US Rates Strategy Weekly

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- In his remarks, Chair Warsh emphasized the Fed's dual mandate. **But the much-abbreviated FOMC statement appeared to emphasize the price mandate more than full employment; the "Committee will deliver price stability."**

- **Whether the FOMC delivers on the (hike) dots remains to be seen**. Lingering pass-through and downstream price effects from higher oil prices are still working through the economy. That said, wages continue to slow despite the acceleration in hiring. And while consumer spending has held up, the savings rate is falling and sentiment is poor.

- Warsh already appears to be reshaping the Fed's forward guidance. He did not include a dot forecast in the Survey of Economic Projections (SEP). He also sharply shortened the FOMC statement and his post-meeting conference was shorter than those under previous Chairs.

- **We expect the FOMC will stop producing dots. Removing forward guidance will increase market volatility. But will the Fed's tolerance for market volatility also increase?**

- **One of the task forces will consider the size of the balance sheet.** While the Fed has identified several ways to shrink the balance sheet the mechanics are complicated. We expect the Fed to revise bank liquidity requirements in such a way to encourage lower reserve demand and more reliance on the discount window.

- **We look for a 0.6% m/m increase in personal spending with a 0.4% m/m increase in income**. Last month the personal savings rate fell sharply to 2.6% as households have not pulled back on their spending despite weaker income growth.

- There is **increased risk that two-year yields can rise** towards 4.25-4.40% following the shift in Fed's reaction function.

- Our analysis of past hiking cycles shows **that 75bp of hikes can flatten the 2s10s and 5s30s curve by around 35bp**.

Dot plots

The FOMC was roughly evenly divided about the need to hike rates later this year. **The median 2026 fed funds dot shifted up to pencil in one rate hike**. But among the nine FOMC members looking for rate hikes this year, opinions were divided. Five of the 9 expected two rate hikes this year, with another 3 looking for just one. And a single FOMC member penciled in 3 rates hikes this year. The FOMC largely looks for inflation to dissipate quickly – 10 of the 18 members look for rate cuts in 2027.[1] As expected, the FOMC revised up its 2026 core PCE forecast from 2.7% to 3.3%. When the last Survey of Economic Projections (SEP) was made in March, the Fed had very little information about pass-through and downstream effects from higher oil prices. The Committee made small downward adjustments to both the GDP and the unemployment rate projections for this year.

In his remarks, Chair Warsh emphasized the Fed's dual mandate. **But the much-abbreviated FOMC statement appeared to emphasize the price mandate more than full employment; the "Committee will deliver price stability."** One of Chair Warsh's recently hired advisors, Paul Winfree, has argued that the Fed should have a single (price) mandate. While we don't think the Fed is gearing up to narrow its mandate, our sense is that Warsh and the FOMC are indicating that tolerance for above-target inflation is over. Indeed, Chair Warsh argued that inflation is a "choice."

Whether the FOMC delivers on the (hike) dots remains to be seen. Lingering pass-through and downstream price effects from higher oil prices are still working through the economy. But the FOMC statement suggests that only *part* of the above-target inflation is due to supply shocks. Indeed, our sense is that some of the pressure on overall consumer prices is coming from an AI-economy that may be overheating. Memory chip prices have jumped 6-fold since last year and companies are signing contracts committing them to purchase future chips years in advance. Compute expenditures have increased as the tasks assigned to AI have grown more complex. In addition, investments in AI are expected to double this year.

That said, wages continue to slow despite the acceleration in hiring. And while consumer spending has held up, the savings rate is falling and sentiment is poor. While we think the Fed may not hike rates this year, it has become a closer call following this week's FOMC meeting.

Ending forward guidance

The market's intense focus on the dots highlights a key criticism raised by Warsh (and others). Chair Warsh argues that the dots are part of a broader communications problem for the Fed. "Radical transparency" has encouraged markets to expect the Fed to telegraph any planned policy changes in advance. **This desire to avoid surprises reflects the central bank's general concern about market volatility**. Since the global financial crisis, the Fed has had little tolerance for interest rate volatility. It has regularly stepped into the Treasury market to expand its balance sheet – buying off-the-run Treasuries or bills – when the Treasury market sells off. Less aggressively, Fed officials have frequently used press conferences or appearances on Capitol Hill to reset market expectations. Fed officials argue that disorderly sell-offs hurt the economy so smoothing out the edges by removing volatility tied to policy uncertainty makes sense.

Warsh already appears to be reshaping the Fed's forward guidance. He did not include a dot forecast in the Survey of Economic Projections (SEP). He also sharply shortened the FOMC statement and his post-meeting conference was shorter than those under previous Chairs. Separately, Warsh is creating a task force to work up a plan on the Fed's communications. This task force is due to publish its results by year-

[1] Fed Chair Warsh did not submit a projection reflecting his dissatisfaction with forward guidance.

end. While the communications to be reviewed include the FOMC statement, minutes and the SEP, our sense is the most significant focus might be the dot plot. **We expect the FOMC will stop producing dots**.

Outside the FOMC meetings, we think Warsh will discuss monetary policy less often than his predecessors. Yesterday, he avoided forward guidance by referring reporters to the FOMC statement. Whether Warsh manages to convince other FOMC members to do the same remains to be seen. **Removing forward guidance will increase market volatility. But will the Fed's tolerance for market volatility also increase?**

Other task forces

Warsh announced the creation of three other task forces focusing on the balance sheet, data quality and productivity/jobs. These committees are also tasked with coming up with plans by year-end. But unlike communications, these other task forces have more technical work assignments which could take longer to complete.

Outside of the communications task force, we think the balance sheet one will have the most significant market implications. Warsh has argued for shrinking the size of the Fed's balance sheet since he left the Fed over a decade ago. But mechanically, this is more complicated than simply ending the publication of fed funds dot projections. Ultimately, the size of the balance sheet is determined by three factors – the demand for currency, the Treasury's cash balance and bank demand for reserves. Bank reserve demand is a function of their regulatory requirements as well as the size of their preferred precautionary buffers. As we have argued, **to substantially reduce the size of the balance sheet, the Fed needs to either change bank liquidity regulation or consider other changes like tiering IORB**. Shrinking the balance sheet without reducing reserve demand would cause significant disruption in funding markets. As the end of QT in 2019 and 2025 illustrated, the Fed has little tolerance for repo market volatility.

And even these changes might not reduce the demand for reserves much if, for example, bank demand increases because of the shift to faster, 24/7 payments. The Fed might consider moving away from real time gross settlements to reduce reserve demand, but our sense is that it might be some time before it can deploy AI to settle bank-to-bank payments on a net basis. Smaller reductions in the balance sheet could be achieved by reducing the size of the Treasury's cash balance and investing in the repo market. However, that would be a Treasury decision – not the Fed's. That said, it appears that Fed officials have begun considering alternatives.[2]

At the press conference Warsh argued that the mix of indicators the Fed uses to monitor the economy is antiquated and an "echo" of an economy that no longer exists. This may also be addressed by the productivity/jobs task force. Our sense is that the Fed may be referring to survey data used to compile the Beige Book or the Philadelphia Fed's PMI. That said, the Fed's data collection and monitoring efforts have expanded in recent years. It publishes several market-based indicators – on r* and term premia – as well as others on trends in hiring and household inflation expectations. These indicators may be enhanced with others that use AI to process large amounts of data or others that collect private sector information.

Risk of higher front-end yields

Going into the FOMC, we expected the two-year to trade in a 3.90-4.20% range in the near term, with the view that investors would fade any spikes in yields above 4.20% given the downtrend in wages, mild May

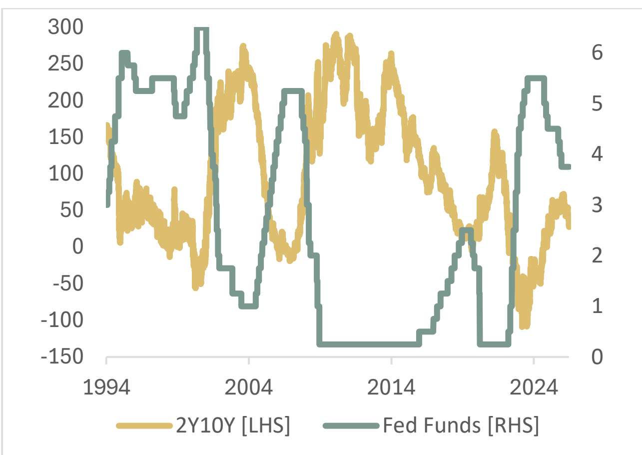
[2] See, "Options for reducing the size of the Fed's balance sheet", L. Logan and S. Schulhofer-Wohl, Federal Reserve Bank of Dallas, April 2, 2026

CPI print, and the decline in inflation expectations in May versus April. However, following the hawkish FOMC, **if the data remains resilient and oil starts moving higher after the post MOU decline, the risk is that the 4.20% high in yields could be breached, pushing yields towards 4.25-4.45%**. Our base case remains that the Fed is unlikely to hike, but the shift in the reaction function is likely to keep investors away from the front-end unless the labor market or growth data show a material change.

Hawkish fed reaction function favors flatteners

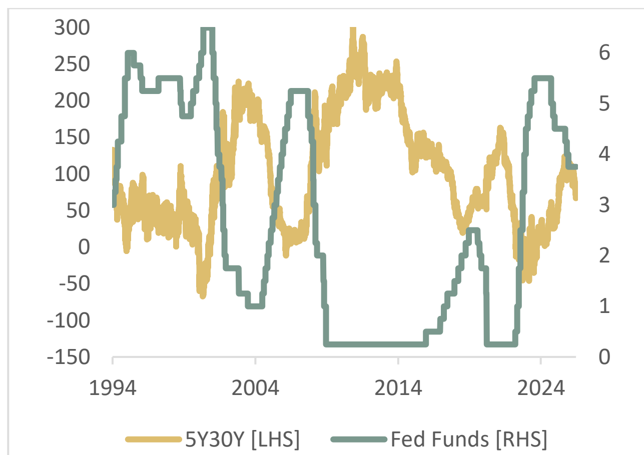
A resilient economy and inflation above target combined with a hawkish reaction function favors a flatter curve as the Fed hikes put upward pressure on the front-end yields and term premia falls as confidence increases that the Fed would not allow inflation to rise or remain high. Figures 1 and 2 show that the curve flattens with Fed hikes. However, with 40bp and 45bp of flattening in 2s10s and 5s10s respectively since the beginning of the year, the question is how much more can the curve flatten?

Figure 1: 2s10s UST Curve vs. Fed Funds (bp)



Source: Bloomberg, SMBC Nikko

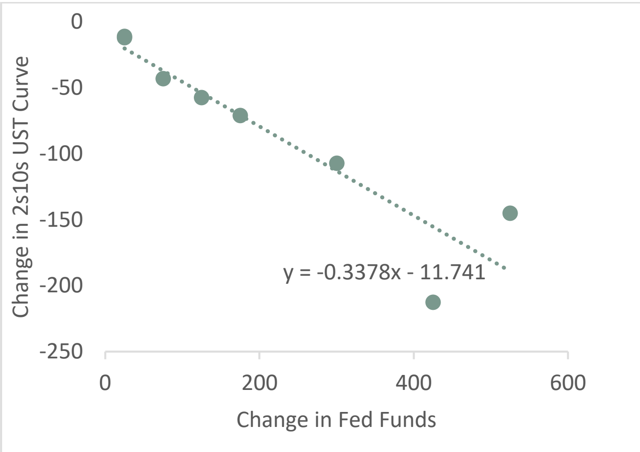
Figure 2: 5s30s UST Curve vs. Fed Funds (bp)



Source: Atlanta Fed, Bloomberg, SMBC Nikko;

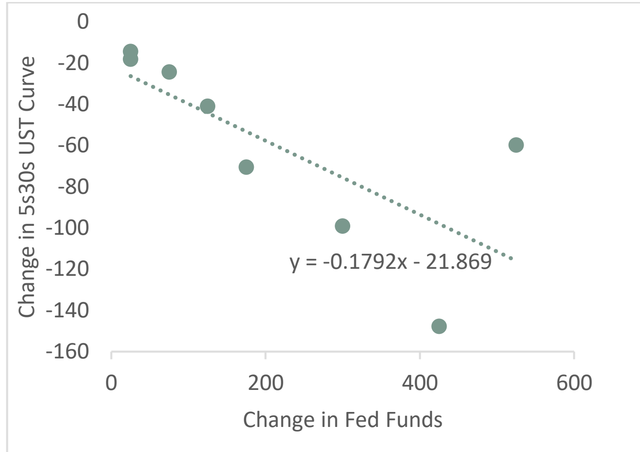
To answer our question, we examine hiking cycles going back to 1994. Figures 3 and 4 show the change in the curve (2s10s and 5s30s UST) from one month prior to the start of each hiking cycle through the final hike, plotted against the total magnitude of hikes. While no two cycles are identical and the starting point of the curve matters, this framework still provides a useful guide for how much flattening one might expect based on the size of the hiking cycle. Using a simple regression, three hikes imply roughly 34 bp of flattening in the 2s10s and 37 bp in the 5s30s. However, the question comes to whether we get the hikes being priced in or is the market incorrect in reading Fed's reaction function.

Figure 3: Change in 2s10s vs. Fed Funds (bp)



Source: Bloomberg, SMBC Nikko

Figure 4: Change in 5s30s vs. Fed Funds (bp)



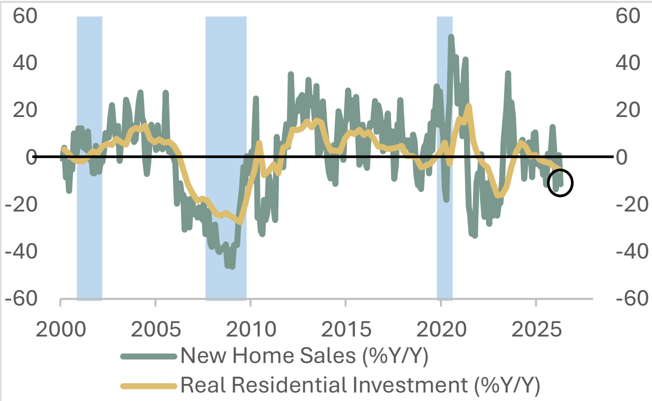
Source: Bloomberg, SMBC Nikko;

Week ahead

- **New Home Sales (May, Wed)**: New home sales have trended sideways at roughly 622k since March 2017. Although we are forecasting an increase of 4.2% in May, partly due to a 1.3% increase in mortgage applications for home purchases, we expect this sideways trend to persist. Demand is challenged by the lowest home affordability since the global financial crisis, high mortgage rates and house prices. We see little prospect for material near-term improvement in either prices or mortgage rates (Figure 5).

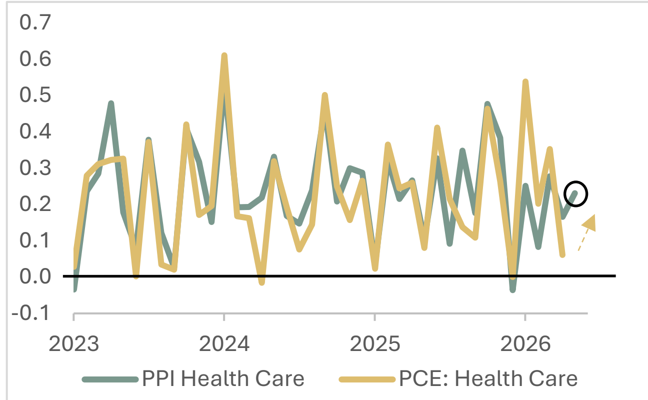
- **Personal Income, Spending, PCE and Core PCE Inflation (May, Thurs)**: Inflation data for the month of May are somewhat stale, given the recent peace agreement between the US and Iran. We are forecasting a 0.4% m/m increase in headline PCE inflation and 0.3% m/m in core PCE inflation. Health care costs increased 0.2% in the May PPI report (Figure 6). In April, the personal savings rate fell to 2.6% as household spending rose faster than income. We look for a 0.6% m/m increase in spending with a 0.4% m/m increase in income.

Figure 5: New home sales and real residential investment (%y/y)



Source: Census, BEA, Haver, SMBC Nikko

Figure 6: PPI and PCE healthcare costs (%m/m)



Source: BLS, BEA, Haver, SMBC Nikko

Table 3: Economic indicator forecasts

SMBC US Forecasts						
Date	Indicator	SMBC Forecast	Market Consensus (Median)	Prior	Range of Est.	Notes:
Jun 24	New Home Sales (10 AM)	4.2%	3.3%	-6.2%	2.1% - +4.5%	New home sales have trended sideways since 2017 at roughly 622k. Home prices continue to slow.
Jun 25	Personal Income (8:30 AM)	0.4%	0.4%	0.0%	0.2% - +0.7%	Wages increased 0.3% MoM, hours flat, payrolls up by +0.11% MoM.
Jun 25	Personal Spending (8:30 AM)	0.6%	0.5%	0.5%	0.2% - +1.0%	Retail sales jumped 0.9% MoM. Spending also supported by +0.5% in CPI & a 0.6% in auto sales.
Jun 25	PCE Deflator (8:30 AM)	0.39%	0.4%	0.4%	0.3% - +0.7%	Headline CPI increased 0.47% MoM in May.
Jun 25	Core PCE Deflator (8:30 AM)	0.25%	0.3%	0.2%	0.2% - +0.4%	Core CPI increased 0.21% MoM in May. PPI healthcare -- a direct input into PCE -- increased just 0.2% MoM.
Jun 25	Durable Goods New Orders (8:30 AM)	-6.3%	-5.0%	8.0%	-9.0% - -2.6%	Likely to see a mechanical downshift in May following a 8% MoM surge, due to a deluge of aircraft orders.
Jun 25	Durable Goods ex trans (8:30 AM)	0.4%	0.2%	1.1%	0.0% - +0.8%	Durable goods ex transportation new orders at record highs, growing at 9.1% YoY (April) and accelerating.
Jun 25	Q1 GDP (third est.) (8:30 AM)	1.6%	1.6%	1.6%	1.4% - +2.3%	Third estimate for Q1 data
Jun 25	Q1 PCE (third est.) (8:30 AM)	1.4%	1.4%	1.4%	1.2% - +1.5%	Third estimate for Q1 data
Jun 25	Q1 GDP Deflator (third est.) (8:30 AM)	3.5%	3.5%	3.5%	3.5% - +5.6%	Third estimate for Q1 data
Jun 25	Q1 core PCE Deflator (third est.) (8:30 AM)	4.4%	4.4%	4.4%	1.9% - +4.4%	Third estimate for Q1 data

Forecasts subject to change

Source: SMBC Nikko Securities US Economics Forecasts

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