US Rates Strategy Weekly

January 30, 2026

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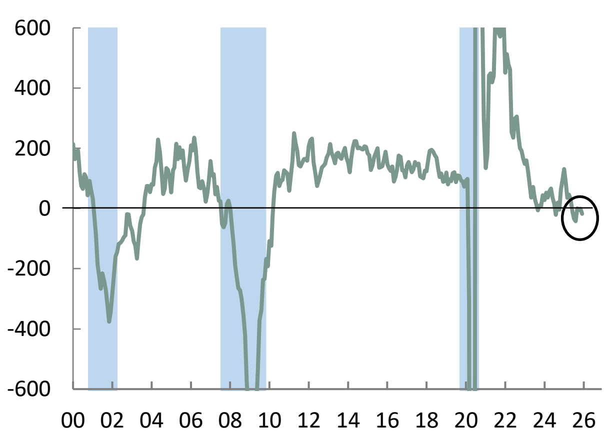
Week ahead

- **ISM Manufacturing (Jan., Monday)**: We are forecasting an above consensus print of 49.1 for the ISM manufacturing index. All headline measures of activity from the regional Fed bank manufacturing surveys increased in January except for Kansas City, which was flat. **ISM Services (Jan., Wednesday)**: Meanwhile, the regional Fed surveys all accelerated for the services sector, signaling strength. We are looking for a 54.0 reading in January.

- **Employment Report (Jan., Friday)**: We are forecasting relatively modest job gains of +62k for headline NFP and +49k for private NFP. However, +42k job gains are expected to come from the government-sensitive private education and health services sector. As shown below (Figure 1), private job gains excluding this sector have been stuck in neutral. The cyclical pockets 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 demonstrated by the increase in “marginally attached workers” and those “working part time for economic reasons” (Figure 2). We are forecasting an above consensus 4.5% unemployment rate for January.

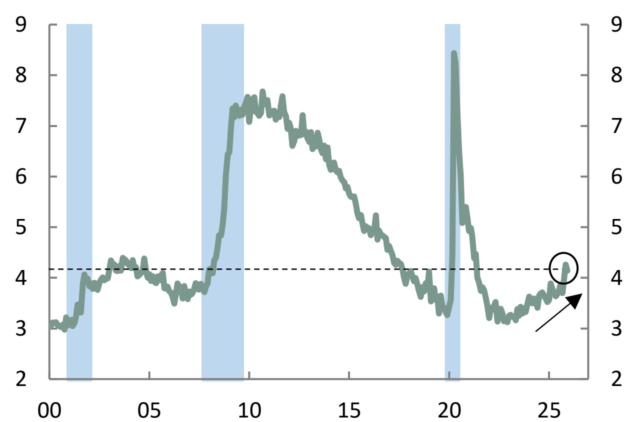
- **Treasury quarterly refunding**: The Treasury will release its borrowing estimates (Monday) along with its projected quarterly issuance on Wednesday. We do not expect any changes to either buybacks or coupon sizes. Markets will be watching for clues about when the Treasury may increase coupon auction sizes.

Figure 1: Private NFP excluding Private Education and Health Services (Thous., 3m ma)



Source: BLS, Haver, SMBC Nikko

Figure 2: Marginally Attached + Those Working Part Time for Economic Reasons (% of LF)



Source: BLS, Haver, SMBC Nikko

Can Warsh deliver a smaller Fed balance sheet?

Wanting a smaller Federal Reserve balance sheet is very different from practically achieving one. As last fall's funding pressure illustrated, the demand for bank reserves - and, as a result, the size of the Fed's balance sheet - is determined by banks' regulatory and internal liquidity needs. If their demand is greater than what the Fed has supplied, repo rates will trade higher and it will become more expensive to finance long Treasury positions.

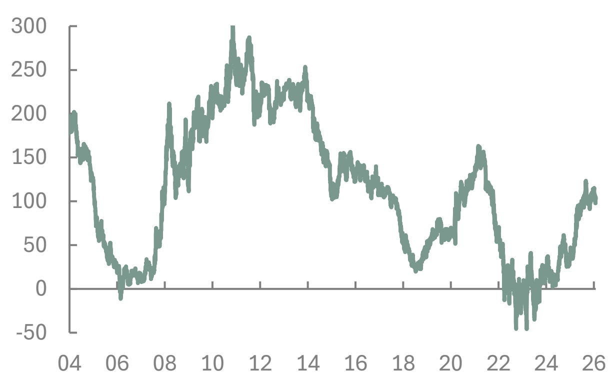
The only way the Fed can accommodate the demand for bank reserves while maintaining a small(er) balance sheet is if it can convince banks to use the SRP or the discount window to monetize their Treasury holdings in a crisis.[1] This would allow banks to replace their reserves with Treasuries to meet their liquidity requirements. But banks are reluctant to use the SRP. And, SRP use is only a temporary solution. As banks grow their demand for regulatory and internal liquidity increases. So, all things equal, the Fed's balance sheet must grow at least as fast as their demand for reserves or there will be continual upward pressure on funding rates.

Case for steepeners

The curve had flattened from early-January highs into the FOMC meeting. We continue to favor steepeners with the carry being less onerous in the 5s30s (Figure 3). Several supportive factors going forward are:

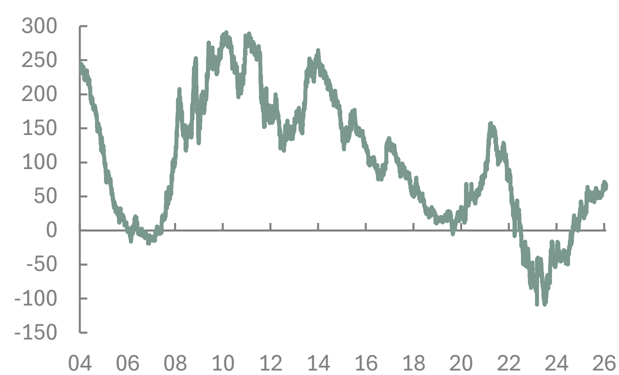
1) **Dovish Powell**: Powell's press conference signaled a low bar for rate cuts despite the statement's upgrade to economic activity and a labor market described as showing "some signs of stabilization."

Figure 3: 5y30y Treasury Spread (bps)



Source: Bloomberg, SMBC Nikko

Figure 4: 2y10y Treasury Spread (bps)



Source: Bloomberg, SMBC Nikko

2) **Geopolitics and oil**: Treasuries should catch a flight-to-quality bid with the curve bull steepening if tensions with Iran increase. Unlike June 2025, where rates sold off in the subsequent two days after the start of the Iran-Israel conflict due to inflation concerns (tariff in the background), the reaction should be different with Chair Powell's confidence that ex tariff inflation is near target.
3) **Warsh favors lower front-end rates**: Unless the data lean strongly against cuts, the markets will expect the new Chair to cut policy rates one or two times after taking office.
4) **Higher Commodities**: Commodities are up 22% from the August lows, adding marginal pressure to the long end, especially with a dovish Fed. A hawkish pivot, by contrast, would shift the bias toward flatteners.

[1] Strictly speaking, the Fed could also reduce bank liquidity requirements. But this would require FOMC support and runs counter to the Basel III principles.

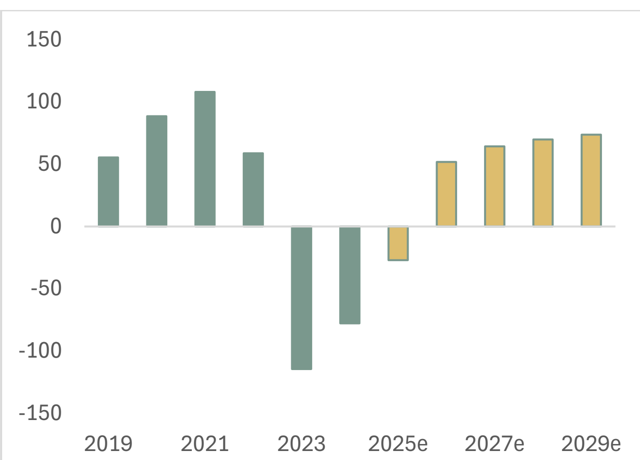
5) The key **risk** would be if the Treasury makes hints about cutting the 10y-30y issuance at next week's quarterly refunding. **However, we think this is unlikely**.

QE effects on Federal Reserve earnings

The Federal Reserve earns interest income from the $6.3trn of Treasury and MBS securities in its portfolio.[2] Last year, the interest income generated from its Treasury and MBS holdings was $155bn.[3] From this, the Fed paid $170bn in interest expenses tied to RRP balances and bank reserves. It also had another $10bn or so in operating expenses, mostly from employee salaries. As a result, its operating income looks to be -$30bn in 2025. This follows on top of steeper income shortfalls in 2023 and 2024 (Figure 5).

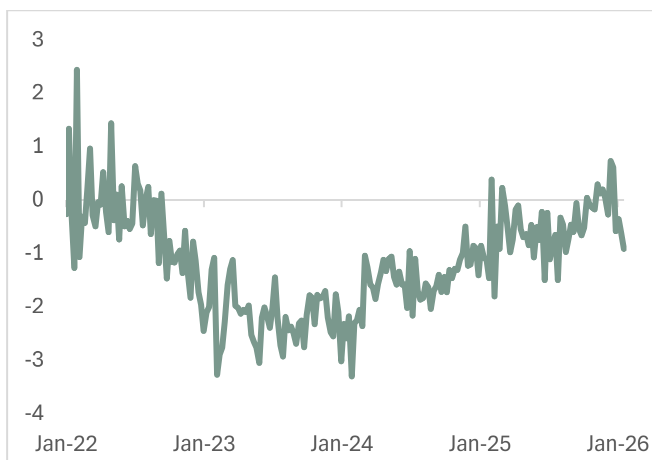
The Fed's negative earnings results from QE and the rapid increase in interest rates that followed beginning in 2022. As the Fed added securities to its portfolio, its interest earnings rose from $102bn in 2020 to $175bn in 2023. To guide term interest rates lower, the Fed purchased longer maturity Treasuries and lengthened its WAM. But it was accumulating Treasuries at the low point in the interest rate cycle – when overnight rates were pinned at 0%. As a result, the weighted average yield on its Treasury holdings fell to just 1.93% in January 2022 and is still only 2.70%. During QT, the Fed initially let its securities holdings fully roll off without replacement. But as it slowed the pace of QT, it began replacing some of the lowest yielding, short-maturity paper acquired in 2020-2022 with higher yielding coupons. Although its reserve management purchases are directed toward bills, the Fed is now fully reinvesting all its maturing coupons. If coupon rates remain higher than they were in 2020-2023, the Fed's interest income will gradually increase. Based on our projections for the size of the Fed's balance sheet and assuming a modest increase in the portfolio yield of 20bp we think the Fed's interest income might reach $210bn by 2029.

Figure 5: Net operating income ($bn)



Source: Federal Reserve, SMBC Nikko

Figure 6: Earnings on remittances due Treasury (change, $bn)



Source: Federal Reserve, SMBC Nikko

[2] We focus on the Fed's income statement. The Fed does not mark to market its securities holdings, so we are ignoring its unrealized, held-to-maturity losses.
[3] All the 2025 figures are annualized totals from the unaudited balance sheet as of September 30.

The Fed's interest expenses have grown faster than its income. The Fed's largest interest-bearing liabilities are bank reserves and the RRP.[4] The Fed does not pay interest on currency or the Treasury's cash deposit. Its interest-bearing liabilities have overnight maturities, so as the Fed raised rates rapidly beginning in 2022, its interest expenses surged from $9bn in 2020 to $281bn in 2023. Likewise, these costs have fallen (to about $170bn in 2025) as the Fed loosened policy. Assuming the Fed cuts rates twice this year, we estimate that its interest expenses will fall to $110bn from $170bn in 2025. Even if rates hold at this level through 2029, the Fed's IORB expenses will increase as bank reserves steadily grow to match bank demand. **That said, we think the Fed's net income will turn positive this year for the first time since 2022.**

Treasury remittances

Ordinarily, the Fed would remit any surplus income to the US Treasury. But when its income is negative it suspends remittances and creates a (cumulative) deferred asset. The deferred asset is used to keep a running tab of the shortfall. Before the Fed can resume its Treasury remittances, it needs to "earn back" all its past negative income. Over the last three years, the Fed's negative earnings have grown to $245bn. Interestingly, the balance has stopped growing since last fall – that is, for the first time since late 2022, the Fed's earnings are roughly offsetting its expenses (Figure 5). The $50bn in projected 2026 earnings, however, are not large enough to resume remittances. **Instead, depending on the path of interest rates, our rough projections suggest that the Fed may not be able to resume Treasury remittances until after 2029.**

Separately, QE created a similar dynamic on bank balance sheets. As the Fed's balance sheet grew, so did banks'. Their assets increased as bank reserve balances swelled to nearly $4.3trn and their securities holdings increased. On the opposite side of their balance sheet, banks' non-interest-bearing deposits climbed. However, once the Fed began pushing interest rates higher, banks began losing these balances to money funds and the prices on their holdings of low coupon securities fell. This dynamic created stress at some banks heavily reliant on uninsured, flight-prone deposits in March 2023. **While QE is still part of the Fed's policy toolkit, our sense is that its appeal has diminished somewhat since 2023**.

[4] While balances in the domestic program are near zero, central banks maintain about $375bn in the foreign RRP program. The interest rate on both programs is the same.

Weekly economic indicator calendar

SMBC US Forecasts						
Date	Indicator	SMBC Forecast	Market Consensus (Median)	Prior	Range of Est.	Notes:
Feb 2	ISM Manufacturing (10 AM)	49.1	48.3	47.9	48.0 - +48.6	Regional Fed mfg surveys all accelerated on a month over month basis except for Kansas City which was flat.
Feb 4	ADP Employment (8:15 AM)	40k	48k	41k	45k - +119k	Expecting continued job market weakness, primarily in the cyclical sectors (housing, energy, mfg, et al).
Feb 4	ISM Services (10 AM)	54.0	53.0	54.4	52.8 - 54.1	All regional Fed services surveys accelerated on a month over month basis. Portends a strong ISM print.
Feb 6	NFP (8:30 AM)	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 6	Private NFP (8:30 AM)	49k	73k	37k	42k - +120k	Forecasting just +7k job gains for private NFP excluding the private education and health services sector.
Feb 6	Unemployment Rate (8:30 AM)	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 6	Avg. Hourly Earnings (8:30 AM)	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 6	U Mich. Consumer Sentiment (10 AM)	56.7	54.7	56.4	-	

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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