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Economics Group

Interest Rate Weekly

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Net Treasury Issuance: A Longer-Term Outlook

Recent years have been characterized by declining U.S. budget deficits and a pullback in net new Treasury issuance. However, the latest CBO outlook indicates that deficits are set to rise again, boosting net issuance.

The Latest CBO Outlook: Larger Deficits Ahead

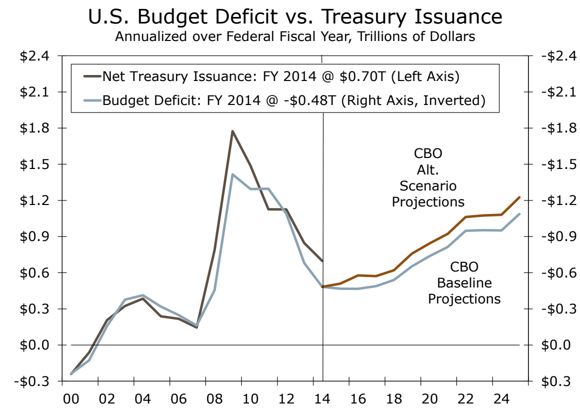
For the Congressional Budget Office (CBO), the short-term federal budget outlook is little changed from last year; however, the longer-term outlook for the budget deficit contains some important information for investors. First, the need for greater federal borrowing will begin to arise again in fiscal year 2016. Second, this higher borrowing need will help provide more new Treasury issuance over the next several years (top graph). Given that tight Treasury supply has been a dominant theme over the past couple of years amid increased capital requirements for financial institutions, greater holdings of U.S. Treasuries by foreign central banks and a flight to quality to U.S. Treasuries amid global political and economic turmoil, we expect these dynamics to begin to change. The greater need for federal borrowing should serve to help increase longer-term bond yields and will eventually result in higher borrowing costs for the federal government.

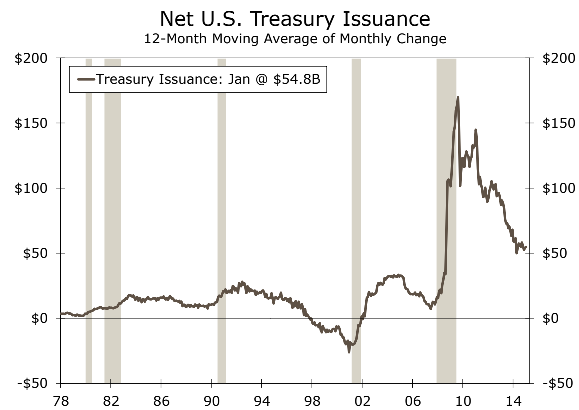
A More Realistic Look at the Deficit Projections?

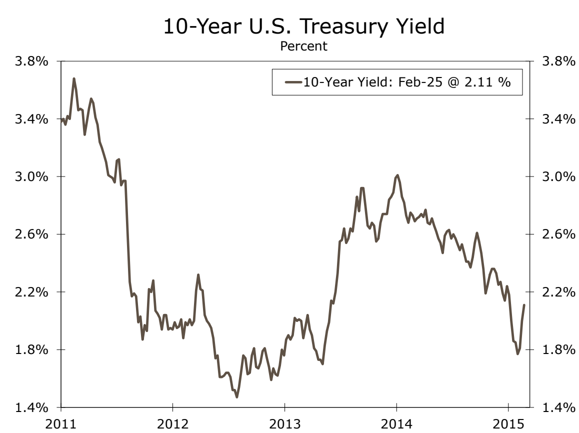
While the CBO's baseline projections provide useful insight, they do not tell the whole story. One of the key provisions of the tax code in recent years has been the continued extension of several tax provisions that were set to expire under existing law. The CBO's baseline projections assume that these provisions that have been extended numerous times over the past several years are allowed to expire. The top graph shows the difference in the federal budget deficit under the baseline scenario and an alternative scenario that extends the tax provisions set to expire, as has occurred in prior years. The implication is that there would be a greater need for new Treasury issuance under this alternative, and arguably more realistic, scenario.

Implications in a Rising Rate Environment

For the Treasury market in recent years, particularly at the longer end of the yield curve, supply has been particularly tight as a result of slower net issuance. At the same time, global demand has strengthened for these longer-dated U.S. Treasuries. As shown in the middle graph, the rate of decline in net Treasury issuance has begun to slow. In addition, the first fed funds rate hike has begun to approach just as other global central banks have begun to enact stimulus measures, which has helped slow the flight to quality into U.S. Treasuries. The net result has been a stabilization of the 10-year Treasury yield (bottom graph). Going forward, we continue to expect rates to slowly rise across the curve this year. Beyond the next year or two, we foresee some of the unusual dynamics that have played out over the past couple of years to change as net new Treasury issuance begins to grow once again and the Federal Reserve gradually normalizes the monetary policy environment.







Source: CBO, U.S. Dept. of the Treasury, Federal Reserve Board 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	2.85
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	3.60	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: February 20, 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 20, 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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