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Economics Group

Interest Rate Weekly

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Silos Fall in a Financial Windstorm: Reality TV for Investors

Each week, our news is presented in silos—credit, economics and foreign currency—yet the financial markets know no such silos. Events in recent weeks have reinforced this theme. Timing offers some clues.

Cross-Silo Lessons from the FOMC's Non-Move

Market volatility reflects the gap between expected and actual—a regular occurrence in recent days. When the FOMC decided not to raise the funds rate, the impact was felt across multiple markets. In contrast to the assertion that the FOMC's action would have little effect, the broader truth is that prices had to adjust across many markets.

First, of course, the paths of short- and long-term rates were altered. However, any adjustment in the market for fed funds and short-term Treasury debt dictates an adjustment in several crucial areas. The equity markets (top graph) reflected two opposing forces. Does the FOMC inaction suggest a weaker economy and thereby weaker earnings growth ahead? Certainly, the emphasis on "global developments" reinforces investor concerns about growth in Asia, particularly China, and thereby the earnings outlook for companies with business in China. In opposition, the lower level of short-term interest rates would suggest a lower discount factor for future corporate earnings and is a plus for equity valuations. After a short dip in the two-year rate in August, the rate returned to its pre-August level. In contrast, the S&P index did not—global earnings expectations downshift may be the key factor.

Lessons from the Chinese Devaluation

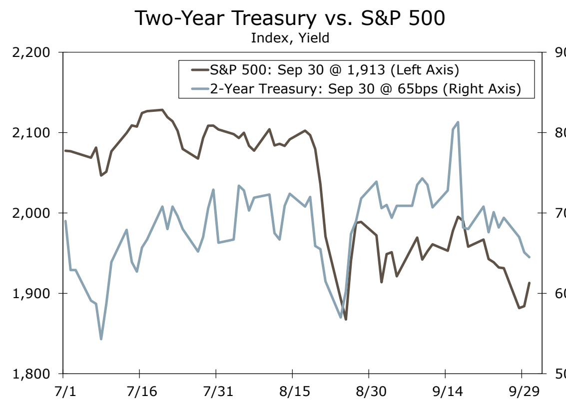
Two opposing winds are in play. Does the devaluation indicate current economic weakness in China and, thereby, an attempt by Chinese policymakers to offset that weakness or, alternatively, just an adjustment to open the foreign exchange market for future maturation and open trading for the yuan? Note the timing—as the devaluation of the yuan actually occurred before the dip in the Shanghai index—perhaps the devaluation was a signal in itself that lowered equity investor expectations.

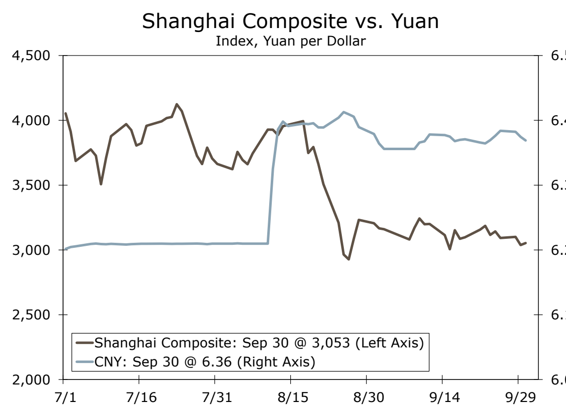
Lessons from Disappointing Growth

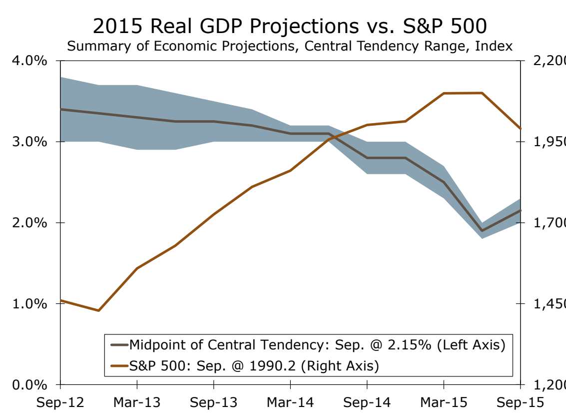
Downshifting economic growth expectations by FOMC members have influenced the level of caution at the FOMC. Moreover, this downshift in expectations may have fed into equity market expectations of future earnings and, thereby, equity valuations (bottom graph). Both channels have been reinforced by the perceived weakness in Asian economies relative to prior growth expectations, which, in turn, has been reinforced by the Chinese devaluation. Timing indicates that equity values did not decline in line with lower FOMC GDP projections—until the August break—once again suggesting that the break reflected factors other than domestic economic expectations or the two-year rate (see above).

Dynamic Feedback in an Investor's World

Decision making for investors does not proceed in a static world. Financial markets interact—there are no silos—case in point—midyear 2015.







Source: Bloomberg LP, Federal Reserve Board 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	0.75	1.00	1.25	1.50	1.75	2.00	2.25	2.50
3 Month LIBOR	0.27	0.28	0.45	0.70	0.95	1.20	1.45	1.70	1.95	2.20	2.45	2.70
Prime Rate	3.25	3.25	3.25	3.50	3.75	4.00	4.25	4.50	4.75	5.00	5.25	5.50
Conventional Mortgage Rate	3.77	3.98	4.00	4.15	4.23	4.28	4.37	4.63	4.75	4.76	4.84	4.93
3 Month Bill	0.03	0.01	0.03	0.13	0.56	0.84	1.17	1.34	1.63	1.81	2.12	2.38
6 Month Bill	0.14	0.11	0.14	0.30	0.61	0.89	1.23	1.43	1.66	1.94	2.19	2.41
1 Year Bill	0.26	0.28	0.38	0.68	0.96	1.23	1.59	1.80	2.09	2.29	2.38	2.57
2 Year Note	0.56	0.64	0.70	0.85	1.07	1.26	1.71	1.92	2.27	2.39	2.50	2.62
5 Year Note	1.37	1.63	1.55	1.73	1.87	1.99	2.20	2.34	2.52	2.60	2.69	2.78
10 Year Note	1.94	2.35	2.20	2.40	2.49	2.53	2.63	2.77	2.83	2.88	2.95	3.03
30 Year Bond	2.54	3.11	3.10	3.16	3.23	3.26	3.33	3.58	3.66	3.73	3.81	3.89

Forecast as of: September 18, 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	2.7	2.2
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	0.9	1.9	1.9
FOMC	0.3 to 0.5	1.5 to 1.8	1.8 to 2.0

Forecast as of: September 18, 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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