SMBC SMBC Group

US Rates Strategy Weekly

March 20, 2026

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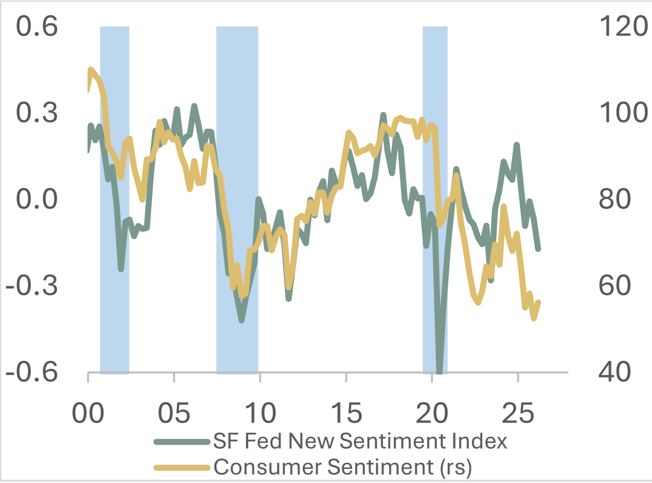
Week ahead

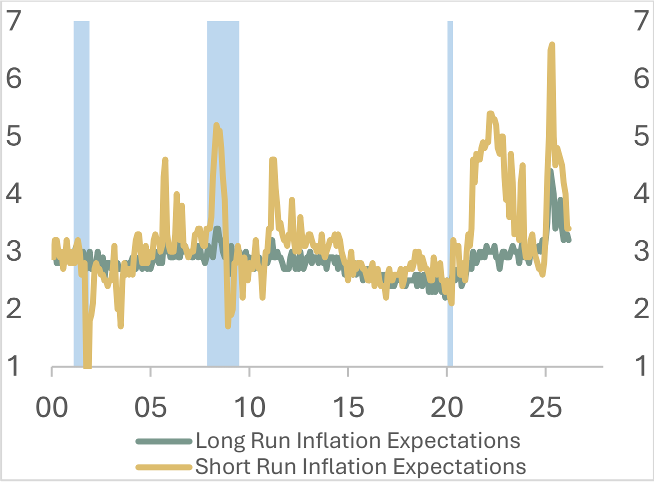
- **University of Michigan Consumer Sentiment Index (final, Mar, Fri)**: Consumer sentiment continues to print at very low readings, which from a historical standpoint were last seen only in 2022, the Global Financial Crisis of 2008 (GFC), and in April 1980. Low current readings likely reflect a weakening labor market, high inflation — which is likely to head higher — and negative news coverage. As we show below, news sentiment, as measured by the San Francisco Federal Reserve, is a key driver of consumer psychology (Figure 1). As for inflation, we estimate that the initial energy shock onto gasoline prices will add 0.9% to the headline CPI and 0.6% to the PE deflator. As a result, consumers' inflation expectations are also likely to move in kind and keep the Federal Reserve in a relatively hawkish position. **We expect the Fed will pay careful attention to household short and long-run inflation expectations for signs that they are becoming unanchored** (Figure 2). Still anchored inflation expectations allow the Fed to look through the oil price shock without increasing rates.

Figure 1: U/M Consumer Sentiment vs. SF Fed News Sentiment Index



Source: SF Fed, University of Michigan, Haver, SMBC Nikko

Figure 2: U/M Long Run and Short Run Inflation Expectations (%)



Source: University of Michigan, Haver, SMBC Nikko

Fed policy uncertainty

At this point, oil prices and the Iran conflict are too unsettled to have much confidence in the timing of the Fed's next move. **We think the Fed could be sidelined all year and our sense is that a rate cut is more likely than a hike**. As a result, we disagree with the market's (low-probability) assessment for rate hikes at the April and June FOMC meetings. Instead, we are *tentatively* penciling in a single rate cut this year at either the October or December FOMC meeting.

Reflecting their uncertainty policymakers left one rate cut in their Summary of Economic Projections (SEP) for both 2026 and 2027 while revising up their inflation expectations over the period. Their expected inflation shock is short-lived – it fades at both the headline and core levels by 2027. The labor market appeared to be cooling before the Iran conflict began. FOMC members left their jobless forecast unchanged at 4.4% this year and only 0.1% higher in 2027.

Higher energy prices will increase inflation we expect they will also "tax" consumer spending and dent consumer confidence enough to chill growth in H2 26. Obviously, the scale of this effect depends on the duration of the conflict and the extent to which there is any permanent damage to oil and gas infrastructure.

Replacement tariffs under Sections 232 and 301 are likely to further add to goods prices later this year. The administration is looking to fully recover the lost revenue from the IEEPA tariffs and is currently pursuing investigations against 60 different countries. **Because the investigations will take time our sense is that the replacement tariffs will be implemented piecemeal and gradually, so the effect on inflation is likely to be lumpy**. Both oil and tariffs are supply shocks that the Fed should in theory be able to look through in expectation that growth will cool enough to dampen prices.

Bill issuance uncertainty

The Treasury may need to ramp up bill issuance several hundred billion dollars more than we anticipated just few weeks ago. It faces two large upcoming bills – the cost of the Iran conflict and the IEEPA refunds. The Pentagon is asking for $200bn in a supplemental spending bill.[1] While it is too soon to tell how much Congress will approve, our sense given the immediacy of the Pentagon's need is that it will be funded through heavier bill issuance. Separately, the US Court of International Trade has ordered the Customs Bureau to refund its IEEPA collections. But, the Bureau recently argued that it cannot begin processing refunds until it has built an automated website. Once built, the Customs Bureau expects to be able to send out refunds within 45d of claims filings. This suggests that much of the $170bn in last year's IEEPA collections might be refunded in Q3 or Q4 2026. Like the Iran funding, we expect this will also come from heavier bill issuance.

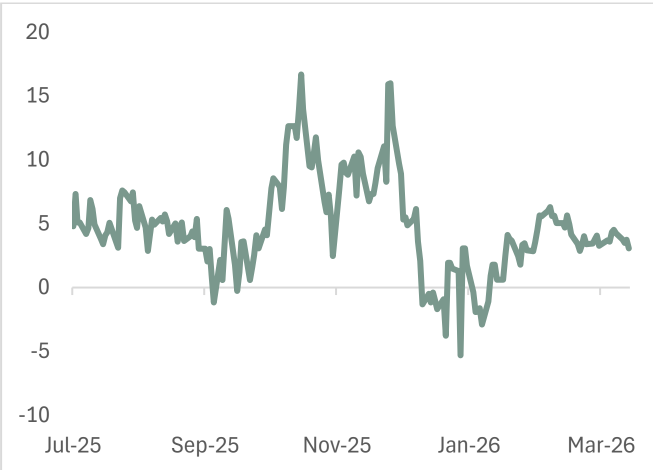
Iran financing might absorb much of the $300bn bill paydown we were anticipating after the April tax date. As a result, we do not expect this to push bill spreads wider (Figure 3) or to increase SOFR rates. Instead, it will occur just as the Treasury's cash balance peaks after the April 15 tax date. To date, non-withheld taxes are running about 15% above their 2025 pace (Figure 4). That said, the extra bill supply later this year to finance the IEEPA refunds will occur just as the Treasury seasonally ramps up bill issuance. The Treasury was already set to issue $400bn or so in new bill supply in Q3 and Q3 so the refunds may add another $100bn to this amount.

This extra supply will come to market after the Fed has slowed the pace of its RMPs. We look for these purchases to slow to less than $10bn/mo from $40bn/mo currently. The Fed will continue to reinvest the

[1] See, "Pentagon Seeks $200bn for Iran as Hegseth Denies Quagmire", G. Korte, T. Capaccio, C. McBride, and R. Tiron, Bloomberg News March 19, 2026.

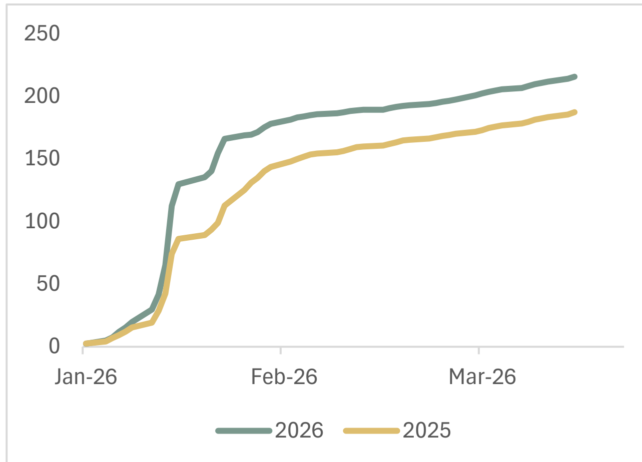
$15-20bn in MBS maturities into bills. As a result, its purchases will absorb some of the increased issuance but there may remain enough supply to cheapen bill and repo rates. We look for bill-OIS spreads to rise 3-5bp with a similar increase in SOFR and tri-party rates.

Figure 3: 3m bill less OIS



Source: Bloomberg, SMBC Nikko

Figure 4: Non-withheld tax receipts ($bn)



Source: US Treasury, SMBC Nikko

Gasoline tax suspension

Congress is considering a bill to temporarily suspend the collection of the federal tax on gasoline. **Under the proposal, the 18.4c/gallon federal tax would not be collected through October 1**. The Treasury would be required to ensure that the "benefits of the tax suspension are passed on to consumers".[2] Although not mentioned explicitly in the press release, we assume the tax suspension might also apply to the 24.4c/gallon excise on diesel fuel. Federal taxes on gasoline and diesel are dedicated to financing the Highway Trust Fund (HTF). The HTF is used to finance the federal contribution to transportation projects like bridges and mass transit. At its current pace of spending and assuming no changes to its revenues, the trust fund is expected to run out of money sometime in 2028. At that point, it will not be able to reimburse states for approved projects. The Congressional bill requires the Treasury to replace the missing tax revenue from other sources.

How much will this cost?

The CFRB estimates that a six-month suspension would cost about $21bn – or about $3.5bn/mo.[3] The Treasury could easily borrow this amount by issuing more bills – on top of the already heavy issuance financing the conflict in Iran and the IEEPA refunds.

Between the end of February and March 18, the national average price of gasoline has risen 30% to $3.88/gallon. We look for prices to increase further – to more than $4/gallon. Thus, an immediate savings of 18.4c/gallon would lower the average price around 4% *assuming* no further increase. The CFRB

[2] See, "Kelly, Blumenthal, and Pappas Introduce Bill to Immediately Lower Gasoline Prices at the Pump", Mark Kelly (D-AZ) website press release, March 9, 2026

[3] See, "A Gasoline Tax Holiday Would Cost Billions Each Month", Center for a Responsible Budget, March 17, 2026.

estimates this would free up about 0.2% of household consumption. **But the actual relief may be somewhat less**.

The CBO estimates that from every $1 reduction in excise taxes, the Treasury “recaptures” 24c from higher income and payroll taxes. So, the *effective* reduction in gasoline prices might be closer to 14c/gallon once income taxes are considered.

And while a federal tax holiday would lower gasoline prices immediately it might not get fully passed on to consumers. Tsvetanov examines the behavior of gasoline prices following local tax holidays in 2022.[4] A post-COVID surge in traveling and the Russian invasion of the Ukraine caused national average gasoline prices to spike above $5/gallon by early June. To ease pressure on consumers several states suspended their local levies. Because the suspensions took effect at different times and in different amounts, Tsvetanov was able to estimate pass-through effects based on heterogenous factors related to gasoline supply and local markets. **On average, about 79% of the tax savings was passed on to consumers**. But there were significant differences across locations which reflected differences in the relative market power of suppliers. Areas requiring specific blends, in rural parts or further from wholesale terminals had smaller pass-through effects. **As a result, the actual benefit to the consumer may be closer to 11c/gallon – or less than 3%**.

[4] See, “Tax Holidays and the Heterogenous Pass-through of gasoline taxes”, T. Tsvetanov, Energy Economics, June 2024.

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