US Interest rates monitor

Limited room for long-term yields to fall further if a soft landing remains in sight

Javier Amador / Iván Fernández

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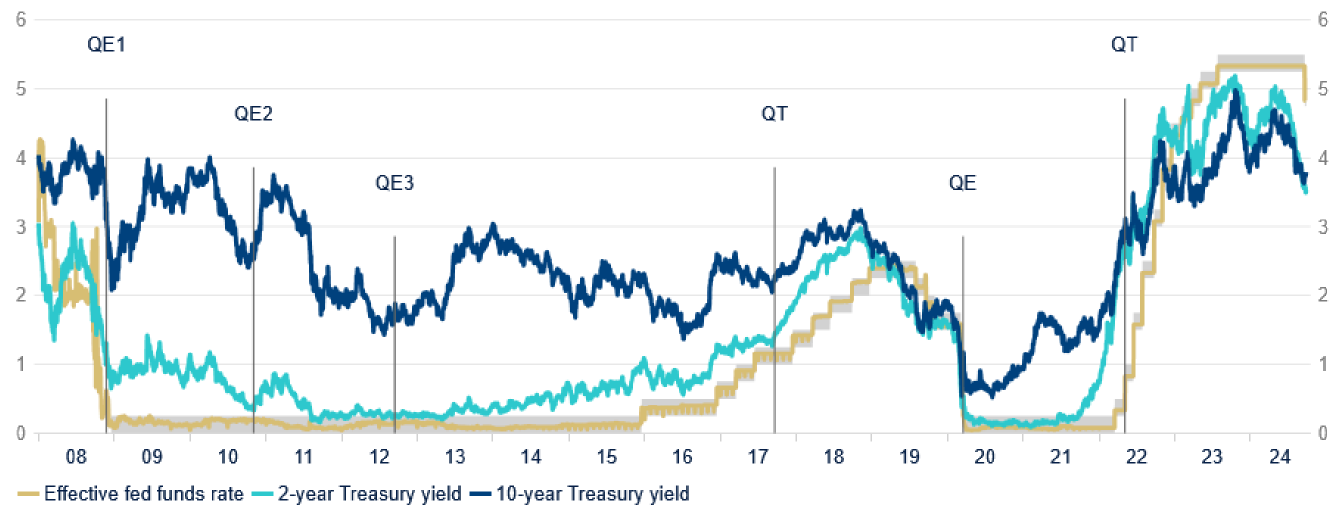
They could decline markedly if markets begin to price in that the Fed will need to lower rates below neutral to avoid a recession

- The Fed's main goal has shifted to keeping the labor market at its current sweet spot. In such a case, there would be no need to bring rates anywhere near the zero lower bound (Figures 2 and 3).
- Likewise, mid- and long-term Treasury yields would not have much further room to fall since markets have been pricing in the rate cut-cycle for several months now (Figures 4 and 5).
- The baseline expectation that the Fed will opt for a gradual cycle of consecutive 25bp rate cuts implies that the yield curve could become completely upward-sloping by mid 2025 (Figure 10).
- The implied expectation of a policy rate below 3% by the end of next year suggests that markets are relatively less confident in a smooth soft landing than the median FOMC participant (Figures 21 and 22).
- Powell joined the signal sent by the updated SEP and said that "it feels [...] that the neutral rate is probably significantly higher than it was back" in the pre-pandemic period (Figure 31).

The Fed kicked off the easing cycle with a forceful 50bp rate cut last week, but signaled a likely streak of consecutive 25bp rate cuts going forward. The 2-year Treasury yield has fallen to a 3.5% 24-month low

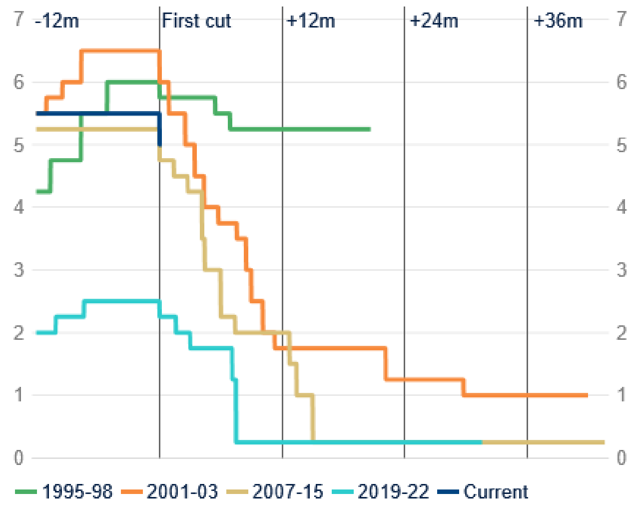
Figure 1. **FED FUNDS RATE AND TREASURY YIELDS** (%)



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

With inflation out of the spotlight, the Fed's main goal has shifted to keeping the labor market at…

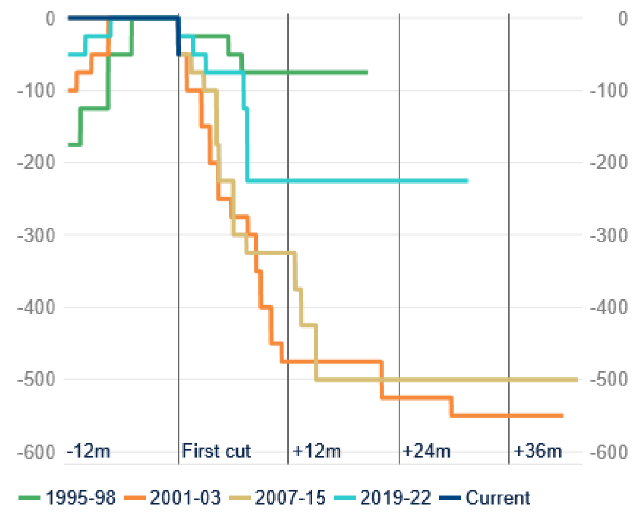
Figure 2. **FED FUNDS RATE IN EASING CYCLES** (%)



Target rate for the 1995-98, 2001-03, and 2007-15 (prior to 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

… its current sweet spot. If a soft landing is achieved, there would be no need to bring the…

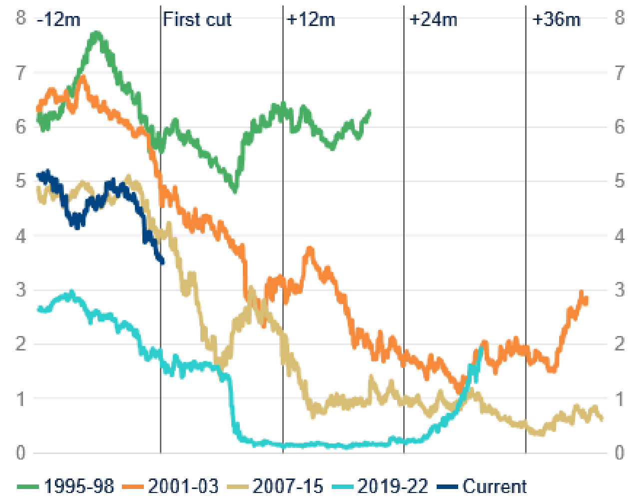
Figure 3. **FED FUNDS RATE IN EASING CYCLES** (BPS VS RATE AT FIRST CUT)



Source: BBVA Research / Fed

… fed funds rate anywhere near the zero lower bound as in recent easing cycles. Thus, mid- …

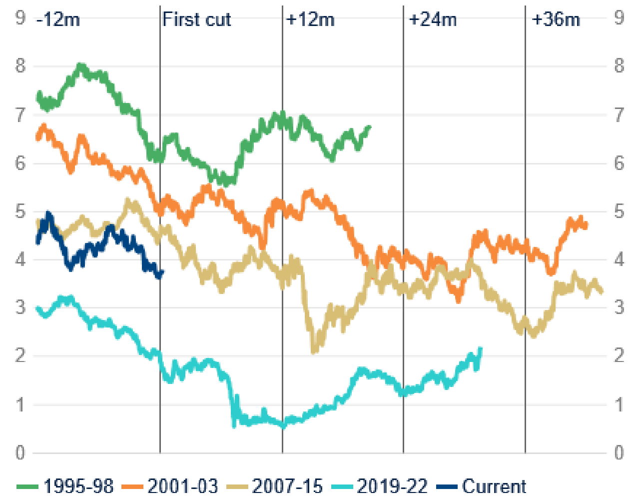
Figure 4. **2-YEAR TREASURY YIELD IN TIGHTENING CYCLES** (%)



Source: BBVA Research / Treasury

… and long-term Treasury yields would not have much further room to fall since markets have…

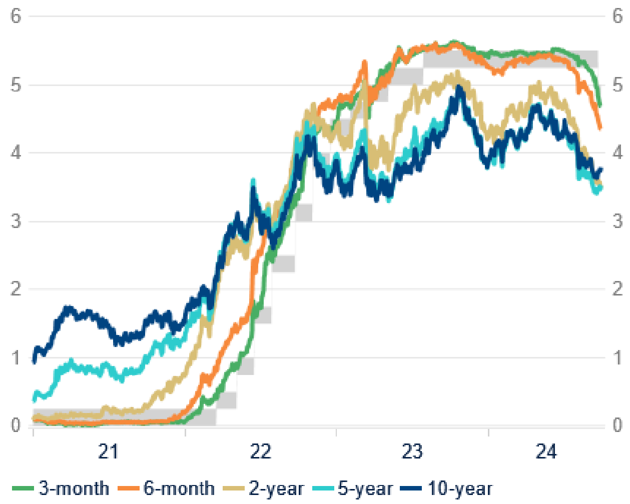
Figure 5. **10-YEAR TREASURY YIELD IN TIGHTENING CYCLES** (%)



Source: BBVA Research / Treasury

... been pricing in the rate cut-cycle for several months now. As the Fed continues to loosen...

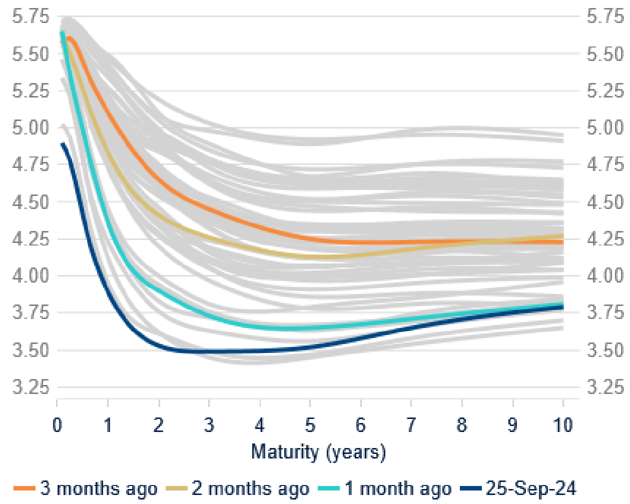
Figure 6. **TREASURY YIELDS**
(%)



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

... monetary policy, we'll see the biggest changes in the short-end of the yield curve. Overall, this...

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

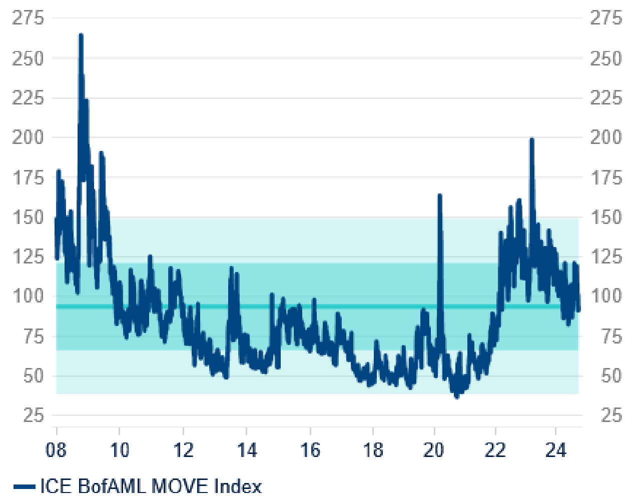
... may lead to lower bond price fluctuations. This outlook could come into question if the labor...

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

... market weakens significantly and chances of a hard landing rise accordingly

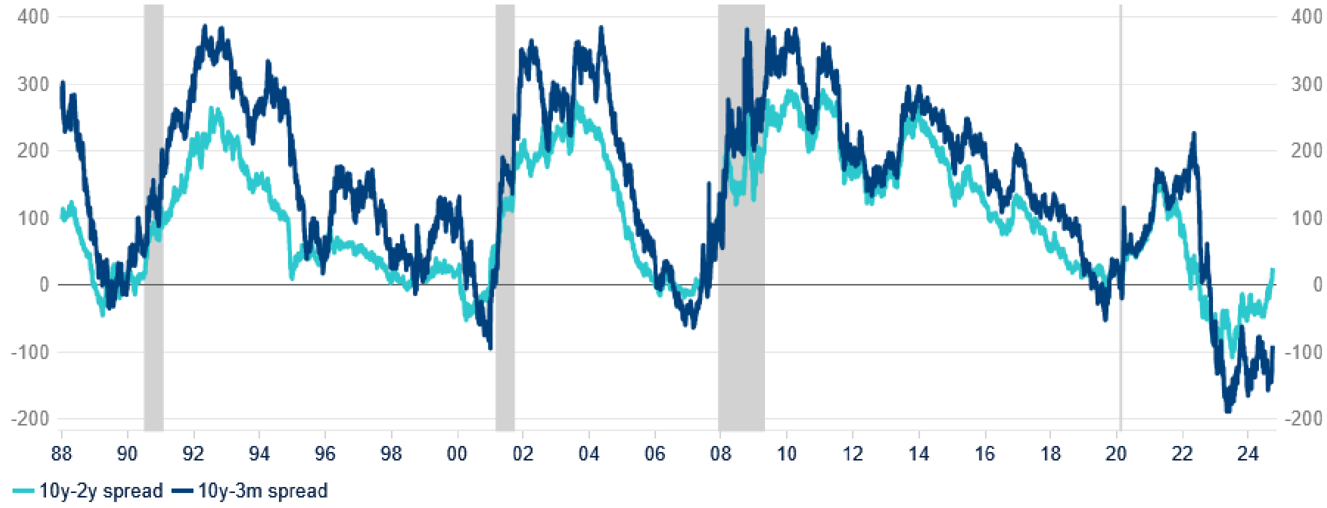
Figure 9. **ICE BOFAML MOVE INDEX**
(BPS)



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

The yield curve began a definitive process of disinversion this month, which has become more than evident in the 10y-2y yield spread. With time, it will also unfold in the 10y-3m spread. The baseline…

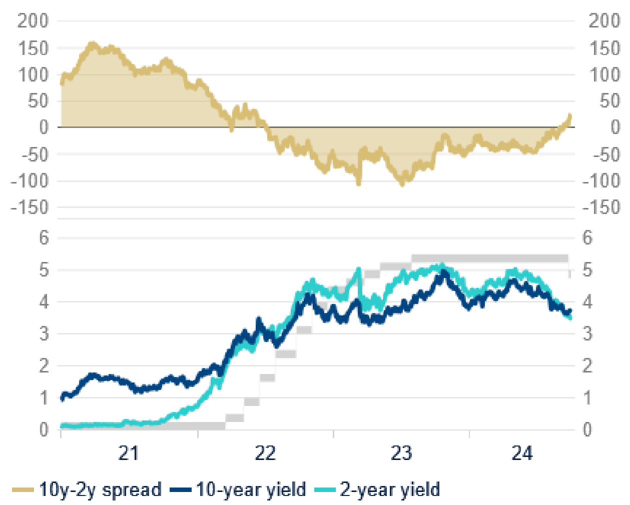
Figure 10. **TREASURY YIELD SPREADS** (BPS)



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

… expectation that the Fed will opt for a gradual cycle of consecutive 25bp rate cuts implies…

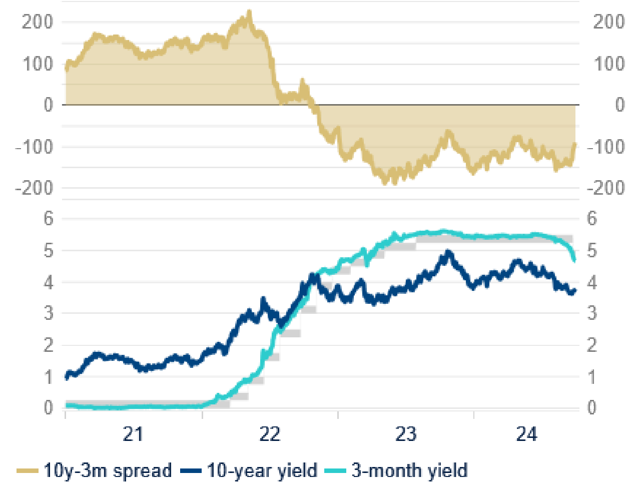
Figure 11. **10Y-2Y TREASURY YIELD SPREAD** (BPS AND %)



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

… that the yield curve could become completely upward-sloping by mid 2025

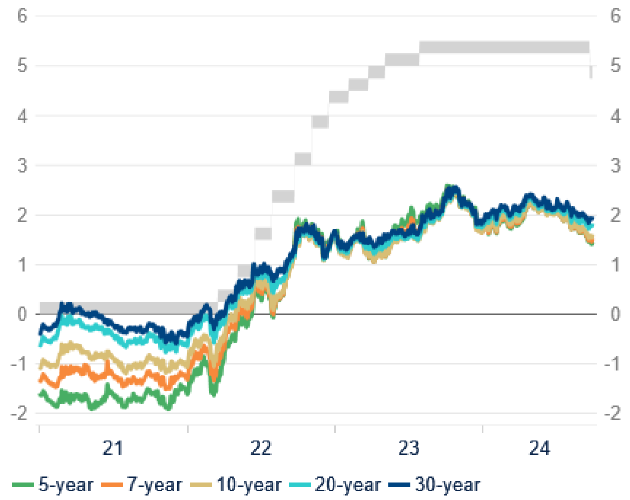
Figure 12. **10Y-3M TREASURY YIELD SPREAD** (BPS AND %)



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

Initial steps towards the removal of monetary restriction is starting to show too in the real…

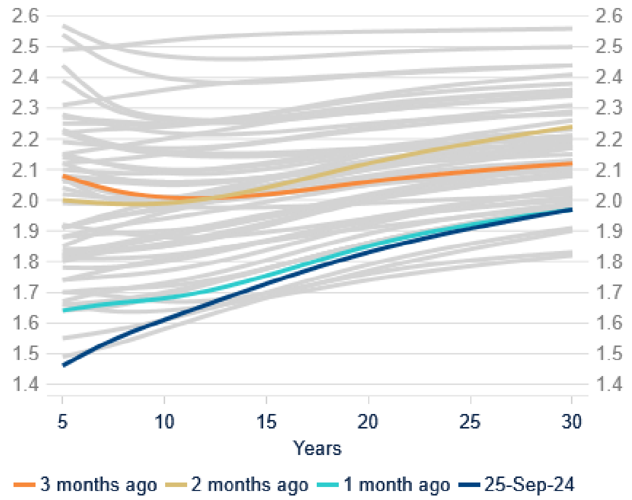
Figure 13. **TREASURY REAL YIELDS (TIPS)** (%)



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

… yield curve, in which the spread between the yields on 10- and 5-year TIPS is at a 2-year high

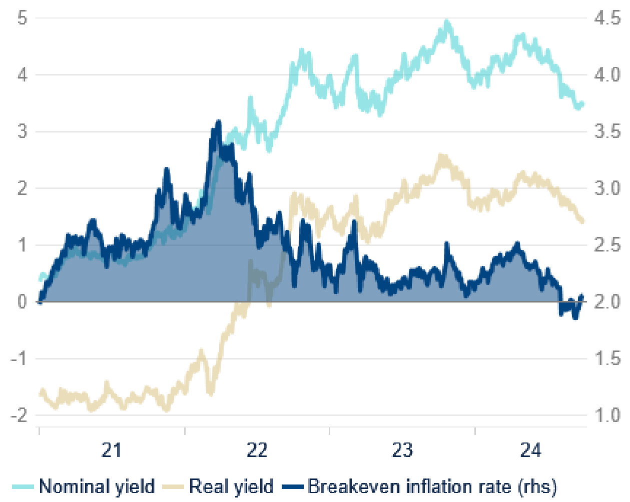
Figure 14. **TREASURY REAL YIELD CURVE (TIPS)** (%)



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

The fall in both nominal and real yields has kept market-based inflation expectations in line with…

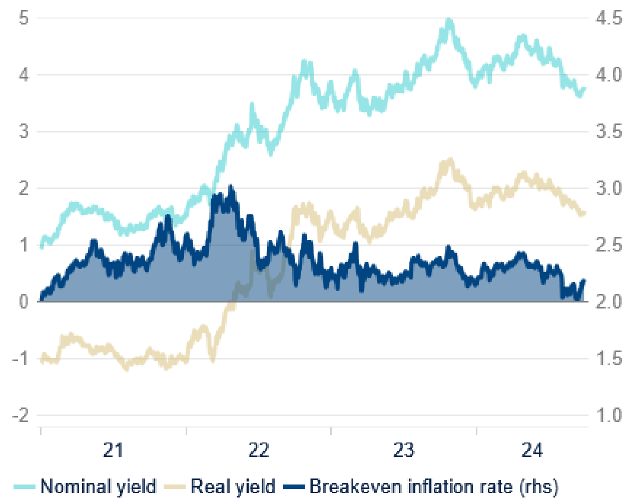
Figure 15. **5-YEAR TREASURY BREAKEVEN INFLATION RATE** (%)



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

… the Fed's 2% goal. Although signs of housing inflation stickiness may continue for some …

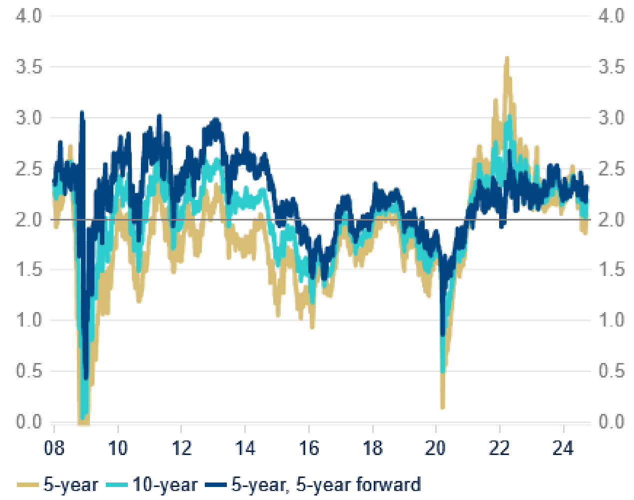
Figure 16. **10-YEAR TREASURY BREAKEVEN INFLATION RATE** (%)



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

… time, risks of inflation expectations becoming unanchored seem negligible at this point

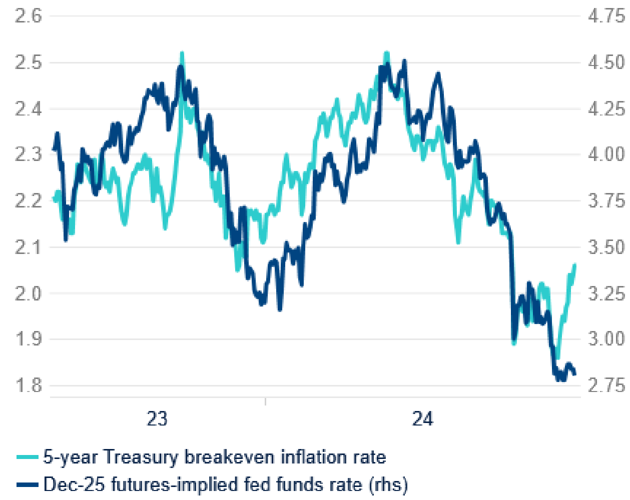
Figure 17. **BREAKEVEN INFLATION RATES** (%)



Source: BBVA Research / Treasury

The market remained confident in the Fed's ability to restore price stability all time

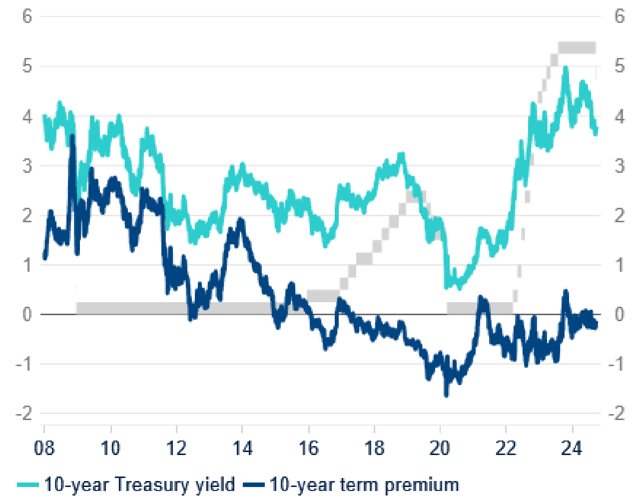
Figure 18. **BREAKEVEN INFLATION AND FUTURES-IMPLIED FED FUNDS RATE** (%)



Source: BBVA Research / Treasury / CME

Long-term yields have ceased from being driven by changes in inflation compensation, but they…

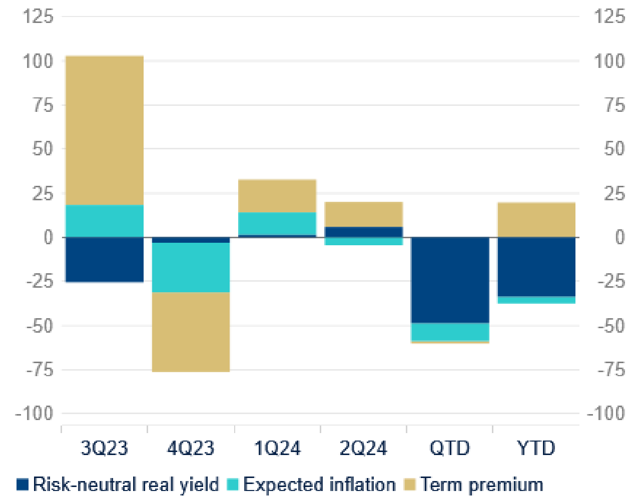
Figure 19. **10-YEAR TREASURY YIELD AND TERM PREMIUM** (%)



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

… could decline markedly if markets begin to price in the need to lower rates below neutral

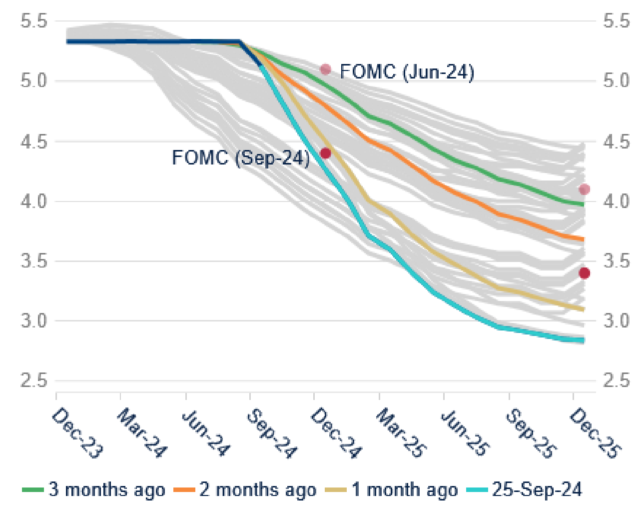
Figure 20. **10-YEAR TREASURY YIELD CHANGE BREAKDOWN** (BPS)



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

The implied expectation of a policy rate below 3% by year-end 2025 suggests that markets…

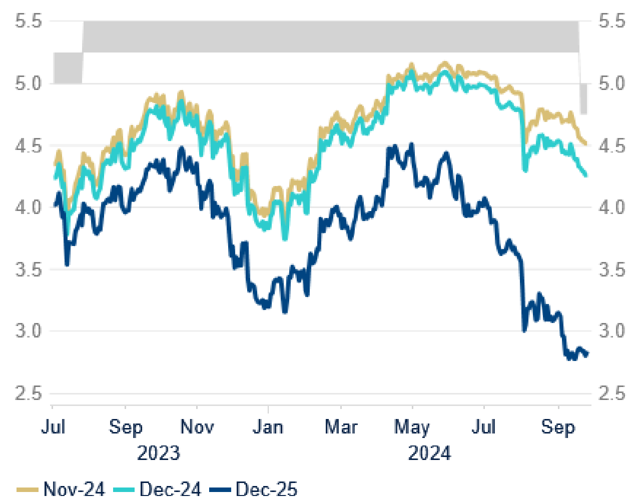
Figure 21. **FUTURES-IMPLIED FED FUNDS RATE** (%)



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

… are somewhat less confident in a smooth soft landing than the median FOMC participant

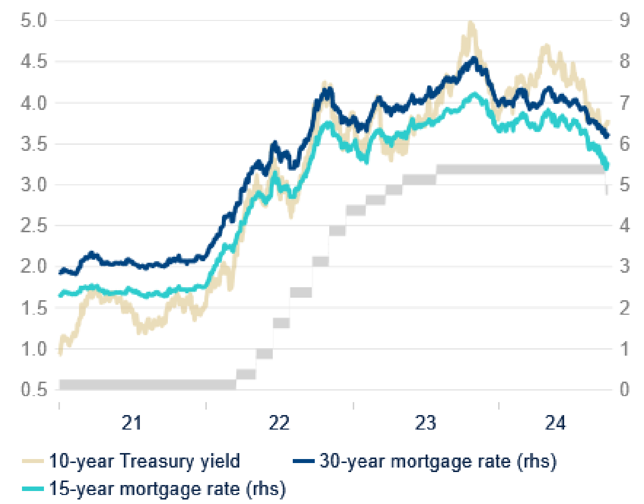
Figure 22. **FUTURES-IMPLIED FED FUNDS RATE** (%)



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

Despite a brighter outlook for the housing sector, mortgage rates would need to keep falling to…

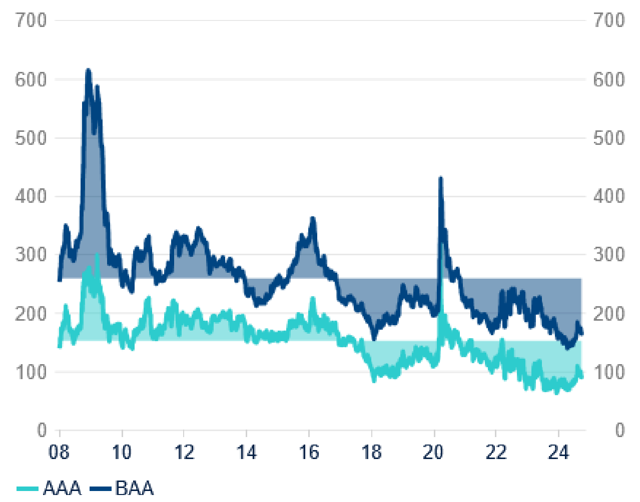
Figure 23. **MORTGAGE RATES** (%)



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

… offset the fact that many households locked-in very low mortgage rates during the pandemic

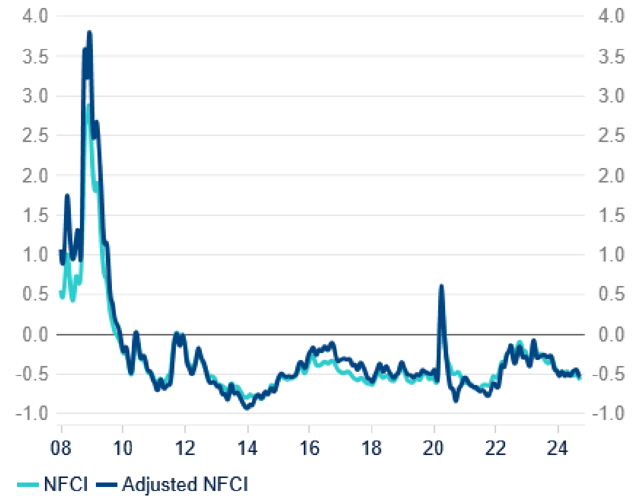
Figure 24. **CORPORATE BOND YIELD SPREADS** (BPS)



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

Fed's decisive move to cut rates while private consumption and investment remain robust…

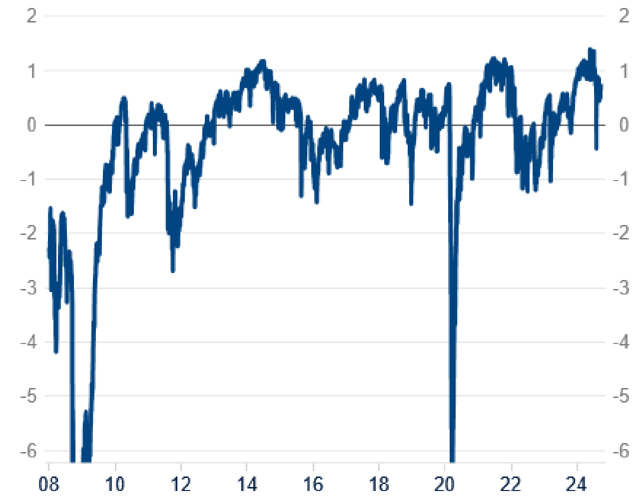
Figure 25. **CHICAGO FED NATIONAL FINANCIAL CONDITIONS INDEX** (>0: TIGHTER THAN AVG.)



Source: BBVA Research / Fed

… has sparked concerns about the risk of over-stimulating the economy via looser financial…

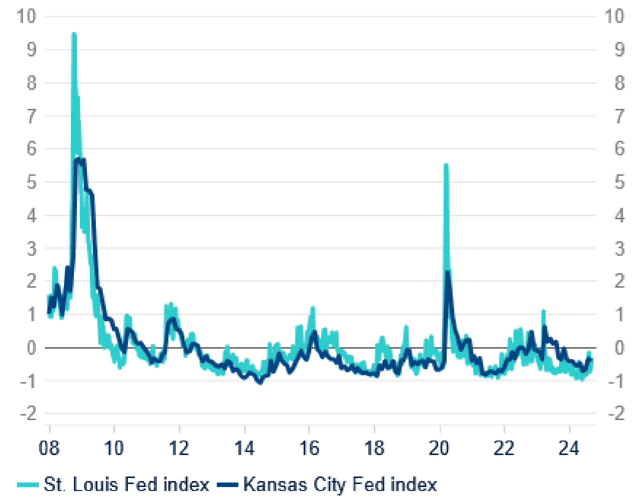
Figure 26. **BLOOMBERG US FINANCIAL CONDITIONS INDEX** (<0: TIGHTER THAN PRE-GFC AVG.)



Source: BBVA Research / Bloomberg

… conditions. However, the relatively limited scope for long-term yields to decline further…

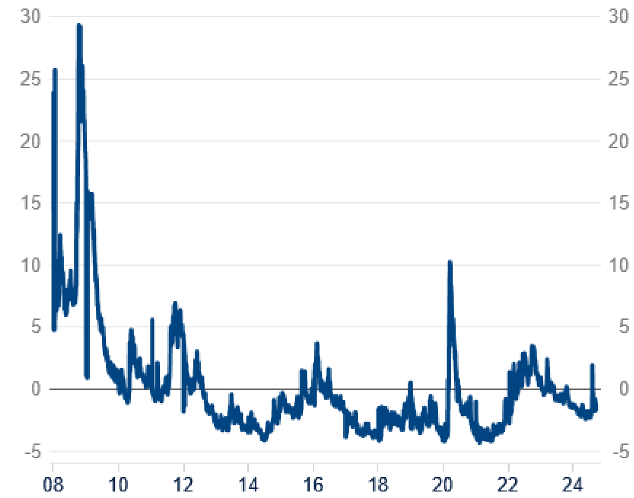
Figure 27. **FED FINANCIAL STRESS INDEXES** (>0: ABOVE AVG. FINANCIAL STRESS)



Source: BBVA Research / Fed

… implies that asset prices may not experience excessive exuberance in the short term

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

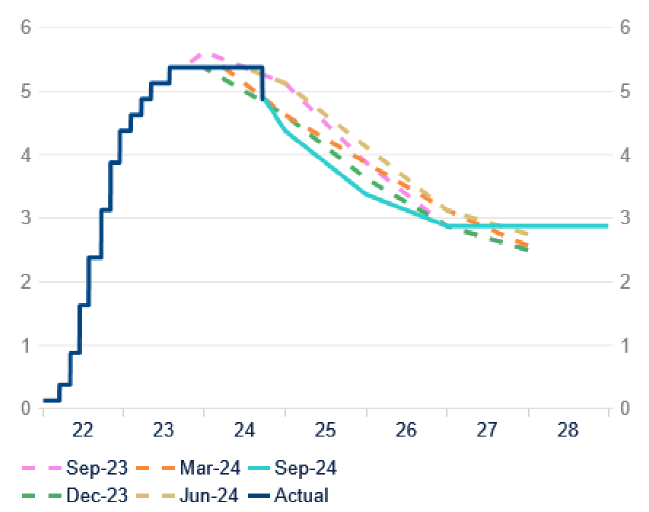


OFR: Office of Financial Research
Source: BBVA Research / Treasury

The world isn’t going back to “that era where there were trillions of dollars of sovereign bonds trading at negative rates”

The Fed’s goal at this point is recalibrating the policy stance towards a sense of neutral

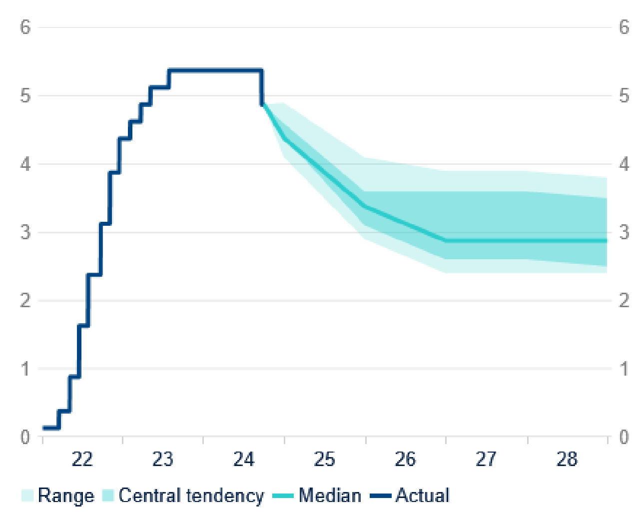
Figure 29. **FOMC PROJECTED FED FUNDS RATE (%)**



Source: BBVA Research / Fed

They will “move as fast or as slow as [they] think is appropriate in real-time”

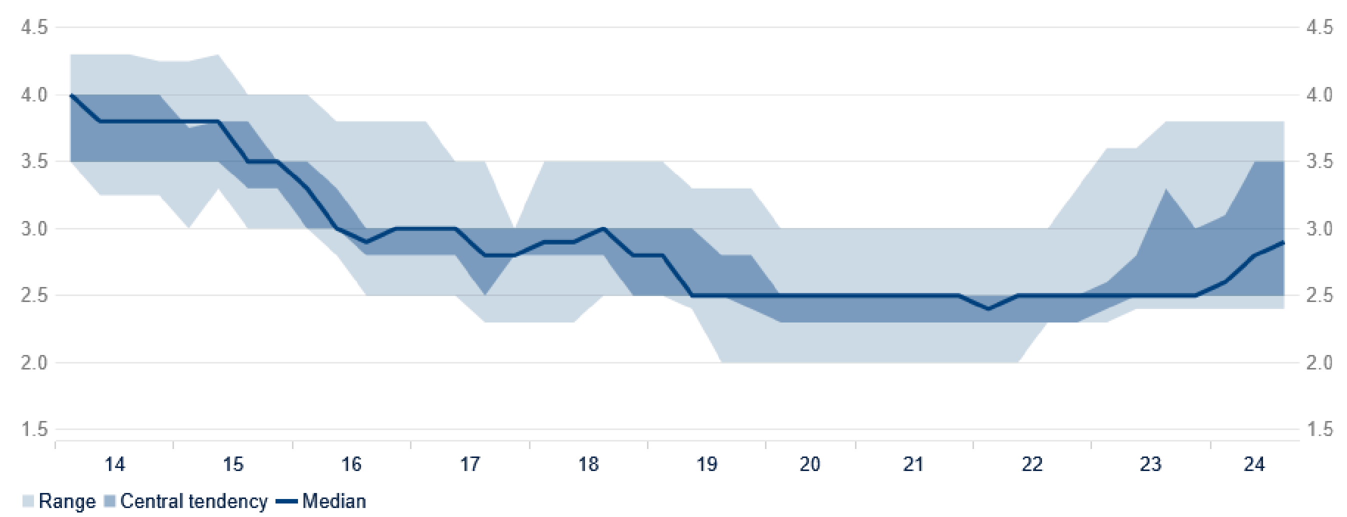
Figure 30. **FOMC PROJECTED FED FUNDS RATE (%)**



Source: BBVA Research / Fed

Powell joined the signal sent by the updated SEP and said that “it feels [...] that the neutral rate is probably significantly higher than it was back” in the pre-pandemic period

Figure 31. **FOMC LONGER RUN FED FUNDS RATE ESTIMATION (%)**



Source: BBVA Research / Fed

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ENQUIRIES TO:
BBVA Research: Paseo de la Reforma 510, Colonia Juárez, C.P. 06600 Mexico City, Mexico.
Tel.: +52 55 5621 3434
www.bbvaresearch.com