US Rates Strategy Weekly

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- New Fed Chair Warsh is likely to emphasize continuity in the direction of rates at his first press conference. Instead of signaling any shift, he may **stress that the Fed remains on vigilant hold**.

- **We expect the FOMC to revise the 2026 median core PCE estimates higher by 0.5%**, following three months of elevated oil prices amid a firming labor market.

- **Markets may spend the most time parsing the dot plot**. In March, the year-end 2026 dots were evenly divided between no change and a rate cut (at 7 each). **Our sense is that 3 or more of the rate cut forecasters will migrate into the no change camp.**

- We think it is **too early for the new chair to have formulated any practical views on the appropriate size of the balance sheet.**

- Following the mild core CPI and more benign wage and inflation expectation readings, **we expect any hawkish reaction to the Fed (absent geopolitical escalation) to be faded**, capping two-year yields near 4.20%.

- The geopolitical situation remains fragile. A **signed deal would likely extend the rally in 10y Treasuries toward 4.25%**. Conversely, a **breakdown in talks would likely push 10y yields to break out above 4.60% with 4.70%** as the first target.

- **Retail Sales -** We forecast a 0.6% increase in headline retail sales and a 0.4% increase in ex autos in May, largely driven by price increases. The consumer continues to struggle to beat economy-wide inflation.

FOMC outlook – The dots will do the talking

Warsh chairs his first FOMC meeting having been in the seat less than a month, too short a period to have formed strong views on the direction of rates. We expect him to lean on continuity and let the statement, summary of economic projections (SEP) and the dot plot do the talking. The risk sits with the committee. An unchanged easing bias could attract more than three dissents from Fed members who may not be willing to sign up for the easing bias in the statement.

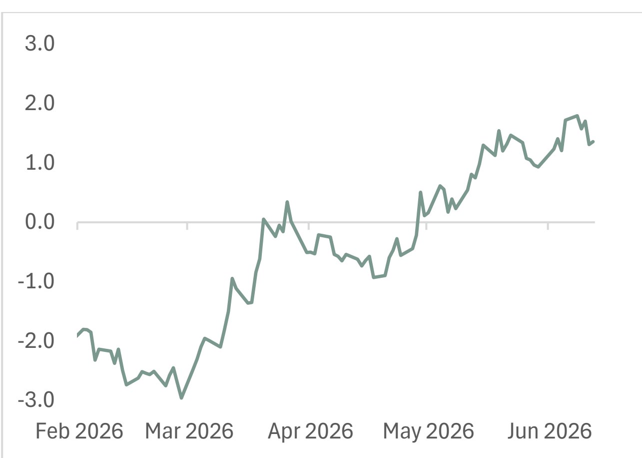
The more consequential signal will be the dots and the changes to the SEP. The March SEP was published with little visibility on the conflict's duration or scope. Three months of elevated oil prices, geopolitical uncertainty and a resilient labor market has led economist surveyed by Bloomberg to project year-end core PCE expectations up to 3.2%, a 0.5% increase from the March SEP projection. Fed committee is likely to follow. The question is whether the market reads any upward revision as mark-to-market of current inflation or as a signal that inflation is set to be more longer lasting and thus raises the risk of hikes. **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 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 is 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.

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 May inflation and wage data shows that the secondary impact on downstream prices have not been as much as feared. Yet with little sign of a pullback in spending and a strengthening labor market might push workers to increase their wage demands to offset higher prices. These uncertainties might be enough for Warsh to argue for **remaining on "vigilant" hold – at least in the near-term**.

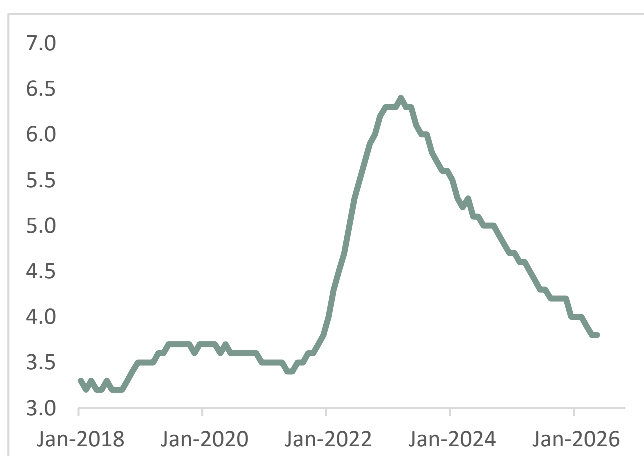
We expect the new Chair to be asked about his broader views about reforming the Federal Reserve and the implementation of policy. We expect he will be asked to discuss his views on the Fed's inflation mandate – both with respect to the target measure (trimmed mean or median CPI) as well as the 2% target. 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.

Figure 1: 25bp hikes/cuts priced by mid-2027



Source: Bloomberg, SMBC Nikko

Figure 2: Atlanta Fed Wage Growth Tracker (%)



Source: Atlanta Fed, Bloomberg, SMBC Nikko;

Market reaction to a hawkish Fed

Prior to the inflation print, we expected a hawkish Fed scenario to price in two-three hikes, pushing two-year yields to 4.25-4.40%, a level they nearly touched 4.20% earlier this week. The mild core CPI reading changes that calculus. With core goods declining and shelter moderating, three hikes are hard to justify absent a material surge in oil prices from geopolitical escalation. Wages also remain in a downtrend (Figure 2) and NY Fed's one-year ahead inflation expectations fell in May compared to April. In such a scenario, any **hawkish reaction to the Fed is likely to be faded (absent geopolitical escalation), capping two-year yields near 4.20%**. On the other side, a resilient economy and firm labor market should prevent yields from falling below 3.90%. Taken together, this anchors the two-year in a roughly 3.90-4.20% trading range near-term, with risks skewed higher if geopolitics reignite energy concerns.

Escalation vs. de escalation

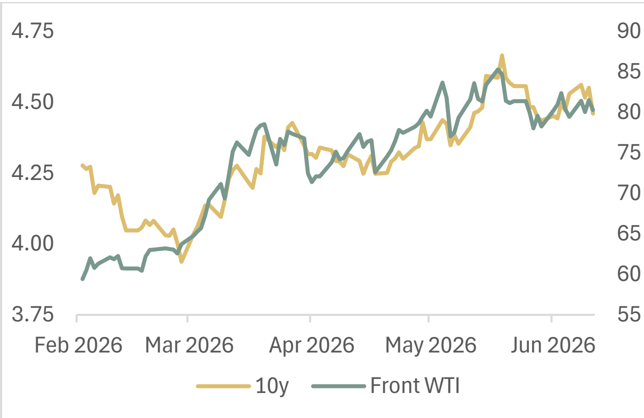
Duration continues to trade alongside oil, and noise around the US-IRan talks is a reminder of how fragile the situation remains. Yields retreated from their highs on signals that a memorandum of understanding was close. **If those signals prove premature, that move can unwind quickly**.

The **rally in Treasuries should extend if the deal is signed** but the floor of yields is not fixed, it also depends on where the economy lands. Figure 4 shows the Economic Surprise index near recent highs. If data holds up, **yields can retrace towards 4.25%** but are unlikely to breach it without some signs of softer growth. If the surprise index rolls over, the path towards 4.00-4.10% opens up.

Breakdown of talks would reprice energy risk and in such a scenario 10y yields would likely breakout above 4.60%, with 4.70% as the first target and 4.90- 5.00% in view if the shock is sustained.

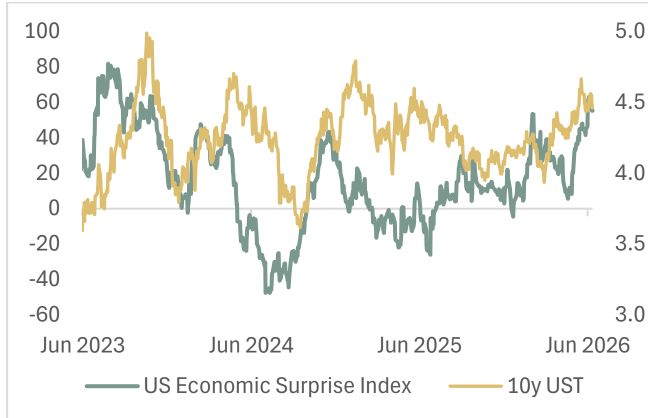
A **hawkish Fed in either of the above scenarios should flatten the curve** with **a steepening likely if they are less hawkish than expected.**

Figure 3: 10y vs. December WTI (%, LHS and $/bbl, RHS)



Source: FRB, SMBC Nikko;

Figure 4: Economic surprise index vs. 10y (index, LHS and %, RHS)



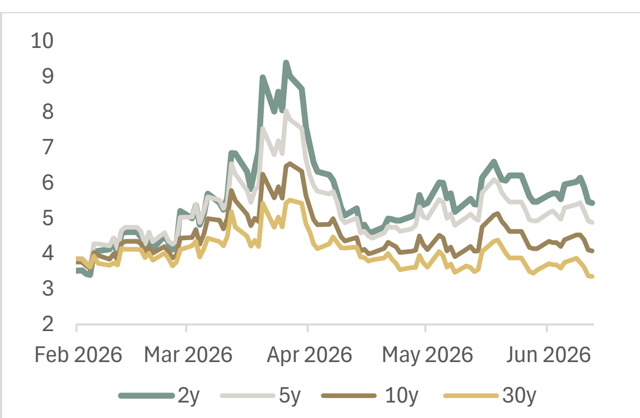
Source: FRB, Bloomberg, SMBC Nikko;

Vol – Options on longer tails are attractive

Front-end implied vol remains elevated given event risks around geopolitics and shifting expectations around the Fed reaction function. While a constructive Iran outcome combined with a fed that remains on hold could put pressure on front-end gamma, a renewed escalation in the middle east and a more hawkish Fed could push implieds back toward the highs seen earlier in March.

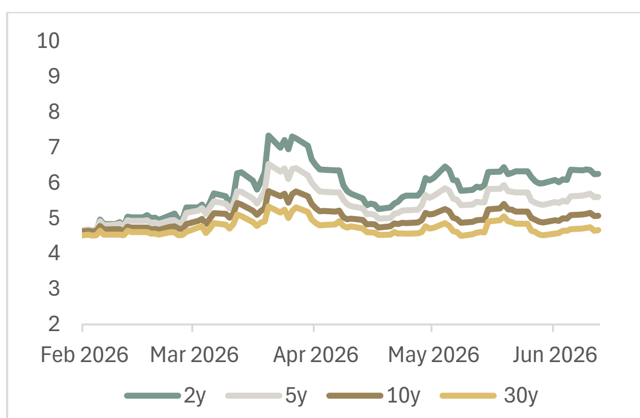
1y-2y options on longer dated tails look attractive. Since the start of the year, market concerns have shifted from growth risks to inflation and term-premium risks. **With the current macro backdrop, the plausible outcomes remains wide and we favor owning 1y-2y options on long end on dips**.

Figure 5: 3m Implieds (daily bp vol)



Source: ICAP, Bloomberg, SMBC Nikko

Figure 6: 1y Implieds (daily bp vol)



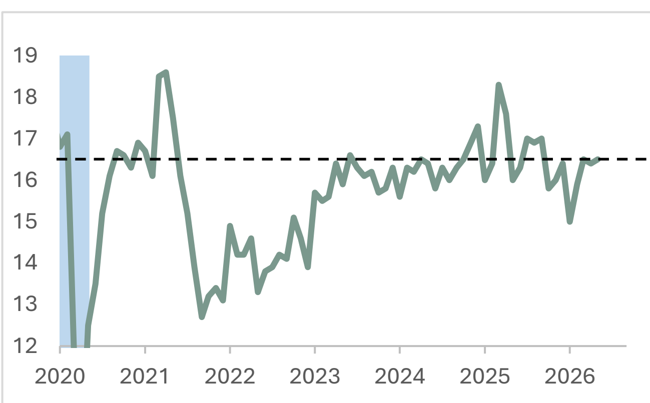
Source: ICAP, Bloomberg, SMBC Nikko;

Week ahead

- **Retail Sales (May, Wed)**: Although real PCE continues to pace above the pre-Covid trend, this has largely been due to strength in the services economy. Goods spending, and durable goods particularly, have softened. Weakness in this area can also be seen in retail sales, which have trended sideways since April 2021 on an inflation-adjusted basis. While nominal retail sales were strong in May — we estimate headline and ex autos retail sales increased by 0.6% and 0.4% MoM respectively in May — this was largely the result of price increases, which is best proxied by gasoline prices which increased 8.8% (EIA). While total vehicle sales did increase by 0.6% in May, the level of sales has remained flat at ~16.5 million units since November 2020. The consumer is struggling to beat the rate of economy-wide inflation.

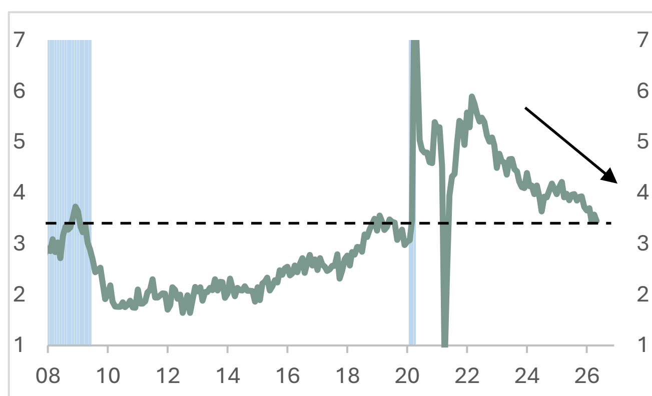
- **FOMC Meeting (June, Wed)**: In addition to receiving dots and economic forecasts, the June FOMC meeting will be the first under the tutelage of Kevin Warsh. We expect the FOMC to express heightened uncertainty over the path of inflation and interest rate policy. While the committee will likely continue to drift in a comparatively hawkish direction. Despite this, we see the FOMC stopping short of promulgating any overt tightening bias. Our forecast is for the Fed to remain on hold in the near term despite the headline inflation acceleration. One reason for this is because wages (shown below) have not shown any such acceleration suggesting that demand destruction is likely to occur, should the Iran war and associated backlogs persist, thus restraining core prices.

Figure 5: Total Vehicle Sales (Millions of Units)



Source: BEA, Haver, SMBC Nikko

Figure 6: Average Hourly Earnings (%Y/Y)



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 15	Industrial Production (9:15 AM)	0.3%	0.2%	0.7%	0.0% - +0.5%	Steel production up 13.1% MoM, and manufacturing payrolls up slightly (+7k).
Jun 16	Housing Starts (8:30 AM)	-2.3%	-1.7%	-2.8%	-6.1% - +1.1%	Since 2022, housing starts have trended sideways at ~1.4m due to a dearth of existing home supply.
Jun 17	Retail Sales (8:30 AM)	0.6%	0.5%	0.5%	0.0% - +0.7%	Struggling to keep up with inflation, real retail sales have moved sideways since April 2021.
Jun 17	Retail Sales ex Autos (8:30 AM)	0.4%	0.5%	0.7%	-0.1% - +0.8%	Nominal retail spending was likely strong: vehicle sales rose 0.6% MoM in May, gasoline prices +8.8% MoM.
Jun 17	Fed Funds (Upper Bound) (2:00 PM)	3.75%	3.75%	3.75%	-	New set of the forecasts/dots. Expecting greater rates and inflation uncertainty. Expecting hawkish tilt in rhetoric.

Forecasts subject to change

Source: SMBC Nikko Securities US Economics Forecasts

Disclaimers