US Rates Strategy Weekly

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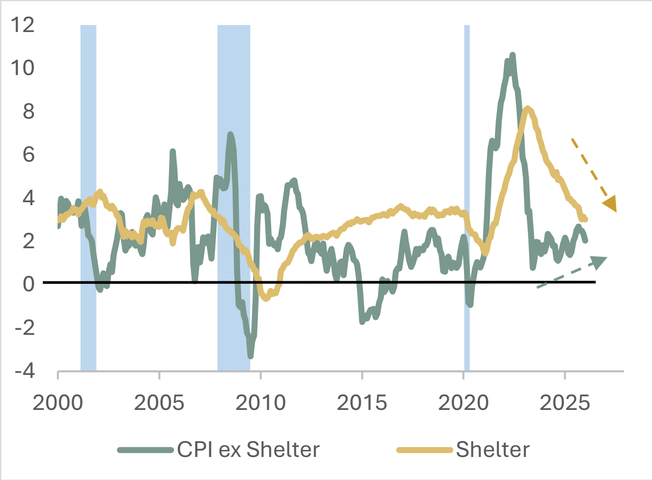
Week ahead

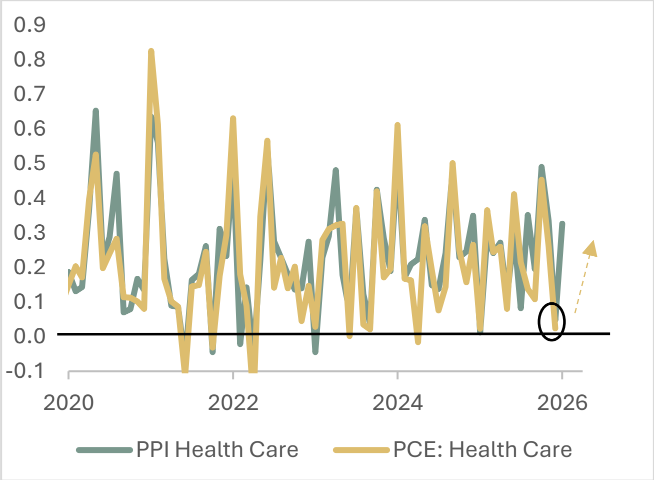
- **Consumer Price Index (Feb., Wed.)**: We are forecasting gains of 0.36% m/m (2.5% y/y) for headline CPI and 0.26% m/m (2.5% y/y) for the core CPI. Implicit in these gains is an expected 1.6% increase in energy prices and a 0.3% increase in food prices. While shelter inflation continues to decelerate steadily due to broader housing market weakness, progress here has been offset by rising pressures elsewhere (Figure 1). For the CPI excluding shelter series, the Iran conflict is likely to stoke inflationary pressures and keep the Fed in wait-and-see mode. Gasoline prices increased by 3.5% m/m, agriculture and livestock prices increased by 0.5% m/m, while used vehicle prices declined -0.2% m/m.
- **Personal Income, Spending and PCE Deflator (Jan., Fri.)**: We are forecasting m/m gains of 0.3% and 0.4% gains for the headline and core PCE deflators, respectively. This partly reflects higher health care prices which increased by 0.9% m/m in the PPI report (Figure 2). We will also receive personal income and spending data for which we are forecasting 0.4% m/m and 0.3% m/m, respectively. Real spending has been slowing as high inflation and interest rates have led to a deterioration in household financial health, and this is becoming a growing concern in our outlook. Specifically, we point to the savings rate (3.6%) which is low and trending lower, leaving households vulnerable to shocks at a time when delinquencies for credit cards, auto loans, and student loans are already elevated.
- **UST Auctions:** The Treasury will sell $59 Bn 3-Year on Tuesday, $39 Bn 10-Year (reopening) on Wednesday and $22 Bn 30-Year (reopening) on Thursday.

Figure 1: CPI ex Shelter vs. CPI Shelter (%Y/Y)



Source: BLS, Haver, SMBC Nikko

Figure 2: PPI Health Care (%M/M) vs PCE Health Care (%M/M)



Source: BLS, BEA, Haver, SMBC Nikko

Mild and brief or worse?

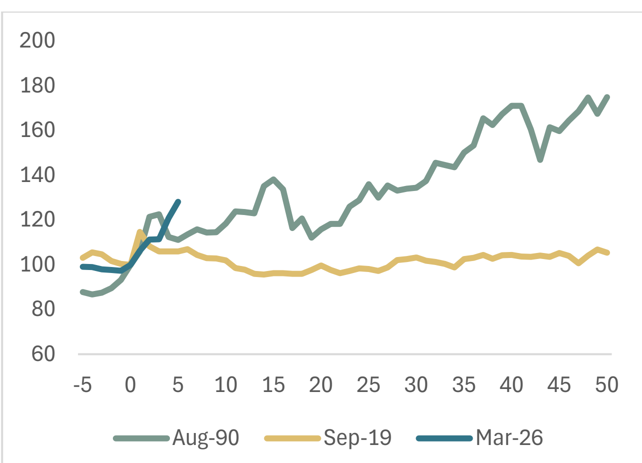
How the economy responds to the conflict in Iran may depend on how high and for how long oil prices stay elevated. **Supply side shocks like the increase in oil prices create a conundrum for the Fed because they reduce growth and simultaneously increase inflation**. And the Fed likely has some lingering memory of the supply chain shock to prices during COVID that morphed into more durable, longer-lasting inflation. Markets expect a short-lived spike in oil prices that the Fed will be able to look through with little or no deviation from its planned policy path. Markets have pushed back the timing of the first full easing to September and look for between one and two rate cuts this year. However, for the Fed to be able look past oil prices, the spike must be brief enough not to shift inflation expectations or dent consumer confidence. **We do not have a strong sense of how long "brief" is**.

To frame the outlook we consider two scenarios – a mild and a harsh one. In both episodes roughly 5% of the world's oil supply was disrupted. However, during the Gulf War (August 1990), the disruption was longer and tipped the economy into recession. By contrast the effects from the drone attack on Saudi Aramco's largest refining facility in September 2019 were quickly reversed with little change in either confidence or inflation. In figure 3, we index oil prices to the level the day before the shock. In the harsh scenario, oil prices rise sharply *and continue* moving higher. **Our sense is that 2w might be long enough to determine whether the Iran conflict is trending toward a 1990 or 2019-style shock**.

Mild: In mid-September 2019, Saudi Arabia's largest oil refinery was attacked by drones and set on fire. While the fire was quickly put out, the plant was taken offline for repairs and Saudi output fell by half. Output was quickly restored – within 2w, output was back to pre-attack levels. During the outage, Aramco was able to draw down oil from storage.

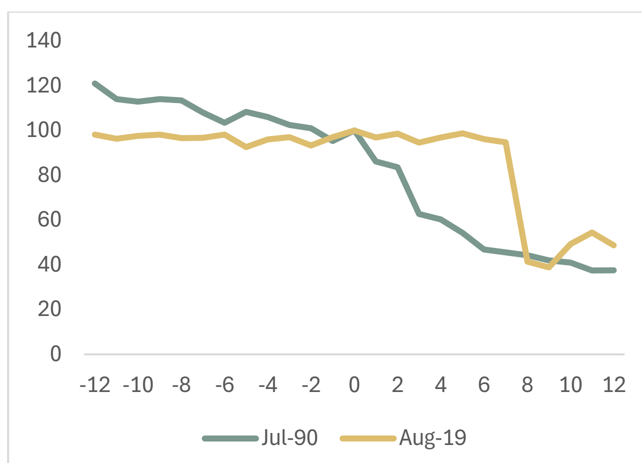
Harsh: After Iraq invaded Kuwait in early August 1990, oil prices moved steadily higher and eventually doubling by October (Figure 3). CPI jumped from 4.8% y/y in July to over 6% by December. And while oil prices were already heading lower by the time Desert Storm began (January 1991), the economy had already slipped into recession. Consumer confidence fell sharply – the Conference Board's measure of present conditions fell over 50% between July and December 1990. The rapid retreat of Iraqi forces by mid-February helped pull oil prices lower despite the destruction of 500 Kuwaiti wells.

Figure 3: Oil prices (index)



Note: Prices are indexed to the day before the shock (0 on the x-axis). Source: Bloomberg, SMBC Nikko

Figure 4: Consumer confidence (index)



Note: Confidence measure is indexed to the month before (0 on the x-axis) the oil shock. Source: Conference Board, SMBC Nikko

In Figure 4, we plot the evolution of consumer confidence. Consumer confidence fell sharply – the Conference Board's measure of present conditions fell over 50% between July and December 1990. By contrast, there was little change in 2019 – at least until COVID.

Rates and curve under the mild and severe scenarios

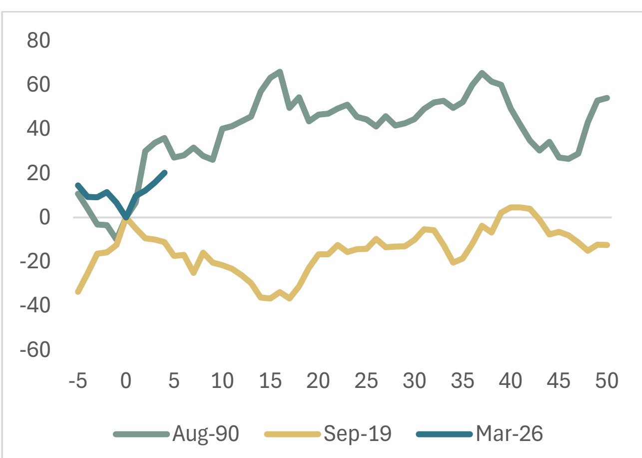
In the mild scenario, the brief spike in oil prices had little direct impact on Treasuries. Instead, 10y yields moved lower, following the September 17, 2019 repo market shock and the corresponding pressure on equities with the curve flattening modestly. By contrast, in the severe 1990 Gulf War episode, 10y Treasury yields moved sharply higher alongside the sustained energy shock. The curve also steepened significantly with the Fed in easing mode.

Why has there not been a flight to quality?

The market's sense that this is closer to 2019 than 1990 might explain why there have been few signs of any flight to quality. Not only have on-the-run Treasuries sold off but there are no signs of money flowing into safe harbors such as Treasury bills and gov-only fund balances. Instead, institutional gov-only money fund balances fell on Wednesday by the most since late January. Likewise, bill yields are still trading above OIS and repo rates have hardly budged.

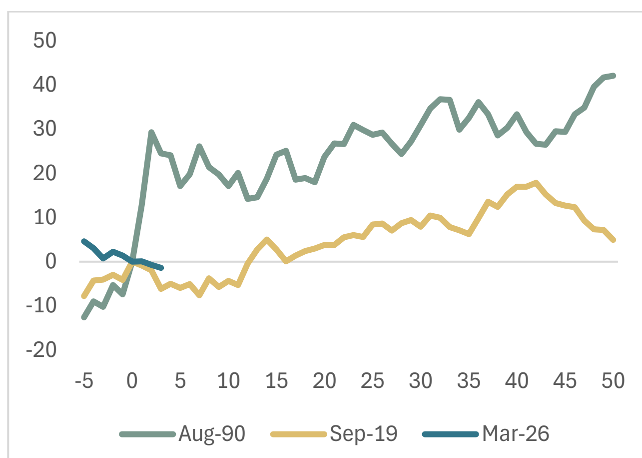
As of writing (9am Friday), nominal 10y yields have risen by 20 bp since the conflict began. However, we believe factors beyond oil prices are playing an important role. First, recent data have surprised to the upside, including the strong ISM reports, a better than expected ADP employment report and lower initial jobless claims. While the payroll report was softer, the initial reaction suggests investors are attributing much of the weakness to weather effects and strike disruptions. Second, positioning in Treasuries was very bullish heading into the Iran conflict, leaving the market vulnerable to a selloff. Decomposing the ~20 bps increase in the 10y yield indicates that about half came from higher real yields (TIPS), and half from wider inflation breakevens. This suggests that that a large portion of the move reflects stronger economic data and market positioning rather than purely oil-driven inflation concerns. Our sense is that markets are not expecting a prolonged rise in oil prices.

Figure 4: 10y Treasury yield change (bps)



Note: Yields changes are from the day before the shock (0 on the x-axis). Source: Bloomberg, SMBC Nikko

Figure 5: 2s10s Treasury curve change (bps)



Note: Curve changes are from the day before the shock (0 on the x-axis). Source: Bloomberg, SMBC Nikko

Weekly economic indicator calendar

SMBC US Forecasts						
Date	Indicator	SMBC Forecast	Market Consensus (Median)	Prior	Range of Est.	Notes:
Mar 10	Existing Home Sales (10 AM)	1.5%	-1.5%	-8.4%	-2.8% - +2.3%	Sitting near record lows at 3910k. Mortgage applications for home purchase down -12.6% MoM.
Mar 11	CPI MoM (8:30 AM)	0.36%	0.2%	0.2%	0.2% - +0.4%	Forecasting: CPI energy at 1.6% MoM; food at +0.3%, shelter at +0.26% MoM.
Mar 11	CPI YoY (8:30 AM)	2.5%	2.4%	2.4%	2.3% - +2.6%	Feb gasoline prices +3.5% MoM, WTI +7.1%, ag & livestock prices +0.5%, used vehicle prices -0.2%.
Mar 11	Core CPI MoM (8:30 AM)	0.26%	0.2%	0.3%	0.2% - +0.4%	Weak national home price growth continues to soften shelter and overall CPI in 2026.
Mar 11	Core CPI YoY (8:30 AM)	2.5%	2.4%	2.5%	2.3% - +2.6%	Core inflation lags incomes by 12 months and suggests continued disinflationary progress.
Mar 12	Housing Starts MoM (8:30 AM)	-4.2%	-3.8%	6.2%	-5.6% - -2.4%	Construction investment continues its steady decline. Homes under construction down -10.5% YoY.
Mar 13	Personal Income (8:30 AM)	0.4%	0.4%	0.3%	0.4% - +0.7%	Strong wage gains (0.4%), NFP (0.08%), and hours suggest strong income gains.
Mar 13	Personal Spending (8:30 AM)	0.3%	0.3%	0.4%	0.1% - +0.5%	Spending is slowing. Real retail sales are -2% below pre-covid trend. Durable goods spending -2.8% YoY.
Mar 13	PCE Deflator MoM (8:30 AM)	0.3%	0.3%	0.4%	0.2% - +0.4%	January CPI +0.17% MoM, core CPI at 0.3% MoM.
Mar 13	Core PCE Deflator (8:30 AM)	0.4%	0.4%	0.4%	0.3% - +0.5%	Likely to be strong as PPI healthcare increased by 0.9% MoM.
Mar 13	Q4 GDP (2nd est.) (8:30 AM)	1.4%	1.4%	1.4%	-	2nd estimate for Q4
Mar 13	Q4 Core PCE Deflator (2nd est.) (8:30 AM)	2.7%	-	2.7%	-	2nd estimate for Q4
Mar 13	U Michigan Consumer Sentiment (10 AM)	55.1	56.3	56.6	54.0 - 57.4	Gasoline prices up 9.1% over first three days of March--sentiment negative.

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	1.4	3.0	1.5	2.6	2.2
Real GDP YoY	2.3	2.2	3.2	2.6	2.1	2.3
Core PCE YoY	2.9	2.9	2.6	2.6	2.3	2.4
Unemployment	4.3	4.4	4.4	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

Disclaimers