US Rates Strategy Weekly

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- A temporary gasoline tax suspension could provide **modest near-term consumer relief** but incomplete pass through would limit the broader macro impact. The actual benefit may be closer to 11c/gallon after considering the pass through and the recapture by Treasury, rather than 18.4c/gallon.

- **The cost of the gasoline tax suspension would be around $20bn,** that the Treasury could easily borrow this amount by issuing more bills – on top of the issuance financing the conflict in Iran and the IEEPA refunds.

- Treasury yields remain **vulnerable to further upside pressure** from resilient economic data and elevated oil/geopolitical risks**.**

- **With 35bp of hikes priced by mid-2027, we continue to favor legging into front-end longs,** particularly December 2027 SOFR**.** Even a stressed oil scenario likely leaves the medium-term distribution relatively constrained.

- FOMC minutes – Fed **rhetoric is likely to be hawkish** with inflation risks tied to the Iran war. While some officials have opened the door to hikes if inflation stays sticky, cooling core CPI ex shelter keeps hikes from becoming a base case for now.

Gasoline tax suspension

President Trump has voiced support for a temporary suspension of the federal tax on gasoline and diesel that Congress is considering. **Under the Democratic proposal, the 18.4c/gallon federal tax would not be collected through October 1**. The Treasury would be required to ensure that the "benefits of the tax suspension are passed on to consumers".[1] Although not mentioned explicitly in the press release, we assume the tax suspension might also apply to the 24.4c/gallon excise on diesel fuel. Separately, Republicans have introduced legislation that would suspend the tax for at least 90 days.

Federal taxes on gasoline and diesel are dedicated to financing the Highway Trust Fund (HTF). The HTF is used to finance the federal contribution to transportation projects like bridges and mass transit. At its current pace of spending and assuming no changes to its revenues, the trust fund is expected to run out of money sometime in 2028. At that point, it will not be able to reimburse states for approved projects. The Congressional bill requires the Treasury to replace the missing tax revenue from other sources.

[1] See, "Kelly, Blumenthal, and Pappas Introduce Bill to Immediately Lower Gasoline Prices at the Pump", Mark Kelly (D-AZ) website press release, March 9, 2026

How much will this cost?

The CFRB estimates that a six-month suspension would cost about $21bn – or about $3.5bn/mo.[2] The Treasury could easily borrow this amount by issuing more bills – on top of the already heavy issuance financing the conflict in Iran and the IEEPA refunds.

Between the end of February and May 13, the national average price of gasoline has risen 52% to $4.53/gallon. An immediate savings of 18.4c/gallon would lower the average price by around 4% *assuming* no further increase. The CFRB estimates this would free up about 0.2% of household consumption. **But the actual relief may be somewhat less**.

The CBO estimates that from every $1 reduction in excise taxes, the Treasury "recaptures" 24c from higher income and payroll taxes. So, the *effective* reduction in gasoline prices might be closer to 14c/gallon once income taxes are considered.

And while a federal tax holiday would lower gasoline prices immediately it might not get fully passed on to consumers. Tsvetanov examines the behavior of gasoline prices following local tax holidays in 2022.[3] A post-COVID surge in traveling and the Russian invasion of the Ukraine caused national average gasoline prices to spike above $5/gallon by early June. To ease pressure on consumers several states suspended their local levies. Because the suspensions took effect at different times and in different amounts, Tsvetanov was able to estimate pass-through effects based on heterogenous factors related to gasoline supply and local markets. **On average, about 79% of the tax savings was passed on to consumers**. But there were significant differences across locations which reflected differences in the relative market power of suppliers. Areas requiring specific blends, in rural parts or further from wholesale terminals had smaller pass-through effects. **As a result, the actual benefit to the consumer may be closer to 11c/gallon – or less than 3%**.

Breakout in yields?

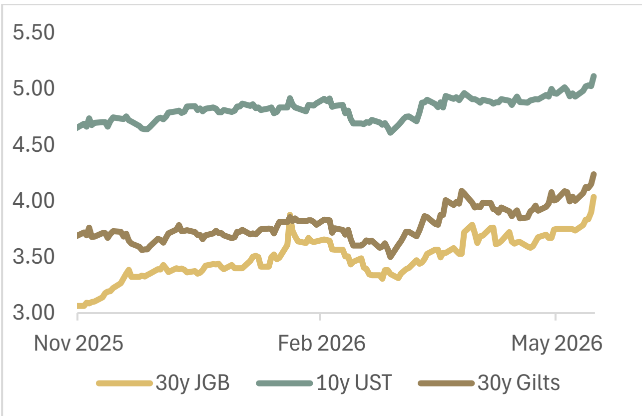
Treasury yields appear to be breaking above the upper end of their recent range, driven by the sharp selloff in UK and Japanese long-end bonds (Figure 1) alongside renewed geopolitical risk. Middle East negotiations are at a standstill, increasing the risk that oil prices stay elevated or move higher. At the same time, recent economic data has remained broadly resilient, reinforcing relatively hawkish policy pricing. Current yield levels (2y near 4.07% and 10y near 4.57%) are attractive. However, with correlations between oil and Treasuries elevated (Figure 2), **<u>rates remain vulnerable to further upside if energy disruptions broaden</u>** and inflation concerns intensify.

To gauge the extent of the current shock, we compare the present episode to the 1990 supply shock (Gulf War). Figure 3 shows that the rise in oil prices is broadly comparable across the two periods. So far, 10y Treasury yields have risen by 64bp versus a peak move of around 75bp in 1990. Because yields started at different levels (3.93% in Feb 2026 versus 8.27 in Jul 1990), the percentage increase in yields has been larger in the current episode (16% versus 9% in 1990). In the case of 2y Treasury yields, the current

[2] See, "A Gasoline Tax Holiday Would Cost Billions Each Month", Center for a Responsible Budget, March 17, 2026.
[3] See, "Tax Holidays and the Heterogenous Pass-through of gasoline taxes", T. Tsvetanov, Energy Economics, June 2024.

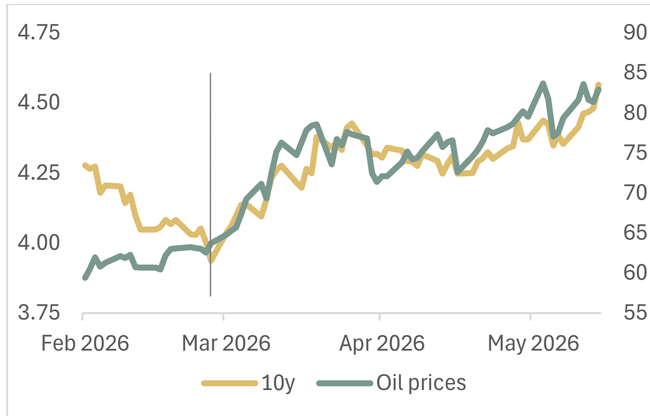
move has already exceeded the 1990 episode, with yields rising 70bp versus a peak move of 48bp in 1990.

Figure 1: 30y UST, JGB and Gilt Yields (%)



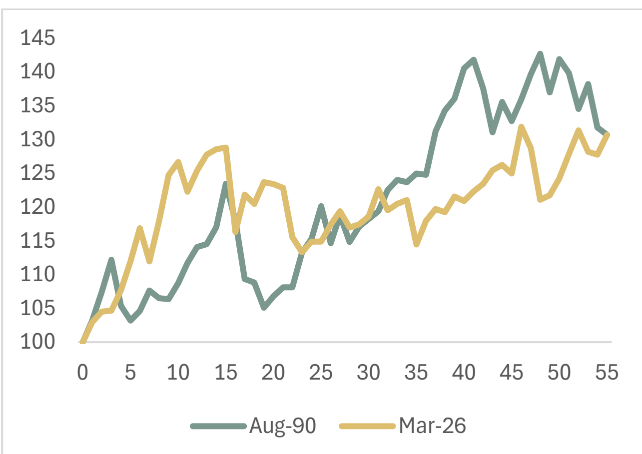
Source: SMBC Nikko, Bloomberg;

Figure 2: 10y (LHS, %) versus Oil price (RHS, $)



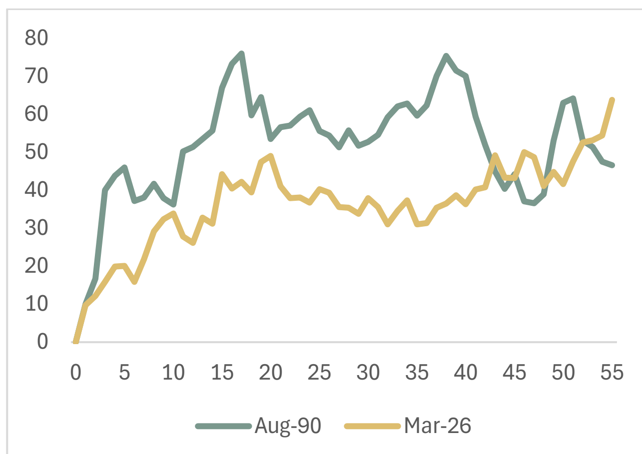
Source: SMBC Nikko, Bloomberg;

Figure 3: Oil prices (index, 9m forward contract)



Source: Bloomberg; Note: December 2026 and June 1991 WTI contracts

Figure 4: 10y Treasury yield change (bps)



Source: Federal Reserve, Bloomberg;

Leg into the front end

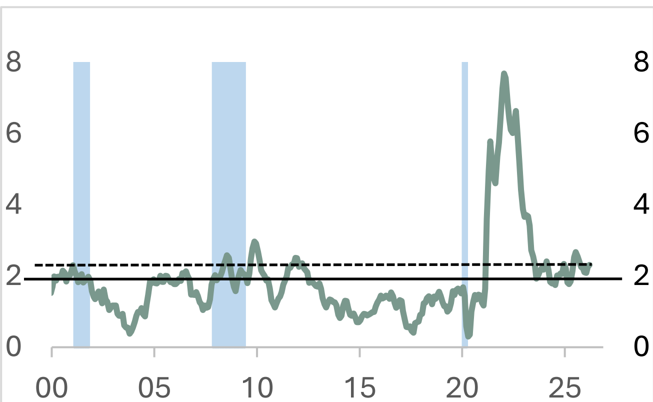
With 35 bp of hikes priced in by mid-2027, markets are already pricing a Fed that is likely to drop its easing bias. Longer-term investors who believe the bar to hikes remains high should use these attractive levels to leg into longs. The medium-term distribution for the front-end remains relatively constrained. In our view, a stressed Mid-East scenario would likely take the 2y towards 4.25% (roughly 3 hikes). While it is easy to focus on the worst-case scenario of higher oil prices, downside risks to growth and/or path toward de-escalation also needs to be added into the distribution. We also favor the SOFR December 2027 contract.

Week ahead

- **FOMC Meeting Minutes (Apr, Wed)**: We expect Fed rhetoric to gradually drift more hawkish in the coming weeks as the impacts from the Iran war continue to pass-through into inflation. Lately, some Fed governors and regional Fed bank presidents have moved toward two-sided language in their public communication, indicating that either rate hikes or cuts are possible. In fact, three members at the April 29 meeting dissented in favor of officially promulgating this view in the Fed's statement. In the March FOMC minutes, we learned that "Some participants judged […] that upward adjustments to the target range for the federal funds rate could be appropriate if inflation were to remain at above-target levels." Seeing as core CPI excluding shelter has risen at just a 2.3% YoY pace, hikes are not yet a base case in our view.

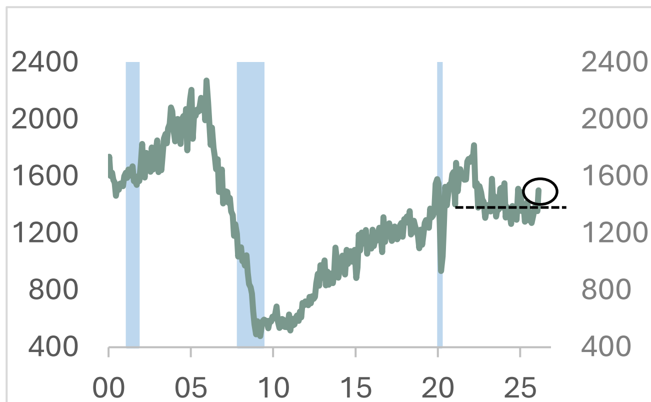
- **Housing Starts (Apr, Thurs)**: Housing demand remains weak on the back of high home prices, high mortgage rates and slowing wage growth. The supply side of existing homes also remains challenged as homeowners are locked into ultra-low pandemic mortgage rates. Housing starts have trended flat since 2023 in line with pre-pandemic levels of building. We are forecasting a -7.8% MoM decline, bringing the level of starts to 1384k, roughly equal to the 2023-to-present average.

Figure 5: Core CPI ex Shelter (%Y/Y)



Source: BLS, Haver, SMBC Nikko

Figure 6: Housing Starts (thous.)



Source: Census, Haver, SMBC Nikko

Table 3: Economic indicator forecasts

SMBC US Forecasts						
Date	Indicator	SMBC Forecast	Market Consensus (Median)	Prior	Range of Est.	Notes:
May 20	FOMC Minutes (2 PM)	-	-	-	-	Expecting Fed rhetoric to drift in a comparatively hawkish direction, especially as the war and shortages persists.
May 21	Housing Starts (8:30 AM)	-7.8%	-4.5%	10.8%	-5.5% - -3.0%	Mechanical correction following last month's 10.8% gain. Housing starts have trended sideways since 2022.
May 28	PCE Deflator (8:30 AM)	0.51%	-	0.7%	-	April CPI increased by 0.64% MoM.
May 28	Core PCE Deflator (8:30 AM)	0.33%	-	0.3%	-	April core CPI increased at 0.38% MoM. PPI healthcare increased by 0.18% MoM (SA).

Forecasts subject to change

Source: SMBC Nikko Securities US Economics Forecasts

Disclaimers