

US Interest rates monitor

Long-term Treasury yields steeped in recession fears as inflation does not (yet) give in to Fed action

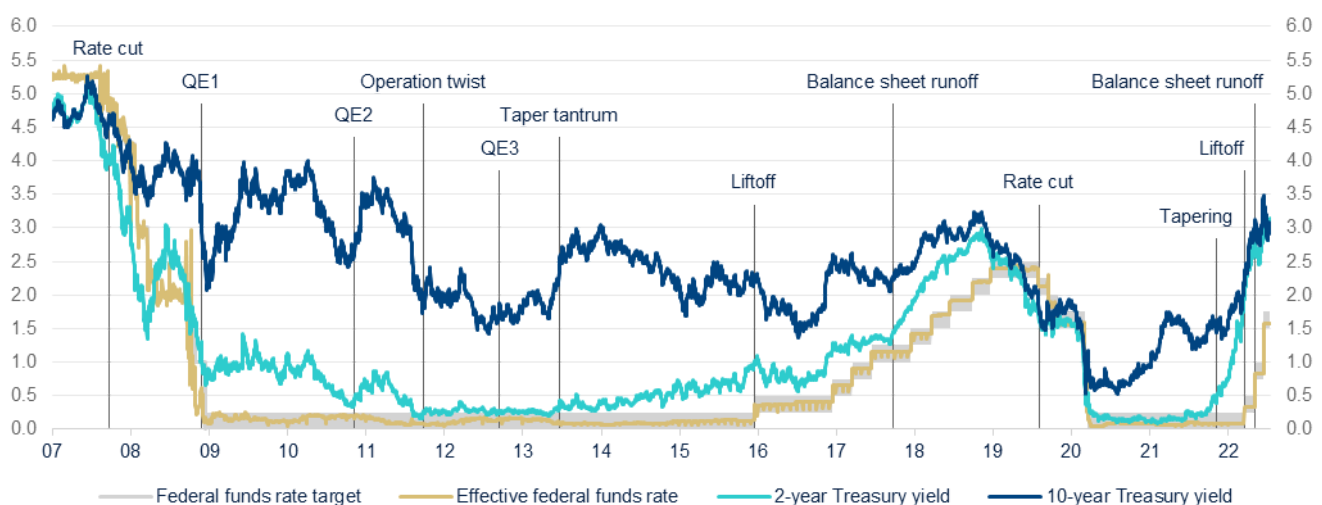
Javier Amador / Iván Fernández
July 19, 2022

Flatter yield curve on rate hike-frontloading and increased growth outlook concerns; are markets about to price in a hard landing?

- With the Fed set to continue front-loading rate hikes to take the fed funds rate above neutral levels by year-end, the current cycle will be the fastest in more than three decades ([Figure 3](#)).
- Both the 2-year and 10-year yields reached c. 3.5% before pulling back somewhat on growth outlook concerns ([Figures 4](#) and [5](#)). With short-term rates soaring on monetary policy and longer-term yields easing on recession fears ([Figure 6](#)), the yield curve flattened further ([Figure 7](#)).
- Overall, current Treasury yield spreads seem to start to price increased recession odds. The 10y3m Treasury yield slope shrank by about 100 bps since mid-June ([Figure 10](#)) and will likely turn negative soon ([Figure 12](#)).
- 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 ([Figures 18](#) and [19](#)).
- Shortly after the June CPI release, the probability of a 100 bps hike climbed up to 80%, but as of now, futures markets are pricing a 2.25-2.50% target rate range after next week's FOMC meeting ([Figures 20](#) and [21](#)).

Last month's sudden 75 bps hike took the 2- and 10-year yields to levels not seen since 2007 and 2011, respectively; both pulled back somewhat as markets continue to assess where the economy might go

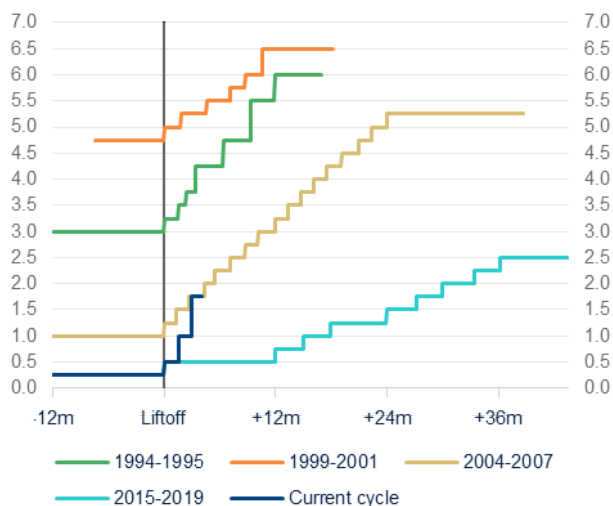
Figure 1. 2-YEAR, 10-YEAR TREASURY YIELDS AND FED FUNDS RATE (CONSTANT MAT., DAILY DATA, %)



Source: BBVA Research based on data by Haver Analytics.

With inflation (9.1% YoY in June) still not offering "clear and compelling" signs of slowing down...

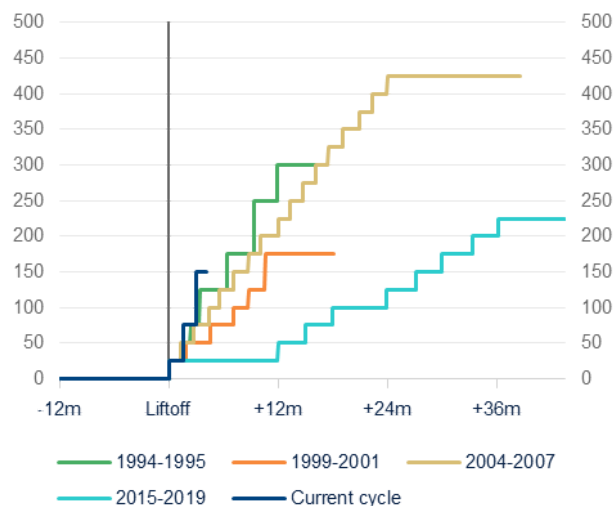
Figure 2. **FED FUNDS RATE IN TIGHTENING CYCLES**
(DAILY DATA, %)



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 Fed is likely to keep front-loading rate hikes above long-run neutral levels as planned

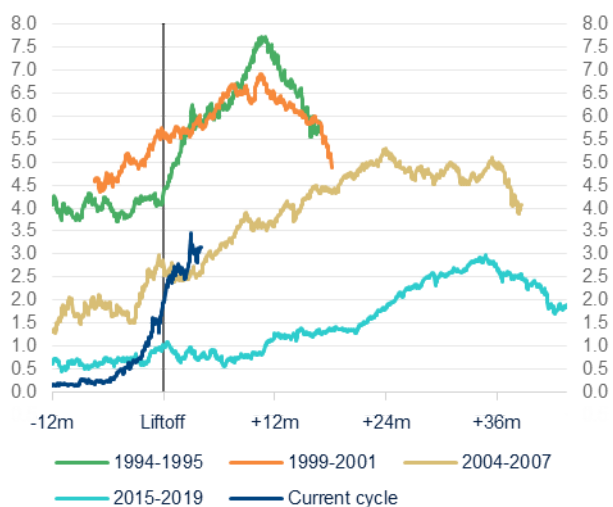
Figure 3. **FED FUNDS RATE IN TIGHTENING CYCLES**
(DAILY DATA, BPS VS RATE LEVEL AT LIFTOFF)



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.

Key Treasury yields evolution still resembles the one registered in the 1990s tightening cycles

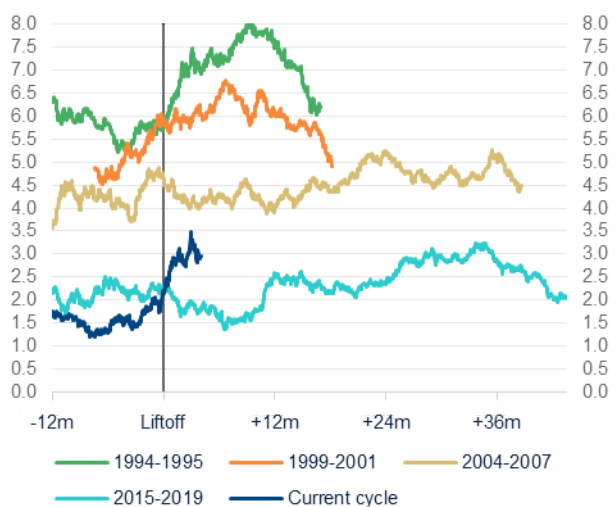
Figure 4. **2-YEAR TREASURY YIELD IN TIGHTENING CYCLES**
(CONSTANT MAT., DAILY DATA, %)



Source: BBVA Research based on data by Haver Analytics.

Treasury yields are likely to continue rising as it is still not clear cut how high the Fed will go

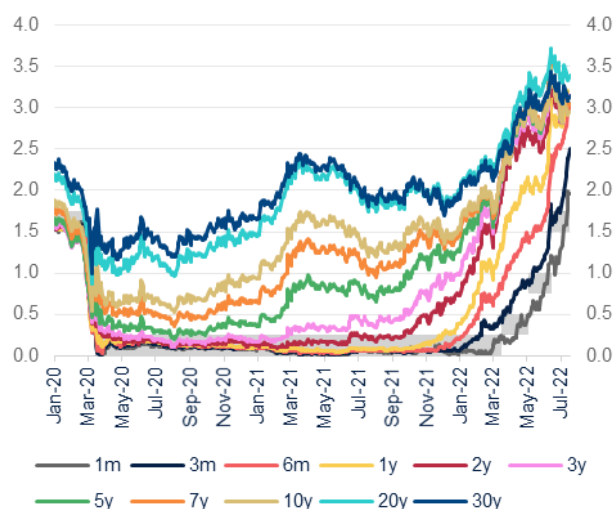
Figure 5. **10-YEAR TREASURY YIELD IN TIGHTENING CYCLES**
(CONSTANT MAT., DAILY DATA, %)



Source: BBVA Research based on data by Haver Analytics.

Shorter yields soar with policy moves, but longer rates ease as recession fears take front stage

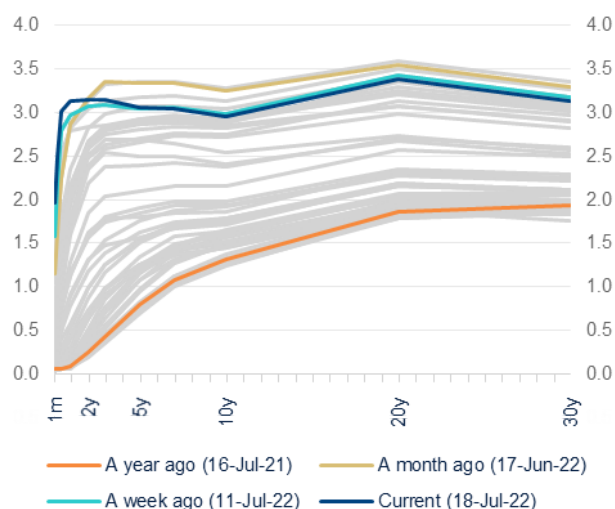
Figure 6. **TREASURY YIELDS**
(CONSTANT MAT., DAILY DATA, %)



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

The yield curve kept flattening, pulling back from its current-cycle peak level reached last month

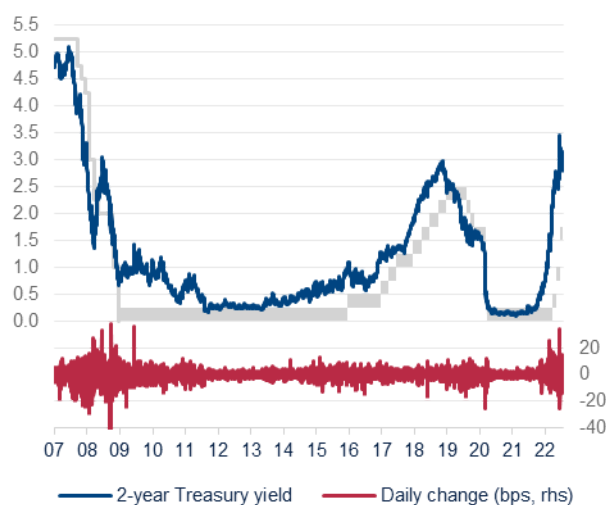
Figure 7. **TREASURY YIELD CURVE**
(CONSTANT MAT., DAILY DATA, %)



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

Volatility in yields will continue as long as economic data keep surprising; looking ahead,...

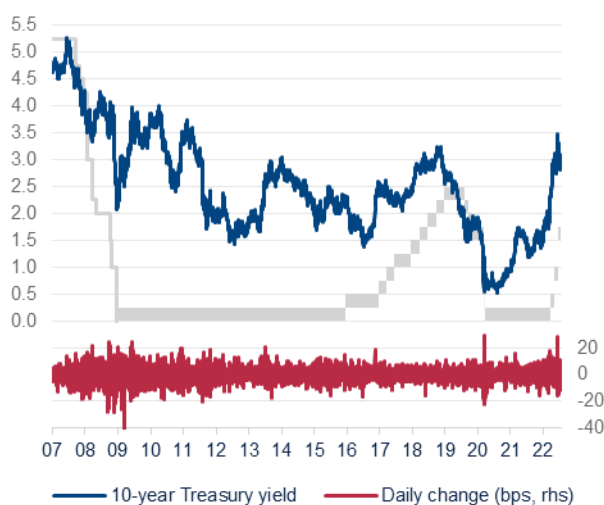
Figure 8. **2-YEAR TREASURY YIELD DAILY CHANGE**
(CONSTANT MAT., DAILY DATA, % AND BPS)



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

... the just-launched QT could offset the safe-asset effect currently pushing down long yields

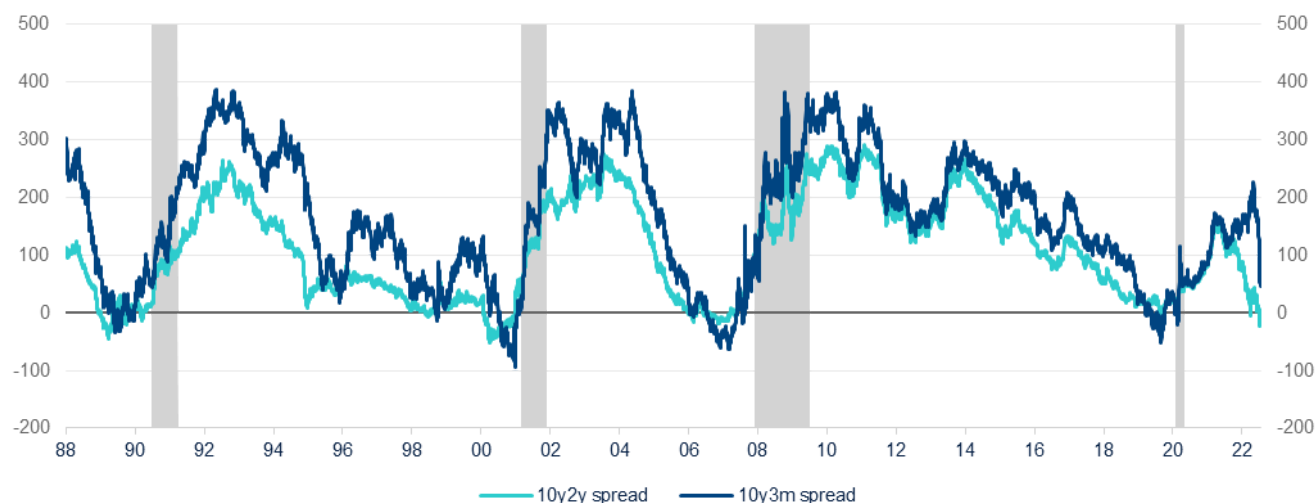
Figure 9. **10-YEAR TREASURY YIELD DAILY CHANGE**
(CONSTANT MAT., DAILY DATA, % AND BPS)



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 100 bps since mid-June as the 3-month Treasury yield reached a maximum of 2.40% last week, a level not seen since the peak of the last tightening cycle in mid-2019

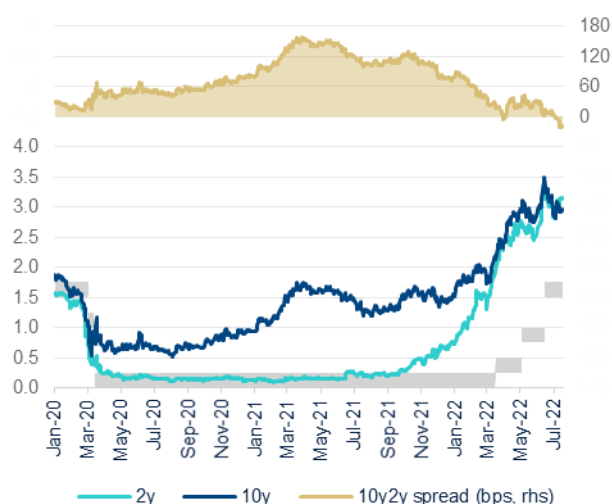
Figure 10. **TREASURY YIELD SPREADS** (CONSTANT MAT., DAILY DATA, BPS)



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.

The 10y2y yield spread is likely to hover around slightly below zero levels in the following months

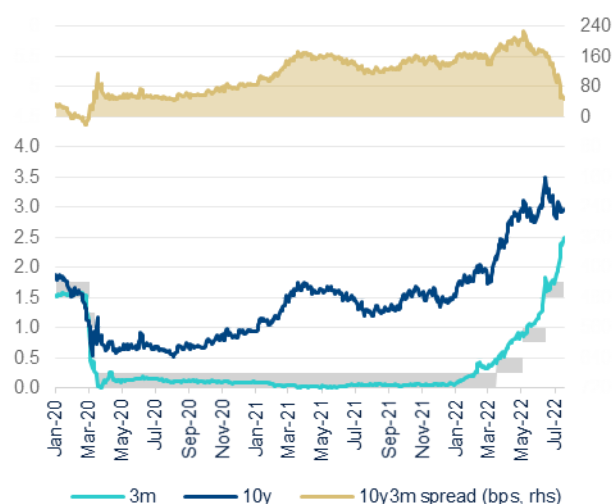
Figure 11. **10Y2Y TREASURY YIELD SPREAD** (CONSTANT MAT., DAILY DATA, % AND BPS)



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

If long-term yields remain stagnant, the 10y3m spread will become negative in one month or two

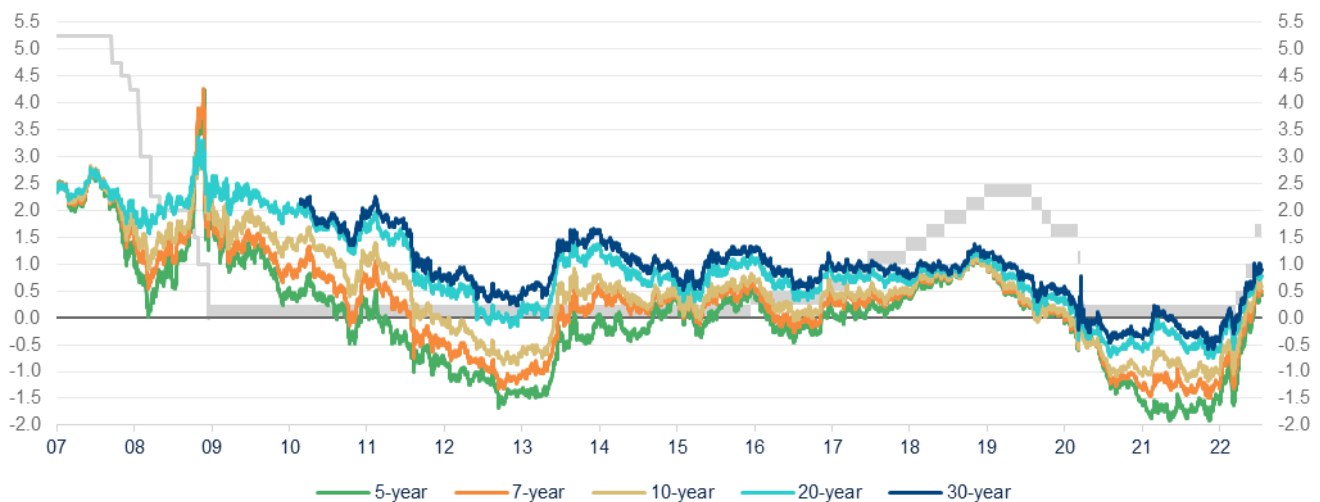
Figure 12. **10Y3M TREASURY YIELD SPREAD** (CONSTANT MAT., DAILY DATA, % AND BPS)



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

Inflation-indexed yields were practically unchanged during the last month despite rising recession fears

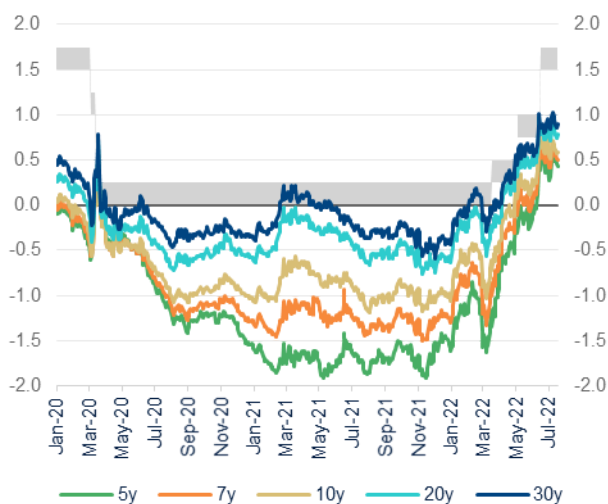
Figure 13. **INFLATION INDEXED TREASURY (TIPS) YIELDS** (CONSTANT MAT., DAILY DATA, %)



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

They will continue to help tighten financial conditions as long as they remain positive, and...

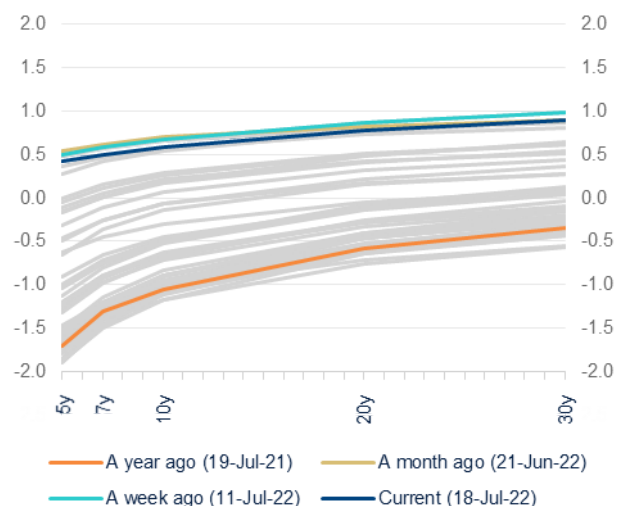
Figure 14. **INFLATION INDEXED (TIPS) YIELDS** (CONSTANT MAT., DAILY DATA, %)



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

... as the nominal yield curve, the TIPS yield curve will keep flattening

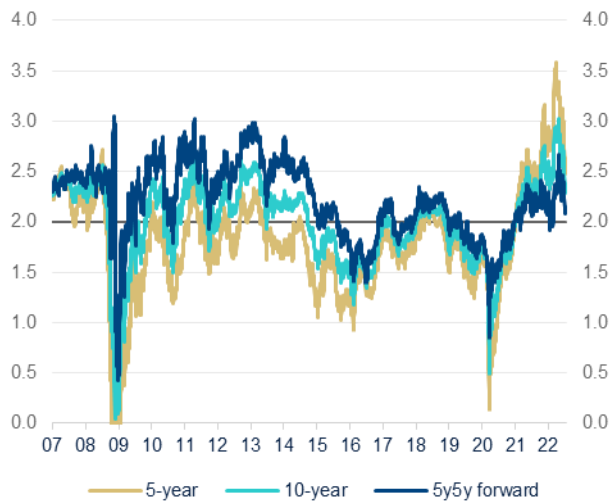
Figure 15. **INFLATION INDEXED (TIPS) YIELD CURVE** (CONSTANT MAT., DAILY DATA, %)



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

Unchanged real yields and stagnant nominal yields pushed inflation expectations down

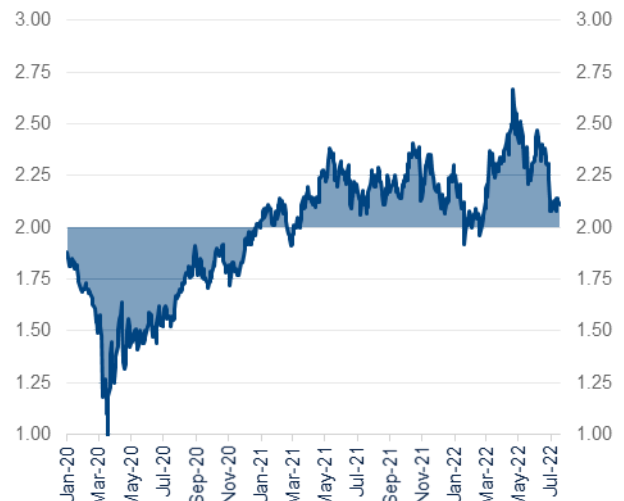
Figure 16. **BREAKEVEN INFLATION RATES**
(CONSTANT MAT., DAILY DATA, %)



Source: BBVA Research based on data by Haver Analytics.

The 5-year average inflation expected 5 years from now dropped to its lowest level in 5 months

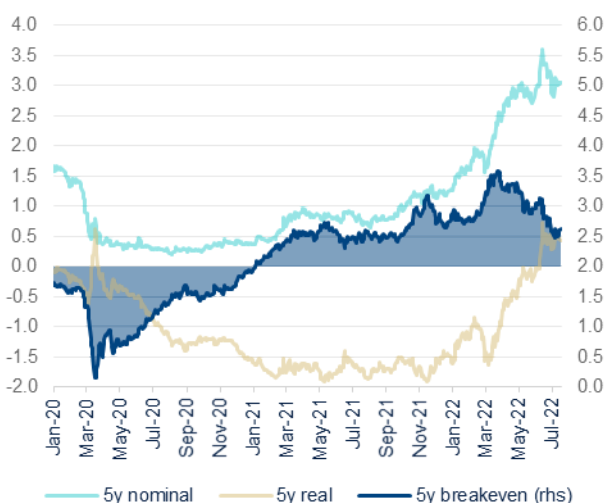
Figure 17. **5Y5Y FORWARD IMPLIED INFLATION RATE**
(CONSTANT MAT., DAILY DATA, %)



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

Investors are still confident that the Fed will be able to bring inflation down over the long term...

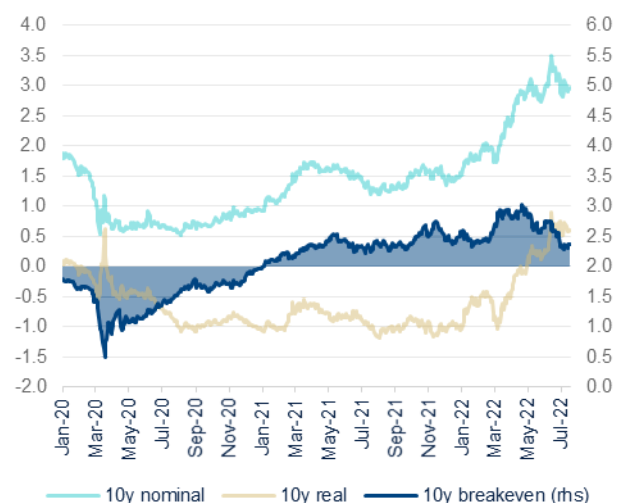
Figure 18. **5-YEAR BREAKEVEN INFLATION RATE**
(CONSTANT MAT., DAILY DATA, %)



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

... and that an inflation easing environment will not accompany an eventual recession

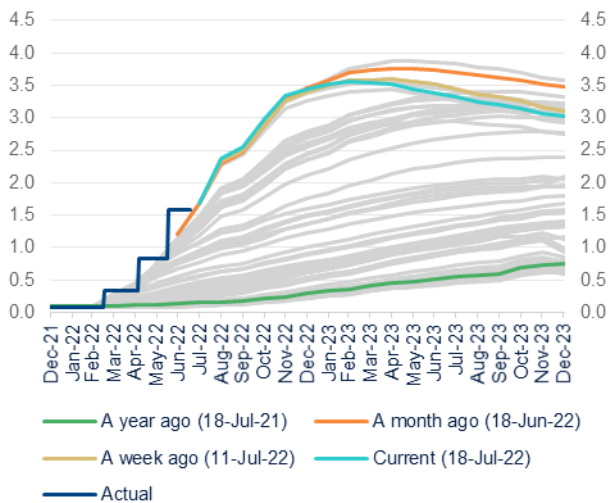
Figure 19. **10-YEAR BREAKEVEN INFLATION RATE**
(CONSTANT MAT., DAILY DATA, %)



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

Shortly after the June CPI release, the implied probability of a 100 bps hike climbed up to 80%

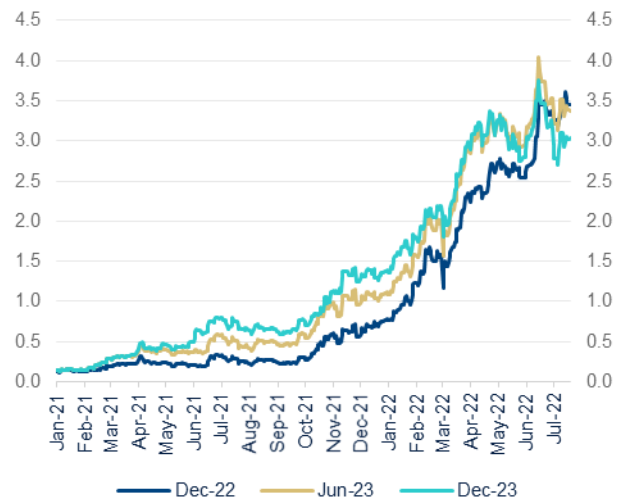
Figure 20. **IMPLIED RATE IN 30-DAY FED FUNDS FUTURES** (DAILY DATA, %)



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

As of now, however, the odds are 3 to 2 for a 75 bps rate hike next week

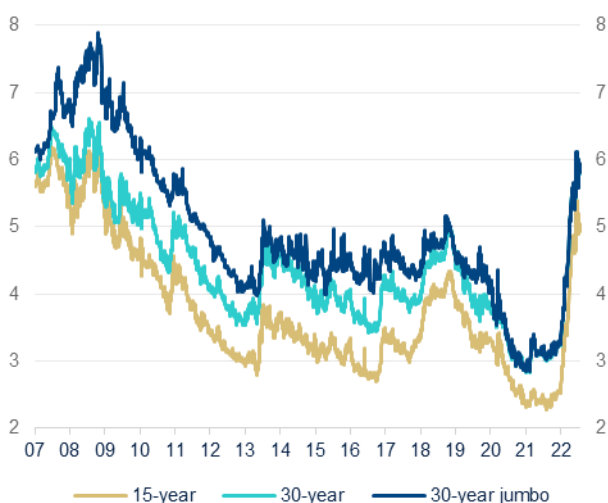
Figure 21. **IMPLIED RATE IN 30-DAY FED FUNDS FUTURES** (DAILY DATA, %)



Source: BBVA Research based on data by Bloomberg.

Mortgage rates eased a bit from their June max figures, though they remain at one-decade highs

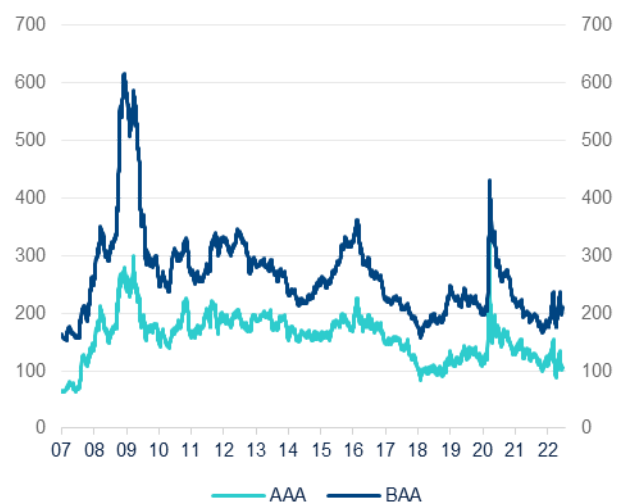
Figure 22. **MORTGAGE RATES** (WSJ CONSUMER FIXED RATES, DAILY DATA, %)



Source: BBVA Research based on data by Haver Analytics.

No signals of credit strains are evident in investment-grade corporate bond spreads

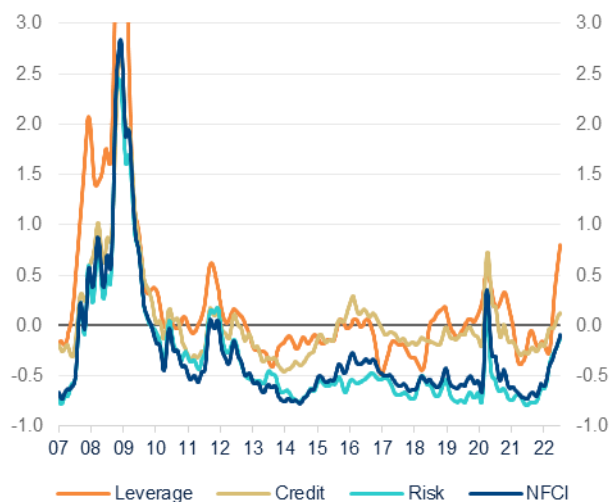
Figure 23. **CORPORATE BOND SPREADS** (MOODY'S SEASONED YIELDS, DAILY DATA, BPS)



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

The spike in the leverage indicator of the NFCI is a clear sign of tightening financial conditions

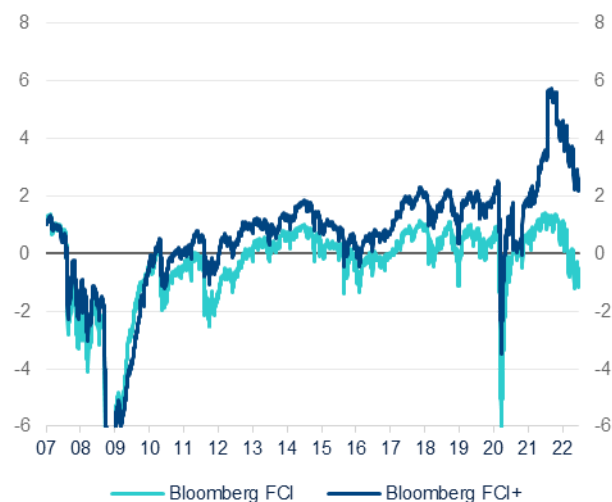
Figure 24. **CHICAGO FED'S NATIONAL FINANCIAL CONDITIONS INDEX (>0 = TIGHTER THAN AVG)**



Source: BBVA Research based on data by Haver Analytics.

However, despite the uncertainty around upcoming policy actions...

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



Source: BBVA Research based on data by Bloomberg.

... broad financial conditions and stress indices do not suggest major concerns; ...

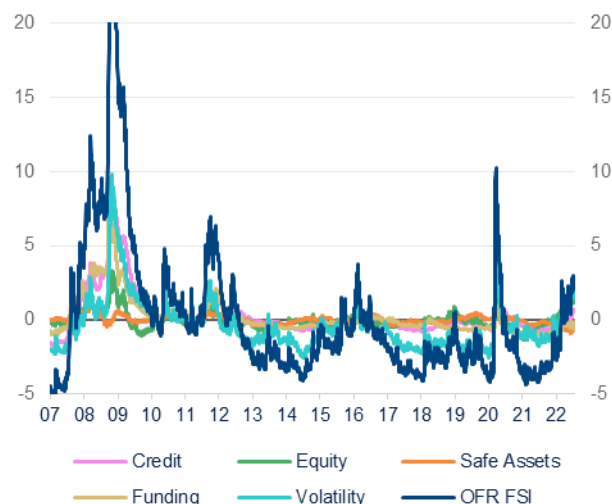
Figure 26. **FED'S FINANCIAL STRESS INDICES (>0 = ABOVE AVG FINANCIAL STRESS)**



Source: BBVA Research based on data by Haver Analytics.

... this would point, up to now, to an orderly ongoing process of monetary normalization

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.

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