



Economics Group

Interest Rate Weekly

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Optimism on the Dollar: An Economic Driver and a Rider

Dollar strength since Election Day has signaled financial market confidence that expansionary fiscal policy will work. Yet, too much or too little movement in the dollar might challenge market optimism.

The Economics Iron Triangle: Dollar, Growth, Interest Rates

Economics is a science of interrelationships between markets, and the value of the dollar reflects the confluence of exchange rate, goods & services and credit markets. The value of the dollar is both a driver and a rider in economic activity.

Financial markets have discounted a combination of easier fiscal and tighter monetary policy. In an economy with a floating exchange rate and open capital markets, as associated with a Mundell-Fleming model, an easier fiscal policy/tighter monetary mix would typically be associated with a stronger dollar. This pattern adheres to a traditional economic framework. Yet, little of recent experience is anything like typical.

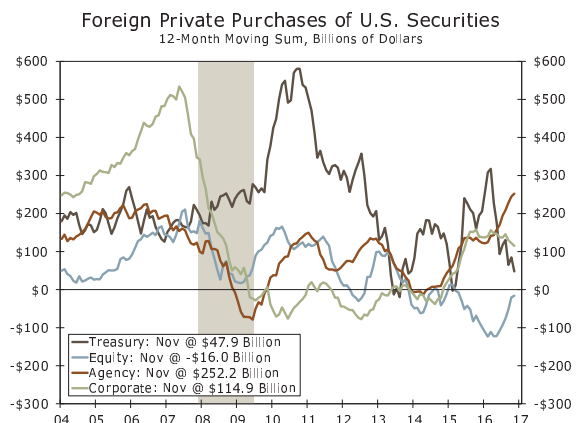
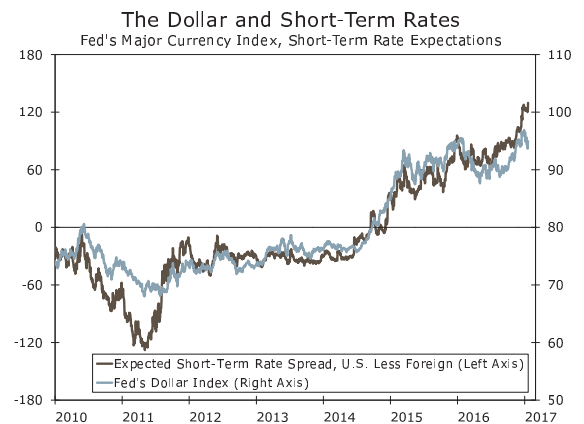
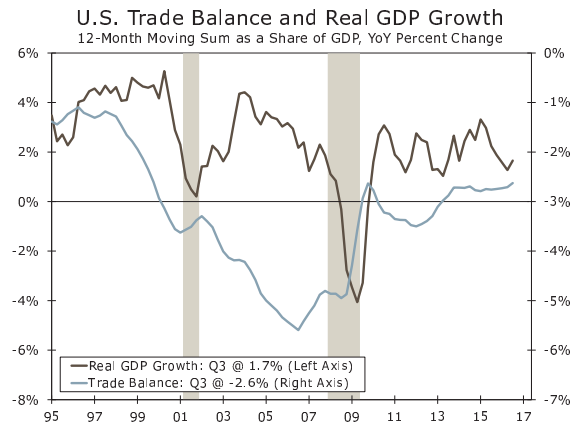
Going forward, policy and the character of this expansion have the opportunity to create a path for the dollar of moderate appreciation. This path would not too harshly limit growth in exports and GDP while also helping keep a lid on inflation through import prices. Moreover, concerns linking the trade deficit to the exchange rate may be overstated as growth, both here and abroad, plays a larger role than the dollar in determining trade deficits (top graph). The elasticity of import growth with respect to growth in domestic demand is much higher than the elasticity of import growth with respect to changes in the exchange rate—the same holds for export growth. Given the policy focus on boosting U.S. economic growth, a wider trade deficit would be expected to follow.

After Accounting For Growth: Dollar and Interest Rates

Divergence among global short-term rates has been a persistent phenomenon for some time. On the side of the U.S., the Fed raised rates in 2015 and increased the benchmark fed funds rate again in December 2016. With the labor market continuing to tighten and inflation trending up, the Fed will likely raise rates multiple times in 2017. Meanwhile, other major central banks, such as the Bank of Japan, Bank of England and the European Central Bank, have shown few signs of raising short-term interest rates in the near future. As illustrated in the middle graph, recent dollar strength follows the difference in relative interest rates.

Stronger Growth Drives Multiple Factors

A policy to pursue stronger growth also brings it with the prospect of drawing in capital from abroad that can finance economic growth as well as limit the rise in interest rates. Fiscal and monetary policymakers, however, will have to walk a fine line. Too much dollar appreciation would inhibit exports and boost imports, thereby exerting a drag on economic growth. A depreciation of the dollar, however, would lead to higher import prices and potentially losing hold of the inflation target. Economics is also a science of trade-offs, a fact policymakers will need to bear in mind moving forward.



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	0.50	0.50	0.50	0.75	0.75	1.00	1.00	1.25	1.25	1.25	1.50	1.50	1.75	2.00
Federal Funds Target Rate	0.63	0.65	0.85	1.00	1.05	1.25	1.25	1.50	1.50	1.50	1.75	1.75	2.00	2.25
3 Month LIBOR	3.50	3.50	3.50	3.75	3.75	4.00	4.00	4.25	4.25	4.25	4.50	4.50	4.75	5.00
Prime Rate	3.69	3.57	3.46	4.20	4.22	4.24	4.26	4.29	4.31	4.31	4.38	4.43	4.43	4.49
Conventional Mortgage Rate	0.21	0.26	0.29	0.51	0.57	0.78	0.84	1.02	1.10	1.10	1.30	1.50	1.50	1.75
3 Month Bill	0.39	0.36	0.45	0.62	0.69	0.88	0.94	1.12	1.20	1.20	1.40	1.60	1.60	1.85
6 Month Bill	0.59	0.45	0.59	0.85	0.88	1.03	1.08	1.38	1.46	1.46	1.65	1.82	2.02	2.02
1 Year Bill	0.73	0.58	0.77	1.20	1.23	1.35	1.42	1.66	1.73	1.73	1.91	2.08	2.22	2.22
2 Year Note	1.21	1.01	1.14	1.93	1.95	1.99	2.06	2.21	2.27	2.27	2.38	2.49	2.62	2.62
5 Year Note	1.78	1.49	1.60	2.45	2.47	2.50	2.53	2.57	2.60	2.60	2.68	2.74	2.81	2.81
10 Year Note	2.61	2.30	2.32	3.06	3.10	3.18	3.21	3.29	3.32	3.32	3.40	3.48	3.48	3.56
30 Year Bond														

Forecast as of: January 20, 2017

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

	2016	2017	2018
Change in Real Gross Domestic Product			
Wells Fargo	1.9	2.3	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 20, 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

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