



Economics Group

Interest Rate Weekly

John E. Silvia, Chief Economist
john.silvia@wellsfargo.com • (704) 410-3275
Sarah House, Economist
sarah.house@wellsfargo.com • (704) 410-3282

Optimism on Inflation: When Is Enough Just Enough?

Moderate inflation remains the central economic barometer to keep growth and interest rates on the optimistic path already anticipated by financial markets. How do we maintain moderate inflation?

A 30-Year History in Favor of Moderate Inflation

A modest amount of inflation is considered a means to grease the wheels of enterprise. Yet, too much inflation is a threat to monetary policy goals and the bond market. As illustrated in the top graph, the U.S. economy has maintained an average rate of inflation a little below 2 percent despite the volatility of the economy and financial markets over several business cycles.

Domestic policy changes, combined with the global movements of goods/services and financial capital, have supported this pattern of persistent, moderate inflation. The flow of goods and services has lowered the inflation rate of final products as well as the major inputs that go into the final products produced in the U.S. Meanwhile, capital flows into the U.S. have supported business investment and thereby increased the aggregate supply of final products as well as the fixed structures and business equipment that increase the domestic production capabilities of the economy. Recent inflation trends highlight the difference between goods and services within consumer prices. Core goods *deflation* has averaged 0.5 percent over the past two years, while core services *inflation* has averaged 2.8 percent over the same period. Movement of tradeable goods has certainly moderated the pace of inflation for goods. In a sense, the movement of tradeable goods acts as an increase in the aggregate supply of goods and thereby helps moderate inflation.

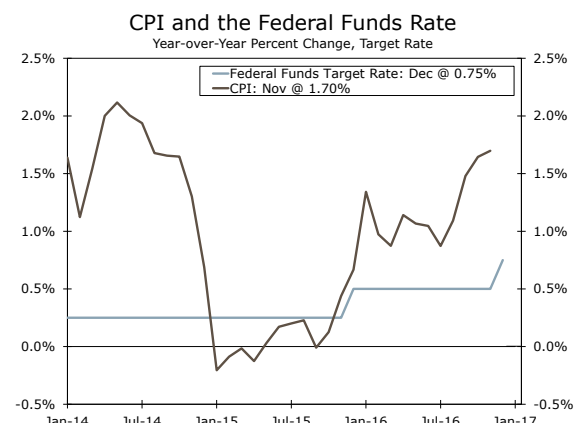
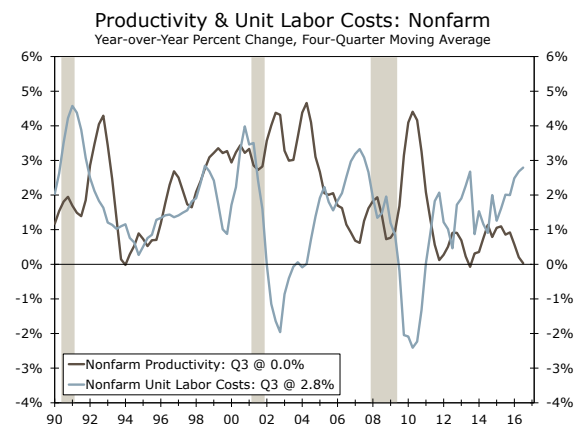
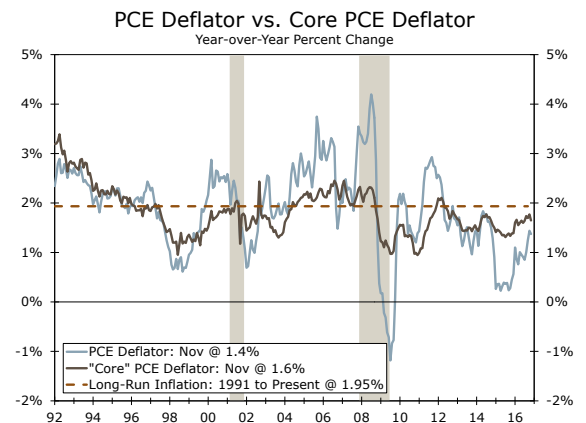
Aggregate Supply and the Fed: The Case for Optimism

Supply-side initiatives remain the key to maintain low inflation in the real economy, while the commitment by the Fed to its medium-term inflation target remains the central policy pillar.

On the supply-side, incentives need be focused on improving the availability and quality of the labor force—neither an easy nor a quick task. Higher wages, without productivity gains, simply raise unit labor costs without benefiting the medium-term outlook for the economy. The global competitive environment demands a more educated workforce than in the past as American production of both goods and services is compelled to move up the value chain. For non-labor costs, a sense of balance between the costs and benefits in our regulations would provide incentives for development. More investment would help overcome the stagnant technology in many sectors as well as the gap between the least and most productive firms

Long-Run Inflation Control Depends on the Fed

The conduct of monetary policy since the 1970s has focused on controlling inflation in the medium-term. This focus remains the central core to any strategy of stronger, more sustained, growth over time. Moderating interest rates in the face of rising inflation is not a signal for sustained growth.



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 | 1.75 | 2.00 |
| 3 Month LIBOR | 0.63 | 0.65 | 0.85 | 1.00 | 1.05 | 1.25 | 1.25 | 1.50 | 1.50 | 1.75 | 2.00 | 2.25 |
| Prime Rate | 3.50 | 3.50 | 3.50 | 3.75 | 3.75 | 4.00 | 4.00 | 4.25 | 4.25 | 4.50 | 4.75 | 5.00 |
| Conventional Mortgage Rate | 3.69 | 3.57 | 3.46 | 4.20 | 4.22 | 4.24 | 4.26 | 4.29 | 4.31 | 4.38 | 4.43 | 4.49 |
| 3 Month Bill | 0.21 | 0.26 | 0.29 | 0.51 | 0.57 | 0.78 | 0.84 | 1.02 | 1.10 | 1.30 | 1.50 | 1.75 |
| 6 Month Bill | 0.39 | 0.36 | 0.45 | 0.62 | 0.69 | 0.88 | 0.94 | 1.12 | 1.20 | 1.40 | 1.60 | 1.85 |
| 1 Year Bill | 0.59 | 0.45 | 0.59 | 0.85 | 0.88 | 1.03 | 1.08 | 1.38 | 1.46 | 1.65 | 1.82 | 2.02 |
| 2 Year Note | 0.73 | 0.58 | 0.77 | 1.20 | 1.23 | 1.35 | 1.42 | 1.66 | 1.73 | 1.91 | 2.08 | 2.22 |
| 5 Year Note | 1.21 | 1.01 | 1.14 | 1.93 | 1.95 | 1.99 | 2.06 | 2.21 | 2.27 | 2.38 | 2.49 | 2.62 |
| 10 Year Note | 1.78 | 1.49 | 1.60 | 2.45 | 2.47 | 2.50 | 2.53 | 2.57 | 2.60 | 2.68 | 2.74 | 2.81 |
| 30 Year Bond | 2.61 | 2.30 | 2.32 | 3.06 | 3.10 | 3.18 | 3.21 | 3.29 | 3.32 | 3.40 | 3.48 | 3.56 |

Forecast as of: January 11, 2017

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

| | 2016 | 2017 | 2018 |
|--|------------|------------|------------|
| Change in Real Gross Domestic Product | | | |
| Wells Fargo | 1.7 | 2.4 | 2.2 |
| FOMC | 1.8 to 1.9 | 1.9 to 2.3 | 1.8 to 2.2 |
| Unemployment Rate | | | |
| Wells Fargo | 4.7 | 4.6 | 4.5 |
| FOMC | 4.7 to 4.8 | 4.5 to 4.6 | 4.3 to 4.7 |
| PCE Inflation | | | |
| Wells Fargo | 1.5 | 2.0 | 2.3 |
| FOMC | 1.5 | 1.7 to 2.0 | 1.9 to 2.0 |
| "Core" PCE Deflator | | | |
| Wells Fargo | 1.7 | 1.9 | 2.1 |
| FOMC | 1.7 to 1.8 | 1.8 to 1.9 | 1.9 to 2.0 |

Forecast as of: January 11, 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: December 14, 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 Viloría, 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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