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Economics Group

Interest Rate Weekly

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Three Rising Pressure Points for Investors

We have witnessed in recent months a continued movement in three economic fundamentals that signal rising pressures on the sustainability of the economic expansion at recent rates of growth.

Fed's Inflation Target Met

As illustrated in the top graph, the gains in the PCE deflator have largely met the Fed's inflation target. Both the overall PCE and the core PCE have risen over the past six months. Our outlook has been that the PCE deflator would hit two percent in the first quarter of 2017, with the core deflator reaching the two percent mark later this year.

One factor supporting the rise in the PCE deflator has been the steady rise in labor costs. Wages have been accelerating over the past year, as illustrated by the rise in average hourly earnings and the Atlanta Fed wage index, which now registers 3.2 percent year-over-year growth and has been steadily rising over the past year as well.

What we have witnessed, therefore, is that the pattern of wage/price movements has reached the point that the "low-wage growth, low-inflation" framework of decision making of recent years has now faded away. We are challenged to look forward and drop the price assumptions of the past five years.

Room to Move

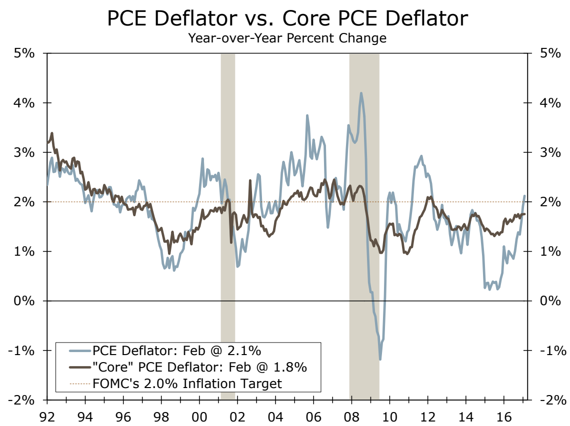
Now that the inflation data have shown firm signs of moving toward the two percent policy threshold, we note that the FOMC instrument, the nominal fed funds rate, remains far below the current pace of inflation (middle chart). As a result, there is plenty of room for the FOMC to move to achieve a target zero percent real funds rate.

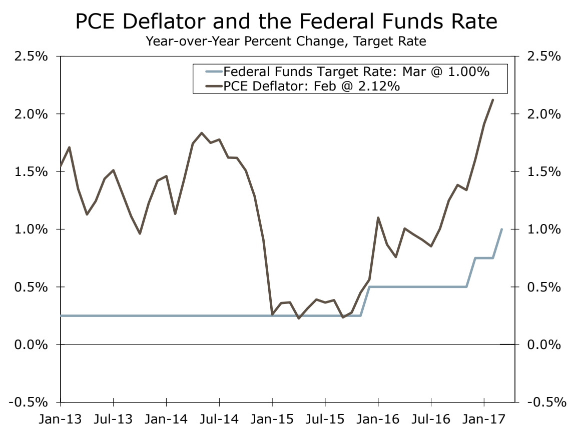
There is an active debate about what should be the target real federal funds rate to return policy to normal. This debate typically focuses on the options of either a zero real funds rate or some number above that. Therefore, the bias is that the FOMC has plenty of room to move.

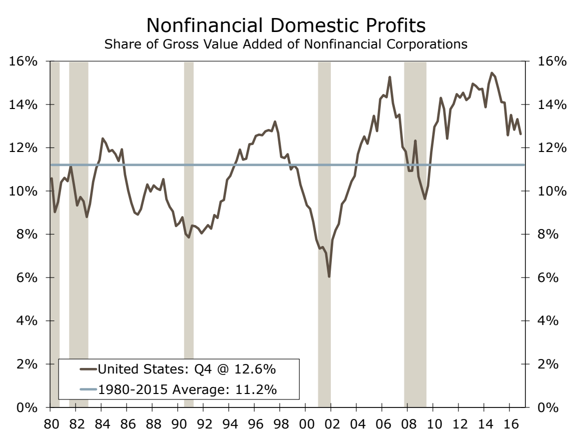
Yet, a move to zero would indicate a funds rate increase of about 100 basis points that would likely boost short-term borrowing costs for housing and business lending. Current market pricing may not account for this, and this magnitude of movement in short-term borrowing costs could generate a moderation in the pace of economic growth. Moreover, a movement of FOMC policy that marches toward a zero real funds rate would be consistent with the rise in the funds rate indicated in the dot plot.

Shrinking Margin for Error

For both investors and private businesses, the peak in profit margins indicates that the combination of rising short-term interest rates and shrinking profit margins provides a smaller margin of error for decision makers (bottom chart). Looking forward, the rise in unit labor costs, in the face of another year of two percent real growth, likely means the pressure on profit margins continues.







Source: U.S. Department of Commerce, Federal Reserve Board and Wells Fargo Securities

Wells Fargo U.S. Interest Rate Forecast

	Actual 2016				Forecast 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 31, 2017

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

	2017	2018
Change in Real Gross Domestic Product		
Wells Fargo	2.0	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	2.2	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 31, 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

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