

US Interest rates monitor

# Long-term rates are likely past their peak...

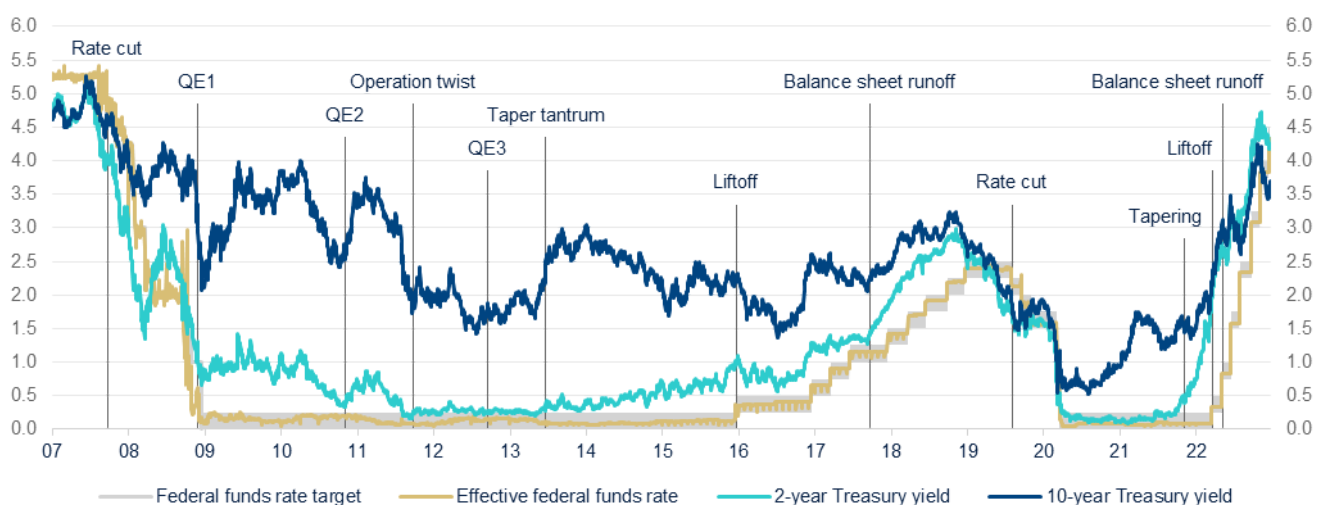
Javier Amador / Iván Fernández  
December 21, 2022

## ... but the Fed is not convinced that inflation is “on a sustained downward path”, and thus, it will try to reverse the recent downshift of the yield curve

- The Fed shifted gears down with a 50bp rate hike, but outlined a more hawkish outlook as cooling goods inflation meets sticky services inflation and a still hot labor market ([Figures 28](#) and [29](#)).
- Reversing the recent downward shift in the yield curve ([Figures 6](#) and [7](#)) might prove difficult with cooling inflation and the scenario of a “short and shallow” recession becoming less and less likely.
- Both the 10y-2y and 10y-3m yield spreads have kept falling ([Figure 10](#)), signaling increasing odds of a more severe recession while FOMC members remain (only publicly?) hopeful on the odds of a soft landing.
- The futures market did not buy the idea that the Fed will raise the fed funds rate above 5% ([Figure 20](#)), and expects a much sooner start for the rate cut cycle (in 2H23) than signaled by the FOMC ([Figure 21](#)).
- Powell downplayed the recent easing of financial conditions ([Figures 24](#) through [27](#)) as the “focus is not on short-term moves but on persistent moves”: a strong hint that the Fed will aim for a reversal.

Last week, the Fed slowed down its tightening pace after an extraordinarily fast set of four consecutive 75bp hikes, but signaled a more hawkish outlook suggesting that the policy rate might peak above 5%

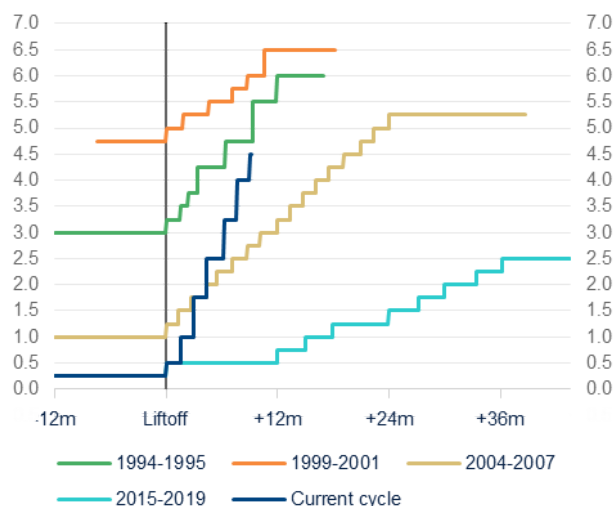
Figure 1. 2-YEAR, 10-YEAR TREASURY YIELDS AND FED FUNDS RATE (%)



Source: BBVA Research based on data by Haver Analytics.

**Chair Powell welcomed easing inflation but signaled multiple hikes in 2023 as...**

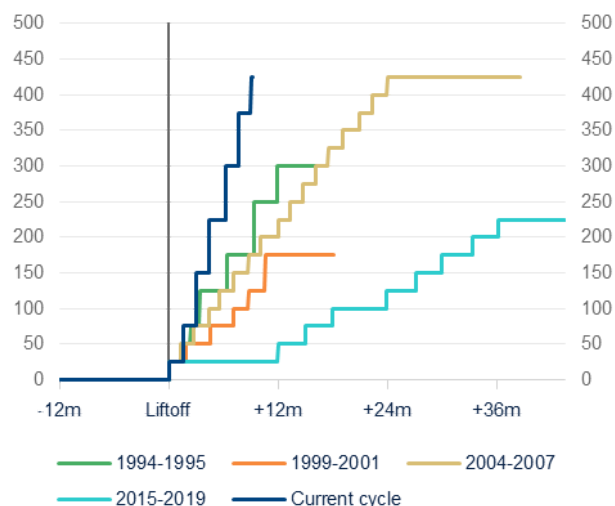
Figure 2. **FED FUNDS RATE IN TIGHTENING CYCLES (%)**



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.

**... “it will take [...] more evidence” to be confident that it “is on a sustained downward path”**

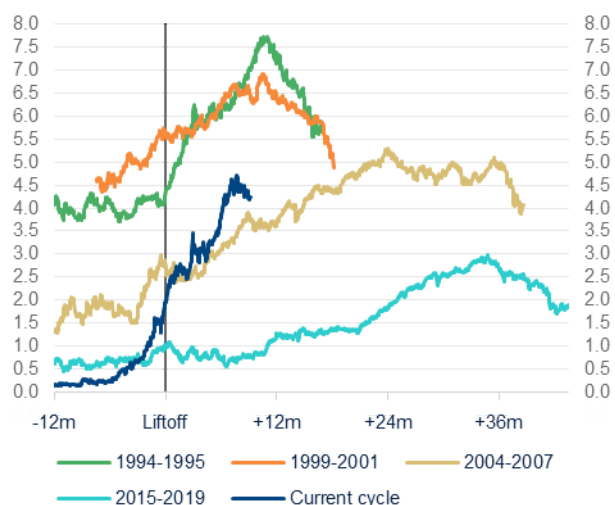
Figure 3. **FED FUNDS RATE IN TIGHTENING CYCLES (BPS VS RATE LEVEL AT LIFTOFF)**



Source: BBVA Research based on data by Haver Analytics.

**Another reason to stick to the tough talk is the discomfort with the easing of financial...**

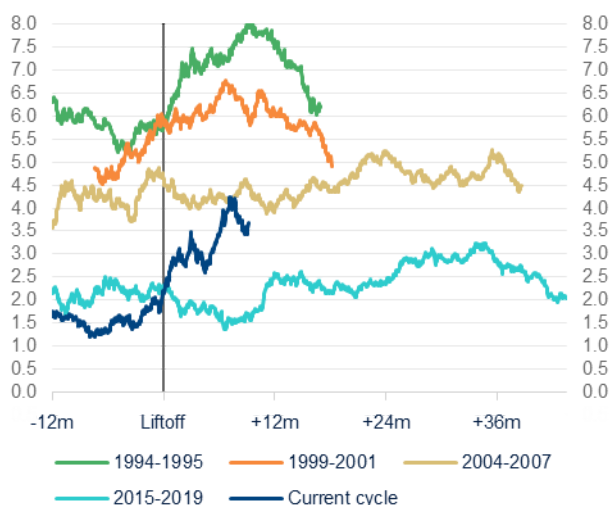
Figure 4. **2-YEAR TREASURY YIELD IN TIGHTENING CYCLES (%)**



Source: BBVA Research based on data by Haver Analytics.

**... conditions over the last weeks: long-term rates have come down sharply**

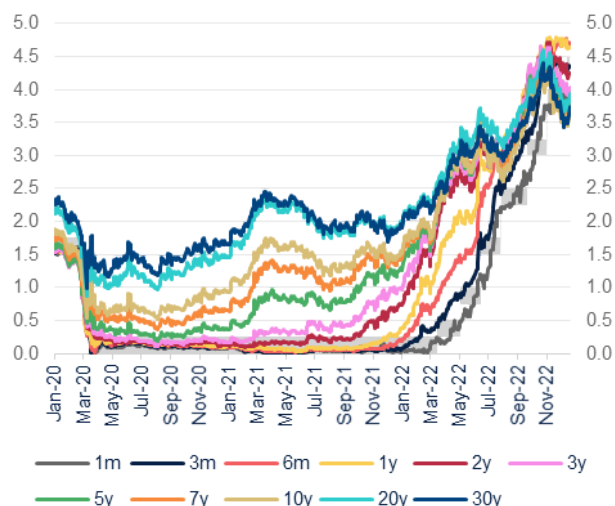
Figure 5. **10-YEAR TREASURY YIELD IN TIGHTENING CYCLES (%)**



Source: BBVA Research based on data by Haver Analytics.

## Reversing the downward shift in the yield curve might prove difficult with cooling inflation...

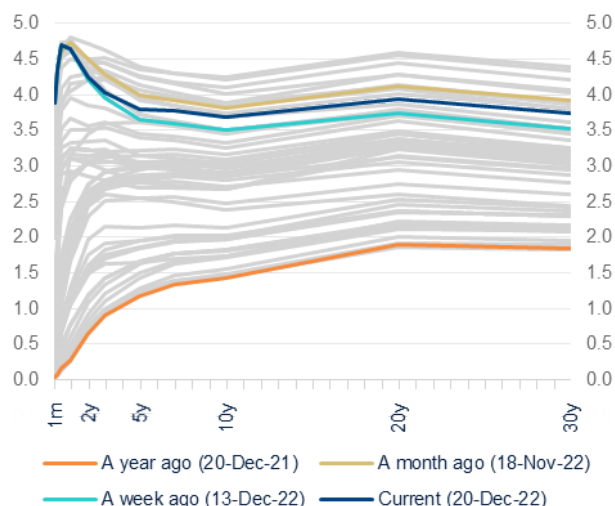
Figure 6. **TREASURY YIELDS**  
(%)



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

## ... and rising risks of a more severe recession: likely, long-term rates are already past their peak

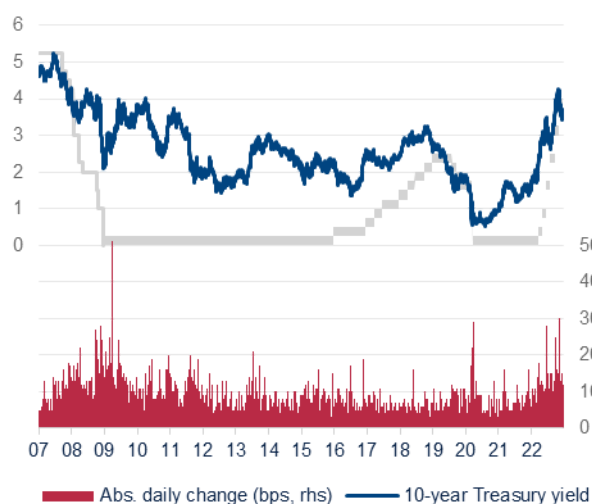
Figure 7. **TREASURY YIELD CURVE**  
(%)



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

## Although the 10y yield has come down, it recorded three 10+ bps movements in...

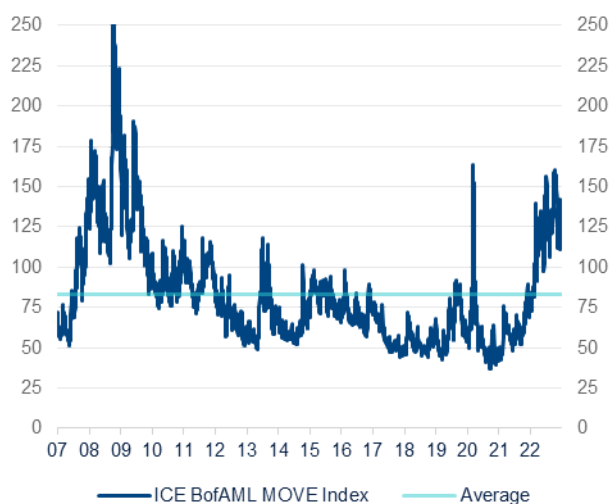
Figure 8. **10-YEAR TREASURY YIELD DAILY CHANGE**  
(% AND BPS)



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

## ... the last month as bond market volatility remains well above its historical average

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



Source: BBVA Research based on data by Haver Analytics.

Both the 10y-2y and 10y-3m yield spreads have kept falling, signaling increasing odds of a more severe recession. Yet, publicly, FOMC members remain hopeful on the odds of a soft landing, even though...

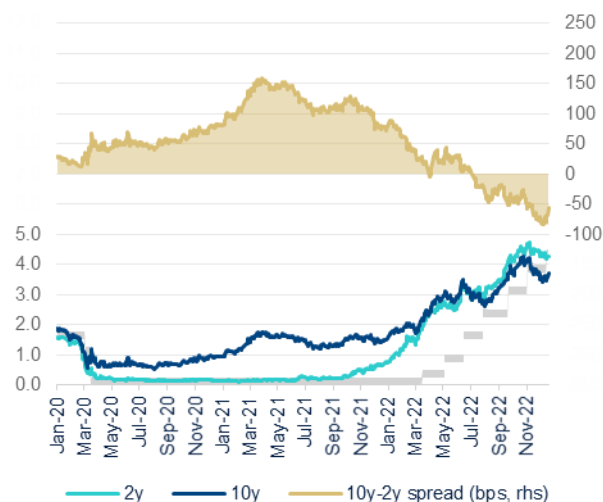
Figure 10. **TREASURY YIELD SPREADS (BPS)**



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.

... Nov's FOMC minutes revealed that the staff "viewed the possibility that the economy...

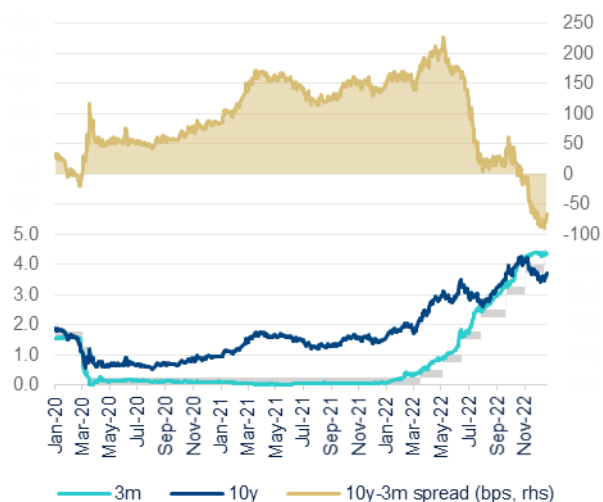
Figure 11. **10Y-2Y TREASURY YIELD SPREAD (% AND BPS)**



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

... would enter a recession sometime over the next year as almost as likely as the baseline"

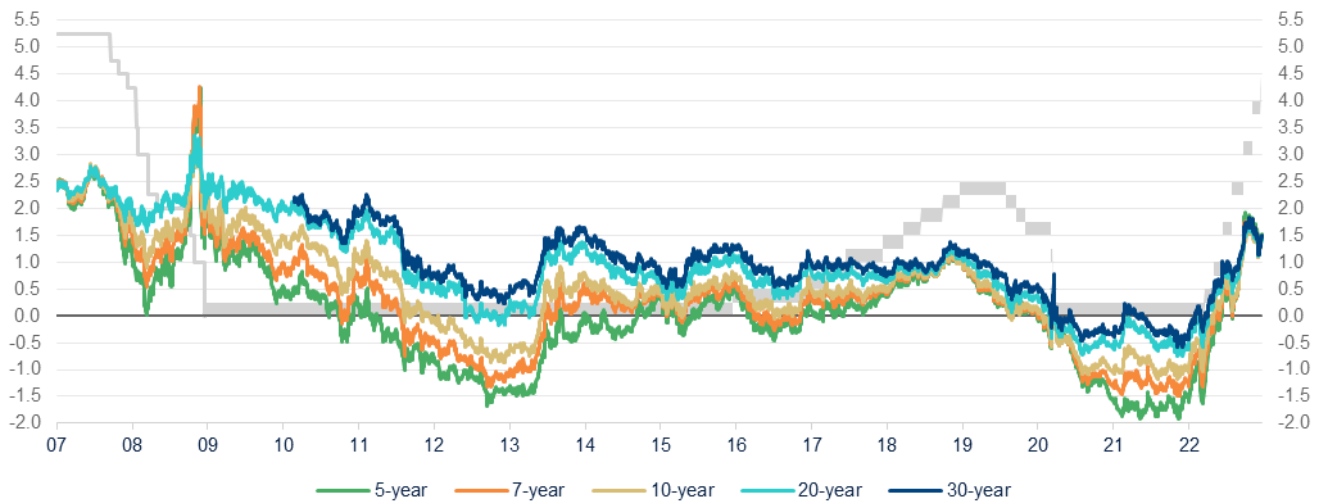
Figure 12. **10Y-3M TREASURY YIELD SPREAD (% AND BPS)**



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

**Inflation-protected Treasury yields mirrored the decline in nominal yields, but are still parked in solidly positive territory and near decade-highs, which is helpful for the financial conditions tightness that the...**

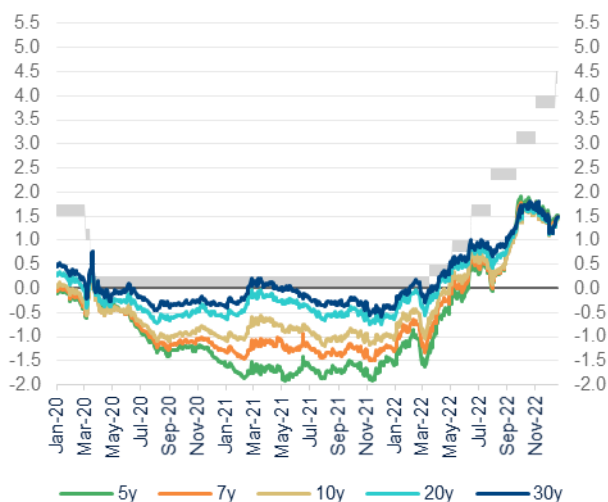
Figure 13. **INFLATION INDEXED TREASURY (TIPS) YIELDS (%)**



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

**... Fed is aiming to deter a misjudged search for yield on risky assets**

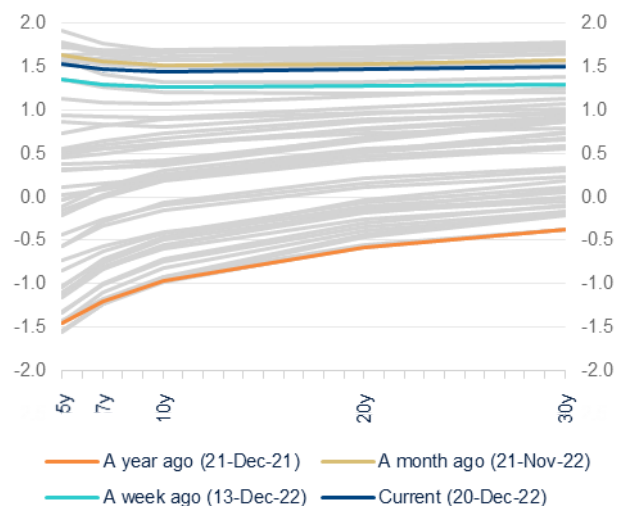
Figure 14. **INFLATION INDEXED (TIPS) YIELDS (%)**



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

**The real yield curve remains practically flat around 1.5%**

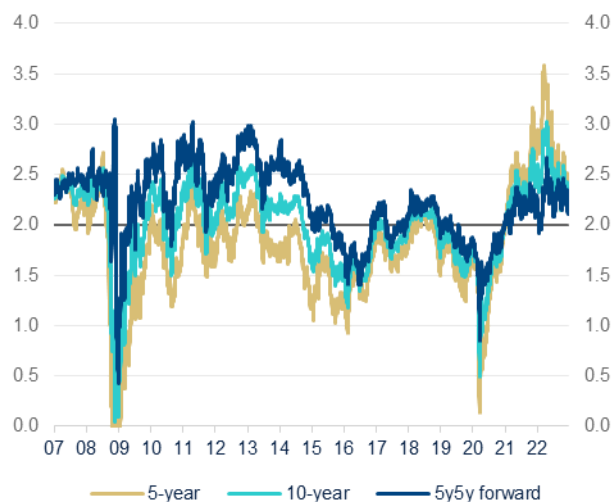
Figure 15. **INFLATION INDEXED (TIPS) YIELD CURVE (%)**



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

Markets seem to be increasingly confident that inflation will not be a problem in the long run...

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



Source: BBVA Research based on data by Haver Analytics.

... as shown by the further decline of breakeven inflation rates. Markets now expect inflation...

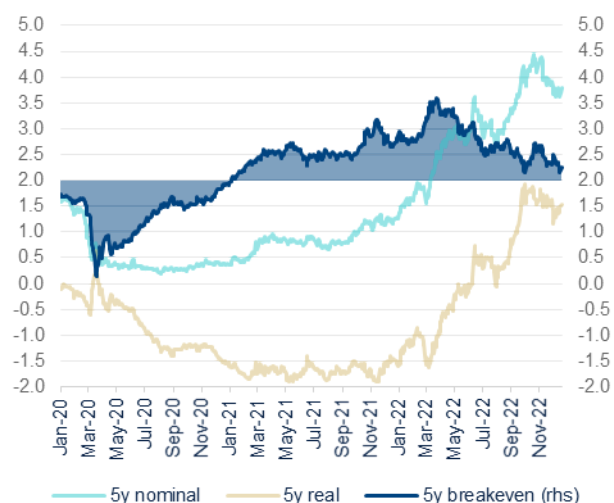
Figure 17. **5Y5Y FORWARD IMPLIED INFLATION RATE**  
(%)



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

... to average 2.2% in the next decade, probably underestimating the likelihood of...

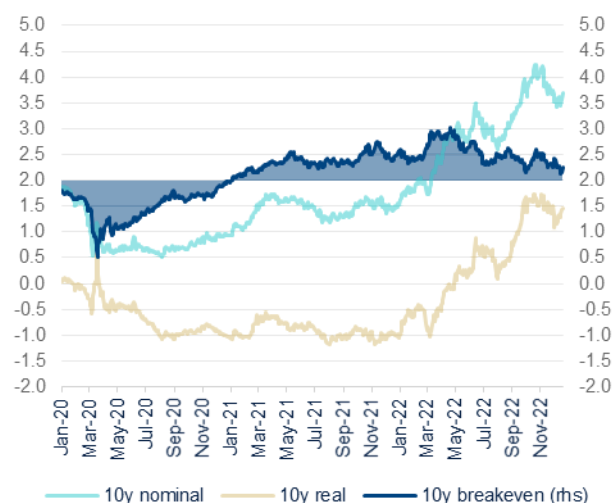
Figure 18. **5-YEAR BREAKEVEN INFLATION RATE**  
(%)



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

... a less benign environment for inflation in the medium run

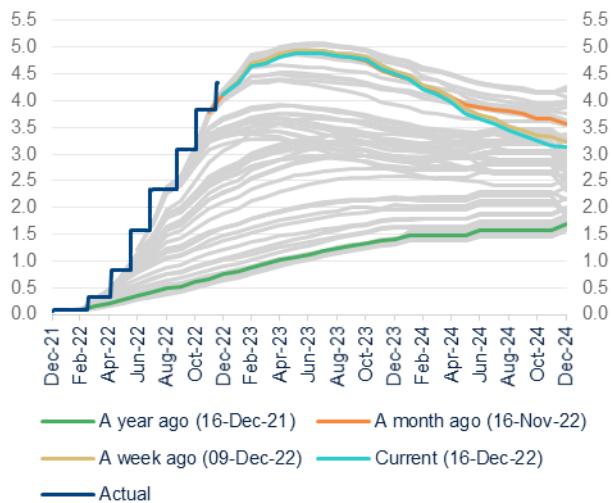
Figure 19. **10-YEAR BREAKEVEN INFLATION RATE**  
(%)



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

The futures market did not buy the idea that the Fed will raise the fed funds rate above 5%...

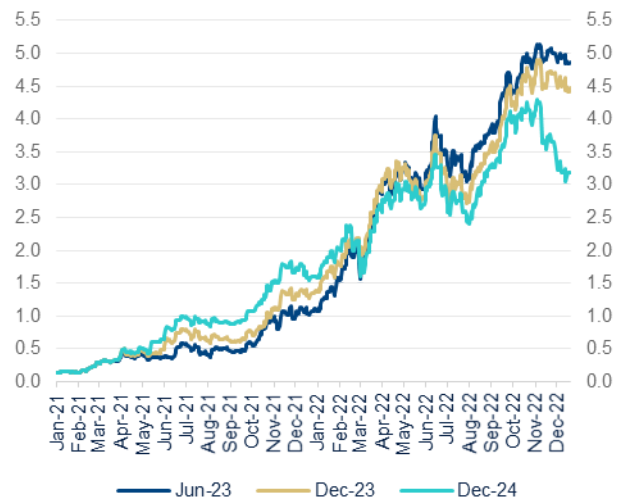
Figure 20. **IMPLIED RATE IN 30-DAY FED FUNDS FUTURES (%)**



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

... and expects a much sooner start for the rate cut cycle (in 2H23) than signaled by the FOMC

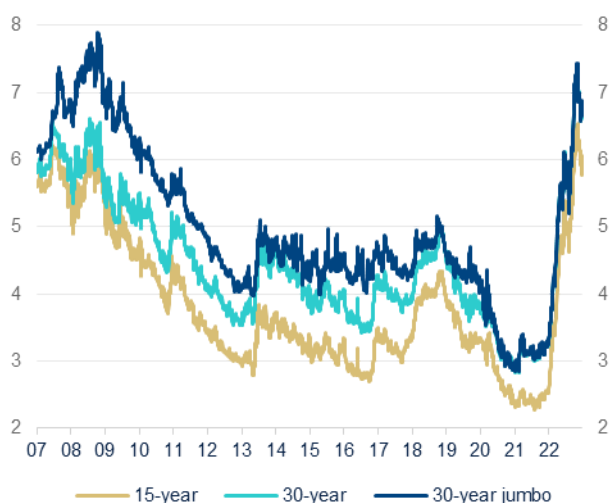
Figure 21. **IMPLIED RATE IN 30-DAY FED FUNDS FUTURES (%)**



Source: BBVA Research based on data by Bloomberg.

30-year fixed mortgage rates declined further but remain sky-high

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)

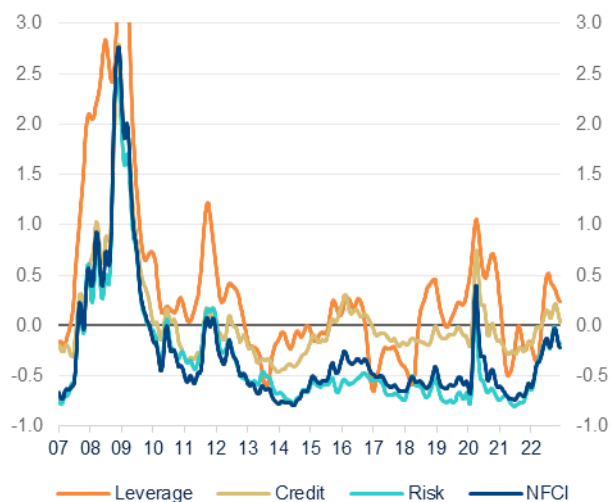


Spreads over the 10-year Treasury yield.  
Source: BBVA Research based on data by the Fed of St. Louis (FRED) and Haver Analytics.



Although explicitly asked, Chair Powell downplayed the importance of the recent...

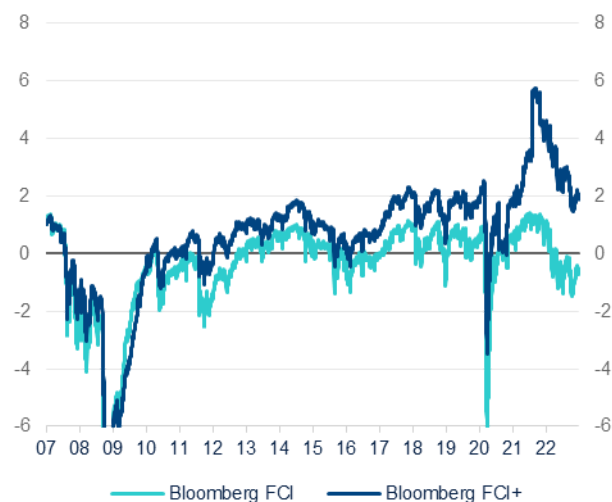
Figure 24. **CHICAGO FED NATIONAL FINANCIAL CONDITIONS INDEX** (>0 = TIGHTER THAN AVG)



Source: BBVA Research based on data by Haver Analytics.

... easing of financial conditions following the string of positive inflation data...

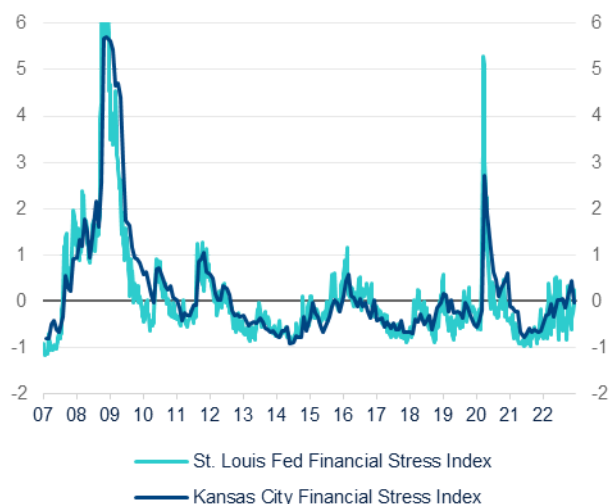
Figure 25. **BLOOMBERG FINANCIAL CONDITIONS INDICES** (<0 = TIGHTER THAN PRE-GFC AVG)



Source: BBVA Research based on data by Bloomberg.

... as the Fed's "focus is not on short-term moves but on persistent moves", ...

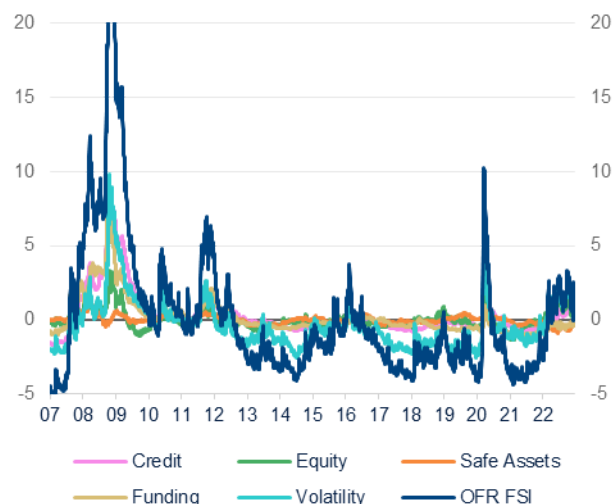
Figure 26. **FED FINANCIAL STRESS INDICES** (>0 = ABOVE AVG FINANCIAL STRESS)



Source: BBVA Research based on data by Haver Analytics.

... a strong hint that it is unwelcomed and the Fed will aim for a reversal

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



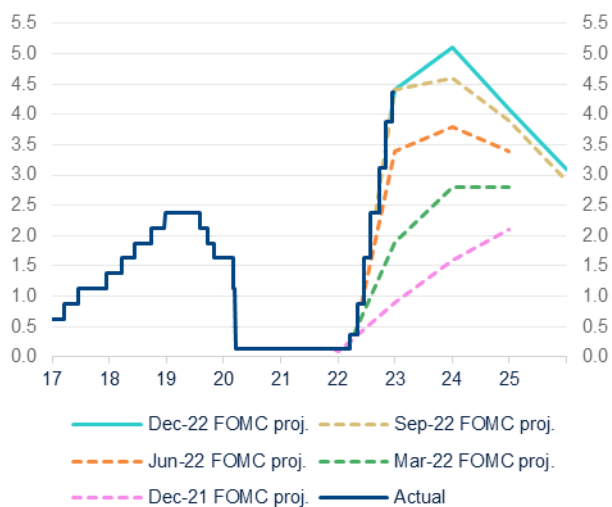
OFR: Office of Financial Research, US Department of the Treasury.  
Source: BBVA Research based on data by Haver Analytics.



## November's SEP outlined a somewhat weaker economic scenario aligned with a more hawkish projected policy stance

The median estimate for the policy rate by the end of 2023 was revised up from 4.6 to 5.1%

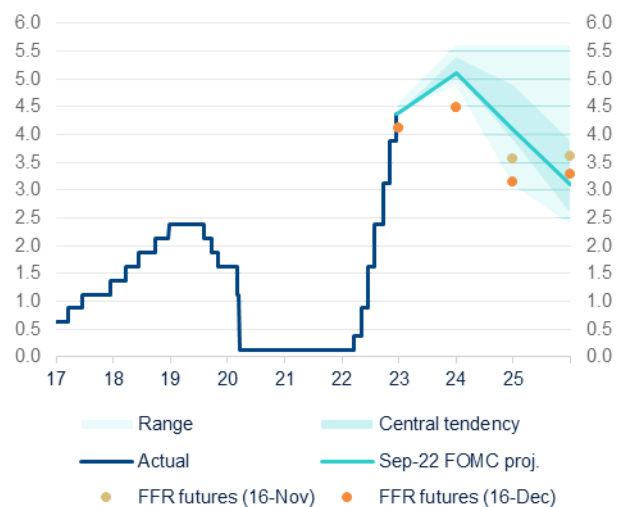
Figure 28. **FOMC PARTICIPANTS PROJECTED FED FUNDS RATE (MEDIAN PROJECTION, %)**



Source: BBVA Research based on data by Haver Analytics.

This suggests a hawkish outlook with 75bp worth of additional tightening (likely?) to come

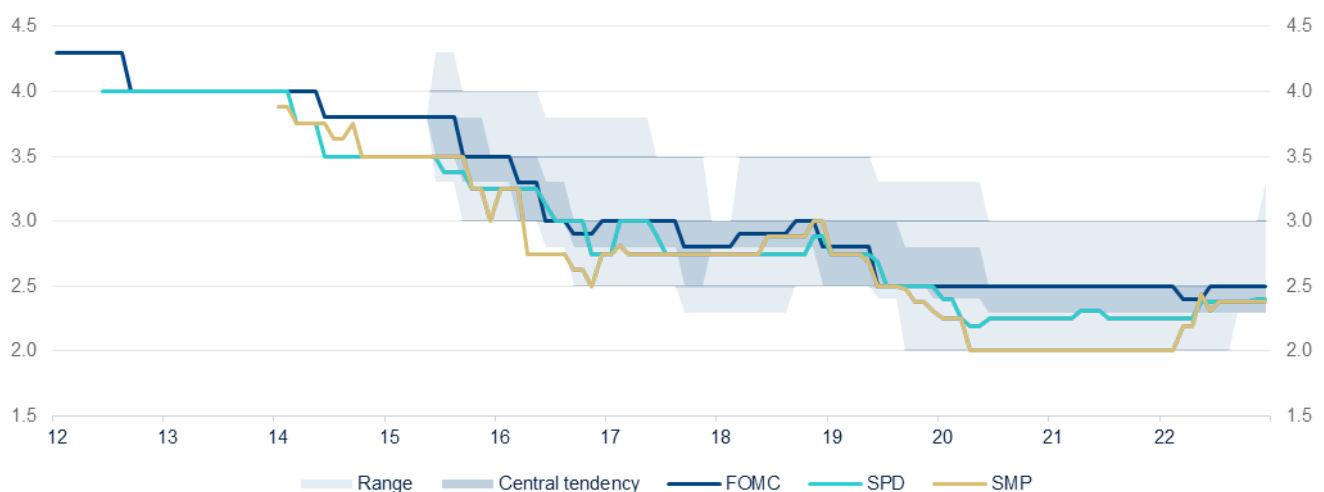
Figure 29. **FOMC PARTICIPANTS PROJECTED FED FUNDS RATE (MEDIAN PROJECTION, %)**



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

The estimated steady-state fed funds rate remains unchanged in the 2.0-3.0% range, still implying the absence of significant expectations of changes in the structural factors that have driven it to that level

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.

## 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](http://www.bbvaresearch.com).