Economic Analysis

Long-Term Rate Volatility Is Within Historic Norms

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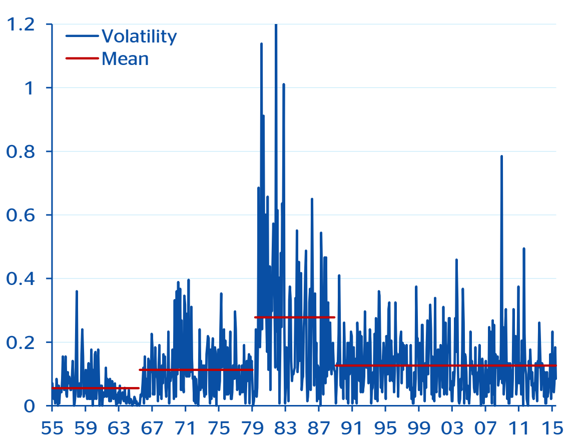
- **The long-term yield volatility increase is much milder in comparison to the "taper tantrum"**
- **The rise in the 10-year treasury yield has eased the compression of medium to long-term treasury term premium curves**
- **The Fed will continue to stress its strategy of clear communication targeted to align market expectations with FOMC projections**

The 10-year treasury yield has reached its highest point since October 2014, closing at 2.41% on Friday, June 5th. Meanwhile the term-premium on long-term bonds has remained low with quick on-and-off decoupling episodes between term premium and inflation expectations. The sudden long-term yield increase resembled the "taper-tantrum" experience, while the volatility jump was much milder with only a 6 basis point increase above the mean compared to a 14 basis point increase in June 2013. The large scale asset purchase programs implemented by the Fed and currently undertaken by the European Central Bank, as well as post-financial crisis regulations, continue to put downward pressure on the duration risk of long-term government bonds. However, the jump in the 10-year treasury yield has eased the compression of medium to long-term treasury term premium curves. Overall, the prevailing supply-demand imbalance in the long-term treasuries market has made the U.S. treasury yield particularly sensitive to both global portfolio rebalancing and to further carry trade capital flows.

In light of unexpected tightening in U.S. financial conditions, the Fed will continue to stress its strategy of clear communication targeted to align market expectations with FOMC projections. Although the tightening is not a direct result of Fed communication, the treasuries market has also readjusted to the Fed speak of steeper Fed funds rate increases. Furthermore, given the added pressure on inflation from the improvement in average hourly earnings coupled with a weaker productivity report, long-term treasury volatility could pick up once again and shift Fed speak conversation towards heightened inflationary pressure.

Chart 1
10-Year U.S. Treasury Yield Volatility (%)

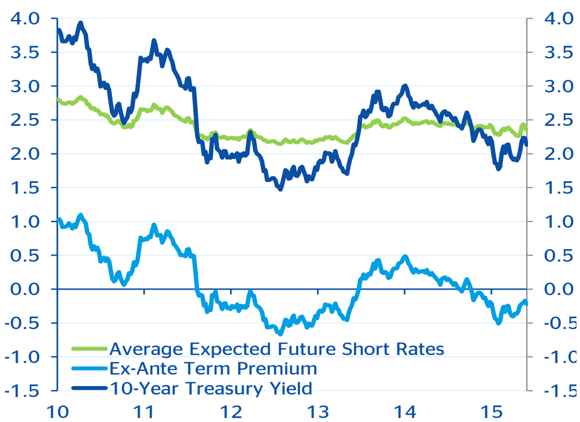


Source: BBVA Research

Chart 2
10-Year U.S. Treasury Note Volatility Index

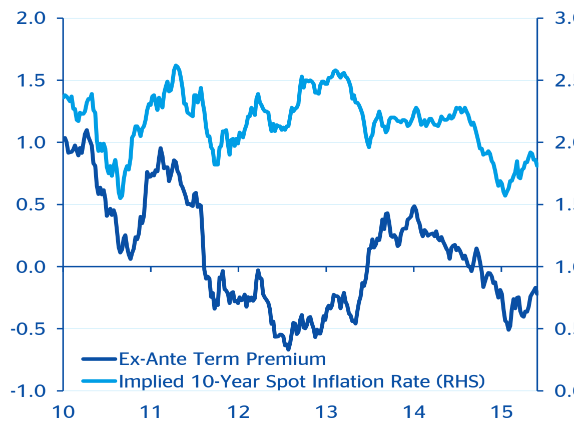
Source: CBOE & BBVA Research

Chart 3
10-Year U.S. Treasury Yield and Term Premium (%)



Source: FRB & BBVA Research

Chart 4
10-Year U.S. Treasury Term Premium and Market Inflation Expectations (%)

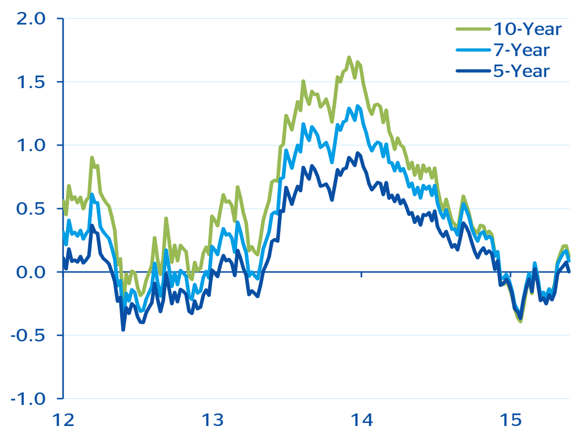


Source: FRB & BBVA Research

Chart 5
Term Premium Spread (%)

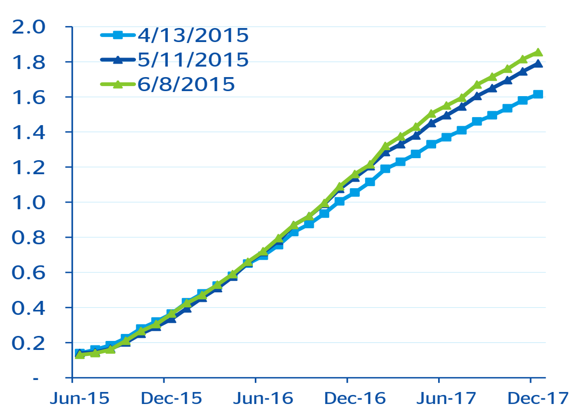
Source: FRBNY & BBVA Research

Chart 6
Term Premium (%)



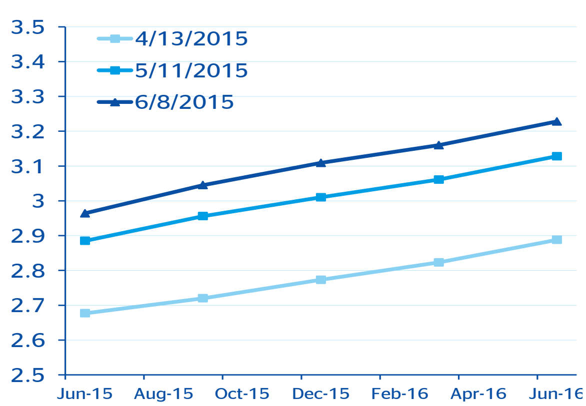
Source: FRBNY & BBVA Research

Chart 7
Fed Funds Futures (%)



Source: Bloomberg & BBVA Research

Chart 8
10-Year U.S. Treasury Yield Futures (%)



Source: Bloomberg & BBVA Research

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