December 07, 2016

Economics Group

Interest Rate Weekly

John E. Silvia, Chief Economist
john.silvia@wellsfargo.com • (704) 410-3275

Expectations and Evolution Along the Yield Curve

Financial markets have moved in anticipation of Trump administration policy actions. Will interest rates evolve along the patterns represented by these expectations? We suspect the fundamentals are in line.

Yield Curve as a Benchmark for Expectations

As illustrated in the top graph, the yield curve has shifted upward following Donald Trump's election. We view this shift as a product of an increase in expectations for growth and inflation as well as Federal Reserve policy actions. For growth, financial markets appear to be discounting some combination of additional federal spending (infrastructure/defense), income tax cuts (both corporate and individual) as well as a turn in federal regulatory actions toward some deregulation. These actions all hint at higher real economic growth.

Yet, in the context of current fiscal trends, additional federal spending along with tax cuts would signal rising federal deficits. These deficits may represent a problem in a closed economy with a fixed trend growth rate. For now, additional capital inflows, signaled by a stronger dollar, would take up some of the deficit financing as global capital inflows seek higher interest rate returns as well as an expectation of greater real returns in equities as the economy improves.

Rising Inflation as a Driving Force

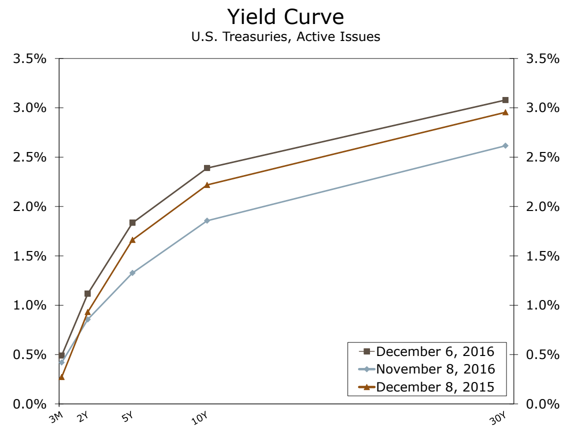
Inflation trends represent an interesting reversal of risk and reward compared to the Trump election. While the prior years of the expansion highlighted deflation risks, the outlook now is for a steady rise in the inflation rate towards the Fed's two percent target (middle graph). In fact, inflation, as measured by the benchmark PCE deflator, had already started to rise in the second half of 2016 as labor costs began to rise and non-labor costs picked up as well. A tighter labor market is the most visible source of rising inflation with a resulting increase in unit labor costs.

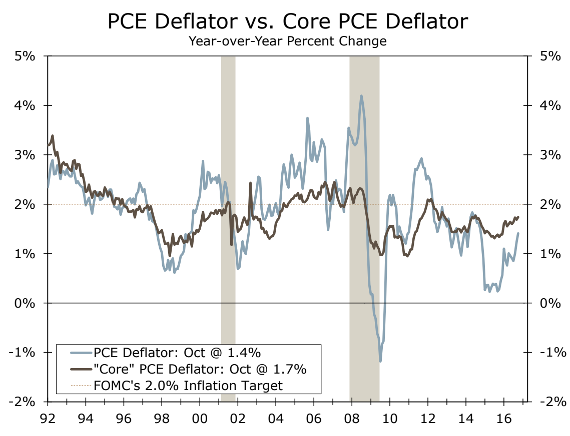
As a market proxy, we note that five-year five years forward rates on Treasury securities have shifted upward, providing support for the expectation of rising inflation and an upward shift in the yield curve.

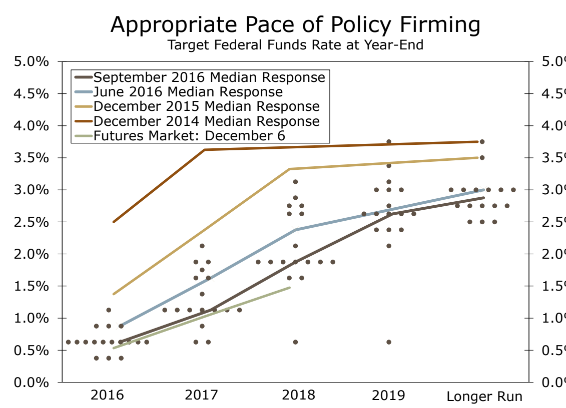
Inflation Validates the Dot Plot

Rising inflation provides the Fed with the opportunity to raise the funds rate in a way that appears to simply validate prior financial market movements and the Fed's own dot plot (bottom graph). The fundamentals of continued economic growth, rising inflation and significant capital inflows provide a basis for our expectation that the recent rise in benchmark two- and ten-year rates will be sustained and will increase in the year ahead. We expect that the yield curve spread between ten- and two-year Treasury yields will flatten as the year progresses.

We have not raised the pace of FOMC actions in 2017 as we see the pace of inflation to be consistent with the Fed's dot plot and thereby not requiring more aggressive action. In addition, the strength of the dollar will moderate imported goods inflation and increase the import drag on real GDP growth.







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

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	0.75	1.00	1.00	1.25	1.25	1.50	1.50	1.75
3 Month LIBOR	0.63	0.65	0.85	1.05	1.05	1.25	1.25	1.50	1.50	1.75	1.75	2.00
Prime Rate	3.50	3.50	3.50	3.75	3.75	4.00	4.00	4.25	4.25	4.50	4.50	4.75
Conventional Mortgage Rate	3.69	3.57	3.46	4.21	4.23	4.28	4.30	4.34	4.37	4.42	4.46	4.52
3 Month Bill	0.21	0.26	0.29	0.49	0.57	0.78	0.84	1.02	1.10	1.25	1.30	1.55
6 Month Bill	0.39	0.36	0.45	0.62	0.69	0.88	0.94	1.12	1.20	1.35	1.40	1.65
1 Year Bill	0.59	0.45	0.59	0.82	0.86	1.02	1.08	1.38	1.46	1.58	1.65	1.79
2 Year Note	0.73	0.58	0.77	1.06	1.17	1.33	1.40	1.66	1.73	1.86	1.91	2.03
5 Year Note	1.21	1.01	1.14	1.70	1.75	1.83	1.90	2.10	2.16	2.26	2.30	2.41
10 Year Note	1.78	1.49	1.60	2.27	2.30	2.35	2.38	2.43	2.47	2.53	2.58	2.65
30 Year Bond	2.61	2.30	2.32	2.95	2.97	2.99	3.02	3.04	3.06	3.08	3.10	3.14

Forecast as of: November 30, 2016

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

	2016	2017	2018
Change in Real Gross Domestic Product			
Wells Fargo	1.8	2.0	2.1
FOMC	1.7 to 1.9	1.9 to 2.2	1.8 to 2.1
Unemployment Rate			
Wells Fargo	4.9	4.6	4.5
FOMC	4.7 to 4.9	4.5 to 4.7	4.4 to 4.7
PCE Inflation			
Wells Fargo	1.5	2.1	2.3
FOMC	1.2 to 1.4	1.7 to 1.9	1.8 to 2.0
"Core" PCE Deflator			
Wells Fargo	1.8	2.0	2.1
FOMC	1.6 to 1.8	1.7 to 1.9	1.9 to 2.0

Forecast as of: November 30, 2016

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 21, 2016

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

Wells Fargo Securities 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
Anika R. Khan	Senior Economist	(212) 214-8543	anika.khan@wellsfargo.com
Eugenio J. Alemán, Ph.D.	Senior Economist	(704) 410-3273	eugenio.j.aleman@wellsfargo.com
Azhar Iqbal	Econometrician	(704) 410-3270	azhar.iqbal@wellsfargo.com
Tim Quinlan	Senior 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
Jamie Feik	Economist	(704) 410-3291	jamie.feik@wellsfargo.com
Erik Nelson	Currency Analyst	(212) 214-5652	erik.f.nelson@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
Julianne Causey	Economic Analyst	(704) 410-3281	julianne.causey@wellsfargo.com
E. Harry Pershing	Economic Analyst	(704) 410-3034	edward.h.pershing@wellsfargo.com
Donna LaFleur	Executive Assistant	(704) 410-3279	donna.lafleur@wellsfargo.com
Dawne Howes	Administrative Assistant	(704) 410-3272	dawne.howes@wellsfargo.com

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