Creating Opportunities

US Interest rates monitor

Treasury yields likely to increase further; they will peak once the Fed is done tightening

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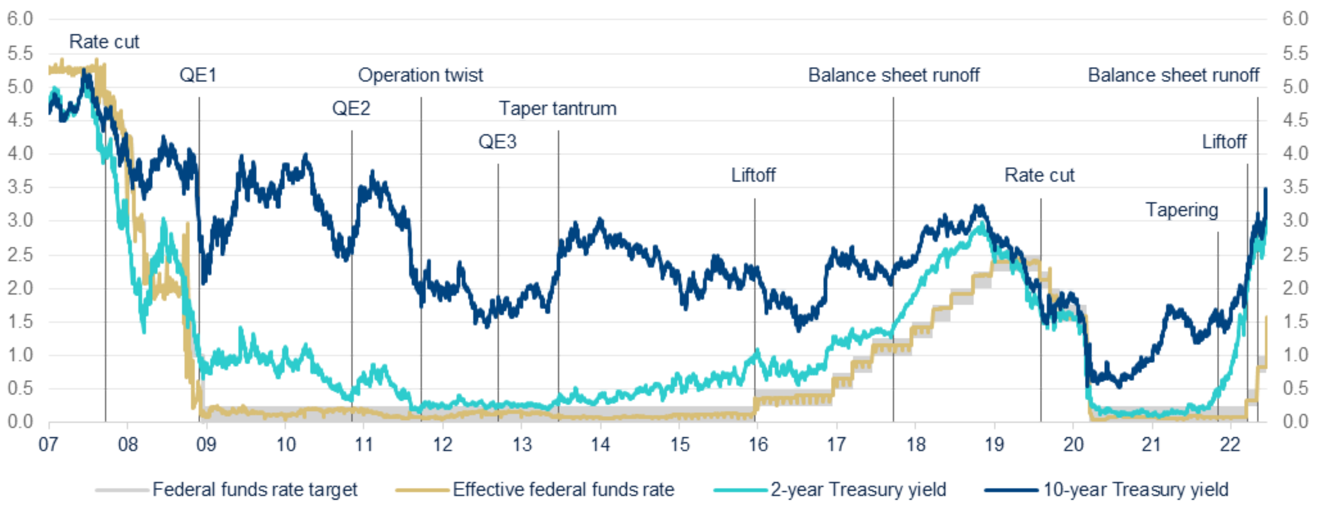
June 20, 2022

Slowing demand to bring down inflation without significant pain is "not getting any easier"; markets (still?) price in a soft landing

- With the Fed set to hike rates to a "modestly restrictive level" by year-end, the tightening pace is already faster than the one seen in the 1994-95 hiking cycle (Figure 3).
- The 2-year yield rose beyond 3.0% (Figure 4) and although long-term yields also increased sharply (Figure 5), shorter-term rates soared on revised policy rate expectations (Figure 6) and the yield curve flattened (Figure 7).
- Overall, current Treasury yield spreads seem to continue to price in a soft landing. The 10y3m Treasury yield slope (at 162 bps as of June17th) is not currently pointing to high recession odds (Figure 10).
- Market-based inflation expectations point to continued confidence that, over the longer term, the Fed will be able to bring down inflation to the 2.0% target (Figure 16).
- Futures markets are currently pricing that the fed funds rate will peak above 3.5% in mid-2023 (Figures 20 and 21) which is broadly in line with the updated fed funds rates central tendency FOMC projections (Figure 29).

The FOMC stepped up its tightening pace (+75 bps to 1.50%-1.75%); a hint (likely from the Fed) in a WSJ note before the meeting signaled a more aggressive approach and sharply reshaped policy expectations

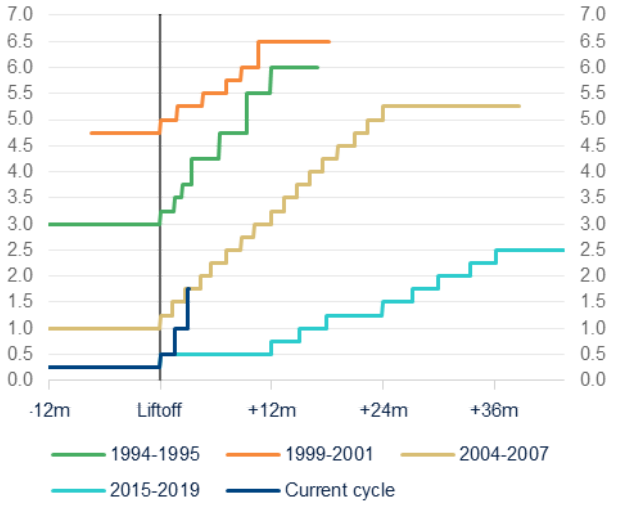
Figure 1. **2-YEAR, 10-YEAR TREASURY YIELDS AND FED FUNDS RATE** (CONSTANT MAT., DAILY DATA, %)



Source: BBVA Research based on data by Haver Analytics.

Even though Chair Powell signaled that multiple consecutive 75 bps hikes were unlikely, …

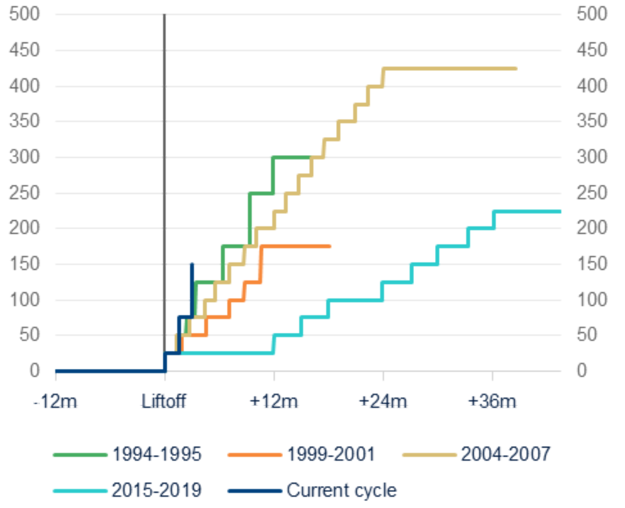
Figure 2. **FED FUNDS RATE IN TIGHTENING CYCLES** (DAILY DATA, %)



Target rate for the 1994-1995, 1999-2001, and 2004-2007 cycles; upper limit of the target rate range for the 2015-2019 and current cycles.
Source: BBVA Research based on data by Haver Analytics.

… the pace of rate hikes is already faster than the one seen in the 1994-95 cycle

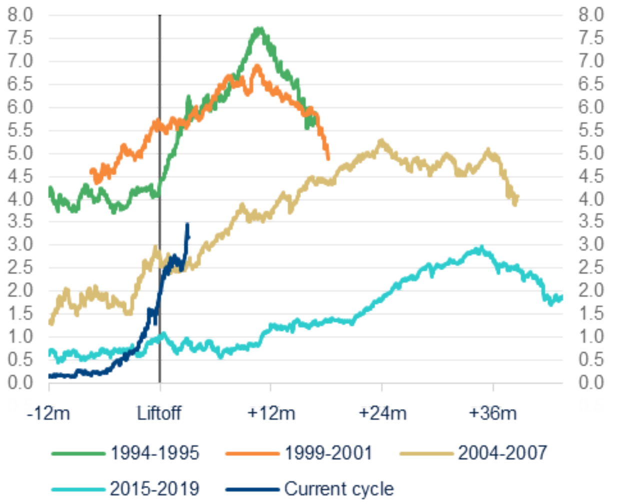
Figure 3. **FED FUNDS RATE IN TIGHTENING CYCLES** (DAILY DATA, BPS VS RATE LEVEL AT LIFTOFF)



Target rate for the 1994-1995, 1999-2001, and 2004-2007 cycles; upper limit of the target rate range for the 2015-2019 and current cycles.
Source: BBVA Research based on data by Haver Analytics.

The 2-year Treasury yield exceeded the 3.0% threshold for the first time in the current cycle…

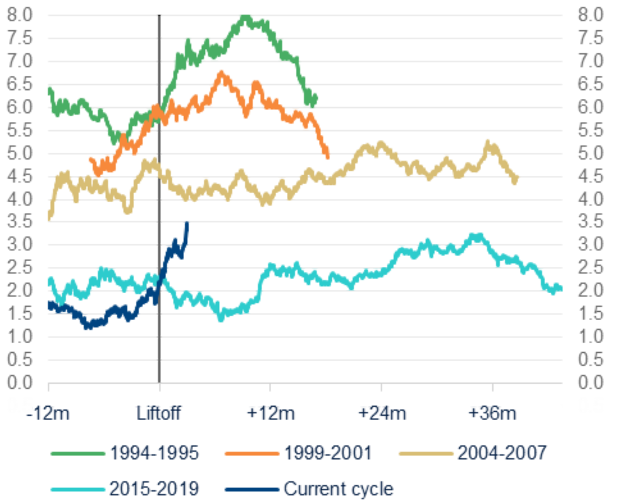
Figure 4. **2-YEAR TREASURY YIELD IN TIGHTENING CYCLES** (CONSTANT MAT., DAILY DATA, %)



Source: BBVA Research based on data by Haver Analytics.

… while longer-term yields have also risen sharply, but remain relatively low

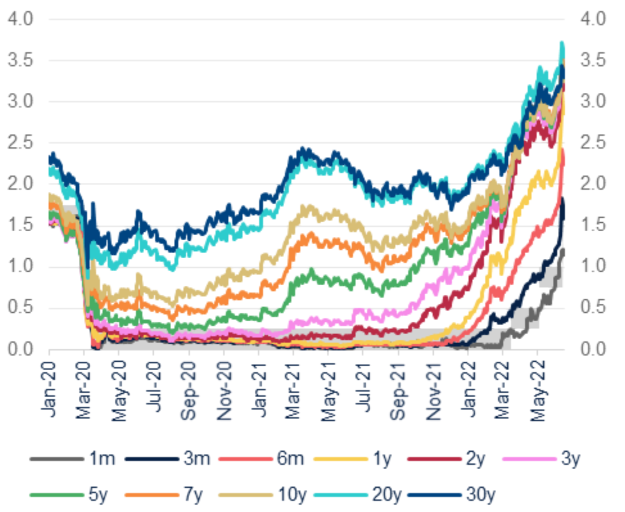
Figure 5. **10-YEAR TREASURY YIELD IN TIGHTENING CYCLES** (CONSTANT MAT., DAILY DATA, %)



Source: BBVA Research based on data by Haver Analytics.

Short-term Treasury yields soared on revised expectations following the Fed’s second pivot…

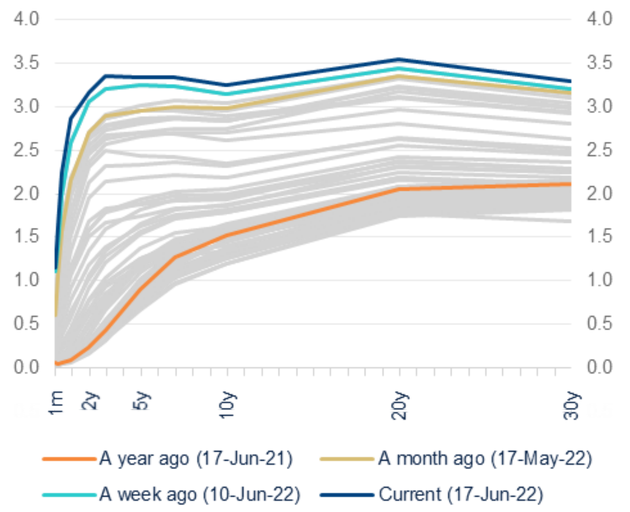
Figure 6. **TREASURY YIELDS**
(CONSTANT MAT., DAILY DATA, %)



The gray area indicates the federal funds rate target range.
Source: BBVA Research based on data by Haver Analytics.

… driving the yield curve towards a flat shape; we think there is still room for a higher overall level

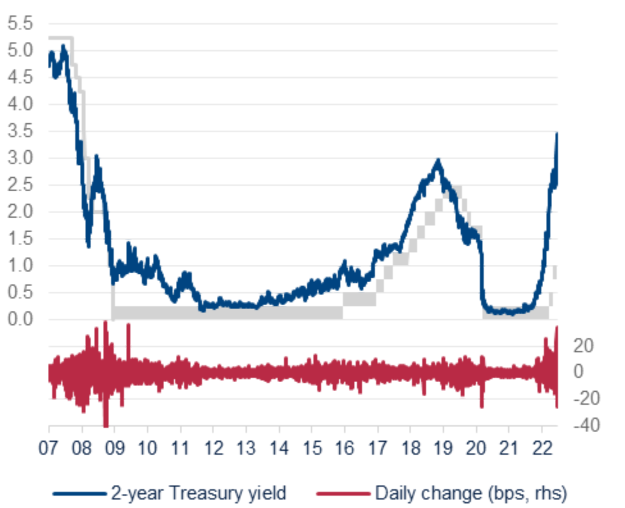
Figure 7. **TREASURY YIELD CURVE**
(CONSTANT MAT., DAILY DATA, %)



The gray lines indicate weekly yield curves from a year ago.
Source: BBVA Research based on data by Haver Analytics.

Uncertainty around inflation has made Fed's forward guidance somewhat less reliable, …

Figure 8. **2-YEAR TREASURY YIELD DAILY CHANGE**
(CONSTANT MAT., DAILY DATA, % AND BPS)



The gray line and area indicate the federal funds rate target.
Source: BBVA Research based on data by Haver Analytics.

… which is reflected in recent episodes of higher volatility in the Treasury market

Figure 9. **10-YEAR TREASURY YIELD DAILY CHANGE**
(CONSTANT MAT., DAILY DATA, % AND BPS)

The gray line and area indicate the federal funds rate target.
Source: BBVA Research based on data by Haver Analytics.

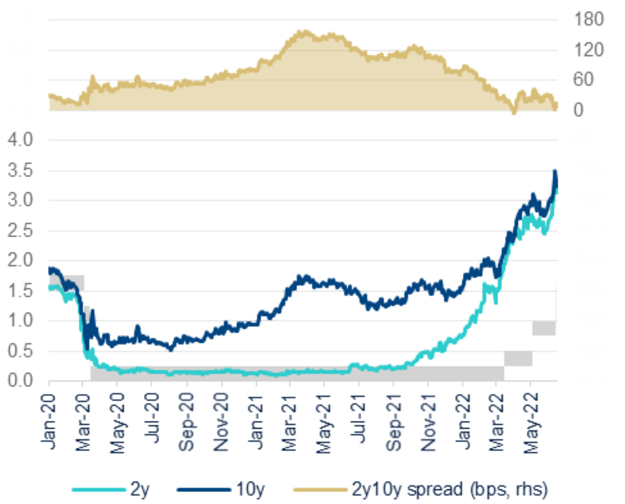
The 10y3m yield spread shrank by around 50 bps from its recent May peak, but it still remains far from signaling an upcoming recession; the 10y2y slope is likely to remain flat through the following months

Figure 10. **TREASURY YIELD SPREADS** (CONSTANT MAT., DAILY DATA, BPS)

Gray shaded areas indicate US recessions as defined by the National Bureau of Economic Research (NBER).
Source: BBVA Research based on data by Haver Analytics.

With a flat yield curve ahead, we expect both 2- and 10-year yields to keep moving in sync…

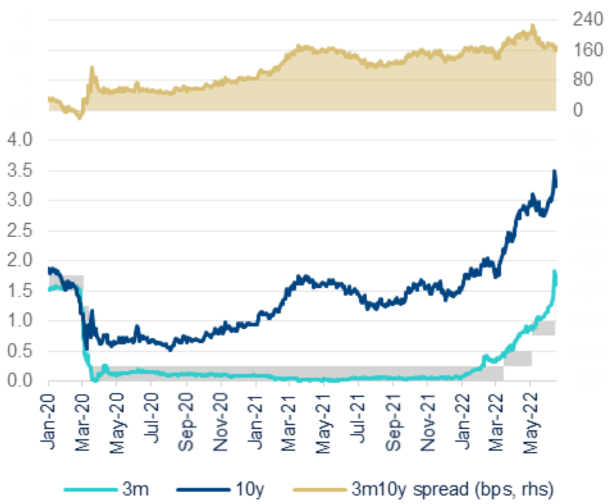
Figure 11. **2Y10Y TREASURY YIELD SPREAD** (CONSTANT MAT., DAILY DATA, % AND BPS)



The gray area indicates the federal funds rate target range.
Source: BBVA Research based on data by Haver Analytics.

… while shorter-term Treasury yields continue to catch up, driven by upcoming Fed hikes

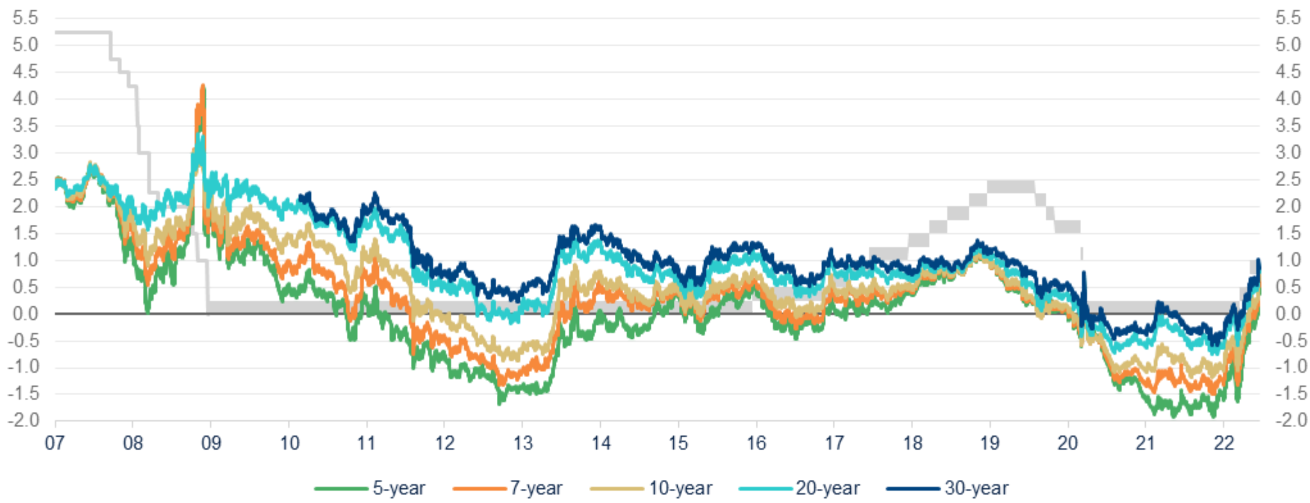
Figure 12. **3M10Y TREASURY YIELD SPREAD** (CONSTANT MAT., DAILY DATA, % AND BPS)



The gray area indicates the federal funds rate target range.
Source: BBVA Research based on data by Haver Analytics.

TIPS yields are now above pre-pandemic levels at all maturities; with nominal yields rising at a similar pace, they are not signaling inflation persistence over the long term

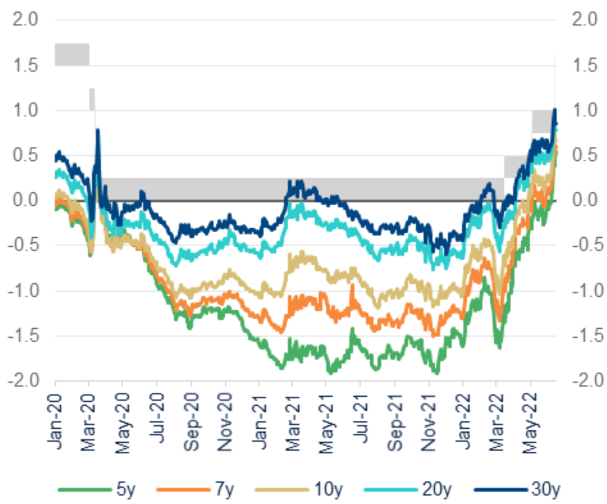
Figure 13. **INFLATION INDEXED TREASURY (TIPS) YIELDS** (CONSTANT MAT., DAILY DATA, %)



The gray line and area indicate the federal funds rate target.
Source: BBVA Research based on data by Haver Analytics.

The era of negative real rates seems to be behind us after almost two years of monetary easing

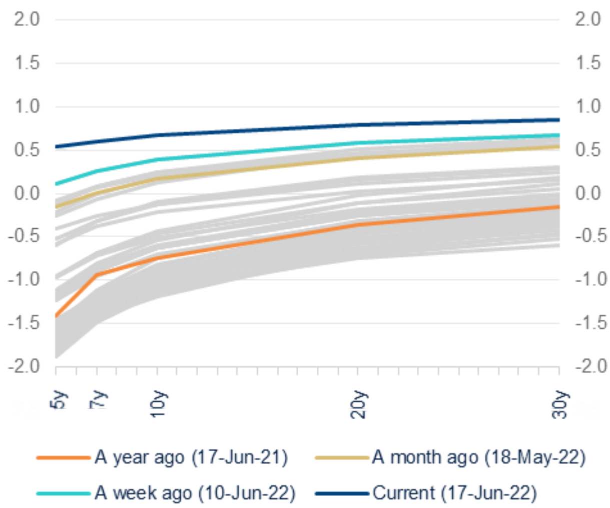
Figure 14. **INFLATION INDEXED (TIPS) YIELDS** (CONSTANT MAT., DAILY DATA, %)



The gray area indicates the federal funds rate target range.
Source: BBVA Research based on data by Haver Analytics.

The 5-year TIPS yield jumped by nearly 70 bps from its then-still-negative end-of-May level

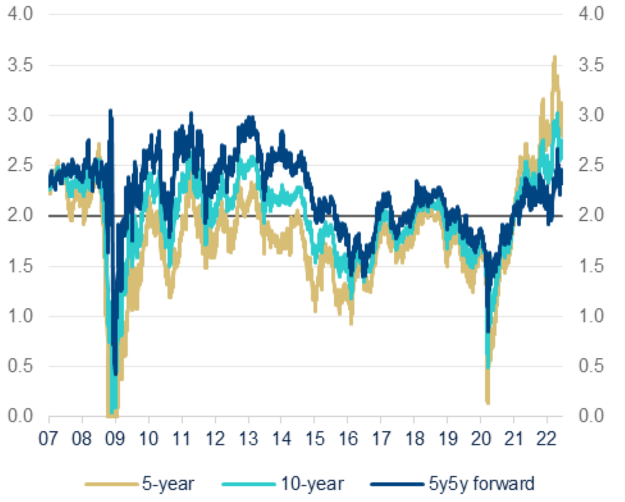
Figure 15. **INFLATION INDEXED (TIPS) YIELD CURVE** (CONSTANT MAT., DAILY DATA, %)



The gray lines indicate weekly yield curves from a year ago.
Source: BBVA Research based on data by Haver Analytics.

Market-based inflation expectations point to continued confidence that, over the longer term…

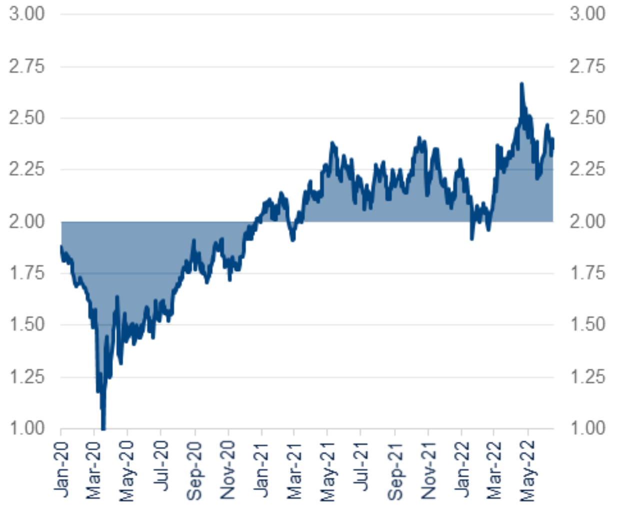
Figure 16. **BREAKEVEN INFLATION RATES**
(CONSTANT MAT., DAILY DATA, %)



Source: BBVA Research based on data by Haver Analytics.

… the Fed will be able to bring down inflation

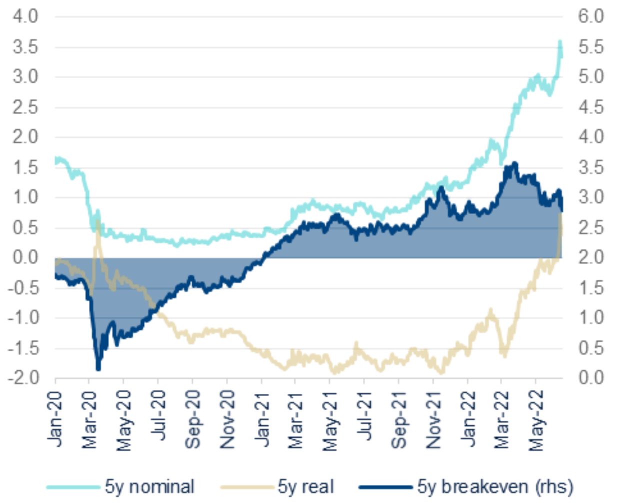
Figure 17. **5Y5Y FORWARD IMPLIED INFLATION RATE**
(CONSTANT MAT., DAILY DATA, %)



The shaded area indicates deviations from the FOMC's inflation target.
Source: BBVA Research based on data by Haver Analytics.

Both the 5- and 10-year breakeven inflation rates have fallen back…

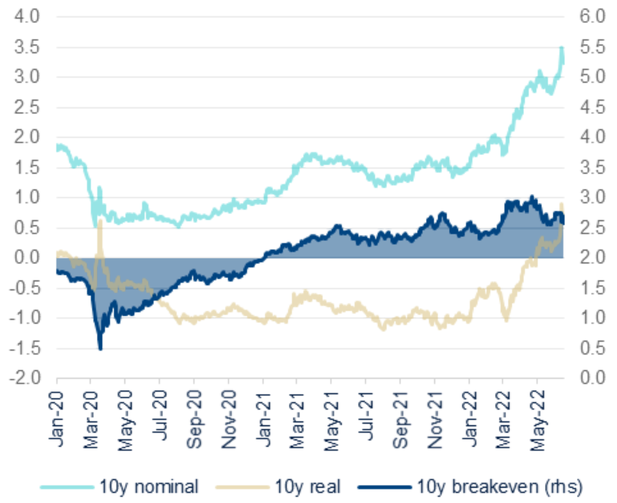
Figure 18. **5-YEAR BREAKEVEN INFLATION RATE**
(CONSTANT MAT., DAILY DATA, %)



The shaded area indicates deviations from the FOMC's inflation target.
Source: BBVA Research based on data by Haver Analytics.

… to levels seen prior the Russian invasion of Ukraine

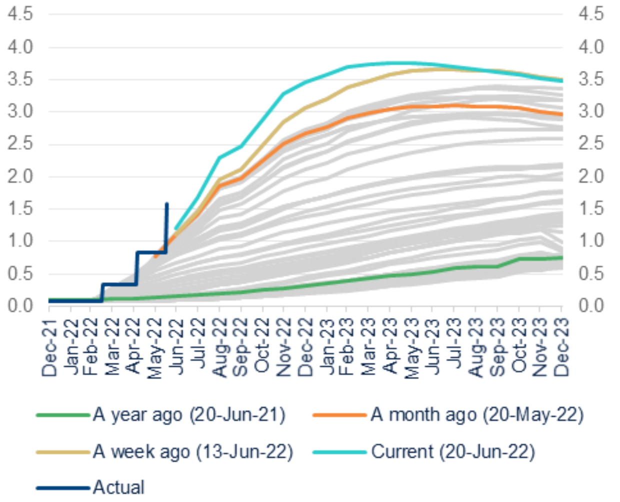
Figure 19. **10-YEAR BREAKEVEN INFLATION RATE**
(CONSTANT MAT., DAILY DATA, %)



The shaded area indicates deviations from the FOMC's inflation target.
Source: BBVA Research based on data by Haver Analytics.

Fed funds rate expectations abruptly adjusted to the new pace of hikes signaled by the Fed

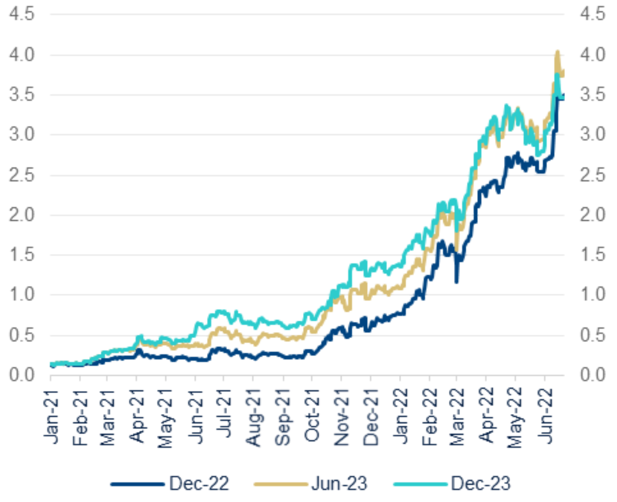
Figure 20. **IMPLIED RATE IN 30-DAY FED FUNDS FUTURES** (DAILY DATA, %)



The gray lines indicate weekly implied rate paths from a year ago.
Source: BBVA Research based on data by Bloomberg.

The fed funds rate is expected to peak above 3.5% by mid-2023

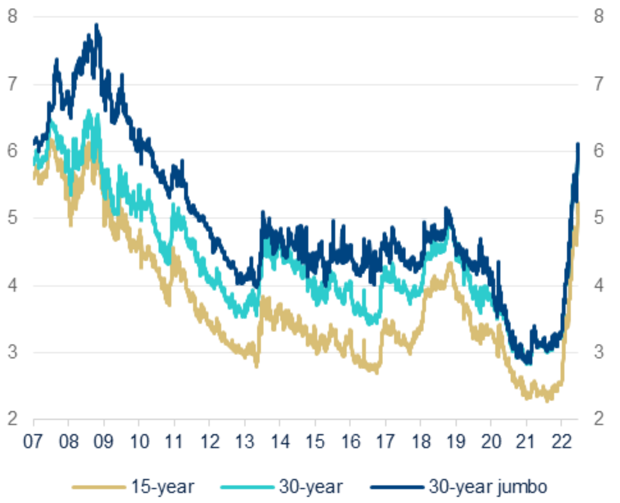
Figure 21. **IMPLIED RATE IN 30-DAY FED FUNDS FUTURES** (DAILY DATA, %)



Source: BBVA Research based on data by Bloomberg.

The housing market will likely cool with mortgage rates reaching highs not seen since late 2010s

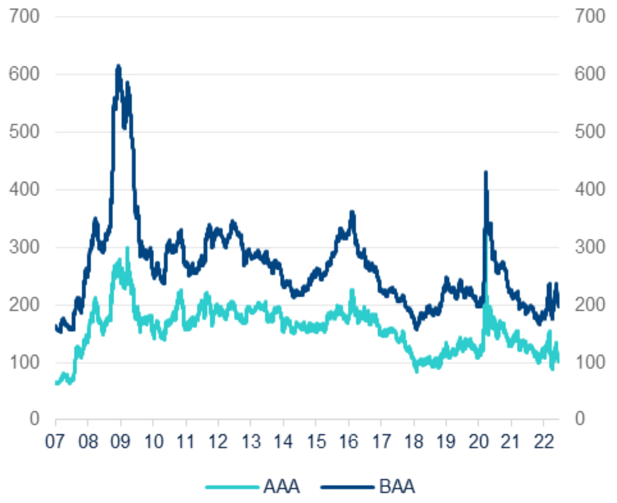
Figure 22. **MORTGAGE RATES** (WSJ CONSUMER FIXED RATES, DAILY DATA, %)



Source: BBVA Research based on data by Haver Analytics.

No signs of credit stress is evident in corporate bond spreads

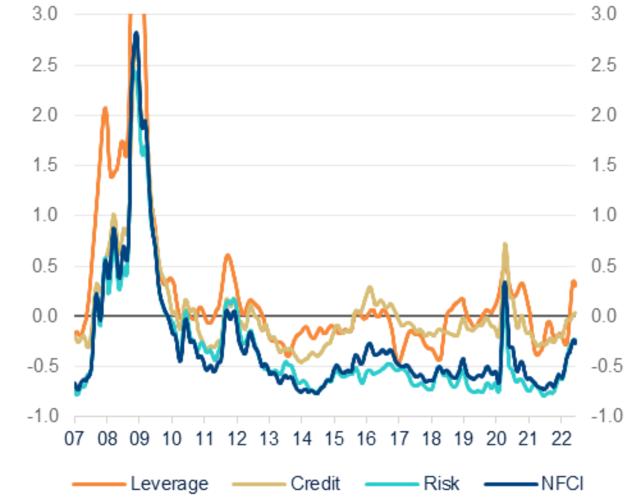
Figure 23. **CORPORATE BOND SPREADS** (MOODY'S SEASONED YIELDS, DAILY DATA, BPS)



Spreads over the 10-year Treasury yield.
Source: BBVA Research based on data by the Federal Reserve Bank of St. Louis and Haver Analytics.

Broad financial conditions indices keep gradually tightening as expected

Figure 24. **CHICAGO FED'S NATIONAL FINANCIAL CONDITIONS INDEX** (>0 = TIGHTER THAN AVG)



Source: BBVA Research based on data by Haver Analytics.

Severe damage to financial markets will be avoided as long as the Fed maintains public trust

Figure 25. **BLOOMBERG FINANCIAL CONDITIONS INDICES** (<0 = TIGHTER THAN PRE-GFC AVG)

Source: BBVA Research based on data by Bloomberg.

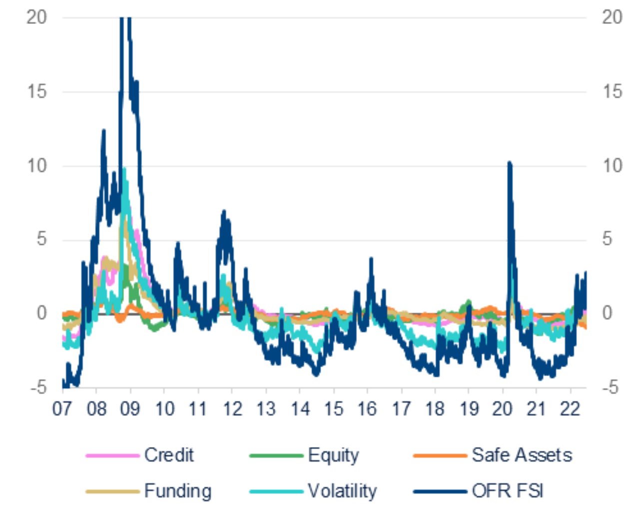
Financial stress indices do not suggest major concerns; this leads us to think that…

Figure 26. **FED'S FINANCIAL STRESS INDICES** (>0 = ABOVE AVG FINANCIAL STRESS)

Source: BBVA Research based on data by Haver Analytics.

… the financial system is likely more prepared than in the past to face a rapid tightening cycle

Figure 27. **OFR FINANCIAL STRESS INDEX** (>0 = ABOVE AVG FINANCIAL STRESS)

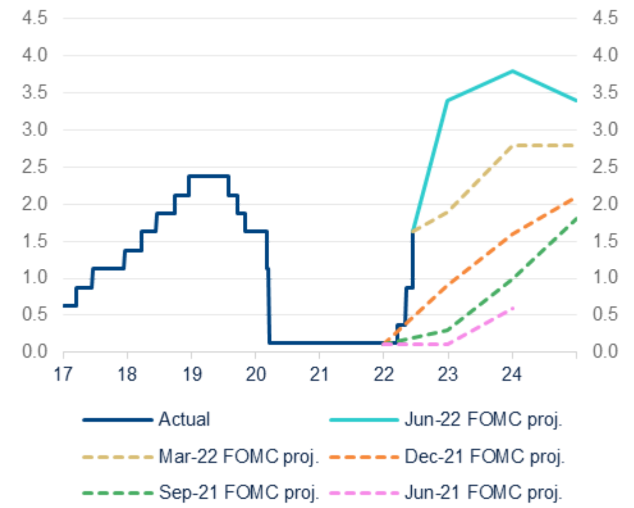


OFR: Office of Financial Research, US Department of the Treasury
Source: BBVA Research based on data by Haver Analytics.

The June Summary of Economic Projections (SEP) showed that FOMC participants revised up their interest rate projections

The updated SEP signaled a much steeper path of rate hikes and more consensus among…

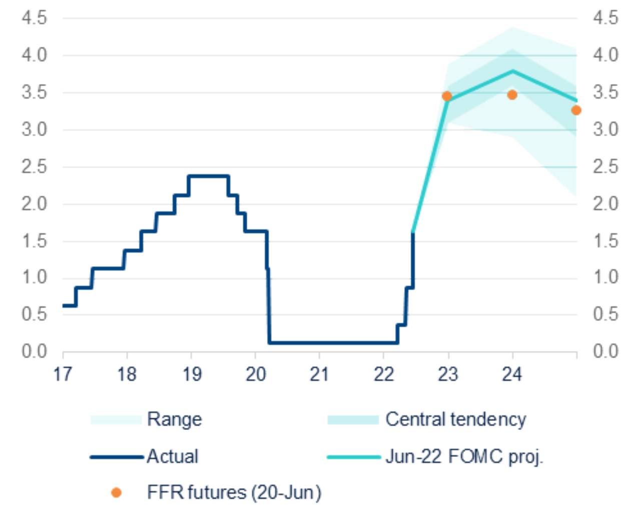
Figure 28. **FOMC PARTICIPANTS PROJECTED FED FUNDS RATE** (MEDIAN PROJECTION, %)



Source: BBVA Research based on data by Haver Analytics.

… FOMC participants on the need to take the fed funds rate to a restrictive level

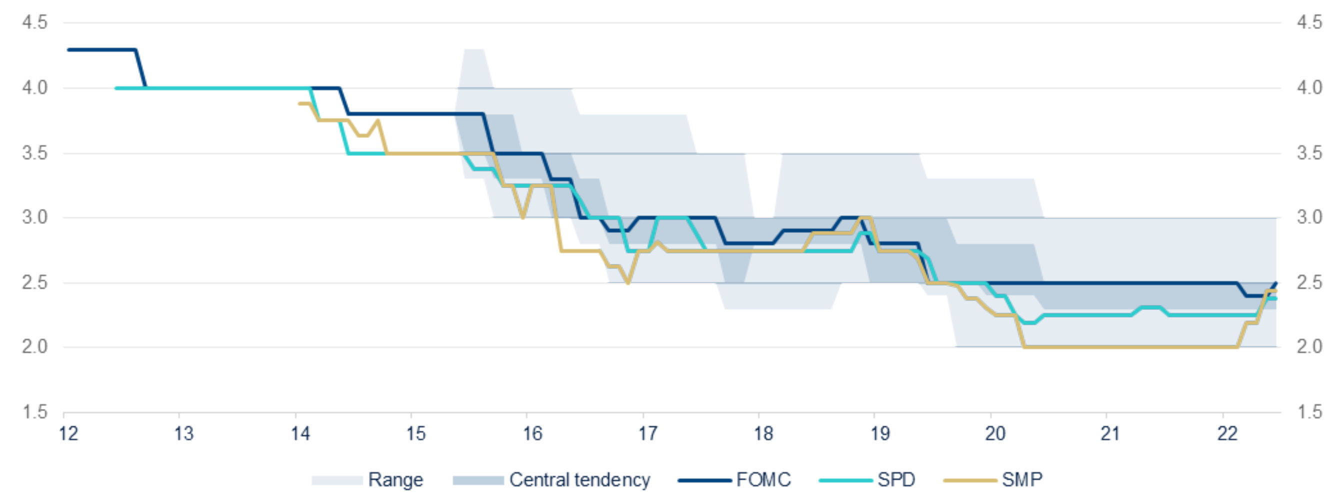
Figure 29. **FOMC PARTICIPANTS PROJECTED FED FUNDS RATE** (MEDIAN PROJECTION, %)



Source: BBVA Research based on data by Haver Analytics and Bloomberg.

The estimated steady-state fed funds rate remain unchanged at the 2.0%-3.0% range; it could likely move upwards in the upcoming years

Figure 30. **PROJECTED LONGER RUN FEDERAL FUNDS RATE** (MEDIAN ESTIMATE, %)



SPD: Survey of Primary Dealers; SMP: Survey of Market Participants. Source: BBVA Research based on data by Haver Analytics.

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