

Fed repricing lowers inflation expectations, lifts the dollar and caps long-term yields

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While policy rate expectations have risen, lower inflation expectations and term premia cap long-term yields

Warsh's focus on price stability alongside a massive hawkish shift in the dot plot put concerns over the Fed's independence to rest, unwinding the debasement trade.

The futures market is broadly aligned with a high-for longer outlook on rates: it expects the Fed to remain on hold in July, but now prices in a 60% chance of a 25 bp hike in September ([Figure 5](#)).

The recent evolution of the two-year yield reflects this shift in expectations: it reached 4.2% this week, c. 80 bps above its February level and its highest level in 16 months ([Figure 6](#)).

In contrast, following the mid-May sell-off, long-term Treasury yields have trended lower over the past month, leading to a bullish flattening of the nominal yield curve ([Figure 9](#)).

Inflation expectations have fallen sharply over the past month ([Figure 12](#)) and the term premium has also declined ([Figure 13](#)), partly offsetting the policy expectations shift.

The case for high rates—amid well-anchored inflation expectations—has bolstered the dollar's relative appeal. Since mid-May, the USD has appreciated roughly 3.5% ([Figure 18](#)).

Last week, the Fed kept rates unchanged for a fourth straight meeting, dropped its easing bias and forward guidance, and the updated SEP signaled a more hawkish stance among participants

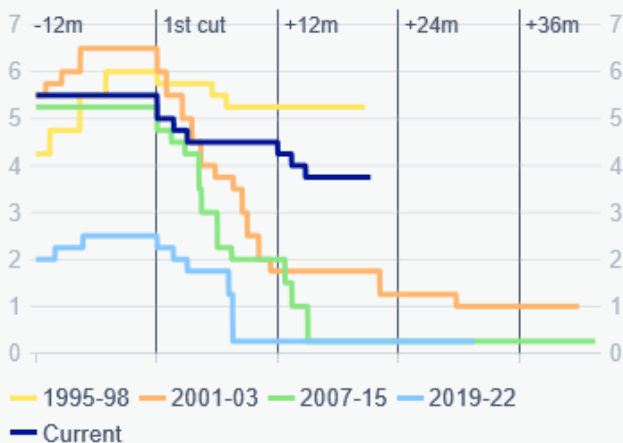
FIGURE 1. FED FUNDS RATE AND TREASURY YIELDS (%)



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

According to the median federal funds rate projection, the policy rate is now expected to...

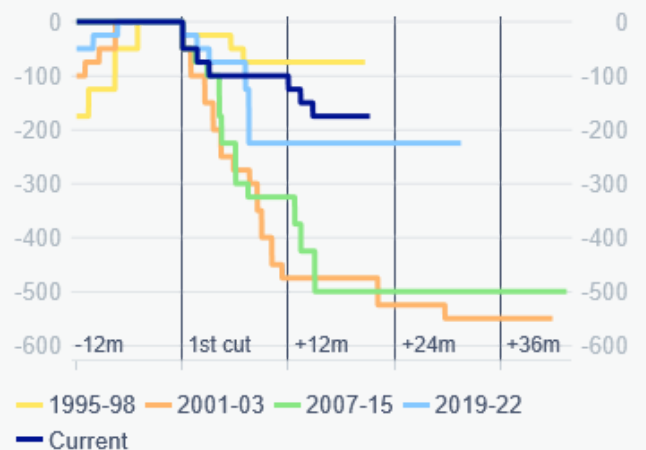
FIGURE 2. FED FUNDS RATE IN EASING CYCLES (%)



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

... remain above its 3.1% long-run level through 2028 (3.6% in 2027 and 3.4% in 2028)

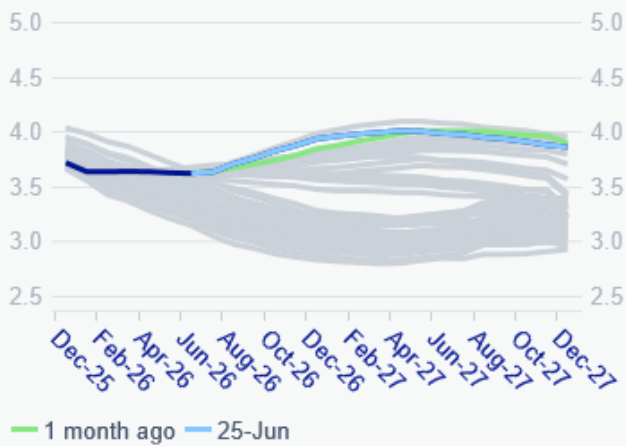
FIGURE 3. FED FUNDS RATE IN EASING CYCLES (BPS VS RATE AT FIRST CUT)



Source: BBVA Research, Treasury Dept.

The futures market is broadly aligned with this view: while traders expect the Fed to remain...

FIGURE 4. FUTURES-IMPLIED FED FUNDS RATE (%)



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

... on hold at the July meeting, they now see a 60% probability of a 25 bp hike in September

FIGURE 5. FUTURES-IMPLIED FED FUNDS RATE (%)



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

The recent evolution of the two-year yield reflects this shift in expectations: it reached...

FIGURE 6. 2-YEAR TREASURY YIELD IN EASING CYCLES (%)



Source: BBVA Research, Treasury Dept.

... 4.2% this week, c. 80 bps above its February level and its highest level in 16 months

FIGURE 7. 10-YEAR TREASURY YIELD IN EASING CYCLES (%)



Source: BBVA Research, Treasury Dept.

In contrast, following the mid-May sell-off, long-term Treasury yields have trended lower...

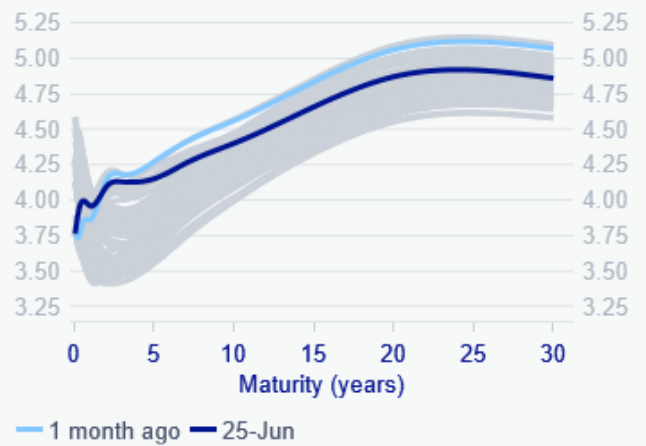
FIGURE 8. TREASURY YIELDS (%)



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

... over the past month, leading to a bullish flattening of the nominal yield curve

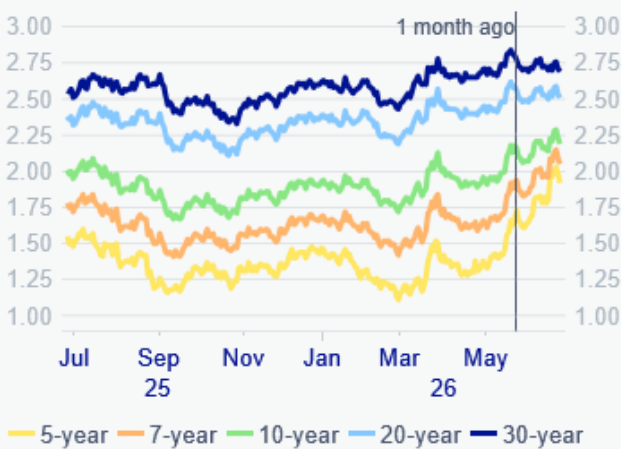
FIGURE 9. TREASURY YIELD CURVE (%)



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

The reason is that real yields have not declined alongside nominal yields. While monetary...

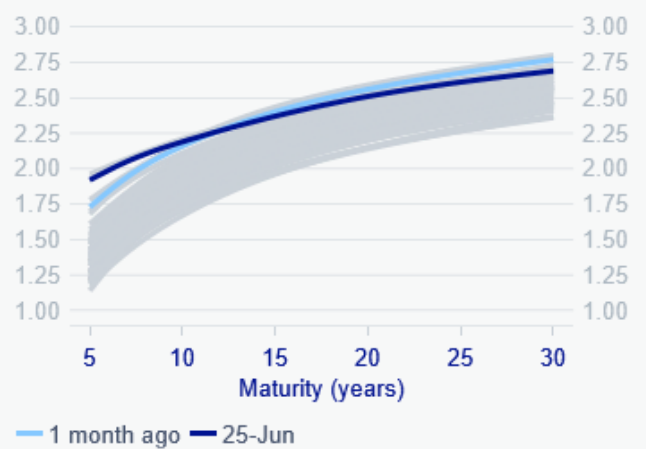
FIGURE 10. TREASURY REAL YIELDS (TIPS) (%)



Source: BBVA Research, Fed, Treasury Dept.

... policy expectations have turned more hawkish, inflation expectations have fallen...

FIGURE 11. 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.

... sharply over the past month and the term premium has also declined, partly offsetting...

FIGURE 12. BREAKEVEN INFLATION RATES (%)



Source: BBVA Research, Treasury Dept.

... the policy expectations shift. A mechanical implication of higher short-term rates...

FIGURE 13. 10-YEAR TREASURY YIELD BREAKDOWN (%)



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

... coupled with a less-than-proportional rise in long-term yields has been the recent tightening in term spreads. For now, they do not appear to reflect the risk that a high-rate environment could eventually...

FIGURE 14. TREASURY YIELD SPREADS (BPS)



Source: BBVA Research, NBER, Treasury Dept.

... place material strain on the U.S. fiscal position through debt-servicing costs. This...

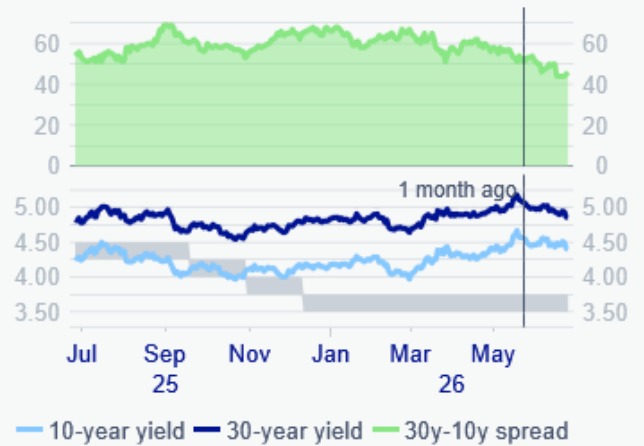
FIGURE 15. 10Y-2Y TREASURY YIELD SPREAD (BPS AND %)



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

... suggests that investors do not yet perceive a threat to the dollar's exorbitant privilege

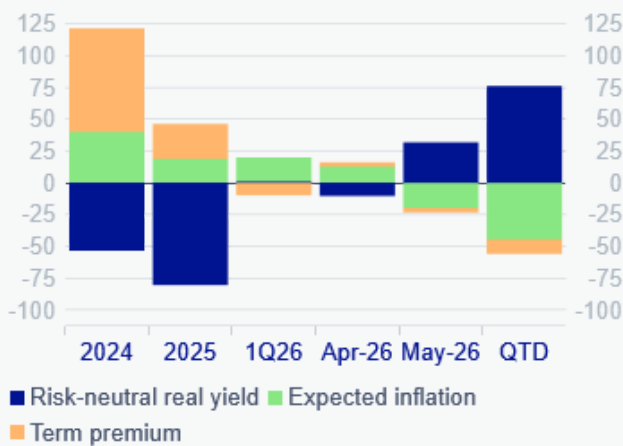
FIGURE 16. 30Y-10Y TREASURY YIELD SPREAD (BPS AND %)



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

The case for high rates—amid well-anchored inflation expectations—has bolstered...

FIGURE 17. 10-YEAR TREASURY YIELD CHANGE BREAKDOWN (BPS)



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

... the dollar's relative appeal. Since mid-May, the USD has appreciated roughly 3.5%

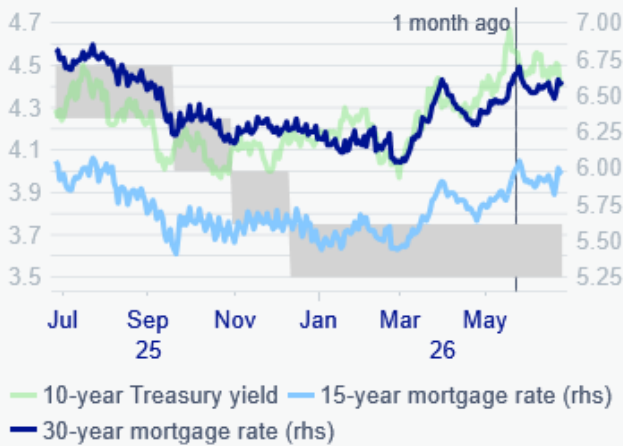
FIGURE 18. 10-YEAR TREASURY YIELD & DXY INDEX (% & INDEX POINTS)



Source: BBVA Research, ICE, Treasury Dept.

Mortgage rates remained broadly range-bound over the past month, with some volatility

FIGURE 19. MORTGAGE RATES (%)



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

Stress remains largely absent from the investment-grade corporate bond market

FIGURE 20. 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 measures of bond market volatility remained largely below historical averages, pointing to continued orderly market functioning and limited signs of stress

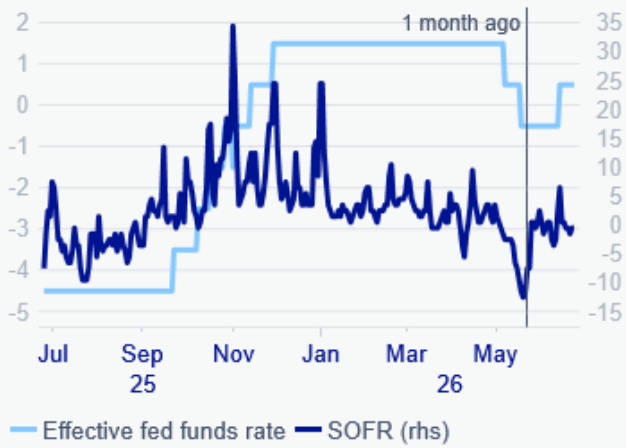
FIGURE 21. ICE BOFAML MOVE INDEX (INDEX POINTS)



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

Broad measures of financial stress tell a similar story: the market response to the Iran war...

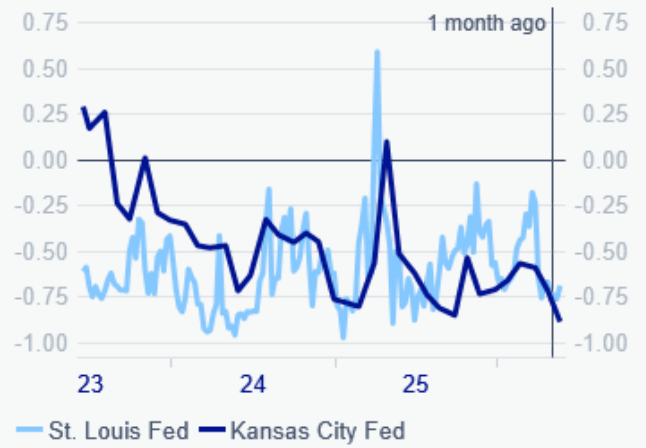
FIGURE 22. MONEY MARKET RATE SPREADS (BPS)



Spreads over the midpoint target fed funds rate
Source: BBVA Research, Fed

... has been considerably lower than during the stress episode following Liberation Day

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



Source: BBVA Research, Fed

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