

US Interest rates monitor

The yield curve has shifted further down and is headed to fully invert soon

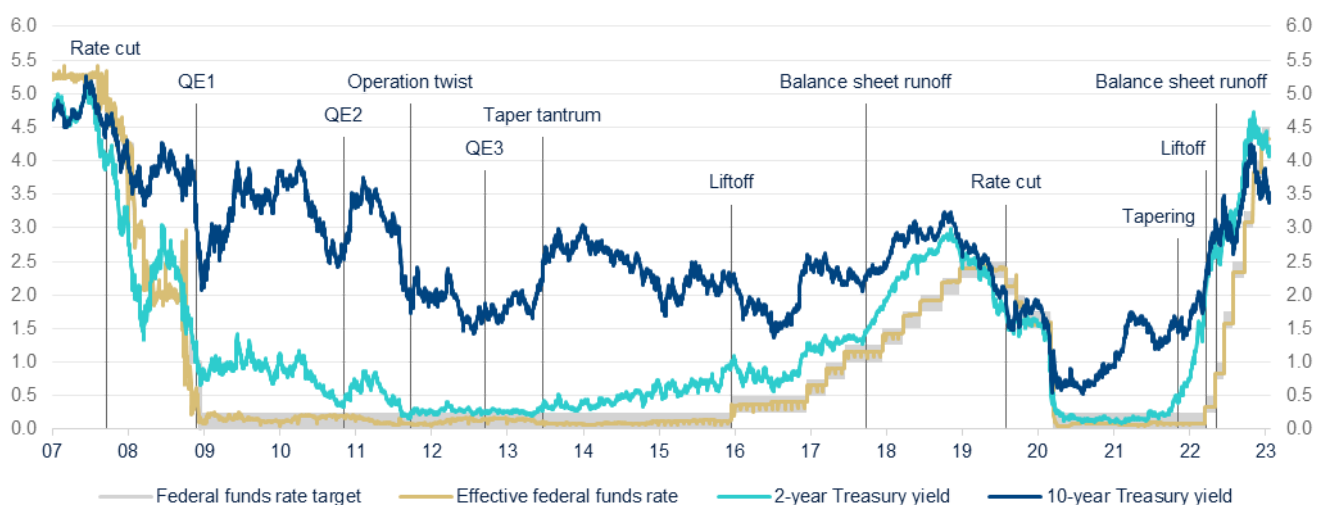
Javier Amador / Iván Fernández
January 24, 2023

The Fed is attempting to reverse this downshift saying it is set to keep policy “sufficiently restrictive for some time”

- The Fed is set to slow rate hikes again and discuss how much further to go ([Figures 2](#) and [3](#)).
- The attempt to reverse the downward shift in the yield curve ([Figures 6](#) and [7](#)) is becoming more challenging as evidence of a gloomy outlook for economic activity and a more benign one for inflation continues to mount.
- The debate surrounding a likely recession this year is focused on its possible severity, not on its probability of occurrence ([Figure 10](#)), as both the 10y-2y and 10y-3m Treasury yield spreads have hit four-decade lows ([Figures 11](#) and [12](#)).
- Markets' expectation of the terminal rate hasn't changed much, but they're pricing in an earlier easing of policy in late 2023, and a much faster one than signaled by Fed projections in 2024 ([Figures 20](#) and [21](#)).
- Broad financial conditions indices kept easing ([Figures 24](#) and [25](#)). Dec's FOMC minutes revealed members remain concerned that “an unwarranted easing in financial conditions, especially if driven by a misperception by the public of the [Fed's] reaction function, would complicate the [Fed's] effort to restore price stability”.

Next week, the Fed will likely slow down again its tightening pace by delivering a 25bp hike, bringing the fed funds rate to a 4.50-4.75% target range for a cumulative increase of 450 bps in less than 12 months

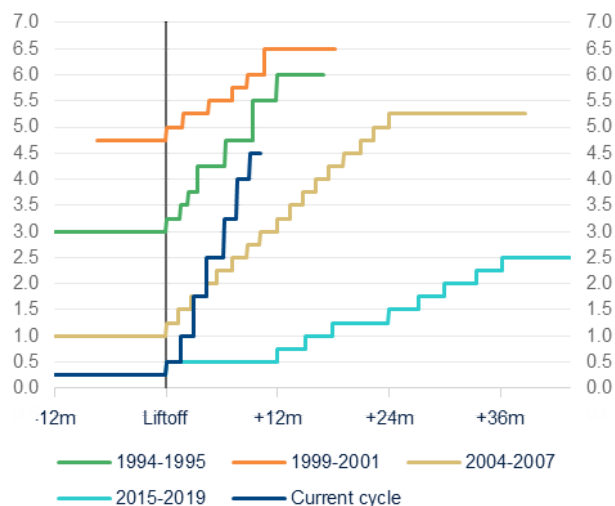
Figure 1. 2-YEAR, 10-YEAR TREASURY YIELDS AND FED FUNDS RATE (%)



Source: BBVA Research based on data by Haver Analytics.

This will likely be the second last hike in the current tightening cycle before the FOMC shifts...

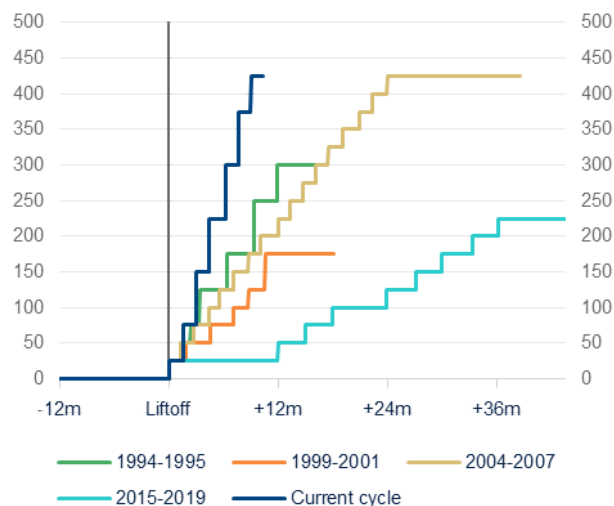
Figure 2. **FED FUNDS RATE IN TIGHTENING CYCLES (%)**



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.

... to an already signaled long (?) pause to tame inflation and weigh policy effects; however, ...

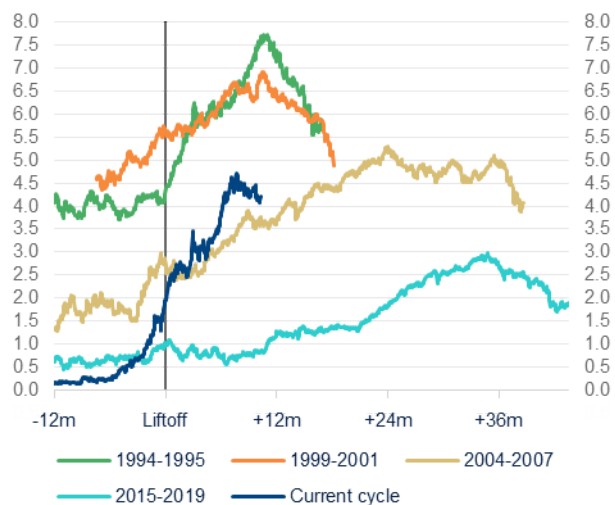
Figure 3. **FED FUNDS RATE IN TIGHTENING CYCLES (BPS VS RATE LEVEL AT LIFTOFF)**



Source: BBVA Research based on data by Haver Analytics.

... the Treasury market seems to be betting that this time the Fed won't stick to its hawkishness...

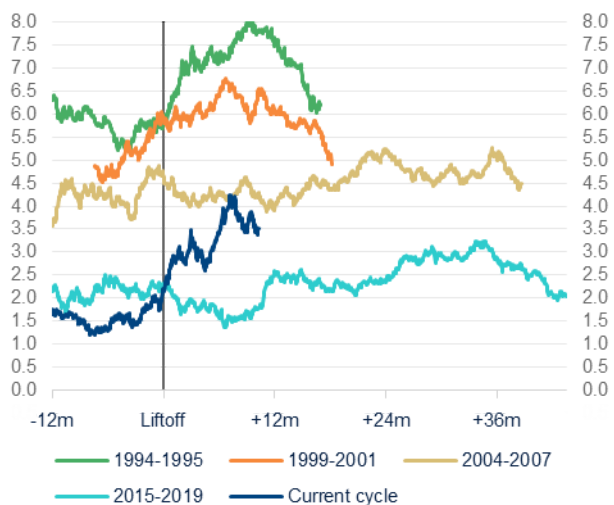
Figure 4. **2-YEAR TREASURY YIELD IN TIGHTENING CYCLES (%)**



Source: BBVA Research based on data by Haver Analytics.

... and will not take more than a few months before it decides to cut its rate later this year

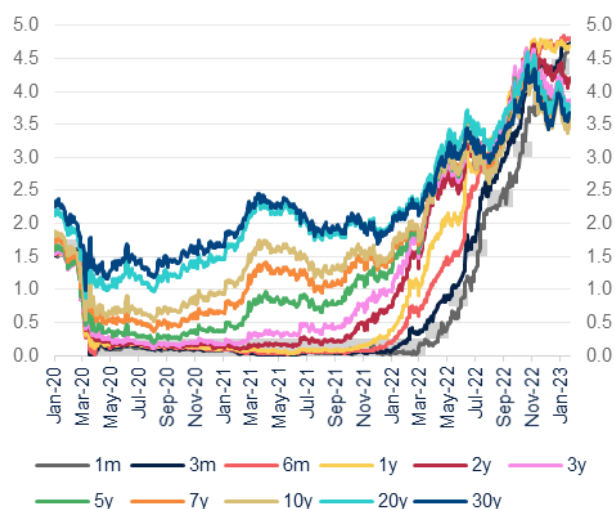
Figure 5. **10-YEAR TREASURY YIELD IN TIGHTENING CYCLES (%)**



Source: BBVA Research based on data by Haver Analytics.

Long- and mid-term yields have kept falling after peaking 3 months ago, as evidence of a...

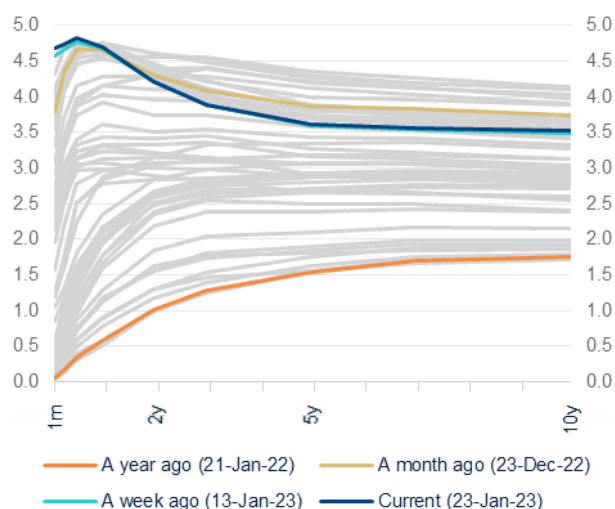
Figure 6. **TREASURY YIELDS**
(%)



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

... gloomy outlook for economic activity and a more benign one for inflation continues to mount

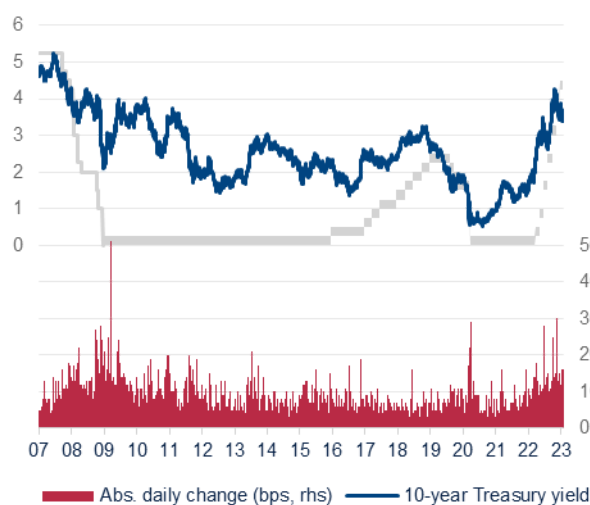
Figure 7. **TREASURY YIELD CURVE**
(%)



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

Volatility in the bond market has eased on less uncertainty about how much further...

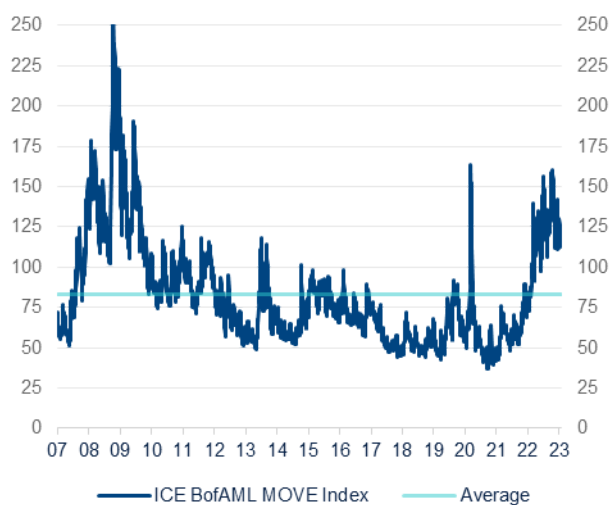
Figure 8. **10-YEAR TREASURY YIELD DAILY CHANGE**
(% AND BPS)



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

... the Fed might push its rate, though it remains above its pre-Russia-Ukraine-conflict levels

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



Source: BBVA Research based on data by Haver Analytics.

The debate surrounding a recession this year in the US is focused today on its possible severity, not on its probability of occurrence. One of the first recession predictions was given by the yield curve when...

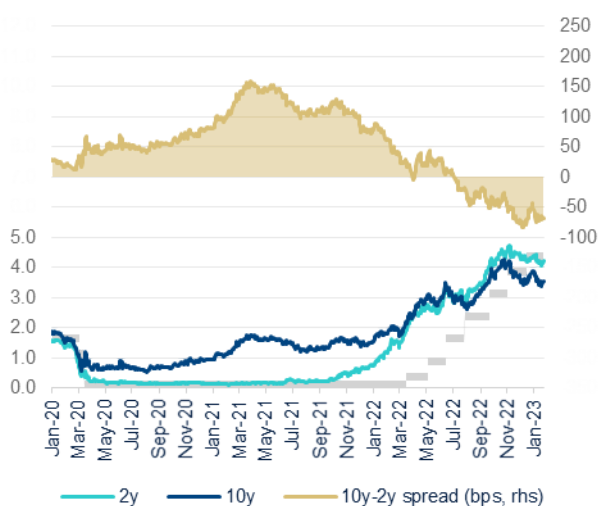
Figure 10. **TREASURY YIELD SPREADS (BPS)**



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.

... the 10y-2y yield spread first turned negative in April. That signal has only strengthened as...

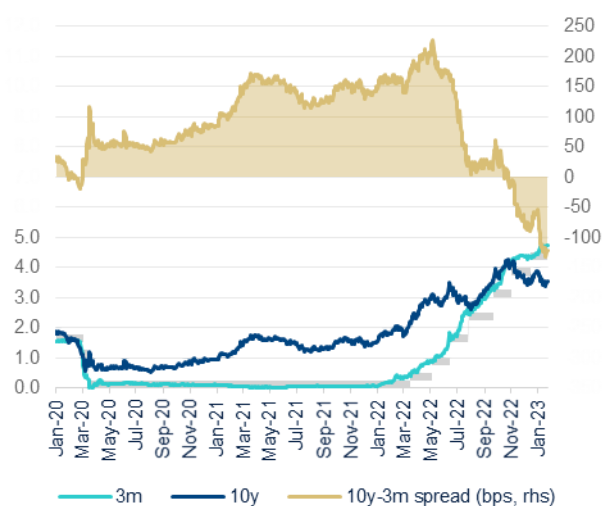
Figure 11. **10Y-2Y TREASURY YIELD SPREAD (% AND BPS)**



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

... both the 10y-2y and 10y-3m Treasury yield spreads have hit four-decade lows

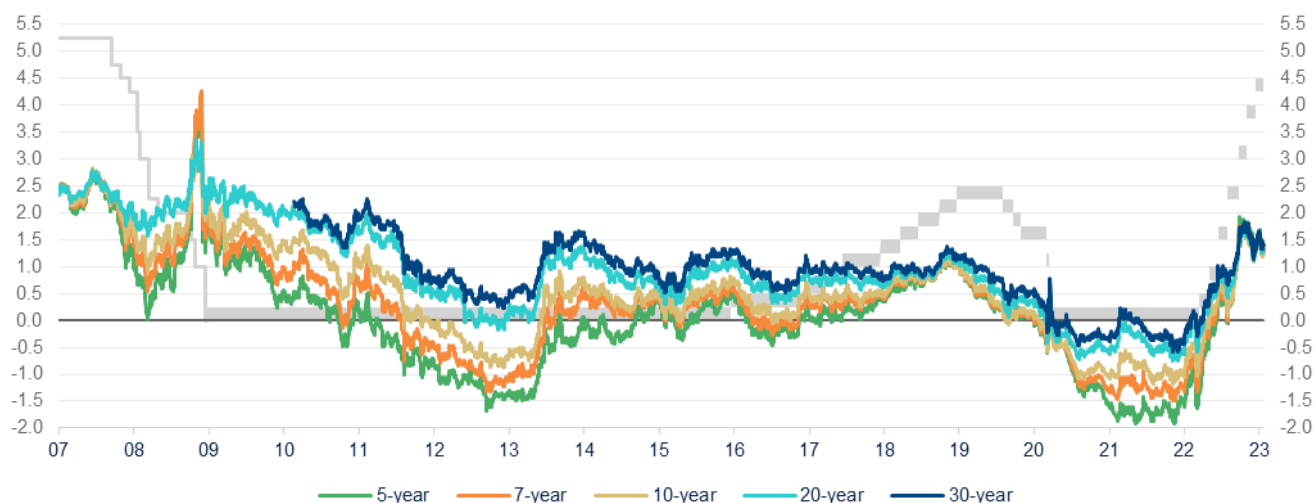
Figure 12. **10Y-3M TREASURY YIELD SPREAD (% AND BPS)**



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

The monetary adjustment applied by the Fed in just over a year managed to increase real yields above their maximum levels reached in the past decade. Mirroring the behavior of their nominal counterparts,...

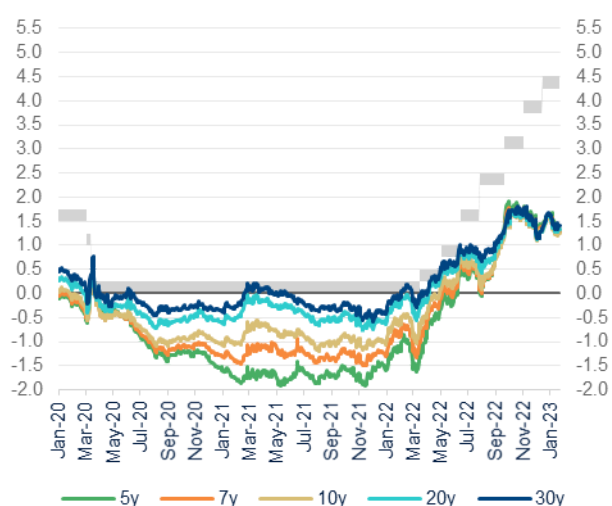
Figure 13. INFLATION INDEXED TREASURY (TIPS) YIELDS (%)



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

... inflation-indexed Treasury (TIPS) yields have declined somewhat from their October peaks,...

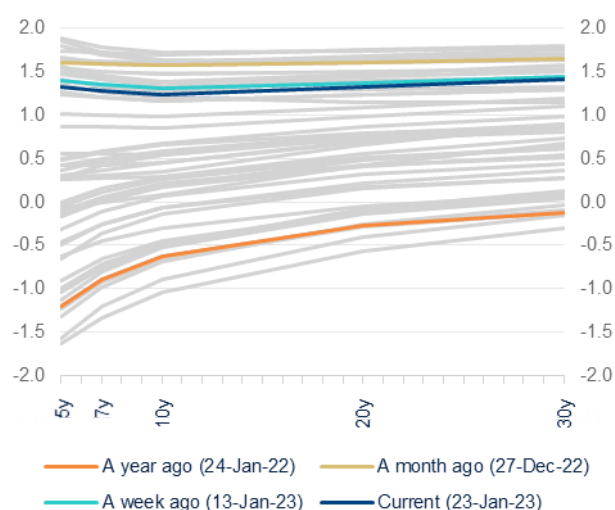
Figure 14. INFLATION INDEXED (TIPS) YIELDS (%)



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

... but remain in positive territory, adding to a relatively tight financial environment

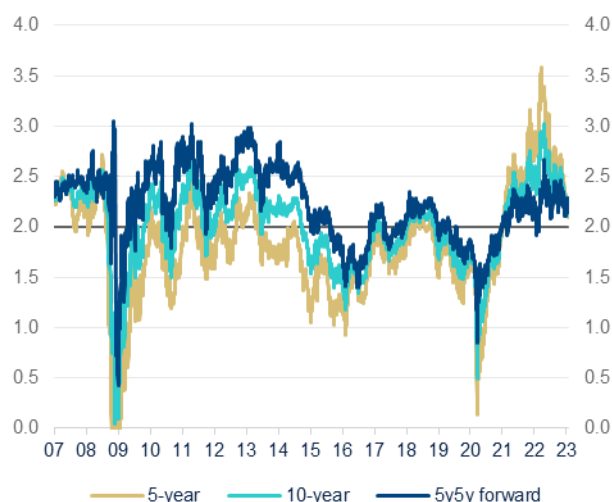
Figure 15. INFLATION INDEXED (TIPS) YIELD CURVE (%)



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

Recent positive surprises on CPI inflation have allowed market-based inflation expectations to...

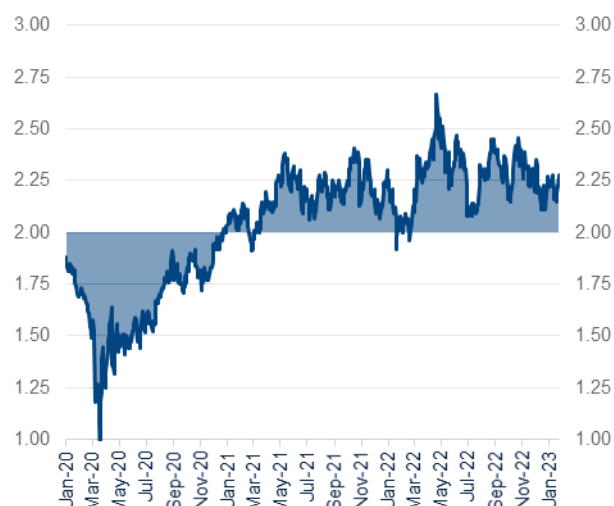
Figure 16. **BREAKEVEN INFLATION RATES (%)**



Source: BBVA Research based on data by Haver Analytics.

... remain well anchored even though the Fed has strongly conveyed its concern that...

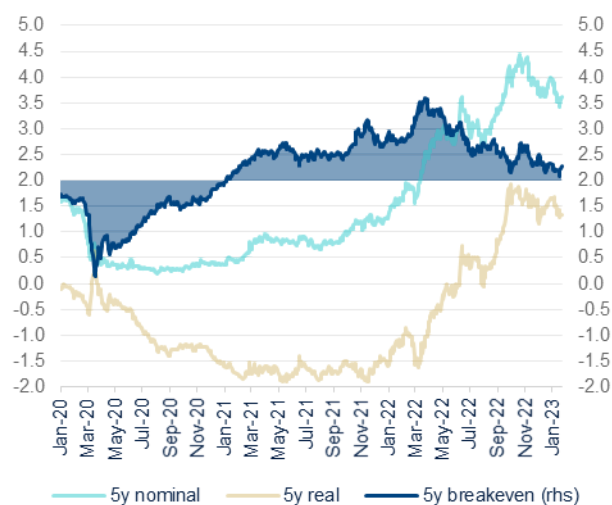
Figure 17. **5Y5Y FORWARD IMPLIED INFLATION RATE (%)**



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

... non-housing core services inflation is likely to be reluctant to budge anytime soon given its...

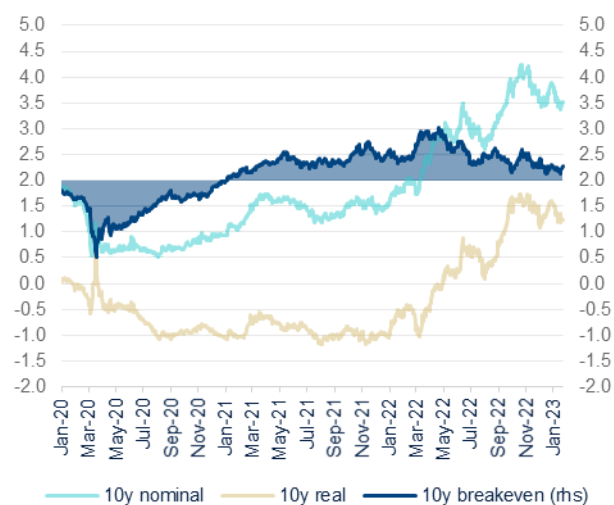
Figure 18. **5-YEAR BREAKEVEN INFLATION RATE (%)**



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

... close relationship with a still-tight job market that scored a 3.5% unemployment rate last month

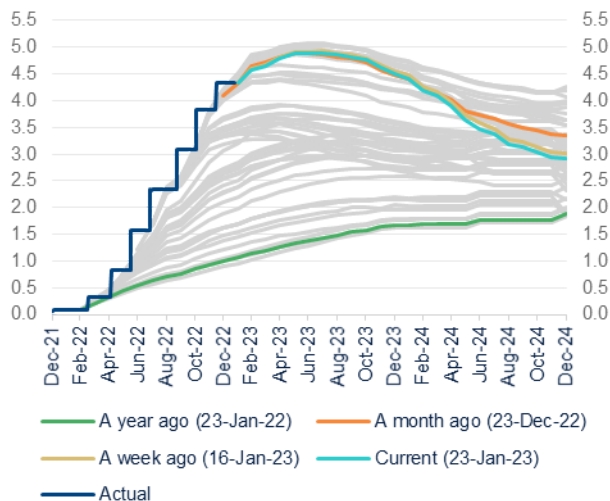
Figure 19. **10-YEAR BREAKEVEN INFLATION RATE (%)**



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

Markets' expectation of the terminal rate hasn't changed much, but they're pricing in an earlier...

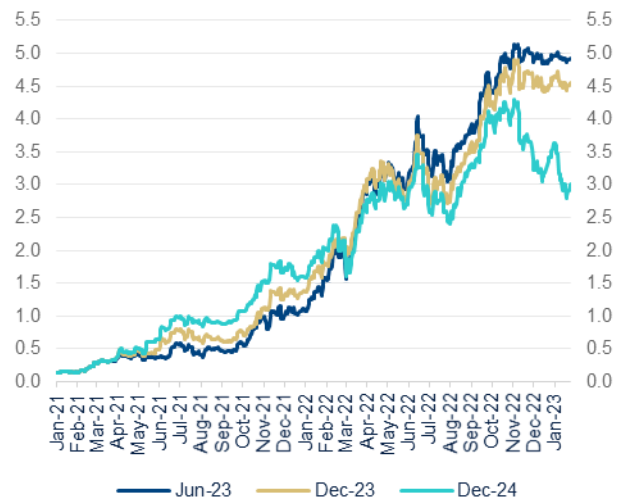
Figure 20. **IMPLIED RATE IN 30-DAY FED FUNDS FUTURES (%)**



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

... easing of policy in late 2023, and a much faster one than signaled by Fed projections in 2024

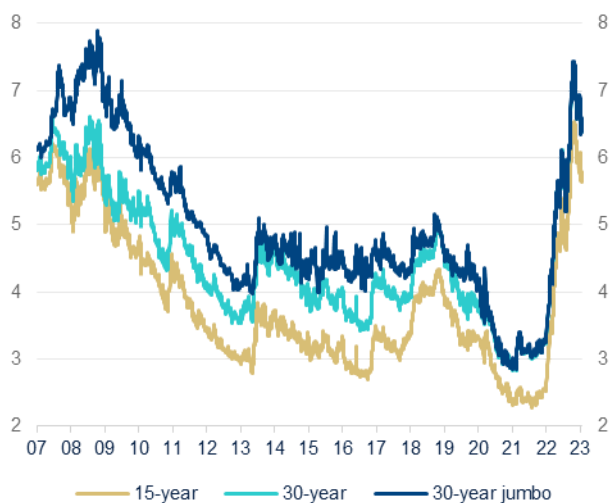
Figure 21. **IMPLIED RATE IN 30-DAY FED FUNDS FUTURES (%)**



Source: BBVA Research based on data by Bloomberg.

Despite falling in recent months, mortgage rates remain well above last-decade levels

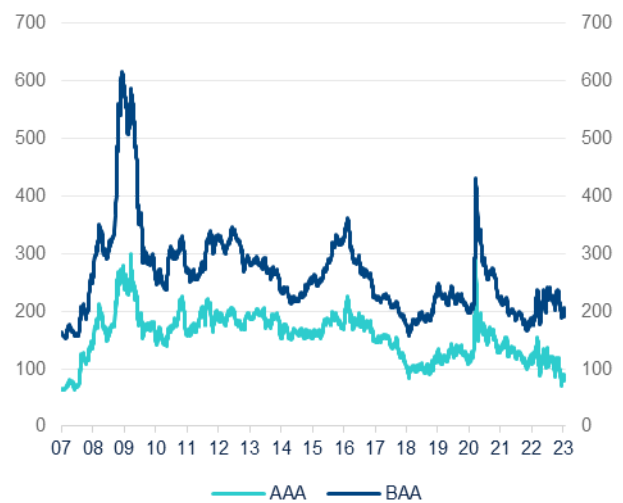
Figure 22. **MORTGAGE RATES (WSJ CONSUMER FIXED RATES, %)**



Source: BBVA Research based on data by Haver Analytics.

The investment-grade corporate credit market appears to remain immune to financial stress

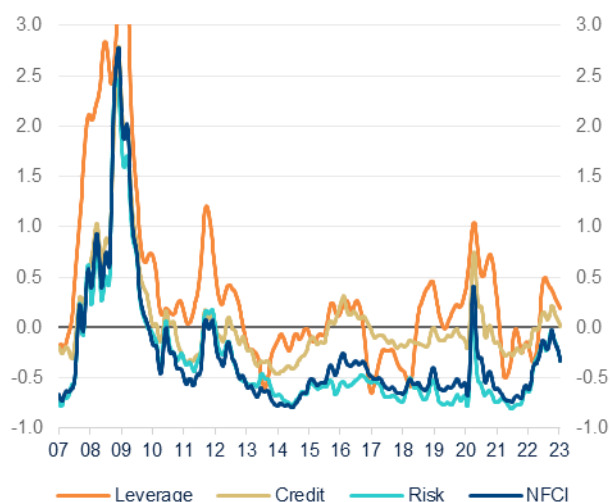
Figure 23. **CORPORATE BOND SPREADS (MOODY'S SEASONED YIELDS, DAILY DATA, BPS)**



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

Broad financial conditions indices kept easing somewhat. Dec's FOMC minutes revealed...

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



Source: BBVA Research based on data by Haver Analytics.

... members remain concerned that “an unwarranted easing in financial conditions, ...

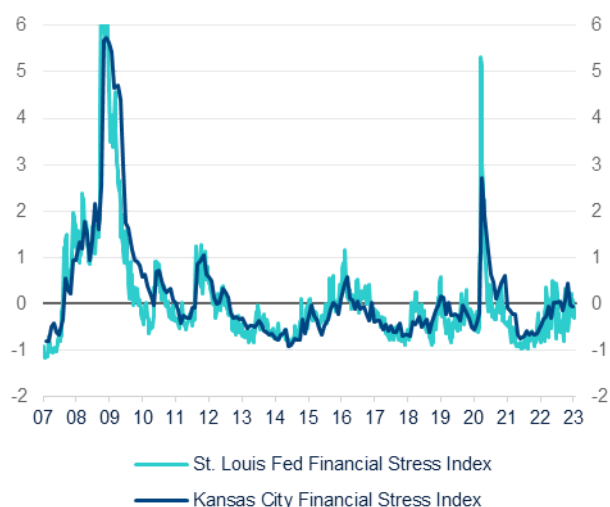
Figure 25. **BLOOMBERG FINANCIAL CONDITIONS INDICES** (<0 = TIGHTER THAN PRE-GFC AVG)



Source: BBVA Research based on data by Bloomberg.

... especially if driven by a misperception by the public of the Committee’s reaction function, ...

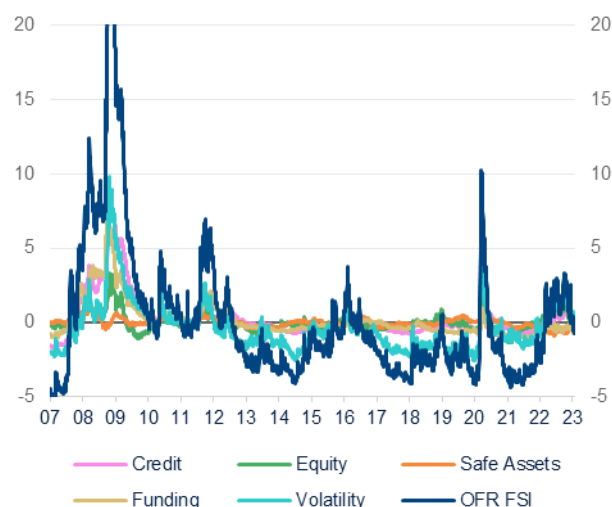
Figure 26. **FED FINANCIAL STRESS INDICES** (>0 = ABOVE AVG FINANCIAL STRESS)



Source: BBVA Research based on data by Haver Analytics.

... would complicate the Committee’s effort to restore price stability”

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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