US Rates Strategy Weekly

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- The Treasury Borrowing Advisory Committee (TBAC) has begun studying ways for the Treasury to invest its "surplus cash" into the repo market.

- **TBAC's analysis suggested Treasury might add between $80-$200bn into the repo market with a standard deviation in these flows of about $40bn.** Mechanically, we think the Treasury might *eventually* be able to invest this amount of its cash in the repo market.

- **But it faces two hurdles: how much do dealers and other counterparties want the Treasury's cash and what operational constraints does the Treasury need to overcome.**

- **Demand for Treasury's repo cash is uncertain. Treasury's repo cash is likely to be less predictable than dealers' tradition funding sources.**

- Mechanically, the Treasury's repo lending operations would likely be daily, competitive auctions with fixed quantities. **But this transfers the volatility in the Treasury's cash flows back into its Federal Reserve account and ultimately bank reserves**.

- We think the shape of the SOFR curve is surprising given market uncertainty. It alternates between hikes and cuts in 2027-29. **We are skeptical that the market can precisely time multiple policy shifts this far ahead**. If the pattern even extends more, investors should look to fade it through M7M8 steepeners or M7M8M9 flies

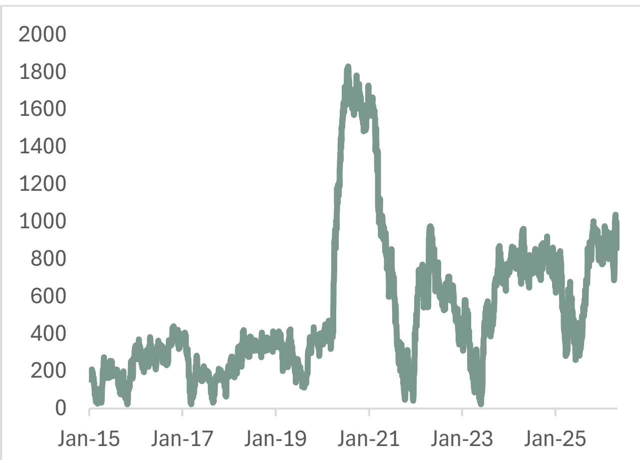
- **We look for April CPI to rise by 0.7% m/m with the core up 0.27% m/m**. Rental costs in the April report may be distorted by aftershocks of last October's government shutdown. Higher gasoline prices are expected to push retail sales up 0.5% m/m in April. Excluding autos, we think sales will be up 0.7% m/m.

Idle cash

The Treasury Borrowing Advisory Committee (TBAC) has begun studying ways for the Treasury to invest its "surplus cash" – that is, balances above its precautionary buffer. This buffer is set equal to 5-7d of expected outflows. As the Treasury's debt issuance increases, the amount of precautionary cash the Treasury needs to hold in its non-interest bearing account at the Federal Reserve has grown (Figure 1). Swings in this balance create echo effects on the level of bank reserves. The daily standard deviation in the Treasury's cash balance in 2024 was $78bn/day.[1] **Since the buffer is large and not immediately necessary, would it be possible smooth out its volatility while earning extra yield?**

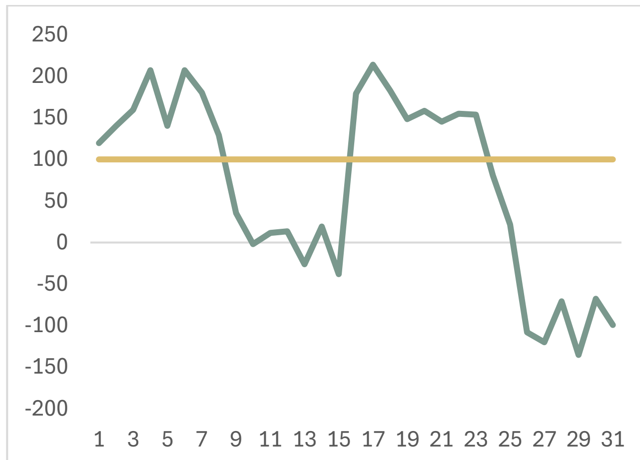
We recently looked at how the Treasury might soften the volatility in bank reserves by targeting a fixed balance in its account at the Fed and investing the remainder in the repo market.[2] The Treasury Borrowing Advisory Committee (TBAC) took up the issue at this week's Quarterly Refunding, although from a slightly different angle. While the idea of investing Treasury cash in the repo market was the same, the purpose seems less about stabilizing bank reserves and more about earning a little extra revenue on its "idle cash". **Our sense is that while there may be some merit to smoothing the volatility in the Treasury's cash balance, the operational hurdles of investing balances in the repo market are likely to be high**.

Figure 1: Treasury cash ($bn)



Source: US Treasury, SMBC Nikko

Figure 2: Surplus cash available for repo ($bn)



Note: x-axis is calendar day in 2024 excluding April. Source: US Treasury, SMBC Nikko

The TBAC defined surplus cash as either balances above the Treasury's 5d expected outflows or a variant of balances above the 3d precautionary buffer. The Treasury's average daily cash balance in 2024 was $785bn (it is $870bn so far this year). And its realized 5d and 3d expected outflows were $710bn and $425bn, respectively. **Depending on how comfortable the Treasury is with the level of its non-repo cash balances at the Fed, it might have been able to invest an average of $75bn to $360bn in the repo market in 2024**. Like the aggregate balance itself, there would be significant day-to-day volatility in its 'repo-investable cash'. To keep this from disrupting the repo market, TBAC explored different variations of the proposal where the **investable amount was capped** (at $100bn or $200bn) – surplus balances (if available) below these caps would be shifted into repo (Figure 2).

The Committee estimated that the Treasury might earn an extra 2bp from such a strategy. Earnings would be higher when bank reserves are scarce and tri-party rates are trading above IORB. By contrast, it would earn less if reserves were abundant.

[1] TBAC chose 2024 for its analysis to avoid distortions created by the debt ceiling.
[2] See, "Capping the Treasury's account", April 21, 2026.

Can it be done?

Mechanically, we think the Treasury might *eventually* be able to invest a sizeable amount of its cash in the repo market. **But it faces two hurdles: how much do dealers and other counterparties want the Treasury's cash and what operational constraints does the Treasury need to overcome.**

Demand for Treasury's repo cash is uncertain. Dealers typically provide term financing to their clients against overnight borrowing raised from money funds. As a result, they prefer funding sources that are somewhat predictable from day-to-day. But Treasury's repo cash is likely to be noisier than its traditional funding sources. **The TBAC's analysis suggested to average repo sizes of between $80-$200bn with a standard deviation in daily flows of about $40bn**.[3] While "workable end-state goals", the TBAC acknowledges that it might take some time for the market to adapt to this amount of Treasury cash.

Separately, the repo market would also need to adapt to debt ceiling episodes that regularly force the Treasury to spend down its cash balance to preserve its debt issuance capacity. For most of last year, the Treasury's cash balance was below its 5d buffer – often by as much as $400bn. In effect, the debt ceiling constraints (and the Treasury's slow cash rebuild once the ceiling was lifted) would have kept it out of the repo market from February to August. The lower cash balance would release bank reserves so the effect on funding rates from the Treasury's repo absence would be negligible. That said, dealers would still need to find replacement funding to the extent they were borrowing from the Treasury.

Operational issues

As the TBAC acknowledges there are several operational issues that might need to be addressed before launching a repo-investment program.

First, because the Treasury's cash outflows are concentrated at certain times during the month, its surplus of investable repo cash will also be concentrated. All things equal, the Treasury would be able to add cash into the repo market in the first and third weeks of the month. This could partly offset the departure of GSE cash in the third week so the effect on repo rates might be small. However, heavier funding needs around settlement dates may not line up neatly with the availability of Treasury repo cash. **The alignment between dealers' funding needs and the Treasury's repo cash availability will determine how aggressively dealers (and potentially, other eligible counterparties) bid for the Treasury's cash**.

We think the Treasury might need to pre-announce the size of its daily repo operations a week in advance so that the market could have some clarity about the amount of cash it could raise from the Treasury. However, all its repo operations are contingent on the Treasury having the available resources to invest in the market. In turn this makes it harder for the dealers to plan.

Mechanically, our sense is that the Treasury would lend its repo cash in the morning at a fixed-quantity auction. Fixing auction quantities would also give the Treasury more certainty about where its cash will be although the clearing rate would vary. **But this transfers the volatility in the Treasury's cash flows back into its Federal Reserve account and ultimately bank reserves**.

Separately, tri-party transactions normally settle and unwind in the afternoon. However, like the FHLBs, the Treasury might prefer to have its unwinding cash returned first thing the following morning as this easier to plan and adapt its daily cash outflows. And while the tri-party market can handle "early return", there is not much demand from borrowers

[3] The amount depends on the size of the cap.

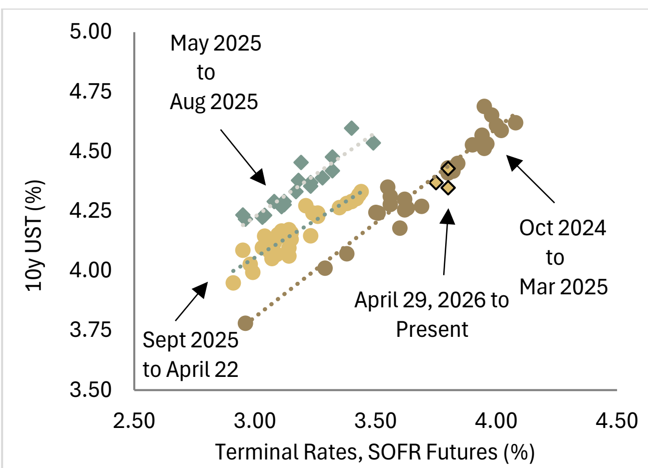
We assume that these operations would be centrally cleared to prevent balance sheet crowding out effects on other cash lenders. But the exact mechanism for clearing this activity, like the SRP, still needs to be worked out. As we noted a few weeks ago, our sense is that some form of collateral in lieu (CiL) approach might work. The Treasury would have a lien against the collateral pledged by borrowers in the tri-party account. For the intermediating dealer CiL is more margin cost effective

Finally, the Treasury would have to determine who to trade with. **We assume that all the primary dealers would be eligible as they already participate in Treasury auctions**. But could the Treasury also require primary dealers to participate in its daily repo auctions? Beyond the primary dealers it is unclear which other counterparties the Treasury might face. The Treasury recently expanded its buyback counterparties to include other "approved entities" such as large asset managers. To be eligible, the asset managers had to prove their commitment to Treasury trading. The SRP allows bank participation with Fed approval.

10y: Back to the Pre-Liberation Day regime

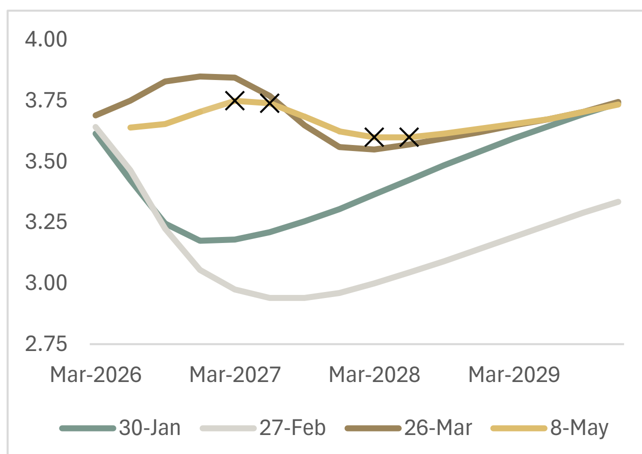
Treasuries are likely to remain range bound, fluctuating between the late January and March highs, as geopolitics dominate investor focus. Separately, following the hawkish shift at the April FOMC, the relationship between the 10y yields and the SOFR implied terminal rate has moved back toward the Oct 2024 – Mar 2025 regime, away from the post-Liberation Day regimes (Figure 3). Before the April FOMC, the market had been trading in an intermediate regime between those two periods.

Figure 3: 10y yield vs. terminal rate



Source: Bloomberg, SMBC Nikko

Figure 4: SOFR curve



Source: Bloomberg, SMBC Nikko

One way to explain the recent shift is reduced inflation concerns which is difficult to reconcile with the ongoing supply-side shock backdrop. Rather, the market may be pricing demand destruction from higher energy prices, implying weaker growth may start to dominate the inflation impulse.

While it is too early to tell if the new relationship holds, it is likely to be so if the Fed remains hawkish and growth remains robust.

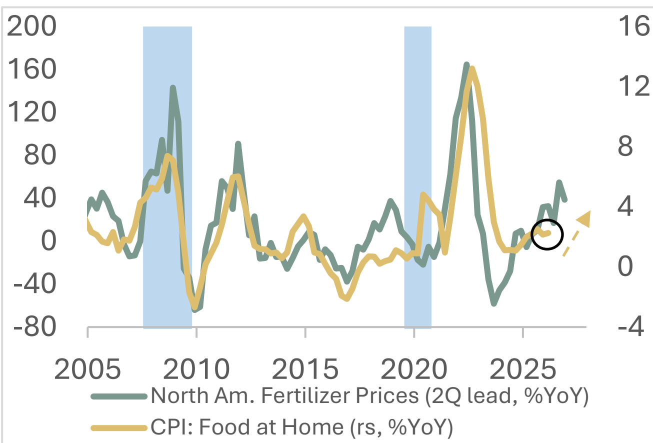
Imprecise precision in the SOFR curve

We think the shape of the SOFR curve is surprising given market uncertainty. It alternates between hikes and cuts in 2027-29. The curve shape has shifted since before the Iran conflict began (Figure 4). We are skeptical that the market can precisely time multiple policy shifts this far ahead. If the pattern even extends more, investors should look to fade it through M7M8 steepeners or M7M8M9 flies.

Week ahead

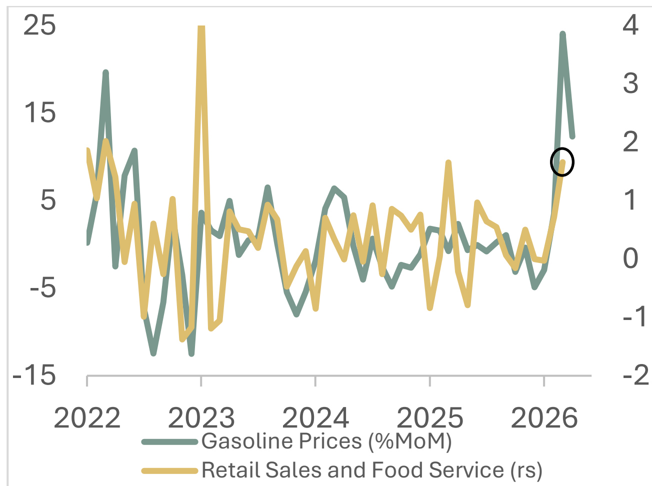
- **Consumer Prices (Apr, Tues)**: We are forecasting headline CPI at 0.7% MoM / 3.8% YoY and core CPI at 0.27% MoM / 2.8% YoY. This is based CPI energy costs rising 6.1% MoM, food rising 0.4%, shelter rising 0.3% and core ex shelter rising 0.24%. Previously, we estimated that the Middle East shock would add roughly 1.3% to headline CPI, with 90 bps from energy and approximately 40 bps from fertilizer and food prices. We expect some energy passthrough to affect the April CPI report, while higher fertilizer costs should push food prices higher over the next two quarters (Figure 5).

Figure 5: Fertilizer and Food at Home Prices (%Y/Y)



Source: Green Markets, BLS, Haver, SMBC Nikko

Figure 6: Gasoline Prices and Retail Sales (%M/M)



Source: EIA, Census, Haver, SMBC Nikko

- Core CPI data may be somewhat difficult to interpret this month. The government shutdown prevented the collection of rental data from housing units included in the October sampling cohort. BLS used carry forward imputation to fill in the gap but this assumed that rents for these units were unchanged in October. In April, these units rolled back into the sampling. As a result, the rental measures in the CPI may be biased higher.

- For the producer prices report which will be released on May 13, we are expecting 0.5% and 0.4% for headline and core PPI respectively.

- **Retail Sales (Apr, Thur)**: We are expecting relatively strong retail sales figures for the month of April on the back of high inflation. We are forecasting 0.5% for headline retail sales and 0.7% for retail sales ex autos. Although total vehicle sales declined by a modest -1.2%, the sharp 12.2% rise in gasoline prices was enough to boost nominal spending growth (Figure 6). However, on an inflation-adjusted basis, real retail spending has remained virtually unchanged since 2021, as spending has struggled to keep up with an elevated rate of inflation.

Table 3: Economic indicator forecasts

SMBC US Forecasts						
Date	Indicator	SMBC Forecast	Market Consensus (Median)	Prior	Range of Est.	Notes:
May 11	Existing Home Sales (10 AM)	0.5%	2.4%	-3.6%	1.0% - +3.0%	Mortgage applications for home purchase increased by 1.0% MoM in April.
May 12	CPI MoM (8:30 AM)	0.70%	0.6%	0.9%	0.4% - +0.8%	Forecasting CPI energy at 6.1% MoM, food at 0.4% MoM, shelter at 0.3% MoM.
May 12	CPI YoY (8:30 AM)	3.8%	3.7%	3.3%	3.6% - +3.9%	Gasoline prices up +12.2% MoM, agricultural prices up 2.5%, used car prices -1.6%.
May 12	Core CPI MoM (8:30 AM)	0.27%	0.3%	0.2%	0.2% - +0.4%	More energy inflation passthrough still expected from the Middle East shock
May 12	Core CPI YoY (8:30 AM)	2.8%	2.7%	2.6%	2.6% - +3.3%	Food shock over next 2Q. Middle East shock could add 0.4% to the CPI from the fertilizer-food price channel.
May 13	PPI MoM (8:30 AM)	0.5%	0.5%	0.5%	0.4% - +0.7%	PPI is highly sensitive to oil & commodities. WTI and Brent increased by 7.8% MoM and 2.9% respectively.
May 13	Core PPI MoM (8:30 AM)	0.4%	0.3%	0.1%	0.3% - +0.4%	Broad bloomberg commodities index increased by 3.4% MoM.
May 14	Retail Sales (8:30 AM)	0.5%	0.4%	1.7%	0.1% - +0.7%	Total vehicle sales declined by -1.2% MoM in April (BEA).
May 14	Retail Sales ex Autos (8:30 AM)	0.7%	0.5%	1.9%	0.3% - +0.9%	Gasoline prices up 12.3% MoM.
May 15	Industrial Production MoM (9:15 AM)	0.3%	0.2%	-0.5%	-0.5% - +0.4%	ISM manufacturing production positive at 53.4 in April. Steel production up +12.4%.

Forecasts subject to change

Source: SMBC Nikko Securities US Economics Forecasts

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