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Softer Start to 2015 Gives The Fed More to Consider

The FOMC noted that it would need to see additional improvement in the labor markets before it would begin to hike the federal funds target rate. The soft start to 2015 may give the Fed even more to consider.

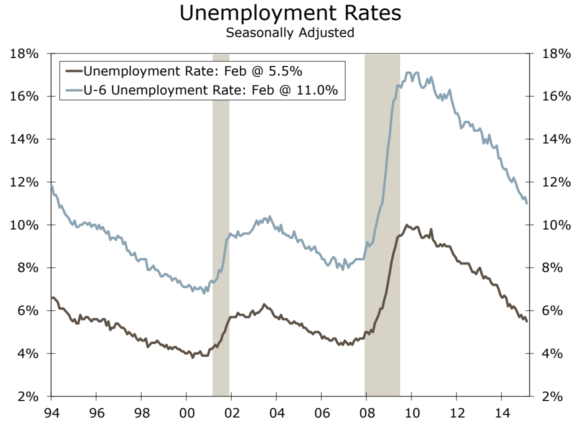
Still Looking for Further Improvement

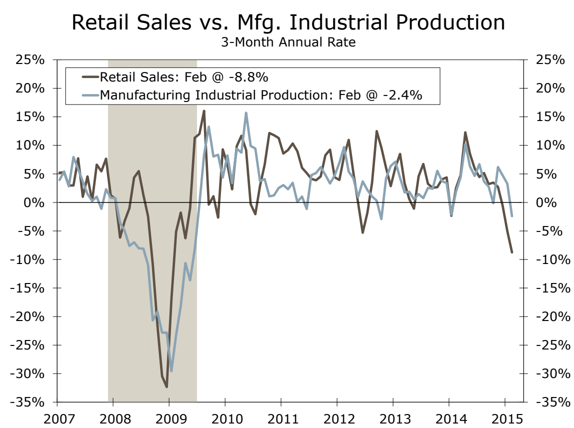
With the federal funds rate stuck at essentially zero for the past six years, the prospect of the Federal Reserve finally getting around to raising interest rates hardly comes as a surprise. We had expected the Fed to raise rates in mid-2015 in our December 2013 annual outlook. The Federal Reserve slashed the federal funds rate during the darkest hours of the financial crisis and subsequently announced several rounds of asset purchases in a bid to bring the economy back from the brink. While progress on the economic front has been slow and sometimes halting, progress has been made. Employment has surpassed its pre-recession peak and the unemployment rate has fallen back to just 5.5 percent. A credible argument can now be made that the economy is closer to full employment than it is to the brink of the abyss, and interest rates should reflect this reality.

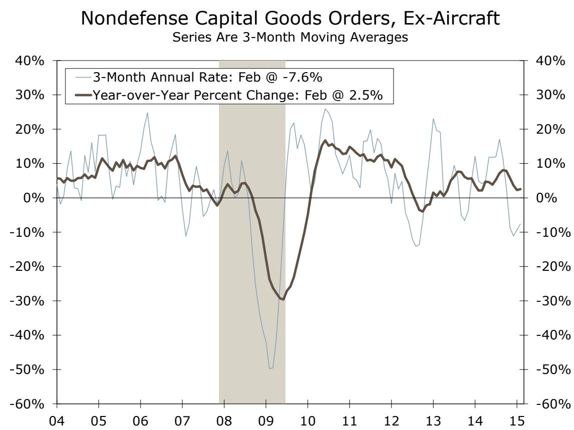
While the case for higher interest rates seems solid on the surface, there are good reasons for the continued caution by the Fed. At last week's press conference, Fed Chair Janet Yellen noted that central banks around the world have had a great deal of difficulty moving away from the "zero bound." Japan is the best recent example (2000), where just a small rise in the overnight lending base rate snuffed out a fledgling economic recovery, causing the central bank to quickly reverse course. Japan's experience is one of the reasons many Fed officials have cautioned that it is far better for the Fed to wait a little too long to raise interest rates than to move too soon.

Is it too soon now? That depends on which data the data-dependent Fed are looking at. The employment data have clearly improved. Not only has nonfarm employment growth accelerated but the mix of jobs is weighted more heavily toward full-time jobs. Hours worked have risen solidly, helping compensate for the lack of growth in average hourly earnings. Other data have not been as strong. Retail sales and industrial production have both fallen in each of the past three months. These two highly coincident economic indicators have not both fallen for three consecutive months since the fall of 2008. While there are special circumstances surrounding the most recent declines (plummeting oil prices, the stronger dollar, the West Coast port slowdown and bad weather), there have also been plenty of extenuating circumstances during the past six years.

A slower start to 2015 is not a complete surprise to us. We have long had one of the lowest estimates for first quarter growth, with real GDP expected to grow at just a 1 percent pace, down from 2.2 percent the prior quarter. Most of that slowing is due to the negative effects of falling oil prices. The stronger dollar and West Coast port slowdown appear to have also taken a big toll on growth, cutting into factory orders and output. Our earlier forecast may have been too optimistic and first quarter growth could very well come in at less than a one percent pace.







Source: U.S. Dept. of Labor, U.S. Dept. of Commerce, 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	0.25	0.50	0.75	1.00	1.25	1.75	2.25
3 Month LIBOR	0.23	0.23	0.24	0.26	0.28	0.30	0.70	0.95	1.20	1.45	1.95	2.45
Prime Rate	3.25	3.25	3.25	3.25	3.25	3.25	3.50	3.75	4.00	4.25	4.75	5.25
Conventional Mortgage Rate	4.34	4.16	4.16	3.86	3.88	3.95	4.16	4.22	4.27	4.35	4.62	4.74
3 Month Bill	0.05	0.04	0.02	0.04	0.05	0.14	0.56	0.86	1.15	1.41	1.80	2.28
6 Month Bill	0.07	0.07	0.03	0.12	0.15	0.26	0.62	0.92	1.20	1.52	1.83	2.36
1 Year Bill	0.13	0.11	0.13	0.25	0.23	0.29	0.68	0.98	1.22	1.56	1.87	2.43
2 Year Note	0.44	0.47	0.58	0.67	0.63	0.71	0.89	1.08	1.28	1.74	2.05	2.47
5 Year Note	1.73	1.62	1.78	1.65	1.52	1.69	1.79	1.90	1.99	2.22	2.33	2.62
10 Year Note	2.73	2.53	2.52	2.17	2.00	2.20	2.36	2.40	2.45	2.51	2.76	2.88
30 Year Bond	3.56	3.34	3.21	2.75	2.65	2.80	2.91	2.98	3.08	3.17	3.35	3.57

Forecast as of: March 19, 2015

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

	2015	2016	2017
Change in Real Gross Domestic Product			
Wells Fargo	2.5	3.0	N/A
FOMC	2.3 to 2.7	2.3 to 2.7	2.0 to 2.4
Unemployment Rate			
Wells Fargo	5.2	4.8	N/A
FOMC	5.0 to 5.2	4.9 to 5.1	4.8 to 5.1
PCE Inflation			
Wells Fargo	0.9	2.1	N/A
FOMC	0.6 to 0.8	1.7 to 1.9	1.9 to 2.0

Forecast as of: March 19, 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: March 18, 2015

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

Wells Fargo Securities, LLC Economics Group

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