US Rates Strategy Weekly

April 24, 2026

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 look for the Fed to keep rates on hold at this week's meeting**. Inflation remains "somewhat elevated" amid heightened growth uncertainty from the Iran conflict.

- **Warsh argues for a fundamental reform of monetary policy; revisiting how the Fed targets price stability and how it responds to price shocks**. Warsh was careful to avoid discussing interest rates and instead emphasized the Fed's independence.

- A more flexible and broader interpretation of the inflation mandate might mean expanding the focus from a 2% PCE target to include other barometers like median and trimmed mean indexes.

- **Warsh is skeptical about QE and the value of using Fed asset purchases to commit to future policy or forward guidance**. He argues that this creates market distortions when policy should be grounded more in the current data.

- A smaller balance sheet might allow the Fed to return to its pre-crisis policy framework of using interest rates rather than asset purchases to achieve price stability. **The Fed could gradually let its balance sheet shrink while offsetting the effect on liquidity by cutting interest rates**.

- Range-bound rates near term, but with two-sided risks. Favor front-end, steepeners medium term and expect front-end gamma to underperform the belly.

- **We expect Q1 GDP to increase by just 1.4% q/q with the price deflator rising 4.1% q/q**. It is unclear how extensively the Iran conflict affected late-quarter growth and prices. The April ISM reading is expected to inch higher – to 53.5. Manufacturing confidence has so far been unaffected by the Iran conflict.

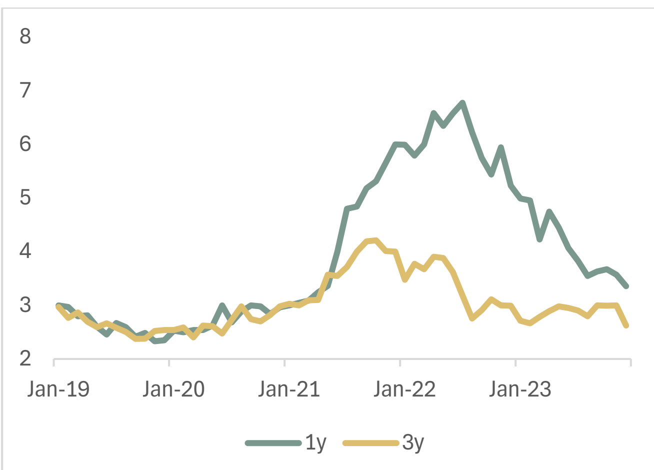
"The tyranny of the *status quo*"

In his opening remarks in front of the Senate Banking Committee, Chair Warsh cited this quote from Milton Friedman in arguing for a fundamental reform of the Fed. One area he appears focused on is its current inflation framework. **In particular, the Fed needs to revisit how it targets inflation and responds to price shocks**.

The Fed interprets its price mandate in the form of an inflation target. But Warsh argues that it needs to reconsider its 2% PCE target. **Instead, the Fed should think about inflation more broadly; it needs to consider other measures and across longer time horizons**. It is not clear that the PCE deflator or CPI are complete barometers of price pressures. Each relies on imputed prices for services that cannot be directly observed or billed for. Chain type indexes like the PCE update their expenditure weights continuously, but this may make them more sensitive to categories where large price changes cause expenditure shares to shift more rapidly than fixed weight indexes like the CPI.

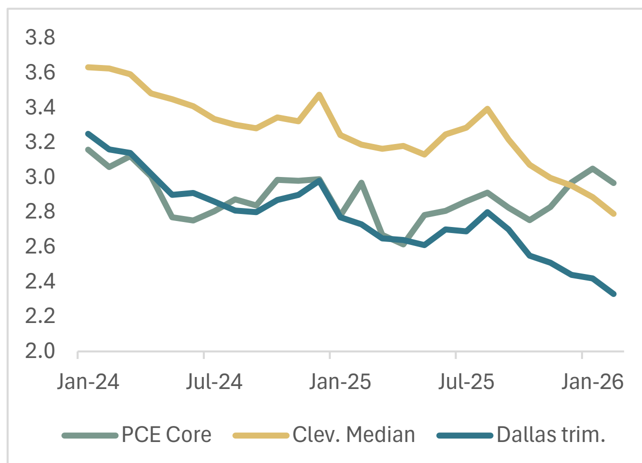
It is often difficult to separate the monthly noise from the underlying price trend. Warsh notes that this difficulty caused the Fed to misread price pressure after COVID. It incorrectly attributed the inflation to temporary effects from supply chain disruptions that would resolve on their own. Consequently, it postponed tightening policy, allowing inflation expectations to build into rising wage demands from an already tightening labor market (Figure 1). This suggests that the Fed should pay less attention to the month-to-month noise from volatile goods like used cars and airfares and instead base policy more on standard rules over longer horizons. That said, Warsh is critical of the Fed's reliance on complex models (DSGE) that may be too removed from reality.

Figure 1: Median cons. inflation expectations (%)



Source: Federal Reserve, SMBC Nikko

Figure 2: Alternative inflation measures (%y/y)



Source: Federal Reserve, SMBC Nikko

A more flexible and broader interpretation of the inflation mandate might mean expanding the focus from 2% PCE to less noisy barometers like the Cleveland Fed's median inflation index or the Dallas Fed's trimmed mean index. Both measures remove the most volatile components from the calculation of the annual growth rate subject to some established exclusion rule. These other measures have cooled faster than the core PCE deflator since last summer (Figure 2).

Warsh was careful to avoid discussing interest rates and instead emphasized the Fed's independence. That said, he acknowledged that while the administration and outsiders all have opinions about interest rates it is the Fed alone that is accountable for achieving price stability.

Separately, Warsh's views on the balance sheet appear to reflect two considerations. First, he is skeptical about QE and the value of using Fed asset purchases to commit to future policy (forward guidance). He argues that this creates market distortions when policy should be grounded more in the current data. Relatedly, he may have a similar dim view about the communications value of the Fed's dot plot as a tool to communicate longer run policy expectations.

Second, he argues that a smaller balance sheet would allow the Fed to return to its pre-crisis policy framework of using interest rates rather than asset purchases to achieve price stability. **His approach would be to shrink the balance sheet gradually while simultaneously cutting interest rates to offset the drain in market liquidity caused by the Fed's asset roll-offs**. A recent study examines this question.[1] Copeland and Engbretson examine repo spreads to measure the opportunity cost to banks and dealers of holding cash. As expected, the liquidity premium or spread increases with an increase in IORB and a decrease in the Fed's liabilities. They note that a $400bn decrease in bank reserves would neutralize the effect on dealer repo spreads of a 100bp reduction in IORB.[2]

Range bound absent a deal or sustained oil shock

We expect Treasuries to remain range-bound between the late March highs and April lows in yields, reflecting the current Middle East stalemate. While the risk premium remains elevated, it appears capped. Separately, although the market interpreted Warsh's testimony as hawkish, we see little incremental signal relative to the current situation, as explained above.

In a scenario of further escalation in the Middle East, yields could move higher initially, although we continue to view hikes as unlikely even under a sustained oil shock. AI-led disinflation forces and private credit concerns that weighed on markets in February remain in place and Warsh's recent comments do not suggest a material shift in the AI's disinflationary assessment. If oil prices rise materially above March highs, markets may eventually shift focus from inflation towards demand destruction. As such, any large selloff in Treasuries is likely to be used by investors as an opportunity to buy Treasuries, in our view. We favor the front-end at current levels and would add on a move toward 3.90-4.00% in 2y yields driven by geopolitics. Under our base case, where the Fed is on hold in 2026 with a cut in spring 2027, 2y yields should settle around 3.60%.

Favor steepeners

We continue to favor steepeners. Front-end positioning is cleaner versus March, and the Fed is likely to look through energy driven price pressures given still soft overall labor market conditions. In a de-escalation scenario, lower oil prices and earlier rate cuts should support the front end. In contrast, escalation, where oil moves higher, has historically impacted the long end more directly. More broadly, the combination of firmer inflation and rising fiscal spending across G10 economies should lead to higher term premia and steeper curves.

Vol – Gamma on shorter tails to underperform belly

The path for vol is likely to remain headline driven. However, positioning in the front-end now appears cleaner across US and Europe. With the Fed likely to maintain a wait and see stance with upside inflation risks and weaker growth expected in the coming months, we favor using any spikes in front end vol due to renewed geopolitical escalation to enter into long 10y tails vs. 2y tails.

---

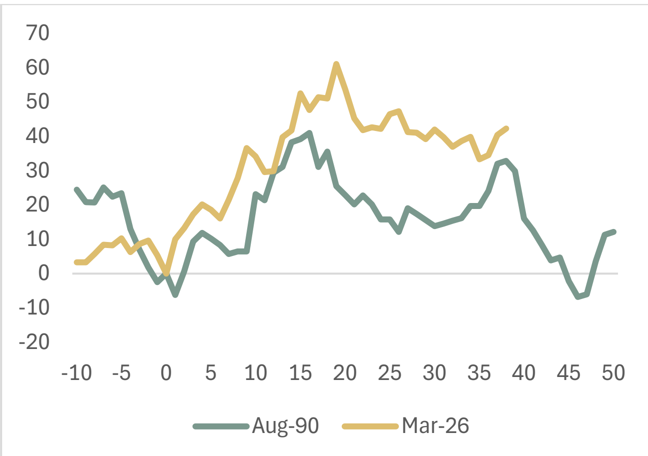
[1] See, "The Fed Has Two Tools to Influence Money Market Conditions", A. Copeland, and O. Engbretson, Federal Reserve Bank of New York, April 6, 2026

[2] Fed liabilities also include the Treasury's cash balance and the RRP program. We wrote about capping the former and reinvesting the difference in the Treasury repo market earlier this week.

2026 versus 1990 Analog

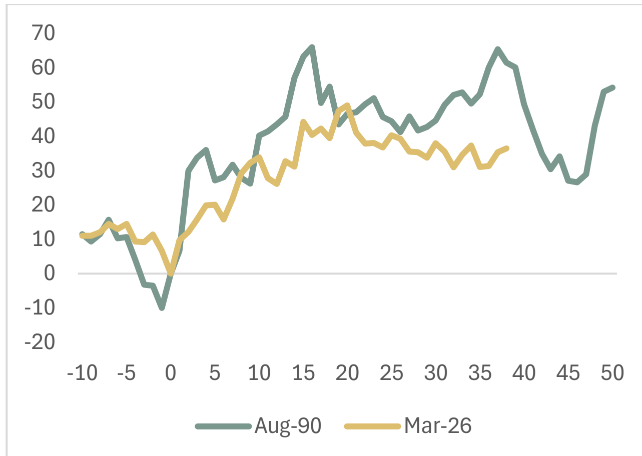
While both episodes had supply side energy shocks, the starting points, the economic environment and yield levels in the two scenarios are materially different. A few observations: a) The current episode has seen the 2y underperform relative to the 10y, in contrast to 1990. b) Natural gas has underperformed relative to the 1990 shock. c) Growth was significantly weaker in 1990, with Greenspan highlighting credit stress, whereas activity going into the shock was more resilient this time.

Figure 3: 2y UST (bps)



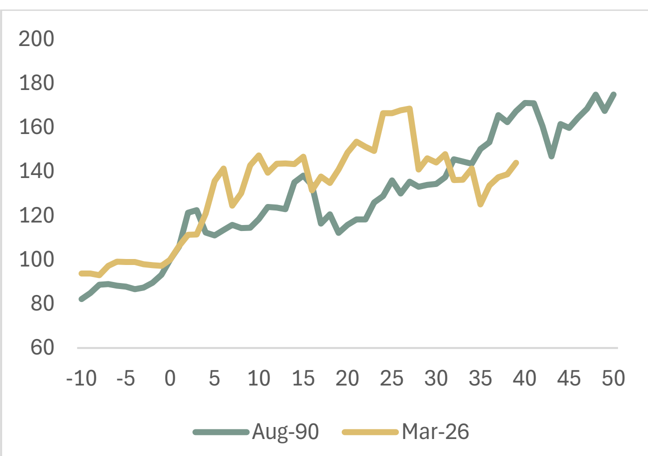
Source: Bloomberg, SMBC Nikko; Note: Prices are indexed to the day before the shock (0 on the x-axis).

Figure 4: 10y UST (bps)



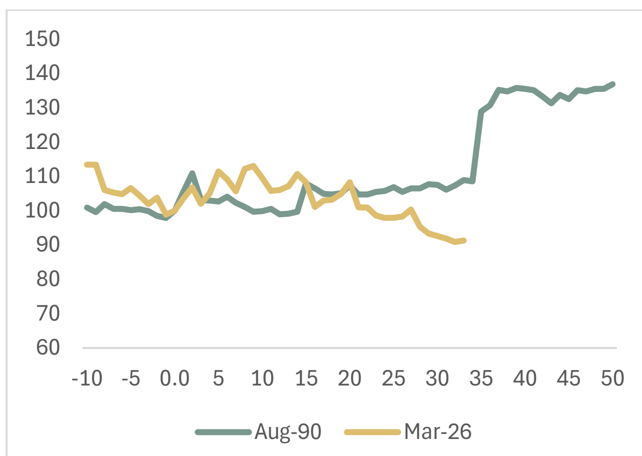
Source: Bloomberg, SMBC Nikko; Note: Prices are indexed to the day before the shock (0 on the x-axis).

Figure 5: WTI (index)



Source: Bloomberg, SMBC Nikko; Note: Prices are indexed to the day before the shock (0 on the x-axis).

Figure 6: Natural gas (index)



Source: Bloomberg, SMBC Nikko; Note: Prices are indexed to the day before the shock (0 on the x-axis).

Week ahead

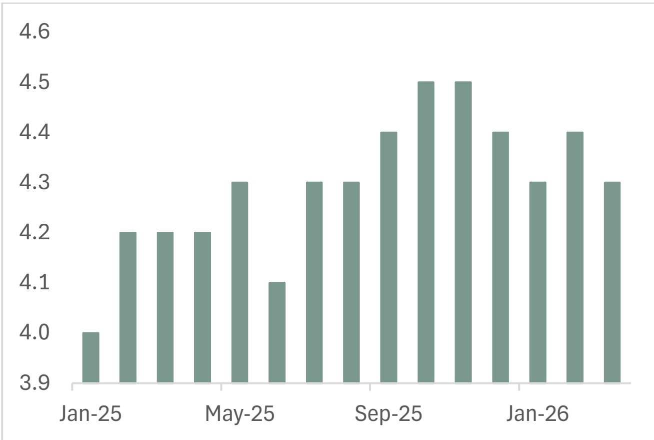
- **FOMC announcement (Wed)**: **We look for the Fed to keep policy on hold amid heightened uncertainty**. Indeed, its description of economic conditions and its policy prescription is likely to duplicate the March announcement. The unemployment rate remains range-bound despite modest average monthly gains in payrolls (Figure 7). Inflation is still "somewhat elevated" – total and core PCE have been above the Fed's threshold of 2% since early 2021. Initially, markets assumed the Iran conflict would be short and any shock from higher oil prices would be brief. Markets priced in a higher likelihood that the Fed would raise interest rates rather than "look through" the oil price supply shock. The sense was that because the Fed had misread the supply chain shock in 2021-22 it was less likely to patiently wait out higher oil prices. But as the conflict continues, there are signs that higher energy prices are damaging household and business confidence. While these have not be large enough to cause a recession, we think they suggest that the Fed's next move is unlikely to be a hike. That said, it may take some time after the Iran conflict has ended for oil to resume flowing and prices to return to their pre-February levels. As a result, while the next move is likely to be a rate cut, we do not think the economy will weaken quickly enough for the Fed to move soon.

- **GDP (Q1, Thu)**: The BEA will publish its initial estimate of Q1 GDP. **We look for GDP to increase 1.4% q/q with the deflator boosted to 4.1% q/q by higher energy prices**. We expect the Iran conflict to reduce spending and investment although given the timing it is possible that most of the oil shock will show up in the Q2 data. Higher gasoline prices may have diverted consumer discretionary spending in the GDP accounts, but data on the control group of retail sales for March were unexpectedly strong.[3] Our sense is that households may not have started to pull back and that the extra $70/m in gasoline expenses for the average family is coming from savings. We think higher diesel prices may have a bigger effect on spending as these prices are included in shipping and other costs of goods sold. AI related spending continues to grow rapidly, adding about 0.5% to quarterly growth since early 2024. However, most of this spending is directed to *producing* AI rather than its use. As a result, it is difficult to see signs of an AI-related surge in productivity.

- **ISM manufacturing (Apr, Fri)**: We look for the manufacturing ISM to increase to 53.5 in April from 52.7 in March (Figure 8). The diffusion index rose sharply in January and is above 52.0 suggesting manufacturers' confidence has improved since last year. It is unclear if this is tied to termination of the IEEPA tariffs. Likewise, some of the sub-components (like new orders) may have been dented by the Iran conflict. The ISM prices paid index has risen nearly 20pp since January and is at its highest level since mid-2022.

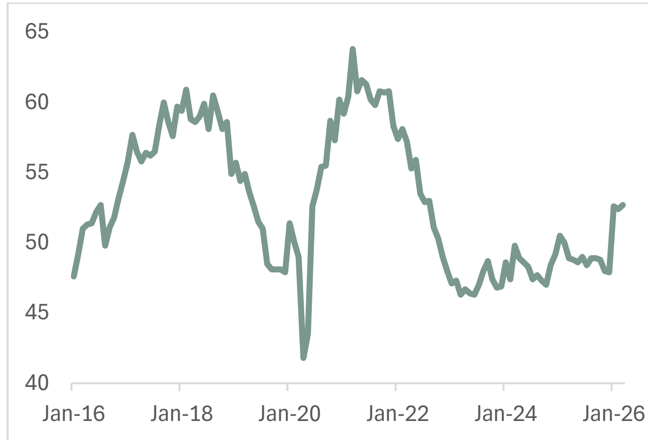
[3] Retail sales control excludes spending on autos, gasoline, building materials and food services. In March it rose 0.7% - more than expected – following an upwardly revised February reading.

Figure 7: Unemployment rate (%)



Source: BLS, SMBC Nikko

Figure 8: ISM (index)



Source: Institute of Supply Management, SMBC Nikko

Table 1: Economic indicator forecasts

SMBC US Forecasts						
Date	Indicator	SMBC Forecast	Market Consensus (Median)	Prior	Range of Est.	Notes:
Apr 28	Case Shiller Home Prices (9:00 AM)	0.0%	-0.1%	0.2%	-	Leads CPI shelter by 16 months and indicates more housing led disinflation ahead.
Apr 28	Conf. Board Cons. Confidence (10 AM)	88.0	90.0	91.8	83.3 - 91.5	Labor market differential series suggests higher unemployment rate.
Apr 29	Housing Starts (8:30 AM)	-4.2%	1.4%	7.2%	-	Housing starts gradually trending lower due to single family starts, which are back at pre covid levels.
Apr 29	Durable Goods (8:30 AM)	1.1%	0.5%	-1.3%	-4.0% - +1.1%	Unfilled orders of durable goods at all time highs. Continued positive for manufacturing production.
Apr 29	Durable Goods ex trans (8:30 AM)	0.4%	0.4%	0.9%	-0.3% - +0.4%	Also at record highs
Apr 29	Fed Funds Rate Upper Bound (2:00 PM)	3.75%	3.75%	3.75%	3.25% - 3.75%	Fed in wait and see mode. We are not forecasting any changes to rates this year.
Apr 30	Personal Income (8:30 AM)	0.4%	0.3%	-0.1%	0.2% - +0.9%	Payrolls up 0.1% MoM, hours down a tick, earnings up 0.24% MoM.
Apr 30	Personal Spending (8:30 AM)	1.0%	0.7%	0.5%	0.6% - +0.9%	Nominal spending was strong due to gasoline prices jumping 24% MoM. Total vehicle sales increased +3.7%.
Apr 30	PCE Deflator (8:30 AM)	0.7%	0.6%	0.4%	0.5% - +1.0%	CPI up 0.87% MoM in March.
Apr 30	Core PCE Deflator (8:30 AM)	0.2%	0.3%	0.4%	0.2% - +0.3%	Core CPI up just 0.2% MoM in March.
Apr 30	Employment Cost Index (8:30 AM)	0.8%	0.8%	0.7%	0.8% - +0.9%	Employment costs continue to slow from elevated levels. Decline in quits rate implies pre-Covid levels for the ECI.
Apr 30	Q1 GDP (8:30 AM)	1.4%	1.2%	0.5%	0.5% - +4.1%	Preliminary estimate for Q1. Growth weighed down by inflation shock from the Middle East conflict.
Apr 30	Q1 PCE (8:30 AM)	1.2%	1.9%	1.9%	-	Atlanta Fed est: 1.3% for GDP and 1.1% for PCE 1.1%.
Apr 30	Q1 GDP Deflator (8:30 AM)	4.1%	4.1%	3.7%	-	Q1 CPI up +3.7% QoQar.
Apr 30	Q1 Core PCE Deflator (8:30 AM)	2.3%	-	2.7%	-	Q1 core CPI up +2.8% QoQar.
May 1	ISM Manufacturing (10 AM)	53.5	52.9	52.7	51.0 - 54.1	ISM manufacturing index has surged in 2026.

Forecasts subject to change

Source: SMBC Nikko Securities US Economics Forecasts

Table 2: GDP and interest rate projections (%)

	2025	2026				2027	
(%)	Q4 Act	Q1F	Q2F	Q3F	Q4F	Q1	Q2
Real GDP QoQar	1.4	2.0	1.1	2.1	2.2	2.0	2.4
Real GDP YoY	2.2	2.9	2.2	1.6	1.8	1.8	2.2
Core PCE YoY	2.9	2.7	3.0	2.7	2.4	2.3	1.9
Unemployment	4.4	4.5	4.8	4.7	4.6	4.6	4.6
Fed Funds Rate Upper Bound	3.75	3.75	3.75	3.75	3.75	3.75	3.50
2 Year	3.47	3.79	3.65	3.60	3.60	3.50	3.50
5 Year	3.73	3.94	3.80	3.75	3.75	3.60	3.60
10 Year	4.17	4.32	4.20	4.25	4.30	4.30	4.30
30 Year	4.84	4.91	4.70	4.80	4.85	4.90	4.90

Source: SMBC Nikko

Disclaimers