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Economics Group

Interest Rate Weekly

John E. Silvia, Chief Economist
john.silvia@wellsfargo.com • (704) 410-3275
Mark Vitner, Senior Economist
mark.vitner@wellsfargo.com • (704) 410-3277
Michael A. Brown, Economist
michael.a.brown@wellsfargo.com • (704) 410-3278

Debt Ceiling Debates and Their Effects on Yields and Volatility

Leading up to the Nov. 3 debt ceiling deadline, Treasury markets have shown signs of greater volatility while the five-year U.S. Treasury credit default swap spread started to edge higher.

Fiscal Fights and Financial Markets

With multiple fiscal deadlines on the docket in the coming weeks, U.S. fiscal uncertainty has created some recent volatility in Treasury markets. While a deal has been announced this week that should allay fears about a federal government default this time around, these periods of uncertainty can still create market disruptions. This week, we take a look at the market reaction related to the latest debt ceiling fight. Treasury Secretary Jack Lew's most recent comments cited Nov. 3 as the date by which Congress must lift the debt ceiling. Uncertainty this past week set off greater volatility in the Treasury market and led to a spike in some short-term Treasury rates.

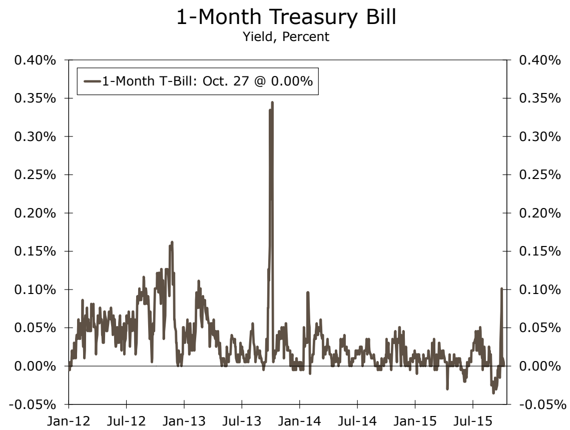
Short-Rates and CDS Spreads Showed Signs of Unease

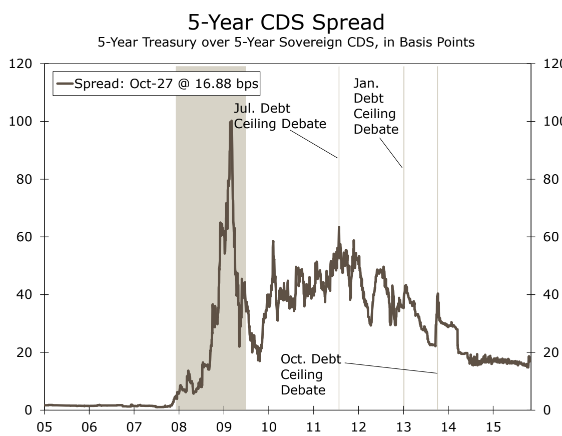
Among the preliminary market effects observed over the past week as a result of the debt ceiling debate have been spikes in the one-month U.S. Treasury yield and a slight widening in the five-year Treasury credit default swap (CDS) spread. Last week, the one-month T-bill yield hit a high of 0.10 percent, but later fell during the week. As of this writing, the yield had begun to fall back toward negative territory since the announcement of a debt ceiling deal. The jump in the one-month yield led to a situation where, at one point, the one-month bill had a higher yield than the three-month bill. In addition, last week the Department of the Treasury postponed a scheduled two-year Treasury auction due to debt ceiling constraints.

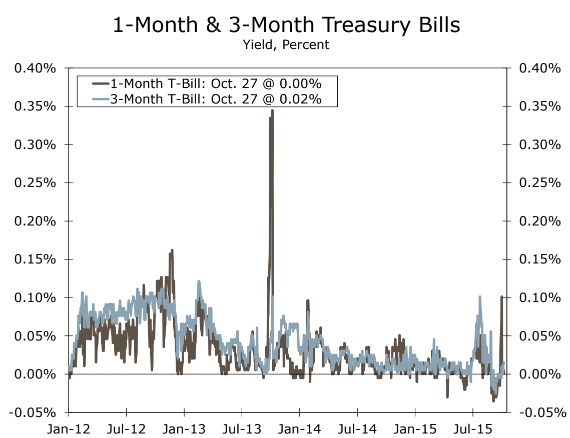
Another way to monitor the market reaction to the ongoing debt limit debate is through the five-year Treasury CDS spread, which reached the highest reading since December of last year during the last debt ceiling debate. The measure still remains well below the spikes that occurred during past debates, while the magnitude of movement in the CDS spread has been diminishing over time with each successive debt ceiling debate. We believe that this partially reflects markets' ambivalence towards repeated down-to-the-wire votes that ultimately lead to a resolution in time to avoid default.

When Will This Be Resolved?

Late Monday night, Congressional leadership and the White House announced a two-year budget deal that would establish federal spending levels for the current and next federal fiscal year and, importantly for Treasury markets, suspend the debt ceiling until March 2017, well beyond the 2016 election. The House of Representatives is set to vote first on the package on Wednesday before sending it to the Senate for approval. Early indications are that the bill should pass with bipartisan support. At least for the time being, there should be some reprieve from debt limit fights that could be disruptive to Treasury markets.







Source: Federal Reserve Board, Bloomberg LP and Wells Fargo Securities, LLC

Wells Fargo U.S. Interest Rate Forecast

	Actual			Forecast								
	2015				2016				2017			
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q
Quarter End Interest Rates												
Federal Funds Target Rate	0.25	0.25	0.25	0.50	0.50	0.75	1.00	1.25	1.50	1.75	2.00	2.00
3 Month LIBOR	0.27	0.28	0.33	0.65	0.70	0.95	1.20	1.45	1.70	1.95	2.20	2.20
Prime Rate	3.25	3.25	3.25	3.50	3.50	3.75	4.00	4.25	4.50	4.75	5.00	5.00
Conventional Mortgage Rate	3.77	3.98	3.89	3.92	3.94	3.99	4.11	4.25	4.35	4.42	4.48	4.55
3 Month Bill	0.03	0.01	0.00	0.09	0.21	0.60	0.86	1.19	1.27	1.60	1.85	1.89
6 Month Bill	0.14	0.11	0.08	0.20	0.28	0.69	0.95	1.28	1.36	1.69	1.94	1.98
1 Year Bill	0.26	0.28	0.33	0.53	0.62	0.98	1.16	1.43	1.51	1.84	2.07	2.10
2 Year Note	0.56	0.64	0.64	0.85	1.01	1.28	1.55	1.80	2.01	2.28	2.35	2.40
5 Year Note	1.37	1.63	1.37	1.58	1.72	1.81	1.94	1.97	2.20	2.32	2.38	2.42
10 Year Note	1.94	2.35	2.06	2.08	2.10	2.15	2.25	2.37	2.45	2.50	2.54	2.59
30 Year Bond	2.54	3.11	2.87	2.89	2.88	2.90	2.92	2.94	2.96	2.96	2.98	2.98

Forecast as of: October 16, 2015

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

	2015	2016	2017
Change in Real Gross Domestic Product			
Wells Fargo	2.1	2.6	2.3
FOMC	2.0 to 2.3	2.2 to 2.6	2.0 to 2.4
Unemployment Rate			
Wells Fargo	5.0	4.6	4.4
FOMC	5.0 to 5.1	4.7 to 4.9	4.7 to 4.9
PCE Inflation			
Wells Fargo	0.8	1.9	1.9
FOMC	0.3 to 0.5	1.5 to 1.8	1.8 to 2.0

Forecast as of: October 16, 2015

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 17, 2015

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

Wells Fargo Securities, LLC 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
Eugenio J. Alemán, Ph.D.	Senior Economist	(704) 410-3273	eugenio.j.aleman@wellsfargo.com
Anika R. Khan	Senior Economist	(704) 410-3271	anika.khan@wellsfargo.com
Azhar Iqbal	Econometrician	(704) 410-3270	azhar.iqbal@wellsfargo.com
Tim Quinlan	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
Erik Nelson	Economic Analyst	(704) 410-3267	erik.f.nelson@wellsfargo.com
Alex Moehring	Economic Analyst	(704) 410-3247	alex.v.moehring@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
Donna LaFleur	Executive Assistant	(704) 410-3279	donna.lafleur@wellsfargo.com
Cyndi Burris	Senior Admin. Assistant	(704) 410-3272	cyndi.burris@wellsfargo.com

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