US Rates Strategy Weekly

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- **Market uncertainty about the outcome of this month's FOMC meeting is unusually high**. While we expect the Fed to hold off hiking rates this week, we would not be surprised if they did.

- Pricing appears to reflect the sense that Warsh wants to forcefully establish his anti-inflation *bona fides* by moving early rather than waiting for more data to confirm the recent data trend. But there are no signs of any un-anchoring of long-term inflation expectations that would require a surprise hike.

- **Markets haven't learned yet how to "read" the new Chair.** Warsh's unwillingness to discuss future policy may make it difficult for markets to map out his reaction function or gauge how sensitive his policy views are to changes in inflation and growth.

- Moreover, markets do not have a good sense yet for how his plans for a "good family fight" will affect policy outcomes on the FOMC. Assuming the *pater familias* is leaning toward a hike this year, can he convince the other voting members on the FOMC to go along in July?

- **Our sense is that long-term rates might rally on a hike suggesting that the Warsh-led Fed means what it says about restoring price stability**. But, front-end rates might sell off as markets would begin pricing in a series of hikes.

- We think 2y yields between 4.40-4.50% looks like a natural profit taking zone for shorts, which gets us 3 hikes or a bit more priced in.

- **It is unclear what the Fed might gain with greater market uncertainty heading into an upcoming meeting. Avoiding *longer-term* policy pre-commitments makes sense when the Fed is off the zero lower bound.**

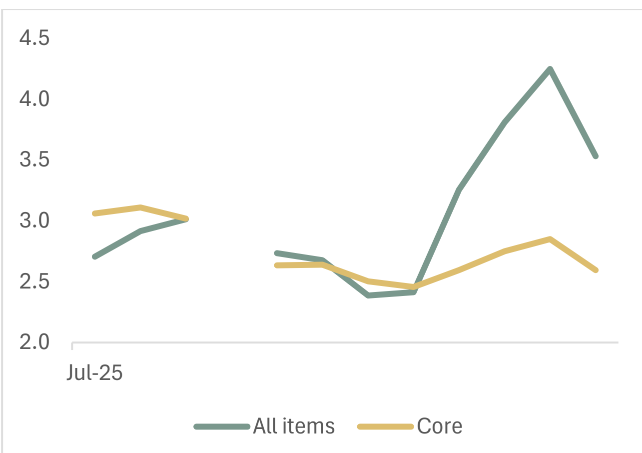
- We expect Q2 GDP to increase 2.7% q/q (or 2.4% y/y) led by strong consumer expenditures (up 2.6% q/q) and robust growth in capex (up 11.6% q/q).

Will they? Or won't they?

There is an unusual amount of uncertainty heading into next week's FOMC meeting. Markets rate hike probabilities were near 40% on Thursday morning after more than doubling in the past week. There doesn't seem to be an economic catalyst for this shift in expectations. Data look better than they did ahead of the June meeting. Inflation – although high – decelerated in June (Figure 1) and new hiring moderated. The Iran conflict appears to be spreading and oil prices are rising again but this began before Wednesday's July rate hike reassessment. Instead, the higher probability may reflect the sense that Warsh wants to forcefully establish his anti-inflation *bona fides* by moving early rather than waiting for more data to confirm the recent data trend. This would be consistent with an FOMC that has become more impatient with inflation running about its 2% target for several years. But, are there signs that markets have begun to doubt his (and the Fed's) anti-inflation credibility? Warsh emphasized a return to price stability during the June FOMC press conference. Long-term household expectations suggest inflation remains anchored (Figure 2).

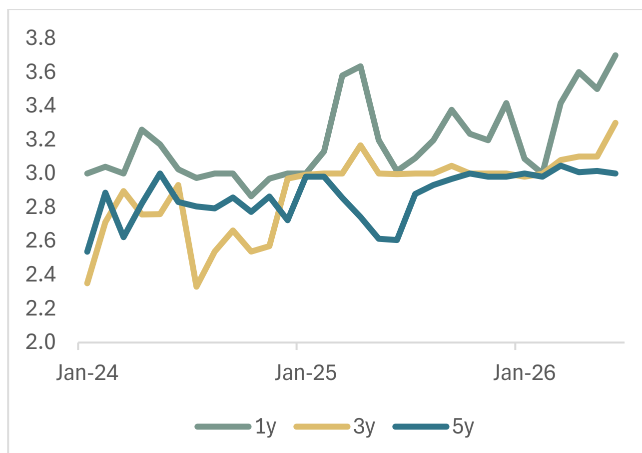
While we think the Fed will keep rates on hold next week, we would not be surprised if there was a hike.

Figure 1: CPI (% y/y)



Source: BLS, SMBC Nikko

Figure 2: Household inflation expectations (%)



Source: Federal Reserve Bank of New York, SMBC Nikko

The lack of clarity heading into next week's meeting reflects an absence of forward guidance. Some of this is probably temporary. **Markets haven't learned yet how to "read" the new Chair**. As he speaks publicly more often markets will become more familiar with his thinking and which data he is watching. In keeping with past policy, Warsh is scheduling press conferences after FOMC meetings.

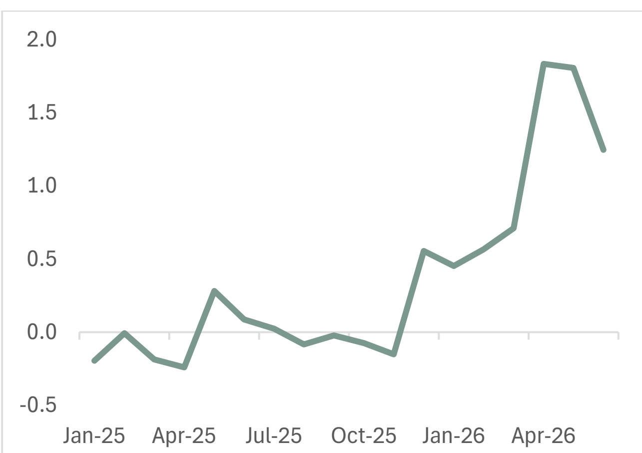
But in the longer run, Warsh's unwillingness to discuss future policy may make it difficult for markets to map out his reaction function or gauge how sensitive his policy views are to changes in inflation and growth. During his testimony on Capitol Hill earlier this month, he noted that the friendly June CPI readings were not sufficient to declare "mission accomplished" with respect to inflation. However, most analysts *already* share this view and are waiting for more months of CPI readings to confirm the trend. What markets do not know is how many months the Fed is willing to wait for this confirmation.

Moreover, markets do not have a good sense yet for how his plans for a "good family fight" will affect policy outcomes on the FOMC. Structurally, this is a significant departure from the more consensus-building approaches adopted by Fed Chairs Bernanke, Yellen, and Powell. "Good family fights" that lead to more frequent and larger numbers of dissents may add to the near-term policy confusion created by a lack of forward guidance.

The June SEP suggested there was an even divide among FOMC members between a hike and no change in rates this year. Opinions were even more divided about the 2027 outlook. **Assuming the *pater familias* is leaning toward a hike this year, can he convince the other voting members on the FOMC to go along in July?** Especially, as the employment and inflation data look friendlier than they were ahead of the June meeting.

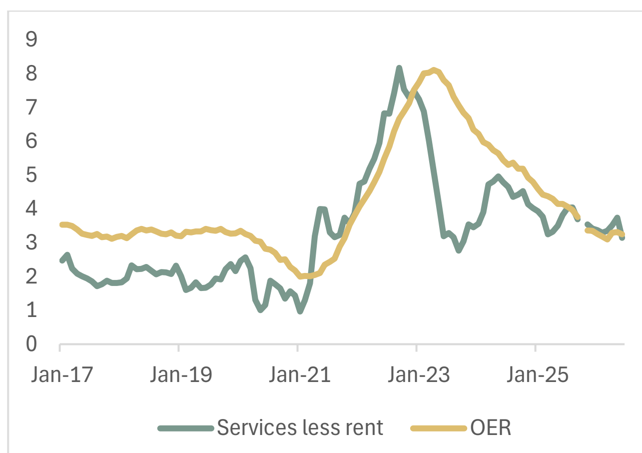
In the June minutes, there was a wide-ranging discussion about the inflation outlook. Some argued that the lingering effects of tariffs, oil price pass-through and supply chain disruptions were ebbing (Figure 3). This may be short-circuited by the Administration's plans to impose 10% tariffs against 60 countries based on their use of forced labor. Such duties would still need to go through a review process so it might take months before they are implemented. But others observed that price effects seemed to be broadening out from energy and goods prices and services costs less housing have not fallen much (Figure 4). The minutes suggest that like rates, there is some divergence between FOMC members' inflation outlook.

Figure 3: Global supply chain pressure index



Source: Federal Reserve Bank of New York, SMBC Nikko

Figure 4: Service prices (% y/y)



Source: BLS, SMBC Nikko

This raises a question about how markets might react following a rate hike next week. **Our sense is that long-term rates might rally on a hike – or more hawkish post-meeting commentary**. Either would suggest that the Warsh-led Fed means what it says about restoring price stability. But, front-end rates might sell off. We doubt that markets would interpret a somewhat surprising July hike as the type of "tap the brakes hike" mentioned by Treasury Secretary Bessent.[1] Instead, they might view it as the first of a series of hikes designed to quickly restore price stability.

[1] Referenced after his speech at an Economic Club of New York event on June 23, 2026

More generally, it is unclear what the Fed might gain with greater market uncertainty heading into the next FOMC meeting. In theory, it would remove the sense of policy pre-commitment that Warsh has argued unduly binds the Fed to a particular outcome. Indeed, policy pre-commitment works best when interest rates are at the zero lower bound and the Fed wants to pull term rates lower.[2] The post-COVID policy stickiness reflected mis-judgement about the strength of the relationship between inflation and the unemployment rate along with residual scaring from the post-GFC jobless recovery and the 2013 taper tantrum. But at much shorter horizons having a little more clarity about the policy decision could reduce the type of volatility that has pushed 2y yields up 15bp in the past week despite an absence of market moving data or Fed commentary. We expect the communications task force to address this trade-off.

Where the front end goes from here?

The 2y is currently pricing approximately 2.5 hikes. The natural question is where this repricing stops in the near term.

Our base case remains that the Fed does not hike in 2026 and delivers a single cut in 2027. Key risks to this view are higher oil prices combined with a hawkish Fed reaction function. That said, with 65bp of hikes already priced in, a significant amount of inflation concern from the recent increase in oil prices is already priced into the market. But if oil prices rise further on deepening escalation this may not be enough tightening. We think some of what the market currently has priced in reflects a risk premium around a Chair it cannot read yet.

That said, ~4.40-4.50% on the 2y looks like a natural profit taking zone for shorts, which gets us 3 hikes or a bit more priced in. Even in a scenario of a hawkish FOMC and press conference, we believe that 4.50% is a natural exhaustion point. Positioning will be stretched at that point, last year’s cuts would have been priced out and our base case of no hikes provides a fundamental anchor that should begin to attract duration buyers. Our assumption here is that WTI does not rally materially above $100/bbl.

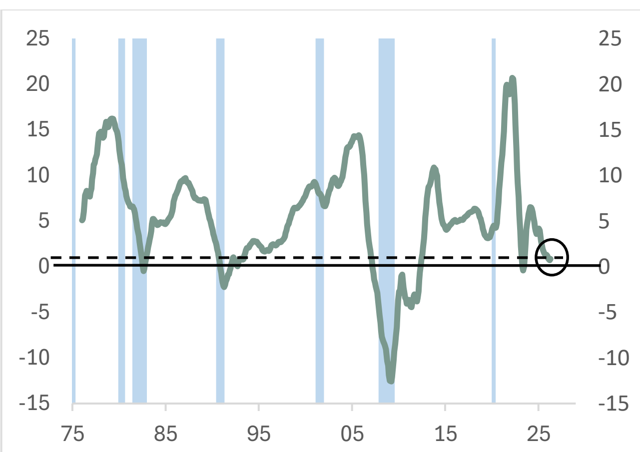
[2] See, “The Power of Forward Guidance Revisited”, A. McKay, E. Nakamura, and J. Steinsson, American Economic Review, 2016 and “The Forward Guidance Puzzle”, M. Del Negro, M. Giannoni, and C. Patterson, Federal Reserve Bank of New York, December 2015

Week ahead

- **Case Shiller Home Prices (May, Tues)**: The housing market has confronted elevated home prices and high and rising mortgages rates in recent years. Consequently, home affordability has fallen to the lowest level since pre-GFC (as measured by the Atlanta Fed). This affordability challenge is limiting capital inflows into the housing market, which is a precondition for price appreciation. As a result, national home prices have risen by just 0.8% y/y in April which is low by historical standards (Figure 5). In our view, house prices are likely to decline modestly over the coming year in response to rising inflation and still high borrowing rates. New supply remains anemic. We look for May prices to fall 0.1% m/m following declines in both March and April of 0.2% m/m.

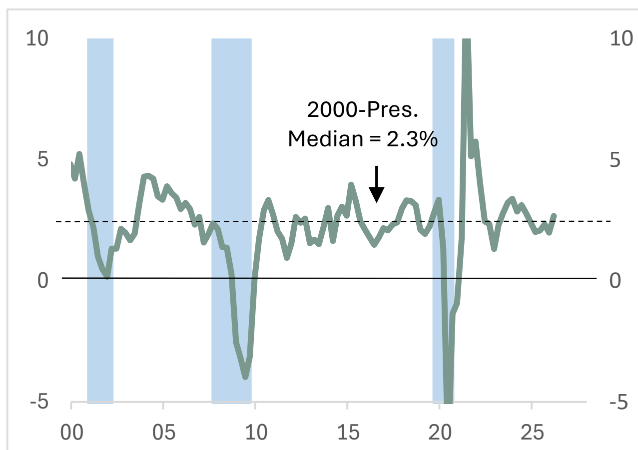
- **GDP Report (Q2, Thurs)**: The economy grew 2.7% y/y in Q1 (Figure 7). We expect Q2 GDP to increase 2.7% q/q (or 2.4% y/y) led by strong consumer expenditures (up 2.6% q/q) and robust growth in capex (up 11.6% q/q). Equipment investment has surged on the rapid buildout of the AI ecosystem. Residential investment is expected to decline -3.5% q/q, its sixth consecutive quarterly decline. This is the result of high home prices and interest rates suppressing mortgage demand, which is unlikely to change in the near-term.

Figure 5: Case-Shiller Home Prices (% y/y)



Source: S&P, Haver, SMBC Nikko

Figure 6: Real GDP (% y/y)



Source: BEA, Haver, SMBC Nikko

Table 3: Economic indicator forecasts

SMBC US Forecasts						
Date	Indicator	SMBC Forecast	Market Consensus (Median)	Prior	Range of Est.	Notes:
Jul 28	Case Shiller Home Prices (9 AM)	-0.12%	0.0%	0.0%	-	National home price growth is very weak at just 0.8%. We expect home prices will decline over the next 12m.
Jul 28	Conf. Board Cons. Confidence	94.1	92.0	91.2	91.6 - 94.0	News sentiment index picked up in the first half of July. Americans quickly paring back vacation and travel plans.
Jul 29	Fed Funds Upper Bound (2 PM)	3.75%	3.75%	3.75%	-	No hike expected in July, but a continued hawkish drift on the FOMC.
Jul 30	Personal Income (8:30 AM)	0.3%	0.3%	0.7%	0.1% - +0.4%	Hours flat in June, wages up 0.3%, jobs increased by 0.04%.
Jul 30	Personal Spending (8:30 AM)	0.3%	0.3%	0.7%	0.1% - +0.4%	Retail sales increased 0.2% MoM in June.
Jul 30	PCE Deflator (8:30 AM) (June)	-0.2%	-0.1%	0.4%	-0.3% - +0.1%	Oil prices fell -17% MoM in June. Gasoline prices fell -9.2%.
Jul 30	Core PCE Deflator (8:30 AM) (June)	0.1%	0.1%	0.3%	0.0% - +0.2%	PPI healthcare, which is a direct input into the PCE defator data, increased by 0.4% MoM
Jul 30	Q2 GDP (8:30 AM)	2.7%	2.3%	2.1%	1.5% - +3.1%	Weighed on by high inflation, declining inventories, trade deficit. Drivers: spending, equip. + IP investment, govt.
Jul 30	Q2 PCE (8:30 AM)	2.6%	2.3%	0.5%	0.1% - +2.3%	Real retail sales increased by a staggering 6.1% QoQar in Q2.
Jul 30	Q2 GDP Deflator (8:30 AM)	4.2%	3.7%	3.6%	3.5% - +4.2%	Headline CPI rose 6.1% QoQar in Q2.
Jul 30	Q2 Core PCE Deflator (8:30 AM)	3.0%	3.5%	4.4%	-	Core CPI rose 2.9% QoQar in Q2.

Forecasts subject to change

Source: SMBC Nikko Securities US Economics Forecasts

Disclaimers