

US Interest rates monitor

Treasury yields price in the “last mile is the hardest” narrative

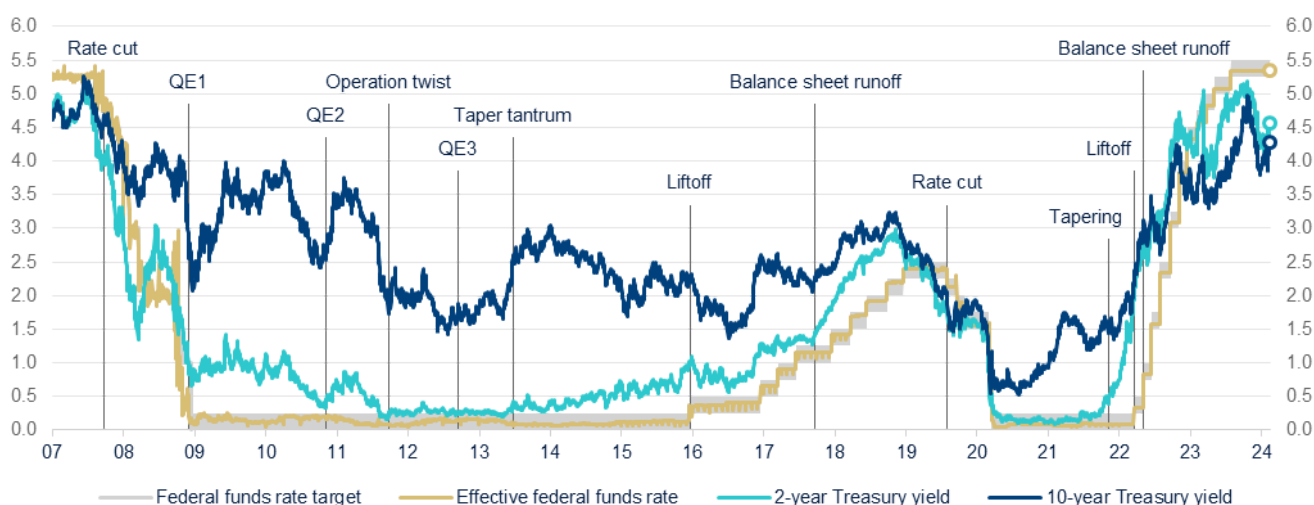
Javier Amador / Iván Fernández
February 15, 2024

Markets seem to be overreacting to a puzzling core CPI figure despite continued evidence from core PCE prices disinflation

- Fed’s argument on the need to wait for “more good data” has been recently supported by recent strong job creation data as well as by signals of sticky core CPI services inflation ([Figures 2](#) and [3](#)).
- The more benign outlook depicted by continued core PCE prices disinflation did not prevent the Treasury market from pricing in some of the recent “last mile is the hardest” narrative ([Figures 4](#) and [5](#)).
- This was reflected in a notable upward shift of the yield curve ([Figure 7](#)). The renewed uncertainty around the near-future Fed’s actions has prevented bond volatility to fall closer to last-decade levels ([Figures 8](#) and [9](#)).
- The term premium rose again amid renewed doubts on the timing and speed of this year’s easing cycle ([Figures 13](#) and [14](#)), but further evidence of core PCE prices disinflation will likely bring it back down.
- Expectations for rate cuts this year experienced a notable shift this month as they moved from anticipating 150bp worth of rate cuts closer to December’s Fed projections of three 25bp rate cuts ([Figures 21](#) and [22](#)).

Doors seem to have closed to the possibility of a rate cut in March. FOMC participants’ argument for needing “more good data” to achieve “greater confidence” of the ongoing disinflation process...

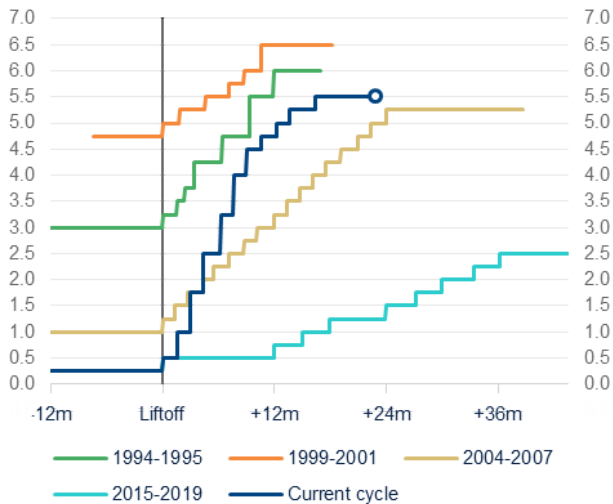
Figure 1. 2-YEAR, 10-YEAR TREASURY YIELDS AND FED FUNDS RATE (%)



Source: BBVA Research / Haver

... has been recently supported by strong job creation data for Dec (+333k) and Jan (+354k), ...

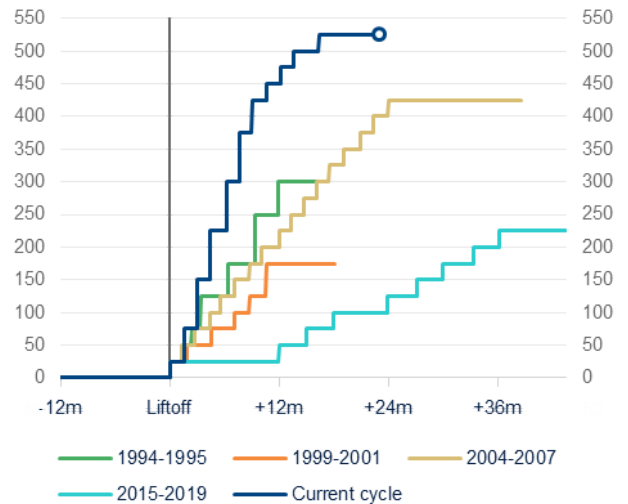
Figure 2. **FED FUNDS RATE IN TIGHTENING CYCLES (%)**



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

... as well as by Jan's sticky core CPI inflation fueled by a puzzling 0.6% MoM rise in OER prices

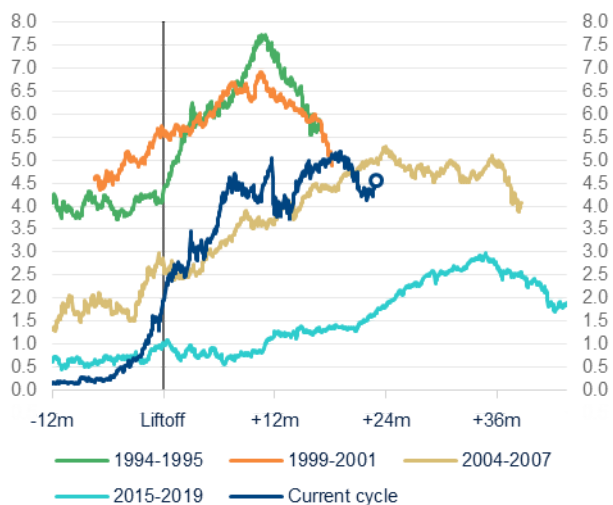
Figure 3. **FED FUNDS RATE IN TIGHTENING CYCLES (BPS VS RATE LEVEL AT LIFTOFF)**



Source: BBVA Research / Haver

The recent evolution of core PCE prices has been more consistent to recent data pointing to a...

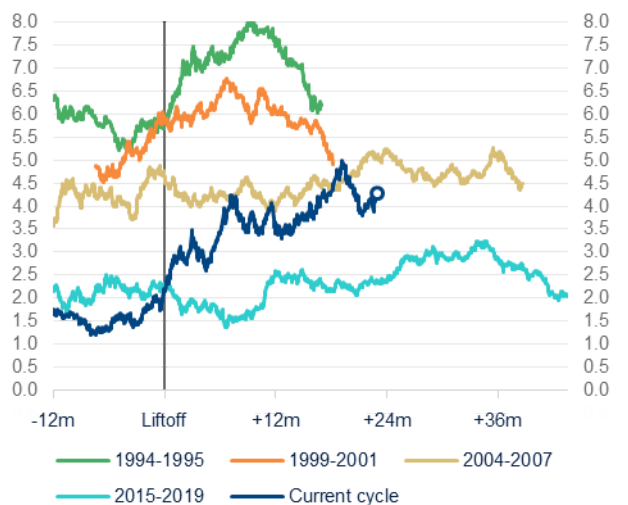
Figure 4. **2-YEAR TREASURY YIELD IN TIGHTENING CYCLES (%)**



Source: BBVA Research / Haver

... better supply-demand balance (e.g., lower job openings and voluntary quits), but this did not...

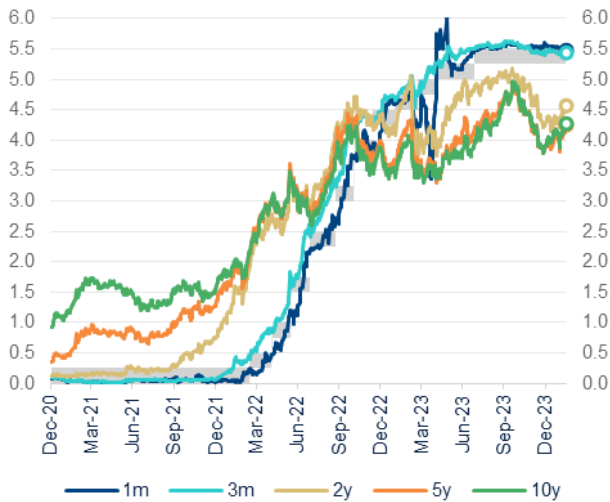
Figure 5. **10-YEAR TREASURY YIELD IN TIGHTENING CYCLES (%)**



Source: BBVA Research / Haver

... prevent the Treasury market from pricing in some of the “last mile is the hardest” narrative,...

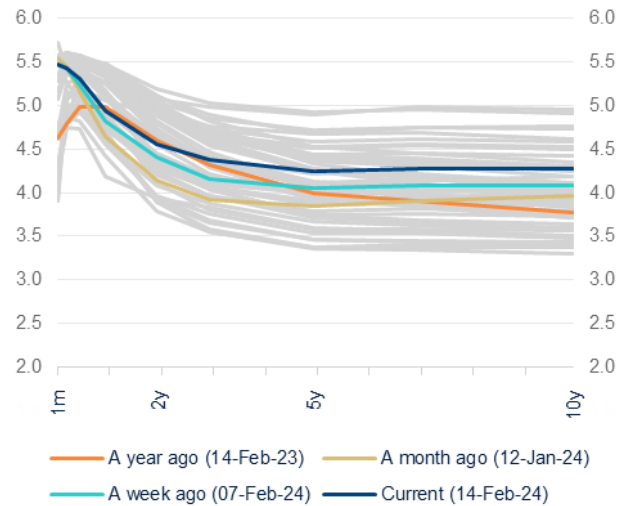
Figure 6. **TREASURY YIELDS**
(%)



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

... as reflected in a notable upward shift of the yield curve, which however remains well below...

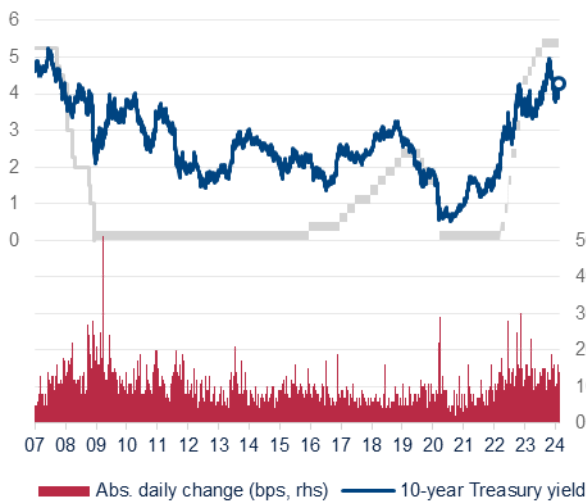
Figure 7. **TREASURY YIELD CURVE**
(%)



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

... its late-2023 maximums, when the 10y yield touched 5%. This renewed uncertainty around...

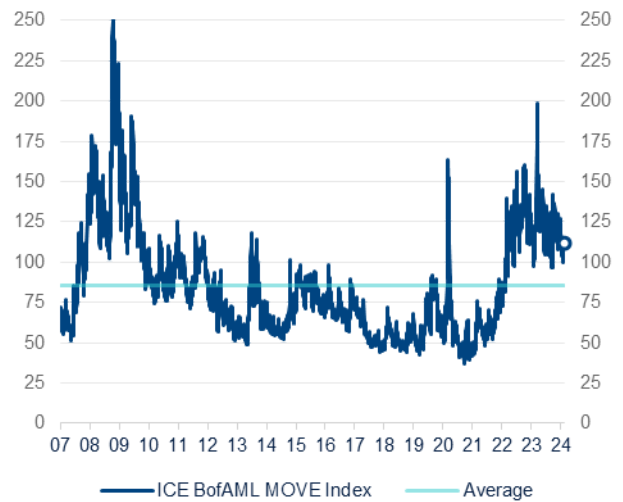
Figure 8. **10-YEAR TREASURY YIELD DAILY CHANGE**
(% AND BPS)



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

... the near-future Fed's actions has prevented bond volatility to fall closer to last-decade levels

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



Source: BBVA Research / Haver

The renewed surge of the 10y Treasury yield is likely to be transitory as doubts on the risks of strong economic activity are settled with more data. The reduction (in abs. terms) in the 10y-3m spread...

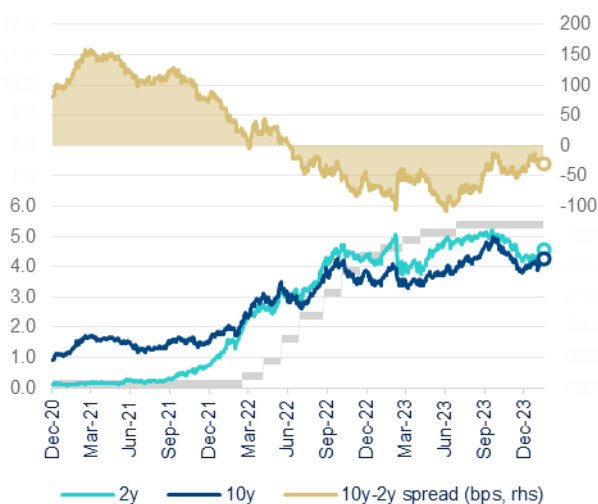
Figure 10. **TREASURY YIELD SPREADS (BPS)**



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

... in the coming months is likely to come from declines in the 3m yield amid monetary policy...

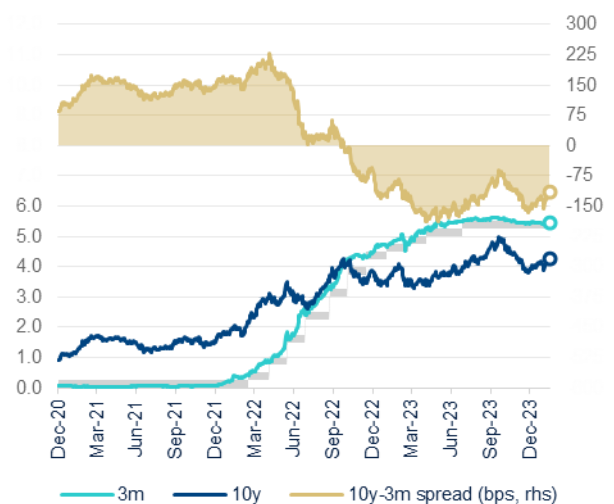
Figure 11. **10Y-2Y TREASURY YIELD SPREAD (% AND BPS)**



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

... rate cuts. Nevertheless, the yield curve is likely to remain inverted throughout 2024

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 rose again amid renewed doubts on the timing and speed of this year's...

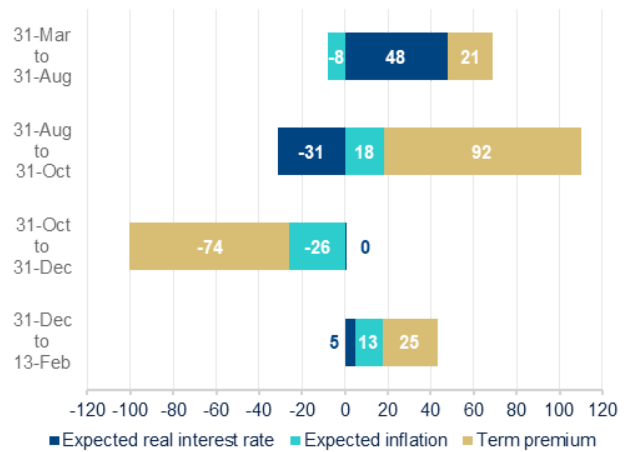
Figure 13. 10-YEAR TREASURY YIELD AND TERM PREMIUM (%)



Source: BBVA Research / Haver

... easing cycle. Further evidence of core PCE disinflation will likely bring it back down

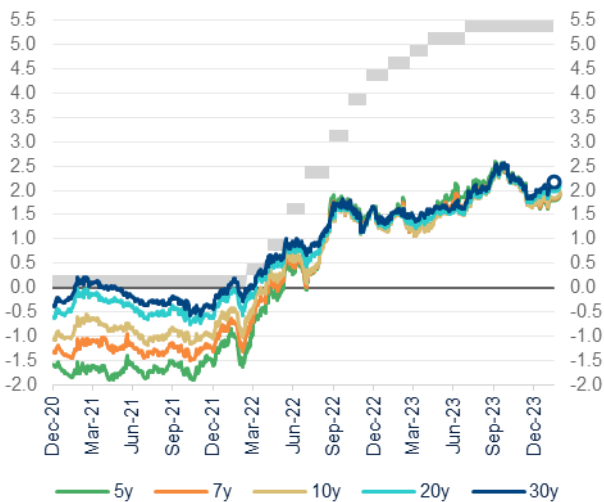
Figure 14. CHANGE IN 10-YEAR TREASURY YIELD (BPS)



Source: BBVA Research / Haver

The Fed's ongoing search for tight broad financial conditions continues to be supported...

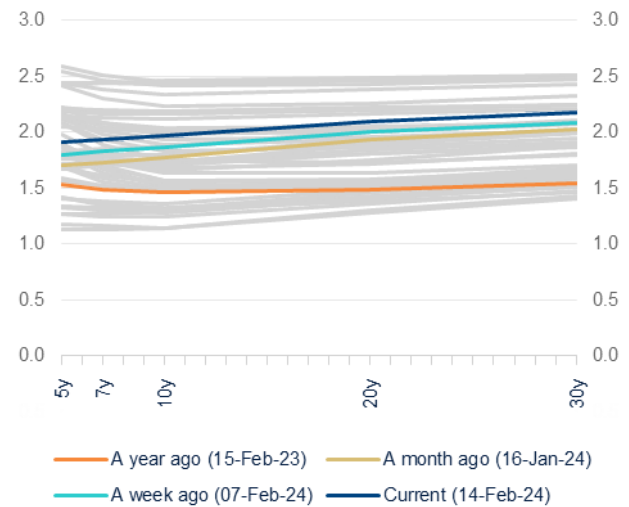
Figure 15. INFLATION INDEXED (TIPS) YIELDS (%)



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

... by the real yield curve, which has been in positive territory for nearly 20 months

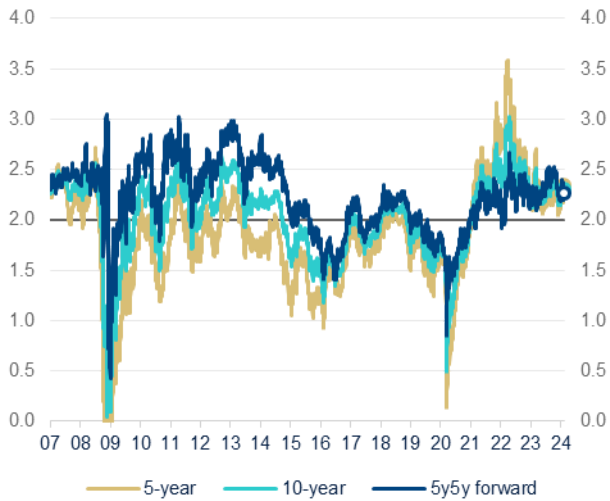
Figure 16. INFLATION INDEXED (TIPS) YIELD CURVE (%)



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

Market-based inflation expectations remain in line with historical standards even as some...

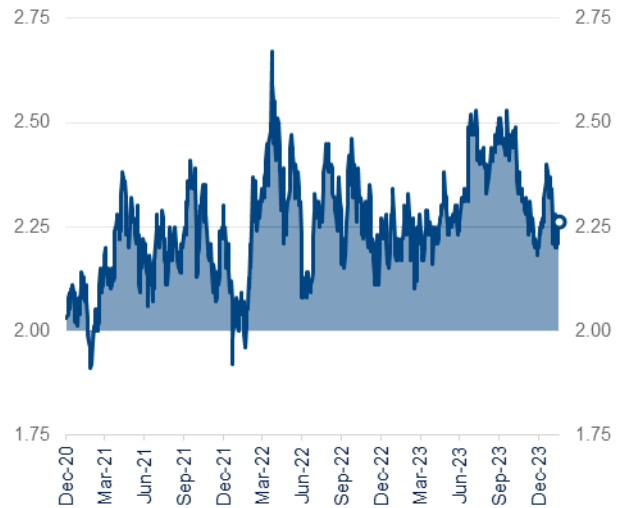
Figure 17. **BREAKEVEN INFLATION RATES** (%)



Source: BBVA Research / Haver

... doubts have risen around the stickiness of core services prices. Overall, financial markets...

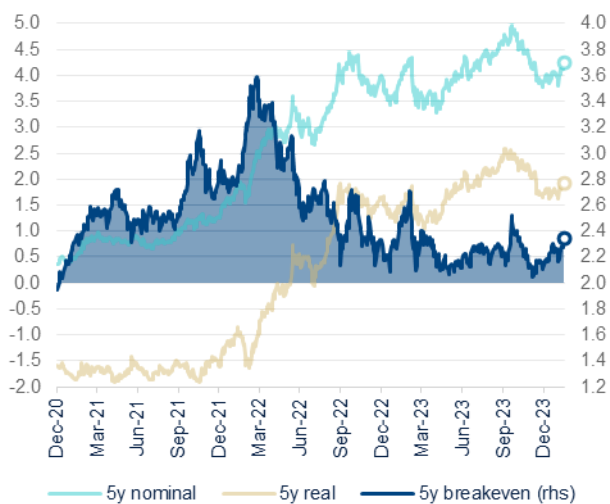
Figure 18. **5Y5Y FORWARD IMPLIED INFLATION RATE** (%)



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

... seem to continue to think that high inflation will soon cease to be a problem despite strong...

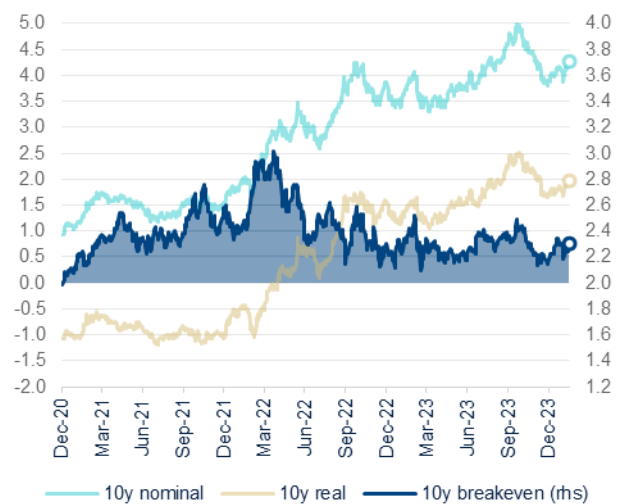
Figure 19. **5-YEAR BREAKEVEN INFLATION RATE** (%)



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

... job creation as (lower) job openings and voluntary quits point to slower wage growth

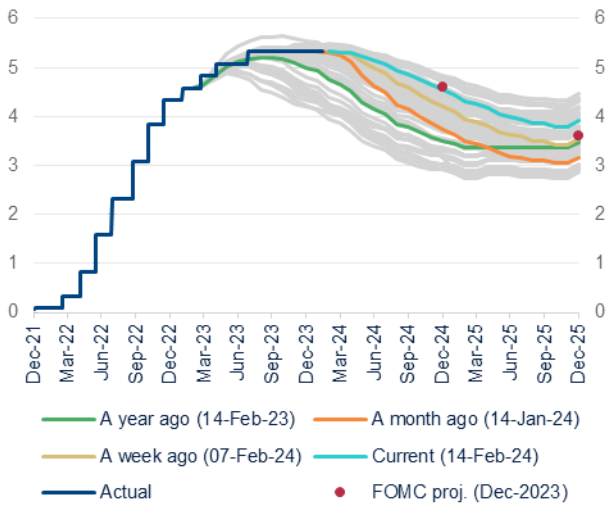
Figure 20. **10-YEAR BREAKEVEN INFLATION RATE** (%)



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

Expectations for rate cuts this year experienced a notable shift this month as they moved from...

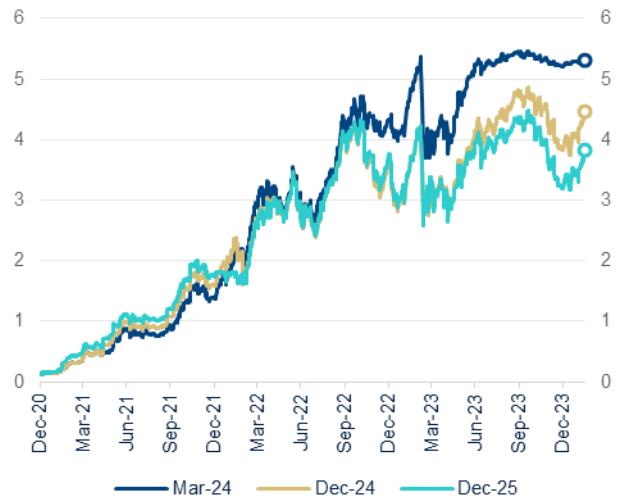
Figure 21. **IMPLIED RATE IN 30-DAY FED FUNDS FUTURES (%)**



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

... anticipating 150bp worth of rate cuts closer to Dec's Fed projections of three 25bp rate cuts

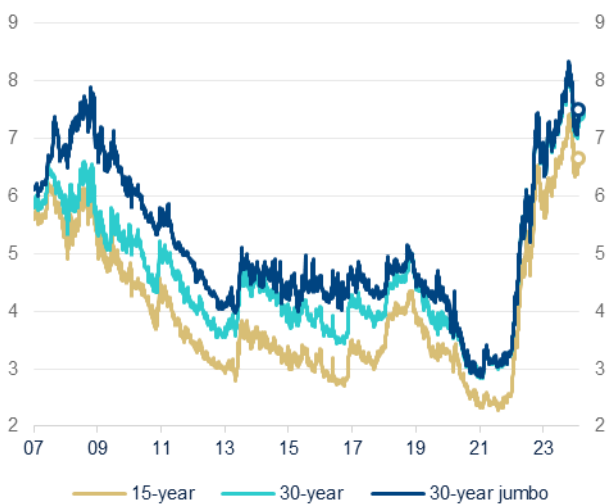
Figure 22. **IMPLIED RATE IN 30-DAY FED FUNDS FUTURES (%)**



Source: BBVA Research / Bloomberg

The recent upward shift of long-term Treasury yields halted the recent decline in mortgage rates

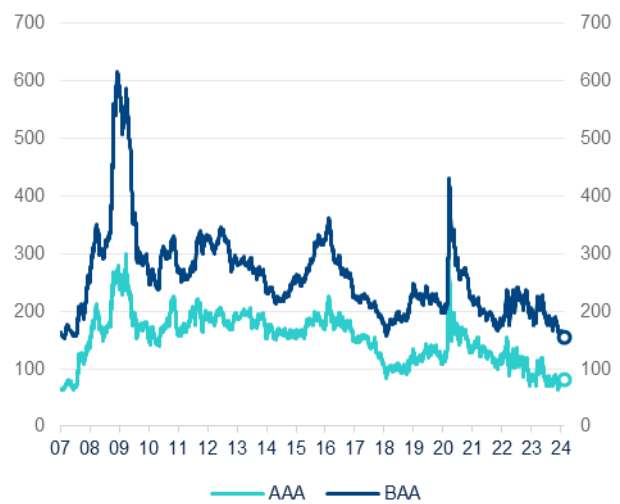
Figure 23. **MORTGAGE RATES (WSJ CONSUMER FIXED RATES, %)**



Source: BBVA Research based / Haver

Investment-grade bond yields continue to signal a healthy credit risk profile among companies

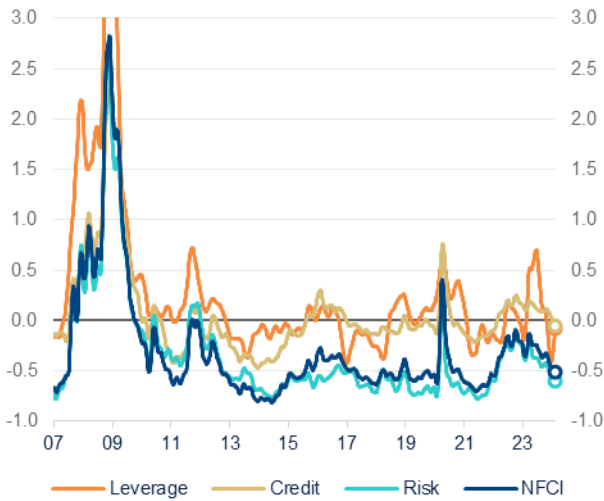
Figure 24. **CORPORATE BOND SPREADS (MOODY'S SEASONED YIELDS, DAILY DATA, BPS)**



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

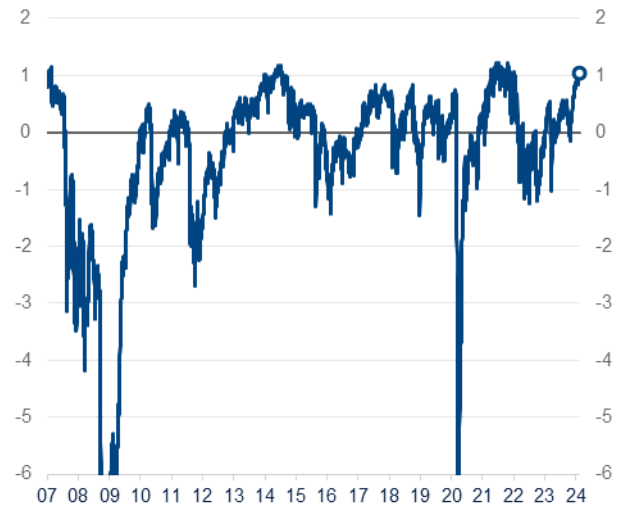
Figure 25. **CHICAGO FED NATIONAL FINANCIAL CONDITIONS INDEX (>0: TIGHTER THAN AVG)**



Source: BBVA Research / Haver

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

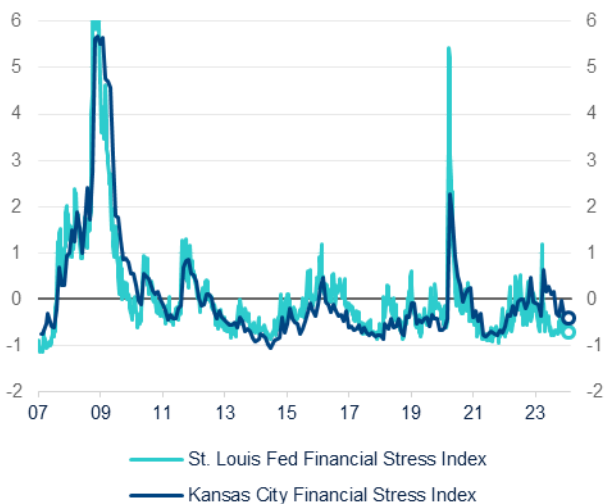
Figure 26. **BLOOMBERG FINANCIAL CONDITIONS INDEX (<0: TIGHTER THAN PRE-GFC AVG)**



Source: BBVA Research / Bloomberg

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

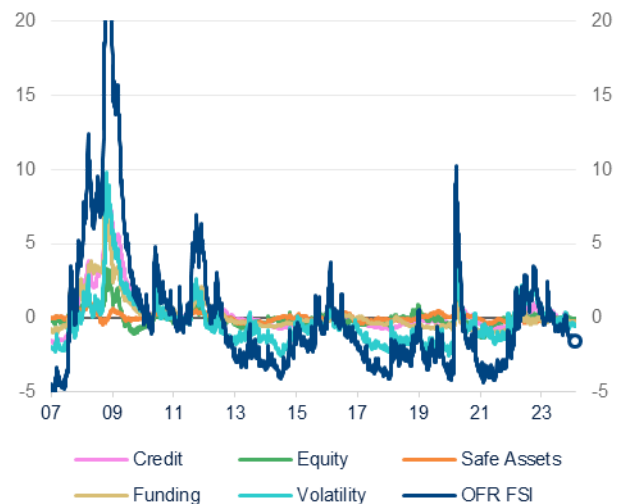
Figure 27. **FED FINANCIAL STRESS INDICES (>0: ABOVE AVG FINANCIAL STRESS)**



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)**



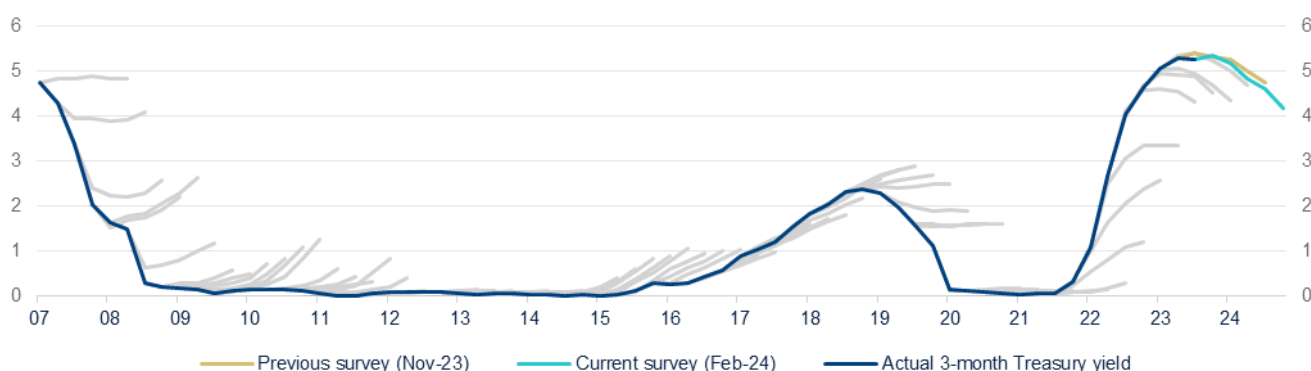
OFR: Office of Financial Research, US Department of the Treasury
Source: BBVA Research / Haver

Professional forecasters revised down their 10-year Treasury yield projections for 2024 amid continued disinflation evidence

- Professional forecasters surveyed this month by the Philadelphia Fed expect a 4.6% 3-month Treasury yield by 4Q24, which is roughly equivalent to an expectation of three policy rate cuts (Figure 29).
- The median forecaster revised down its projection for the 10-year Treasury yield, which is expected to land at a longer-run 3.7% level from end-2025 onwards (Figure 30).
- The implied expectation that an eventual easing cycle will take at least three years means that the yield curve is expected to remain inverted for an extended period of time (Figure 32).

Professional forecasters' projections for short-term Treasury yields continue to reflect the expectation of a slower rate-cut cycle than the one implied by market prices before last week's CPI report

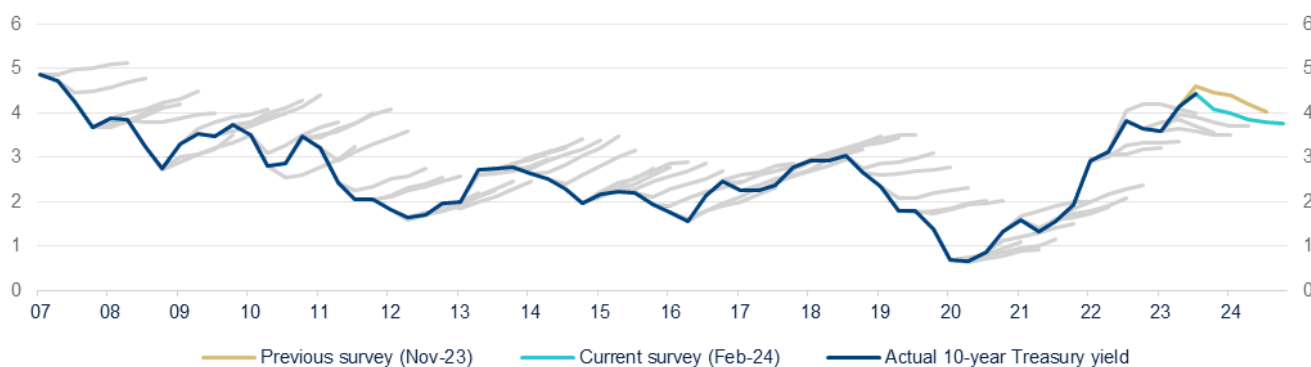
Figure 29. PROFESSIONAL FORECASTERS 3-MONTH TREASURY YIELD EXPECTATIONS (%)



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

Continued evidence of disinflation and the Fed's dovish shift in December also caused professional forecasters to step back from their previous belief of a 10-year Treasury yield above 4% throughout 2024

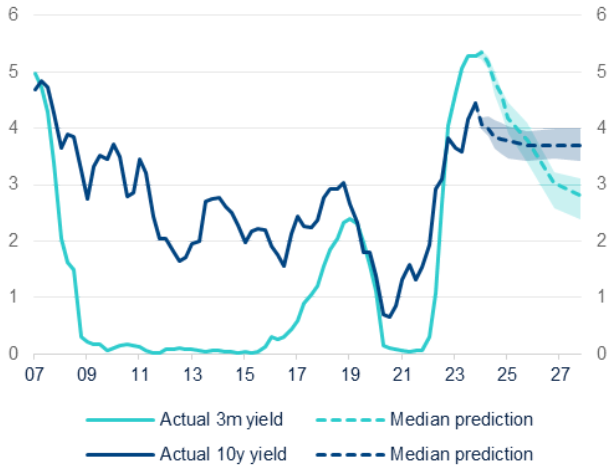
Figure 30. PROFESSIONAL FORECASTERS 10-YEAR TREASURY YIELD EXPECTATIONS (%)



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

The implied expectation that the upcoming easing cycle will take at least three years...

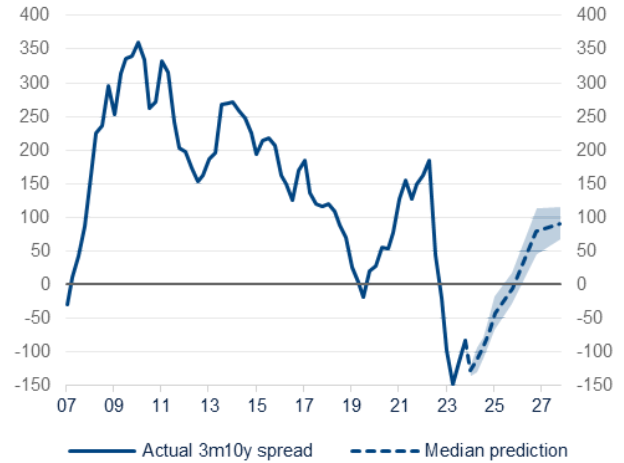
Figure 31. **PROF. FORECASTERS TREASURY YIELDS EXPECTATIONS (%)**



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

... means that the yield curve is expected to remain inverted for an extended period of time

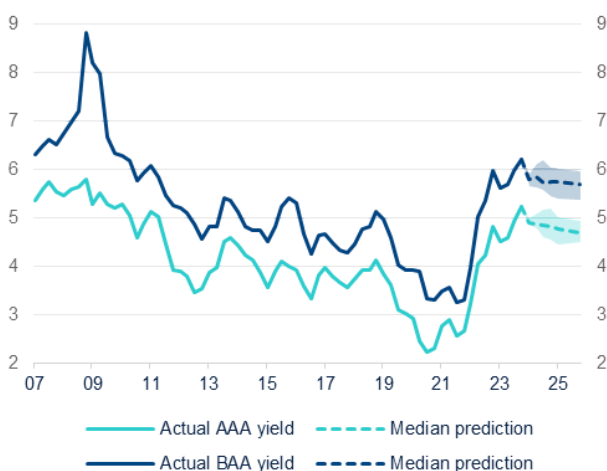
Figure 32. **PROF. FORECASTERS IMPLIED 10Y-3MY SPREAD EXPECTATIONS (BPS)**



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

Companies' credit risk profile appears to remain immune to high interest rates as investment...

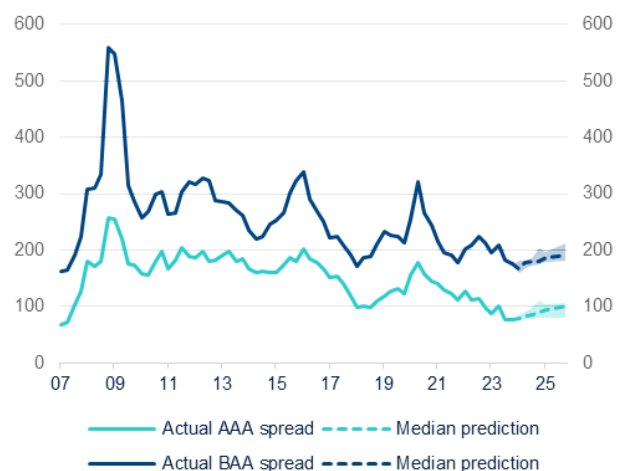
Figure 33. **PROF. FORECASTERS CORPORATE YIELDS EXPECTATIONS (%)**



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.

... grade corporate bond spreads are projected to remain stable below pre-pandemic levels

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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