US Rates Strategy Weekly

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Week ahead

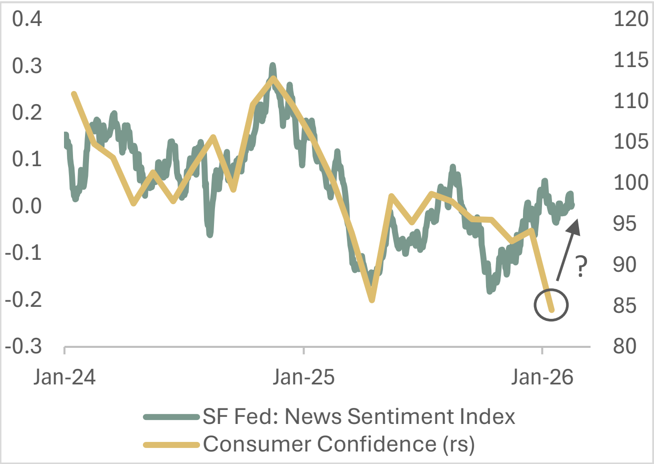
- **Consumer Confidence (Feb., Wed.)**: The consumer confidence index is likely to bounce back from January's weak 84.5 reading — the lowest since May 2014. We note that the consumer *sentiment* index jumped +6.3 points between December and February, while the consumer *confidence* series fell by -9.7 points in January. Moreover, daily news sentiment, as measured by the San Francisco Fed, has been flat. This disconnect is shown below.

- **Producer Prices (Jan, Fri.)**: We are forecasting relative strength in January producer prices, despite a relatively contained January CPI report where headline and core CPI returned at 0.2% MoM and 0.3% MoM respectively. PPI is also sensitive to oil prices which increased 4.1% MoM. At 3.0%, producer prices are elevated and at the upper end of pre-Covid readings (shown below).

- **Fedspeak**: The Fed's rhetoric has become less tolerant of above-target inflation. Core PCE inflation — the Fed's preferred metric — remains stubbornly high. Waller (2/23 & 2/24), Goolsbee (2/24), Collins (2/24), Cook (2/24), Richmond's Barkin (2/24 & 2/25), St. Louis' Musalem (2/25).

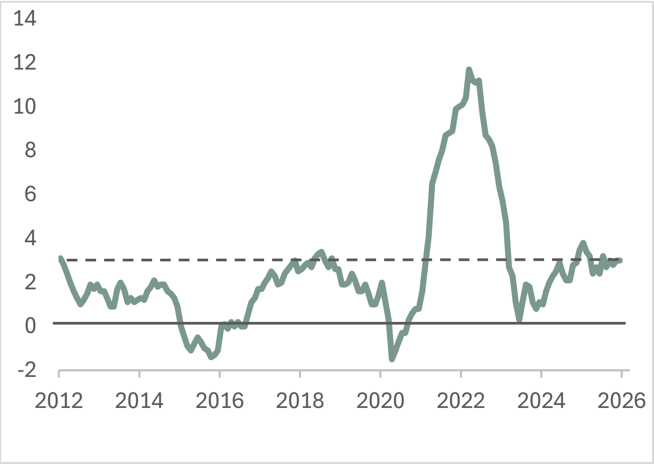
- **UST Auctions**: The Treasury will sell $69bn 2-Year on Tuesday, $70bn 5-Year on Wednesday and $44bn 7-Year on Thursday.

Figure 1: News Sentiment (Index) vs. Consumer Confidence (Index)



Source: SF Fed, Conference Board, Haver, SMBC Nikko

Figure 2: PPI (%y/y)



Source: BLS, Haver, SMBC Nikko

Stubborn inflation draws Fed's ire

The 0.4% m/m core PCE print for December corroborates our view that the Fed is likely to be on hold until inflation declines back to the Fed's 2% target. We expect one rate cut this year in July compared to the futures market pricing in 56 bps of cuts. 10y yields have moved towards the lower end of the 3.90-4.30% range due to geopolitical worries (risk off) and as the negative impulse from Japanese and European bond market have run its course. **A further correction in risk assets or flare up in geopolitical risk is likely to take 10y yields towards the lows of the range**. However, we expect yields to move towards the middle of the **4.00-4.25% range once the geopolitical risk passes on**. We favor the steepener (5s30s) with the IEEPA ruling once again bringing fiscal concerns to the fore.

Impact of IEEPA reversal

Supreme Court struck down the use of IEEPA for tariffs, affecting $170bn in annual tariff revenues (including $110bn from reciprocal tariffs and remainder from fentanyl related actions). The White House has already said that it would re-impose tariffs under alternative statutory authorities, but the key questions are how much revenue those new authorities can generate and how long implementation can take.

From an issuance perspective, even assuming only 50% of the lost revenue is replaced, the resulting $85bn shortfall could be **comfortably absorbed in the bills market**. The Supreme Court did not rule on refunds and instead highlighted that jurisdiction for remedies lies with other courts. Lower courts or the Court of International Trade are likely to manage any refund process that would be slow and drawn-out.

Using a QE-style duration template, a **shortfall of this magnitude would be equivalent to roughly a 30bp upward impact on 10-year yields**. However, this assumes the Treasury compensates with coupon issuance. **If Treasury instead leans more heavily on bill issuance, the rate impact could differ meaningfully**.

Alternative to IEEPA: Section 122 and 338 can be applied broadly although we suspect each would face some legal challenge. Section 122 allows the Administration to impose 15% tariffs for up to 150d. While it can be extended, the extension requires Congressional approval. Section 338 was created in 1930 and allows for unilateral tariffs of 100% or even import bans.

Under Section 232 rules, the President can impose tariffs on imported products that are deemed a threat to national security by the Commerce Department. There are no limits on the rate applied or the duration of these levies. Section 232 tariffs on steel, aluminum and autos have been in place since 2018 so extending coverage to other products seems to have more legal support than some of the other tariff alternatives. The Commerce Department is currently reviewing 12 other products for national security-based tariffs. But Section 232 tariffs raised just $35bn in FY 25.

The other major source of tariff revenue is Section 301. Section 301 is applied against countries deemed to be discriminating against US businesses. Like 232 there is no limit on the rate, but Section 301 tariffs have a 4y limit after which they must be renewed. Currently, Section 301 applies only to Chinese goods. It raised about $36bn in FY 25.

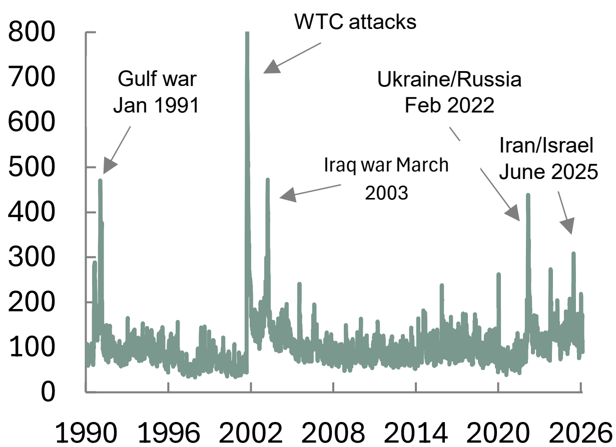
Pricing the Iran risk

President Trump's 10–15 day window for an Iran deal keeps geopolitical risk front and center. Polymarket pricing now implies ~59% odds of a U.S.–Iran military engagement by March 31 (vs. ~32% on Feb 14) and ~54% odds of a Strait of Hormuz closure. Markets are likely to extrapolate from the recent playbooks—the Russian invasion of Ukraine and the Israel/U.S.–Iran flare ups—where an **initial volatility spike ultimately gives way to Fed- and fundamentals-driven rate dynamics**.

We are in line with market pricing, expecting that this episode will not exceed prior Middle East conflicts (Iraq wars, past Iran flare-ups) **or the Russia-Ukraine war**. However, uncertainty is highly elevated, and **the market may be underpricing the events**. If things escalate, the market is likely to: (i) **derisk,** leading to higher volatility and (ii). **oil-prices are likely to spike**, given the potential supply disruptions to the Strait of Hormuz.

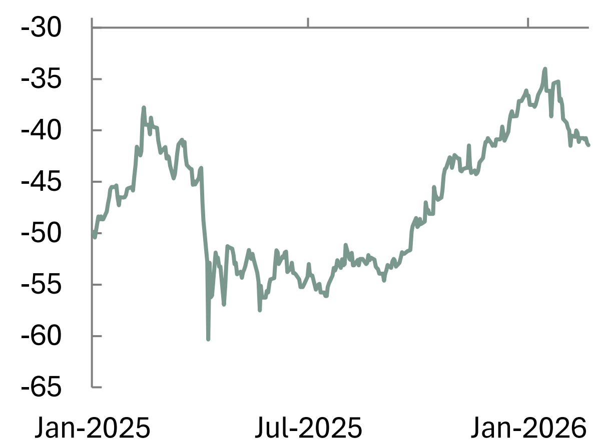
In the current low vol regime, **carry trades** (long swap spreads in the rates space) **would be at risk**. 10y swap spreads have widened significantly from the lows in April 2025 only to retrace a bit since January. Currently at -41.4bps, it can easily retrace to the 38.2% Fibonacci levels (April low to January high) that would at -45 bps. If the situation worsens, the 50% Fibonacci level is at -48.8 bps. The **IEEPA tariff ruling by the Supreme Court should also weigh in on spreads**. Separately, implied vol remains at multi-year lows and it is likely that higher VIX would also take rates vol higher.

Figure 3: Geopolitical risk index (7dma)



Note: Caldara & Iacoviello geopolitical risk Source: Federal Reserve, Bloomberg, SMBC Nikko

Figure 4: 10y sofr swap spreads (bps)



Source: Bloomberg, SMBC Nikko

Weekly economic indicator calendar

SMBC US Forecasts						
Date	Indicator	SMBC Forecast	Market Consensus (Median)	Prior	Range of Est.	Notes:
Feb 24	Case Shiller (9:00 AM)	0.3%	0.2%	0.5%	0.1% - +0.3%	We expect home prices will slow to 0% YoY due to a dearth of demand. Affordability is near record lows.
Feb 24	Conf. Board Consumer Confidence (10 AM)	92.2	87.8	84.5	86.0 - 91.5	SF Fed's daily news sentiment index is suggesting a sharp MoM bounceback in consumer confidence.
Feb 27	PPI MoM (8:30 AM)	0.3%	0.3%	0.5%	0.1% - +0.5%	In January, headline CPI increased 0.17% MoM while core CPI increased 0.3% MoM.
Feb 27	Core PPI MoM (8:30 AM)	0.5%	0.3%	0.7%	0.1% - +0.5%	PPI is oil price sensitive. WTI increased 4.1% MoM in Jan.

Forecasts subject to change

Source: SMBC Nikko Securities US Economics Forecasts

Quarterly GDP and Rates Forecasts

	2025		2026			
(%)	Q3 Act	Q4 Act	Q1F	Q2F	Q3F	Q4F
Real GDP QoQar	4.3	3.0 (f)	2.4	1.5	2.6	2.2
Real GDP YoY	2.3	2.6 (f)	3.4	2.8	2.4	2.2
Core PCE YoY	2.9	2.7 (f)	2.4	2.4	2.2	2.3
Unemployment	4.3	4.4	4.3	4.4	4.4	4.5
Fed Funds Rate Upper Bound	4.25	3.75	3.75	3.75	3.50	3.50
2 Year	3.61	3.47	3.50	3.40	3.40	3.40
5 Year	3.74	3.73	3.60	3.50	3.50	3.50
10 Year	4.15	4.17	4.15	4.30	4.30	4.30
30 Year	4.73	4.84	4.75	4.75	4.80	4.85

Source: SMBC Nikko

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