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Economics Group

Interest Rate Weekly

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Short-term Credit: Cycles and Trends – Part I

Short-term credit, especially from private banks, exhibits elements of both economic cycle and secular trends. Separating these two trends is critical to understanding the flow of credit that supports economic growth.

Pro-cyclical Credit—Bank/Nonbank Finance

As each economic cycle matures, the problem of pro-cyclical credit appears as both the demand and supply of credit rises with the economic expansion. One example is the tendency for growth in short-term credit, such as call money, to rise with the cycle—independent of the growth of the underlying money supply—an expansion of financial transactions relative to the underlying monetary base or supply. This call-money expansion and rising short-term rates have a long history going back to France in the 1880s and the U.S. in the 1920s. In the current economic expansion, we have witnessed an expansion of credit from non-banking sources independent of the growth of bank lending and the money supply (top graph). Popular commentary focuses on the slow pace of bank lending but fails to notice the gains in non-bank finance.

As long as growth continues and financial markets rise, all this appears normal. The problem, as history illustrates, is that any slowdown in economic growth or financial gains leads to calls on all this credit and even higher risk-adjusted interest rates.

Pro-cyclical Credit Growth—Both Up and Down

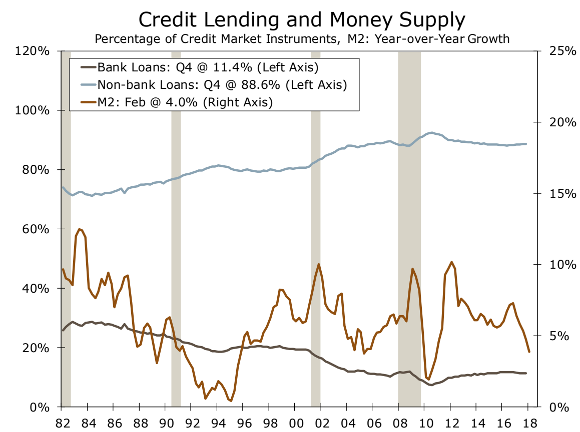
As illustrated in the middle graph, commercial and industrial lending has a strong pro-cyclical element in its behavior. On the demand side, firms are likely to retrench at times of recession (shaded areas) and economic weakness/uncertainty (1985, 1998) for example. Without a clear, positive, vision of the strength of the economy, firms will remain cautious on going to the borrowing window. Meanwhile, on the supply side, banks will be cautious to lend in a recession period and periods of economic uncertainty. Moreover, the depth of the decline during the 2008/2009 period reflects the influence of the extent for financial regulation.

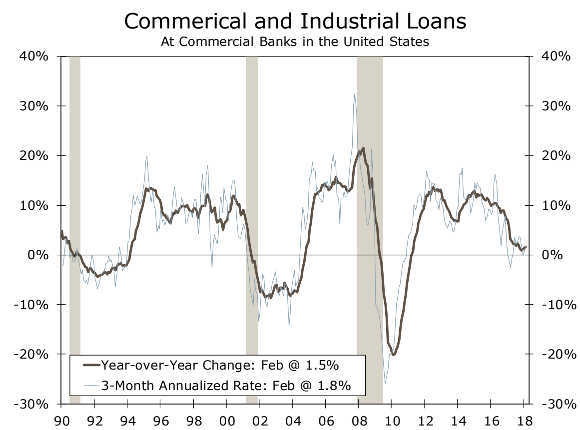
To emphasize the structural shift in ban/non-bank lending, note how bank lending has slowed in recent years despite the strength of the overall economy.

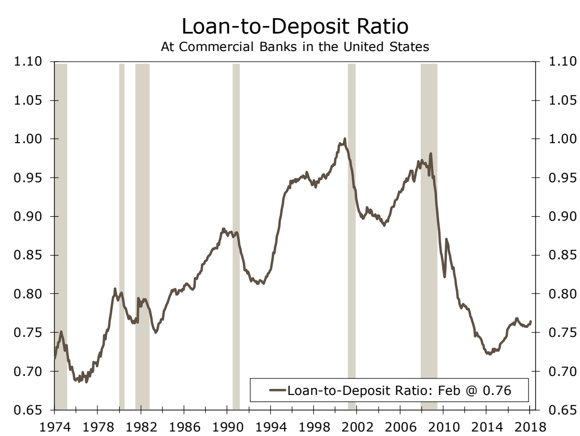
Loan/Deposit Ratio: A More Cautious Bank Lending Environment

Both cyclical and secular characteristics appear in the behavior of the loan-deposit ratio at commercial banks (bottom graph). Over the 1980s and 1990s cycles, loans expanded relative to deposits as banks employed a more intensive application of their funds to lending in an expanding economy. When recession hits, we witness a retrenchment in bank lending.

On the secular path, up until the current cycle, the intensive use of loans relative to deposits rose in the prior three cycles. Then, it stopped. During the current cycle, there is no cyclical uptrend. Bank lending has become more cautious, and this helps explain the recent modest economic growth.







Source: Federal Reserve, 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	1.75	2.00	2.25	2.50	2.50	2.75	2.75	3.00
3 Month LIBOR	1.15	1.30	1.33	1.69	2.05	2.30	2.55	2.80	2.80	3.05	3.05	3.30
Prime Rate	4.00	4.25	4.25	4.50	4.75	5.00	5.25	5.50	5.50	5.75	5.75	6.00
Conventional Mortgage Rate	4.20	3.90	3.81	3.94	4.35	4.37	4.45	4.60	4.72	4.77	4.82	4.87
3 Month Bill	0.76	1.03	1.06	1.39	1.85	2.10	2.15	2.40	2.60	2.65	2.70	2.75
6 Month Bill	0.91	1.14	1.20	1.53	1.95	2.20	2.25	2.50	2.70	2.75	2.80	2.85
1 Year Bill	1.03	1.24	1.31	1.76	2.12	2.25	2.30	2.55	2.75	2.80	2.85	2.90
2 Year Note	1.27	1.38	1.47	1.89	2.32	2.50	2.70	2.92	3.05	3.12	3.19	3.26
5 Year Note	1.93	1.89	1.92	2.20	2.72	2.80	2.88	2.97	3.10	3.17	3.24	3.31
10 Year Note	2.40	2.31	2.33	2.40	2.90	2.95	3.05	3.20	3.32	3.37	3.42	3.47
30 Year Bond	3.02	2.84	2.86	2.74	3.25	3.35	3.45	3.60	3.66	3.70	3.74	3.78

Forecast as of: March 14, 2018

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

	2017	2018	2019
Change in Real Gross Domestic Product			
Wells Fargo	2.5	2.6	2.8
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	2.0	2.1
FOMC	1.5	1.7 to 1.9	2.0

Forecast as of: March 14, 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 Markit and Wells Fargo Securities

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