US Rates Strategy Weekly

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- Friendly inflation data reduced the market's near-term rate hike expectations. That said, we suspect the sharp decline in gasoline prices is temporary.

- **Despite Fed Chair Warsh's reiteration of the FOMC's strong commitment to price stability, 10y yields failed to rally much this week**. Instead, the market has been rangebound since May between 4.40% and 4.60%.

- The Fed's Monetary Policy Report to Congress pointed to additional factors beyond energy prices for the acceleration in inflation this year. These include tariff pass-through and AI buildout effects on electricity prices.

- **Higher prices seem to have had a mixed effect on demand.** For example, although airfares are nearly 30% higher than last year, bookings for future travel are about 15% higher than a year ago. At the same time, households may be using their credit card rewards for mundane purchases rather than "dream" trips.

- The Treasury has returned just over $90bn to importers who paid IEEPA tariffs. We expect that total to rise to $125bn by month-end. To finance its refunds, the Treasury has sharply increased bill issuance this month; bill supply has increased $130bn and is projected to rise another $200bn through September.

- **Despite the ramped up bill issuance, funding rates have been tame with SOFR regularly trading below the fed funds rate.** Financing demand eased after the start of the Iran conflict.

- Over half of hedge funds' financing is provided by US GSIBs. Most of the remainder comes from non-US GSIBs. **The largest funds have more financing counterparties (around 25) and less concentrated funding than smaller funds**.

- **We forecast a 4% m/m rebound in new home sales in June**. New home sales remain challenged by a range of factors including high home prices and high mortgage rates.

Friendly data, sour market sentiment

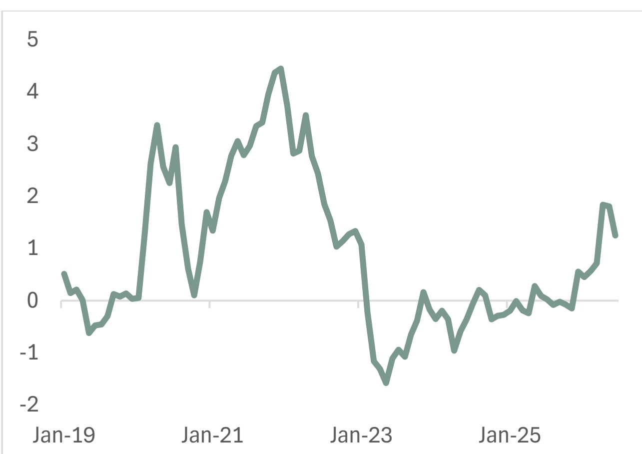
Friendly inflation data reduced the market's near-term rate hike expectations. The probability of a 25bp increase at the July FOMC meeting fell from near 50% before Tuesday's CPI release to less than 15% on

Wednesday after the PPI release.[1] And while 2y yields initially rallied 14bp, they drifted higher mid-week. Yields fell on Thursday night following a selloff in chip stocks. Despite better-than-expected retail and wholesale prices, Chair Warsh warned markets that the Fed is committed to restoring price stability and that it is too early to declare “mission accomplished”. The payback in 2y yields after benign inflation datea may be a sign of uncertainty as the market adapts to a new regime of terser policy statements and a lack of forward guidance. A re-escalation of the Iran conflict could push oil prices back to their spring highs. As a result, we think the sharp declines in June gasoline prices at wholesale and retail levels are temporary and backward looking.

That said, our expectation was that Warsh’s reiteration of the Fed’s firm commitment to price stability would have lowered 10y yields more. Instead, 10y yields continue to hover toward the upper end of the 4.40%-4.60% range where they have been since May. While yields may struggle to slip below 4.4%, we suspect that it will be difficult for them to rise much above 4.60% without some supply catalyst or doubts about the FOMC’s credibility. Treasury issuance is expected to remain concentrated in the front-end; we expect *all* coupon auctions sizes to be kept steady through February 2027. And, of course, Chair Warsh has been very vocal about restoring and maintaining Fed credibility.

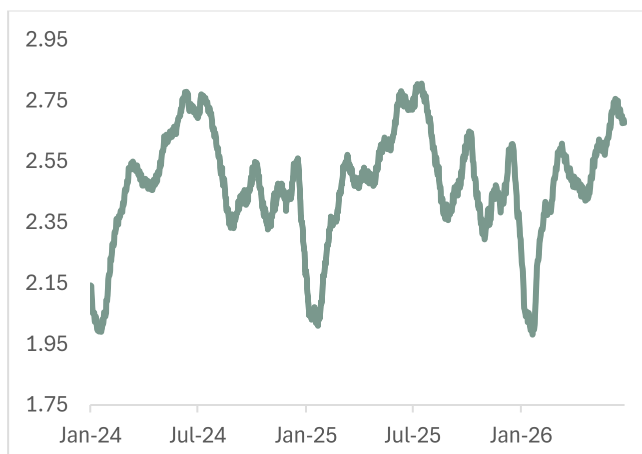
Supply side price measures have generally cooled since May. The NY Fed’s global supply chain pressure index slowed in June (Figure 1). At the same time, the percentage of manufacturing purchasing managers reporting slower deliveries or higher order backlogs has returned to pre-Conflict levels. But lagged energy effects on fertilizer and plastic packaging prices may still be working through the data.

Figure 1: Global supply chain pressures (%)



Source: Federal Reserve Bank of New York, SMBC Nikko

Figure 2: TSA checkpoint travel numbers (mns)



Source: TSA, SMBC Nikko

However, this year’s acceleration in inflation may not be entirely energy-driven. The Fed’s Monetary Policy Report to Congress pointed to additional factors including tariff pass-through and AI buildout effects on electricity prices. A recent study noted that more tariff pass-through effects were expected.[2] Among service sector and manufacturing firms that had paid tariffs in the past year, roughly half had plans to

[1] And 10% on Friday morning.

[2] See, “More Tariff Pass-through is in the Pipeline”, J. Abel, M. Amiti, R. Deitz, S. Heise, and N. Montalbano, Liberty Street Economics, Federal Reserve Bank of New York, July 8, 2026.

increase consumer prices further to recapture the taxes paid. Interestingly, this is despite February's IEEPA reversal and $90bn in tariff refunds issued since the beginning of May. The delay in tariff price pass-through may reflect fixed contracts where prices can only be adjusted higher at the start of a new agreement. It may also reflect companies' pricing strategies designed to minimize the effect on demand by recovering tariff expenses through gradual price increases.

Separately, the AI buildout may be pushing retail prices higher. There seems to be some disagreement about its role in pushing prices higher.[3] Fed Chair Warsh views the effect as a transitory one-time shock that shifts the level of prices up but doesn't cause them to accelerate. That said, electricity prices have risen since last year. And while they have cooled in recent months, at 4% household electricity prices are rising faster than the overall price level. Memory chip prices have risen 6-fold since last fall as much of the output is consumed by AI companies in long-term contracts that leave little supply available for PCs.

Higher prices seem to have had a mixed effect on demand. For example, although airfares are nearly 30% higher than last year, bookings for future travel are about 15% higher than a year ago. And TSA checkpoint screenings look like last summer's travel season. Households are not postponing their previously booked trips (Figure 2). That said, Bloomberg reported that higher prices may be pushing households to cash in their credit card points for mundane expenses like gasoline, groceries and cat litter.[4] Previously, a large share of credit card rewards were allowed to accrue to fund "dream" purchases like trips.

Bill supply and funding

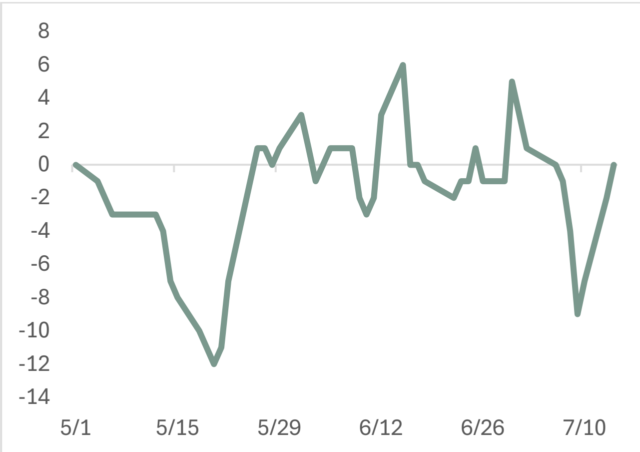
As noted above, the Treasury has returned just over $90bn to importers who paid IEEPA tariffs. We expect that total to rise to $125bn by month-end at which point the Treasury will have paid back nearly 75% of what it collected. To finance its refunds, the Treasury has sharply increased bill issuance this month; since July 1, bill supply has increased $130bn.

Yet, despite the ramped up bill issuance, funding rates have been tame with SOFR regularly trading below the fed funds rate (Figure 3). Softening repo rates briefly pulled the funds rate lower. The softness in financing costs began this spring. We initially expected repo rates to go higher with the Iran conflict as investors moved to raise financing and hoarded cash. But this did not happen and instead, investors seem to have trimmed their long positions and reduced their demand for secured funding. Indeed, as we recently wrote, while cash futures basis trades likely still account for a significant share of hedge fund long Treasury positions, their thin return has led to some reduction in positions. This position reduction has been large enough to offset the effects of higher bill supply. Sponsored repo volumes fell this spring but since late June these cleared transactions have inched higher (Figure 4). It is possible that range-bound yields might be encouraging investors to take on more leverage.

Over half of hedge funds' financing is provided by US GSIB banks. Most of the remainder comes from non-US GSIBs. The largest funds have more financing counterparties (around 25) and less concentrated funding than smaller funds. Creditor concentration at the top ten funds have declined since 2023 as these funds have increased their counterparties.

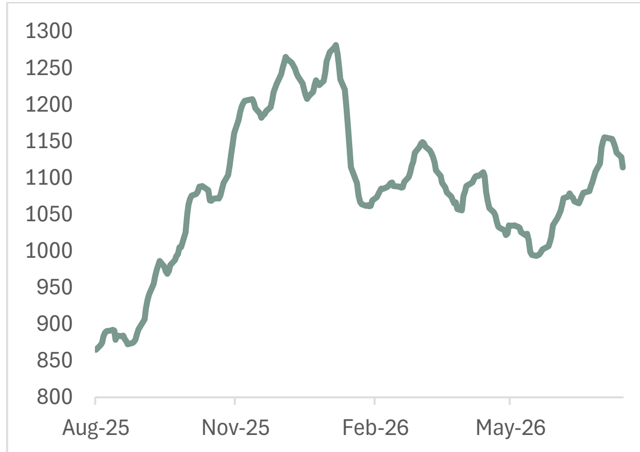
[3] Warsh argues that this may be the subject of a "good family fight".
[4] See, "Credit-Card Rewards Fund More Everyday Costs as Inflation Bites", J. Joshua, Bloomberg News, July 15, 2026.

Figure 3: SOFR-FF (bp)



Source: Federal Reserve, SMBC Nikko

Figure 4: Sponsored repo ($bn)



Note: 20d average. Source: DTCC, SMBC Nikko

Week ahead

- **New Home Sales (Jun, Fri)**: We forecast a 4% m/m rebound in new home sales in June. New home sales remain challenged by a range of factors including high home prices and high mortgage rates. New construction is helping to pull home prices lower.

Table 3: Economic indicator forecasts

SMBC US Forecasts						
Date	Indicator	SMBC Forecast	Market Consensus (Median)	Prior	Range of Est.	Notes:
Jul 24	New Home Sales (10 AM)	4.1%	2.6%	-7.3%	2.1% - +3.1%	Mechanical rebound. Home sales are challenged by high mortgage rates, high prices and ultra low affordability.

Forecasts subject to change

Source: SMBC Nikko Securities US Economics Forecasts

Disclaimers