



Economics Group

Interest Rate Weekly

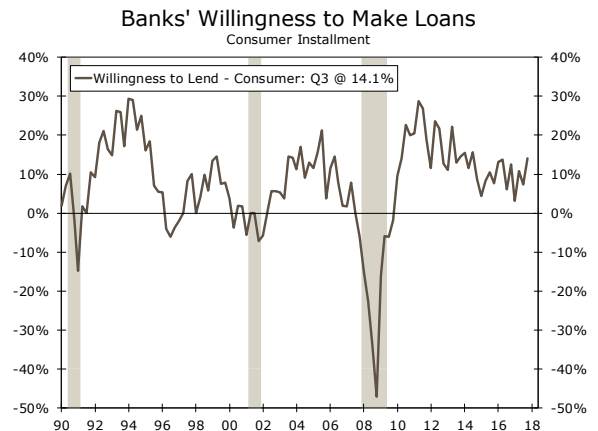
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Cycles in Credit, Economics and National Finance

Business cycle trends differ across major sectors; while some series are mean-reverting, others are shifting over time. Careful analysis leads to a better understanding of ‘normalcy.’

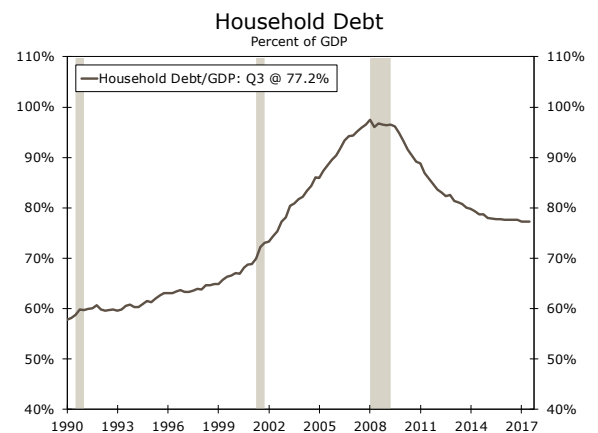
The Bank Credit Cycle: Mean-Reverting

The Federal Reserve reports a bank’s willingness to make loans on a quarterly basis as part of the Senior Loan Officer Opinion Survey. Such a qualitative measure is telling of lender expectations and is often consulted to predict the coming credit conditions in the market. A bank’s willingness to make loans is a stationary series, which contains no structural breaks. That is, the series acts in a predictable nature, allowing one to refer to it as a benchmark to assess lending practices over a business cycle (top chart). At the beginning of an expansionary period, as banks are very willing to extend credit, the series rises. Once reaching its peak, a bank’s willingness gradually decreases until turning negative during a recessionary period. That said, it would appear that willingness has peaked in the current expansion, which is in line with our assessment of the business cycle being in the late stage.



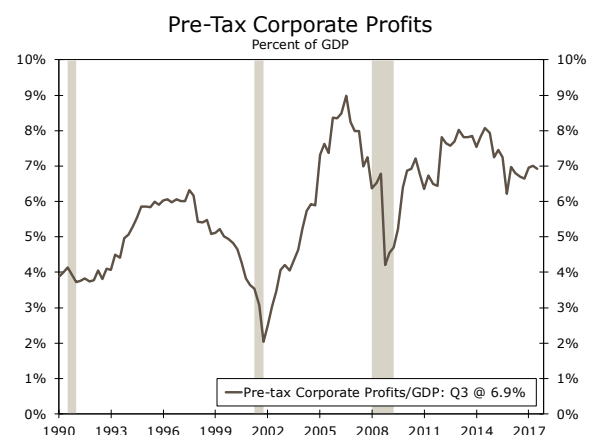
Elevated Household Debt: Not Back to “Normal” Ratio

Debt as a percentage of GDP serves as a good measurement of indebted households relative to the size of the economy. However, analyzing averages can be significantly misleading. As seen in the middle chart, after rising exponentially in the prior expansion, household debt as a percent of GDP never returns to its “average” trend, as portrayed in the 1991-2000 expansionary period. Despite decreasing significantly from its peak prior to the Great Recession, household debt still remains quite elevated, stabilizing around 77 percent. As this series is not mean-reverting, it does not follow a cyclical trend, and the behavior of the series in this cycle is distinct compared to prior expansions. The recent deleveraging is likely attributable to increased caution as households acquired large amounts of debt during the previous expansion, which led to a sharp increase in the debt burden.



Unusual Behavior of Profits

Corporate profits as a share of GDP appear to follow a cyclical pattern in which they gradually increase, peaking late in an expansionary period, before steadily declining during a recession. However, pre-tax corporate profits are non-stationary, and thereby are a less predictable series. Although profit growth as a percent of GDP appears to follow a traditional peak to trough trend, there have also been various structural breaks within the series leading to highly irregular and quite misleading judgements based on prior trends. Although this might not be very surprising, the larger decline being in the 2001 recessionary period seems unusual (bottom chart). The greatest decline in corporate profits would be assumed to have occurred during the Great Recession, as we saw dramatic movements in a bank’s willingness to lend as well as households acquiring record amounts of debt. That is, one might suspect a similar case of dramatics in the decline of profits during the Great Recession; however, the drop was more significant in 2001.



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	1.75	2.00	2.25	2.25	2.50	2.50	2.75	2.75
3 Month LIBOR	1.15	1.30	1.33	1.69	1.90	2.15	2.40	2.40	2.65	2.65	2.90	2.90
Prime Rate	4.00	4.25	4.25	4.50	4.75	5.00	5.25	5.25	5.50	5.50	5.75	5.75
Conventional Mortgage Rate	4.20	3.90	3.81	3.94	3.97	4.05	4.22	4.35	4.45	4.50	4.62	4.67
3 Month Bill	0.76	1.03	1.06	1.39	1.60	1.85	2.10	2.15	2.35	2.40	2.60	2.65
6 Month Bill	0.91	1.14	1.20	1.53	1.70	1.95	2.20	2.25	2.45	2.50	2.70	2.75
1 Year Bill	1.03	1.24	1.31	1.76	1.80	2.05	2.25	2.30	2.50	2.55	2.75	2.80
2 Year Note	1.27	1.38	1.47	1.89	2.00	2.25	2.45	2.60	2.70	2.80	2.93	3.00
5 Year Note	1.93	1.89	1.92	2.20	2.39	2.58	2.75	2.85	2.90	2.97	3.10	3.17
10 Year Note	2.40	2.31	2.33	2.40	2.52	2.65	2.82	2.95	3.05	3.10	3.22	3.27
30 Year Bond	3.02	2.84	2.86	2.74	3.05	3.25	3.37	3.50	3.53	3.56	3.66	3.70

Forecast as of: January 10, 2018

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

	<u>2017</u>	<u>2018</u>	<u>2019</u>
Change in Real Gross Domestic Product			
Wells Fargo	2.4	2.8	2.6
FOMC	2.4 to 2.5	2.2 to 2.6	1.9 to 2.3
Unemployment Rate			
Wells Fargo	4.1	3.8	3.7
FOMC	4.1	3.7 to 4.0	3.6 to 4.0
PCE Inflation			
Wells Fargo	1.7	2.1	2.1
FOMC	1.6 to 1.7	1.7 to 1.9	2.0
"Core" PCE Deflator			
Wells Fargo	1.5	1.8	1.9
FOMC	1.5	1.7 to 1.9	2.0

Forecast as of: January 10, 2018

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 13, 2017

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

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