February 11, 2015

Economics Group

Interest Rate Weekly

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Will Better Loan Performance Improve Lending Terms?

Nonperforming asset balances on bank balance sheets continue to fall. A strengthening economy should continue this trend and may have a positive (easing) effect on banks' lending standards and terms.

Noncurrent Loans Declining, Expect to Continue

While the domestic U.S. economy continues to post solid gains, nonperforming asset balances have declined on the balance sheets of banks as reported by the FDIC. As loan performance continues to improve, we would expect to see easier lending standards and better lending terms. This has begun to show up in the Senior Loan Officer Opinion Survey, where banks have been consistently easing standards for commercial and industrial (C&I) loans.

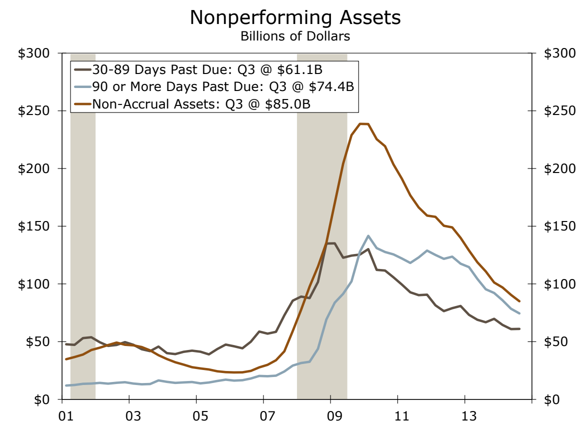
In addition, the spread between the average interest rate on floating rate C&I loans and LIBOR, as reported by the Federal Reserve's Survey of Terms of Business Lending, has trended downward since the recession ended, suggesting banks are viewing the loans as less risky. Although the spread between the interest rate on C&I loans and LIBOR has decreased, it is still slightly elevated relative to prerecession levels, suggesting there remains room for improvement. If the economy continues to strengthen as we are forecasting, it should support businesses' cash flows and the value of their assets. This would likely improve their credit quality and lead to further improvement in willingness to lend and lending terms, measured as the spread of floating rate loans over LIBOR.

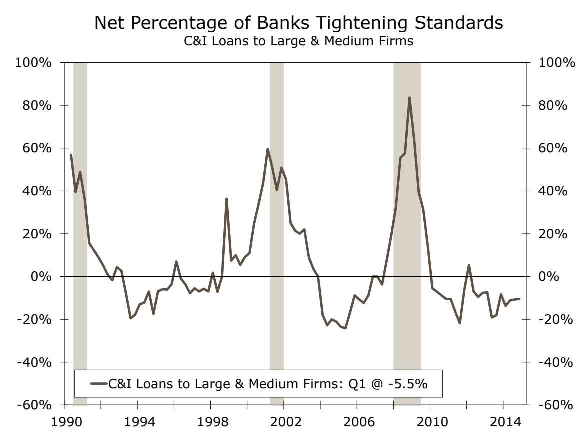
Implications for Lending Activity in Coming Quarters

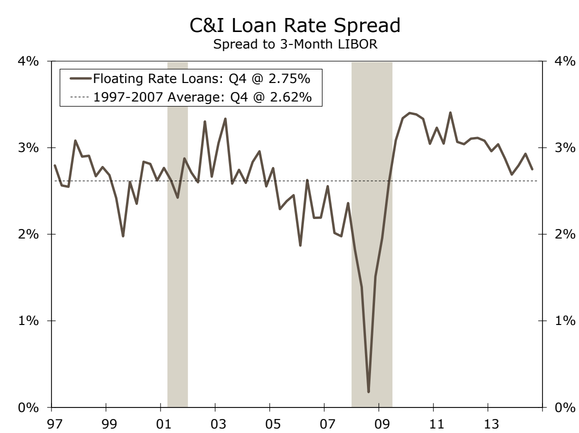
This has many implications for bank lending activity in the coming year. Although we expect the Fed to begin to raise the fed funds rate in June, the improving loan quality may help diminish the impact of higher benchmark rates on commercial borrowers. We expect rising interest rates to have less of an effect on the demand for loans because of the offsetting effect that the improving economy will have on loan performance and the terms of lending, given that rates will remain relatively low.

One risk to this outlook is if lenders' expectations deteriorate regarding the economy, and thus loan performance, beyond our forecast horizon. Although the FDIC data show improving loan performance today, lenders must make assumptions about future loan performance, which is affected by expectations for future growth. Slow global growth, the collapse in energy prices and uncertainty surrounding Fed tightening could cause some lenders to have a more cautious outlook for the economy beyond our forecast horizon. This could make them hesitant to loosen standards as expectations for loan performance deteriorate. In addition, structural factors may prevent the spread from reverting to its historical mean.[1]

A strengthening economy should continue to bring down nonperforming asset balances on bank's balance sheets. This may increase the propensity to lend as new loans are viewed as relatively less risky, potentially offering a partial offset to the gradual rise in interest rates we are forecasting.







Source: Federal Reserve Board, FDIC, IHS Global Insight and Wells Fargo Securities, LLC

[1] **Kwan, Simon (2014).** ***Long Road to Normal for Bank Business Lending*****. Federal Reserve Bank of San Francisco Economic Letter**

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	2.85
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	3.36	3.32	3.56	3.70	3.82	3.97	4.35	4.60
3 Month Bill	0.05	0.04	0.02	0.04	0.09	0.51	0.76	1.01	1.26	1.78	2.26	2.77
6 Month Bill	0.07	0.07	0.03	0.12	0.11	0.52	0.77	1.02	1.27	1.80	2.27	2.78
1 Year Bill	0.13	0.11	0.13	0.25	0.22	0.54	0.78	1.03	1.28	1.81	2.28	2.79
2 Year Note	0.44	0.47	0.58	0.67	0.57	0.79	0.88	1.11	1.33	1.85	2.32	2.81
5 Year Note	1.73	1.62	1.78	1.65	1.30	1.41	1.54	1.63	1.77	1.97	2.34	2.82
10 Year Note	2.73	2.53	2.52	2.17	1.85	1.92	1.98	2.07	2.21	2.46	2.64	2.84
30 Year Bond	3.56	3.34	3.21	2.75	2.39	2.49	2.66	2.76	2.88	2.92	3.00	3.30

Forecast as of: February 11, 2015

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

	2014	2015	2016
Change in Real Gross Domestic Product			
Wells Fargo	2.5	2.4	2.9
FOMC	2.3 to 2.4	2.6 to 3.0	2.5 to 3.0
Unemployment Rate			
Wells Fargo	5.7	5.3	4.9
FOMC	5.8	5.2 to 5.3	5.0 to 5.2
PCE Inflation			
Wells Fargo	1.1	1.1	2.1
FOMC	1.2 to 1.3	1.0 to 1.6	1.7 to 2.0

Forecast as of: February 11, 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

Source: Bloomberg LP, Federal Reserve Board and Wells Fargo Securities, LLC

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