



Economics Group

Interest Rate Weekly

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Revisiting Our Rates Forecast

Treasury yields have been gradually rising in the early months of 2018, causing some analysts to predict the end of the three-decade long bull market in bonds. In this week's piece we take a look at our rates forecasts.

Treasury Yields Rising; Room to Run?

The 10-year Treasury is up 30 bps in January, touching 2.7 percent for the first time since April of 2014. The recent rout in Treasuries has been attributed to less central bank easing across the globe and the potential for higher government spending domestically. A weakening dollar and rising oil prices have strengthened the case for those that predict rates will rise further. We are in the camp that rates will continue to rise through 2018 and 2019, a position that is largely held by the wider market.

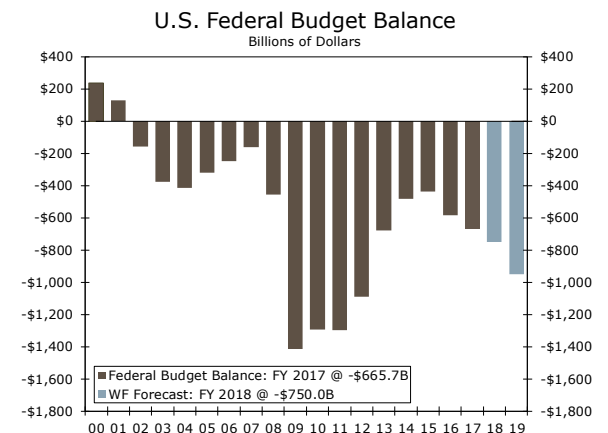
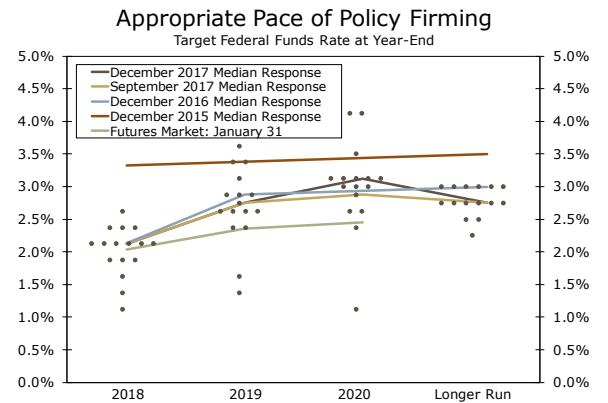
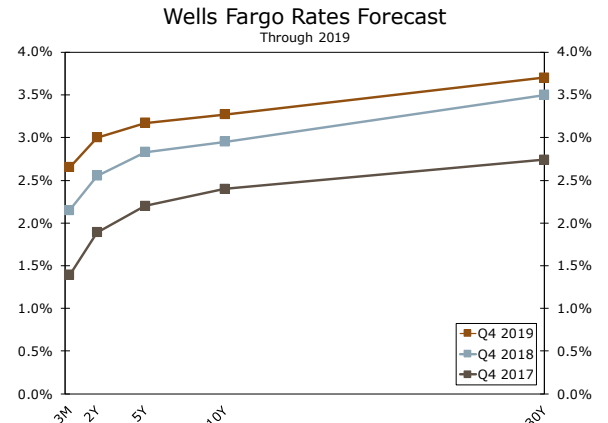
A Comparative Look

Looking ahead, we expect the 10-year Treasury to have an average yield of 2.80 percent through 2018, slightly greater than the 2.70 percent consensus estimate from the most recent Blue Chip forecast survey. While we do not foresee the 10-year yield breaking above 3 percent in 2018, we think it will get very close, climbing to 2.95 percent to close out Q4. Likewise, we predict the 3-month bill to carry an average yield of 1.93 percent through 2018, slightly larger than the 1.80 percent consensus estimate. Moreover, we expect the Federal Reserve to hike rates three times in 2018, at its March, June and September meetings. Thus, rate movements at the short end of the curve, typically the policy-sensitive part of the curve, will likely be more pronounced around those meeting dates. According to the fed funds futures market, a rate hike is largely priced in for the March FOMC meeting; however the exact timing of the potential remaining hikes is not as assured.

How Do Our Rate Forecasts Compare to Forward Rates?

Currently, we believe forward rates are not pricing in enough rate increases for 2018 and 2019 for several reasons. First, we see the Fed moving more aggressively than the market, hiking rates three times in 2018. This will have the largest effect on the front end of the curve. Second, we feel that Fed balance sheet normalization will likely have a larger effect on the belly of the curve, and do not feel the forward market is paying enough attention to this factor. Additionally, at the long end of the curve, we believe we could see a return of risk premium if the recently-passed tax cuts materially affect the U.S. fiscal standing, causing longer rates to rise more quickly. We think the long end of the curve will steepen as market participants take the view that Treasury is not concentrating solely on the front end.

Many unknowns still exist regarding Treasury net issuance in 2018, which has implications on shifts in the yield curve. Net issuance was artificially held down last year due to the U.S. Treasury spending much of the year using extraordinary measures to keep the nation under the borrowing limit. We expect net issuance to accelerate in 2018 to fund greater monthly budget deficits. The exact timing of this issuance acceleration depends on when Congress lifts/suspends the debt ceiling, which we expect to be lifted as part of an overall spending package, likely to pass before March.



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	4.10	4.15	4.25	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	1.85	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	2.10	2.30	2.45	2.55	2.70	2.80	2.93	3.00
5 Year Note	1.93	1.89	1.92	2.20	2.45	2.60	2.75	2.83	2.93	2.97	3.10	3.17
10 Year Note	2.40	2.31	2.33	2.40	2.65	2.75	2.85	2.95	3.05	3.10	3.22	3.27
30 Year Bond	3.02	2.84	2.86	2.74	3.13	3.25	3.37	3.50	3.53	3.56	3.66	3.70

Forecast as of: January 26, 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	2.5	2.9	2.7
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 26, 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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