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Economics Group

Interest Rate Weekly

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Optimism on Growth on the Basis of Thoughtful Stimulus

Since the U.S. election, gains in the equity market indicate an upward shift in expectations for economic growth and corporate earnings ahead. How can we corroborate these expectations?

Fiscal Stimulus: One Positive but Not Alone

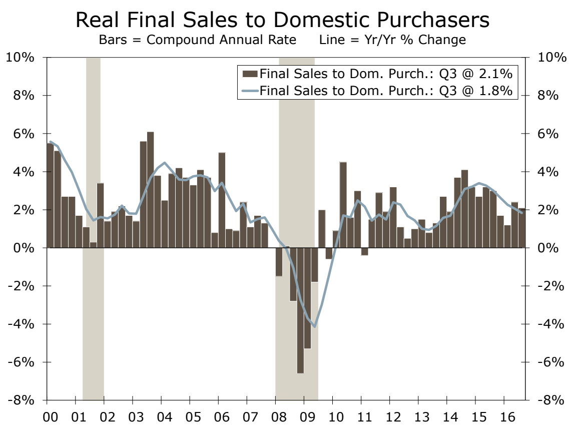
Fiscal stimulus, through tax cuts and/or infrastructure/defense spending, has come forward as the primary policy factor for promoting growth and domestic real final sales (top graph). In theory, if stimulus were to be enacted, aggregate demand would be promoted through lower personal income taxes, which would drive gains in consumer spending and housing. Increased personal spending would improve the outlook for jobs as well as wages & salaries and thereby increase income. Further, recent stronger wealth gains due to home price appreciation and equity market returns would reinforce consumer spending.

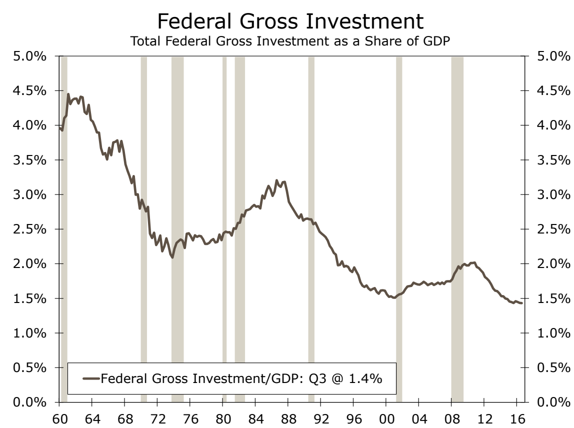
In addition, business investment and structure spending would be promoted by lower business taxes as well as any movement toward business expensing of equipment. Direct federal spending—on both defense and infrastructure projects–would, if thoughtfully pursued, add to the fiscal stimulus. As indicated in the middle graph, the strong pace of infrastructure spending on highways and schools in the 1960s, accompanied by the growth in suburbs and the space race, has gradually given way to slower spending growth as federal priorities have shifted. We are cautious, however, going forward about the ease and timing of the permitting and environmental approval processes. Commentary by Larry Summers about the difficulties of permitting the Anderson Bridge over the Charles River between Boston and Cambridge serves as a cautious reminder of the speed of implementation of infrastructure spending. Fiscal realities, as ever, also remain a challenge in a rising deficit environment. For further reading on the outlook, see our report "Key Issues to Watch in the 115th Congress," available on our website.

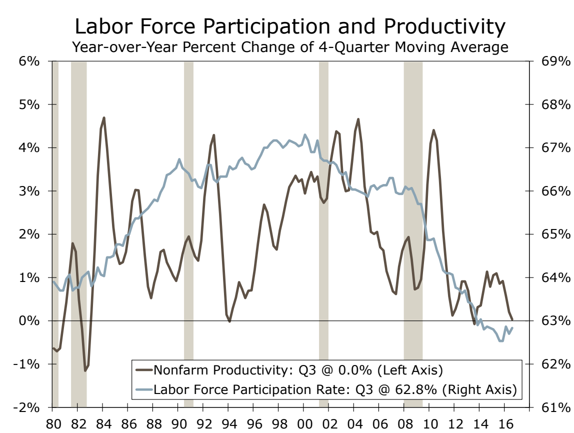
What about the Supply Side?

Stimulating demand alone, without any efforts on the supply side, would likely generate a quick gain in measured GDP gains, along with higher inflation, but very little sustained growth over time. Sustained real economic growth and a low inflation economy require a supply-side effort focused on improving productivity, labor force growth and labor force participation rates (bottom graph).

How could this be achieved? Increased business investment and better labor education and training would be one solution to improve productivity. In addition, easier regulation would lower the risk and cost of implementing new technology as well as increasing the availability of credit to finance innovation. Meanwhile, gains in labor force growth and participation rates could be promoted by lower income taxes and other ways of altering the work-leisure tradeoff. Raising long-term growth prospects will likely require a multifactor approach that demands a long-term focus on the economic fundamentals.







Source: U.S. Department of Commerce, U.S. Department of Labor 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	0.85	1.05	1.05	1.25	1.25	1.50	1.50	1.75	1.75	2.00
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	3.46	4.12	4.13	4.15	4.17	4.19	4.22	4.26	4.30	4.35
3 Month Bill	0.21	0.26	0.29	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	0.45	0.62	0.69	0.88	0.94	1.12	1.20	1.35	1.40	1.65
1 Year Bill	0.59	0.45	0.59	0.82	0.86	1.02	1.08	1.38	1.46	1.58	1.65	1.79
2 Year Note	0.73	0.58	0.77	1.14	1.17	1.33	1.40	1.66	1.73	1.86	1.91	2.03
5 Year Note	1.21	1.01	1.14	1.86	1.91	1.99	2.06	2.21	2.27	2.37	2.41	2.51
10 Year Note	1.78	1.49	1.60	2.42	2.45	2.48	2.51	2.54	2.58	2.63	2.68	2.74
30 Year Bond	2.61	2.30	2.32	3.09	3.16	3.22	3.28	3.34	3.41	3.49	3.57	3.66

Forecast as of: December 23, 2016

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

	2016	2017	2018
Change in Real Gross Domestic Product			
Wells Fargo	1.8	2.3	2.2
FOMC	1.8 to 1.9	1.9 to 2.3	1.8 to 2.2
Unemployment Rate			
Wells Fargo	4.8	4.6	4.5
FOMC	4.7 to 4.8	4.5 to 4.6	4.3 to 4.7
PCE Inflation			
Wells Fargo	1.5	2.1	2.3
FOMC	1.5	1.7 to 2.0	1.9 to 2.0
"Core" PCE Deflator			
Wells Fargo	1.7	1.9	2.1
FOMC	1.7 to 1.8	1.8 to 1.9	1.9 to 2.0

Forecast as of: December 23, 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: December 14, 2016

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

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