

US Interest rates monitor

Treasury yields fall amid strong optimism about inflation. Is it an overreaction?

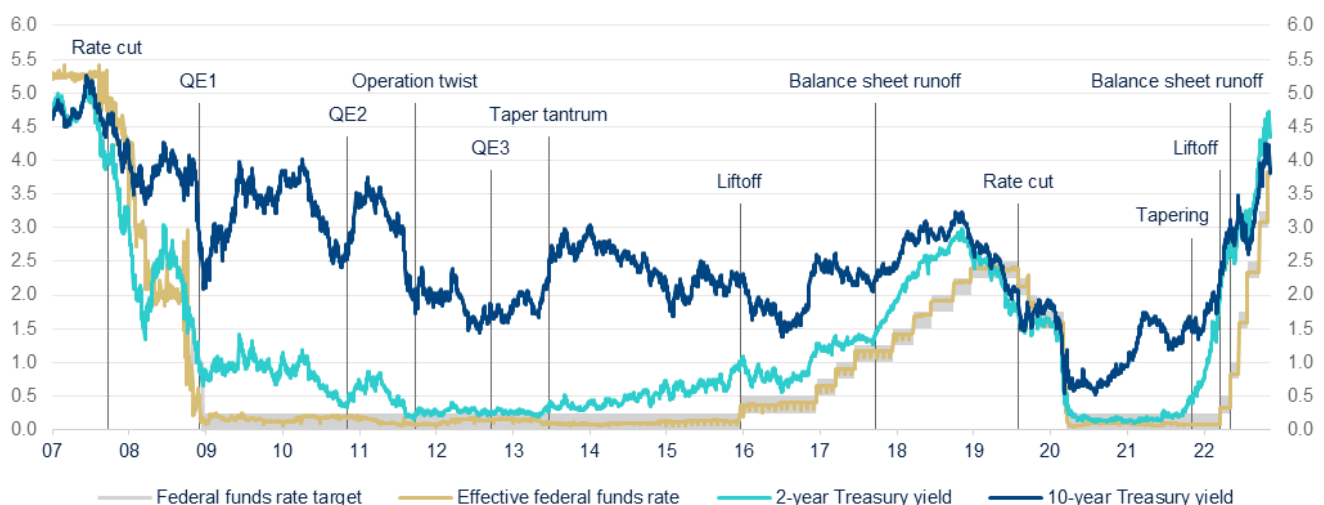
Javier Amador / Iván Fernández
November 18, 2022

A slower rate-hike pace might be in the cards but 100bp worth of additional hikes still seem likely

- Treasury yields reversed their upward course amid speculation that the Fed will pivot earlier than previously signaled to a less aggressive stance in its fight against inflation ([Figures 4](#) and [5](#)).
- The 10y-3m Treasury yield spread turned negative since late October, and deepened in recent days to c. -50 bps after the strong fall in long-term yields that followed last week's surprising CPI inflation report ([Figure 10](#)).
- Both the 10y-2y and 10y-3m yield spreads ([Figures 11](#) and [12](#)) add to the already widespread expectation that the US economy is heading towards a recession, although it is still broadly expected to be short and shallow.
- The futures market is pricing in a 75% chance that the Fed will deliver a 50bp hike next month. Expectations that rates will remain restrictive throughout 2023 did not change dramatically ([Figures 20](#) and [21](#)).
- Optimism from the recent inflation data will likely lead to a slight easing of financial conditions in the short term, but it is important to consider that the Fed has been vocal about the risks of precipitously claiming victory.

Earlier this month, the Fed delivered the fourth consecutive 75bp hike, taking the fed funds rate to 3.25-4.00%; Powell's remarks signaled that the peak rate level will be higher than previously expected but also that speed is becoming less important now, opening the door for a smaller (50bp) hike in December

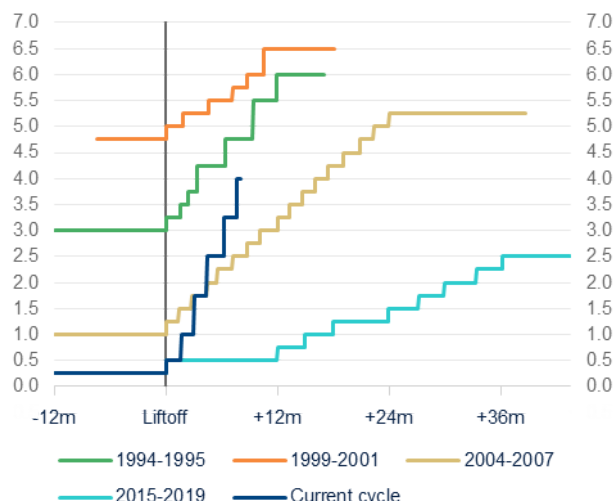
Figure 1. 2-YEAR, 10-YEAR TREASURY YIELDS AND FED FUNDS RATE (%)



Source: BBVA Research based on data by Haver Analytics.

Last week's positive surprise on inflation tilted the balance significantly towards an upcoming...

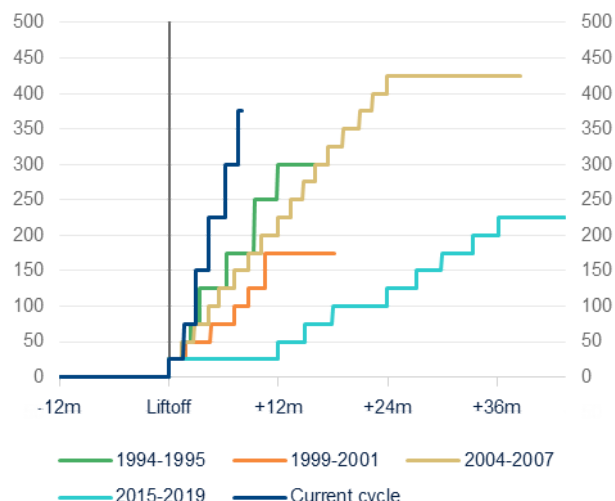
Figure 2. **FED FUNDS RATE IN TIGHTENING CYCLES (%)**



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.

... slower rate-hike pace. It seems clear that a smaller 50bp hike in Dec is now more likely

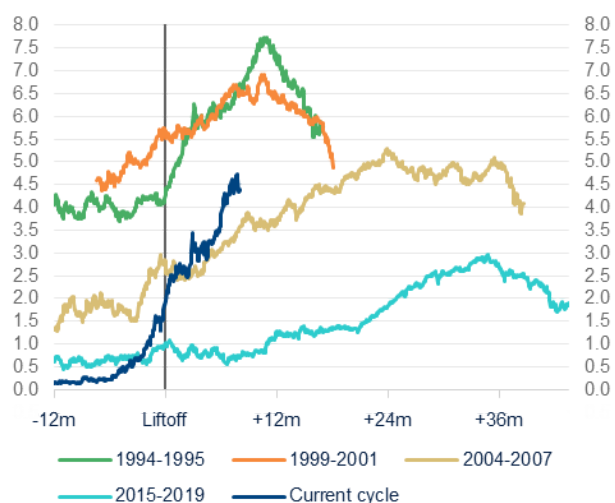
Figure 3. **FED FUNDS RATE IN TIGHTENING CYCLES (BPS VS RATE LEVEL AT LIFTOFF)**



Source: BBVA Research based on data by Haver Analytics.

Treasury yields backed down amid speculation that the Fed will turn less hawkish; it could be...

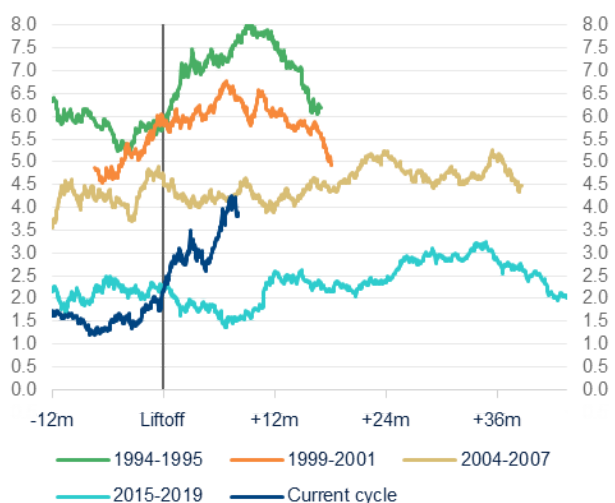
Figure 4. **2-YEAR TREASURY YIELD IN TIGHTENING CYCLES (%)**



Source: BBVA Research based on data by Haver Analytics.

... an overreaction since Fed's message is: fight against inflation is not done, rates will keep rising

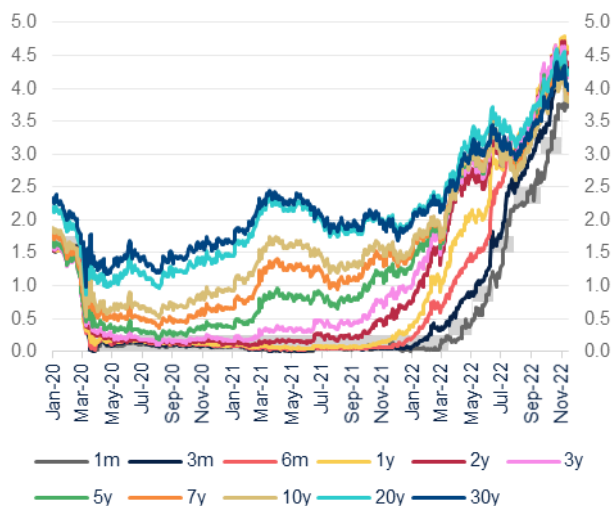
Figure 5. **10-YEAR TREASURY YIELD IN TIGHTENING CYCLES (%)**



Source: BBVA Research based on data by Haver Analytics.

Last week's better-than-expected CPI report caused the Treasury yield curve to shift down

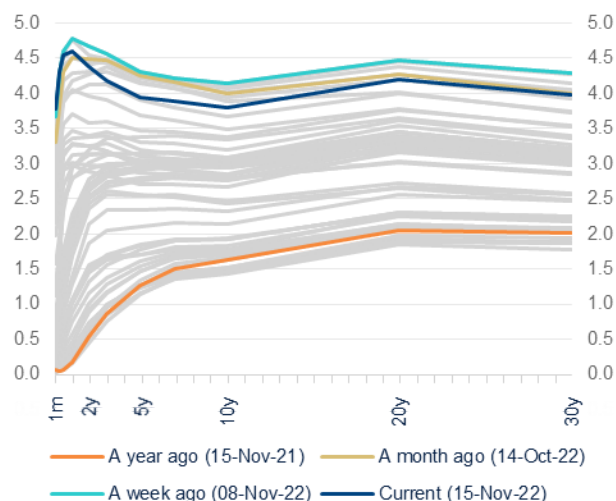
Figure 6. **TREASURY YIELDS**
(%)



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

1- and 2-year yields still point to the expectation that the Fed has some hikes in the pipeline

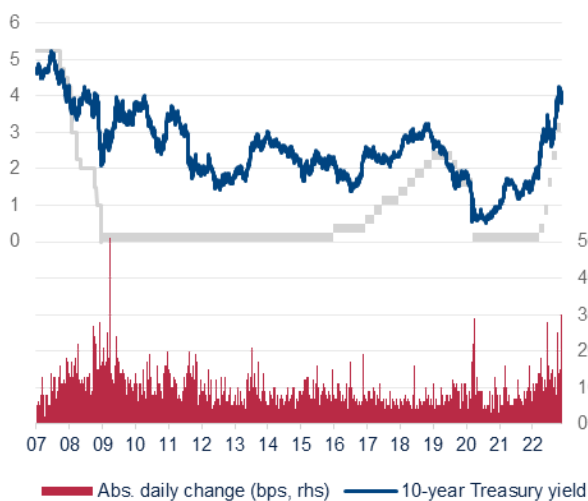
Figure 7. **TREASURY YIELD CURVE**
(%)



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

The 10y Treasury yield fell by more than 40 bps to around 3.8% from its late-October 4.25% high

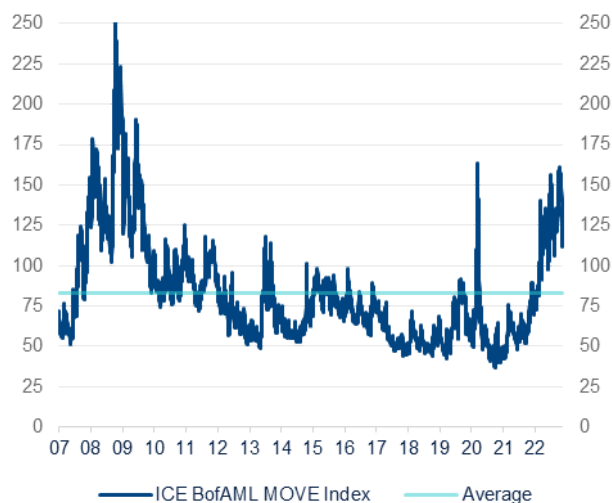
Figure 8. **10-YEAR TREASURY YIELD DAILY CHANGE**
(% AND BPS)



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

Bond market volatility is likely to remain high as upcoming data sheds more light on the outlook

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



Source: BBVA Research based on data by Haver Analytics.

The 10y-3m Treasury yield spread turned negative since late October, and deepened in recent days to c. -50 bps after the strong fall in long-term yields that followed last week's positive CPI inflation surprise

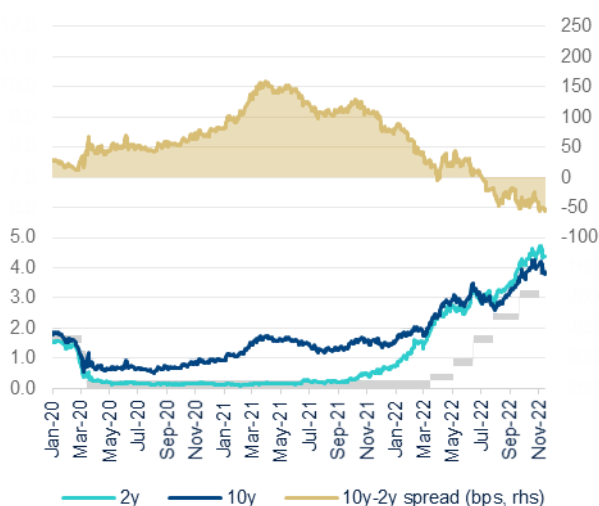
Figure 10. **TREASURY YIELD SPREADS (BPS)**



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.

Both yield spreads add to the already widespread expectation that the US is heading towards a...

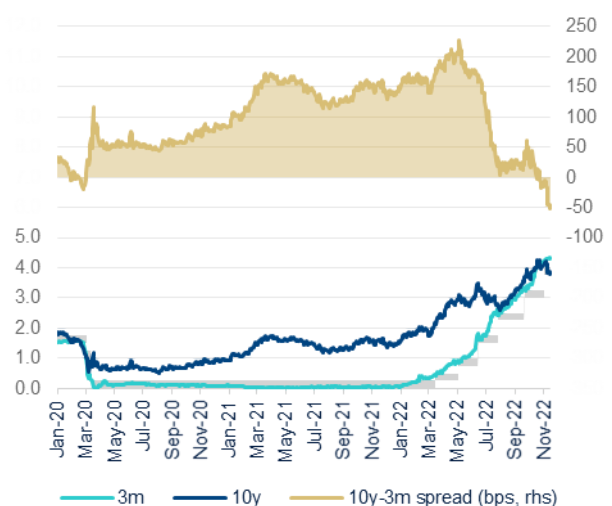
Figure 11. **10Y-2Y TREASURY YIELD SPREAD (% AND BPS)**



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

... recession in the coming months, although it is still broadly expected to be short and shallow

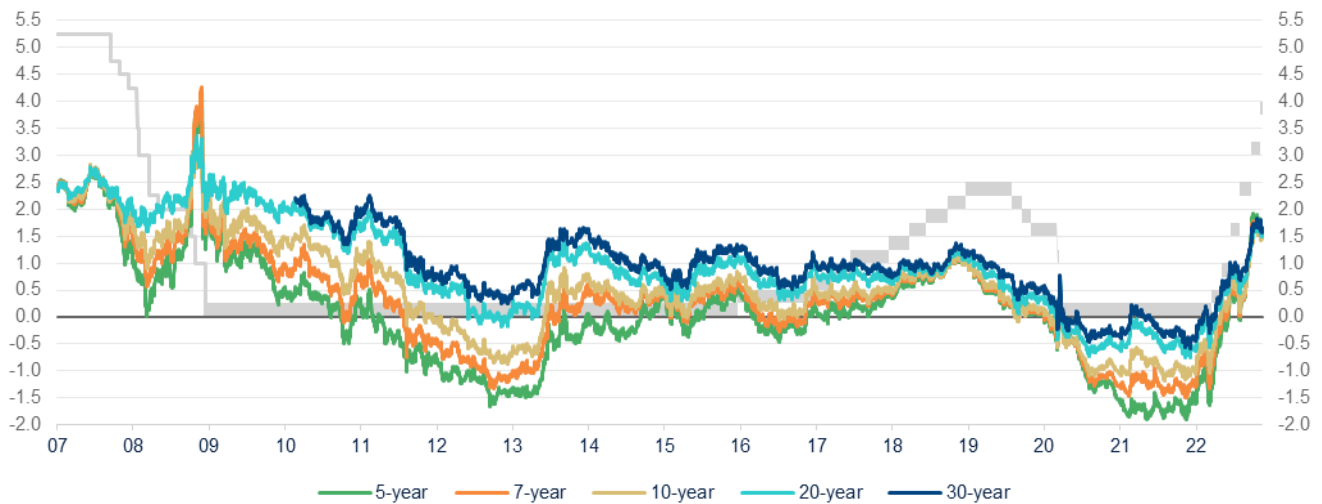
Figure 12. **10Y-3M TREASURY YIELD SPREAD (% AND BPS)**



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

Inflation-indexed Treasury yields reflect that, at least for terms starting at 5 years, the level that the monetary policy rate has reached so far has managed to park real rates in solidly positive territory

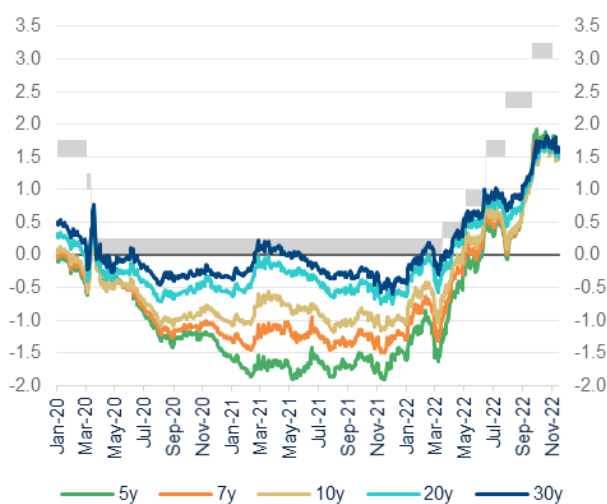
Figure 13. **INFLATION INDEXED TREASURY (TIPS) YIELDS (%)**



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

The real yield curve also shifted downward after last week's inflation data, but to a lesser extent...

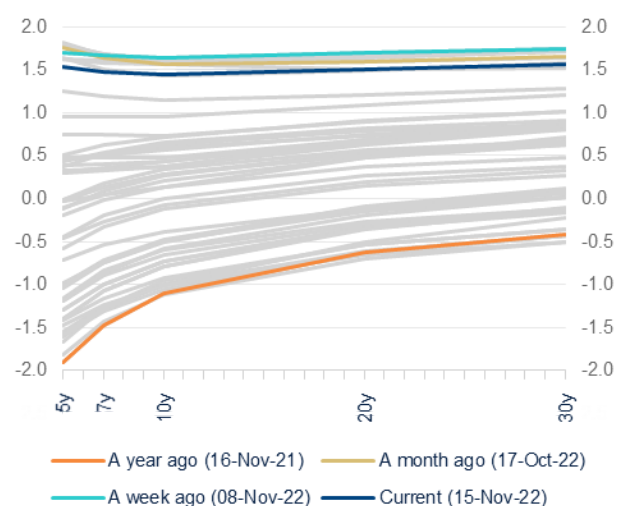
Figure 14. **INFLATION INDEXED (TIPS) YIELDS (%)**



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

... than the nominal curve. The real yield curve remains practically flat around 1.5%

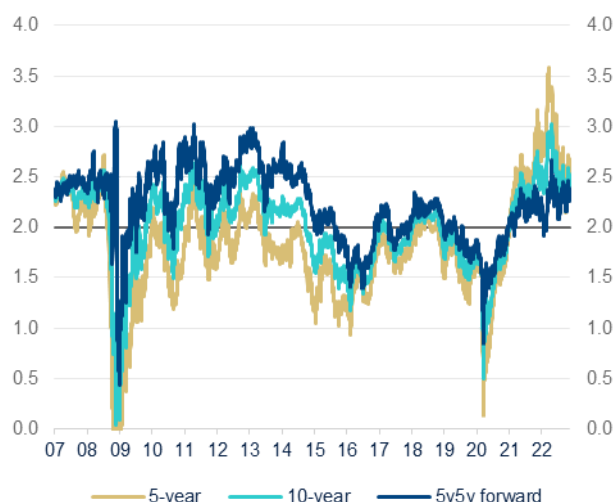
Figure 15. **INFLATION INDEXED (TIPS) YIELD CURVE (%)**



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

Market-based medium- and long-term inflation expectations remain moderately above 2%

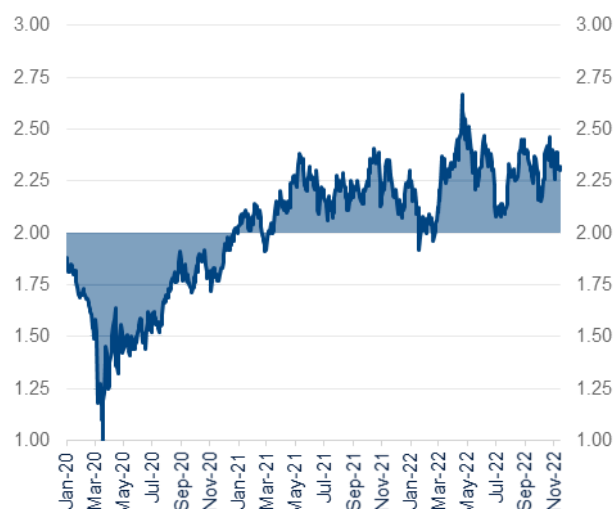
Figure 16. **BREAKEVEN INFLATION RATES (%)**



Source: BBVA Research based on data by Haver Analytics.

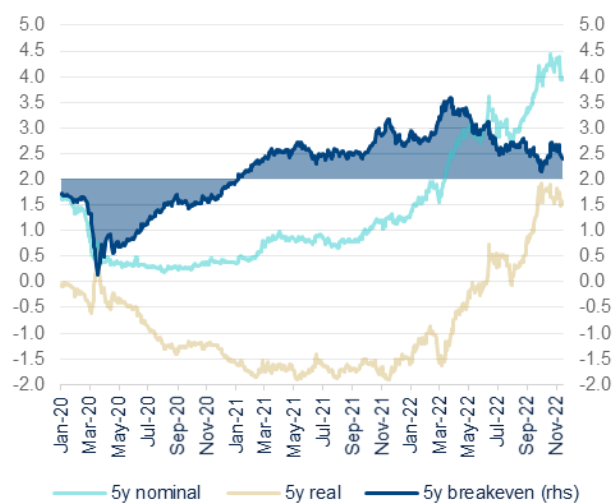
5-year and 10-year breakeven inflation rates dipped to their lowest levels since early October

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



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

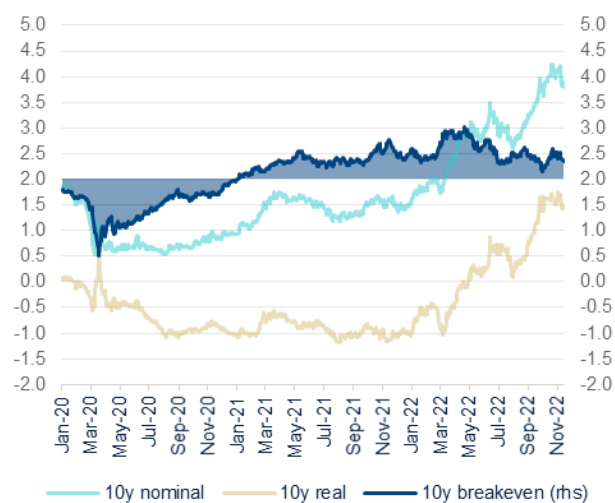
Figure 18. **5-YEAR BREAKEVEN INFLATION RATE (%)**



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

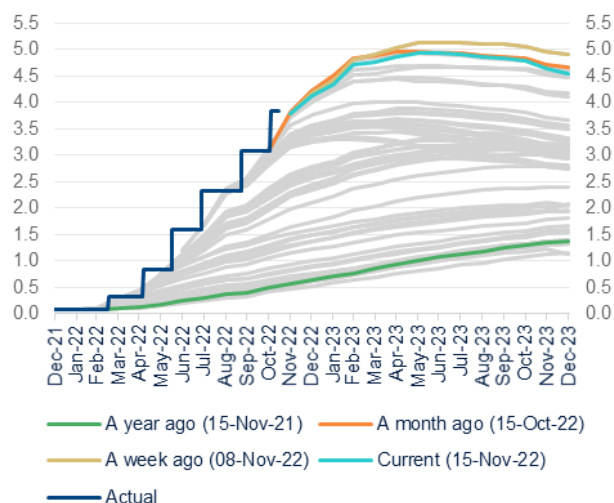
Figure 19. **10-YEAR BREAKEVEN INFLATION RATE (%)**



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

The futures market is pricing in a 75% chance that the Fed will deliver a 50bp hike next month

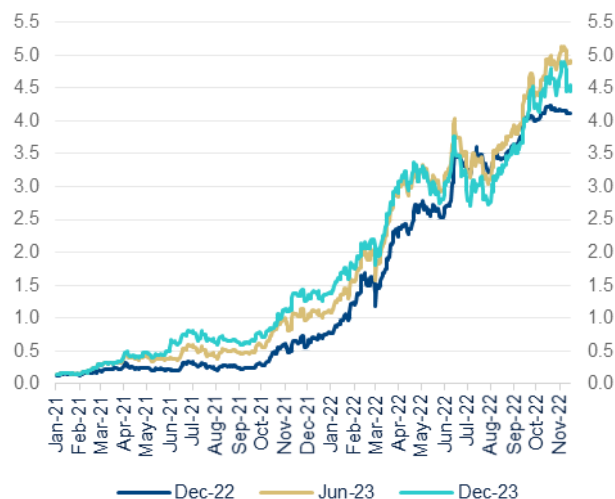
Figure 20. **IMPLIED RATE IN 30-DAY FED FUNDS FUTURES (%)**



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

Expectations that rates will remain restrictive throughout 2023 did not change dramatically

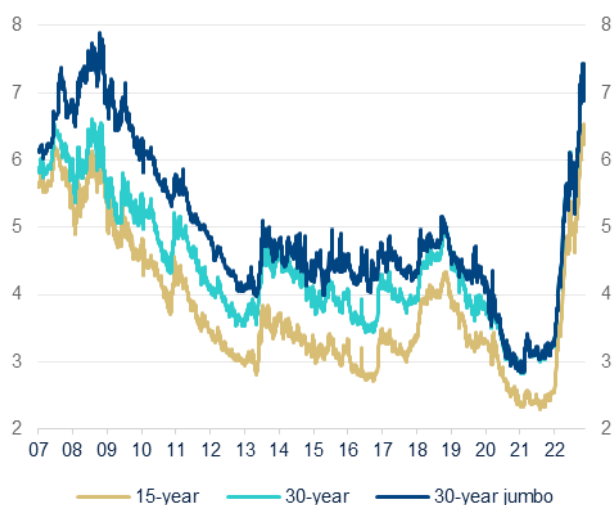
Figure 21. **IMPLIED RATE IN 30-DAY FED FUNDS FUTURES (%)**



Source: BBVA Research based on data by Bloomberg.

The fall in long-term yields gave a breather to 30y mortgage rates, which last month exceeded 7.4%

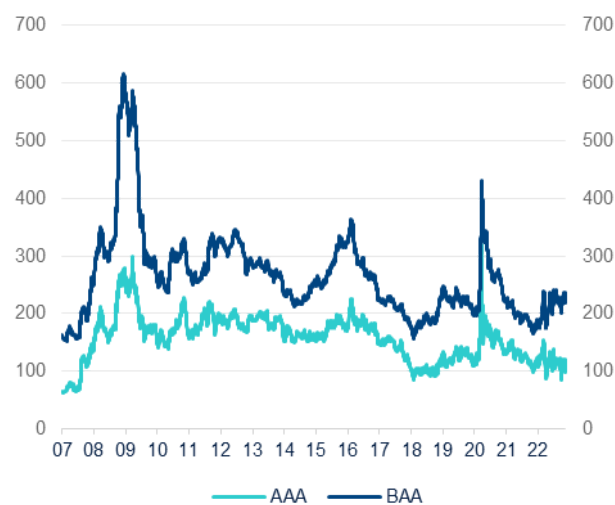
Figure 22. **MORTGAGE RATES (WSJ CONSUMER FIXED RATES, %)**



Source: BBVA Research based on data by Haver Analytics.

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

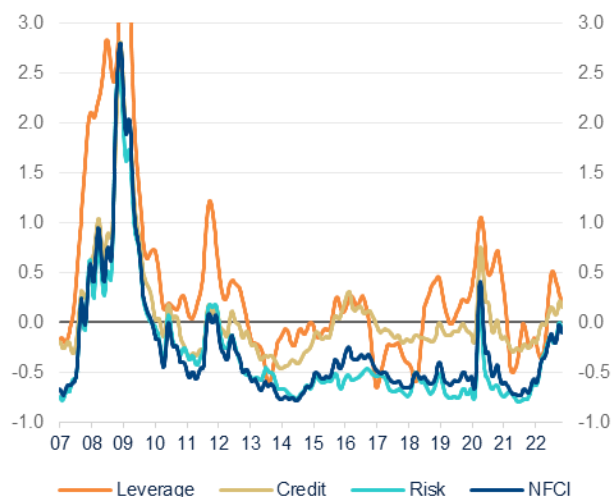
Figure 23. **CORPORATE BOND SPREADS (MOODY'S SEASONED YIELDS, DAILY DATA, BPS)**



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

Optimism from the recent inflation data will likely lead to a slight easing of financial conditions in...

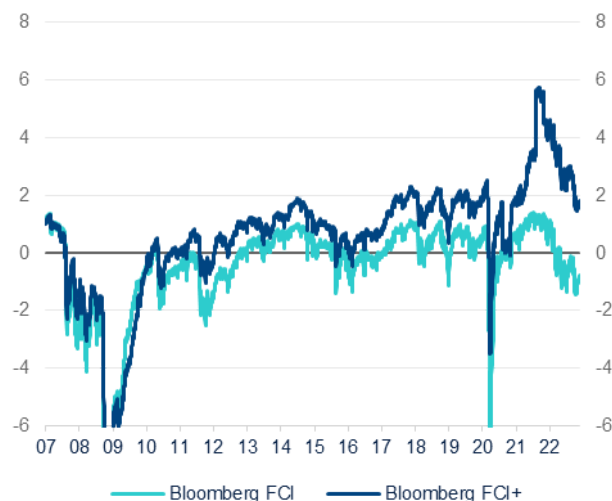
Figure 24. **CHICAGO FED NATIONAL FINANCIAL CONDITIONS INDEX** (>0 = TIGHTER THAN AVG)



Source: BBVA Research based on data by Haver Analytics.

... the short term. The Fed has been vocal about the risks of precipitously claiming victory

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



Source: BBVA Research based on data by Bloomberg.

Various Fed officials welcomed the positive inflation news. But, as Esther George noted...

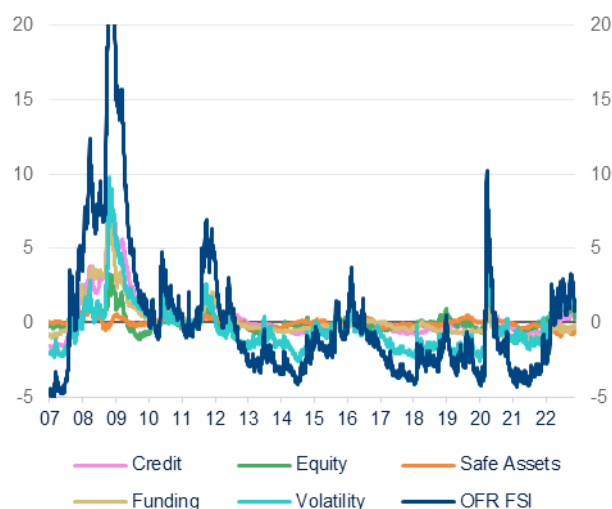
Figure 26. **FED FINANCIAL STRESS INDICES** (>0 = ABOVE AVG FINANCIAL STRESS)



Source: BBVA Research based on data by Haver Analytics.

“with inflation still elevated and likely to persist, monetary policy clearly has more work to do”

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



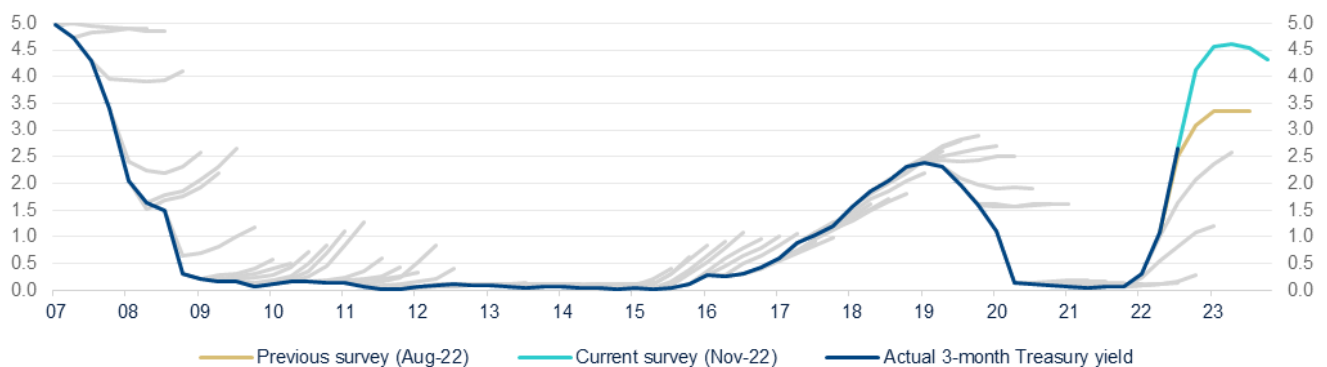
OFR: Office of Financial Research, US Department of the Treasury.
Source: BBVA Research based on data by Haver Analytics.

Professional forecasters revised up their interest rate projections

- Last Monday, the Federal Reserve Bank of Philadelphia released the 4th Quarter 2022 Survey of Professional Forecasters, showing significant revisions to the projected path of interest rates ([Figures 28](#) and [29](#)).
- For the first time in the current hiking cycle, the 10y-3m Treasury yield spread is expected by the median forecaster to turn negative and hover around -30 bps throughout 2023 ([Figure 31](#)).
- Professional forecasters still expect credit spreads to remain at relatively low levels ([Figure 33](#)).

Professional forecasters revised up significantly their short- and long-term Treasury yield projections. The median forecaster now expects the 3-month Treasury yield to peak at 4.6% by mid-2023...

Figure 28. **PROFESSIONAL FORECASTERS 3-MONTH TREASURY YIELD EXPECTATIONS (%)**



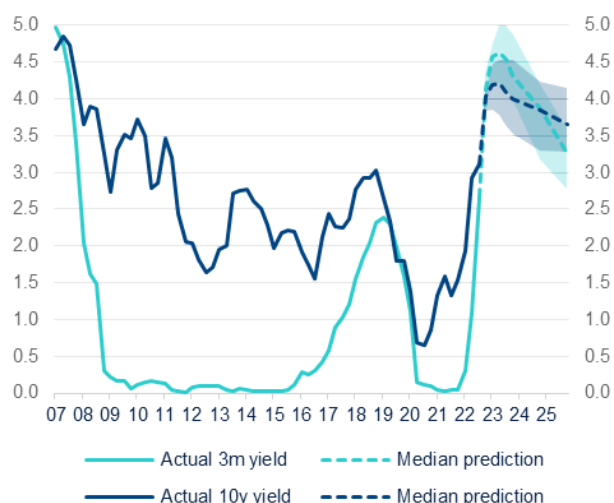
... and the 10-year Treasury yield to climb slightly above 4% and to hover around there throughout 2023.

Figure 29. **PROFESSIONAL FORECASTERS 10-YEAR TREASURY YIELD EXPECTATIONS (%)**



For the first time in the current hiking cycle, the 10y-3m Treasury yield spread is expected...

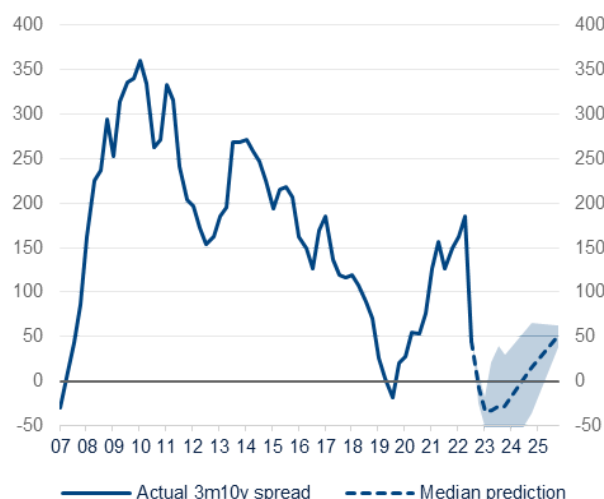
Figure 30. **PROF. FORECASTERS TREASURY YIELDS EXPECTATIONS (%)**



Shaded areas indicate interquartile ranges.
Source: BBVA Research based on data by the Federal Reserve Bank of Philadelphia and Haver Analytics.

... by the median forecaster to turn negative and hover around -30 bps throughout 2023

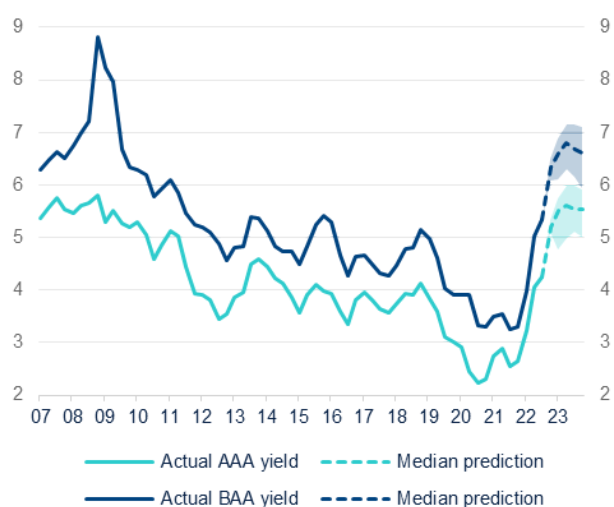
Figure 31. **PROF. FORECASTERS IMPLIED 3M10Y SPREAD EXPECTATIONS (BPS)**



The shaded area indicates the interquartile range.
Source: BBVA Research based on data by the Federal Reserve Bank of Philadelphia and Haver Analytics.

Professional forecasters still expect investment-grade bond yields to rise in an orderly fashion...

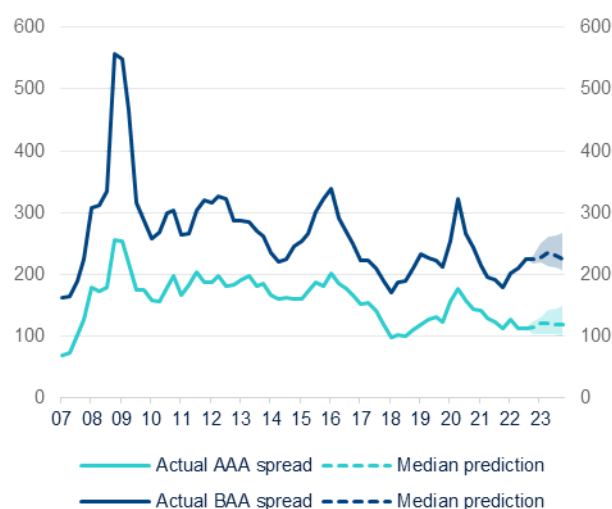
Figure 32. **PROF. FORECASTERS CORPORATE YIELDS EXPECTATIONS (%)**



Shaded areas indicate interquartile ranges..
Source: BBVA Research based on data by the Federal Reserve Bank of St. Louis, the Federal Reserve Bank of Philadelphia, and Haver Analytics.

... and credit spreads to remain at relatively low and flat levels

Figure 33. **PROF. FORECASTERS IMPLIED CORPORATE SPREADS EXPECTATIONS (%)**



Spreads over 10y Treasury. Shaded areas indicate interquartile ranges.
Source: BBVA Research based on data by the Federal Reserve Bank of St. Louis, the Federal Reserve Bank of Philadelphia, and Haver Analytics.

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