

US Interest rates monitor

# Strong bond rally on growing expectations of rate cuts in 2024

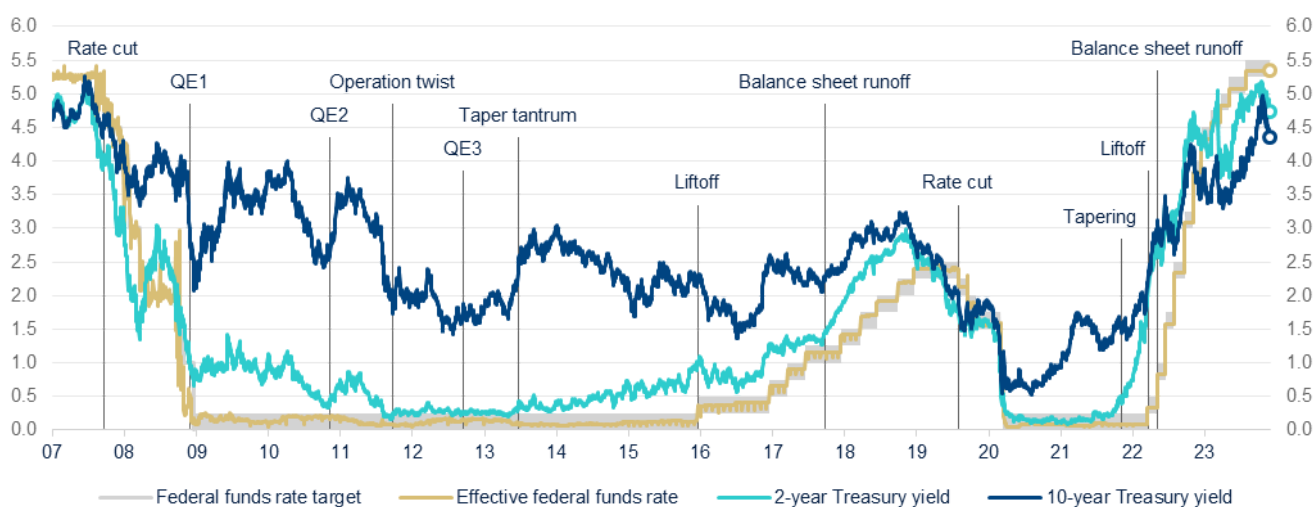
Javier Amador / Iván Fernández  
November 29, 2023

## Lower uncertainty on the possible range of outcomes for the fed funds rate path has brought down the term premium

- Following a less hawkish tone from Chair Powell in his press conference early this month, the yield curve now suggests a potential turning point has been reached (Figures 4 to 7), reflecting investors' belief that the Fed is done raising rates and growing expectations of rate cuts in 2024, which were fueled recently by Waller's (typically a hawk) dovish comments.
- The drop in long-term yields is driven by growing confidence that the Fed is done raising rates, while lower uncertainty on the fed funds rate path has brought down the term-premium (Figures 13 and 14).
- Futures are now fully pricing a 25bp rate cut by the Fed's May meeting, a notable change from October, when it was thought that there was no chance of a rate cut in the first half of 2024 (Figures 21 and 22).
- Easier financial conditions increase the risk that the Fed might attempt to bolster rates along the yield curve in December signaling that the door for rate cuts is unlikely to open soon (Figures 25 to 28).

The fed funds rate has remained unchanged at its current 5.25-5.50% target range for four consecutive months. The Fed will most likely stay on the sidelines at next month's FOMC meeting

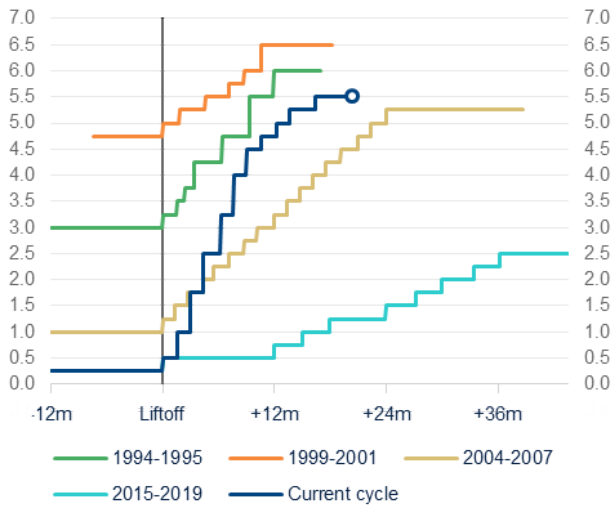
Figure 1. 2-YEAR, 10-YEAR TREASURY YIELDS AND FED FUNDS RATE (%)



Source: BBVA Research based on data by Haver Analytics.

**Recent data supports the view that the Fed won't raise rates further as the economy seems to be...**

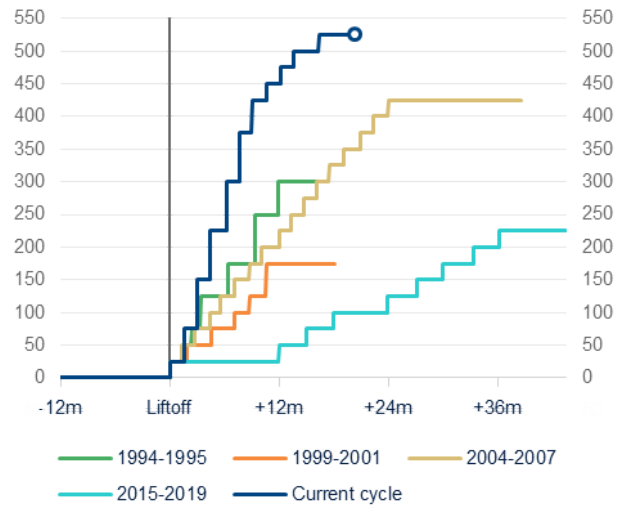
Figure 2. **FED FUNDS RATE IN TIGHTENING CYCLES (%)**



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.

**... on track for a steady inflation deceleration and labor market rebalancing process**

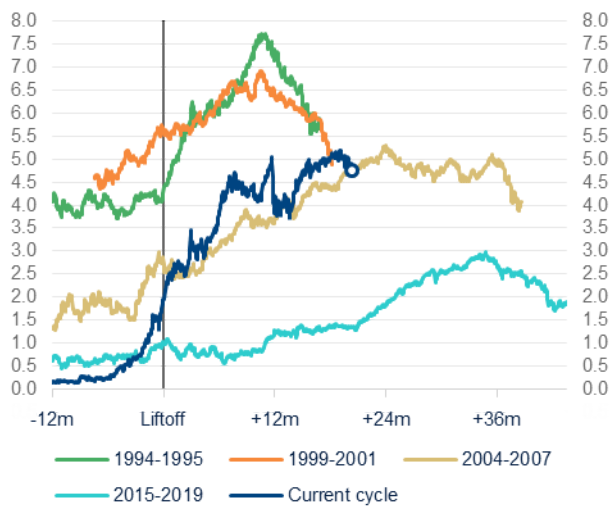
Figure 3. **FED FUNDS RATE IN TIGHTENING CYCLES (BPS VS RATE LEVEL AT LIFTOFF)**



Source: BBVA Research based on data by Haver Analytics.

**Following a less hawkish tone from Chair Powell in his press conference early this month, the ...**

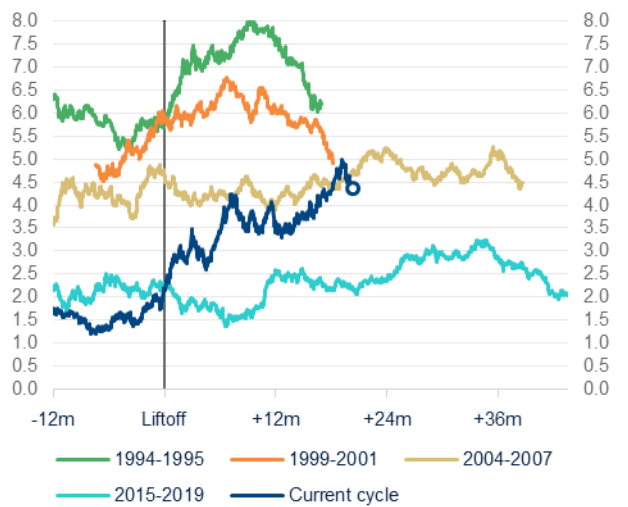
Figure 4. **2-YEAR TREASURY YIELD IN TIGHTENING CYCLES (%)**



Source: BBVA Research based on data by Haver Analytics.

**... yield curve now suggests a potential turning point has been reached, reflecting investors'...**

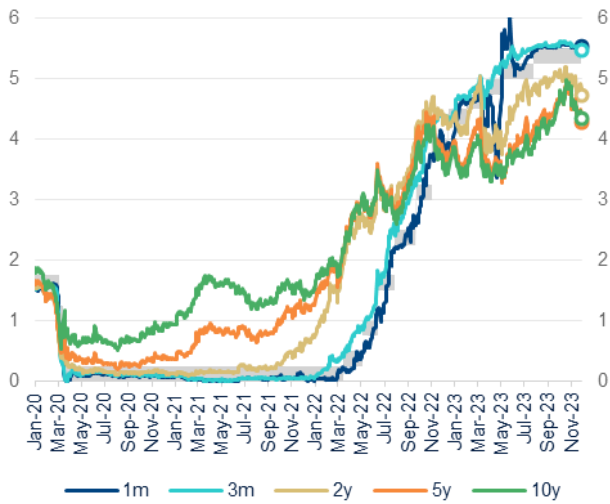
Figure 5. **10-YEAR TREASURY YIELD IN TIGHTENING CYCLES (%)**



Source: BBVA Research based on data by Haver Analytics.

... belief that the Fed is done raising rates and growing expectations of rate cuts in 2024...

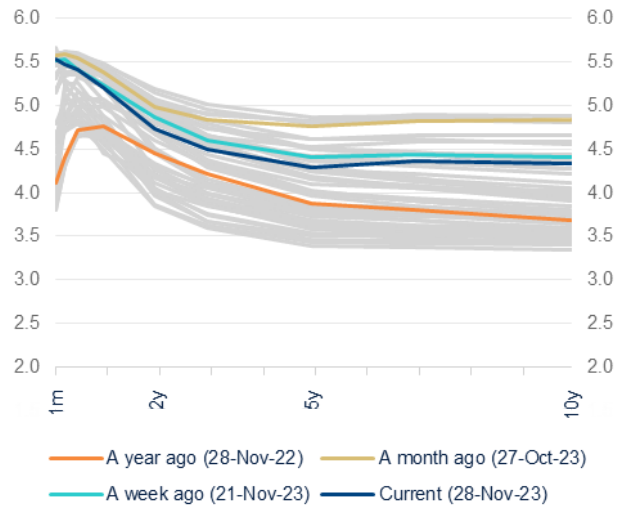
Figure 6. **TREASURY YIELDS**  
(%)



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

... which were fueled recently by Waller's (typically a hawk) dovish comments

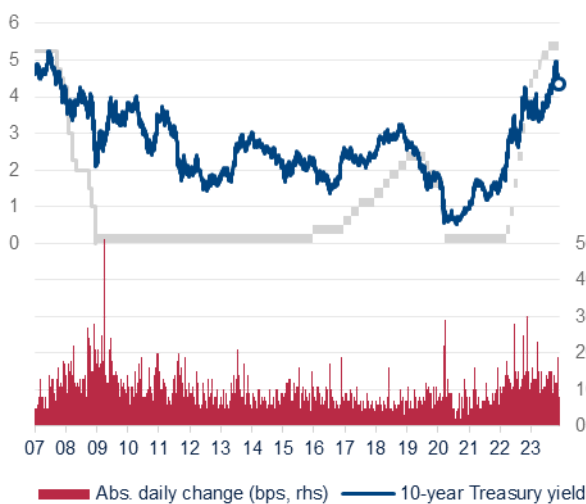
Figure 7. **TREASURY YIELD CURVE**  
(%)



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

This pushed down the 10-year Treasury yield from a 16-year peak of 5% a month ago to 4.3%

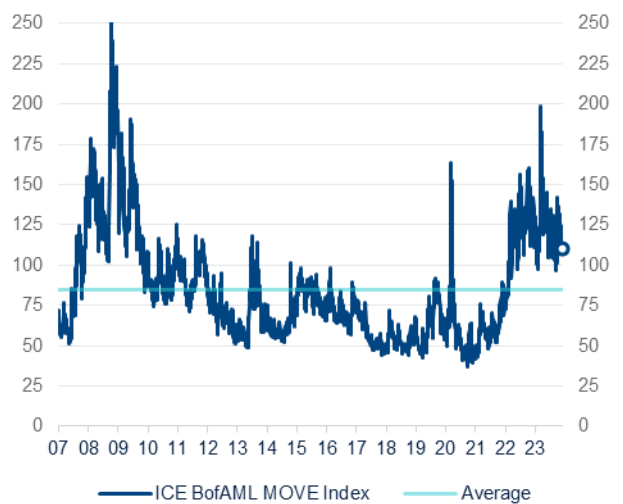
Figure 8. **10-YEAR TREASURY YIELD DAILY CHANGE**  
(% AND BPS)



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

Volatility has also come down as the outcome for the fed funds rate path seems more predictable...

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



Source: BBVA Research based on data by Haver Analytics.

... as markets are now only questioning the timing and the extent of the rate cuts in 2024; with stable short-term yields and lower mid-and-long-term yields, spreads widened again (in absolute terms)

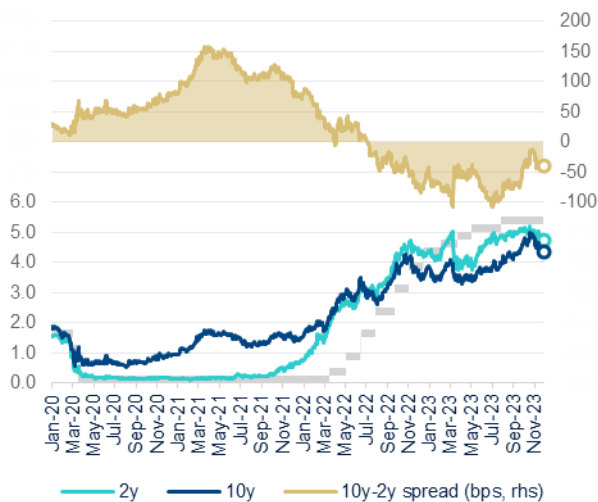
Figure 10. **TREASURY YIELD SPREADS (BPS)**



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.

With long-term yields falling more, the negative 10y-2y spread widened again

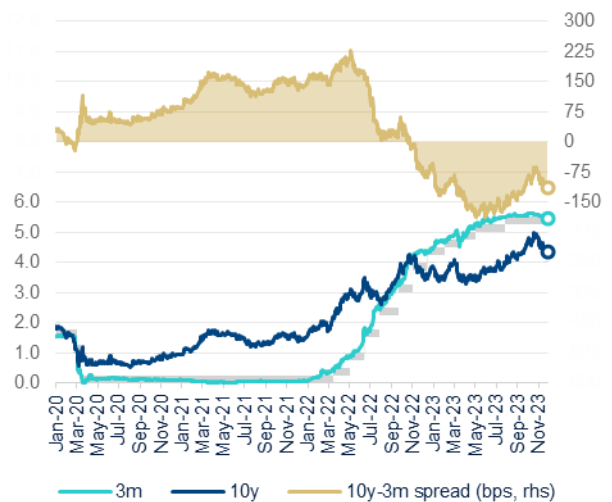
Figure 11. **10Y-2Y TREASURY YIELD SPREAD (% AND BPS)**



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

Negative Treasury yield spreads continue 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.

The drop in long-term yields is driven by growing confidence that the Fed is done raising rates

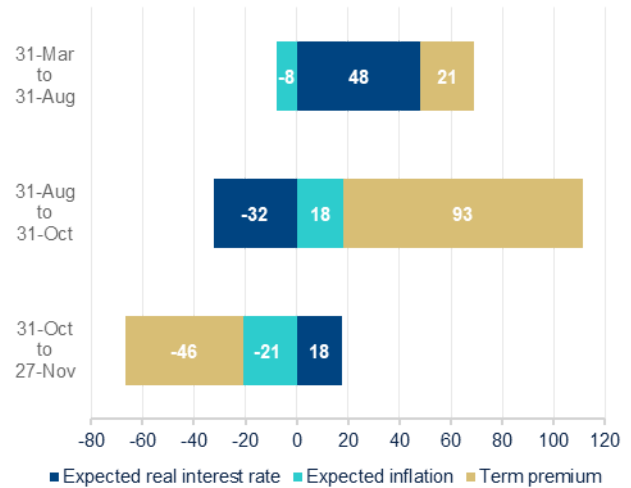
Figure 13. 10-YEAR TREASURY YIELD AND TERM PREMIUM (%)



Source: BBVA Research based on data by Haver Analytics.

Lower uncertainty on the fed funds rate path has brought down the term-premium

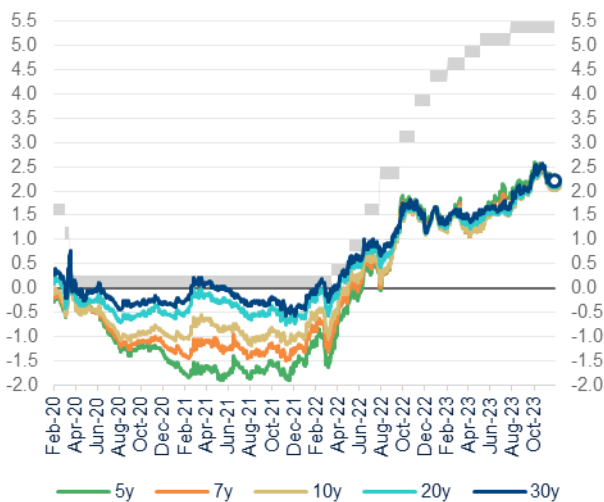
Figure 14. CHANGE IN 10-YEAR TREASURY YIELD (BPS)



Source: BBVA Research based on data by Haver Analytics.

Long-term real yields have fallen back since the recent October peak

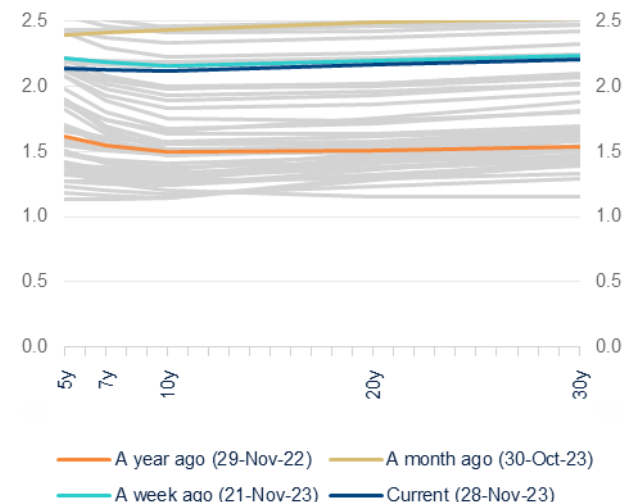
Figure 15. INFLATION INDEXED (TIPS) YIELDS (%)



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

The real yield curve shifted down by roughly 30 bps over the last month

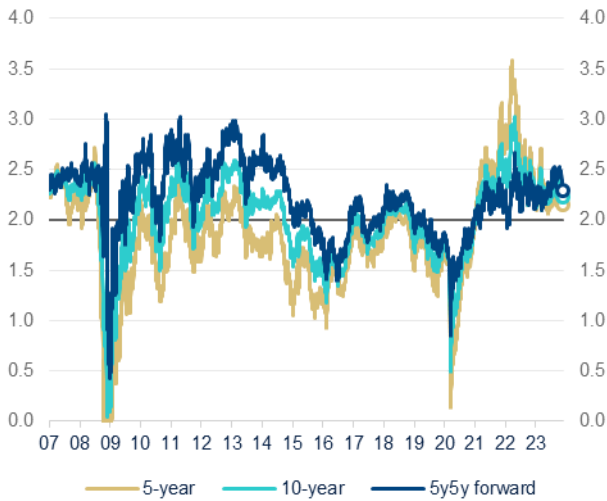
Figure 16. INFLATION INDEXED (TIPS) YIELD CURVE (%)



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

**With the drop in real yields mirroring the movement of nominal yields, market-based...**

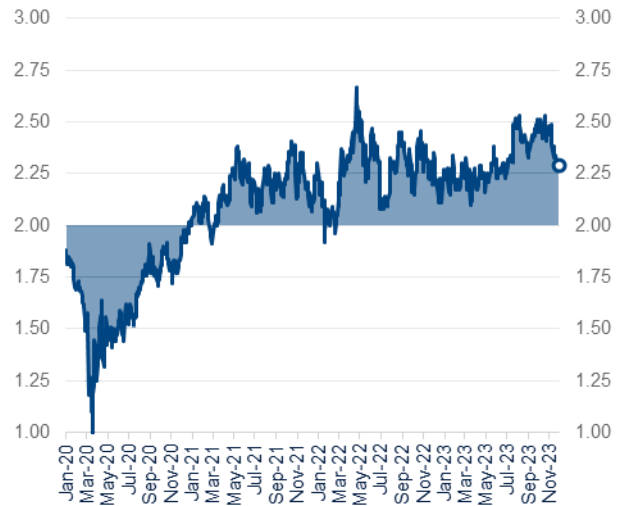
Figure 17. **BREAKEVEN INFLATION RATES (%)**



Source: BBVA Research based on data by Haver Analytics.

**... inflation expectations came down to levels last seen before the Fed turned more hawkish in Sep**

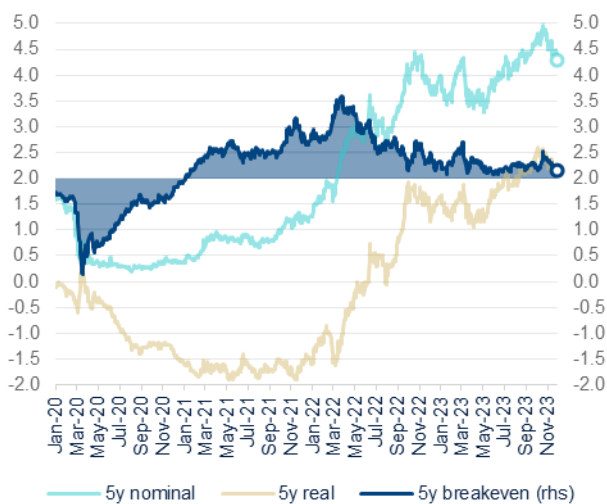
Figure 18. **5Y5Y FORWARD IMPLIED INFLATION RATE (%)**



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

**Recently, market participants have become even more confident that inflation is set to return...**

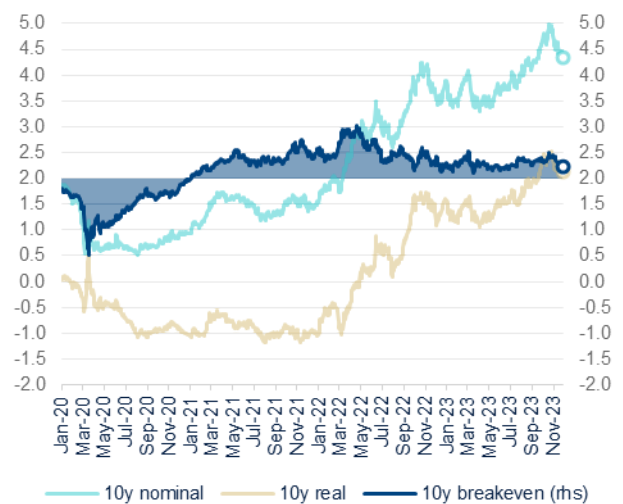
Figure 19. **5-YEAR BREAKEVEN INFLATION RATE (%)**



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

**... to target in the medium term as 5 and 10-year breakeven inflation rates are now close to 2.0%**

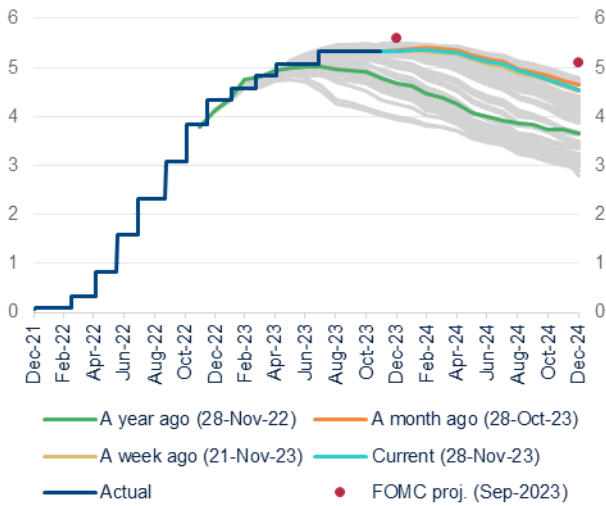
Figure 20. **10-YEAR BREAKEVEN INFLATION RATE (%)**



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

**Futures are now fully pricing a 25bp rate cut by Fed's May meeting, a notable change from Oct...**

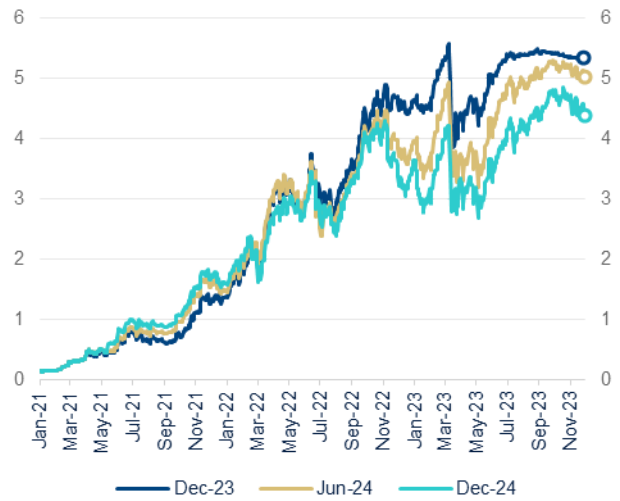
Figure 21. **IMPLIED RATE IN 30-DAY FED FUNDS FUTURES (%)**



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

**... when it was thought that there was no chance of a rate cut in the first half of 2024**

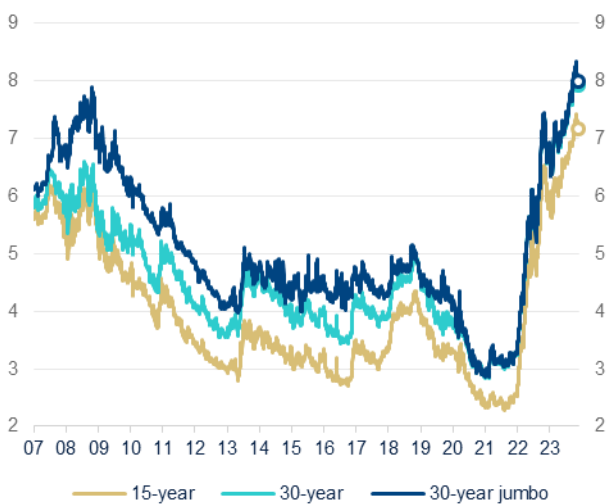
Figure 22. **IMPLIED RATE IN 30-DAY FED FUNDS FUTURES (%)**



Source: BBVA Research based on data by Bloomberg.

**Mortgage rates have come back from recent highs in tandem with long-term Treasury yields**

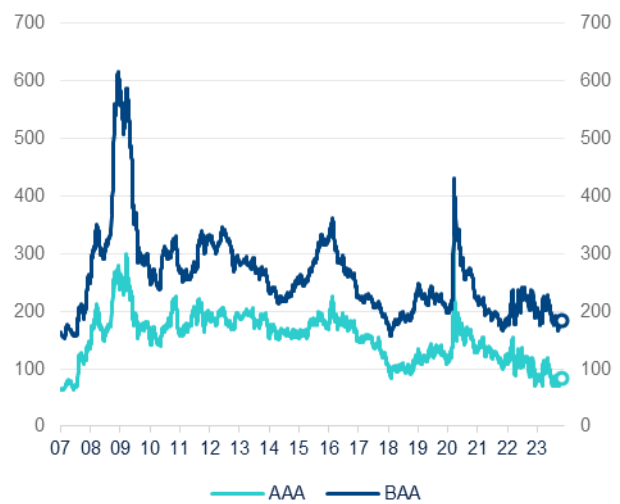
Figure 23. **MORTGAGE RATES (WSJ CONSUMER FIXED RATES, %)**



Source: BBVA Research based on data by Haver Analytics.

**Investment-grade bond spreads have narrowed further to their lowest since September**

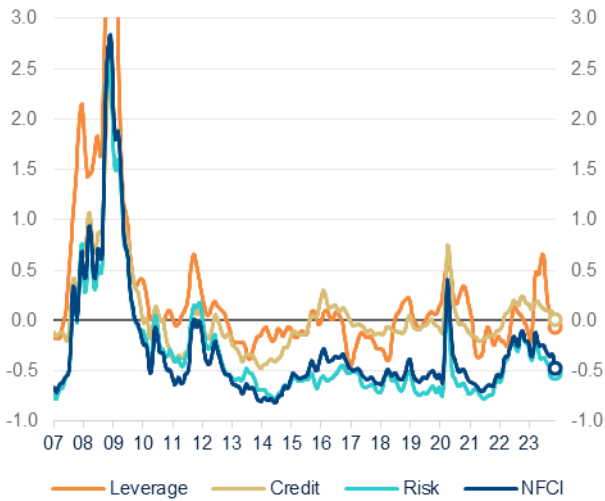
Figure 24. **CORPORATE BOND SPREADS (MOODY'S SEASONED YIELDS, DAILY DATA, BPS)**



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

**Easier financial conditions increase the risk that the Fed might attempt to bolster rates along the...**

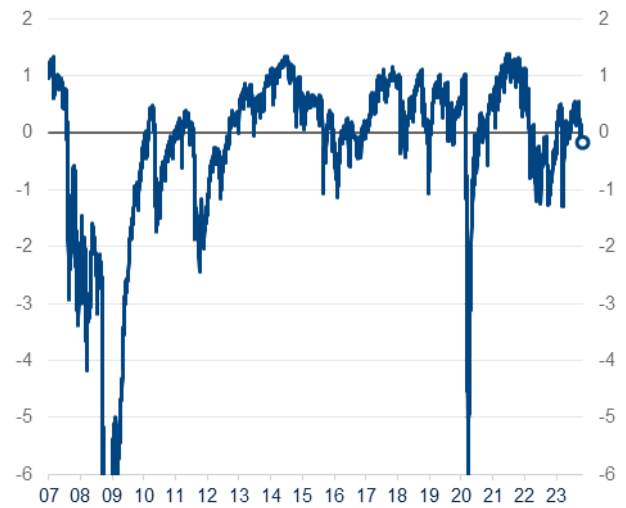
Figure 25. **CHICAGO FED NATIONAL FINANCIAL CONDITIONS INDEX (>0: TIGHTER THAN AVG)**



Source: BBVA Research based on data by Haver Analytics.

**... yield curve in December signaling that the door for rate cuts is unlikely to open soon**

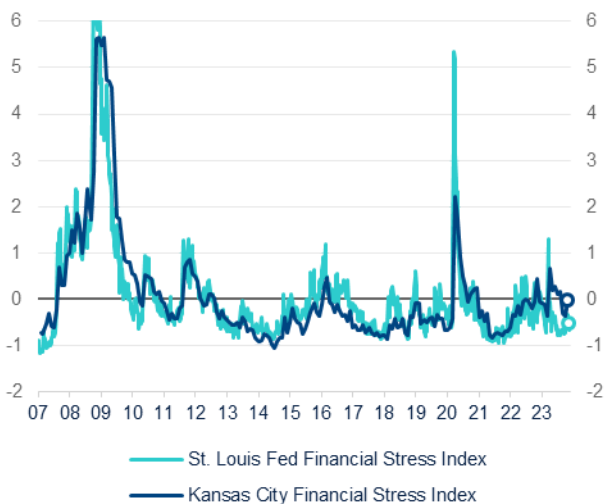
Figure 26. **BLOOMBERG FINANCIAL CONDITIONS INDEX (<0: TIGHTER THAN PRE-GFC AVG)**



Source: BBVA Research based on data by Bloomberg.

**Although indices point to low stress, households and businesses will face growing interest costs...**

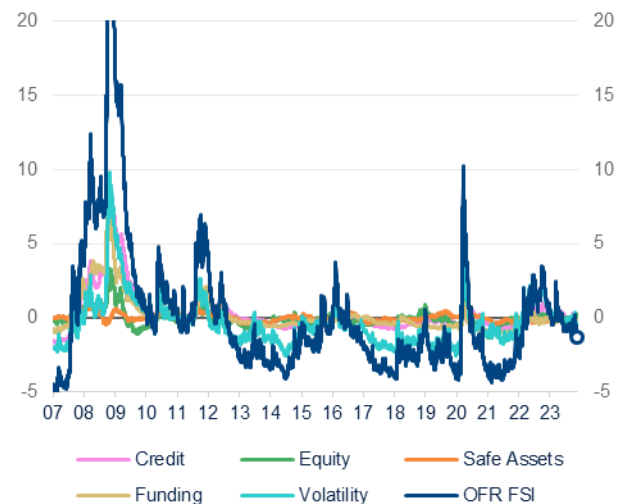
Figure 27. **FED FINANCIAL STRESS INDICES (>0: ABOVE AVG FINANCIAL STRESS)**



Source: BBVA Research based on data by Haver Analytics.

**... 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.

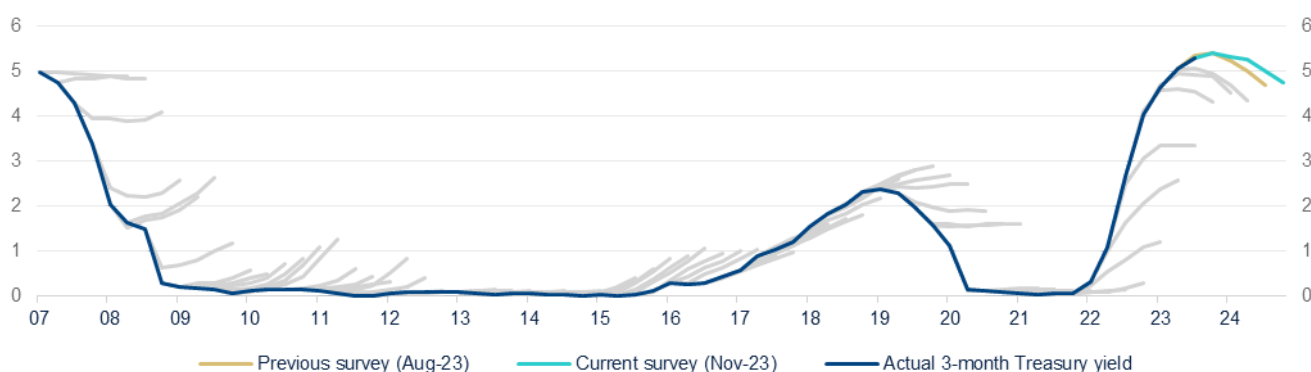


## Professional forecasters revised up their 10-year Treasury yield projections amid higher term premia

- Professional Forecasters surveyed this month by the Philadelphia Fed still expect the 3-month Treasury yield to have peaked at its current 5.50% level, but also to stay high for a longer period of time (Figure 29).
- The median forecaster revised significantly up its 10-year Treasury yield projection (Figure 30), but the recent fall in the term premium suggests that the forecasters' reaction was likely somewhat exaggerated.
- It continues to be noteworthy that corporate spreads do not seem to indicate a potential credit crunch on the horizon despite an environment of tight financial conditions for several months now (Figure 34).

Professional forecasters' expectations for short-term interest peak rates remained virtually unchanged, but the belief that the Fed will stick to its plan of keeping rates high for a long period solidified

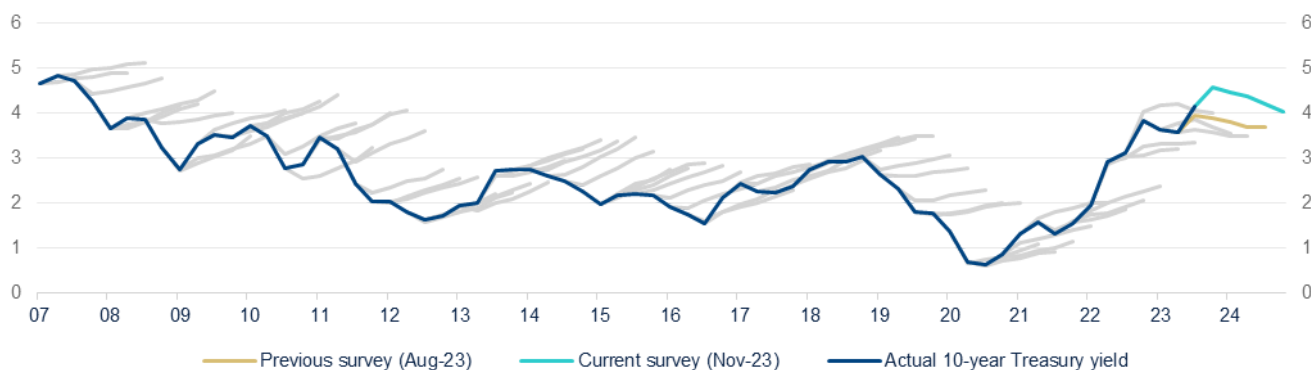
Figure 29. PROFESSIONAL FORECASTERS 3-MONTH TREASURY YIELD EXPECTATIONS (%)



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

The spike of the term premium in 3Q23 drove professional forecasters to significantly revise up their projections for the 10-year Treasury yield, which is expected to remain above 4% at least until 2025

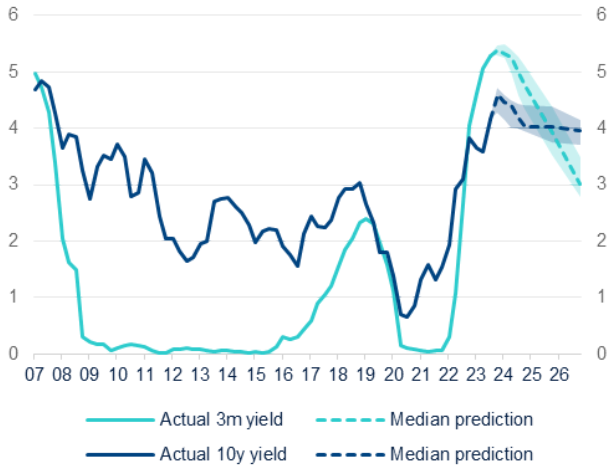
Figure 30. PROFESSIONAL FORECASTERS 10-YEAR TREASURY YIELD EXPECTATIONS (%)



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

**One of the implications of a stronger conviction of rates remaining high-for-longer is that the...**

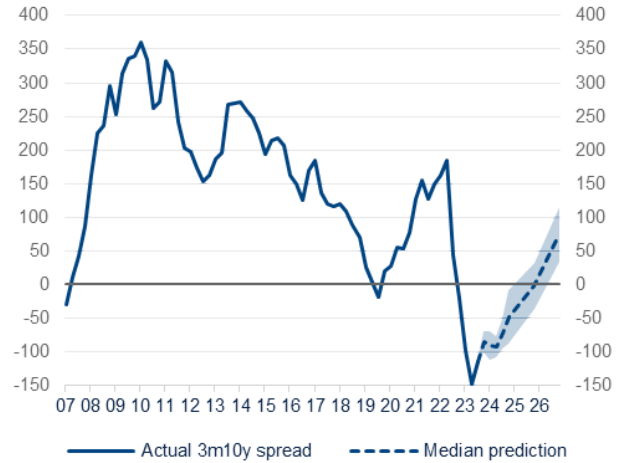
Figure 31. **PROF. FORECASTERS TREASURY YIELDS EXPECTATIONS (%)**



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

**... yield curve will likely remain inverted next year**

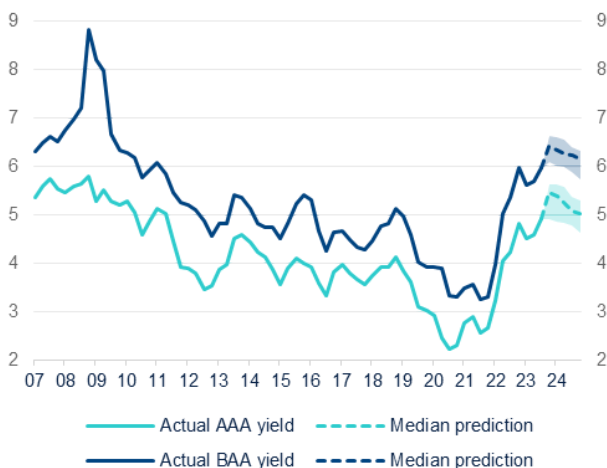
Figure 32. **PROF. FORECASTERS IMPLIED 10Y-3MY SPREAD EXPECTATIONS (BPS)**



The shaded area indicates the interquartile range.  
 Source: BBVA Research based on data by the Federal Reserve Bank of Philadelphia and Haver Analytics.

**Investment grade corporate spreads do not seem to indicate a potential credit crunch on the...**

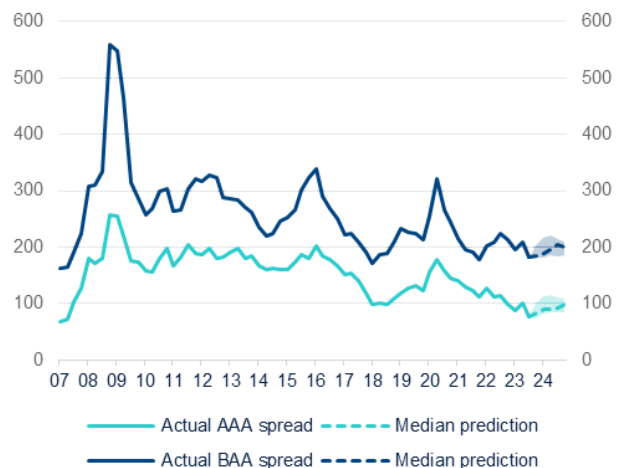
Figure 33. **PROF. FORECASTERS CORPORATE YIELDS EXPECTATIONS (%)**



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.

**... horizon despite an environment of tight financial conditions for several months now**

Figure 34. **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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