

## Economics Group

### Interest Rate Weekly

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## Profits: Overlooked Contribution to Growth and Lower Rates

*Profits serve as a source of funds that accomplish two important functions. First, profits are a source of funds to support real economic growth. Second, profits provide an alternative to credit demands.*

### Profits, Growth and Their Symbiotic Relationship

As illustrated in the top graph, there is a clear link between profit and nominal GDP growth. This is important because profits have a dual character. First, stronger nominal GDP growth creates greater corporate top line revenue and allows for greater pricing power. Alternatively, greater profit growth creates alternatives to credit finance for corporations and small businesses. For larger corporations, improved profit growth acts as a substitute for capital market finance and bank borrowing. For smaller owner-manager businesses, better profits substitute for bank borrowing and reliance on credit cards and other means of meeting small cash needs.

In our work, we continue to emphasize the interactions between economic growth/profits and credit markets/interest rates.

### Profits and Raising Capital Funds: A Different View

Profits offer an alternative way to raise capital in a way to reduce the demand for credit and thereby put some downward pressure on interest rates. As evidenced in the middle graph there is a link between economic profit growth and the S&P 500 EPS growth. What is important here is that profit growth leads EPS growth over the 1983-2017 period. This is empirically verified by using the Granger causality test.

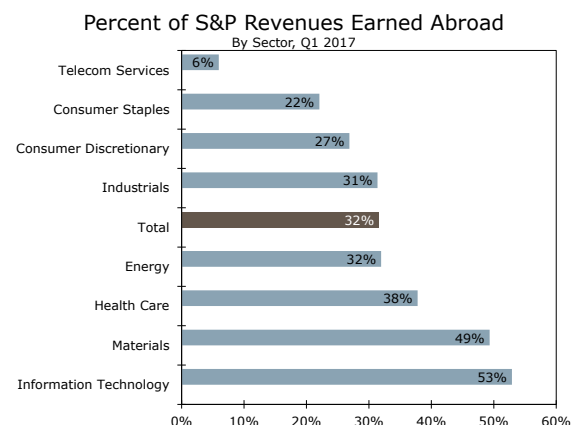
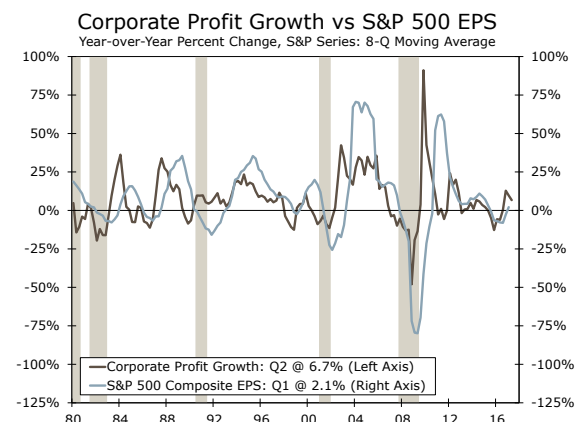
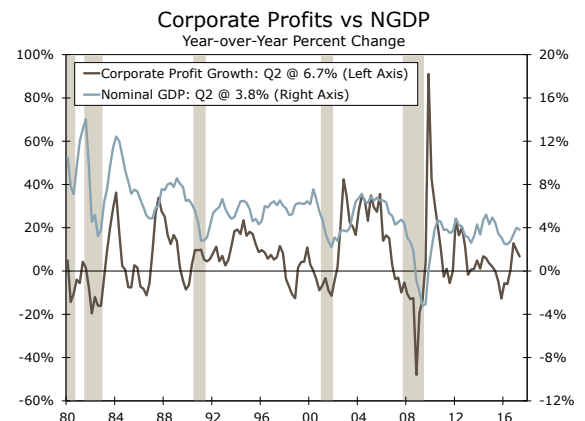
Therefore, investors can anticipate that an improvement in profit growth will lead to an improvement in sustained EPS. Moreover, improvement in profits also signals downward pressure on interest rates going forward. In this case, profit gains offer a different view on the outlook for both equity and credit finance.

### Domestic Exposure to Global Economy: Two Channels

Two drivers of profits that reflect the global economy are the dollar exchange rate and economic growth. As illustrated by the bottom graph, 32 percent of S&P revenues are earned abroad. This percentage is even higher for four sectors; energy, health care, materials and information technology.

These revenues are the product of income and relative price pressures. For income, the improvement of global growth has been a plus. Growth in both the Eurozone and Canada has improved nicely over last year. Chinese economic growth has remained steady despite market expectations. Brazil and Russia have evidenced sharp turnarounds from 2016 recessions.

Exchange rates represent a second channel and represent the influence of relative prices on the flows of exports/imports and the measure of profits adjusted for exchange rate moves. Going forward, the recent declines in the dollar improve the value of foreign earnings and thereby reinforce the gains in foreign earnings of U.S. corporations. This result further reduces the pressure on credit financing, and interest rates, in the United States.



Source: U.S. Department of Commerce, IHS Global Insight, Bloomberg LP and Wells Fargo Securities

## Wells Fargo U.S. Interest Rate Forecast

	Actual				Forecast							
	2017				2018				2019			
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q
Quarter End Interest Rates												
Federal Funds Target Rate	1.00	1.25	1.25	1.50	1.50	1.75	1.75	2.00	2.00	2.25	2.25	2.50
3 Month LIBOR	1.15	1.30	1.35	1.65	1.65	1.90	1.90	2.15	2.15	2.40	2.40	2.65
Prime Rate	4.00	4.25	4.25	4.50	4.50	4.75	4.75	5.00	5.00	5.25	5.25	5.50
Conventional Mortgage Rate	4.20	3.90	4.03	4.20	4.28	4.36	4.40	4.46	4.49	4.55	4.57	4.65
3 Month Bill	0.76	1.03	1.08	1.30	1.45	1.60	1.67	1.85	1.95	2.10	2.15	2.30
6 Month Bill	0.91	1.14	1.15	1.40	1.55	1.70	1.77	1.95	2.05	2.20	2.25	2.40
1 Year Bill	1.03	1.24	1.27	1.55	1.68	1.80	1.87	2.05	2.15	2.25	2.30	2.45
2 Year Note	1.27	1.38	1.46	1.72	1.83	1.93	2.00	2.15	2.23	2.33	2.38	2.50
5 Year Note	1.93	1.89	1.95	2.20	2.29	2.39	2.45	2.58	2.65	2.75	2.80	2.90
10 Year Note	2.40	2.31	2.30	2.49	2.57	2.66	2.71	2.78	2.82	2.88	2.91	3.00
30 Year Bond	3.02	2.84	2.95	3.19	3.29	3.41	3.49	3.58	3.62	3.68	3.71	3.80

Forecast as of: September 7, 2017

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

	<u>2017</u>	<u>2018</u>	<u>2019</u>
<b>Change in Real Gross Domestic Product</b>			
Wells Fargo	2.5	2.5	2.6
FOMC	2.1 to 2.2	1.8 to 2.2	1.8 to 2.0
<b>Unemployment Rate</b>			
Wells Fargo	4.3	4.0	3.8
FOMC	4.2 to 4.3	4.0 to 4.3	4.1 to 4.4
<b>PCE Inflation</b>			
Wells Fargo	1.3	1.6	2.0
FOMC	1.6 to 1.7	1.8 to 2.0	2.0 to 2.1
<b>"Core" PCE Deflator</b>			
Wells Fargo	1.4	1.8	1.9
FOMC	1.6 to 1.7	1.8 to 2.0	2.0 to 2.1

Forecast as of: September 7, 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: June 14, 2017

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

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