

US Interest rates monitor

Treasury yields priced in a more aggressive Fed after Sep's core inflation surprise

Javier Amador / Iván Fernández

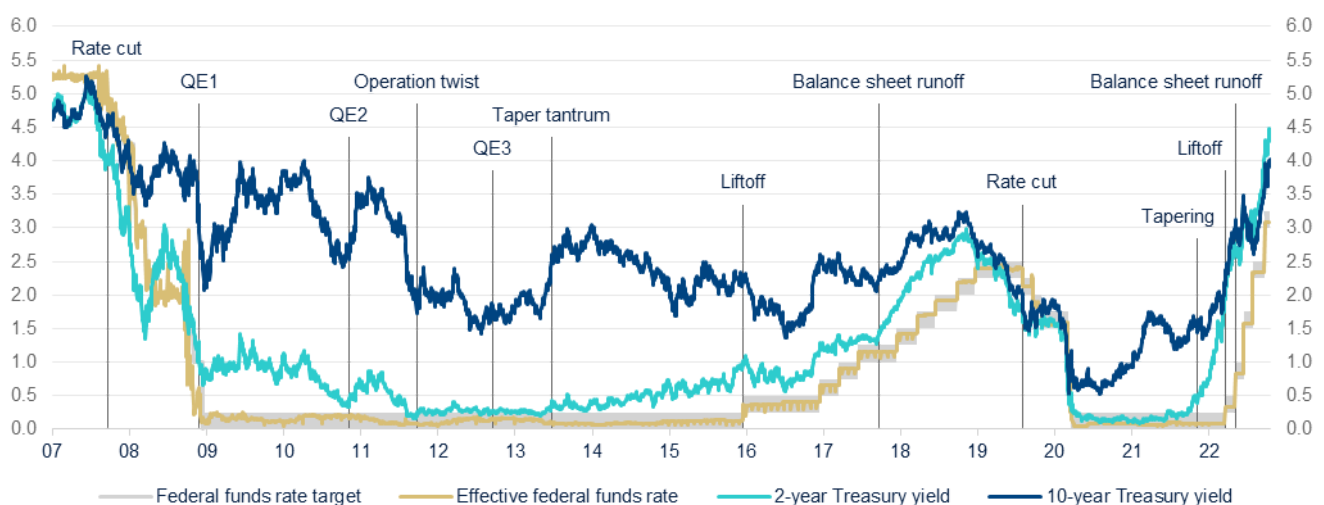
October 18, 2022

Rates are now pricing in that the Fed will not stop until data shows clear signs of easing inflation and a more balanced labor market

- Another fourth consecutive supersized rate increase (75 bps) in Nov is locked in; the odds of a fifth in Dec will continue to increase unless core inflation shows clear signs of easing in Oct and Nov.
- Treasury yields across the yield curve keep rising amid the expectation that the hiking cycle still has some way to go, moving decisively away from the (low) levels seen over the past 15 years ([Figures 4](#) and [5](#)).
- Volatility in the Treasury market is at peak COVID-crisis levels as evidenced by the bond market's version of the VIX index, reflecting growing concerns about liquidity ([Figures 8](#) and [9](#)).
- A 75bp hike in November is fully priced in by the futures market, while the odds that the Fed hikes rates above the 5% threshold in 1H23 are rising ([Figures 20](#) and [21](#)).
- With the fed funds rate still far from peaking, avoiding a disorderly tightening of financial conditions is becoming increasingly challenging for policymakers ([Figures 26](#) and [27](#)).

The Fed has raised the fed funds rate by 75 bps in three meetings in a row; a fourth same-size hike in Nov is locked in, while the odds of a fifth in Dec are now high with core inflation at four-decade highs

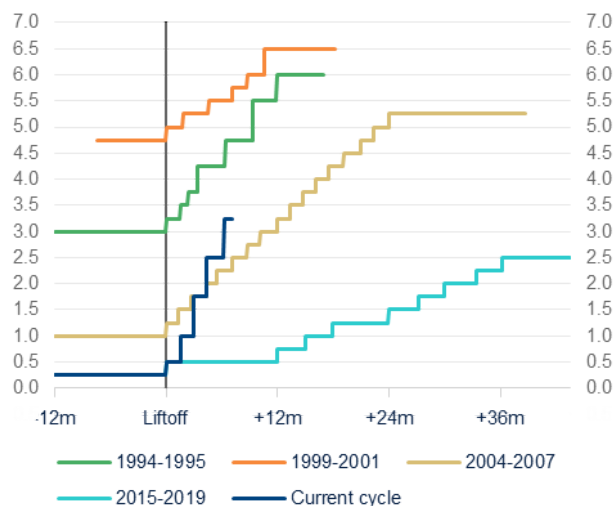
Figure 1. 2-YEAR, 10-YEAR TREASURY YIELDS AND FED FUNDS RATE (%)



Source: BBVA Research based on data by Haver Analytics.

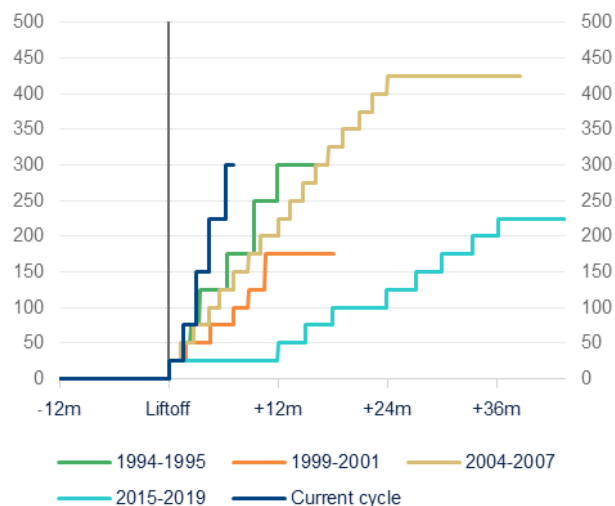
The fed funds rate has risen 300 bp in the current cycle. The Fed will raise rates much more...

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



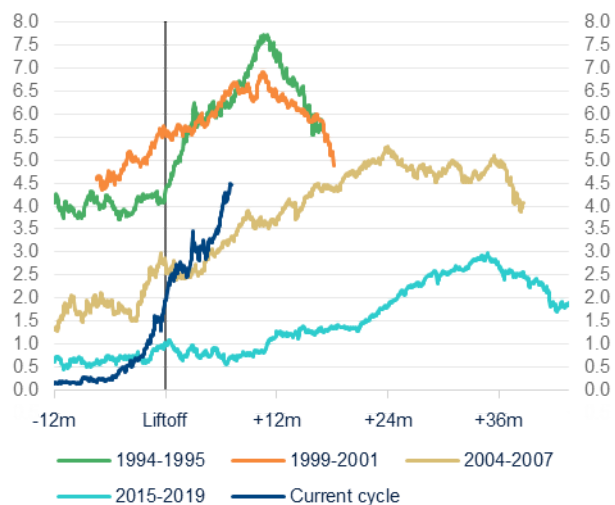
... to tackle a (still) rising core inflation before it pauses and holds them "higher for longer"

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



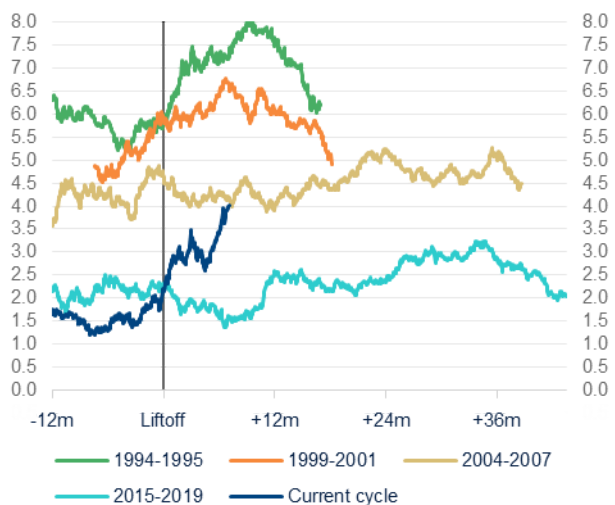
Treasury yields across the yield curve keep rising amid the expectation that the hiking cycle...

Figure 4. **2-YEAR TREASURY YIELD IN TIGHTENING CYCLES (%)**



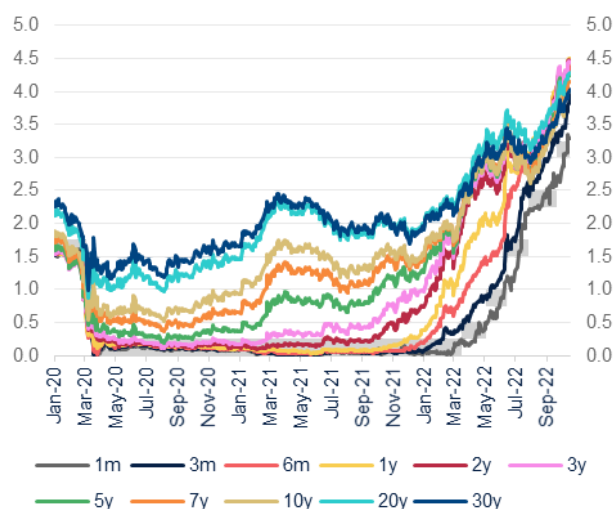
... still has some way to go, moving decisively away from their last-decade low levels

Figure 5. **10-YEAR TREASURY YIELD IN TIGHTENING CYCLES (%)**



The yield curve shifted further up during the last month as short-term yields seem not to...

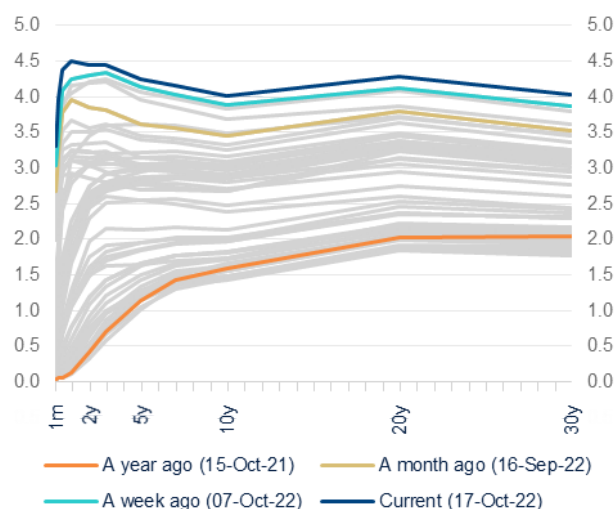
Figure 6. **TREASURY YIELDS**
(%)



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

... anticipate that the Fed is close to putting the brakes on its efforts to bring inflation down

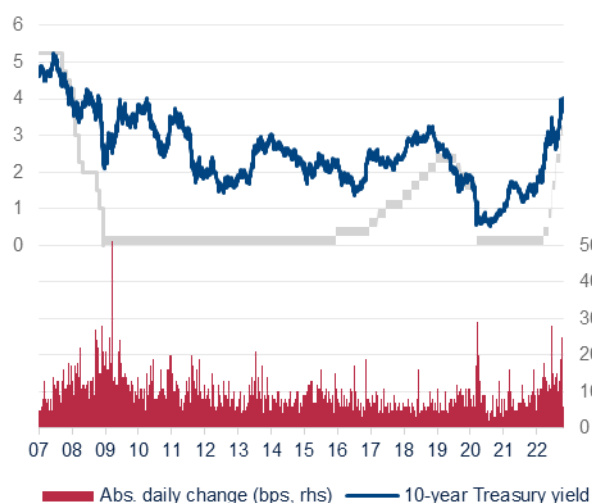
Figure 7. **TREASURY YIELD CURVE**
(%)



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

Volatility in the Treasury market is at peak COVID-crisis levels as evidenced by the...

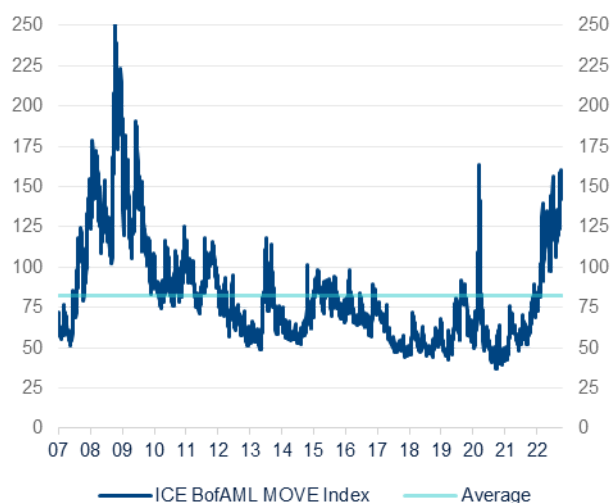
Figure 8. **10-YEAR TREASURY YIELD DAILY CHANGE**
(% AND BPS)



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

... bond market's version of the VIX index, reflecting growing concerns about liquidity

Figure 9. **ICE BOFAML US BOND MARKET OPTION VOLATILITY ESTIMATE INDEX (BPS)**



Source: BBVA Research based on data by Haver Analytics.

Both the 2-year and 10-year yields increased by c.50 bps since mid-September, which has prevented the 10y-2y slope from depressing further; the 10y-3m slope remains positive

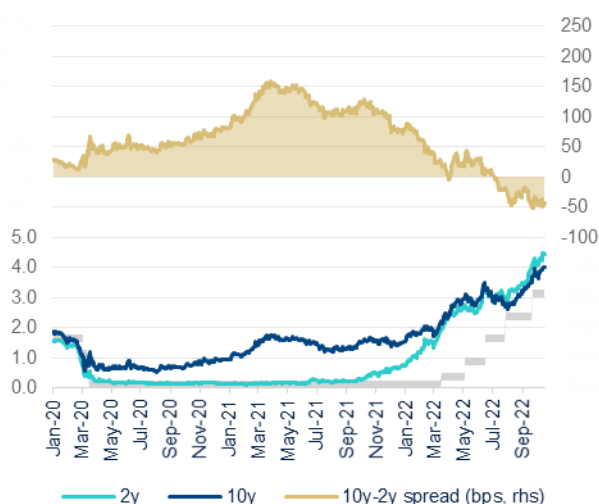
Figure 10. **TREASURY YIELD SPREADS (BPS)**



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.

We still anticipate that the inversion of both yield slopes won't be much more pronounced than...

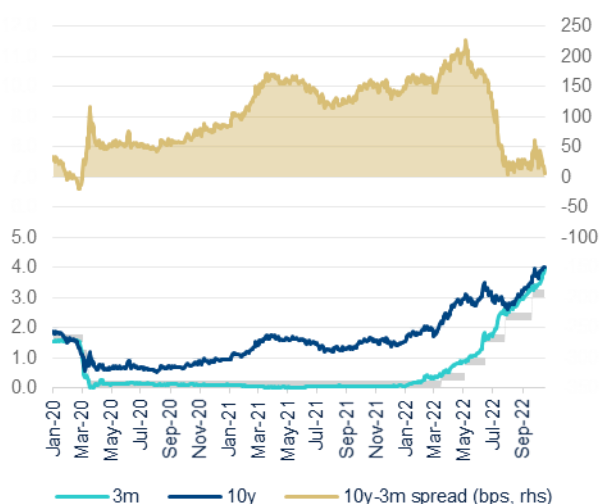
Figure 11. **10Y-2Y TREASURY YIELD SPREAD (% AND BPS)**



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

... historical standards as QT provides support to yields on the long end of the yield curve

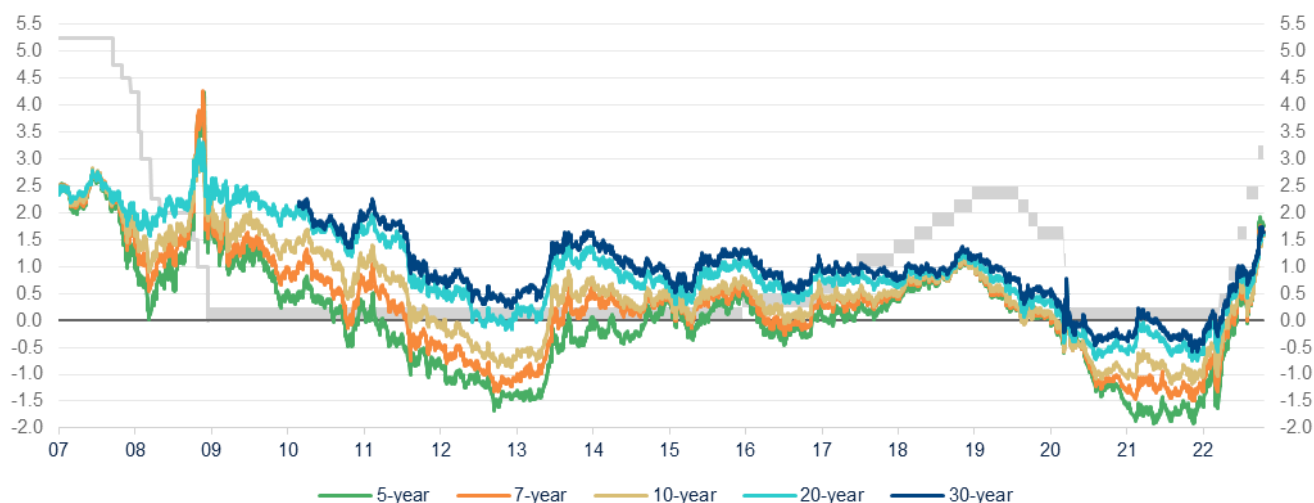
Figure 12. **10Y-3M TREASURY YIELD SPREAD (% AND BPS)**



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

The “higher rates for longer” approach signaled by the Fed is driving real yields further up. The real yield curve is now in solidly positive territory after two years in which it fell deeply into...

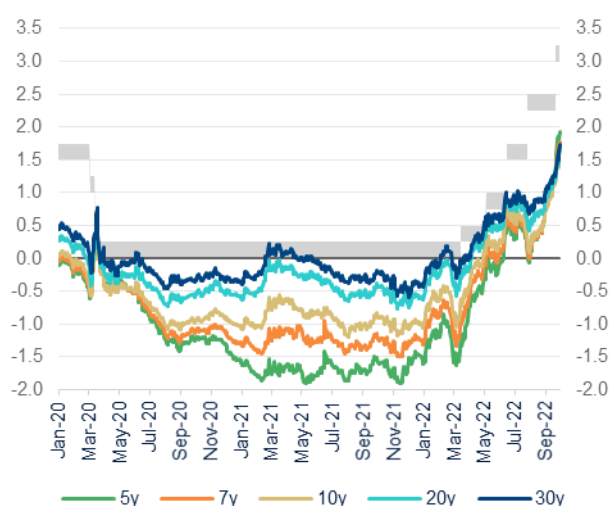
Figure 13. INFLATION INDEXED TREASURY (TIPS) YIELDS (%)



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

... negative grounds at the height of the COVID crisis when the Fed decidedly cut interest rates

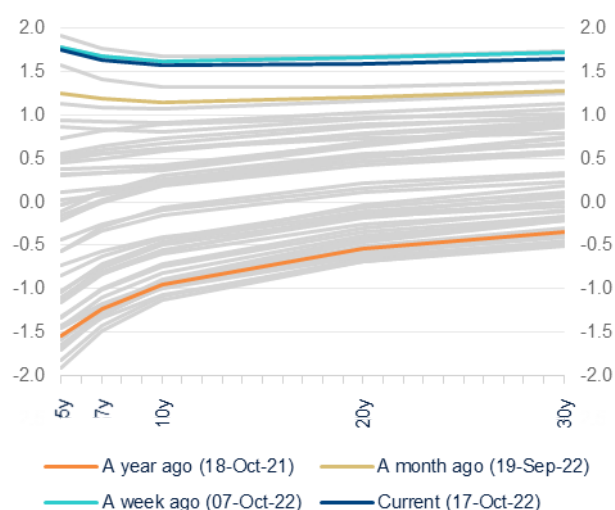
Figure 14. INFLATION INDEXED (TIPS) YIELDS (%)



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

The real yield curve is likely to continue to shift upward as the tightening cycle proceeds

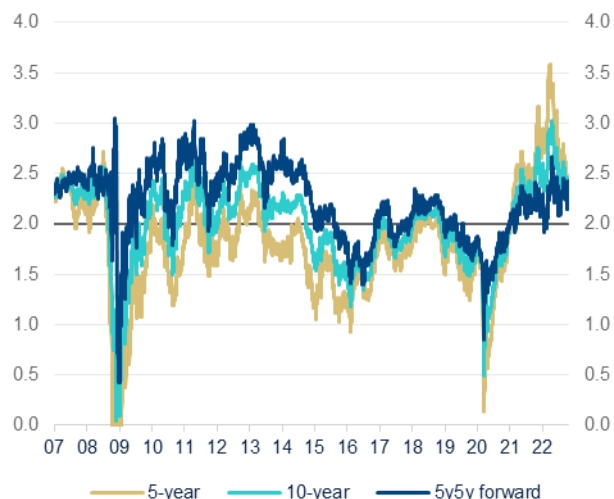
Figure 15. INFLATION INDEXED (TIPS) YIELD CURVE (%)



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

Despite persistently high levels of inflation, medium- and long-term market expectations...

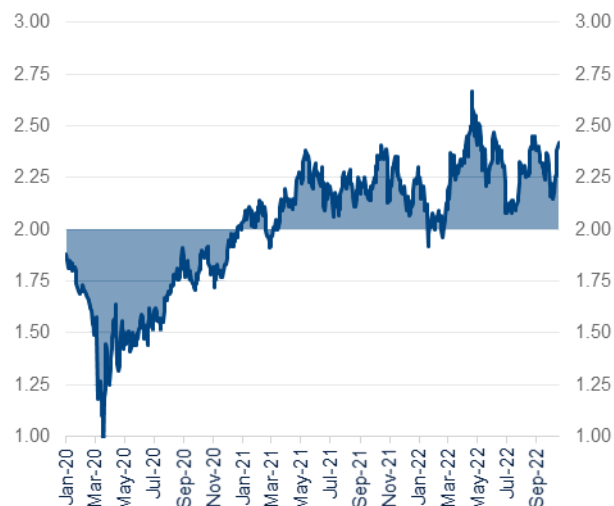
Figure 16. **BREAKEVEN INFLATION RATES (%)**



Source: BBVA Research based on data by Haver Analytics.

... continue to ease and remain below early-2022 highs

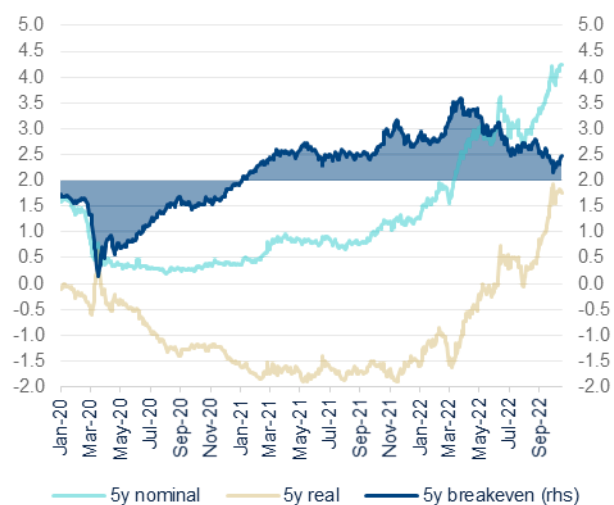
Figure 17. **5Y5Y FORWARD IMPLIED INFLATION RATE (%)**



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

Expectations show continued confidence that the Fed will succeed in bringing down inflation but...

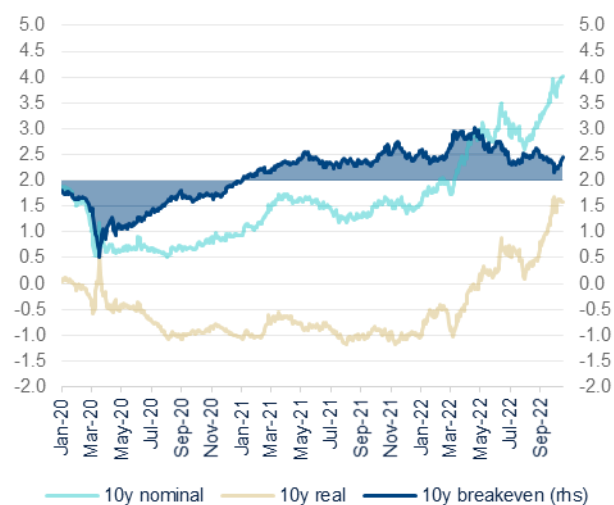
Figure 18. **5-YEAR BREAKEVEN INFLATION RATE (%)**



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

... also that the backdrop for inflation ahead will likely be less benign than in the last two decades

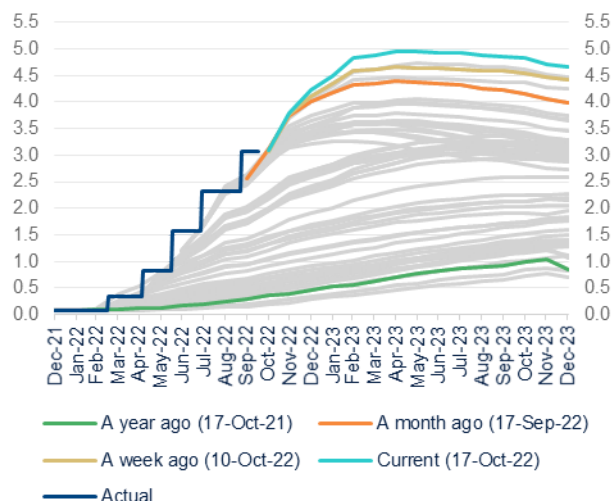
Figure 19. **10-YEAR BREAKEVEN INFLATION RATE (%)**



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

A 75bp hike in November is fully priced in by the futures market, while the odds...

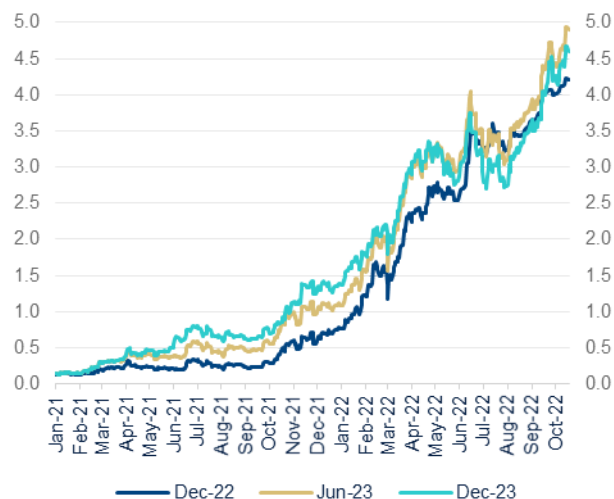
Figure 20. **IMPLIED RATE IN 30-DAY FED FUNDS FUTURES (%)**



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

... that the Fed hikes rates above the 5% threshold in 1H23 are rising

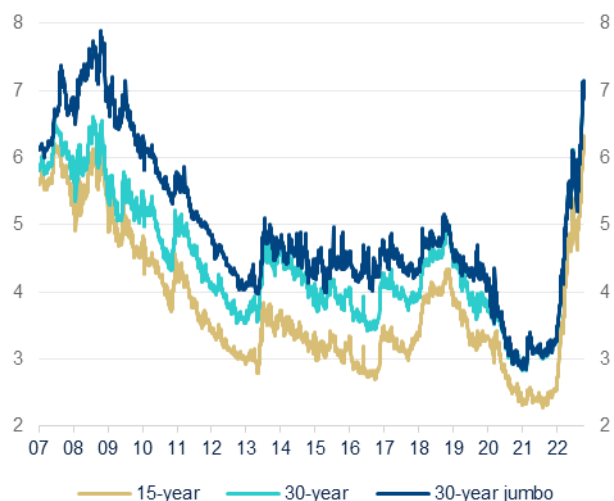
Figure 21. **IMPLIED RATE IN 30-DAY FED FUNDS FUTURES (%)**



Source: BBVA Research based on data by Bloomberg.

Soaring mortgage rates, now above 7%, will continue to weaken the housing market

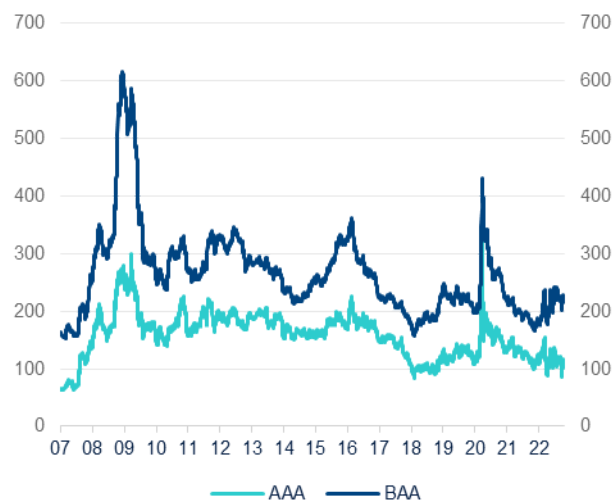
Figure 22. **MORTGAGE RATES (WSJ CONSUMER FIXED RATES, %)**



Source: BBVA Research based on data by Haver Analytics.

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

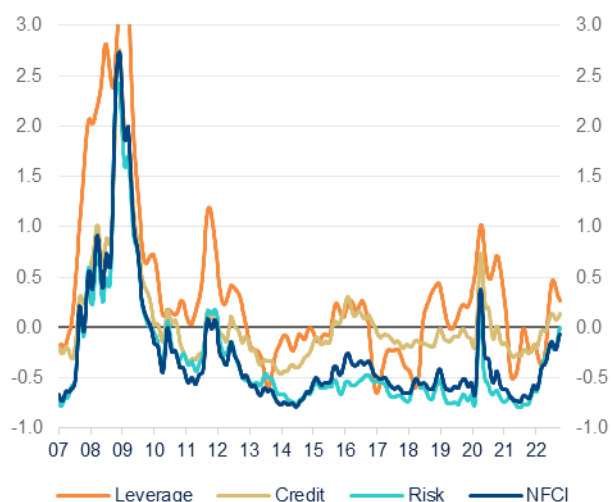
Figure 23. **CORPORATE BOND SPREADS (MOODY'S SEASONED YIELDS, DAILY DATA, BPS)**



Spreads over the 10-year Treasury yield.
Source: BBVA Research based on data by the Fed of St. Louis (FRED) and Haver Analytics.

Several financial conditions and financial stress indices continue to point...

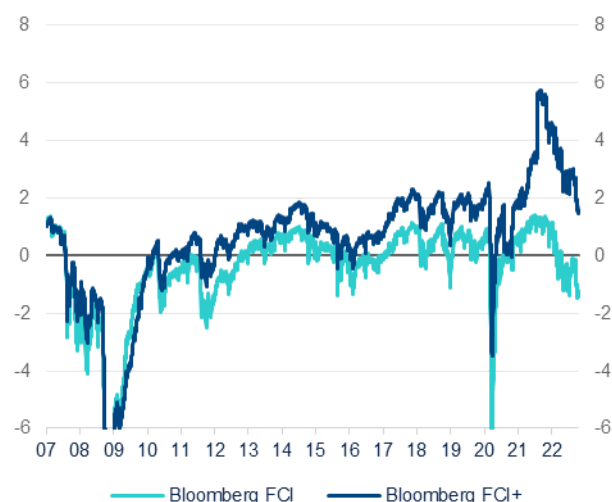
Figure 24. **CHICAGO FED NATIONAL FINANCIAL CONDITIONS INDEX (>0 = TIGHTER THAN AVG)**



Source: BBVA Research based on data by Haver Analytics.

... to a gradual but ongoing tightening of financial conditions

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



Source: BBVA Research based on data by Bloomberg.

With the fed funds rate still far from peaking, avoiding a disorderly tightening of financial...

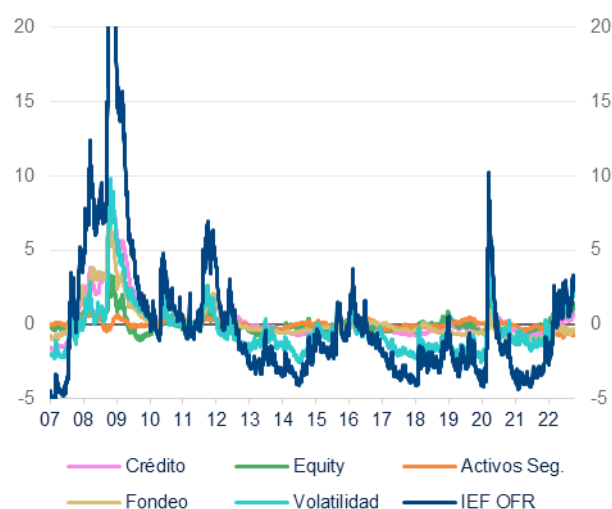
Figure 26. **FED FINANCIAL STRESS INDICES (>0 = ABOVE AVG FINANCIAL STRESS)**



Source: BBVA Research based on data by Haver Analytics.

... conditions is becoming increasingly challenging for policymakers

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.

DISCLAIMER

The present document does not constitute an “Investment Recommendation”, as defined in Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse (“MAR”). In particular, this document does not constitute “Investment Research” nor “Marketing Material”, for the purposes of article 36 of the Regulation (EU) 2017/565 of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive (MIFID II).

Readers should be aware that under no circumstances should they base their investment decisions on the information contained in this document. Those persons or entities offering investment products to these potential investors are legally required to provide the information needed for them to take an appropriate investment decision.

This document has been prepared by BBVA Research Department. It is provided for information purposes only and expresses data or opinions regarding the date of issue of the report, prepared by BBVA or obtained from or based on sources we consider to be reliable, and have not been independently verified by BBVA. Therefore, BBVA offers no warranty, either express or implicit, regarding its accuracy, integrity or correctness.

This document and its contents are subject to changes without prior notice depending on variables such as the economic context or market fluctuations. BBVA is not responsible for updating these contents or for giving notice of such changes.

BBVA accepts no liability for any loss, direct or indirect, that may result from the use of this document or its contents.

This document and its contents do not constitute an offer, invitation or solicitation to purchase, divest or enter into any interest in financial assets or instruments. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.

The content of this document is protected by intellectual property laws. Reproduction, transformation, distribution, public communication, making available, extraction, reuse, forwarding or use of any nature by any means or process is prohibited, except in cases where it is legally permitted or expressly authorised by BBVA on its website www.bbvaresearch.com.