see upward pressure on their borrowing costs which, in turn, could create challenges for corporate profit growth in the year ahead. The ongoing low-rate environment at the longer end of the curve should still be conducive for further investment in business equipment and commercial real estate as reflected in our views for economic activity next year. The changing yield curve should still be supportive of growth even with a tighter monetary policy environment as long as decision makers are prepared for the changes in the economic game plan.







Source: Bloomberg LP, U.S. Dept. of the Treasury, Congressional Budget Office 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	0.24	0.24	0.38	0.70	0.95	1.20	1.45	1.95	2.45	2.95
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	4.16	4.14	4.16	4.20	4.30	4.40	4.48	4.80	5.20	5.30
3 Month Bill	0.05	0.04	0.02	0.05	0.20	0.54	0.78	1.02	1.28	1.77	2.28	2.79
6 Month Bill	0.07	0.07	0.03	0.09	0.24	0.58	0.80	1.03	1.29	1.80	2.30	2.80
1 Year Bill	0.13	0.11	0.13	0.14	0.25	0.65	0.95	1.25	1.55	2.05	2.55	3.05
2 Year Note	0.44	0.47	0.58	0.65	0.66	0.98	1.18	1.39	1.61	2.09	2.57	3.06
5 Year Note	1.73	1.62	1.78	1.68	1.71	1.83	1.90	1.96	2.05	2.40	2.76	3.15
10 Year Note	2.73	2.53	2.52	2.30	2.40	2.51	2.59	2.66	2.76	3.12	3.37	3.55
30 Year Bond	3.56	3.34	3.21	3.00	3.19	3.37	3.40	3.46	3.54	3.75	3.85	4.00

Forecast as of: December 10, 2014

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

	2014	2015	2016
Change in Real Gross Domestic Product			
Wells Fargo	2.0	2.7	3.0
FOMC	2.0 to 2.2	2.6 to 3.0	2.6 to 2.9
Unemployment Rate			
Wells Fargo	5.8	5.4	5.1
FOMC	5.9 to 6.0	5.4 to 5.6	5.1 to 5.4
PCE Inflation			
Wells Fargo	1.4	1.8	2.1
FOMC	1.5 to 1.7	1.6 to 1.9	1.8 to 2.0

Forecast as of: December 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: September 17, 2014

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