Interest Rates Focus

Updated USD rates forecasts

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- *We now expect a 25bp hike in the target range for the Fed funds rate at September FOMC meeting, to 3.75-4.00%.*
- *We have revised upward USD rates and UST yields forecasts accordingly. We maintain a downward trajectory in our forecasts as market pricings appears overly hawkish.*
- *Downward move in 10Y UST yield would require short-end yields to fall, as room for further curve flattening may be small.*

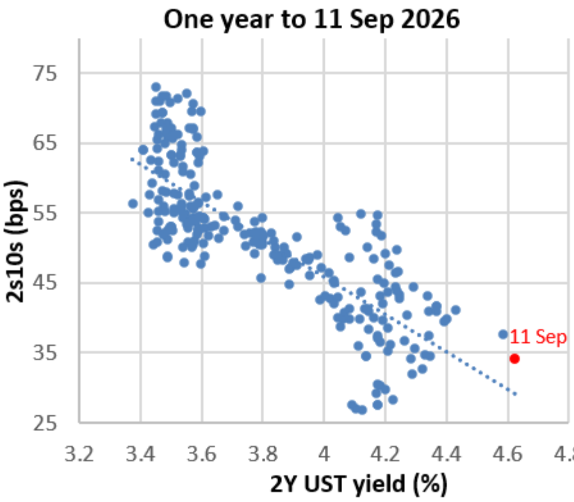
Fed outlook

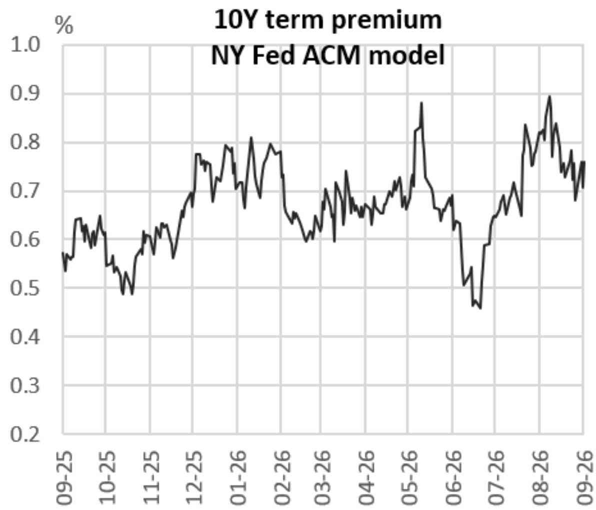
We now expect the FOMC to hike the target range for the Fed funds rate by 25bps at the upcoming September meeting, to 3.75-4.00%. August CPI alone does not argue firmly for a rate hike. The pick-up in August core CPI month-on-month inflation was driven by motor fuel, shelter and education & communications, while on a YoY basis core inflation eased to 2.4%. However, the August inflation outcome, combined with the recent upside surprise to payrolls and more importantly the re-escalation in geopolitical tensions and the higher oil prices would likely lead the FOMC into tightening to guard against renewed inflation risks. The split of votes, if any, and the updated SEP (summary of economic projections) which includes the dot-plot will be watched.

We previously mentioned if a hike was delivered this year, then it would likely be reversed in 2027 – we still hold this view. We have pencilled in a 25bp cut for 3Q-2027, which will then bring the target range for the Fed funds rate back to 3.50-3.75%.

USD rates forecasts

We have revised upward USD rates forecasts higher accordingly to reflect our updated Fed outlook. We keep a downward trajectory in our USD interest rates and UST yields forecasts. At the short end, current market pricings are more hawkish than our expected Fed funds rate path. Fed funds futures last priced a total of 92bps of hikes on a one-year horizon (by September 2027 FOMC meeting). Granted, the outlook remains uncertain, and investors will scrutinize comments from Warsh and other FOMC members, for guidance of the policy rate path ahead. If Warsh focuses on explaining the September policy decision while striking a more balanced tone, then there is room for market to pare back rate hike expectations. If Warsh continues to sound hawkish, then market is likely to maintain current pricing profile. Downward move in 10Y UST yield would require short-end yields to fall, as room for further curve flattening may be small. The 2s10s segment has narrowed to around 34bps from 55bps attained around mid-August. Our previous expected slope was 45-55bps based on the no-Fed-funds-rate-hike scenario. Now as we expect one 25bp Fed funds rate hike, the 2s10s segment is expected to trade mostly in a narrower range of 30-45bps given the negative directionality – but the curve has already narrowed. We have a downward bias to 2Y UST yield and therefore expect some easing in 10Y UST yield as well on a multi-quarter horizon.

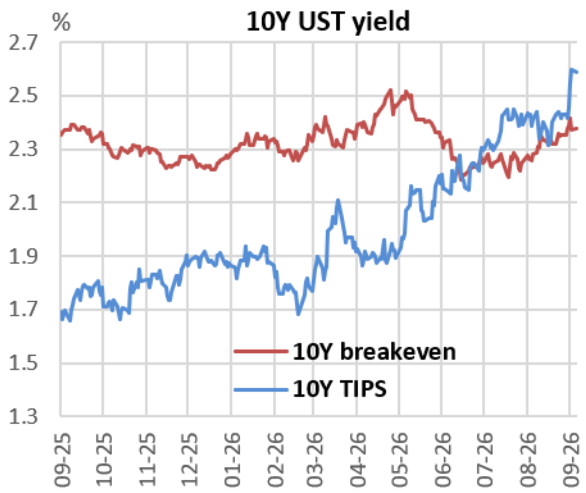


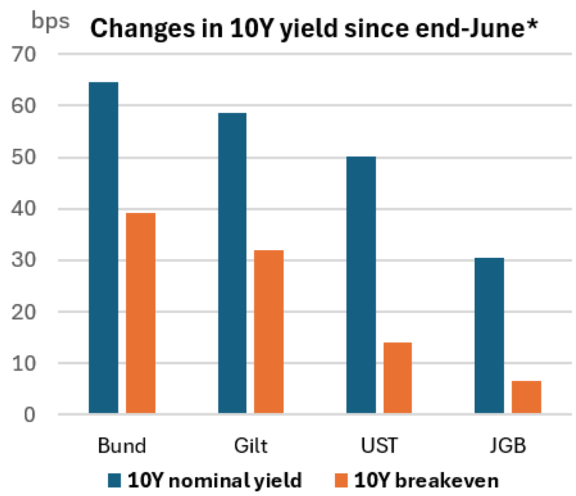


Source: Bloomberg, OCBC Group Research

The upward move in 10Y UST yield since end-June was still mainly driven by 10Y real yield (which explained around 70% of the move), although 10Y breakeven has been creeping higher recently. The 10Y term premium, as estimated by NY Fed's ACM model, was last at 76bps on 10 September, having normalized upward from the lows seen in late June. This compared to one-year average of 67bps and ten-year average of -29bps. The term premium is wide on a historical basis, reflecting the uncertain outlook for short-term rates and fiscal concerns. Further upside to the 10Y nominal yield from the term premium may have become more limited, although room for a meaningful narrowing in the term premium is also small. A 10Y UST yield at 4.75% (our year-end target) would be consistent with breakeven at 2.25% and real yield at 2.50%. For 10Y UST yield to ease further to 4.65%, we would be looking for breakeven at 2.20% and real yield to move towards 2.45%. A rate hike delivered by the FOMC may help anchor inflation expectations.

Any additional fiscal concerns may be more reflected in longer-end performances, with investors staying cautious against the 20Y and 30Y tenors. That said, we also note the possibility of reduction in long-end supply. First, there is willingness to do so, as reflected by the tweak in the guidance in the recent quarterly refunding documents – to "potential future changes" from "potential future increases" in auction sizes. Second, there is leeway – weighted average maturity of marketable debt outstanding was last at 70 months, versus multi-year average of 61.4 months, while demand for bills and short-end bonds is solid or supportive. On balance, range for 30Y UST yield is seen at 5.15-5.35%.





Source: Bloomberg, OCBC Group Research
*as of 11 September

Interest Rates Forecasts

Forecasts for USD Interest Rates	4Q26	1Q27	2Q27	3Q27	4Q27
FFTR upper	4.00	4.00	4.00	3.75	3.75
SOFR	3.95	3.95	3.95	3.70	3.70
3M SOFR OIS	4.00	4.00	4.00	3.75	3.75
6M SOFR OIS	4.00	4.00	4.00	3.75	3.75
1Y SOFR OIS	4.30	4.20	4.10	3.80	3.80
2Y SOFR OIS	4.35	4.25	4.15	3.85	3.85
5Y SOFR OIS	4.40	4.30	4.20	3.90	3.90
10Y SOFR OIS	4.45	4.35	4.25	4.00	4.00
30Y SOFR OIS	4.60	4.50	4.40	4.20	4.20
Forecasts for UST yields	**4Q26**	**1Q27**	**2Q27**	**3Q27**	**4Q27**
2Y UST	4.40	4.25	4.20	3.95	3.95
5Y UST	4.60	4.50	4.35	4.15	4.15
10Y UST	4.75	4.65	4.55	4.45	4.45
30Y UST	5.25	5.20	5.20	5.15	5.15

Source: OCBC Group Research

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