

Economics Group

Interest Rate Weekly

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Secular Patterns Overlying Cyclical Nonfinancial Finance

Three patterns of long-term secular behavior in the nonfinancial corporate finance world provide a context to judging the character of the credit cycle to upcoming movements in interest rates and possible tax policy.

Falling Share of Short-Term Debt

Along with the long-term drop in private market interest rates, there has been the expected decline in short-term debt as a share of total credit market debt, as illustrated in the top graph.

Terming out debt makes sense as when long-term rates are expected to rise in the future such that firms avoid rolling over short-term debt as increasingly higher interest rates. In addition, since the interest is deductible, this helps lower a firm's effective tax rate. This is significant given the anticipated lower corporate income tax rate going forward if current policy proposals are put into place. In contrast, however, the proposed elimination of the interest rate deduction would significantly increase the cost of debt capital and would discourage debt finance at the margin, offsetting some of the effects of a lower rate.

Corporate Bonds Rise as AA Rates Decline

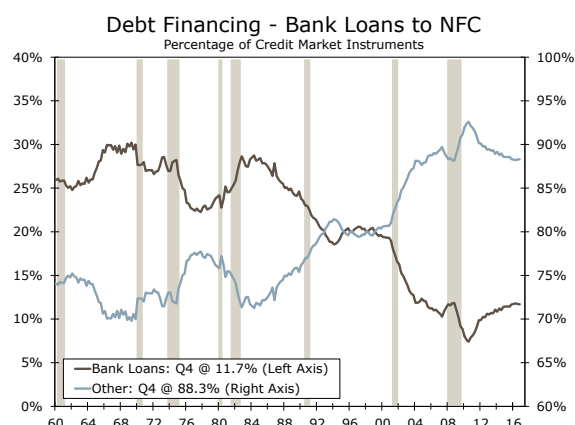
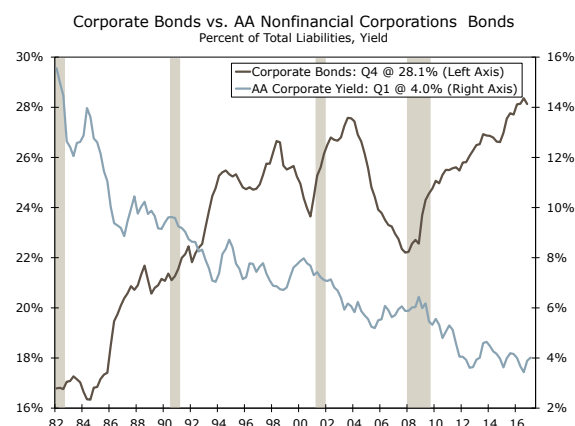
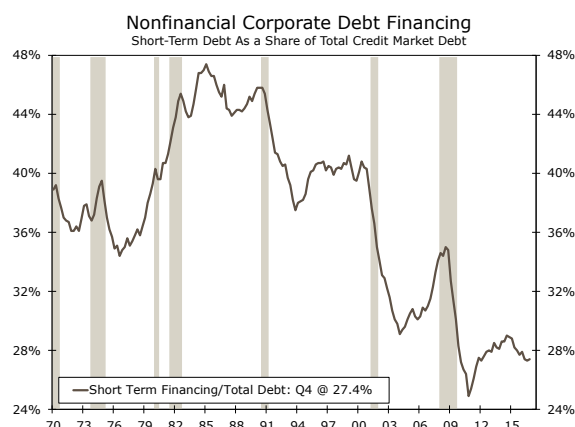
For another view of a similar phenomenon, the middle graph illustrates that corporate bonds have increased their role in the total liabilities of the nonfinancial corporations from about 16 percent in 1984 to 28.8 percent as of the fourth quarter of 2016. Once again, this is an interesting tradeoff going forward given the outlook for gradually tighter monetary policy, higher long-term benchmark rates and the outlook for corporate tax reform/changes to interest deductibility.

Bank Loans as Debt Finance: Smaller Share Since 1980s

Bank loans as a share of credit market financing have declined since the early 1980s. There are two parts to this story that bear watching. First, the lower cost of long-term finance has encouraged firms to term-out their financing since the early 1980s. Second, alternative non-bank financing options have grown. In some cases, the term shadow banking is utilized, but this is often given a negative connotation. This growth on non-bank finance is expected to continue to grow as firms seek to provide flexible finance to an increasingly uncertain economic global outlook.

Here, corporate tax reform and bank regulation/deregulation provide a conflict of influences on what may be the pattern of credit financing going forward. Economic activity and credit finance will continue to grow. Yet how that finance is conducted, either through banks or bank-like conduits or in other more "shadow-like" channels, will reflect the decision of tax and regulatory policies.

Secular trends over the last thirty years have reflected a pattern of lower interest rates and financial innovation. Both these factors are now up for grabs in a new policy environment.



Wells Fargo U.S. Interest Rate Forecast

	Actual				Forecast							
	2016				2017				2018			
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q
Quarter End Interest Rates												
Federal Funds Target Rate	0.50	0.50	0.50	0.75	1.00	1.25	1.50	1.50	1.50	1.75	2.00	2.25
3 Month LIBOR	0.63	0.65	0.85	1.00	1.15	1.50	1.75	1.75	1.75	2.00	2.25	2.50
Prime Rate	3.50	3.50	3.50	3.75	4.00	4.25	4.50	4.50	4.50	4.75	5.00	5.25
Conventional Mortgage Rate	3.69	3.57	3.46	4.20	4.20	4.29	4.45	4.46	4.47	4.48	4.55	4.62
3 Month Bill	0.21	0.26	0.29	0.51	0.76	1.02	1.30	1.40	1.45	1.50	1.75	2.02
6 Month Bill	0.39	0.36	0.45	0.62	0.91	1.19	1.45	1.56	1.60	1.66	1.92	2.18
1 Year Bill	0.59	0.45	0.59	0.85	1.03	1.35	1.65	1.80	1.85	1.90	2.10	2.31
2 Year Note	0.73	0.58	0.77	1.20	1.27	1.75	2.05	2.15	2.20	2.26	2.41	2.56
5 Year Note	1.21	1.01	1.14	1.93	1.93	2.10	2.40	2.46	2.49	2.52	2.66	2.80
10 Year Note	1.78	1.49	1.60	2.45	2.40	2.55	2.72	2.75	2.76	2.78	2.86	2.94
30 Year Bond	2.61	2.30	2.32	3.06	3.02	3.18	3.44	3.54	3.56	3.58	3.67	3.76

Forecast as of: April 12, 2017

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

	<u>2017</u>	<u>2018</u>
Change in Real Gross Domestic Product		
Wells Fargo	2.1	2.6
FOMC	2.0 to 2.2	1.8 to 2.3
Unemployment Rate		
Wells Fargo	4.5	4.5
FOMC	4.5 to 4.6	4.3 to 4.6
PCE Inflation		
Wells Fargo	2.0	2.4
FOMC	1.8 to 2.0	1.9 to 2.0
"Core" PCE Deflator		
Wells Fargo	1.9	2.2
FOMC	1.8 to 1.9	1.9 to 2.0

Forecast as of: April 12, 2017

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: March 15, 2017

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

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