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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

Interest Rates and Rising U.S. Federal Debt

Although deficits have stabilized in recent years, the long-term federal budget outlook remains bleak. If left unchecked, rising federal debt could lead to higher interest rates in the long-run.

Long-Term Debt: The Key Drivers

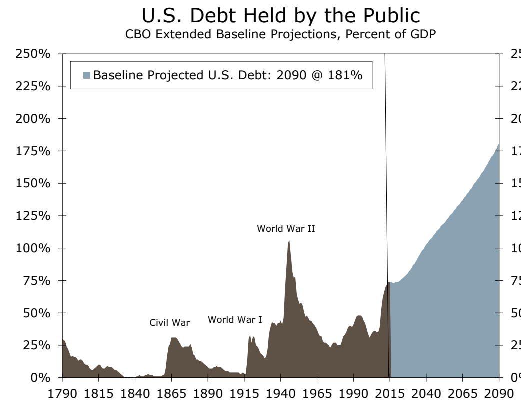
The U.S. budget deficit has narrowed in recent years as a result of moderate GDP growth and spending cuts. Fiscal year 2015 will most likely have a budget deficit around 2.5 percent of GDP, near the average of the past 50 years. From a long-run perspective, however, the federal deficit is set to steadily rise over time, increasing U.S. federal debt to unprecedented levels.

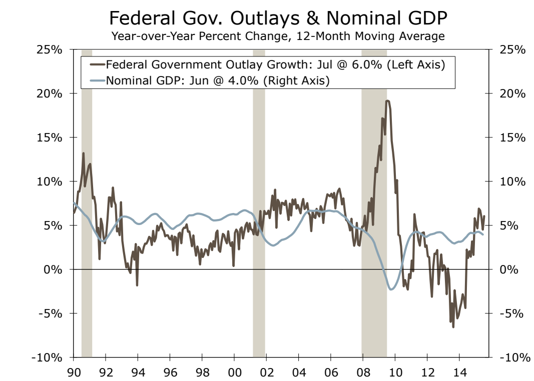
An aging population, coupled with rising health care costs, presents the greatest challenge for federal coffers. The Congressional Budget Office (CBO) predicts that the deficit will grow from less than 3 percent of GDP this year to nearly 4 percent in 2025 and more than 6 percent in 2040. As the top chart illustrates, debt would exceed 180 percent of GDP by 2090 in the CBO's extended baseline projections, well above levels ever experienced in U.S. history. Mandatory spending programs, such as Medicare, Medicaid, and Social Security, are expected to be the key drivers of this surge in federal debt. In the extended baseline scenario, the CBO projects that net federal spending for major healthcare programs will grow from an estimated 5.2 percent of GDP in 2015 to 8 percent in 2040. Strong economic growth could help offset some of this surge in spending by putting debt on a more stable path relative to economic output. While this has occurred in the past, during the 1990s for example (middle chart), lower potential growth in the future would inhibit this possibility.

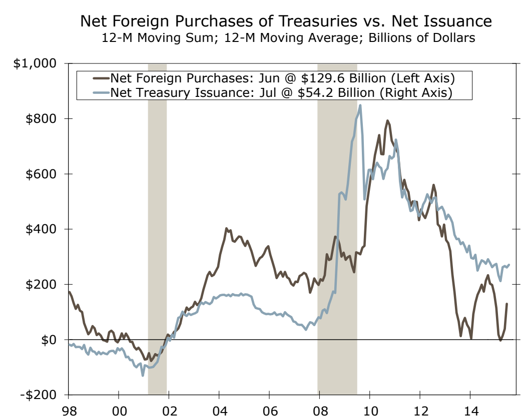
Rising Debt and Connection with Interest Rates

As federal debt climbs, the government will need to issue more and more Treasury securities to cover the gap between outlays and revenues. If demand for Treasuries were to remain constant, this glut of supply would push bond prices down and yields up, raising the cost of borrowing in the private sector. Over the long-run, increased federal government borrowing would crowd out private investment, leading to a lower capital stock and lower output. The CBO estimates that when the deficit goes up by one dollar, national saving falls by 57 cents and foreign capital inflows rise by 24 cents (as higher interest rates attract foreign capital flows), leaving a net decline of 33 cents in investment in the long-run.*

Supply and demand dynamics are subject to change over time. Foreign demand, for example, might rise in step with greater supply. There is some precedent for this pattern in the past, as spikes in net Treasury issuance have aligned with greater net foreign purchases (bottom chart). If the U.S. fails to address the fiscal imbalance in the long-run, the government would need to run consistently large deficits by historical standards. As a result, growing debt and rising interest rates could lead to a downward spiral in which higher interest rates make the growing debt more costly to service, leading to even more borrowing. For now, the U.S. fiscal situation has stabilized, but the long-run outlook remains ominously unclear.







Source: CBO, U.S. Dept. of the Treasury, U.S. Dept. of Commerce and Wells Fargo Securities, LLC

***Congressional Budget Office. (Jun. 2015). "The 2015 Long-Term Budget Outlook."**

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	1.75
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	1.95
Prime Rate	3.25	3.25	3.25	3.25	3.25	3.25	3.50	3.75	4.00	4.25	4.50	4.75
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	1.62
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	1.65
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	2.07
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	2.28
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	2.51
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	2.81
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	3.62

Forecast as of: August 12, 2015

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

	2015	2016	2017
Change in Real Gross Domestic Product			
Wells Fargo	1.7	2.7	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	0.9	2.1	N/A
FOMC	0.6 to 0.8	1.6 to 1.9	1.9 to 2.0

Forecast as of: August 12, 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

Source: 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
Erik Nelson	Economic Analyst	(704) 410-3267	erik.f.nelson@wellsfargo.com
Alex Moehring	Economic Analyst	(704) 410-3247	alex.v.moehring@wellsfargo.com
Misa Batcheller	Economic Analyst	(704) 410-3060	misa.n.batcheller@wellsfargo.com
Michael Pugliese	Economic Analyst	(704) 410-3156	michael.d.pugliese@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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