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Economics Group

Interest Rate Weekly

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If Not Normal, Where Are We in the Cycle? Late

Searching for normal rates may be an unproductive exercise but, perhaps, we might be more productive in our efforts to determine where we are in the credit cycle.

Late Cycle Pricing of High Yield Credit

As illustrated in the top graph, the steady rise in the risk premium on high yield credit can signal credit concerns even before the signs of recession are evident in the real economy. From 2000-2001 and 2007-2008 there was a rise in the risk premium. In contrast, as the economic recovery takes hold, the risk premia tends to decline fairly steadily until just before the next recession.

The outcome is that pricing of risk in the high yield bond market is actually quite sensitive to changes in market perceptions. This pattern is reminiscent of the pattern of corporate profit growth that we have written about before as another signal of potential economic difficulties. Both indicate that credit premia are rising with the aging of the credit cycle.

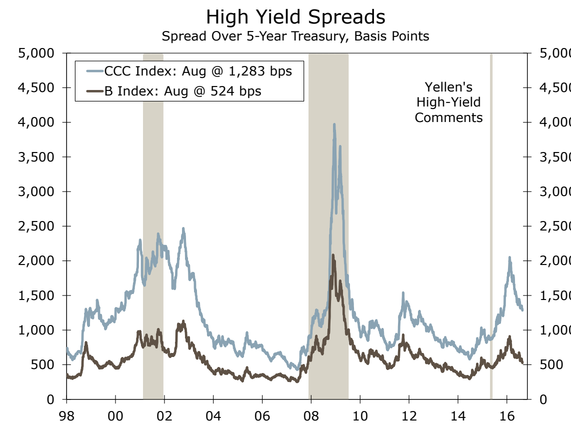
Credit Standards: Move to Tighter Standards

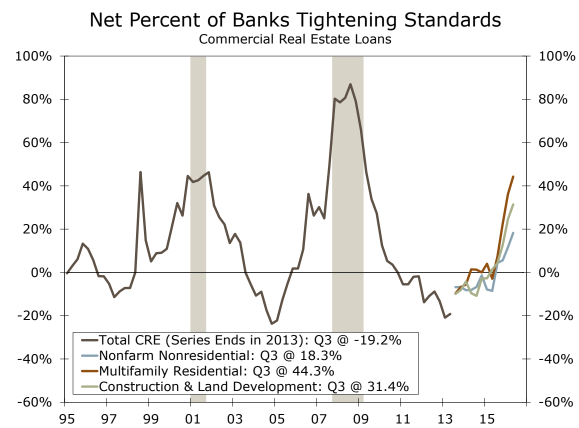
Over the economic cycle, banks adjust their lending standards but, unfortunately, the dynamic adjustment of credit standards appears to impart a very pro-cyclical bias to the credit cycle. From the middle graph, we can see that the percentage of banks that tighten credit drops dramatically in the early phase of an economic recovery (1992-1994, 2002-2004, 2010-2011) and remains low for most of the economic expansion. Then the percentage of banks that tighten credit rises sharply just before a recession (1999-2000, 2007-2008). This credit cycle, while certainly rational from an individual bank's point of view, becomes quite pro-cyclical when viewed in the aggregate. We have entered the tighter credit phase of this cycle.

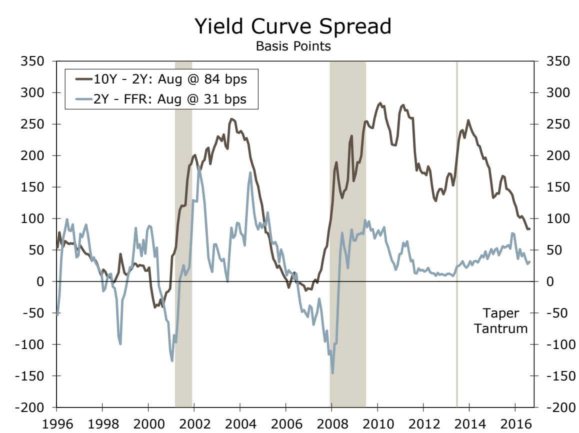
For Whatever the Reason: A Flatter Yield Curve

Ever since the taper tantrum in 2013, there have been two distinct moves in the yield curve as illustrated in the bottom graph. The long-end of the yield curve has exhibited a bullish flattening trade with the decline in the 10-year/two-year spread. This reflects the yield pick-up for U.S. Treasury debt relative to what is available for investors in Europe and Japan, while also reflecting the incentive of a stronger dollar to attract foreign inflows. Meanwhile, the short end of the yield curve reflects the anticipation of a FOMC increase in rates or at least some form of tighter policy going forward.

Uncertainty in financial markets provides the motivation for two distinct moves. First, investor uncertainty at the global level has prompted a safe-haven move into U.S. Treasury debt. Meanwhile, uncertainty on the economic outlook limits the extent of Fed tightening of policy as well as the private market discounting of future fed funds moves.







Source: FactSet, Federal Reserve Board and Wells Fargo Securities

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	0.50	0.50	0.75	0.75	1.00	1.00	1.25
3 Month LIBOR	0.27	0.28	0.33	0.61	0.63	0.65	0.80	0.95	0.95	1.20	1.20	1.45
Prime Rate	3.25	3.25	3.25	3.50	3.50	3.50	3.50	3.75	3.75	4.00	4.00	4.25
Conventional Mortgage Rate	3.77	3.98	3.89	3.96	3.69	3.57	3.54	3.56	3.59	3.62	3.66	3.69
3 Month Bill	0.03	0.01	0.00	0.16	0.21	0.26	0.29	0.49	0.57	0.78	0.84	1.02
6 Month Bill	0.14	0.11	0.08	0.49	0.39	0.36	0.40	0.60	0.67	0.88	0.94	1.12
1 Year Bill	0.26	0.28	0.33	0.65	0.59	0.45	0.50	0.69	0.75	0.96	1.01	1.22
2 Year Note	0.56	0.64	0.64	1.06	0.73	0.58	0.68	0.84	0.93	1.14	1.23	1.36
5 Year Note	1.37	1.63	1.37	1.76	1.21	1.01	1.08	1.19	1.22	1.36	1.41	1.50
10 Year Note	1.94	2.35	2.06	2.27	1.78	1.49	1.49	1.53	1.57	1.62	1.68	1.73
30 Year Bond	2.54	3.11	2.87	3.01	2.61	2.30	2.19	2.23	2.30	2.33	2.35	2.38

Forecast as of: August 10, 2016

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

	2016	2017
Change in Real Gross Domestic Product		
Wells Fargo	1.5	2.0
FOMC	1.9 to 2.0	1.9 to 2.2
Unemployment Rate		
Wells Fargo	4.7	4.5
FOMC	4.6 to 4.8	4.5 to 4.7
PCE Inflation		
Wells Fargo	1.4	2.0
FOMC	1.3 to 1.7	1.7 to 2.0
"Core" PCE Deflator		
Wells Fargo	1.7	1.7
FOMC	1.6 to 1.8	1.7 to 2.0

Forecast as of: August 10, 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: June 15, 2016

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

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