US Rates Strategy Weekly

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- **We are somewhat skeptical that the Fed's inflation-fighting credibility has fallen enough to justify the back up in term interest rates.** That said we expect Fed officials to provide some "guidance correction" this week.

- Some of the backup in term rates, however, reflects the Warsh Fed's shift in communications strategy. Fed Chair Warsh is philosophically opposed to forward guidance arguing that the wisdom of financial markets is greater than the Fed's phalanx of economists.

- **Rather than guiding markets, Warsh feels the Fed should be guided by them.** This reverses the direction of the guidance and it also creates a problematic mirroring effect which exacerbates near-term volatility.

- The Fed may need to rethink forward guidance time horizons. **While it makes sense to increase policy setting flexibility in the intermediate and long run, there may be little value in surprising markets at upcoming FOMC meetings**.

- We look for the Treasury to keep coupon auction sizes steady for another "several" quarters. It may shift the 7y to quarterly new issues at this refunding.

- **We expect the Treasury to issue $300bn in bills this quarter and a similar amount in Q4 (with a year-end cash target of $1trn)**. Next year's bill issuance may be around $800bn with the bill debt share increasing to 22.6% in December 2027.

- With 30y yields at post 2007 highs and the 10y near top of its recent range, capping the long end requires a hawkish Fed, benign inflation prints, lower oil prices, risk off episode or a G10 long-end rally.

- 30y real yields (TIPS) near 3% are at the highest levels since 2002. Combined with breakevens near lows, we think long term investors should start building positions.

- We look for the ISM manufacturing index to come in at 53.2 in July unchanged from its June reading of 53.3. **Non-farm payrolls are expected to rise by 110,000 in July with the unemployment rate holding steady at 4.2%**.

Dovish tilt…

Outside of the front-end of the Treasury curve, markets were disappointed by the absence of a rate hike at this week's FOMC meeting. On Wednesday, 10y and 30y yields increased 7 and 11bp, respectively and the 2s-10s curve steepened 9bp (Figure 1). However, much of the move occurred during the new Chair's post-meeting press conference. Markets interpreted his remarks as being less than forceful endorsements of the Fed's inflation mandate. Remarks that the Fed Chair was looking at a broader array of inflation measures in addition to its PCE-defined mandate or that the FOMC was in a "watchful thinking" period were poorly received. This was particularly true for Warsh's observation that the backup in yields between the June and July FOMC meetings had done some of the Fed's "job"; tightening financial conditions without the need for an increase in the fed funds target. Rightly or wrongly, there was a sense that although Warsh has consistently sounded hawkish, he has been slower to act.

We are somewhat skeptical that the Fed's inflation-fighting credibility has fallen enough to justify the back up in term interest rates. **That said, it has been dented enough for Fed officials to offer some "guidance correction" next week that reinforces the Fed's vigorous commitment to price stability.**

…or failure to communicate?

The Fed was probably in an unwinnable position with respect to the outcome of its meeting. On the one hand, if it raised interest rates, the front-end rates would have sold off to reflect expectations of further, more aggressive rate hikes. On the other, by not hiking and delivering what was priced into futures ahead of the meeting, the Fed triggered a sharp sell-off at the back end of the curve. We suspect this "catch 22" was partly the result of the Warsh Fed's shift in communications strategy.

Fed Chair Warsh is philosophically opposed to forward guidance. One purpose of forward guidance is to minimize market reactions; to guide its expectations toward the Fed's view so that when the Fed does move there are no surprises. This is equivalent to its approach toward QT – balance sheet shrinkage should be so well-telegraphed that it is as eventful as drying paint. But in trying to bubble-wrap the market, Warsh argues that past forward guidance has bound the Fed to maintaining policies were outpaced by shifting economic fundamentals.

Instead, Warsh argues that the wisdom of financial markets is greater than the Fed's phalanx of economists. Markets collectively "know" more about the pace of inflation and health of the economy. As a result, the Fed should pay more attention to market "signals" than its own economic forecasts. **Rather than guiding markets, the Fed should be guided by them**. Consequently, as the hike probability heading into the July meeting was 30%, the "signal" it received from the markets "guided" the Fed to keep policy on hold.

This reverses the direction of the guidance the Fed and markets have relied on since the GFC. It also creates a problematic mirroring effect. Meeting outcomes are "supposed" to be high probability events that create few surprises. Surprises come only from the color the Fed chair provides at the post-meeting press conference. **With no forward guidance and a meeting outcome determined through healthy debate, markets struggle how to price the next FOMC meeting**. As a result, the markets reflect what they expect the Fed will do which is neither corrected nor revised through Fed guidance. In turn, the Fed interprets this "reflection" as a pure, unfiltered assessment of the economy and inflation. This creates feedback and introduces volatility to rate markets. At a minimum, markets need some help to learn to read the new Chair. They require more information about what he watches and importantly, which indicators he puts more emphasis on. If Warsh relies only on "market reflections" the resulting feedback loop will create recurring post-FOMC meeting volatility.

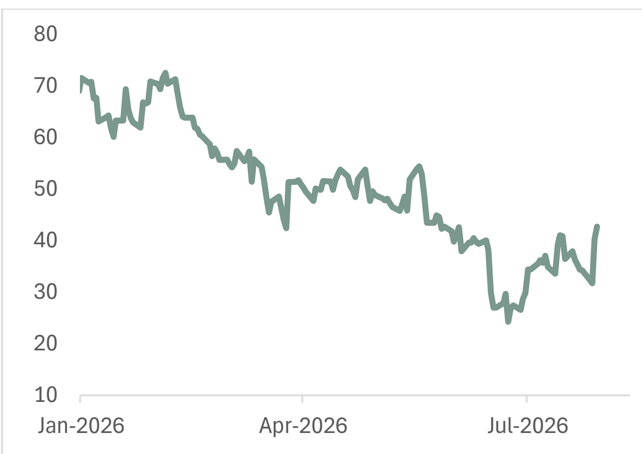
The Fed may also need to rethink the time horizon for using forward guidance instead of abandoning it. It makes sense for the Fed to have plenty of flexibility with respect to policy setting over intermediate and longer-term horizons where economic forecasts are likely to be as important as the collective wisdom of markets. **At these horizons, the Fed should make use of data contingent scenarios – not so much**

to guide expectations as to outline its reaction function and to reinforce its price stability commitment. However, at shorter intervals, like the next FOMC meeting, we think surprising markets is unproductive. That said, we think Warsh has an opportunity to reinforce the Fed's inflation-fighting credibility without creating market volatility in the front-end of the curve by delivering a hike at the September meeting in line with current market pricing.

Quarterly refunding outlook

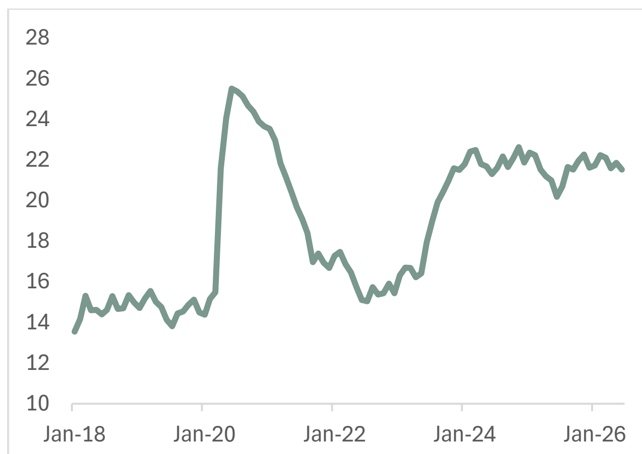
We expect the Treasury to keep its coupon auction sizes steady for another "several quarters". Our sense is that it will begin increasing shorter maturity coupons (2-5y) next summer. In the meantime, it will rely more heavily on the bill market for financing. **We expect bill supply to increase by nearly $800bn next year, pushing the bill/debt ratio to 22.6%** (Figure 2). The Treasury's bill ratio is close to its optimal debt issuance frontier which reflects the tradeoff between debt servicing costs and the volatility of those costs. Our sense is the Treasury might be able to increase shorter maturity coupon issuance somewhat next year without pushing up its servicing costs. That said, the Treasury's debt service costs are expected to exceed 4% of GDP over the next 20 years.

Figure 1: 2s-10s spread (bp)



Source: Bloomberg, SMBC Nikko

Figure 2: Bill share (% debt outstanding)



Source: US Treasury, SMBC Nikko

We look for bill issuance to increase $300bn in Q3 with a similarly sized gain in Q4 assuming a $1trn year-end cash target. Through early August, bill issuance has risen $320bn as the Treasury has amped up 4w, 6w, and 8w offerings instead of issuing cash management bills. Issuance should cool later this month as it works through the remaining IEEPA refunds. To date, the Treasury has already refunded $105bn out of the $170bn in collected duties.

The Treasury may decide to change the 7y auction cycle this month. It would move from monthly new issues to quarterly ones with two monthly reopenings. We think it has gathered enough information from dealers on settlement dates and repo trading patterns to shift to quarterly new issues at this week's refunding. We are unsure when the new 7y cycle could begin – perhaps this fall.

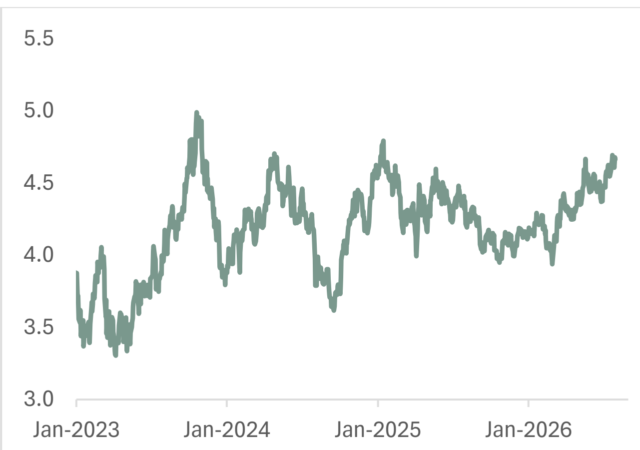
Separately, the Treasury asked primary dealers about investing a portion of its surplus cash (above its expected 5d buffer) in the repo market. As we wrote recently, we are uncertain the

Treasury's potential revenues from such a strategy would justify the volatility its cash could introduce into the repo market. Importantly, how much the Treasury can earn will depend on where tri-party repo rates trade relative to IORB. Assuming bank reserves remain ample, tri-party repo rates will trade close to IORB and the Treasury might earn less than $100mn annually.

What can stop the bond vigilantes

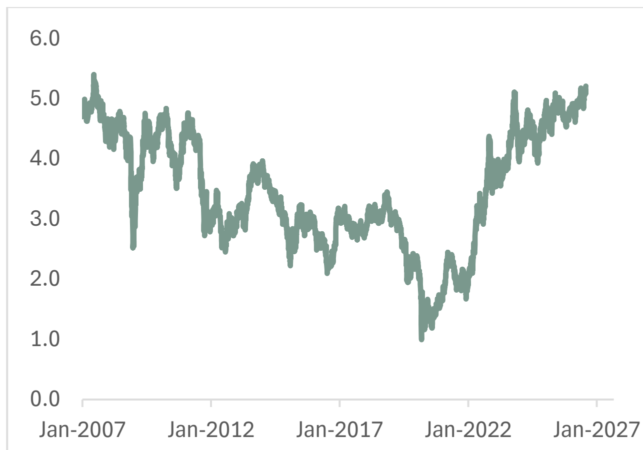
Long end (30y) yields are at their highest levels since 2007, while the 10y is near the top of its recent range (Figures 3 and 4). Yields are at crucial levels, and the risk of a breakout remains high. Capping the long end from here requires one or more of the following. First, as flagged previously, a hawkish message from Fed officials to repair dented credibility. Second, weaker economic data, particularly benign inflation prints (or lower oil prices) that would make a hawkish pivot redundant. Volatility is likely to pick up ahead the release of summer inflation indicators. Third, a risk-off episode (keep weak August/September seasonals in US equities in mind), which should also relieve upward pressure on long end rates. Lastly, a large move lower in G10 long end rates would help on the margin too. Until we get one or more of these, the risk is that the long end stays under pressure and the curve continues to steepen.

Figure 3: 10y Treasury (%)



Source: Bloomberg, SMBC Nikko

Figure 4: 30y Treasury (%)

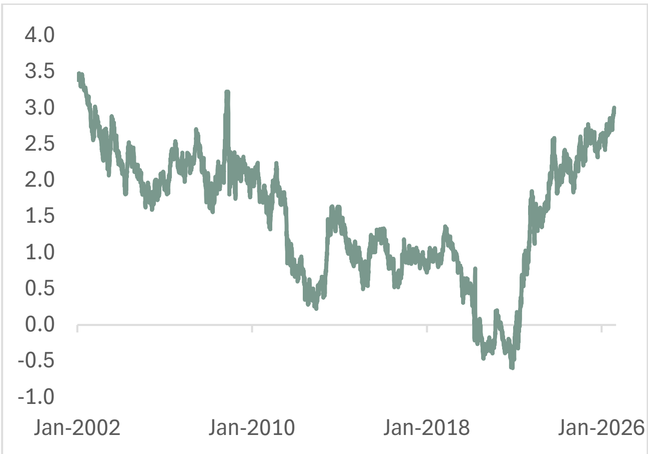


Source: US Treasury, SMBC Nikko

30y real yields: entry point for long term investors

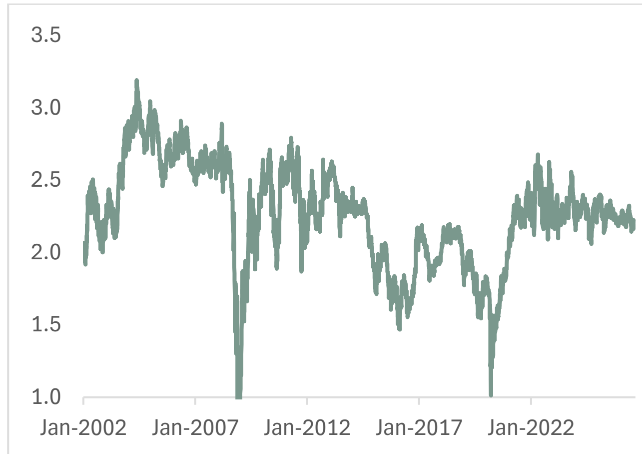
30y real yields (TIPS) are near 3%, the highest since 2002 aside from a brief spike above that level during the 2007 crisis (Figure 5). Several drivers have been cited – geopolitical risk premium with concerns about higher oil prices, fiscal concerns, Fed hawkishness. But at these levels we think they are appealing for long-term investors, who could start accumulating in here. The case is reinforced by breakevens, 10y and 30y are both near recent lows, and if the Fed's inflation fighting credibility is genuinely in question, breakevens should be trading higher (Figure 6).

Figure 5: 30y Real yields (%)



Source: Bloomberg, SMBC Nikko

Figure 6: 30y BEs (%)



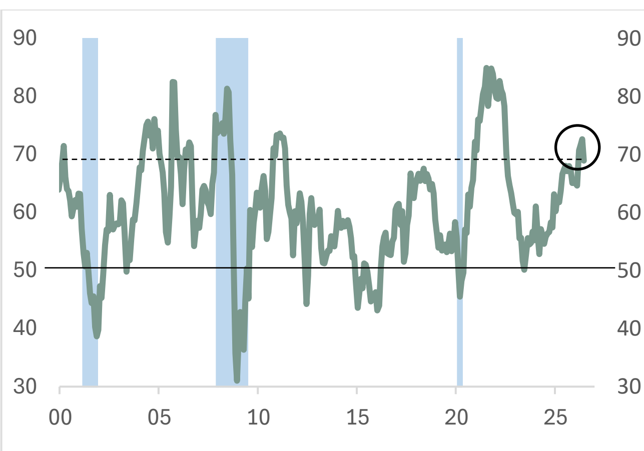
Source: US Treasury, SMBC Nikko

Week ahead

- **ISM Manufacturing and Services Reports (Jul, Mon & Tues)**: We look for the ISM manufacturing index to come in at 53.2 in July unchanged from its June reading of 53.3. We expect new orders and production to increase with inventories declining. The ISM services index is expected to increase modestly to 54.8 from 54.0 in June on the back of gains in business activity and new orders. Prices in both indexes are likely to remain elevated. In Figure 7 we plot the composite price index across both indexes.

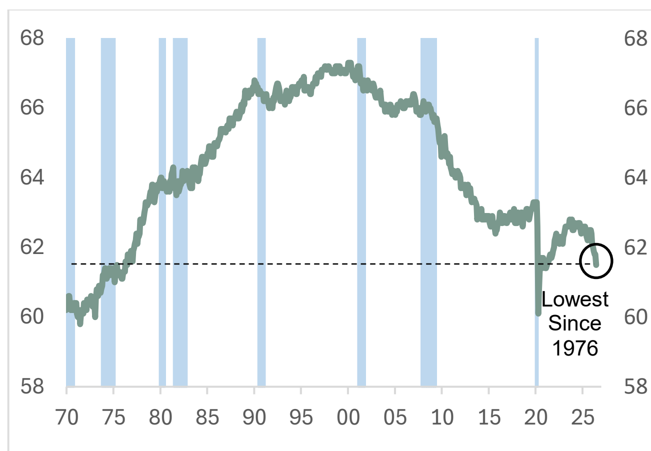
- **Employment Report (Jul, Fri)**: We look for non-farm payrolls to increase 110,000 in July with the unemployment rate holding steady at 4.2%. Job growth rebounded this spring but it unclear how sustainable this hiring following very anemic growth in 2025. Some of the recent acceleration in hiring may be related to leisure and entertainment hiring ahead of this summer's travel season and games. And while job openings have fallen from their 2022 peak, there is still slightly more than one job available for every single unemployed worker. Labor force participation has fallen to 61.5% in June – its lowest level since 1976 (Figure 8). Prime age worker participation is near a record high but participation for workers 55 and over has fallen to its lowest since 2005.

Figure 7: Composite ISM Prices (Index)



Source: ISM, BEA, Haver, SMBC Nikko

Figure 8: Labor Force Participation Rate (%)



Source: BLS, Haver, SMBC Nikko

Table 3: Economic indicator forecasts

SMBC US Forecasts						
Date	Indicator	SMBC Forecast	Market Consensus (Median)	Prior	Range of Est.	Notes:
Aug 3	ISM Manufacturing (10 AM)	53.2	54.0	53.3	52.9 - 55.4	Expecting production and new orders to accelerate and inventories to fall.
Aug 4	JOLTS (10 AM)	-	-	-	-	Look for job openings. The V/U ratio currently sits at a solid 1.0 reading and appears to have stabilized.
Aug 5	ADP Employment (8:15 AM)	65k	75k	98k	75k - +101k	Weekly ADP employment showed +31k job gains in first two weeks of July.
Aug 5	ISM Services (10 AM)	54.8	54.3	54.0	54.0 - 56.4	Forecasting business activity, new orders, and delivery times to all increase.
Aug 6	Productivity (8:30 AM)	2.4%	3.0%	0.3%	-	Based on our 2.7% Q2 GDP forecast
Aug 6	Unit Labor Costs (8:30 AM)	0.4%	0.5%	1.8%	-	Based on our 2.7% Q2 GDP forecast
Aug 7	NFP (8:30 AM)	111k	90k	57k	65k - +157k	forecasting: government +17k. Private education and health services at +45k.
Aug 7	Private NFP (8:30 AM)	94k	83k	49k	65k - +143k	6m ma private NFP at +88k, the highest since June 2024.
Aug 7	Unemployment Rate (8:30 AM)	4.2%	4.3%	4.2%	4.1 - 4.3%	Forecasting household employment at +150k, labor force at +140k. LF participation is at the lowest since 1977!
Aug 7	Avg Hourly Earnings MoM (8:30 AM)	0.3%	0.3%	0.3%	0.2% - +0.4%	Avg hourly earnings growing at 3.5% YoY--in line with pre covid pace.

Forecasts subject to change

Source: SMBC Nikko Securities US Economics Forecasts

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