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Economics Group

Interest Rate Weekly

John E. Silvia, Chief Economist
john.silvia@wellsfargo.com • (704) 410-3275

Shifting Benchmarks: What Is an Investor To Do?

Anchoring to a fixed numerical benchmark for all-time is a convenient intellectual crutch but not an effective standard in a constantly evolving economy. Economic tides cannot be stopped.

Policy Benchmark: No Single Number but the Result of Many

In the modern era post the 1970s inflation boom, the movement in the federal funds rate reflects a series of structural breaks and a pattern that is not mean-reverting (top graph). The pattern of the funds rate reflects numerous structural breaks that are familiar to analysts of Fed history and the associated shift in economic tides that drove such shifts (October 1984, October 1994, December 2008). Moreover, since 1982, the fed funds rate does not exhibit mean-reverting behavior and the trend of the funds rate is in a non-linear pattern over that same period.

For investors, the conclusion is that the Fed follows a pattern of altering the funds rate in response to its perceived economic vision. A fixed, numerical funds rate as a benchmark for short-term interest rates is not to be expected.

A Fixed Dollar? How About Not

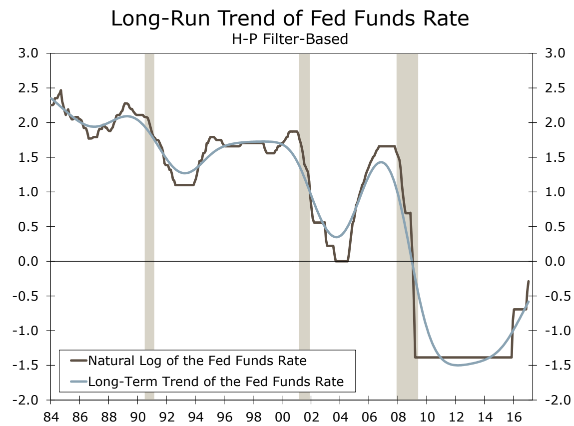
Pursuit of a stable dollar exchange rate faces the same economic reality that confronts all economic benchmarks—the evolution of the economy and, in this case, the evolution of the global economy. The pattern of the dollar, middle graph, exhibits two significant structural breaks. First, there is a break at October 2008 as would be expected with the recession at that time. Second, there is a break at July 1985 associated with the Plaza Accord. Both instances reflect the impact of reality on the pursuit of a fixed dollar exchange rate. Moreover, the dollar exchange rate is not mean-reverting and, to further complicate the analysis, the dollar exhibits a non-linear trend.

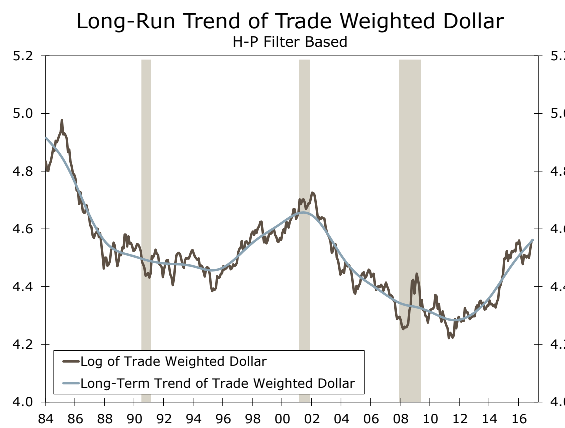
These results highlight the challenge for investors. Dollar exchange forecasts reflect a myriad of global economic factors and there is no tendency for the dollar exchange rate to return to any specific given benchmark.

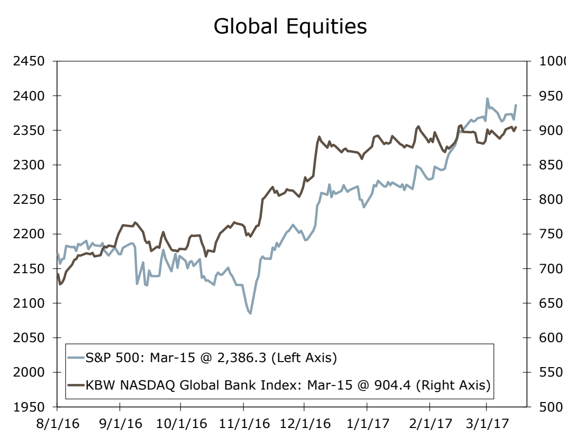
No Simple Benchmarks in a Complex Economic World

There is no effective alternative to watching the data, following policy turns and avoiding the anchoring bias that economic values will return to previous benchmarks. More recent, we have witnessed a clear break in trend in equity valuations in response to a shift in expectations in public policy.

This pattern highlights another challenge with market information. This information reflects the combination of actual economic fundamentals as well as the expectations of market actors where such expectations can be dashed when the future actual outcomes do not match expectations. This mismatch is the driver for second-round market pricing and thereby further economic adjustments. This constant action/reaction drives activity and undermines the search for fixed, permanent benchmarks.







Source: Federal Reserve Board, Bloomberg LP 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	1.00	1.25	1.25	1.50	1.50	1.75	2.00	2.25
3 Month LIBOR	0.63	0.65	0.85	1.00	1.30	1.50	1.50	1.75	1.75	2.00	2.25	2.50
Prime Rate	3.50	3.50	3.50	3.75	4.00	4.25	4.25	4.50	4.50	4.75	5.00	5.25
Conventional Mortgage Rate	3.69	3.57	3.46	4.20	4.30	4.36	4.41	4.44	4.46	4.48	4.55	4.62
3 Month Bill	0.21	0.26	0.29	0.51	0.76	1.02	1.10	1.30	1.40	1.50	1.76	2.02
6 Month Bill	0.39	0.36	0.45	0.62	0.88	1.12	1.20	1.40	1.51	1.61	1.87	2.13
1 Year Bill	0.59	0.45	0.59	0.85	1.02	1.38	1.46	1.66	1.75	1.84	2.05	2.26
2 Year Note	0.73	0.58	0.77	1.20	1.34	1.66	1.75	1.93	2.02	2.11	2.26	2.41
5 Year Note	1.21	1.01	1.14	1.93	2.08	2.21	2.29	2.40	2.46	2.52	2.66	2.80
10 Year Note	1.78	1.49	1.60	2.45	2.55	2.62	2.68	2.72	2.75	2.78	2.86	2.94
30 Year Bond	2.61	2.30	2.32	3.06	3.18	3.34	3.40	3.49	3.54	3.58	3.67	3.76

Forecast as of: March 15, 2017

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

	2017	2018
Change in Real Gross Domestic Product		
Wells Fargo	2.1	2.6
FOMC	2.0 to 2.2	1.8 to 2.3
Unemployment Rate		
Wells Fargo	4.6	4.5
FOMC	4.5 to 4.6	4.3 to 4.6
PCE Inflation		
Wells Fargo	2.1	2.4
FOMC	1.8 to 2.0	1.9 to 2.0
"Core" PCE Deflator		
Wells Fargo	2.0	2.2
FOMC	1.8 to 1.9	1.9 to 2.0

Forecast as of: March 15, 2017

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: March 15, 2017

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

Wells Fargo Securities Economics Group

Diane Schumaker-Krieg	Global Head of Research, Economics & Strategy	(704) 410-1801 (212) 214-5070	diane.schumaker@wellsfargo.com
John E. Silvia, Ph.D.	Chief Economist	(704) 410-3275	john.silvia@wellsfargo.com
Mark Vitner	Senior Economist	(704) 410-3277	mark.vitner@wellsfargo.com
Jay H. Bryson, Ph.D.	Global Economist	(704) 410-3274	jay.bryson@wellsfargo.com
Sam Bullard	Senior Economist	(704) 410-3280	sam.bullard@wellsfargo.com
Nick Bennenbroek	Currency Strategist	(212) 214-5636	nicholas.bennenbroek@wellsfargo.com
Anika R. Khan	Senior Economist	(212) 214-8543	anika.khan@wellsfargo.com
Eugenio J. Alemán, Ph.D.	Senior Economist	(704) 410-3273	eugenio.j.aleman@wellsfargo.com
Azhar Iqbal	Econometrician	(704) 410-3270	azhar.iqbal@wellsfargo.com
Tim Quinlan	Senior Economist	(704) 410-3283	tim.quinlan@wellsfargo.com
Eric Viloria, CFA	Currency Strategist	(212) 214-5637	eric.viloria@wellsfargo.com
Sarah House	Economist	(704) 410-3282	sarah.house@wellsfargo.com
Michael A. Brown	Economist	(704) 410-3278	michael.a.brown@wellsfargo.com
Jamie Feik	Economist	(704) 410-3291	jamie.feik@wellsfargo.com
Erik Nelson	Currency Strategist	(212) 214-5652	erik.f.nelson@wellsfargo.com
Misa Batcheller	Economic Analyst	(704) 410-3060	misa.n.batcheller@wellsfargo.com
Michael Pugliese	Economic Analyst	(704) 410-3156	michael.d.pugliese@wellsfargo.com
Julianne Causey	Economic Analyst	(704) 410-3281	julianne.causey@wellsfargo.com
E. Harry Pershing	Economic Analyst	(704) 410-3034	harry.pershing@wellsfargo.com
Donna LaFleur	Executive Assistant	(704) 410-3279	donna.lafleur@wellsfargo.com
Dawne Howes	Administrative Assistant	(704) 410-3272	dawne.howes@wellsfargo.com