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Markets double down on expectations of a deep easing cycle

Javier Amador, Iván Fernández

A cautious Fed may challenge these expectations, prompting a partial rebound in long-term yields after their recent decline

The easing cycle is set to continue next week through a second consecutive 25bp rate cut despite the government shutdown delaying key jobs and inflation data releases (Figures 2 and 3).

The 2-year yield fell 20 bps over the past month (Figure 4) amid easing expectations, mirrored by a similar drop in the 10-year yield (Figure 5), which dipped below 4% for the first time in a year.

Lower perceived uncertainty about the policy path kept volatility low (Figure 8), even as some have called for caution amid mixed signals from strong activity data and a softening labor market.

Term premium changes this year have been largely offset by alternating up and down periods. Still, most risks priced in since Trump's election have not unwound (Figures 15 and 16).

Markets price in a much deeper policy easing for 2026 than Fed projections; caution expressed by dovish officials like Waller has done little to curb such expectations (Figures 18 and 19).

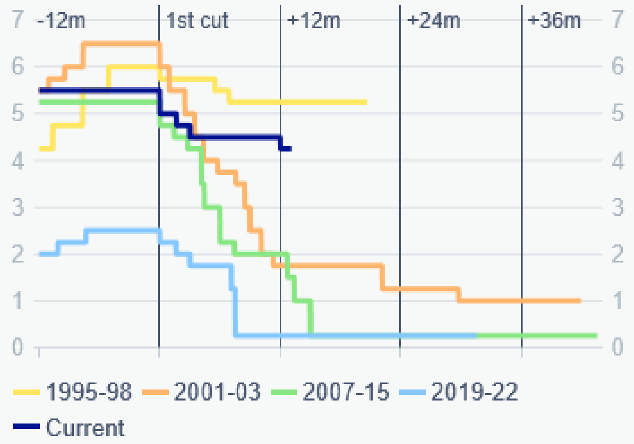
Treasury yields fell over the past month as markets almost fully price in a second straight rate cut next week, after Powell warned last week that the labor market may now be at a…

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

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

... stage where "further declines in job openings might very well show up in unemployment"

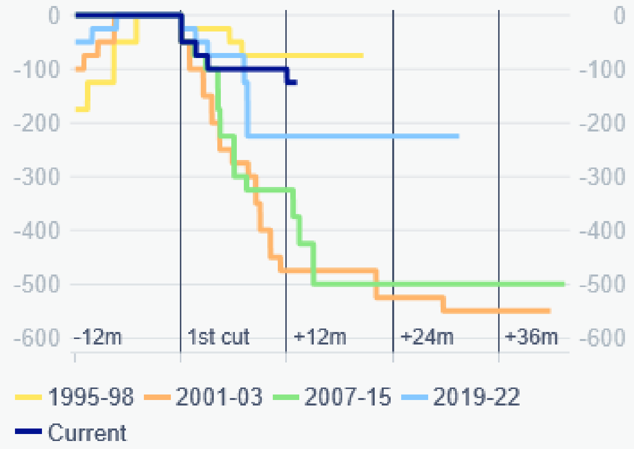
FIGURE 2. FED FUNDS RATE IN EASING CYCLES (%)



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

The easing cycle is thus set to continue despite the gov't shutdown delaying key data releases

FIGURE 3. FED FUNDS RATE IN EASING CYCLES (BPS VS RATE AT FIRST CUT)



Source: BBVA Research / Treasury Dept.

The 2y yield fell c. 20 bps over the past month amid stronger easing expectations, mirrored...

FIGURE 4. 2-YEAR TREASURY YIELD IN EASING CYCLES (%)

Source: BBVA Research / Treasury Dept.

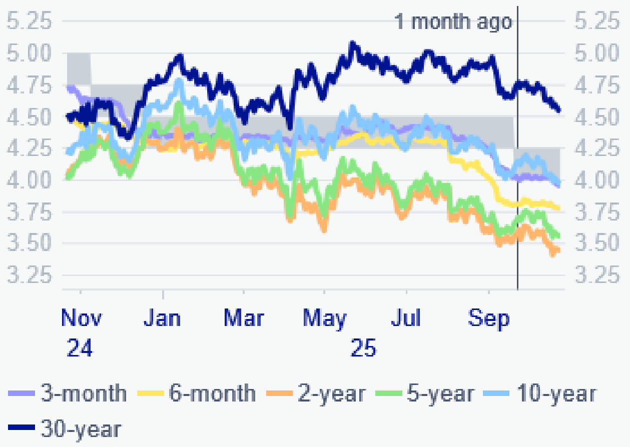
... by a similar drop in the 10y yield, which dipped below 4% for the first time in a year

FIGURE 5. 10-YEAR TREASURY YIELD IN EASING CYCLES (%)

Source: BBVA Research / Treasury Dept.

This parallel shift in the yield curve likely reflects reduced uncertainty over the policy…

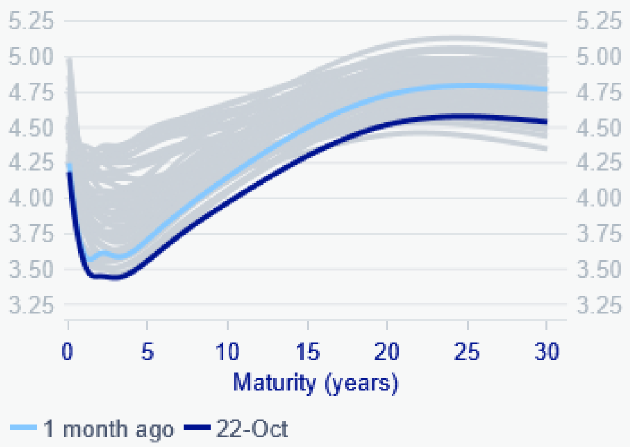
FIGURE 6. TREASURY YIELDS
(%)



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

… outlook, as markets grow more confident that the path ahead points to further easing

FIGURE 7. 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.

Lower perceived uncertainty about the policy path kept volatility low, even as dovish voices (Waller) have struck a caution tone amid conflicting signals between strong activity data and a softening labor market

FIGURE 8. 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

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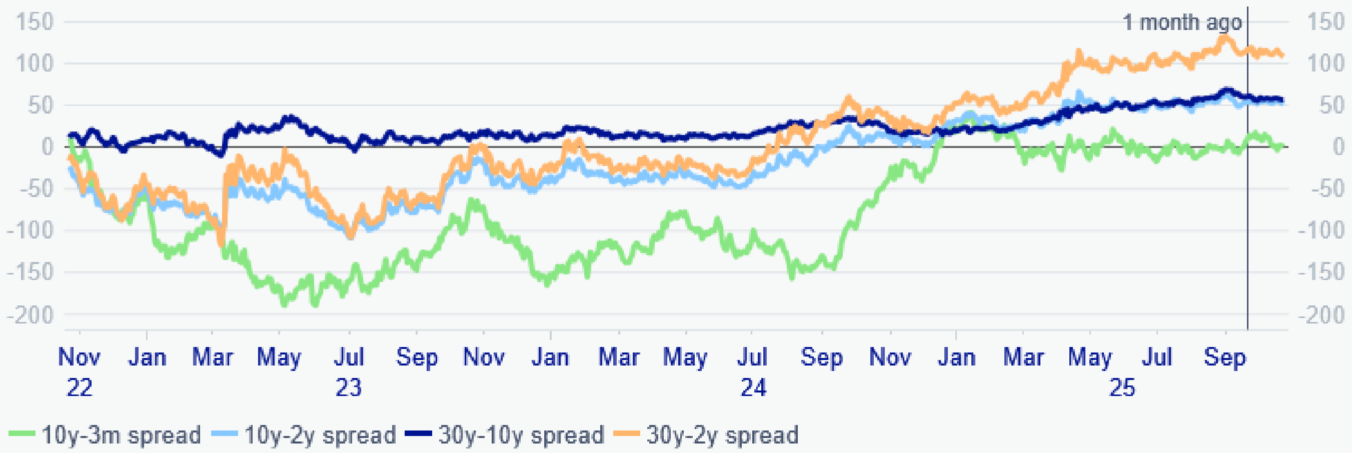
Term spreads remained broadly stable over the past month, consistent with the parallel downward shift observed in the yield curve. This steadiness is likely driven by firmer…

FIGURE 9. TREASURY YIELD SPREADS (BPS)



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

… easing expectations and a clearer policy outlook. However, spreads remain elevated,…

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

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

… largely driven by persistent fiscal and institutional risks

FIGURE 11. 30Y-10Y TREASURY YIELD SPREAD (BPS AND %)

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

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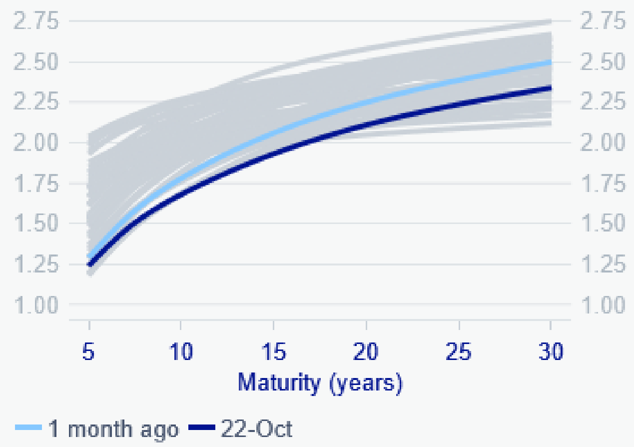
With nominal yields falling more than real rates, inflation breakevens narrowed, erasing…

FIGURE 12. TREASURY REAL YIELDS (TIPS) (%)

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

… much of the rise seen since July and reflecting that the inflationary impact of new…

FIGURE 13. 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.

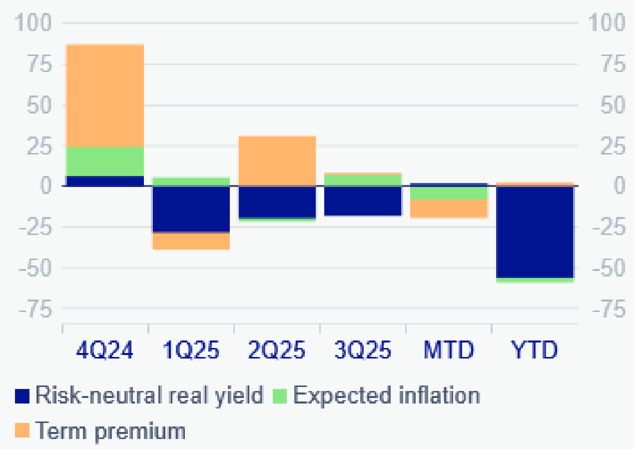
… tariffs has so far been smaller than initially feared. This year's term premium changes…

FIGURE 14. BREAKEVEN INFLATION RATES (%)

Source: BBVA Research / Treasury Dept.

… have mostly canceled out through alternating up and down periods

FIGURE 15. 10-YEAR TREASURY YIELD CHANGE BREAKDOWN (BPS)



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

Yet, most of the risks priced in since Trump's win remain in place. Recent weeks saw the...

FIGURE 16. 10-YEAR TREASURY YIELD BREAKDOWN (%)

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

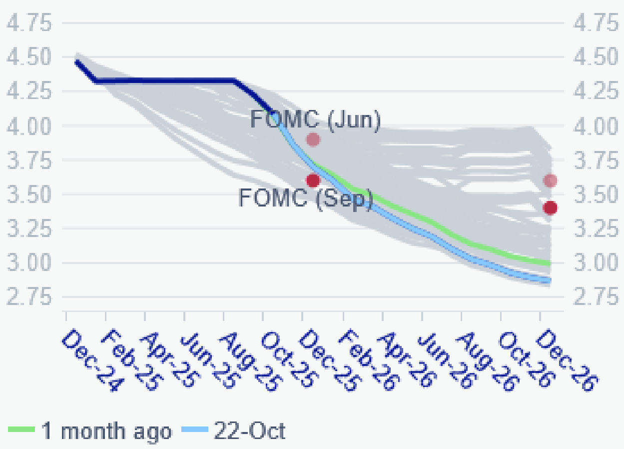
... USD regain some of its typical correlation with yields. Markets are still pricing in...

FIGURE 17. 10-YEAR TREASURY YIELD & DXY INDEX (% & INDEX POINTS)

Source: BBVA Research / ICE / Treasury Dept.

... a much deeper policy easing for 2026 than the SEP projection, and even the caution...

FIGURE 18. FUTURES-IMPLIED FED FUNDS RATE (%)



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

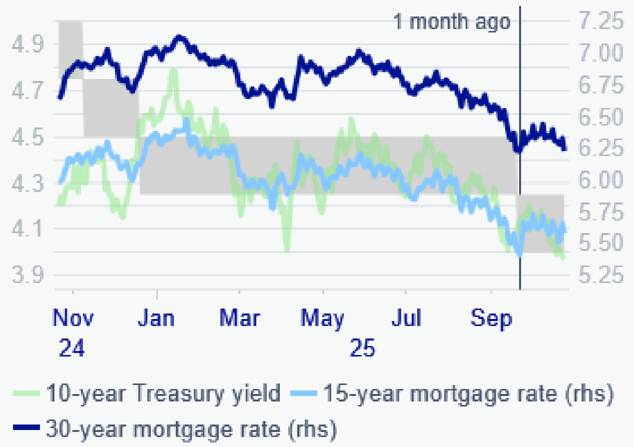
... expressed by dovish officials like Waller has done little to curb such expectations

FIGURE 19. FUTURES-IMPLIED FED FUNDS RATE (%)

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

Mortgage rates could still have some room to decline, following the recent drop in 10y yields

FIGURE 20. MORTGAGE RATES (%)



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

Investment-grade corporate spreads remain unusually tight, well below historical levels

FIGURE 21. 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.

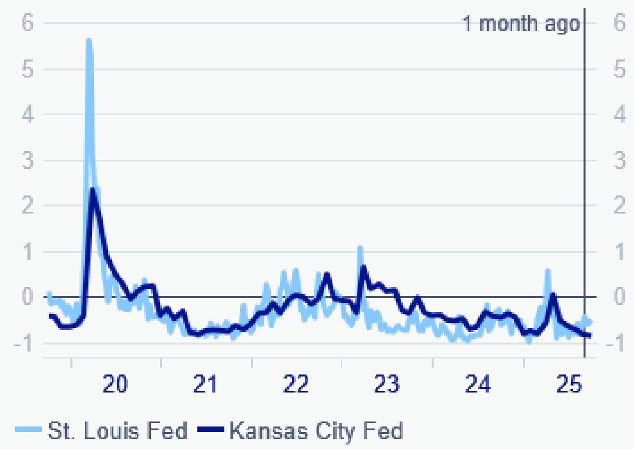
Broad indicators still signal overall financial stability and limited market stress, despite…

FIGURE 22. CHICAGO FED NATL. FIN. COND. INDEX (>0: TIGHTER THAN AVG.)

Source: BBVA Research / Fed

… the depth of recent U.S. economic policy shifts and the uncertainty surrounding them

FIGURE 23. FED FINANCIAL STRESS INDEXES (>0: ABOVE AVG. FIN. STRESS)



Source: BBVA Research / Fed

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