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Economics Group

Interest Rate Weekly

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No New Signals from the Fed, but Rates Are on the Move

Over the course of the past week, interest rates, particularly at the longer-end of the yield curve, began to migrate higher. Meanwhile, shorter-term rates edged lower, resulting in a somewhat steeper yield curve.

What We Learned from the Fed Last Week: Not Much

April's policy statement from the Federal Open Market Committee (FOMC) last week maintained the target fed funds rate but it also showed that the committee's assessment of current economic conditions was downgraded, consistent with the disappointing GDP report, which indicated that the economy expanded at a meager 0.2 percent pace in the first quarter of this year. Even with the downgrade in its view of current conditions, the committee viewed the slowdown as transitory and continued to expect a rebound in the pace of growth as the year progressed.

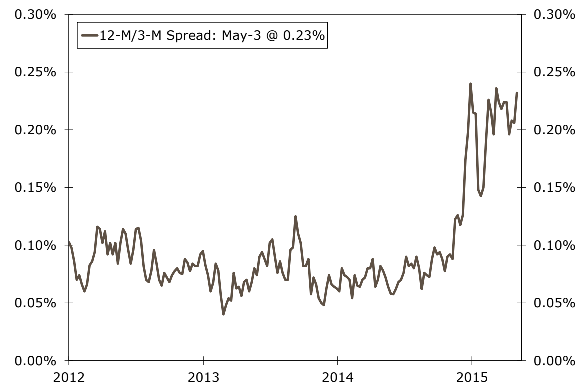
Other than the downgrade of the committee's assessment of current conditions, little else was changed in statement that would signal a change in the timing of a rate hike. We maintain our view of a September rate hike and expect shorter-term interest rates to begin reflecting this reality this summer as we continue to march closer to the anticipated liftoff date. Short-term rates have moved lower, however, with the spread between the 12-month and 3-month Treasury widening over the past week as the Fed's assessment of the economy was downgraded, leaving many wondering if the slow start to the year will again serve as a reason to delay interest rate hikes (top graph).

Long-Term Treasury Yields Still a Function of Capital Flows

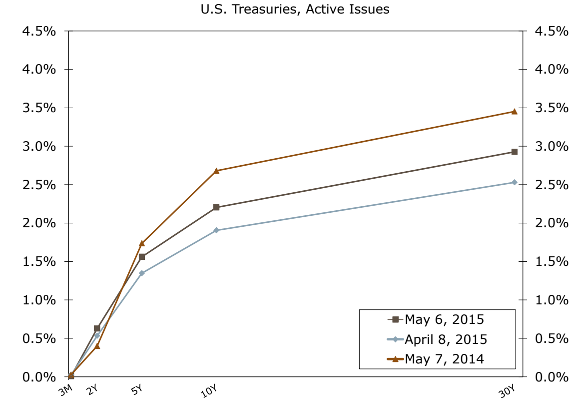
While short-term rates edged lower over the past week, there was a pronounced rise at the longer end of the yield curve (middle graph). The net result of the lower short-term rates and higher longer-term rates was a steepening of the yield curve, which in our view is temporary. We suspect that the rise in longer-term interest rates over the past week was a byproduct of the disappointing GDP report and the FOMC's assessment of current economic conditions, which led to capital outflows and thereby resulted in higher Treasury yields. By contrast, recent economic data out of Europe have been more upbeat and deflation fears there have largely subsided. We suspect that the shift in international capital flows out of the United States is only temporary and will likely reverse course, sending longer-term yields a little lower over the coming weeks as U.S. economic data gradually improve.

We maintain our view for a flatter yield curve as the year progresses (bottom graph). For starters, we agree with the FOMC that the first quarter downshift in growth was temporary and expect growth to pick up over the next couple of quarters, returning to the 3 percent range by the third quarter. This pickup in growth would once again lead to capital inflows into the United States as investors more fully price in a Fed rate hike. In addition, shorter-term rates will likely begin to rise as we approach the September liftoff date. In short, investors should not view movements over the past week in Treasury rates as a permanent shift in market dynamics.

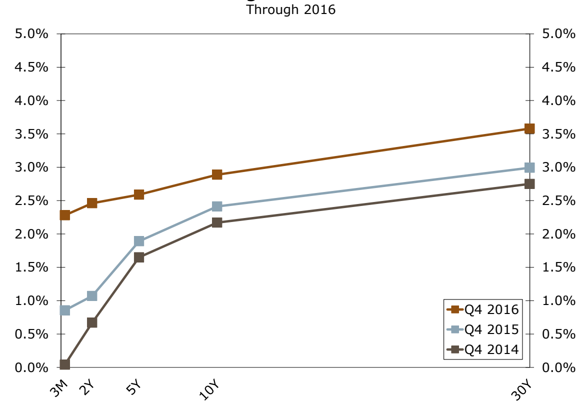
12-Month/3-Month U.S. Treasury Spread
Percent



Yield Curve
U.S. Treasuries, Active Issues



Wells Fargo Rates Forecast
Through 2016



Source: Federal Reserve Board, Bloomberg LP 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	0.27	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	3.77	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: May 1, 2015

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

	2015	2016	2017
Change in Real Gross Domestic Product			
Wells Fargo	2.0	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: May 1, 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

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