

US Interest rates monitor

Treasury yields signal confidence that inflation will soon cease to be an issue

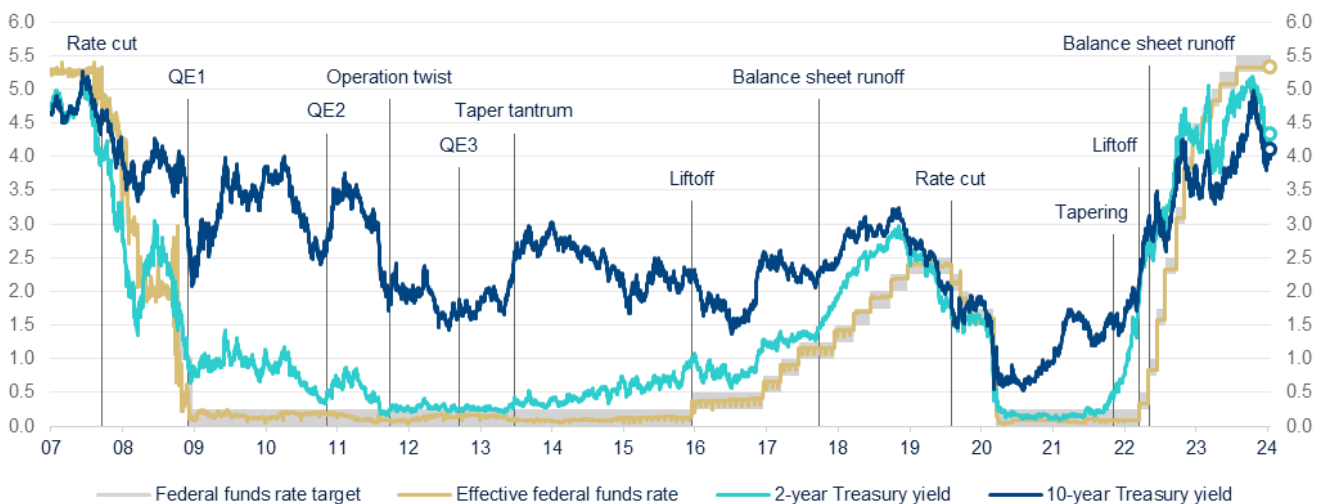
Javier Amador / Iván Fernández
January 18, 2024

Improved inflation expectations mean the Fed will likely need to cut rates soon as risks of over-tightening its policy stance grow

- Even though the recent bond rally appears to have come to a halt, both mid- and long-term Treasury yields have been pricing in the start of a rate-cut cycle for some time ([Figures 4 and 5](#)).
- Short-term yields will eventually follow suit once the rate-cut cycle begins, possibly resulting in a complete flattening or even a slight steepening of the yield curve by year-end ([Figures 6 and 7](#)).
- The term premium has been in negative territory since mid-December, which seems to support the idea that its spike last year was mainly linked to uncertainties around the monetary policy path ([Figures 13 and 14](#)).
- Market-implied inflation expectations will likely continue to gradually lose relevance for policy decisions as hard data continue to consistently suggest that inflation will soon cease to be a problem ([Figures 17 to 20](#)).
- The futures market has ruled out further hikes and prices in a 57% chance (down from 70% in recent days) of a rate cut in March. It continues to anticipate 150 bps worth of rate cuts throughout 2024 ([Figures 21 and 22](#)).

FOMC members will most likely keep the fed funds rate unchanged at the end of this month, leaving the nominal policy rate at its current 5.25-5.50% target range for six consecutive months

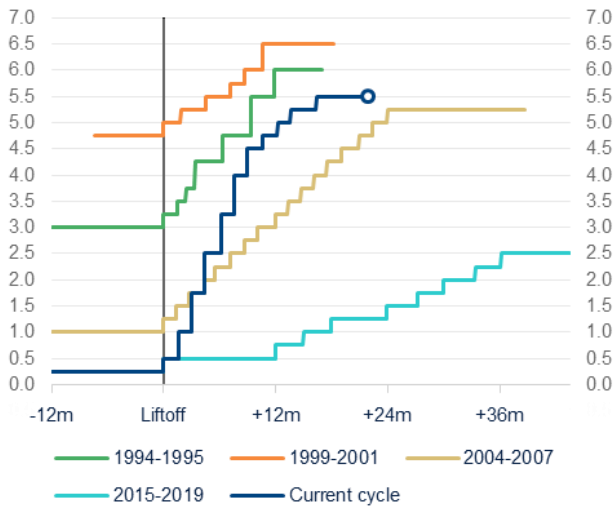
Figure 1. 2-YEAR, 10-YEAR TREASURY YIELDS AND FED FUNDS RATE (%)



Source: BBVA Research / Haver

Continued progress on inflation and recent signs of moderation in the pace of economic activity...

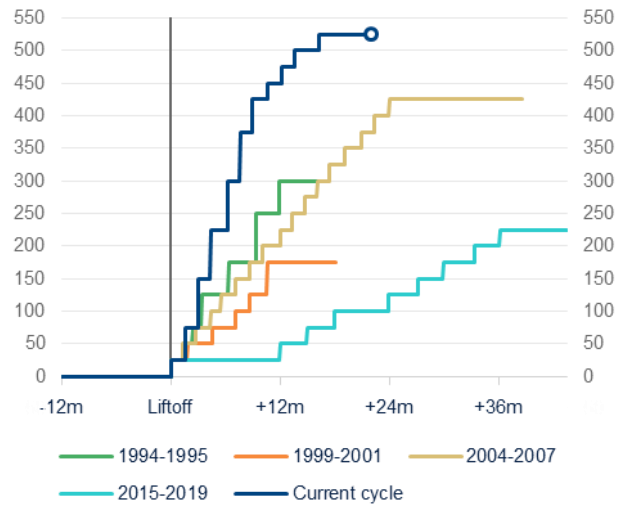
Figure 2. **FED FUNDS RATE IN TIGHTENING CYCLES (%)**



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 / Haver

... suggest that the Fed will soon need to cut rates in order to avoid over-tightening its real...

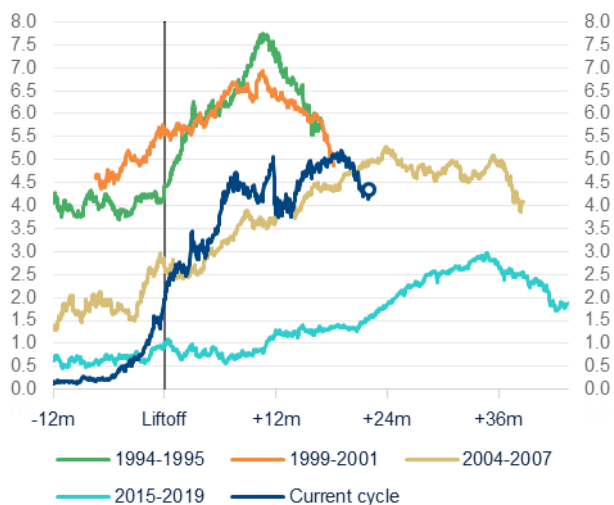
Figure 3. **FED FUNDS RATE IN TIGHTENING CYCLES (BPS VS RATE LEVEL AT LIFTOFF)**



Source: BBVA Research / Haver

... policy stance. Even though the recent bond rally appears to have come to a halt, mid- and...

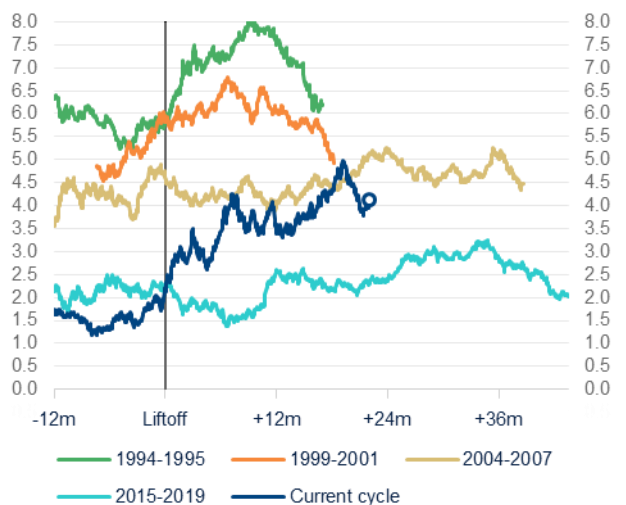
Figure 4. **2-YEAR TREASURY YIELD IN TIGHTENING CYCLES (%)**



Source: BBVA Research / Haver

... long-term Treasury yields have been pricing in the start of a rate-cut cycle for some time

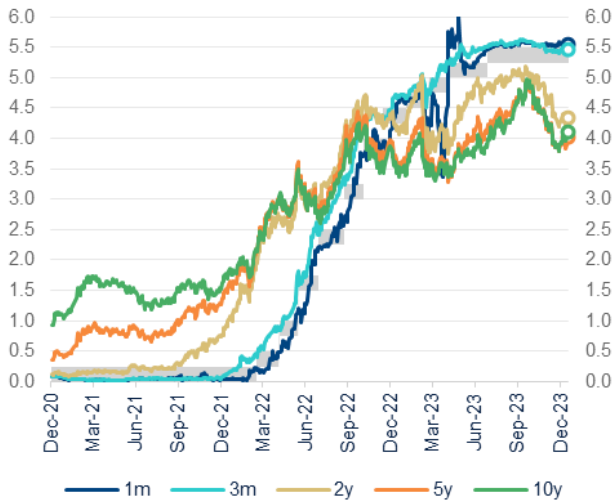
Figure 5. **10-YEAR TREASURY YIELD IN TIGHTENING CYCLES (%)**



Source: BBVA Research / Haver

Short-term yields will eventually follow suit once the rate-cut cycle begins, possibly resulting in...

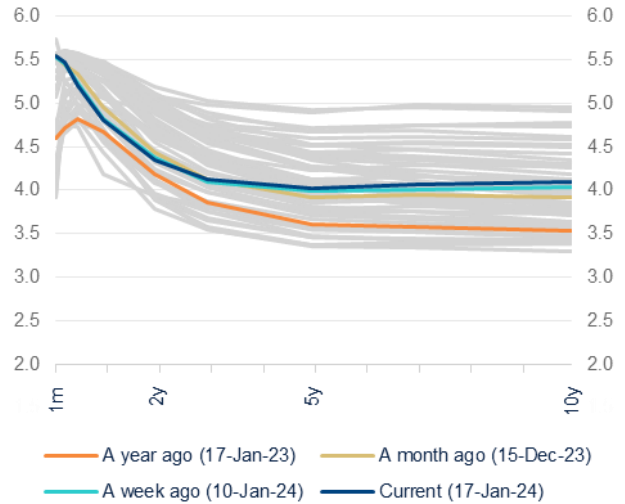
Figure 6. **TREASURY YIELDS**
(%)



The gray area indicates the federal funds rate target range
Source: BBVA Research / Haver

... a complete flattening or even a slight steepening of the yield curve by year-end

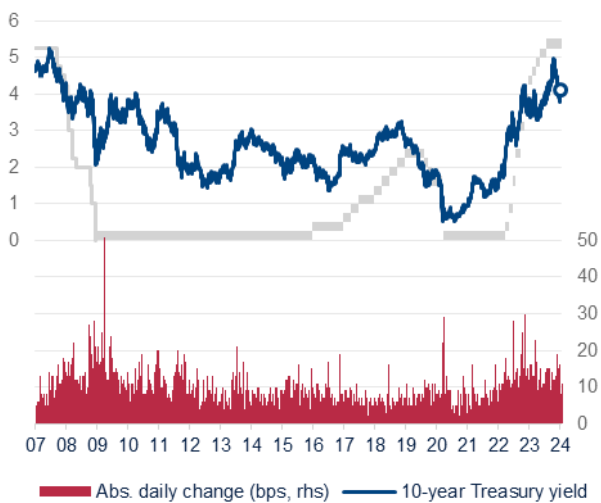
Figure 7. **TREASURY YIELD CURVE**
(%)



The gray lines indicate weekly yield curves from a year ago
Source: BBVA Research / Haver

Looking ahead, Treasury yield volatility will likely be driven more by growing uncertainty around...

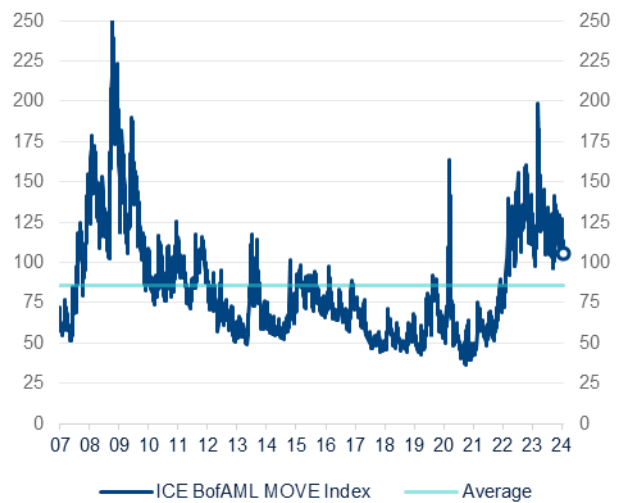
Figure 8. **10-YEAR TREASURY YIELD DAILY CHANGE**
(% AND BPS)



The gray line and area indicate the federal funds rate target
Source: BBVA Research / Haver

... QT, geopolitical or electoral events, rather than by concerns around the outlook for inflation

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



Source: BBVA Research / Haver

The 10y-3m yield spread shrank from -180 to -65 bps from early June to mid-October, driven by a robust upward trend in the 10-year Treasury yield. The recent bond rally brought it back to around -150 bps

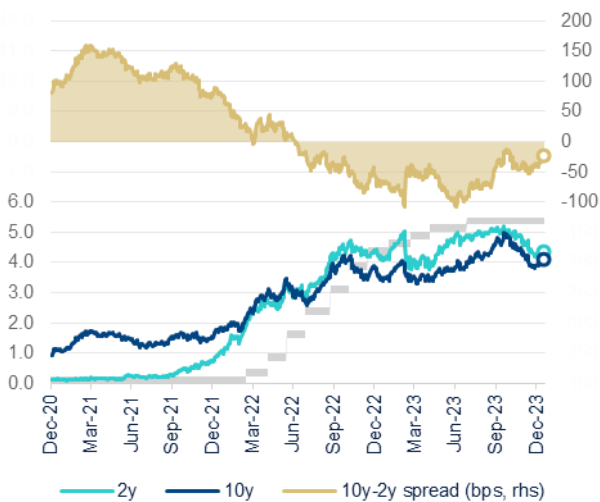
Figure 10. **TREASURY YIELD SPREADS (BPS)**



Gray shaded areas indicate US recessions as defined by the National Bureau of Economic Research (NBER)
Source: BBVA Research / Haver

This year, a reduction (in abs. terms) in the 10y-3m spread will likely come from declines in the...

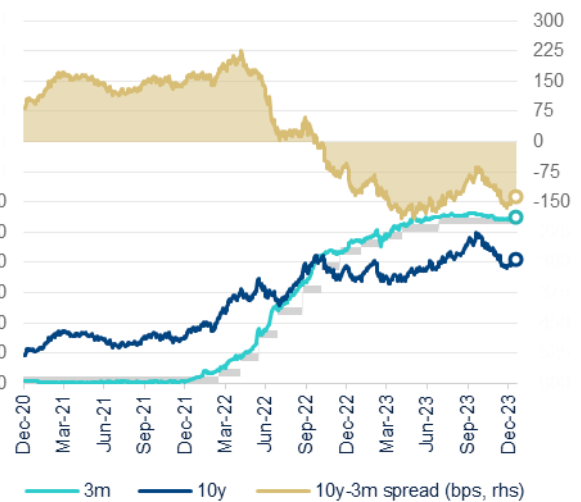
Figure 11. **10Y-2Y TREASURY YIELD SPREAD (% AND BPS)**



The gray area indicates the federal funds rate target range
Source: BBVA Research / Haver

... 3m yield amid monetary policy rate cuts rather than by a renewed surge of the 10y Treasury yield

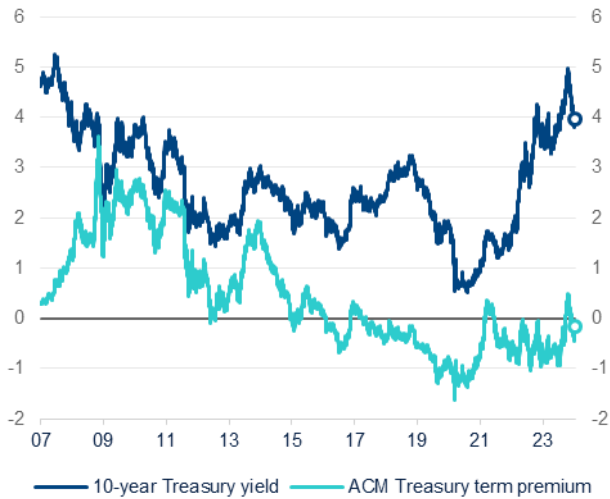
Figure 12. **10Y-3M TREASURY YIELD SPREAD (% AND BPS)**



The gray area indicates the federal funds rate target range
Source: BBVA Research / Haver

The term premium has been in negative territory since mid-Dec, which seems to support the...

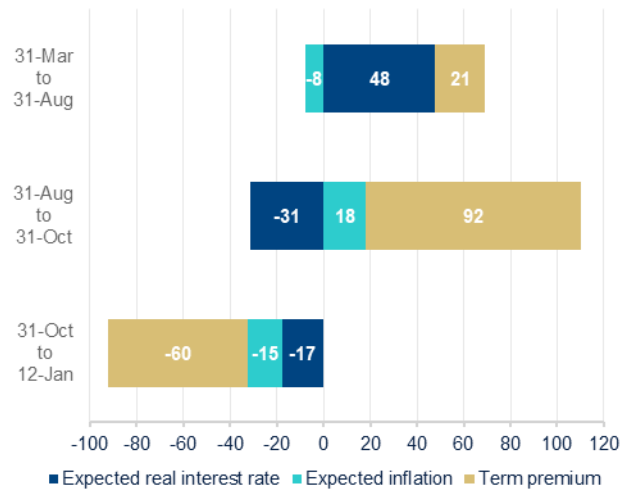
Figure 13. 10-YEAR TREASURY YIELD AND TERM PREMIUM (%)



Source: BBVA Research / Haver

... idea that its spike last year was mainly linked to uncertainties around the monetary policy path

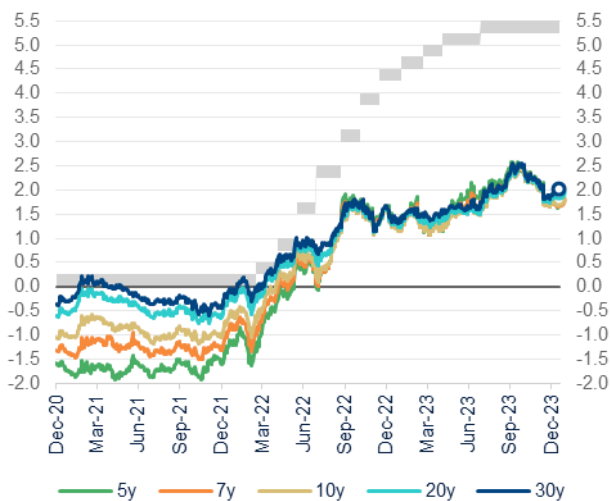
Figure 14. CHANGE IN 10-YEAR TREASURY YIELD (BPS)



Source: BBVA Research / Haver

The Fed's monetary tightening continues to be shown clearly in the real yield curve, which ...

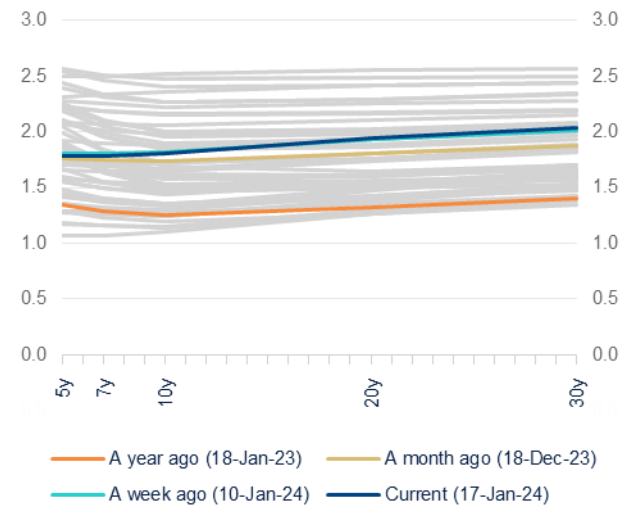
Figure 15. INFLATION INDEXED (TIPS) YIELDS (%)



The gray area indicates the federal funds rate target range
Source: BBVA Research / Haver

... has been in positive territory for 18 months, even after its downside shift from its Oct's highs

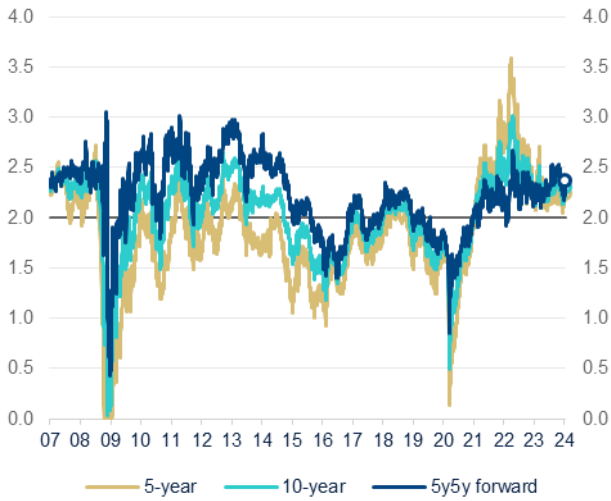
Figure 16. INFLATION INDEXED (TIPS) YIELD CURVE (%)



The gray lines indicate weekly yield curves from a year ago
Source: BBVA Research / Haver

Market-implied inflation expectations remain within historical standards despite noisy spikes

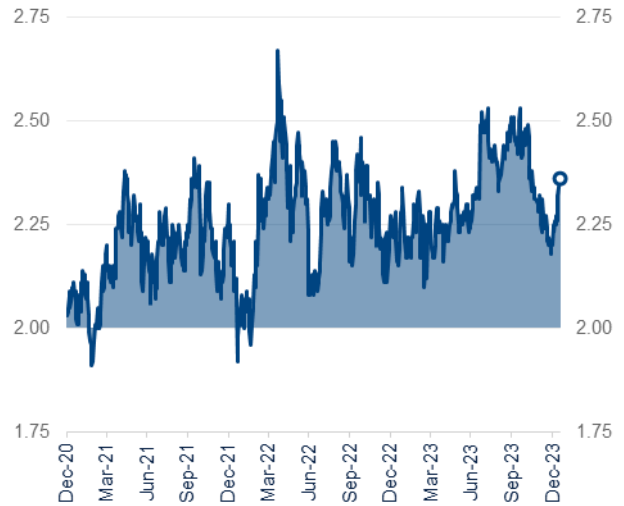
Figure 17. **BREAKEVEN INFLATION RATES** (%)



Source: BBVA Research / Haver

These measures will likely continue to gradually lose relevance for policy decisions...

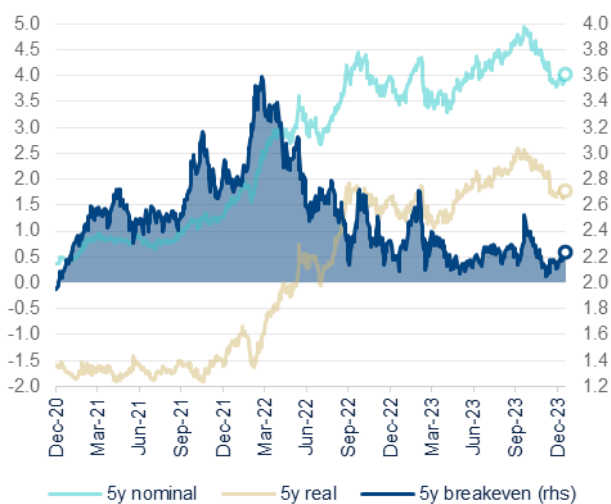
Figure 18. **5Y5Y FORWARD IMPLIED INFLATION RATE** (%)



The shaded area indicates deviations from the Fed's inflation target
Source: BBVA Research / Haver

... as hard data and the inflationary outlook continue to consistently suggest that the...

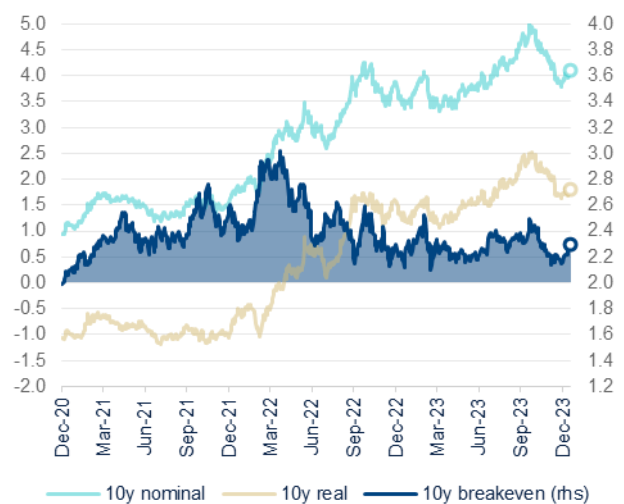
Figure 19. **5-YEAR BREAKEVEN INFLATION RATE** (%)



The shaded area indicates deviations from the Fed's inflation target
Source: BBVA Research / Haver

... post-pandemic inflationary issue will soon cease to be a problem

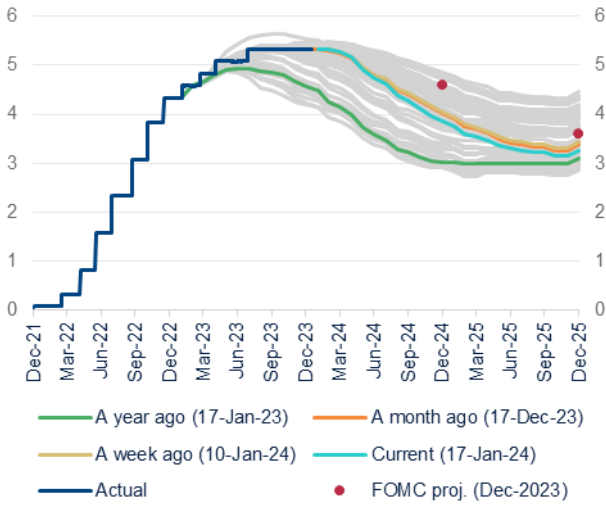
Figure 20. **10-YEAR BREAKEVEN INFLATION RATE** (%)



The shaded area indicates deviations from the Fed's inflation target
Source: BBVA Research / Haver

The futures market has ruled out the possibility of further hikes and is pricing in a 57% chance...

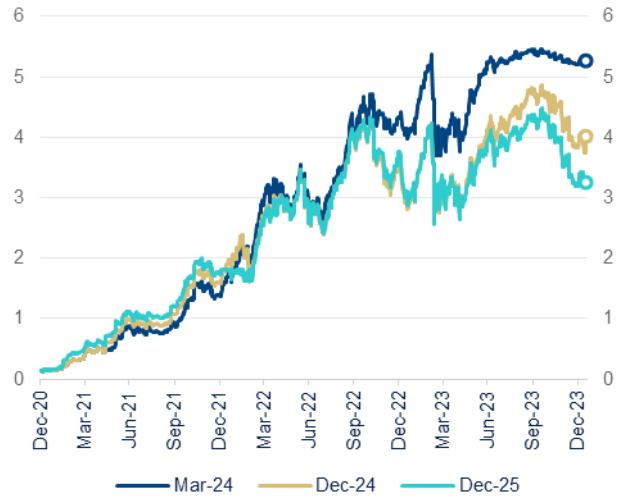
Figure 21. **IMPLIED RATE IN 30-DAY FED FUNDS FUTURES (%)**



The gray lines indicate weekly implied rate paths from a year ago
Source: BBVA Research / Bloomberg

... of a rate cut in March. It also anticipates ~150 bps worth of rate cuts throughout this year

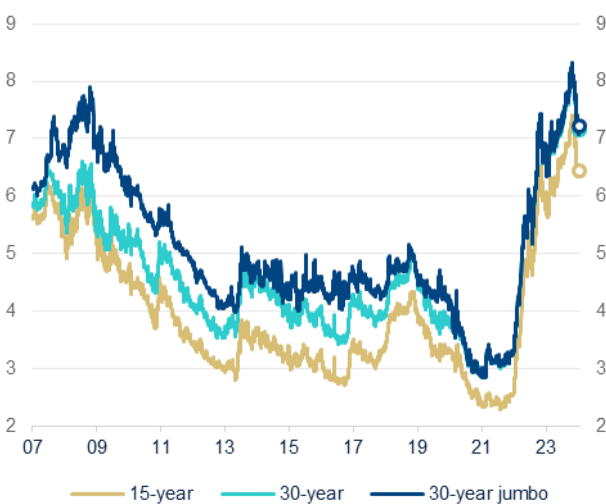
Figure 22. **IMPLIED RATE IN 30-DAY FED FUNDS FUTURES (%)**



Source: BBVA Research / Bloomberg

Mortgage rates have benefited from the recent decline in long-term Treasury yields, ...

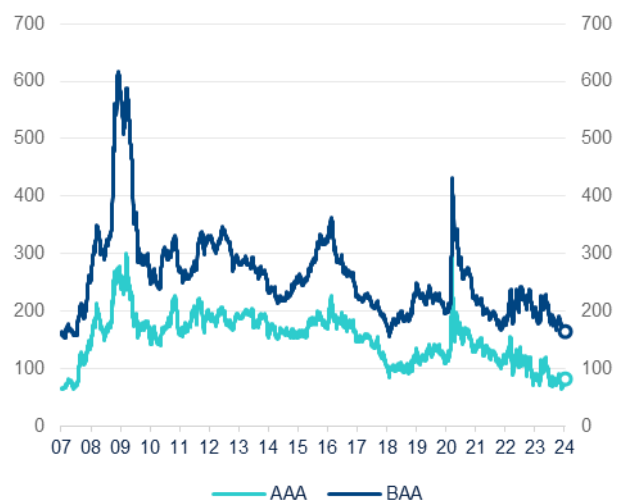
Figure 23. **MORTGAGE RATES (WSJ CONSUMER FIXED RATES, %)**



Source: BBVA Research based / Haver

... while the investment-grade corporate bond market remains surprisingly stable

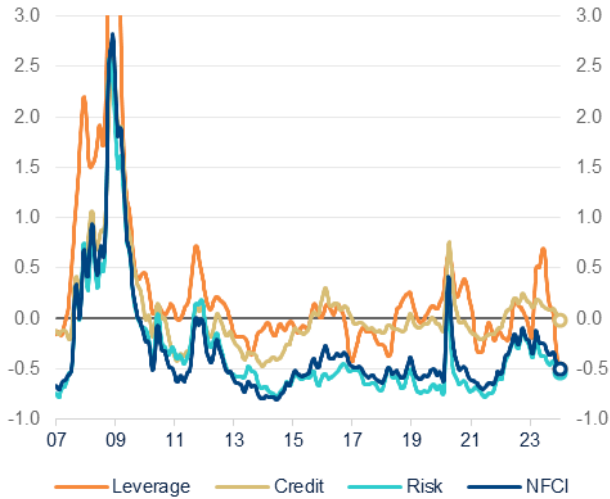
Figure 24. **CORPORATE BOND SPREADS (MOODY'S SEASONED YIELDS, DAILY DATA, BPS)**



Spreads over the 10-year Treasury yield
Source: BBVA Research / FRED / Haver

Broad indexes continue to point to easier financial conditions compared to past standards

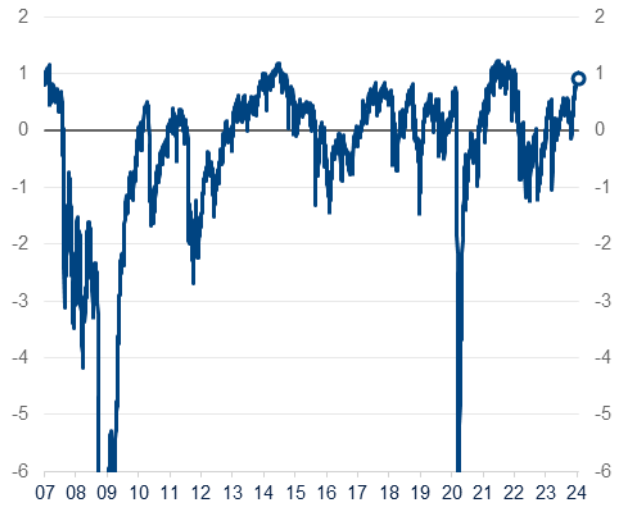
Figure 25. **CHICAGO FED NATIONAL FINANCIAL CONDITIONS INDEX (>0: TIGHTER THAN AVG)**



Source: BBVA Research / Haver

A likely explanation is that both households and businesses have not been severely affected...

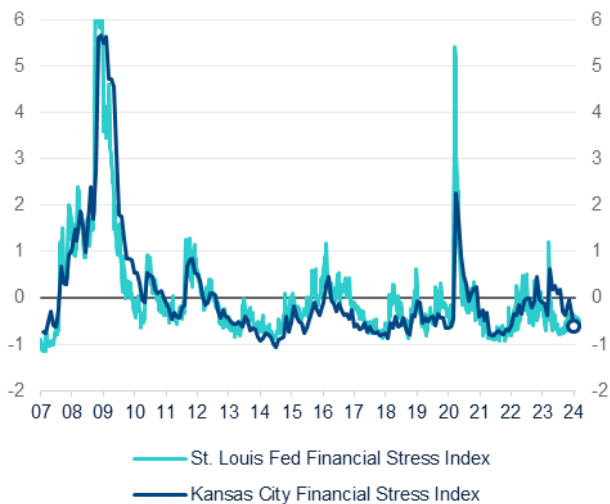
Figure 26. **BLOOMBERG FINANCIAL CONDITIONS INDEX (<0: TIGHTER THAN PRE-GFC AVG)**



Source: BBVA Research / Bloomberg

... by the increase in financing costs because they managed to shield their liabilities during...

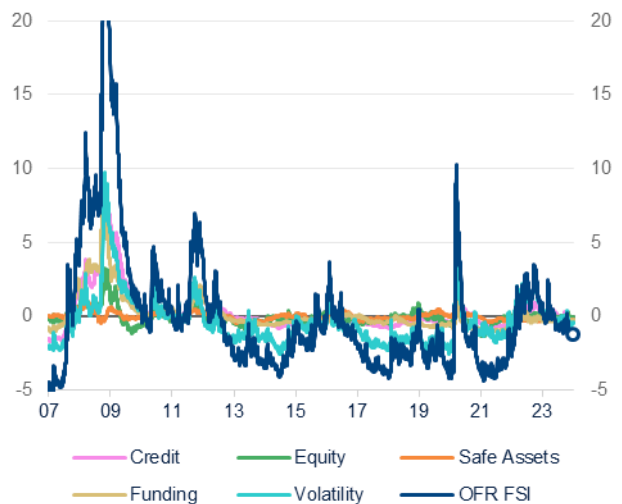
Figure 27. **FED FINANCIAL STRESS INDICES (>0: ABOVE AVG FINANCIAL STRESS)**



Source: BBVA Research / Haver

... the ultra-low rates period. Risks remain as debts mature and are 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 / Haver

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