SMBC Group

US Rates Strategy Weekly

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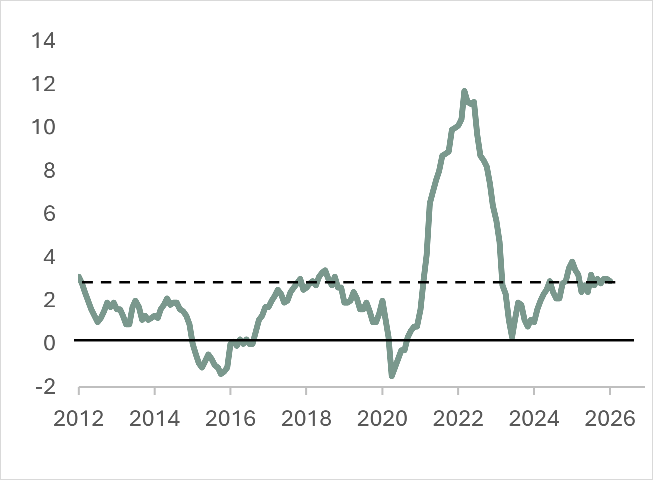
Week ahead

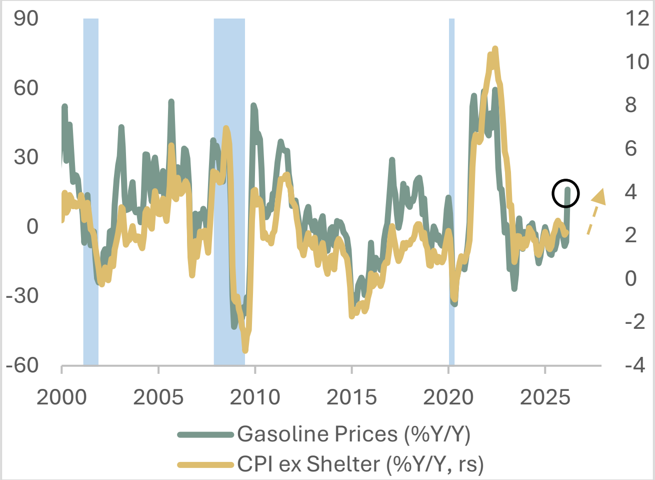
- **Producer Price Index (Feb., Wed.)**: Producer prices as of January were running at a 2.9% y/y rate, which is at the upper end of their pre-COVID range (Figure 1). Supply side pricing pressures were elevated even before the current Middle East conflict took shape and are likely to increase further from here. We are forecasting 0.3% MoM for both the headline and core PPI indices, in line with the consensus. This follows 0.3% and 0.2% increases in the headline and core consumer prices report for February. Critically, producer prices tend to be more sensitive to oil prices, which rose a hearty 7.1% in the month indicating there is some upside risk potential for the release. Oil prices are up 42.8% so far in March.
- **FOMC Meeting (Mar., Wed.)**: This current oil price shock is generating stagflationary pressures for the US and global economies. We estimate that the current shock could lead to the CPI excluding shelter index accelerating to a 3.2% YoY reading from February's 2.2% reading (Figure 2), contributing 0.6 percentage points to headline CPI. This is critical because until there is greater clarity on the geopolitical and oil front, the Federal Reserve is unlikely to adjust the stance of policy, which is currently in restrictive territory. The Fed's rhetoric is likely to highlight this heightened level of uncertainty, while also recognizing this development will bring their employment and prices mandates into greater conflict.
- **UST Auctions:** The Treasury will sell $13 Bn 20-Year (reopening) on Tuesday, $19 Bn 10-Year TIPS (reopening) on Thursday.

Figure 1: Producer Prices Index (%y/y)



Source: BLS, Haver, SMBC Nikko

Figure 2: Gasoline Prices and CPI ex shelter (%y/y)



Source: EIA, BLS, Haver, SMBC Nikko

Energy Shock and the Front-end Repricing

Last week we argued that roughly two weeks might be sufficient to determine whether the Iran conflict would evolve into a **brief 2019 Aramco attack style shock or a more persistent 1990s Gulf War type episode (severe scenario**). Price action in **energy markets is pointing toward the latter**. Oil prices have risen roughly 40% since the conflict began, a much sharper move than the short-lived spike following the 2019 Saudi attack and more consistent with the rally seen during the 1990 Gulf War. As a result, the market response has been dominated by inflation concerns and de-grossing flows.

This repricing has been most visible in the front end. 2y yields have broken above the range that had held since September as markets price out rate cuts and reassess the inflation implications of an energy shock. De-grossing flows that dominated since last week in Europe have also spilled over into the US front end, where heightened uncertainty may have amplified the move.

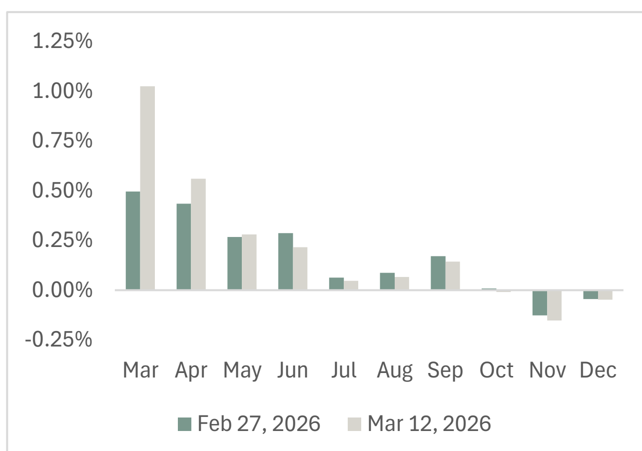
While the flat carry makes long 2y positions tempting, we **do not recommend fading the breakout higher in the 2y yields for now**, particularly with the risk that positioning adjustment continues into the upcoming FOMC meeting.

The CPI fixings are pricing a 0.5% and 0.1% increase in the March and April prints compared to the pre conflict levels. The energy shock now being priced appears more like a level shift rather than a temporary spike that subsequently reverses. **Investors could tactically turn long into or shortly after the FOMC**. We only favor tactical longs with large upside inflation risk, as the rise in commodity prices (Figure 4), combined with potential cyclical tailwind from the OBBB, could keep the front end under pressure (higher yields) until the commodity impulse fades and/or there is deescalation in middle east.

Figure 3: 2y and Bloomberg Commodity Index

Source: Bloomberg, SMBC Nikko

Figure 4: CPI fixings



Source: Bloomberg, SMBC Nikko

Favor Steepeners

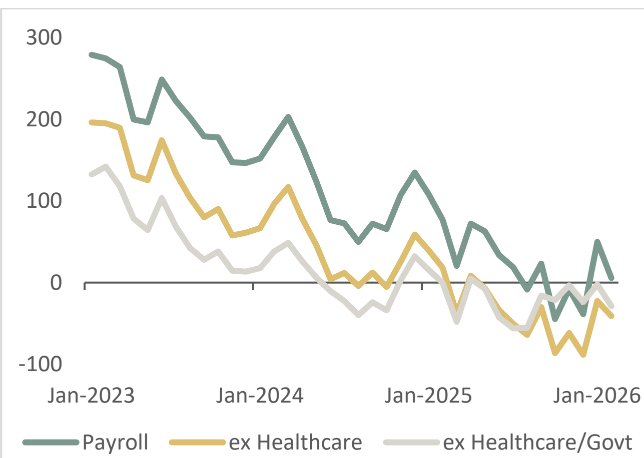
The recent flattening driven partly by moves in European curves, has created attractive entry points levels for steepeners. Inflation is still a risk, but the **hurdle for hikes remains high**. If the Fed looks through supply-driven inflation and weakening consumer confidence starts to feed into growth, cuts would be brought forward versus current market pricing.

The view is reinforced by a labor market that looks weaker below the surface. The unemployment rate remains low and headline payrolls (3mma, Figure 5) have bounced from the Q4 lows, but underlying measures are not showing much improvement. Payroll trends excluding healthcare and excluding healthcare/government remain soft across the 3m, 6m and 12m horizon (Figure 5), suggesting that the recent gains are narrower than it looks. Added to that, worries around potential AI driven labor displacement and private credit have not gone away. Meanwhile, the improvement last year in the budget deficit dynamics could fade if war-related pressure persists.

Environment for carry trades to remain challenging

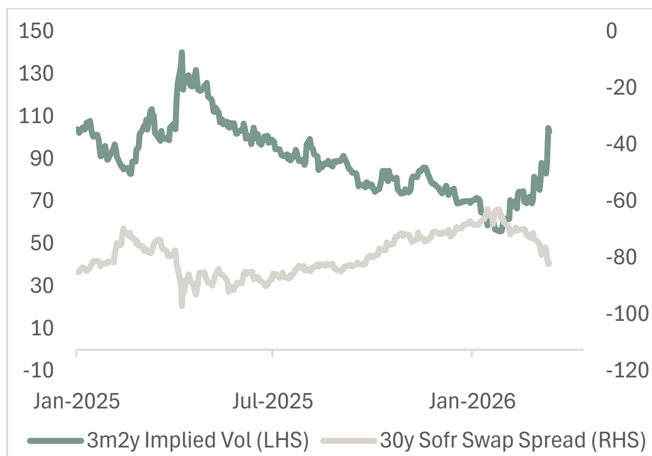
The range trade since September favored carry trades, including short vol positions and long swap spreads expressions. That backdrop has become materially less supportive. First, growth fears resurfaced in February; more recently, the energy supply shock since March has added another layer of instability, leading to stop-outs across popular carry positions (Figure 6).
Valuations are becoming more compelling, with implied vol and spreads now at better levels to enter into carry trades. But the near-term backdrop still argues for caution. Carry may work tactically, but it is unlikely to be a comfortable strategic hold over the next month or so. In this environment, investors should be prepared to harvest gains quickly.

Figure 5: Non-farm payroll (000s, monthly change, 3mma)



Note: Source: Bloomberg, SMBC Nikko

Figure 6: 3m2y implied vol (normal bps) and 30y swap spreads (bps)



Note: Source: Bloomberg, SMBC Nikko

Basel III and more

Bank regulators gave a hint of some of the upcoming regulatory changes they are considering. As Fed Vice Chair Bowman noted this week, a revised Basel III proposal is set to be released this month. **Overall, the intention is not so much to reduce large banks' overall capital requirements, but to enhance their capacity to make markets and provide short-term financing.[1] At the same time, there is some interest**

[1] See, "Capital Rules for the Real Economy", Federal Reserve Vice Chair for Supervision, M. Bowman, March 12, 2026.

in reducing their liquidity burden - perhaps with the hope of allowing the Fed to shrink its balance sheet.[2]

Bank regulators appear to be considering an **expansion of the use of banks' own internal risk models rather than the minimum requirements under the standardized, regulatory risk methodology. Banks will likely still need to prove to the regulators that their internal risk models are fit for purpose.** The standardized approach did not recognize some risk offsets and applied higher weightings on some types of exposures. Likewise, Bowman suggested the CVA capital requirements would focus more on banks and financial contract users as opposed to derivative end users. Separately, FASB recently proposed a short-term project that would allow for interest rate hedge accounting to be applied to HTM portfolios. It is unclear how this expansion might change the maturity composition of banks' Treasury holdings or how much their demand for interest rate derivatives could increase.

GSIB risk surcharge

Regulators seem ready to modify the GSIB risk surcharge. This score is designed so that large banks internalize the systemic risk cost of their size and complexity through higher capital surcharges. First, the risk coefficients will be updated to reflect nominal economic growth since 2015. **The absence of a growth adjustment has meant that over time, banks risk scores have trended higher even though their overall systemic risk profile had not fundamentally changed**. This "risk inertia" has forced banks to diet over time to counteract the upward drift in their scores and capital requirements. **Most of the dieting occurs in the easiest to adjust risk categories of the score: complexity and cross jurisdictional activity**. This meant that banks regularly pulled back from OTC derivatives trading, repo, and XCCY basis trading.

Second, the Fed wants to shift the score to an annual average of daily components rather than the Q4 reading. This reduces incentives to risk-diet at year-end which in the past has created volatility in repo and XCCY basis markets. Keep in mind that some parts of the score are already daily averages - short-term wholesale funding, for example. But the current methodology creates distinctions between elements that are on balance sheet and off.

Third, under the current framework each 100bp increase in the risk score increases a bank's capital surcharge by 50bp. **To eliminate the cliff effects, the Fed is proposing that capital increases be reduced to 10bp.** While her speech does not mention it, our sense is that the Fed wants to keep the same slope in the relationship between capital and risk. This would mean that each 20bp increase in the score would result in a 10bp increase in the required capital.

Finally, it seems that regulators are considering a reduction in the **relative risk weighting of the short-term wholesale funding component (STWF) from 30 to 20%**. The STWF component includes all bank financing - secured and unsecured raised with a maturity of less than 1y. Since most of this is repo, all things equal the reduction in the coefficient weight together with the other changes described above may reduce the regulatory burden of repo lending.

[2] See, "Remarks by FDIC Chairman Travis Hill: An Update on Reforms to the Regulatory Toolkit, FDIC Chair T. Hill, March 11, 2026.

One key takeaway from FDIC Chair Hill’s speech was that regulators might be considering changes **to bank liquidity requirements that would allow banks to include a capped amount of their borrowing capacity at the discount window as part of their HQLA under the LCR and liquidity stress testing requirements**. Rather than holding explicit amounts of bank reserves, banks could assume some pre-determined dollar volume of discount window borrowing in their overall liquidity requirements. Since banks hold over $3trn in pre-placed collateral at the discount window, they could in theory replace reserves with their discount window borrowing assumption. Effectively, banks could "convert" the loan collateral that they pre-place at the Fed into the functional equivalent of bank reserves. This would reduce their demand for reserves and allow the Fed to shrink its balance sheet.

Weekly economic indicator calendar

SMBC US Forecasts						
Date	Indicator	SMBC Forecast	Market Consensus (Median)	Prior	Range of Est.	Notes:
Mar 16	Industrial Production MoM (9:15 AM)	-0.1%	0.1%	0.7%	-0.2% - +0.4%	Normalizing following January surge. ISM mfg production down -2.4 points and raw steel production -13.3% MoM.
Mar 18	PPI MoM (8:30 AM)	0.3%	0.3%	0.5%	0.2% - +0.5%	Headline CPI +0.27% MoM
Mar 18	Core PPI MoM (8:30 AM)	0.3%	0.3%	0.8%	0.2% - +0.8%	Core CPI up 0.22% MoM. WTI up +7.1% in Feb.
Mar 18	Fed Funds Rate (upper bound) (2 pm)	3.75%	3.75%	3.75%	3.5% - +3.75%	Fed is stuck amid stagflationary pressures. Statement rhetoric is likely to turn comparatively hawkish.
Mar 19	New Home Sales (10 AM)	-3.6%	-2.7%	-1.7%	-9.4% - -0.7%	NAHB new home sales index down -2.4% MoM.

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