



Economics Group

Interest Rate Weekly

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Growth, Liquidity and Asset Prices

The relative movements in money, M2, and asset prices provide a perspective of where we are in the credit cycle. However, the foundations of economic growth and inflation cannot be ignored.

Benchmarking Nominal GDP: Growth and Inflation

As illustrated in the top graph, the pace of growth in real final sales to domestic purchasers has been strikingly stable compared to the prior economic expansion. However, the average pace of real final sales growth has slowed over time. The average pace of real final sales has been 2.8 percent since 1982, and just 2.0 percent since 2000. While we expect the stability in this metric to continue, we do not foresee a breakneck pace to develop anytime soon.

Meanwhile, since the initialization of NAFTA in 1994, the PCE deflator has averaged 1.8 percent, which is slightly below the 2 percent target set by the FOMC. While we expect the PCE deflator to sustain 2 percent growth in 2018, these are relatively subdued inflation rates.

Money and Nominal Growth

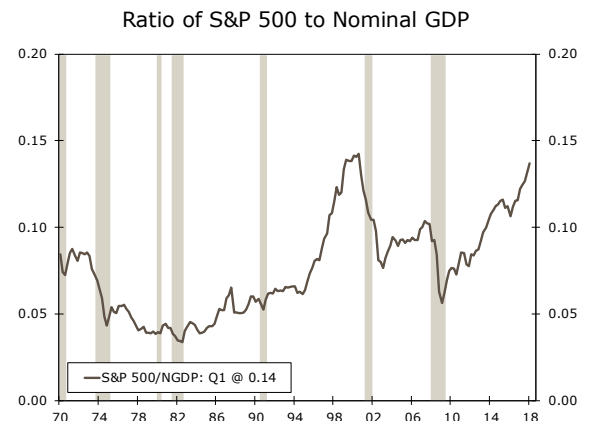
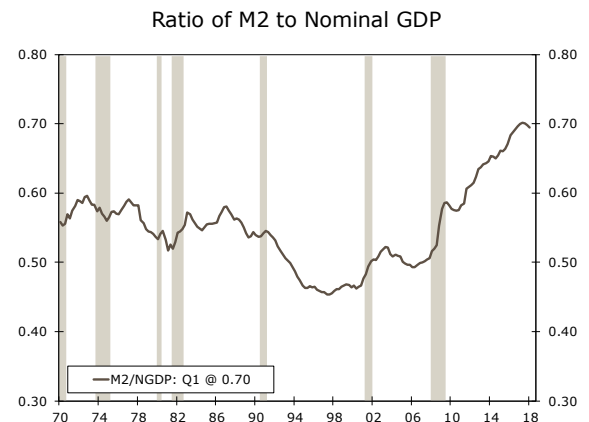
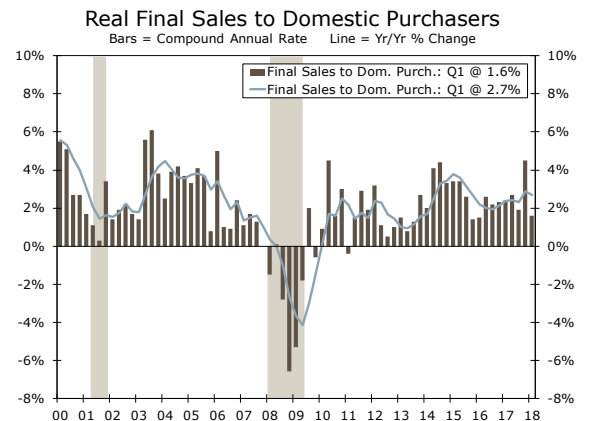
Since the implementation of quantitative easing (QE) measures, market participants have been wary about the increase in the money supply stoking future inflation. As illustrated in the middle graph, M2, as a measure of the money supply, has risen sharply relative to nominal GDP growth with the advent of QE policy at the Fed. This increase in the ratio intimates that there is an excess of liquidity in the economic system that has been associated with a decline in the velocity of money. This excess of liquidity is a concern, because if that liquidity was put to work then some combination of more rapid economic growth or inflation could result as a solution.

As of yet, the pick-up of velocity has not yet appeared. Traditionally, velocity would increase as interest rates rise. As money becomes more expensive to borrow, cash begins to look more attractive as a financing solution. Going forward, it will be interesting to see how velocity reacts as the FOMC continues to raise interest rates.

Asset Prices and Nominal GDP

Fair valuation is another topical concern in the market. While the equity market has risen sharply over the past couple of years, the question remains to what extent the rise in equity valuations is out of line with the overall economy. While we have seen equity markets reverse some of their gains more recently, questions regarding fair value still remain. As illustrated in the bottom graph, the rise in the S&P 500 has been sharp since 2010 but not quite as high as the 1998-1999 peak.

Over the 1982-to-now period, we have seen interest rates and inflation expectations decline, while a third factor, global trade opportunities, has risen dramatically. These three factors would support a rise in equity valuations relative to a domestic measure of nominal GDP. However, the expectations of these factors have reversed more recently, which can partially explain the recent retrenchment in equity markets.



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	2.31	2.35	2.50	2.65	2.65	2.90	2.90	3.15
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	4.44	4.50	4.55	4.70	4.82	4.87	4.92	4.97
3 Month Bill	0.76	1.03	1.06	1.39	1.73	1.95	2.15	2.40	2.60	2.65	2.70	2.75
6 Month Bill	0.91	1.14	1.20	1.53	1.93	2.15	2.30	2.55	2.70	2.75	2.80	2.85
1 Year Bill	1.03	1.24	1.31	1.76	2.09	2.25	2.35	2.60	2.75	2.80	2.85	2.90
2 Year Note	1.27	1.38	1.47	1.89	2.27	2.49	2.67	2.90	3.05	3.12	3.19	3.26
5 Year Note	1.93	1.89	1.92	2.20	2.56	2.86	2.98	3.08	3.20	3.27	3.34	3.41
10 Year Note	2.40	2.31	2.33	2.40	2.74	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	2.97	3.20	3.30	3.45	3.64	3.70	3.74	3.78

Forecast as of: May 9, 2018

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

	<u>2018</u>	<u>2019</u>
Change in Real Gross Domestic Product		
Wells Fargo	3.0	2.6
FOMC	2.6 to 3.0	2.2 to 2.6
Unemployment Rate		
Wells Fargo	3.8	3.6
FOMC	3.6 to 3.8	3.4 to 3.7
PCE Inflation		
Wells Fargo	2.2	2.2
FOMC	1.8 to 2.0	2.0 to 2.2
"Core" PCE Deflator		
Wells Fargo	2.0	2.1
FOMC	1.8 to 2.0	2.0 to 2.2

Forecast as of: May 9, 2018

NOTE: Projections of change in real gross domestic product (GDP) and in unemployment rate 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: March 21, 2018

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

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