

# Are markets underestimating the risks of tariff-related inflation?

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## Markets seem to reflect recent soft inflation data and dovish members' views on the limited impact of tariffs on inflation

Last week's updated SEP showed the median FOMC participant still expects two rate cuts before year-end, but Fed officials are increasingly split on where rates will end up ([Figures 2](#) and [3](#)).

The parallel downward shift of the yield curve in the past month ([Figure 10](#)) likely reflects the market dissent on the need to extend the pause amid the lack of evidence showing tariff impact on prices.

Market volatility from early April remains contained ([Figure 11](#)), yet new outbreaks are not ruled out amid geopolitical risks and the end of the 90-day pause on reciprocal tariffs in a couple of weeks.

The absence of signs that the U.S. is set to address debt sustainability is likely contributing to the c. 50bp spread between 10-year and 30-year Treasury yields ([Figure 14](#)).

The historical disconnect between rate levels and the U.S. dollar persists ([Figure 20](#)), but a sudden loss of the exorbitant privilege seems unlikely, as private domestic investors hold most of U.S. debt.

Mid- and long-term Treasury yields have pulled back from last month's highs amid soft inflation prints and dovish signals from Fed officials like Bowman and Waller, who have voiced support for a July rate cut

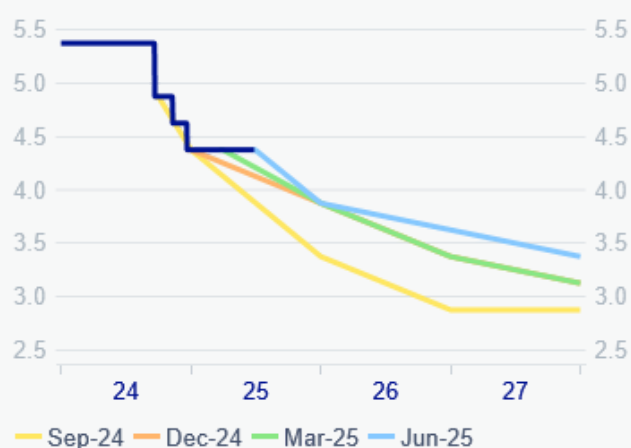
**FIGURE 1. FED FUNDS RATE AND TREASURY YIELDS (%)**



The gray area indicates the fed funds rate target range  
Source: BBVA Research / Fed / Treasury Dept.

Last week's updated SEP showed the median FOMC participant still expects two rate cuts...

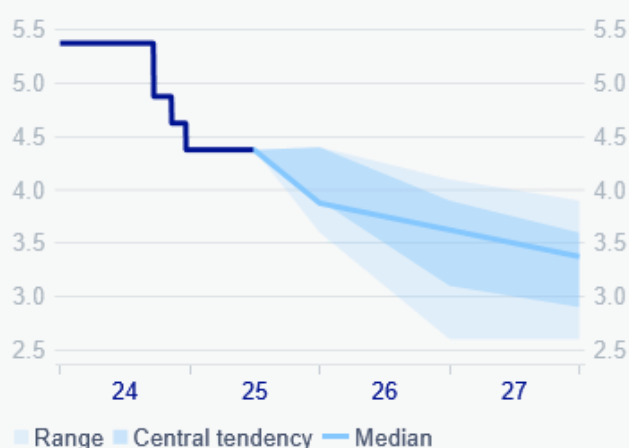
**FIGURE 2. FOMC PROJECTED FED FUNDS RATE (%)**



Source: BBVA Research / Fed

... before the end of this year, but Fed officials are increasingly split on rate projections ([see](#))

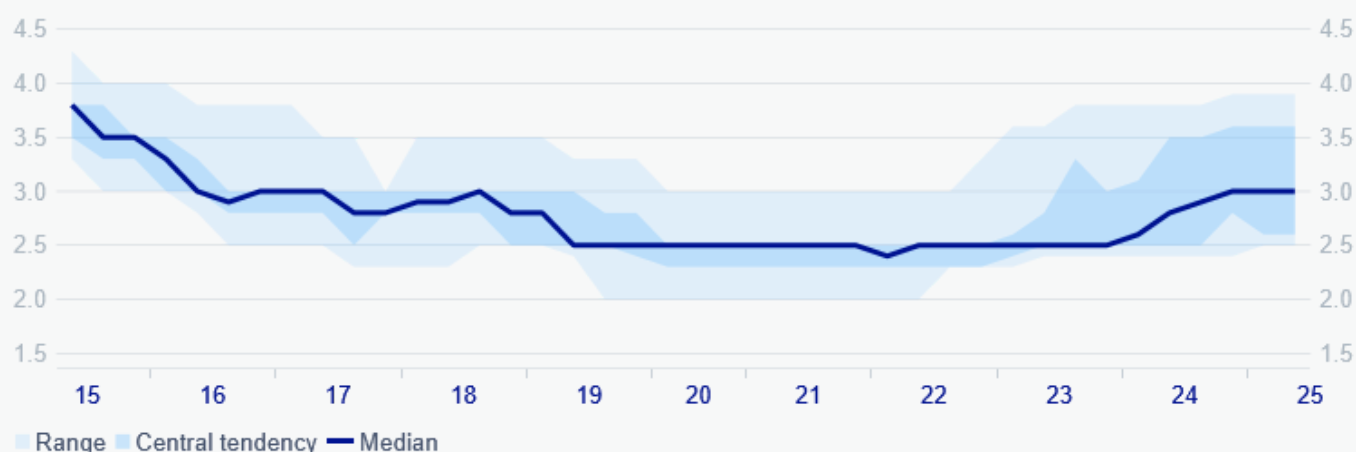
**FIGURE 3. FOMC PROJECTED FED FUNDS RATE (%)**



Source: BBVA Research / Fed

For 26 and 27, median rate expectations edged higher to 3.6 and 3.4% (from 3.4 and 3.1%). If revisions continue, the longer-run rate estimate—so far unchanged—could eventually move higher

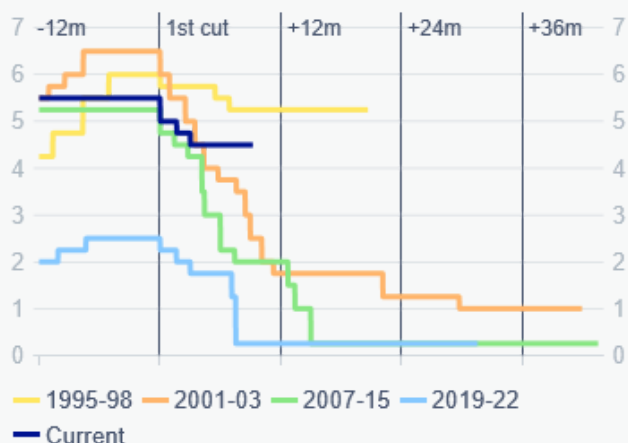
**FIGURE 4. FOMC LONGER RUN FED FUNDS RATE ESTIMATION (%)**



Source: BBVA Research / Fed

The timing of the Fed's next move remains very uncertain, as Powell noted that no one is...

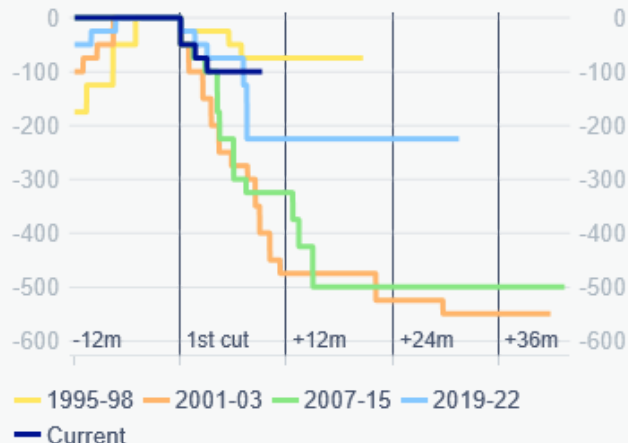
**FIGURE 5. FED FUNDS RATE IN EASING CYCLES (%)**



Target rate for the 1995-98, 2001-03, and 2007-15 (before 16-Dec-08) cycles; upper limit of the target rate range for the 2007-15 (after 16-Dec-08), 2019-22, and current cycles. Source: BBVA Research / Fed

... strongly confident in their forecast. Despite ample support for being "well-positioned"...

**FIGURE 6. FED FUNDS RATE IN EASING CYCLES (BPS VS RATE AT FIRST CUT)**



Source: BBVA Research / Treasury Dept.

... to wait and Powell's emphasis on sticking to a "forward-looking" approach, some of the...

**FIGURE 7. 2-YEAR TREASURY YIELD IN EASING CYCLES (%)**



Source: BBVA Research / Treasury Dept.

... recent market dissent on the policy path appears driven by the lack of clear evidence...

**FIGURE 8. 10-YEAR TREASURY YIELD IN EASING CYCLES (%)**



Source: BBVA Research / Treasury Dept.

... showing tariffs' impact on prices. This is reflected in the parallel downward shift of the...

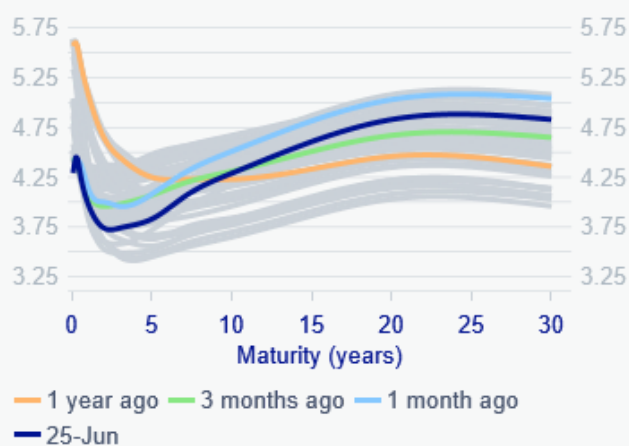
**FIGURE 9. TREASURY YIELDS (%)**



The gray area indicates the fed funds rate target range  
Source: BBVA Research / Fed / Treasury Dept.

... yield curve, which drove a c. 30 bps decline in the 10 year yield from a mid-May 4.6% high

**FIGURE 10. TREASURY YIELD CURVE (%)**



The gray lines indicate weekly curves over the past year; intermediate rates calculated with natural cubic spline interpolation  
Source: BBVA Research / Treasury Dept.

Despite lingering uncertainty, the early April market volatility peak remains contained, yet new outbreaks are not ruled out due to increased geopolitical risks and the uncertainty around upcoming U.S. actions...

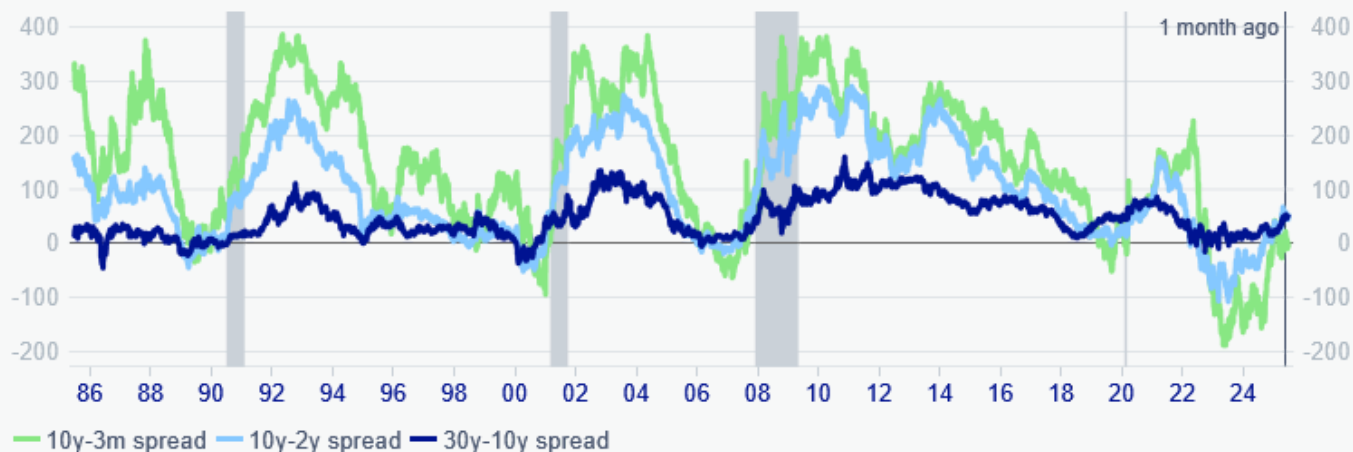
**FIGURE 11. ICE BOFAML MOVE INDEX (INDEX POINTS)**



The shaded areas indicate the ranges within one and two standard deviations from the mean  
Source: BBVA Research / ICE BofAML

... when the 90-day pause on reciprocal tariffs ends in a couple of weeks. The steepening of the yield curve continues to indicate ongoing concerns about long-term U.S. economic risk rather than a positive outlook

**FIGURE 12. TREASURY YIELD SPREADS (BPS)**



The gray shaded areas indicate US recessions as defined by NBER  
Source: BBVA Research / NBER / Treasury Dept.

The absence of signs that the U.S. is set to address debt sustainability is likely fueling...

**FIGURE 13. 10Y-2Y TREASURY YIELD SPREAD (BPS AND %)**



The gray area indicates the fed funds rate target range  
Source: BBVA Research / Fed / Treasury Dept.

... the c. 50bp spread between 10-year and 30-year Treasury yields. The upward trend...

**FIGURE 14. 30Y-10Y TREASURY YIELD SPREAD (BPS AND %)**



The gray area indicates the fed funds rate target range  
Source: BBVA Research / Fed / Treasury Dept.

... driven by these concerns seems to have come to a halt. The real yield curve downshift ...

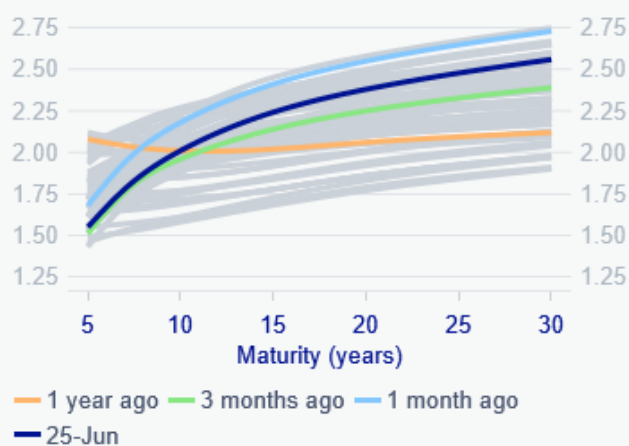
**FIGURE 15. TREASURY REAL YIELDS (TIPS) (%)**



The gray area indicates the fed funds rate target range  
Source: BBVA Research / Fed / Treasury Dept.

... reflects a slight decrease in the term premium. Besides, the recent drop in...

**FIGURE 16. TREASURY REAL YIELD CURVE (TIPS) (%)**



The gray lines indicate weekly curves over the past year; intermediate rates calculated with natural cubic spline interpolation  
Source: BBVA Research / Treasury Dept.

... nominal rates is also likely reflecting easing inflation concerns after the latest CPI data

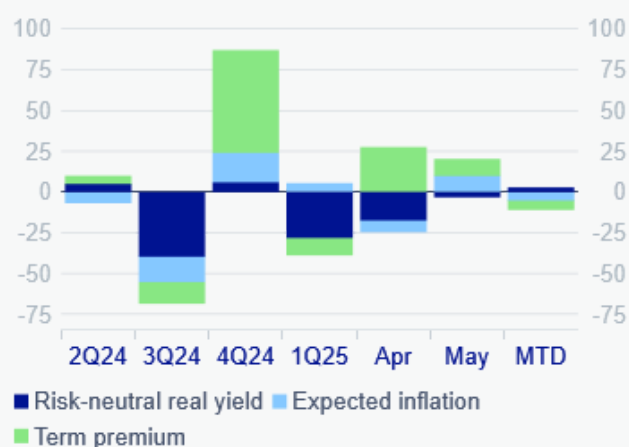
**FIGURE 17. BREAK EVEN INFLATION RATES (%)**



Source: BBVA Research / Treasury Dept.

Nevertheless, a historical disconnect between interest rate levels and the US dollar's...

**FIGURE 18. 10-YEAR TREASURY YIELD CHANGE BREAKDOWN (BPS)**



Based on the NY Fed ACM model  
Source: BBVA Research / Fed / Treasury Dept.

... performance persists. However, a sudden loss of the US's exorbitant privilege seems...

**FIGURE 19. 10-YEAR TREASURY YIELD BREAKDOWN (%)**



Based on the NY Fed ACM model  
Source: BBVA Research / Fed

... unlikely, as most of its debt is currently held by private domestic investors

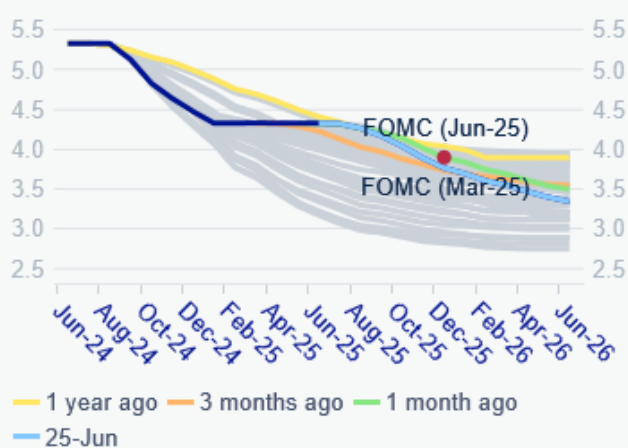
**FIGURE 20. 10-YEAR TREASURY YIELD & DXY INDEX (% & INDEX POINTS)**



Source: BBVA Research / ICE / Treasury Dept.

The futures market now prices a 90% chance of at least two 25bp rate cuts this year, ...

**FIGURE 21. FUTURES-IMPLIED FED FUNDS RATE (%)**



The gray lines indicate weekly implied rate paths over the past year. Source: BBVA Research / CME / Fed

... up from 2-to-3 odds last month

**FIGURE 22. FUTURES-IMPLIED FED FUNDS RATE (%)**

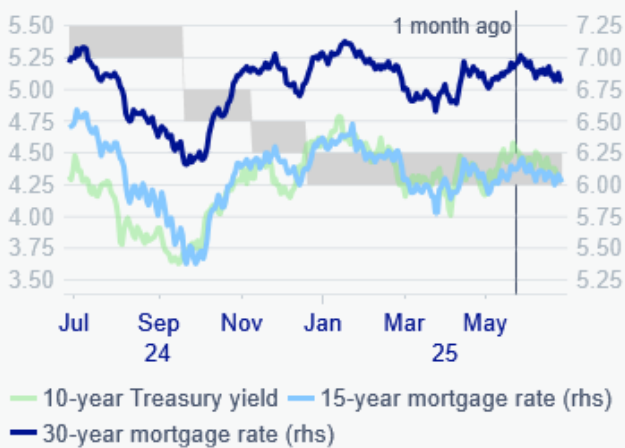


The gray area indicates the fed funds rate target range  
Source: BBVA Research / CME / Fed



Mortgage rates edged down last month, in line with long-term Treasury yields

**FIGURE 23. MORTGAGE RATES (%)**



The gray area indicates the fed funds rate target range (rhs)  
Source: BBVA Research / Bankrate / Fed / Treasury Dept.

Early-April's pressure on investment-grade corporate spreads continued to ease slightly

**FIGURE 24. CORPORATE BOND YIELD SPREADS (%)**



Spreads over the 10-year Treasury yield; the shaded area indicates the deviation from the historical average since 2008  
Source: BBVA Research / Fed / Treasury Dept.

The relative calm in financial conditions indexes reflects the fact that the Fed has not...

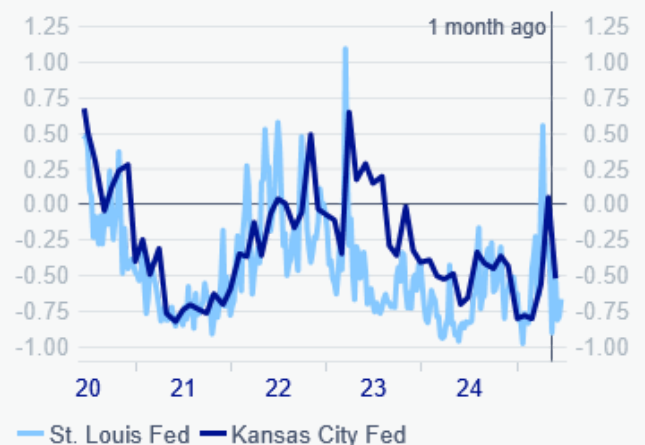
**FIGURE 25. CHICAGO FED NATL. FIN. COND. INDEX (>0: TIGHTER THAN AVG.)**



Source: BBVA Research / Fed

... had to intervene with extraordinary liquidity measures to this year's volatility bouts

**FIGURE 26. FED FINANCIAL STRESS INDEXES (>0: ABOVE AVG. FIN. STRESS)**



Source: BBVA Research / Fed



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