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Economics Group

Interest Rate Weekly

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Rising Asset Prices Give the Fed Something Else to Worry About

Years of ultra-low interest rates have failed to deliver a burst of economic growth but have driven asset prices higher. Household assets are larger relative to GDP and income than seen at the height of earlier bubbles.

Fed Remains Data Dependent

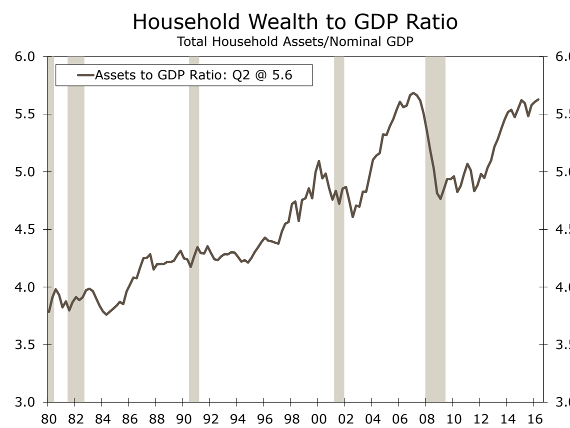
The Federal Reserve did not reveal any major surprises at its Sept. 21 Federal Open Market Committee meeting. The key takeaway from the policy statement, press conference and summary of economic projections is that the case for an increase in the federal funds rate has strengthened. The Fed continues to stress that it remains data dependent. Unfortunately, there is so much data available today and much of it seems to be conflicting with the case the Fed has laid out for normalizing interest rates. The unemployment rate is low and nearing the Fed's latest threshold of full employment. Consumer spending is strong, but business investment is weak and inflation remains below the Fed's desired 2 percent target. The bottom line for the Fed, however, is that an economy with an unemployment rate below 5 percent is inconsistent with a federal funds rates near zero, hence the drive to normalize rates.

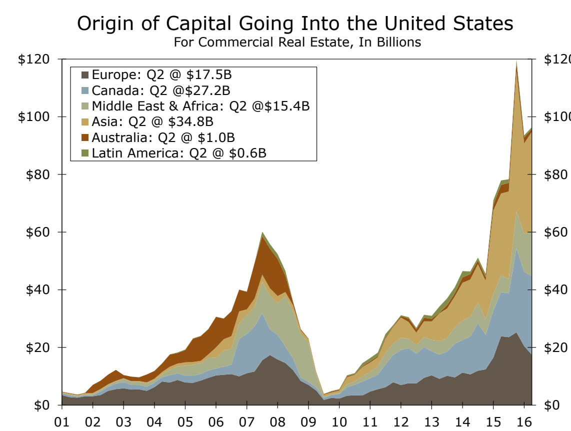
Years of ultra-low interest rates have given the Fed something else to think about. The search for yield has sent asset prices soaring in the United States, as investors have bid up the prices of just about everything that has a dependable income stream behind it. The rise in asset prices has not gone unnoticed. Federal Reserve Bank of Boston President Eric Rosengren's dissenting vote at the Sept. 21 FOMC meeting was in part due to his concerns about "potentially increasing financial market imbalances." Rosengren's comments are mostly directed at commercial real estate (CRE) values, a subject that he has spoken about repeatedly.

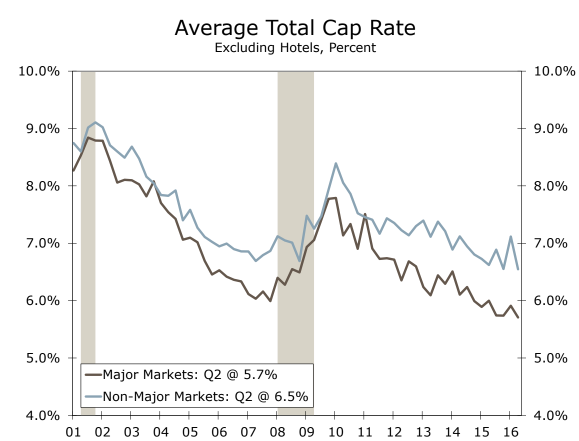
The rise in CRE values is being fueled by an influx of investment from overseas (middle chart), which is fleeing even lower interest rates in Europe and Japan. The influx of foreign investment into CRE swamps what was seen in the last cycle and has primarily been focused on global gateway cities, which are larger markets that are better known to international investors and typically have non-stop flights to other global business centers. The split is apparent in cap rates, which have shown a more marked drop in major markets (bottom chart).

Commercial real estate is not the only asset that has seen prices escalate. Home prices have largely recovered their losses from the housing crash, at least in nominal terms, even though the recovery in home sales and new home construction has been tepid at best. Stock and bond prices have also soared relative to past valuations, particularly on a risk-adjusted basis.

The message for policymakers is that ultra-accommodative monetary policy alone has likely done about as much good as it can in this cycle. The time for normalizing rates is now at hand. This will likely make for a bumpy road, as rate hikes occur in an environment of conflicting economic signals, political changes in the U.S. and Europe and hyper-sensitive asset markets.







Source: Federal Reserve Board, U.S. Dept. of Commerce, Real Capital Analytics Inc. and Wells Fargo Securities

Wells Fargo U.S. Interest Rate Forecast

	Actual			Forecast								
	2016				2017				2018			
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q
Quarter End Interest Rates												
Federal Funds Target Rate	0.50	0.50	0.50	0.75	0.75	1.00	1.00	1.25	1.25	1.50	1.50	1.75
3 Month LIBOR	0.63	0.65	0.80	0.95	0.95	1.20	1.20	1.45	1.45	1.70	1.70	1.95
Prime Rate	3.50	3.50	3.50	3.75	3.75	4.00	4.00	4.25	4.25	4.50	4.50	4.75
Conventional Mortgage Rate	3.69	3.57	3.58	3.59	3.61	3.62	3.66	3.69	3.73	3.82	3.85	4.02
3 Month Bill	0.21	0.26	0.30	0.49	0.57	0.78	0.84	1.02	1.10	1.25	1.30	1.55
6 Month Bill	0.39	0.36	0.43	0.60	0.67	0.88	0.94	1.12	1.20	1.35	1.40	1.65
1 Year Bill	0.59	0.45	0.54	0.69	0.75	0.96	1.02	1.22	1.30	1.45	1.50	1.75
2 Year Note	0.73	0.58	0.74	0.84	0.93	1.13	1.20	1.36	1.44	1.59	1.64	1.88
5 Year Note	1.21	1.01	1.13	1.21	1.25	1.36	1.41	1.50	1.58	1.71	1.75	1.98
10 Year Note	1.78	1.49	1.53	1.56	1.59	1.62	1.68	1.73	1.78	1.88	1.92	2.10
30 Year Bond	2.61	2.30	2.24	2.27	2.30	2.33	2.35	2.38	2.41	2.44	2.47	2.52

Forecast as of: September 7, 2016

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

	2016	2017	2018
Change in Real Gross Domestic Product			
Wells Fargo	1.9	2.1	2.2
FOMC	1.7 to 1.9	1.9 to 2.2	1.8 to 2.1
Unemployment Rate			
Wells Fargo	4.7	4.5	4.4
FOMC	4.7 to 4.9	4.5 to 4.7	4.4 to 4.7
PCE Inflation			
Wells Fargo	1.3	2.0	2.0
FOMC	1.2 to 1.4	1.7 to 1.9	1.8 to 2.0
"Core" PCE Deflator			
Wells Fargo	1.7	1.7	2.0
FOMC	1.6 to 1.8	1.7 to 1.9	1.9 to 2.0

Forecast as of: September 7, 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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