

Markets price higher rates, not a less independent Fed

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Swings at the long end have lifted LT yields to multi-year highs; yet, markets continue to expect inflation to remain under control

The shift in the curve was particularly eye-catching at the long end, where 30-year yields reached 5.2% in mid-May, a level not seen since the onset of the GFC in 2007 (Figures 6 and 7).

Broad measures of bond market volatility, however, have remained mostly below their historical averages, pointing to continued orderly market functioning and limited signs of stress (Figure 8).

The somewhat narrower 30y-10y yield spread suggests that investors do not (yet?) perceive a meaningful long-term threat to the US exorbitant privilege (Figures 9 and 11).

The rise in Treasury yields toward their mid-May peak was initially driven by a higher term premium, followed recently by a growing contribution of policy rate expectations (Figure 15).

Markets appear to be pricing a higher-for-longer fed funds rate while remaining broadly confident that inflation will remain under control (Figures 18 and 19).

After moderating in April, expectations for Fed rate hikes, as implied by the 2-year Treasury yield, strengthened again in May, driven by uncertainty surrounding the prolonged conflict in the Middle East, ...

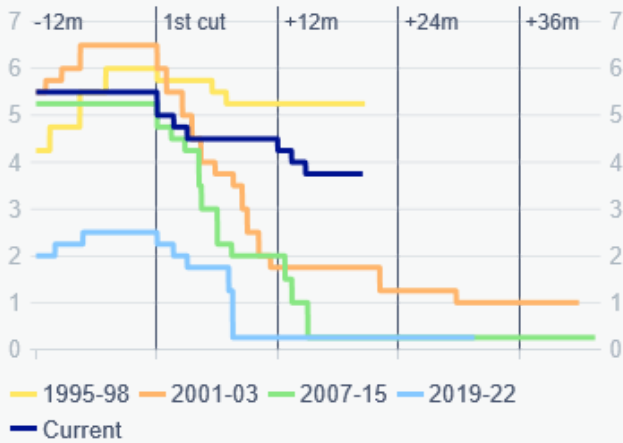
FIGURE 1. FED FUNDS RATE AND TREASURY YIELDS (%)



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

... persistently elevated oil prices, resilient economic activity, and the Fed's hawkish tone...

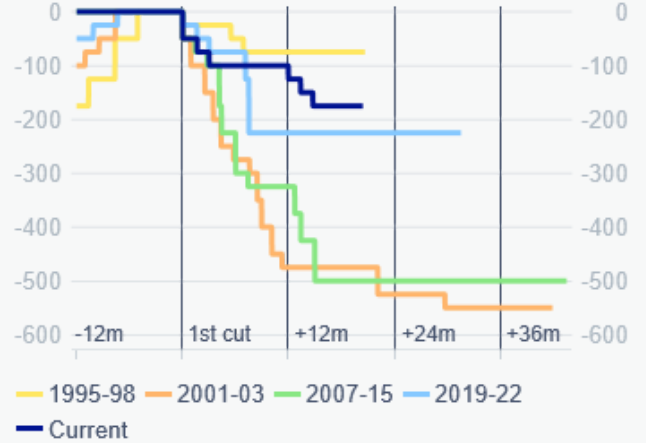
FIGURE 2. FED FUNDS RATE IN EASING CYCLES (%)



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

... adopted in its latest policy decision, during which Powell announced he...

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



Source: BBVA Research / Treasury Dept.

... would remain a member of the FOMC amid continued concerns about potential future...

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



Source: BBVA Research / Treasury Dept.

... pressures on the Fed, which complicate Chair Warsh's chances of building a dovish consensus

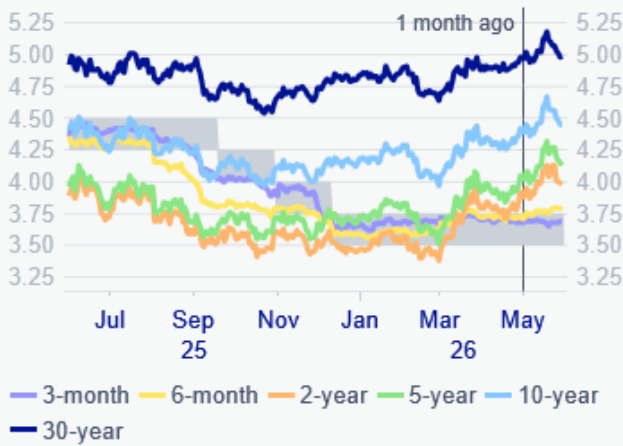
FIGURE 5. 10-YEAR TREASURY YIELD IN EASING CYCLES (%)



Source: BBVA Research / Treasury Dept.

The shift in the curve was particularly eye-catching at the long end, where 30-year...

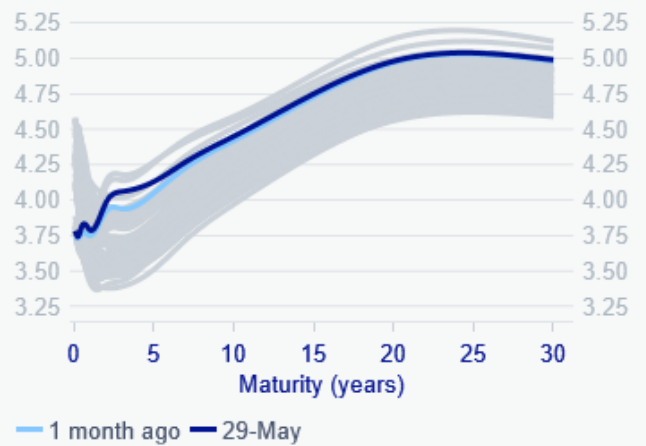
FIGURE 6. TREASURY YIELDS (%)



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

... yields reached 5.2% in mid-May, a level not seen since the onset of the GFC in 2007

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.

Broad measures of bond market volatility have, however, remained largely below historical averages, pointing to continued orderly market functioning and limited signs of stress

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

Despite the rise in 30-year yields, the somewhat narrower spread relative to the 10-year Treasury suggests that investors do not (yet?) perceive a meaningful long-term threat to the US exorbitant privilege

FIGURE 9. TREASURY YIELD SPREADS (BPS)



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

Although a higher term premium initially drove Treasury yields toward their mid-May peak, ...

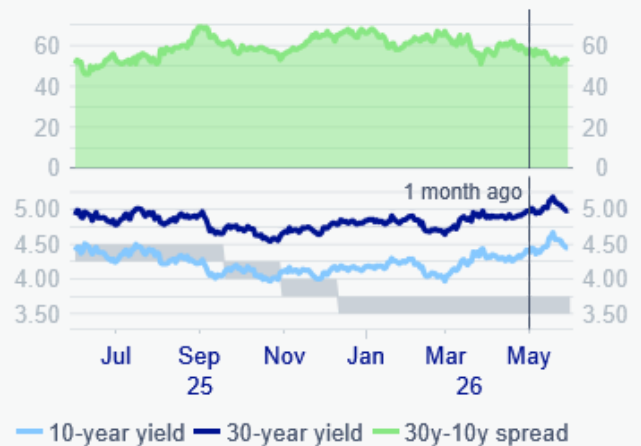
FIGURE 10. 10Y-2Y TREASURY YIELD SPREAD (BPS AND %)



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

... expectations of a higher path for short-term rates have since become ...

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.

... the primary driver as the term premium has moderated...

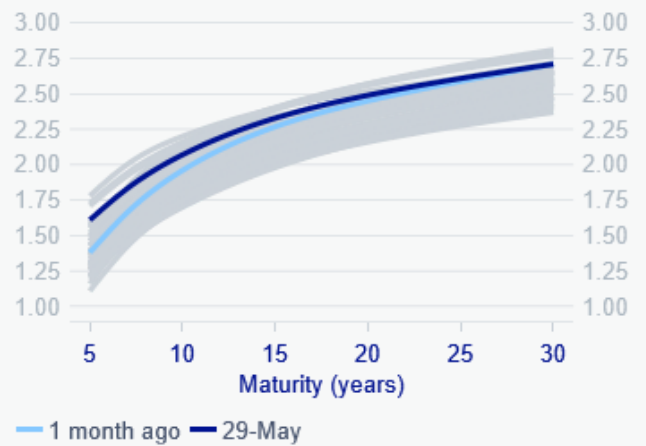
FIGURE 12. TREASURY REAL YIELDS (TIPS) (%)



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

This helps explain why inflation- indexed yields have declined less than...

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.

... nominal yields over the past couple of weeks. In this sense, markets appear to be...

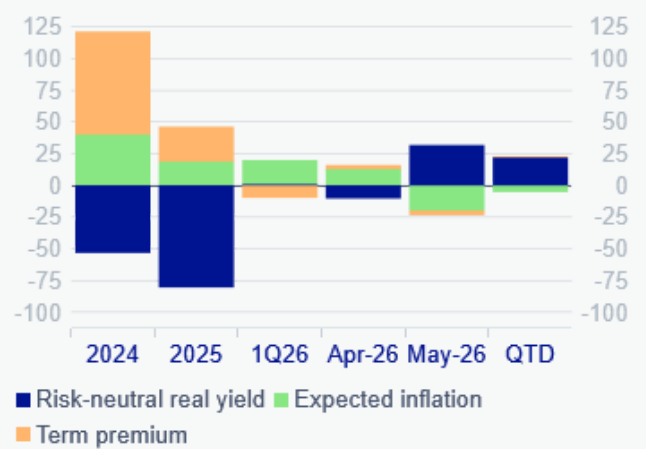
FIGURE 14. BREAK-EVEN INFLATION RATES (%)



Source: BBVA Research / Treasury Dept.

... pricing a higher-for-longer fed funds rate while remaining confident that inflation...

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



* Last: 16-Apr-26; based on the NY Fed ACM model
Source: BBVA Research / Fed / Treasury Dept.

... will remain under control, particularly after the latest FOMC minutes revealed that “a...

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



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

... majority of participants” believed that “some policy firming would likely become...

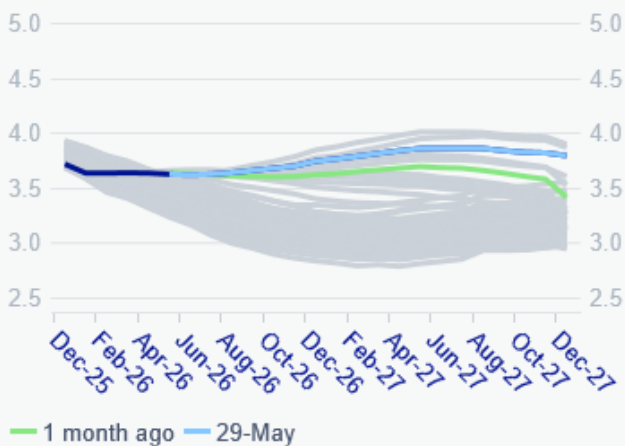
FIGURE 17. 10-YEAR TREASURY YIELD & DXY INDEX (% & INDEX POINTS)



Source: BBVA Research / ICE / Treasury Dept.

... appropriate” if inflation were to continue running persistently above 2%. However, ...

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



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

... markets may be underpricing the risk of renewed Fed easing in the event of labor...

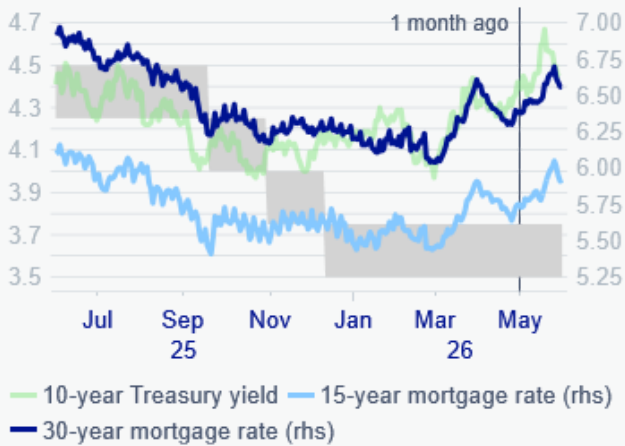
FIGURE 19. FUTURES-IMPLIED FED FUNDS RATE (%)



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

... market downturn. Unsurprisingly, mortgage rates reached their highest since Aug-25

FIGURE 20. 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

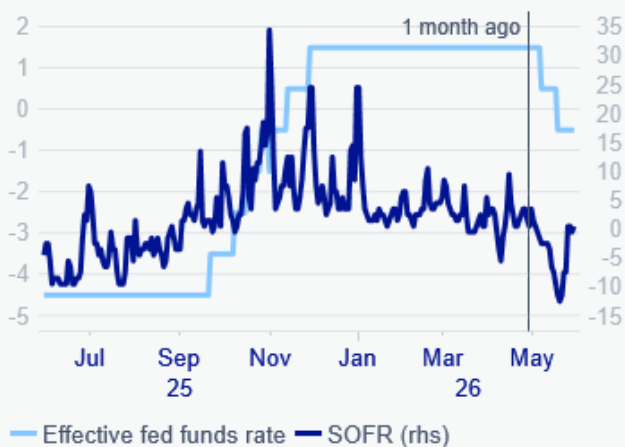
FIGURE 21. CORPORATE BOND YIELD SPREADS (%)



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.

Money markets have continued to stabilize in recent weeks despite seasonal pressures...

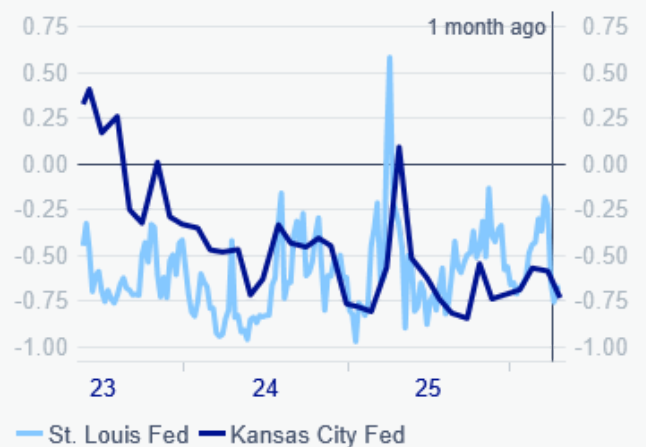
FIGURE 22. MONEY MARKET RATE SPREADS (BPS)



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

... from tax payments, supported by the Fed's ongoing reserve management purchases

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

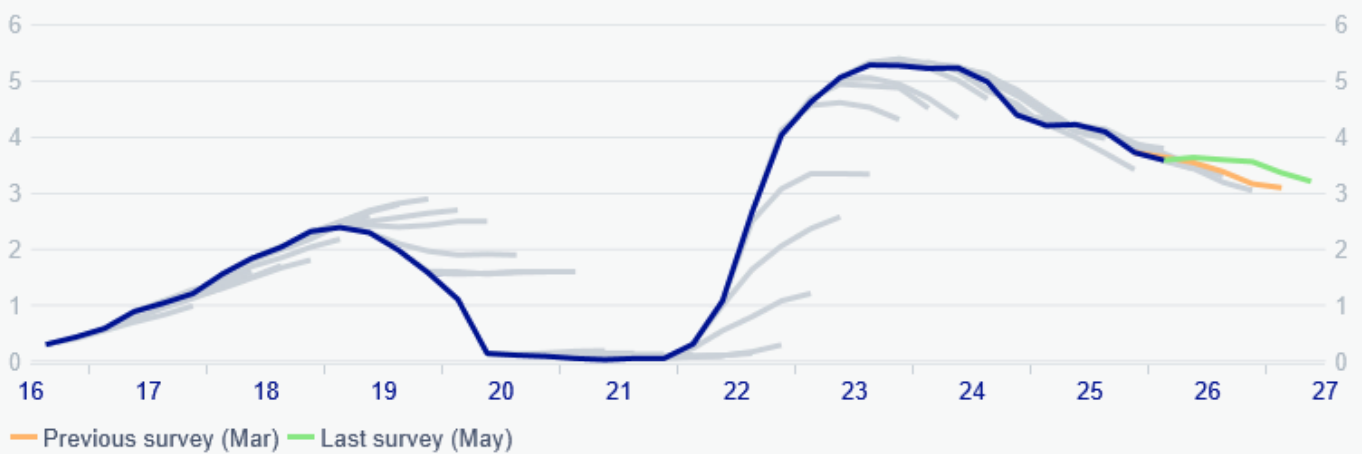


Source: BBVA Research / Fed

The May survey showed that professional forecasters have embraced the higher-for-longer narrative

Unlike the March survey, which was conducted before the outbreak of the war and therefore did not reflect its potential implications for inflation and monetary policy, the May release shows a clear...

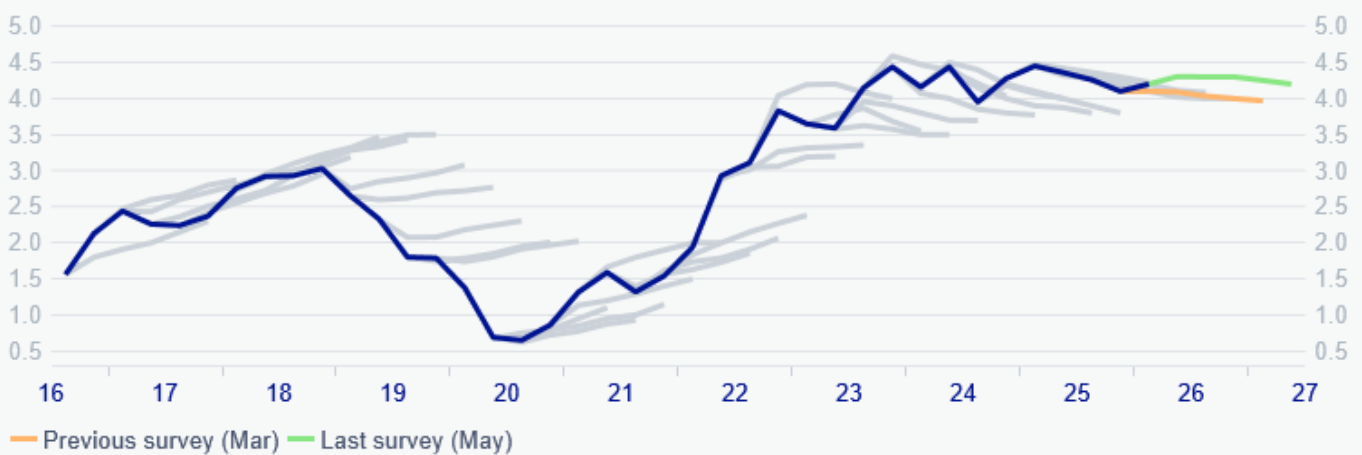
FIGURE 24. PROFESSIONAL FORECASTERS 3-MONTH TREASURY YIELD EXPECTATIONS (%)



Median forecast
Source: BBVA Research / Fed

... upward revision in the expected path for both short- and long-term yields. In particular, the median forecast now envisages the 10-year Treasury yield remaining around 4.3% for the remainder of the year

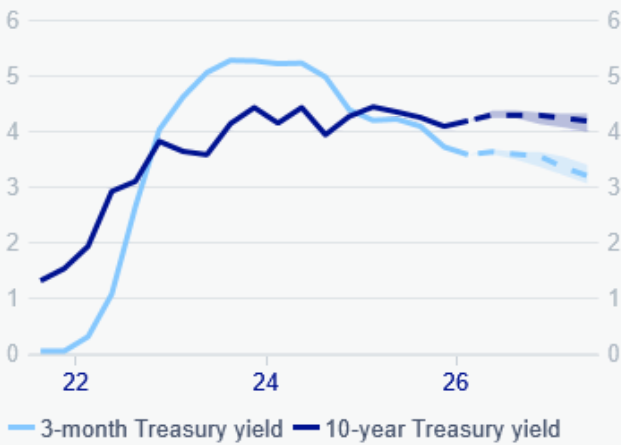
FIGURE 25. PROFESSIONAL FORECASTERS 10-YEAR TREASURY YIELD EXPECTATIONS (%)



Median forecast
Source: BBVA Research / Fed

However, unlike market pricing, which sees policy tightening ahead, prof. forecasters'...

FIGURE 26. PROF. FORECASTERS TREASURY YIELDS EXPECTATIONS (%)



Shaded areas indicate interquartile ranges
Source: BBVA Research / Fed

... baseline scenario still anticipates an eventual resumption of the Fed's rate-cutting cycle

FIGURE 27. PROF. F'CASTERS IMPLIED YIELD SPREAD EXPECTATIONS (BPS)



The shaded area indicates the interquartile range
Source: BBVA Research / Fed

No stress is anticipated in corporate bonds, with forecasters...

FIGURE 28. PROF. FORECASTERS CORPORATE YIELDS EXPECTATIONS (%)



Shaded areas indicate interquartile ranges
Source: BBVA Research / Fed

... expecting the stability of the past couple of years to persist

FIGURE 29. PROF. F'CASTERS IMPLIED CORP. SPREADS EXPECTATIONS (%)



Spreads over the 10-year Treasury yield. Shaded areas indicate interquartile ranges. Source: BBVA Research / Fed

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