Interest Rates Focus

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Thoughts on US yields post payrolls; funding rates another focus

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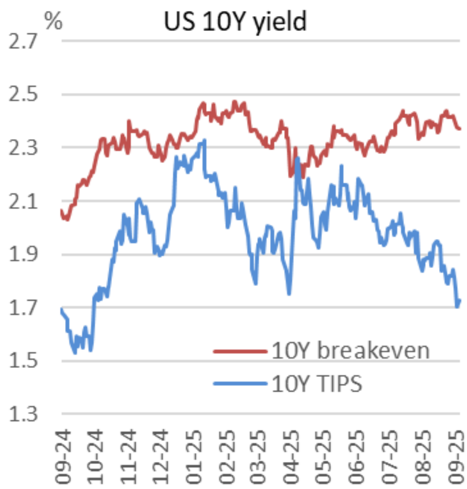
- **Market pricings and our base-case**. UST yields slid and market added to rate cut expectations upon the payroll release. Fed funds futures more than fully price a 25bp cut at the September FOMC meeting (chance of a 50bp cut was last priced at 10%), and price a total of 70bps of cuts for this year. **Our base-case remains for a total of 75bps of cuts this year and one 25bp cut in Q1-2026**, where we have pencilled in a 25bp cut at each of the remaining FOMC meetings this year. Risks to this forecast profile is rate cuts may be more paced out, as some FOMC members have continued to focus on the upside risk to inflation while shrugging off the low payrolls as it came alongside a lower labour supply.

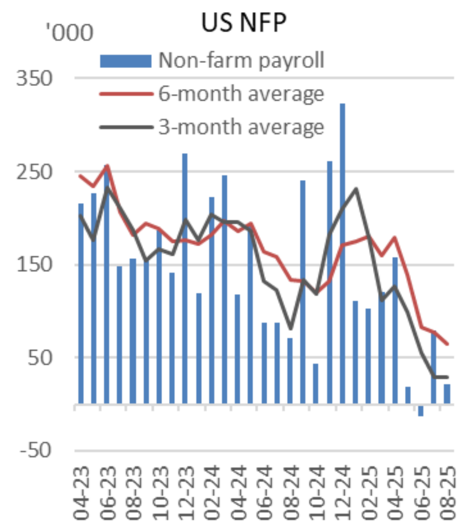
- We have been of the view that triggers for rate cuts will likely need to come from the labour market and the growth front. Continued cooling in the labour market will justify rates at less restrictive levels as long as there is no strong rebound in inflation. With more signs underlining our view that the US labour market is loosening and Fed funds rate is overly restrictive, we and market await the final greenlight from August CPI, together with PPI. There are also QCEW (quarterly census of employment and wages) initial value and revisions to be released on Tuesday.

- **Thoughts on UST yields and the curve**. Between now and end-2026, Fed funds futures price a total of 149bps of cuts, and the terminal rate is priced a tad below 3%. These pricings appear dovish enough at this juncture given upside risk to inflation. The 2Y UST yield at 3.50% is roughly in line with such pricings (present value plus a yield premium). **At current valuation, 2Y UST appears to be prone to upside surprises in inflation prints** – PPI on Wednesday and CPI on Thursday. Estimates for August core CPI range from 0.2% to 0.4%MoM with median at 0.3%; or from 3.0% to 3.1%YoY. Given the relatively tight range of forecasts compared to those for the more unpredictable payrolls, we suspect a print of 0.4%MoM or 3.2%YoY may be enough to trigger some correction in 2Y UST and the expected fed funds rate trajectory, but to dent expectation for a 25bp cut at the September meeting, bigger surprises may be required.

- At 10Y UST, in the downward move since the recent high on 18 August, a lower real (TIPS) yield explained around 95% of the move. This underlines our view that "**the subdued growth outlook will probably constrain the steepening momentum across the 2s10s**



Source: Bloomberg, OCBC Research



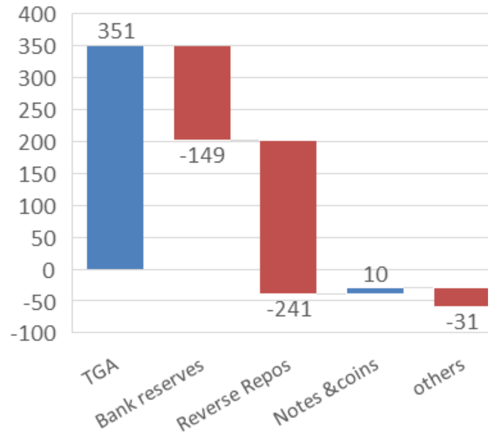
Source: Bloomberg, OCBC Research

segment." 10Y term premium at 0.76% (last estimated by New York Fed's ACM model) is not particularly low while 10Y swap spread appears lacking inertia to break decisively lower. 10Y yield was last at around our year-end expectation of 4.10%; near-term range is now seen at 4.06-4.20%. With potential upward correction in 2Y UST yield, we expect the 2s10s segment of the UST curve to settle at around 50-55bps area. Any further fiscal and/or Fed independence concerns may be more reflected at 20Y and 30Y yields.

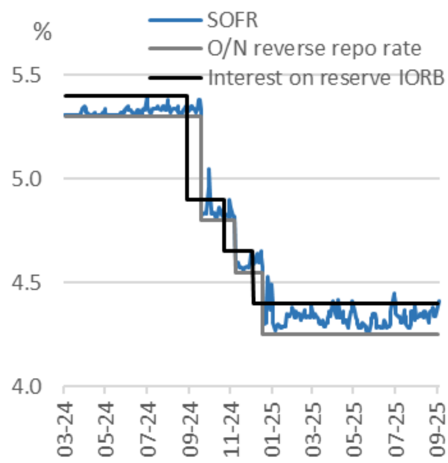
- **USD liquidity**. US Treasury has been rebuilding its cash positions since early July. TGA balance was last at USD669bn as of 4 September, USD181bn away from quarter-end and year-end target of USD850bn. **The increase in TGA balance has been matched with decreases in reverse repos and in bank reserves**, in line with our expectations. Reserve repos (all tenors) stood at USD369bn and bank reserves at USD3.18trn as of 3 September. We have been of the view that bank reserves will likely stay at above USD3trn when US Treasury replenishes cash to target, and we maintain this expectation. According to NY Fed's August update of RDE (reserve demand elasticity), the elasticity of Fed funds rate to reserve changes "is very small and statistically indistinguishable from zero", and hence the estimate "suggests that reserves remain abundant". That said, **with bank reserves moving closer to the USD3trn mark, market watch the behaviour of front-end USD funding rates** closely. SOFR has been grinding higher gradually, and was last fixed at 4.41% on Thursday, compared to IORB (interest on reserve balances) at 4.40%. While SOFR had been fixed higher than IORB occasionally, it happened mostly at month-end/quarter-end.

- **Labour market.** August non-farm payrolls were low at 22K while there were further revisions to previous months' data which saw a fall of 13K in June non-farm payrolls; three-month average of non-farm payrolls were low at 29K. Meanwhile, the unemployment rate ticked up to 4.3% (versus 4.2% prior) and the August underemployment rate rose to 8.1% (versus 7.9% prior) under the household survey. We also note the average weekly hours at 34.2 was on the low side. And according to Atlanta Fed's wage growth tracker, wage growth for job switcher has become lower than wage growth for job stayer since February this year. Still, in addition to the split opinions as to whether upside risk to inflation or downside risk to the labour market is the predominating consideration, FOMC members also differ in their interpretation of the labour market itself. Some opined that since the Fed's mandate is full employment, the unemployment rate – which had not risen more because of a lower labour supply – is more important than payrolls.

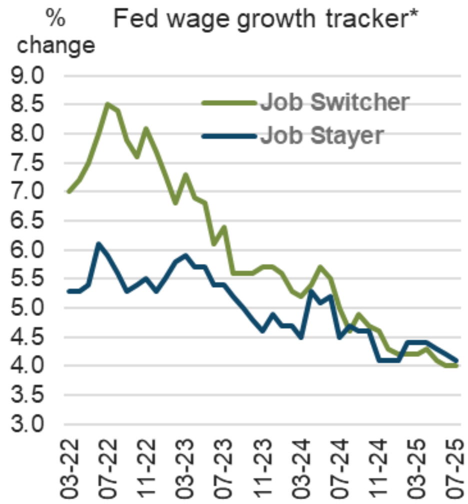
- **Fed Beige Book.** The Fed Beige Book continued to show the dilemma the FOMC face with their dual mandates but was somewhat skewed to softness in the labour market. The September issue of Fed Beige Book, with information collected on or before 25 August, said "Seven Districts noted that firms were hesitant to hire workers because of weaker demand or uncertainty. Moreover, contacts in two Districts reported an increase in layoffs". Regarding prices,



Source: Bloomberg, OCBC Research
*9 July marked the recent low in TGA balance as per weekly data



Source: Bloomberg, OCBC Research



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

"nearly all Districts noted tariff-related price increases…especially impactful on the prices of inputs". It is a matter as to whether firms can pass the cost onto customers and on this, "while some firms reported passing through their entire cost increases to customers, some firms in nearly all Districts described at least some hesitancy in raising prices, citing customer price sensitivity, lack of pricing, power, and fear of losing business."

Interest rates forecasts*	3Q25	4Q25	1Q26	2Q26
FFTR Upper	4.25	3.75	3.50	3.50
3M SOFR OIS	4.15	3.70	3.50	3.50
2Y UST	3.75	3.60	3.60	3.60
10Y UST	4.20	4.10	4.05	4.05
30Y UST	4.85	4.80	4.75	4.70

*forecasts made on 2 September; no change since then

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