SMBC SMBC Group

US Rates Strategy Weekly

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- Treasury Secretary Bessent seemed to hint that it might be appropriate for the Fed to raise rates once. **The sense was that the Fed might be able to bring inflation back to target with a single rate hike – just like it did in March 1997**.

- But in 1997, the Fed was concerned that the economy was overheating and that its achievement of bringing inflation below 3% was in jeopardy. By contrast, the recent acceleration in inflation has been caused by a supply shock.

- Rate hikes may no longer only reflect pass-through effects from higher energy prices. **Instead, there may be a sense that the demand side of the economy is overheating. And, the Fed's June FOMC statement was less tolerant of above-target inflation**.

- Inflation swaps have retraced sharply. 1y and 5y are back to or below December 2025 levels. Forward inflation is consistent with 2% PCE.

- The apparent disconnect with 35 bp of hike pricing is largely explained by real yields.

- Demand is rising for low strike receiver skew, a likely result of investors hedging against AI-led and private credit driven downside risks.

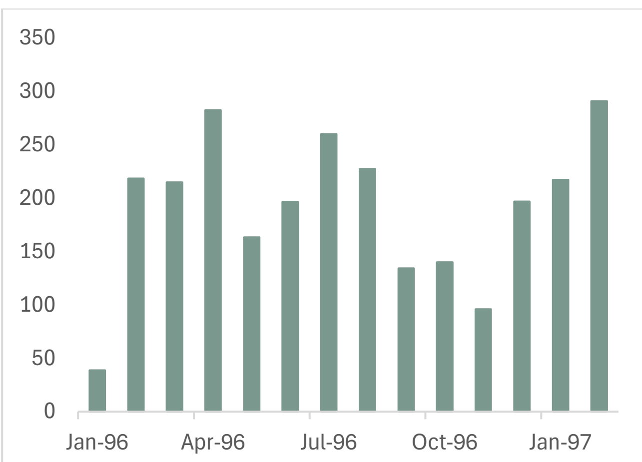
- We are forecasting a decline in the June ISM manufacturing index to 52.8 (from 54.0). **We look for headline and private non-farm payrolls to increase 125,000 and 121,000, respectively**. We expect the unemployment rate will remain at 4.3% near the FOMC's long-term estimate of full employment

Tapping the brakes

In a speech earlier this week, Treasury Secretary Bessent seemed to hint that it might be appropriate for the Fed to raise the fed funds rate by 25bp.[1] The sense was that the Fed might be able to bring inflation back to target with a single rate hike – just like it did in March 1997. Markets are pricing in about 32bp of tightening through year-end.

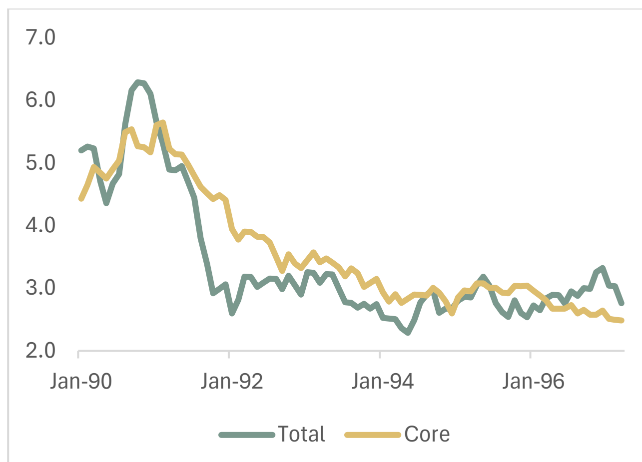
However, the "tap the brakes" hike in March 1997 occurred under different circumstances than what the Warsh Fed is currently facing. At the time, the Fed acknowledged, "persisting strength in demand, [was] progressively increasing the risk of inflationary imbalances developing in the economy".[2] This followed an unexpected acceleration in hiring and a pick-up in spending on consumer durables (Figure 1). At earlier FOMC meetings, the Board was looking for growth to slow in 1997 and 1998. But it was concerned about losing the gains it had achieved toward reducing inflation since 1990 (Figure 2). With the unemployment rate falling (to 5.2%) and capacity utilization slightly higher than its long run average, the Fed felt a rate hike was necessary to cool the economy off. In addition, Fed Chair Greenspan was concerned that the stock market was overheating – having delivered his "irrational exuberance" remarks at an American Enterprise Institute appearance on December 5, 1996.

Figure 1: Non-farm payrolls (chng, 3ma)



Note: As reported. Source: BLS, SMBC Nikko

Figure 2: Inflation (% y/y)



Source: BLS, SMBC Nikko

By contrast, the recent acceleration in inflation is supply-driven. And, unlike the early 1990s when inflation was falling, it has remained above the Fed's target now for several years. As oil prices fall, these supply-side pressures may be ebbing. And while we think there may be some lingering downstream price increases, our sense is that inflation has peaked. **But could markets be pricing too many rate hikes?**

Our sense is that market sentiment has shifted. Rate hike expectations may no longer *only* reflect

[1] See, "Did the Trump White House just give Warsh the green light to hike interest rates?", Bloomberg, G. Robb, June 24, 2026

[2] The Fed's policy statement from that meeting was a mere 5 sentences – 4 if the boilerplate sentence on the discount rate is excluded.

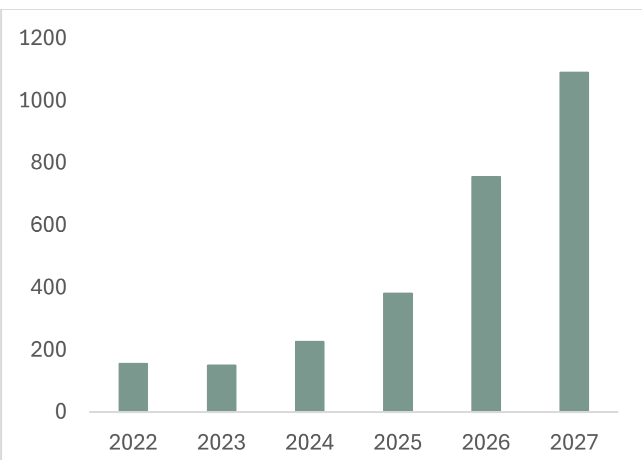
expected pass-through effects from higher energy prices. Instead, two other influences may be playing a role – that is, the sense that the economy is overheating and a feeling that current policy has been too tolerant of above-target inflation.

Indeed, growth in non-farm payrolls has recently accelerated and household spending remains robust despite higher gasoline prices. The unemployment (4.3%) is close to the Fed's estimate of full employment.[3] At the same time, equity prices are rising.

Our sense is that the AI economy is becoming heated. How much this is carrying over to the broader economy is unclear. Last year, five companies accounted for nearly $400bn in capital expenditures (Figure 3). **These companies have announced plans to *double* their expenditures this year.**[4] Wachter et al expect their capital spending to exceed $1trn in 2027.[5] While these are huge numbers, much of these outlays are on imported equipment so the *measured* effect on GDP growth is much smaller. That said, the Wachters assume a 25% depreciation rate (matching industry assumptions) which suggests that 68% of the installed AI capital stock will depreciate after 4 years. While some of this "aging" capital stock can be redeployed to other uses, the high depreciation suggests that expenditures could remain vigorous over the next few years.

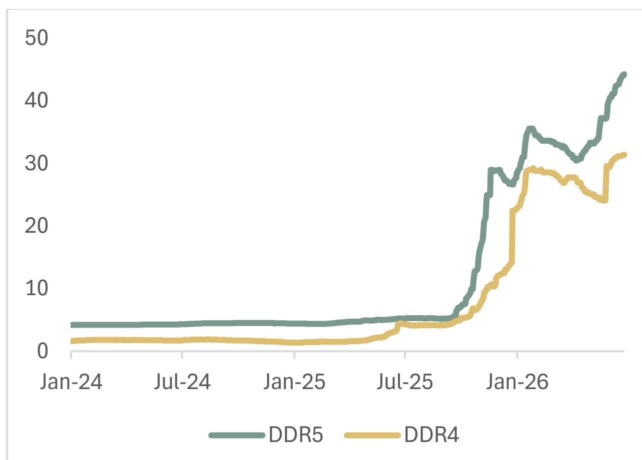
Although the GDP direct effect is smaller than the company-level spending numbers suggest there are signs that demand is outstripping production capacity. Advanced chip prices (DDR5) have increased 55% since December. As these have become more difficult to find, manufacturers have begun substituting less advanced models (DDR4) and these prices have risen 38% over the period.

Figure 3: Capital expenditures ($bn)



Source: Wacher et al., SMBC Nikko

Figure 4: Chip prices ($)



Source: Bloomberg, SMBC Nikko

[3] The FOMC's longer run unemployment rate forecast in the Survey of Economic Projections (SEP) for June was 4.2%.
[4] The companies are Amazon, Alphabet, Microsoft, Meta, and Oracle.
[5] See, "What Investment Data Implies about the AI Transition", J. Wachter and J. Wachter, Wharton, University of Pennsylvania, June 12, 2026

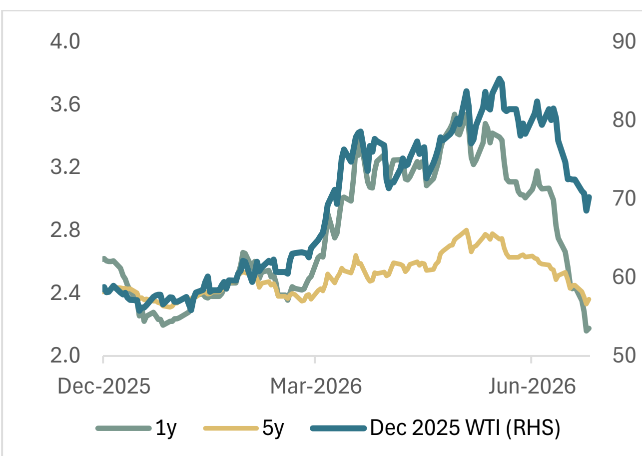
At the same time, new Fed Chair Warsh seems far more intolerant of above-target inflation. The June FOMC statement emphasized the Fed's intent to "deliver price stability". Together with the distribution of the dots, we think this has strengthened the market's view about rate hikes this year in light of the acceleration in payrolls.

Rate hikes vs. inflation markets: Disconnect or consistency?

On the surface, there is a notable disconnect between what inflation swap spreads imply and the front-end rate curve. Figure 5 shows 1-year inflation swaps have retreated to levels at or below where they stood in December 2025. Similarly, 5-year inflation swaps have fallen back to their late February lows. At the same time, forward inflation measures are within the 2.25-2.40% range that is broadly consistent with 2% PCE (Figure 6). The inflation market suggests that the price shock is fading and medium-term expectations remain anchored.

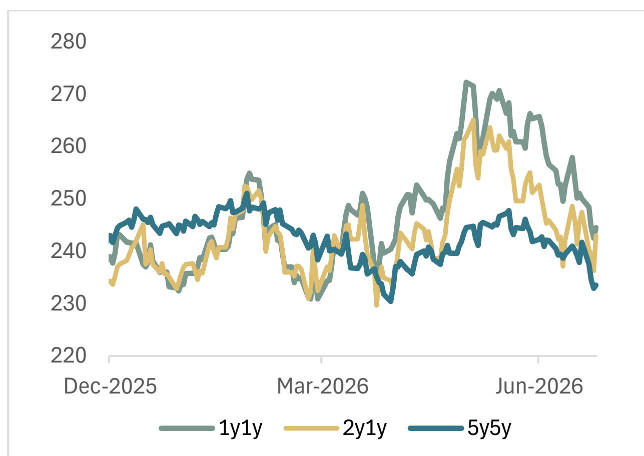
But the rates market is pricing 35 bp of hikes into 2027. The rise in yields has been driven by the real component while the inflation component has fallen. If inflation is genuinely under control, the case for tightening rests on the demand side – the strength of payrolls, AI-driven capex and the Fed's apparent discomfort with above target prints.

Figure 5: Inflation swaps (%) vs. WTI ($/bbl)



Source: Bloomberg, SMBC Nikko

Figure 6: Forward Inflation Swaps (bps)

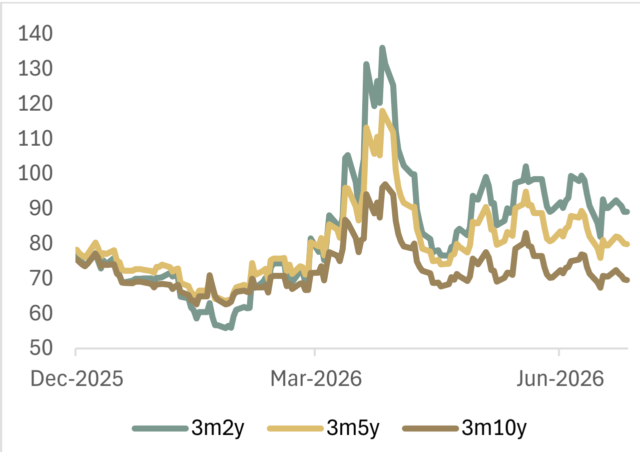


Source: Bloomberg, SMBC Nikko

Shifting skew in vol markets

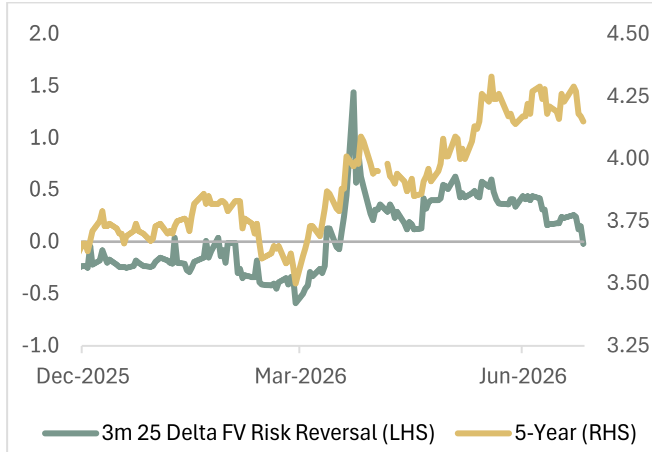
Figure 7 shows that outright vol remains range bound. However, skew dynamics suggest a shift toward the pre-war environment. As shown in Figure 8, put skew has moved lower relative to calls, likely reflecting a transition in market focus, from inflation concerns toward the risk of further selloff in risk assets tied to AI and private credit.

Figure 7: Implied vol (annual bp vol)



Source: Bloomberg, SMBC Nikko

Figure 8: 25 delta FV skew (puts less calls)



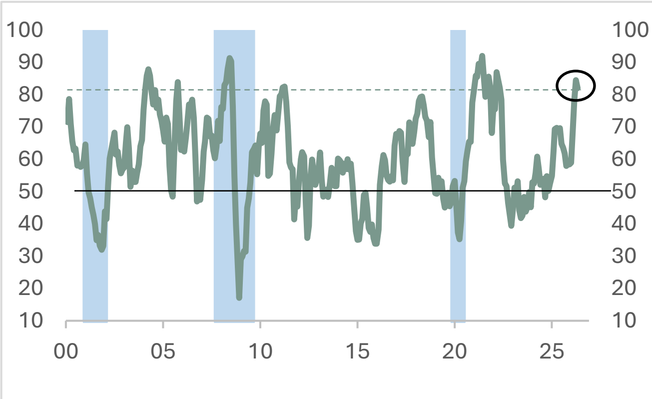
Source: Bloomberg, SMBC Nikko

Week ahead

- **ISM Manufacturing (Jun, Wed)**: We are forecasting a step down in the June ISM manufacturing index to 52.8 (from 54.0). The manufacturing index has increased 6.1 points since December, largely due to a jump in new orders. Supply chain bottlenecks have pushed supplier delivery times higher by 9.8 points over the period. The combination of high demand and supply chain backlogs has pushed goods sector pricing pressures to 82.1, near a record high (Figure 9). The potential for a durable peace agreement between the US and Iran is likely to normalize these pressures over the coming months.

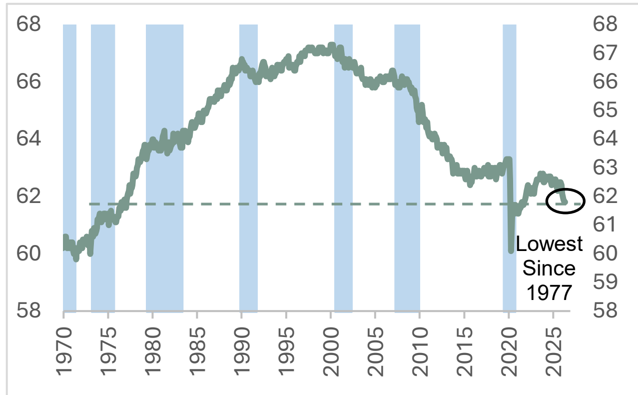
- **Employment report (June, Thurs)**: We look for headline and private non-farm payrolls to increase 125,000 and 121,000, respectively. We see professional and business services adding 23k jobs, private education and health services adding 59k, and leisure and hospitality adding +21k. We expect the unemployment rate will remain at 4.3% near the FOMC's long-term estimate of full employment. Household employment is expected to fall 64,000 while we look for a 92,000 decline in the labor force. While the trajectory of job openings suggests that labor demand has returned to pre-COVID levels, labor supply is also weak. At 61.8%, the labor force participation rate at its lowest since 1977, as changes in immigration policy and aging demographics have pushed participation lower (Figure 10). Meanwhile, survey-based evidence from the regional Fed bank manufacturing and services sector surveys show a modest acceleration in hiring plans since October 2025.

Figure 7: ISM Manufacturing Prices (Index)



Source: ISM, Haver, SMBC Nikko

Figure 8: Labor Force Participation (%)



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 30	Case Shiller Home Prices (9:00 AM)	-0.1%	-0.1%	-0.2%	-	Expecting home prices to decline nationally on the basis of low demand (rates) and incrementally positive supply.
Jun 30	Conf. Board Consumer Confidence (10 AM)	93.8	94.3	93.1	92.8 - 97.0	labor market differential series pointing to low-to-mid 5% unemployment.
Jul 1	ADP Employment (8:15 AM)	+105k	110k	122k	105k - +134k	ADP employment averaging +73k monthly gains over the last 5 months.
Jul 1	ISM Manufacturing (10 AM)	52.8	53.9	54.0	53.0 - 54.2	Expecting a mechanical downshift in ISM mfg. Regional Fed manufacturing surveys were mixed.
Jul 2	NFP (8:30 AM)	+125k	+118k	+172k	75k - +145k	5m avg NFP at +114k--highest since Dec 2024. 5m avg Private NFP at 106k--highest since Apr 2024.
Jul 2	Private NFP (8:30 AM)	+121k	+115k	+120k	65k - +138k	Upside risk from World Cup & leisure and hospitality hiring. Forecasting Priv Ed. & Health Services at +59k.
Jul 2	Unemployment Rate (8:30 AM)	4.3%	4.3%	4.3%	4.2% - +4.3%	Forecasting: HH employment at -64k and labor force at -92k. Lowest labor force participation since 1977.
Jul 2	Avg Hrly Earnings (8:30 AM)	0.3%	0.3%	0.3%	0.2% - +0.3%	Average hourly earnings have steadily slowed back to pre-Covid rates of 3.5% YoY.

Forecasts subject to change

Source: SMBC Nikko Securities US Economics Forecasts

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