May 4, 2016

Economics Group

Interest Rate Weekly

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

Investing Under an Inconsistent Policy Framework

In previous reports, we dealt with the reality that the framework for interest rate behavior has evolved. But, what happens if policy itself is inconsistent and what are the broader implications for markets?

The Price of Success

Since 1994, the PCE deflator has averaged less than 2 percent (top graph). Shall we then just declare victory and go on vacation? Alternatively, given this success, what happens if a policy maker wishes to push the envelope to achieve greater economic growth/employment given the current low inflation even though the unemployment rate has reached full employment? This is the choice faced by policymakers today.

For the policymaker, the advantage is that with current inflation so low, and inflation expectations down over the past six months, the marginal cost of additional inflation appears temptingly low. Even if inflation were to overshoot the 2 percent target, the perceived damage to inflation expectations appears limited to some commentators.

Collateral Damage Along the Road to Inflation

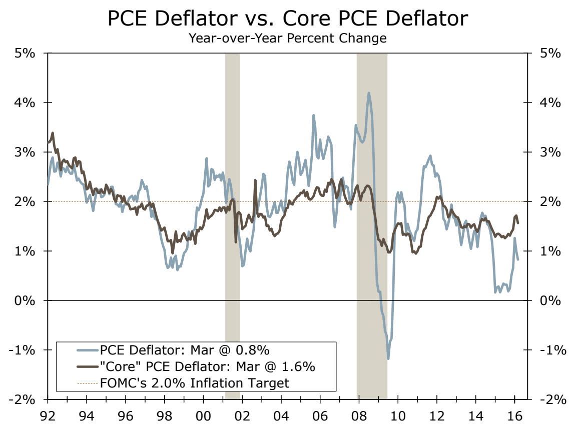
However, there are economic issues associated with continued easing in the pursuit of growth through increased injections of liquidity, and the risk of rising inflation remains. The flow of liquidity can, like water, move anywhere. As a result, the distortions in private markets may already be appearing, not through mispriced goods (inflation), but through financial/real assets.

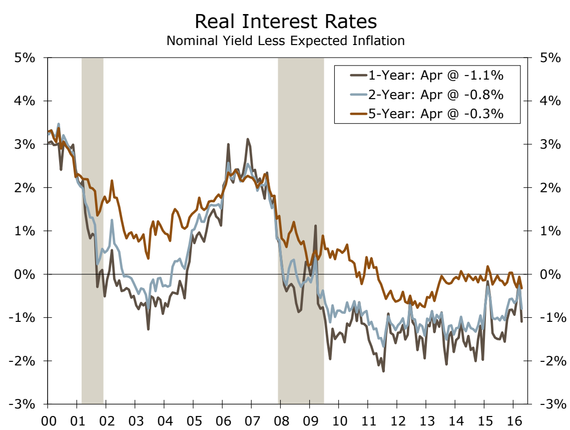
Persistent zero rates made it easy to justify the purchase of new equipment in an industry (energy) perceived to have a growing output potential. The result was excess capacity in an industry now undergoing retrenchment. In the meantime, low interest rates allowed firms with visions of limited potential to substitute capital for labor.

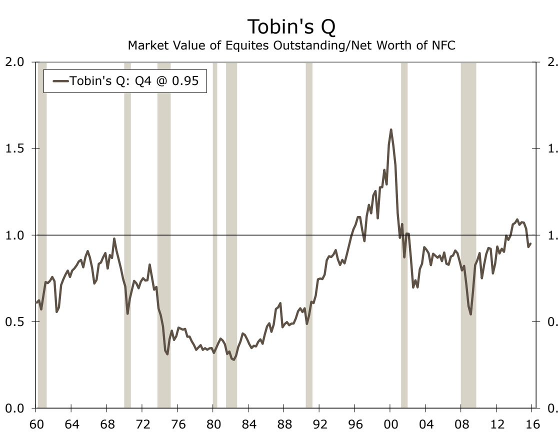
As illustrated in the middle graph, the policy of administered low short-term rates has produced an era of financial repression where the real return to short-term investments—one- and two-year Treasury yields—is negative and the proper pricing off a risk-free short-term rate is not possible given that the rate is an administered rate by policy makers and not set in the marketplace. For savers, to gain a real return the imperative is to extend maturity out to five years.

Buy Existing: Not New

With the persistent low current interest rates, firms may find it easier to purchase existing equipment rather than buy new. This helps to explain the high levels of merger and acquisition activity this cycle along with subpar business investment. As illustrated by the Tobin Q ratio (bottom graph), when the Q-ratio is below 1.0 the market value of equities is less than the recorded value of the assets of the company—the market is undervaluing the company. In this case the incentive is to buy the company rather than buy new capital. Low interest rates are providing an incentive to invest—but not in new equipment, rather, in existing equipment, given an environment with excess capacity.







Source: U.S. Department of Commerce, Federal Reserve 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	0.75	1.00	1.25	1.50	1.75	2.00
3 Month LIBOR	0.27	0.28	0.33	0.61	0.63	0.95	0.95	1.20	1.45	1.70	1.95	2.20
Prime Rate	3.25	3.25	3.25	3.50	3.50	3.75	3.75	4.00	4.25	4.50	4.75	5.00
Conventional Mortgage Rate	3.77	3.98	3.89	3.96	3.69	3.89	3.95	4.06	4.12	4.26	4.33	4.42
3 Month Bill	0.03	0.01	0.00	0.16	0.21	0.61	0.69	0.87	1.15	1.30	1.57	1.87
6 Month Bill	0.14	0.11	0.08	0.49	0.39	0.67	0.78	0.92	1.18	1.40	1.63	1.95
1 Year Bill	0.26	0.28	0.33	0.65	0.59	0.82	0.93	1.01	1.29	1.52	1.79	2.03
2 Year Note	0.56	0.64	0.64	1.06	0.73	1.08	1.20	1.34	1.57	1.81	1.97	2.08
5 Year Note	1.37	1.63	1.37	1.76	1.21	1.58	1.67	1.74	1.84	1.94	2.05	2.14
10 Year Note	1.94	2.35	2.06	2.27	1.78	1.94	2.01	2.13	2.22	2.38	2.47	2.54
30 Year Bond	2.54	3.11	2.87	3.01	2.61	2.69	2.78	2.84	2.89	2.95	3.00	3.05

Forecast as of: April 22, 2016

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

	2016	2017
Change in Real Gross Domestic Product		
Wells Fargo	1.9	2.2
FOMC	2.1 to 2.3	2.0 to 2.3
Unemployment Rate		
Wells Fargo	4.6	4.4
FOMC	4.6 to 4.8	4.5 to 4.7
PCE Inflation		
Wells Fargo	1.6	2.1
FOMC	1.0 to 1.6	1.7 to 2.0

Forecast as of: April 22, 2016

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 16, 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
Anika R. Khan	Senior Economist	(704) 410-3271	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	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
Julianne Causey	Economic Analyst	(704) 410-3281	julianne.causey@wellsfargo.com
Donna LaFleur	Executive Assistant	(704) 410-3279	donna.lafleur@wellsfargo.com
Dawne Howes	Administrative Assistant	(704) 410-3272	dawne.howes@wellsfargo.com