SMBC SMBC Group

US Rates Strategy Weekly

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Joseph Abate, US Rates Strategy
joseph.abate@smbcnikko-si.com
1 212 893-1592

Monty Gandhi, US Rates Strategy
mgandhi@smbc-cm.com
1 212 224-5114

Troy Ludtka, US Economist
troy.ludtka@smbcnikko-si.com
1 212-224-5483

- **We expect the Fed to keep rates unchanged in the meeting in two weeks.** New Fed Chair Warsh is unlikely to provide forceful commentary about the direction of rates as his first press conference. Instead, he may emphasize that the Fed is on vigilant hold.

- **Since the March SEP projections were made, economists have revised up their 2026 inflation projections. We expect the FOMC to follow suit – increasing their median and core PCE estimates by 0.5%.**

- **Markets may spend the most time parsing the dot plot**. Ironically, the dot plot is an area that Warsh is seeking to de-emphasize.

- In March, the year-end 2026 dots were evenly divided between no change and a rate cut (at 7 each). **Our sense is that perhaps 3 or more of the rate cut forecasters will migrate into the no change camp. But will any of the 3 dissenters from the last meeting's symmetric bias statement put in a rate hike for 2026?**

- Against a backdrop of geopolitical uncertainty, a resilient economy and signs of a reaccelerating labor market**,** the market may interpret this shift as the **Fed validating what the market wants to price in. As a result, the market could price-in up to three hikes** in the weeks ahead**.**

- **Three hikes translate to a 4.25-4.40% two-year yield,** depending on how early the hikes are front-loaded. The 2s10s curve would bear flatten in such a scenario.

- We look for headline CPI to increase 0.6% m/m in May with the core up 0.4% m/m. Inflationary pressures continue to build.

Warsh to keep powder dry

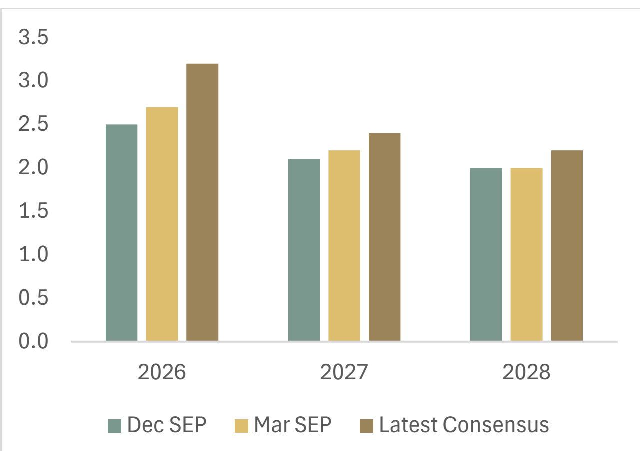
Warsh chairs his first FOMC meeting in two weeks, and we think he is **unlikely to provide a forceful commentary on the direction of rates**. He has been in the seat for less than a month, too short a time to read the room and know where the other voters stand. That argues for restraint. We expect him to keep his powder dry, lean on continuity and let the statement that looks like April do the talking. The risk in this scenario sits with the committee. If he keeps the bias the same, there could be more than three dissents (possibly including Waller). As the Iran conflict has gone on for three months and with no resolution yet, more Fed members may not be willing to sign up for the easing bias in the statement.

Would the inflation consensus turn?

The real signal will be in the projections. The question is whether a quarter of conflict has tipped the median participant from considering the energy shock as a one-off event or something more sustained. At the time the March Survey of Economic Projections (SEP) was published, FOMC members had little sense of the duration and extent of the conflict – their forecasts were "made in the dark". Even so, median PCE and core PCE projections for 2026 were each revised up by 0.2%. We think **FOMC members are ready to pencil in higher revisions to the 2026 inflation projections**. Economist surveyed by Bloomberg currently project year-end core PCE to rise to 3.2% - a 0.5% increase from the Fed's March SEP projection (Figure 1). On the one hand it would suggest that the Fed sees more pass-through to other goods and services as well as a potentially longer supply shock. But on the other hand, the market could see any upward revision as an acknowledgment of its own expectations – a recognition of "on-the-ground" facts.

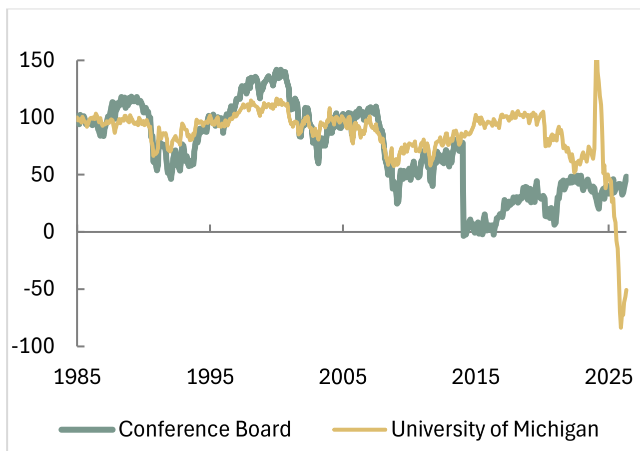
Separately, we (and the market) will pay very close attention to Chair Warsh's press conference. **Our sense is that the overall tone of his remarks will be similar to Powell's back in April**. The Fed is uncertain about how far downstream prices may increase and how much they may hurt consumer and business confidence. So far, while confidence measures have fallen, there has been little sign of a pullback in spending (Figure 2). A strengthening labor market might push workers to increase their wage demands to offset higher prices but evidence of this is absent even in the latest strong payroll report. These uncertainties might be enough for Warsh to argue for **remaining on "vigilant" hold – at least in the near-term**.

Figure 1: Summary of Economic Projections (SEP), core PCE yoy (%)



Source: Federal Reserve Board, SMBC Nikko

Figure 2: Consumer Confidence (index to 1985 at 100)



Source: Conference Board, University of Michigan, SMBC Nikko;

We expect the new Chair to be asked about his broader views about reforming the Federal Reserve and the implementation of policy. We expect he will be asked to discuss his views on the Fed's inflation mandate – both with respect to the target measure (trimmed mean or median CPI) as well as the 2% target. Warsh's newly hired advisers appear to favor a single-mandate (inflation). Separately, we think it is too early for the new chair to have formulated any practical views about the size of the balance sheet. This includes tiering IORB to reduce bank demand for reserves as well as any long-run changes to the maturity distribution of the Fed's portfolio. More immediately, we think the softness in repo rates is temporary and related less to the level of reserves than declining demand for funding as investors remain leery of getting long or taking on leverage. That said, we expect the Fed to trim the size of its RMPs (reserve management purchases) this month – to perhaps as little as $5bn/mo – to acknowledge the seasonal slowing in currency demand.

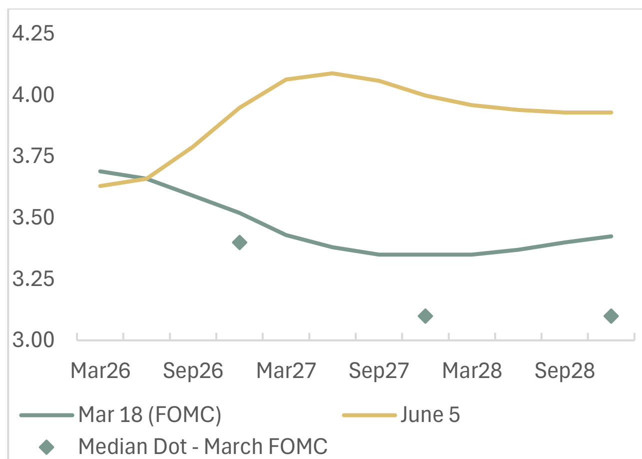
Markets may spend the most time parsing the dot plot. Ironically, the dot plot is an area that Warsh is seeking to deemphasize. Markets spend too much attention on reading the plot and attempting to divine future policy based on the distribution of funds rate forecasts. Earlier Fed Chairs have also been interested in changing the dots – either replacing them entirely with scenarios published as part of a monetary policy report, or simply publishing them after the FOMC meeting.

In March, the year-end 2026 dots (Figure 3) were evenly divided between no change and a rate cut (at 7 each). Our sense is that perhaps 3 or more of the rate cut forecasters will migrate into the no change camp. But will any of the 3 dissenters from the last meeting's symmetric bias statement put in a rate hike for 2026? And how much might the distribution of the year-end 2027 dots shift? Reflecting the uncertainty about the Iran conflict, these dots were widely distributed across cuts and hikes at the March meeting. Only one participant looking for hikes and five for more than two cuts. Doves at the tail are likely to give up cuts such that the mass of the distribution would shift higher.

Figure 3: March dot plot (%)

Source: FRB, SMBC Nikko;

Figure 4: Median Dots vs. SOFR futures (%)



Source: FRB, Bloomberg, SMBC Nikko; Note: 9:30am mark for June 5

How do markets react if the Fed is hawkish?

Figure 4 shows that the curve is pricing 44 bps of hikes by Q3 2027, contrasting with the 50 bps of cuts implied in the December median dot. There is a chance the market perceives a hawkish SEP and dot plot as a mark to market exercise. However, against a backdrop of geopolitical tension (inflation risk), a resilient economy and the strong May payroll report, we believe that investors may instead view this as the **Fed validating what the market wants to price in**. Consequently, **up to three hikes may be priced in** or completely price out the 2025 cuts.

This translates into a **4.25-4.44% two-year rate based on how much the hikes are front-loaded**. Three consecutive hikes starting in early 2027 implies a 4.25% yield, an earlier start in December 2026 lifts it to 4.34% and an aggressive September 2026 start pushes it to 4.40%. Overall, the **curve should bear**

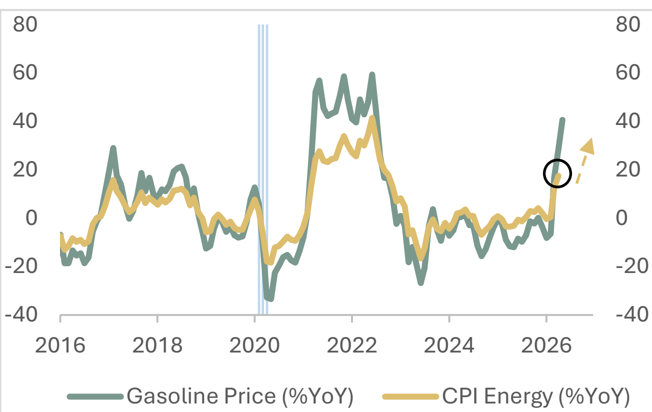
flatten. The **10y yields should back up too but by less**, as it gets some support from a Fed willing to stay tight to anchor inflation expectations and eventual demand destruction from higher oil prices and tight policy.

Week ahead

- **Consumer Prices (May, Wed)**: We look for headline CPI to increase 0.57% m/m in May with the core up 0.36% m/m. Inflationary pressures continue to build. We are estimating that energy will add another 30 basis points to headline inflation, while food prices could add another 38 bps to the headline CPI over the coming months on a year over year basis. Additionally, the BLS will be adding back into shelter costs the prices missed in its November sampling because of the shutdown. This may push the May shelter reading up 0.6% m/m. Meanwhile, used vehicle prices (Mannheim) increased by 0.6% in May. Gasoline prices (EIA) increased by a hefty 8.8% m/m in May (Figure 5).

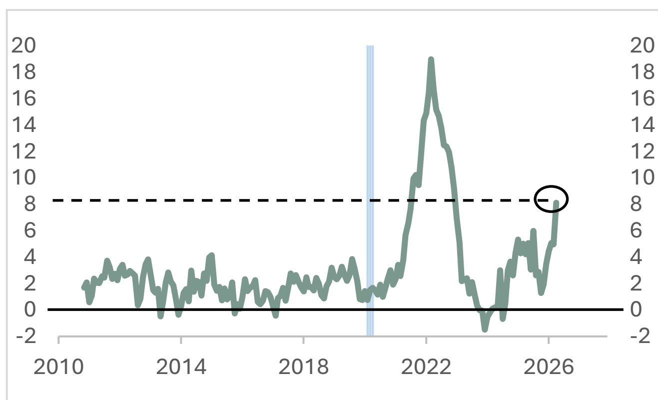
- **Producer Prices (May, Thurs)**: We are forecasting a 0.6% MoM reading for headline PPI and 0.6% for core PPI. Compared to the CPI which is sensitive to gasoline prices, the PPI is particularly sensitive to crude oil prices and commodities. WTI and brent increased by 0.5% and 0.7% respectively. We will be paying special attention to two subcomponents, final demand trade services — a measure of margins captured by wholesalers and retailers — and the PPI healthcare component which is a direct input into the PCE healthcare component. Despite broader macroeconomic volatility, the PPI data show that margins for retailers and wholesalers have grown 8.1% YoY, which is the highest reading on record outside of the post pandemic era (Figure 6).

Figure 5: Gasoline Prices (%Y/Y) vs. CPI: Energy (%Y/Y)



Source: EIA, BLS, Haver, SMBC Nikko

Figure 6: PPI: Final Demand Trade Services (%YoY)



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:
Jun 9	Existing Home Sales (10 AM)	1.9%	1.4%	0.2%	-0.1% - +2.0%	Mortgage applications for home purchase increased by 1.3% MoM.
Jun 10	CPI MoM (8:30 AM)	0.57%	0.5%	0.6%	0.4% - +0.6%	Forecasting CPI energy at 3.1% MoM, food at 0.5% MoM, shelter at 0.6% MoM (make up for missing November).
Jun 10	CPI YoY (8:30 AM)	4.3%	4.2%	4.8%	4.1% - +4.3%	Gasoline prices up +8.8% MoM, agricultural prices up 1.2%, used car prices +0.6%.
Jun 10	Core CPI MoM (8:30 AM)	0.36%	0.3%	0.4%	0.2% - +0.4%	More energy inflation passthrough still expected from the Middle East shock
Jun 10	Core CPI YoY (8:30 AM)	3.0%	2.9%	2.8%	2.9% - +3.0%	Food shock over next 4-months. Middle East shock could add 0.4% to CPI from the fertilizer-food price channel.
Jun 11	PPI MoM (8:30 AM)	0.6%	0.7%	1.4%	0.4% - +0.8%	PPI is highly sensitive to oil & commodities. WTI and Brent increased by 0.5% MoM and 0.7% respectively.
Jun 11	Core PPI MoM (8:30 AM)	0.6%	0.5%	1.0%	0.3% - +0.7%	Broad bloomberg commodities index increased by 3.3% MoM.
Jun 12	U Mich. Cons. Sentiment (10 AM)	48.0	46.5	44.8	45.5 - 48.5	Lowest consumer sentiment reading on record in May (44.8). At odds w/ conf. board cons. confidence index.

Forecasts subject to change

Source: SMBC Nikko Securities US Economics Forecasts

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