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IDEA

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US Economics and Fixed Income Strategy | North America

October FOMC Reaction: Tightening without urgency

We think the statement and press conference signaled further tightening, but without urgency. We continue to expect two more 25bp hikes in December and March, bringing the terminal range to 4.25-4.5%.

Key points

- The Fed's measured approach, tightening financial conditions, and Chair Warsh's emphasis on productivity-led growth suggest less need for aggressive tightening.
- Balance sheet reform could begin in 2Q27. Warsh expects task force recommendations in 1Q27, with any policy changes following a period of careful consideration of the proposal.
- The Fed will maintain eight annual FOMC meetings but reduce rate-setting meetings to seven in 2027 and six in 2028, reserving the remaining meetings for broader monetary policy strategy discussions.
- Our rates strategists suggest investors remain neutral to their benchmarks in duration and curve, but maintain SFRZ6Z7 curve flatteners.
- Our FX strategists note that USD looks modestly cheap relative to recent moves in rates, oil, and French spreads, supporting our expectation for a stronger USD.
- Our agency MBS strategists stay long the basis with nominal spreads near the wides, though recognizing OAS levels are less compelling.
- Our muni team expects supply will rebound, but stay neutral on muni duration here.

Michael T Gapen
Chief US Economist
Michael.Gapen@morganstanley.com +1 212 761-0571

Matthew Hornbach
Strategist
Matthew.Hornbach@morganstanley.com +1 212 761-1837

Jay Bacow
Strategist
Jay.Bacow@morganstanley.com +1 212 761-2647

Sam D Coffin
Economist
Sam.Coffin@morganstanley.com +1 212 761-4630

Diego Anzoategui
Economist
Diego.Anzoategui@morganstanley.com +1 212 761-8573

Arunima Sinha
Global Economist
Arunima.Sinha@morganstanley.com +1 212 761-4125

Heather Berger
Economist
Heather.Berger@morganstanley.com +1 212 761-2296

Lingdi Xu
Economist
Lingdi.Xu@morganstanley.com +1 212 761-2957

Andrew M Watrous
Strategist
Andrew.Watrous@morganstanley.com +1 212 761-5287

Martin W Tobias, CFA
Strategist
Martin.Tobias@morganstanley.com +1 212 761-6076

Mark T Schmidt, CFA
Strategist
Mark.Schmidt1@morganstanley.com +1 212 296-8702

Aryaman Singh
Strategist
Aryaman@morganstanley.com +1 212 761-1993

Eli P Carter
Strategist
Eli.Carter@morganstanley.com +1 212 761-4703

Janie Xue
Strategist
Janie.Xue@morganstanley.com +1 212 761-6051

Jacob F Bjurstrom
Strategist
Jacob.Bjurstrom@morganstanley.com +1 212 296-4544

investors should be aware that the firm may have a conflict of

Research as only a single factor in making their investment decision.

For analyst certification and other important disclosures, refer to the Disclosure Section, located at the end of this report.

US Economics: Tightening without urgency

Michael Gapen
Michael.Gapen@morganstanley.com +1 212 761-0571

Sam Coffin
Sam.Coffin@morganstanley.com +1 212 761-4630

Diego Anzoategui
Diego.Anzoategui@morganstanley.com +1 212 761-2305

Arunima Sinha
Arunima.Sinha@morganstanley.com +1 212 761-4125

Heather Berger
Heather.Berger@morganstanley.com +1 212 761-2296

Lingdi Xu
Lingdi.Xu@morganstanley.com +1 212 761-2957

The decision: As expected, the Fed kept the target range for the policy rate unchanged at 3.75-4.0% and it made no changes to its balance sheet policies. We continue to project two additional 25bp rate hikes, one in December and the second in March, for a terminal target range of 4.25-4.5%.

Key takeaway: We continue to expect fewer rate hikes than the market. We read the Fed's actions and guidance, the chair's belief that AI spending is not immune to higher interest rates, the perceived tightening in financial conditions, and the chair's view that supply-side forces are driving growth as consistent with our outlook that the Fed will hike fewer times than is priced into the market. The gap between market pricing at 2.8 additional hikes (of 25bp each) and our forecast (2 additional hikes) is smaller than it was a few weeks ago, but the gap remains.

Key takeaway part 2: Balance sheet reform might be a 2Q 27 story. Chairman Warsh expects the balance sheet task force to deliver its recommendations in 1Q27. However, any policy decision will follow "serious consideration of their proposals and recommendations." We think this is consistent with balance sheet policy implementation beginning in 2Q27.

Key takeaway part 3: Moving from 8 policy-based FOMC meetings to 6 over two years. The Fed will maintain eight meetings annually. But starting in 2027, one meeting will be dedicated exclusively to broader monetary policy strategy discussions, increasing to two in 2028. These meetings will not include a vote on the federal funds rate or a policy statement.

We expand on our reasoning for expecting fewer rate hikes than markets below:

The evidence suggests to us that an aggressive tightening cycle is not the plan. We harken back to the chair's speech at Jackson Hole where he told a story of how invited guests to the Fed's annual economic symposium could enjoy the surroundings by taking a leisurely hike or an aggressive hike, which we interpreted as a story of what may lie ahead for monetary policy. In our view, the Fed's decisions and actions since then point to a "leisurely" pace for rate hikes, or what we have referred to as a measured recalibration of monetary policy.

The Fed's actions and guidance do not suggest urgency. The Fed raised its policy rate in September, projected modest further rate hikes on roughly a quarterly basis in the Summary of Economic Projections, and provided forward guidance during the intermeeting period that did not signal urgency (at least everyone except the chair who declined to provide a projection or explain his thinking). Then the Fed stayed on hold this month.

AI-related capex spending is not immune to higher interest rates. A commonly held view about the US economy at present is AI-related spending is unaffected by changes in interest rates and geopolitics. Proponents of this view use this to argue for resiliency of US growth and the connectivity between AI-related spending, asset prices, and spending by upper income consumers. We are in this camp generally, while recognizing it likely holds true for highly-rated hyperscalers more than lower-rated hyperscalers. We found it noteworthy that Chair Warsh had a different view.

In our view, a Fed chair that sees modesty higher interest rates as likely to dent AI-related spending is not thinking about an aggressive tightening cycle, which reinforces our conclusion above. We provide his response to the question about interest rates and the sensitivity of AI capex spending in its entirety below (with light editing):

> "So there was a narrative for quite a while, maybe even in this room over the course of the last several press conferences, well, [the Fed is] going to raise rates or talking about raising rates, but it's not going to have any effect on AI because the returns that investors are expecting are so different.
>
> I was skeptical of that view. Interest rates get in the cracks. Interest rates affect directly or indirectly almost everything. And what have we seen since early September? What we've seen inside of the technology complex, outside of the technology complex...interest rates have had an effect. You see market participants that are discriminating between the kinds of investments they want to make. You've seen credit spreads for certain assets widen out, gap out. For others, you've seen some tightening in financial conditions, but not significantly.
>
> So, on the thrust of your question of with respect to the new technology and this investment surge, do interest rates matter? I believe they do, and I don't believe that they're somehow divorced from the rest of the economy.

Financial conditions have tightened. Chair Warsh also indicated that the Fed's prior action to raise its policy rate, among other items, tightened financial conditions. He said:

> "Since our policy action in September, we have started to see so
> financial and credit conditions. They have tightened for some bu
> households, much as we would expect, market participants are b
> somewhat more discerning in their capital allocations. And while
> conditions are tighter, I'm unwilling and unable to call them tight
> these developments go in the direction of achieving a longer, mo
> of economic growth and price stability"



followed by,

"A dominant means by which this policy will be put into practice is we are tightening financial conditions. They have tightened a bit since we met last time. That is not something we are uncomfortable with. It tells me that policy is working, and we can do that and make the economy more durable, have it last longer, and still achieve stable prices."

His language here remains a bit of a conundrum – financial conditions tightened, but are not tight – and is similar to language he used in September when he characterized the rate hike as "removing a dose of accommodation." Nonetheless, if the Fed sees financial conditions as tightening, then there is reason to do less rather than more.

The chair sees growth as supply-side driven. Whether the Fed sees activity as driven by demand- or supply-side forces is important for the outlook for monetary policy. In this regard, Warsh gave a strong nod in the direction of growth being supported by supply forces that are boosting productivity. He did not say that productivity-led growth would cause disinflation and Fed cuts, but it could be used to justify fewer hikes if strong growth did not cause inflation to firm. He said:

"Productivity has been moving higher in the economy, however imperfectly measured, for a couple of years. Economic growth is higher, but it does not tell me that economic growth is somehow causing inflation, making our job harder.""The goal in my view, you have heard me say this before, is not to throw sand in the gears of the economy, throw people out of work. I don't think we have to do that."

Global Macro Strategy

Matthew Hornbach, CMT
Matthew.Hornbach@morganstanley.com +1 212 761-1837

Andrew Watrous
Andrew.Watrous@morganstanley.com +1 212 761 5287

Martin Tobias, CFA, CMT
Martin.Tobias@morganstanley.com +1 212 761-6076

Shaun Zhou
Shaun.Zhou@morganstanley.com +1 212 761-1993

Eli Carter
Eli.Carter@morganstanley.com +1 212 761-4703

Modest medicine, modest curve steepening

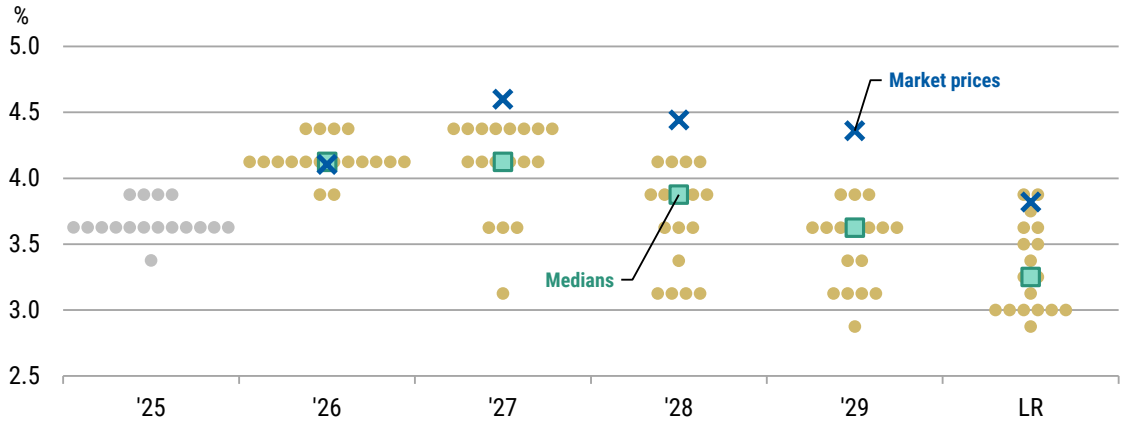
The yield curve steepening in response to Chair Warsh's press conference accelerated after he answered a question on whether a part of the statement meant that the current level of the rate might already be the right one. Chair Warsh said:

> *...the overwhelming consensus, the overwhelming judgment, is that what we've done with this modest medicine is starting to work some, but there are no firm conclusions. If we had a firm conclusion about the conduct of monetary policy, we'd announce it to much fanfare today.*

To our ears, this sounded dovish relative to the then-prevailing, high (>90%) market-implied probability of a 25bp rate hike at the December meeting. This dovish spin drove the curve steeper with longer maturity bond yields rising on the day.

The positive term premium in the market price for Fed policy makes it clear how investors see the skew of risks: to the hawkish side (see Exhibit 1 for how the market prices the path for Fed policy relative to the median FOMC participant's modal expectations).

Exhibit 1: FOMC participants' assessments of appropriate monetary policy: midpoint of target range or target level for the federal funds rate: September 2026, medians, and market pricing



How investors assess the evolution of these risks and how FOMC participant modal expectations shift around determines how the market prices the path of Fed policy. And, as we've shown for several years now, the pricing of Fed policy influences Treasury yields significantly – even at the 10y maturity point (see Exhibit 2).

The risk premium in the Treasury market over-and-above that which relates to the Fed policy remains stable – and has done for six months now (see Exhibit 3).

- Absent a strong view on more idiosyncratic events that could move Treasury yields, investors need a view on how the market will reprice either expectations and/or risk premiums related to Fed policy to take risk in the Treasury market.

Exhibit 2: Market-implied trough fed funds rate vs. 10y US Treasury yield

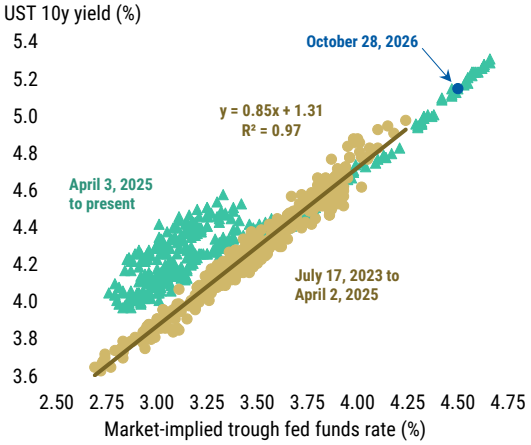
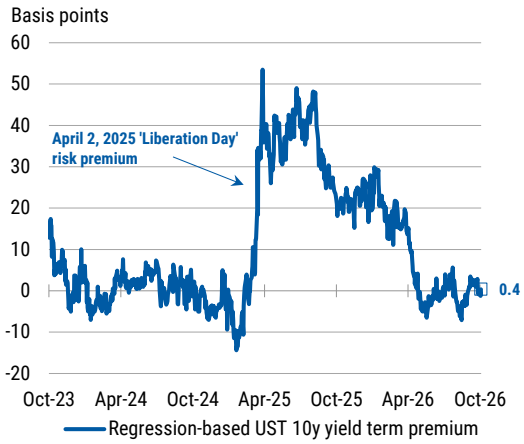


Exhibit 3: Market-implied trough fed funds rate vs. 10y US Treasury yield regression residual



At the moment, we lack the type of conviction needed to suggest a risk position. As such, we advise investors remain neutral to their benchmarks in duration and curve.

Financial conditions in focus, maintain SFRZ6Z7 flatteners

We think Chair Warsh's assessment of monetary medicine starting to work referred to changes in financial and credit conditions since the 25bp rate hike in September. He later made a specific reference to interest rates effects on financial and credit conditions:

> *Interest rates affect directly or indirectly almost everything. And what have we seen since early September?...What we've seen inside of the technology complex, outside of the Technology complex...Interest rates have had an effect. You see market participants that are discriminating between the kinds of investments they want to make. You've seen credit spreads for certain assets widen out, gap out. For others, you've seen some tightening in financial conditions, but not significantly.*

From our vantage point, overall financial conditions will factor into the accumulation of more information that will help determine the appropriate policy stance.

We have believed risky assets – most sensitive to the marginal cost of capital – would be an important gauge to monitor for investors moving on from pricing persistent policy restraint to pricing the economic consequences of such restraint.

Chair Warsh spotlighted the recent shift in correlations between oil prices and interest rates. This correlation shift reflects concerns about future activity are beginning to outweigh the inflation risks that still should weigh on duration's hedging properties.

In that context, we think the positive term premium in the market price for Fed policy has ample room to compress, as this monetary medicine continues to do its work.

- Market pricing implies Fed policy will remain restrictive for the foreseeable future – with the trough fed funds rate well above the median longer-run dot.

We illustrate – using different SOFR futures curves – how market participants have increasingly concentrated pricing for higher rates in the latter half of 2027.

- We think this leaves the Z7 contract vulnerable to a repricing as investor reassess the risk of continued tightening in financial and credit conditions.

Exhibit 4: Market-implied trough fed funds rate and FOMC median long-run dot

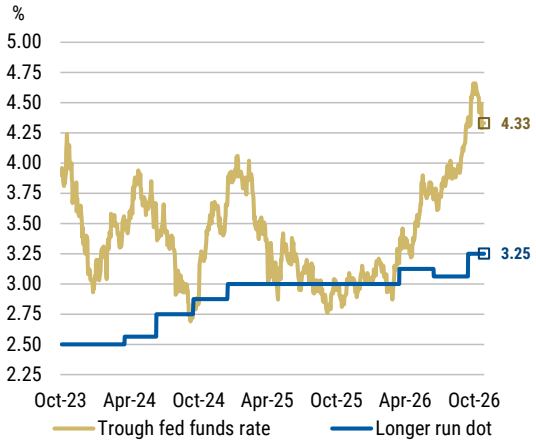
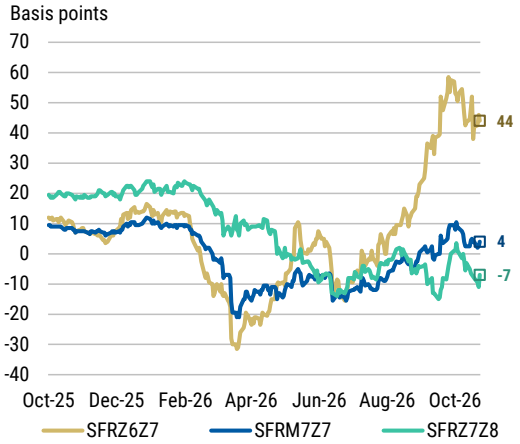


Exhibit 5: SOFR futures curves: Z6Z7, M7Z7, and Z7Z8 over the past year



The rolling 20-day R2 of the trough fed funds rate and SFRZ6Z7 provides empirical evidence of how SFRZ6Z7 flatteners can express the view for a lower trough rate.

- Movements in the trough rate have explained ~75% of the variation in the SFRZ6Z7 curve over the most recent rolling window period.

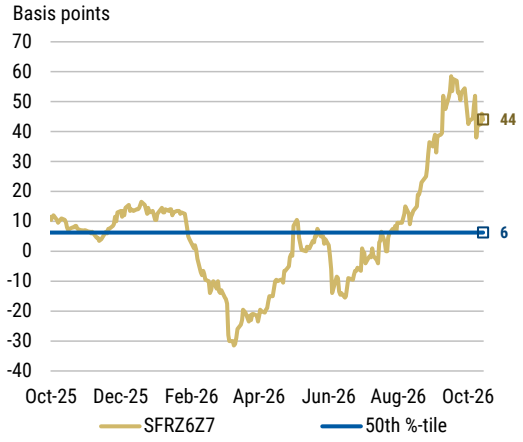
From a technical and relative value standpoint, the recent steepening in SFRZ6Z7 has taken the curve to levels well in excess of its median over the last year.

- The distance from its historical reference levels suggests the curve has recently become increasingly extended.

Exhibit 6: Rolling 20-day R^2 between the market-implied trough fed funds rate and SFRZ6Z7



Exhibit 7: SFRZ6Z7 curve over the last year and 50th percentile mark



We think the combination of an usually steep curve, growing divergence between the trough rate and longer-run dot, and strengthening relationship between SFRZ6Z7 and the trough rate all create a more compelling case to fade the recent steepening.

- We suggest investors maintain SFRZ6Z7 curve flatteners with tighter financial conditions presenting an avenue for why the Fed could deliver less hikes than implied by market pricing.

How much can volatility drop for strategy meetings?

At his press conference, Chair Warsh announced plans to restructure the FOMC meeting schedule starting in fall 2027. The Fed will retain eight meetings annually, but one meeting in 2027 will focus exclusively on monetary policy strategy, with no rate decision or policy statement expected. In 2028, two meetings will be dedicated to strategy, leaving six regular policy-setting meetings.

The most immediate implication is for short-dated option volatility. Options typically price an event risk premium ahead of FOMC meetings, with greater uncertainty around the policy decision commanding a higher premium. Meetings designated exclusively for strategy discussions should carry little, if any, policy event premium.

While the timing of these meetings remain uncertain, we use the past two years of data to estimate the potential impact on the volatility surface once the schedule is confirmed.

Methodology

We use aggregate Fed OIS trading volume reported to SDR as a proxy for uncertainty surrounding each FOMC meeting. We define Fed OIS as swaps maturing on an FOMC date, with a start date of either spot (T+1) or another FOMC date.

For each meeting, we compare aggregate Fed OIS volume over the preceding four weeks against a six-month baseline. A higher volume ratio signals greater perceived uncertainty around the policy decision. SDR volumes are capped, and we make no adjustments for these caps.

To measure the FOMC event premium, we calculate the change in 1m expiry implied volatility from the close before the meeting to the close after the meeting. This captures the volatility repricing as policy uncertainty is resolved, although other market developments may also contribute.

Key Findings

Higher Fed OIS activity is associated with a larger decline in 1m expiry volatility around FOMC meetings, confirming our thesis that greater policy uncertainty commanding a higher event premium.

- The relationship is stronger for the 2y tail, reflecting its greater sensitivity to monetary policy expectations. The 10y tail shows a weaker but still positive relationship.
- The regression implies little volatility repricing when the volume ratio is near 1x, consistent with limited event premium when Fed OIS activity remains near its baseline.
- **A 2x Fed OIS volume ratio is associated with approximately 14bp/year of event premium for the 2y tail and 8.5bp/year for the 10y tail**.

These results suggest that replacing regular policy meetings with strategy-only meetings could reduce the event premium embedded in short-dated options, particularly for the 2y tail. The magnitude will depend on the meeting schedule and the extent to which markets continue to price policy-relevant uncertainty around strategy discussions.

Exhibit 8: Market prices in higher risk premium (1m2y vol) for meetings that carry higher uncertainty

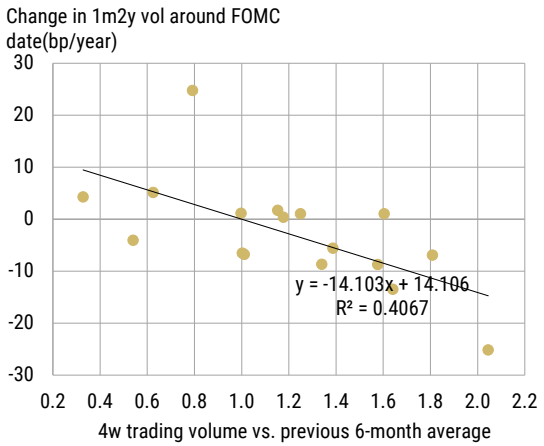
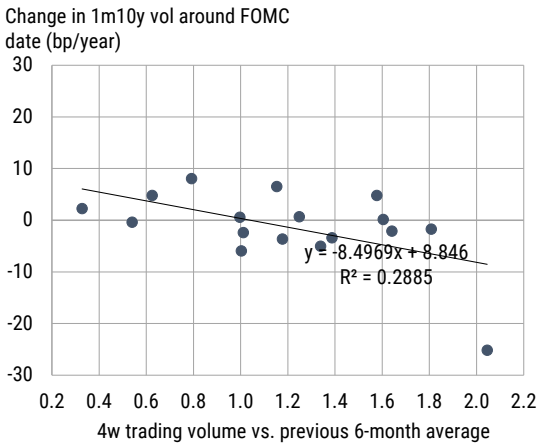


Exhibit 9: Market prices in higher risk premium (1m2y vol) for meetings that carry higher uncertainty



- **Trade idea: Maintain SFRZ6Z7 curve flattener at +44bp with a target of +10bp and an initial stop of +55bp.**
- **Trade idea: Maintain long 2-year (Sep '27) UST SOFR swap spreads at -7bp with a target of 0bp and a trailing stop of -8bp.**

USD outlook

The USD still screens as modestly cheap relative to recent moves in macro fundamentals. We continue to recommend long USD positions versus JPY.

We consider three market proxies for major global macro narratives: (1) differences in central bank reaction functions (proxied by 2y yield differentials, Exhibit 10); (2) energy prices; and (3) the spread between 10y OAT and Bund yields (Exhibit 11).

Exhibit 10: DXY and yield differentials

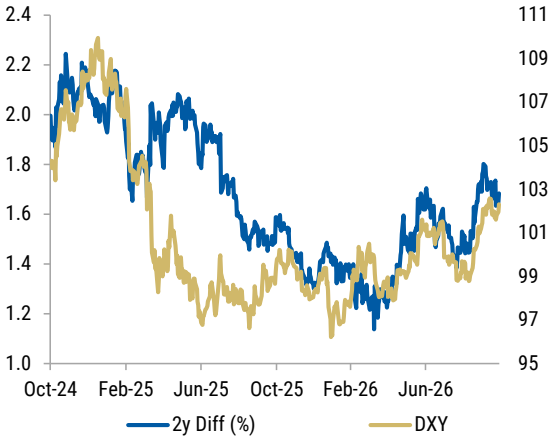


Exhibit 11: French spreads and energy prices

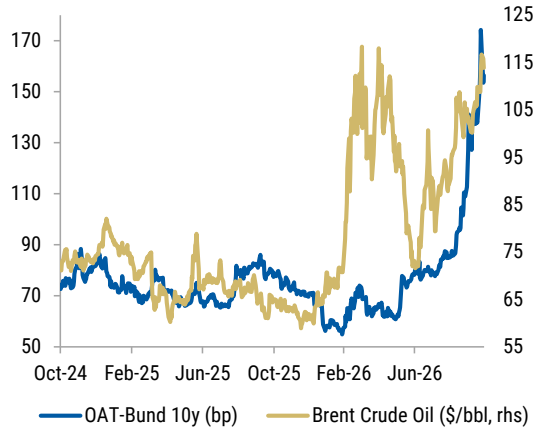


Exhibit 12 shows the sensitivity of the DXY to changes in each of these variables over the past 6m, 1y, and 2y, controlling for movements in the other two variables.

For example, over the past six months a 1% rise in oil prices has been associated with a 0.045% rise in the DXY, holding 10y OAT-Bund spreads and 2y US-RoW rate differentials constant. And over the past two years, a 1bp rise in 2y US yields relative to DXY-weighted RoW yields has been associated with a 0.034% rise in the DXY, controlling for oil prices and French spreads.

Exhibit 12: Regression betas

	Dollar Index Sensitivity (Weekly % Change β)		
	6m Window	1y Window	2y Window
10y OAT-Bund (per bp)	0.021%	0.049%	0.045%
2y Diff (per bp)	0.081%	0.054%	0.034%
Brent Oil (elasticity)	0.045%	0.040%	0.032%
R^2	0.57	0.37	0.21

Exhibit 13: Residuals

	DXY Residual (%)		
Horizon	6m β	1y β	2y β
1 m	0.2%	-1.1%	-1.0%
3 m	-1.3%	-3.0%	-2.3%
6 m	-	-2.6%	-1.5%

Exhibit 13 applies these historical sensitivities to changes in each variable over the past 1m, 3m, and 6m. The residual measures the difference between the DXY's actual performance and what movements in these three variables would have predicted.

At most horizons, the USD appears cheap relative to these macro indicators, as changes in rates, oil prices, and French spreads would suggest greater USD appreciation than has occurred.

French spreads are particularly notable. The recent widening in OAT-Bund spreads has historically been associated with a substantially larger increase in the DXY than observed recently. As we discuss here, we think EUR-negative risk premium could increase as the first round of the French presidential election approaches and markets increasingly price in fiscal tail risks.

US Agency MBS

Jay Bacow
Jay.Bacow@morganstanley.com
+1 212 761-2647

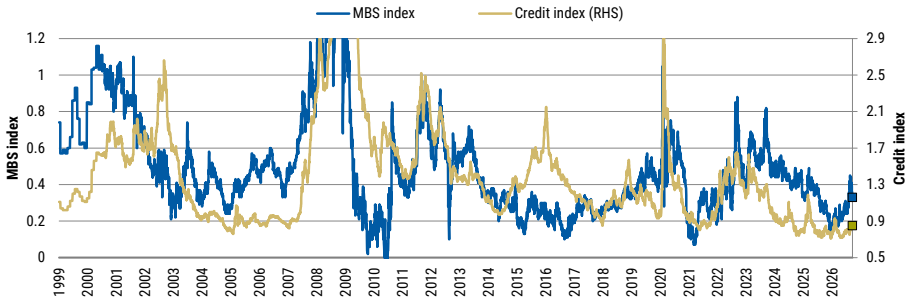
Janie Xue
Janie.Xue@morganstanley.com
+1 212 761-6051

Jacob Bjurstrom
Jacob.Bjurstrom@morganstanley.com
+1 212 296-4544

On a day where the market wasn't expecting much from the Fed, the Fed delivered not much, and thus vol fell and mortgages outperformed modestly. The two key things from today on the Fed side are the repricing lower of Fed expectations, with about 1/5 of a hike coming out of 2027 Fed expectations, and the announcement that 2027 will see only seven live meetings and 2028 only six. Working under the simplified assumption that the Fed would want to get to the same place at the same time using only live meetings, fewer live meetings mean fewer vol events but the vol on each Fed day is higher.

In the grand scheme of things, this probably doesn't have a huge impact on the level of things like 1yr10yr, though obviously calendar spreads will be priced massively differently depending on if they cover a live Fed meeting. What might matter on the margin is that if each live meeting is more volatile, then investors' realized P&L on those days would also be larger. Those investors who use something like the five worst drawdown days to measure risk would then likely have slightly lower risk tolerances, implying somewhat reduced leverage in the system. This could be a marginal headwind for trades with lots of embedded leverage like the Treasury basis trade or mortgage positions.

Exhibit 14: The mortgage index has tightened off the wides while credit has widened off the tights



While this note is an FOMC reaction, we'd highlight two other stories today that were risk positive. First, Fannie reported 3Q26 earnings, and they appeared to have added about $9bn of securities in September and $13bn in TBA over the quarter. The $9bn increase was their largest increase since March, and we'd note that September was the local wides in the basis. It's possible that the GSEs could be providing something of a backstop bid for mortgages if/when spreads get wide, which would clearly be a positive.

Secondly, this past week we had mentioned the decoupling of the basis-rate correlation, as the concerns around AI-funding stresses had caused a flight-to-quality rally in rates but not a correspondent tightening in the basis that we had previously seen in rates rallies. A

number of tech companies announced earnings today, but ORCL credit spreads tightened by the most in nine months after saying it would undertake just $20 billion of additional capital raises the next several years. Basically, if the GSEs can take some of the tail risk out of mortgage widening and hyperscalers can take some of the tail risks away from too much issuance, then risk assets should be in a better place.

Exhibit 15: Yield on mortgages are near highs, though not as attractive to the forwards

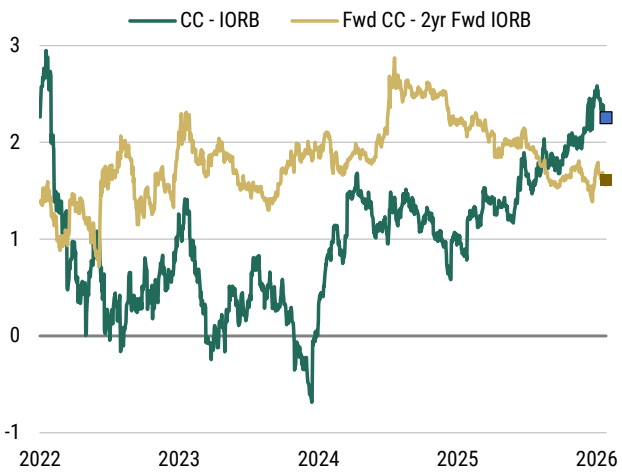
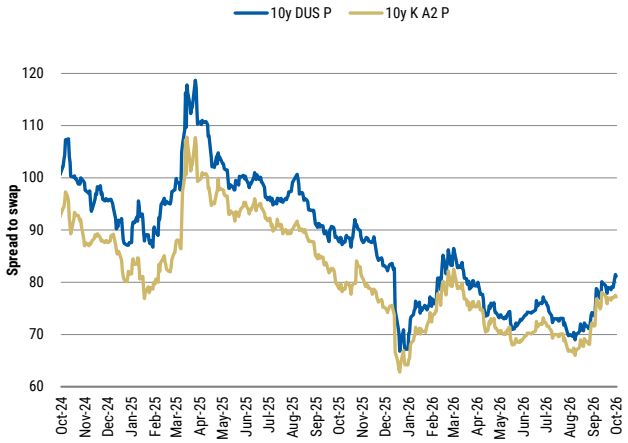


Exhibit 16: 10yr MF spreads to swaps are near the wides of the past 8 months



At this point, we continue to like holding mortgages, but recognize that valuations are less compelling than they have been adjusted for vol (i.e., on an OAS basis). That said, the elevated levels of vol have kept nominal spreads at effectively the wides of the year, which could bring in continued demand. Our preference is to hold exposure in one of three ways:

1. Par coupon Ginnie TBA which are trading quite cheap to conventionals and vs rates and likely have less policy risk given how efficient their refi program already is.
2. Conventional loan balance to protect against some of the prepay concerns and get more clarity in model uncertainty.
3. 10yr multifamily which has cheapened up but could also benefit from increased bank demand as banks will be able to hedge interest rate risk in HTM (see our latest weekly).

We continue to think that around these rate levels supply and origination will be minimal while demand from GSEs, future demand from sovereign wealth funds, and inflows will be supportive. Our concerns are macro risk and a worsening convexity profile impacting par coupon, particularly from both things like the recent executive order and AI improvements on the consumer side.

Munis: Green October

Mark T Schmidt, CFA
mark.schmidt1@morganstanley.com
+1 212 296-8702

The Fed meeting capped off a remarkable October for tax-exempts. A December hike could provide a reality check.

We continue to expect that issuers will resume issuance to get ahead of a potential December hike. With nearly $3bn of new issue ratings reports filed so far this week, we anticipate a building calendar after election day.

As the cyclical low in visible supply reverses, we expect sideways performance for 10Y and 30Y ratios. We remain neutral on muni duration for several reasons:

- Fall seasonals may turn favorable, given a relative lack of "full" trading weeks left in the year.
- Retail sentiment towards municipals remains positive.
- A midterm election that results in a "blue wave" could cause munis to outperform as investors draw early conclusions about 2028, and anticipate higher marginal tax rates under the next presidential administration.

Valuation Methodology & Risks

Exhibit 17: GMS live trades and recommendations

Interest Rate Strategy				
TRADE	**ENTRY LEVEL**	**ENTRY DATE**	**RATIONALE**	**RISKS**
SFRZ6Z7 flattener	42bp	10/23/2026	We think the combination of an usually steep curve, growing divergence between the trough rate and longer-run dot, and strengthening relationship between SFRZ6Z7 and the trough rate all create a more compelling case for fading the recent steepening.	The main risk to the trade is stronger-than-expected economic activity or an increase in the perceived neutral rate could keep the December 2027 implied rate elevated.
Long 2y (Sep '27) UST SOFR swap spread	-21.6bp	10/3/2025	We expect softer funding conditions and a steepening of the very front end to cause swap spreads in the front end to widen given recent relationships.	Risks to the trade include firmer funding than expected or a stabilizing job market.
Currency and Foreign Exchange				
TRADE	**ENTRY LEVEL**	**ENTRY DATE**	**RATIONALE**	**RISKS**
Long USD/JPY	153.40	9/11/2026	We think expectations for GPIF repatriation looks too speculative, while rising oil prices and markets' pricing of a high US terminal rate continue to support the pair.	A key risk to this trade is that JPY carry positions continue to be unwound, driven by the further speculation about repatriation from GPIF and Japanese investors more broadly.

Exhibit 18: Agency MBS live trades and recommendations

Trade	Entry Date	Rationale	Risks
Long 10y K A2 on swap	10/23/2026	Consistent demand further supported by HTM hedging rule, high quality carry	Corporates widening/rotational move
Long lower payup loan balance with some WALA 5.0s vs TBA	10/2/2026	Very low payup, OAS pick, two-sided convexity	Roll goes special
Long G2 6.5 and 6.0 vs rates	9/25/2026	Ginnie basis at wides and G2/FN has underperformed	Further selloff/macro deleveraging
Long Conv 6.5 specs	9/25/2026	Wide OAS adjusted for both coupon and dollar price, easier to hedge at these prices	Deleveraging, risk off