Interest Rates Focus

Central banks outlook

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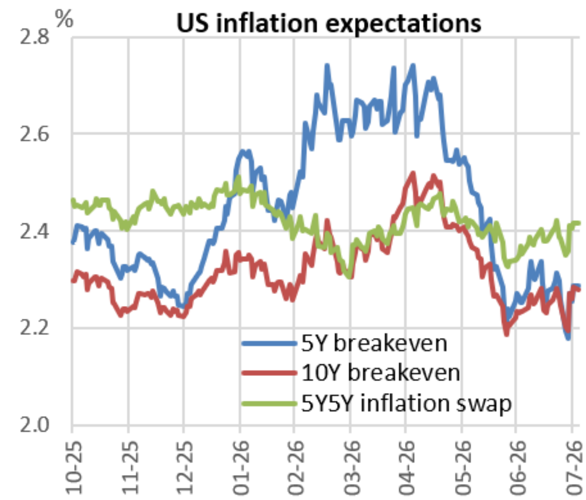
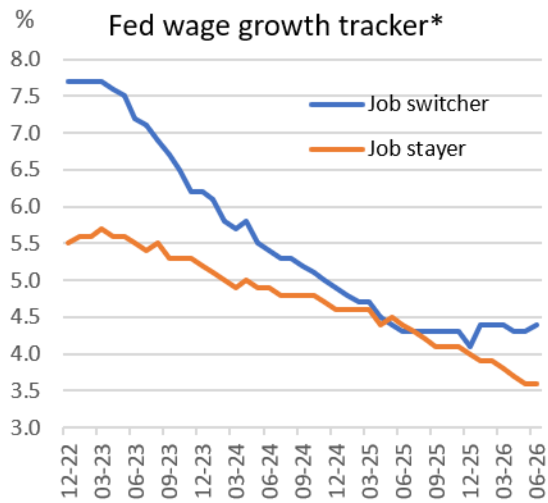
- *Our base-case remains for the Fed and the BoE to keep policy rates unchanged for the remainder of this year.*
- *RBA is likely to stay in a pause mode, while we expect one additional 25bp hike by the ECB and by the BoJ before year-end.*
- *Risk is for more hawkish reaction functions should second-round inflation impact become more prominent or there be renewed inflation pressure.*

Fed

The FOMC decided to keep the target range for the Fed funds rate unchanged at 3.50-3.75% at July meeting, in line with expectations. The presence of three dissenters – who preferred a 25bp hike – was not more hawkish than market expectations. Market subsequently pared back rate hike expectations to a 64% chance of a 25bp September hike versus fully pricing it in before FOMC decision; Fed funds futures last priced a total of 34bps of hikes by year end versus 45bps priced in late July. Our base-case remains for the FOMC to keep the target range for the Fed funds rate unchanged at 3.50-3.75% for the rest of the year. Our economists noted "core inflation remains relatively contained, while the disinflationary trend in several services categories has not been materially disrupted by the energy shock."

Geopolitics developments and the inflation outlook remain highly uncertain. We have flagged the risk of a hike, which if materialises, would likely be reversed in 2027. For the risk of a more hawkish central bank reaction function, we continue to monitor wage growth and inflation expectations. Wage growth for job stayers remained at 3.6%YoY in June, after an extended period of easing. There has been a recent pick-up in inflation expectations, but these are still off the peaks observed earlier in the year. For the market to further reduce rate hike pricings, another round (July) of benign inflation prints and some de-escalation in geopolitics is required. July CPI is scheduled to be released on 12 August and July PCE on 26 August.





Source: Bloomberg, OCBC Group Research
*nominal wage growth - median percent change in the hourly wage of individuals observed 12 months apart, three-month moving average

ECB

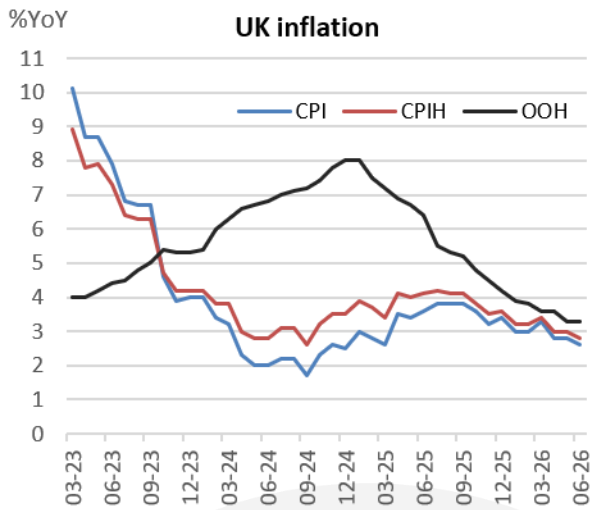
ECB kept the three key ECB policy rates unchanged at July meeting as expected. ECB commented "while developments in underlying inflation have remained contained, the full effects of the energy shock have yet to play out". Lagarde did not give much forward guidance, as decision is made meeting by meeting. On this, ECB continues to see downside risks to the growth outlook and upside risks to the inflation outlook. We have one final 25bp rate hike in our forecast profile, pencilled in for the September meeting. We are not expecting a more aggressive hiking cycle at this juncture. Granted, the size and persistence of the supply shock are crucial factors affecting ECB's decision making.

Inflation expectations have come off from earlier peaks, although the inflation swap curve is still mildly inverted - short-end inflation expectations are higher than medium to long term. EUR OIS last priced a total of 42bps of hikes by year end, with a September hike priced at an 87% chance.

BoE

BoE kept Bank Rate on hold at 3.75% at July meeting as expected. The 6-3 vote vs the previous 7-2 vote was not an entire surprise either. While the statement maintained that "the Committee stands ready to act as necessary", the assessment on growth was somewhat dovish. Key risk remains on energy prices and second-round effects, as "members continued to look through direct effects". Members who voted for the status quo decision are of the view that "holding Bank Rate, combined with the significant tightening of financial conditions that had occurred since the conflicts started, was providing sufficient insurance against the upside risks to inflation stemming from fluctuations in energy prices". The current level of Bank Rate being restrictive is precisely one of the reasons that we do not expect a hike. Governor Bailey said at the press conference "please do not leave this room thinking that the BoE is edging towards a hike". Our base-case remains for BoE to keep Bank Rate unchanged at 3.75% through this year.

CPIH (CPI including owner occupiers' housing costs) eased to 2.8%YoY in June, and CPI eased to 2.6%YoY. Inflation may re-accelerate as a higher Ofgem price cap is set for July-September, with uncertainty for 4Q26. Nevertheless, softness in demand and in the labour market is likely to mitigate second-round inflation impact. As Taylor noted, wage and private-sector AWE growth are reaching target-consistent rates. We forecast 2026 and 2027 CPI inflation at 3.1% and 2.3% respectively. GBP OIS trimmed pricing of rate hikes to 32bps by year-end versus 42bps priced before BoE decision.

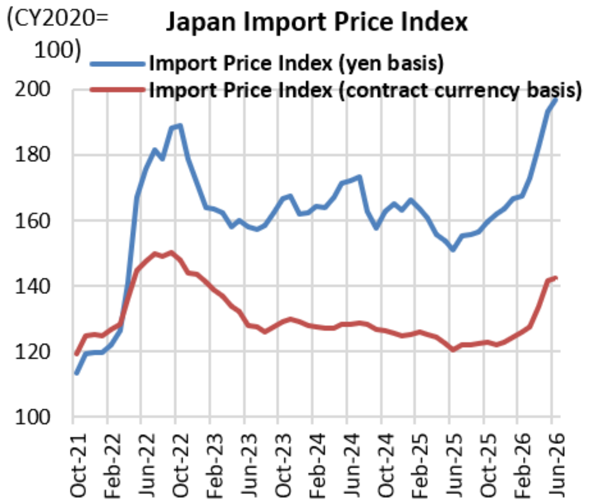


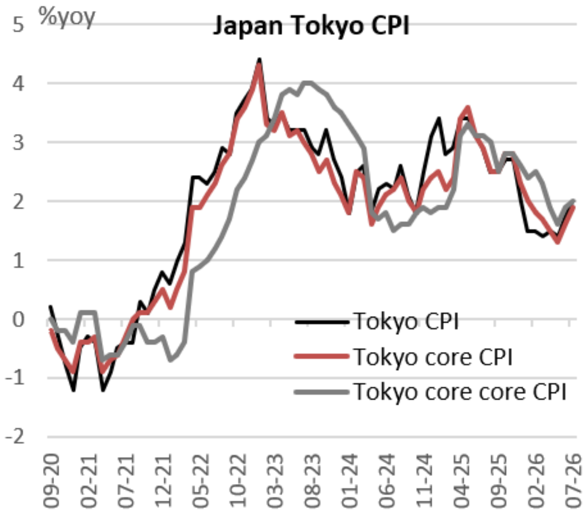
Source: Bloomberg, OCBC Group Research

BoJ

The Bank of Japan kept its policy target rate unchanged at 1.00% at July meeting as widely expected. One member dissented, preferring a 25bp hike. The 8-1 vote was however seen as not hawkish enough, suggesting the consensus among the committee has not shifted much to a sooner hike/quicker pace of tightening than the twice-a-year pace. We maintain our expectation for the next hike to come in 4Q2026 and are still more inclined to see this at October meeting rather than the December meeting. We expect a total of 50bps of hikes in 2027, as policy normalization is likely to continue given a tight labour market, pro-active firms' price-setting behaviour, and imported inflation pressure. BoJ raises rates to normalise monetary policy, as the policy rate has stayed negative in real term.

Apart from policy normalisation, inflation development also supports the case for further hikes. Tokyo CPI came in firmer-than-expected, accelerating to 2.0%YoY in July versus 1.7% in June; core CPI and core core CPI picked up as well. Import price inflation also accelerated, more so for the yen-basis index which was up 29.7%YoY in June.





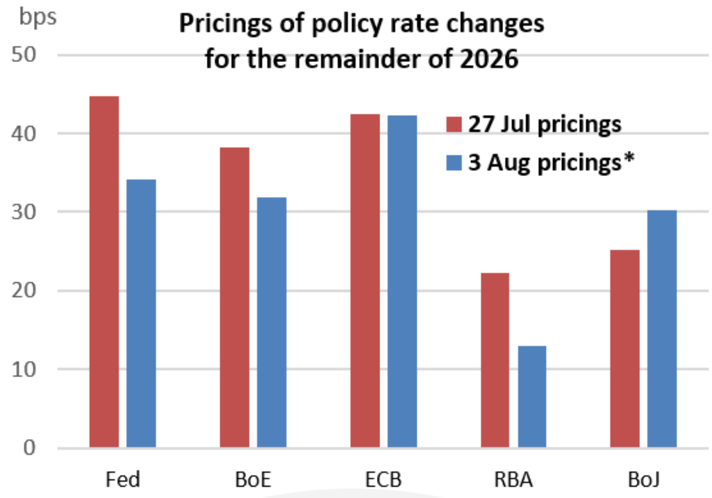
Source: Bank of Japan, Bloomberg, OCBC Group Research

RBA

We expect the RBA to keep policy Cash Rate on hold at 4.35% at August meeting, with the central bank likely in a wait-and-see mode after three hikes this year. Softer-than-expected Q2 and June CPI mean the central bank can afford to be patient. There were some hawkish elements at Governor Bullock's recent speech on *Monetary Policy in an Era of Shocks,* but market reaction was muted as those were seen as not more hawkish than expected. Bullock commented "against a backdrop of ongoing capacity pressures, the Board remains focused on preventing elevated cost pressures from entrenching inflation", and the Board "is prepared to act as required to achieve its mandate, including by increasing the cash rate further if needed". Nevertheless, she repeated the opinion that "the full effects of increases in the cash rate from earlier in the year will take time to materialise". We continue to expect no more hike in this cycle as our base-case. The AUD IRS curve is mildly inverted across 1s2s and 1s3s segments, reflecting expectation for some easing in 2027 or 2028. AUD rates appear as toppish. We expect the spread between 3M BBSW and RBA cash rate to narrow back to around 10bps over the coming months as and when market gradually price out rate hikes. Cash rate futures trimmed rate hike expectation to 13bps by year-end, versus 20bps priced before Q2/June CPI releases.

Interest rates forecasts	Current	Q326	Q426	Q127	Q227	Q327
Fed Funds Rate (upper)	3.75	3.75	3.75	3.75	3.75	3.75
BoE Bank Rate	3.75	3.75	3.75	3.50	3.50	3.50
ECB Depo Rate	2.25	2.50	2.50	2.50	2.50	2.50
BoJ Policy Rate	1.00	1.00	1.25	1.25	1.50	1.50
RBA Cash Rate	4.35	4.35	4.35	4.35	4.10	4.10
RBNZ OCR	2.50	2.50	2.75	3.00	3.00	3.00

Source: OCBC Group Research



Source: Bloomberg, OCBC Group Research
*Asia morning.

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