Takeaways

❖ The FOMC announced the start of the balance sheet normalization process to begin in October while maintained the Fed funds rate target range at 1%-1.25%

❖ The FOMC participants’ trajectory for the Fed funds rate has maintained an additional rate hike by the end of 2017, revealed elevated uncertainty around the 2018-2020 path, while the longer-run median declined by 25 basis points

❖ The Fed funds futures market has aligned with the FOMC, pricing in a December 2017 rate hike with a 78% implied probability

❖ As geopolitical risks take backstage, the 10-Year Treasury yield has normalized to the higher rates seen in July, in line with attrition of the Fed’s reinvestment policy already priced in

❖ The yield curve is expected to flatten due to upward pressure on short-term rates from the Fed funds rate hikes while long-term yields will remain under downward pressure from safe-haven flows and low term-premium
Unconventional Monetary Policy

FEDERAL FUNDS RATE AND 10-YEAR TREASURY NOTE (%)

Source: BBVA Research, Federal Reserve Board and Haver Analytics
FOMC 2017 and 2018 Policy Firming Trajectory Medians Remain Unchanged with a 25 Basis Points Decline in the Longer-Run

Source: BBVA Research, Federal Reserve Bank of New York and Federal Reserve Board
A Fifth Rate Hike is Priced in for December 2017

FED FUNDS FUTURES IMPLIED PROBABILITIES, FIFTH 25BP HIKE

Source: BBVA Research and Bloomberg
Fed Funds Futures Rise as the FOMC Near-Term Policy Outlook Firms

Source: BBVA Research and Bloomberg
Fed Funds Firming Pace Forecast

**FEDERAL FUNDS RATE**
(%, Upper Bound, End of Period)

Source: BBVA Research, Federal Reserve Board and Haver Analytics
Baseline Forecasts of Treasury Bill Yield

3-MONTH TO 12-MONTH RATES (%)

Source: BBVA Research, Federal Reserve Board and Haver Analytics
Baseline Forecast of Federal Reserve’s Balance Sheet

FEDERAL RESERVE TOTAL FACTORS SUPPLYING RESERVE FUNDS
(Monthly, Trillions $)

Source: BBVA Research and Federal Reserve Board
Treasuries Monthly Attrition Will Start with $6 Billion Cap in October and Increase to Reach $30 Billion per Month

SOMA* TREASURY SECURITIES MATURITY PROFILE
(Monthly, Billions $)

* The Federal Reserve System Open Market Account (SOMA) is a portfolio of U.S. Treasury and Federal Agency securities, foreign currency investments and reciprocal currency arrangements.

Source: BBVA Research and Federal Reserve Board
Agency Securities Monthly Attrition Will Start with $4 Billion Cap in October and Increase to Reach $20 Billion per Month

SOMA* AGENCY DEBT AND MBS** PAY-DOWN PROFILE
(Monthly, Billions $)

- The Federal Reserve System Open Market Account (SOMA) is a portfolio of U.S. Treasury and Federal Agency securities, foreign currency investments and reciprocal currency arrangements.
- Mortgage-backed security

Source: BBVA Research and Federal Reserve Board
Slow Adjustment of Term Premium to Balance Sheet Normalization

10-YEAR U.S. TREASURY TERM PREMIUM IMPACT
(Basis Points, Term Premium Effect = -100)

-140 -120 -100 -80 -60 -40 -20 0 20 40 60 80 100 120 140

FRB Calculated* Effect  FRB 90% Confidence Interval  BBVA Baseline Effect  BBVA 90% Confidence Interval


Source: BBVA Research and Federal Reserve Board
Long-Term Yield Volatility Has Normalized Substantially Below Its Historic Mean

10-YEAR U.S. TREASURY NOTE VOLATILITY
(Daily index)

Index measures a constant 30-day expected volatility of 10-Year Treasury Note futures prices, and is calculated based on transparent pricing from the Chicago Board of Trade's actively traded options on the Treasury Note futures.

Source: BBVA Research, Chicago Board Options Exchange and Bloomberg
Downward Pressure on Term Premium Softens

10-YEAR U.S. TREASURY TERM PREMIUM & MARKET INFLATION EXPECTATIONS
(Weekly, %)

Source: BBVA Research, Federal Reserve Board and Federal Reserve Bank of New York
Mid-Term Duration-Risk Compression Has Declined to 5 Basis Points

**DURATION-RISK COMPRESSION**
(Daily, %)

Calculated as the difference between 5-Year and 3-Year term premium reported by the New York Fed ACM (Adrian, Crump, and Moench) five-factor, no-arbitrage term structure model incorporating pricing factors.

Source: BBVA Research, Federal Reserve Bank of New York and Haver Analytics
Long-Term Duration-Risk Compression Has Declined to Lows of 2 Basis Points

DURATION-RISK COMPRESSION
(Daily, %)

Calculated as the difference between 10-Year and 5-Year term premium reported by the New York Fed ACM (Adrian, Crump, and Moench) five-factor, no-arbitrage term structure model incorporating pricing factors.

Source: BBVA Research, Federal Reserve Bank of New York and Haver Analytics
Futures Discount an 3.5 Basis Points Raise in 10-Year Treasury Yield Over the Next 3 Quarters

10-YEAR U.S. TREASURY YIELD FUTURES – MOST RECENT, 1 WEEK PRIOR, 4 WEEKS PRIOR, 8 WEEKS PRIOR (%)

Source: BBVA Research and Bloomberg
10-Year Treasury Yield Forecasts

10-YEAR U.S. TREASURY YIELD (%)

- Historic
- Upside Risk
- CBO*** (Yr. Avg, Jun 29)
- Baseline
- NABE* (EOP, Sep 24)
- Administration**** (Yr.Avg, May 23)
- Downside Risk
- SPF** (EOP, Aug. 11)

* National Association for Business Economics (NABE) Outlook median forecast compiled from a panel of NABE members. Last release date September 24, 2017
** Survey of Professional Forecasters (SPF) conducted by Federal Reserve Bank of Philadelphia. Last release date August 11, 2017
*** Congressional Budget Office (CBO). Last release date June 29, 2017
**** Administration: 2018 Budget. Last release date May 23, 2017

Source: BBVA Research, NABE, FRB Philadelphia, FRB New York, CBO and Haver Analytics
Yield Curve Slope Forecasts

TREASURY YIELD CURVE SLOPE
(%, 10Y-2Y)

Historic  Baseline  Downside Risk  Upside Risk

Source: BBVA Research, Federal Reserve Board and Haver Analytics
Treasury yield curve baseline forecasts

U.S. TREASURY YIELD CURVE (%)

Treasury yield curve is estimated with a three-factor no-arbitrage model linked to macroeconomic factors measuring growth, inflation and monetary policy. Estimates are based on BBVA research baseline forecast for GDP growth, inflation and Fed funds rate.

Source: BBVA Research, Federal Reserve Board and Haver Analytics
Yield Curve Forecasts

TREASURY YIELD CURVE BASELINE FORECAST
(%, End of Period)

*BBVA Research baseline forecast. Treasury yield curve is estimated with a three-factor no-arbitrage model linked to macroeconomic factors measuring growth, inflation and monetary policy. Estimates are based on BBVA Research baseline forecast for GDP growth, inflation and Fed funds rate.

Source: BBVA Research, Federal Reserve Board and Haver Analytics
Swap Curve Baseline Forecasts

U.S. SWAP RATES (%)

Source: BBVA Research, Federal Reserve Board and Haver Analytics
LIBOR Curve Baseline Forecasts

U.S. DOLLAR LIBOR RATES
(\%)
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