

US Interest rates monitor

# Recession fears and debt ceiling anxiety are both weighing on interest rates

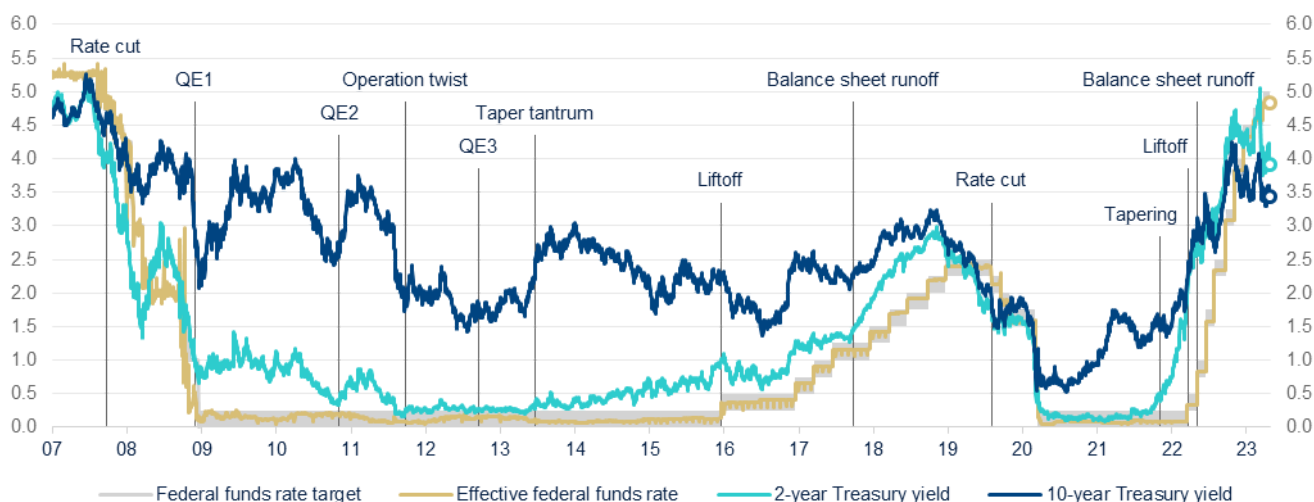
Javier Amador / Iván Fernández  
April 27, 2023

## Markets are still pricing in that the Fed is going to cut rates sooner and faster than signaled

- As suggested by the FOMC last month, “some additional policy firming” will likely mean that the Fed will decide to take the fed funds rate to a 5.00- 5.25% target range peak next wednesday (Figures 2 and 3).
- Short-term rates have pushed higher on debt ceiling concerns (Figure 6) but the yield curve shifted to the downside on recession concerns and renewed anxiety about regional banks (Figure 7).
- The 10y-3m yield spread moved sharply lower as increased anxiety about the debt ceiling collided with recession worries; the 10y-2y spread continued to edge up with the peak fed funds rate in sight (Figure 10).
- Markets now price in a 5.00-5.25% target range peak, but expect the Fed to keep rates at that level for longer before starting a rate cut cycle in 4Q, moving closer to our baseline scenario over the last month (Figure 21).
- Credit conditions are likely tighter than what traditional financial conditions indices are currently suggesting. The Fed will move to the sidelines to assess how tighter conditions feed into the economy (Figures 24 and 27).

The Fed is set to deliver a final 25bp hike next week and hint that it wants to stick to its plan of keeping rates high as a period of “below-trend growth” is needed to bring down inflation

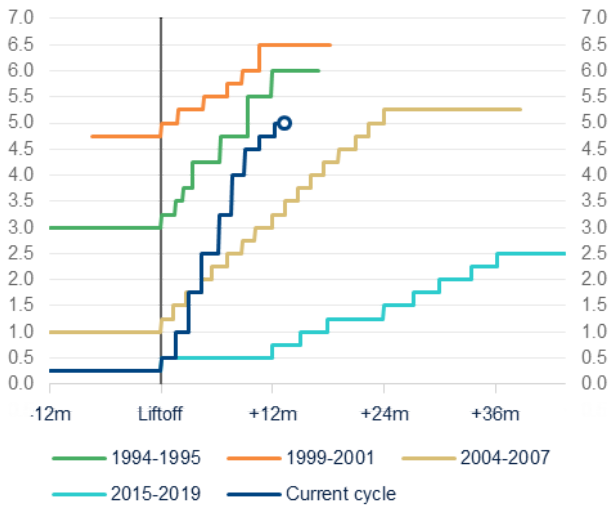
Figure 1. 2-YEAR, 10-YEAR TREASURY YIELDS AND FED FUNDS RATE (%)



Source: BBVA Research based on data by Haver Analytics.

As suggested by the FOMC last month, “some additional policy firming” will likely mean that...

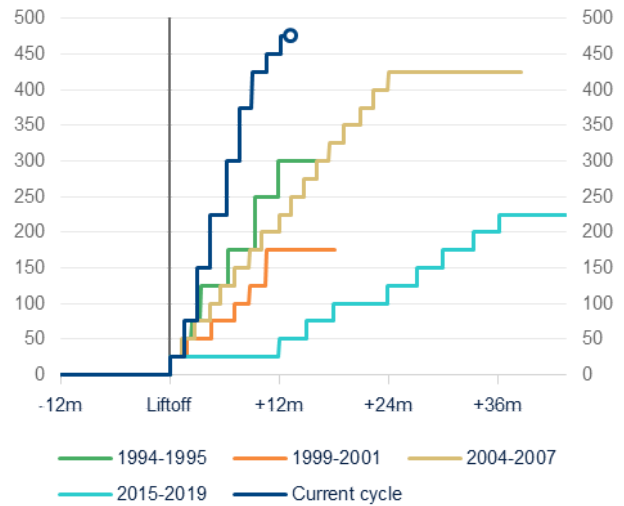
Figure 2. **FED FUNDS RATE IN TIGHTENING CYCLES (%)**



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.

... the Fed will decide to take the fed funds rate to a 5.00- 5.25% target range peak next wednesday

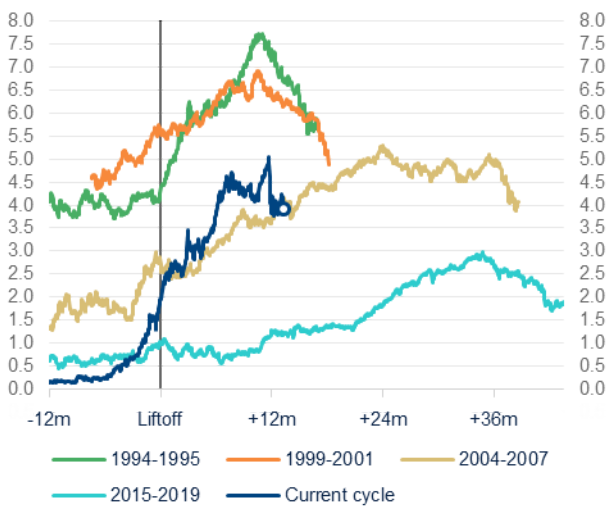
Figure 3. **FED FUNDS RATE IN TIGHTENING CYCLES (BPS VS RATE LEVEL AT LIFTOFF)**



Source: BBVA Research based on data by Haver Analytics.

Both 2 and 10-year nominal Treasury yields continue to hover around recent lows...

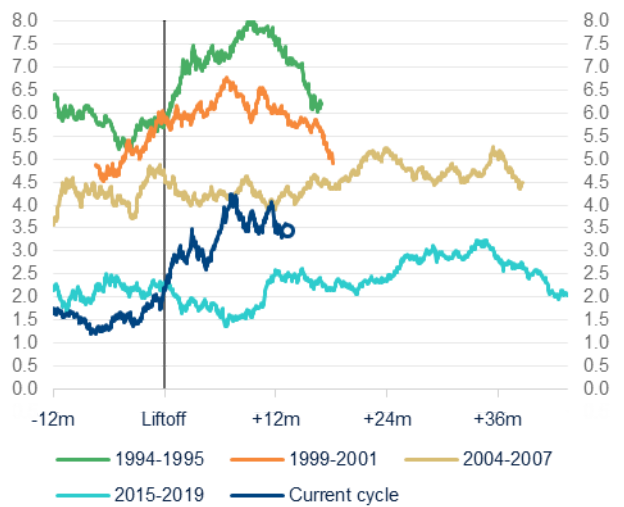
Figure 4. **2-YEAR TREASURY YIELD IN TIGHTENING CYCLES (%)**



Source: BBVA Research based on data by Haver Analytics.

... as markets continue to price in that after next week's hike, the Fed will cut rates in 2H23

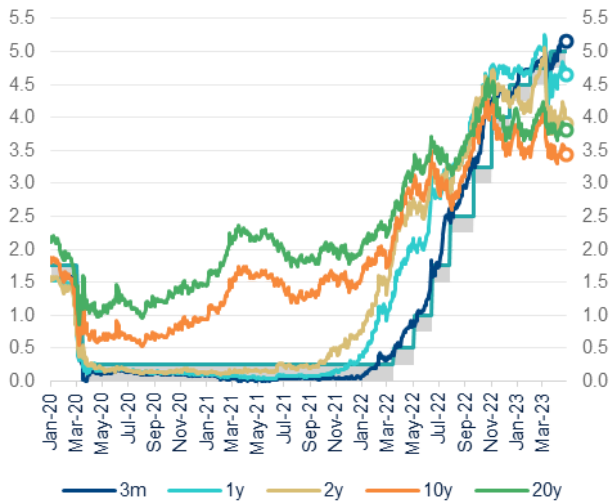
Figure 5. **10-YEAR TREASURY YIELD IN TIGHTENING CYCLES (%)**



Source: BBVA Research based on data by Haver Analytics.

**Short-term rates have pushed higher on debt ceiling concerns but the yield curve shifted...**

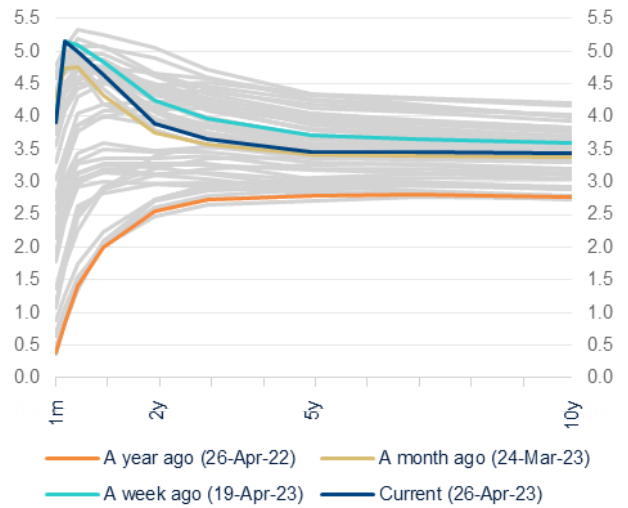
Figure 6. **TREASURY YIELDS**  
(%)



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

**... to the downside on recession concerns and renewed anxiety about regional banks**

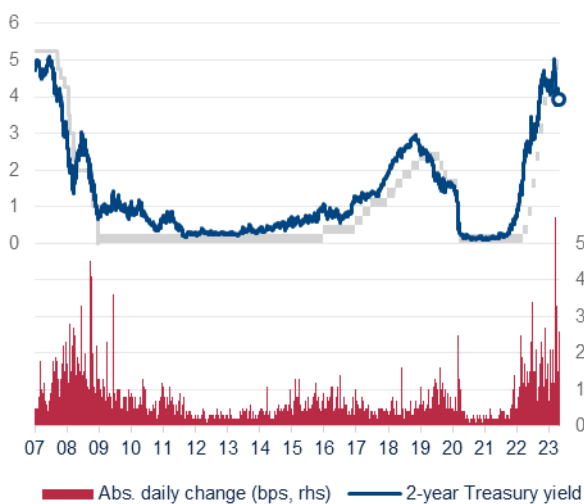
Figure 7. **TREASURY YIELD CURVE**  
(%)



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

**The 2-year Treasury yield returned to its recent lows this month**

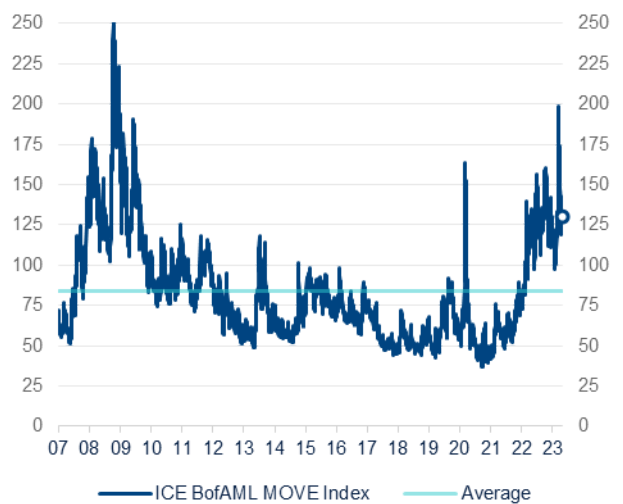
Figure 8. **2-YEAR TREASURY YIELD DAILY CHANGE**  
(% AND BPS)



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

**Bond market volatility remains hovering around multi-year highs**

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



Source: BBVA Research based on data by Haver Analytics.

The 10y-3m yield spread moved sharply lower as increased concerns about the debt ceiling collided with recession worries; the 10y-2y spread continued to edge up with the peak fed funds rate in sight

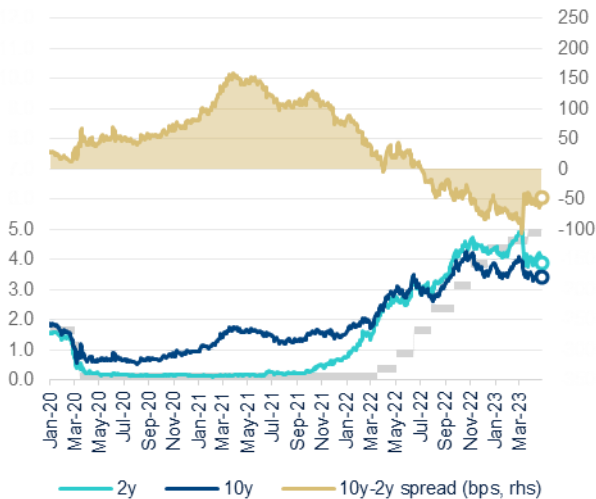
Figure 10. **TREASURY YIELD SPREADS (BPS)**



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.

2-year yields have fallen more than 10-year yields cutting the 10y-2y negative spread in half...

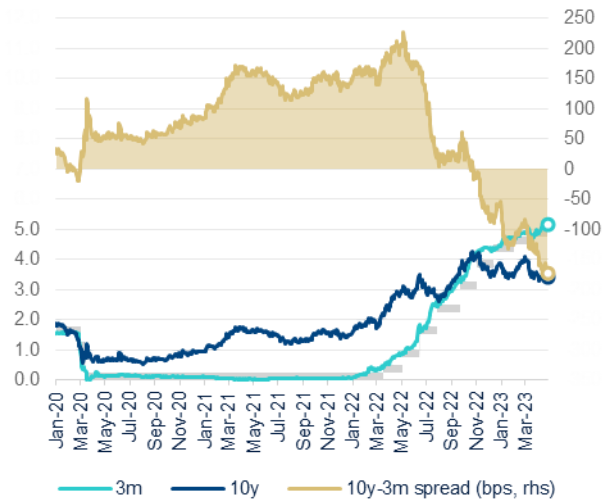
Figure 11. **10Y-2Y TREASURY YIELD SPREAD (% AND BPS)**



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

... but with markets dropping 3-month T-Bills, the negative 10y-3m spread turned sharply lower

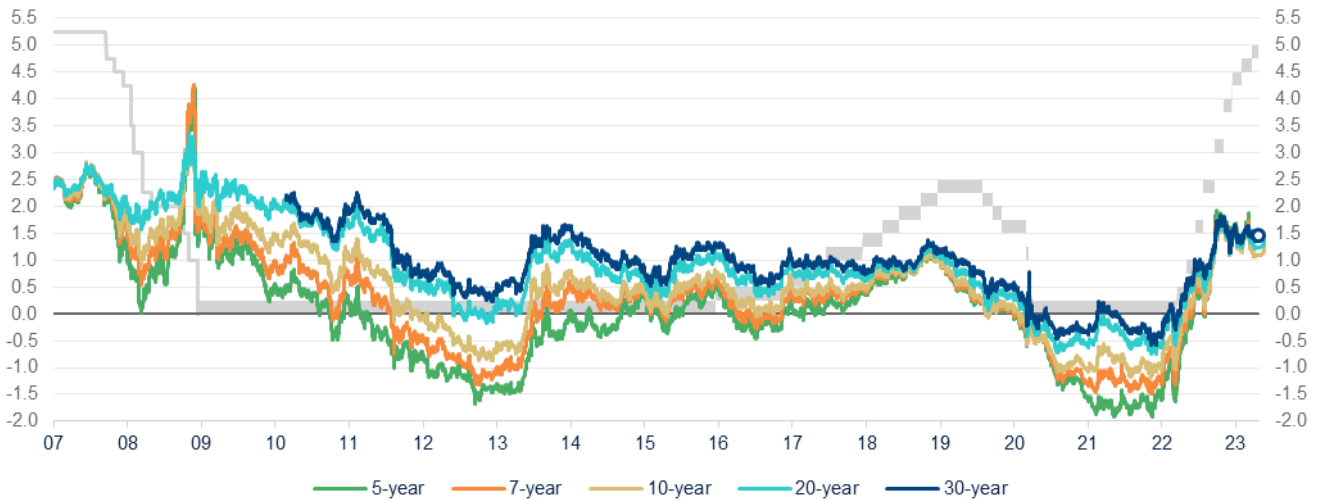
Figure 12. **10Y-3M TREASURY YIELD SPREAD (% AND BPS)**



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

**Inflation-indexed Treasury (TIPS) yields pulled back somewhat more recently with nominal rates edging down**

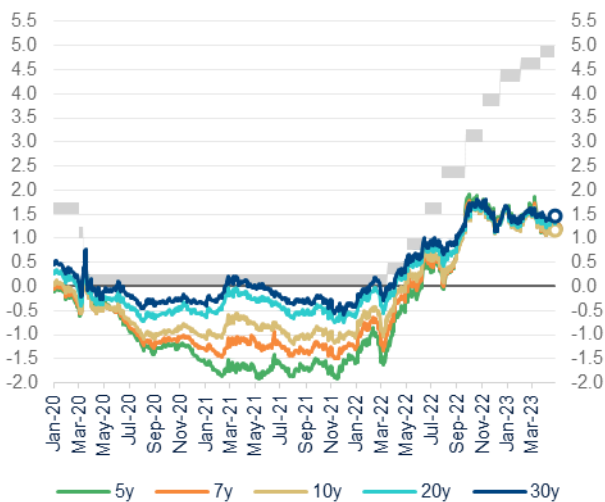
Figure 13. **INFLATION INDEXED TREASURY (TIPS) YIELDS (%)**



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

**Although the real yield curve is still hovering around a narrow range, the real yield curve...**

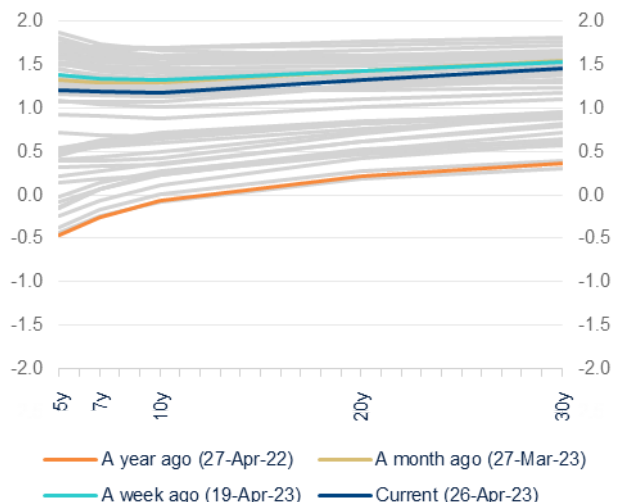
Figure 14. **INFLATION INDEXED (TIPS) YIELDS (%)**



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

**... shifted slightly to the downside. Yet, real yields along the curve remain relatively high**

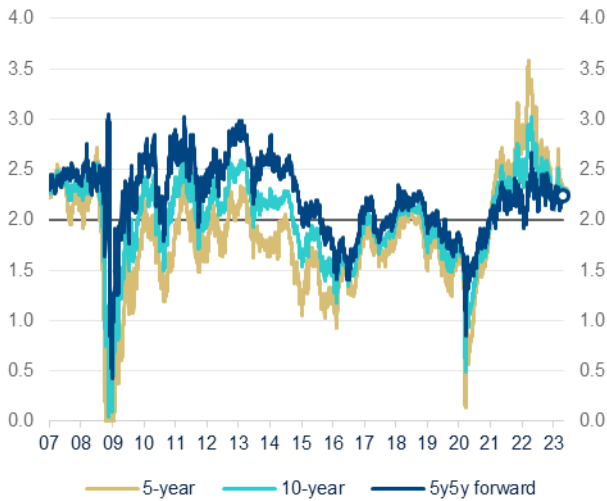
Figure 15. **INFLATION INDEXED (TIPS) YIELD CURVE (%)**



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

**Market-based inflation expectations have remained relatively stable around low levels...**

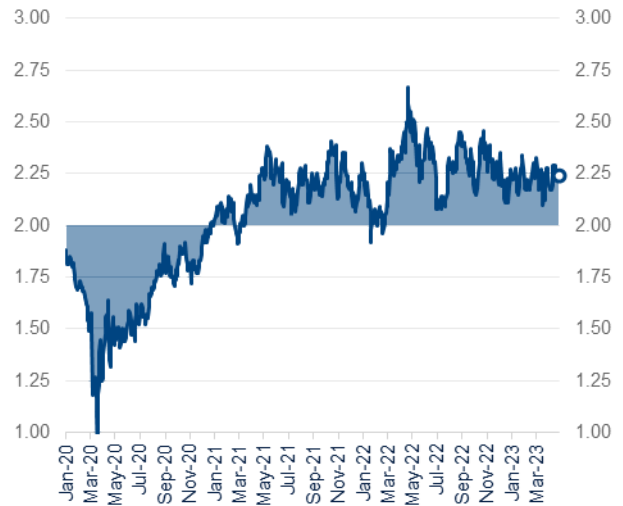
Figure 16. **BREAKEVEN INFLATION RATES (%)**



Source: BBVA Research based on data by Haver Analytics.

**... even though the progress on inflation has been slower than most anticipated...**

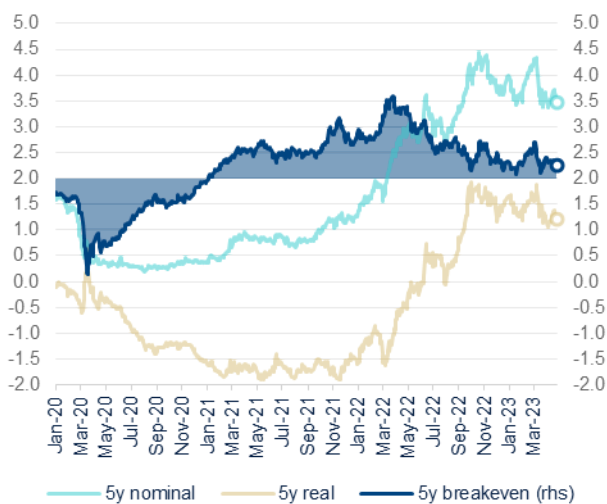
Figure 17. **5Y5Y FORWARD IMPLIED INFLATION RATE (%)**



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

**... which shows there is continued confidence among market participants that the Fed...**

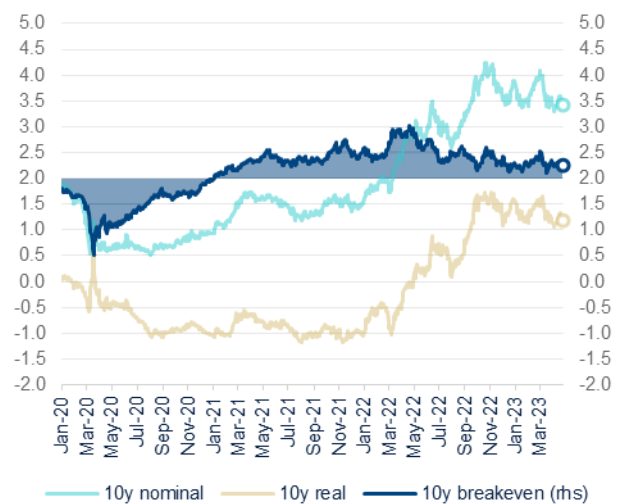
Figure 18. **5-YEAR BREAKEVEN INFLATION RATE (%)**



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**

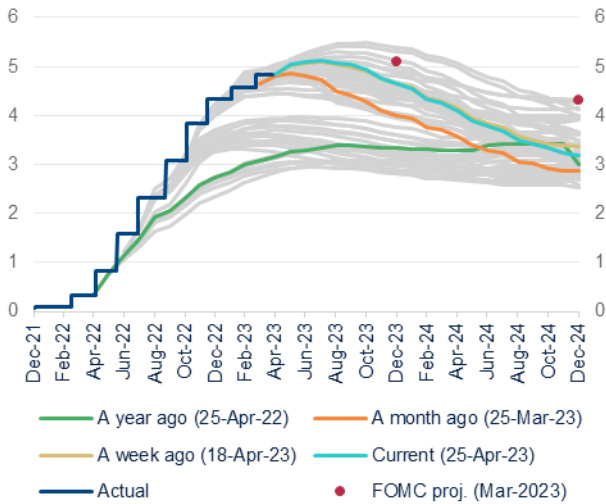
Figure 19. **10-YEAR BREAKEVEN INFLATION RATE (%)**



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

**Markets now price in a 5.00-5.25% fed funds target range peak, but expect the Fed to keep...**

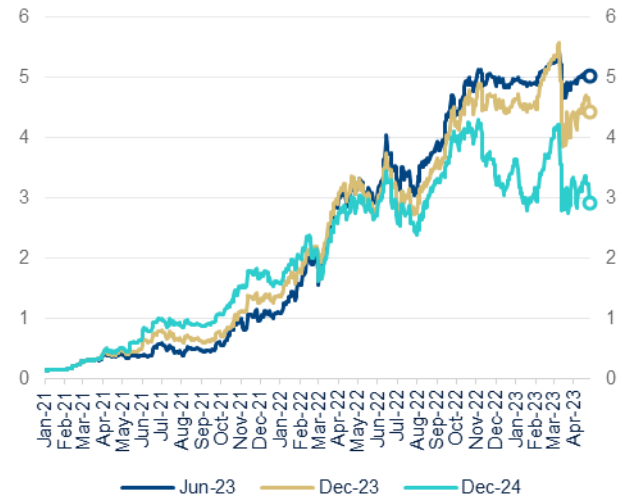
Figure 20. **IMPLIED RATE IN 30-DAY FED FUNDS FUTURES (%)**



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

**... rates at that level for longer before starting a rate cut cycle in 4Q, moving closer to our baseline scenario over the last month**

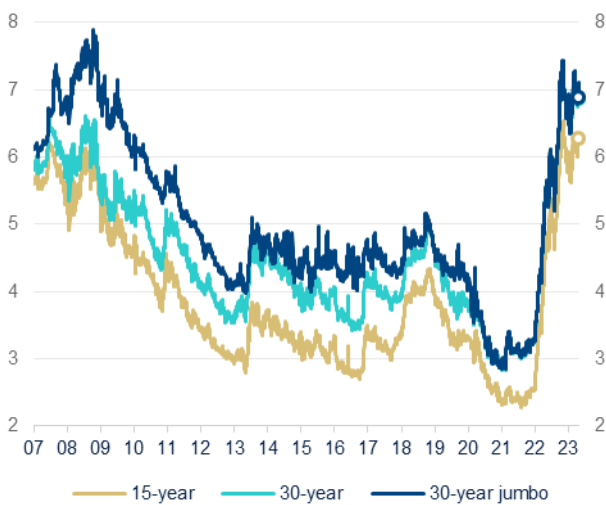
Figure 21. **IMPLIED RATE IN 30-DAY FED FUNDS FUTURES (%)**



Source: BBVA Research based on data by Bloomberg.

**Mortgage rates bounced back to levels closer to their recent highs**

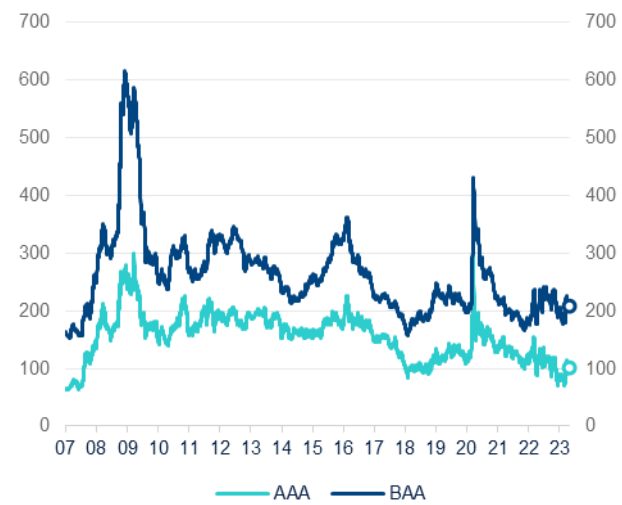
Figure 22. **MORTGAGE RATES (WSJ CONSUMER FIXED RATES, %)**



Source: BBVA Research based on data by Haver Analytics.

**The investment-grade corporate credit market is (still?) not showing any signs of stress**

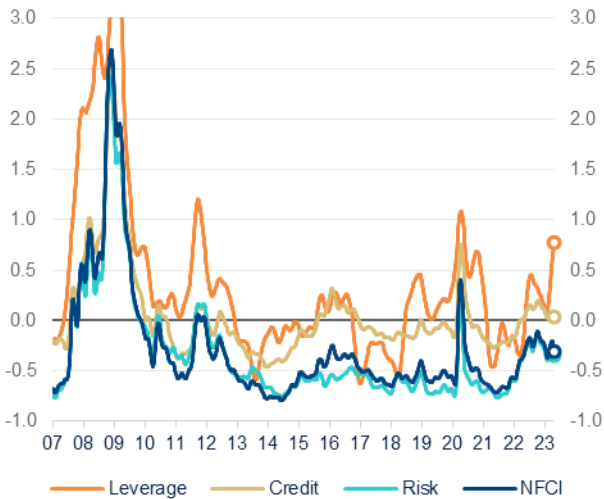
Figure 23. **CORPORATE BOND SPREADS (MOODY'S SEASONED YIELDS, DAILY DATA, BPS)**



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

**Signs of strain arising from high leverage...**

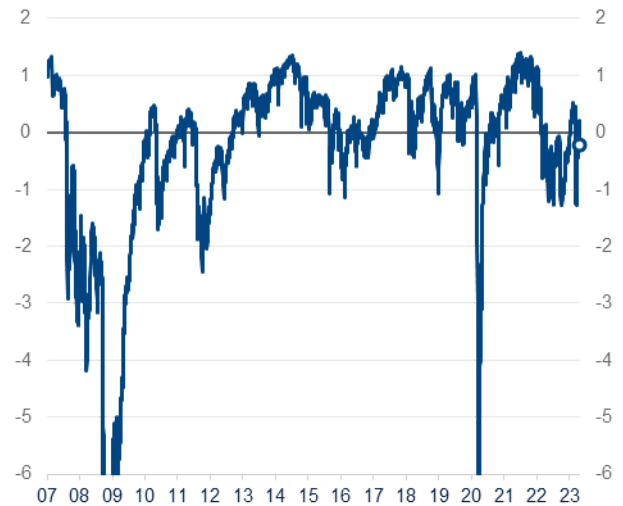
Figure 24. **CHICAGO FED NATIONAL FINANCIAL CONDITIONS INDEX (>0 = TIGHTER THAN AVG)**



Source: BBVA Research based on data by Haver Analytics.

**... have kept traditional financial conditions indices only somewhat tighter-than-average...**

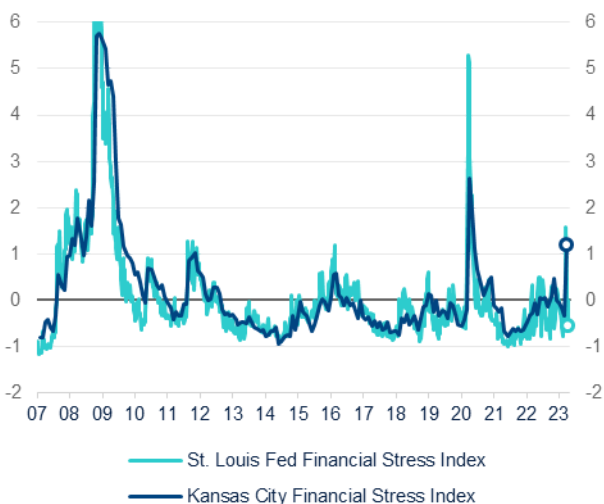
Figure 25. **BLOOMBERG FINANCIAL CONDITIONS INDEX (<0 = TIGHTER THAN PRE-GFC AVG)**



Source: BBVA Research based on data by Bloomberg.

**... largely because cost (interest rates) and qualitative measures (e.g., lending standards) are not accounted for in stress indices**

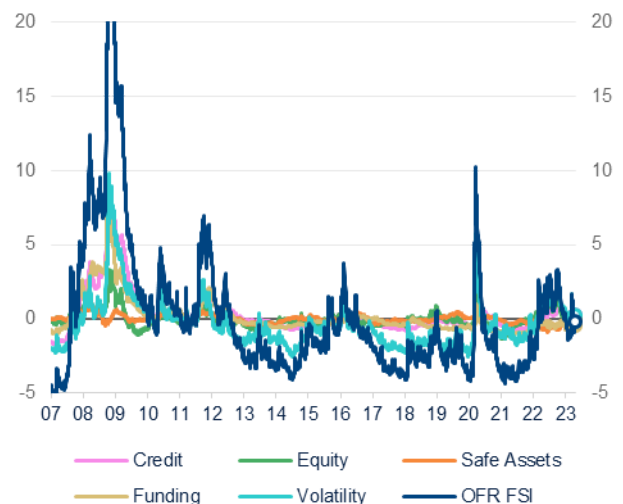
Figure 26. **FED FINANCIAL STRESS INDICES (>0 = ABOVE AVG FINANCIAL STRESS)**



Source: BBVA Research based on data by Haver Analytics.

**Credit conditions are likely tighter. The Fed will move to the sidelines to assess how tighter conditions feed into the economy**

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



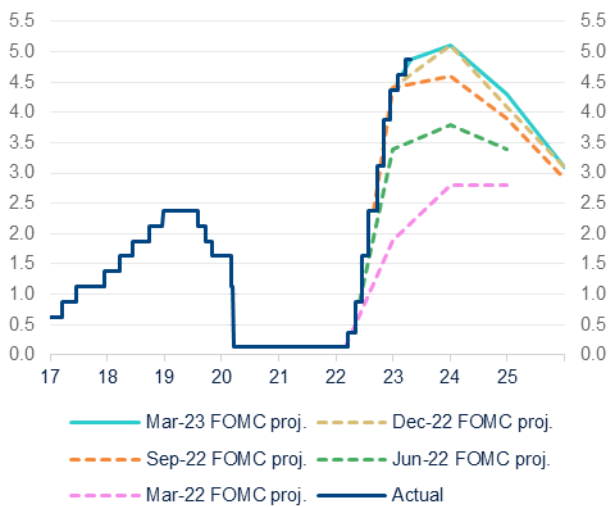
OFR: Office of Financial Research, US Department of the Treasury.  
Source: BBVA Research based on data by Haver Analytics.



## March's SEP outlined a weaker economic scenario aligned with a hawkish projected policy stance

The median estimate for the policy rate was kept unchanged at 5.1% for end-23 and mostly...

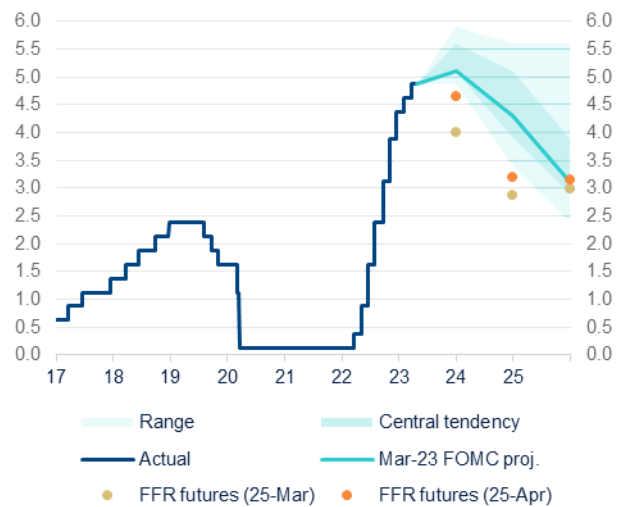
Figure 28. FOMC PARTICIPANTS PROJECTED FED FUNDS RATE (MEDIAN PROJECTION, %)



Source: BBVA Research based on data by Haver Analytics.

... unchanged for 24-25, which is at odds with the market's view of a sooner and faster cut cycle

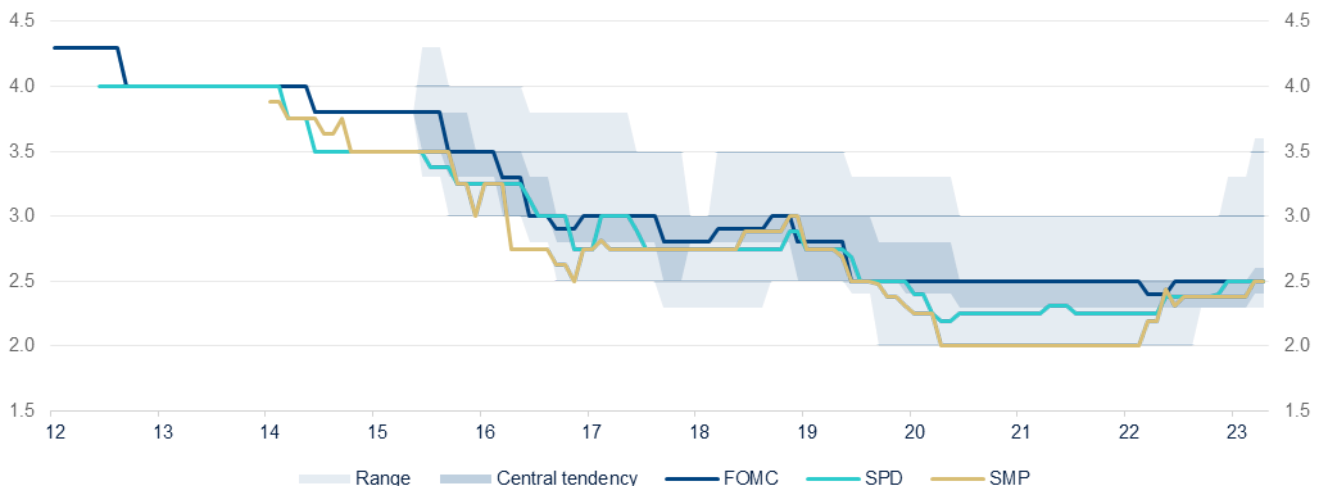
Figure 29. FOMC PARTICIPANTS PROJECTED FED FUNDS RATE (MEDIAN PROJECTION, %)



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

The estimated steady-state fed funds rate remains unchanged, 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.

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