April 08, 2015

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

Lessons from History: Don't Underestimate the Fed

Recently, more attention has been paid to the date of the first rate hike than to the actual path of rates. History shows markets and Fed members tend to err on the side of underestimating the pace of rate hikes.

Fed Reassesses, Market Reacts

Following the most recent Federal Open Market Committee (FOMC) meeting, all eyes turned to the committee's updated economic projections. Arguably the most notable change was the downshift in the Fed's projections for the appropriate pace of policy firming (top chart). Committee members' median fed funds projection for year-end fell 50 bps, motivating us to shift our call for the first rate hike to September. Treasury yields across the maturity spectrum dropped, with the 10-year yield falling 15 bps overnight.

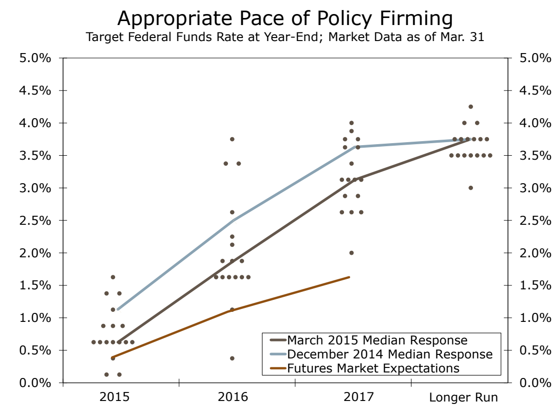
A less-discussed development was the downward shift in growth and inflation expectations, along with a lower range for the unemployment rate central tendency forecast. On balance, the FOMC's updated projections generally pointed to a later date to begin policy normalization, along with a more gradual pace of tightening. The top chart shows that, despite the downshift in the FOMC's path of policy firming, the market continues to expect an even more gradual pace of tightening than the committee.

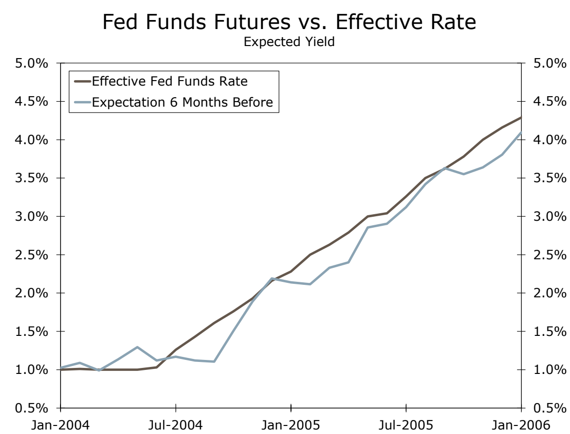
Hiking Through History: A Cautious Note from Lacker

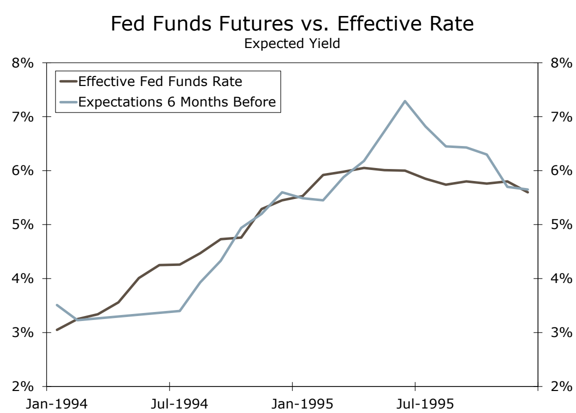
History suggests that the discrepancy between market and FOMC expectations is not out of the ordinary. Leading up to the initial hike in the 2004-2006 tightening cycle, markets actually prematurely predicted the first move, but lagged behind the actual path once rates began rising (middle chart). The cycle that began in 1994 showed a similar pattern—markets overshooting the initial hike, but generally lagging behind the true path once the cycle progressed (bottom chart).

It is not just the markets that have underestimated the FOMC—the committee has historically had a tendency to underestimate itself. In March 2004, the FOMC projected that it would "begin to tighten policy in 2005, raising the target federal funds rate to 2 percent by the end of that year."[1] In fact, the committee began tightening policy in June 2004 and the fed funds rate ended 2005 at 4.25 percent. The prior cycle was similar; in January 1994, the committee stated that its baseline policy was to "hold the [fed] funds rate at 3 percent into the summer [of 1994] before raising it over the next two years…rising to 4.5 percent in 1996."[2] Instead, it started tightening in February 1994 and the funds rate reached 6 percent by February 1995.

Will we see the same pattern repeated in this cycle? We note that policy communication was far more opaque in prior tightening cycles, particularly in the 1990s, and, more broadly, no two tightening cycles are alike. That said, in a March 31 speech, Richmond Fed President Jeffrey Lacker said the Fed "needs to be ready for the possibility that we could need to tighten more rapidly than people expect." Perhaps his words should be heeded.







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

[1] See the Federal Reserve Bluebook (Mar. 11, 2004). http://www.federalreserve.gov/monetarypolicy/files/FOMC20040316bluebook20040311.pdf
[2] See the Federal Reserve Bluebook (Jan. 29, 1994). http://www.federalreserve.gov/monetarypolicy/files/fomc19940204bluebook19940129.pdf

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	0.27	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	3.71	3.95	4.15	4.23	4.28	4.37	4.63	4.75
3 Month Bill	0.05	0.04	0.02	0.04	0.03	0.13	0.55	0.86	1.15	1.43	1.81	2.28
6 Month Bill	0.07	0.07	0.03	0.12	0.14	0.27	0.63	0.91	1.22	1.52	1.85	2.35
1 Year Bill	0.13	0.11	0.13	0.25	0.26	0.30	0.69	0.99	1.24	1.57	1.89	2.43
2 Year Note	0.44	0.47	0.58	0.67	0.56	0.70	0.87	1.07	1.26	1.71	2.00	2.46
5 Year Note	1.73	1.62	1.78	1.65	1.37	1.68	1.78	1.89	2.01	2.19	2.31	2.59
10 Year Note	2.73	2.53	2.52	2.17	1.94	2.19	2.35	2.41	2.46	2.53	2.77	2.89
30 Year Bond	3.56	3.34	3.21	2.75	2.54	2.77	2.89	2.99	3.09	3.18	3.39	3.58

Forecast as of: April 8, 2015

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

	2015	2016	2017
Change in Real Gross Domestic Product			
Wells Fargo	2.4	2.9	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: April 8, 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: Federal Reserve Board, Bloomberg LP and Wells Fargo Securities, LLC

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 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
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

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