OCBC TREASURY RESEARCH

Interest Rates Monthly

15 September 2022

Rates Theme – Higher for some time

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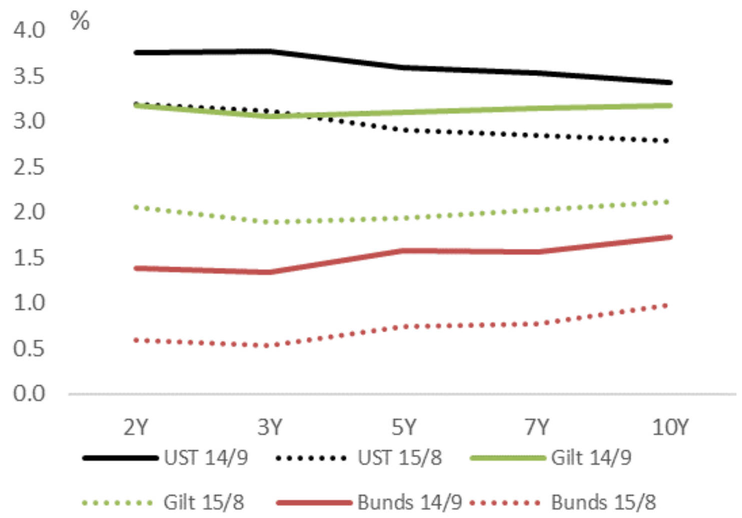
- In the USD market, rates to stay higher 'for some time" shall see the remaining easing expectation in 2023 being gradually priced out, allowing the 2Y UST yield to adjust further higher to better align with the expected terminal rate. We have brought forward our rate hike expectations, now expecting the Fed funds rate to reach 3.75-4.00% by year-end, instead of by Q1-2023 as we originally expected. This could be achieved by a 75bp-50bp-25bp hiking schedule for the remaining FOMC meetings of the year; thereafter, we have also penciled in a further 25bp hike in Q1-2023 leading to a terminal rate of 4.00-4.25%. Risk is our expected final 25bp hike would also be delivered within this year if core CPI refused to moderate.

- The Gilt yield curve is biased to steepening amid potential impact of the UK energy bill – supply risk and a potential dampening effect on inflation. GBP OIS pricing stays overly hawkish and front-end bond/swap spreads fairly negative; any adjustment to the less hawkish side shall be better expressed via OIS instead of Gilt.

- The IndoGB yield curve shall stay flat amid Bank Indonesia's "operation-twist". MoF is on track with its funding requirement; there is no pressure to upsize auctions unless the yields at auctions are seen as favourable by MoF. We expect the 10Y IndoGB yield to trade in a range of 7.00-7.20% on a multi-week horizon.

- CNY IRS tend not to price in future policy rate action, given the PBoC approach has always been targeted with various possible combinations of policies, and hence the unpredictable nature of the policy/administered rates. We expect CNY IRS to trade in narrow ranges before the next policy action. On bond side, supply risk appears to be lower than initially feared.



Source: Bloomberg. OCBC

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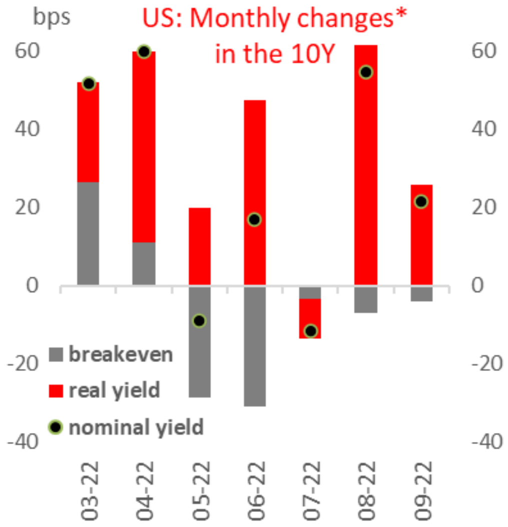
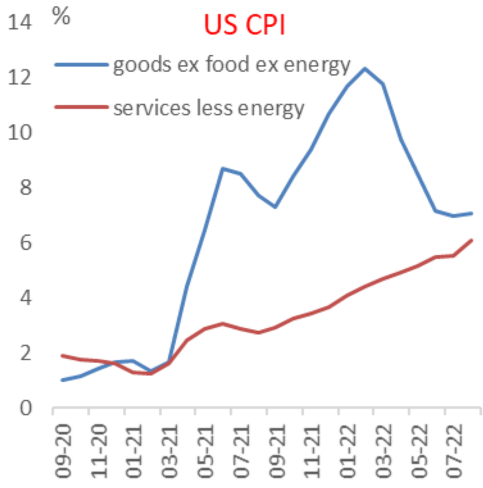
USD:

The UST curve moved up by 40-65bp across the 2s10s segment over the past month, as investors added to rate hike expectations while the 10Y real yield was pushed higher. Rates to stay higher 'for some time" shall see the remaining easing expectation in 2023 being gradually priced out, allowing the 2Y UST yield to adjust further higher to better align with the expected terminal rate. Fed comments have stayed squarely on the hawkish side, preparing the market for a 75bp hike at the September FOMC meeting, while the latest US CPI print reinforces such prospect. We have brought forward our rate hike expectations, now expecting the Fed funds rate to reach 3.75-4.00% by year-end, instead of by Q1-2023 as we originally expected. This could be achieved by a 75bp-50bp-25bp hiking schedule for the remaining FOMC meetings of the year; thereafter, we have also penciled in a further 25bp hike in Q1-2023 leading to a terminal rate of 4.00-4.25%. Risk is our expected final 25bp hike will also be delivered within this year if core CPI refused to moderate.



Source: Bloomberg, OCBC
*as of 14 September

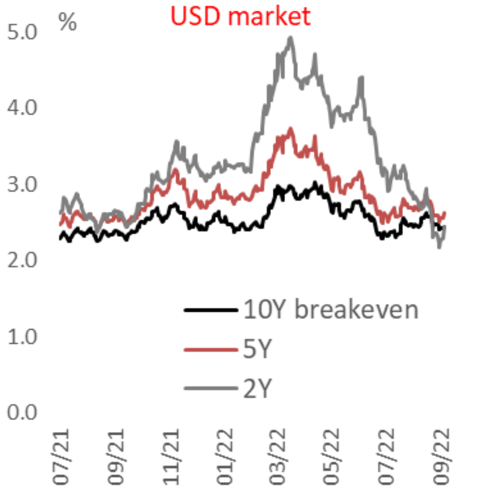
CPI. August US inflation came in stronger than expected. Headline CPI decelerated less than expected, and more importantly core CPI rebounded more strongly to 6.3% YoY. Services less energy inflation continued to pick up, while goods ex food ex energy inflation also turned higher breaking the 5-month moderating trend. Higher core CPI means inflation is sticky downward, underlining the Fed's view that rates will stay higher for some time.



Source: CEIC, OCBC

Treasury securities supply. Estimates for Q3 borrowing was revised upward, to USD444bn from USD182bn; USD120bn of the increase is due to QT, the rest to changes in projections of fiscal spending/revenues. The Q3 amount is mildly higher than expected. As for Q4, expected borrowing is at USD400bn, of which QT impact is USD139bn. Cash balance is expected at a relatively higher level of USD700bn at end-2022, versus USD602bn as of 12 September. Overall, the funding need is still within normal ranges and supply pressure is neutral.

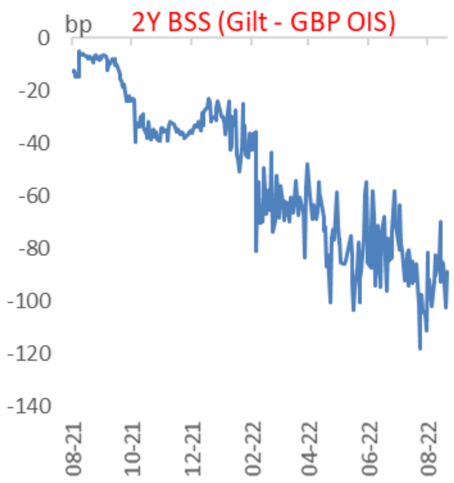
Breakeven and real yield. The upticks in the 10Y nominal yield over the past weeks was brought about by higher real yields. The 10Y real yield at 0.97% is only 19bp below pre-Covid peak, which shall face resistance to the upside, before market sees additional, strong data. Consequently, upside to the 10Y nominal yield shall be limited running into the September FOMC meeting. 2Y inflation expectation has been adjusting lower steadily, with the 2Y breakeven having broken below the 10Y breakeven. The earlier steepening in the UST curve was also partly driven by the steepening in the breakeven curve, a move which seems to be losing some momentum as the 2Y breakeven is already low while long-term inflation expectation appears well anchored.



Source: Bloomberg, OCBC

GBP:

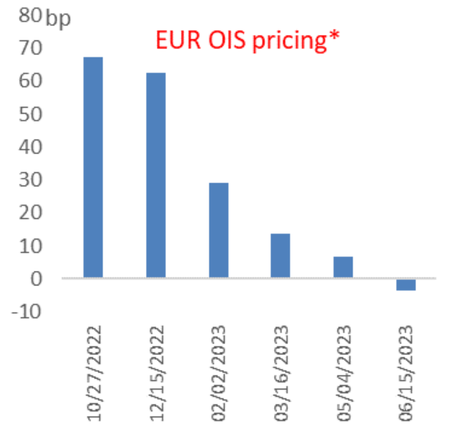
Gilts underperformed over the past month on heightened inflation and rate hikes expectations. The size of the planned energy bill has not been confirmed, but the Institute of Fiscal Studies put it at GBP100bn over a 12-month period. This is a significant amount compared to Gilt supply of GBP194.8bn (gross) or GBP115.5bn (net) for fiscal year 2021/22. This is also significant compared to QT – potentially GBP80bn in the next 12-month comprising GBP40bn of run-off and GBP40bn of active selling. Bailey had said the BoE might revise plans to start selling gilts next month if it judges that the market cannot digest the supply needed to fund the energy bill. We watch for the final decision at the September MPC but would see the bar as high for the BoE to step back from its plan. Meanwhile, the energy bill will "weigh on" inflation as Pill opined. When the 2Y Gilt yield is already running well ahead of the Bank Rate, **the yield curve shall be biased to steepening. GBP OIS pricing stays overly hawkish** and front-end bond/swap spreads fairly negative; any adjustment to the less hawkish side shall be **better expressed via OIS** instead of Gilt.



Source: Bloomberg, OCBC

EUR:

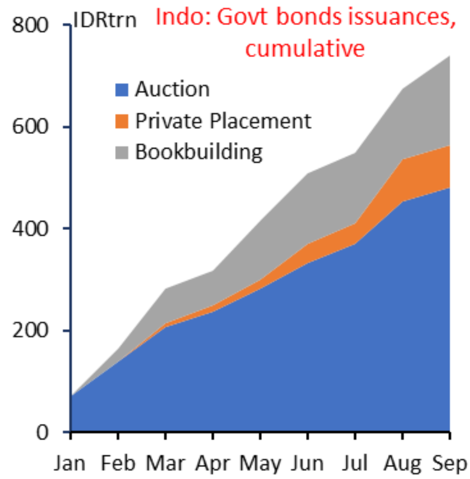
Bunds underperformed USTs over the past month amid Europe's energy crisis and as the ECB is increasingly hawkish. The ECB delivered a 75bp hike at its September MPC meeting and signalled the potential for another jumbo move. Lagarde in the press conference sounded hawkish, saying inflation remains "far too high" and is likely to stay above target for an extended period. EUR OIS now fully price in another 75bp hike at the October MPC. QT is still not being discussed yet, when the need is to get prepared to buy peripheral bonds depending on market conditions and the transmission of monetary policy. Since EUR OIS is already more hawkish than USD OIS pricing, room for further compression in UST-Bund yields spread may be more limited from here.



Source: Bloomberg, OCBC *14 September 2022

IDR:

The IndoGB curve bearish flattened over the past month, and **the curve shall stay flat in the coming months**. Bank Indonesia started its hiking cycle with a 25bp move at its August MPC meeting. BI said it would undertake an operation twist-style measure to stabilize the currency. The plan is to sell more short-term government bonds in the market which will help keep yield differentials attractive for foreign investors, and to buy bonds with longer maturity to help flatten the yield curve and lower borrowing costs. The recent policy rate hike, the operational twist, together with the earlier announced 2023 budget numbers which paint a constructive outlook for long-end supply, shall keep the IndoGB curve flat. MoF is on track with its funding requirement, with proceeds coming from private placement and book building in addition to auctions; the latest international bond issuance (USD) added around IDR38trn to the proceeds. There is no pressure to upsize auctions unless the yields at auctions are seen as favourable by MOF. We expect

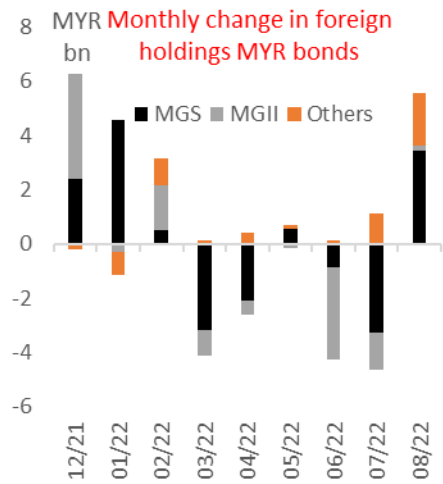


Source: DJPPR, OCBC

the **10Y IndoGB yield to trade in a range of 7.00-7.20%** on a multi-week horizon.

MYR:

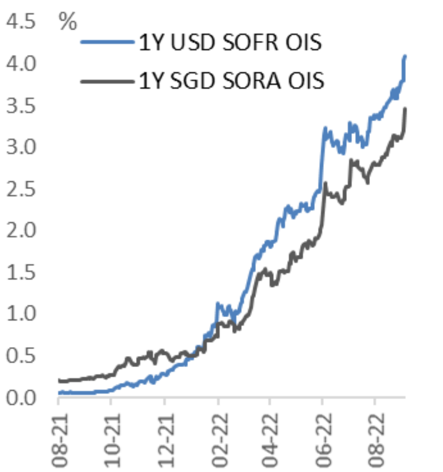
MGS outperformed USTs over the past month, with yields at the front-end and belly mostly lower. BNM hiked its policy rate by 25bp at its September MPC meeting, which was widely expected. The central bank reiterated their measured and gradual approach, and said their tightening is “not on any pre-set course”; these are all in line with expectations. The 3Y yield, after the recent retracement, is still well ahead of OPR. We remain of the view that **the 3Y MGS is to stay resilient in the face of higher US yields** on monetary policy gap; yield is **expected in the range of 3.3-3.5%**. Swaps are pricing in around 20-25bp of hike on a 3-month horizon, which looks fair. MGS saw a return of inflows, at MYR3.451bn, in August, the biggest since January 2022. Inflows to bills were also relatively strong, probably as investors took advantage of the low basis. The suppressed basis shall continue to be supportive of inflows especially into the short end.



Source: CEIC, OCBC

SGD:

SGD rates have mostly followed USD rates higher over the past month and failed to outperform, as the broad dollar strength and flush dollar liquidity together had lent some support to the forward points. Looking ahead, we expect SGD rates outperformance to resume. 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 -55/-60bp as an initial target. On bond side, the last auction of the year is to be conducted on 28 September; there will be no more supply in Q4. YTD issuance is at SGD24.9bn, well on track with our full year estimate of SGD27-30bn. We **expect SGS outperformance over USTs through to year-end**, especially at the longer-end, on favourable supply and the absence of direct QT impact.



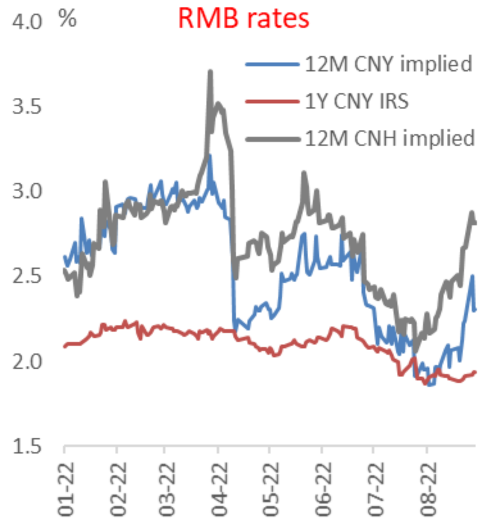
Source: Bloomberg, OCBC

CNY / CNH:

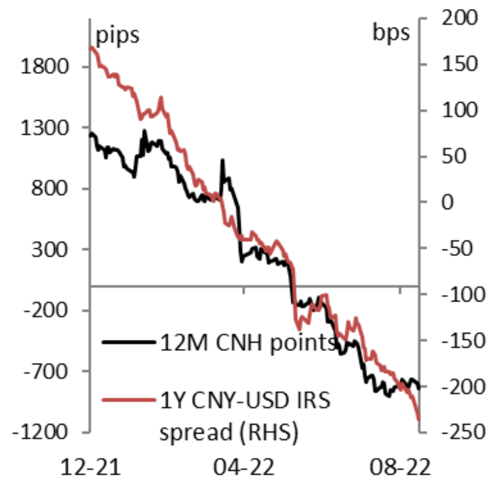
The PBoC partially rolled over the CNY600bn of MLF that matured in the month, net withdrawing RMB200bn of liquidity from the market, in line with expectations. The CNY IRS market tends not to price in future policy rate action, given the PBoC approach has always been targeted with various possible combinations of policies, and hence the unpredictable nature of the policy/administered rates. We expect CNY IRS to trade in narrow ranges before the next policy action. Separately, the PBoC cut the reserve requirement ratio on foreign currency (FCY) deposits by 200bp, effective 15 September. The foreign currency liquidity released is not big, especially compared to cross-border flows, and as such had not had a meaningful impact on spot or the FX swap points. On bond side, supply risk appears to be lower than initially feared, as the amount of additional special LGBs, to be issued by the end of October, has been said at CNY500bn odd, lower than the

CNY1.5trn leftover quota. On balance, CGBs are likely to trade in range, with the 10Y CGB yield eyed at 2.60-2.70%, especially if growth is seen as supported by fiscal stimulus.

Back-end CNH points have rebounded from lows despite CNY-USD rate spreads narrowed (became more negative) further. The recent move in the points might have been driven by outright positions amid the bearish RMB sentiment, while we had earlier turned more cautious chasing the points lower in view of policy risk (ahead of the confirmation of the reserve ratio cut on FCY deposits) and of the low implied CNY rates compared to repo rates. After the recent upward adjustment, however, we are more inclined to switch back to a sell-on-rally strategy on back-end CNH points. First, implied CNY rates are not as low compared to repo rates as a few weeks back; for example, 12M implied CNH rate was at 2.82%, implied CNY rate at 2.31% and 1Y repo-IRS at 1.94%, at the time of writing; and the lower onshore curve shall remain as a pull factor for the offshore DF curve. Second, the RMB sentiment appears to have stabilized somewhat. Third, it is still more likely for CNY-USD rates spread to narrow (before more negative) than to widen.



Source: Bloomberg, OCBC



Source: Bloomberg, OCBC

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