US Rates Strategy Weekly

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- Fed Chair Warsh is critical of the Fed's use of forward guidance. **Markets have interpreted this hawkishly largely because the Fed has in the past used forward guidance to "pre-commit" to easier policy**.
- Warsh argues that because the Fed seeks to avoid surprising markets, forward guidance may inadvertently commit it to stale forecasts. **In effect, policy flexibility becomes trapped by forward guidance**.
- However, we wonder if the problem is more with the frequency of its intermediate-term forecasts than forward guidance *per se*.
- **Last September, the Fed reviewed its communications strategy**. Nothing has been released so far to suggest that the Fed is considering a revamp although that may happen once the new Chair is seated.
- A solution might be to change the dot plot. **The FOMC could highlight a series of contingent paths in its dot plot**. This approach would help to clarify that forward guidance is conditional and data dependent.
- We look for the Treasury to keep coupon auction sizes steady through year-end. The Treasury can probably reduce bill issuance this quarter by at least $250bn although the magnitude depends on the size and timing of tariff refunds.
- We view any further selloff in rates, particularly on geopolitical escalation, as an opportunity to add front-end longs. We think rate hikes are unlikely this year and next.
- **We are forecasting gains of 42,000 and 41,000 for headline and private NFP, respectively.** Weak labor demand *and* supply have kept the unemployment rate range-bound. The unemployment rate is projected to increase 0.1% to 4.4%.

Too transparent?

Fed Chair Warsh is critical of the Fed's use of forward guidance. **Markets have interpreted this hawkishly largely because the Fed has in the past used forward guidance to "pre-commit" to easier policy**. *But is the issue forward guidance or simply too much transparency?*

Warsh's criticism seems to reflect a central line of reasoning – that is, **in the past 30y the Fed has become *too* transparent and perhaps *too* communicative.** Prior to February 1994, the Fed did not even communicate changes in its fed funds target; policy changes were inferred based on the size and type of daily reserve injections done by the New York Fed. Now, in addition to communicating rate changes, the Fed Chair holds press conferences after each FOMC meeting and the central bank publishes its growth, inflation and rate projections in the quarterly Survey of Economic Projections (SEP). Fed officials have always discussed policy in public and in the press.[1]

Analysts have become conditioned to the Fed telegraphing its policy intentions to avoid surprising markets. As a result, they scrutinize every word uttered by Fed officials for subtle signals about any shift in sentiment. Likewise, they pour over the dot plot looking for subtle changes in the distribution of the fed funds projections. **This week's FOMC statement added a new twist to this analysis with voting members dissenting on the direction of the bias statement**. Three FOMC members preferred an asymmetric bias tilted toward higher inflation risk. This is a little unusual as these types of "bias dissents" have usually been confined the meeting minutes where, as in March, "some participants remarked that further progress in reducing inflation had been absent in recent months." We interpret "some" to mean 3-5 and "participants" to include non-voting members. So this week's FOMC statement suggest that there may be more FOMC members leaning in the direction of an asymmetric bias the just Logan, Hammack, and Kashkari. We may have to wait until the June FOMC meeting to learn if bias dissents are a permanent refinement to the Fed's policy statement.

Because the Fed wants to avoid market surprises, it may inadvertently stick with a stale forecast for too long. Warsh cites the last round of QE as an example. The Fed's commitment to buy MBS after COVID continued long after that market recovered. And because language like "extended period" is imprecise it can cause the market to over-estimate the duration of existing policy or make it difficult for the Fed to quickly adapt to changing economic conditions.

But we wonder if the "locking in" effect from forward guidance may be more of an issue with the frequency of the Fed's intermediate-term forecast updates and how they are presented. Indeed, forward guidance was helpful in crises such as in 2008 and 2020. In both cases, the Fed needed to demonstrate it was committed to bringing down interest rates even though it could not (practically) take the fed funds rate below zero. QE "worked" in 2020 not so much because it sharply increased bank liquidity at the zero lower bound but because the Fed's purchases *proved* it was committed to bringing down term interest rates.

Last September, the Fed reviewed its communications strategy. Nothing has been released so far to suggest that the Fed is considering a revamp although that may happen once the new Chair is seated. **We think one area where forward guidance could be changed is with respect to the dot plot.**

Graphically, the plot does not provide any additional information beyond the (anonymous) rate assumption of an individual FOMC member. **There is no context around the participant's forecast or any risks the member sees. Similarly, the dots do not allow FOMC participants to provide contingent guidance**. Nor do they allow the member to emphasize any data dependency around the appropriate policy path.

Former Fed Chair Bernanke recommends the Fed consider publishing a quarterly Monetary Policy Report (MPR) that allows for a broad discussion of the risk and uncertainties in the outlook.[2] The MPR could be

[1] We focus on forward guidance here rather than say, limiting the number of Fed speakers and engagements.
[2] See, "Improving Fed Communications: A Proposal", B. Bernanke, Brookings Institute, Second Thomas Laubach Research Conference, May 16, 2025

based on forecasts provided by Board staff together with input from the district banks. It would include a summary of alternative scenarios for growth and inflation which could then be plugged into model simulations of the fed funds rate.[3] **Rather than a single path, the Fed would be able to highlight a series of "state contingent" ones in the dot plots**. This approach would clarify the Fed's forward guidance as the FOMC could more carefully outline the set of conditions necessary, for say, ending QE or cutting interest rates. Scenario analysis would allow the market to gauge the Fed's response to oil prices.

But there may be some complications with releasing conditional dot plots. Which and how many alternative scenarios should be provided? For example, in January 2019, the Board staff outlined seven different scenarios. The number of scenarios needs to be weighed against their detail. Simply publishing "high/low growth (inflation)" paths from meeting to meeting might not be very useful. To counter accusations of "groupthink" the alternative scenarios should create enough path divergence across FOMC members for the market to get a sense for the Fed's overall reaction function. That said, overly detailed alternatives may be too specific or too closely tied to current events to have a useful shelf life. There is also a risk of "forecast overload". Markets may stop paying attention if the Fed provides too many versions of alternative policy paths. Finally, it is not clear when the Fed should provide these scenarios. Should they be published before the FOMC meeting or, later with a lag. And, should these discussions be limited to the longer-term rate path rather than upcoming FOMC meetings.

May Refunding outlook

The Treasury is likely to leave its guidance unchanged. **We look for it to maintain current coupon auction sizes at least through year-end**. We think there is little reason for the Treasury to ramp up coupons given the strong demand for bills.

In the absence of the IEEPA refunds, the Treasury was set to pay down $300bn in bills through June 30. The Customs Bureau is scheduled to refund $166bn across 53m "entries". But the timing of these payments is a bit uncertain. The Custom Bureau's website opened on April 20 and as of April 26, 13.3m "entries" have been filed. Just 1.74m have moved to the payment phase.[4] The Bureau has previously indicated that they plan to pay out refunds within 45d of filing's approval. **Depending on how quickly Bureau can work through its claims, we think most of the refund payments will drift into Q3**. While we expect approximately $125bn to be refunded, it is not clear how much of this amount will flow out of the Treasury this quarter. Assuming a quarter of the total is paid out by June 30, the paydown amount may be closer to $270bn. We have increased our Q3 bill issuance projection ($350bn) to reflect these payments.

A decline in the demand for funding (as well as the Fed's earlier RMPs) has helped to keep repo rates slightly under IORB in April despite the $1trn sitting in the Treasury's account at the Fed.[5] We expect bill paydowns this month may tip repo rates down a couple of basis points.

Use dips to buy front-end

Treasury yields are back near late March highs, driven by higher oil and a more hawkish FOMC tone. **We view further selloff – particularly on geopolitical escalation, as opportunities to add front end longs.**

[3] See, "Could the Fed Replace the Dot Plot with Scenarios?", D. Wessel, Brookings Institute, August 1, 2024.
[4] About 15% of the claims filings have been denied, but it is not clear if these will be revised and resubmitted.
[5] Last week, we reviewed the possibility of capping the Treasury account and investing the difference directly into the repo market.

While near-term risks remain tied to developments in Mid-East, the medium-term distribution remains relatively constrained, in our view. As we outline in Table 1, even under more adverse scenarios, it is difficult to generate a sustained hiking cycle. A European-style repricing with peak event risk, where inflation concerns led to 90bp worth of hike expectations, would likely take the 2y toward 4.25% (4 hikes equivalent), which we view as a stress outcome.

Even assuming higher oil prices do not trigger slower growth, the distribution remains skewed against rate increases. Downside risk to growth and/or de-escalation in the Mid-East would likely see cuts priced back. Our base case remains one cut in spring 2027. Importantly, the 2027 voting cohort appears more dovish than the current composition, raising the bar for additional hikes in a supply driven inflation scenario (Table 2).

Table 1: Oil scenarios - limited hiking outcomes

		Deal $70-80 range	Higher for longer $100-120 range	Escalation $150-200
Growth	Weak	2-3 cuts	on hold	on hold
	Moderate	1 cut	on hold	1-2 hikes
	Strong	on bold	1 hike	2 hikes

Source: SMBC Nikko

Table 2: 2027 voting composition skews dovish

FOMC Voters	2026	2027
Dovish/Slightly dovish	4	5
Neutral	5	7
Hawkish/Slightly hawkish	3	0

Source: SMBC Nikko; Note: Warsh (slightly dovish)

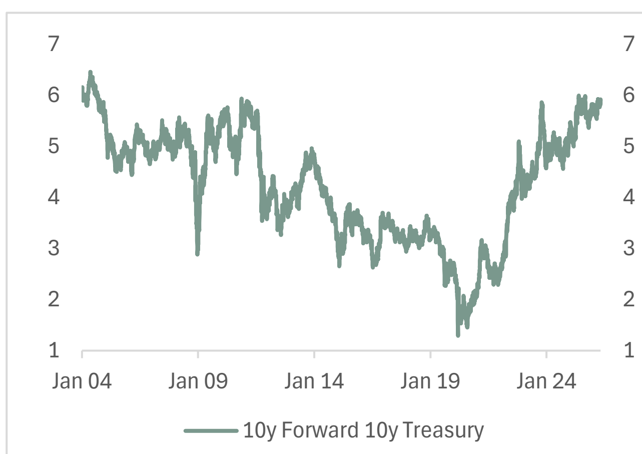
The FOMC's three dissents against an easing bias are already in forwards (Figure 1). While recent data have been firm (initial claims at 57year lows, real final sales to private domestic purchasers up 2.5% q/q,ar), it does not materially alter the medium-term policy path.

Long-end forwards (10y10y Treasury in Figure 2) are near highs last seen multiple times in 2025, and prior to that, over two decades ago. We think these levels will increasingly attract demand, reinforcing our preference for 2s10s steepeners over 5s20s or 5s30s.

Figure 1: Easing bias priced out in forwards (bps)

Source: Bloomberg, SMBC Nikko

Figure 2: Long-end forwards near highs (%)



Source: Bloomberg, SMBC Nikko

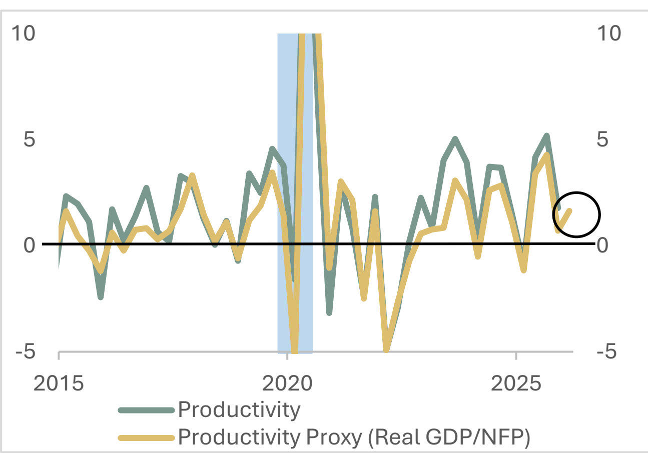
Week ahead

- **ISM Services Report (Apr, Tues)**: Services sector activity has remained robust in 2026 as Q1 real spending on services increased 2.8% y/y. We are forecasting the April ISM Services index to decline slightly to 53.7. We look for a normalization in the new orders component which was very high in March (60.6). Separately, we look for a rebound in the employment component.

- **Productivity (Q1, Thu)**: We estimate non-farm productivity will increase by 2.2% in Q1. Output growth remains solid. Capital deepening has increased with rapid investment in AI-related tech. It is unclear how much of this investment will increase output per hour and how quickly it will start to show up in the official indicators. Real GDP per worker increased 1.7% q/q, ar in Q1 (Figure 3).

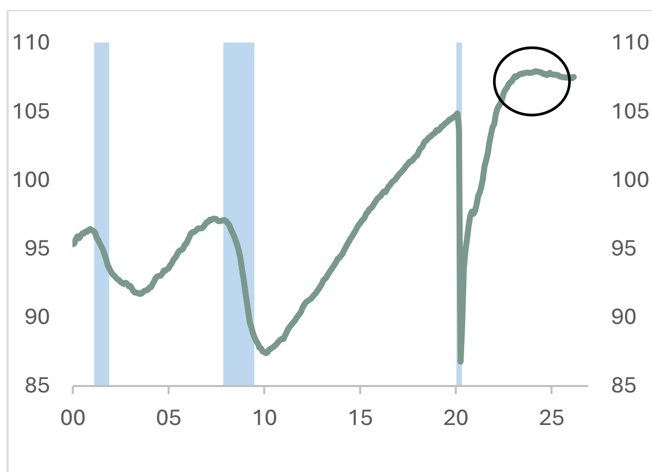
- **Employment Report (Apr, Fri)**: Payroll employment has been flat over the past year, averaging monthly gains of just 22,000/mo. Gains have been concentrated in private education and health services sector employment. Excluding this hiring, the private sector has *shed* 161,000 jobs cumulatively in the past year (Figure 4). **We are forecasting gains of 42,000 and 41,000 for headline and private NFP, respectively. Weak labor demand *and* supply have kept the unemployment rate range-bound**. We look for the unemployment rate to increase 0.1% to 4.4% in April on the back of a 61,000 decline in household employment and a 140,000 increase in the labor force.

Figure 3: Productivity and real GDP/worker (%q/q)



Source: BEA, BLS, Haver, SMBC Nikko

Figure 4: Private Payrolls excl. education and health services (m)



Source: BLS, Haver, SMBC Nikko

Table 3: Economic indicator forecasts

Date	Indicator	SMBC Forecast	Market Consensus (Median)	Prior	Range of Est.	Notes:
		SMBC US Forecasts				
May 5	ISM Services (10 AM)	53.7	53.7	54.0	53.0 - 54.5	Expecting new orders to decline from elevated levels and jobs to normalize from low levels in offsetting moves.
May 5	New Home Sales (10 AM)	1.9%	0.0%	-17.6%	-	New home sales trending flat at 2016-2018 levels.
May 6	ADP Employment (8:15 AM)	40k	85k	62k	50k - +120k	ADP continues to show mildly positive job growth of 0-100k gains over the last 12 months.
May 7	Productivity (8:30 AM)	2.2%	1.9%	1.8%	-	Real GDP per worker -- one measure of productivity -- increased by 1.7% QoQar in Q1.
May 7	Unit Labor Costs (8:30 AM)	3.3%	1.6%	4.4%	-	Small business data (NFIB) show Q1 worker compensation jumped by the most since Q4 2021.
May 8	NFP (8:30 AM)	42k	60k	178k	0k - +140k	12m average job growth = +22k.
May 8	Private NFP (8:30 AM)	41k	80k	186k	45k - +140k	We forecast: private ed. & health services at +46k. Forecasting private NFP excl P.E. & H.S. at -5k.
May 8	Unemployment Rate (8:30 AM)	4.4%	4.3%	4.3%	4.2% - 4.4%	Expecting household survey to show 140k increase in labor force and -61k decrease in HH employment.
May 8	Avg. Hrly Earnings (8:30 AM)	0.3%	0.3%	0.2%	0.3% - +0.4%	Avg hourly earnings running at 3.5% YoY, which is in line with pre-Covid levels. We expect wages will slow further.
May 8	U Mich. Consumer Sentiment (10 AM)	51.1	48.8	49.8	48.0 - 49.8	Jobs and news sentiment remains low, while inflation is high. Consumer sentiment should remain low.

Forecasts subject to change

Source: SMBC Nikko Securities US Economics Forecasts

Table 4: GDP and interest rate projections (%)

(%)	2025	2026				2027	
	Q4 Act	Q1F	Q2F	Q3F	Q4F	Q1	Q2
Real GDP QoQar	1.4	2.0	1.1	2.1	2.2	2.0	2.4
Real GDP YoY	2.2	2.9	2.2	1.6	1.8	1.8	2.2
Core PCE YoY	2.9	2.7	3.0	2.7	2.4	2.3	1.9
Unemployment	4.4	4.5	4.8	4.7	4.6	4.6	4.6
Fed Funds Rate Upper Bound	3.75	3.75	3.75	3.75	3.75	3.75	3.50
2 Year	3.47	3.79	3.65	3.60	3.60	3.50	3.50
5 Year	3.73	3.94	3.80	3.75	3.75	3.60	3.60
10 Year	4.17	4.32	4.20	4.25	4.30	4.30	4.30
30 Year	4.84	4.91	4.70	4.80	4.85	4.90	4.90

Source: SMBC Nikko

Disclaimers