

US Interest rates monitor

Rate expectations remain broadly unchanged following Trump's inauguration

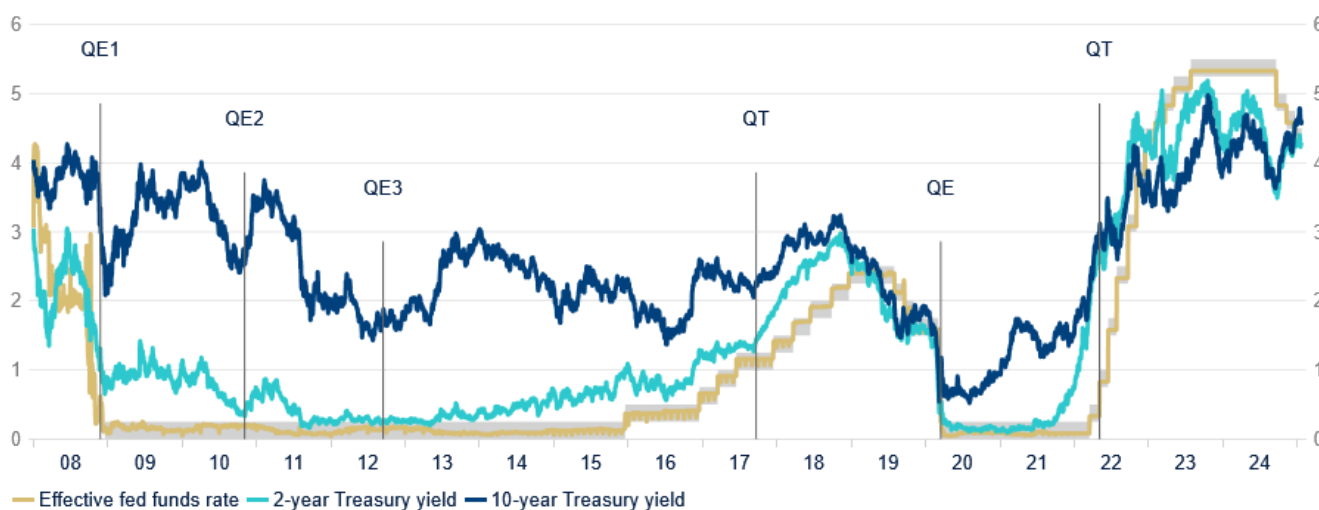
Javier Amador / Iván Fernández
January 23, 2025

Still high long-term yields suggest that markets continue to share the view of increased risks to the inflation outlook

- The Fed will likely stick to last month's forward guidance and will decide to keep rates unchanged next week, as it continues to believe that "a gradual approach" is the most appropriate way to proceed ([Figures 2](#) and [3](#)).
- The inverted hump at the short-end of the yield curve suggests the market still expects the Fed to deliver a bit more easing before entering a prolonged pause in the rate-cutting cycle later this year ([Figure 7](#)).
- Markets seem to share the Fed's view of increased risks to the inflation outlook, but the likely one-off nature of a tariff-driven inflation shock is unlikely to de-anchor inflation expectations ([Figures 15](#) and [16](#)).
- Futures-implied chances of a 25bp rate cut in March fell from 50 to 25% over the past month. Further easing of at most 50 bps by year-end is still on the table ([Figures 21](#) and [22](#)), but the Fed will likely stay on the sidelines while the uncertainty around renewed immigration policies lingers and until it knows if Trump follows through on his plans to impose tariffs.

Uncertainty appears to have peaked exactly a week before Trump's inauguration, when the 10-year yield hit 4.8%, its highest since Oct 2023, and 120 bps above the 3.6% mid-Sep low from last year. Trump's...

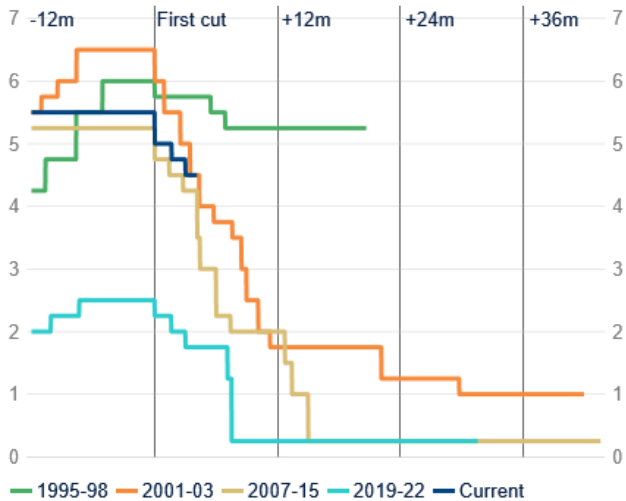
Figure 1. FED FUNDS RATE AND TREASURY YIELDS (%)



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

... initial actions were not surprising. He decided not to implement tariffs from day one, but the...

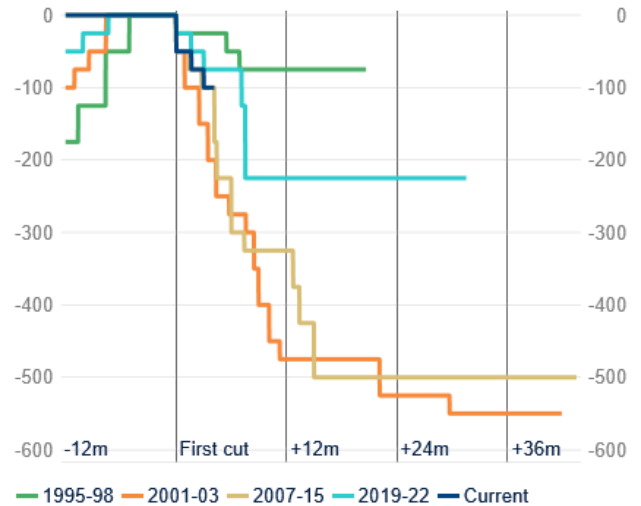
Figure 2. **FED FUNDS RATE IN EASING CYCLES** (%)



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

... expectation is that they are coming. Thus, the Fed will likely stick to last month's forward...

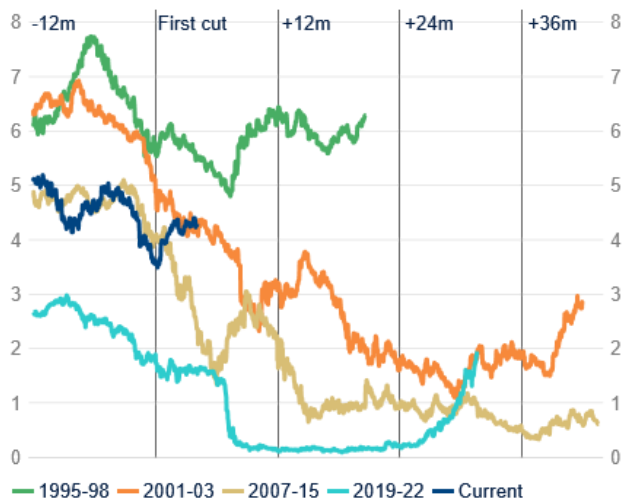
Figure 3. **FED FUNDS RATE IN EASING CYCLES** (BPS VS RATE AT FIRST CUT)



Source: BBVA Research / Fed

... guidance and will hold rates unchanged next week at 4.25-4.50%, as it continues to believe...

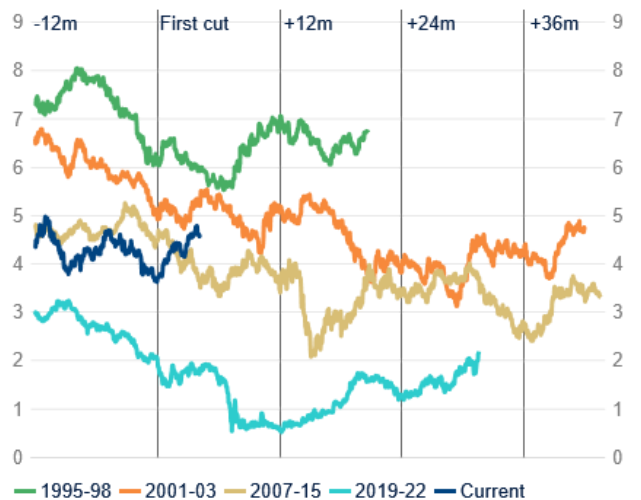
Figure 4. **2-YEAR TREASURY YIELD IN EASING CYCLES** (%)



Source: BBVA Research / Treasury Dept.

... that taking "a gradual approach as [they move] toward a neutral policy stance" is the most...

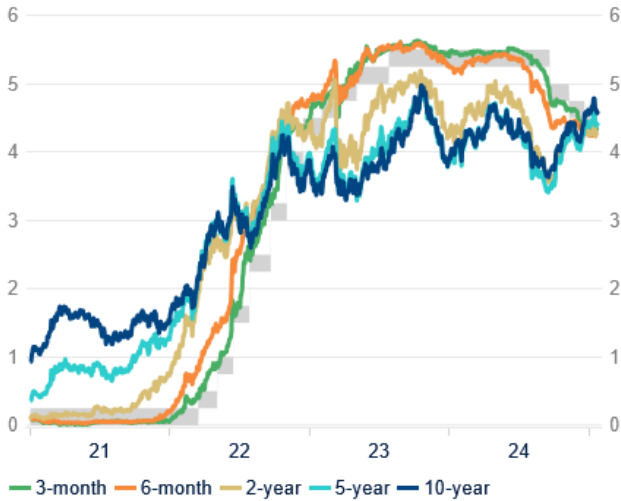
Figure 5. **10-YEAR TREASURY YIELD IN EASING CYCLES** (%)



Source: BBVA Research / Treasury Dept.

... appropriate way to proceed. The inverted hump at the short-end of the curve suggests...

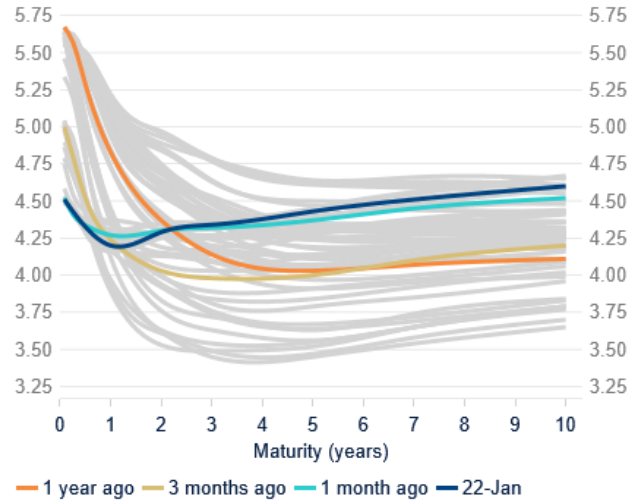
Figure 6. **TREASURY YIELDS**
(%)



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

... the market still expects the Fed to deliver a bit more easing before entering a prolonged pause...

Figure 7. **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.

... in the rate-cutting cycle later this year. Thus far, there has been no market disruptions...

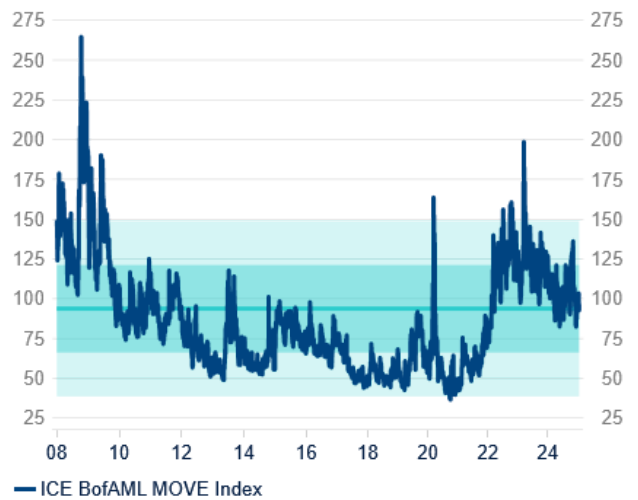
Figure 8. **10-YEAR TREASURY YIELD DAILY CHANGE**
(% AND BPS)



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

... following the administration change. Elevated long-term yields have allowed both the 10y-2y...

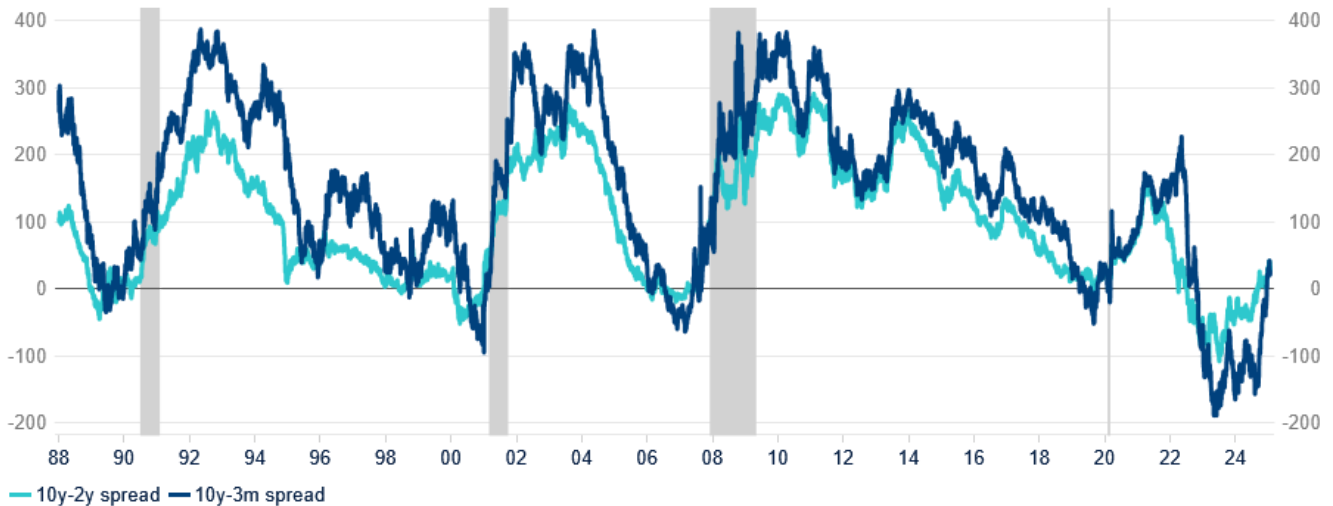
Figure 9. **ICE BOFAML MOVE INDEX**
(BPS)



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

... and 10y-3m yield spreads to continue to hover above zero despite the expectation that the monetary policy easing process could take longer than previously thought. High nominal yields are largely a...

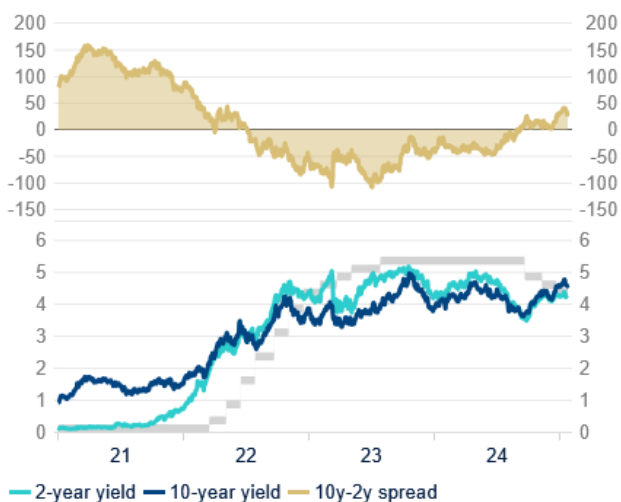
Figure 10. **TREASURY YIELD SPREADS (BPS)**



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

... result of higher real yields, with markets mainly factoring in increased risks around both...

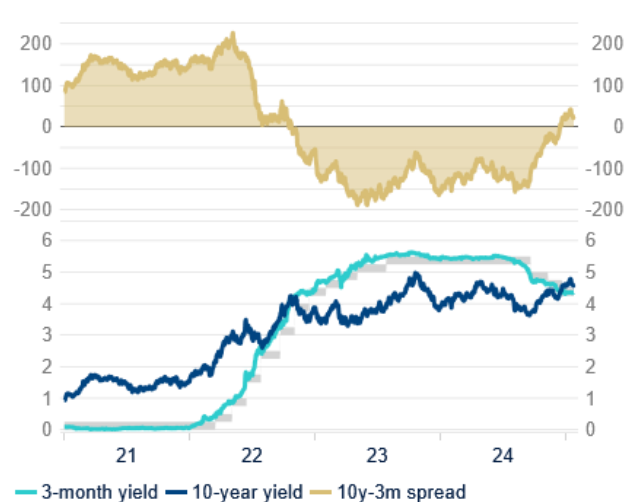
Figure 11. **10Y-2Y TREASURY YIELD SPREAD (BPS AND %)**



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

... growth and inflation outlooks rather than simply adding higher inflation compensation

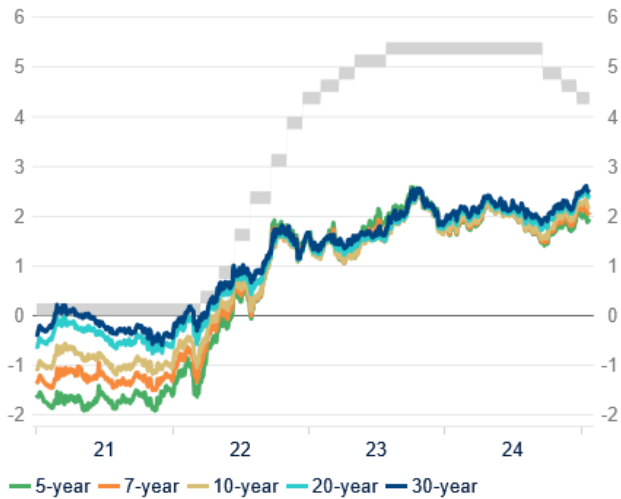
Figure 12. **10Y-3M TREASURY YIELD SPREAD (BPS AND %)**



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

Some FOMC members such as Gov. Waller continue to think that “we need...

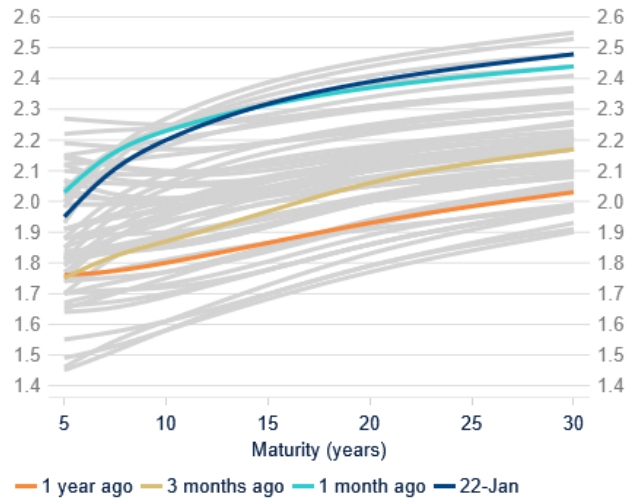
Figure 13. **TREASURY REAL YIELDS (TIPS)** (%)



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

... to see what policies are enacted before we can seriously consider their effects.” Markets...

Figure 14. **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.

... seem to share the view that “upside risks to the inflation outlook [have] increased,” but also...

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



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

... that the likely one-off nature of a tariff-driven inflation shock is unlikely to de-anchor...

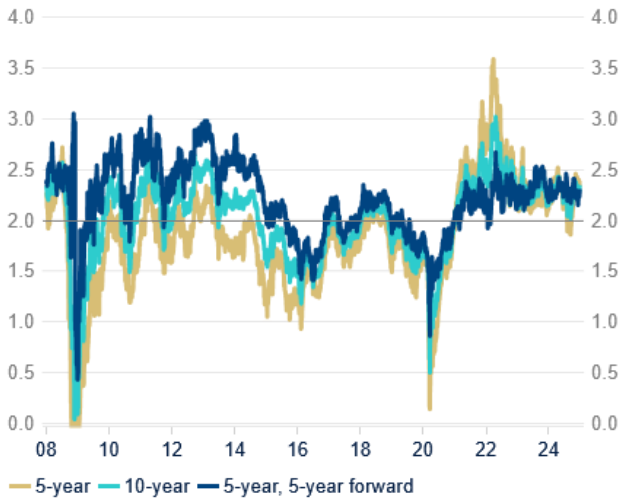
Figure 16. **10-YEAR TREASURY BREAK-EVEN INFLATION RATE (%)**



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

... their inflation expectations. More permanent effects on prices would come from a massive...

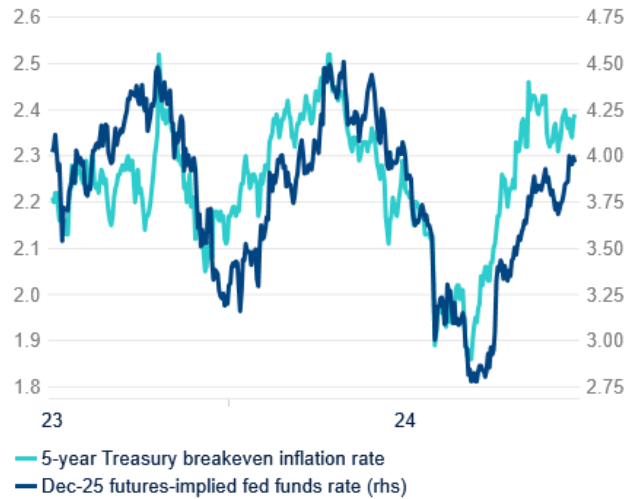
Figure 17. **BREAKEVEN INFLATION RATES (%)**



Source: BBVA Research / Treasury Dept.

... hit to immigration, but markets do not appear to be pricing in such a scenario now

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



Source: BBVA Research / CME / Treasury Dept.

Although it stepped back in the last few days, the 10y term premium rose to a 68bp decade-high...

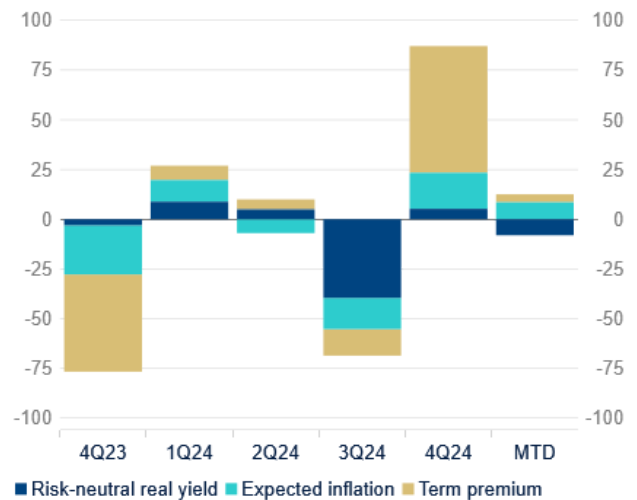
Figure 19. **10-YEAR TREASURY YIELD AND TERM PREMIUM (%)**



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 Dept.

... earlier last week as concerns about inflation risks and fiscal sustainability continued to mount

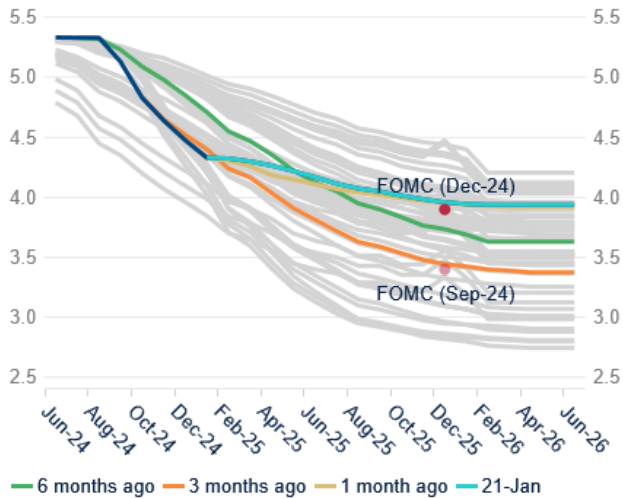
Figure 20. **10-YEAR TREASURY YIELD CHANGE BREAKDOWN (BPS)**



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

Futures-implied chances of a 25bp rate cut in March fell from 50 to 25% over the past month, ...

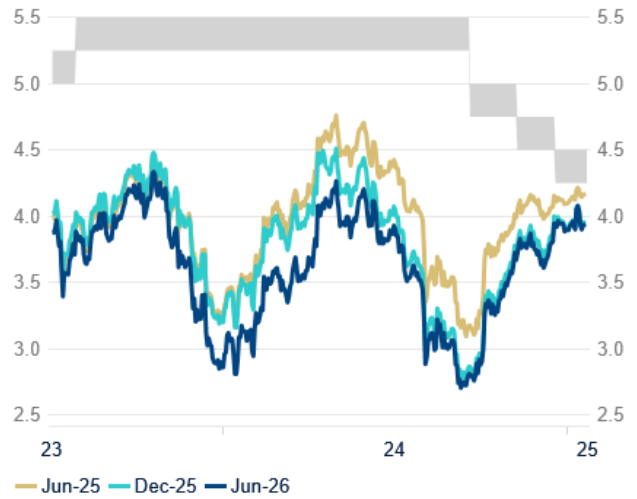
Figure 21. **FUTURES-IMPLIED FED FUNDS RATE (%)**



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

... but further easing of at most 50 bps by year-end is still on the table

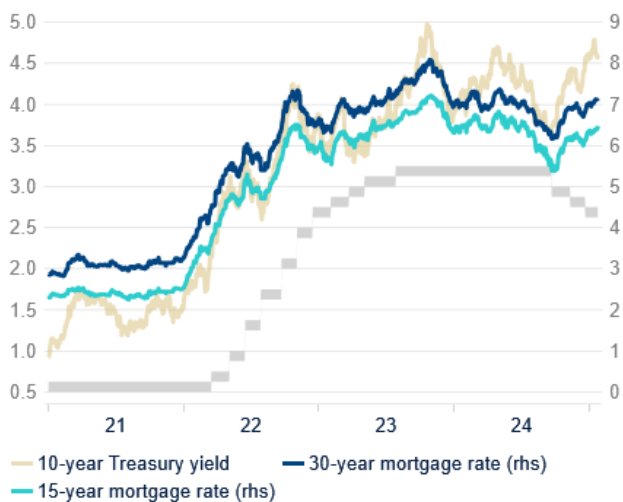
Figure 22. **FUTURES-IMPLIED FED FUNDS RATE (%)**



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

A tight policy stance will continue to weigh on rate-sensitive sectors, particularly real estate, ...

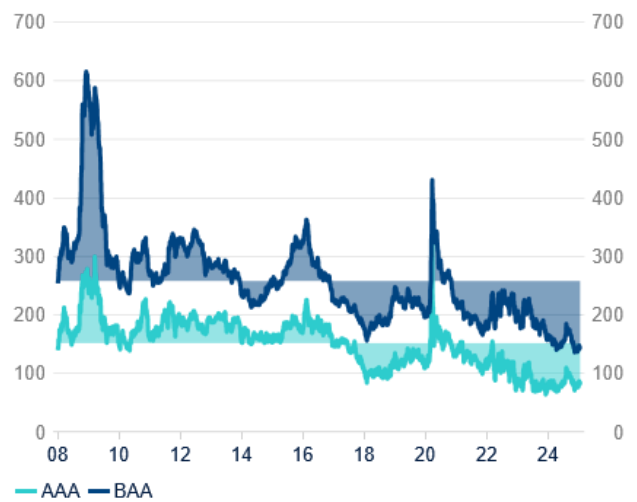
Figure 23. **MORTGAGE RATES (%)**



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

... while corp.-debt risk premia remain near the bottom of their historical distributions. Indeed, ...

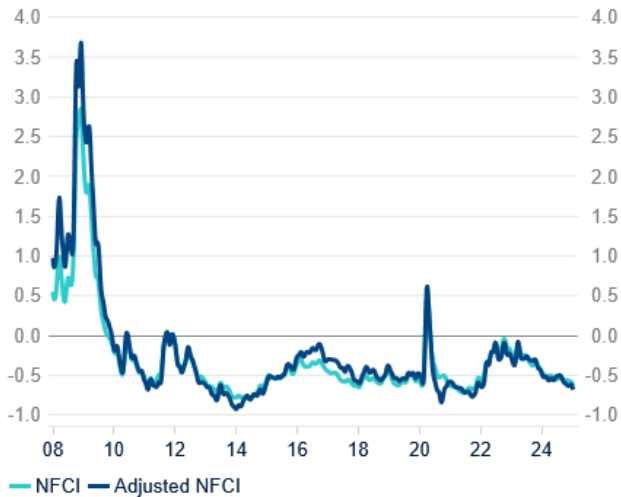
Figure 24. **CORPORATE BOND YIELD SPREADS (BPS)**



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

... while Gov. Cook said recently that the financial system remains sound and resilient, she also...

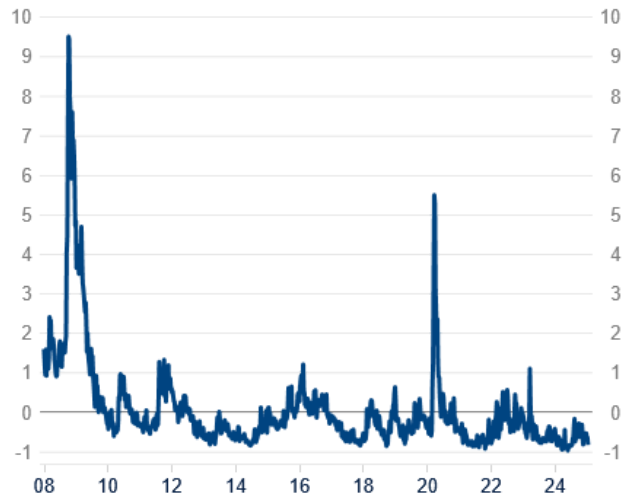
Figure 25. **CHICAGO FED NATIONAL FINANCIAL CONDITIONS INDEX (>0: TIGHTER THAN AVG.)**



Source: BBVA Research / Fed

... raised a few potential vulnerabilities that will require close monitoring: i) valuations are...

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



Source: BBVA Research / Fed

... elevated in a number of asset classes which, thus, are susceptible to large price declines, ...

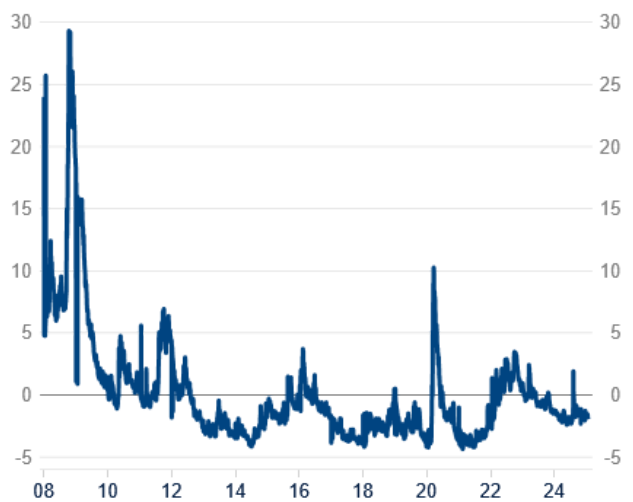
Figure 27. **KANSAS CITY FED FINANCIAL STRESS INDEX (>0: ABOVE AVG. FINANCIAL STRESS)**



Source: BBVA Research / Fed

... and ii) prices of commercial properties have fallen substantially, particularly office buildings

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



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

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