

US Interest rates monitor

Optimism over a debt ceiling deal eases pressure on the short-end of the yield curve...

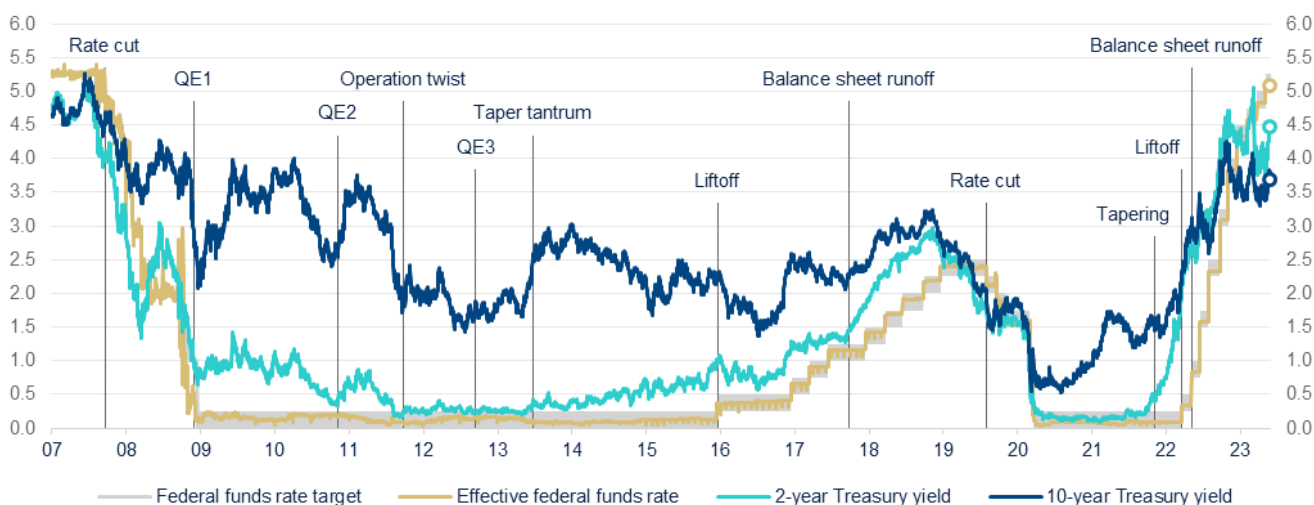
Javier Amador / Iván Fernández
May 31, 2023

... while different views among Fed members have resulted in an upward shift in market expectations for the fed funds rate

- Divisions among Fed members before the blackout period are evident: the hawks think the Fed needs to go further, others seem to support a pause to wait until the economic picture becomes clearer, and some others seem to think that the Fed has done enough to bring inflation down (Figures 2 and 3).
- Short-term rates have pushed higher on debt ceiling concerns (Figure 6). The yield curve shifted to the upside despite continued 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 are no longer expecting the Fed to start a rate cut cycle this year, but are still anticipating a fast easing cycle in 2024—faster than signaled by the dot-plot—moving closer to our baseline scenario over the last month (Figure 21).

Early this month, the Fed delivered a widely expected 25bp rate hike and tilted its overall tone to less hawkish by no longer explicitly anticipating the need for more hikes, which significantly increased the...

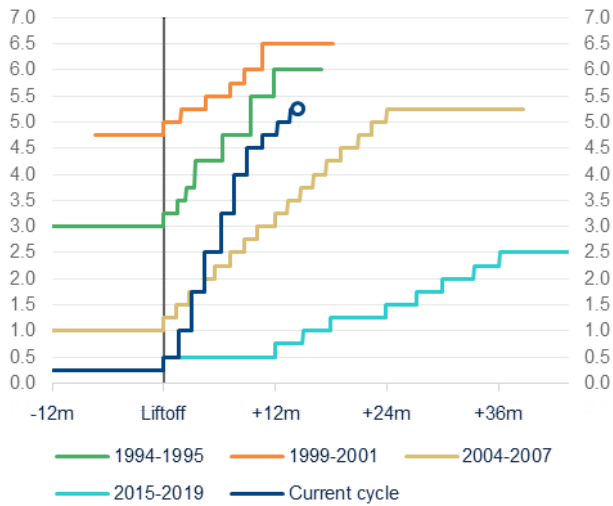
Figure 1. 2-YEAR, 10-YEAR TREASURY YIELDS AND FED FUNDS RATE (%)



Source: BBVA Research based on data by Haver Analytics.

... likelihood that the fed funds rate has peaked at its current 5.00-5.25% target range. However, ...

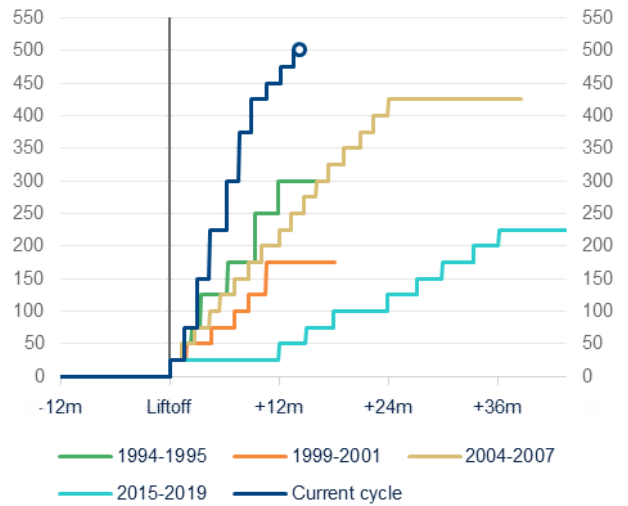
Figure 2. **FED FUNDS RATE IN TIGHTENING CYCLES (%)**



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.

... some FOMC officials have recently conveyed a hawkish tone by stressing the risks of a pause...

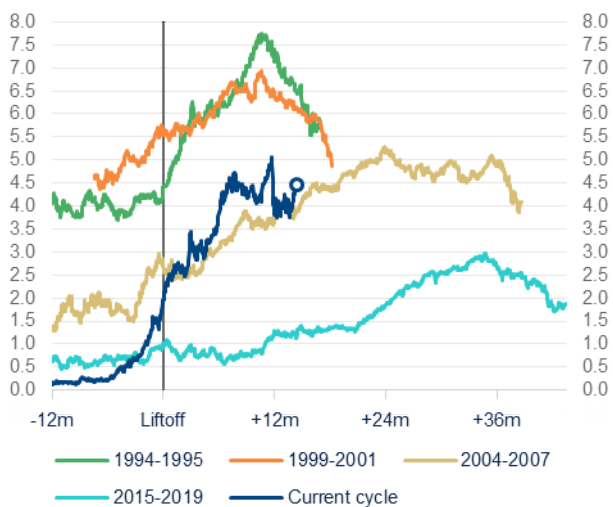
Figure 3. **FED FUNDS RATE IN TIGHTENING CYCLES (BPS VS RATE LEVEL AT LIFTOFF)**



Source: BBVA Research based on data by Haver Analytics.

... in a context of still robust job gains and elevated inflation. This, together with recent...

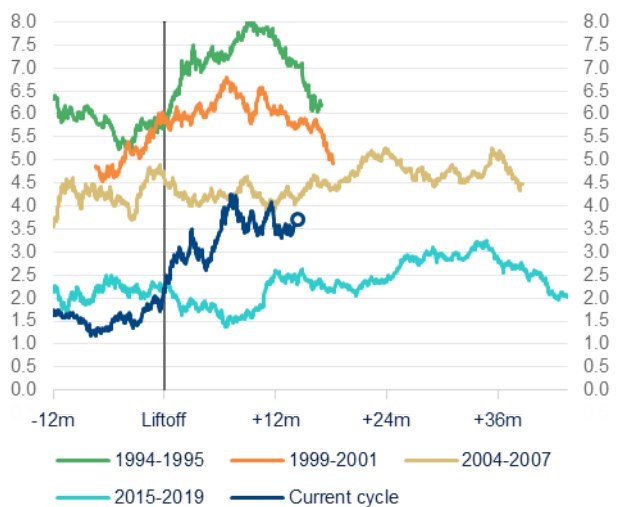
Figure 4. **2-YEAR TREASURY YIELD IN TIGHTENING CYCLES (%)**



Source: BBVA Research based on data by Haver Analytics.

... debt ceiling concerns, drove mid- and long-term Treasury yields slightly up

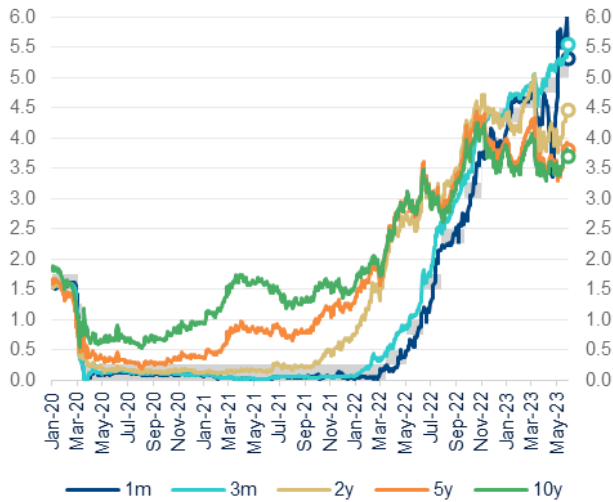
Figure 5. **10-YEAR TREASURY YIELD IN TIGHTENING CYCLES (%)**



Source: BBVA Research based on data by Haver Analytics.

Uncertainty on the debt ceiling resolution was particularly evident on the short-end of the...

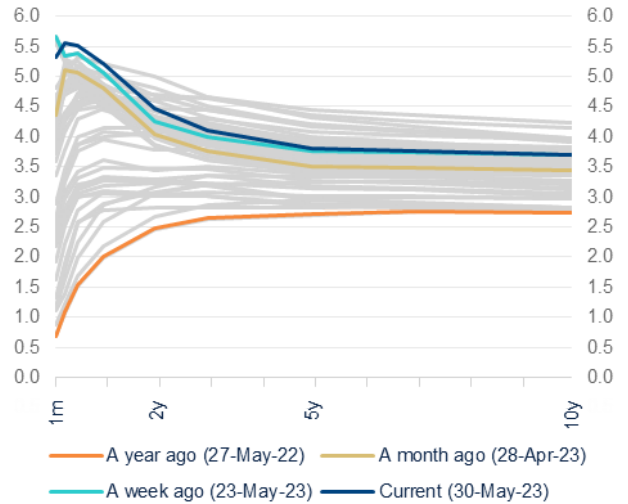
Figure 6. **TREASURY YIELDS**
(%)



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

... Treasury yield curve. Last week, the yield curve was fully inverted for the first time in the...

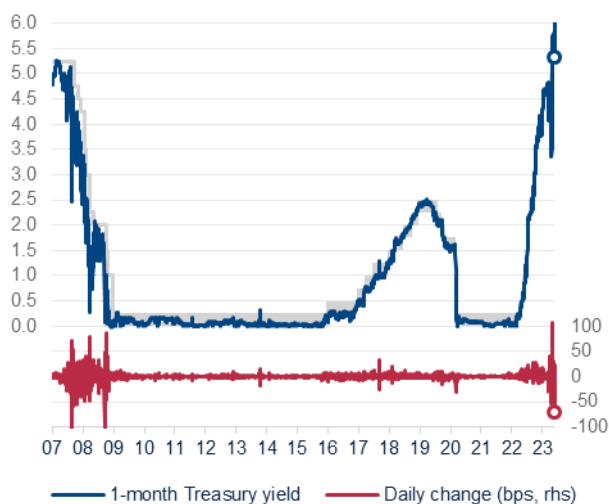
Figure 7. **TREASURY YIELD CURVE**
(%)



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

... current hiking cycle as the 1-month Treasury yield rose to 6%. It fell back to 5.3% this week...

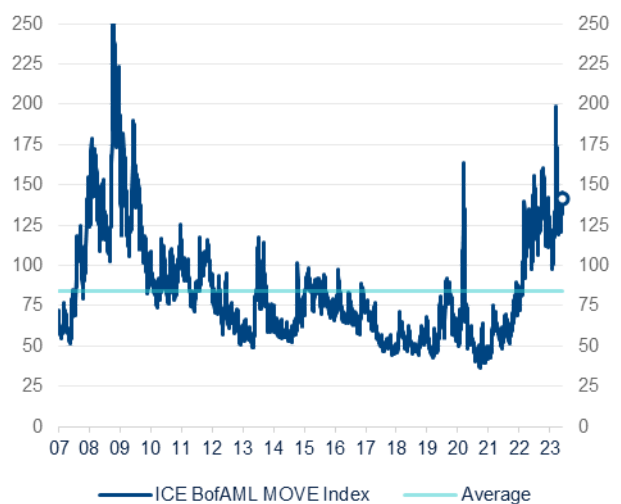
Figure 8. **1-MONTH TREASURY YIELD DAILY CHANGE**
(% AND BPS)



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

... amid positive news on a bipartisan deal set to be voted tonight by the House of Representatives

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



Source: BBVA Research based on data by Haver Analytics.

Even though the 10-year Treasury yield recently ticked up to 3.7% from 3.4% in mid-May, the 10y-3m yield spread plunged below -180 bps following this month's hike. 2-year and 10-year Treasury yields have...

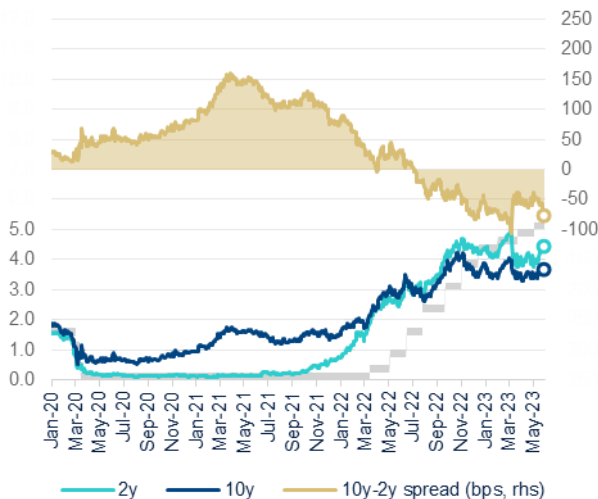
Figure 10. **TREASURY YIELD SPREADS (BPS)**



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.

...been moving in sync since late-2022, implying a relatively stable 10y-2y spread at ~-60 bps

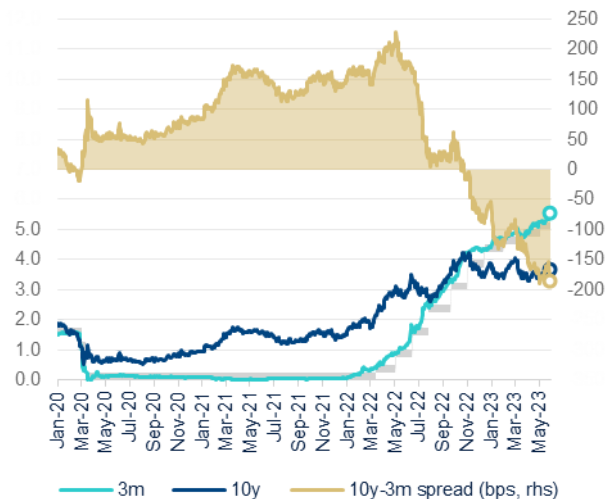
Figure 11. **10Y-2Y TREASURY YIELD SPREAD (% AND BPS)**



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

An additional 25bp rate hike in June would take the 10y-3m spread below -200 bps

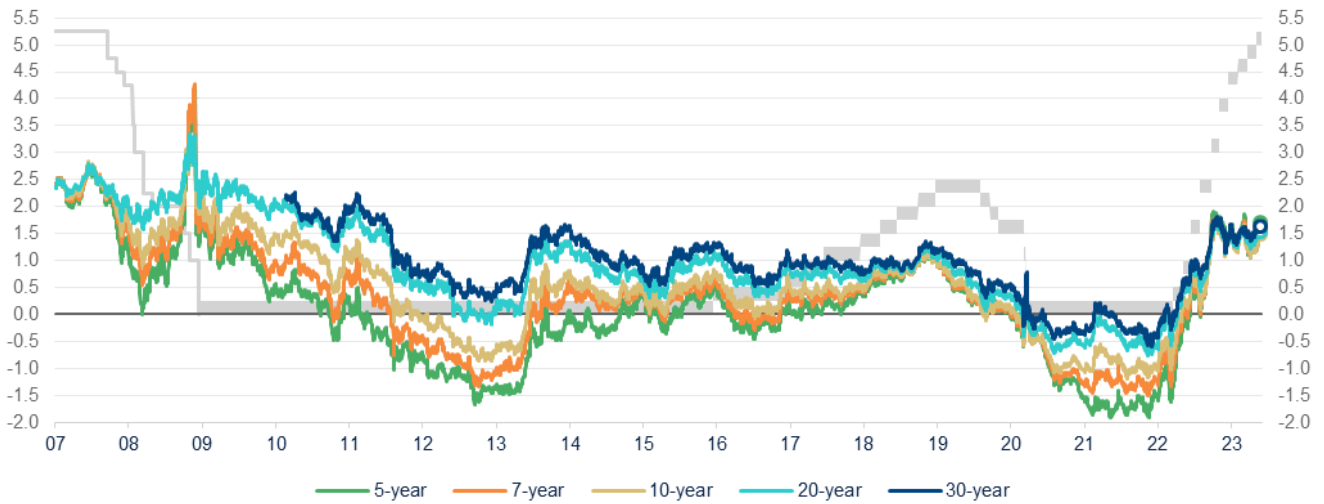
Figure 12. **10Y-3M TREASURY YIELD SPREAD (% AND BPS)**



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

Inflation-indexed Treasury (TIPS) yields recently pushed modestly higher with nominal rates edging up

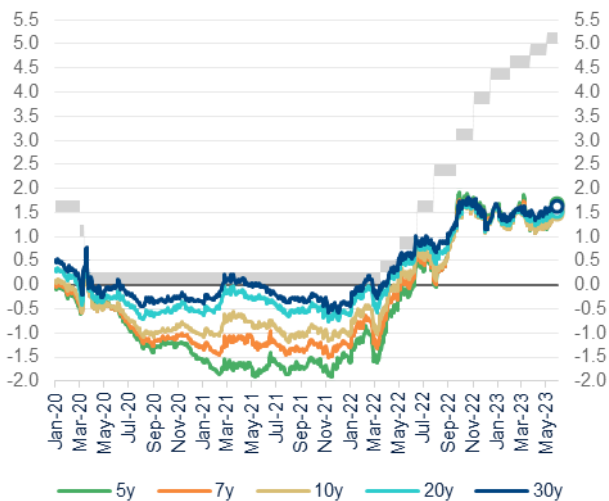
Figure 13. **INFLATION INDEXED TREASURY (TIPS) YIELDS (%)**



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

The real yield curve is still hovering around a narrow range, even after shifting...

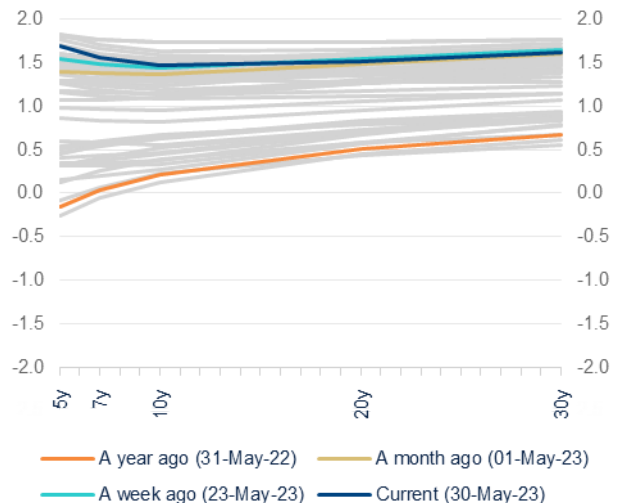
Figure 14. **INFLATION INDEXED (TIPS) YIELDS (%)**



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

... slightly up in the 5 to 10-year section. Real yields along the curve remain relatively high

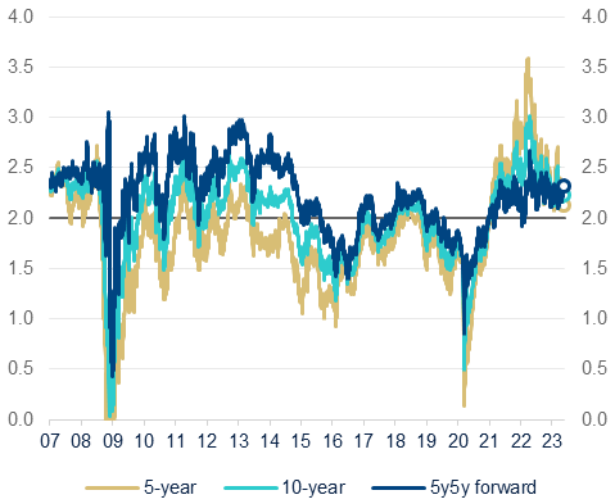
Figure 15. **INFLATION INDEXED (TIPS) YIELD CURVE (%)**



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 continued to hover around a narrow range...

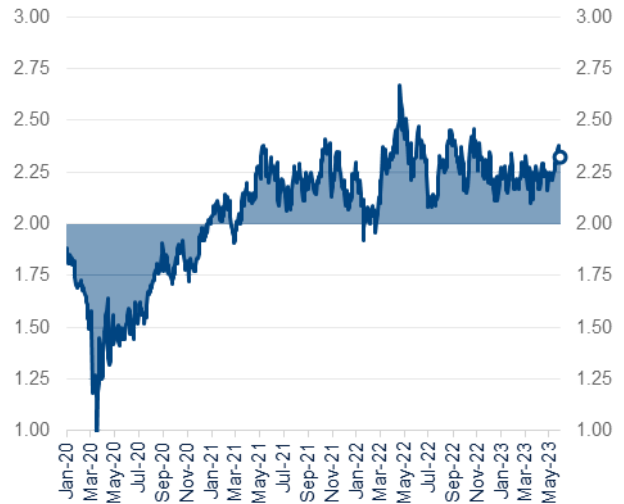
Figure 16. **BREAKEVEN INFLATION RATES** (%)



Source: BBVA Research based on data by Haver Analytics.

... at low levels, even though the pace at which inflation has come down has been disappointing

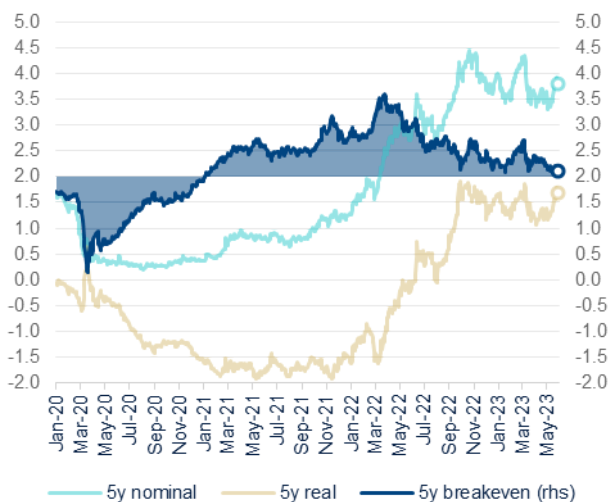
Figure 17. **5Y5Y FORWARD IMPLIED INFLATION RATE** (%)



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 will...

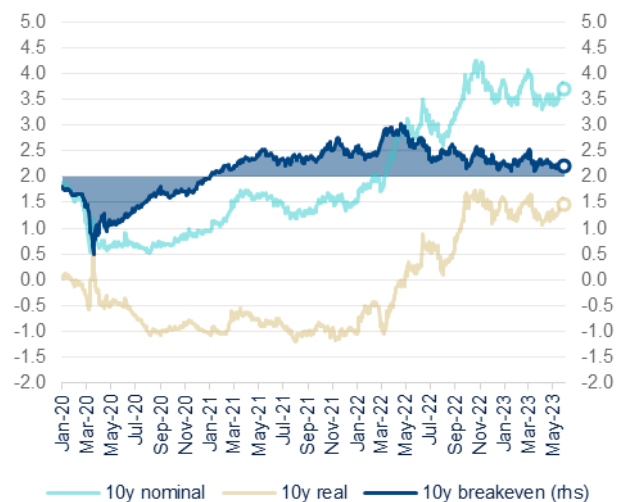
Figure 18. **5-YEAR BREAKEVEN INFLATION RATE** (%)



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

... succeed in bringing inflation down, and the economy will return to a low inflation setting

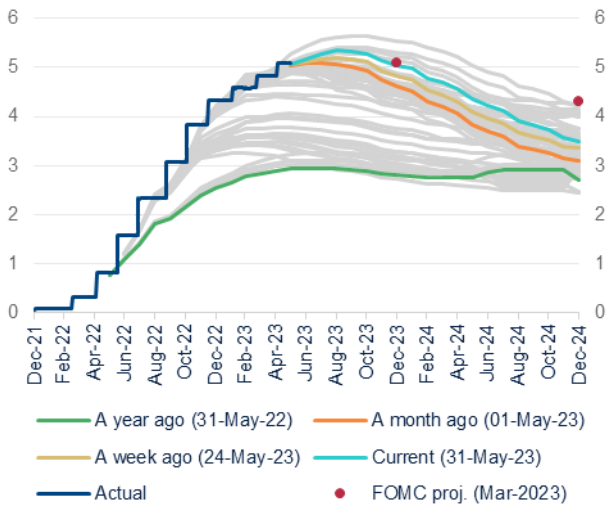
Figure 19. **10-YEAR BREAKEVEN INFLATION RATE** (%)



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

Fed funds market expectations shifted up meaningfully over the last month, to the point...

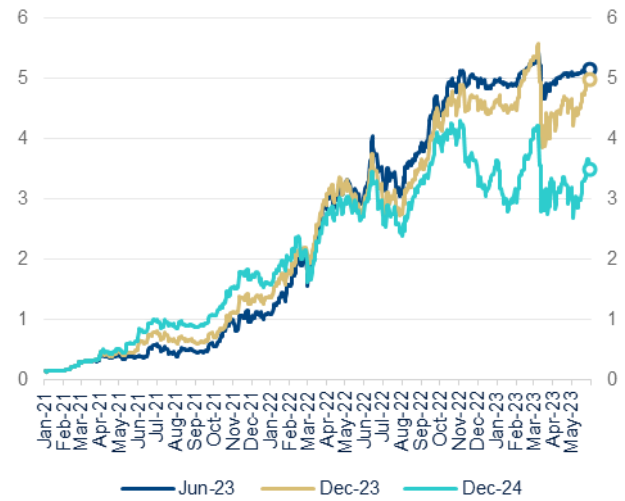
Figure 20. **IMPLIED RATE IN 30-DAY FED FUNDS FUTURES (%)**



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

... that markets are now close to expecting the Fed to stay on the sidelines through year end

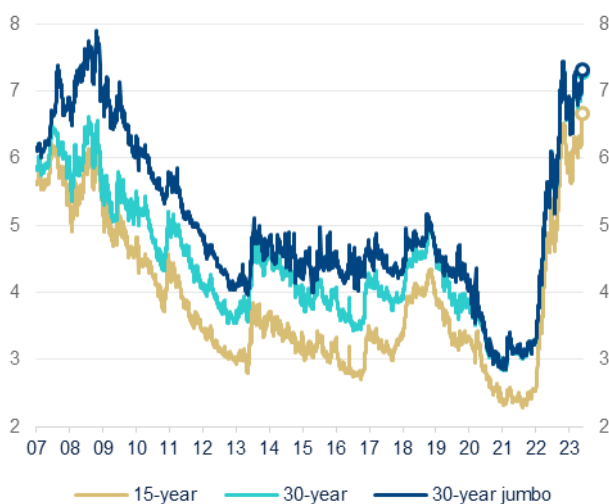
Figure 21. **IMPLIED RATE IN 30-DAY FED FUNDS FUTURES (%)**



Source: BBVA Research based on data by Bloomberg.

Mortgage rates are on the rise again: 30-yr's' close to recent highs, 15-yr's' have hit fresh 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

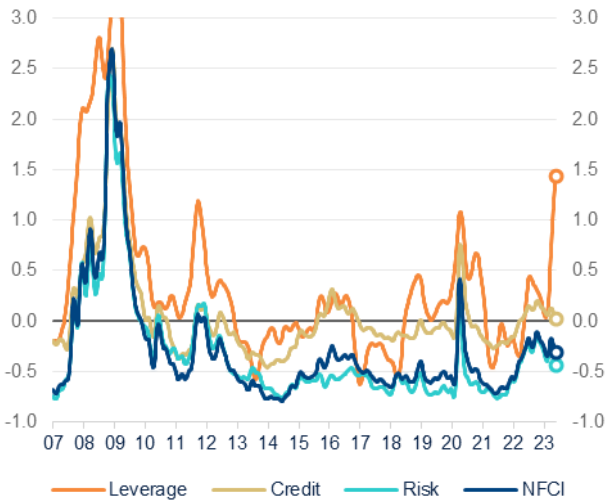
Figure 23. **CORPORATE BOND SPREADS (MOODY'S SEASONED YIELDS, DAILY DATA, BPS)**



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

The leverage component of the NFCI, which takes into account borrowing costs and debt levels, ...

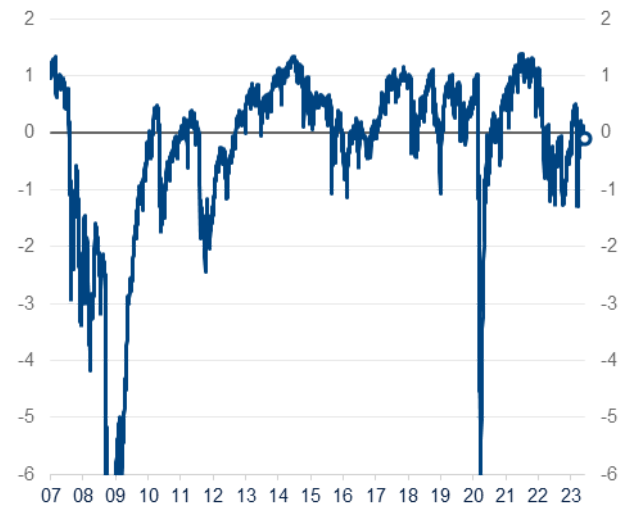
Figure 24. **CHICAGO FED NATIONAL FINANCIAL CONDITIONS INDEX (>0 = TIGHTER THAN AVG)**



Source: BBVA Research based on data by Haver Analytics.

... is one of the few measures that are signaling that the financial system is currently more...

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



Source: BBVA Research based on data by Bloomberg.

... vulnerable to stress as interest rates hover around decade-highs. Overall, significantly...

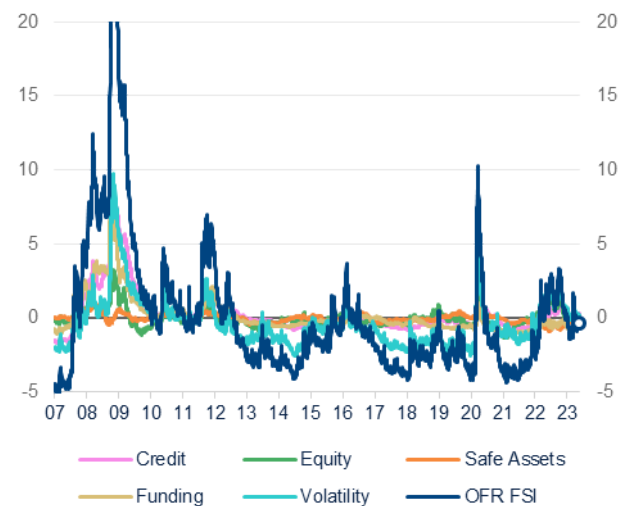
Figure 26. **FED FINANCIAL STRESS INDICES (>0 = ABOVE AVG FINANCIAL STRESS)**



Source: BBVA Research based on data by Haver Analytics.

... tighter credit conditions are still not evident in most of broad financial conditions indices

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



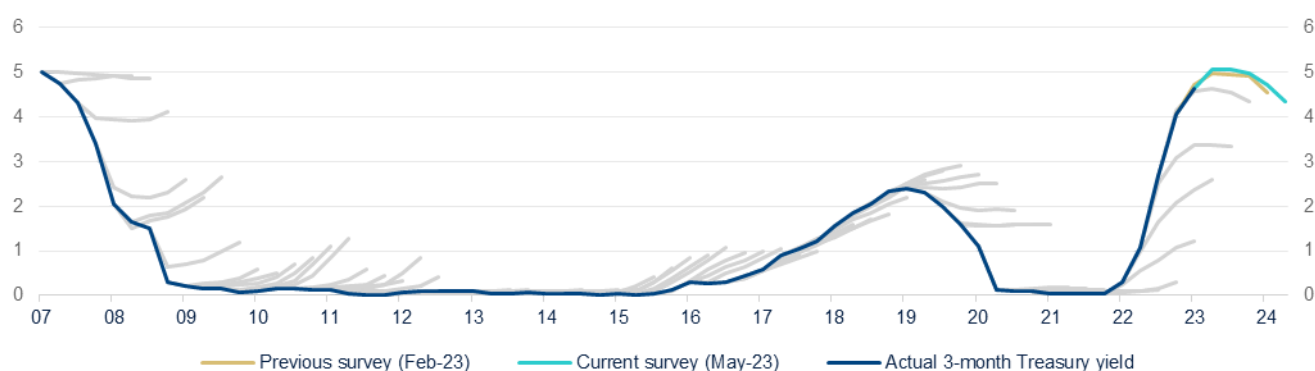
OFR: Office of Financial Research, US Department of the Treasury.
Source: BBVA Research based on data by Haver Analytics.

Professional forecasters expect the 10-year Treasury yield to move sideways going forward amid a fast monetary easing cycle

- Professional Forecasters surveyed this month by the Philadelphia Fed expect the 3-month Treasury yield to trend down to 4.3% by 2Q24 (Figure 28) and to 3.3% by 4Q25 (Figure 30).
- The median forecaster revised slightly down its 10-year Treasury yield projections and expects it to hover just above 3.5% over the next year (Figure 29), broadly in line with our baseline scenario.
- Treasury yields expectations show that markets expect the 10y-3m Treasury yield curve slope to remain negative throughout 2023 and 2024 (Figure 31).

Professional forecasters' expectations for short-term interest peak rates remained virtually unchanged, but an extended forecast horizon revealed the expectation of a rapid easing cycle ahead

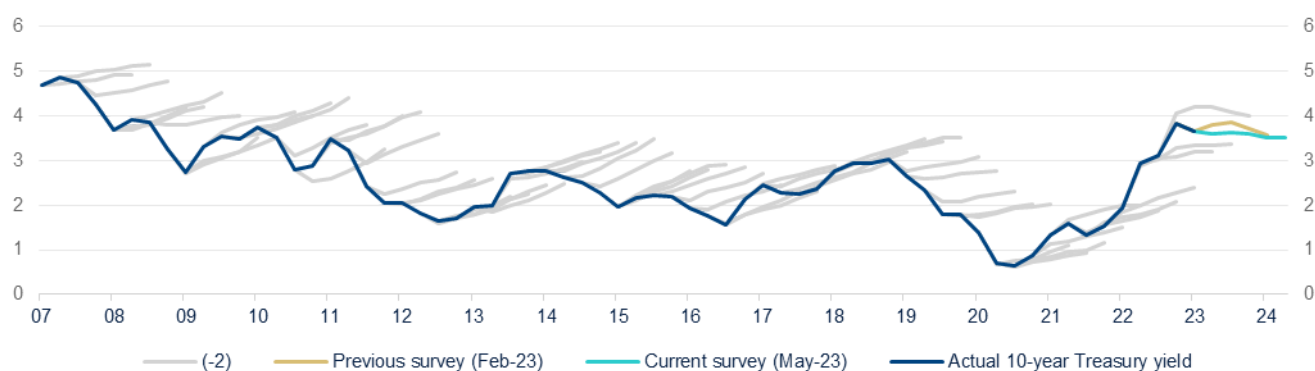
Figure 28. PROFESSIONAL FORECASTERS 3-MONTH TREASURY YIELD EXPECTATIONS (%)



Median values. The gray lines indicate historic Professional Forecasters' expectations.
Source: BBVA Research based on data by Haver Analytics.

For the second time in a row, the median forecaster revised down its 10-year Treasury yield projections and now expects it to hover just above 3.5% over the next four quarters

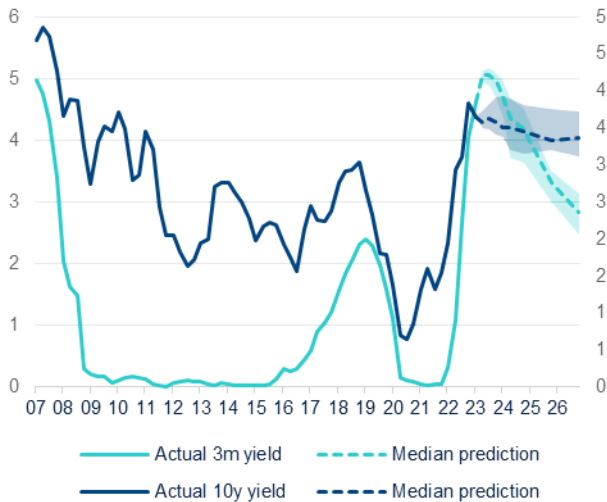
Figure 29. PROFESSIONAL FORECASTERS 10-YEAR TREASURY YIELD EXPECTATIONS (%)



Median values. The gray lines indicate historic Professional Forecasters' expectations.
Source: BBVA Research based on data by Haver Analytics.

Treasury yields expectations show that markets expect the 10y-3m Treasury yield curve slope ...

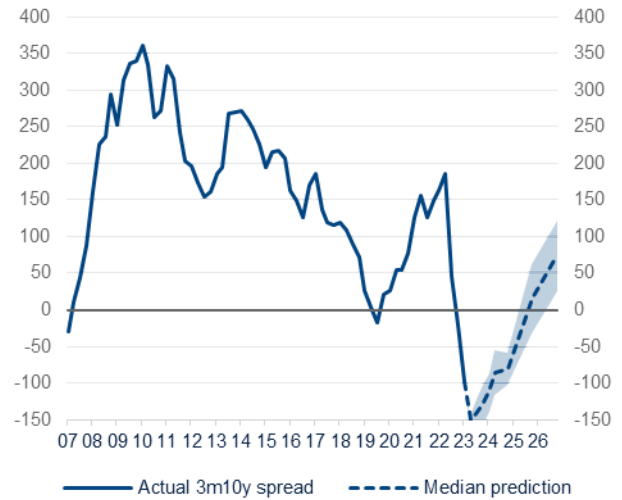
Figure 30. **PROF. FORECASTERS TREASURY YIELDS EXPECTATIONS (%)**



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

... to remain negative throughout 2023 and 2024

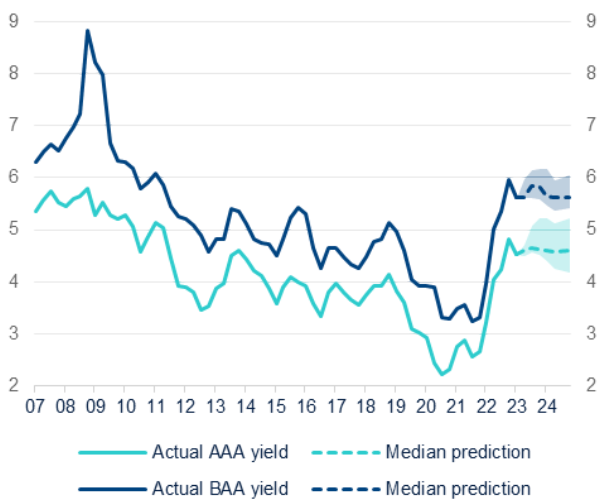
Figure 31. **PROF. FORECASTERS IMPLIED 10Y-3MY SPREAD EXPECTATIONS (BPS)**



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...

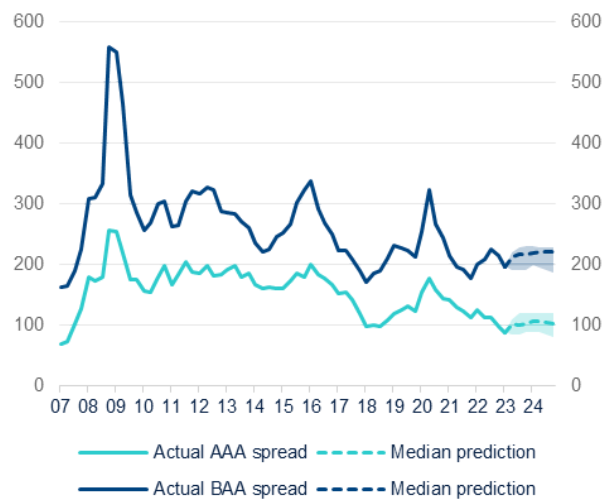
Figure 32. **PROF. FORECASTERS CORPORATE YIELDS EXPECTATIONS (%)**



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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ENQUIRIES TO:

BBVA Research – BBVA: Paseo de la Reforma 510, Colonia Juárez, C.P. 06600 Mexico City, Mexico.

Tel.: +52 55 5621 3434

www.bbvarresearch.com