September 09, 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

We Do Not Expect a Repeat of the Taper Tantrum

The Federal Reserve appears poised to begin raising the federal fund rates but should be able to avoid a repeat of the Taper Tantrum, which upended the mortgage market back in 2013.

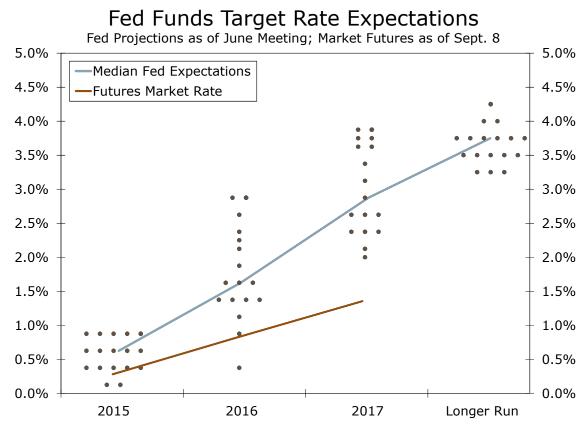
The Fed's Brave New Normal

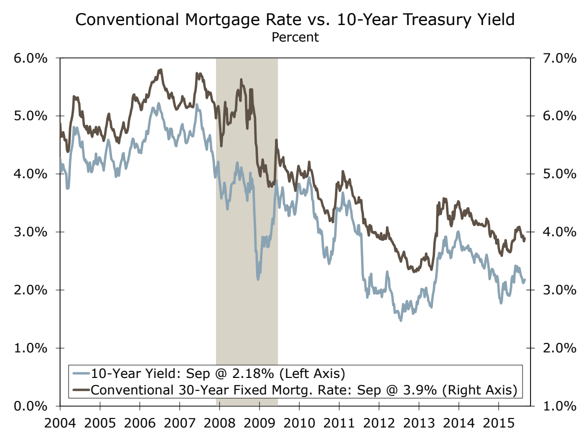
Anticipation has been building ahead of the Sept. 16-17 Federal Open Market Committee meeting for the past few weeks, when the Federal Reserve is expected to announce its first hike in the federal funds rate in more than nine years. While an increase is far from certain, given all the recent turmoil in the financial markets, the move would hardly come as a surprise or shock to the financial markets. The Fed has well-choreographed its intentions to begin normalizing interest rates at some point this year in numerous speeches by Fed officials and in its regular forward guidance, provided in its "dot-plot" (top graph) of expected future year-end levels for the federal funds rate.

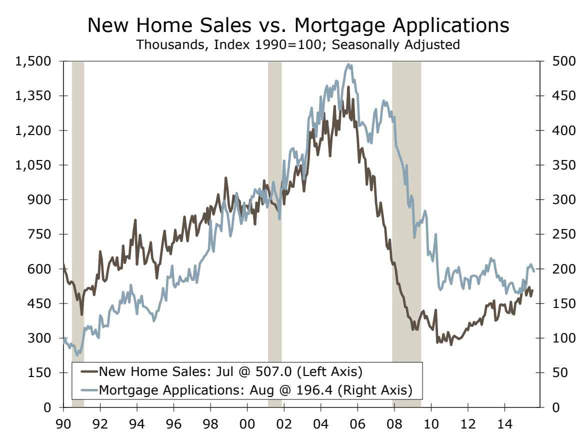
Monetary policy decision-making is more complicated today. Fed leaders are receiving all sorts of conflicting signals from the financial markets and economy. The Fed's mission is also more multifaceted. In addition to its primary goals of maintaining price stability and pursuing full employment, the Fed has a more immediate goal of normalizing monetary policy (moving the funds rate away from zero) without upending the financial markets. The latter risk is perhaps the most immediate. The decision to taper securities purchases in 2013 shocked the financial markets, leading to a surge in mortgage rates (middle graph) and collapse in home sales that may have set the housing recovery back by two years or more. The Fed will go to great pains to avoid a repeat.

Global events might still push the first rate hike into late this year or 2016, but we are holding to our forecast that the Fed will raise the target for the federal funds rate by one-quarter percentage point at their September meeting. Our logic is that as tough as it would be for the Fed to raise interest rates in September, it would not likely be any easier in October or December. Financial market volatility almost always picks up prior to the Fed's first interest rate hike and the recent volatility essentially means that the Fed has already paid for the first move. We also expect the Fed to reduce its forward guidance by lowering the dots. Such a move would strike just the right balance by acknowledging the more delicate global economic and financial situation and still get the first rate hike behind it, thereby possibly avoiding more abrupt moves later.

Some reduction to the Fed's forward guidance is likely even if the Fed chooses not to raise the federal funds rate, due to the global economic slowdown. If the Fed chooses to simply reduce its forward guidance and leave interest rates unchanged, however, it would either expose the first rate hike as occurring at one of the next two meetings or imply that it has been pushed to 2016 altogether. We doubt the Fed would want to show their hand to narrow its options. This would also increase the chance of a policy surprise, an outcome it is trying to avoid.







Source: Federal Reserve Board, Bloomberg LP, FHLMC, MBA, U.S. Department of Commerce and Wells Fargo Securities, LLC

Wells Fargo U.S. Interest Rate Forecast

	Actual				Forecast							
	2015				2016				2017			
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q
Quarter End Interest Rates												
Federal Funds Target Rate	0.25	0.25	0.50	0.50	0.75	1.00	1.25	1.50	1.75	2.00	2.25	2.50
3 Month LIBOR	0.27	0.28	0.60	0.70	0.95	1.20	1.45	1.70	1.95	2.20	2.45	2.70
Prime Rate	3.25	3.25	3.50	3.50	3.75	4.00	4.25	4.50	4.75	5.00	5.25	5.50
Conventional Mortgage Rate	3.77	3.98	4.00	4.15	4.23	4.28	4.37	4.63	4.75	4.76	4.84	4.93
3 Month Bill	0.03	0.01	0.10	0.13	0.56	0.84	1.17	1.34	1.63	1.81	2.12	2.38
6 Month Bill	0.14	0.11	0.25	0.30	0.61	0.89	1.23	1.43	1.66	1.94	2.19	2.41
1 Year Bill	0.26	0.28	0.55	0.68	0.96	1.23	1.59	1.80	2.09	2.29	2.38	2.57
2 Year Note	0.56	0.64	0.75	0.85	1.07	1.26	1.71	1.92	2.27	2.39	2.50	2.62
5 Year Note	1.37	1.63	1.65	1.73	1.87	1.99	2.20	2.34	2.52	2.60	2.69	2.78
10 Year Note	1.94	2.35	2.38	2.40	2.49	2.53	2.63	2.77	2.83	2.88	2.95	3.03
30 Year Bond	2.54	3.11	3.14	3.16	3.23	3.26	3.33	3.58	3.66	3.73	3.81	3.89

Forecast as of: September 9, 2015

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

	2015	2016	2017
Change in Real Gross Domestic Product			
Wells Fargo	2.2	2.7	2.2
FOMC	1.8 to 2.0	2.4 to 2.7	2.1 to 2.5
Unemployment Rate			
Wells Fargo	5.0	4.6	4.4
FOMC	5.2 to 5.3	4.9 to 5.1	4.9 to 5.1
PCE Inflation			
Wells Fargo	0.9	1.9	1.9
FOMC	0.6 to 0.8	1.6 to 1.9	1.9 to 2.0

Forecast as of: September 9, 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

WELLS FARGO SECURITIES