

US Interest rates monitor

The yield curve is pricing in more uncertainty around inflation next year

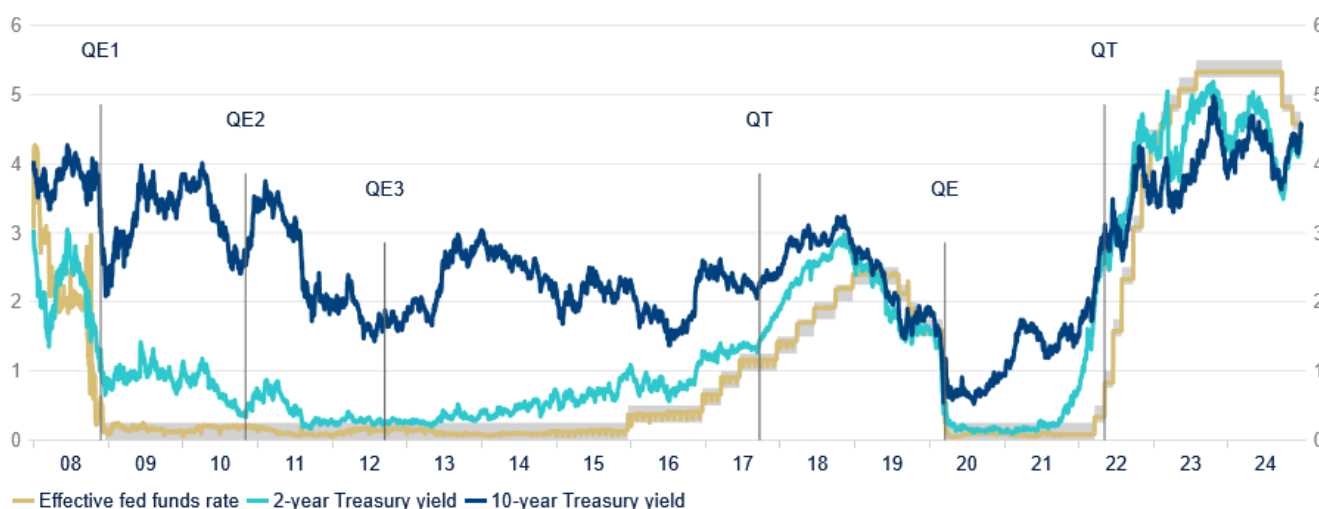
Javier Amador / Iván Fernández
December 26, 2024

The Fed signaled a slower pace of further rate cuts as it discusses the ways in which tariffs could affect inflation and the economy

- Increased Fed caution led to mixed movements along the yield curve: the 2-year yield inched up by 20 bps from its early-Dec low, while the 10-year yield climbed by more than 40 bps in the same period ([Figure 7](#)).
- The combination of rising 10-year Treasury yields and continued monetary easing pushed the 10y-3m yield spread into positive territory for the first time in more than two years ([Figure 10](#)).
- The rise in long-term yields is largely driven by rising real yields, which suggests that markets are primarily factoring in inflation risk rather than focusing solely on greater inflation compensation ([Figures 13 and 14](#)).
- This is further evidenced by the term premium, which has risen by c. 50 bps in 4Q, exceeding the roughly 20bp increase in the expected inflation component over the same period ([Figures 19 and 20](#)).
- While the futures market had already anticipated a slower pace of rate cuts before the Fed's shift in tone from last week, it strengthened its view that the Fed will not reach a neutral rate next year ([Figures 21 and 22](#)).

The dissipation of election noise and better inflation data led to a decline in mid- and long-term Treasury yields earlier this month, but a more hawkish tone from the Fed put upward pressure on them again

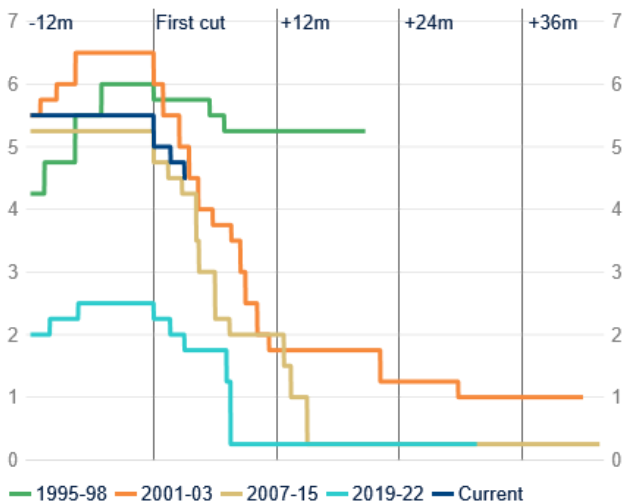
Figure 1. FED FUNDS RATE AND TREASURY YIELDS (%)



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

All but one FOMC member voted last week to continue removing monetary policy restriction...

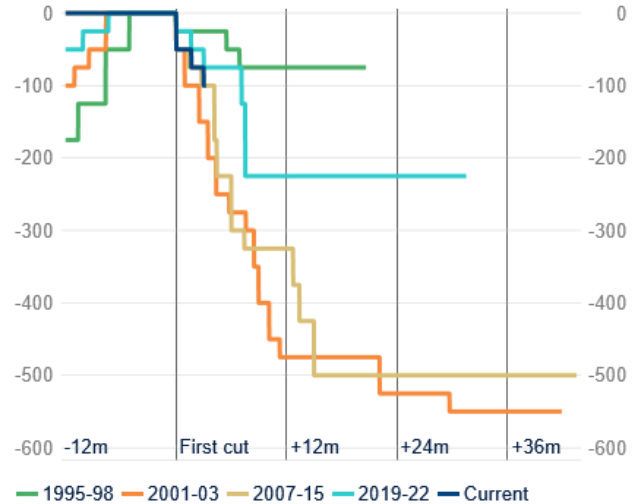
Figure 2. **FED FUNDS RATE IN EASING CYCLES (%)**



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

... through a 25bp cut, but the Fed also signaled a slower pace of further adjustments due to the...

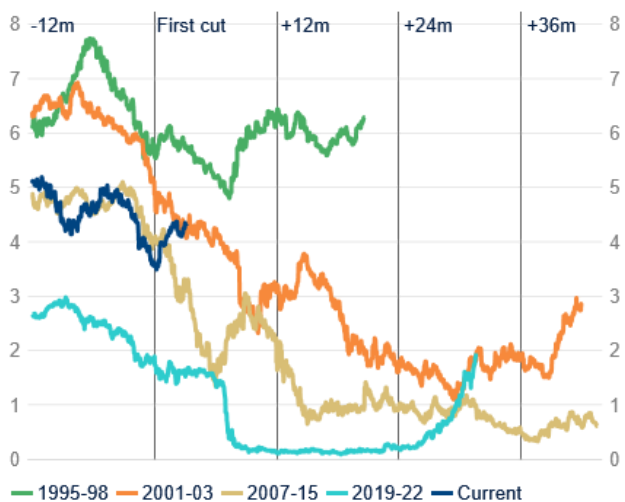
Figure 3. **FED FUNDS RATE IN EASING CYCLES (BPS VS RATE AT FIRST CUT)**



Source: BBVA Research / Fed

... incipient but increased uncertainty about inflation next year. Chair Powell was careful to...

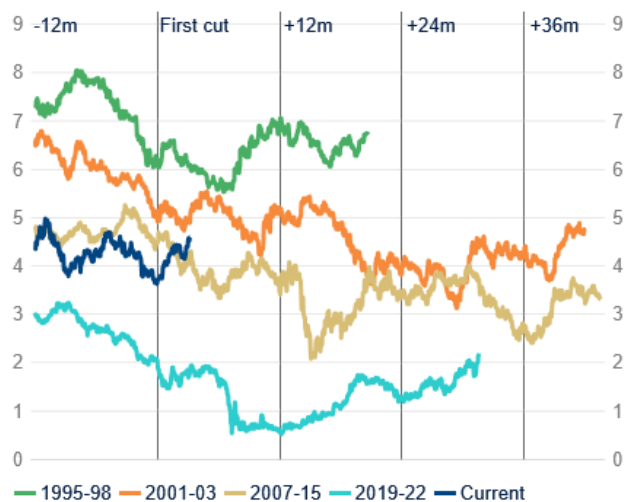
Figure 4. **2-YEAR TREASURY YIELD IN TIGHTENING CYCLES (%)**



Source: BBVA Research / Treasury

... stress that despite higher risks, they still see themselves "on track to continue to cut"

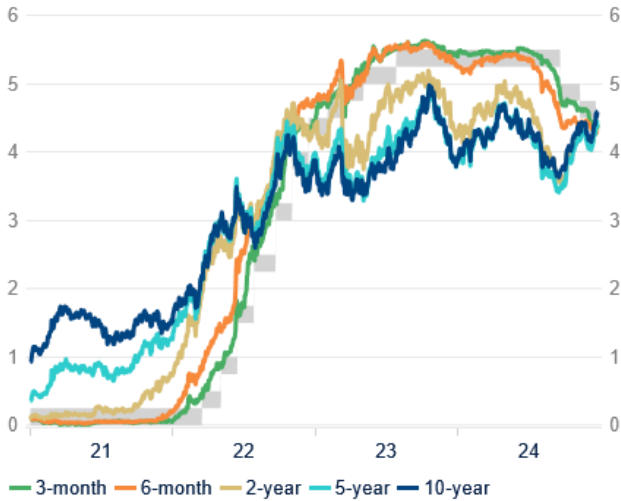
Figure 5. **10-YEAR TREASURY YIELD IN TIGHTENING CYCLES (%)**



Source: BBVA Research / Treasury

This led to mixed movements along the Treasury yield curve: the 2-year yield has inched up by...

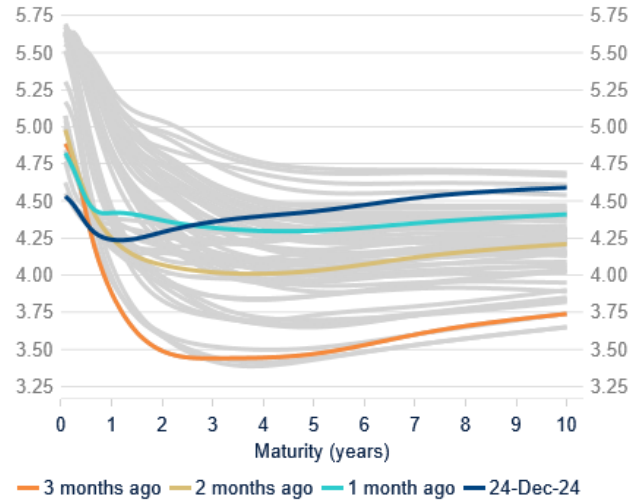
Figure 6. **TREASURY YIELDS**
(%)



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

... 20 bps to 4.3% from its early-Dec 4.1% low, while the 10-year yield has climbed by more...

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

... than 40 bps to a 6-month 4.6%-high in the same period. Despite this, the bond market...

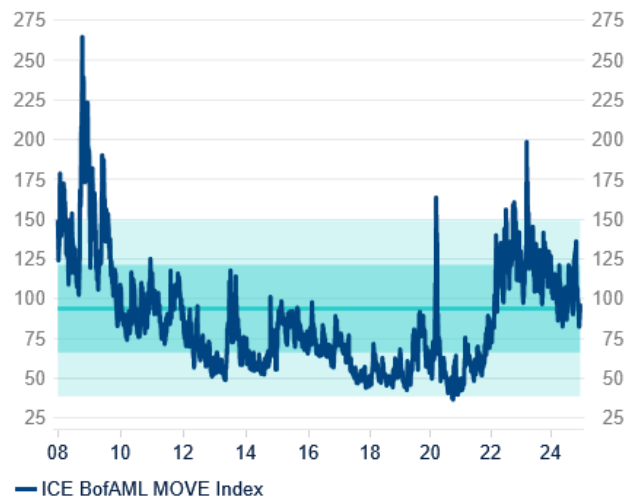
Figure 8. **10-YEAR TREASURY YIELD DAILY CHANGE**
(% AND BPS)



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

... continues to function with a degree of volatility consistent with historical norms

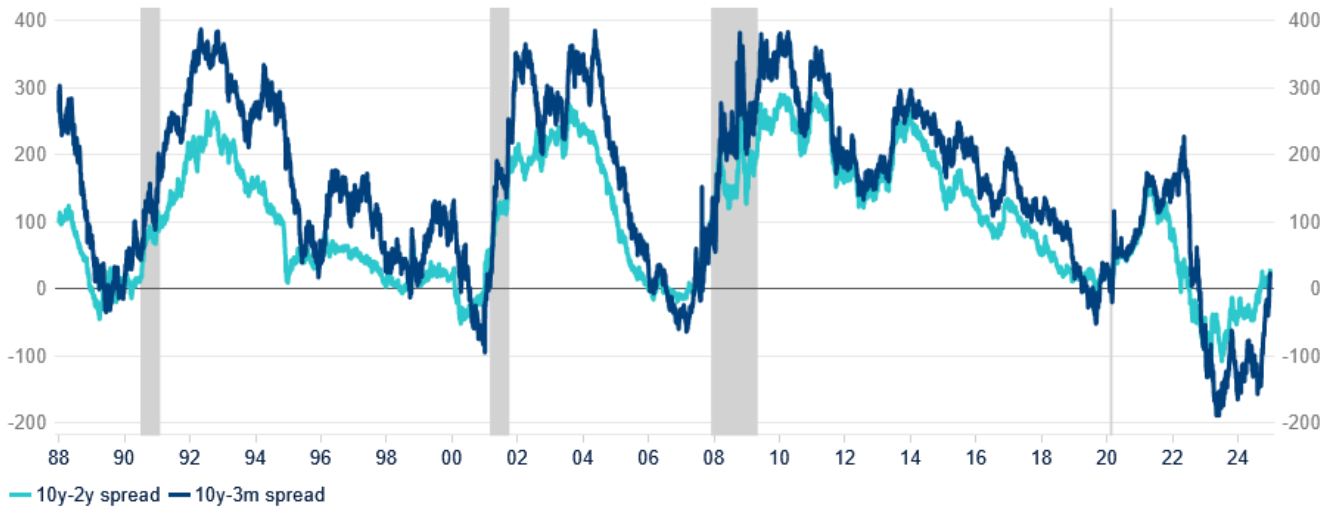
Figure 9. **ICE BOFAML MOVE INDEX**
(BPS)



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

The combination of rising 10-year Treasury yields and continued monetary easing (which to date has accumulated a total of 100 bps of cuts) pushed the 10y-3m yield spread into positive territory for...

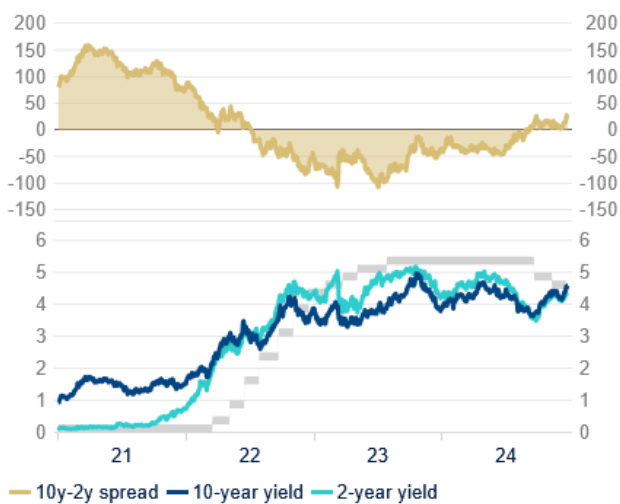
Figure 10. **TREASURY YIELD SPREADS (BPS)**



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

... the first time in more than two years. This takes place in a context where a soft-landing...

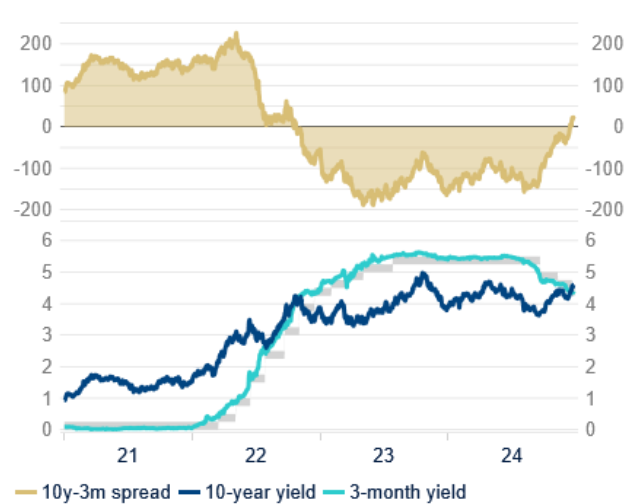
Figure 11. **10Y-2Y TREASURY YIELD SPREAD (BPS AND %)**



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

... scenario continues to prevail over recession fears even amid next year's increased uncertainty

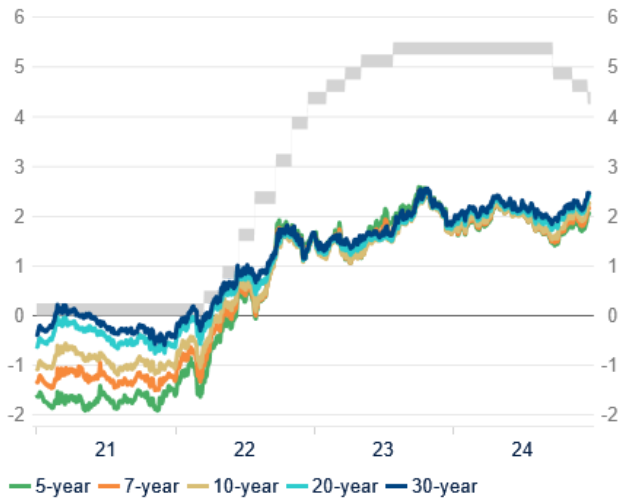
Figure 12. **10Y-3M TREASURY YIELD SPREAD (BPS AND %)**



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

The rise in long-term yields is largely driven by rising real yields, which suggests that markets...

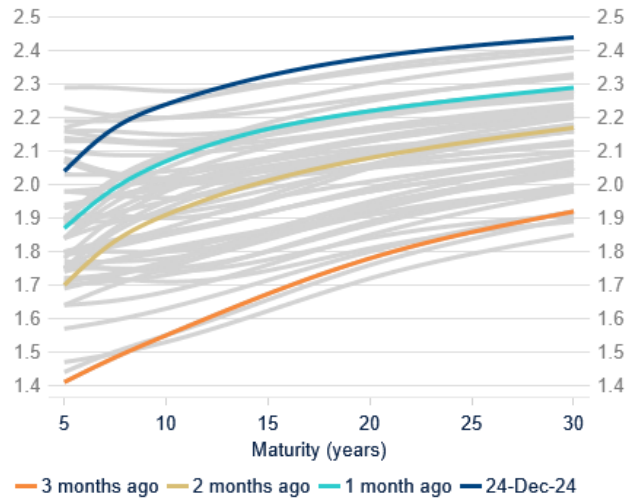
Figure 13. **TREASURY REAL YIELDS (TIPS)**
(%)



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

... are primarily factoring in inflation risk rather than focusing solely on inflation compensation

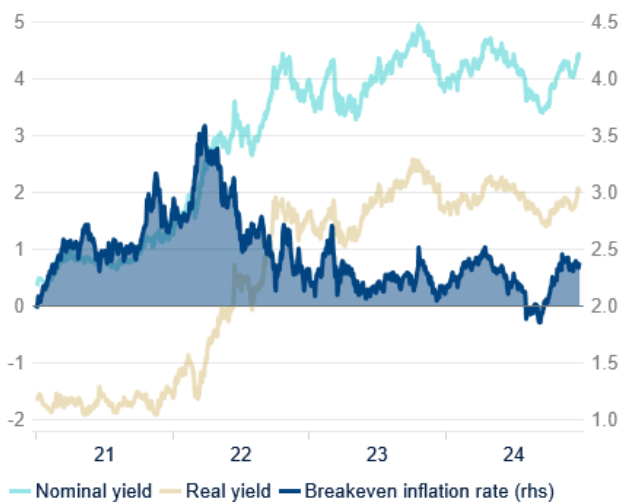
Figure 14. **TREASURY REAL YIELD CURVE (TIPS)**
(%)



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

Trump's potential trade, tax, and immigration policies are likely to be inflationary, but for the...

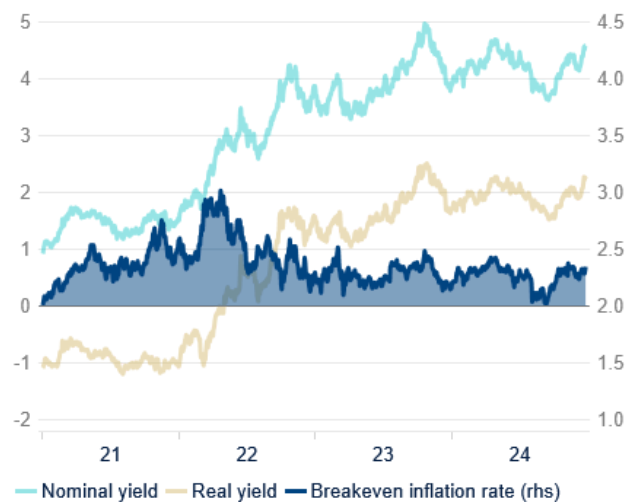
Figure 15. **5-YEAR TREASURY BREAKEVEN INFLATION RATE (%)**



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

... time being, markets seem to agree with Powell, who noted that "we need to take our time, not..."

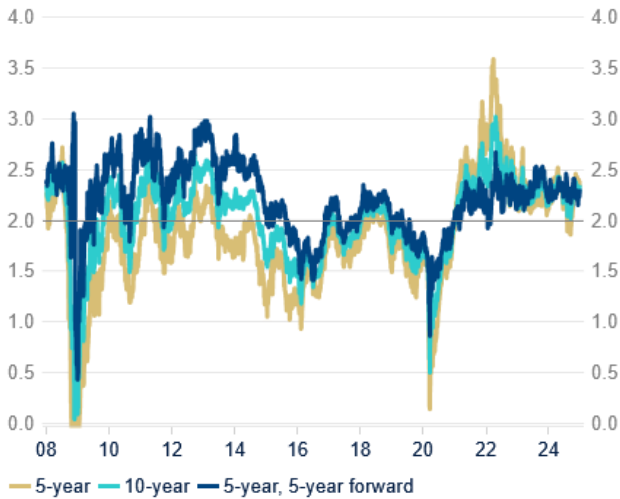
Figure 16. **10-YEAR TREASURY BREAKEVEN INFLATION RATE (%)**



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

... rush and make a very careful assessment, but only when we've actually seen what the...

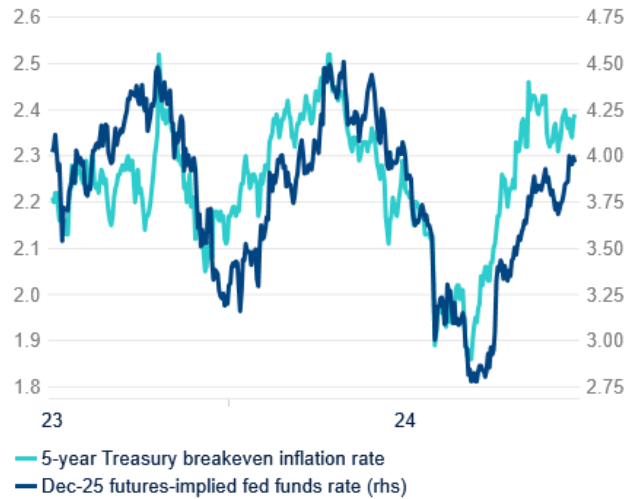
Figure 17. **BREAKEVEN INFLATION RATES (%)**



Source: BBVA Research / Treasury

... policies are and how they're implemented. [...] We're just not at that stage"

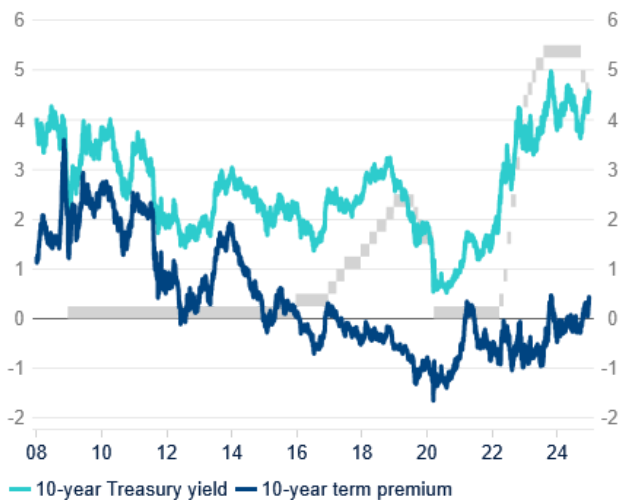
Figure 18. **BREAKEVEN INFLATION AND FUTURES-IMPLIED FED FUNDS RATE (%)**



Source: BBVA Research / Treasury / CME

This is further evidenced by the term premium, which has risen by c. 50 bps in 4Q, exceeding...

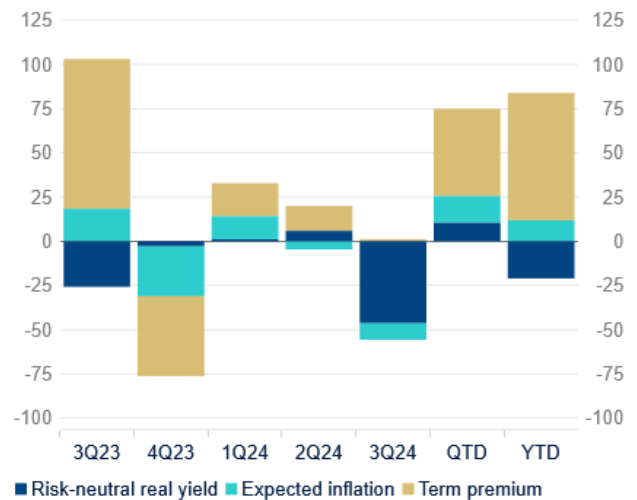
Figure 19. **10-YEAR TREASURY YIELD AND TERM PREMIUM (%)**



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

... the roughly 20bp increase in the expected inflation component over the same period

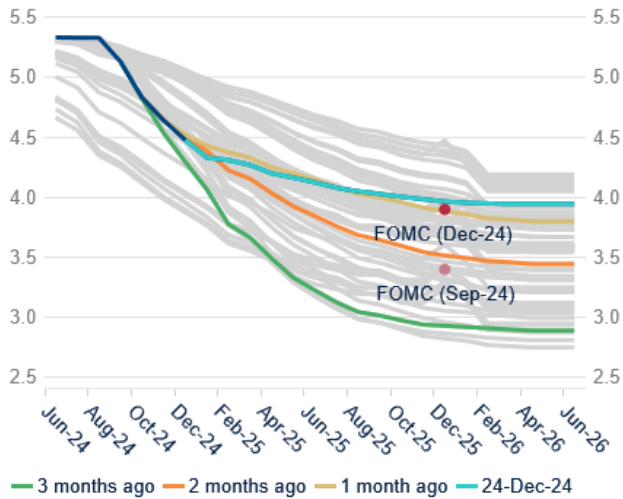
Figure 20. **10-YEAR TREASURY YIELD CHANGE BREAKDOWN (BPS)**



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

While the futures market had already anticipated a slower pace of rate cuts before the Fed's shift...

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



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

... in tone from last week, it strengthened its view that the Fed will not reach a neutral rate next year

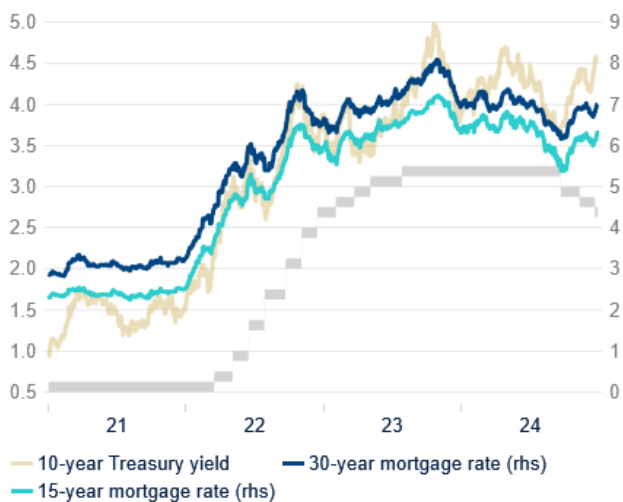
Figure 22. **FUTURES-IMPLIED FED FUNDS RATE (%)**



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

Mortgage rates look set to close the year at the levels they started at

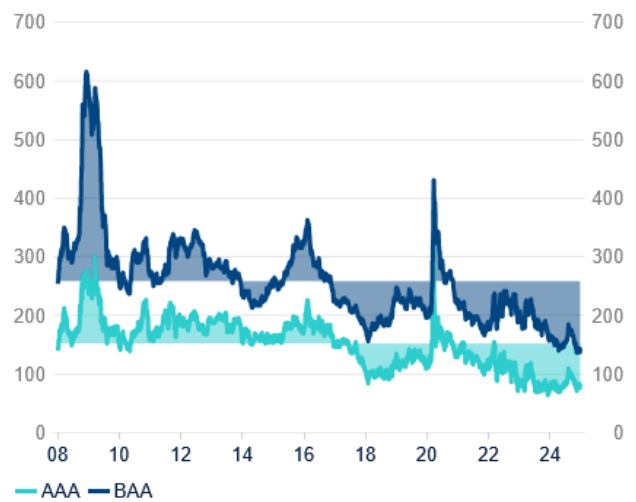
Figure 23. **MORTGAGE RATES (%)**



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

The corporate bond market remains immune to the increased uncertainty

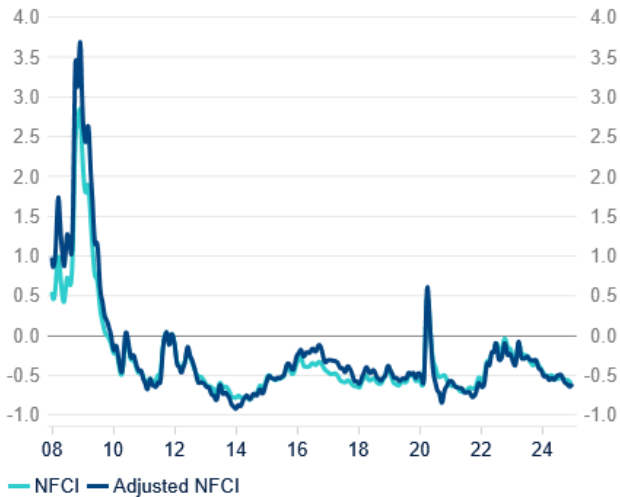
Figure 24. **CORPORATE BOND YIELD SPREADS (BPS)**



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

Although a still tight policy stance is not directly evident in broad financial conditions indexes, ...

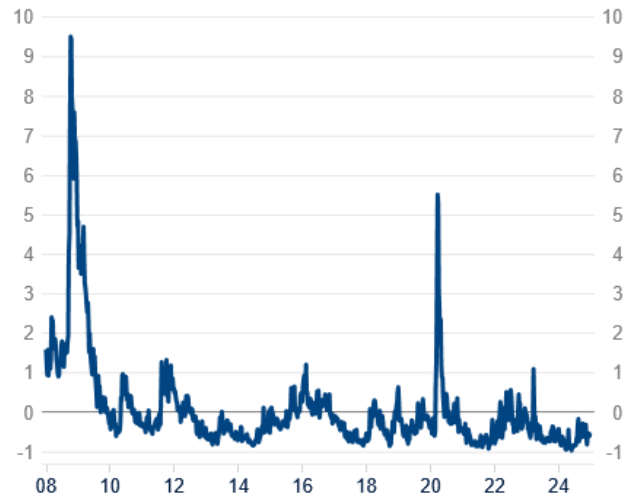
Figure 25. **CHICAGO FED NATIONAL FINANCIAL CONDITIONS INDEX (>0: TIGHTER THAN AVG.)**



Source: BBVA Research / Fed

... Fed officials think their “policy is working, it’s transmitting and it’s having the effects on...”

Figure 26. **ST. LOUIS FED FINANCIAL STRESS INDEX (>0: ABOVE AVG. FINANCIAL STRESS)**



Source: BBVA Research / Fed

... [their] target variables that [they] would want.” As Powell said last week, “we’ve seen inflation...”

Figure 27. **KANSAS CITY FED FINANCIAL STRESS INDEX (>0: ABOVE AVG. FINANCIAL STRESS)**



Source: BBVA Research / Fed

... [...] come down a lot, we’ve seen the labor market cool off quite a bit”

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

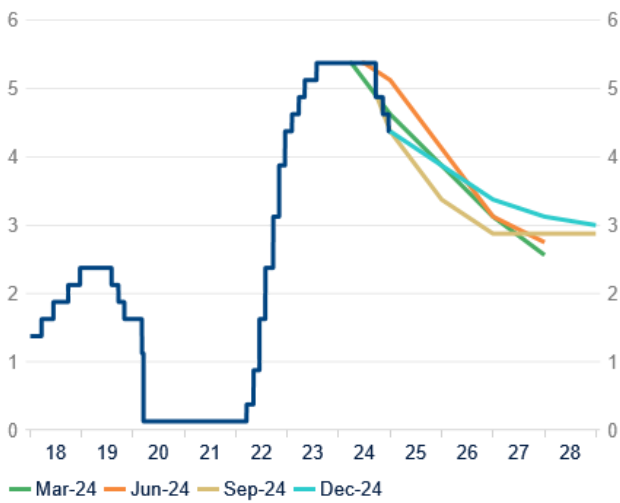


* OFR: Office of Financial Research
Source: BBVA Research / Treasury

The updated SEP points to a slower pace of monetary policy easing next year amid higher inflation uncertainty

The median steady-state fed funds rate projection inched up by 0.1 pp to 3.0%; it is now expected...

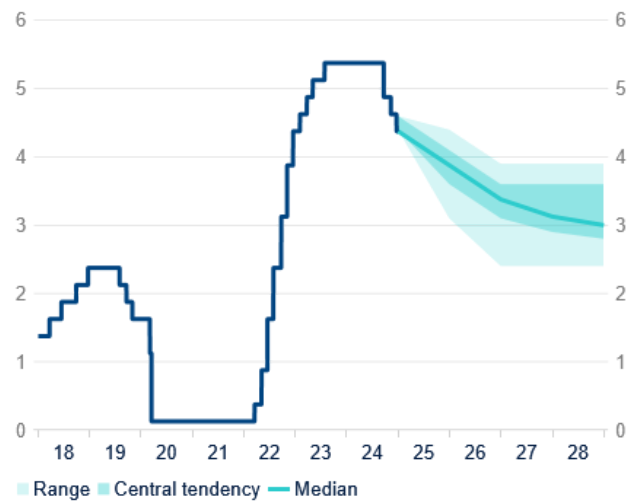
Figure 29. FOMC PROJECTED FED FUNDS RATE (%)



Source: BBVA Research / Fed

... to be reached by the end of 2027. Indeed, one of the reasons behind being more cautious...

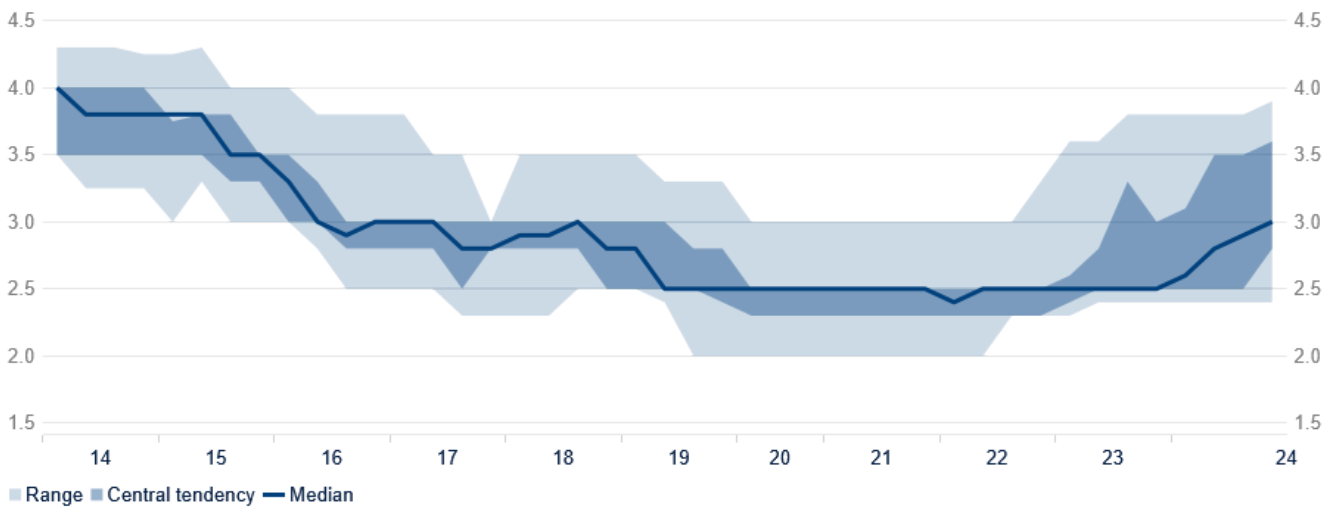
Figure 30. FOMC PROJECTED FED FUNDS RATE (%)



Source: BBVA Research / Fed

... about further cuts is also related to the uncertainty around r^* . In Powell's words: "we don't know exactly where it is, but [...] I think what we know for sure is that we're 100 bps closer to it right now"

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



Source: BBVA Research / Fed

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