Monthly Interest Rates Chartbook
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Economic summary

Summary of views

- What's next in the Iran conflict?
    - An intensification or resolution might pull yields lower – either through a flight-to-safety or a decline in oil prices
    - But the current unresolved state of the conflict means that oil prices could stay high enough to keep inflation elevated
        - Although not high enough significantly slow growth
    - Moreover, the economy still has solid momentum despite 3m of higher energy prices
    - The Administration's pursuit of additional tariffs will likely push goods prices higher
        - On a rolling, piecemeal, basis as they are implemented by country and good
    - *Unless there is a significant change in the nature of the conflict, we expect the Fed will stay on hold through early 2027*

US Forecasts

- Although we look for the Fed to stay sidelined this year, the market is pricing in a potential rate hike before year-end and potentially more in 2027
- Growth remains solid; business investment is robust although concentrated in tech
- We expect the labor market to move sideways
- And inflation to move higher through summer

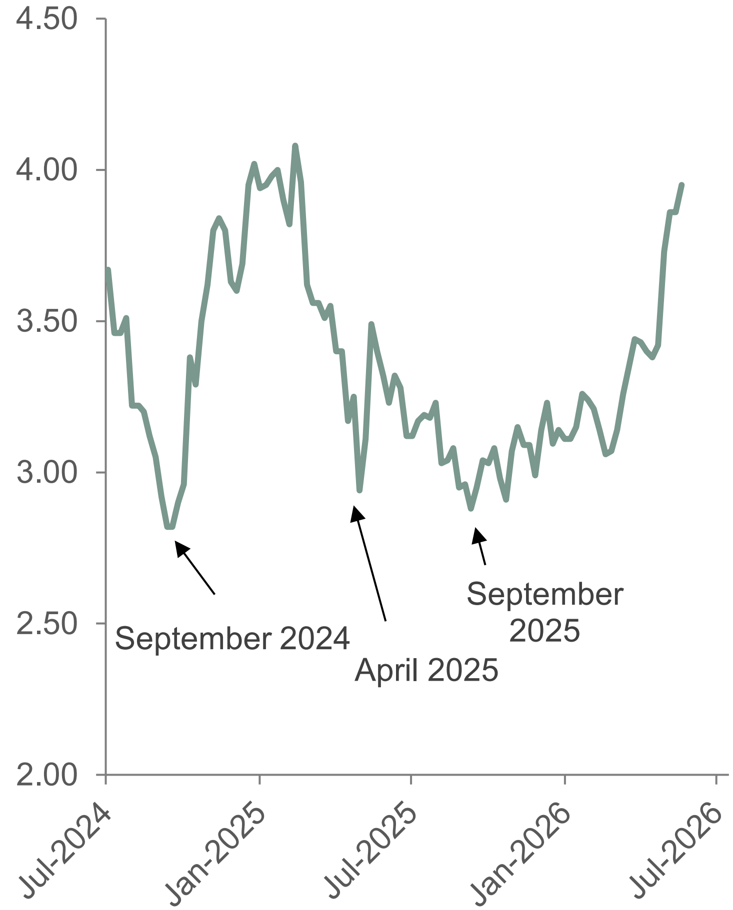
	2026				2027			
(%)	Q1F	Q2F	Q3F	Q4F	Q1	Q2	Q3	Q4
Real GDP QoQar	2.0	3.1	1.3	1.3	2.0	2.3	1.8	2.2
Core PCE YoY	2.7	3.0	2.8	2.5	2.3	2.3	2.2	2.2
Unemployment	4.5	4.5	4.6	4.6	4.6	4.6	4.5	4.5
Fed Funds Rate Upper Bound	3.75	3.75	3.75	3.75	3.75	3.50	3.50	3.50
2 Year	3.79	4.00	3.90	3.80	3.60	3.60	3.60	3.60
10 Year	4.32	4.40	4.40	4.50	4.50	4.50	4.50	4.50

Source: BEA, BLS, Federal Reserve and SMBC Nikko

Fed policy expectations

- The market looks for the Fed to hike interest rates
  - And is pricing in an 80% chance of at least one rate hike by year-end
- Rate hikes in the face of an oil price shock would be unusual
  - But inflation has exceeded the Fed's mandate since 2021
  - And officials may be out of patience[1/]

Terminal rate pricing (%)



Note: Using SOFR futures. Sources: Bloomberg, SMBC Nikko

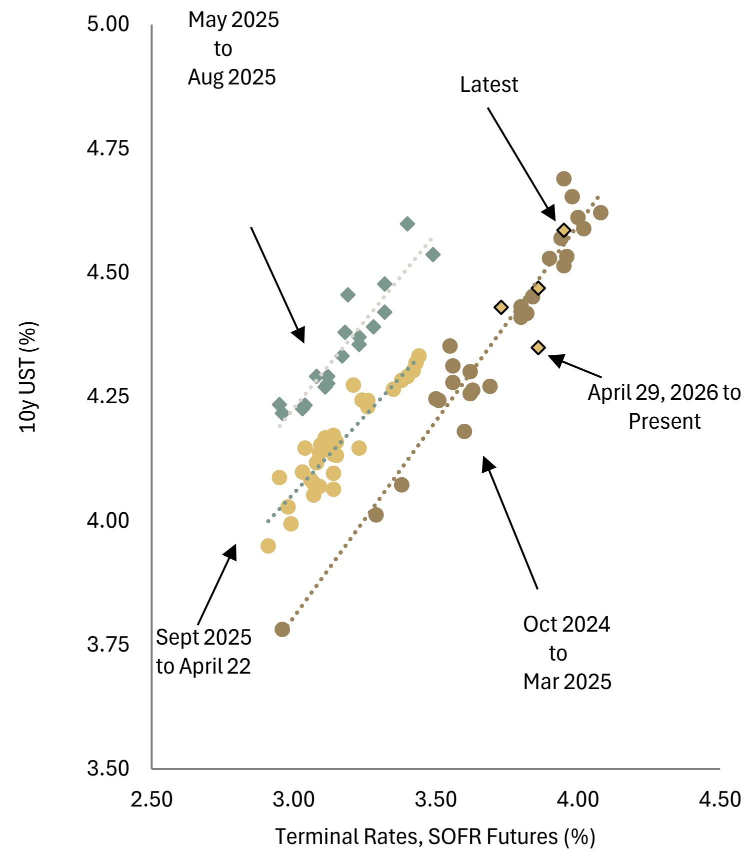
1/ See the April 2026 FOMC Minutes

10y and terminal rate expectations

- 10y Treasury yields are trading in a new regime relative to the SOFR implied terminal rate after the April FOMC meeting - back to the pre-Liberation Day regime from October 2024 to March 2025.

- Since this cannot be explained on reduced inflation concerns because of the ongoing supply-side shock, we believe that the market may be pricing demand destruction.

Terminal rate pricing (%)



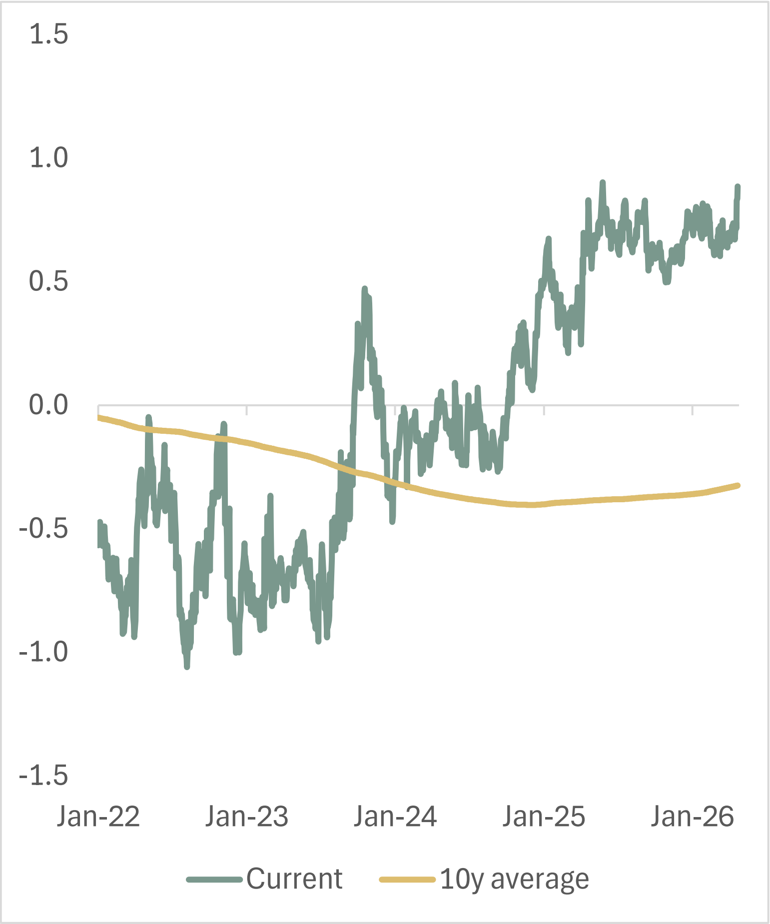
Sources: Bloomberg, SMBC Nikko

Should term premia be higher?

- The increase in 10y term premia since January 2024 reflects expectations of bigger deficits

- *But should term premia also reflect a more uncertain global economy?*
  - With potentially higher inflation
  - And greater risk for key commodity chokepoints
    - Such as the Strait of Hormuz has become for oil prices

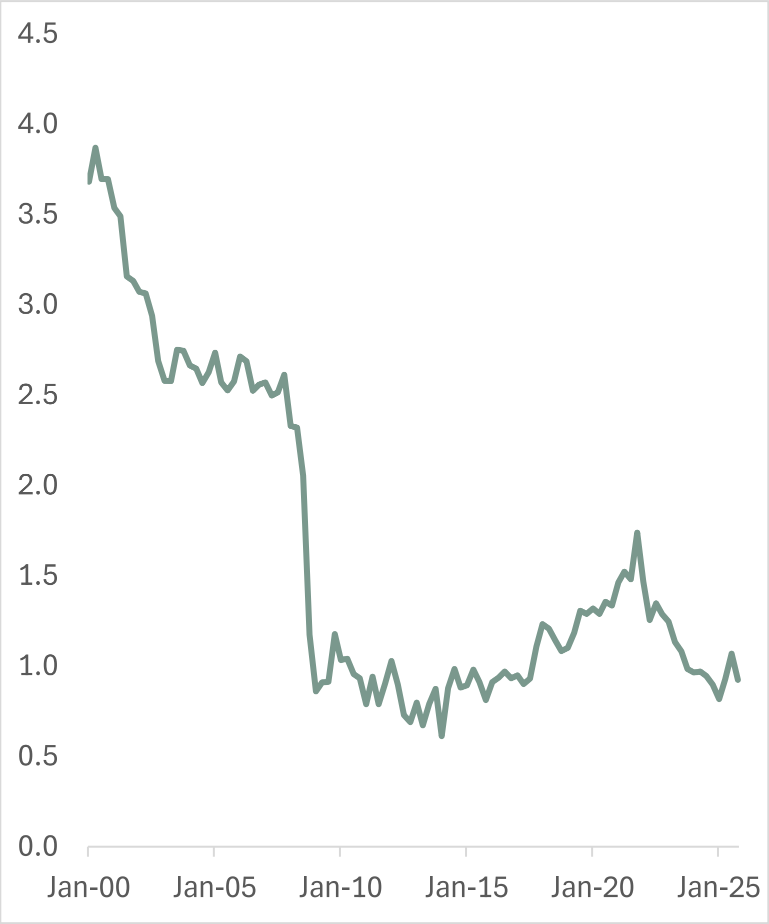
10y term premia (bp)



Sources: Adrian, Crump, and Moench, Federal Reserve Bank of New York, SMBC Nikko

Should r* be higher?

Estimated r* (%)

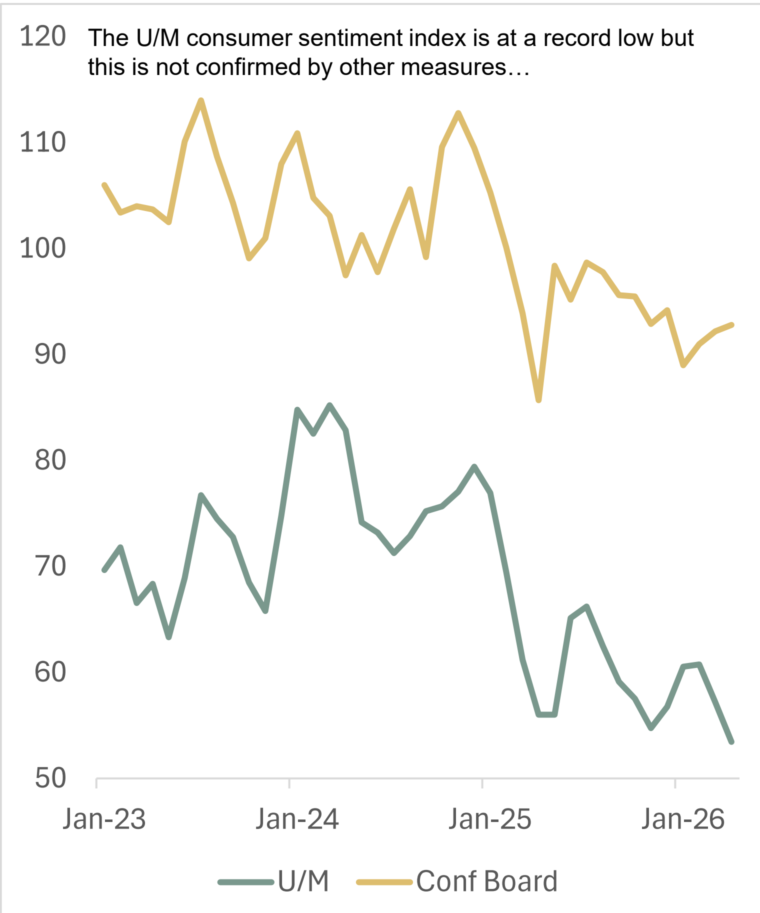


- AI-driven productivity gains should push r*, or the economy's equilibrium interest rate, higher
  - As it increases the imbalances between savings and investment
- Heavy investments in tech should bid up interest rates
- At the same time productivity gains increase employees' expected earnings and reduce savings

Sources: BLS, SMBC Nikko

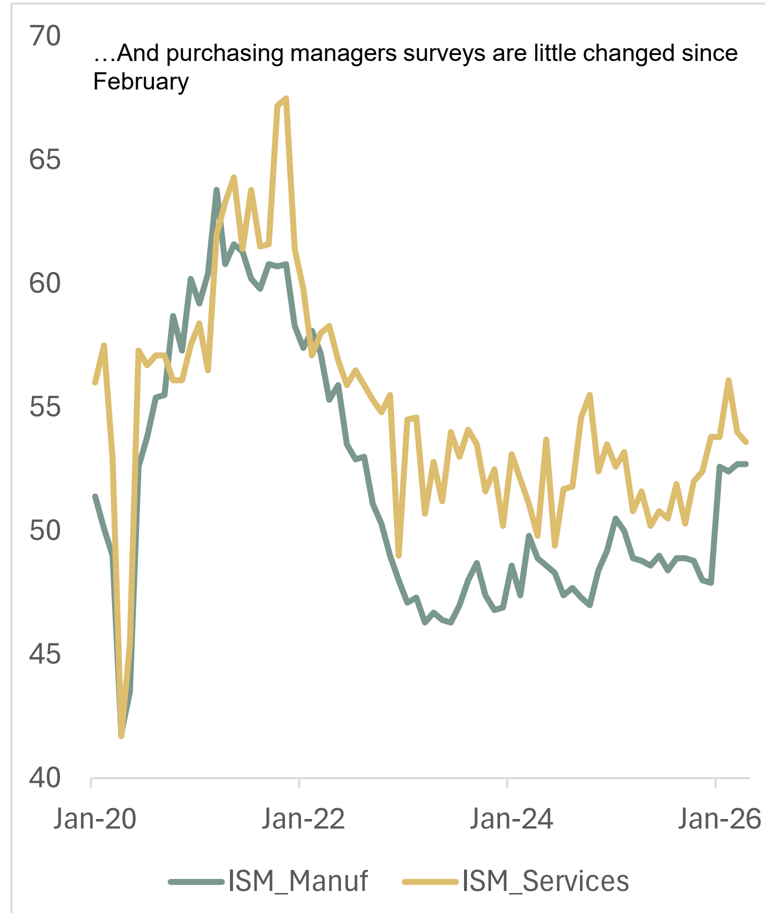
Confidence shock…

Consumer confidence (1985=100)



Sources: University of Michigan, Conference Board, SMBC Nikko

ISM manufacturing and services (index)

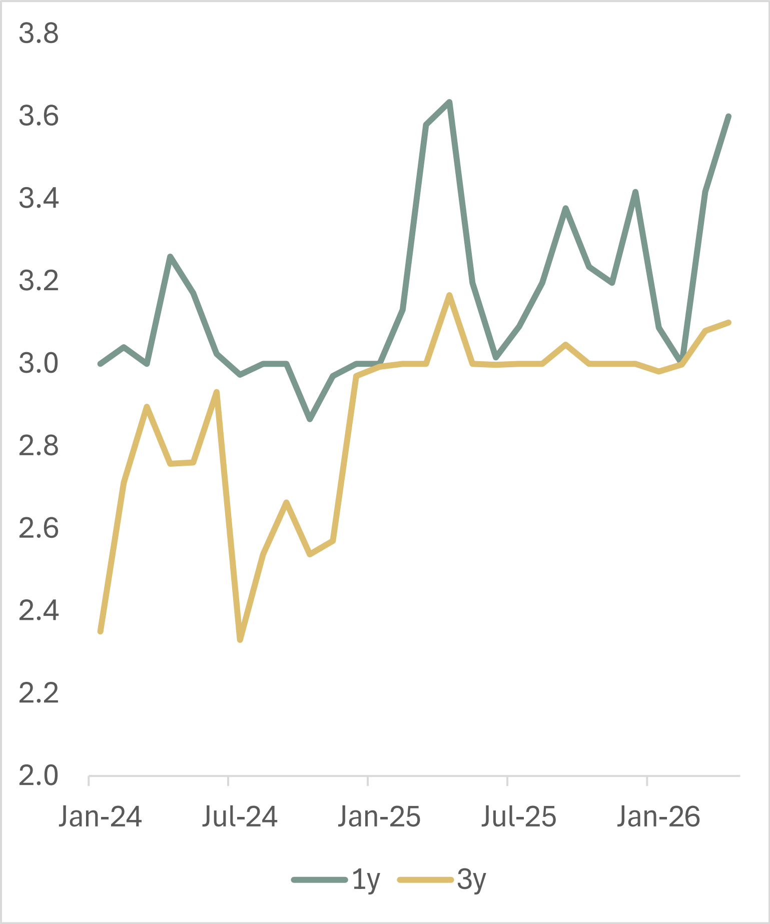


Sources: Institute of Supply Management, SMBC Nikko

SMBC

Household inflation expectations have moved higher

Median inflation expectations (%)



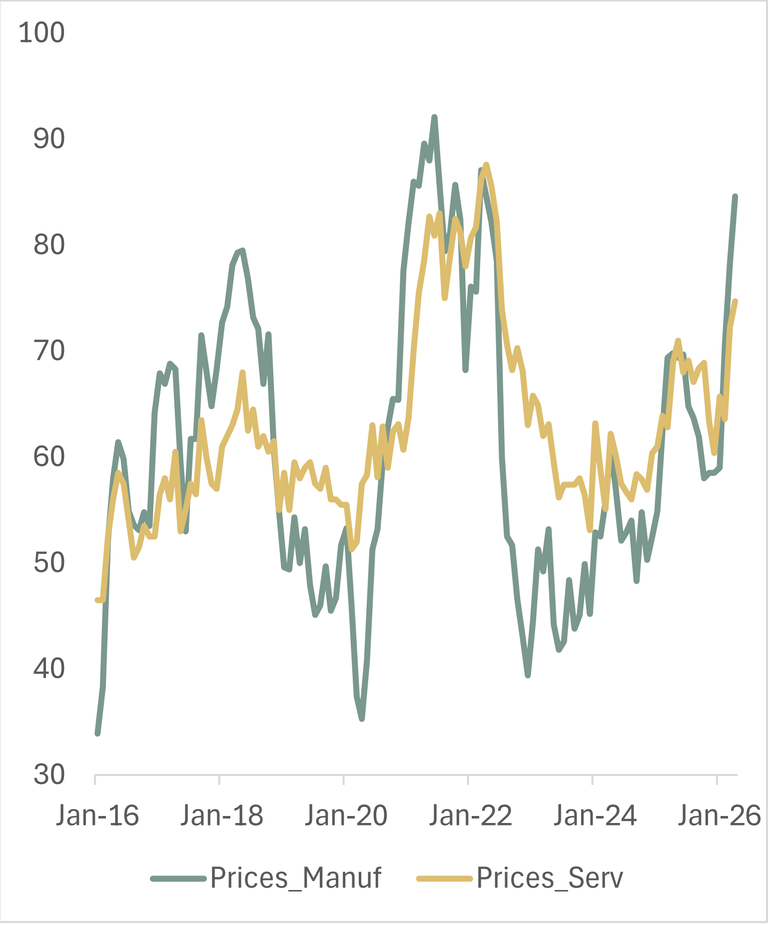
- Household median inflation expectations continue to rise
- We are looking for signs that inflation expectations are becoming entrenched
  - And pushing wage demands higher
- But unlike 2022, the labor market is softer

Sources: Federal Reserve Bank of New York, SMBC Nikko

Along with business prices paid…

- Prices paid, as measured by the PMI surveys, are near record levels

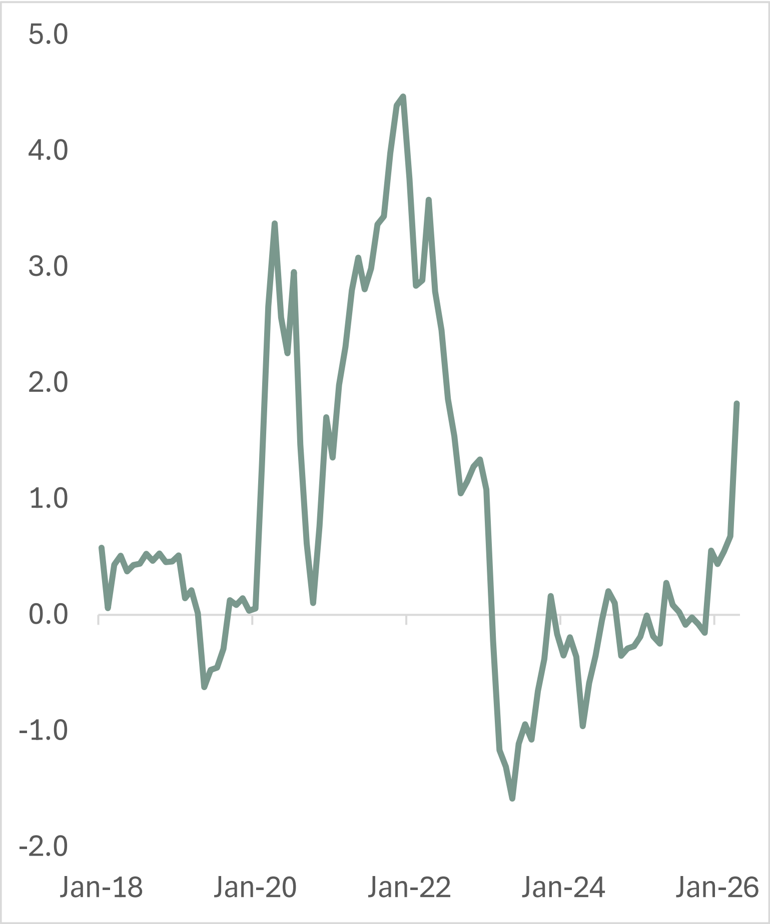
PMI prices paid (index)



Sources: Institute of Supply Management, SMBC Nikko

…Reflecting global supply chain pressures

Global supply chain pressure index (%)

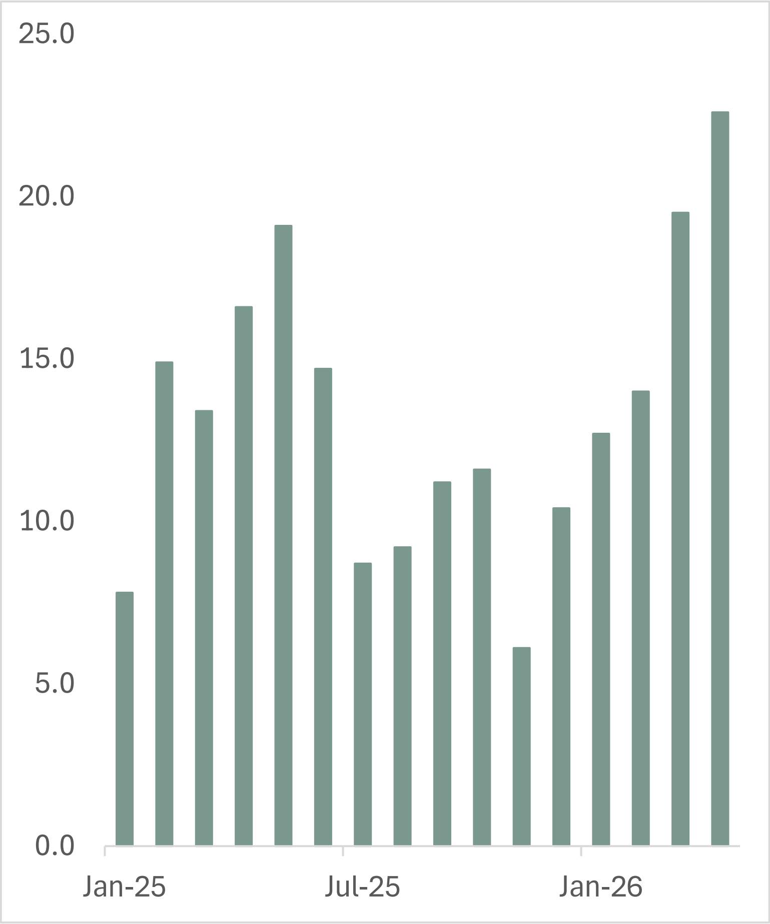


- Global supply chain pressures have risen since February
    - As transportation costs increase
    - And delivery times lengthen along with an increase in backlogs

Sources: Federal Reserve Bank of New York, SMBC Nikko

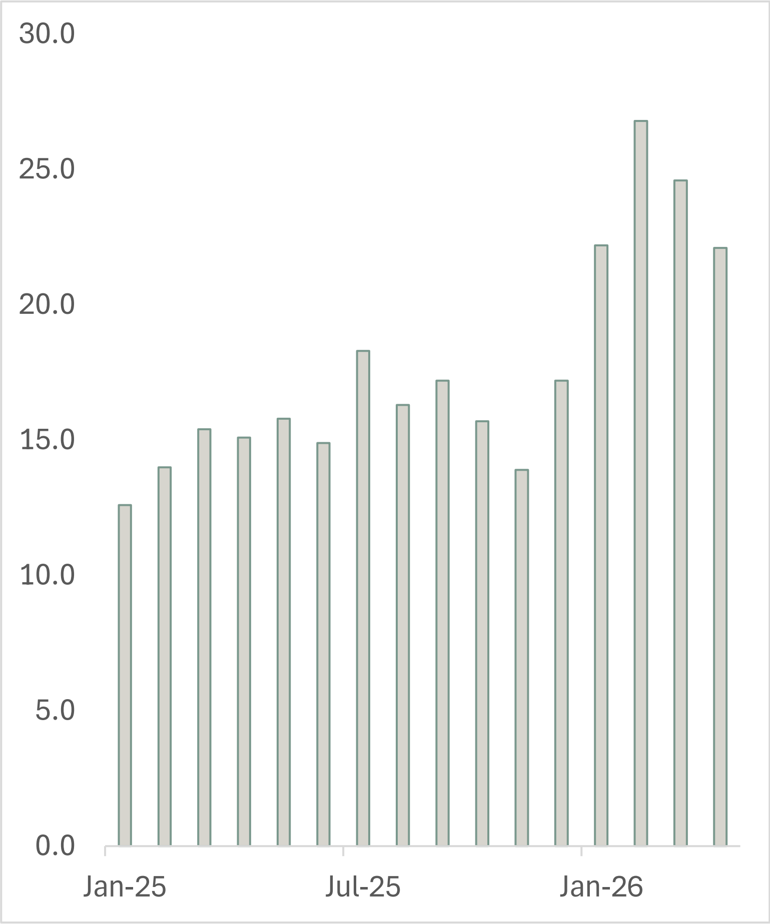
Manufacturing PMI components

Slower supplier deliveries (%)



Sources: Institute of Supply Management, SMBC Nikko

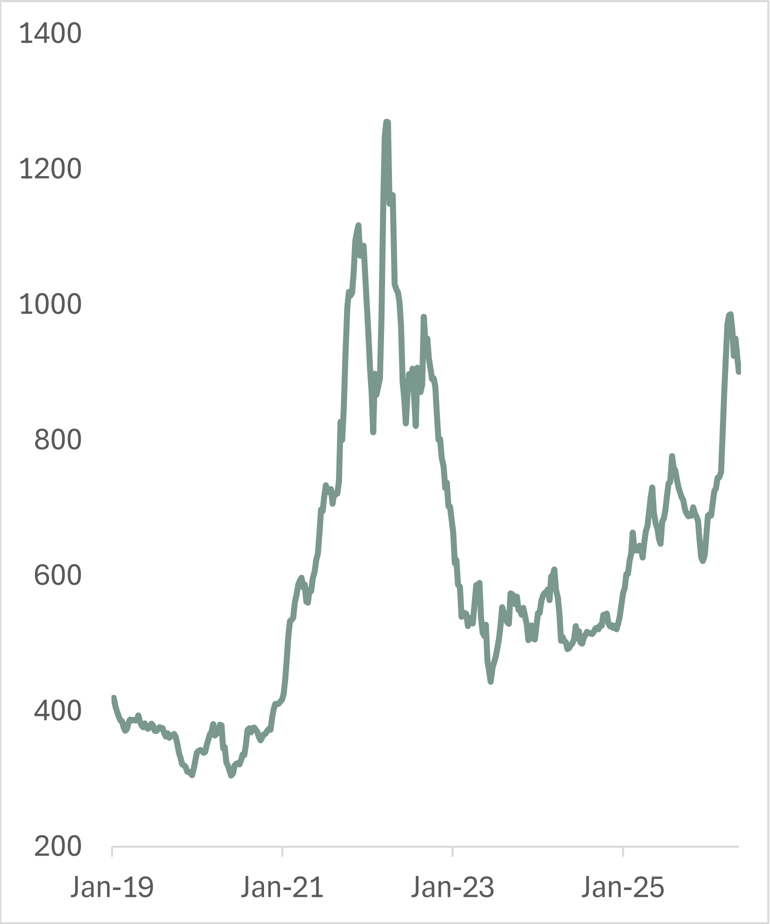
Higher backlogs (%)



Sources: Institute of Supply Management, SMBC Nikko

Downstream shock

Fertilizer prices ($/short ton)

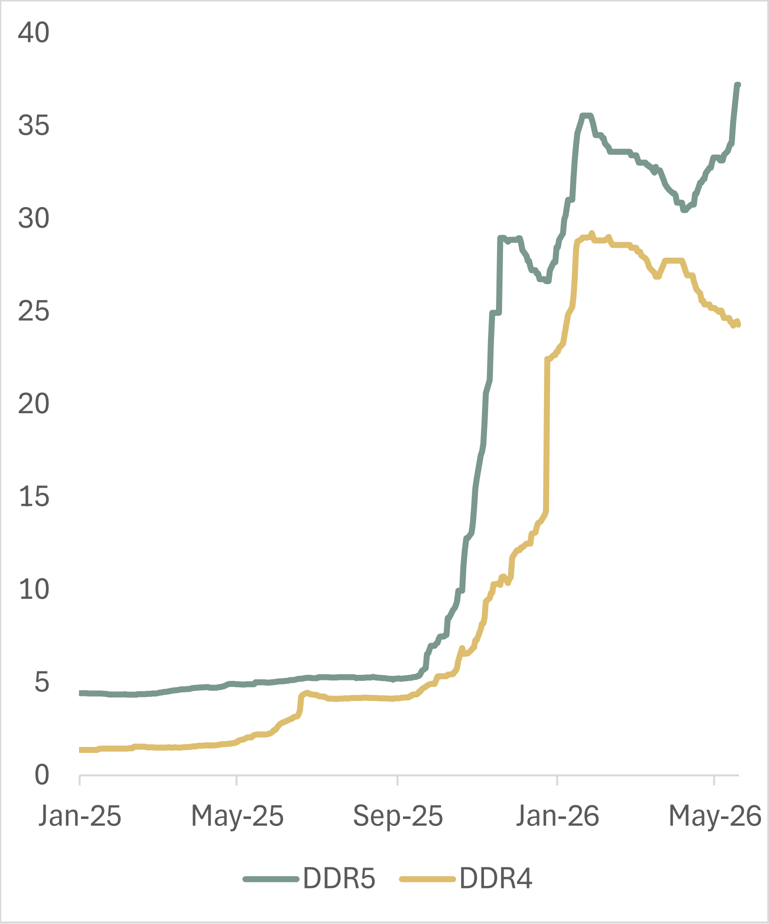


Sources: Green Markets North America Fertilizer Index, SMBC Nikko

- Petrochemical prices have risen since the start of the Iran conflict
    - Pushing prices for plastics and fertilizer higher

“Chip shock”

Memory chip prices ($)



Sources: Bloomberg, SMBC Nikko

- Prices for memory chips were rising before the Iran conflict amid heated demand

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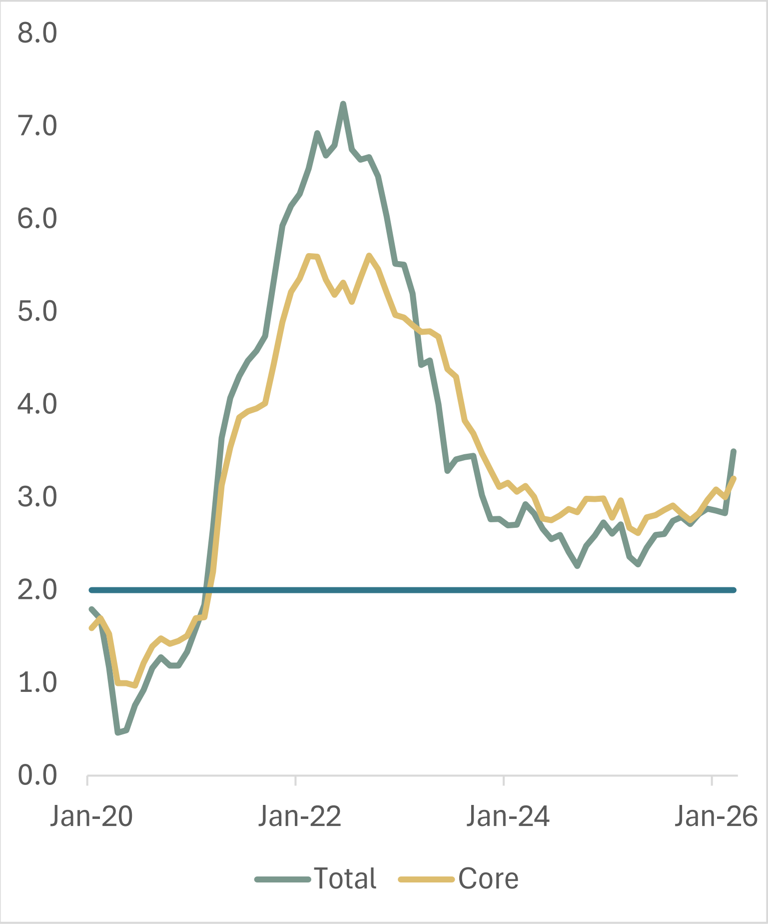
Inflation running above the Fed's target…

- The Fed's preferred inflation gauge has been above its target since 2021
  - Higher oil prices and pass-through effects to the core make rate cuts unlikely in the medium-term

- From the April FOMC meeting minutes:
  "A majority of participants highlighted, however, that some policy firming would likely become appropriate if inflation were to continue to run persistently above 2 percent"[1/]

Total and core PCE (% y/y)

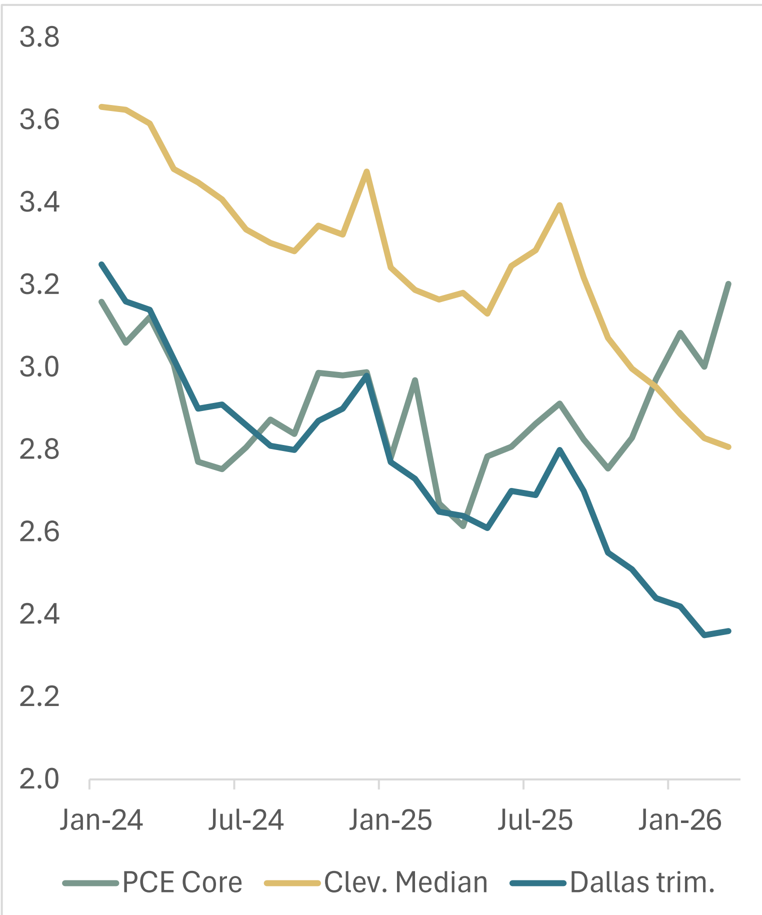


1/ It is not clear how long "persistently" is

Sources: BEA, SMBC Nikko

…Even using different measures

Trimmed and median CPI (%y/y)



Sources: Federal Reserve Banks of Cleveland and Dallas, SMBC Nikko

- Measures of inflation designed to exclude component spikes to uncover “trend inflation” are also above the Fed’s target

Change the target?

- *Could the Fed change its target measure of inflation or its threshold?*

- Incoming Chair Warsh highlighted other measures of inflation in his Senate Banking testimony
  - Which are designed to measure trends in prices through a rules-based exclusion mechanism
    - These measures are running below core PCE[1/]

- While we expect the FOMC will monitor these measures, they are unlikely to become the new policy benchmark

- Nor do we expect the Fed to abandon its 2% target – either directly, by explicitly announcing a new, higher target or range, or indirectly by allowing inflation to run hot for long

  - Changing the target risks jeopardizing the Fed's creditability and pushing interest rates higher
  - A majority of FOMC members felt that inflation was a bigger risk to the outlook at the April meeting
    - So as a practical matter, it might be difficult to get the FOMC to agree to changing the target

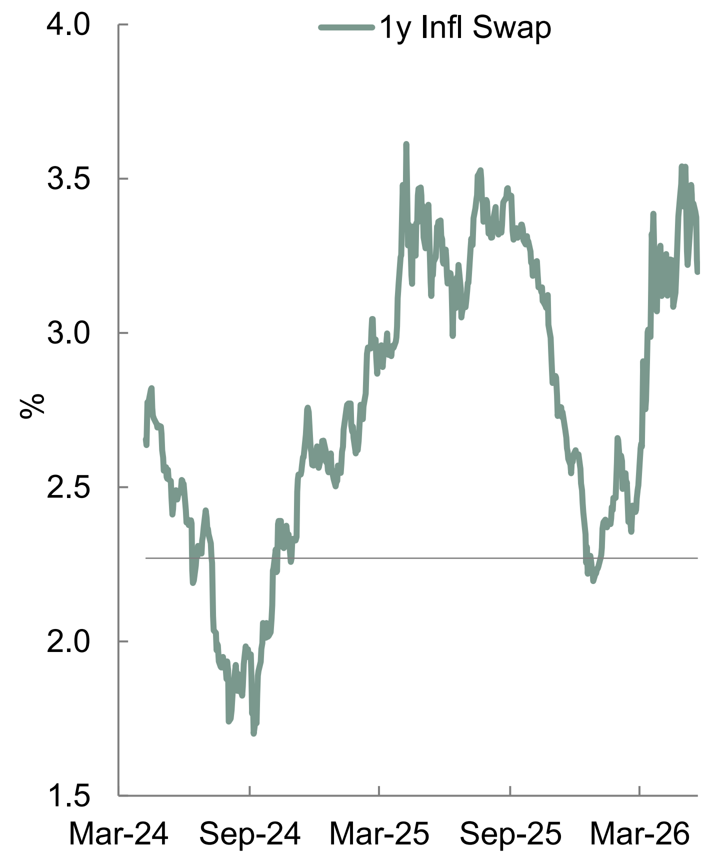
1/ See previous slide

SMBC

Market expectations have risen

- 1y inflation swaps have jumped by 70 bps since the start of the Iran conflict, rising to 3.20%
  - This suggests that the market may be assigning a lower probability to a harsher oil price shock

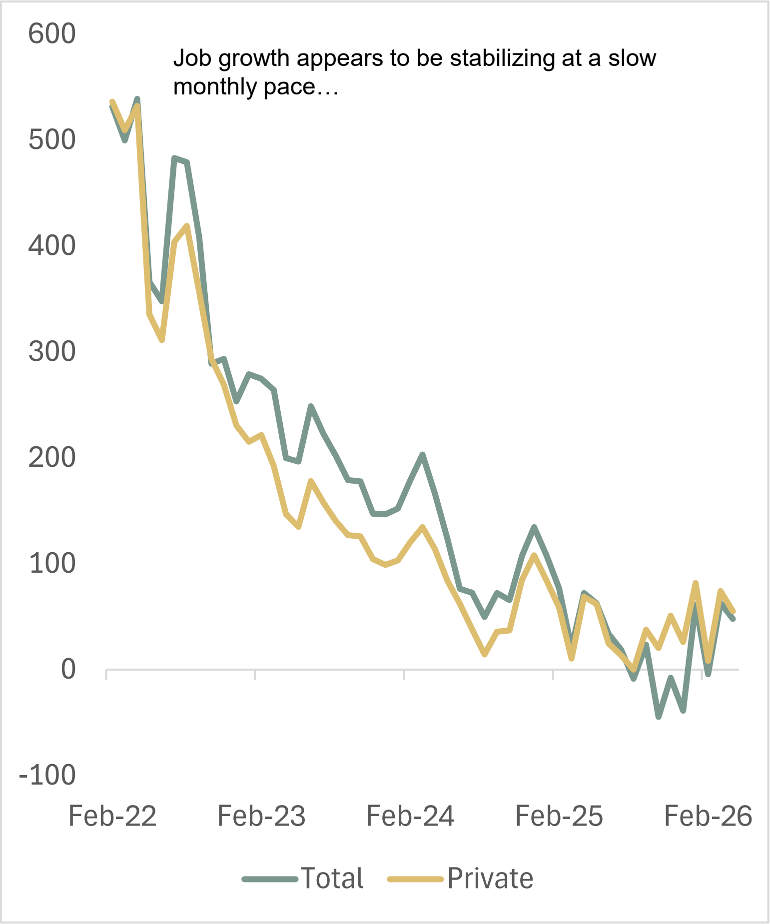
Inflation breakevens (%)



Sources: US Treasury, Bloomberg, SMBC Nikko

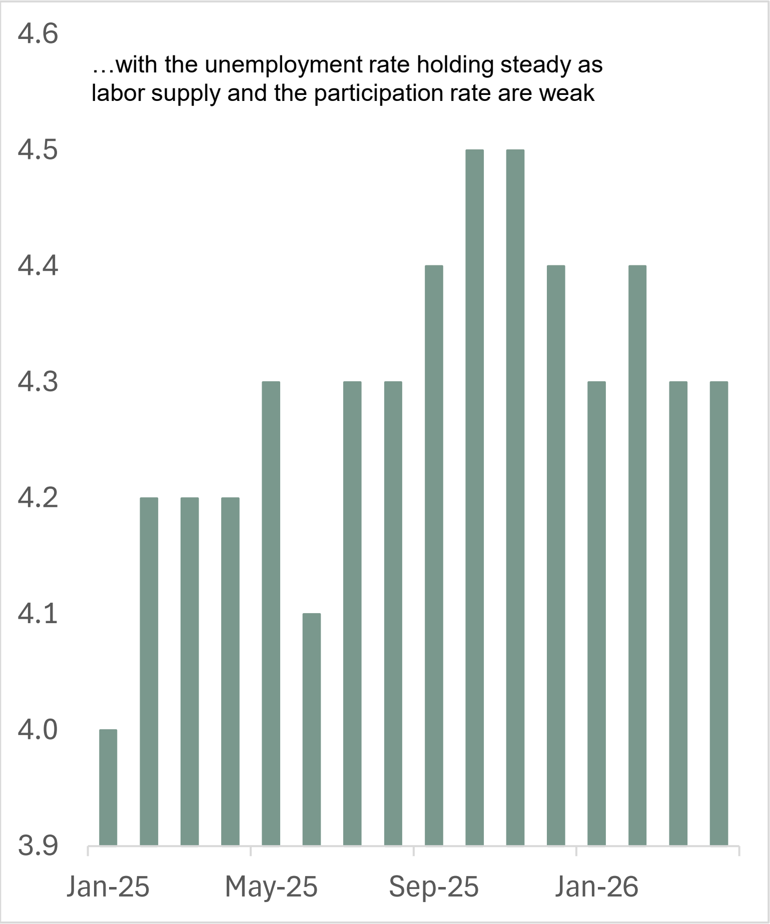
The labor market is stabilizing…

Non-farm payrolls (chng, 000)



Note: 3m averages. Sources: BLS, SMBC Nikko

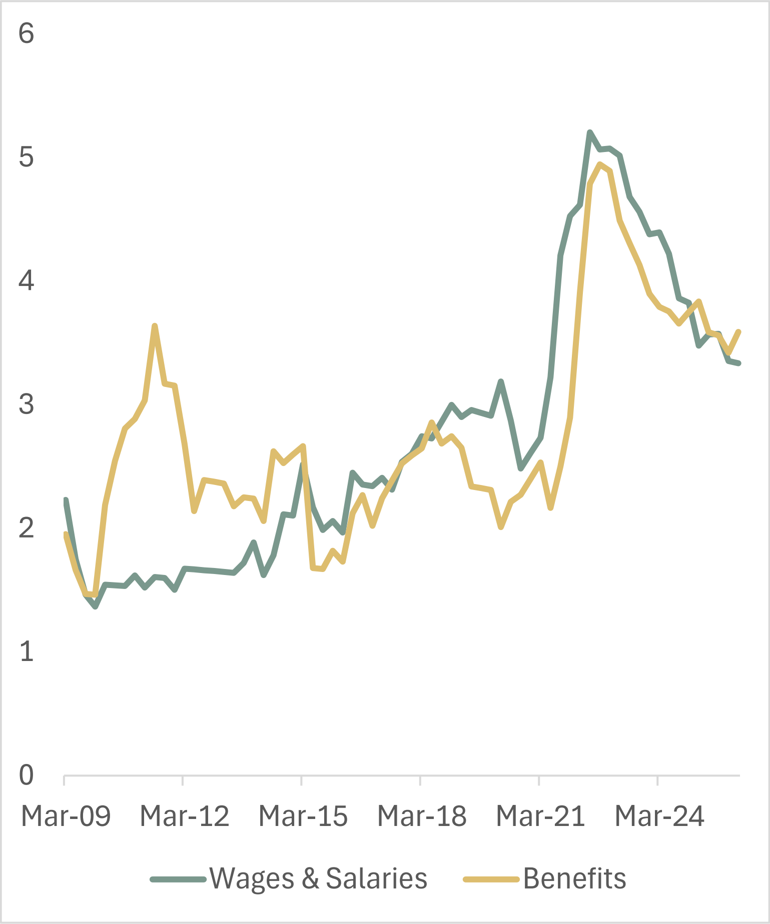
Unemployment rate (%)



Sources: BLS, SMBC Nikko

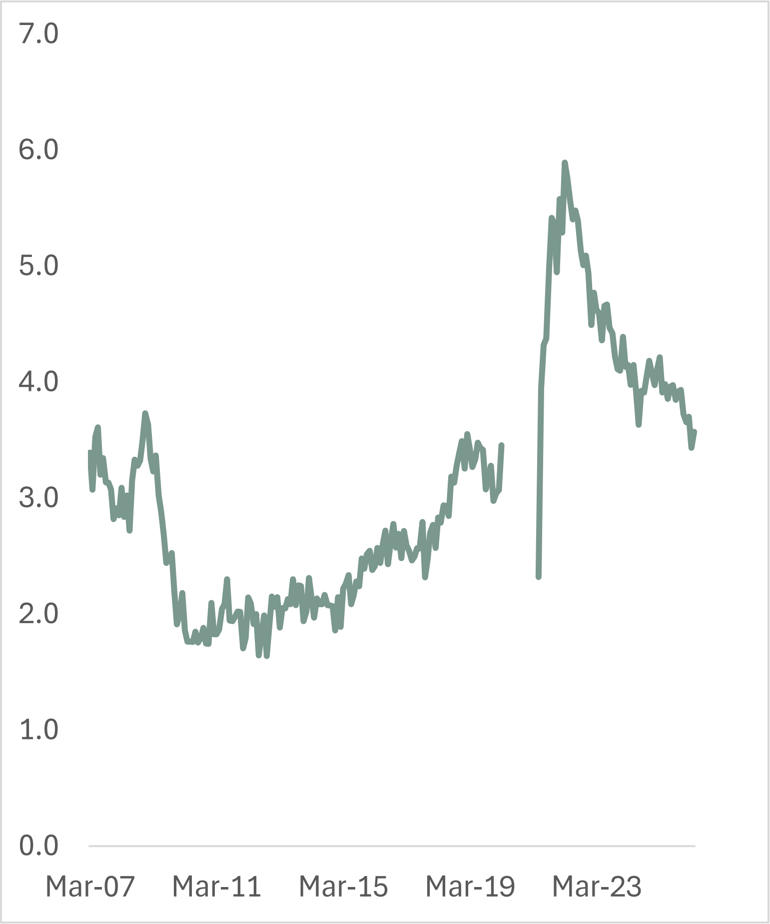
…And wages are cooling

Employment cost index (% y/y)



Sources: BLS, SMBC Nikko

Average hourly earnings (% y/y)

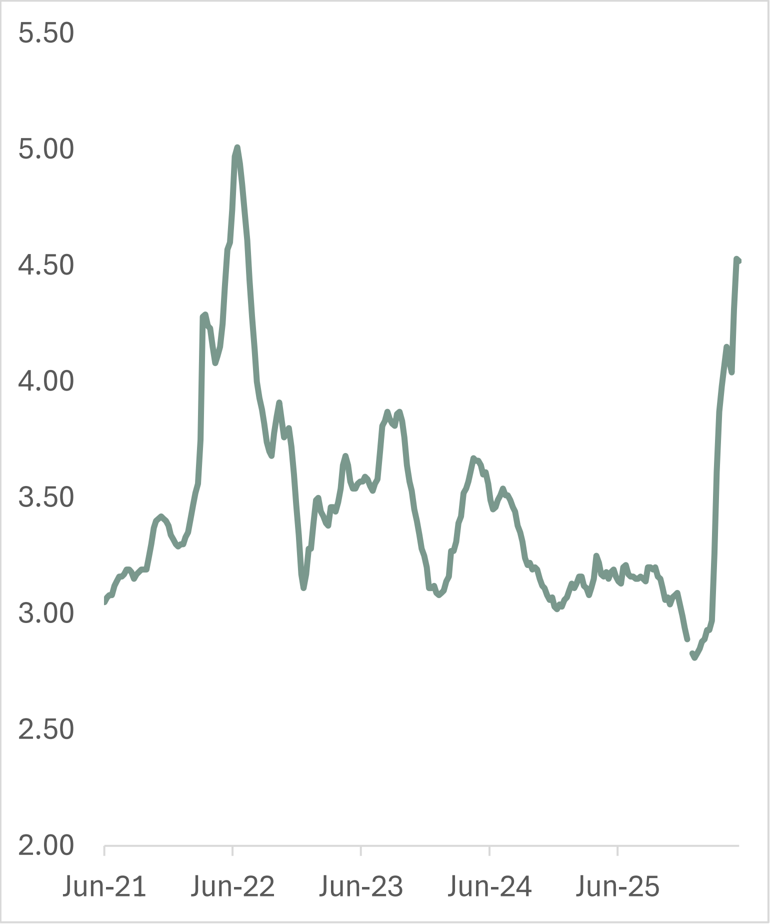


Sources: BLS, SMBC Nikko

Gasoline tax holiday

- Removing the Federal gasoline tax of 18.4c/gallon might lessen price pressures on households
- But gasoline prices have more than $1.50/gallon since the conflict began
    - And it might cost the Treasury $21bn to offset the lost revenues to the Highway Trust Fund of a 6m tax suspension

AAA retail gasoline prices ($/gal)



Note: US average. Sources: AAA, SMBC Nikko

How effective is a gasoline tax holiday?

- In 2022, a Federal tax holiday was proposed but never implemented
  - However, several states suspended or reduced their local tax collections

- The CBO estimates that 24% of the lost revenues from a reduction in excise taxes are recaptured through higher income taxes

- And there is some evidence from the local holidays that the retail pass-through is less than 80%[1/]
  - Pass-through effects are sensitive to local emissions standards, regional proximity to refining depots, as well as location (rural or urban)

1/ See, "Tax Holidays and the Heterogenous Pass-through of gasoline taxes", T. Tsvetanov, Energy Economics, June 2024

Measuring AI

- *Measuring AI's contribution to GDP outside of investment is difficult*

- Spending on AI services is too aggregated
  - Spending on cloud services includes web hosting, database management as well as model training
  - This data is derived from revenues from AI service providers

- The GDP data only include spending on final goods and services
  - But a fair amount of AI is being developed and used internally
    - Or it is an input in the production of other goods and services

- *While we have a good sense for spending on new computers (domestically-made and imported) we only have an imperfect sense for the non-investment components tied to AI in the GDP accounts*
  - Which makes measuring productivity difficult
    - And could explain why there is such a divergence between the results of task surveys and officially measured output/hour
  - Measurement issues are likely to grow over time as the AI build-out nears completion and spending shifts from investment to the purchases of AI services

Value added

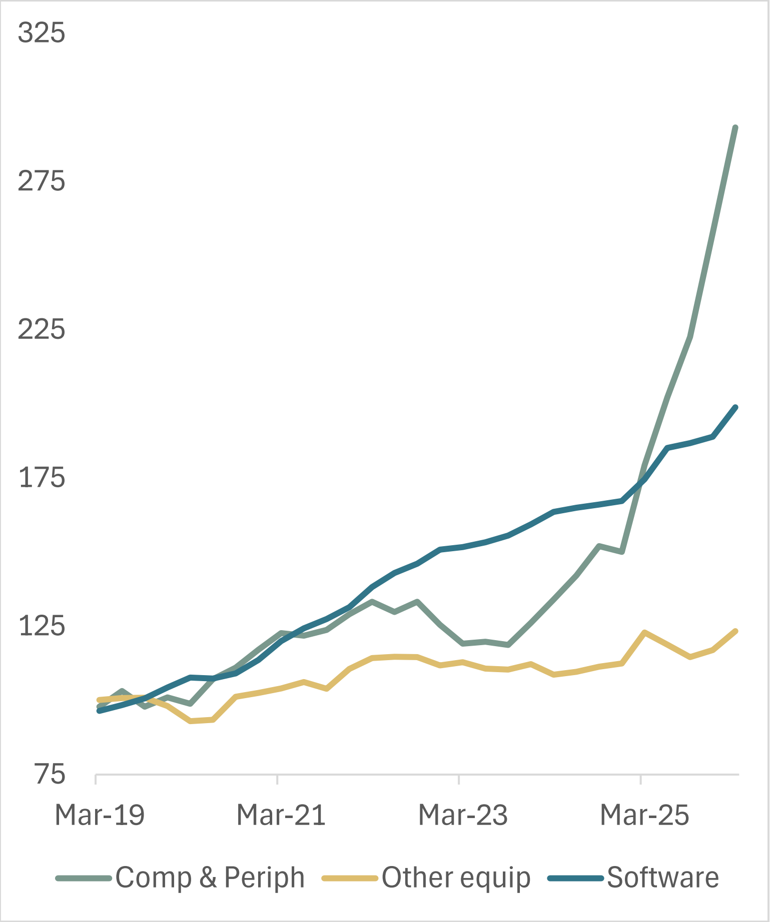
- Heavy investment in AI-related equipment only reflects new spending
  - It does not measure the “value added” to GDP from the manufacturing of computers and business services created from existing capital

- The BEA’s “value added” measures suggest that AI-related services are adding about 0.4%/q to GDP growth

- We are not considering obsolescence effects from rapidly evolving AI technology.
  - AI investments have short lifespans and spending may need to remain elevated just to stay ahead of the innovation cycle
    - But this does not prevent the equipment from being reused for other, less technologically demanding purposes
      - *As a result, measuring AI’s contribution to growth from the value added data may be more useful than the expenditures figures*

AI capital deepening

Real fixed equipment investment



Note: Indexed to 2019. Sources: BEA, SMBC Nikko

- Since 2020, there has been rapid growth in investment in technology1/
  - Spending for computers and peripherals accelerated in 2024
    - This category includes spending on servers

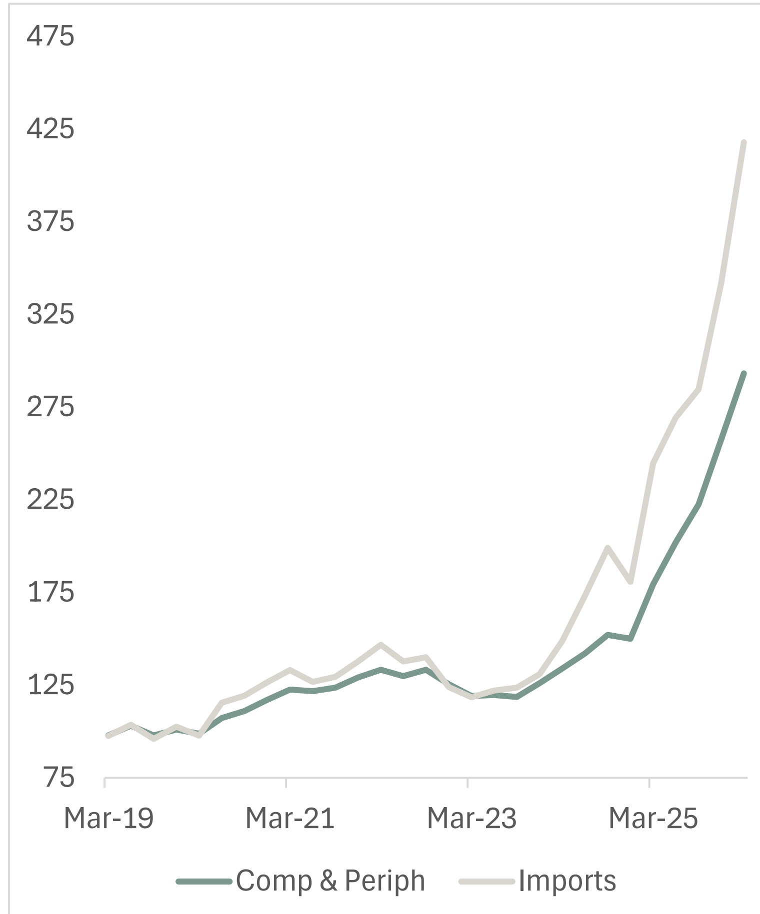
1/ There is no specific GDP measure that captures all AI-related spending. We look at investments in computers & peripherals, other information technology equipment, and software.

Imports of technology

- But a significant portion of the investment in computers and peripherals is on imported goods

- In turn, this reduces domestic production of this equipment
  - And as a result, the direct contribution of AI investment to GDP is smaller than its rapid growth suggests

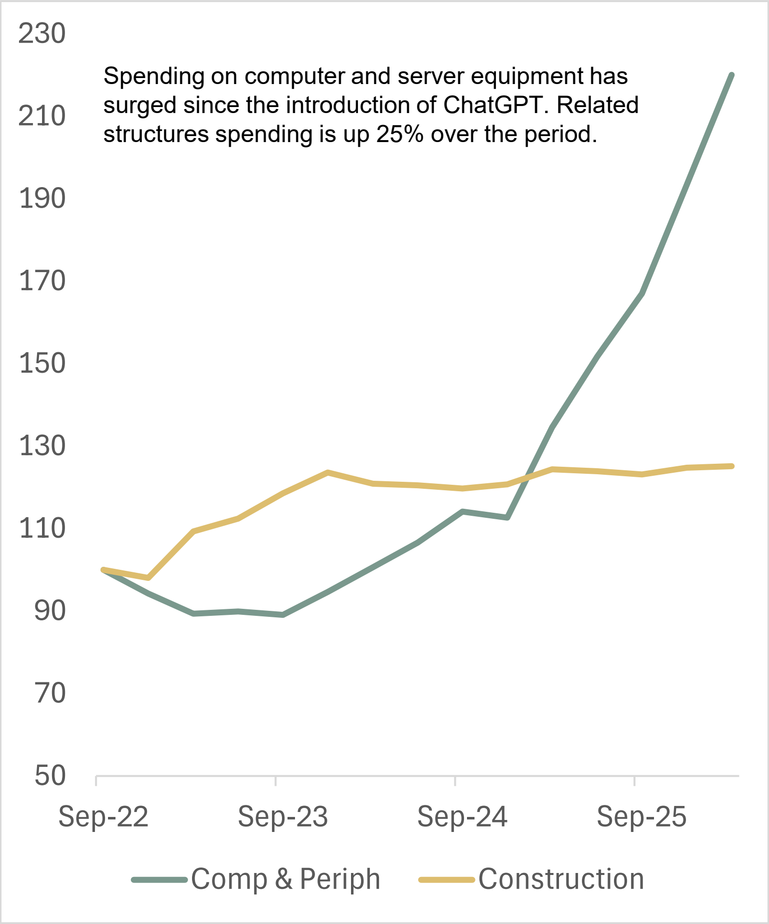
Computer & peripheral spending



Note: Indexed to 2019. Total expenditures on computers and peripherals including imported equipment. Sources: BEA, SMBC Nikko

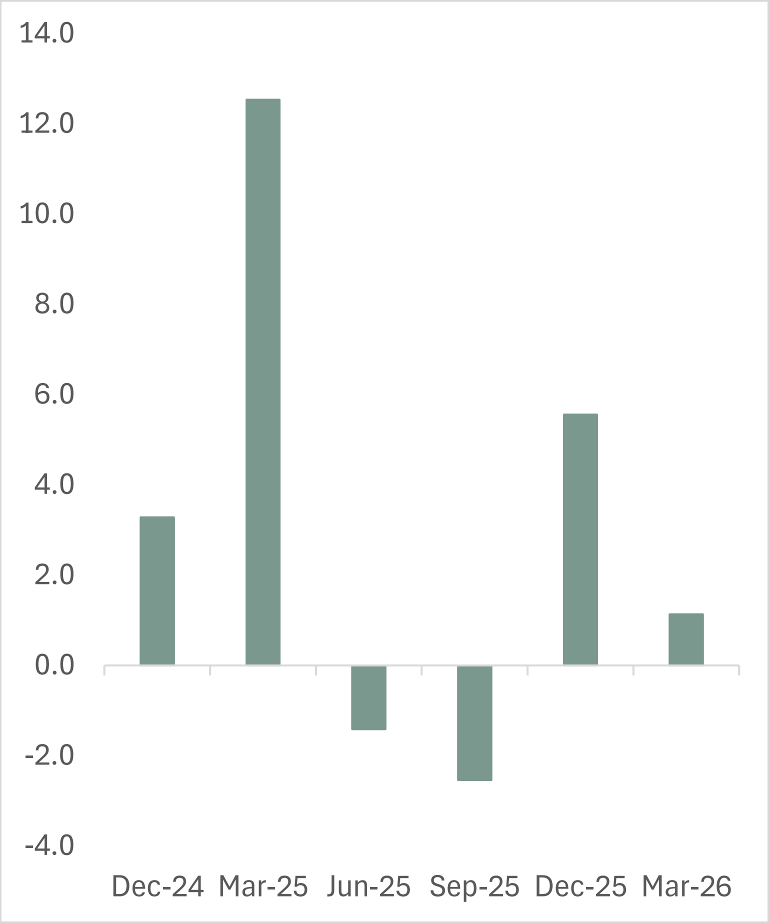
Power and communications structures spending

Index (Q3 22=100)



Sources: BEA, SMBC Nikko

Structures spending (%q/q, ar)



Sources: BEA, SMBC Nikko

AI and technological unemployment

- Depending on the study, job losses related to AI might be as much as 23% of the labor force within 5y.[1/] Other studies project far more modest losses – of around 1-2%.[2/]
- There are signs of "under hiring" of younger, less experienced workers since the introduction of ChatGPT in November 2022.
- But outside of the hiring effects on younger workers, there is little evidence of AI-job loss since the introduction of ChatGPT in November 2022.
- Most of the job loss estimates are derived from task studies that assume AI will eliminate repetitive tasks. But jobs are collections of tasks and employers appear to be re-allocating workers and their freed-up time to higher productivity activities.
- CFO survey data suggest that firms are using AI mainly to speed up innovation and enhance productivity rather than to reduce labor costs.[3/]

1/ See "Artificial Intelligence and Technological Unemployment", P. Wang, and T. Wong, Federal Reserve Bank of Richmond, August 2025
2/ See, "Artificial Intelligence, Productivity, and the Workforce: Evidence from Corporate Executives", S. Baslandze, Z. Edwards, J. Graham, T. McClure, M. Sparks, B. Meyer, S. Ravindranath Waddell, and D. Weitz, Federal Reserve Bank of Atlanta, March 2026
3/ Baslandze et al.

Can workers be AI-retrained?

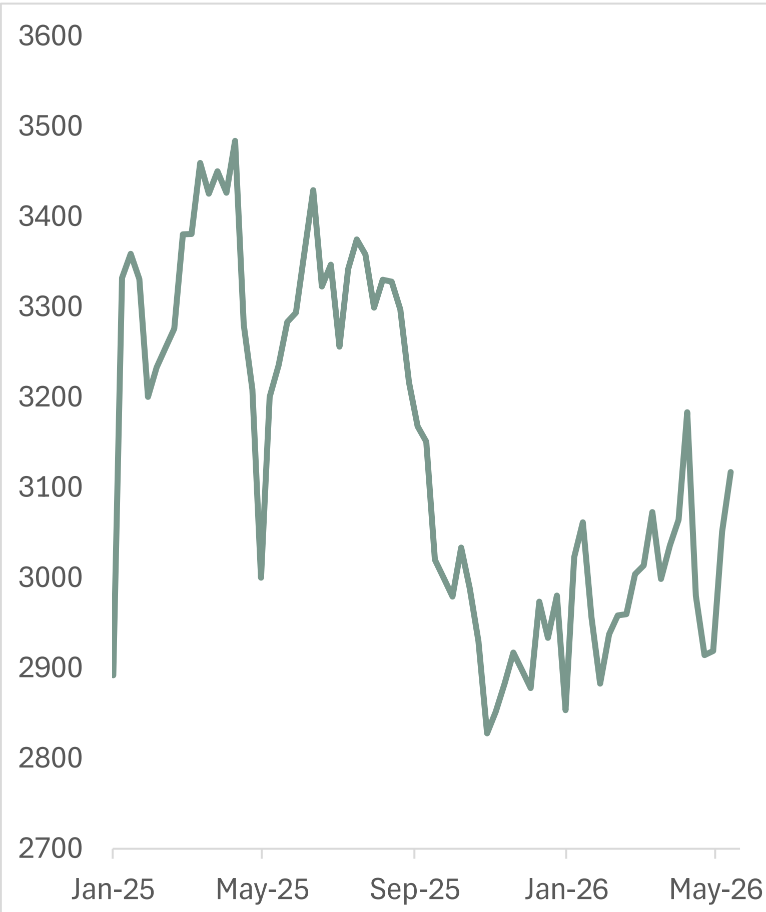
- Cutting interest rates to bring down structural unemployment is ineffective. Lower interest rates might instead stoke inflation already fueled by heated investment and consumer spending.
- Fiscal policies designed to "upskill" workers into AI-complementary jobs are more effective. Hyman et al find that AI-retraining pays off.[1/]
- But while 25-40% of high AI-exposure jobs may be retrainable, the largest payoffs come to workers who target low AI-exposure jobs.
- Retraining program outcomes vary widely; a meta-analysis of the results of 40 different programs found the probability of finding a new job after retraining increases by 2.6%.[2/]
- Most retraining studies, however, focus less on the quality of the job match
  - Simply finding a new job is different from replacing a job with similar skill and educational requirements

1/ See "How Retrainable are AI-exposed Workers?", B. Hyman, B. Lahey, K. Ni, and L. Pilossoph, Federal Reserve Bank of New York, August 2025
2/ See, "Workforce Retraining: The Effectiveness of Adult Retraining, Evidence from a Metanalytic Review", M. Busso, J. Cristia, P. Garofalo, and J. Messina, InterAmerican Development Bank, August 2022

Market summary

Bank reserves

Bank reserves ($bn)

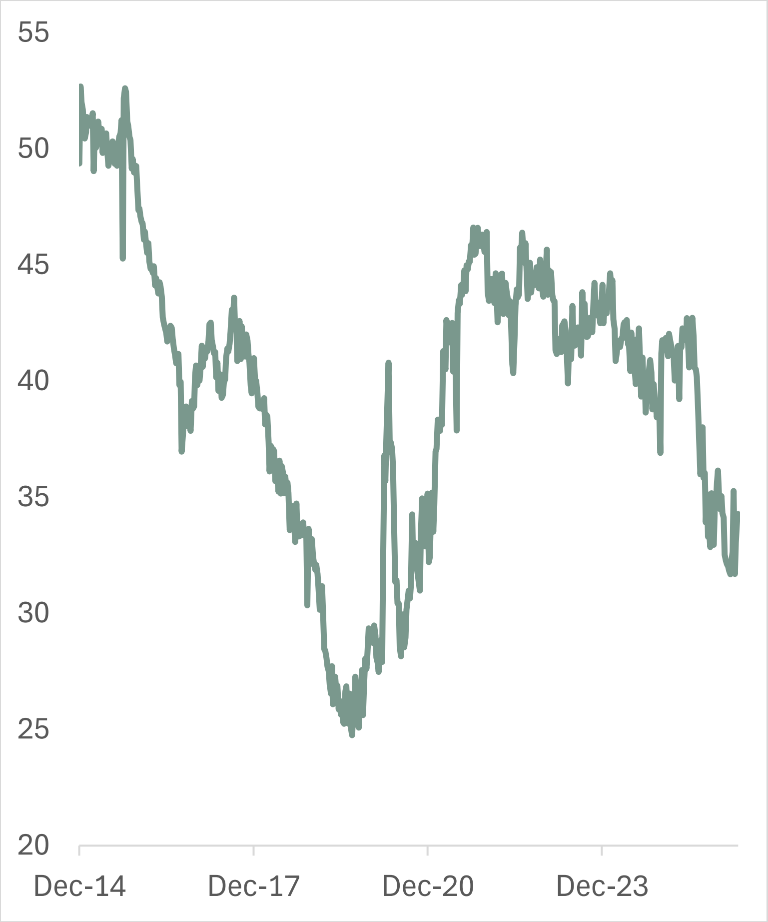


- Bank reserves have rebounded to over $3trn since the mid-April tax date
- The Fed has slowed the pace of its secondary market bill purchases (RMPs) to $10bn/m
  - It may cut these purchases further next month

Sources: Federal Reserve, SMBC Nikko

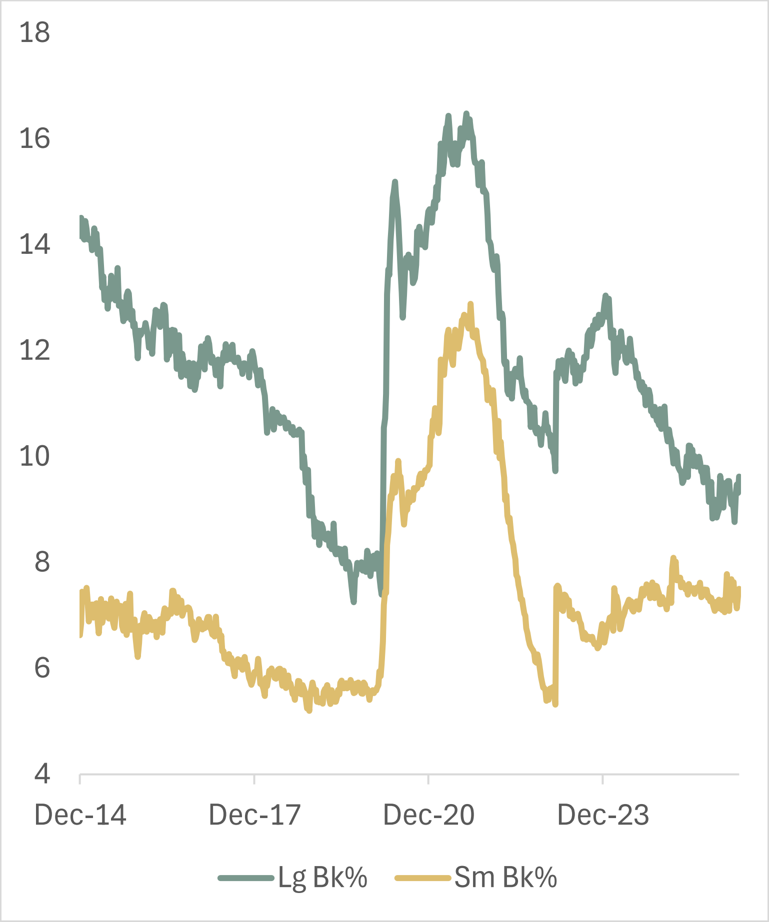
Are reserves ample?

Foreign bank cash (% bank assets)



Sources: Federal Reserve, SMBC Nikko

Domestic bank cash (% bank assets)

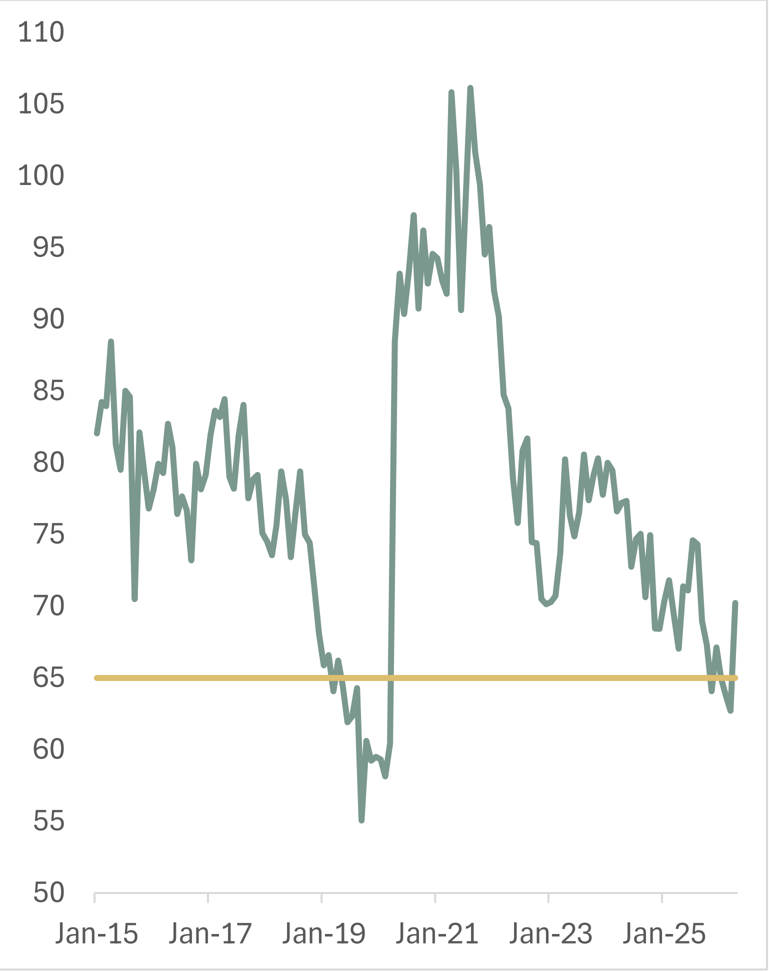


Sources: Federal Reserve, SMBC Nikko

Fedwire payments

- Banks' demand for reserves is influenced by the size of their daily intraday payment flows on Fedwire
    - Banks maintain cushions above their expected peak intraday flows
- Ferris et al. observe that funding rates rise as reserves fall below 65% of Fedwire payments[1/]

Reserves (% avg daily Fedwire payments)



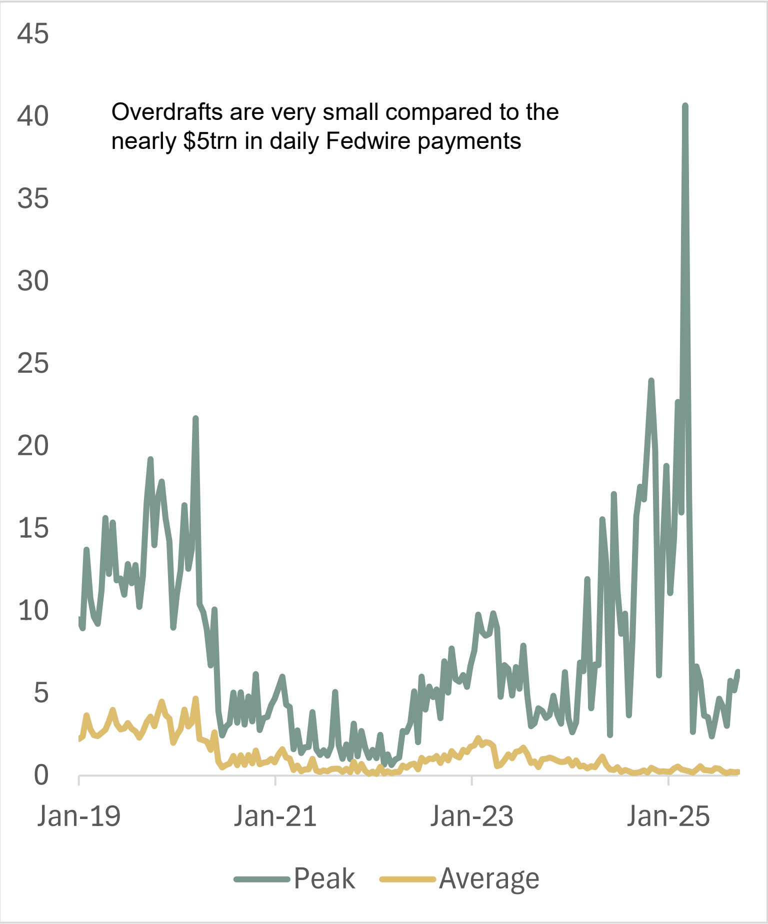
Sources: Federal Reserve, US Treasury, SMBC Nikko

1/ See "What can public Fedwire payments data tell us about ample reserves?", E. Ferris, A. Rose, and M. Tase, Federal Reserve Board of Governors, July 18, 2025

Peak and average intraday overdrafts

- Banks hold pre-placed collateral at the discount window
  - Consisting mostly of mortgage loans
- This collateral can be pledged intraday to cover an overdraft in a bank's clearing account at the Fed
  - There is no charge on this access
- *That said, banks remain leery of using discount window loans*

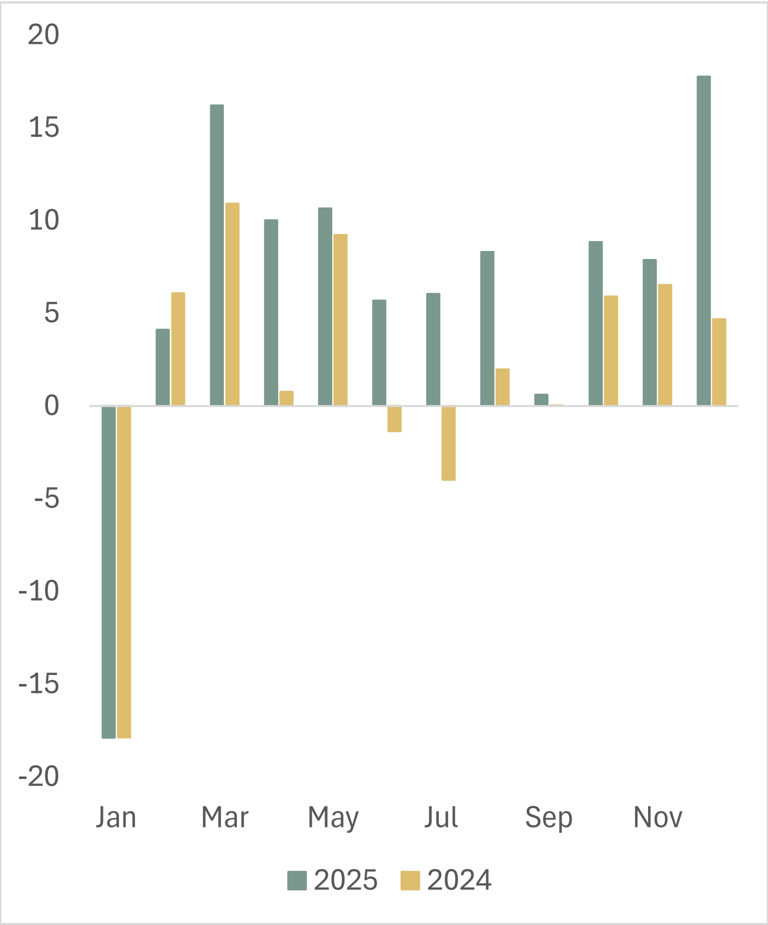
Overdrafts ($bn)



Sources: Federal Reserve, SMBC Nikko

RMPs: Offsetting currency growth

Currency (chng, m/m, $bn)



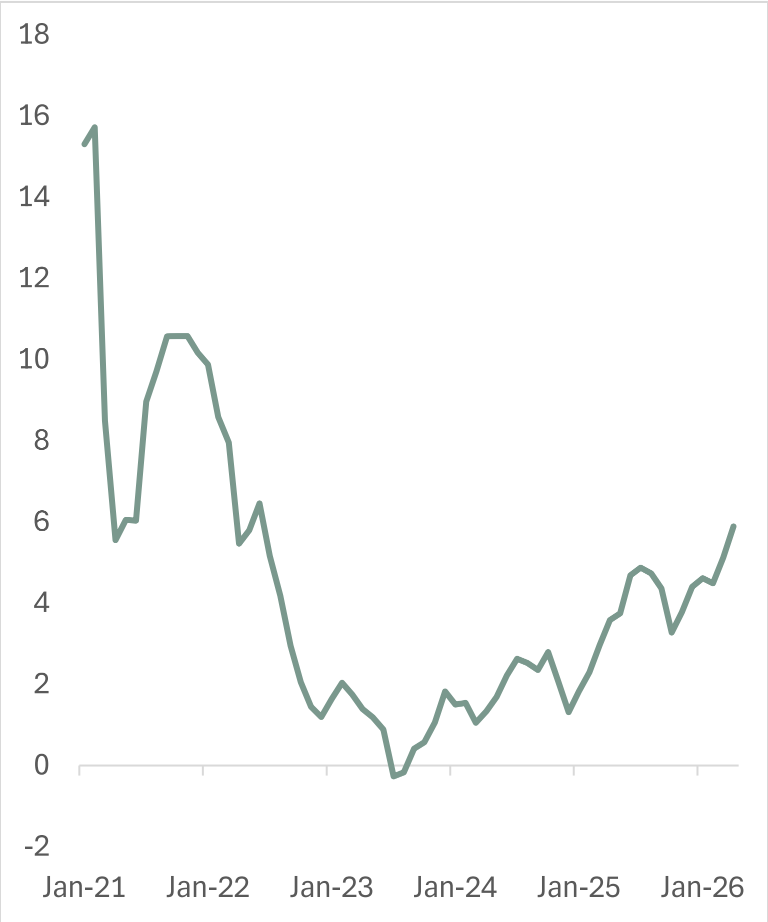
- RMPs are scaled to offset the growth in the Fed's non-reserve liabilities
- Currency growth is seasonal[1/]
  - And typically picks up late in the year
- As a result, we expect the Fed's RMPs will remain low – between $5 and $10bn/m – through October
- RMPs will then grow toward $45bn in early 2027 ahead of the mid-April tax date

Sources: Federal Reserve, SMBC Nikko

1/ Average monthly growth over the two years has been $4bn/mo. RMPs may be scaled up to account for growth in bank assets

RMPs: Growth in bank assets

Bank assets (%y/y)



Sources: Federal Reserve, SMBC Nikko

- Bank asset growth has increased since 2023
- In theory, the Fed should scale the size of its RMPs to the growth in bank assets
    - But this assumes that bank demand for reserves is a relatively fixed share of assets
    - And is invariable
- The Fed may not want to fully accommodate bank demand for reserves
    - If it seeks to slow the growth of its balance sheet

Encouraging reduced reserve demand

- Banks' least comfortable level of reserves (LCLoR) includes precautionary liquidity buffers above their regulatory minimum
    - But they also maintain an additional buffer or "surplus excess" over the LCLoR.

- The size of these buffers reflects their concerns about the ability to monetize other forms of regulatory liquidity through the Fed's SRP and discount window.

Reducing demand: Tiered IORB

- The Fed could increase the relative price of reserves by tiering its payment of IORB
  - Bank balances below the threshold would receive the full IORB rate
    - But balances above would receive a rate below IORB and, potentially, nothing
  - In theory, this might encourage banks to keep their surplus reserves in Treasuries
    - *We think banks might substitute bills for reserves given their liquidity in stress periods*

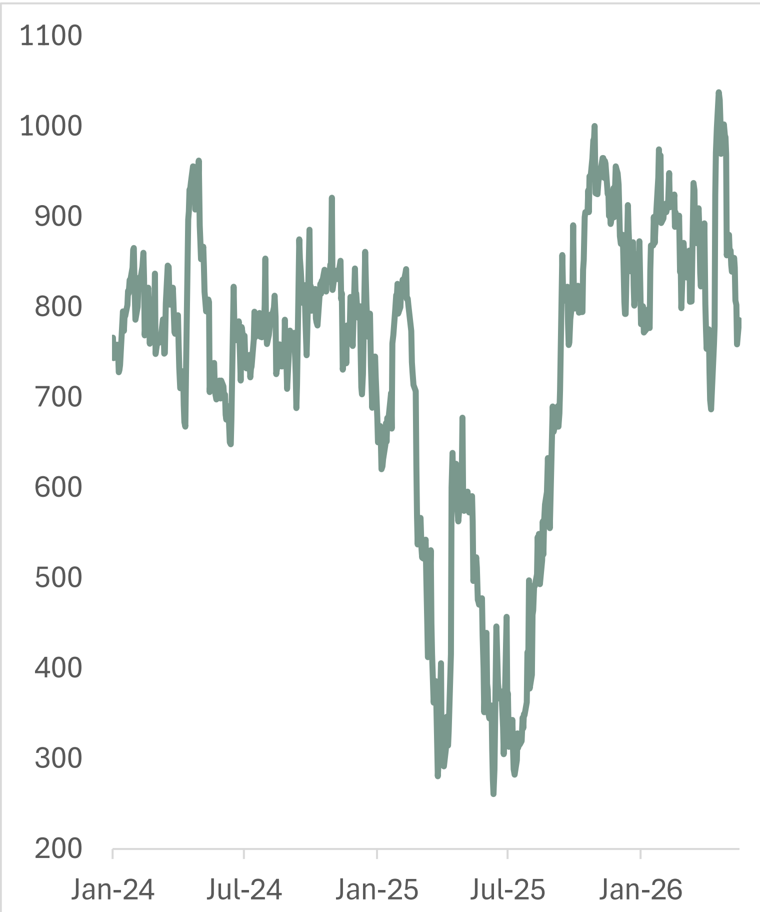
- The latest Senior Financial Officer's Survey suggests that banks' demand for reserves is somewhat interest rate inelastic
  - As a result, it will take a sharply lower (tiered) IORB rate to encourage banks to shed reserves[1/]

- And gauging where to set the remuneration threshold (and rate) on a tiering system is likely to be challenging
  - Bank demand for reserves changes
  - And given their reluctance to use Fed liquidity facilities, banks may simply accept a lower return on their surplus (non-exempt) reserves

1/ See, "Reserve Management and the Fed's System Open Market Account: Recent Experience and Insights from Surveys", R. Perli, Federal Reserve Bank of New York, May 19, 2026.

Treasury cash or repo?

Treasury cash balance ($bn)



Sources: US Treasury, SMBC Nikko

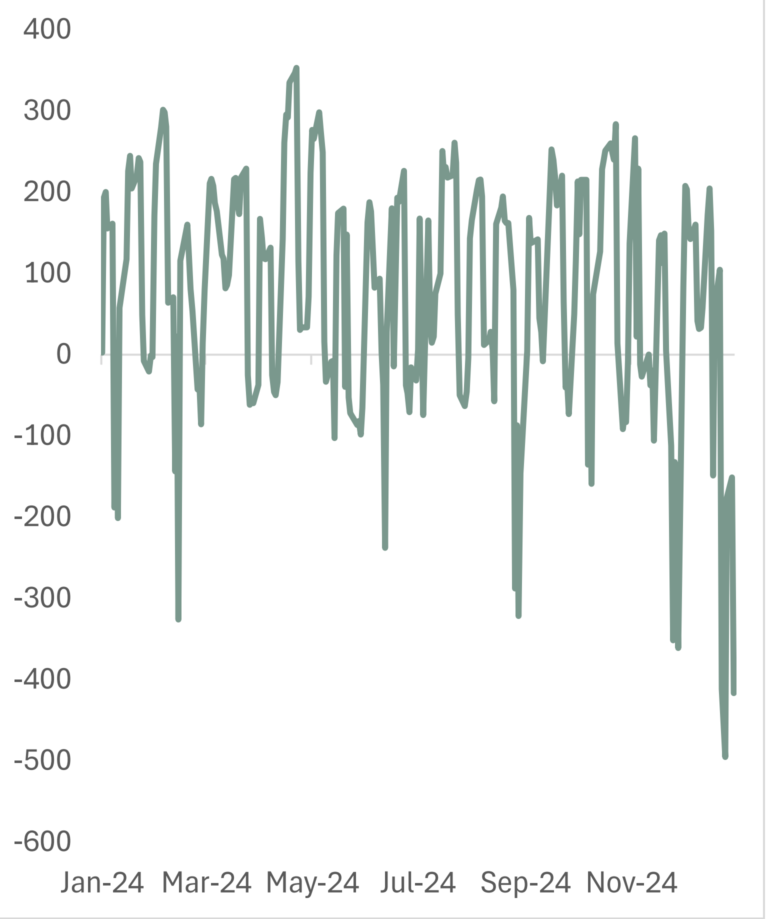
- We expect the Treasury to keep its balance between $900-950bn through year-end
- We do not expect the Treasury to target a cash balance less than 5d of expected cash outflows
- Although it *might* consider investing surplus cash in the tri-party repo market[1/]

1/ We don't expect any decision for a year or more.

How much repo cash?

- How much cash could the Treasury invest in the repo market?
- We assume that it would want maintain its precautionary target buffer in its account at the Fed
  - As this cash is always available
- Any remaining surplus could be invested in the repo market[1/]

Potential repo investment ($bn)



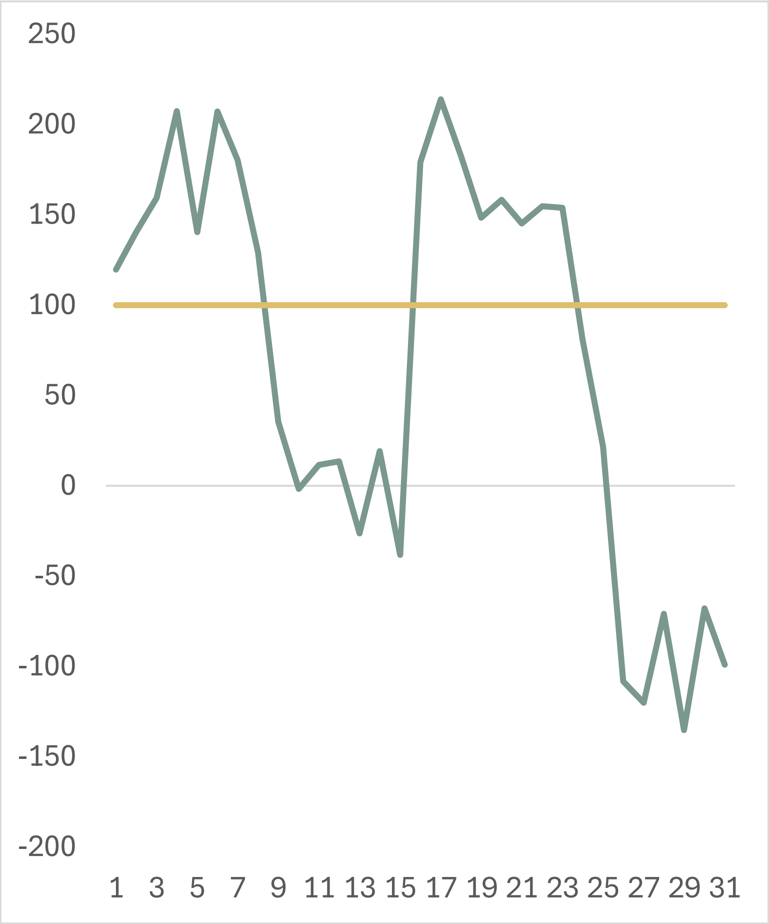
1/ Based on 2024 data, this could mean investing around $100bn/day in the repo market.

Note: Difference between the actual cash balance and the 5d realized expected cash flow. Sources: US Treasury, SMBC Nikko

Treasury's repo cash would be lumpy

- The Treasury's repo cash would vary based on its intramonthly cash inflows
  - Which are concentrated at the beginning of the month and the third week
- These flows may not align well with the market's financing needs

Average daily surplus cash ($bn)



Note: Difference between the actual cash balance and the 5d realized expected cash flow. X-axis is the day of the month; 2024 data. Sources: US Treasury, SMBC Nikko

Other issues

- The Treasury's repo transactions would likely need to be cleared
    - To preserve balance sheet capacity at the dealers

- We assume the Treasury's counterparties would include primary dealers
    - But it is unclear if the Treasury would consider other counterparties
        - As it has for its buybacks[1/]

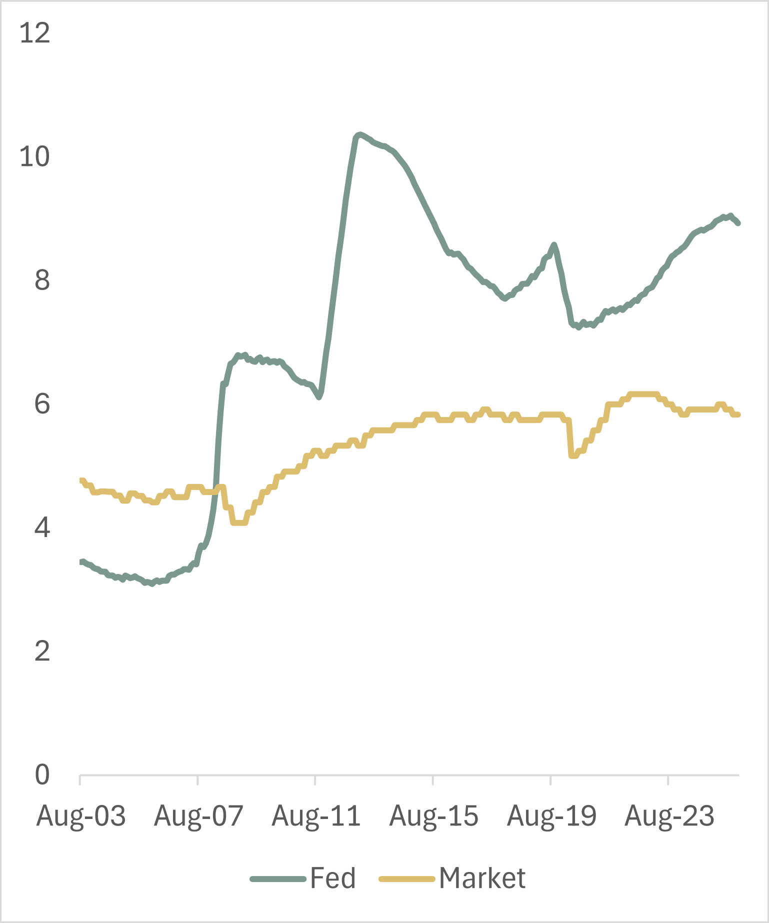
- Our sense is that the Treasury's repo transactions would be excluded from the calculation of SOFR and other benchmark repo rates

1/ The Treasury's repo transactions have the same effect on bank reserves as its buybacks while smoothing out balances in its account at the Fed. Increasing the frequency of its cash management buybacks might be an alternative to daily repo operations.

Market neutral portfolio

- QE lengthened the Fed's portfolio WAM relative to Treasury debt outstanding
- A market neutral portfolio would match the Treasury debt outstanding
    - To minimize the influence the Fed's portfolio has on market rates
- This would require increasing its bill holdings to the market average (22%)

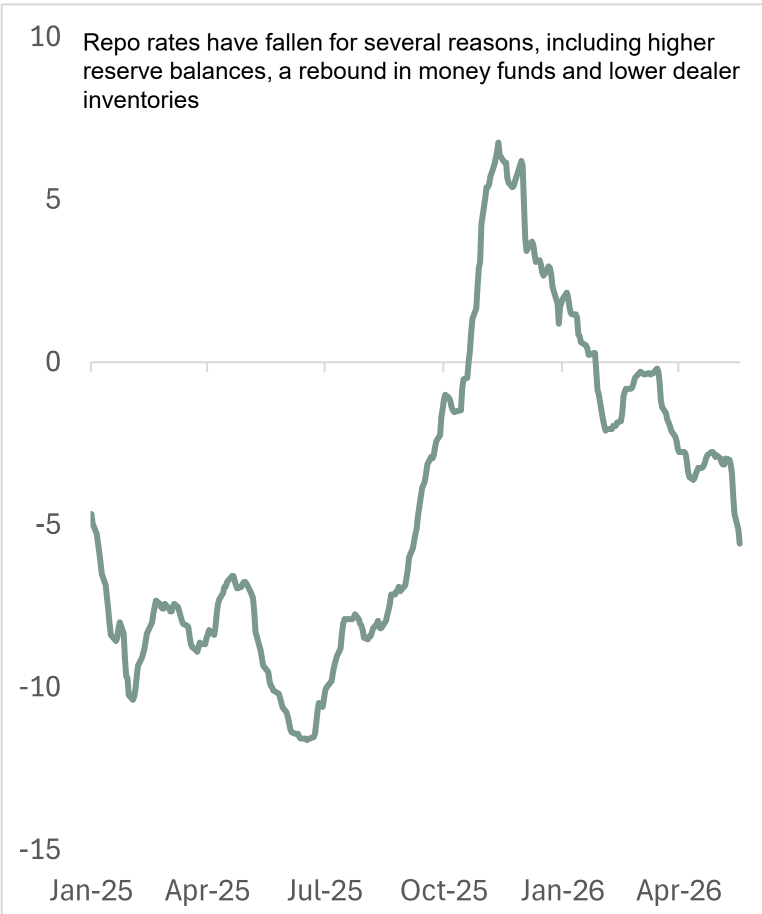
Treasury market WAMs (years)



Sources: US Treasury, Federal Reserve, SMBC Nikko

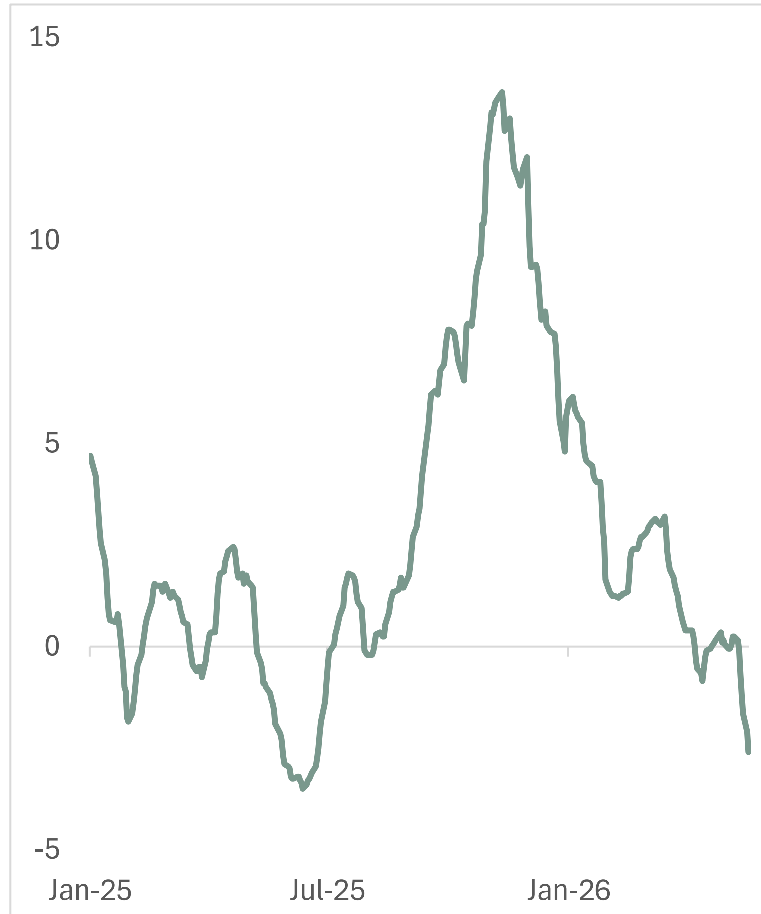
Lower repo rates…

Tri-party less IORB (bp)



Note: 20d average. Sources: Federal Reserve, SMBC Nikko

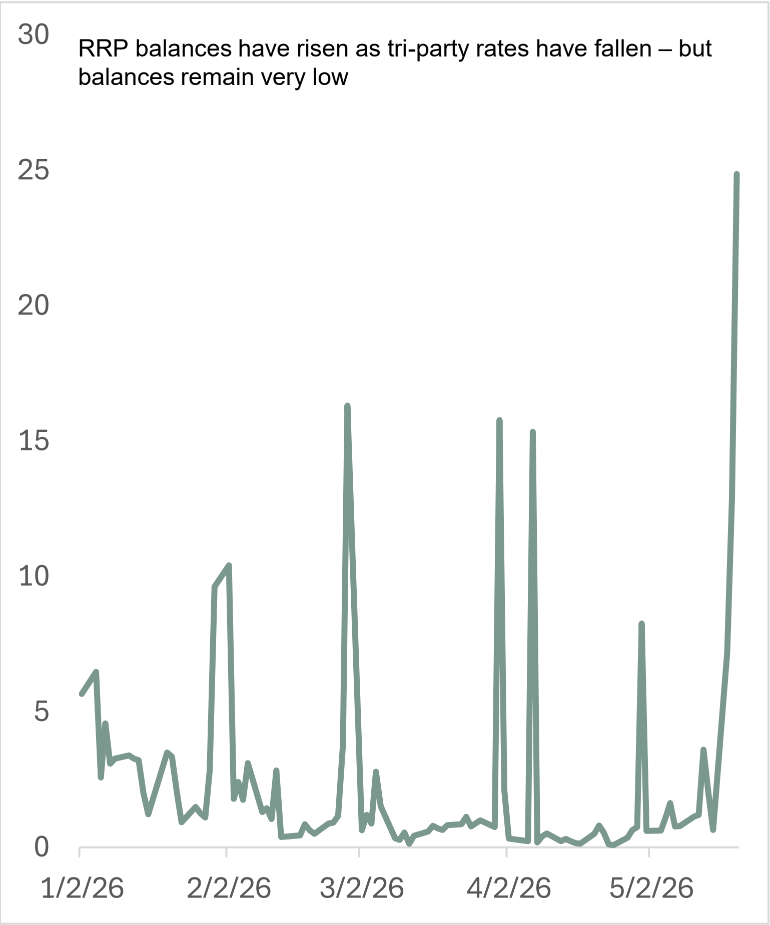
SOFR-fed funds (bp)



Note: 20d average. Sources: Federal Reserve, SMBC Nikko

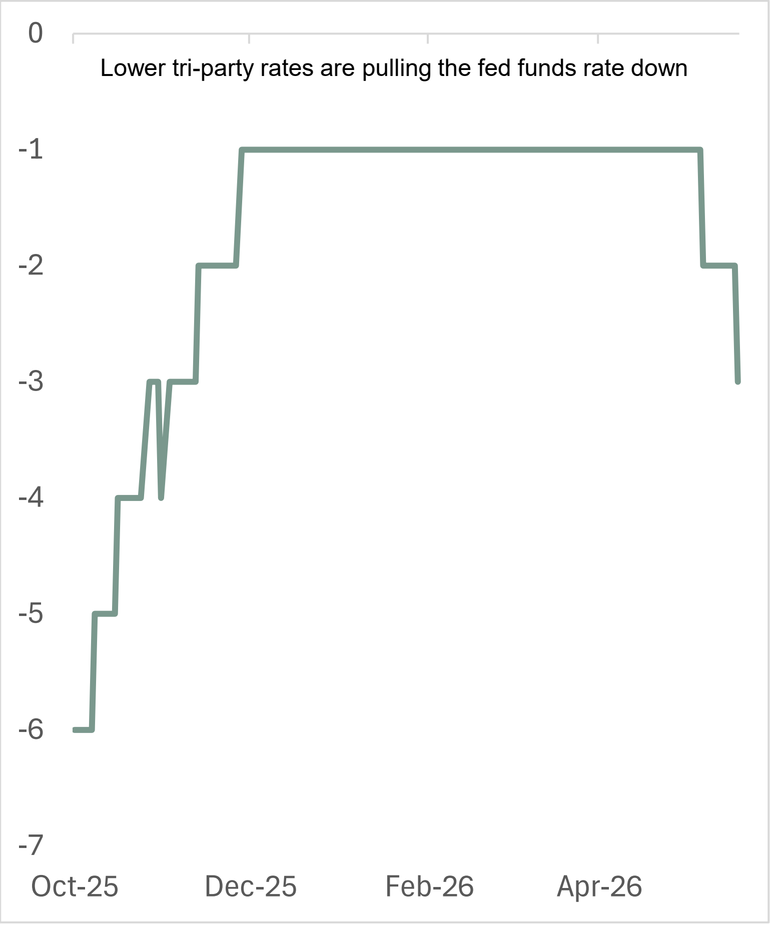
…Are pushing cash into the RRP and lowering the fed funds rate

RRP balances ($bn)



Sources: Federal Reserve, SMBC Nikko

Fed funds less IORB (bp)

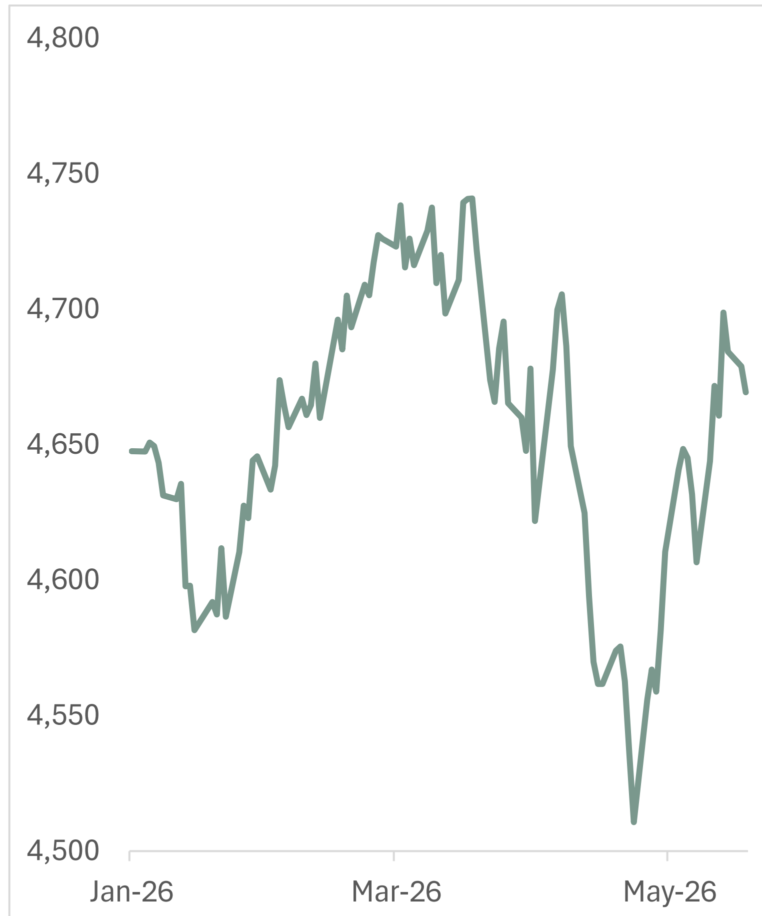


Sources: Federal Reserve, SMBC Nikko

Money fund balances have recovered

- Money fund balances have mostly recovered from their mid-April tax outflows

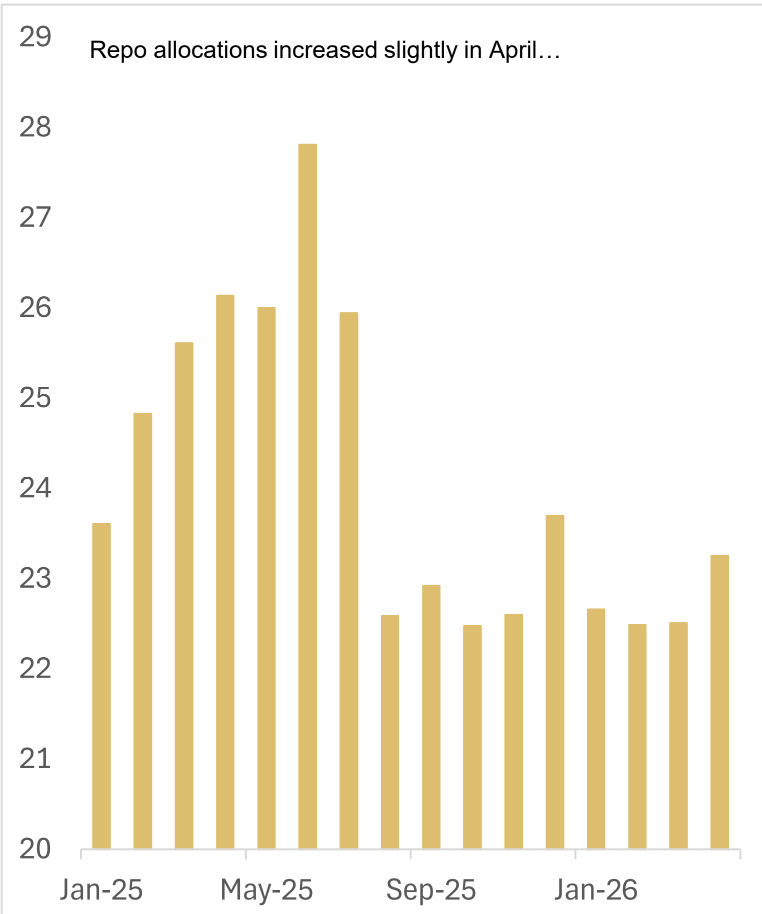
Instit. Gov-only money funds ($bn)



Sources: Crane's Data, SMBC Nikko

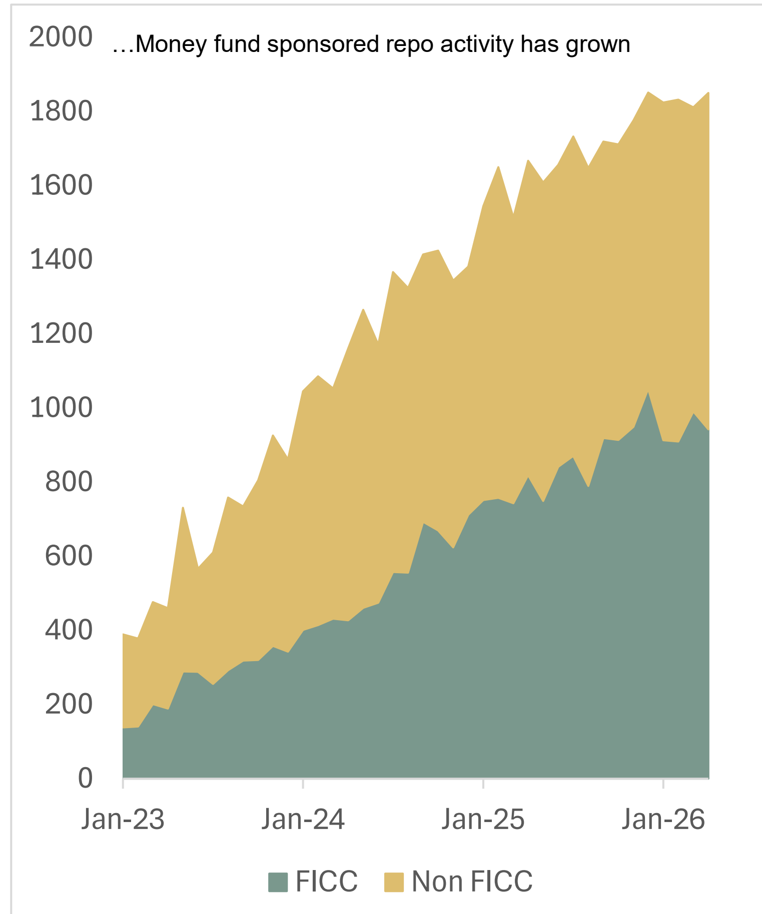
Money fund allocations

Treasury repo (%)



Sources: Crane's Data, SMBC Nikko

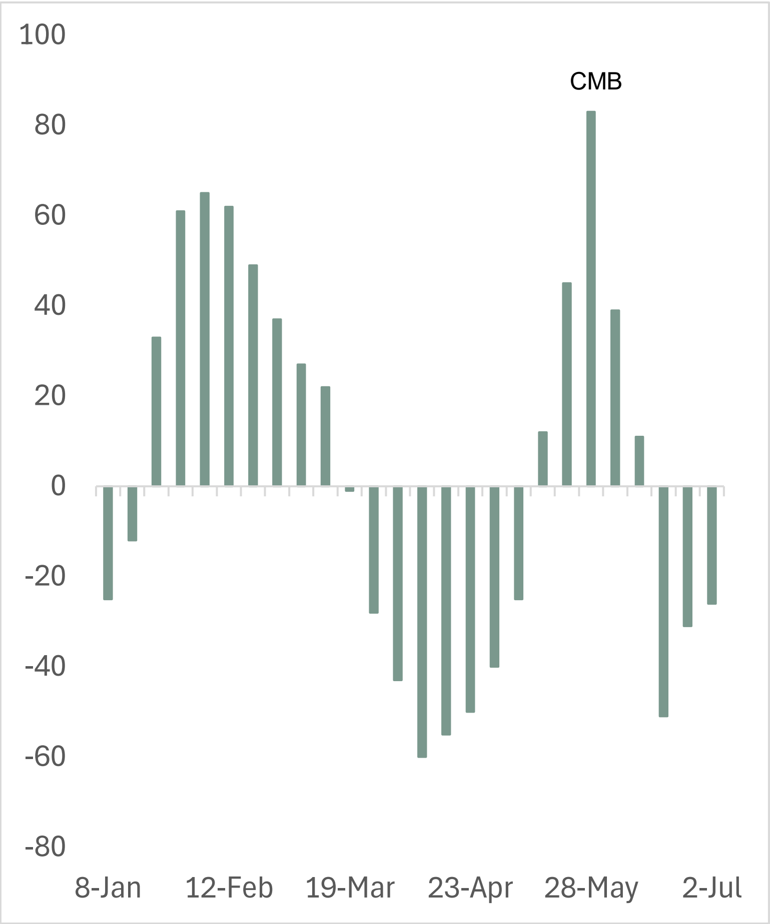
Money fund sponsored repo ($bn)



Sources: Crane's Data, SMBC Nikko

Declining bill supply

Weekly change ($bn)

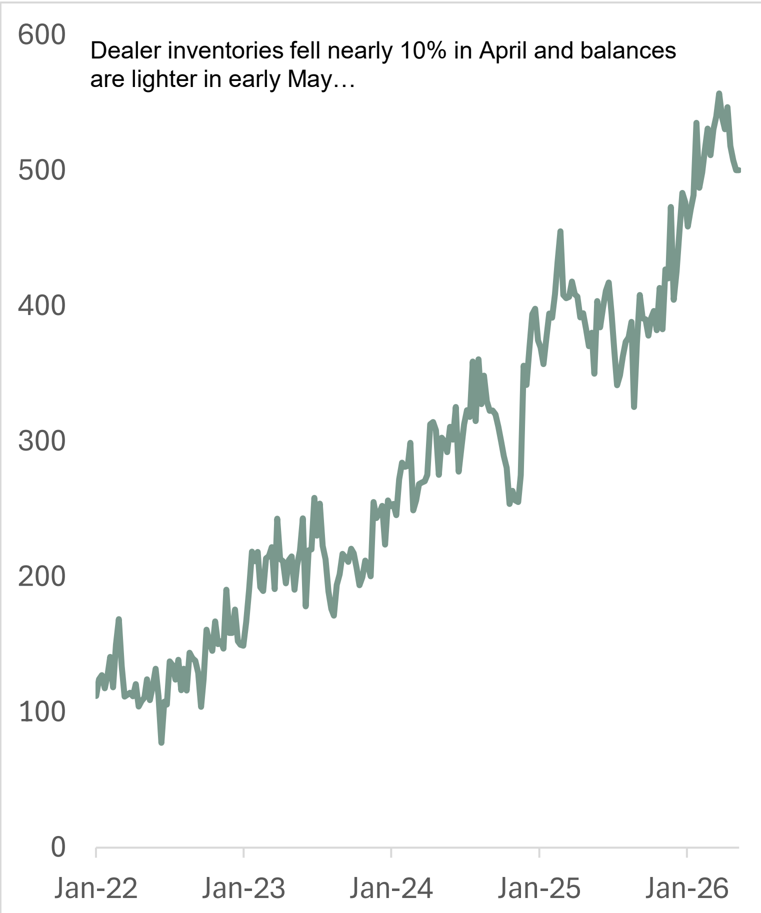


- The Treasury trimmed bill supply in April
  - And has (briefly) increased it this month
- But supply is expected to resume shrinking next month

Sources: US Treasury, SMBC Nikko

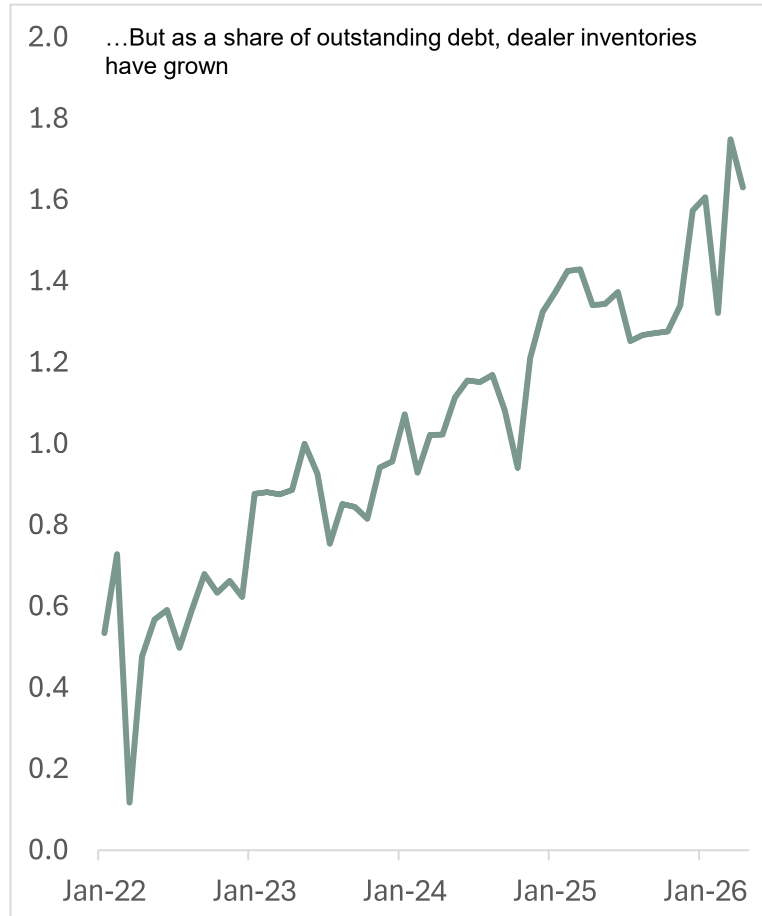
Dealer inventories

Off-the-run holdings ($bn)



Sources: Federal Reserve, SMBC Nikko

As a share of outstanding debt (%)

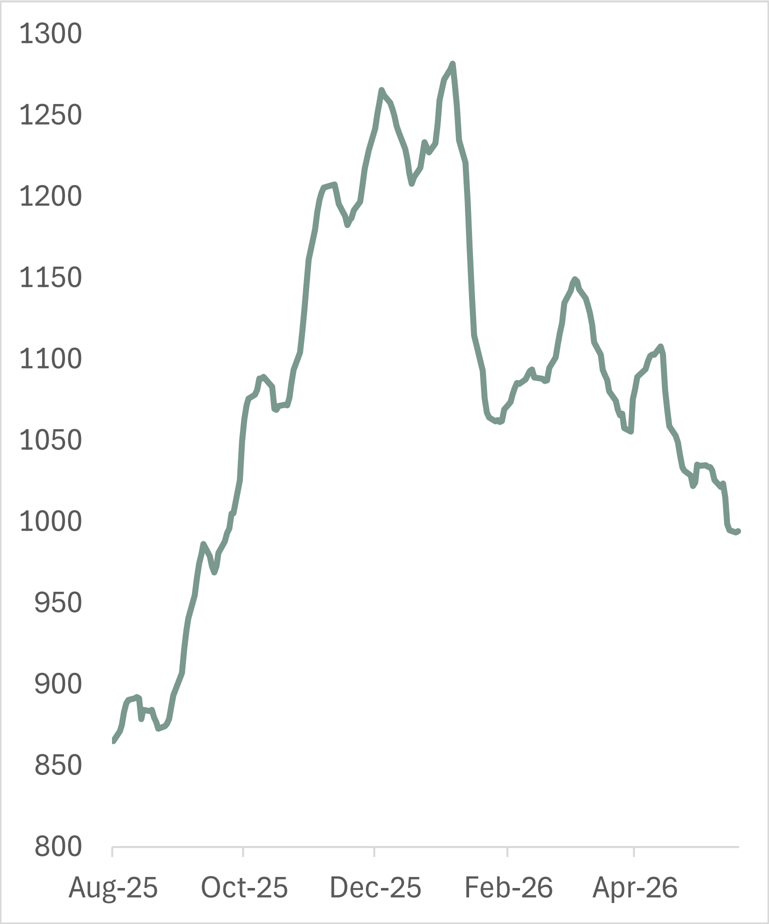


Sources: Federal Reserve, SMBC Nikko

Decline in the demand for funding

- Sponsored repo volumes have fallen since March
- Our sense is that market volatility has reduced investor appetite for long positions funded with leverage
- In turn, this has reduced the demand for repo financing

Sponsored repo ($bn)



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

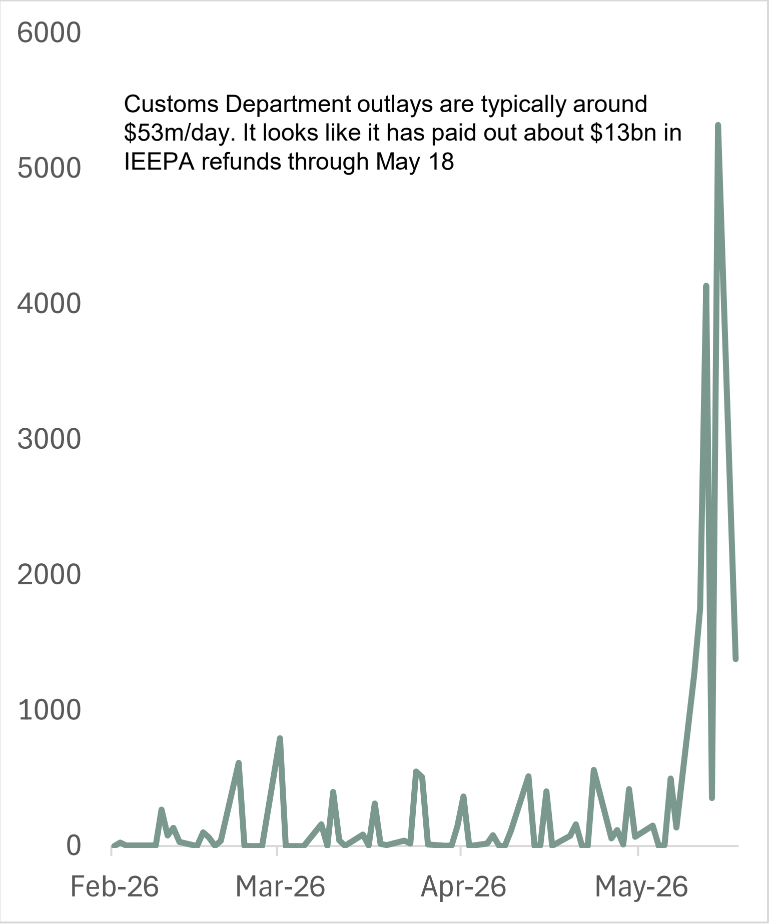
Will repo rates stay low?

- *Are low repo rates the "new normal"?*
- We do not expect the current low level of repo rates to persist
  - Our sense is that funding markets will tighten in late June ahead of quarter-end as dealer balance sheet capacity tightens
  - Bill supply is expected to increase in Q3 (by $350bn)
- If the Iran conflict continues past June, markets may price in more interest rate hikes and higher Treasury yields
  - Potentially reducing the demand for financing
    - And keeping repo rates pinned 10bp or so below IORB

IEEPA refunds and bill supply

- The Customs Bureau has begun paying IEEPA refunds to importers
- We expect that it may pay $125bn or more out of the $170bn collected
  - Most of the refunds are likely to paid out this summer
- We look for the Treasury to increase bill issuance to fund the refunds

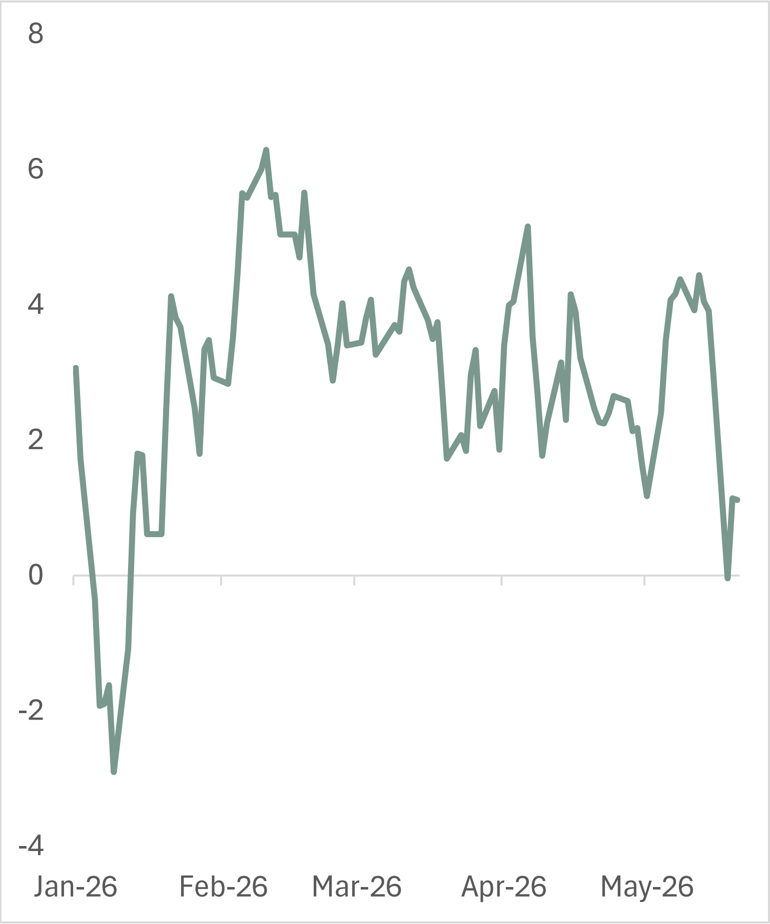
Customs Department outlays ($mn)



Note: 20d average. Sources: US Treasury, SMBC Nikko

Higher bill yields this summer

3m bill less OIS (bp)



Sources: Bloomberg, SMBC Nikko

- We expect yields to rise beginning in July as issuance increases
    - We look for net supply to increase by $350bn in Q3 followed by another $250bn or more in Q4

Clearing questions

- The central clearing deadline for repo is next June
  - There are still some scoping issues that need to be resolved
- Interaffiliate repo – accounts for nearly 25% of uncleared activity
  - While trades between different arms of the same firm are exempt from clearing this requires that all the affiliate's other, "outward facing" trades be cleared
- Extra-territoriality – should transactions between 2 non-US counterparties be subject to the clearing mandate?
  - Clearing these transactions might change the relationship between the non-US counterparties and require them to register as dealers under local laws
- Will an agented clearing access model (ACS) be available when the mandate takes effect?
  - ACS works well with a "done away' access model – where trades are novated to a third party for a fee
    - ACS allows for margin netting
    - And, in theory, has simpler legal and operational requirements
      - But there is legal uncertainty about what happens when a trade fails be novated

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Repo rate fracturing

- Central clearing could lead to some repo rate fracturing that reflects differences in access models and margin costs. Costs may be reflected in the cash borrowing rate or the size of transactions

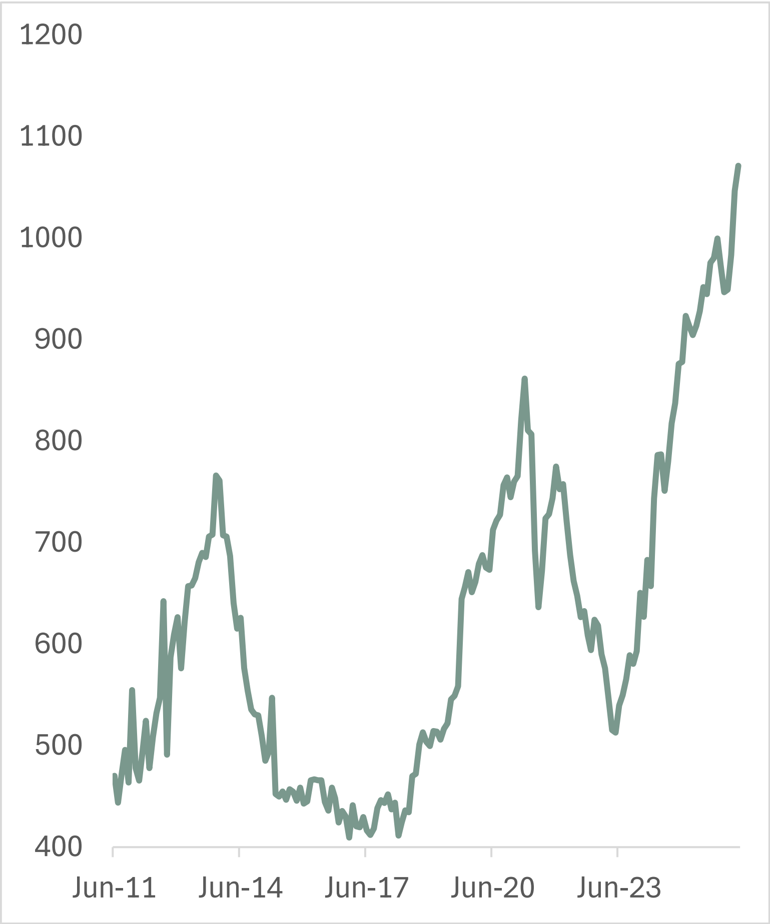
- Margin costs may be partially (or fully) absorbed by the intermediating dealer
  - This may be sensitive to the access model
    - Sponsored or agented; “done with” or “done away”
    - As well as opportunities for cross product margining[1/]

- The FICC’s VaR margining is sensitive to the maturity of the collateral pledged
  - Longer maturity collateral may trade at a different (higher) rate from shorter maturity GC

1/ FICC and the CME offer cross product margining. This requires gross margining.

Other collateral

MBS tri-party repo ($bn)



Sources: Federal Reserve, SMBC Nikko

- Could investors decide to use non-Treasury collateral to raise cash until the clearing rules and access models are finalized?
- The only other repo market with sufficient liquidity is against MBS collateral

Bank capital rules

Basel III

- The Basel III proposal is expected to reduce overall bank tier 1 capital requirements
  - But, its effects on trading activity and market risk are more nuanced
    - As the new rules will increase capital required for some types of trades and securities
      - Capital in these trades will become less pro-cyclical

- Overall capital requirements are expected to fall 5%
  - Most of the reduction at the largest banks (Category I and II) comes from changes to stress testing assumptions
    - And updating the GSIB systemic risk scoring framework

Basel III (2)

- Basel III limits risk diversification benefits and applies stricter assumptions about non-modellable risks
- We expect these changes will increase capital requirements for less liquid securities, those with more complex payouts, and those whose returns are difficult to model
    - But the Basel III changes may affect how these securities are traded rather than their volume
        - With more trading shifting to clearing
        - A reduction in the warehousing of securities
        - And increased efforts to model risk

GSIB risk scoring

- Along with the Basel III proposal, the Federal Reverse is considering changes to the formulas large banks use to calculate their systemic risk, freeing up bank capital
  - Large banks are required to hold an extra cushion of capital to account for the systemic risk their size and activities pose to the economy and markets
    - Required capital is determined by a score across five dimensions of risk
- The Fed plans to update the component risk weights to account for economic growth since 2019. This one-time adjustment would lower aggregate risk scores by 12%.
- And it will also reduce the weight applied to the short-term wholesale funding (STWF) component
  - This would lower aggregate risk scores by an additional 15%
    - Most of the STWF component is made up of Treasury repo.

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GSIB risk scoring (2)

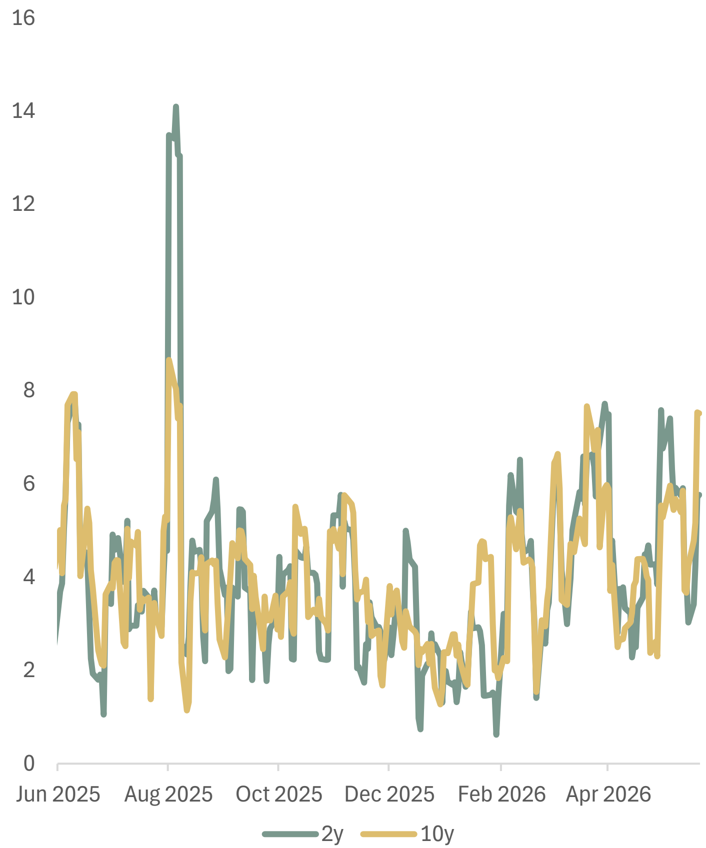
- At the margin, we think changes to the STWF component could increase the repo intermediation capacity of these banks
  - However, the 8 GSIB banks reported over $2.2trn in Treasury repo borrowing at the end of last year[1/]

- Other changes to the score including averaging and reducing cliff effects in the connection between the score and capital requirements could mean that the GSIB banks' intermediation activity is steadier
  - And there is less seasonal "risk dieting"
    - That causes repo rates to spike and cross currency bases to regularly widen in Q4

1/ With maturities out to 30d

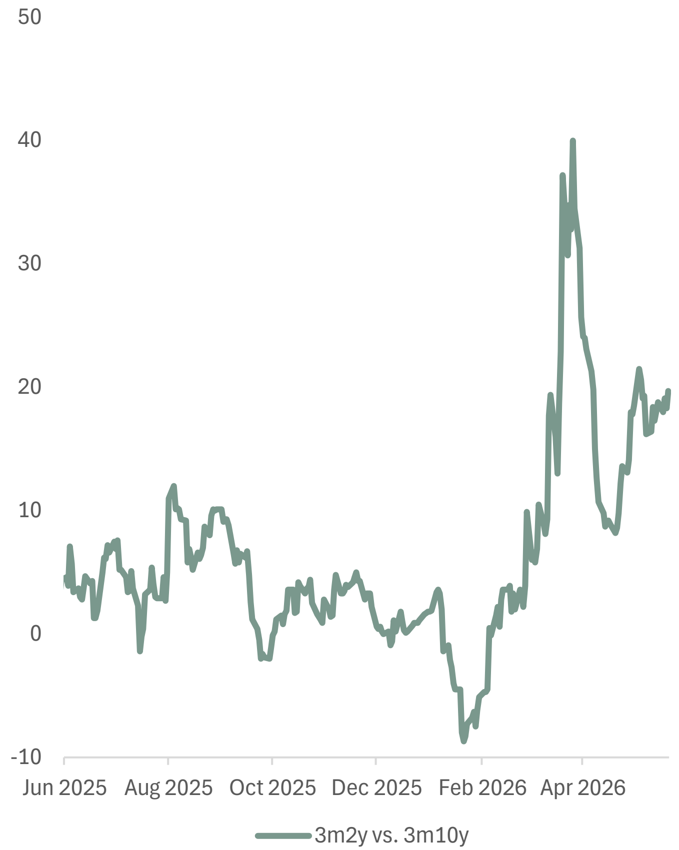
Short tail vol to underperform with strong case for Fed on hold

Realized vol (2-week, bps)



Sources: SMBC Nikko, ICAP, Bloomberg

Implied - 3mx2y less 3mx10y (annual bp vol)



Sources: SMBC Nikko, Bloomberg, ICAP

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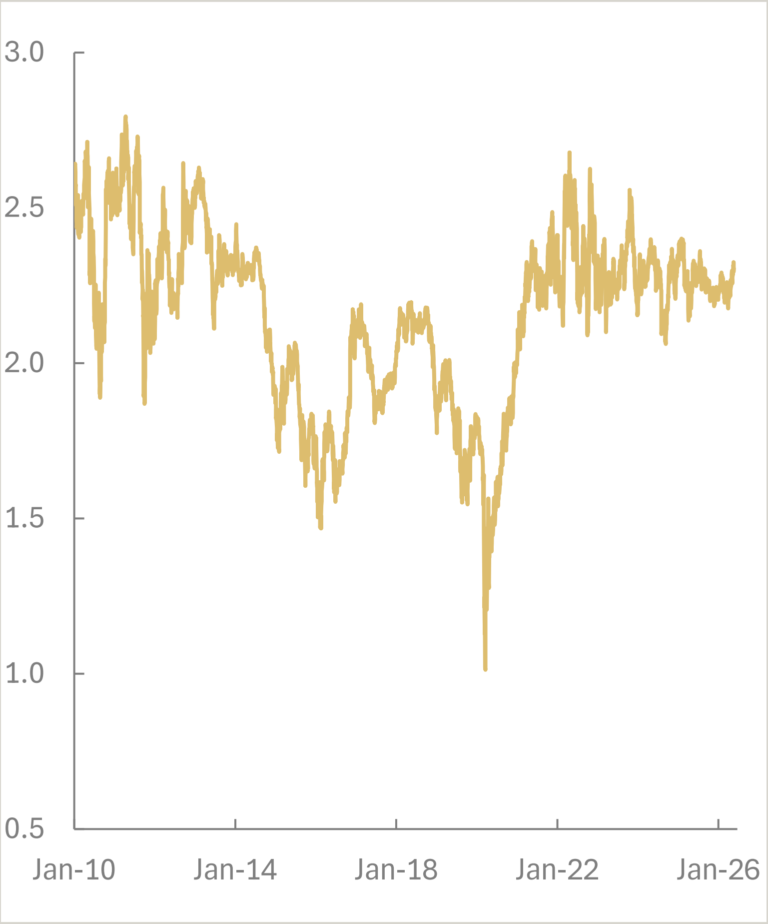
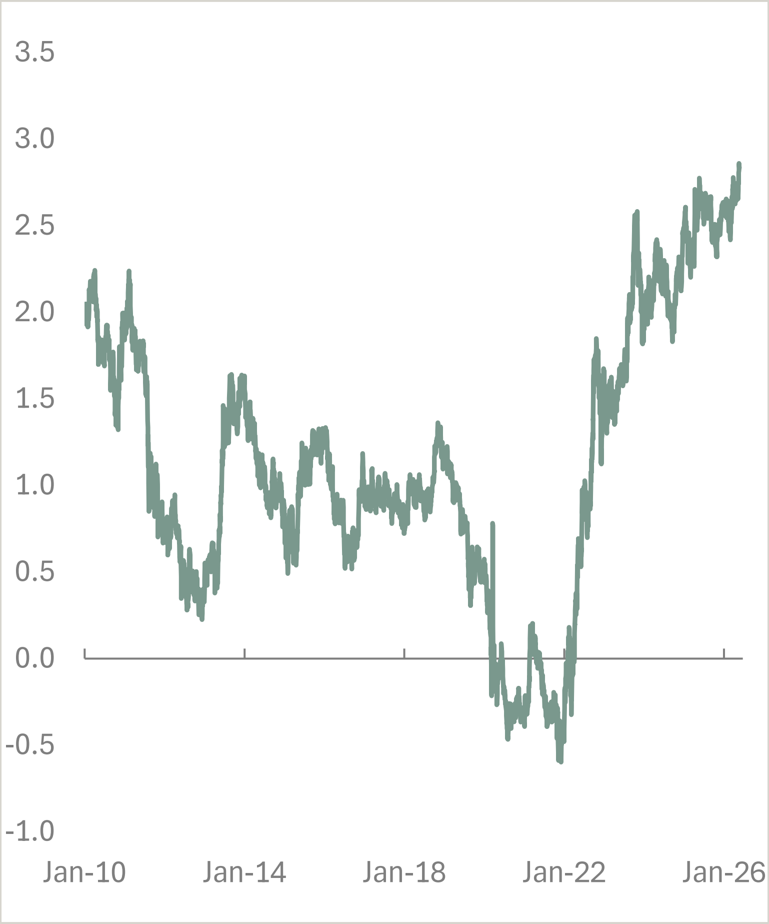
30Y TIPS BEs are cheap with real yields near highs

30y TIPS breakevens (%)



Sources: Bloomberg, SMBC Nikko

30y Real yields (%)



Sources: Bloomberg, SMBC Nikko

Disclaimers