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# *Economics Group*

## Interest Rate Weekly

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# Fiscal Policy Likely to Induce Greater Rate Volatility

***With fiscal policy uncertainty building, we expect interest rates to remain volatile. The debt ceiling debate has the potential to create interest rate market disruptions at the worst possible time for the Fed.***

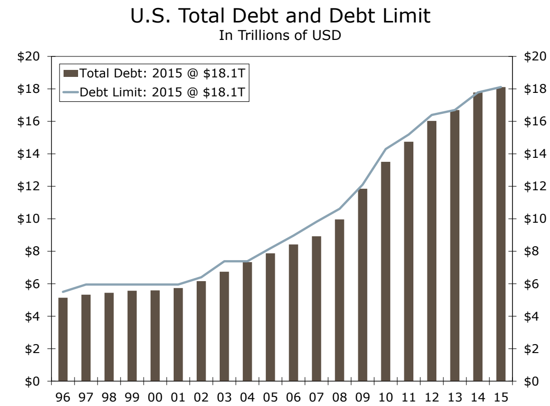
### Q4 Will Be Full of Fiscal Policy Fights

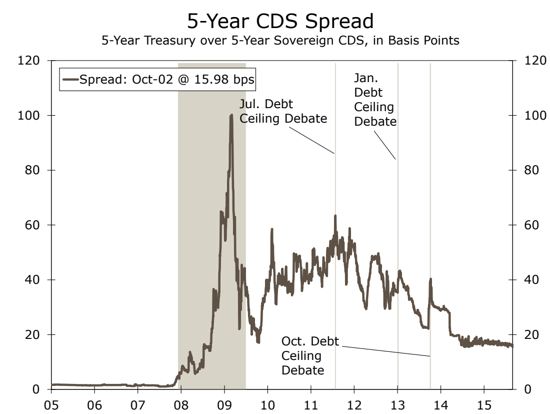
Last week, Congress passed and the president signed into law a continuing resolution (CR) to keep the federal government funded through Dec. 11. While a government shutdown was avoided, the debate leading up to last week was only the first of many major fiscal policy decisions that need to be made before the end of the year. Before Dec. 11, another CR or an omnibus appropriation bill will need to be passed to avoid a partial government shutdown and keep the government funded through the end of the 2016 federal fiscal year. While addressing the funding needs of the federal government is important, the greatest fiscal policy decision that has the potential to affect interest rates is the need to raise the debt ceiling before Nov. 5. Since March, the Department of the Treasury has been using extraordinary measures to keep the federal government under the debt ceiling. According to a letter sent by Treasury Secretary Jack Lew last week, these extraordinary measures will be exhausted by Nov. 5, thus prohibiting the Treasury from issuing new federal debt to pay for obligations already incurred. While there is a legal debate over whether the federal government would be considered in technical default, markets would likely view the situation as a temporary increase in credit risk.

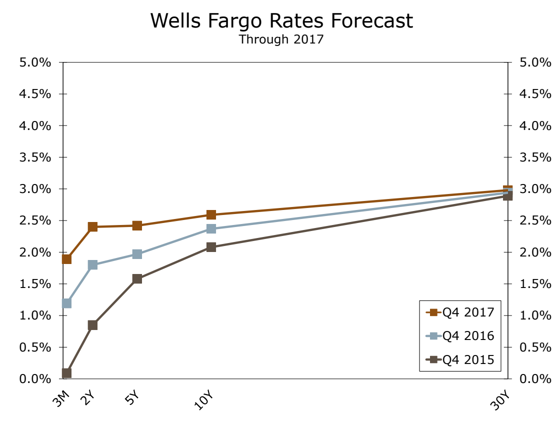
### Implications for Interest Rates

While the debate over the next several weeks on how and when to increase the nation's borrowing limit will not likely have much of an effect on interest rates, the closer to the Nov. 5 deadline the debate gets, the greater the probability that interest rates could be affected. One of the metrics that we will be monitoring closely is the credit default swap (CDS) spread on the five-year U.S. Treasury. As can be seen, the CDS spread widened considerably during the debt ceiling debate in 2011. The CDS is likely to give an early indication of how much influence the debt ceiling debate will have on Treasury yields, specifically at the shorter end of the curve.

In recent history, the U.S. government has not encountered a situation in which it was unable to issue new debt to pay for federal obligations already incurred. Should this occur this time around, there could be a greater risk premium priced into Treasury yields. The other risk of a down-to-the-wire vote on the debt ceiling is that credit rating agencies may once again place U.S. debt on watch for a possible downgrade or cut the credit rating as was the case in 2011 with the last major debt ceiling debate. While it is unlikely, in the case of a partial default for a few days there could be a spike in Treasury yields creating a challenge for the Federal Reserve, which, in our view, is still likely to hike interest rates before the end of the year. With fiscal and monetary policy uncertainty creeping into the Treasury markets over the next couple of months, the likelihood of greater interest rate volatility will increase.




Source: U.S. Department of the Treasury, Bloomberg LP, Congressional Research Service, Federal Reserve Board 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 | 0.25 | 0.50 | 0.50 | 0.75 | 1.00 | 1.25 | 1.50 | 1.75 | 2.00 | 2.00 |
| 3 Month LIBOR | 0.27 | 0.28 | 0.33 | 0.65 | 0.70 | 0.95 | 1.20 | 1.45 | 1.70 | 1.95 | 2.20 | 2.20 |
| Prime Rate | 3.25 | 3.25 | 3.25 | 3.50 | 3.50 | 3.75 | 4.00 | 4.25 | 4.50 | 4.75 | 5.00 | 5.00 |
| Conventional Mortgage Rate | 3.77 | 3.98 | 3.89 | 3.92 | 3.94 | 3.99 | 4.11 | 4.25 | 4.35 | 4.42 | 4.48 | 4.55 |
| 3 Month Bill | 0.03 | 0.01 | 0.00 | 0.09 | 0.21 | 0.60 | 0.86 | 1.19 | 1.27 | 1.60 | 1.85 | 1.89 |
| 6 Month Bill | 0.14 | 0.11 | 0.08 | 0.20 | 0.28 | 0.69 | 0.95 | 1.28 | 1.36 | 1.69 | 1.94 | 1.98 |
| 1 Year Bill | 0.26 | 0.28 | 0.33 | 0.53 | 0.62 | 0.98 | 1.16 | 1.43 | 1.51 | 1.84 | 2.07 | 2.10 |
| 2 Year Note | 0.56 | 0.64 | 0.64 | 0.85 | 1.01 | 1.28 | 1.55 | 1.80 | 2.01 | 2.28 | 2.35 | 2.40 |
| 5 Year Note | 1.37 | 1.63 | 1.37 | 1.58 | 1.72 | 1.81 | 1.94 | 1.97 | 2.20 | 2.32 | 2.38 | 2.42 |
| 10 Year Note | 1.94 | 2.35 | 2.06 | 2.08 | 2.10 | 2.15 | 2.25 | 2.37 | 2.45 | 2.50 | 2.54 | 2.59 |
| 30 Year Bond | 2.54 | 3.11 | 2.87 | 2.89 | 2.88 | 2.90 | 2.92 | 2.94 | 2.96 | 2.96 | 2.98 | 2.98 |

Forecast as of: October 7, 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 | 2.6 | 2.3 |
| FOMC | 2.0 to 2.3 | 2.2 to 2.6 | 2.0 to 2.4 |
| **Unemployment Rate** | | | |
| Wells Fargo | 5.0 | 4.6 | 4.4 |
| FOMC | 5.0 to 5.1 | 4.7 to 4.9 | 4.7 to 4.9 |
| **PCE Inflation** | | | |
| Wells Fargo | 0.8 | 1.9 | 1.9 |
| FOMC | 0.3 to 0.5 | 1.5 to 1.8 | 1.8 to 2.0 |

Forecast as of: October 7, 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: September 17, 2015

Source: IHS Global Insight, Bloomberg LP, Federal Reserve Board and Wells Fargo Securities, LLC

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