

Interest Rates Focus

Fed in a wait-and-see mode

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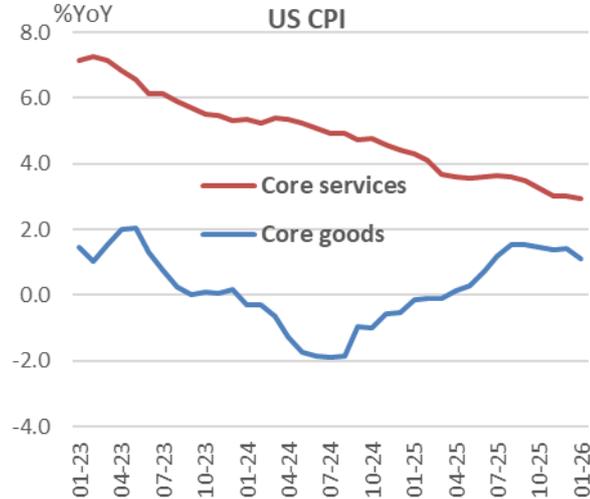
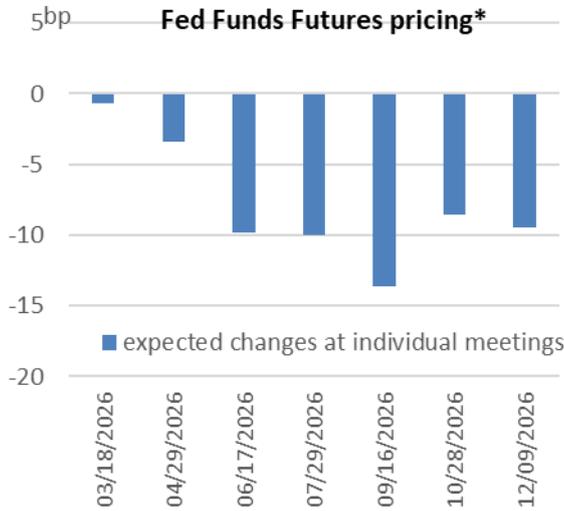
- *With the US labour market not cooling more rapidly while inflation stays above target, the Fed is likely to be in a wait-and-see mode.*
- *We now expect the next Fed funds rate cut to come in June, instead of in March. We hold onto our view that room for easing is small. Our base-case remains for one 25bp rate cut this year.*
- *Fed funds futures continue to price in slightly more than two 25bp cuts, with pricings back loaded to June onwards.*
- *Meanwhile, we expect continuity in Fed balance sheet policy. We do not expect a reversal to QT in the near term.*

FOMC outlook

December PCE index and core PCE index both accelerated to 0.4%MoM versus 0.2%MoM in November. Earlier, January nonfarm payrolls surprised to the upside, printing 130K versus consensus of 65K. On the household survey, the unemployment rate edged lower to 4.3% from 4.4%, while the underemployment rate also fell to 8.0% from 8.4%. Arguably, there was underlying softness in the labour market. January payroll growth concentrated in the sector of education & health services. Under the benchmark annual revisions, 2025 payrolls were revised lower to an average of just 15K per month versus the initially reported 49K.

On balance, the labour market not cooling more rapidly is likely to put most FOMC members on a wait-and-see mode, when inflation stays above target. The most recent FOMC minutes reflected that Committee members have remained split in their opinions towards the inflation and the labour market outlook; several participants would have supported a “two-sided description” of future interest rate decisions.

We push our expectation for the next 25bp Fed funds rate cut to June FOMC meeting, from March meeting as previously expected. We hold onto our view that room for easing is small. **Our base-case remains for one 25bp rate cut this year.** Any additional rate cut will probably require inflation moves near the 2% target, as the Fed funds rate is now “within a broad range of estimates of its neutral value”.



Source: Bloomberg, CEIC, OCBC Group Research
*20 February pricings

Inflation. In YoY terms, PCE index was up 2.9% in December; while most of the increase continued to be accounted for by services, the acceleration was driven by goods. On the other hand, under CPI measures, core goods YoY inflation eased, contributing 0.22ppt to headline YoY CPI inflation in January, versus 0.28pps in December, which painted a slightly different picture of tariff impact.

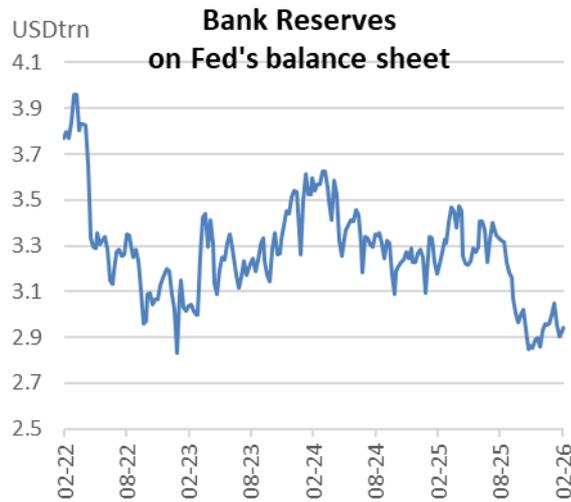
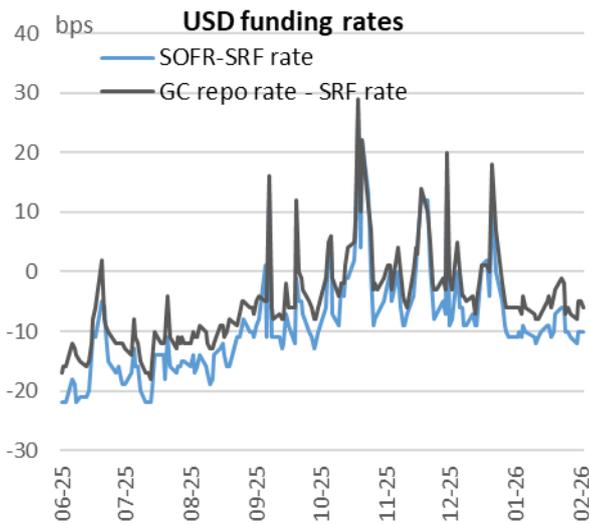
US rates and yields. Fed funds futures last priced 55bps of cuts. Pricings of cuts are backloaded, with market not seeing a meaningful chance of a cut until the June FOMC meeting – even by June, the chance is seen lower at 56% versus 69% before the PCE releases. 2Y UST yield has rebounded from the recent low of 3.4% to the latest 3.48% which is around our year-end expectation of 3.50% which we maintain. We also maintain near-term and year-end 2Y USD OIS forecasts despite the change of the timing of our expected Fed funds rate cut, as our existing forecasts have already incorporated our less-dovish-than-market outlook in terms of the quantum of rate cuts, and we do maintain full year Fed funds rate cut expectation. At the longer end, while we maintain a mild downward bias to UST yields, risk to our forecasts is to the upside as the disinflation progress appears to have slowed and there may be renewed fiscal concerns.

Balance sheet policy

We expect continuity in balance sheet policy. What happened to front end funding rates in late 2025 suggests that bank reserves below US\$2.9trn may no longer be ample. The Fed has ended QT which had lasted for around 3.5 years. Balance sheet run-off via US Treasury securities has stopped, while redemption from agency securities will be reinvested into Treasury bills. These operations keep the balance sheet unchanged. Separately, RMPs (reserve management purchases)

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started from 12 December, which will add to the balance sheet over time. The Open Market Desk will increase SOMA holdings of securities “through purchases of Treasury bills and, if needed, other Treasury securities with remaining maturities of 3 years or less”, to maintain an ample level of reserves. These decisions represent a consensus view at the Fed.



Source: Bloomberg, OCBC Group Research

RMPs are likely to stay at around USD40bn per month before early April, and to become smaller afterwards. Redemption from agency securities is estimated at around USD15bn per month. Recent monthly purchases of T-bills have been at around USD55bn and is likely to remain so until early April. As per the most recent Quarterly Refunding Documents, TBAC (Treasury Borrowing Advisory Committee) estimated a total of USD540bn of T-bills demand (USD180bn from MBS paydowns and USD360bn of RMPs) by the SOMA portfolio in 2026, assuming monthly RMPs at USD25bn after April. TBAC’s estimate on RMPs appears to be on the high side. We see the potential for the Fed to reduce RMPs by more after April. Nevertheless, this means slower RMPs. We do not see a reversal to QT – i.e. a reduction in the balance sheet – in the near term.

Interest Rates Forecasts

	Current	1Q26	2Q26	3Q26	4Q26	1Q27
Fed Funds Rate	3.75	3.75	3.50	3.50	3.50	3.50
2Y UST Yield	3.48	3.55	3.50	3.50	3.50	3.50
5Y UST Yield	3.65	3.65	3.65	3.65	3.65	3.65
10Y UST Yield	4.08	4.05	4.00	3.95	3.95	3.95
30Y UST Yield	4.72	4.80	4.75	4.75	4.70	4.70
2Y SOFR OIS	3.28	3.40	3.40	3.40	3.50	3.50
5Y SOFR OIS	3.34	3.45	3.45	3.45	3.50	3.50
10Y SOFR OIS	3.65	3.65	3.65	3.65	3.65	3.65
30Y SOFR OIS	4.01	3.95	3.90	3.90	3.90	3.90

	Current	3M	6M	12M
Fed Funds Rate	3.75	3.75	3.50	3.50
2Y UST Yield	3.48	3.55	3.50	3.50
5Y UST Yield	3.65	3.65	3.65	3.65
10Y UST Yield	4.08	4.05	4.00	3.95
30Y UST Yield	4.72	4.80	4.75	4.70
2Y SOFR OIS	3.28	3.40	3.40	3.50
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30Y SOFR OIS	4.01	3.95	3.90	3.90

Source: OCBC Group Research (Latest Forecast Update: 23 February 2026)

Note: The 3-, 6-, and 12-month forecasts may vary slightly over time even when the underlying outlook remains unchanged. This is because we use a single set of core FX and interest-rate forecasts anchored on quarter-end levels. From these quarter-end projections, we derive the 3-, 6-, and 12-month forecasts using straightforward methodologies, including interpolation. This approach ensures internal consistency across all forecast horizons.



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