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Economics Group

Interest Rate Weekly

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Why March Matters

Signaling is an important economic phenomenon. At the March FOMC meeting, the Fed will signal its policy intentions. For private-sector decision makers, the FOMC will signal information to command action.

Springtime is a Time for…

Consumers buying autos and homes, for remodeling and planning summer vacations. Critical to both consumers and the lenders on the other side of the trade are interest rates. A conflict may be brewing. Over the past year, credit standards have declined, as evidenced in the decline in the share of new car purchases for prime credits (top chart). This pattern is repeated for used car loans and home purchases as well. There may be a nasty surprise coming this spring if consumers and lenders commit to spending and credit decisions without a clear signal that the FOMC will raise rates. We expect a removal of the word "patient" in March and a June increase in the fed funds rate, which should provide a signal to private agents upon which to make thoughtful decisions. No signal in March and an increase in rates in September would have immediate negative implications for credit markets that must act this spring. Timing matters.

"Reasonably Confident"

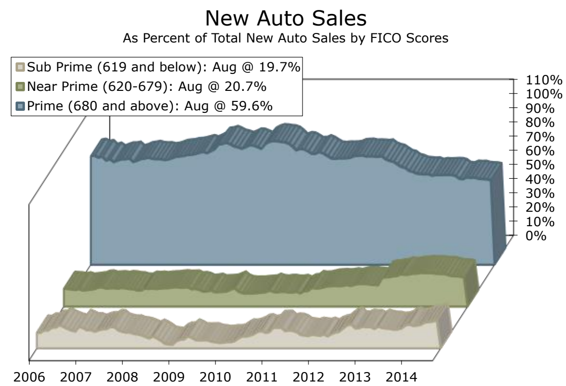
How much information is required to make one reasonably confident? This is a difficult question. However, the private markets must be forward-looking and cannot wait for data on inflation to make decisions in the face of the spring rush to buy homes and autos. For an academic economist, more time is always required to be confidently confident. Waiting for tangible evidence is compounded by the reality that wages and inflation lag the economic cycle, and even more so, the credit cycle. During the run up to the credit-driven recession in housing in 2007-2009, the path of wages and inflation did not provide a clear sign of the excesses in the economy. The issue was one of inflation in asset prices (homes) and not in goods/services.

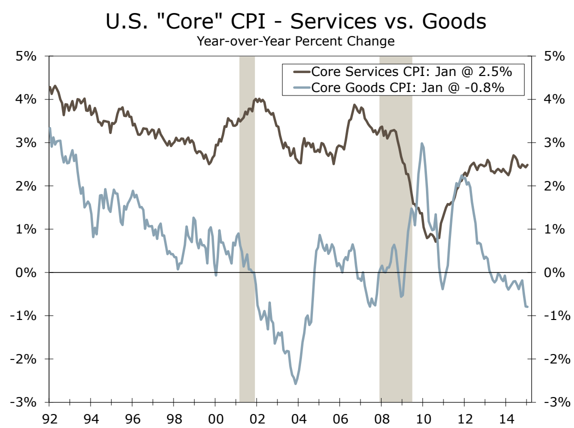
"Transitory"

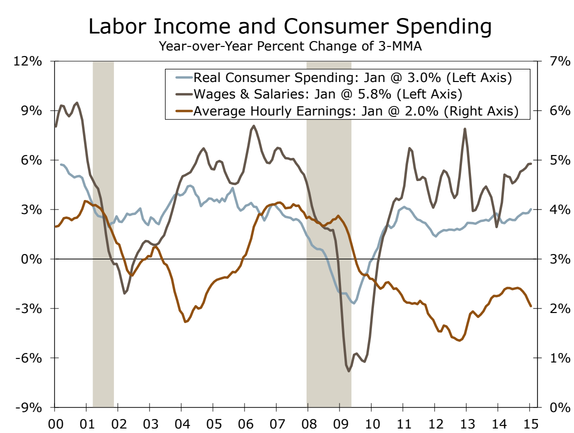
Gas prices are already moving upward, and year-over-year goods inflation data should soon turn around. Will this be enough to signal a return to rising goods inflation? This is uncertain, but we already know that FOMC policy is continuing to suppress borrowing costs, thereby distorting the valuation metrics of financial assets—giving the appearance of a repeat of the 2004-2007 policy period. For the mortgage-backed securities sector, FOMC purchases and subsequent suppressed volatility have weakened the price discovery process for these financial assets.

"Remains Accommodative"

Even if the FOMC removes the word "patient" and raises the funds rate in June, monetary policy will still be accommodative. Moreover, policy benchmarks must be reevaluated in light of the 2007 experience. First, wages are not a good indicator of consumer welfare—wages and salaries together are a much better indicator of consumer spending. Second, since 1994, the PCE deflator has averaged just below 2 percent. Finally, the shift of the Beveridge curve highlights structural shifts in the labor market.







Source: CNW Research, U.S. Department of Labor, U.S. Department of Commerce 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 27, 2015

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

	2014	2015	2016
Change in Real Gross Domestic Product			
Wells Fargo	2.4	2.6	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 27, 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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