

Economics Group

Interest Rate Weekly

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The Fed Looks Past First Quarter Weakness

While acknowledging “growth in economic activity slowed,” the Fed largely looked past recent disappointing economic numbers at today’s FOMC meeting. Policymakers remain on track for a June rate hike.

The Fed Finesses the First Quarter Shortfall

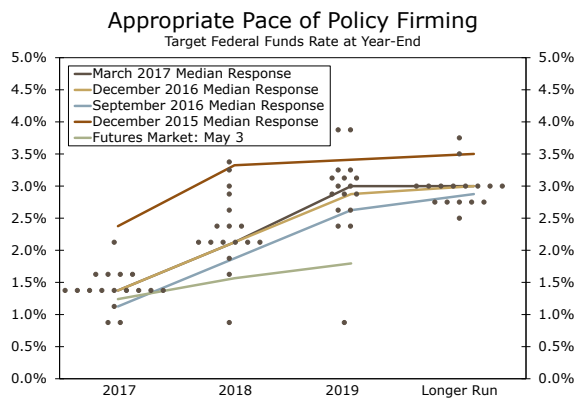
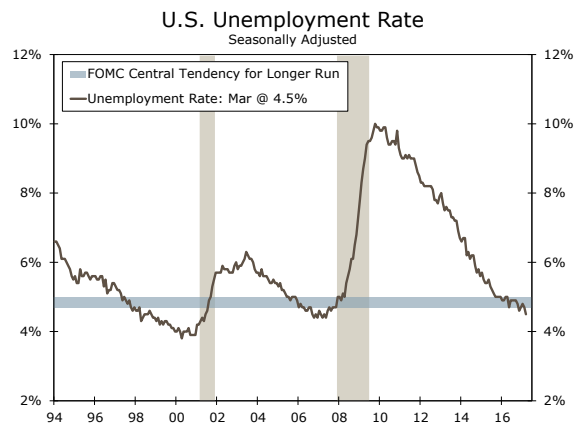
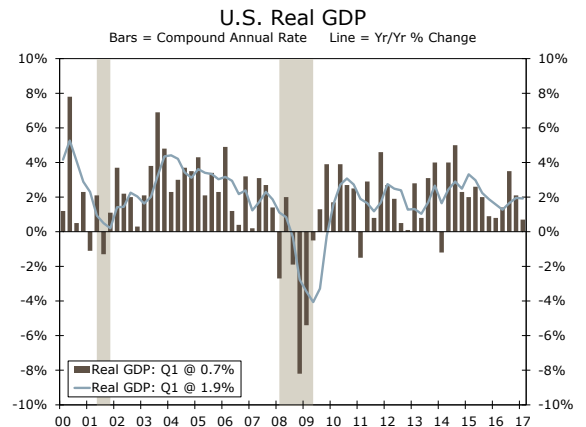
While the first quarter GDP growth, March employment report and deceleration in motor vehicle sales were disappointing, they do not appear to have set off any alarm bells at the Fed. The policy statement from today’s FOMC meeting went to great lengths to downplay the recent shortfall in economic growth in the opening paragraph, noting that the “*growth (our emphasis) in economic activity slowed.*” The Fed’s wordsmiths earn serious style points for placing their emphasis on the growth rate rather than economic activity. Focusing on the growth rate drives home the Fed’s view of the softer economic data as very temporary. If the Fed simply said economic activity slowed then it might be tough to justify another quarter-point rate hike until economic activity picked up again, which would push the Fed’s next move into late summer or beyond.

The policy statement also smoothed over any concerns about slower job growth and weaker motor vehicle sales by noting “job gains were solid, on average, in recent months” and “the fundamentals underpinning the continued growth of consumption remained solid.” In addition, the Fed tweaked its view on inflation, choosing to focus on the recent 12-month change in various inflation measures rather than the performance over recent quarters, as was done following the March meeting. The bottom line is the Fed still sees economic activity, the labor market and inflation on course with its expectations and is looking to hike interest rates at its June meeting.

Beyond Semantics

Any lingering doubts about the Fed’s assessment of economic conditions were put to rest in the second paragraph, where the FOMC provides insights into the future course of monetary policy. The FOMC flatly states that “the Committee views the slowing in growth during the first quarter to be transitory.” Moreover, the Fed noted that it expects “that, with gradual adjustments in the stance of monetary policy, economic activity will expand at a moderate pace, labor market conditions will strengthen somewhat further and inflation will stabilize around 2 percent.”

The ease with which the Fed dismisses recent disappointing economic reports is a big reason why the May FOMC policy statement is widely viewed as being slightly hawkish. Prior to the May FOMC meeting, the financial markets had assigned about a 67 percent probability that the Fed would raise the federal funds target by a quarter-percentage point in June and put little chance of a third hike later in the year. Following the May meeting, the odds of a June rate hike have risen to over 90 percent and the odds of another move later this year have risen to around 40 percent.



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	1.50	1.50	1.50	1.75	2.00	2.25
3 Month LIBOR	0.63	0.65	0.85	1.00	1.15	1.50	1.75	1.75	1.75	2.00	2.25	2.50
Prime Rate	3.50	3.50	3.50	3.75	4.00	4.25	4.50	4.50	4.50	4.75	5.00	5.25
Conventional Mortgage Rate	3.69	3.57	3.46	4.20	4.20	4.29	4.45	4.46	4.47	4.48	4.55	4.62
3 Month Bill	0.21	0.26	0.29	0.51	0.76	1.02	1.30	1.40	1.45	1.50	1.75	2.02
6 Month Bill	0.39	0.36	0.45	0.62	0.91	1.19	1.45	1.56	1.60	1.66	1.92	2.18
1 Year Bill	0.59	0.45	0.59	0.85	1.03	1.35	1.65	1.80	1.85	1.90	2.10	2.31
2 Year Note	0.73	0.58	0.77	1.20	1.27	1.75	2.05	2.15	2.20	2.26	2.41	2.56
5 Year Note	1.21	1.01	1.14	1.93	1.93	2.10	2.40	2.46	2.49	2.52	2.66	2.80
10 Year Note	1.78	1.49	1.60	2.45	2.40	2.55	2.72	2.75	2.76	2.78	2.86	2.94
30 Year Bond	2.61	2.30	2.32	3.06	3.02	3.18	3.44	3.54	3.56	3.58	3.67	3.76

Forecast as of: May 1, 2017

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

	<u>2017</u>	<u>2018</u>
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	4.5	4.5
FOMC	4.5 to 4.6	4.3 to 4.6
PCE Inflation		
Wells Fargo	1.8	2.2
FOMC	1.8 to 2.0	1.9 to 2.0
"Core" PCE Deflator		
Wells Fargo	1.8	2.2
FOMC	1.8 to 1.9	1.9 to 2.0

Forecast as of: May 1, 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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