

US Interest rates monitor

# Are higher risk premia preventing long-term yields from falling further?

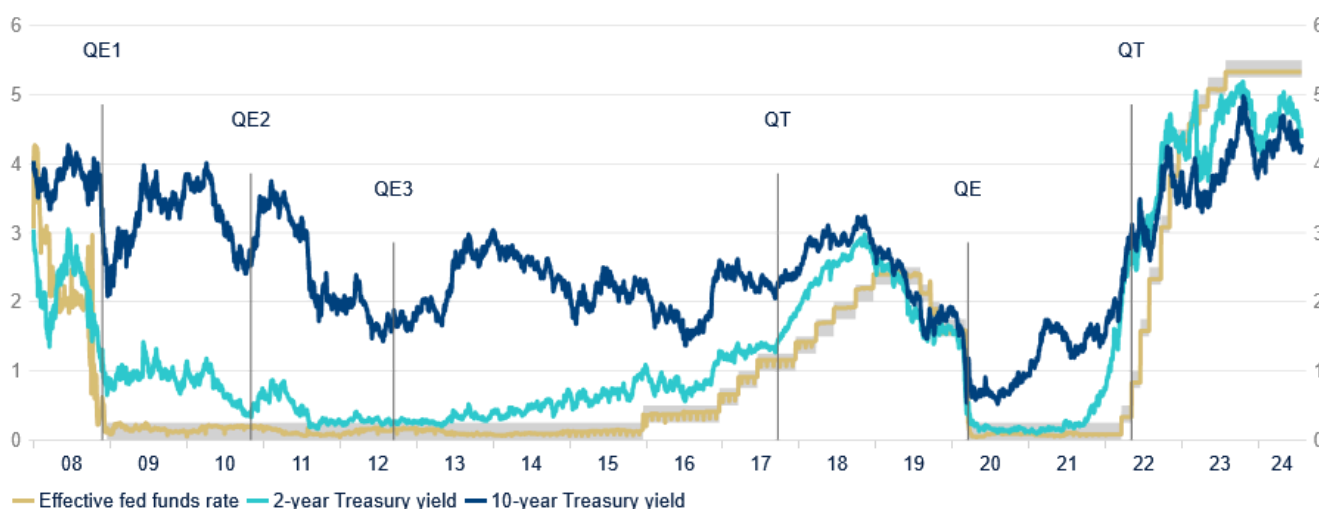
Javier Amador / Iván Fernández  
July 25, 2024

## Markets are certain of a rate cut in September, but are also likely pricing in risks in the event of a Trump’s second term

- The 2-year yield has declined by 30 bps since late June on strong investors’ demand at the most recent auctions; buyers are likely seeking to lock in higher interest rates before cuts from the Fed ([Figure 4](#)).
- The 10-year yield has been hovering in a narrow range around 4.3%, only breached temporarily in the early days of July to a 4.5% high following the first presidential debate ([Figure 5](#)).
- Markets probably brought out their perception of greater long-term risks in the event of a Trump’s second term, since he would likely favor more inflationary trade and tax policies ([Figures 7](#) and [14](#)).
- The FOMC is unlikely to say that recent “good data” is enough to consider rate cuts, but a further recognition of risks around their employment goal could drive the 10y-2y yield spread above zero soon ([Figure 10](#)).
- The futures market is almost fully pricing in that the Fed will cut rates by 50 bps this year (95% implied chances) and continue to anticipate roughly 100 bps worth of rate cuts next year ([Figures 21](#) and [22](#)).

One year has passed since the Fed last raised the policy rate. Since then, the FOMC has gone from being “highly attentive to inflation risks” to recognizing that “elevated inflation is not the only risk [they] face”

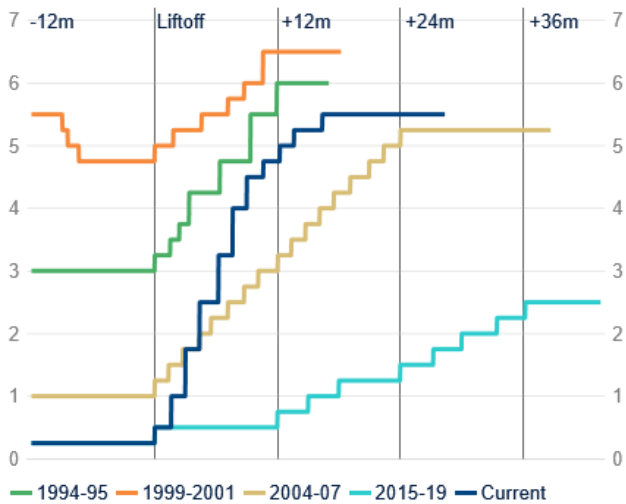
Figure 1. FED FUNDS RATE AND TREASURY YIELDS (%)



The gray area indicates the fed funds rate target range; QE and QT indicate quantitative easing and tightening announcements  
Source: BBVA Research / Fed / Treasury

Growing expectations that the Fed is about to begin a rate-cut cycle (in September) have...

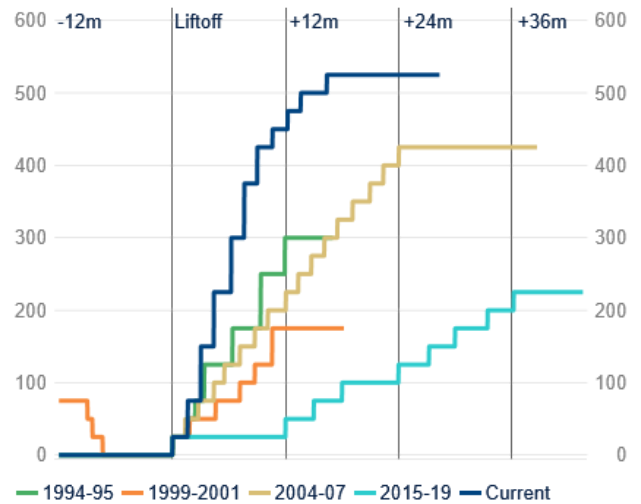
Figure 2. **FED FUNDS RATE IN TIGHTENING CYCLES (%)**



Target rate for the 1994-95, 1999-2001, and 2004-07 cycles; upper limit of the target rate range for the 2015-19 and current cycles  
Source: BBVA Research / Fed

... not fully reflected along the entire yield curve. The 2-year yield has declined by 30 bps...

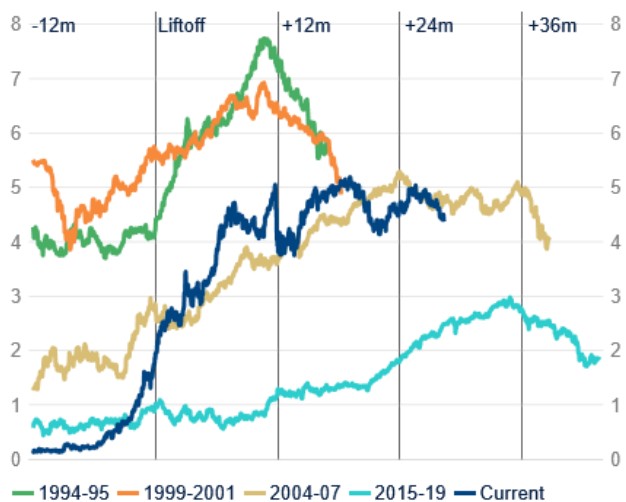
Figure 3. **FED FUNDS RATE IN TIGHTENING CYCLES (BPS VS RATE AT LIFTOFF)**



Source: BBVA Research / Fed

... since late June on strong investors' demand at the most recent Treasury auctions, which likely...

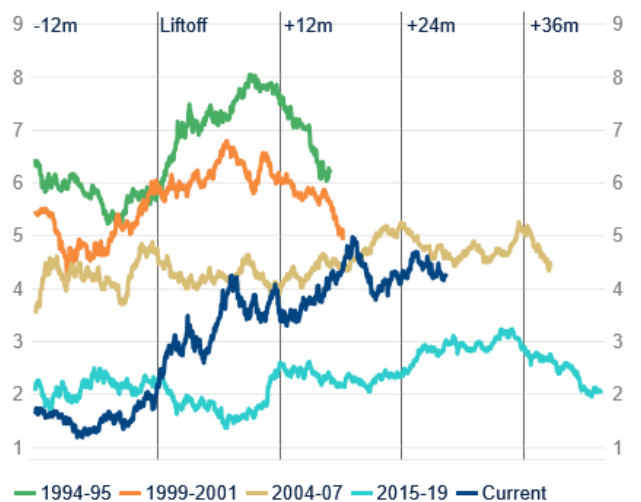
Figure 4. **2-YEAR TREASURY YIELD IN TIGHTENING CYCLES (%)**



Source: BBVA Research / Treasury

... indicates that buyers are seeking to lock in higher interest rates before cuts from the Fed

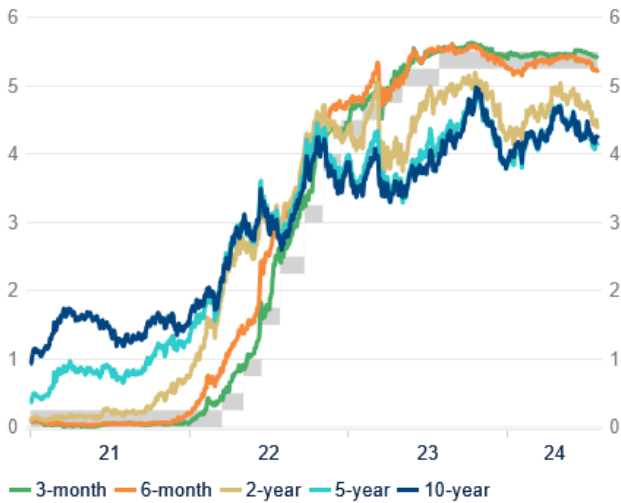
Figure 5. **10-YEAR TREASURY YIELD IN TIGHTENING CYCLES (%)**



Source: BBVA Research / Treasury

On the other hand, the 10-year yield has been hovering in a narrow range around 4.3%, only...

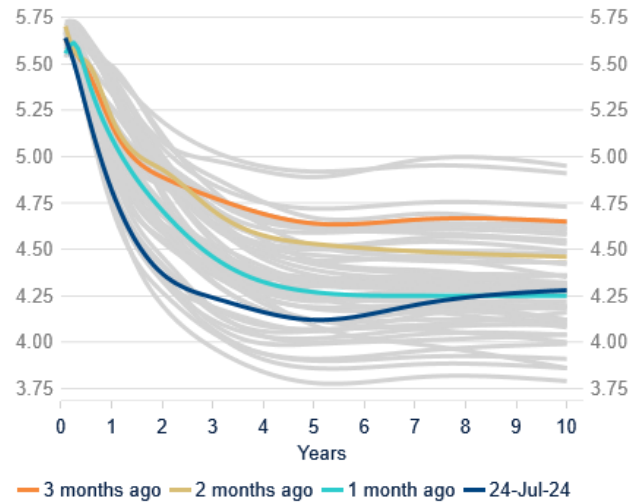
Figure 6. **TREASURY YIELDS**  
(%)



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

... breached briefly in the early days of July (to a 4.5% high) after Trump's second term odds...

Figure 7. **TREASURY YIELD CURVE**  
(%)



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

... jumped following the presidential debate, which likely brought out the market's...

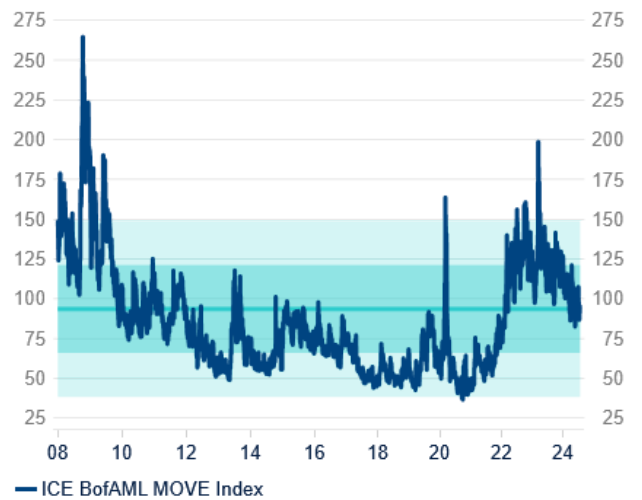
Figure 8. **10-YEAR TREASURY YIELD DAILY CHANGE**  
(% AND BPS)



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

... perception of greater inflation risks on higher chances of inflationary trade and tax policies

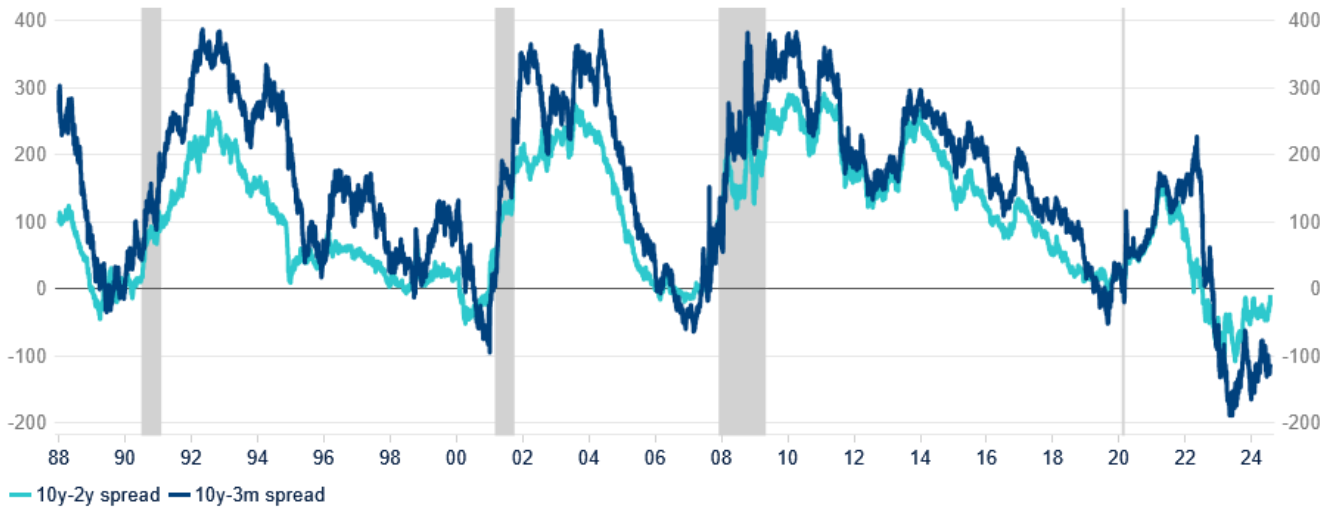
Figure 9. **ICE BOFAML MOVE INDEX**  
(BPS)



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

The decline of the 2-year Treasury yield coupled with the stability of the 10-year yield drove the 10y-2y yield spread to a -9bp two-year high as of yesterday. Even if the FOMC is unlikely to say next week that...

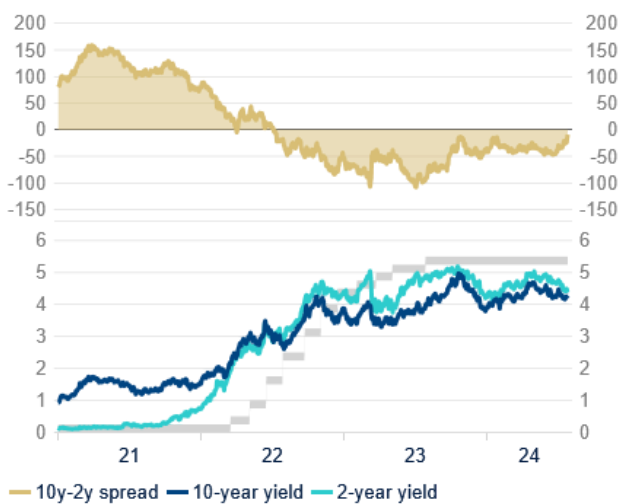
Figure 10. **TREASURY YIELD SPREADS (BPS)**



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

... recent “good data” is enough for them to start considering rate cuts, a further recognition...

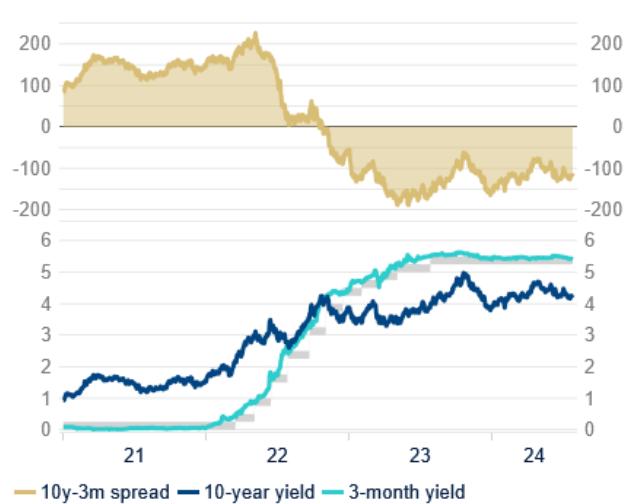
Figure 11. **10Y-2Y TREASURY YIELD SPREAD (BPS AND %)**



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

... of rising risks around their employment goal could drive this spread above zero soon

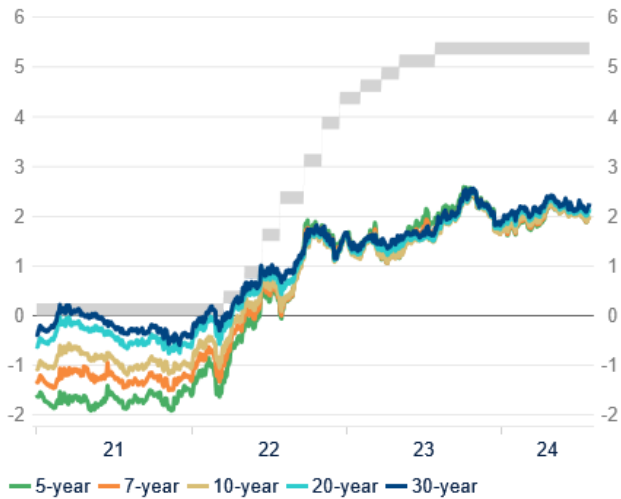
Figure 12. **10Y-3M TREASURY YIELD SPREAD (BPS AND %)**



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

**Higher long-term fiscal risks in the face of a possible return of Trump to the White House...**

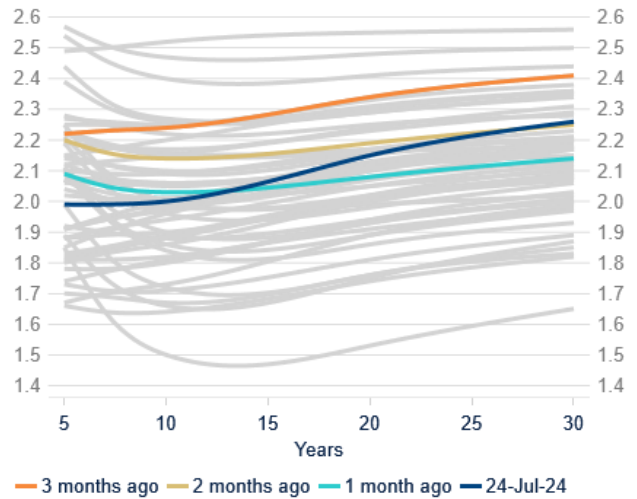
Figure 13. **TREASURY REAL YIELDS (TIPS)** (%)



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

**... are likely mostly priced in behind the relatively smaller decline in very long-term real yields**

Figure 14. **TREASURY REAL YIELD CURVE (TIPS)** (%)



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

**Market-based long-term inflation expectations remain well anchored and thus have generally...**

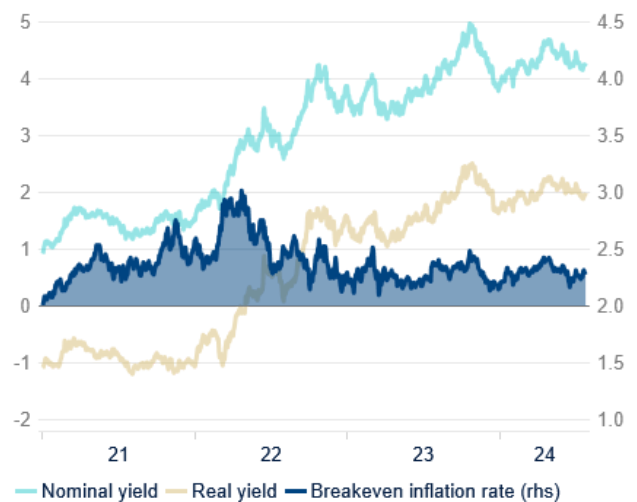
Figure 15. **5-YEAR TREASURY BREAK-EVEN INFLATION RATE (%)**



The shaded area indicates the deviation from the 2% inflation target  
Source: BBVA Research / Treasury

**... stopped explaining relevant movements in nominal yields for several months, though they...**

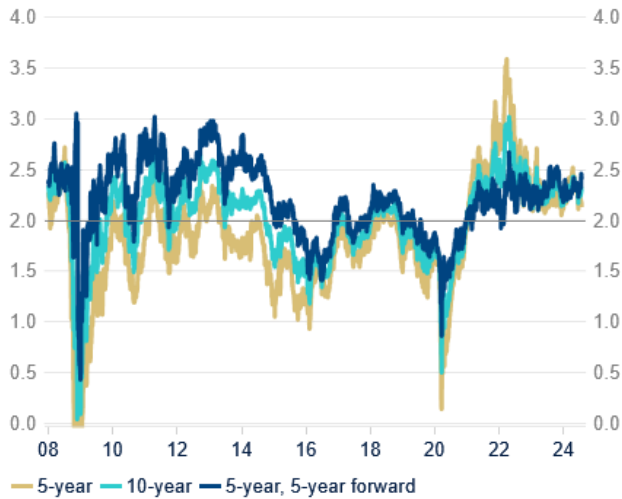
Figure 16. **10-YEAR TREASURY BREAK-EVEN INFLATION RATE (%)**



The shaded area indicates the deviation from the 2% inflation target  
Source: BBVA Research / Treasury

... continue to influence policy rate expectations and suggest there is some more room...

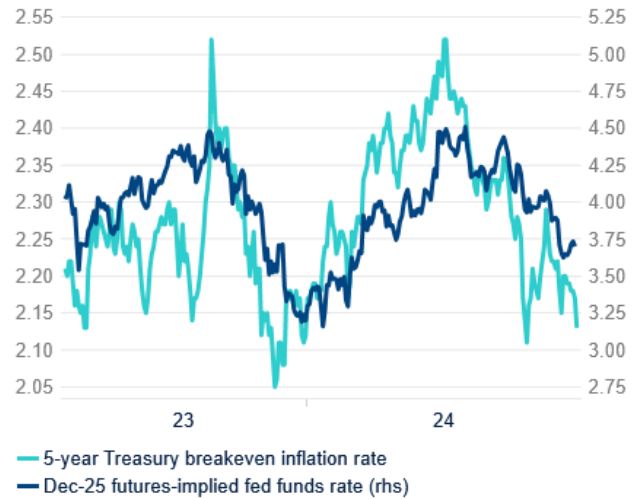
Figure 17. **BREAKEVEN INFLATION RATES (%)**



Source: BBVA Research / Treasury

... for pricing in a lower fed funds rate next year. On the other hand, changes in the term...

Figure 18. **BREAKEVEN INFLATION AND FUTURES-IMPLIED FED FUNDS RATE (%)**



Source: BBVA Research / Treasury / CME

... premium could begin to have greater relative importance as financial markets better assess...

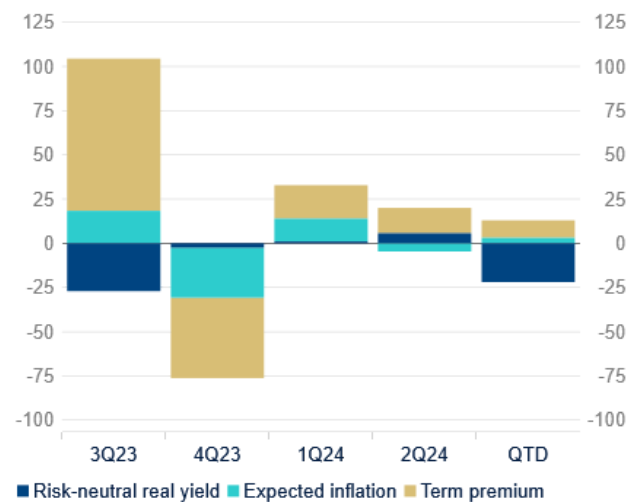
Figure 19. **10-YEAR TREASURY YIELD AND TERM PREMIUM (%)**



The gray area indicates the fed funds rate target range; the term premium is based on the NY Fed ACM model. Source: BBVA Research / Fed / Treasury

... risks ahead amid possible structural changes following the pandemic-related inflationary era

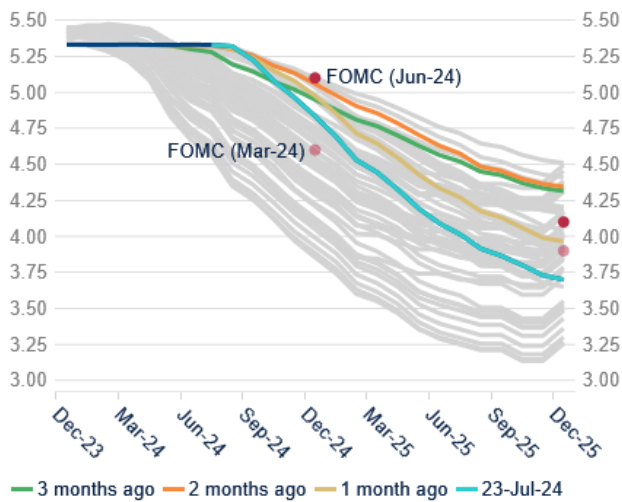
Figure 20. **10-YEAR TREASURY YIELD CHANGE BREAKDOWN (BPS)**



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

The futures market is almost fully pricing in that the Fed will cut rates by 50 bps this year (95% ...

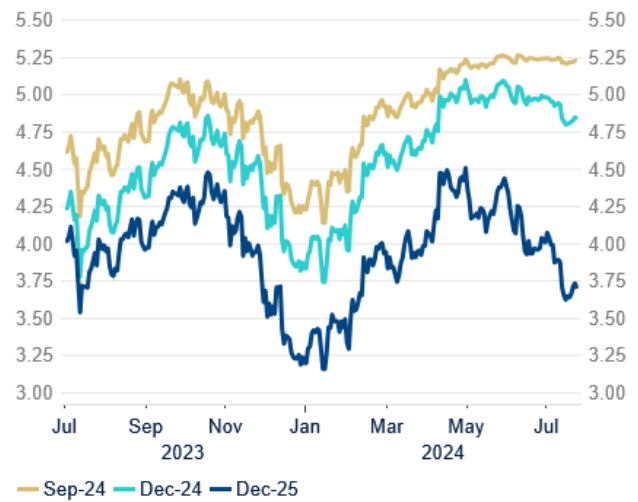
Figure 21. FUTURES-IMPLIED FED FUNDS RATE (%)



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

... implied chances) and continue to anticipate roughly 100 bps worth of rate cuts next year

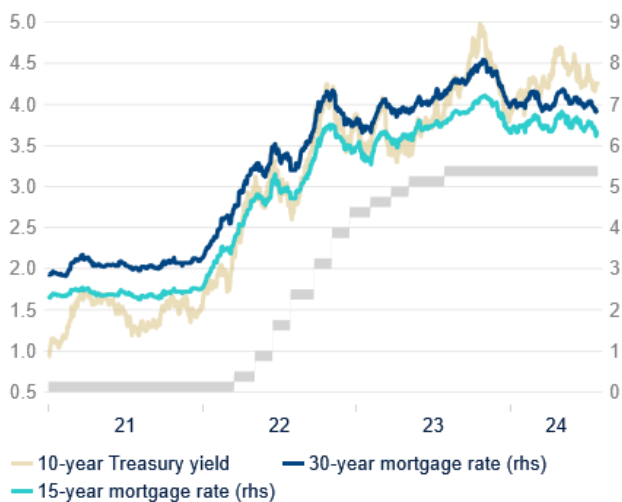
Figure 22. FUTURES-IMPLIED FED FUNDS RATE (%)



Source: BBVA Research / CME

More certainty on rate cuts ahead has driven 30-year mortgage rates below 7%

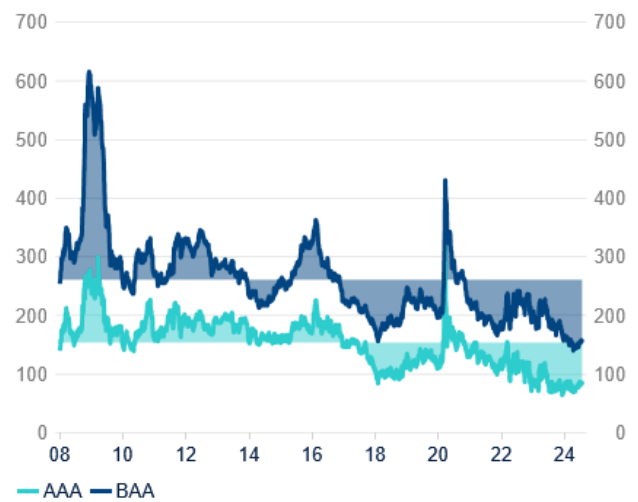
Figure 23. MORTGAGE RATES (%)



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

Investment-grade corporate bond spreads remain well below average

Figure 24. CORPORATE BOND YIELD SPREADS (BPS)

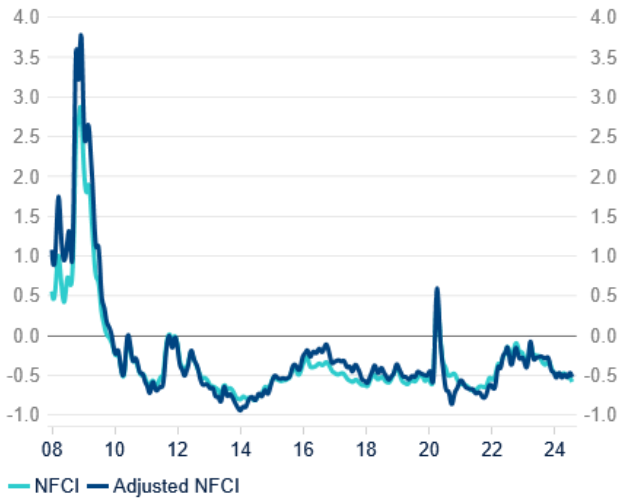


Spreads over the 10-year Treasury yield; the shaded area indicates the deviation from the historical average since 2008  
Source: BBVA Research / Fed / Treasury



A noteworthy aspect of the current tightening cycle is that credit has remained readily...

Figure 25. **CHICAGO FED NATIONAL FINANCIAL CONDITIONS INDEX (>0: TIGHTER THAN AVG.)**



Source: BBVA Research / Fed

... available to most households and businesses, though at elevated interest rates. Delinquency...

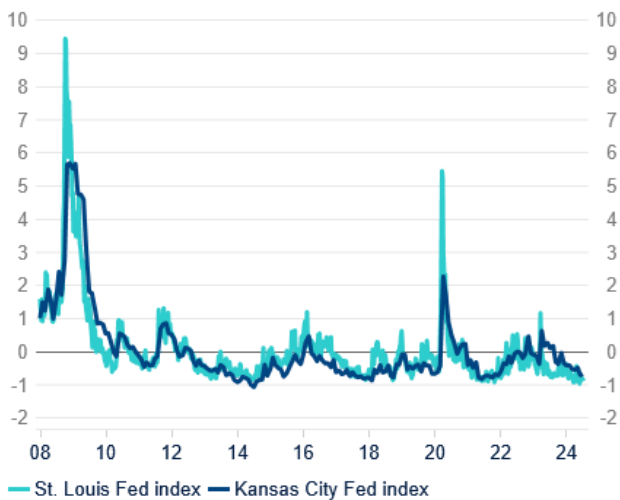
Figure 26. **BLOOMBERG US FINANCIAL CONDITIONS INDEX (<0: TIGHTER THAN PRE-GFC AVG.)**



Source: BBVA Research / Bloomberg

... rates (e.g., credit cards and auto loans) are raising some concerns. Whether the Fed...

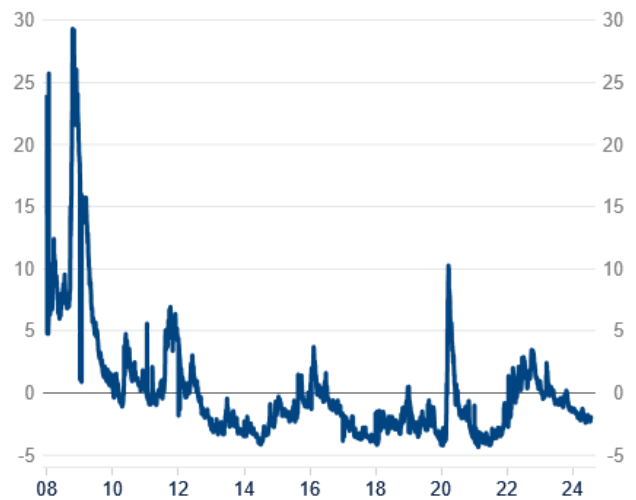
Figure 27. **FED FINANCIAL STRESS INDEXES (>0: ABOVE AVG. FINANCIAL STRESS)**



Source: BBVA Research / Fed

... succeeds in avoiding widespread financial stress remains to be seen

Figure 28. **OFR FINANCIAL STRESS INDEX (>0: ABOVE AVG. FINANCIAL STRESS)**



OFR: Office of Financial Research  
Source: BBVA Research / Treasury



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