US Rates Strategy Weekly

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Joseph Abate, US Rates Strategy
joseph.abate@smbcnikko-si.com
1 212 893-1592

Monty Gandhi, US Rates Strategy
mgandhi@smbc-cm.com
1 212 224-5114

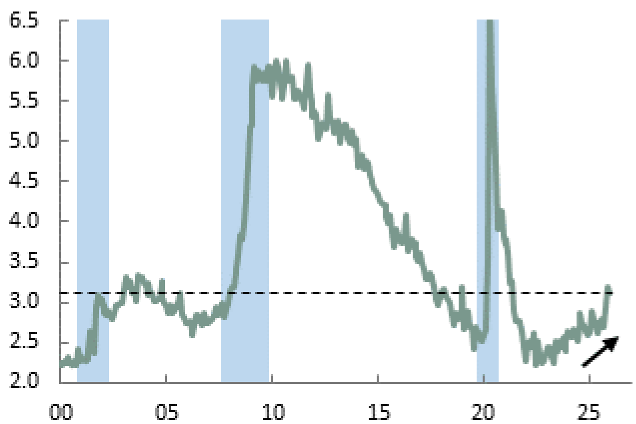
Troy Ludtka, US Economist
troy.ludtka@smbcnikko-si.com
1 212-224-5483

Week ahead

- **Employment Report (Jan., Wed.)**: We are forecasting relatively modest job gains of 62k for headline nonfarm payrolls and 49k for private sector hiring. However, most of the latter is expected to come from an estimated 42k gain in the government-sensitive private education and health services sector. Private payrolls excluding this sector are declining. The cyclical sectors of the labor market are particularly weak. In our view, the decline in labor demand has more than offset the weakness in labor supply (demographics and policy). This is best illustrated by the increase in those "working part time for economic reasons" (Figure 1). We are forecasting an above consensus 4.5% unemployment rate.

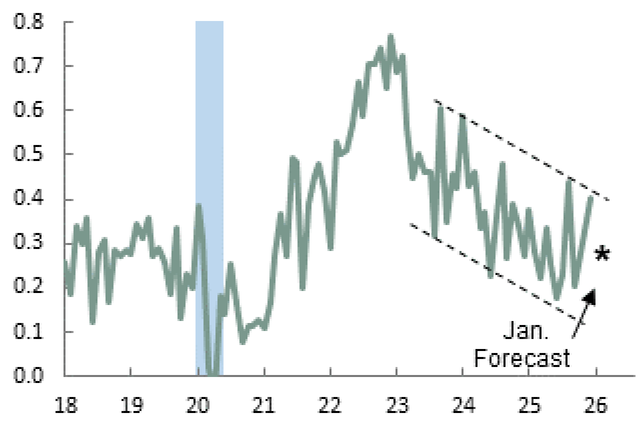
- **Consumer Prices (Jan., Fri.)**: We are forecasting below consensus estimates of 0.21% m/m and 0.26% m/m for headline and core CPI. This is based on forecasts of -0.8% for energy, 0.44% for food and 0.27% for shelter (Figure 2). Gasoline prices declined -2.9% in January and used vehicle prices rose 1.8%. Housing market weakness, quiescent oil prices and a softening labor market all point to lower inflation in 2026.

Figure 1: Those working part time for economic reasons (% labor force)



Source: BLS, Haver, SMBC Nikko

Figure 2: CPI shelter (% m/m)



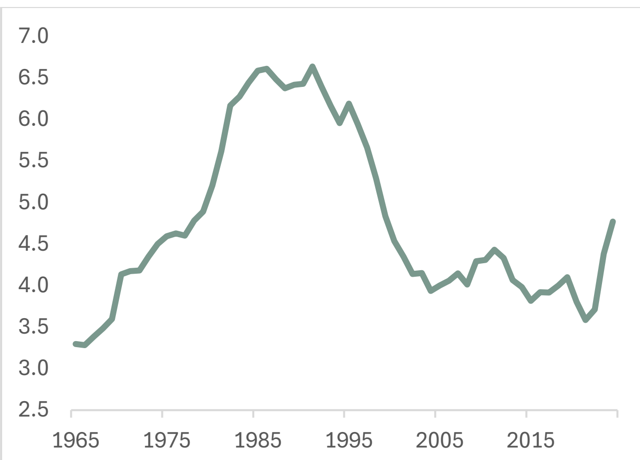
Source: BLS, Haver, SMBC Nikko

A Treasury-Federal Reserve (bill) accord

The new Fed Chair has championed more coordination between the Federal Reserve and the Treasury. **The February quarterly refunding suggests one channel for increased coordination – bill issuance.** Moreover, as we review below, such cooperation has occurred in the (somewhat) recent past.

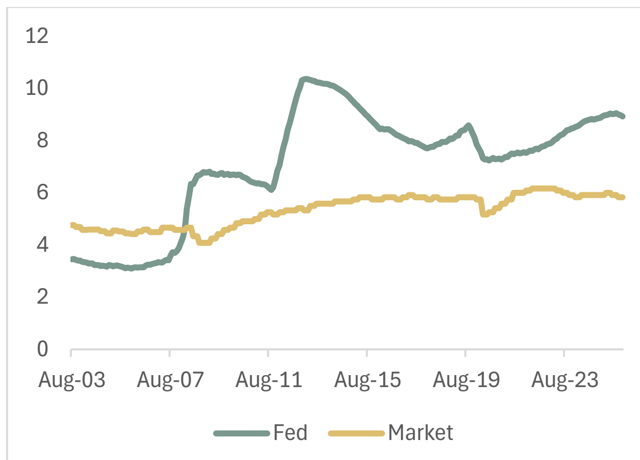
The Treasury would like to keep term interest rates from rising. It can accomplish this while reducing its debt servicing costs by issuing more bills (Figure 3). However, expanding bill supply increases the sensitivity of these costs to changes in the Fed's policy stance. The Treasury's optimal debt mix requires balancing these costs against their volatility. In its November refunding, the Treasury Borrowing Advisory Committee (TBAC) concluded that the Treasury's current maturity mix was roughly optimal and, at the margin, it might be able to reduce debt servicing volatility without much of an increase in cost through heavier short-coupon issuance.

Figure 3: Debt servicing costs (% GDP)



Source: US Treasury, SMBC Nikko

Figure 4: Federal Reserve Treasury WAM (y)



Source: Federal Reserve, US Treasury, SMBC Nikko

In this week's February refunding, the TBAC revisited optimal issuance while considering its interaction with the Fed's portfolio. On a consolidated basis, outstanding debt is the sum of privately held Treasuries and those held by the Fed in its SOMA portfolio. The government is essentially paying itself when it pays interest to the Fed on the SOMA holdings. As noted last week, this is because the central bank remits these earnings (less its operating expenses) to the Treasury. The Fed's decisions about the size and maturity composition of its portfolio influence the volatility of the debt servicing costs on the consolidated debt. It is possible for the Treasury to lower the volatility of its debt servicing costs from increased bill issuance *if* the extra bill supply is absorbed by the Fed.

The Fed is already reducing its portfolio maturity through its RMPs which are directed into bills. It is seeking a more market neutral WAM that matches the maturity distribution of outstanding debt (Figure 4). This is meant to reduce its footprint in term interest rate markets. While we expect the pace of RMPs to slow after the mid-April tax date, we expect the Fed to purchase $400bn or more in bills this year. This would be more than half of new supply. The Fed's bill holdings would grow to about 13% of its (expanding) Treasury portfolio – still well below the market share of 22%.

As the Fed is looking to shorten its portfolio WAM it may make sense for the Treasury to work with the Fed to accommodate their heavier bill demand through expanded issuance. This will not require significant changes to Treasury issuance this year. By keeping coupon auction sizes steady, the Treasury will need to raise an additional $600bn or so in bills. This is more than sufficient to meet the Fed's demand for a shorter portfolio WAM. The $600bn expansion would push the bill/debt ratio slightly higher – to 22.3% from 21.6% in December.

There is precedent for such an agreement. In 2008-2011, the Treasury agreed to issue special purpose bills under the Supplemental Financing Program (SFP). These bills were designed to help the Fed drain bank reserves; the Treasury agreed to keep the money raised in its cash account at the Fed unspent. The SFPs were meant to stand out from regular bill issuance – the 8w maturity was novel at the time, and they were announced separately from the regular bill cycle. SFPs were subject to the debt ceiling so the Treasury had to cut them in 2009-10 which, in turn, created complications for the Fed's reserve management. Ultimately the program ended because the Fed's balance sheet was expanding and in 2013, the Fed created the RRP program to deal with surplus liquidity.

Separately, the quarterly refunding suggests the Treasury expects its non-withheld tax receipts will be strong this April. It looks for its cash balance to reach $1025bn at the end of that month which is higher than the April 30 totals in 2024 and 2025 of $962bn and $678bn, respectively.[1] We look for the Treasury to cut bill issuance by $300bn from mid-April to Memorial Day. The reduction should offset some of the potential funding rate pressure created by the Treasury's elevated cash balance. The supply reduction will likely be concentrated in short maturity (<13w) bills. The Treasury has increased its reliance on these maturities as a substitute for cash management bills.

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[1] Last year's total was dampened by the debt ceiling.

Weekly economic indicator calendar

SMBC US Forecasts						
Date	Indicator	SMBC Forecast	Market Consensus (Median)	Prior	Range of Est.	Notes:
Feb 10	Employment Cost Index (8:30 AM) (Q4)	0.8%	0.8%	0.8%	0.8% - +0.9%	Lags the quits rate and suggests that employment costs should slow from 3.6% YoY to 2.9% by midyear '26.
Feb 10	Dec. Retail Sales (8:30 AM) (Dec.)	0.4%	0.4%	0.6%	0.4% - +0.6%	Total vehicle sales rose +2.5% MoM in December.
Feb 10	Retail Sales ex Autos (8:30 AM) (Dec.)	0.4%	0.4%	0.5%	0.1% - +0.5%	Meanwhile, gasoline prices fell -4.9% MoM in December weighing on nominal retail sales volume.
Feb 11	NFP (8:30 AM) (Jan.)	62k	70k	50k	50k - +130k	Job growth continues to weaken. 3m avg job growth for headline and private NFP at just -22k and +29k.
Feb 11	Private NFP (8:30 AM) (Jan.)	49k	73k	37k	42k - +120k	Forecasting just +7k job gains for private NFP ***excluding*** the private education and health services sector.
Feb 11	Unemployment Rate (8:30 AM) (Jan.)	4.5%	4.4%	4.4%	4.3% - +4.5%	Labor demand continues to soften, but this has been mostly offset by weaker supply from those 55 years+.
Feb 11	Avg. Hourly Earnings (8:30 AM) (Jan.)	0.3%	0.3%	0.3%	0.2% - +0.5%	Quits rate implies that wage growth should slow to pre-pandemic levels (3.4%) from Dec.'s 3.8% YoY rate.
Feb 12	Existing Home Sales (10 AM) (Jan.)	-0.9%	-2.6%	5.1%	-8.7% - +1.2%	Mortgage applications for home purchase increased by +4.9% MoM in January.
Feb 13	CPI MoM (8:30 AM) (Jan.)	0.21%	0.3%	0.3%	0.1% - +0.4%	Forecasting: CPI energy at -0.8% MoM; food at +0.4%, shelter at +0.27% MoM.
Feb 13	CPI YoY (8:30 AM) (Jan.)	2.4%	2.5%	2.7%	2.4% - +2.6%	Jan. gasoline prices -2.9% MoM, WTI +4.1%, ag & livestock prices +1.2%, used vehicle prices +1.8%.
Feb 13	Core CPI MoM (8:30 AM) (Jan.)	0.26%	0.3%	0.2%	0.2% - +0.5%	Weak national home price growth will weigh on shelter and overall CPI in 2026.
Feb 13	Core CPI YoY (8:30 AM) (Jan.)	2.5%	2.5%	2.6%	2.3% - +2.7%	Core inflation lags incomes by 12 months and suggests continued disinflationary progress.

Forecasts subject to change

Source: SMBC Nikko Securities US Economics Forecasts

Quarterly GDP and Rates Forecasts

	2025		2026			
(%)	Q3 Act	Q4F	Q1F	Q2F	Q3F	Q4F
Real GDP QoQar	4.3	1.2	2.4	1.5	2.5	2.4
Real GDP YoY	2.3	2.2	3.0	2.4	1.9	2.2
Core PCE YoY	2.9	2.5	2.3	2.1	2.0	2.1
Unemployment	4.3	4.7	5.1	4.8	4.5	4.5
Fed Funds Rate Upper Bound	4.25	3.75	3.75	3.25	3.25	3.25
2 Year	3.61	3.47	3.25	3.25	3.25	3.25
5 Year	3.74	3.73	3.50	3.50	3.50	3.50
10 Year	4.15	4.17	4.00	4.25	4.25	4.25
30 Year	4.73	4.84	4.75	4.75	4.80	4.85

Source: SMBC Nikko

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