

US Interest rates monitor

# The Treasury market prices in the Fed is likely behind the curve

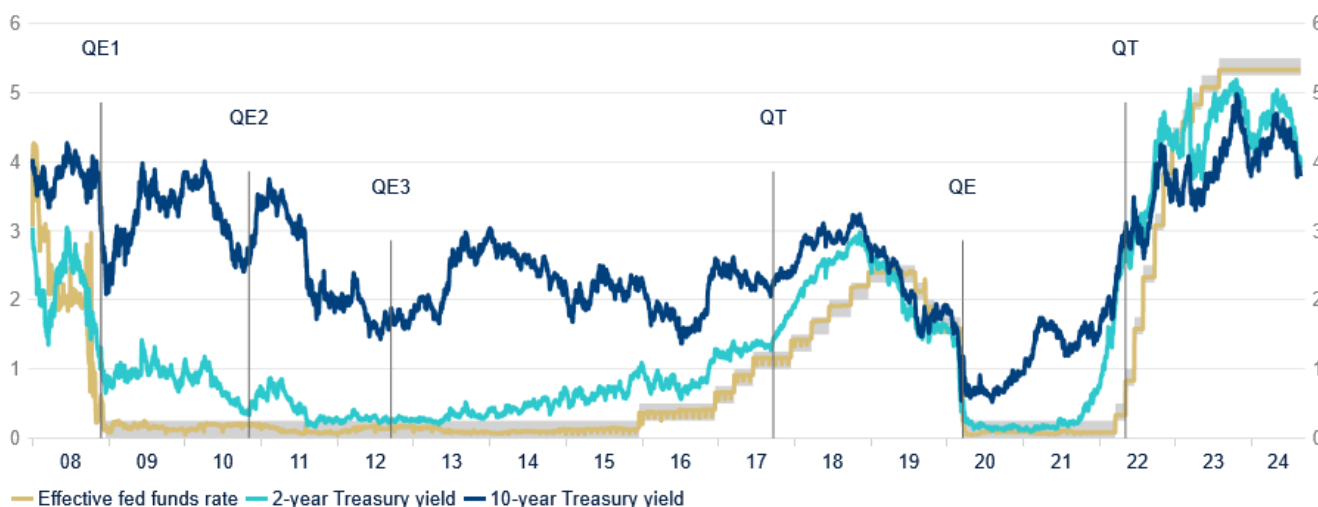
Javier Amador / Iván Fernández  
August 22, 2024

## Investors seem to continue to overweight warning signals from last month’s jobs report despite recent less gloomy activity data

- Yields on 2- and 10-year Treasury notes have declined by c. 40 and 30 bps so far this month to their lowest since late December 2023 (Figures 4 and 5).
- Both 3- and 6-month T-bill yields are down to a level consistent with a 5.00-5.25% fed funds rate target range (Figures 6 and 7), which suggests the Treasury market is fully convinced a 25bp rate cut is around the corner.
- The 10y-2y Treasury yield spread uninverted briefly on an overdone pessimism around the economic outlook (Figure 10). Recent activity data has suggested a soft landing is still the most likely outcome.
- “A couple” of participants noted that inflation pressures “might persist for some time,” but the majority of FOMC officials are likely confident enough to begin cutting rates amid well anchored expectations (Figure 17).
- While just a month ago the futures market was expecting no more than three 25bp rate cuts this year, it now assigns a 30% chance that the Fed will deliver 125bp worth of rate cuts before year end (Figures 21 and 22).

Treasury yields plummeted following a weaker-than-expected 114k new non-farm payrolls figure for July, further enhancing FOMC members’ confidence that disinflation resumed its course towards 2%

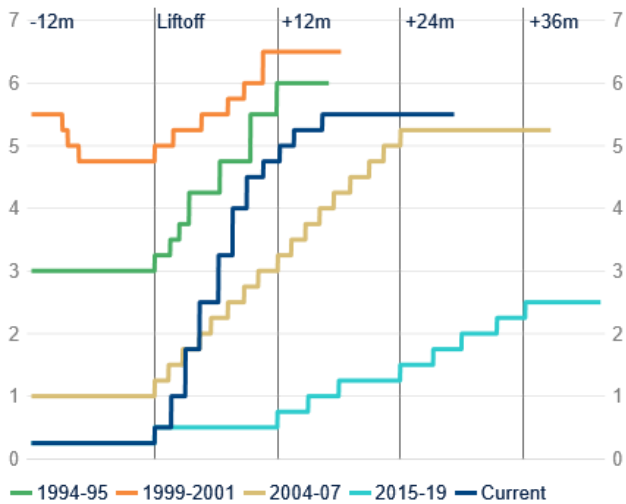
Figure 1. FED FUNDS RATE AND TREASURY YIELDS (%)



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

**July's meeting minutes confirmed a Fed's dovish shift, with "a vast majority" of FOMC officials...**

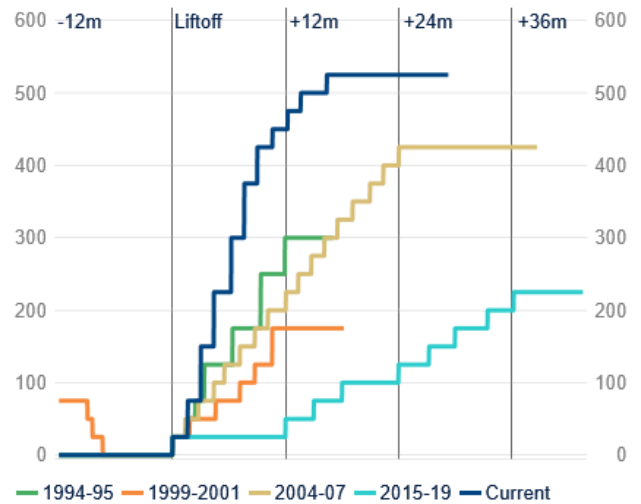
Figure 2. **FED FUNDS RATE IN TIGHTENING CYCLES (%)**



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

**... observing that "it would likely be appropriate to ease policy at the next meeting" in September**

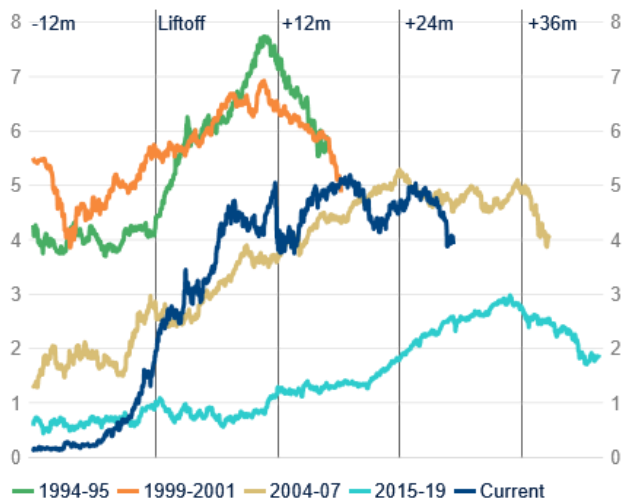
Figure 3. **FED FUNDS RATE IN TIGHTENING CYCLES (BPS VS RATE AT LIFTOFF)**



Source: BBVA Research / Fed

**Yields on 2- and 10-year Treasury notes have declined by c. 40 and 30 bps so far this month...**

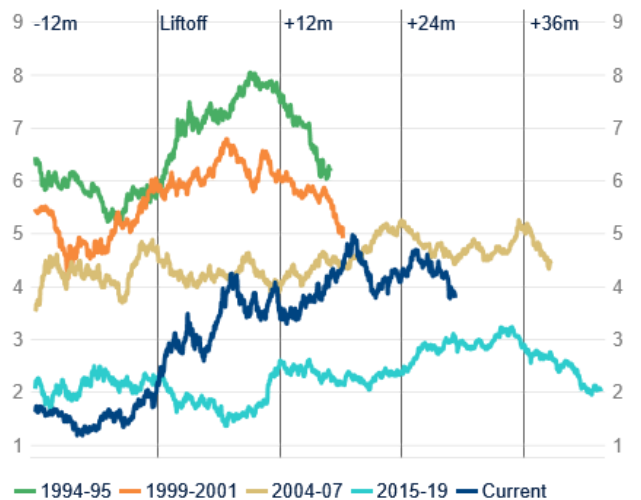
Figure 4. **2-YEAR TREASURY YIELD IN TIGHTENING CYCLES (%)**



Source: BBVA Research / Treasury

**... to their lowest since late Dec-23. Both 3- and 6-month yields are down to a level consistent...**

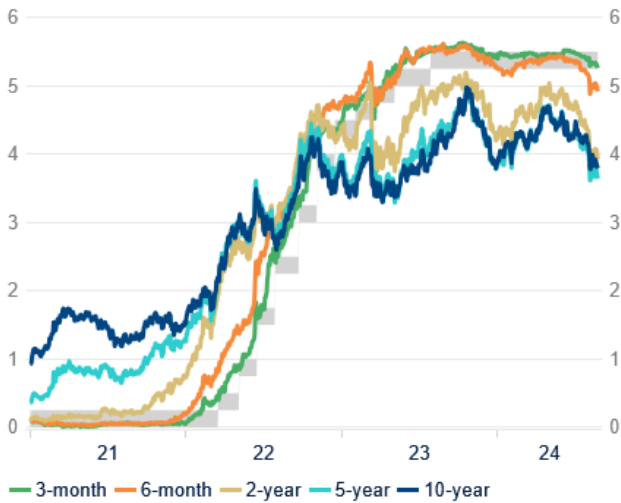
Figure 5. **10-YEAR TREASURY YIELD IN TIGHTENING CYCLES (%)**



Source: BBVA Research / Treasury

... with a 5.00-5.25% fed funds rate target range, which suggests the Treasury market is fully...

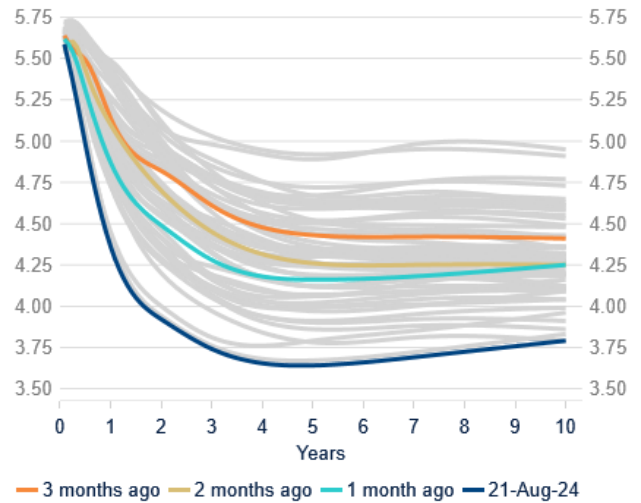
Figure 6. **TREASURY YIELDS**  
(%)



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

... convinced a 25bp rate cut is around the corner. The early-Aug global market turmoil driven by...

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

... a BOJ policy shift combined with the seasonal low market liquidity is likely behind the recently...

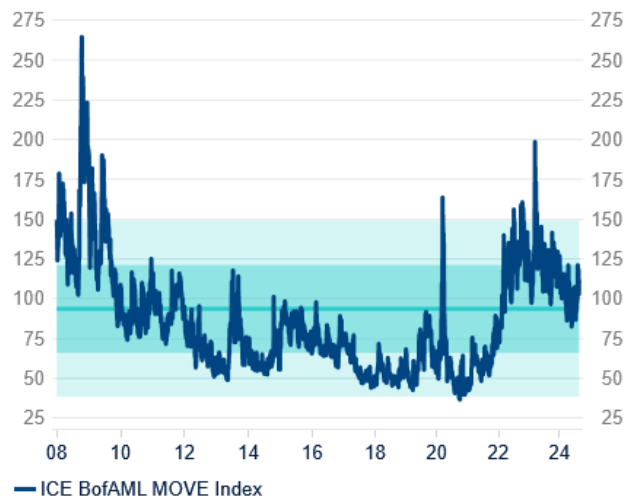
Figure 8. **10-YEAR TREASURY YIELD DAILY CHANGE**  
(% AND BPS)



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

... increased bond market volatility, which has however not exceeded last year's average level

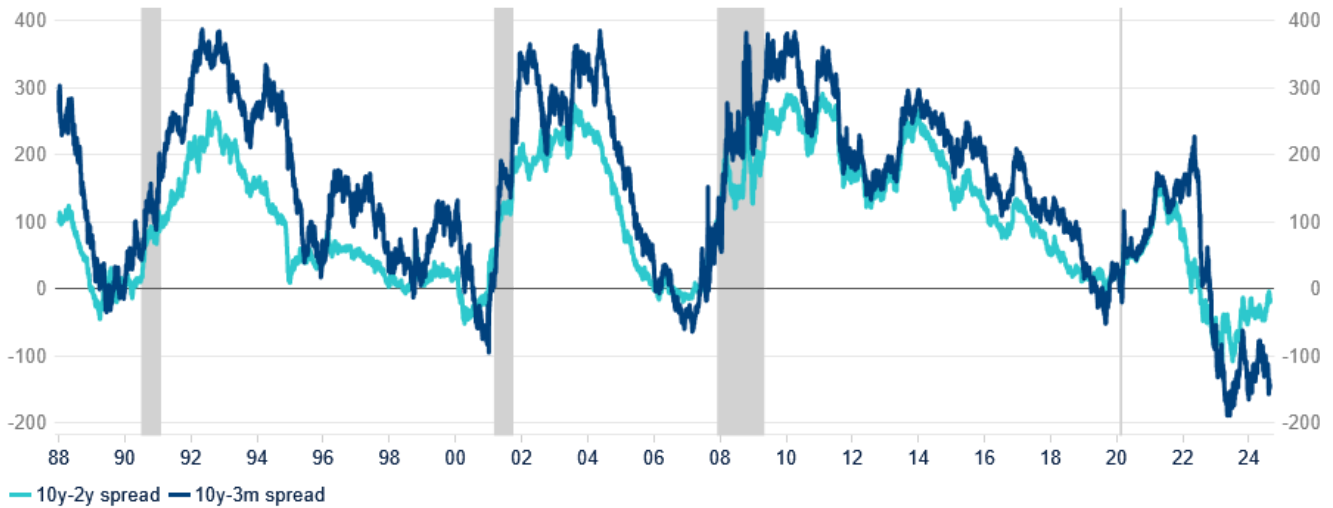
Figure 9. **ICE BOFAML MOVE INDEX**  
(BPS)



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

The mid-to-long section of the Treasury yield curve is now broadly flat as evidenced by the 10y-2y yield spread, which uninverted briefly on intraday operations (August 5th) when markets priced in the need...

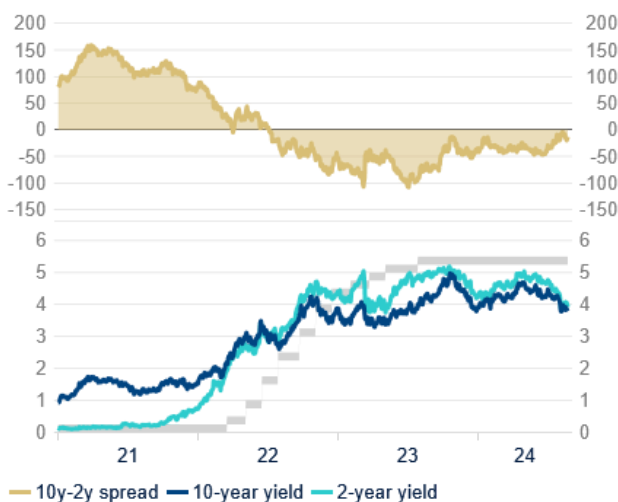
Figure 10. **TREASURY YIELD SPREADS (BPS)**



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

... for a 50bp rate cut on an overdone pessimism around the economic outlook. Recent activity...

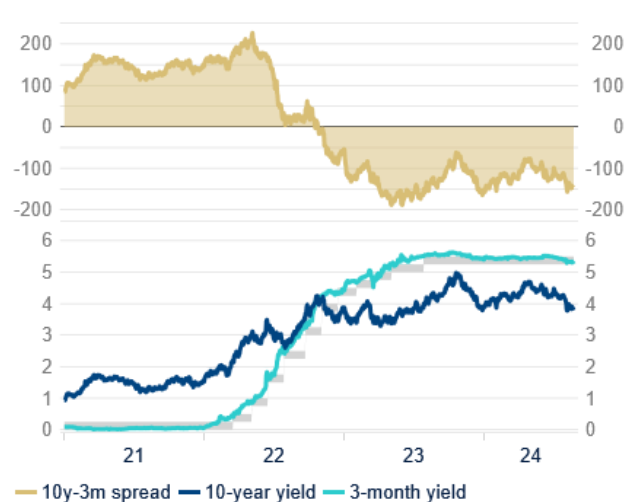
Figure 11. **10Y-2Y TREASURY YIELD SPREAD (BPS AND %)**



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

... data has suggested a soft landing is still the most likely outcome. The Fed is likely to begin...

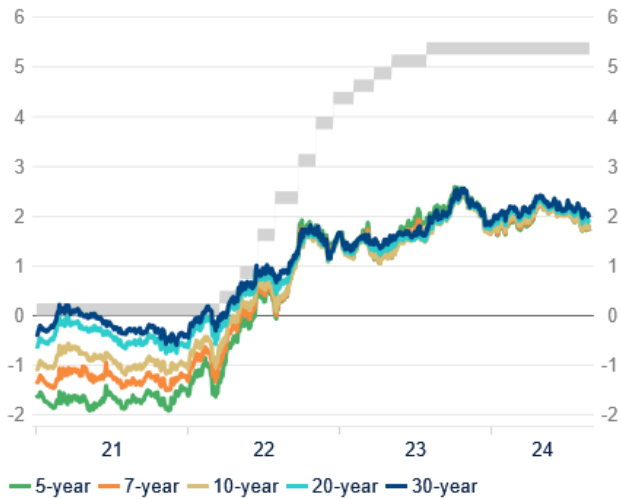
Figure 12. **10Y-3M TREASURY YIELD SPREAD (BPS AND %)**



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

... removing the policy restriction on an orderly basis, but is also aware that “the risk [has]...

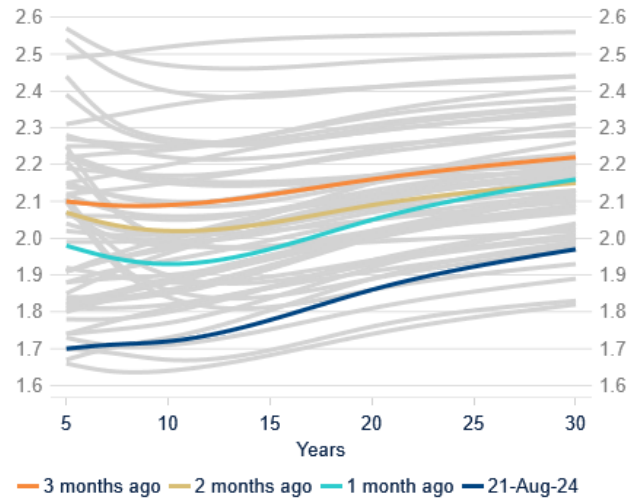
Figure 13. **TREASURY REAL YIELDS (TIPS)**  
(%)



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

... increased that continued easing [in the LM] could transition to a more serious deterioration”

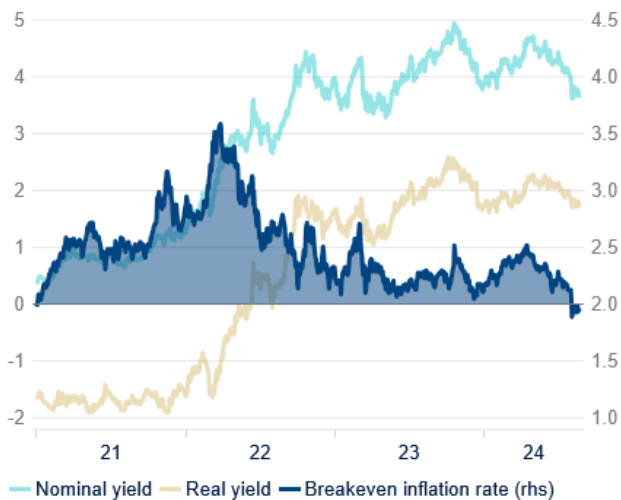
Figure 14. **TREASURY REAL YIELD CURVE (TIPS)**  
(%)



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

At its lowest since early 2021, well-anchored inflation expectations have underpinned the...

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



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

... disinflation process. “A couple” of participants noted that inflation pressures “might persist...”

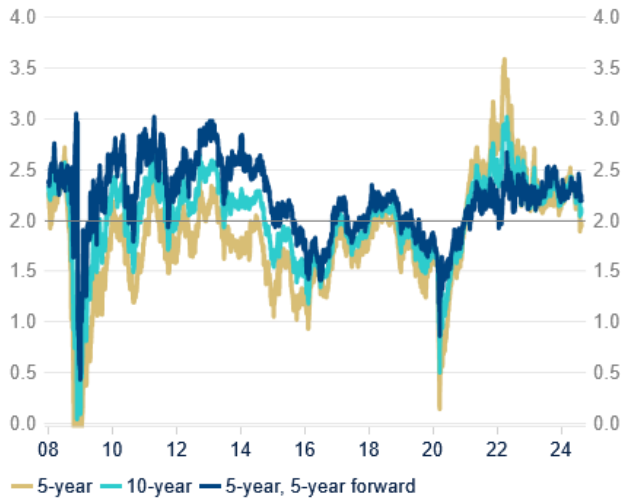
Figure 16. **10-YEAR TREASURY BREAK-EVEN INFLATION RATE (%)**



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

... for some time” based on the “considerable momentum” of the economy. However, the...

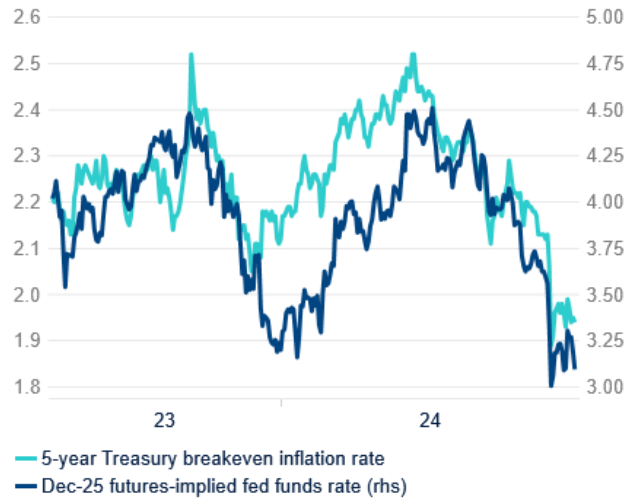
Figure 17. **BREAKEVEN INFLATION RATES (%)**



Source: BBVA Research / Treasury

... majority of FOMC officials are likely confident enough to begin cutting rates next month

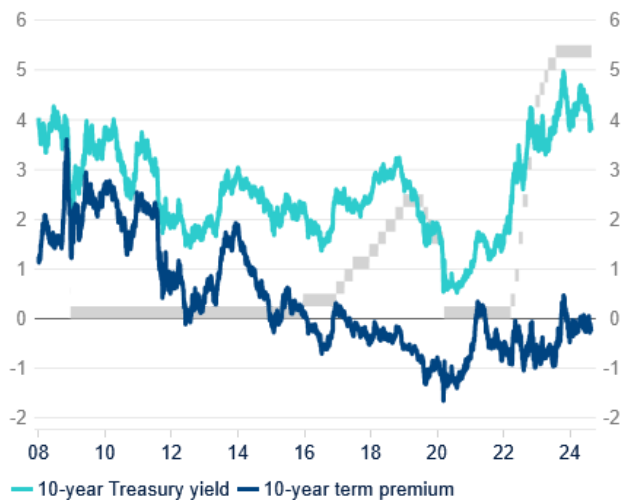
Figure 18. **BREAKEVEN INFLATION AND FUTURES-IMPLIED FED FUNDS RATE (%)**



Source: BBVA Research / Treasury / CME

1Q concerns around inflation have more than reversed in 3Q. Changes in the term premium...

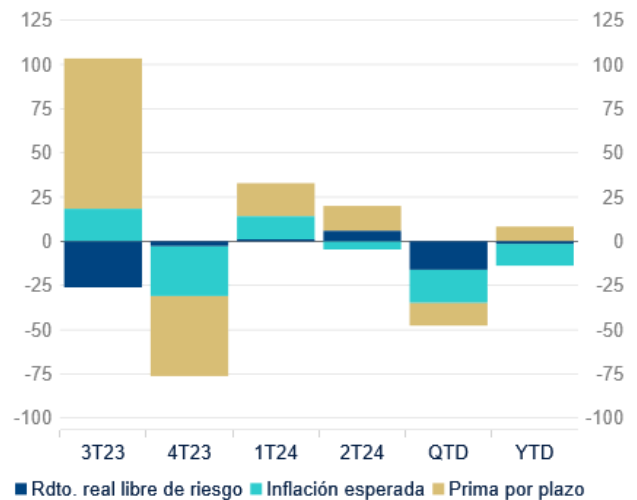
Figure 19. **10-YEAR TREASURY YIELD AND TERM PREMIUM (%)**



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

... going forward will likely cease to relate largely to inflation and monetary policy uncertainty

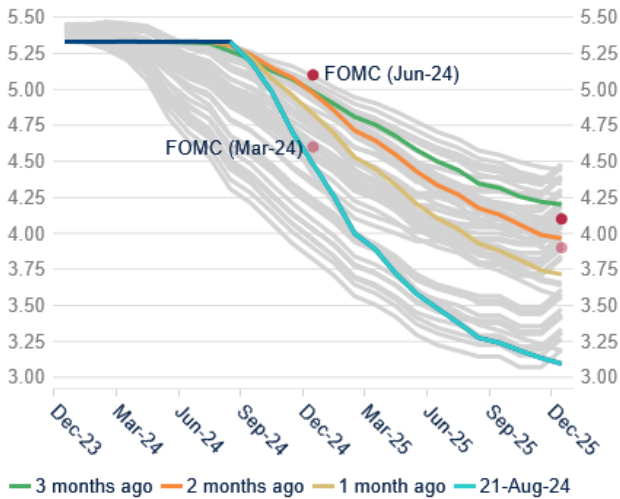
Figure 20. **10-YEAR TREASURY YIELD CHANGE BREAKDOWN (BPS)**



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

While just a month ago the futures market was expecting no more than three 25bp rate cuts...

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



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

... this year, it now assigns a 30% chance that the Fed will deliver 125bp worth of rate cuts

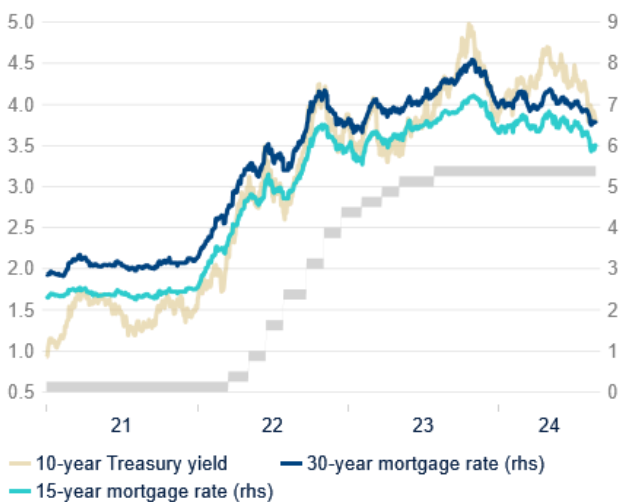
Figure 22. FUTURES-IMPLIED FED FUNDS RATE (%)



Source: BBVA Research / CME

The sharp decline of long-term yields continued to improve prospects for homebuyers, but...

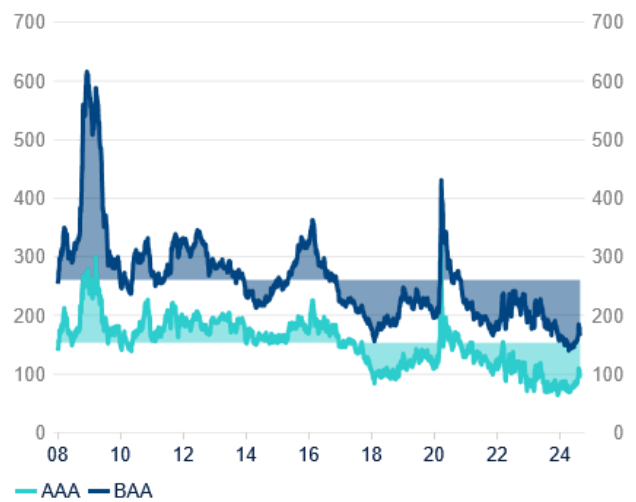
Figure 23. MORTGAGE RATES (%)



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

... at the same time, it led to some pressure on the still historically low IG corporate spreads

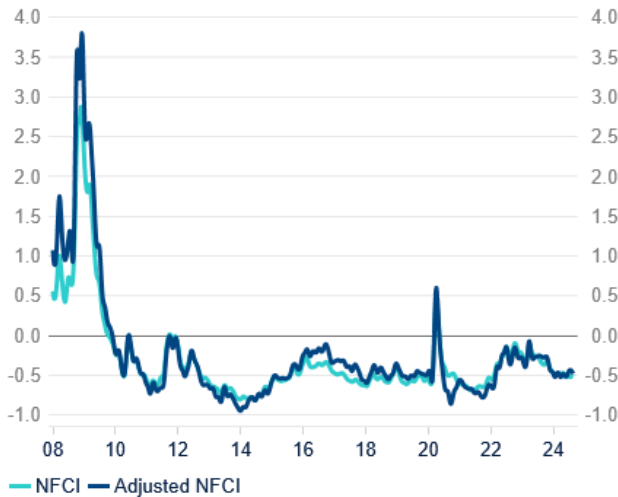
Figure 24. CORPORATE BOND YIELD SPREADS (BPS)



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

**The temporary but sharp spike of financial stress in early-Aug could reinforce the Fed's staff...**

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



Source: BBVA Research / Fed

**... opinion that financial system vulnerabilities remain notable: "estimates of risk premiums..."**

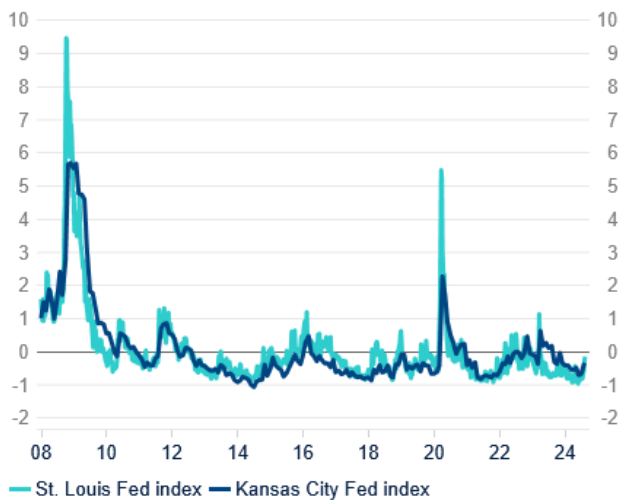
Figure 26. **BLOOMBERG US FINANCIAL CONDITIONS INDEX (<0: TIGHTER THAN PRE-GFC AVG.)**



Source: BBVA Research / Bloomberg

**... across key markets [are] low compared to historical standards," which suggests that...**

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



Source: BBVA Research / Fed

**... some degree of complacency among investors is behind elevated asset valuation pressures**

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



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

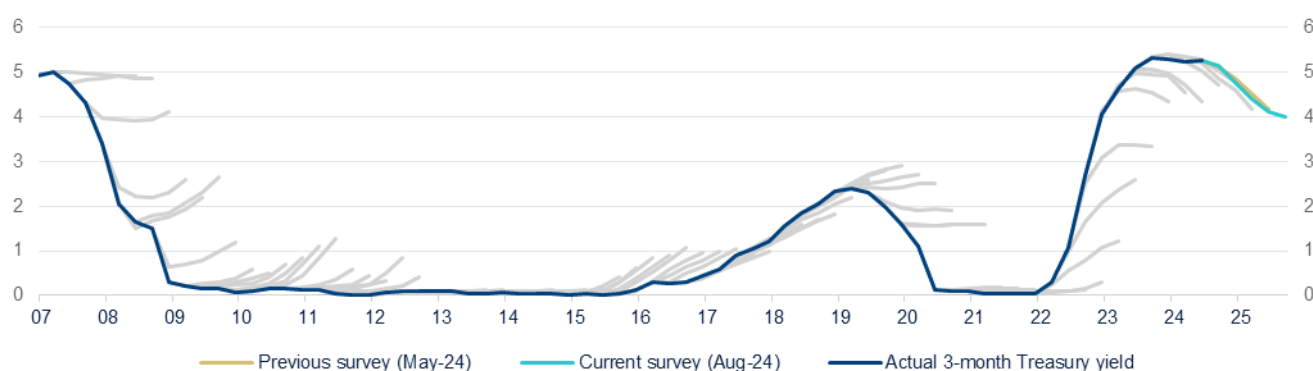


## Professional forecasters revised down their Treasury yield projections, but they likely fell short

- Professional forecasters surveyed this month by the Philadelphia Fed expect a 4.75% 3-month Treasury yield by 4Q24, just 15 bps below their expectation in May (Figure 29).
- The median forecaster slightly revised down his/her 10-year Treasury yield projection, which is still expected to remain above 4% until mid-2025 (Figure 30), even after it dropped below that threshold since August 1st.
- The survey timing may have affected the results: all forecasts were received on or before August 6th, but some respondents could have responded immediately after they were sent the survey questionnaire on July 25th.

**Professional forecasters' projections for short-term Treasury yields are at odds with market-implied expectations of a faster rate-cut cycle than the one signaled by FOMC participants in their latest SEP**

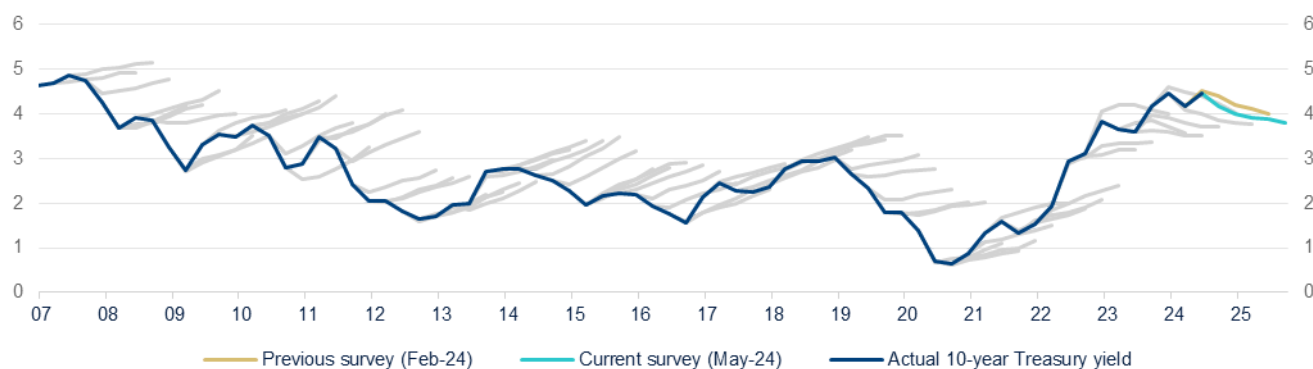
Figure 29. **PROFESSIONAL FORECASTERS 3-MONTH TREASURY YIELD EXPECTATIONS (%)**



Median values. The gray lines indicate historic Professional Forecasters' expectations.  
Source: BBVA Research based on data by Haver Analytics.

**They also revised down their long-term rate forecasts, but they probably failed to incorporate the developments of the last two weeks and thus fell short due to unfortunate survey timing**

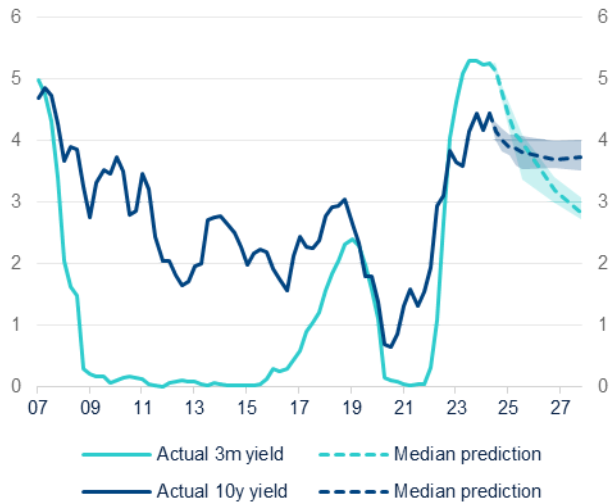
Figure 30. **PROFESSIONAL FORECASTERS 10-YEAR TREASURY YIELD EXPECTATIONS (%)**



Median values. The gray lines indicate historic Professional Forecasters' expectations.  
Source: BBVA Research based on data by Haver Analytics.

**The implied expectation that the upcoming easing cycle will extend through 2027...**

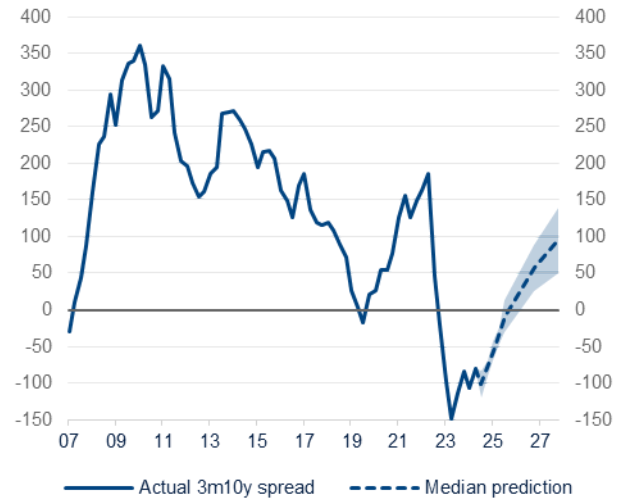
Figure 31. **PROF. FORECASTERS TREASURY YIELDS EXPECTATIONS (%)**



Shaded areas indicate interquartile ranges.  
 Source: BBVA Research based on data by the Federal Reserve Bank of Philadelphia and Haver Analytics.

**... means that the yield curve is expected to remain inverted for an extended period of time**

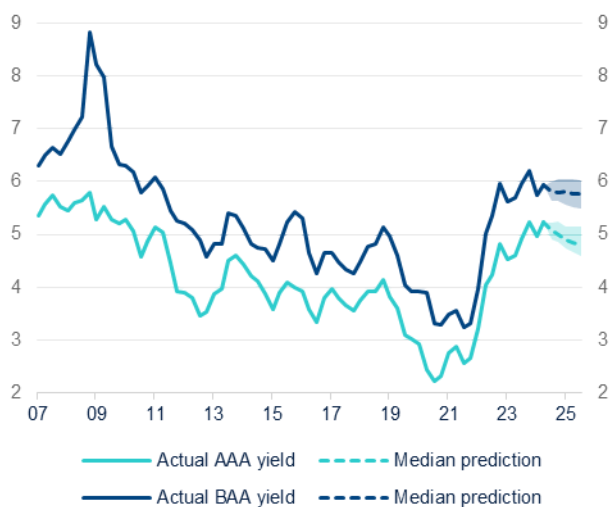
Figure 32. **PROF. FORECASTERS IMPLIED 10Y-3MY SPREAD EXPECTATIONS (BPS)**



The shaded area indicates the interquartile range.  
 Source: BBVA Research based on data by the Federal Reserve Bank of Philadelphia and Haver Analytics.

**Companies' credit risk profile appears to remain immune to high interest rates as investment...**

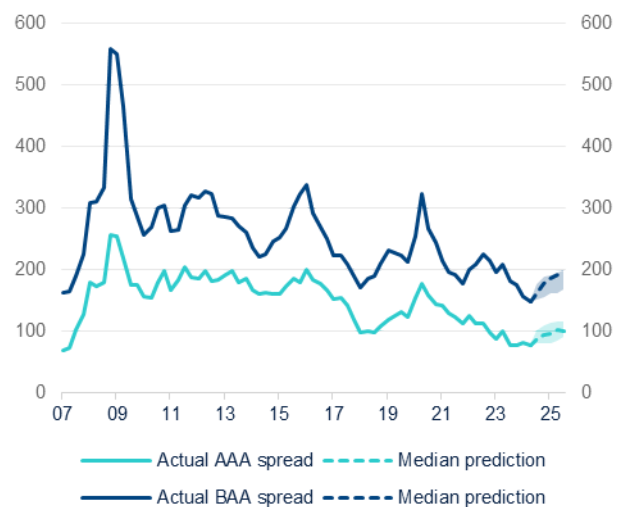
Figure 33. **PROF. FORECASTERS CORPORATE YIELDS EXPECTATIONS (%)**



Shaded areas indicate interquartile ranges.  
 Source: BBVA Research based on data by the Federal Reserve Bank of St. Louis, the Federal Reserve Bank of Philadelphia, and Haver Analytics.

**... grade bond spreads are projected to inch up but to remain below pre-pandemic average levels**

Figure 34. **PROF. FORECASTERS IMPLIED CORPORATE SPREADS EXPECTATIONS (%)**



Spreads over 10y Treasury. Shaded areas indicate interquartile ranges.  
 Source: BBVA Research based on data by the Federal Reserve Bank of St. Louis, the Federal Reserve Bank of Philadelphia, and Haver Analytics.

## **DISCLAIMER**

The present document does not constitute an “Investment Recommendation”, as defined in Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse (“MAR”). In particular, this document does not constitute “Investment Research” nor “Marketing Material”, for the purposes of article 36 of the Regulation (EU) 2017/565 of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive (MIFID II).

Readers should be aware that under no circumstances should they base their investment decisions on the information contained in this document. Those persons or entities offering investment products to these potential investors are legally required to provide the information needed for them to take an appropriate investment decision.

This document has been prepared by BBVA Research Department. It is provided for information purposes only and expresses data or opinions regarding the date of issue of the report, prepared by BBVA or obtained from or based on sources we consider to be reliable, and have not been independently verified by BBVA. Therefore, BBVA offers no warranty, either express or implicit, regarding its accuracy, integrity or correctness.

This document and its contents are subject to changes without prior notice depending on variables such as the economic context or market fluctuations. BBVA is not responsible for updating these contents or for giving notice of such changes.

BBVA accepts no liability for any loss, direct or indirect, that may result from the use of this document or its contents.

This document and its contents do not constitute an offer, invitation or solicitation to purchase, divest or enter into any interest in financial assets or instruments. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.

The content of this document is protected by intellectual property laws. Reproduction, transformation, distribution, public communication, making available, extraction, reuse, forwarding or use of any nature by any means or process is prohibited, except in cases where it is legally permitted or expressly authorised by BBVA on its website [www.bbvarresearch.com](http://www.bbvarresearch.com).

### **ENQUIRIES TO:**

BBVA Research: Paseo de la Reforma 510, Colonia Juárez, C.P. 06600 Mexico City, Mexico.

Tel.: +52 55 5621 3434

[www.bbvarresearch.com](http://www.bbvarresearch.com)