

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

Stronger Loan Demand: Where are the Higher Rates?

U.S. banks are continuing to see loan growth improve, both for businesses and consumers, as the economy has strengthened considerably. However, interest rates have been more influenced by international flows.

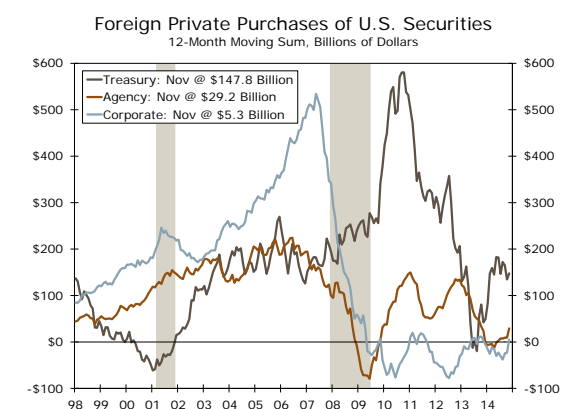
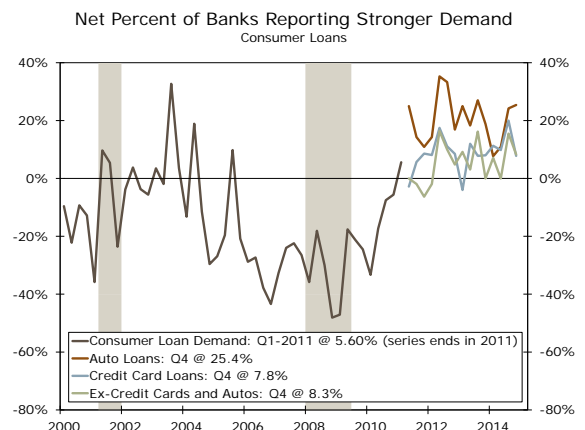
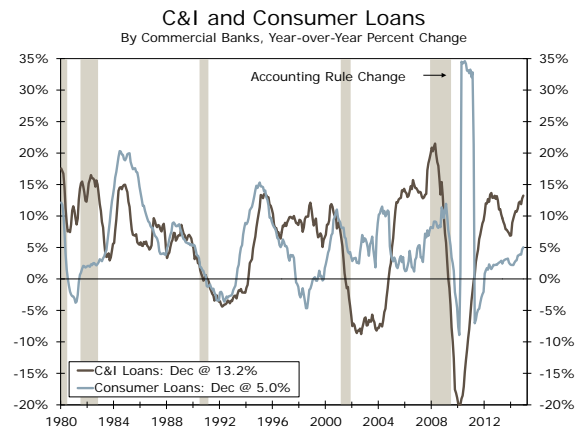
Solid U.S. Economic Fundamentals Drive Loan Demand

Loan growth at commercial banks has continued to trend upward as the U.S. economy is currently experiencing the strongest rate of economic growth in a decade. Propelling loan growth forward over the past two years has consistently been commercial & industrial (C&I) lending, which expanded 13.2 percent in December. Consumer lending has been less impressive during this expansion, however, it has begun to pick up meaningfully in recent months, growing at the fastest pace since June 2009 in December (excluding the accounting rule change in 2010, top chart).

There are a multitude of factors that seem to be playing a role in improved loan growth and money supply growth. The Fed balance sheet has remained around \$4.3 trillion as the Fed continues to reinvest the proceeds from maturing assets. As a result, the M2 money stock continues to grow at near a 6.0 percent pace, almost perfectly in line with the average for the previous expansion. Consumers' balance sheets have also improved with household net worth now more than \$13 trillion higher than its prerecession peak and household debt as a percent of disposable income down from nearly 125 percent at the beginning of the downturn, to 96.6 percent today. Improvement in the labor market and growing consumer confidence have helped to fuel growth in consumer spending, which individuals now feel more comfortable financing with loans, once again. On the supply side, banks are also gradually loosening standards. All these factors result in greater demand for loans, in theory, should put upward pressure on interest rates. So what is keeping long-term rates in check?

Interest Rates Stuck in Low Gear

The current yield on the 10-year U.S. Treasury is at about 1.80 percent. However, this is compared to other advanced economies such as France, Germany and Japan, whose 10-year government bond yields are well below one percent. With U.S. Treasuries still viewed among the safest investments in the world, and with the 10-year yielding over 100 bps more than other advanced economies, international capital flows have continued to flood the U.S. markets. The recent decline in oil prices has been the cause of recent volatility in global financial markets, exaggerating the demand for U.S. assets further. It has become increasingly clear that the rise in foreign portfolio holdings of U.S. assets has trumped loan growth at domestic commercial banks in recent years. In 2002, each metric stood at about \$4.0 trillion, but by 2013 foreign holdings of U.S. assets had grown to \$14.4 trillion, and loans at commercial banks to just \$7.3 trillion. This divergence gives us a look at the role international capital flows have played in the current low interest rate environment, as it seems to have trumped any upward pressure from domestic loan demand factors.



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

| | <u>2014</u> | <u>2015</u> | <u>2016</u> |
|--|-------------|-------------|-------------|
| 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

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 |

Wells Fargo Securities Economics Group publications are produced by Wells Fargo Securities, LLC, a U.S. broker-dealer registered with the U.S. Securities and Exchange Commission, the Financial Industry Regulatory Authority, and the Securities Investor Protection Corp. Wells Fargo Securities, LLC, distributes these publications directly and through subsidiaries including, but not limited to, Wells Fargo & Company, Wells Fargo Bank N.A., Wells Fargo Advisors, LLC, Wells Fargo Securities International Limited, Wells Fargo Securities Asia Limited and Wells Fargo Securities (Japan) Co. Limited. Wells Fargo Securities, LLC ("WFS") is registered with the Commodities Futures Trading Commission as a futures commission merchant and is a member in good standing of the National Futures Association. Wells Fargo Bank, N.A. ("WFBNA") is registered with the Commodities Futures Trading Commission as a swap dealer and is a member in good standing of the National Futures Association. WFS and WFBNA are generally engaged in the trading of futures and derivative products, any of which may be discussed within this publication. Wells Fargo Securities, LLC does not compensate its research analysts based on specific investment banking transactions. Wells Fargo Securities, LLC's research analysts receive compensation that is based upon and impacted by the overall profitability and revenue of the firm which includes, but is not limited to investment banking revenue. The information and opinions herein are for general information use only. Wells Fargo Securities, LLC does not guarantee their accuracy or completeness, nor does Wells Fargo Securities, LLC assume any liability for any loss that may result from the reliance by any person upon any such information or opinions. Such information and opinions are subject to change without notice, are for general information only and are not intended as an offer or solicitation with respect to the purchase or sales of any security or as personalized investment advice. Wells Fargo Securities, LLC is a separate legal entity and distinct from affiliated banks and is a wholly owned subsidiary of Wells Fargo & Company © 2015 Wells Fargo Securities, LLC.

Important Information for Non-U.S. Recipients

For recipients in the EEA, this report is distributed by Wells Fargo Securities International Limited ("WFSIL"). WFSIL is a U.K. incorporated investment firm authorized and regulated by the Financial Conduct Authority. The content of this report has been approved by WFSIL a regulated person under the Act. For purposes of the U.K. Financial Conduct Authority's rules, this report constitutes impartial investment research. WFSIL does not deal with retail clients as defined in the Markets in Financial Instruments Directive 2007. The FCA rules made under the Financial Services and Markets Act 2000 for the protection of retail clients will therefore not apply, nor will the Financial Services Compensation Scheme be available. This report is not intended for, and should not be relied upon by, retail clients. This document and any other materials accompanying this document (collectively, the "Materials") are provided for general informational purposes only.

SECURITIES: NOT FDIC-INSURED/NOT BANK-GUARANTEED/MAY LOSE VALUE

**WELLS
FARGO**

SECURITIES