May 27, 2015

Economics Group

Interest Rate Weekly

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Midyear Interest Rate Outlook: Expect Greater Volatility

Over the course of the past few weeks, the yield curve has steepened, raising questions about the future path of interest rates. We present our views on the current rate environment and what we expect later this year.

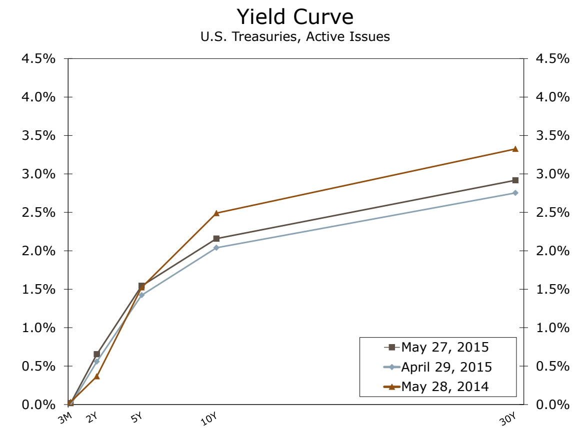
A Look Back at the First Half

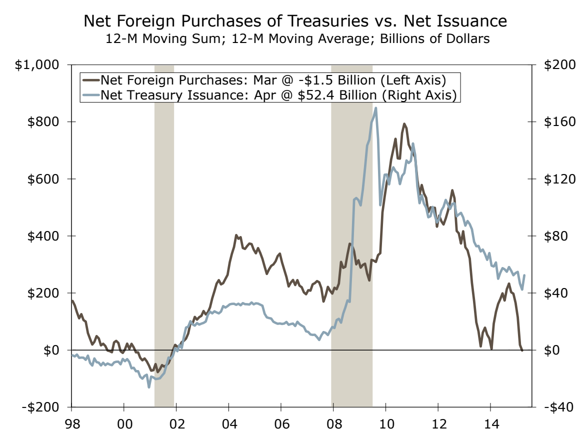
Now that we are nearing the middle of 2015, we wanted to take a moment to update our readers on our views on interest rates through the end of this year. Over the past few months, the yield curve has become noticeably steeper as shorter-term Treasury yields have remained low, while global capital outflows have led to higher long-term rates (top graph). Among the dynamics that resulted in a rise in long-term yields has been a slowdown in capital inflows at the same time that net new Treasury issuance has been fairly steady (middle graph). In our view, rates, particularly at the longer end of the yield curve, have been moving based on the economic news cycle. A prime example is the pronounced downward movement in longer-term rates this week as U.S. economic data have improved, resulting in a stronger U.S. dollar and greater capital inflows. The net result has been a sizable reversal in the climb in long-term rates that has occurred over the past several weeks. In addition to pulling long-term rates lower, the stronger domestic data provided investors greater confidence in the Fed raising short-term rates sometime this fall. Thus, short-term rates have begun to rise, leading to a re-flattening of the yield curve.

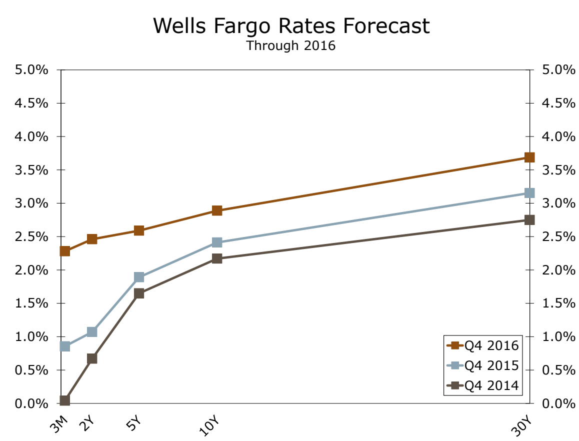
Fed Policy Changes and Short-Term Rate Movements

We maintain our call for the first fed funds rate hike in September of this year. While the Fed will most likely liftoff this year, we do not expect the fed funds rate to rise above 0.75 percent by year end. Consistent with the Fed's Policy Normalization Principles and Plans, we expect the Fed to use interest on excess reserves along with the overnight reverse repo (ON RRP) facility to control short-term interest rates. Yet, as we have noted, the size of the ON RPP, and thus the Fed's role in the money markets, may end up being larger than many expect to effectively establish a floor for short-term rates.

Looking ahead, the short end of the yield curve will continue to be influenced by actual fed rate hikes as well as expectations for future rate hikes. At the longer end of the curve, the story remains tied to global capital flows, which will play more of a role in the movement of longer-term rates than Federal Reserve policy decisions. The relative strength of the U.S. economy compared to the rest of the world and resulting strength of the U.S. dollar will dictate the direction of global capital flows and, in turn, rate movements at the long-end of the yield curve. With shorter-term rates rising and longer-term rates likely to remain low given the relative strength of the U.S. economy, we expect a continued flattening of the yield curve in the months ahead. In addition to the dynamics affecting the yield curve mentioned earlier, we expect volatility to remain high at all points of the yield curve as regulatory changes have resulted in higher demand for both short and long-term Treasury debt while supply remains fairly tight.







Source: U.S. Dept. of the Treasury, 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	4.05	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	2.25	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	2.95	3.07	3.15	3.18	3.29	3.53	3.69

Forecast as of: May 22, 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 22, 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

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