

US Interest rates monitor

# Market interest rate expectations moved towards Fed's plans amid a run of strong data

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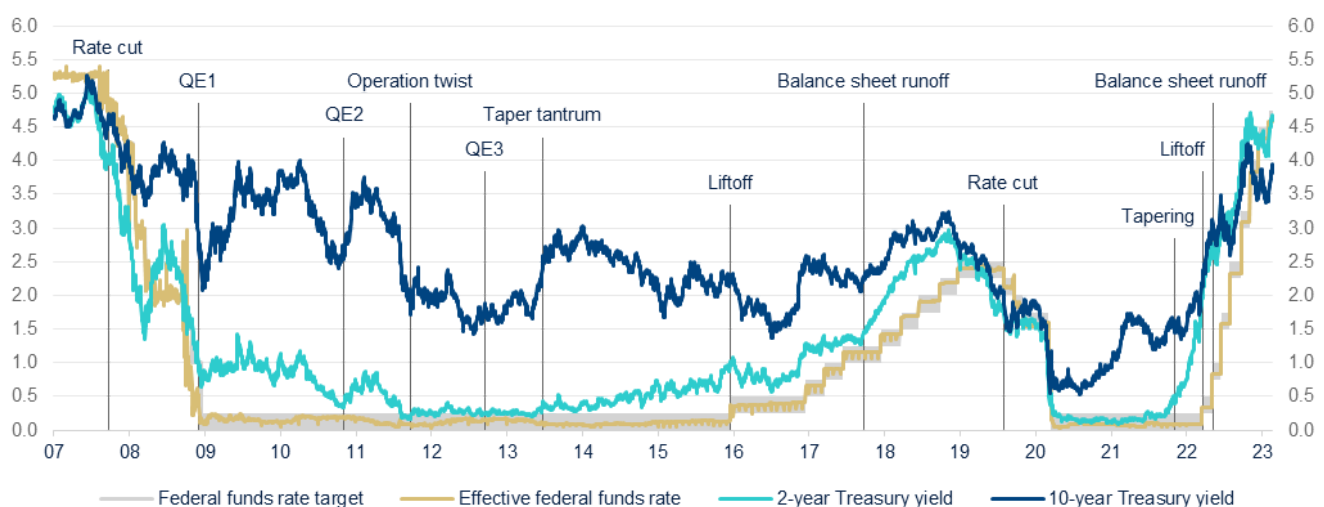
February 23, 2023

## Futures markets now expect a 5.50% peak, but still anticipate a rapid easing cycle in 2024

- The most recent stronger-than-expected payrolls and CPI inflation reports increased investors' inflation and fed funds rate expectations, driving a parallel upshift in the yield curve ([Figures 6 and 7](#)).
- The yield curve remains deeply inverted as measured by both the 10y-2y and 10y-3m spreads ([Figure 10](#)). Will this along with other leading indicators end up giving a false recession signal? It is unlikely in our view.
- Broad financial conditions indices remain roughly at average levels ([Figures 24 to 27](#)). Yesterday's FOMC minutes revealed some members noted that recent easing financial conditions "could necessitate a tighter stance of monetary policy."
- Professional forecasters revised upwards their expectations for short-term rates in response to the Fed's higher-for-longer approach ([Figure 28](#)). However, the median forecaster revised down its 10-year Treasury yield projections and now expects it won't exceed 4% ([Figure 29](#)), in line with our forecasts.

The Fed kicked off the year by downshifting again its tightening pace with a 25bp hike, pushing the fed funds rate into a 4.50-4.75% target range, while acknowledging the start of the disinflationary process

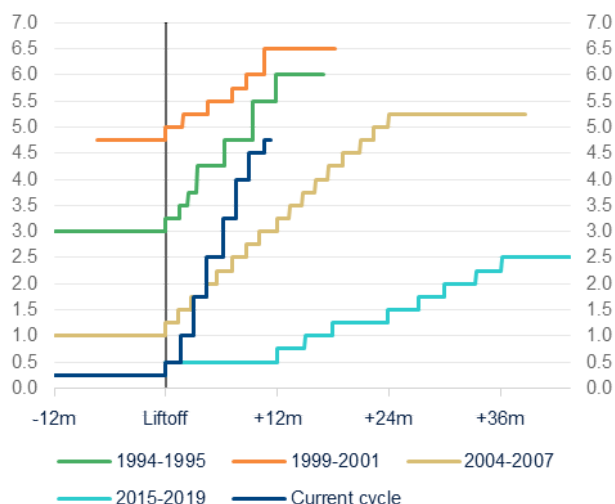
Figure 1. 2-YEAR, 10-YEAR TREASURY YIELDS AND FED FUNDS RATE (%)



Source: BBVA Research based on data by Haver Analytics.

While clear signs of inflation relief are coming from the goods sector, the stickiness...

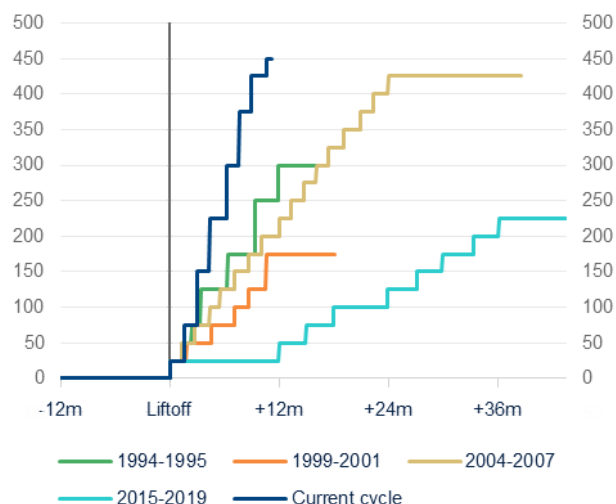
Figure 2. **FED FUNDS RATE IN TIGHTENING CYCLES (%)**



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.

... of core services (ex-housing) inflation has kept the Fed firm in its stance for “ongoing increases”

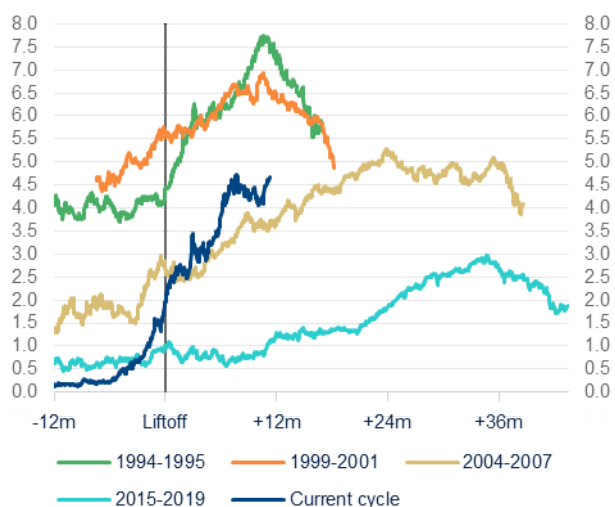
Figure 3. **FED FUNDS RATE IN TIGHTENING CYCLES (BPS VS RATE LEVEL AT LIFTOFF)**



Source: BBVA Research based on data by Haver Analytics.

The Treasury market had been oblivious to this warning until a stronger-than-expected payrolls...

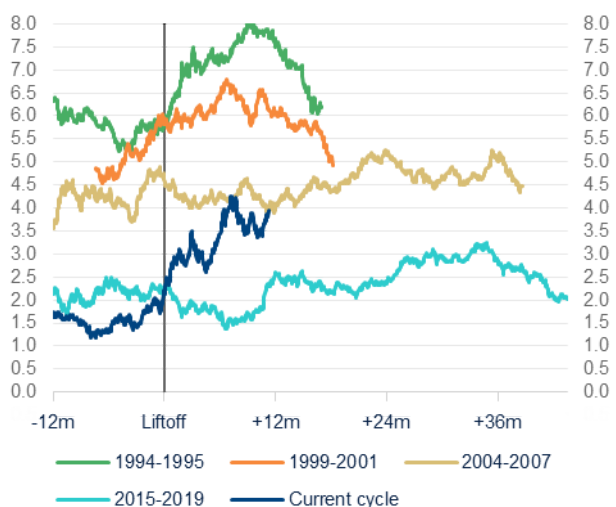
Figure 4. **2-YEAR TREASURY YIELD IN TIGHTENING CYCLES (%)**



Source: BBVA Research based on data by Haver Analytics.

... report increased investors' inflation and fed funds rate expectations, pushing up yields

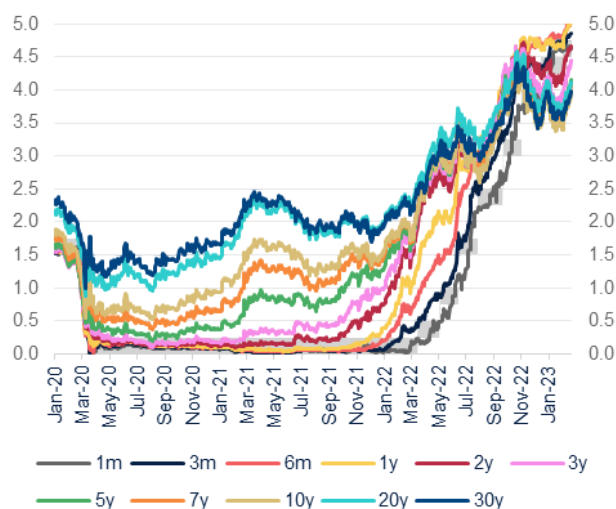
Figure 5. **10-YEAR TREASURY YIELD IN TIGHTENING CYCLES (%)**



Source: BBVA Research based on data by Haver Analytics.

**This shift was further bolstered by last week's news that core inflation rose 0.4% MoM in Jan**

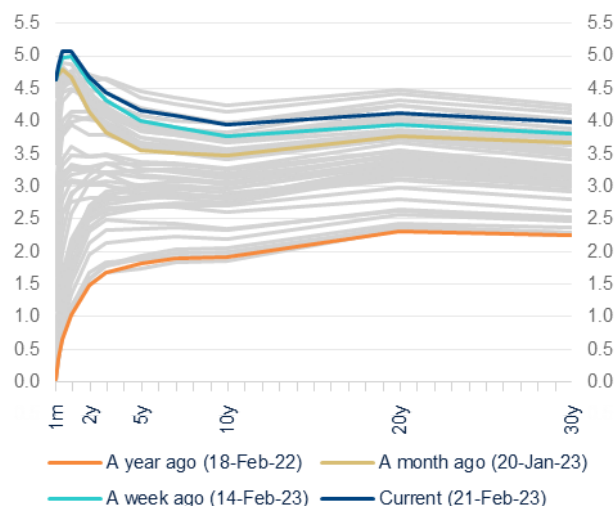
Figure 6. **TREASURY YIELDS**  
(%)



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

**The long end of the yield curve has risen c. 20 bps since then, but it's still below its Oct highs**

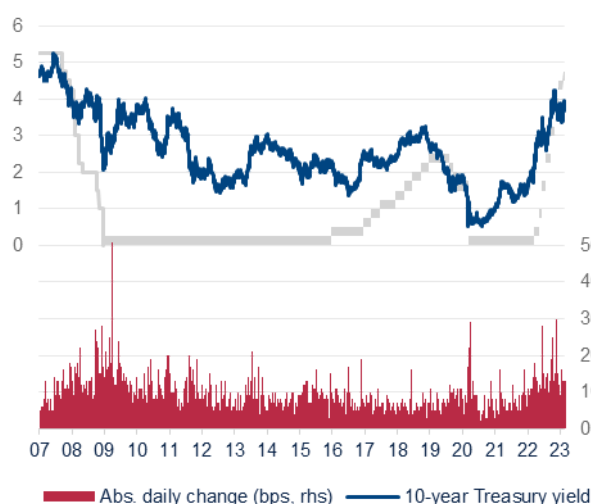
Figure 7. **TREASURY YIELD CURVE**  
(%)



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

**The 10-year Treasury yield bounced back to 3.9% after falling to 3.4% lows last month**

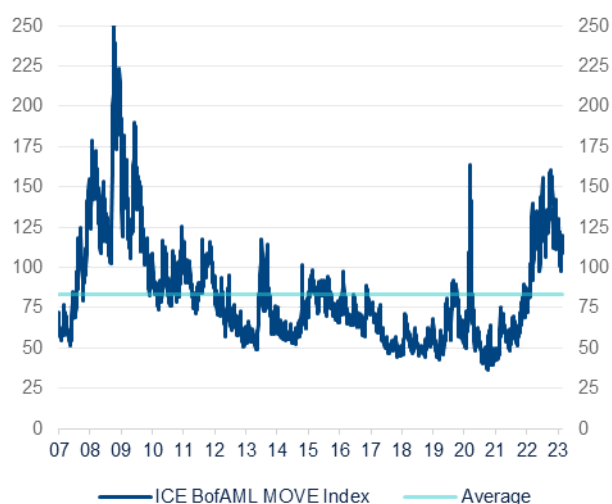
Figure 8. **10-YEAR TREASURY YIELD DAILY CHANGE**  
(% AND BPS)



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

**Bond market volatility ticked up accordingly, faced with a still very uncertain outlook**

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



Source: BBVA Research based on data by Haver Analytics.

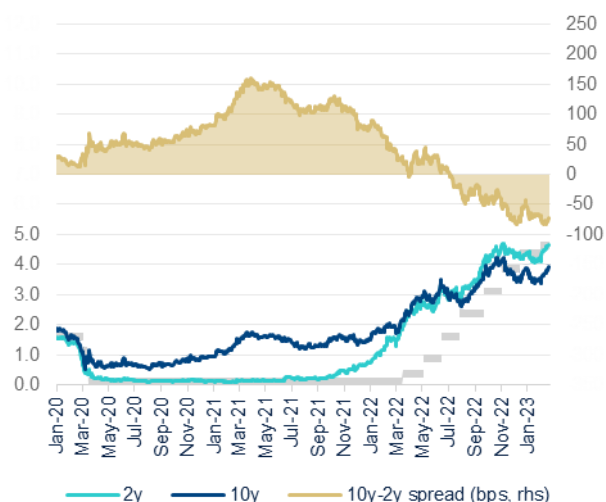
Despite higher long-term yields, the yield curve remains deeply inverted as measured by both the 10y-2y and 10y-3m Treasury yield spreads. The general view continues to be that a recession is a when...

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



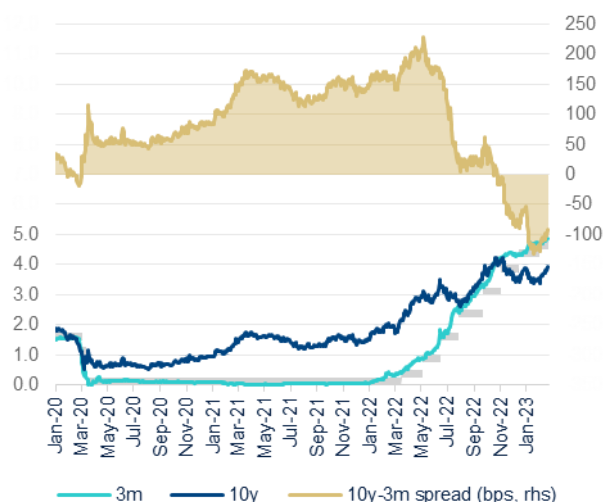
... not an if question as the full effects of monetary policy tightening are yet to be felt

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



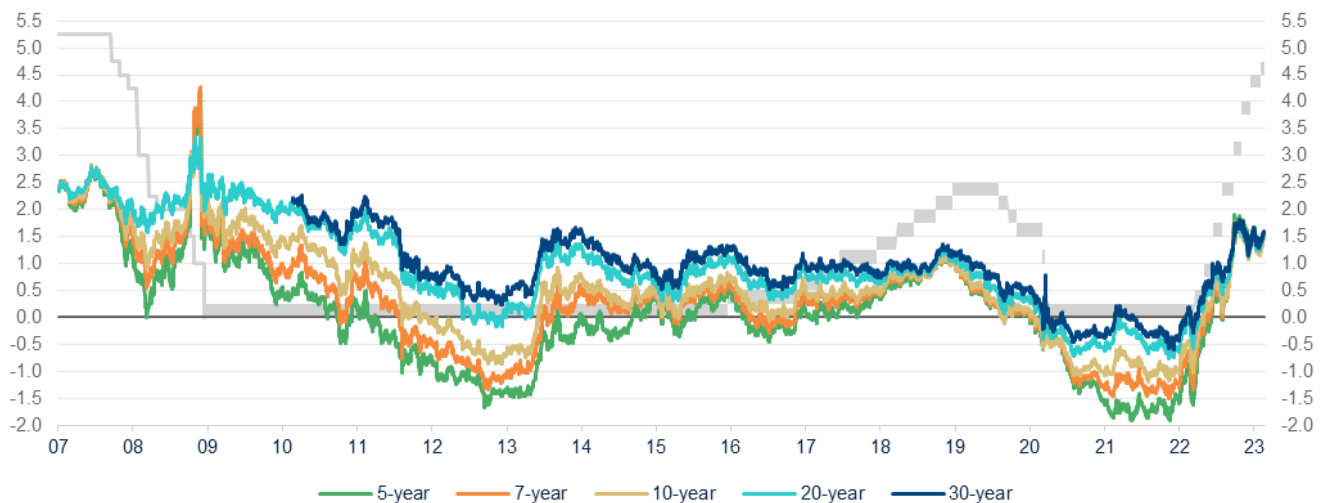
Will this along with other leading indicators end up giving a false signal? It is unlikely in our view

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



**Mirroring the behavior of their nominal counterparts, inflation-indexed Treasury (TIPS) yields have increased somewhat**

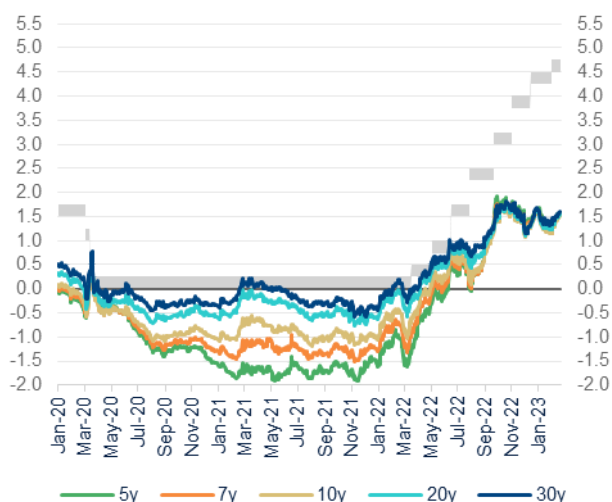
Figure 13. **INFLATION INDEXED TREASURY (TIPS) YIELDS (%)**



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

**The real yield curve remains in positive territory hovering around 1.5%...**

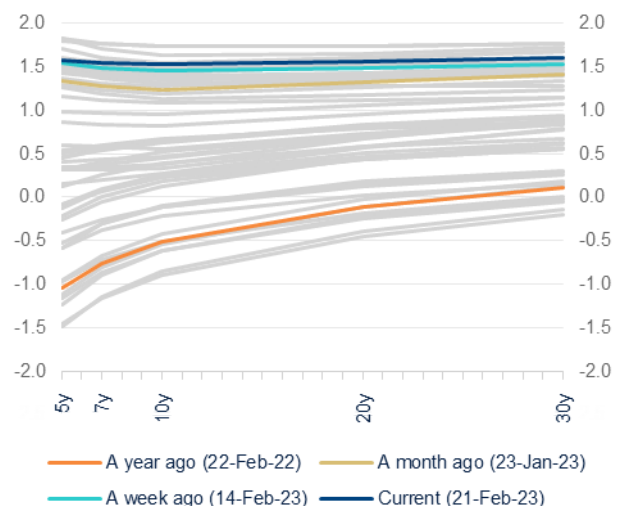
Figure 14. **INFLATION INDEXED (TIPS) YIELDS (%)**



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

**... adding to a relatively tight financial environment**

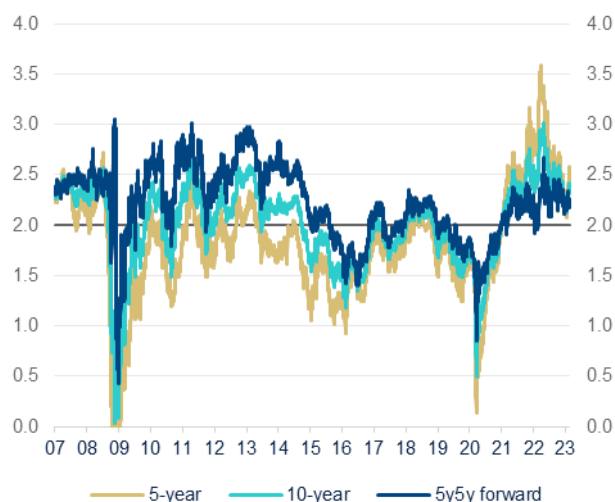
Figure 15. **INFLATION INDEXED (TIPS) YIELD CURVE (%)**



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

## Market-based inflation expectations rose slightly after markets digested the possibility that the...

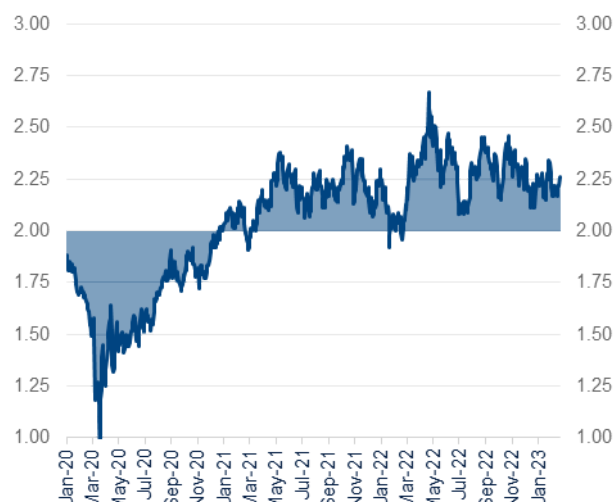
Figure 16. **BREAKEVEN INFLATION RATES**  
(%)



Source: BBVA Research based on data by Haver Analytics.

## ... decline in inflation may be more gradual than recently hoped; however, expectations still...

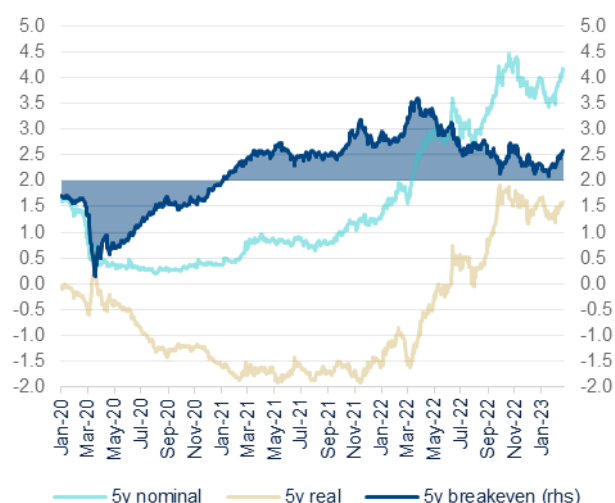
Figure 17. **5Y5Y FORWARD IMPLIED INFLATION RATE**  
(%)



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

## ... show continued confidence among market participants that the Fed...

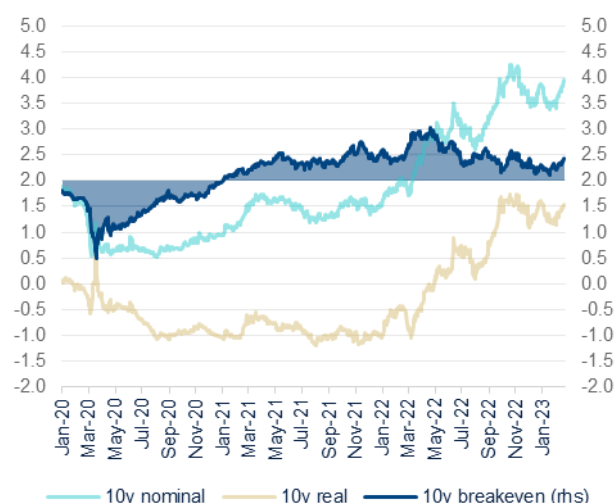
Figure 18. **5-YEAR BREAKEVEN INFLATION RATE**  
(%)



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

## ... will succeed in bringing inflation down

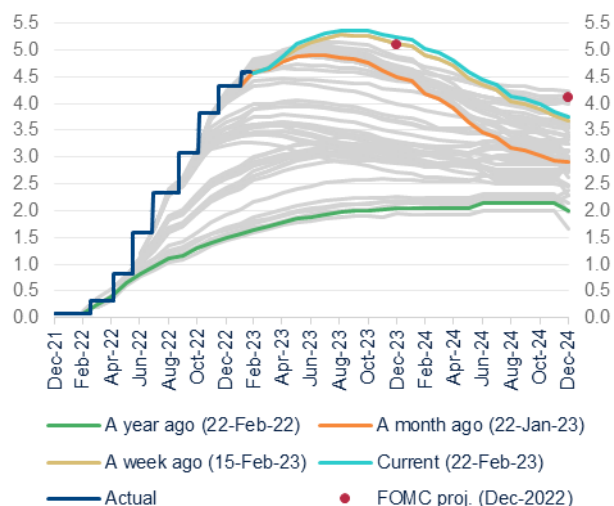
Figure 19. **10-YEAR BREAKEVEN INFLATION RATE**  
(%)



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

**The futures market moved towards Fed's plans and now expects the policy rate to peak at 5.5%**

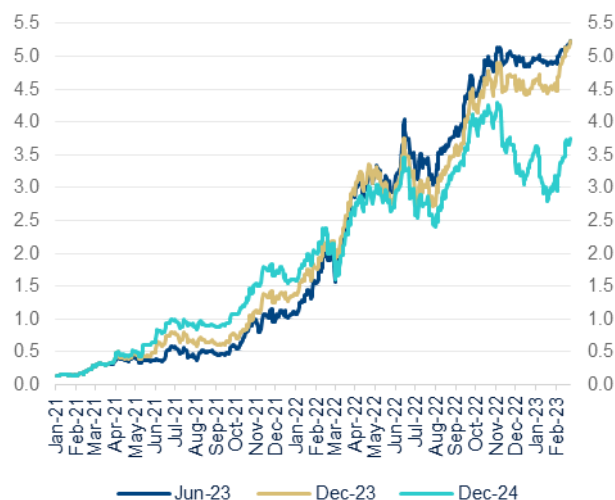
Figure 20. **IMPLIED RATE IN 30-DAY FED FUNDS FUTURES (%)**



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

**Market participants still differ from the Fed on the pace of an eventual easing cycle in 2024**

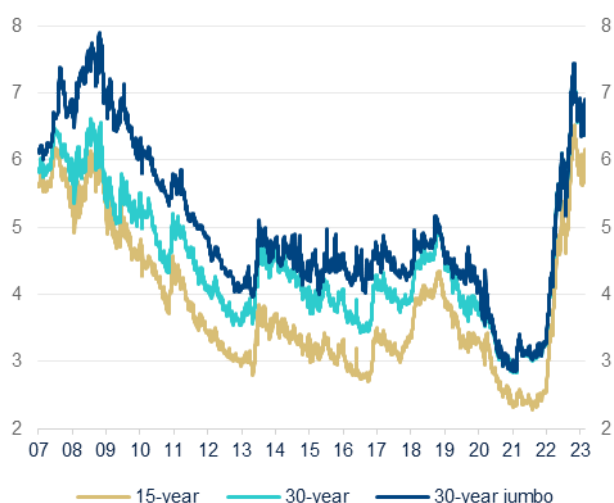
Figure 21. **IMPLIED RATE IN 30-DAY FED FUNDS FUTURES (%)**



Source: BBVA Research based on data by Bloomberg.

**The rise in long yields pushed up mortgage rates to levels close to 7% after a few weeks of easing**

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)**

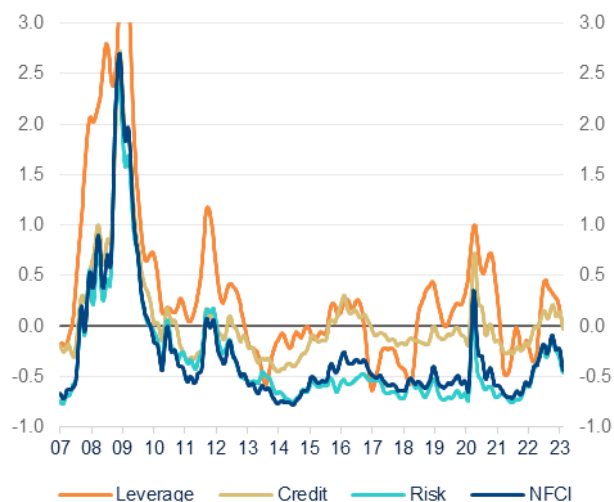


Spreads over the 10-year Treasury yield.  
 Source: BBVA Research based on data by the Fed of St. Louis (FRED) and Haver Analytics.



Neither the Fed's continued hawkish rhetoric nor recent strong hard data seemed to have a...

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



Source: BBVA Research based on data by Haver Analytics.

... significant effect on broad financial conditions indices, which remain roughly at average levels

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



Source: BBVA Research based on data by Bloomberg.

Yesterday's FOMC minutes revealed some members noted that recent easing financial...

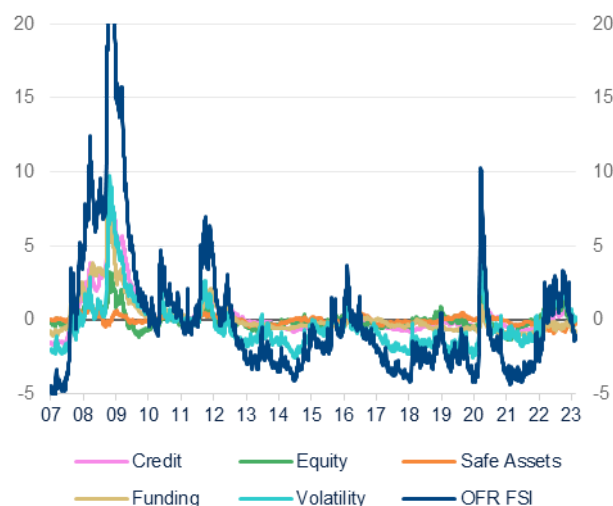
Figure 26. **FED FINANCIAL STRESS INDICES** (>0 = ABOVE AVG FINANCIAL STRESS)



Source: BBVA Research based on data by Haver Analytics.

... conditions "could necessitate a tighter stance of monetary policy"

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.

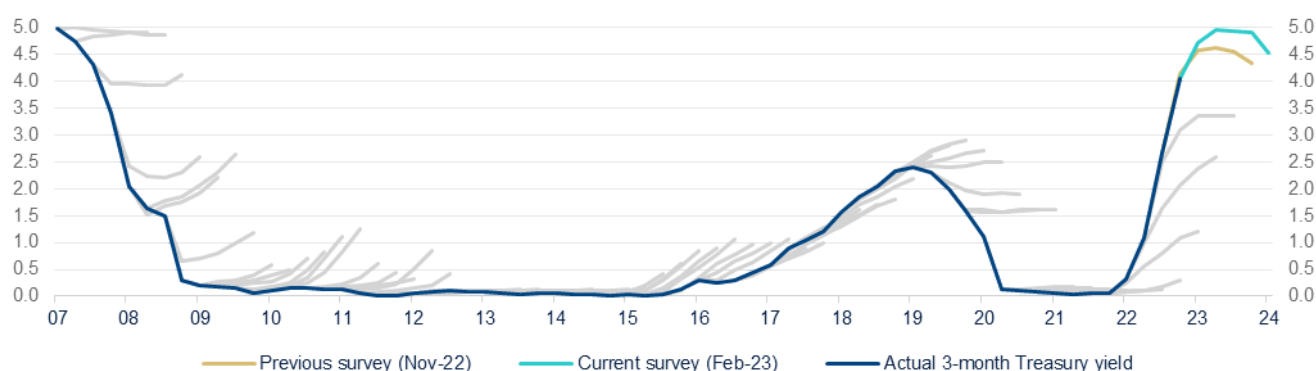


## Professional forecasters lowered their long-term rate expectations

- Two weeks ago, the Philadelphia Fed released the 1Q23 Survey of Professional Forecasters, who once again revised upwards their expectations for short-term interest rates ([Figure 28](#)).
- The median forecaster revised down its 10-year Treasury yield projections and now expects it won't exceed 4% ([Figure 29](#)); this implies an expectation for the yield curve to remain inverted for a long time ([Figure 31](#)).
- Professional forecasters still expect credit spreads to remain at relatively low levels ([Figure 33](#)).

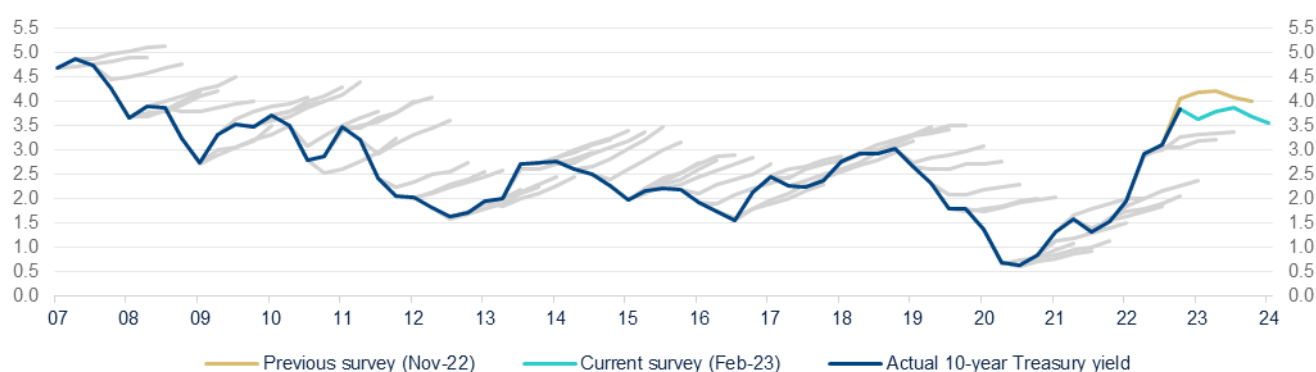
Professional forecasters revised upwards their expectations for short-term interest rates in response to the Fed's higher-for-longer approach

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



However, the median forecaster revised down its 10-year Treasury yield projections and now expects it won't exceed 4%

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



## Higher short-term rates together with lower long-term yields...

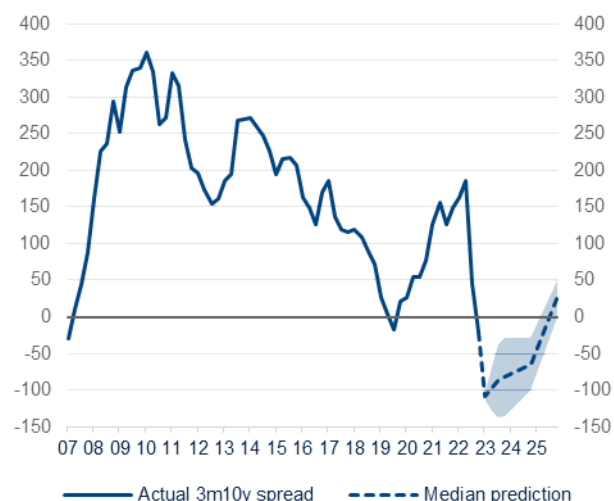
Figure 30. **PROF. FORECASTERS TREASURY YIELDS EXPECTATIONS (%)**



Source: BBVA Research based on data by the Federal Reserve Bank of Philadelphia and Haver Analytics.

## ... imply an expectation for the yield curve to remain strongly inverted for a long time

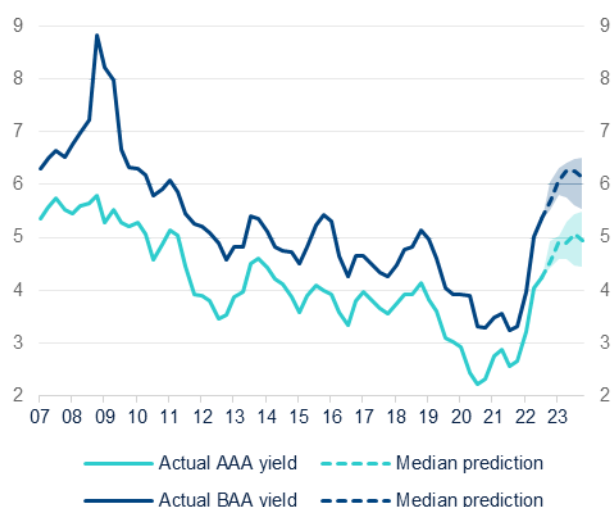
Figure 31. **PROF. FORECASTERS IMPLIED 3M10Y SPREAD EXPECTATIONS (BPS)**



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...

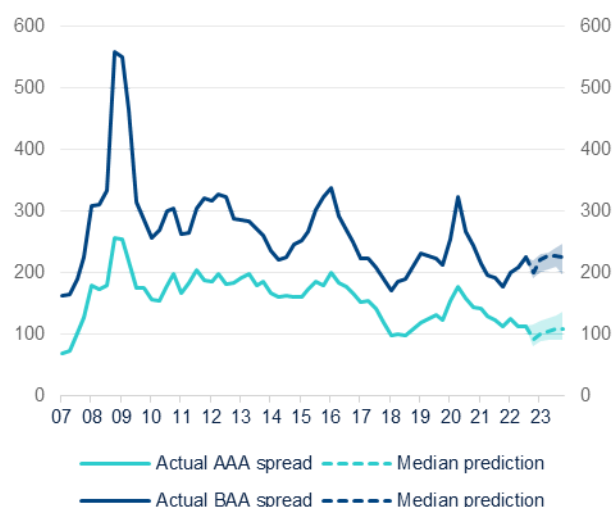
Figure 32. **PROF. FORECASTERS CORPORATE YIELDS EXPECTATIONS (%)**



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 (%)**



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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