

# Economics Group

## Interest Rate Weekly

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## Financing Growth as Inflation and Interest Rates Align

*For some time now, market expectations for inflation have declined. Meanwhile, the ability to finance real growth has improved—a definite plus for the domestic economy.*

### Lowered Inflation Expectations

Market-based measures of inflation expectations for the next five years have declined steadily since early 2013 and are now below the average of the entire 2010-2014 period. As of September 1, the measure of break-even inflation is at 1.3 percent (top chart). Although some of this decline may reflect a flight to quality, as the breakeven-rate of inflation tends to narrow during periods of financial market volatility because of the lower liquidity offered in Treasury Inflation Protected Securities, this also likely represents a decline in expected inflation.

Earlier this year, we forecasted lower inflation from both the PCE deflator and CPI in 2015 relative to 2014, and this certainly appears to be the case.

These declines in expected inflation, along with a more moderate outlook for growth have lowered the expected path for the funds rate and caused Treasury yields to rally.

### Financing Growth: A Broader Venue

Nonfinancial firms are utilizing both bond and bank loans in their quest to finance growth and both are working to support the economy for now (middle chart). The financial background of the economy has continued to improve since 2011 with a clear upward trend in total net financing. High grade corporate debt issuance year to date exceeds \$800 billion compared to \$669 billion in 2014. Issuance has been particularly strong in consumer staples and health care. On the buy side, assets under management have increased in high grade funds by 2 percent compared to a year ago.

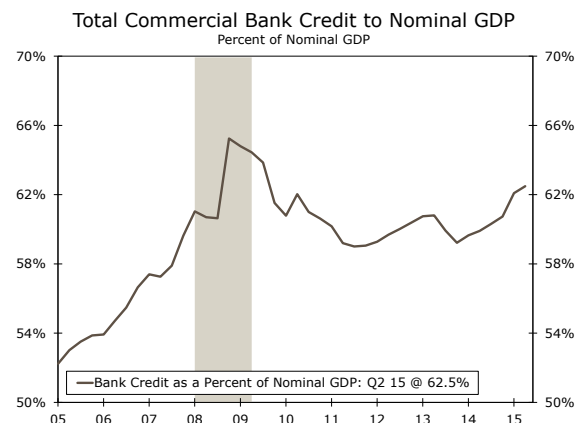
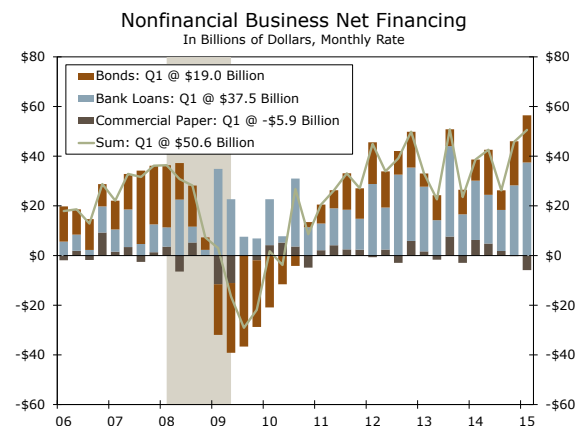
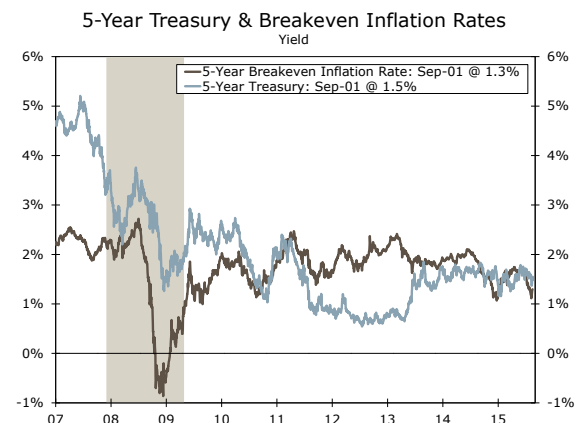
Default rates on nonfinancial corporate bonds remain low, and firms continue to issue debt to take advantage of the current low level of interest rates. Meanwhile, from the demand side, investors are willing buyers of corporate debt as they search for yield.

Finally, small business surveys do not indicate a problem of credit access. Over the past two years, small business optimism has risen, measured by the Wells Fargo and National Federation of Independent Business surveys.

### Commercial Bank Credit: Despite the Rhetoric

Despite the commentaries about the lack of commercial bank credit, the reality is that bank credit has continued to rise as a percent of nominal GDP to a level only surpassed by the peak during the 2008-2009 boom period (bottom chart). The gains reflect moderate loan growth along with continued gains in bank securities holdings.

This improvement is consistent with the Fed's own Senior Loan Officer Opinion Survey that indicates an increase in credit demand and easier terms on the supply side of the market. Meanwhile, there also appears to be evidence that many small firms are funding investment with cash flow, rather than loans, or are utilizing alternative non-bank lending sources.



## 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 28, 2015

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

	<u>2015</u>	<u>2016</u>	<u>2017</u>
<b>Change in Real Gross Domestic Product</b>			
Wells Fargo	2.0	2.7	N/A
FOMC	1.8 to 2.0	2.4 to 2.7	2.1 to 2.5
<b>Unemployment Rate</b>			
Wells Fargo	5.2	4.8	N/A
FOMC	5.2 to 5.3	4.9 to 5.1	4.9 to 5.1
<b>PCE Inflation</b>			
Wells Fargo	1.1	2.1	N/A
FOMC	0.6 to 0.8	1.6 to 1.9	1.9 to 2.0

Forecast as of: August 28, 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

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