Takeaways

- The FOMC March meeting will be Powell's first as Chair. The January minutes confirm that the Committee views the tax cuts with optimism and developments abroad as an additional tailwind, expecting the economy to run above potential for the medium-run. Markets have interpreted Chairman Powell’s stance at the two-day Congressional testimony as hawkish.
  
  “We’ve seen continuing strength in the labor market. We’ve seen some data that will, in my case, add some confidence to my view that inflation is moving up to target. We’ve also seen continued strength around the globe, and we’ve seen fiscal policy become more stimulative.”

- Fed funds futures are pricing in three rate increases for 2018. A March rate increase is fully priced in and the implied probability for a subsequent hike in June is at 98%.

- An increase in long-term yields is supported by a soft but sustained increase in Inflation expectations and moderate upward pressures on term premium. However, term-premium remains negative with near zero long-term duration-risk compression.

- Given that the recent budget deal is expected to result in higher economic growth and inflation, we revised upward our interest rates forecasts. We now expect the Fed to raise rates four times – 25 basis point each, in 2018.

- The baseline remains for a gradual increase in long-term yields stabilizing at a higher rate over the forecast horizon due to higher growth, adjustment to higher inflation expectations, and higher term premium.
Unconventional monetary policy

FEDERAL FUNDS RATE AND THE 10-YEAR TREASURY NOTE

Source: BBVA Research, Federal Reserve Board and Haver Analytics
Dealers’ expectations for the long-run fed funds rate remain in line with the median FOMC projection of 2.75%
Fed funds futures are aligned with the FOMC 2018 trajectory

Source: BBVA Research and Bloomberg
Fully priced in March rate hike and 98% probability of a seventh rate increase in June

FED FUNDS FUTURES IMPLIED PROBABILITIES, SEVENTH 25BP HIKE

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
Long-term yield volatility remains low relative to 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
Modest upward pressure term premium coupled with a mild increase in inflation expectations

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 increases to 3 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 stabilizes in negative territory

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 a 12 basis point rise in 10-year Treasury yields over the next 3 quarters

Source: BBVA Research and Bloomberg
10-year Treasury yield forecasts

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

- **Historic**
- **Upside Risk** (Yr.Avg, Feb. 12)
- **Administration** (Yr.Avg, Feb. 12)
- **Baseline**
- **NABE** (EOP, Dec. 3)
- **WSJ EFS** (EOP, Feb. 1)
- **Downside Risk**
- **SPF** (EOP, Feb. 9)

*National Association for Business Economics (NABE) Outlook median forecast compiled from a panel of NABE members. Last release date December 3, 2017*

**Survey of Professional Forecasters (SPF) conducted by Federal Reserve Bank of Philadelphia. Last release date February 9, 2018***

**Administration: 2018 Budget. Last release date February 12, 2018**

**Economic Forecasting Survey. The Wall Street Journal surveys a group of more than 60 economists on a monthly basis. Last release date February 1, 2018**

Source: BBVA Research, NABE, FRB Philadelphia, FRB New York, CBO, WSJ 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
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
Treasury yield curve baseline forecasts

**U.S. TREASURY YIELD CURVE**

(%)  

Source: BBVA Research, Federal Reserve Board and Haver Analytics

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.
Swap curve baseline forecasts

U.S. SWAP RATES
(%)
LIBOR curve baseline forecasts

U.S. DOLLAR LIBOR RATES (%)

Source: BBVA Research, Federal Reserve Board and Haver Analytics
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