

US Rates Strategy Weekly

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- The Fed is expected to keep rates hold at next week's meeting. We look for it to resume hiking at its December 9 meeting.
- **We look for the Treasury to keep auction sizes steady until February 2028 at which point it will begin increasing coupons in the 2-5y maturities.** We expect bill issuance to increase nearly \$1trn next year to 23.7% of outstanding debt.
- Markets appear more focused on potential supply *reductions* in longer maturities. While this may be discussed with the Treasury Borrowing Advisory Committee at next week's refunding, we think changes in auction sizes are unlikely.
- **Instead, we think the Treasury is more likely to increase the size of its long-maturity liquidity buybacks.** The market expects these will be financed through heavier bill issuance; effectively twisting the yield curve.
- **The success of any twist – either through reduced term issuance or increased buybacks - depends on the strength of bill demand.** If demand is strong enough the Treasury can replace its higher cost debt, dollar-for-dollar, with cheaper bills.
- But while bill demand remains strong, we do not think the Treasury can increase the bill/debt share to 25% without causing bill/OIS spreads to widen.
- **We look for a strong increase in Q3 GDP of 3.6% q/q led by a 3.4% q/q increase in consumption.**
- In early October, Treasuries' negative correlation with oil flipped, while their correlation with equities also reversed. Tactical Treasury shorts were likely unwound between mid-September and present, but material structural shorts remain.

No change

We do not expect any changes to the funds target or the Fed's description of current conditions. Commentary from various Fed officials before the blackout period appeared to push back against market expectations of a rate hike. While Chair Warsh studiously avoids giving forward guidance, his colleagues appear to be less restrained.

More important will be how the Chair describes financial conditions and inflation in his post-FOMC press conference. The September inflation readings were higher-than-expected. Warsh noted in September that financial conditions were hardly restrictive. He also described the September hike as a dose of

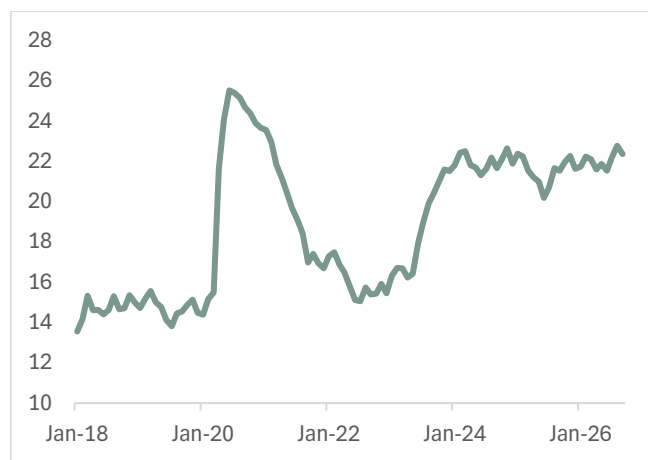
“accommodation removal”. We suspect that there are some members on the Committee who still feel this way. They may even feel strong enough about removing last year’s insurance easings to dissent at this week’s meeting. At the same time, financial conditions have eased slightly with 10y yields lower and equities higher. The bond market is pricing in only 2.5 hikes through year-end 2027, down from almost four in late September. The terminal rate implied from SOFR contracts has fallen nearly 30bp since October 7 (the high in 10y yield) largely from growth and AI-related uncertainty.

Chair Warsh’s opening remarks are considerably more hawkish than his answers. We think this reflects his “word hedging” and the tendency of reporters to ask similar questions meant to elicit some amount of forward guidance.

Refunding outlook

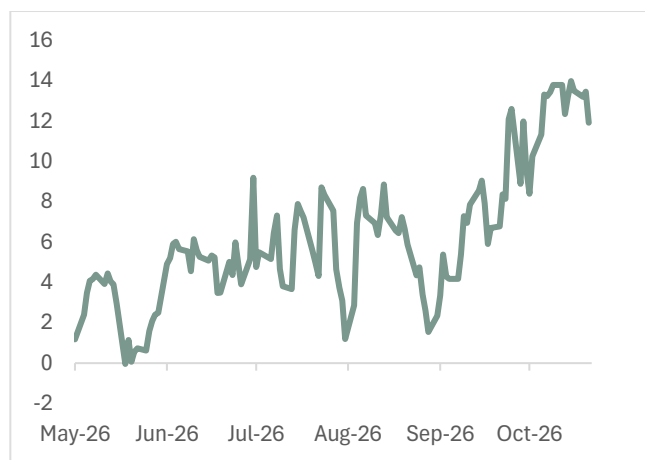
We do not expect any surprises at this week’s refunding. The Treasury is likely to retain its language from the August and earlier refundings on keeping coupon auction sizes steady for “at least the next several quarters”. **We look for the Treasury to keep auction sizes steady until February 2028 at which point it will begin increasing coupons in the 2-5y maturities.** It will meet next year’s financing need and a projected year-end cash balance of \$1trn through heavier bill issuance. We think this will increase bill supply by \$1trn next year – or to 23.7% of outstanding debt (Figure 1). We also think the Treasury will pursue investing some of the Treasury’s cash held at the Fed in the repo market. But it still needs to work out the details. We expect further discussion of the plan in this month’s TBAC minutes.

Figure 1: Bills (% outstanding debt)



Source: US Treasury, SMBC Nikko;

Figure 2: 3m bill less OIS (bp)



Source: Bloomberg, SMBC Nikko

Markets appear more focused on potential supply *reductions*. The Treasury’s surprise buyback increase this summer has heightened expectations of a more “activist” Treasury focused on reducing term interest rates. Such an approach to issuance could include trimming the sizes of longer maturity coupons and even, potentially, eliminating a maturity. While these changes may be discussed at the Treasury Borrowing Advisory Committee (TBAC) meetings, we do not expect the Treasury to reduce auction sizes. **As we discuss below, while the demand for bills is strong, we don’t think it is robust enough to support an expansion beyond 25% of outstanding debt without some back-up in bill/OIS spreads (Figure 2).**

Instead, **our sense is that the Treasury may decide to increase the size of its liquidity buybacks**. At the September Treasury conference Deputy Treasury Secretary Brooke noted that the decision to increase them in August was driven by strong interest from market participants in longer maturity bonds.¹ That said, about 3/5 of the securities repurchased since the start of the program in May 2024 have been short maturities (through its cash management buyback operations). This month's refunding questionnaire inquired whether dealers had noted any changes in customer flows and market liquidity following their August decision. Our sense is that it might be too soon for changes in dealer behavior given the current size of these operations.

The Treasury also asked if there were any enhancements it could make to improve their "effectiveness". Earlier this year, the Treasury broadened counterparty access to include large asset managers. We think it might review additional changes with the TBAC this month including larger and more frequent liquidity operations. But significantly narrowing on-/off-the-run spreads could require buying more longer-term issues at higher prices to absorb more of their outstanding supply.

Bill demand

Of course, whatever the Treasury buys back needs to be funded through increased issuance. The market expects that increased buybacks will be financed through heavier bill issuance. This would make them fundamentally different from its other buybacks where it is curve-neutral. Instead, the Treasury would use these operations to twist the yield curve.

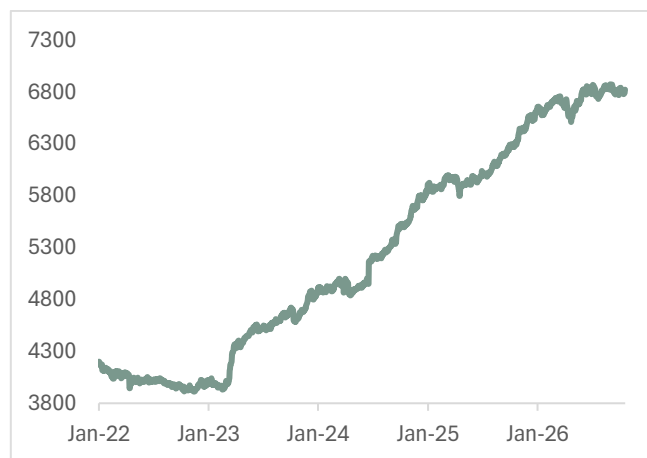
The success of any twist – either through reduced term issuance or increased buybacks - depends on the strength of bill demand. If demand is strong enough the Treasury can replace its higher cost debt, dollar-for-dollar, with cheaper bills.² And while the demand for bills is robust, about half comes from money funds. Other investors – stablecoin issuers and the Federal Reserve – hold smaller amounts. We also think there has been a bit of DIY demand from new buyers this year. This a corollary of the hyperscalers' heavy borrowing. Much of the cash raised temporarily sits in short-maturity bills until it is deployed. They keep the cash raised in bills (and deposits) as money funds have average charged expenses of 24bp.

But money market balances have risen just 3% this year (Figure 3). We think this could accelerate as bill yields increase with the Fed's tightening. However, inflows are unlikely to match their 2022-23 pace. Banks are less over-deposited than they were in 2022 and before the Fed started shrinking its balance sheet (Figure 4). Our sense is that deposit betas (or the sensitivity of deposit rates to changes in the fed funds rate) could be higher this cycle than in 2022 as banks compete more aggressively to keep balances.

¹ See "Remarks by Deputy Secretary of the Treasury Francis Booke" September 22, 2026

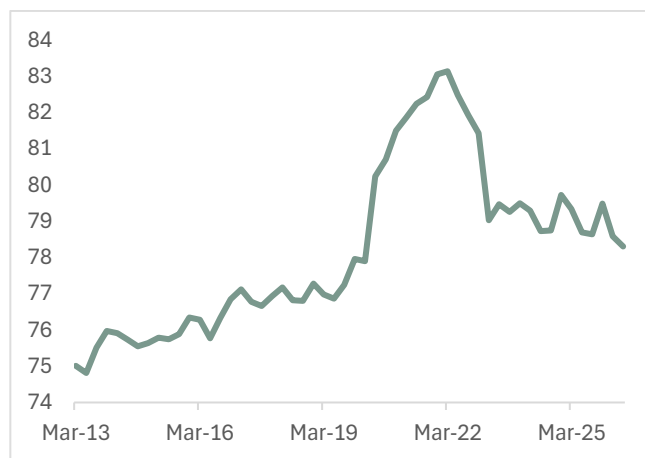
² We are ignoring the increased roll-over risk that makes the Treasury's debt servicing costs more sensitive to changes in monetary policy.

Figure 3: Gov-only fund balances (\$bn)



Source: US Treasury, SMBC Nikko;

Figure 4: Deposits (% bank assets)



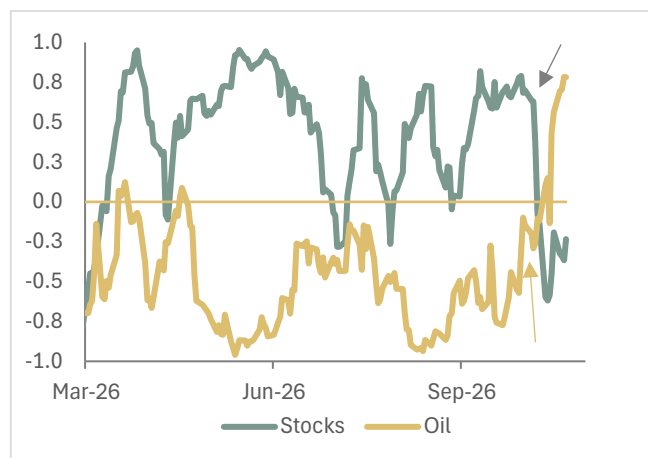
Source: FDIC, SMBC Nikko

Separately, we expect the Fed will restart its RMPs in November ahead of next April's peak in the Treasury cash balance. We look for \$25bn in secondary market bill purchases from the program. RMPs may grow to \$45bn in mid-December and continue at that rate through mid-March. For all of 2027, the Fed would absorb \$200bn in bills – increasing its bill holdings to \$825bn and 16% of its Treasury holdings. In the near-term, we look for the Fed to increase this share to a market neutral level of 24% (assuming our issuance projections are correct). But its balance sheet task force may recommend a higher bill share. Chair Warsh is opposed to QE but at the zero lower bound he might prefer maturity extension purchases (MEPs) to negative interest rates. Holding a larger portion of the SOMA portfolio in bills would allow the Fed to roll these issues into term coupons without expanding its balance sheet. Of course, he may be just as cool to these purchases as, like QE, they are meant to reinforce forward guidance.

Changing Correlations

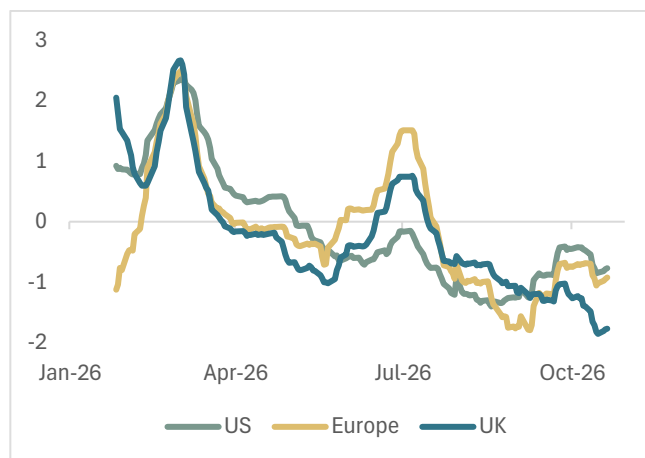
Ten-year yields are testing the 5% level, having rallied from the 5.36% intraday high on October 7, as concerns around France and AI investment fueled a risk-off flight to quality. The charts below show an important shift in cross-asset correlations: Treasuries flipped from a negative correlation with oil (higher oil, lower Treasury prices) to a positive one in early October, while their previously positive correlation with equities (lower stocks, lower Treasury prices) also reversed. This is consistent with a safe-haven bid for Treasuries. Interestingly, the OAT selloff and corresponding safe-haven bid into 10y Bunds led to a peak in yields in Bunds on September 28, roughly a week before the turn in U.S. Treasuries.

Figure 5: Treasury Index rolling correlation (2w)



Source: Bloomberg, SMBC Nikko;

Figure 6: CTA Positioning (Z score)



Source: FRB, Bloomberg, SMBC Nikko

Positioning unwinding to continue

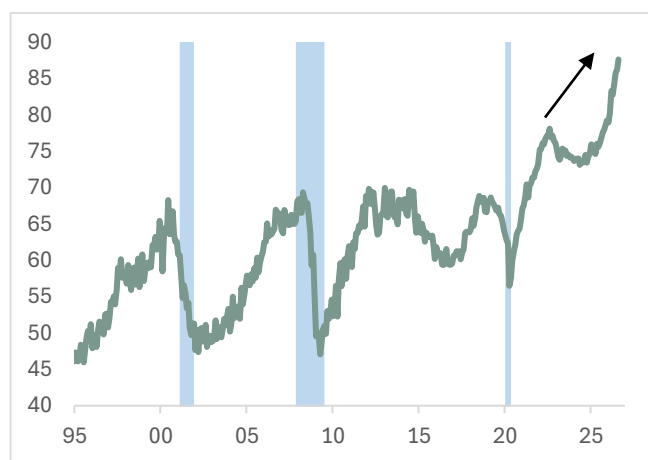
While some tactical shorts were likely unwound between mid-September and early October, structural shorts remain in Treasuries. Figure 6 shows that CTA positioning is less short than in late August, but remains net short. Short-term CTAs may have largely unwound their shorts, with some medium-term CTAs beginning to follow, while long-term CTAs remain short. Either way, an increase in volatility should lead to further risk reduction among systematic investors.

If the risk-off environment persists, markets may begin to question whether all the anticipated AI-related capex will materialize. Such a repricing could provide an additional tailwind to Treasuries.

Week ahead

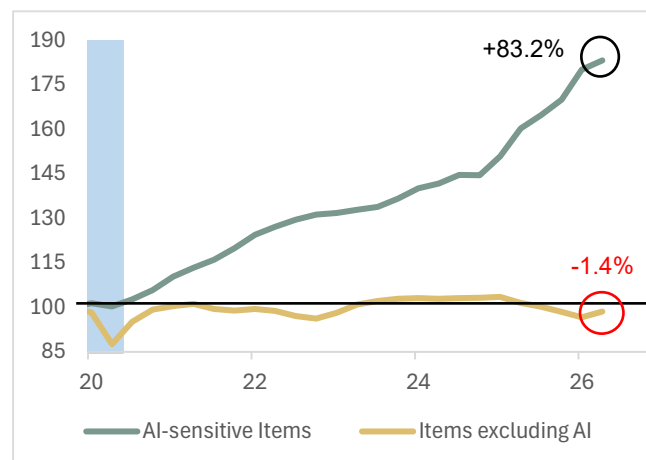
- Durable goods (Sep, Tues):** We are forecasting a 1.3% m/m increase in durable goods new orders and a 0.5% m/m increase for new orders excluding transportation items. New orders of computers and electronic equipment have risen 13%y/y – nearly their fastest pace on record – reflecting the AI buildout. This may have also boosted new orders for primary metals, fabricated metal products and machinery. Core capital goods new orders have risen 14.1% y/y (Figure 7).
- GDP Report (Q3, Thurs):** We look for a strong increase in Q3 GDP of 3.6% q/q led by a 3.4% q/q increase in consumption. The AI buildout is pushing capital expenditures and fixed investment higher (Figure 8). We look for equipment investment to increase 14.6% q/q this quarter and 11% q/q in Q4. However, residential investment is set to fall 5.2% q/q this quarter as affordability remains poor and demand is weak.

Figure 7: Core capital goods orders (\$bn)



Source: Census, Haver, SMBC Nikko

Figure 8: AI and other investment (Q4 2019 = 100)



Source: BEA, Haver, SMBC Nikko

Table 3: Economic indicator forecasts

SMBC US Forecasts						
Date	Indicator	SMBC Forecast	Market Consensus (Median)	Prior	Range of Est.	Notes:
Oct 27	Durable Goods New Orders (8:30 AM)	1.3%	1.4%	-0.1%	0.5% - +4.0%	Unfilled durable goods orders have grown 8.8% y/y, and are now at record highs in level terms of \$1.6T.
Oct 27	Durable Goods ex. trans (8:30 AM)	0.5%	0.5%	0.2%	0.3% - +1.0%	Unfilled durable goods orders have grown 7.2% y/y, and are now at record highs in level terms of \$600B.
Oct 27	Case Shiller Home Prices (9:00 AM)	0.4%	0.3%	0.3%	-	Prices likely to be pressured lower. Housing is facing another demand shock from interest rates.
Oct 27	New Home Sales (10 AM)	-5.6%	-5.5%	6.4%	-7.9% - -1.3%	Pending home sales fell -7.3% in September to record lows. Housing demand is highly constrained.
Oct 28	Fed Funds Rate (Upper) (2:00 PM)	4.0%	4.0%	4.0%	4.00% - 4.25%	We are forecasting no move in October but a rate hike in December.
Oct 29	Personal Income (Sep) (8:30 AM)	0.4%	0.3%	0.2%	0.2% - +1.1%	Incomes were likely soft as payrolls grew by 0.02% m/m, wages increased by just 0.1%, hours were flat at 34.4.
Oct 29	Personal Spending (Sep) (8:30 AM)	0.6%	0.5%	0.9%	0.3% - +0.8%	Retail sales increased by 0.77% m/m in Sep.
Oct 29	PCE Deflator (Sep) (8:30 AM)	0.52%	0.5%	0.3%	0.4% - +0.6%	September CPI increased by 0.65% m/m.
Oct 29	Core PCE Deflator (Sep) (8:30 AM)	0.31%	0.3%	0.2%	0.2% - +0.4%	September core CPI increased y 0.33% m/m.
Oct 29	Q3 GDP (8:30 AM)	3.6%	3.0%	2.2%	2.5% - +4.1%	Drivers: PCE, equipment and IP investment, inventories.
Oct 29	Q3 PCE (8:30 AM)	3.4%	3.5%	3.8%	3.2% - +3.6%	Real retail sales increased by 3.1% QoQar in Q3.
Oct 29	Q3 GDP Deflator (8:30 AM)	3.4%	3.5%	6.1%	2.9% - +4.1%	Q3 CPI increased just 1.7% QoQar, while WTI fell -7.5% QoQ, and gasoline prices decreased -2.2% QoQ.
Oct 29	Q3 Core PCE Deflator (8:30 AM)	2.9%	2.4%	3.3%	-	Q3 Core CPI increased 2.3% QoQar. The core PCE-core CPI spread sits at 0.56%—highest since June 2010

Forecasts subject to change

Source: SMBC Nikko Securities US Economics Forecasts

Table 4: Federal Reserve communication

Federal Reserve Communication		
Oct 28	2:00 PM	October FOMC Meeting and Rate Decision.
Oct 30	12:00 PM	SF Fed President Daly (2027 voter) gives Introductory remarks.
Oct 30	12:30 PM	St. Louis Fed President Musalem (2028 voter) delivers keynote address.

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