US Rates Strategy Weekly

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- Bank reserves are set to fall to $2.9trn in coming weeks as the Treasury's cash balance lingers near $1trn. **We do not expect this level of reserves to push funding rates higher as it did last fall**.

- **Instead, cash market volatility since the start of the Iran conflict seems to have reduced the demand for leverage and helped to soften repo rates**.

- We expect the Fed to cut the size of its RMPs further next month. RMPs may vary more from month to month given seasonality in currency demand and quarterly corporate tax payments.

- **Bill supply is expected to increase in June through year-end (by $500bn) although there is some uncertainty about the size of tariff refund filings**.

- We see **value in longer dated vol as a stagflation hedge**, alongside **selective front-end duration**, with a wide distribution of outcomes in the medium term.

- We are forecasting robust increases of 1.9% m/m and 1.4% m/m in March total and ex autos retail sales.

Competing forces

As households pay their taxes cash flows from bank deposits into the Treasury's account at the Fed draining bank reserves. Tax inflows swelled the Treasury's cash balance to $925bn on April 15, up from $893bn at the end of March. We expect balances to remain near $1trn through early May. **These high balances could pull bank reserves to $2.9trn or less – that is, close to the level prevailing last fall when overnight repo rates traded consistently above IORB** (Figure 1). At the time, there was sporadic use of the SRP and, worried that reserves had become scarce, the Fed began expanding its balance sheet through bill purchases (or reserve management purchases, RMPs). On April 15, banks and dealers tapped the SRP in the morning for $10bn in funding. At the time, Treasury repo rates were 3.76% and only mildly heavy.[1] **With reserves likely to remain near $2.9trn through early May, will repo rates trade above IORB?**

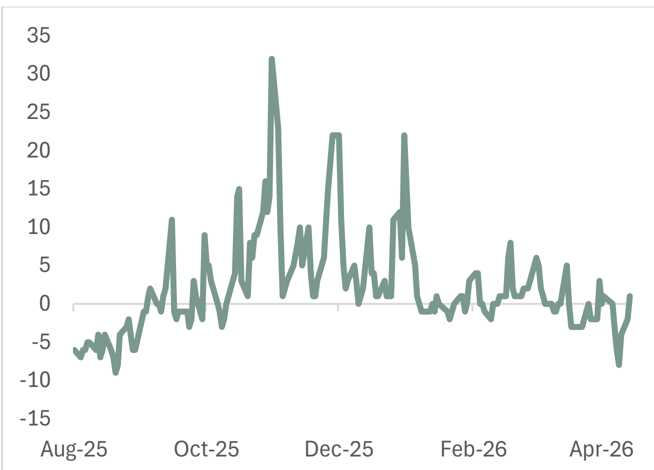
Our sense is that repo rates will hold at or slightly below IORB and that any use of the SRP will be small and infrequent. Reserve balances influence the supply side of the repo rate equation. Our sense is that if the demand for funding was as robust as it was last fall, this level of reserves could push SOFR

[1] The Treasury repo rate was just 1bp above the SRP's minimum bid rate. Most of the funding was against MBS which trade at a higher rate.

back above IORB. But the Treasury began trimming bill supply in late March. These cuts have reduced the supply of a repo substitute for cash investors like money funds. Mechanically, the reductions also redistribute the supply of reserve balances from the Treasury's deposit to bank reserves as bill holders receive their cash back. Bill supply has fallen $125bn since the beginning of the quarter. Assuming weekly auction sizes hold steady at current levels, issuance may shrink another $120bn in the next three weeks.

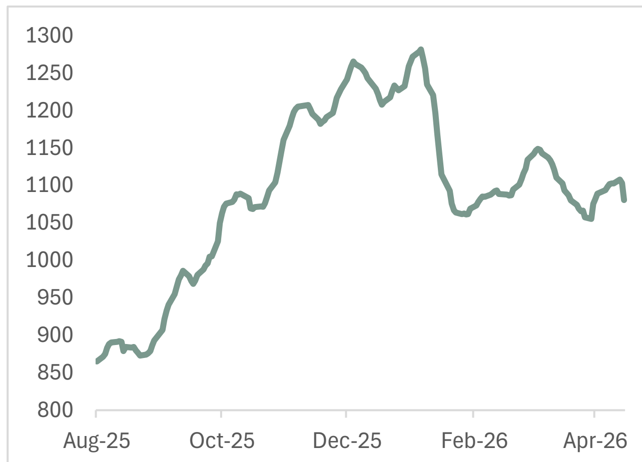
We suspect that recent market volatility will help keep funding rates subdued by reducing demand. As investors reduced their positions last month and moved to the sidelines, their demand for leverage and secured funding fell. Sponsored repo volumes are about 5% lower than they were at the beginning of the conflict (Figure 2). And balances are lower than they were last November when repo rates were trading above IORB. Together with the Fed's RMPs, SOFR has traded a basis point below IORB since the end of February.

Figure 1: SOFR-IORB (bp)



Source: Federal Reserve, SMBC Nikko

Figure 2: Sponsored repo ($bn)



Source: DTCC, SMBC Nikko

RMPs

The Fed announced this week that it was trimming its monthly RMP purchases from $40bn/m to $25bn/m. **We think it could reduce the pace further next month – to perhaps $15bn/m**. When the program was launched last December, the Fed indicated that it would reduce the monthly pace after the April tax date. The purchases were initially set at $40bn/mo to build up a buffer of reserves ahead of the expected Treasury cash drain in April. Without a similarly large anticipated reserve reduction in the near-term, the Fed can slow its RMPs to match the growth in currency and a higher trend balance in the Treasury account. Assuming monthly currency growth of about $5bn/m and a year-end Treasury balance of $950bn, we think the Fed might need to buy between $10-15bn/mo in bills to keep reserve balances steady.

But currency growth is seasonal – it tends to grow faster late in the year around the holidays.[2] As a result, we think the Fed's RMPs could increase in November and December. Together with regular spikes in the Treasury's cash balance on (quarterly) corporate tax dates, this points to more variability in the monthly RMP sizes.

[2] We are ignoring secular effects from changes in interest rates and electronic payments.

We think this raises two issues. First, the Fed can "pre-place" reserves through RMPs if it has a sense for the scale and timing of the expected reserve drain. However, if the drain is sudden or it turns out to be larger than forecast, there is some risk that balances slip to less than ample. Banks and dealers have shown more willingness to use the SRP so a temporary reserve shortfall might be addressed through these operations. But overnight repo rates might first need to trade above the top of the fed funds band (that is, IORB+10bp) for this liquidity to be economical. Second, the variability in RMPs implies more fine tuning and general reserve management with an efficiently sized balance sheet. By contrast, a less-tightly managed balance sheet with a thicker cushion of reserves might absorb variation in the Treasury's cash balance or any other non-reserve factor more easily without SRP use. A criticism of the large size of the Fed's balance sheet is that it requires the Fed to maintain a large financial market "footprint".[3] But size of the "footprint" might also be large in a system where the balance sheet is more efficiently-sized and banks regularly borrow from the SRP. Put differently, is the footprint different if it is temporary (that is, reserve expansion through SRPs) or permanent through secondary market purchases.

Bill supply

Bill supply is expected to increase starting in June. We think the Treasury might need to issue $500bn or more in bills through year-end. However, this amount is sensitive to the amount of tariff refunds the Customs Bureau makes. We assume that most of the $170bn in IEEPA tariffs will be returned to importers once the Bureau's claim filing website becomes operational next week. The Bureau has indicated that it plans to send out refunds within 45d of a claim filing which could mean that most of the $170bn in refunds would be made in Q3 (and financed through heavier bill issuance).[4] However, it appears that only 20% of the 300,000 firms eligible to receive refunds have signed up online. While we expect this share to increase it is possible that less than $170bn is ultimately refunded.

Longer dated vol on belly as a stagflation hedge

Our near-term base case is a stagflationary mix, with growth slowing into Q2 to 1.1% q/q, ar accompanied by a sharp 4% y/y increase in CPI. Under that scenario, we think the Fed reaction function is key. Our strong view is that the Fed is unlikely to respond with hikes, even if inflation proves firmer in coming months and the front-end should not be affected much. Instead, policy inertia alongside sticky inflation should put upward pressure on long-end yields through a rise in term premium, helping payer structures

At the same time, we prefer straddles over outright payers, as the distribution of outcomes remains wide. While stagflation along with a dovish Fed argues for higher long-end rates, a sharper growth slowdown can easily be justified. One potential scenario would be where lower consumer spending due to the drag from higher energy prices is compounded by other shocks – say renewed stress in private credit or broader risk markets. The result would be that rates could be pulled materially lower as expectations of Fed easing are priced into the curve. That two-sided distribution makes volatility more attractive way to express the view than outright duration.

Vega is attractive following the recent retracement. After trading at multi-year lows in late January, vol structures such as 3yx10y repriced higher through March but have since given back roughly about 77% of that move. This leaves them cheap against a backdrop where macro uncertainty remains elevated. These structures allow investors to express view on medium-term regime shifts without the need to time gamma with realized vol low, making them a better vehicle to position for evolving macro risks.

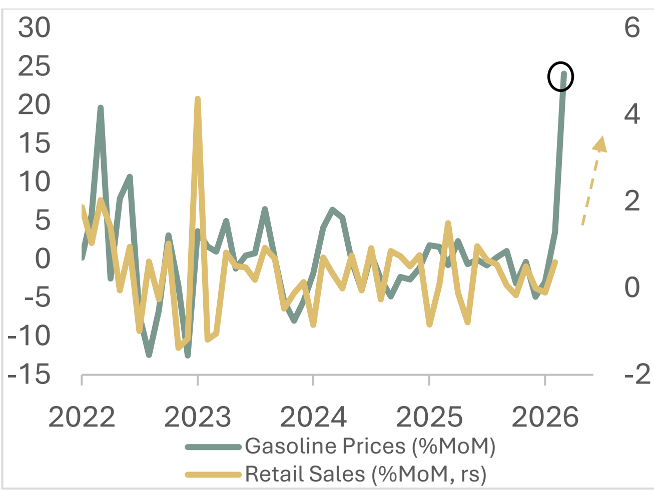
[3] By no means, the only one.
[4] We assume this will take the form of two or more large cash management bills (CMBs).

In parallel, we see value in the 2y sector with yields around 3.75%. It is attractive across a variety of scenarios. In a constructive geopolitical backdrop (e.g. de-escalation in the Middle East), front-end pricing would be anchored while in a downside scenario, cleaner positioning, particularly in Europe and compared to late February when 3 cuts were priced, leaves room for a more conventional flight to quality bid in the 2y. We would scale longs with a portion around 3.75% and add more meaningfully into 3.90-4.00%.

Week ahead

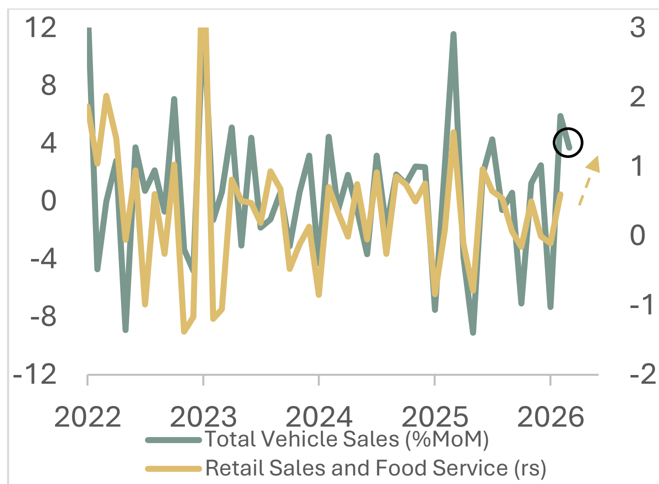
- **Retail Sales (Mar., Tues)**: We are forecasting robust increases of 1.9% m/m and 1.4% m/m in March total and ex autos retail sales, respectively. Two factors stand out. First, there was an inflationary effect on nominal service station sales from the 24%m/m increase in gasoline prices (Figure 3). Second, total unit vehicle sales increased by 3.7% m/m in the month (Figure 4). Inflation adjusted retail sales have trended sideways since 2021, as consumer spending has struggled to beat the rate of economy-wide inflation.

Figure 3: Gasoline Prices (%M/M) and Retail Sales (%M/M)



Source: EIA, Census, Haver, SMBC Nikko

Figure 4: Total Vehicle Sales (%M/M) and Retail Sales (%M/M)



Source: BEA, Census, Haver, SMBC Nikko

Table 1: Economic indicator forecasts

SMBC US Forecasts							
Date	Indicator	SMBC Forecast	Market Consensus (Median)	Prior	Range of Est.	Notes:	
Apr 21	Retail Sales (8:30 AM)	1.9%	1.2%	0.6%	0.6% - +2.0%	Retail spending is likely to increase due to a 24.1% MoM jump in gasoline prices. Real retail sales flat since 2021.	
Apr 21	Retail Sales ex autos (8:30 AM)	1.4%	1.3%	0.5%	0.6% - +2.1%	Additionally, total vehicle sales (BEA) increased by a substantial 3.7% MoM.	

Forecasts subject to change

Source: SMBC Nikko Securities US Economics Forecasts

Table 2: 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

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