

US Interest rates monitor

The yield curve is signaling a patient and data-driven Fed amid still high inflation

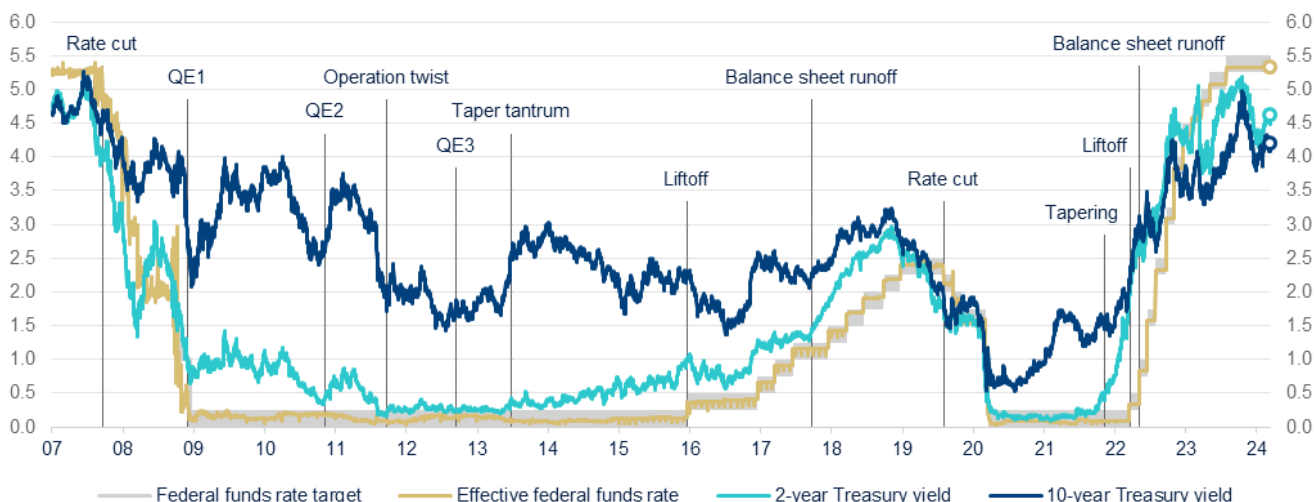
Javier Amador / Iván Fernández
March 14, 2024

Markets have priced in that the Fed will push back the start of the rate cut cycle to June, and possibly even July

- Mid- and long-term yields have reversed 1/3 of the previous rally (Figures 4 and 5) as markets try to reconcile shelter inflation stickiness and newly-signed contracts, which have been pointing to significant disinflation.
- Last week’s less-hawkish-than-expected Powell’s comments before Congress prevented the yield curve from pricing in a more pessimistic outlook (Figures 6 and 7).
- With a still-restrictive policy stance (Figures 15 and 16) and a better balance of risks, the Fed’s decisions going forward will likely gradually focus on avoiding causing unnecessary harm to the labor market.
- The housing market continues to be the most sensitive to high rates (Figure 23), while the investment-grade corporate bond market appears to remain immune to the steepest hiking cycle in decades (Figure 24).
- Markets have all but priced in the Fed’s median outlook from last December of no more than three rate cuts this year, giving Powell leeway to avoid conveying an overly hawkish tone next week (Figures 21 and 22).

While the labor market is still on track to a better supply-demand balance and wage costs cool down, two consecutive 0.4% MoM core inflation readings will likely continue to push the Fed to convey it needs...

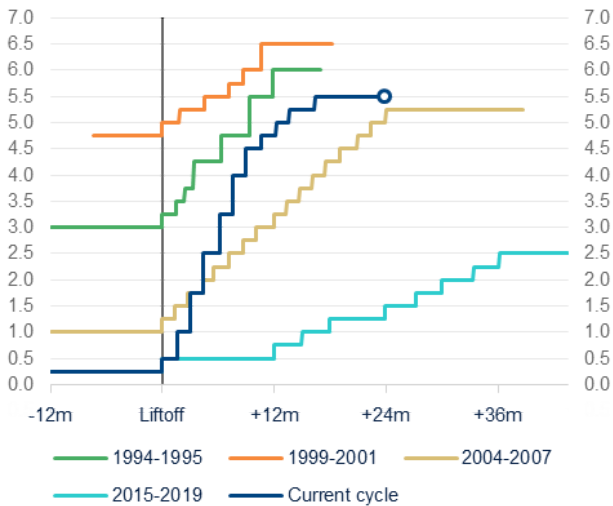
Figure 1. 2-YEAR, 10-YEAR TREASURY YIELDS AND FED FUNDS RATE (%)



Source: BBVA Research / Haver

... “more good data” to gain greater confidence on a sustained disinflationary process ahead

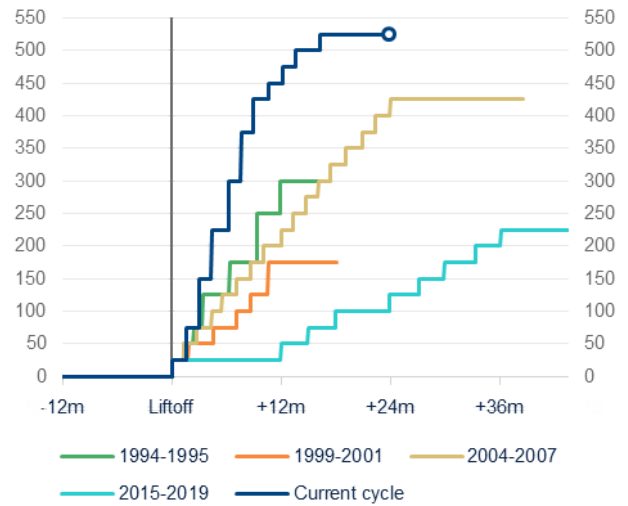
Figure 2. **FED FUNDS RATE IN TIGHTENING CYCLES (%)**



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

A rate hike is highly unlikely, as the Fed faces more balanced risks around its dual mandate

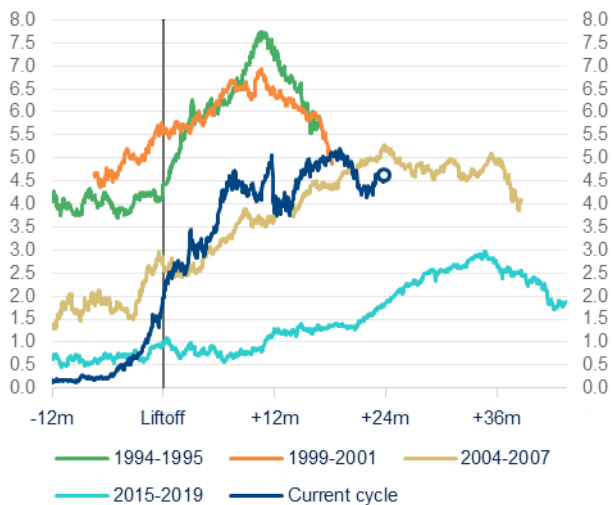
Figure 3. **FED FUNDS RATE IN TIGHTENING CYCLES (BPS VS RATE LEVEL AT LIFTOFF)**



Source: BBVA Research / Haver

Mid- and long-term yields have reversed 1/3 of the previous rally as markets try to reconcile...

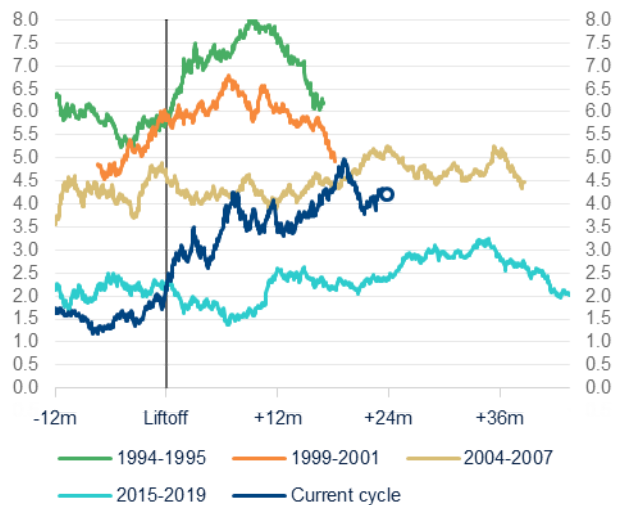
Figure 4. **2-YEAR TREASURY YIELD IN TIGHTENING CYCLES (%)**



Source: BBVA Research / Haver

... shelter inflation stickiness and newly-signed contracts, which have been pointing towards...

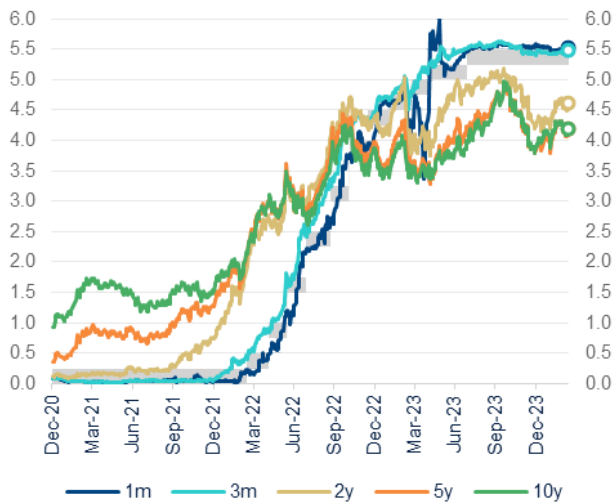
Figure 5. **10-YEAR TREASURY YIELD IN TIGHTENING CYCLES (%)**



Source: BBVA Research / Haver

... significant disinflation ahead. Last week's less-hawkish-than-expected Powell's comments...

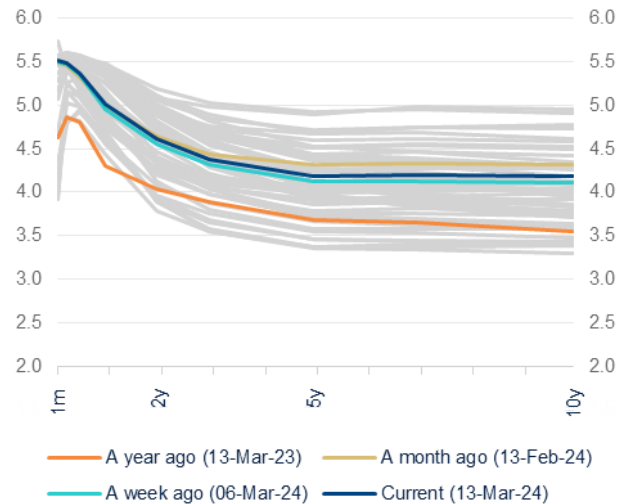
Figure 6. **TREASURY YIELDS**
(%)



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

... before Congress prevented the yield curve from pricing in a more pessimistic outlook, ...

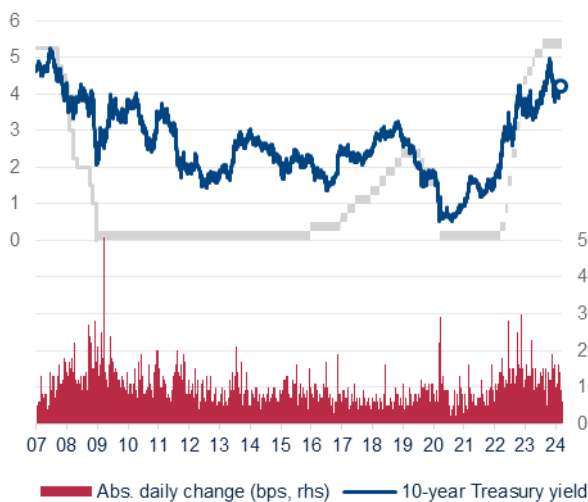
Figure 7. **TREASURY YIELD CURVE**
(%)



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

... and despite bond market volatility remaining above historical standards, investors seem to...

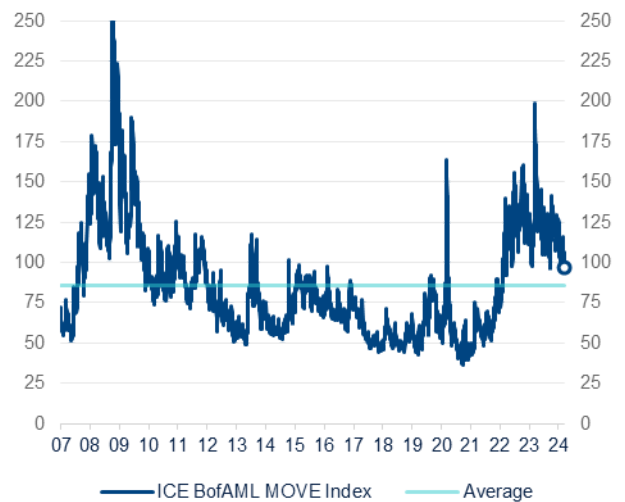
Figure 8. **10-YEAR TREASURY YIELD DAILY CHANGE**
(% AND BPS)



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

... be smoothly navigating the current environment of heightened data-dependency

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



Source: BBVA Research / Haver

The yield curve has been inverted for 17 consecutive months, as 3-month Treasury yields rates remain well above 10-year yields. In addition to being the longest period of inversion in the past 40 years, ...

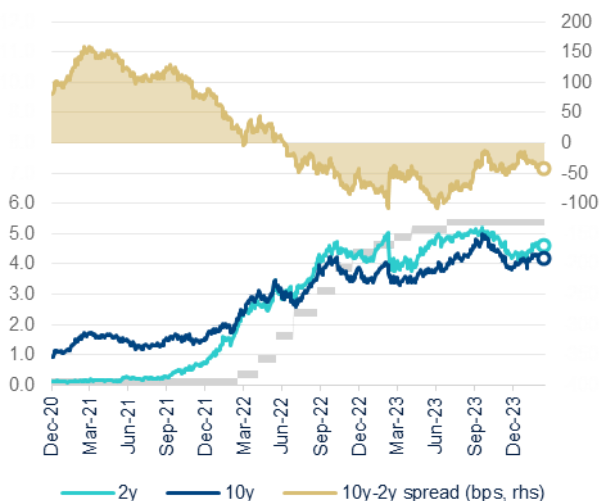
Figure 10. **TREASURY YIELD SPREADS (BPS)**



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

... it has also failed (so far) to predict a recession. As the Fed continues to push back the start...

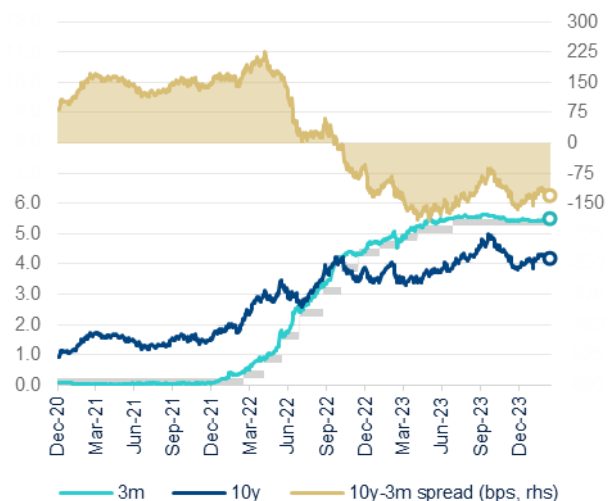
Figure 11. **10Y-2Y TREASURY YIELD SPREAD (% AND BPS)**



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

... of a rate-cut cycle, we may not see a normal, upward-sloping yield curve until 2025

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



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

The evolution of the term premium this year reflects the markets' view that, although it is...

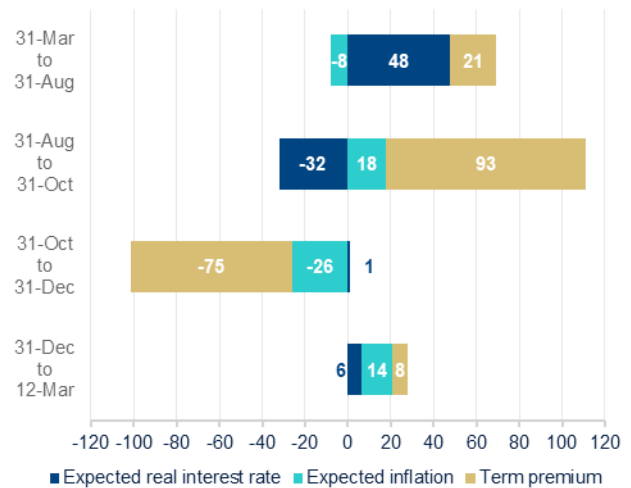
Figure 13. 10-YEAR TREASURY YIELD AND TERM PREMIUM (%)



Source: BBVA Research / Haver

... taking a bit longer than expected, pandemic-related inflation has been nearly resolved

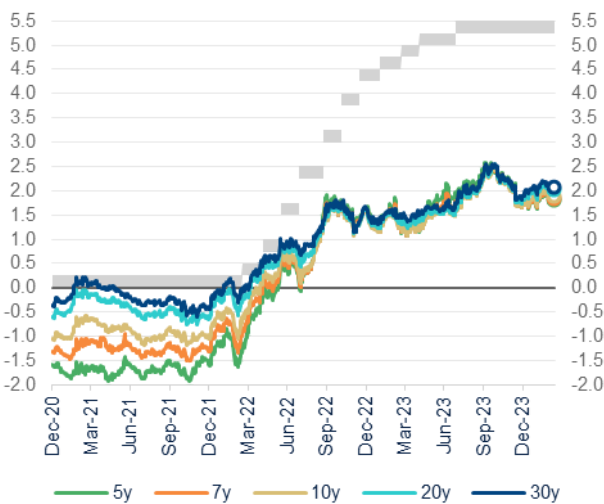
Figure 14. CHANGE IN 10-YEAR TREASURY YIELD (BPS)



Source: BBVA Research / Haver

With a still-restrictive policy stance and a better balance of risks, the Fed's decisions going...

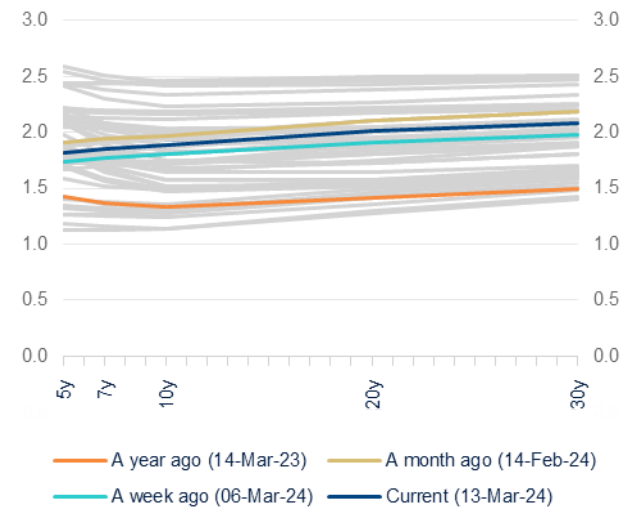
Figure 15. INFLATION INDEXED (TIPS) YIELDS (%)



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

... forward will likely gradually focus on avoiding causing unnecessary harm to the labor market

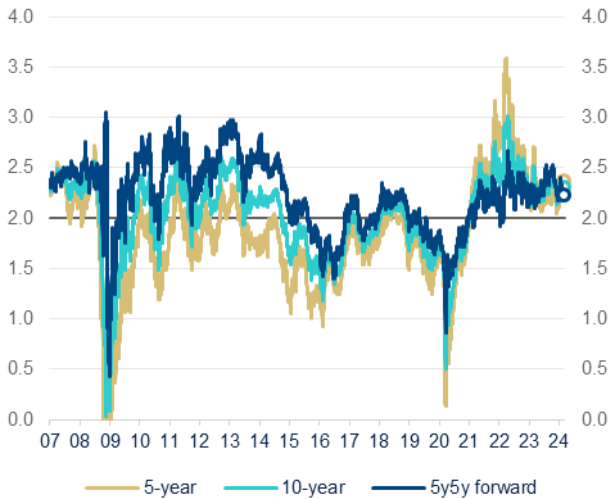
Figure 16. INFLATION INDEXED (TIPS) YIELD CURVE (%)



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...

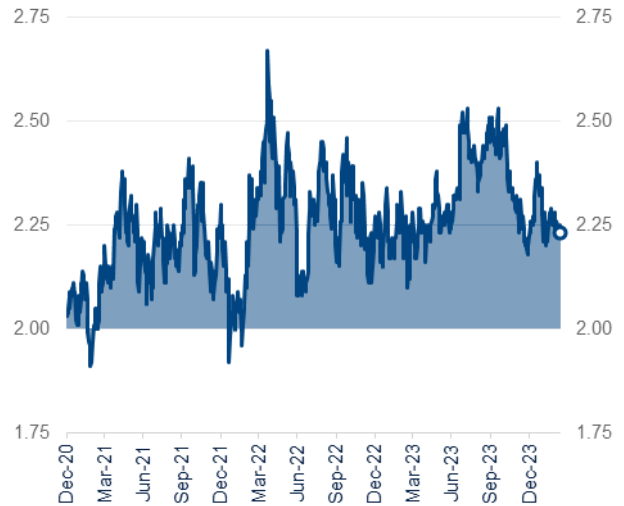
Figure 17. **BREAKEVEN INFLATION RATES** (%)



Source: BBVA Research / Haver

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

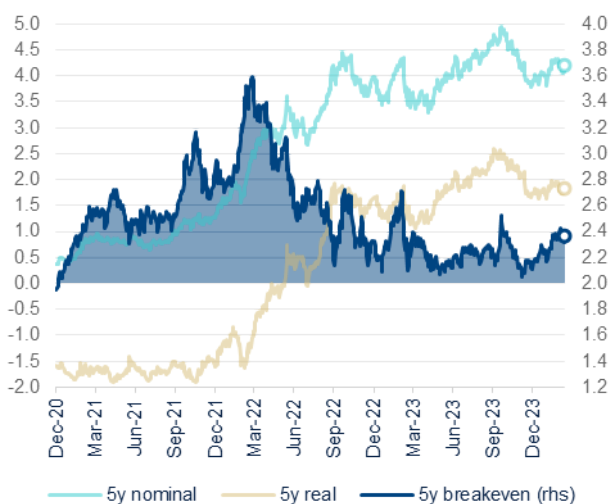
Figure 18. **5Y5Y FORWARD IMPLIED INFLATION RATE** (%)



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...

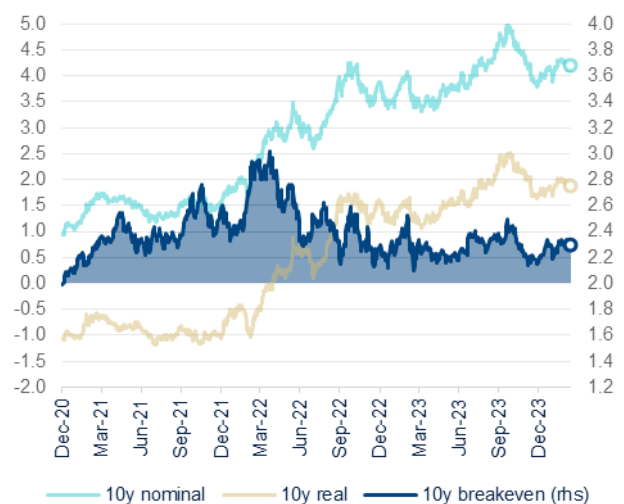
Figure 19. **5-YEAR BREAKEVEN INFLATION RATE** (%)



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

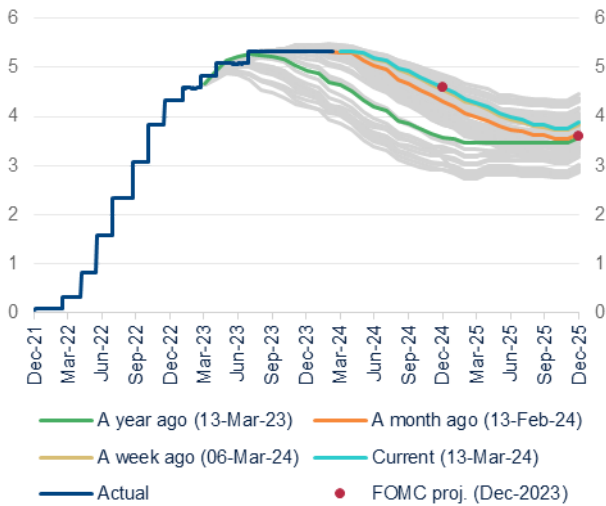
Figure 20. **10-YEAR BREAKEVEN INFLATION RATE** (%)



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

Markets have all but priced in the Fed's median outlook from last December of no more than...

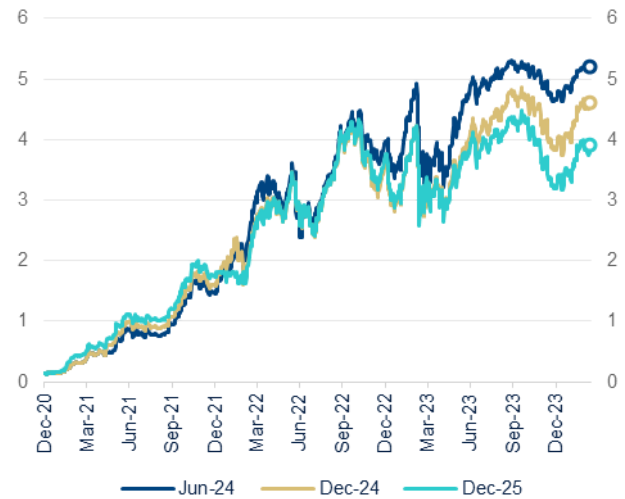
Figure 21. **IMPLIED RATE IN 30-DAY FED FUNDS FUTURES (%)**



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

... three rate cuts this year, giving Powell leeway to avoid conveying an overly hawkish tone

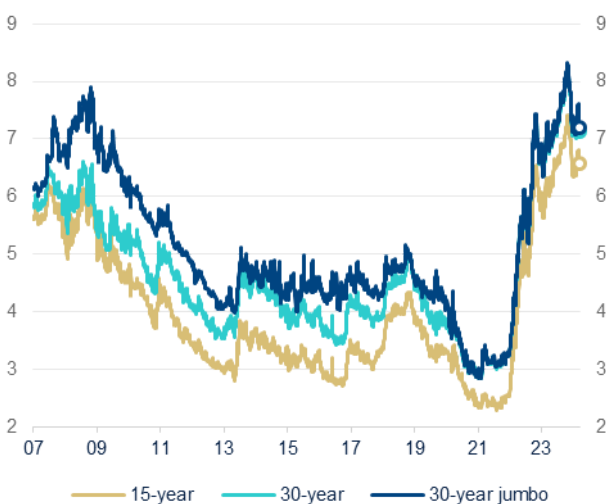
Figure 22. **IMPLIED RATE IN 30-DAY FED FUNDS FUTURES (%)**



Source: BBVA Research / Bloomberg

The housing market continues to be the most sensitive to the high interest rate environment, ...

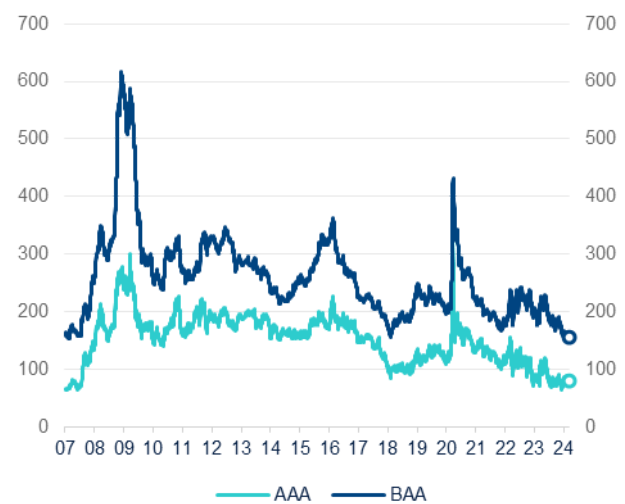
Figure 23. **MORTGAGE RATES (WSJ CONSUMER FIXED RATES, %)**



Source: BBVA Research based / Haver

... while the IG bond market appears to remain immune to the steepest hiking cycle in decades

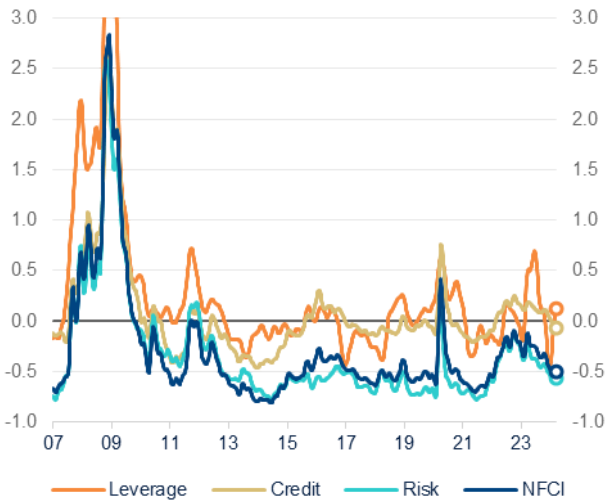
Figure 24. **CORPORATE BOND SPREADS (MOODY'S SEASONED YIELDS, DAILY DATA, BPS)**



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

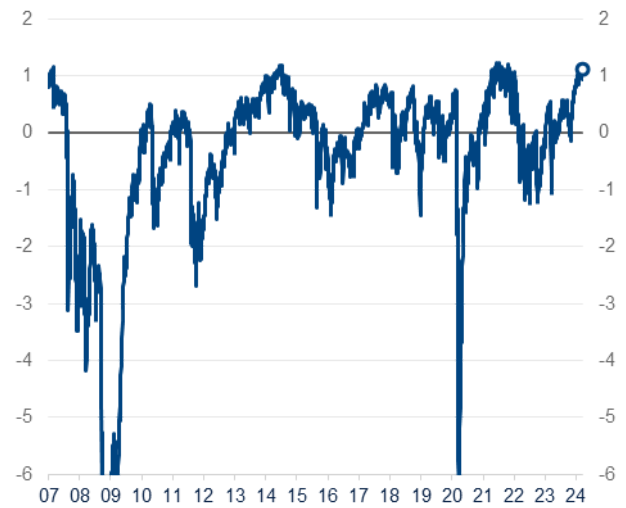
Figure 25. **CHICAGO FED NATIONAL FINANCIAL CONDITIONS INDEX (>0: TIGHTER THAN AVG)**



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...

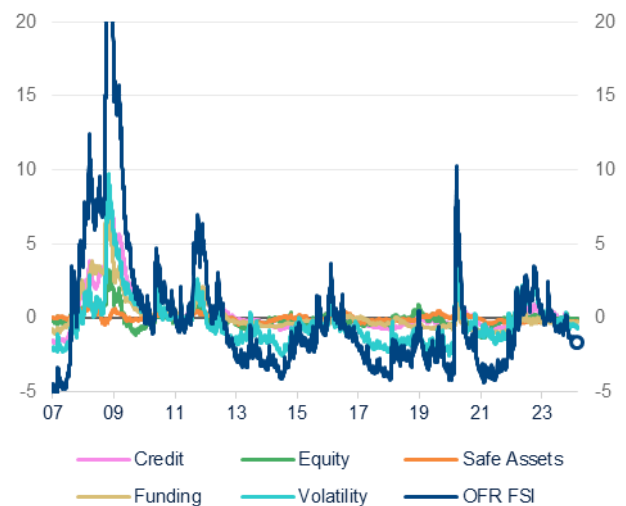
Figure 27. **FED FINANCIAL STRESS INDICES (>0: ABOVE AVG FINANCIAL STRESS)**



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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