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Treasury yields rise as geopolitical risks resurface

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Markets are demanding higher term premia rather than pricing a materially different path for short-term interest rates

While markets still expect the Fed to remain on hold next week, conviction slipped this week—odds fell from 90% to 65% after this week's geopolitical developments (Figures 4 and 5).

The risk repricing has pushed Treasury yields back to levels last seen in early 2025, with the 2-year yield reaching 4.4% and the 10-year yield climbing to 4.7% this week (Figures 6 and 7).

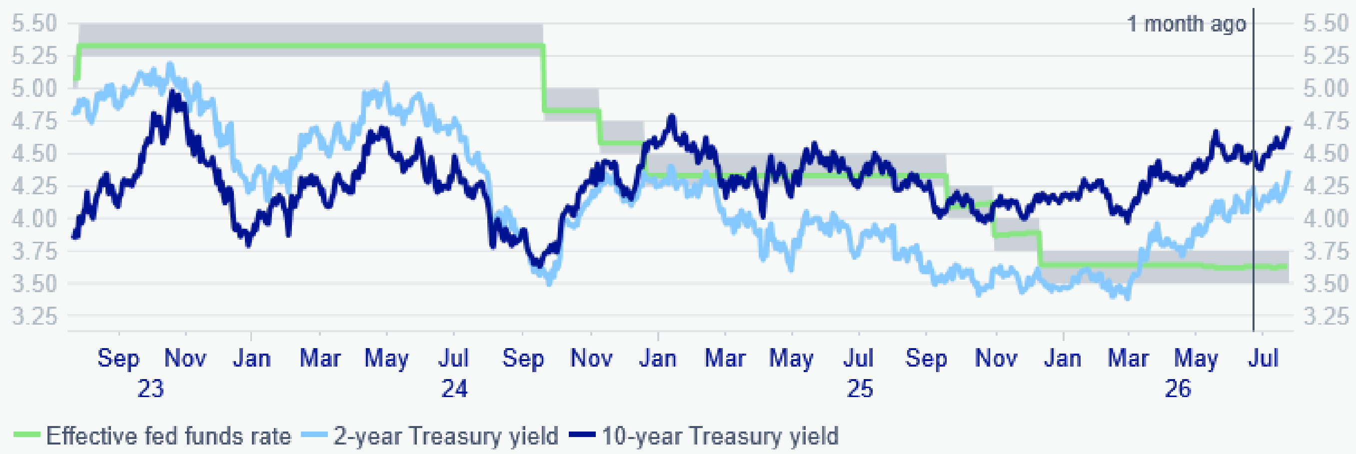
The corresponding rise in real yields and stable breakeven inflation rates suggest that markets are assigning relatively little weight to a deterioration in the inflation outlook (Figures 11 and 12).

It rather indicates that the recent increase in nominal yields has been driven primarily by a rebound in the term premium from its end-June lows (Figure 13).

This explains why the dollar has stopped appreciating. Markets are demanding a higher term premium rather than repricing the short-term interest rate path (Figures 17 and 18).

The renewed escalation in Iran has pushed Treasury yields back to early-2025 levels, as markets again weigh the impact of higher oil prices on inflation and economic growth. As higher oil prices...

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



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

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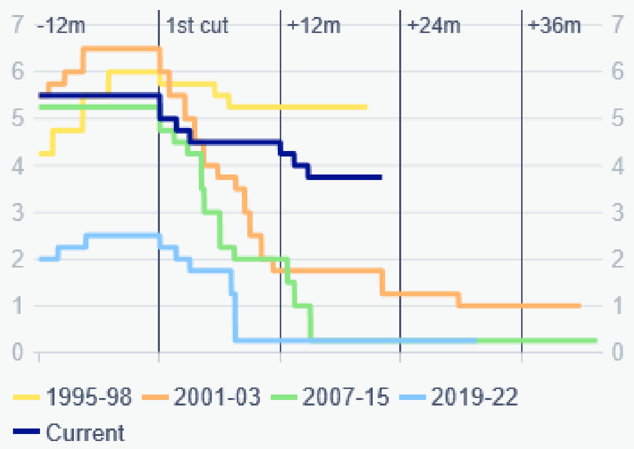
... complicate the inflation outlook, Fed officials will likely maintain or double down on...

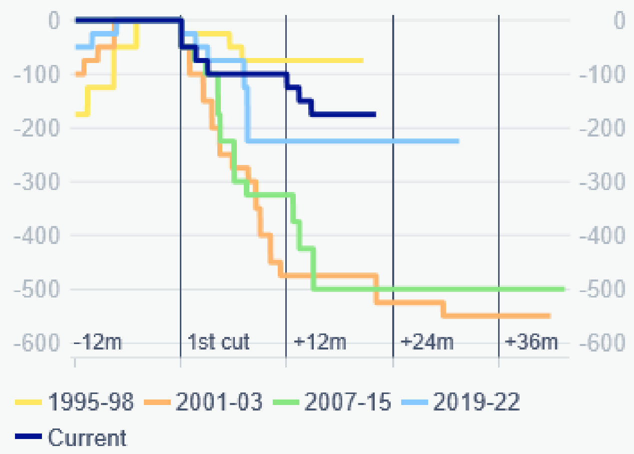
... their cautiously hawkish tone despite June's soft jobs and CPI reports. While markets still...

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

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

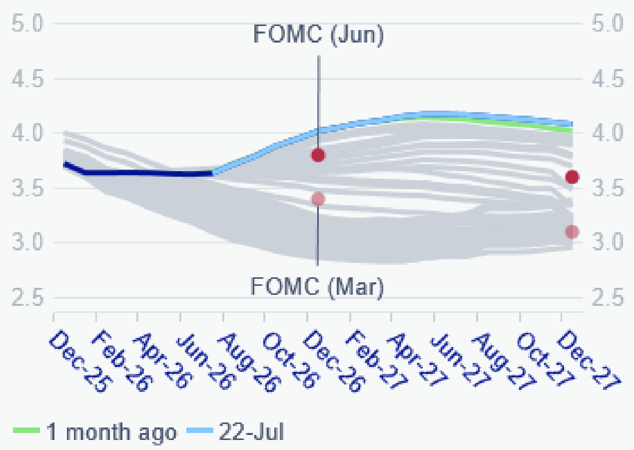


Source: BBVA Research, Treasury Dept.

... expect the Fed to remain on hold next week, conviction slipped this week—odds ...

... fell from 90% to 65% after this week's geopolitical developments

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



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

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

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

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The risk repricing has pushed Treasury yields back to levels last seen in early 2025, with the…

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

Source: BBVA Research, Treasury Dept.

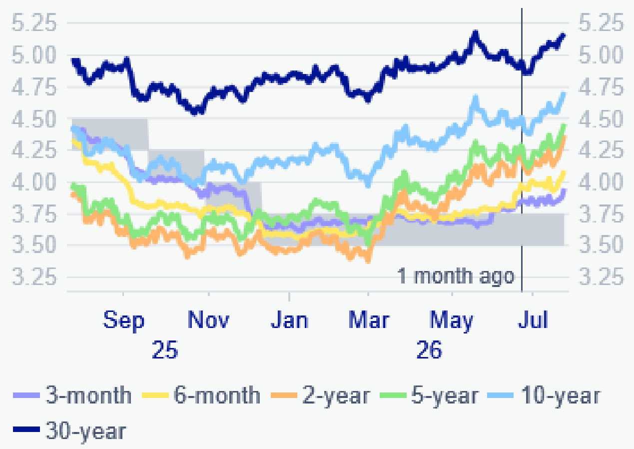
… 2-year yield reaching 4.4% and the 10-year yield climbing to 4.7% this week

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

Source: BBVA Research, Treasury Dept.

The sharpest repricing has taken place at the long end of the curve with the 30-year…

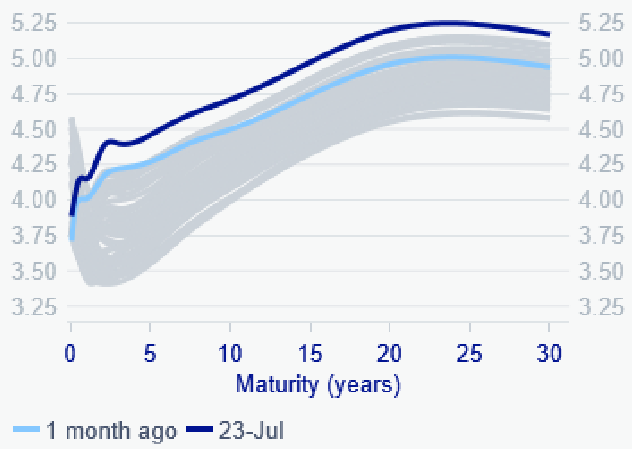
FIGURE 8. TREASURY YIELDS (%)



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

… Treasury yield rising nearly 30 bps in July to 5.2%, its highest level since July 2007

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.

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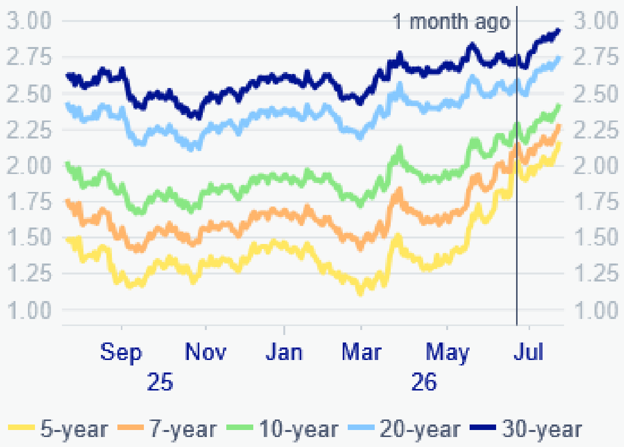
One source of comfort for the Fed is that the corresponding rise in TIPS yields suggests…

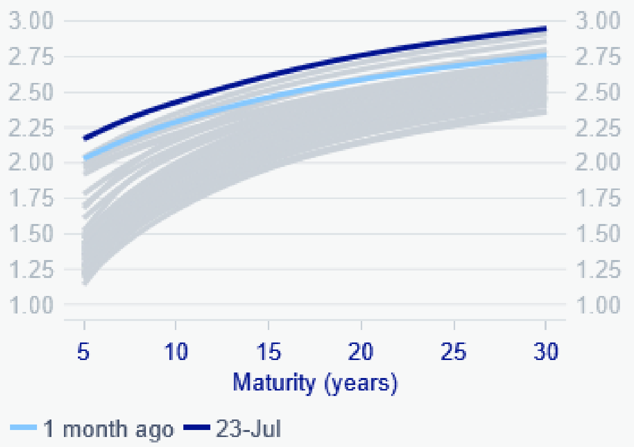
FIGURE 10. TREASURY REAL YIELDS (TIPS) (%)



Source: BBVA Research, Fed, Treasury Dept.

… markets are assigning relatively little weight to a deterioration in the inflation outlook as…

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.

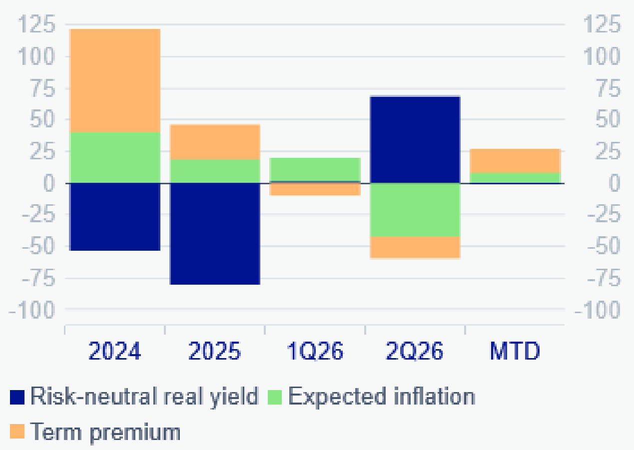
… breakeven inflation remains near last month's levels, indicating the rise in nominal…

FIGURE 12. BREAKEVEN INFLATION RATES (%)

Source: BBVA Research, Treasury Dept.

… yields has been driven primarily by a rebound in the term premium from its end-June lows

FIGURE 13. 10-YEAR TREASURY YIELD CHANGE BREAKDOWN (BPS)



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

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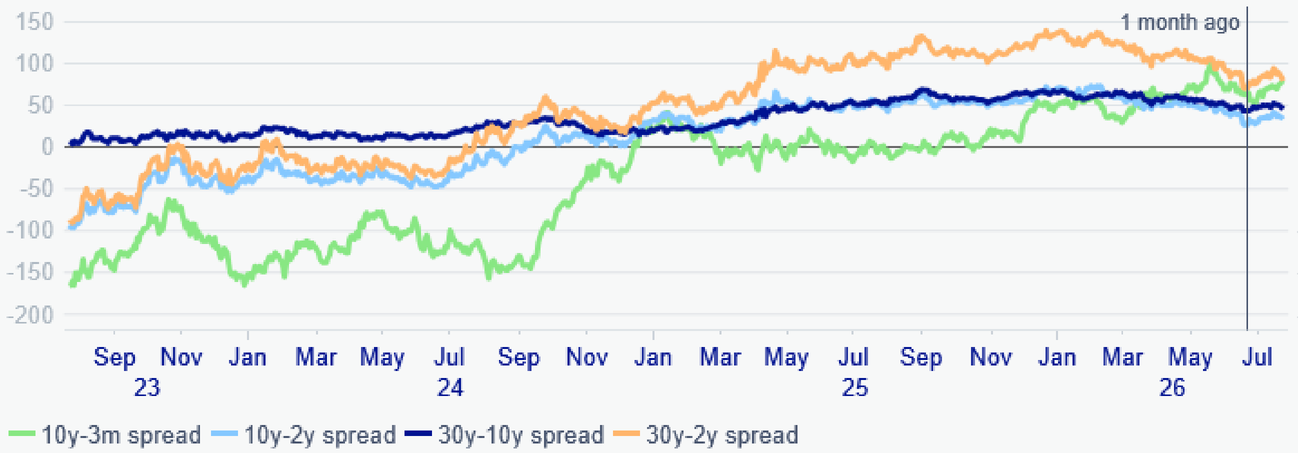
Changes in term spreads have remained relatively limited, suggesting that the repricing has taken place largely through a broad-based upward shift in the yield curve rather than through a material change in…

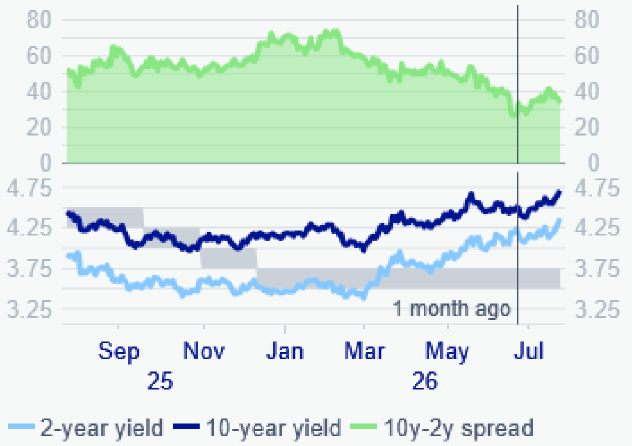
FIGURE 14. TREASURY YIELD SPREADS (BPS)



Source: BBVA Research, NBER, Treasury Dept.

… its slope, consistent with a broad-based increase in compensation for holding mid-…

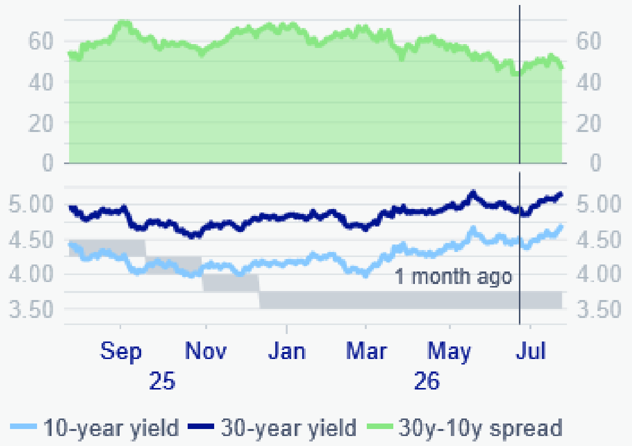
FIGURE 15. 10Y-2Y TREASURY YIELD SPREAD (BPS AND %)



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

… and long-term Treasuries. The shift in what is driving Treasury yields helps explain…

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.

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... why the dollar has stopped appreciating. Markets are demanding a higher term...

FIGURE 17. 10-YEAR TREASURY YIELD BREAKDOWN (%)

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

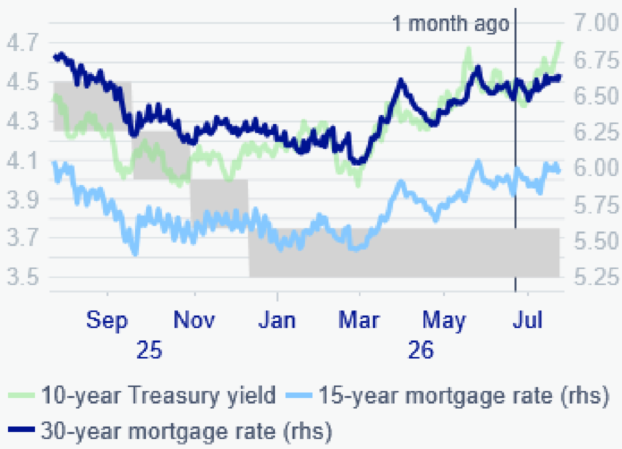
... premium rather than repricing the short-term interest rate path

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

Source: BBVA Research, ICE, Treasury Dept.

Mortgage rates have moved only modestly despite higher Treasury yields

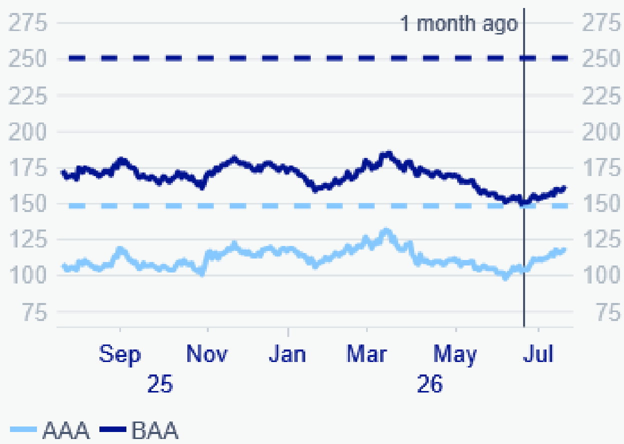
FIGURE 19. MORTGAGE RATES (%)



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.

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

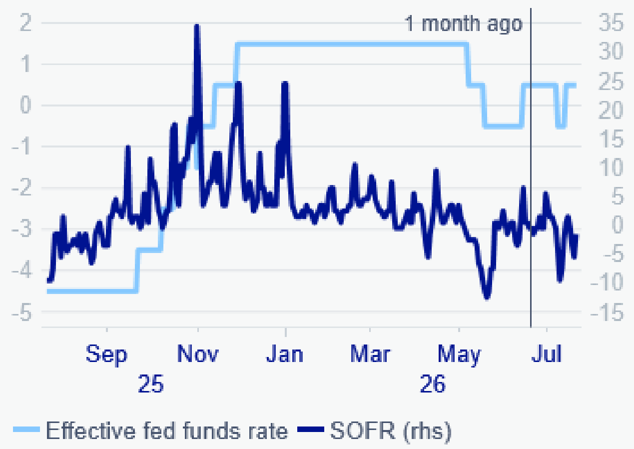
FIGURE 21. ICE BOFAML MOVE INDEX (INDEX POINTS)

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 remain consistent with orderly market functioning…

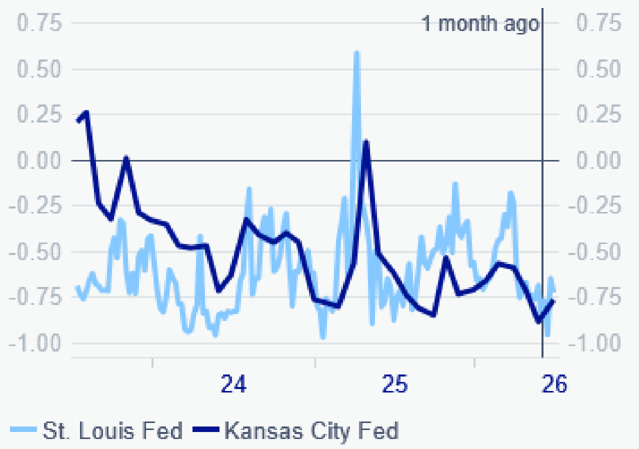
… despite the recent geopolitical developments

FIGURE 22. MONEY MARKET RATE SPREADS (BPS)



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

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



Source: BBVA Research, Fed

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