

US Rates Strategy Weekly

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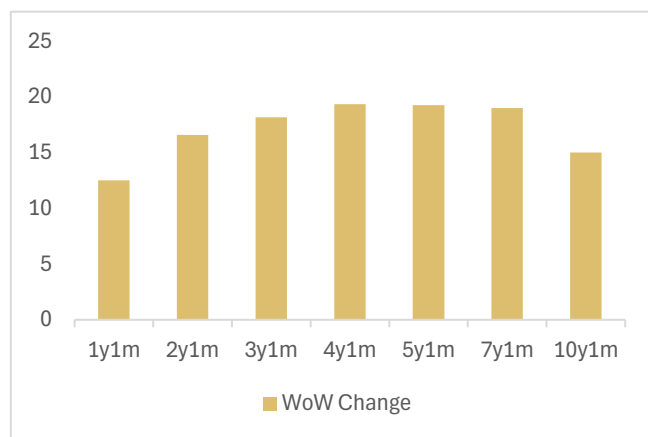
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- **No stress despite increased volatility.** Large rate moves have not been accompanied by signs of market stress, arguing this is a repricing of the policy path rather than capitulation.
- Markets have repriced toward a persistent hiking cycle, but with forwards already pricing ~95bp of additional tightening and real policy expectations near 2024 highs, **we believe the front end is pricing too much Fed hawkishness.**
- What about the long end? **10y yields above 5% remain attractive.** Outside the 1994 and 2022 tightening cycles that are less relevant, 10y Treasury yields typically peaked early in the tightening cycle and fell 11bp on average in the six months after the first Fed hike.
- Deputy Treasury Secretary Brook noted that there was **increased demand for bills** - from money funds, stablecoins, and the Federal Reserve (through its MBS and reserve management purchases). **This suggests, the Treasury may increase bill issuance further while slowing the supply of longer maturities.**
- Participants at this week's Treasury conference seemed to favor investing part of the Treasury's cash in the repo market. We believe that the benefits are small and there are significant trade-offs.
- The Fed's push to modernize the discount window underscores its focus on banks' liquidity resilience. **But its discussion at a Treasury market conference was a bit unusual as most of the underlying pre-placed discount window collateral is loans.** The standing repo program (SRP) is designed for Treasury collateral.
- We forecast a 67,000 payroll gain and a steady 4.1% unemployment rate. The labor market remains tight despite slow hiring, with constrained labor supply and a reacceleration in some wage measures offset by weaker hires and quits data.

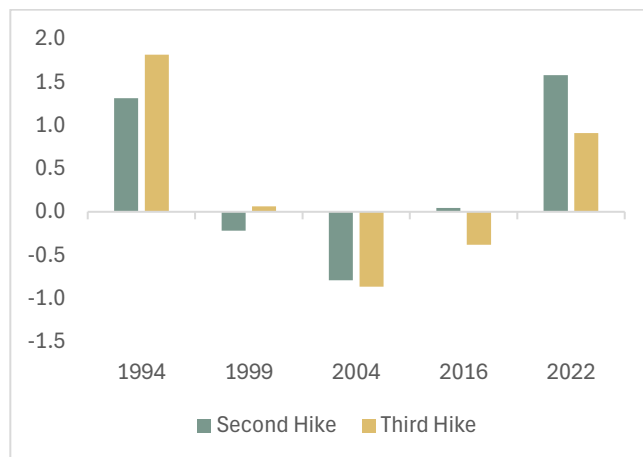
No stress despite volatility

Rates volatility spiked intraweek, with the front end and belly recording moves of more than 2.5 standard deviations on Wednesday. Despite the magnitude of the move, market functioning remained orderly. The futures basis was little changed, while on-the-run/off-the-run spreads remained well behaved. **The selloff therefore appears to have reflected a repricing of the policy path rather than a liquidity or balance-sheet event.** Hence, we are hesitant to call the sharp move higher in yields a capitulation event.

Treasury did not increase the size of the 20y-30y buybacks despite the disappointment in the 10y-20y buybacks. Further, given the rise in yields, markets expected the Treasury would buyback the maximum \$6bn but only \$4bn were bought, putting further pressure on the long-end.

Figure 1: WoW Change in forwards (bp)


Source: Bloomberg, SMBC Nikko; Note: Friday data as of 9am

Figure 2: Beta of 10y to Fed Funds (2nd/3rd Hike)


Source: Bloomberg, SMBC Nikko

Too much priced in the front end? Figure 1 shows that this week's repricing has largely taken the form of a "higher-for-longer" shift, with SOFR forwards now bottoming near 4.60%. With roughly 95bp of additional tightening priced in over the next 12 months, the question is whether the front end has gone too far. We believe it has. Investors are now discounting an even more aggressive path than some of the most hawkish forecasts of economists. The Bloomberg consensus of economists looks for one more Fed hike through 2027. Our Chief Economist is calling for a total of three more hikes (one more, in December and two, successively in early 2027).

While recent Fed communication suggests policymakers are less willing to dismiss supply-driven inflation risks than in prior episodes, markets may be extrapolating that hawkishness too far into the cycle. Chair Warsh's reluctance to provide forward guidance may also be forcing investors to embed a larger policy uncertainty premium into the expected hiking path. Even so, investors may be underestimating the amount of tightening already delivered through financial conditions. Since the end of June, the 10y Treasury yield has risen nearly 75bp and the 30y mortgage rate has increased about 55bp to 7.10%.

What about the long-end? Yields above 5% on the 10y Treasury remain attractive. Still, with investors seemingly caught wrong-footed by the recent repricing of the hiking cycle, it is worth examining how long-end yields have behaved following the first Fed hike in past cycles. Figure 2 shows that 10y yields had a negative beta, on average, to changes in the fed funds rate during the 1999, 2004 and 2016 cycles, into the second and third hikes. By contrast, the 1994 and 2022 cycles, that we view as less relevant, had higher positive betas. Six months after the initial hike, 10y yields were 133bp and 119bp higher in those two cycles, respectively. By contrast, in all the other tightening cycles, 10y yields declined by an average of 11bp over the six-month period.

Key themes discussed at the Treasury conference

Strong demand for Bills

Deputy Treasury Secretary Brook noted that there was increased demand for bills - from money funds,

stablecoins, and the Federal Reserve (through its MBS and reserve management purchases). So, in theory, "twisting" issuance to favor bill issuance over long-maturity TSYs is just accommodating market demand. With this in mind, the Treasury may ask dealers about their opinions on term issuance at next month's refunding.

We are skeptical that [stablecoins](#) will account for a significant amount of future bill demand. Transactions largely appear to be crypto-native and connected to DeFi activity rather than the purchase of goods and services.

TGA Repo

The discussion at the panel suggested that the Treasury wants to invest extra TGA cash into the repo market. There seems to be some expectation that it might be around \$50-100bn/day. This size would be "digestible" – small enough to be easily absorbed without creating interest rate distortions. As this cash would likely trade at the tri-party rate, it would be lower than the IORB unless bank reserves were scarce.

Investing [Treasury's cash](#) in the repo market raises several operational issues. These include whether the trades will be centrally cleared and the role of primary dealers in these transactions. We assume the transactions would be cleared to reduce the dealer's balance sheet consumption from one-directional cash. That said, primary dealers are required to participate in the Treasury's auctions, but would they also need to participate in the repo transactions? As we observed earlier, the intramonthly flow of the Treasury's cash does not line up neatly with the market's funding needs so it is not clear how aggressively dealer's might bid for their cash.

Separately, there is the issue of the Treasury's cash. The Treasury maintains a buffer of cash equal to 5d of its expected outflows. Cash above this buffer adds an additional confidence interval around the Treasury's cash projections. Rather than investing extra cash in the repo market, the Treasury might operating with a thinner surplus cash buffer by issuing fewer bills.

Discount window

Vice Chair Jefferson discussed modernizing the discount window, which is a curious topic for a conference about the Treasury markets as most of the collateral pledged is typically whole loans rather than Treasuries. Instead, Treasuries are more likely to be pledged through the SRP. Jefferson argued that the Fed is modernizing the discount window across three dimensions. First, the Fed has streamlined the borrower in custody process for loan collateral pledged to the discount window. Second, the Fed has created a "self-service" portal for borrowing. And third, the Fed has made it easier to shift collateral pledged at the FHLBs to the discount window. This was an impediment during the SVB collapse in March 2023. Our sense is that the discount window discussion was a prelude to upcoming bank liquidity rule changes that are expected to come this quarter.

Week ahead

- **PCE and Core PCE Deflator (Aug, Wed):** We are forecasting 0.36% m/m and 0.29% for the headline and core PCE deflators. These projected increases follow an elevated CPI report, where the headline and core CPI increased by 0.4% and 0.3% respectively, cementing a September rate hike. In this report, the BEA will also revise its data collection methodology for portfolio management services, legal services, and computer software and accessories which may reduce the overall y/y growth rate by 0.2%. We expect inflation will continue to slow as global supply shocks emanating from changes in tariff/trade policy and the Iran war move into the rearview, while wage growth is steadily slowing (3.1% y/y), and home prices continue to slow due to a lack of

demand. The upswing in market determined interest rates is also expected to further slow consumer demand and price growth.

- **Employment Report (Sep, Friday):** We are forecasting headline non-farm payrolls to increase 67,000 with private payrolls up 74,000, and the unemployment rate steady at 4.1%. The labor market remains broadly in balance. The supply of labor remains constrained with the labor force participation rate at 61.6%, its lowest level since 1976.

Table 3: Economic indicator forecasts

SMBC US Forecasts						
Date	Indicator	SMBC Forecast	Market Consensus (Median)	Prior	Range of Est.	Notes:
Sep 29	Case Shiller MoM (9 AM)	0.2%	0.3%	0.2%	0.2% - +0.3%	Home prices continue to weaken. Nominal prices are up +1.5% y/y while real home prices have fallen -2%.
Sep 29	CB Consumer Confidence (10 AM)	90.2	91.0	89.4	89.0 - 92.7	Labor market differential continues to trend steadily lower. Historically signals higher unemployment.
Sep 29	JOLTS (10 AM)	-	-	-	-	Low hiring low firing environment remains. Labor market has strengthened as V/U ratio has accelerated to 1.05.
Sep 30	ADP Employment (8:15 AM)	60k	58k	38k	35k - +85k	Although generally not a great predictor of private NFP, the correlation has strengthened notably in 2026.
Sep 30	BEA Revisions to GDP & Personal Income	-	-	-	-	BEA is revising its data collection methodology, which in the process should shave 20 bps from PCE deflator.
Sep 30	Personal Income (8:30 AM)	0.4%	0.4%	0.4%	0.3% - +0.5%	August payrolls increased by 0.1%, wages increased 0.3%, ticked up to 34.4.
Sep 30	Personal Spending (8:30 AM)	0.8%	0.8%	0.2%	0.5% - +0.9%	August retail sales increased by 1.2%.
Sep 30	PCE Deflator (8:30 AM)	0.36%	0.4%	0.2%	0.3% - +0.4%	August CPI increased 0.4% MoM.
Sep 30	Core PCE Deflator (8:30 AM)	0.29%	0.3%	0.2%	-	Core CPI increased by 0.3% MoM.
Oct 1	ISM Manufacturing (10 AM)	53.8	55.0	54.6	54.2 - 55.4	In 2026, ISM manufacturing has surged by 6.7 to 54.6 which is the highest since May 2022.
Oct 2	NFP (8:30 AM)	67k	107k	162k	45k - +110k	Forecasting: private education and health services +26k. Local govt -6k. Rebound in pro. and bus. svcs to 28k
Oct 2	Private NFP (8:30 AM)	74k	90k	127k	55k - +95k	Covid era ESSER funding cliff hitting local education payrolls which are down -46k since March funding lapse.
Oct 2	Unemployment Rate (8:30 AM)	4.1%	4.2%	4.1%	4.1% - 4.2%	Forecasting HH employment -226k, Labor force -396k. Labor supply is ultra weak and at lowest since 1976.
Oct 2	Avg. Hrly Earnings (8:30 AM)	0.3%	0.3%	0.3%	0.2% - +0.3%	Labor market still disinflating. Wages steadily weakening. At 3.1% y/y in Aug -- below pre Covid levels.

Forecasts subject to change

Source: SMBC Nikko Securities US Economics Forecasts

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