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US Rates Strategy Weekly

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- An increase in bank reserves and market uncertainty has pushed overnight repo rates to their lowest spreads in months.

- **Bank reserves increased in May as the Treasury's cash balance fell $150bn**. Money fund balances have recovered since the mid-April tax outflows.

- **The demand for financing has fallen;** dealer inventories of off-the-run Treasuries have fallen nearly 10% in the past month. Funding demand has declined as investors have gotten leery about taking long positions. Sponsored repo volumes have declined 12% since the start of the Iran conflict.

- **We look for repo rates to rise ahead of quarter-end although the effect may be muted by Treasury's expected bill supply reductions after the June 15 corporate tax date.** But without a shift in market sentiment, we think it will be difficult for repo rates to trade above IORB.

- **The March TIC data suggest that reserve managers may have liquidated Treasury holdings to support their currencies amid a stronger dollar and rising oil and commodity prices, amplifying the back up in yields.**

- **We look for robust increases of 0.5% m/m and 0.3% m/m in the April headline and core PCE deflators, respectively.**

A new, lower, equilibrium repo rate?

Overnight repo rates fell sharply last week, with the tri-party rate sinking back toward the Fed's interest rate floor and balances in the RRP climbing to their highest level since year-end. Lower repo rates have also pulled the fed funds rate down. As the fed funds rate is stickier than repo rates, the SOFR-FF spread has moved lower (Figure 1). But the decline in repo rates began earlier in the month.

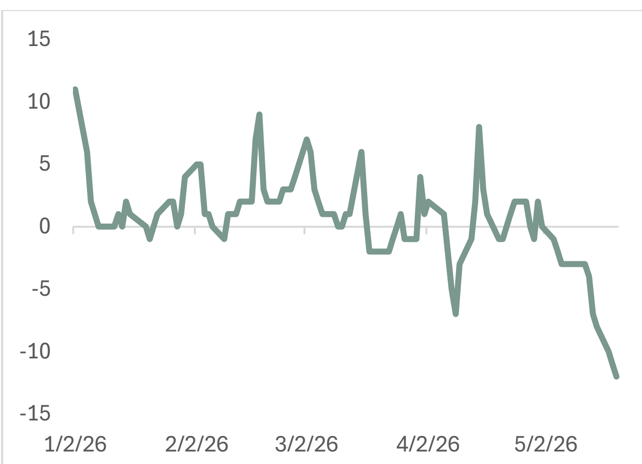
We think the decline in repo rates reflects a confluence of drivers. The primary factor may be the increase in bank reserves since mid-April. Balances have increased nearly $150bn even as the Fed scaled back its RMPs. **The increase in bank reserves has come from a decline in the Treasury's cash balance**. We are not entirely clear why the balance has fallen this sharply in the past month. While the Treasury has used some of its tax receipts to pay down bills, the large reduction in bill supply was completed by early May and issuance has since increased. Similarly, the Treasury began paying IEEPA refunds in late April but the total amount remitted to importers has so far been less than $20bn. In its

Quarterly Refunding announcement, the Treasury indicated that it expected to resume trimming (short-maturity) bill supply after the mid-June corporate tax date.

In addition to the increase in reserves, we suspect that a change in market sentiment might also be pulling repo rates lower. Market volatility may reduce the willingness of investors to take long positions, dampening their demand for financing. While they wait for a better opportunity to get long, they are migrating temporarily into bills and government-only money funds. Balances in gov-only money funds have increased $200bn since their trough in mid-April. While the timing of the rebound is seasonal, our sense is its scale and rapidity are connected to market uncertainty. As the Treasury cut bill issuance last month, money funds had to reallocate their portfolios from bills (-$266bn) to repo (+$36bn) and FHLB discount notes (+$84bn).

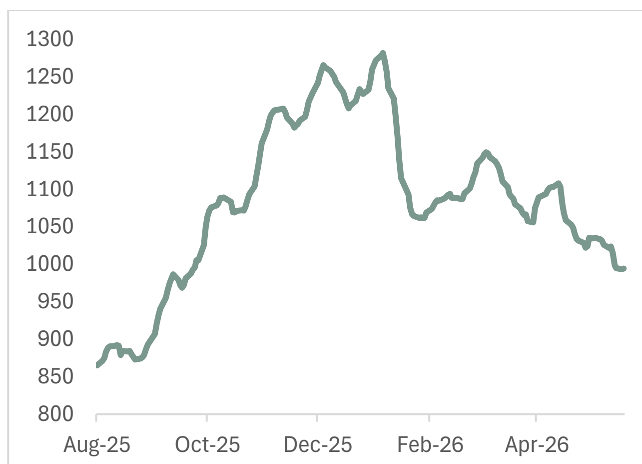
Similarly, primary dealers have reduced their long coupon positions. Their holdings of off-the-run Treasuries have fallen nearly 10% ($50bn) over the same period. **Smaller inventories reduce their need for repo financing**. Their customers have also dialed back their financing demand. Sponsored repo volumes have fallen steadily since mid-April (Figure 2). Dealers increase their sponsored repo activity when the demand for funding increases and they need to net down transactions to economize on their balance sheet consumption. If the demand for funding and leverage has declined dealers may have less need to push financing into sponsored.

Figure 1: SOFR-FF (bp)



Source: Federal Reserve, SMBC Nikko

Figure 2: Sponsored repo volume ($bn)



Note: 10d average. Source: DTCC, SMBC Nikko

We think the current low levels of repo rates are temporary. The Treasury plans to increase bill issuance across all maturities beginning in July. With the market more inclined to price in rate hikes before year-end, the yields on longer maturity bills may start to look more attractive to money funds than overnight repo. That said, it may take some months before money funds start moving from repo – as their average WAM is 41d. We think market uncertainty will remain a key driver for the direction of repo rates. **But until the market is more willing to get long, our sense is that it will be hard for repo rates to trade above IORB**.

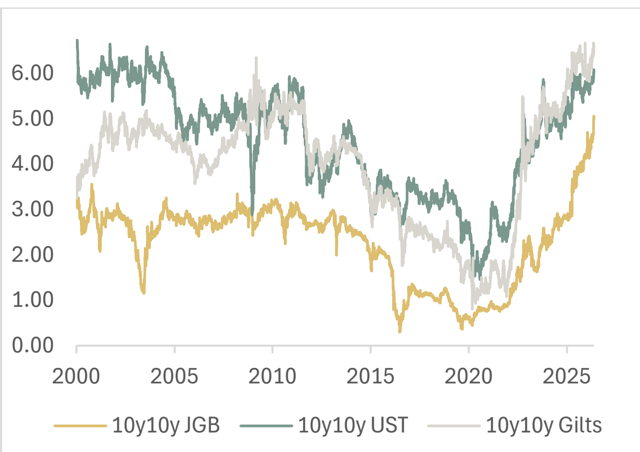
Attractive valuations and supportive seasonals

Ten-year Treasury yields broke above 4.60% earlier this week, driven by the selloff in global long end rates and geopolitical tensions that could keep oil prices elevated or push them higher. However, the stabilization in UK Gilts and Japanese JGBs has provided some respite to Treasuries. While fiscal concerns and term premium pressures are likely to remain a medium-term headwind, positioning and valuations appear increasingly supportive at current levels.

Long-end forward yields have reached multi-decade highs across markets (Figure 3), levels that may prove increasingly attractive to long-term investors. The UK 10y10y forward Gilt yield has risen to around 6.50% while comparable US and Japanese forwards are near 6% and 5%. These levels suggest that significant amount of term premium, fiscal risk and resilient growth is already reflected in market pricing.

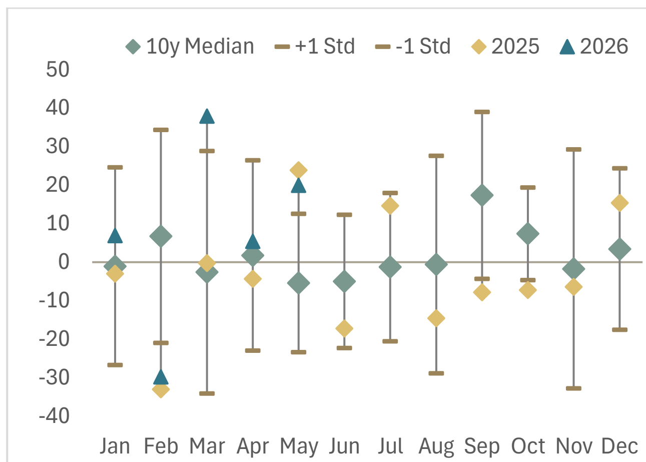
In addition, Treasury seasonals are supportive in June (Figure 4). While seasonality also pointed to a stronger Treasury market in May, it was overwhelmed by inflation concerns. Should those pressures ease or stabilize, elevated yields, attractive forward rates and supportive seasonal trends could provide a firmer backdrop to duration into the summer.

Figure 3: 10y10y UST, JGB and Gilt Yields (%)



Source: SMBC Nikko, Bloomberg;

Figure 4: Monthly seasonals in 10y UST (bp)

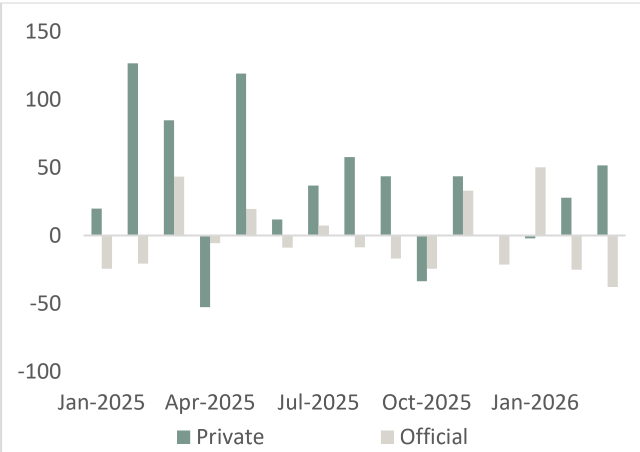


Source: SMBC Nikko, Bloomberg;

Official selling vs. private side buying

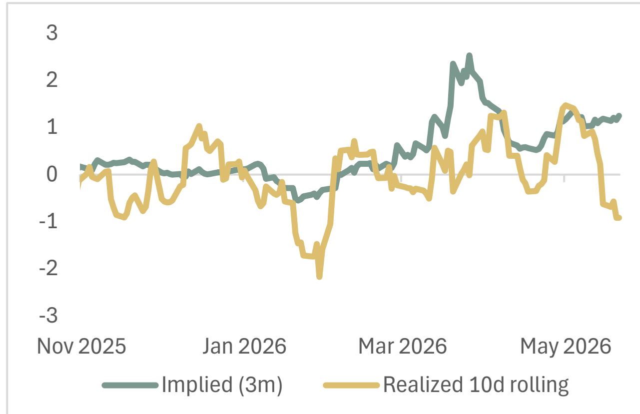
The March Treasury International Capital (TIC) data released earlier this week showed that official foreign accounts sold $37.8bn of long-term UST (notes/bonds) while the private sector bought $51.5bn (Figure 5). **The data suggest that reserve managers may have been liquidating Treasury holdings to support their currencies amid a stronger dollar and rising oil and commodity prices**. While inflation concerns and the repricing of Fed expectations were the likely dominant drivers of the March selloff, reserve manager selling may have amplified the move. If so, part of the recent rise in yields reflects a flow driven adjustment that may be temporary should dollar strength and commodity prices stabilize.

Figure 5: Foreign UST net transactions ($bn)



Source: Bloomberg; US Treasury, SMBC Nikko

Figure 6: Implieds and realized on 2y vs. 10y (daily bp vol)



Source: SMBC Nikko, Bloomberg;

Shorter tail vol to underperform

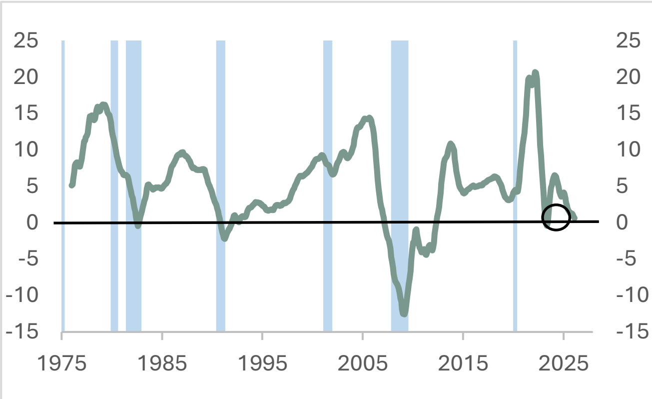
Three-month implied vols on the 2y is more than 1 daily bpvol higher than that on the 10y, despite realized in the 2y running nearly 1bp/day below that of the 10y over the past 10 days (Figure 6). We continue to believe that there is a strong case for the Fed remaining on hold in the near term, and therefore a more constrained range of outcomes for the front-end rates, should ultimately favor implied 10y tails over the 2y.

Week ahead

- **Case Shiller Home Prices (Mar, Tues)**: Home price growth continues to weaken nationally, on the back of softening demand and slowly increasing supply. Nationally home prices rose 0.7% y/y in February, which is among the slowest rate of price appreciation outside of recession (Figure 7). We look for a 0.15% m/m decline in the 20-city price index. Demand remains weak due to ultra-low affordability from high mortgage rates and home prices. We look for home prices to decline between -5 and -10% nationally over the next two years due to poor demand and positive supply dynamics. This will continue to be a key source of economy-wide deflationary pressure.

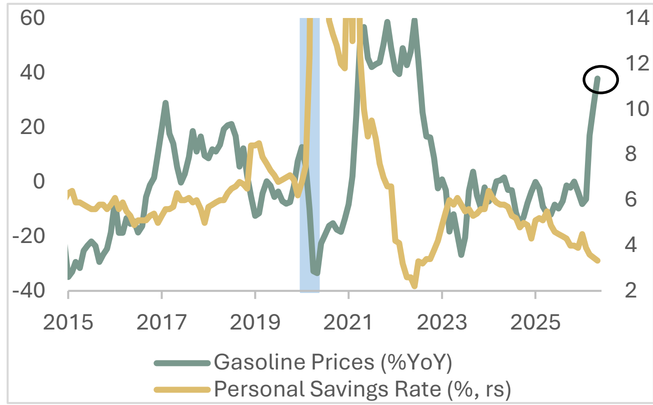
- **PCE and Core PCE Deflator report (Apr, Thurs)**: We look for robust increases of 0.5% m/m and 0.3% m/m for the headline and core PCE deflators, respectively. This follows a 0.6% m/m increase in the overall CPI and 0.4% m/m in the core index. Healthcare prices, as measured in the producer prices report, are a large and direct input into the PCE deflators and were up a modest 0.2% m/m in April. This suggests that headline and core PCE deflators should rise by less than April CPI. Both the PCE (3.5% y/y) and core PCE deflators (3.2% y/y) continue to run well above the Fed's 2% target and could head higher because of supply chain backlogs. Additionally, the personal savings rate is likely to decline from already subdued readings (of 3.6% in March) due to the closure of the Strait of Hormuz (Figure 8). We estimate that if gasoline prices rise to $5.50-$6.00/gallon range, the personal savings rate could fall to 2% — near the record lows of the early 2000s.

Figure 7: Case-Shiller Home Prices (%y/y)



Source: S&P, Haver, SMBC Nikko

Figure 8: Gas prices and savings rate (%y/y, %)



Source: EIA, BEA, Haver, SMBC Nikko

Table 3: Economic indicator forecasts

SMBC US Forecasts						
Date	Indicator	SMBC Forecast	Market Consensus (Median)	Prior	Range of Est.	Notes:
May 26	Case Shiller Home Prices (9 AM)	-0.15%	0.0%	-0.1%	-0.4% - +0.1%	Expecting home prices to decline nationally on the basis of low demand (rates) and incrementally positive supply.
May 26	Conf. Board Cons. Confidence (10 AM)	91.7	92.5	92.8	89.3 - 93.0	labor market differential pointing to low-to-mid 5% unemployment.
May 28	Personal Income (8:30 AM)	0.4%	0.4%	0.6%	0.2% - +0.6%	Payrolls up 0.1% MoM, hours up a tick, earnings up 0.16% MoM.
May 28	Personal Spending (8:30 AM)	0.5%	0.5%	0.9%	0.3% - +0.6%	Nominal spending was strong due to gasoline prices jumping 12.3% MoM. Vehicle sales decreased -1.2%.
May 28	PCE Deflator (8:30 AM)	0.51%	0.5%	0.7%	0.4% - +0.6%	April CPI increased by 0.64% MoM.
May 28	Core PCE Deflator (8:30 AM)	0.33%	0.3%	0.3%	0.2% - +0.4%	April core CPI increased at 0.38% MoM. PPI healthcare increased by 0.18% MoM (SA).
May 28	GDP Q1 (2nd est.) (8:30 AM)	2.0%	2.0%	2.0%	2.0% - +2.1%	2nd estimate of Q1 data
May 28	PCE Q1 (2nd est.) (8:30 AM)	1.7%	1.7%	1.6%	1.6% - +1.8%	2nd estimate of Q1 data
May 28	GDP Deflator Q1 (2nd est.) (8:30 AM)	3.6%	3.6%	3.6%	-	2nd estimate of Q1 data
May 28	Core PCE Deflator Q1 (2nd est.) (8:30 AM)	4.3%	-	4.3%	-	2nd estimate of Q1 data
May 28	New Home Sales (10 AM)	-4.6%	-4.7%	7.4%	-3.9% - -5.4%	New home sales have trended sideways since 2017 at 685k. New homes are the source of marginal supply.

Forecasts subject to change

Source: SMBC Nikko Securities US Economics Forecasts

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