OCBC TREASURY RESEARCH

Interest Rates Monthly

23 May 2022

Rates Theme – Hawkish central banks vs growth concerns

- The 10Y **UST** yield is likely to trade in a range and be capped at 2.95% near-term on growth concerns and a lack of impetus for directional moves in long term inflation expectation or real yield. Upside to the 10Y yield is still likely to be mild on a multi-month horizon on the back of manageable bond supply, towards the 3.00-3.05% area. The 2s10s segment may trade with a flattening bias as market likely holds onto rate hikes expectations as there appears to be no first-tier data recently which are weak enough to alter the Fed's near-term rate hike trajectory.

- **ECB** rhetoric has been increasingly hawkish and EUR OIS pricing has been pushed up to 108bp of hikes by year-end, a level (100bp or mildly higher) that we see as mostly fair. Our base-case is for the ECB to deliver at least three hikes by year-end, with a risk that there will be one more hike.

- **SGD rates** underperformed USD rates in some of the recent sessions, as the subdued risk sentiment and broad dollar strength might have had some spill-over impact on the forward points. Nevertheless, MAS policy shall remain as a mitigating factor for SGD rates. We look for the 2Y SGD-USD OIS spread to narrowed back to -50bp/-55bp as an initial target.

- **IndoGBs** underperformed over the past month amid the mostly risk off environment and as the domestic yields finally caught up with the previous increases in global yields. Demand at the recent auctions have turned weaker. From here, we wait to see if there is pent-up demand unfolding after a slew of below-target issuances.

- The spread between the 3Y **MGS** yield and the OPR is wide compared to BNM's "measured and gradual" approach. We expect the 3Y MGS to manage to trade in a range of 3.50-3.65% near-term despite the prospect of additional rate hikes.

- The theme of monetary policy divergence between China and major central banks remains valid. Without more broad-based outright easing and with fiscal policy being stimulative, downside to **CNY rates** is however limited. Onshore CNY bonds saw another month of relatively big outflows in April, on compressed yield differentials while the RMB was volatile during the month. The FX sentiment and implied RMB rates have improved since then.

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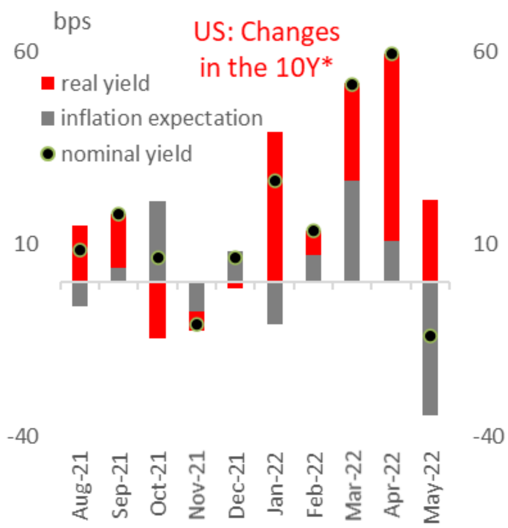
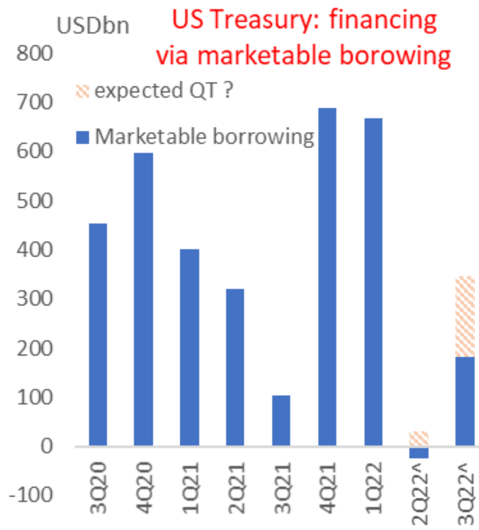


Source: Bloomberg. OCBC
*as of 20 May 2022

USD:

The steepening in the UST curve during April and the early part of May was partly driven by the inflation curve which has become less inverted. The spread between the 2Y UST yield and the Fed funds target rate narrowed slightly, in line with our expectation. From here, we expect range-trading in the 10Y UST yield which is like to be capped at 2.95% near-term; and only a mild upside towards the 3.00-3.05% area over the coming months. The 2s10s segment may trade with a flattening bias as market likely holds onto rate hikes expectations.

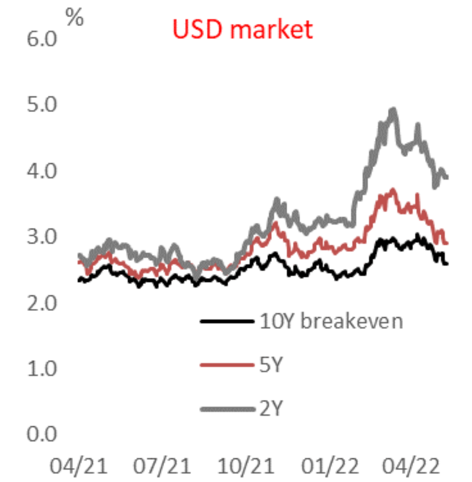
Treasury securities supply and QT. US Treasury released its latest quarterly refunding statement earlier in the month. Supply in Q2 and Q3 are on the low side, mainly because of expectedly higher receipts. These estimates were made without taking QT impact into account. Treasury needs to raise additional funds when the Fed does not reinvest the principals of some of the matured bonds. Hence, we add back the expected QT amounts for the two quarters. Supply will still be low for Q2 and manageable for Q3. Meanwhile, Treasury is expecting a cash balance of USD650bn by the end of Q3, which is higher than pre-COVID levels and can potentially act as a buffer for Q4.



Source: US Treasury, OCBC
^US Treasury estimates on financing via marketable borrowing

Breakeven and real yield. The 10Y breakeven retraced markedly, partly because long-term inflation is expected to be curbed by more aggressive Fed rate hikes. While it has been our long-held view for real yield to go higher, the 10Y real yield has breached our target of par and is trading at around +0.2%; the market probably needs to see additional strong economic data to push real yield materially higher.

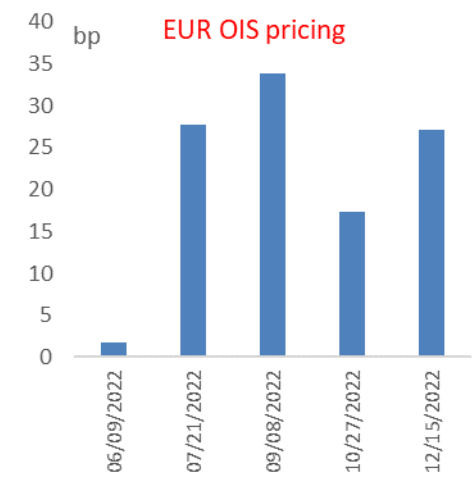
Rate hike pricing. Market has pared back expectation for a 75bp in any of the FOMC meetings, while overall pricing through to year-end has fluctuated within 180-200bp of additional Fed rate hikes between now and year-end, versus our expectation of 175bp. Given the market has tended to be ahead, the current pricing looks roughly fair to us.



Source: Bloomberg, OCBC

EUR:

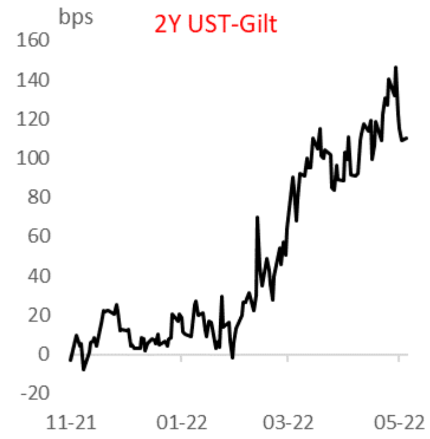
More ECB officials are joining the camp which intends to hike the policy rate soon and to bring it to above zero either by year-end or early next year. We see the **July MPC meeting a live one** for a policy rate decision, by then asset purchases are likely to have ended as well. Our base-case is for the ECB to deliver **at least three hikes**, bringing the policy deposit rate above zero by year-end, with a risk that there will be one more hike given there are four meetings in H2-2022. EUR OIS pricing has been pushed higher to 108bp of rate hikes by year-end, a level (100bp or mildly higher) that we see as mostly fair. Growth concerns however seem to be curbing the transmission from the more hawkish monetary prospect onto the EUR at the moment.



Source: Bloomberg, OCBC

GBP:

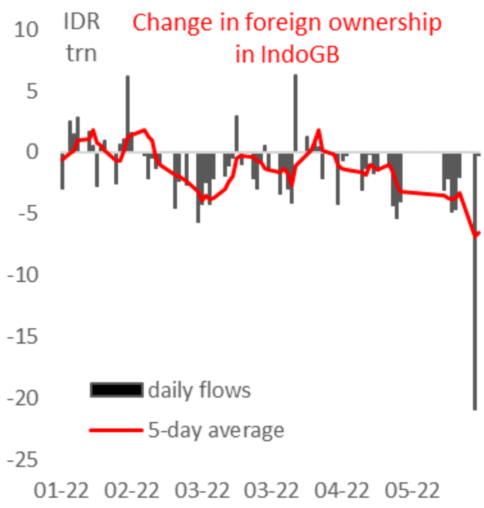
It has been our long-held view that SONIA futures pricing was overly hawkish. Over the past month, SONIA and GBP OIS pricing of rate hikes finally adjusted lower as investors turned to growth concerns, before edging back up mildly upon a strong set of labour market and inflation data in the UK. The BoE is facing the dilemma of inflation being "apocalyptic" (regarding food prices) and the real income squeeze that may hurt growth. Still, the Bank's chief economist Pill opined that "further work needs to be done" to bring inflation down. On balance, the GBP OIS pricing of 128bp of addition hikes by year-end looks fair to a tad too hawkish to us. Our base case is for additional rate hikes of 100bp before year-end.



Source: Bloomberg, OCBC

IDR:

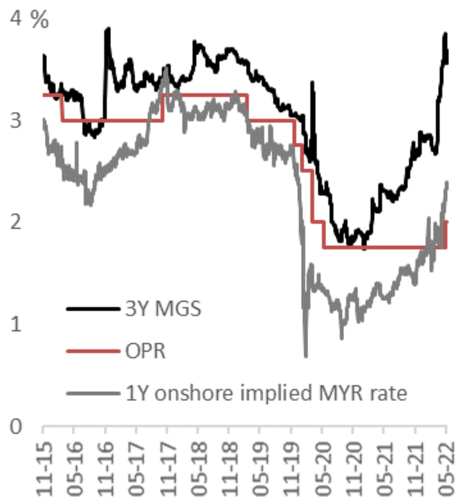
IndoGBs underperformed over the past month amid the mostly risk off environment and as the domestic yields finally caught up with the previous increases in global yields. Demand at the recent auctions have turned weaker, with repeated below-target awards as the MoF is in no hurry to step up funding. IndoGBs saw foreign outflows totaling IDR51.6trn since 8 April, with foreign holding dropping to IDR790trn as of 18 May, or 16.52% of total outstanding; YTD outflows amounted to IDR101.3trn. From here, we **wait to see if there is pent-up demand** unfolding after a slew of below-target issuances. There was a huge batch of foreign outflows on one of the recent days upon maturity; it is unclear as to whether foreign investors were too bearish to re-invest, or there was simply a lack of supply. On the policy front, our economist expects BI to deliver a rate hike as soon as at the May MPC meeting. On balance, we prefer to be defensive on the domestic bonds for now.



Source: Bloomberg, OCBC

MYR:

MGS yields and MYR IRS had risen steadily ahead of the May MPC preparing for a hawkish surprise from BNM – and it indeed came. Post MPC reaction was mainly on the 1Y rate and below, while the 3Y MGS yield did a round trip back to pre-MPC level, and it retraced further lower of late. **The 3Y MGS yield is still running well ahead of the OPR**, appearing to price in a terminal rate of 3% already. The spread between the 3Y yield and the OPR is wide compared to BNM's "measured and gradual" approach. Our central scenario is for up to two more rate hikes by year-end. As such, we expect the 3Y MGS yield to be able to trade in a range of 3.50-3.65% for now despite the rate hike prospect. Meanwhile, implied MYR rates have stayed below bond yields, providing an affordable FX hedge at times of high volatility. MYR bonds saw outflows again in April, albeit of a smaller amount than in March, as global yields adjusted higher.

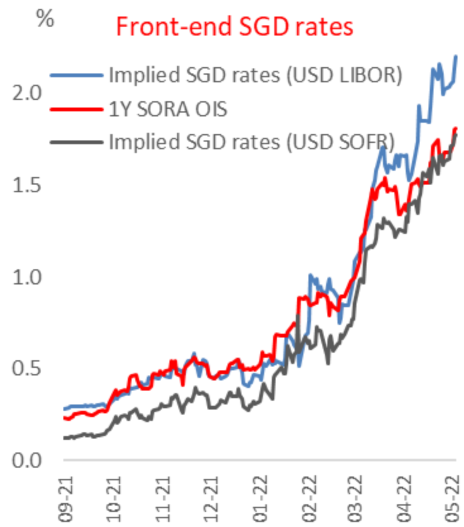


Source: Bloomberg, OCBC

SGD:

SGD rates underperformed USD rates in some of the recent sessions, as the subdued risk sentiment and broad dollar strength might have had some spill-over impact on the forward points; also, there might have been some unwinding of the popular receive SGD rates vs pay USD rates trade. Nevertheless, **front-end SORA has adjusted towards the implied rates from the USD SOFR OIS curve**, away from the implied rates from higher USD LIBOR curve, in line with our expectation.

Looking ahead, we still expect front-end SGD OIS to outperform USD OIS in this cycle of rising interest rates, as **the positive slope of the SGD policy is likely to mitigate the upward pressure** on these rates over time, barring some short-term fluctuations which can be driven by sentiment. We see the door as open for further tightening from the MAS; and even if there is no further tightening, the positive slope itself is a sustained condition unless being reversed which is an unlikely development. We look for the 2Y SGD-USD OIS to narrow (become more negative) to -50bp/-55bp as an initial target.

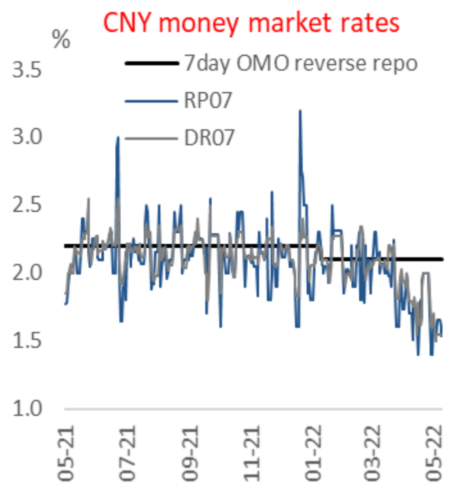


Source: Bloomberg, OCBC

The size of the 5Y SGS has been announced at SGD2.1bn with MAS intending to take SGD300mn. This amount is on the low side of market expectation, which supports our view for SGS resilience on well-manageable supply and the absence of direct QT impact. Issuances thus far are on track to our full-year expectation of SGD26.0-30.0bn.

CNY / CNH:

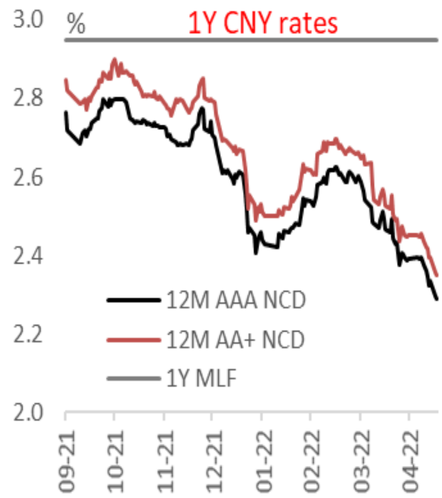
The 5Y LPR (Loan Prime Rate) was lowered by 15bp to 4.45% in May, which followed PBoC decision to cut the floor to mortgage rate by 20bp for first-time homebuyers. The 1Y LPR was kept unchanged. Money market rates have been mostly trading on the liquidity situation which is on the loose side. The market 7-day repo rate and depository repo rate have been trading below the OMO 7-day reverse repo rate for most of the time, while high-grade NCD rates are also lower than the 1Y MLF rate. As such, the market did not react to the unchanged 1Y LPR. Without a broader outright interest rate cut, however, CNY IRS are likely to trade in ranges rather than embarking on a steady downward trend.



Source: Bloomberg, OCBC

CNY bond market saw another month of relatively big outflow at RMB88bn in April, following the outflow of RMB98bn in March (Chinabond data only). Yield differentials being compressed on the one hand, the RMB was relatively volatile during the month when FX hedging costs were not particularly low. Implied RMB rates have fallen more than CGB yields since then, which helps improve the risk-reward if partial FX hedge is needed.

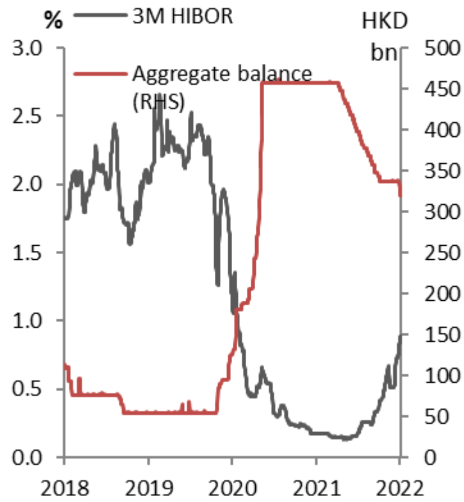
Back-end CNY and CNH points have been falling rapidly barring some daily fluctuations, on the back of monetary divergence theme, despite the absence of further compression in CNY-USD rates spread and despite the subdued RMB sentiment. With a potential period of consolidation in USD rates, and a lack of material downward adjustment in RMB rates, further downside for back-end CNY and CNH points are likely to be limited near-term. If Northbound Stock Connect flows sustain its recovery on China's sectoral support, there may also be a tightening of CNH liquidity. But overall, back-end points shall be trading mainly on US rates movement.



Source: Bloomberg, OCBC

HKD:

As USD/HKD tested 7.8500 – the weak side convertibility undertaking for the HKD, a few rounds of FX interventions have been done. HKD rates underperformed for a couple of days, which precisely reflected the adjustment mechanism sought. That said**, the reaction in HKD rates thus far is not huge**, as after all the aggregate balance (interbank liquidity) is thick to start with. We expect t/t spot to still trade near 7.8500, which means more FX intervention is likely to come. The adjustment process in rates versus spot may last for a while more, with total FX intervention likely at the tune of tens of billions of HKD. Although interbank liquidity will stay supportive of liquidity after these expected FX interventions, HKD rates are nevertheless likely to rise more rapidly than without FX intervention. We expect 3M HKD HIBOR to rise to 2.33% by year-end.



Source: Bloomberg, OCBC

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