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Economics Group

Interest Rate Weekly

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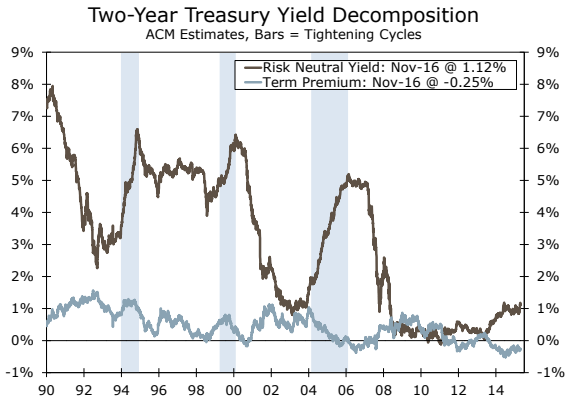
Fed, Inflation and the Two-Year Treasury: Expect Volatility

The term premium component of the two-year Treasury continues to reflect a softening outlook for inflation but greater volatility and some upside risk is likely in the coming weeks as a December rate hike approaches.

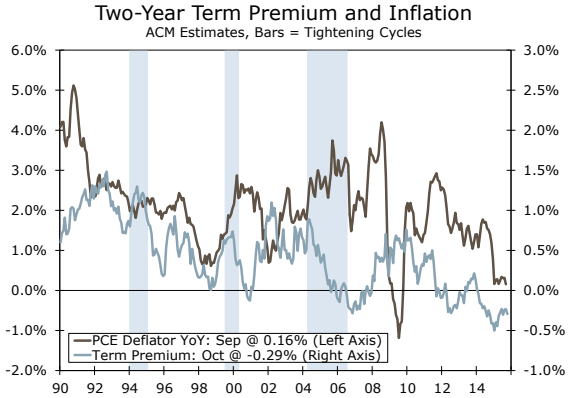
Higher Two-Year Yield as Markets Recalibrate for Fed Hike

Following the readjustment of interest rates to the greater probability of a December rate hike from the Federal Open Market Committee (FOMC), our preferred measure of the point on the curve that most closely reflects economic fundamentals, the two-year Treasury yield, has drifted higher. Once we break down the two components of the two-year yield, the risk neutral yield and the term premium, it is clear that the risk neutral yield of the two-year U.S. Treasury has begun to drift somewhat higher in recent weeks. The term premium, however, remains negative reflecting the subdued rate of expected inflation. In short, once the inflation environment begins to stabilize, there could be some further upside risk to the two-year Treasury yield but the potential upside of the yield is likely to be constrained by further downward revisions to the FOMC's long-run fed funds rate projections.



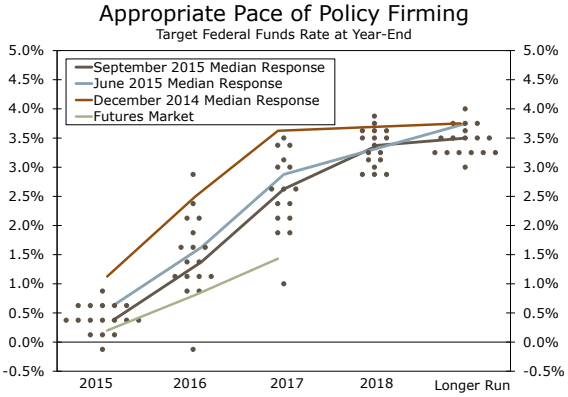
Absence of Inflation and Term Premium Effects

Upon closer inspection of the term premium and inflation expectations, it appears that the term premium continues to be held back by the ongoing current low inflation environment. We would point out to our readers, however, that the year-over-year comparables become a little more difficult for November's inflation readings given that the slide in gasoline prices accelerated in November of last year. The personal consumption expenditure (PCE) deflator tends to track the premium rather closely following the last tightening cycle. As such when the year-over-year inflation measures start turning around, we would expect the term premium to edge higher resulting in a slightly higher nominal two-year Treasury note yield.



What to Expect Next

We continue to expect that inflation measures will have stabilized to a point that the FOMC will be comfortable with a December lift off. As such, we expect greater volatility in the two-year Treasury yield over the coming weeks as markets weigh carefully every economic data point. Furthermore, we expect the two-year yield to gradually march higher on average as we approach the December 16 FOMC meeting announcement and press conference. The magnitude, however, of the upward movement in the two-year yield should be somewhat subdued compared to prior tightening cycles as the long-term fed funds rate expectations are likely to continue to come down when the committee releases their updated projection materials. We expect further downward revisions to the dot plot and long-run potential fed funds rate, which should keep a lid on the two-year yield from climbing significantly higher. We maintain the view of an ongoing flattening of the yield curve as the tightening cycle progresses.



Source: Federal Reserve System, U.S. Dept. of Commerce, 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	2.25
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	2.45
Prime Rate	3.25	3.25	3.25	3.50	3.50	3.75	4.00	4.25	4.50	4.75	5.00	5.25
Conventional Mortgage Rate	3.77	3.98	3.89	4.04	4.13	4.19	4.29	4.39	4.49	4.58	4.66	4.93
3 Month Bill	0.03	0.01	0.00	0.10	0.25	0.68	0.90	1.16	1.31	1.56	1.84	2.09
6 Month Bill	0.14	0.11	0.08	0.25	0.37	0.71	0.98	1.23	1.39	1.62	1.92	2.17
1 Year Bill	0.26	0.28	0.33	0.55	0.65	0.99	1.16	1.46	1.55	1.89	2.11	2.36
2 Year Note	0.56	0.64	0.64	0.86	1.02	1.28	1.57	1.71	1.95	2.17	2.25	2.50
5 Year Note	1.37	1.63	1.37	1.59	1.71	1.81	1.95	2.03	2.22	2.33	2.41	2.66
10 Year Note	1.94	2.35	2.06	2.20	2.29	2.35	2.43	2.51	2.59	2.66	2.72	2.97
30 Year Bond	2.54	3.11	2.87	2.94	2.98	3.00	3.06	3.10	3.13	3.18	3.23	3.48

Forecast as of: November 11, 2015

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

	2015	2016	2017
Change in Real Gross Domestic Product			
Wells Fargo	2.2	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	0.5	1.9	1.9
FOMC	0.3 to 0.5	1.5 to 1.8	1.8 to 2.0

Forecast as of: November 11, 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

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