

US Interest rates monitor

Treasury yields resumed their bearish trend after Powell’s tough talk on inflation

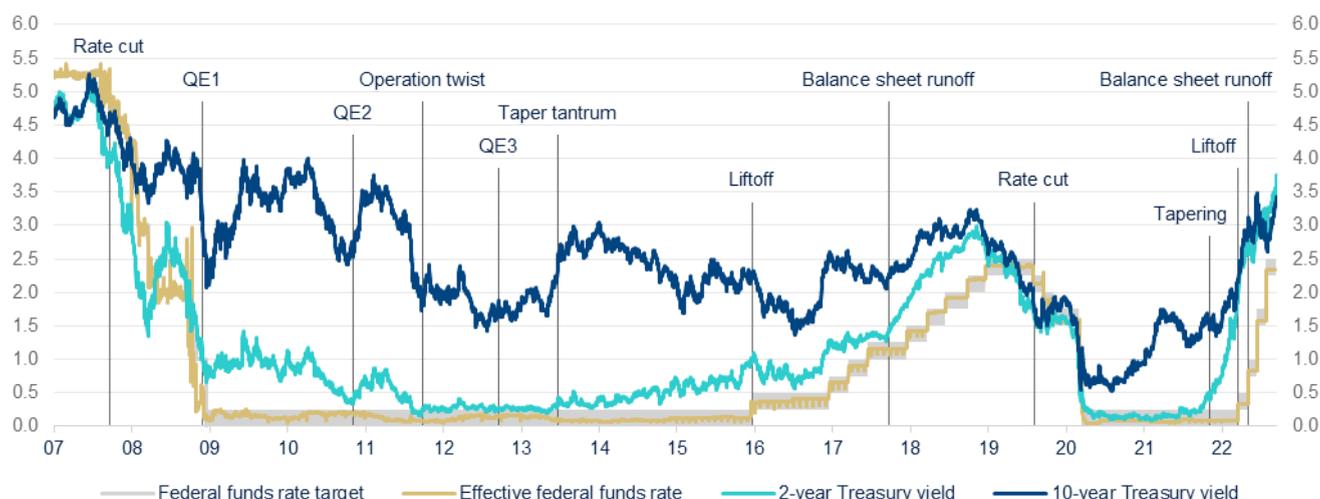
Javier Amador / Iván Fernández
September 13, 2022

Persistent core inflation coupled with a resilient economy give the Fed “flexibility to be aggressive” against inflation

- Another supersized rate increase (75 bps) is coming next week: the Fed will continue to front load rate hikes to add 150bp of tightening by December before shifting to a relatively long pause thereafter (Figures 2 and 3).
- Treasury yields fell significantly from mid-July to mid-August (Figure 6), temporarily depressing the middle- and long-end of the yield curve (Figure 7). Powell reversed this rally with a hawkish speech at Jackson Hole.
- Coming fed funds rate hikes will most likely invert the 3m10y slope, but given that the hiking cycle will likely end in Dec, we anticipate that the inversion won't be much more pronounced than historical standards (Figure 10).
- FOMC members have been vocal on the likely need to keep rates “moderately restrictive” over 2023, but futures markets are still pricing in that rate cuts could come as soon as next year (Figures 20 and 21).
- Overall, our assessment is that the Treasury market is signaling continued confidence in a scenario in which the Fed wins the battle against inflation, and an acknowledgement that some pain now is better than far greater pain later.

The fed funds rate will keep rising to moderately restrictive levels until there are compelling signs that inflation has not only peaked but is headed towards target; a 75bp hike next week is now fully priced in

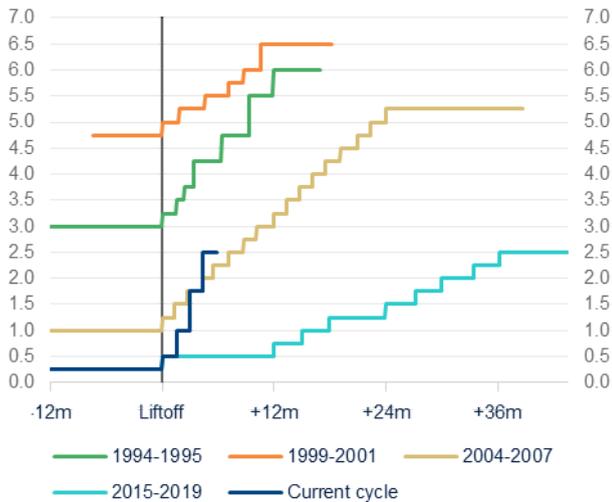
Figure 1. 2-YEAR, 10-YEAR TREASURY YIELDS AND FED FUNDS RATE (CONSTANT MAT., DAILY DATA, %)



Source: BBVA Research based on data by Haver Analytics.

The Fed will likely front load 150bp worth of additional hikes...

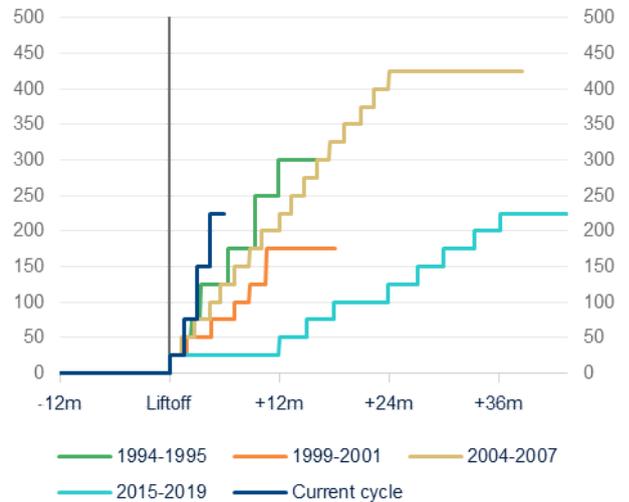
Figure 2. **FED FUNDS RATE IN TIGHTENING CYCLES**
(DAILY DATA, %)



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.

... by year end before shifting to a long pause during 2023

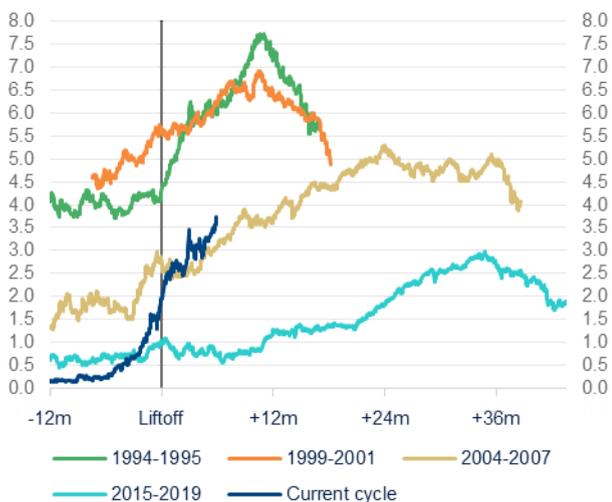
Figure 3. **FED FUNDS RATE IN TIGHTENING CYCLES**
(DAILY DATA, BPS VS RATE LEVEL AT LIFTOFF)



Source: BBVA Research based on data by Haver Analytics.

Treasury yields resumed their bearish trend after easing in previous weeks on the unwarranted...

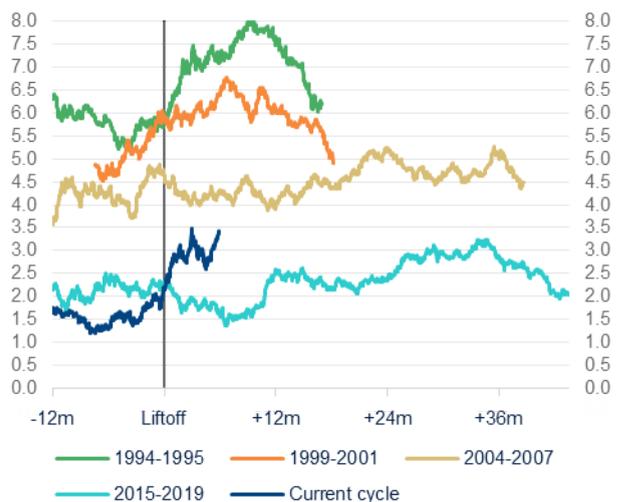
Figure 4. **2-YEAR TREASURY YIELD IN TIGHTENING CYCLES**
(CONSTANT MAT., DAILY DATA, %)



Source: BBVA Research based on data by Haver Analytics.

... optimism that the Fed would ease monetary policy early in 2023

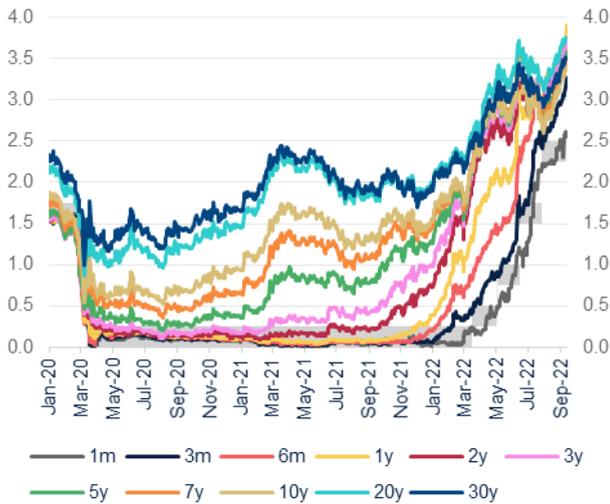
Figure 5. **10-YEAR TREASURY YIELD IN TIGHTENING CYCLES**
(CONSTANT MAT., DAILY DATA, %)



Source: BBVA Research based on data by Haver Analytics.

Government bond yields fell significantly and equities soared from mid-July to mid-August, ...

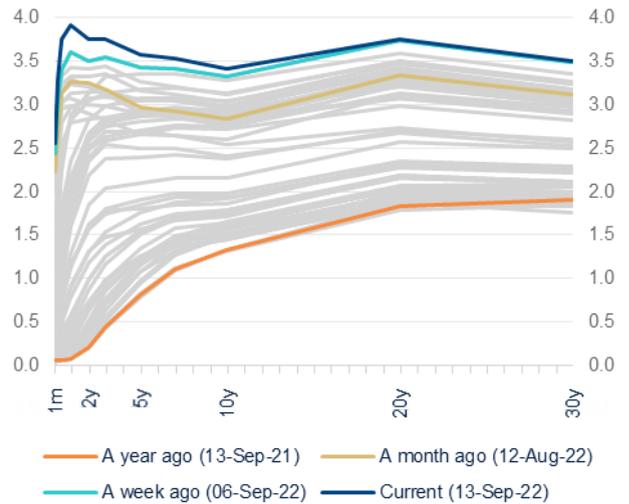
Figure 6. **TREASURY YIELDS**
(CONSTANT MAT., DAILY DATA, %)



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

... temporarily depressing the middle- and long-end of the yield curve. Powell reversed...

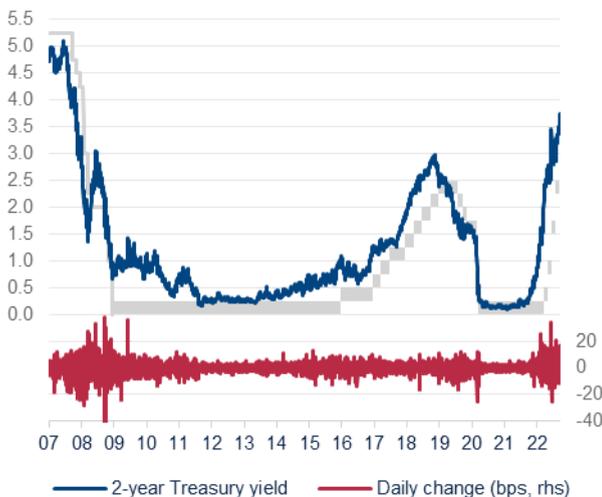
Figure 7. **TREASURY YIELD CURVE**
(CONSTANT MAT., DAILY DATA, %)



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

... this rally with a hawkish speech at Jackson Hole; other FOMC members have also signaled...

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.

... that pain now is better than far greater pain later as it makes the the job on inflation easier

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 2y10y Treasury yield spread has remained negative since early July, hovering around ~-30 bps. Coming fed funds rate hikes will most likely cause the 3m10y yield slope to invert, but...

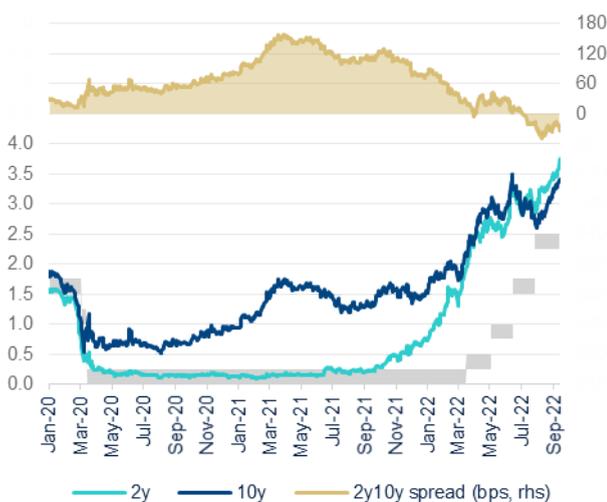
Figure 10. **TREASURY YIELD SPREADS** (CONSTANT MAT., DAILY DATA, BPS)



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.

... given that the tightening cycle will likely end in December, we anticipate that...

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.

... the inversion of both yield slopes won't be much more pronounced than historical standards

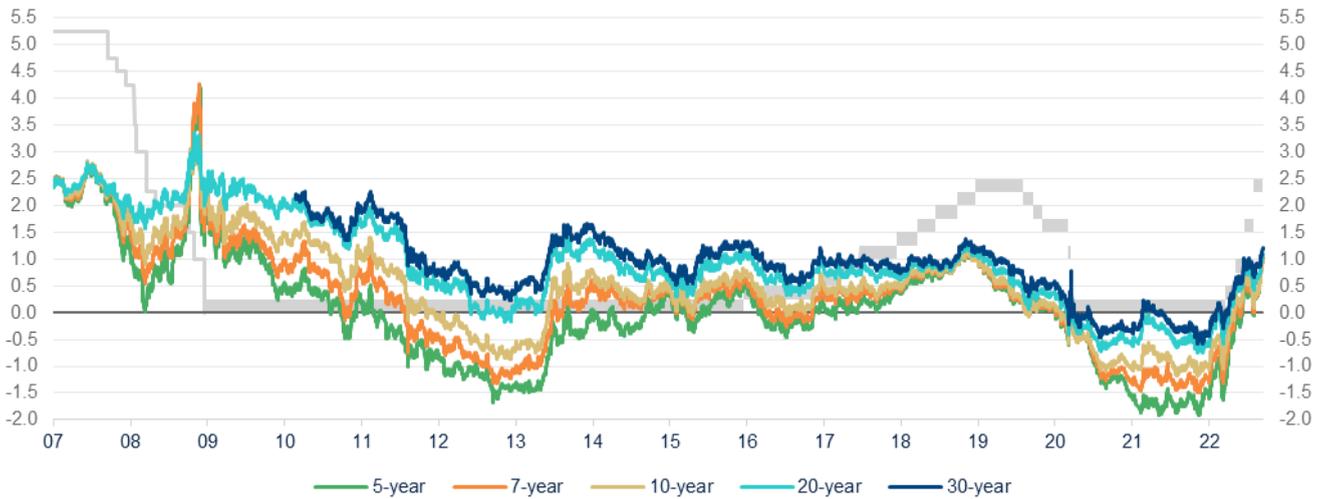
Figure 12. **3M10Y TREASURY YIELD SPREAD** (CONSTANT MAT., DAILY DATA, % AND BPS)



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

The recent rebound in medium- and long-term nominal Treasury yields was fueled by the increase in real rates. TIPS yields have now reached early-2019 levels, and still have room...

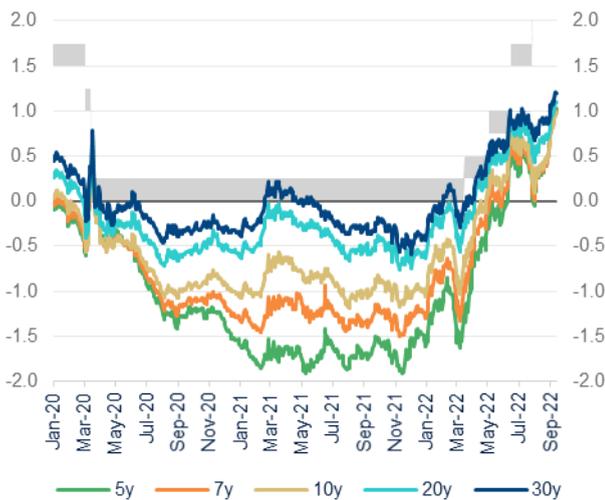
Figure 13. INFLATION INDEXED TREASURY (TIPS) YIELDS (CONSTANT MAT., DAILY DATA, %)



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

... to go up a bit higher before the fed funds rate peaks; positive Treasury real yields support...

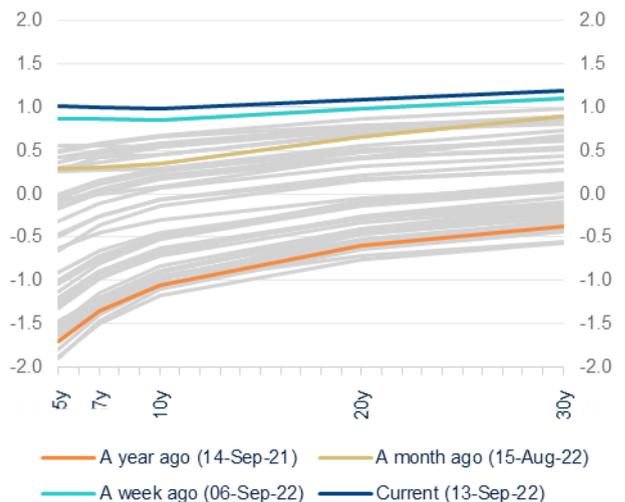
Figure 14. INFLATION INDEXED (TIPS) YIELDS (CONSTANT MAT., DAILY DATA, %)



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

... the market view that in the long term inflation will return to levels close to the Fed's target

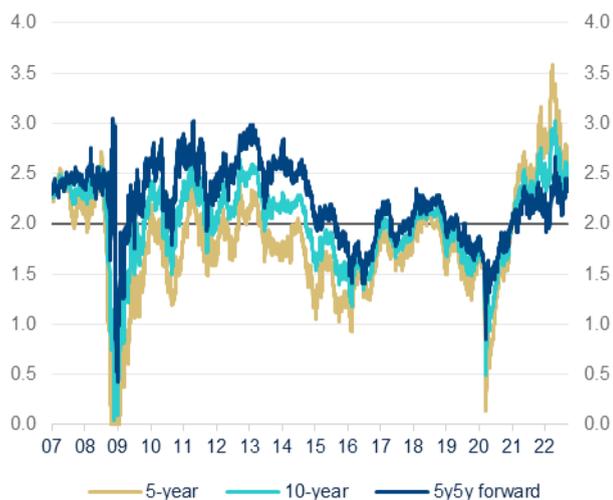
Figure 15. INFLATION INDEXED (TIPS) YIELD CURVE (CONSTANT MAT., DAILY DATA, %)



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

However, breakevens still remain slightly above 2%, which appears to signal 1) continued...

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



Source: BBVA Research based on data by Haver Analytics.

... confidence that the Fed will bring down inflation to 2.0%, yet it will take some time...

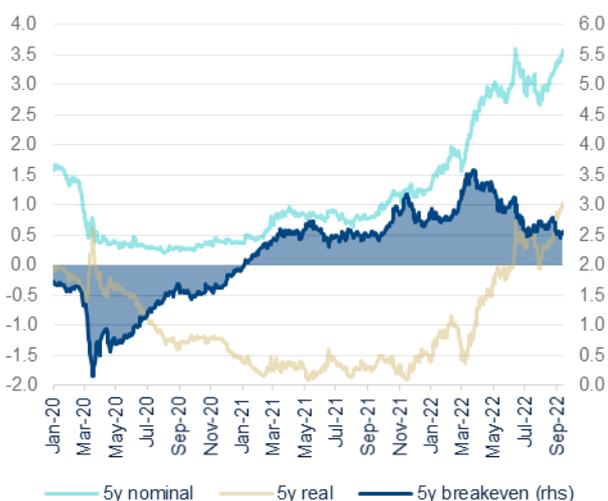
Figure 17. **5Y5Y FORWARD IMPLIED INFLATION RATE**
(CONSTANT MAT., DAILY DATA, %)



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

... but also 2) some “structural pessimism” as varied disinflationary tailwinds...

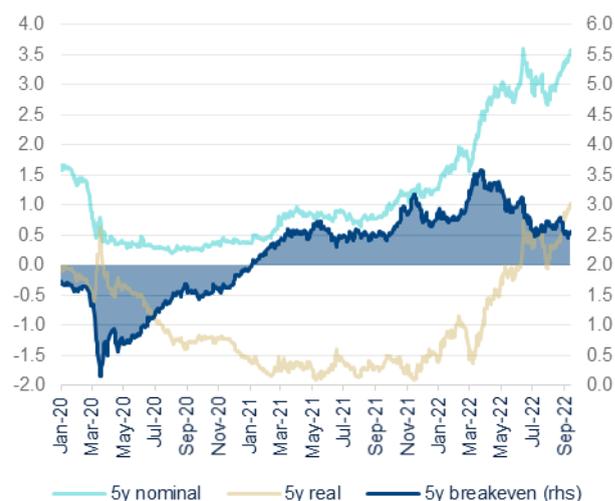
Figure 18. **5-YEAR BREAKEVEN INFLATION RATE**
(CONSTANT MAT., DAILY DATA, %)



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

... of past decades fading away could drive inflation a bit higher in the longer term

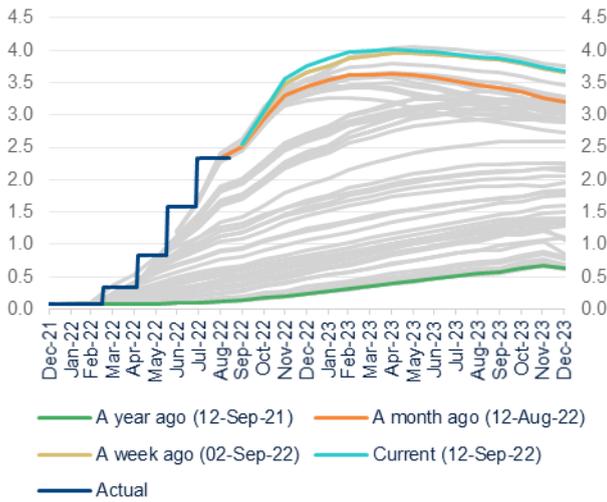
Figure 19. **10-YEAR BREAKEVEN INFLATION RATE**
(CONSTANT MAT., DAILY DATA, %)



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

FOMC members have been vocal on the likely need to keep rates “moderately restrictive”...

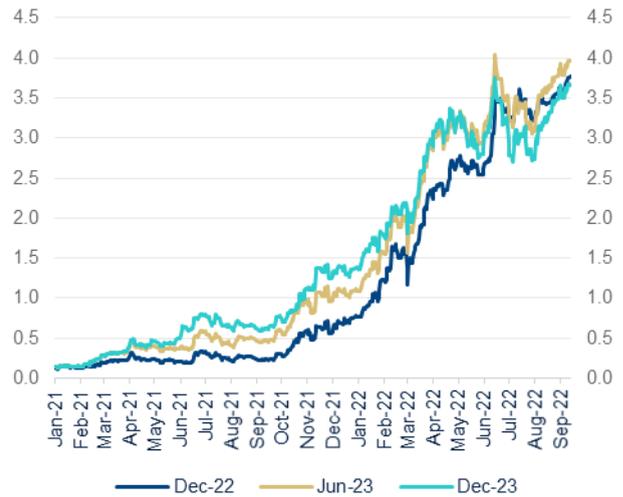
Figure 20. **IMPLIED RATE IN 30-DAY FED FUNDS FUTURES** (DAILY DATA, %)



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

... over 2023, but futures markets are still pricing in that rate cuts could come as soon as next year

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



Source: BBVA Research based on data by Bloomberg.

30-year fixed mortgage rates jumped again above 6% after declining almost 1 pp in late-July

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



Source: BBVA Research based on data by Haver Analytics.

The investment-grade corporate credit market is still not subject to high levels of stress

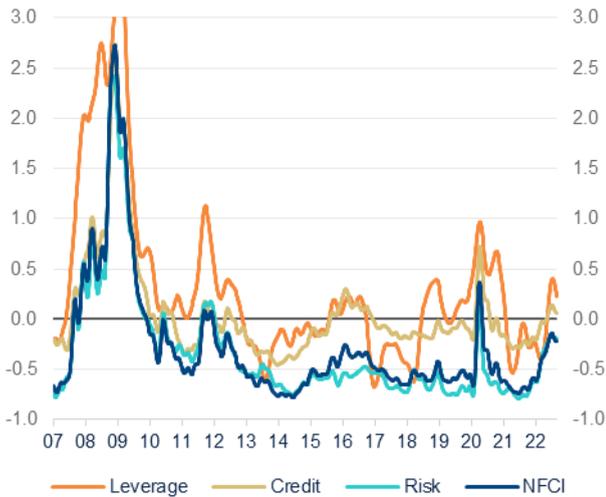
Figure 23. **CORPORATE BOND SPREADS** (MOODY'S SEASONED YIELDS, DAILY DATA, BPS)



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 bucket of cold water thrown by the Fed a couple of weeks ago that shifted expectations...

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



Source: BBVA Research based on data by Haver Analytics.

... for the policy rate didn't distort the still orderly evolution of broad financial conditions indices

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



Source: BBVA Research based on data by Bloomberg.

The Fed will prefer to see tighter financial conditions for inflation to fall steadily, ...

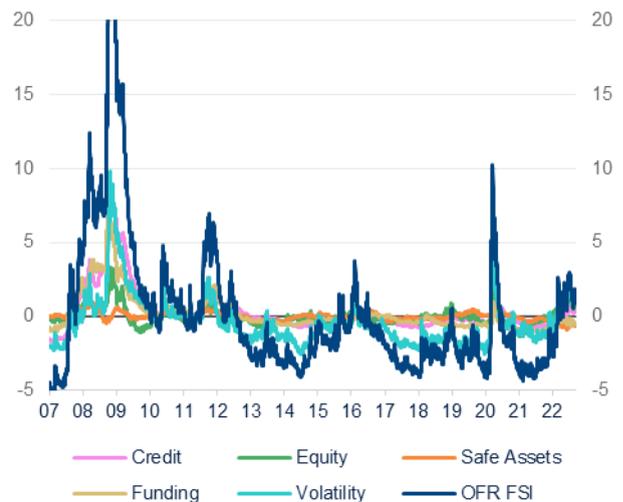
Figure 26. **FED'S FINANCIAL STRESS INDICES (>0 = ABOVE AVG FINANCIAL STRESS)**



Source: BBVA Research based on data by Haver Analytics.

... and won't be easily spooked by weakness in activity indicators as policy tightens further

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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