



Economics Group

Interest Rate Weekly

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What's Behind the Liftoff in Long-Term Bond Yields?

The recent pronounced upward movements in U.S. Treasury yields at the long end of the yield curve signal that the fundamental drivers affecting Treasury yields have shifted for the first time since 2013.

New Sources of Fundamentals Steering Yields

The dominate theme steering U.S. Treasury yields since the taper tantrum in 2013 has been capital inflows in an era of low yields, divergent global monetary policy and low inflation. In the post-election environment, with single party control in the U.S. and an incoming administration intent on expansionary fiscal policy, long-term yields have climbed considerably (top chart). This week we will walk through our expected interaction between fiscal policy actions and their effect on Treasury yields. In response to these market moves, we have adjusted our interest rate forecast.

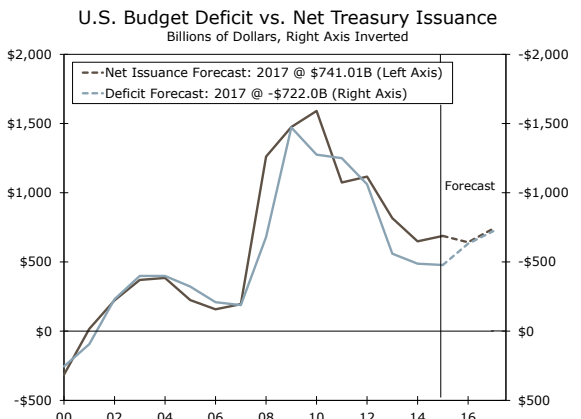
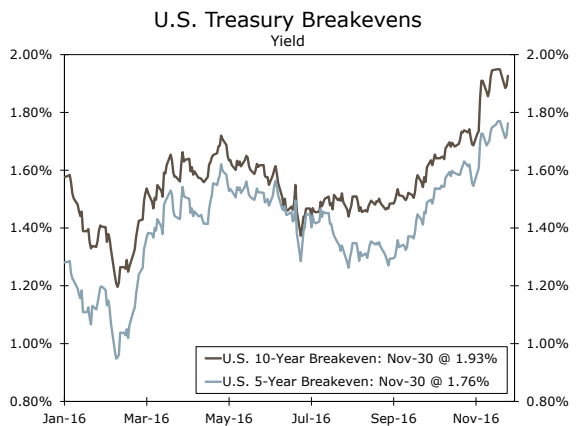
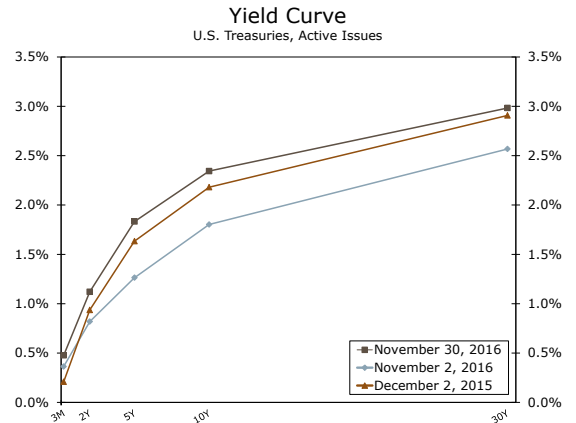
While the specifics of public policy actions out of the Trump administration are unclear, there are three main themes that emerge based on President-elect Trump's campaign promises. First, the desire for more government investment in infrastructure and military spending. Second, the desire for corporate and individual tax reform. Third, the potential for changing trade relationships, perhaps including tariffs on certain imported goods. There are two effects markets have priced-in related to these policies: higher expected inflation and a sizable pick up in net Treasury issuance.

Inflation Expectations Have Drifted Higher

Expectations of greater government spending and higher consumer spending, should tax cuts take place, would likely result in demand-pull inflation, especially given that the economy is close to full employment. Additionally, should barriers to trade increase, the result would likely be higher prices for imported goods which would eventually flow through to consumer and producer prices. Looking at Treasury Inflation-Protected Securities (TIPS) yields, it has become clear that, on net, markets have priced in the likelihood of higher inflation. The 10-year breakeven has climbed about 19 basis points since November 8 (middle chart).

Federal Deficit Projections Key to Near-Term Rate Moves

Since 2009, annual federal budget deficits have been declining, resulting in a downshift in net Treasury issuance (bottom chart). Federal fiscal year 2016, which just ended in September of this year, saw a rise in the annual budget deficit relative to the size of the economy, reversing the trend since 2009. Now with the expectation of tax cuts and greater federal spending in the new administration we, and markets, are expecting net Treasury issuance to rise in-step with much larger federal budget deficits in the years ahead. While we certainly do not expect all of Trump's plans to clear Congress, his policy proposals have been estimated to add between \$2.6 trillion and \$5.3 trillion in additional federal debt over the next 10 years.* Over the near-term, the fiscal policy changes enacted and the resulting inflation expectations and net Treasury issuance projections will become the dominant factors influencing the longer end of the yield curve.



Source: Bloomberg LP, U.S. Department of the Treasury and Wells Fargo Securities

* Tax Foundation. (2016). "Details and Analysis of the Donald Trump Tax Reform Plan, September 2016." Committee for a Responsible Federal Budget. (2016). "Promises and Price Tags: An Update."

Wells Fargo U.S. Interest Rate Forecast

	Actual								Forecast			
	2015				2016				2017			
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q
Quarter End Interest Rates												
Federal Funds Target Rate	0.25	0.25	0.25	0.50	0.50	0.50	0.50	0.75	0.75	1.00	1.00	1.25
3 Month LIBOR	0.27	0.28	0.33	0.61	0.63	0.65	0.85	1.05	1.05	1.25	1.25	1.50
Prime Rate	3.25	3.25	3.25	3.50	3.50	3.50	3.50	3.75	3.75	4.00	4.00	4.25
Conventional Mortgage Rate	3.77	3.98	3.89	3.96	3.69	3.57	3.46	4.21	4.23	4.28	4.30	4.34
3 Month Bill	0.03	0.01	0.00	0.16	0.21	0.26	0.29	0.49	0.57	0.78	0.84	1.02
6 Month Bill	0.11	0.09	0.18	0.50	0.47	0.40	0.47	0.62	0.69	0.88	0.94	1.12
1 Year Bill	0.25	0.28	0.37	0.65	0.66	0.55	0.59	0.82	0.86	1.02	1.08	1.38
2 Year Note	0.56	0.64	0.64	1.06	0.73	0.58	0.77	1.06	1.17	1.33	1.40	1.66
5 Year Note	1.37	1.63	1.37	1.76	1.21	1.01	1.14	1.70	1.75	1.83	1.90	2.10
10 Year Note	1.94	2.35	2.06	2.27	1.78	1.49	1.60	2.27	2.30	2.35	2.38	2.43
30 Year Bond	2.54	3.11	2.87	3.01	2.61	2.30	2.32	2.95	2.97	2.99	3.02	3.04

Forecast as of: November 30, 2016

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

	<u>2016</u>	<u>2017</u>	<u>2018</u>
Change in Real Gross Domestic Product			
Wells Fargo	1.8	2.0	2.1
FOMC	1.7 to 1.9	1.9 to 2.2	1.8 to 2.1
Unemployment Rate			
Wells Fargo	4.9	4.6	4.5
FOMC	4.7 to 4.9	4.5 to 4.7	4.4 to 4.7
PCE Inflation			
Wells Fargo	1.5	2.1	2.3
FOMC	1.2 to 1.4	1.7 to 1.9	1.8 to 2.0
"Core" PCE Deflator			
Wells Fargo	1.8	2.0	2.1
FOMC	1.6 to 1.8	1.7 to 1.9	1.9 to 2.0

Forecast as of: November 18, 2016

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: September 21, 2016

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

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