July 22, 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

Potential Fiscal Policy Challenges to Monetary Policy: Part I

This fall the Federal Reserve is widely expected to begin hiking interest rates. At the same time, federal fiscal policy is likely to become more expansionary, which will present some challenges for the Fed.

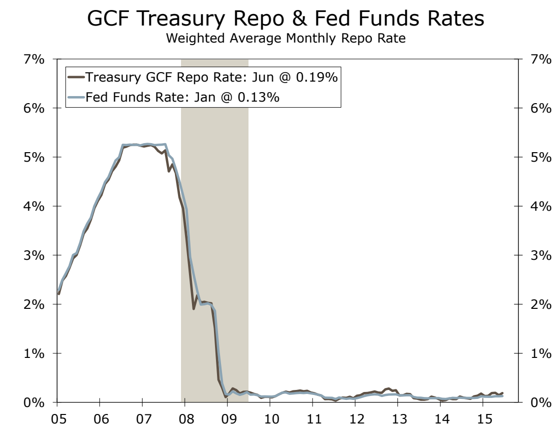
The Interaction of Net Treasury Issuance and Monetary Policy

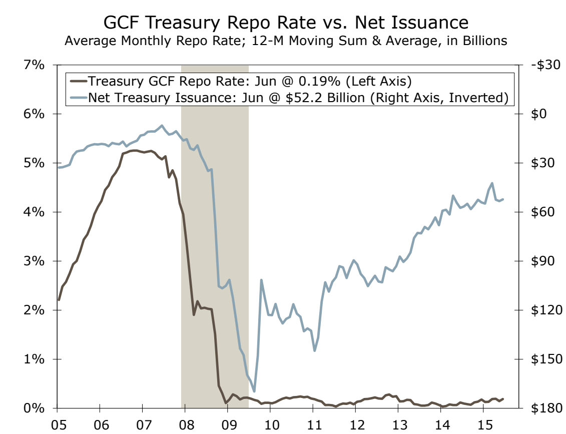
We have highlighted in several of our *Interest Rate Weekly* publications that there will be several challenges for the Federal Reserve when the time comes to hike interest rates. Our concern remains with the Fed's new mechanism to set a lower bound for the fed funds target range, the Overnight Reverse Repo Facility (ON RRP). This new tool is designed to expand the set of potential counter-parties that can transact with the Fed and to establish a floor on rates by creating arbitrage opportunities among other interest rates in money markets. Historically, the Treasury general collateral (GC) rate has closely tracked the effective fed funds rate (top graph). This time around, however, it is likely that the effective fed funds rate will run slightly higher than the GC repo rate as the repo rate establishes the floor, while the upper bound of the range is set by the interest paid by the Fed on excess reserves.

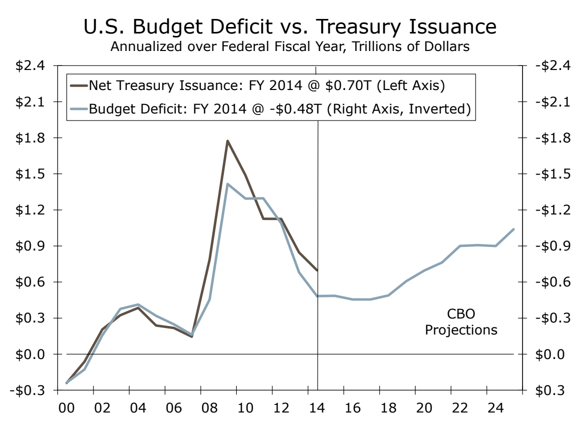
Since the Fed plans to utilize the ON RRP to transact and, in turn, play a larger role in money markets, it is important to understand some of the external factors beyond the scope of monetary policy changes that can affect the GC Treasury rates in particular. One of the dominate factors that can influence GC Treasury rates outside the control of the Fed is a pick-up in net Treasury issuance, which occurs as a result of higher federal deficit spending. In a Federal Reserve Board working paper, Bech, Klee and Stebunovs cite the fact that net Treasury issuance tends to push up repo rates for a period of time but typically does not have an effect on the fed funds rate.* They find that for a $10 billion increase in Treasury issuance, the repo rate increases by 0.4 basis points. Thus, another factor that has the potential to influence the Fed's control over short-term rates this time around could be federal spending decisions and the resulting debt issuance.

Debt Issuance Set to Pick Up as Fed Attempts to Hike Rates

Assuming our timeline is correct for a September rate hike, the announcement of a higher fed funds target range would occur on Sept. 17. The beginning of the 2016 federal fiscal year occurs on Oct. 1. While it is still unclear what the federal budget will look like next fiscal year, the latest Congressional Budget Office (CBO) projections indicate that the federal deficit is expected to fall over the next couple of fiscal years. These projections, however, assume that the federal budget cuts, which have been partially scaled back in recent years, stay in place. Should Treasury issuance start to rise while the Fed is attempting to gradually tighten monetary policy, it could result in higher short-term rates than the Fed would like. Given that rates are not likely to normalize for quite some time, it is highly likely that fiscal policy changes may result in the Fed pausing its rate hikes in order to account for a changing fiscal policy environment.







Source: Depository Trust & Clearing Corp., Federal Reserve Board, CBO, Bloomberg LP, and Wells Fargo Securities, LLC

***Bech, M.L. Klee, E., and Stebunovs, V. (2011). Arbitrage, liquidity and exit: The repo and federal funds markets before, during, and emerging from the financial crisis.**

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	1.50	2.00
3 Month LIBOR	0.23	0.23	0.24	0.26	0.27	0.28	0.70	0.95	1.20	1.45	1.70	2.20
Prime Rate	3.25	3.25	3.25	3.25	3.25	3.25	3.50	3.75	4.00	4.25	4.50	5.00
Conventional Mortgage Rate	4.34	4.16	4.16	3.86	3.77	3.98	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	0.01	0.13	0.55	0.86	1.15	1.33	1.72
6 Month Bill	0.07	0.07	0.03	0.12	0.14	0.11	0.27	0.63	0.91	1.22	1.42	1.75
1 Year Bill	0.13	0.11	0.13	0.25	0.26	0.28	0.69	0.99	1.24	1.57	1.79	2.17
2 Year Note	0.44	0.47	0.58	0.67	0.56	0.64	0.86	1.08	1.27	1.72	1.94	2.38
5 Year Note	1.73	1.62	1.78	1.65	1.37	1.63	1.78	1.89	2.01	2.20	2.32	2.61
10 Year Note	2.73	2.53	2.52	2.17	1.94	2.35	2.41	2.49	2.55	2.66	2.80	2.91
30 Year Bond	3.56	3.34	3.21	2.75	2.54	3.11	3.18	3.22	3.27	3.34	3.55	3.72

Forecast as of: July 17, 2015

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

	2015	2016	2017
Change in Real Gross Domestic Product			
Wells Fargo	2.1	2.9	N/A
FOMC	1.8 to 2.0	2.4 to 2.7	2.1 to 2.5
Unemployment Rate			
Wells Fargo	5.2	4.8	N/A
FOMC	5.2 to 5.3	4.9 to 5.1	4.9 to 5.1
PCE Inflation			
Wells Fargo	1.0	2.0	N/A
FOMC	0.6 to 0.8	1.6 to 1.9	1.9 to 2.0

Forecast as of: July 17, 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: June 17, 2015

Sources: IHS Global Insight, Bloomberg LP, Federal Reserve Board 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
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