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Economics Group

Interest Rate Weekly

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Is Short-Term Corporate Debt a Cause for Concern?

Non-financial corporations' preference for short-term financing has increased recently, but is still near all-time lows. We expect to see increased long-term debt issuance as the yield curve continues to flatten.

Where on the Yield Curve Are Corporations Borrowing?

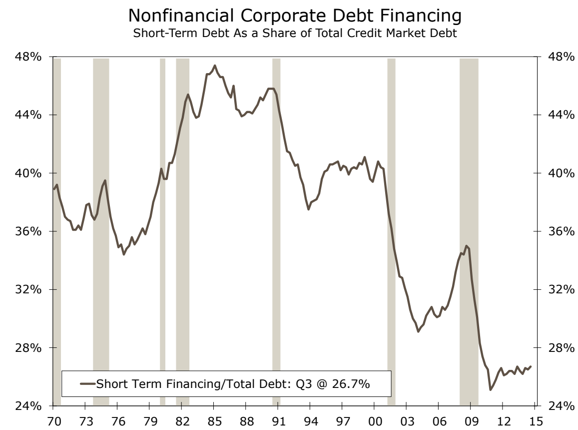
Recently, there has been concern around the exposure of certain sectors of the economy to rising short-term interest rates as the impending Fed rate hike draws nearer. One sector of particular concern has been nonfinancial corporations. Indeed, since bottoming in 2010, short-term debt financing as a share of total debt for these companies has steadily increased, likely reflecting firms taking advantage of the Fed's extended zero-interest rate policy on the front end of the curve (top chart). However, relative to previous cycles, on an aggregate basis, nonfinancial corporations' debt structure is more skewed toward the longer-end of the curve. Taken at face value, this should alleviate some fears about these companies' exposure to increases in short-term rates.

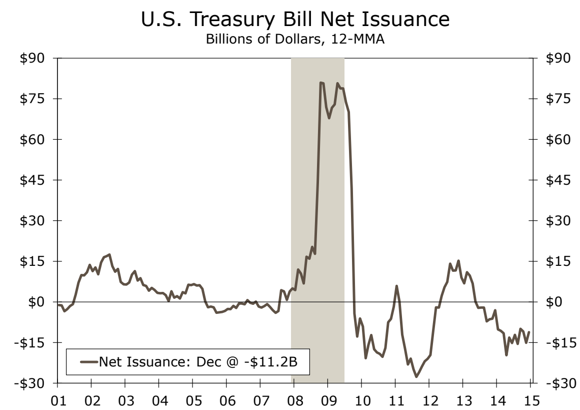
In the prior three business cycles, companies tended to switch to longer-term debt during downturns, taking advantage of lower long-term rates. However, we estimate that this trend may emerge earlier in the current business cycle than we have seen in prior cycles due to our expectations for a continually flattening yield curve in the near term.

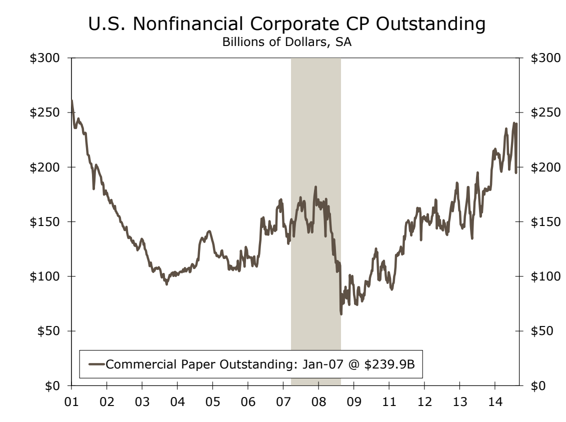
Insight from the Commercial Paper Market: A Change in Trend?

An important implication of this short-term/long-term dichotomy is its effect on the commercial paper market. For investment grade companies, one of the major sources of short-term financing is commercial paper (CP). With net issuance of Treasury bills negative for most of the past five years, there has been a dearth of supply in short-term quality assets for investors (middle chart). As a result, investors have been more willing to supply credit to issuing corporations in the form of CP, which has thus driven down funding costs and made CP a more attractive form of financing. The amount of nonfinancial corporate CP outstanding has subsequently risen steadily over the past few years (bottom chart).

However, despite the years-long rise in CP issuance by these borrowers, the trend may change in the near-term. With the Fed's reverse repo (RRP) facility acting as a supplementary means of policy normalization, CP investors who qualify for the RRP facility may choose to reallocate some of their funds to the facility, allowing repo rates to serve as a floor for CP rates. While this will only affect a limited number of counterparties, it will likely be significant enough to push up CP rates, perhaps even relatively more than we have seen in prior cycles. In the face of higher borrowing costs, companies may look to traditional bank loans as an alternative, or perhaps start to shift to longer-term financing, further contributing to our expectations for an increased preference to finance at the long end of the curve.







Source: Federal Reserve Board, SIFMA 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	0.26	0.30	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	3.86	3.60	3.72	3.87	3.89	4.07	4.39	4.86	4.90
3 Month Bill	0.05	0.04	0.02	0.04	0.13	0.53	0.83	1.10	1.35	1.76	2.27	2.77
6 Month Bill	0.07	0.07	0.03	0.12	0.20	0.56	0.88	1.18	1.46	1.78	2.32	2.79
1 Year Bill	0.13	0.11	0.13	0.25	0.27	0.65	0.92	1.20	1.48	1.79	2.35	2.80
2 Year Note	0.44	0.47	0.58	0.67	0.49	0.91	1.13	1.26	1.60	1.98	2.47	2.82
5 Year Note	1.73	1.62	1.78	1.65	1.42	1.70	1.83	1.85	2.10	2.27	2.48	2.84
10 Year Note	2.73	2.53	2.52	2.17	1.99	2.21	2.29	2.30	2.55	2.75	2.91	3.05
30 Year Bond	3.56	3.34	3.21	2.75	2.63	2.89	2.97	2.95	3.13	3.34	3.51	3.60

Forecast as of: January 14, 2015

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

	2014	2015	2016
Change in Real Gross Domestic Product			
Wells Fargo	2.6	2.7	3.0
FOMC	2.3 to 2.4	2.6 to 3.0	2.5 to 3.0
Unemployment Rate			
Wells Fargo	5.7	5.2	4.8
FOMC	5.8	5.2 to 5.3	5.0 to 5.2
PCE Inflation			
Wells Fargo	1.1	1.4	2.1
FOMC	1.2 to 1.3	1.0 to 1.6	1.7 to 2.0

Forecast as of: January 14, 2015

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: December 17, 2014

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