US Interest rates monitor

Long-term yields join the Fed in its fight against inflation

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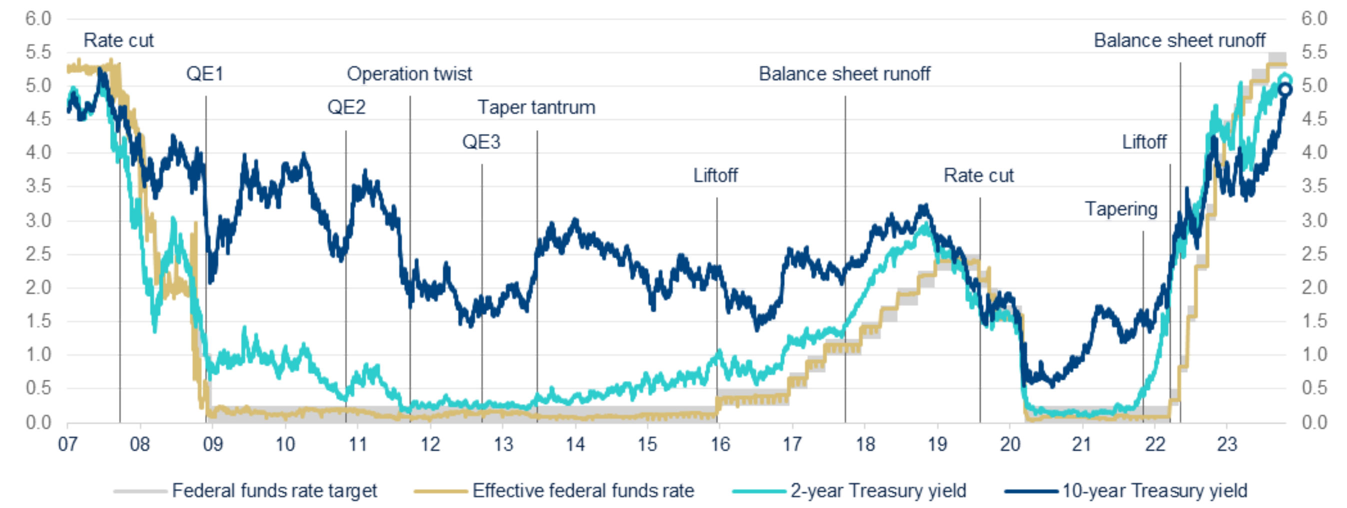
If they remain elevated on higher term premiums, the FOMC will have no need to raise the fed funds rate further

- The 2-year Treasury yield continued to price in no further policy rate hikes (Figure 4), but the 10-year yield spiked and is now near levels not seen since the pre-global-financial-crisis tightening cycle (Figure 5).
- Although certain red flags like both the 10y-2y and 10y-3m Treasury yield spreads appear to be fading, it is too early to conclude that they failed to anticipate an economic recession (Figure 10).
- Long-term yields' sharp upward movement was first driven by expectations of a higher-for-longer fed funds rate and more recently by a higher term-premium (Figures 13 and 14).
- Stronger-than-expected economic resilience continued to support the fed funds market's higher expected trajectory for the policy rate at longer horizons (Figures 21 and 22).
- Financial conditions indexes remain relatively stable (Figures 25 to 28), but households and businesses will eventually face growing interest costs as maturing debt is refinanced at higher rates

The additional tightening of financial conditions resulting from the recent increase in long-term Treasury yields reinforces our view that the federal funds rate has peaked at its current 5.25-5.50% target range

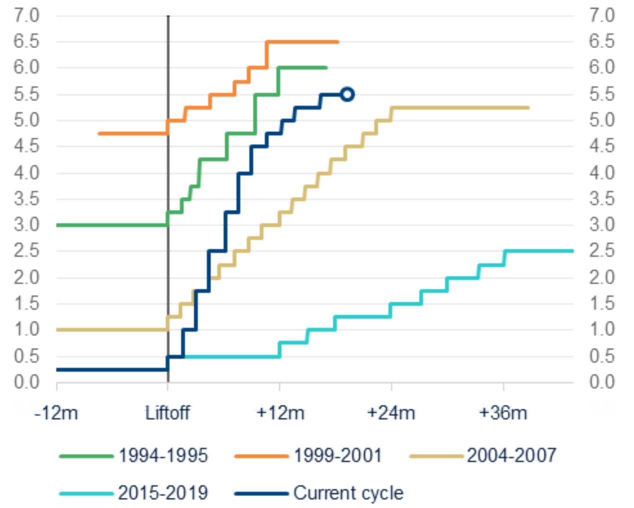
Figure 1. **2-YEAR, 10-YEAR TREASURY YIELDS AND FED FUNDS RATE** (%)



Source: BBVA Research based on data by Haver Analytics.

Though the Fed is likely to leave its options open to avoid over-easing financial conditions, …

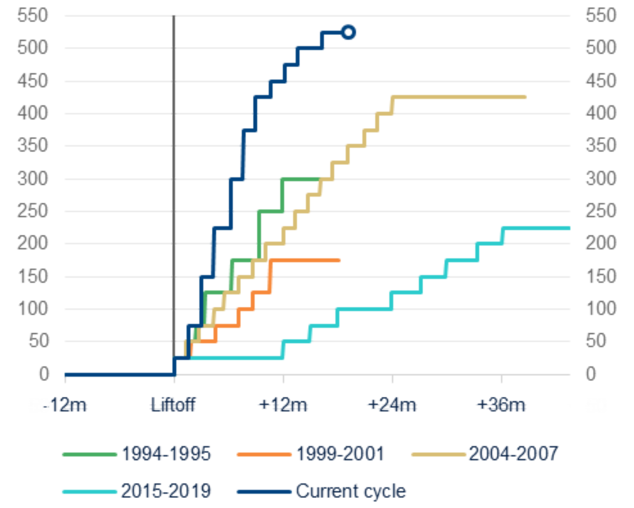
Figure 2. **FED FUNDS RATE IN TIGHTENING CYCLES** (%)



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 most likely not follow through with the additional hike signaled in the last SEP

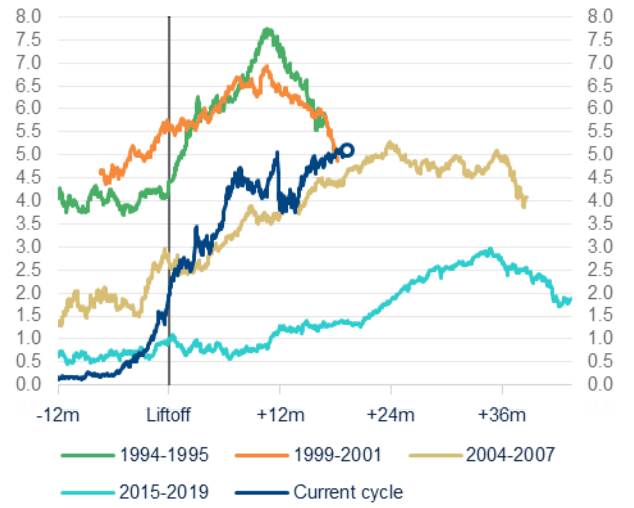
Figure 3. **FED FUNDS RATE IN TIGHTENING CYCLES** (BPS VS RATE LEVEL AT LIFTOFF)



Source: BBVA Research based on data by Haver Analytics.

The 2-year Treasury yield continued to price in no further policy rate hikes, but the 10-year yield…

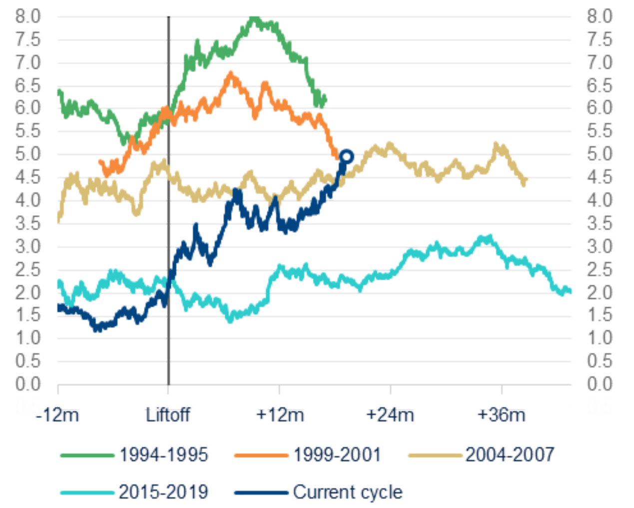
Figure 4. **2-YEAR TREASURY YIELD IN TIGHTENING CYCLES** (%)



Source: BBVA Research based on data by Haver Analytics.

… spiked and is now near levels not seen since the pre-global-financial-crisis tightening cycle

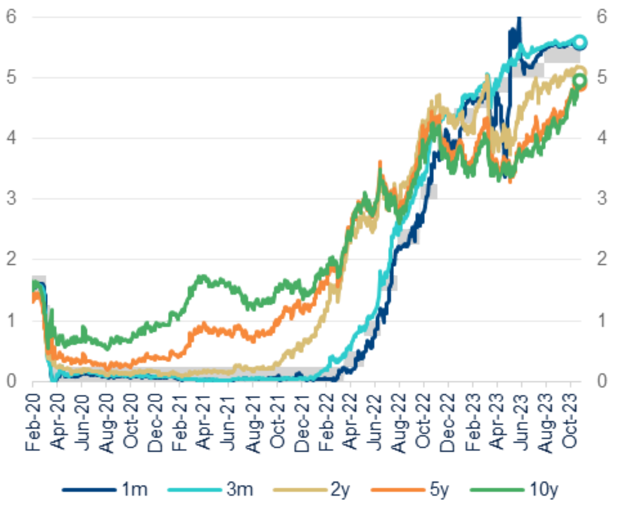
Figure 5. **10-YEAR TREASURY YIELD IN TIGHTENING CYCLES** (%)



Source: BBVA Research based on data by Haver Analytics.

Interlinked factors such as stronger-than-expected economic data, a possible increase…

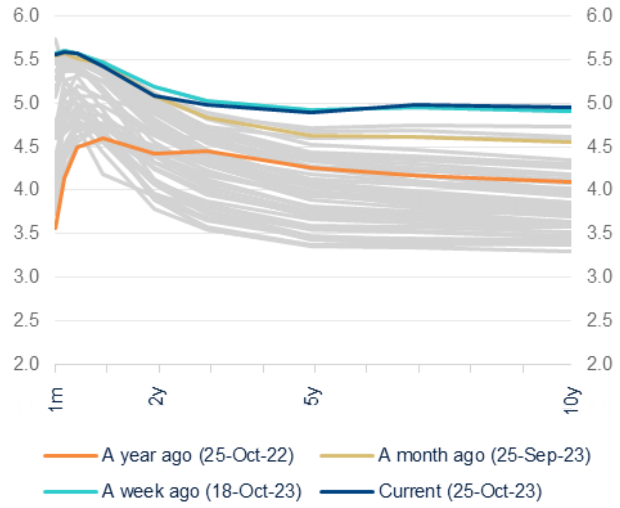
Figure 6. **TREASURY YIELDS** (%)



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

… in the neutral policy rate, greater economic and policy uncertainty, larger-than-expected…

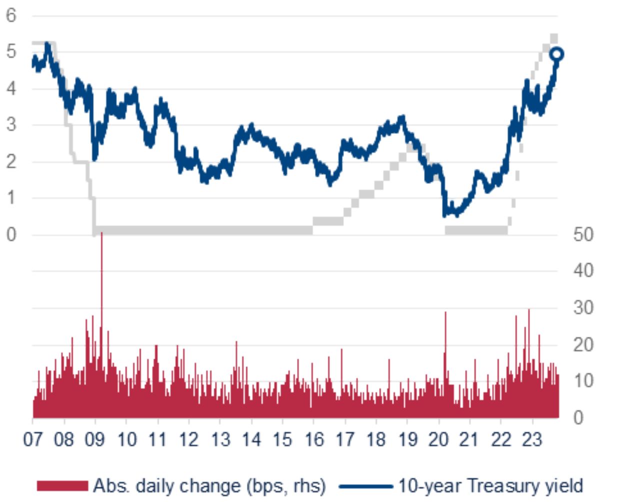
Figure 7. **TREASURY YIELD CURVE** (%)



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

… borrowing from the Treasury, and structurally-evolving global bond supply-demand dynamics…

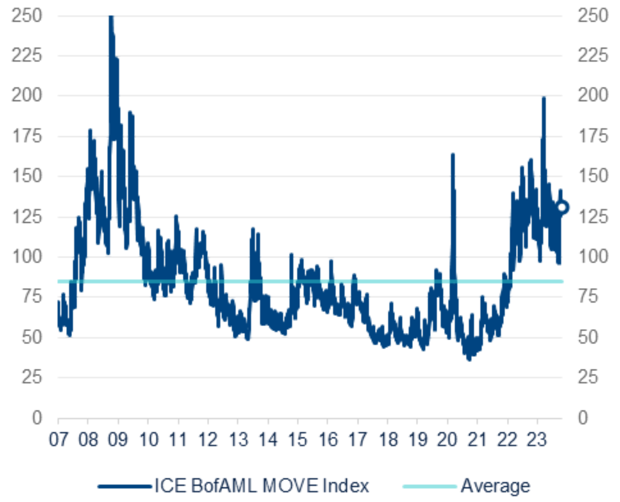
Figure 8. **10-YEAR TREASURY YIELD DAILY CHANGE** (% AND BPS)



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

… are all likely to be behind the recent rise in longer-term nominal Treasury yields

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



Source: BBVA Research based on data by Haver Analytics.

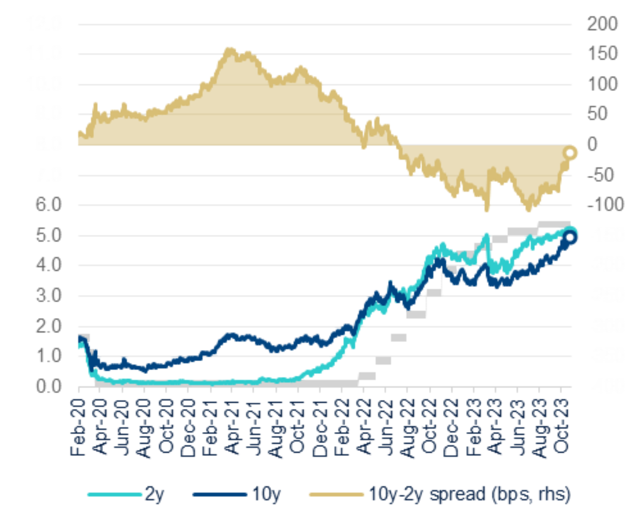
Both the 10y-2y and 10y-3m yield spreads are at its lowest (in absolute terms) since July and December 2022, respectively, amid stable short-term yields and soaring long-term yields

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.

Although certain red flags like these appear to be fading, it is too early to conclude that…

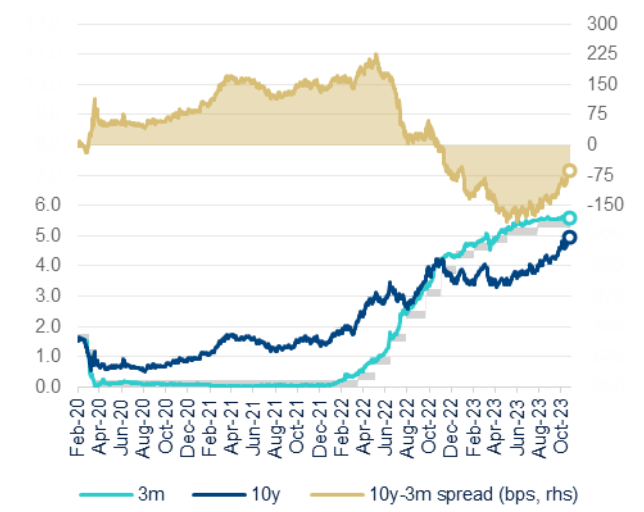
Figure 11. **10Y-2Y TREASURY YIELD SPREAD** (% AND BPS)



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

… the Treasury yield curve spreads failed to anticipate an economic recession

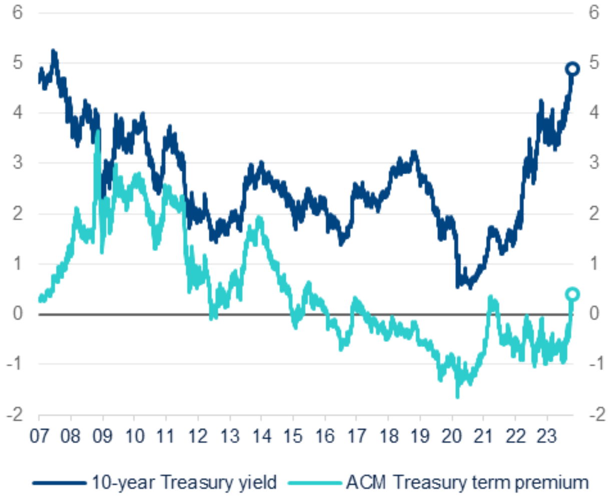
Figure 12. **10Y-3M TREASURY YIELD SPREAD** (% AND BPS)



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

Long-term yields' sharp upward movement was first driven by expectations of a…

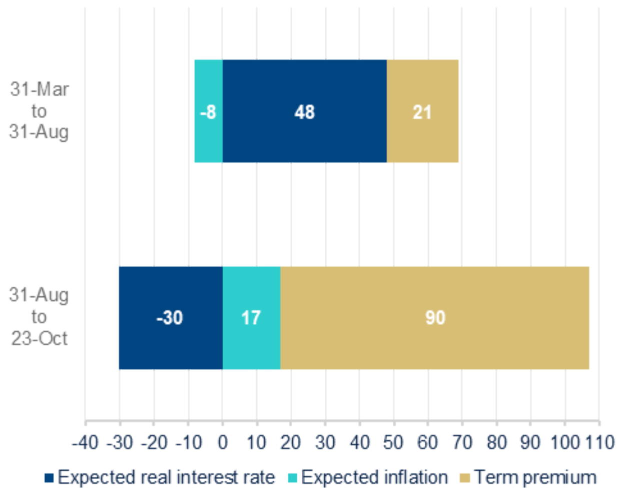
Figure 13. **10-YEAR TREASURY YIELD AND TERM PREMIUM** (%)



Source: BBVA Research based on data by Haver Analytics.

… higher-for-longer fed funds rate and more recently by a higher term-premium

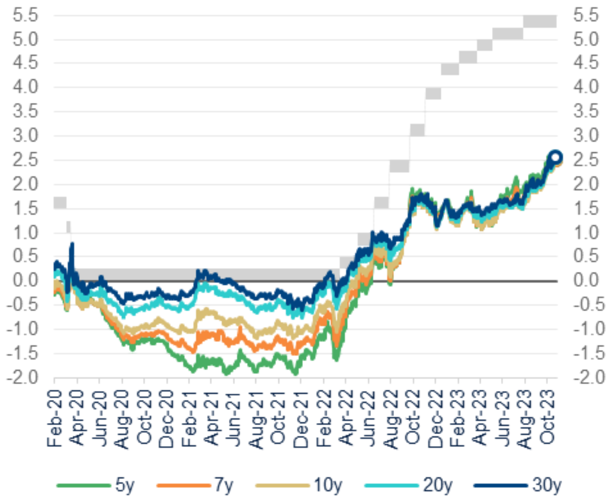
Figure 14. **CHANGE IN 10-YEAR TREASURY YIELD** (BPS)



Source: BBVA Research based on data by Haver Analytics.

Long-term real yields increased by c. 90 bps since early August

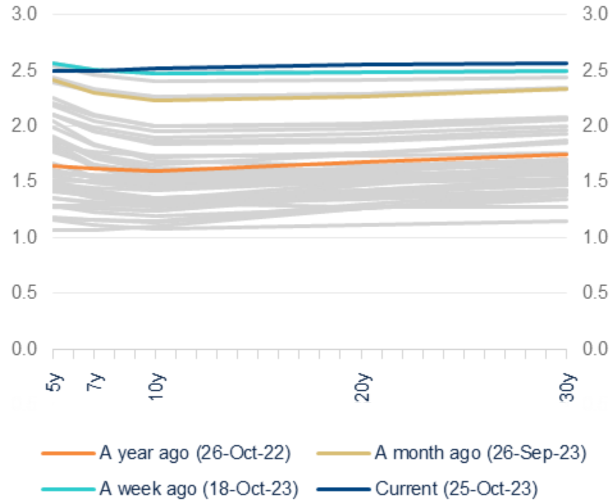
Figure 15. **INFLATION INDEXED (TIPS) YIELDS** (%)



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

The real yield curve is significantly above last years'

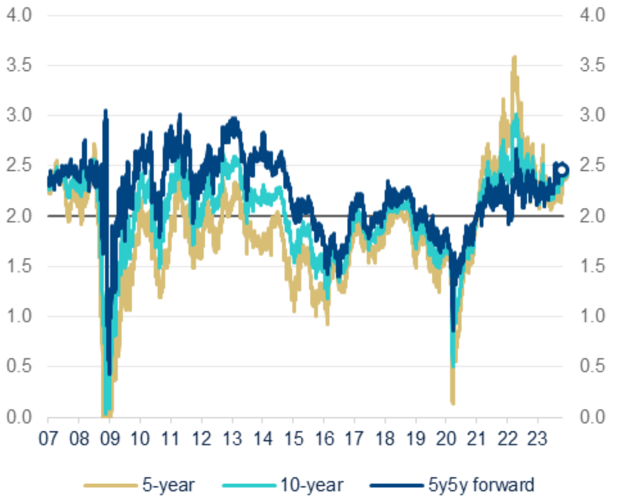
Figure 16. **INFLATION INDEXED (TIPS) YIELD CURVE** (%)



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

With the rise in real yields generally echoing that of nominal yields, market-based inflation…

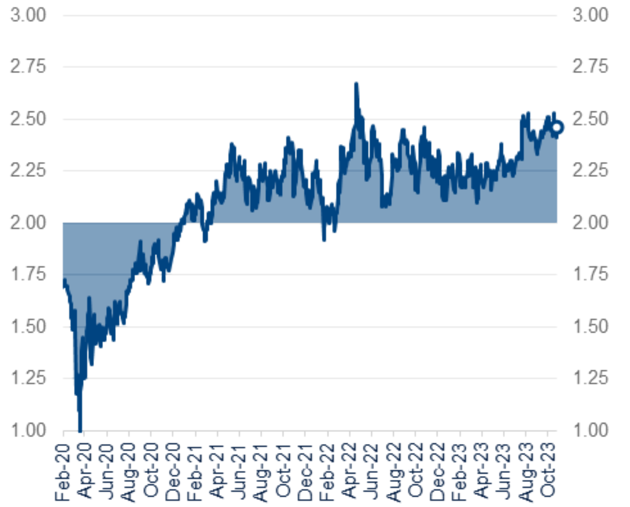
Figure 17. **BREAKEVEN INFLATION RATES** (%)



Source: BBVA Research based on data by Haver Analytics.

… expectations remained broadly stable

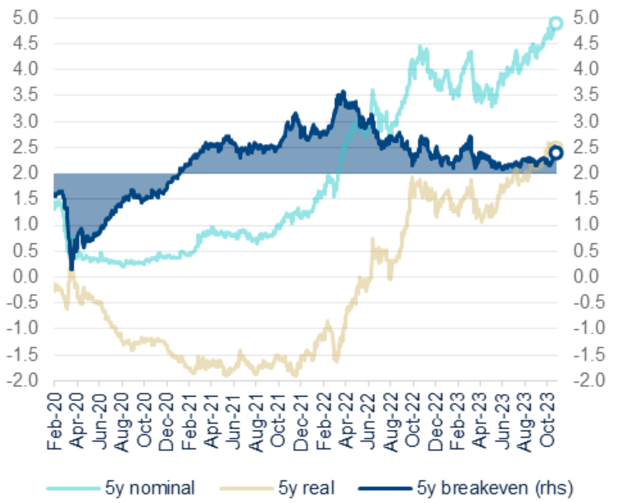
Figure 18. **5Y5Y FORWARD IMPLIED INFLATION RATE** (%)



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

Market participants have been reinforcing their view…

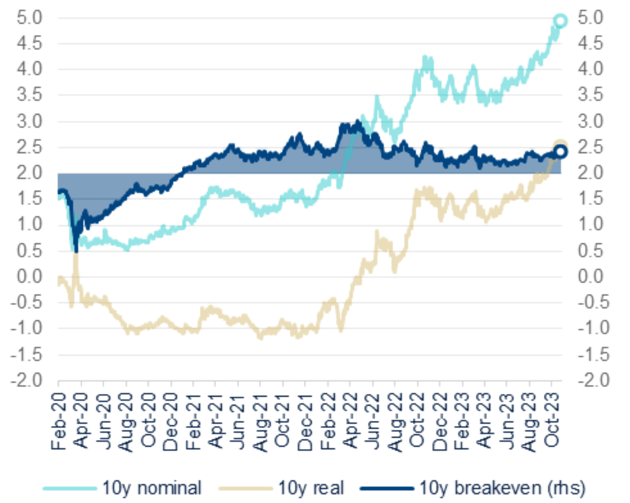
Figure 19. **5-YEAR BREAKEVEN INFLATION RATE** (%)



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

… that the Fed will likely achieve a soft-landing

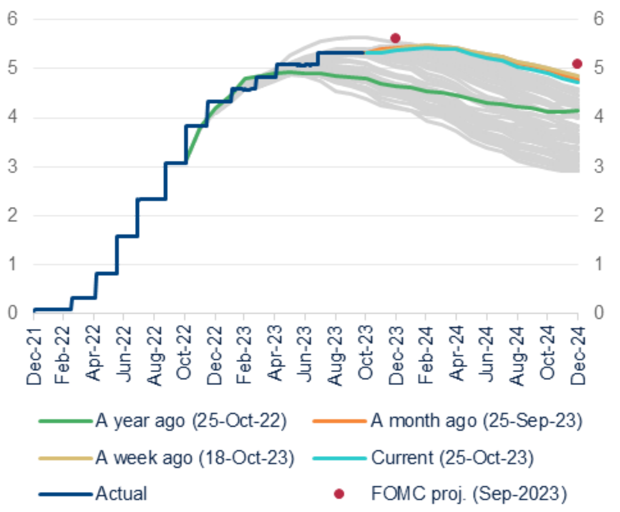
Figure 20. **10-YEAR BREAKEVEN INFLATION RATE** (%)



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

Stronger-than-expected economic resilience continued to support the fed funds market's…

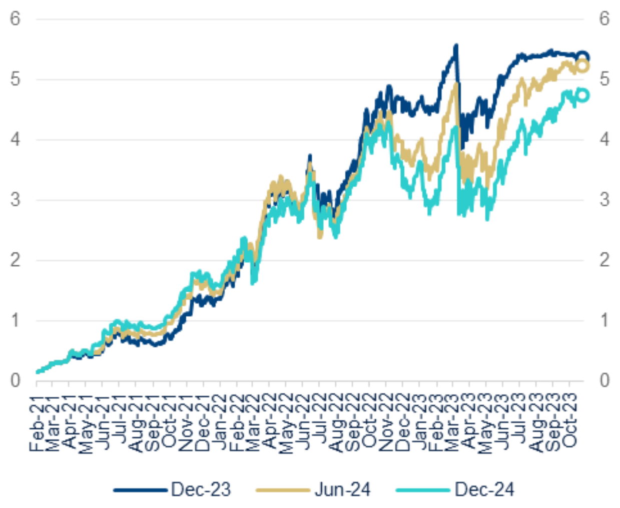
Figure 21. **IMPLIED RATE IN 30-DAY FED FUNDS FUTURES** (%)



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

… higher expected trajectory for the policy rate at longer horizons

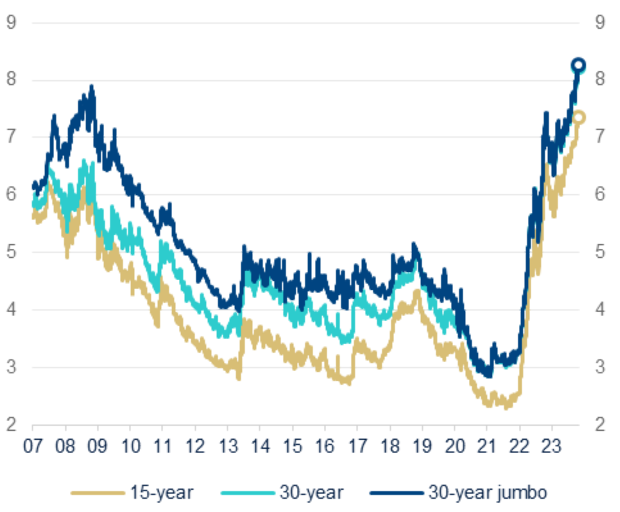
Figure 22. **IMPLIED RATE IN 30-DAY FED FUNDS FUTURES** (%)



Source: BBVA Research based on data by Bloomberg.

Mortgage rates soared, further limiting the inventory of homes available for sale, while…

Figure 23. **MORTGAGE RATES** (WSJ CONSUMER FIXED RATES, %)



Source: BBVA Research based on data by Haver Analytics.

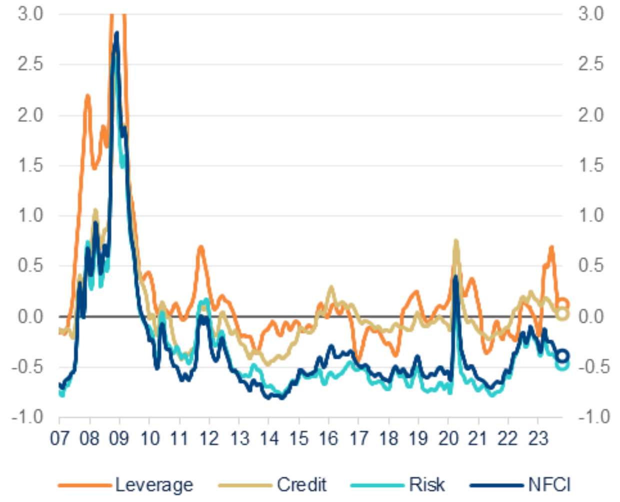
… investment-grade bond spreads continue to suggest the absence of a credit crunch

Figure 24. **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.

Financial conditions indexes continue to point to easier conditions than what would be expected…

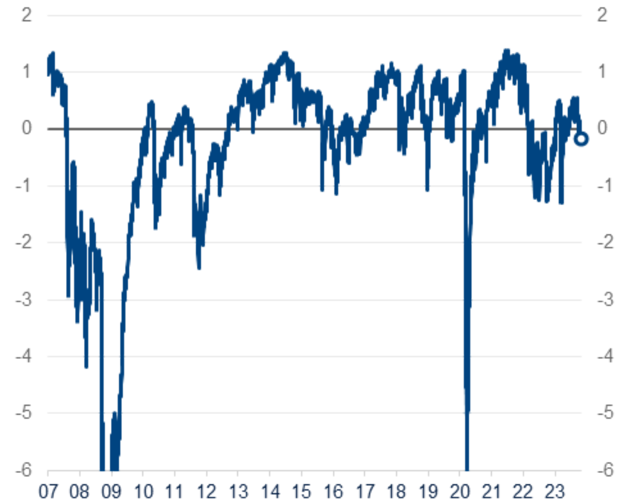
Figure 25. **CHICAGO FED NATIONAL FINANCIAL CONDITIONS INDEX** (>0: TIGHTER THAN AVG)



Source: BBVA Research based on data by Haver Analytics.

… amid recent higher longer-term rates and a stronger dollar. A greater share of fixed-rate…

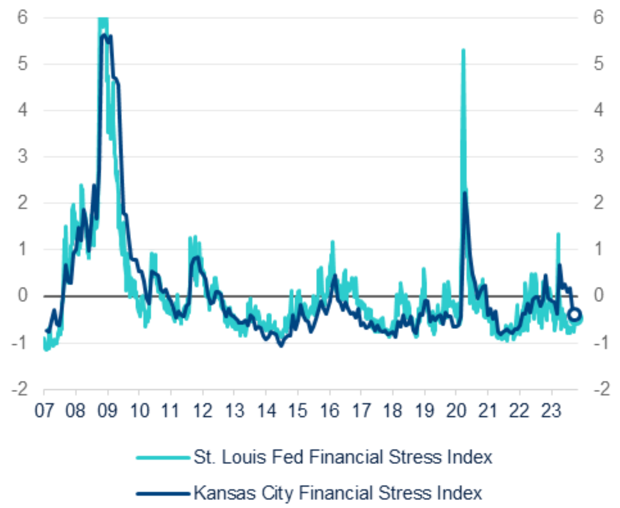
Figure 26. **BLOOMBERG FINANCIAL CONDITIONS INDEX** (<0: TIGHTER THAN PRE-GFC AVG)



Source: BBVA Research based on data by Bloomberg.

… debt is likely to explain this mismatch, but households and businesses …

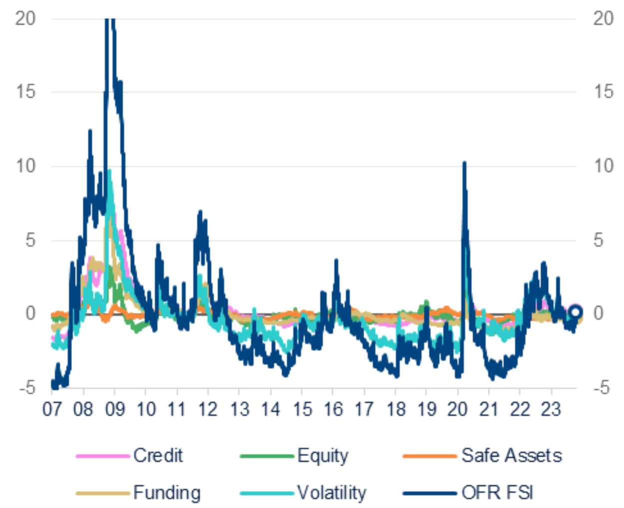
Figure 27. **FED FINANCIAL STRESS INDICES** (>0: ABOVE AVG FINANCIAL STRESS)



Source: BBVA Research based on data by Haver Analytics.

… will eventually face growing interest costs as maturing debt is refinanced at higher rates

Figure 28. **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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