2022 FX and Rates Outlook

14 Dec 2021

Treasury Research & Strategy
Global Treasury

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Summary of views (FX):

Macro environment:

- The slowdown in recovery pace should not be concerning. Focus instead on the persistently elevated price pressures, as the growth-inflation divergence may complicate the central bank policy environment.
- Pandemic-driven risk-off episodes may still whipsaw the market, especially amid a tightening monetary environment. However, these shocks should be increasingly temporary as COVID-19 becomes endemic globally.

G-10 FX:

- With the hawkish Fed being the central assumption, expect the broad USD to stay supported on relative central bank dynamics. This is perhaps best expressed through the EUR and JPY, given the structurally dovish nature of the ECB and BOJ. Between the two, prefer the EUR as it is less hampered by risk dynamics and stretched positioning.
- Potential policy mistakes at the Fed is biased towards too steep a rate hike trajectory. The FX flow through would then be a steeper and more compressed USD gain/loss cycle. Expect accelerated USD gains in the near term before a sharper decline.
- Episodic risk-off events could be opportunities to enter structural long USD-JPY trades on Fed-BOJ divergence and (to a lesser extent) long AUD-USD trades on a RBA that is moving away from the dovish extreme.

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Summary of views (FX):

EM Asia FX:

- Positive BOP dynamics as a result of the pandemic spurred the Asian currencies to outperform G10 currencies in the midst of USD-strengthening environment. However, these dynamics may start to fade into 2022, and the prospects of the Asian currencies will depend on the speed and extent of the shift in these dynamics:
    1. The export boom may have peaked, and the ongoing normalization in domestic economic activities could see imports pick up.
    2. The benign risk and DM yield environment may start to reverse with monetary policy tightening and an uptick in real yields. This could impact the attractiveness of EM Asian assets.
    3. Elevated commodity complex disadvantages the net importers.
    4. Other idiosyncratic factors within each economy, such as tourism in Thailand.

- The RMB complex is still expected to stay supported early-2022. This will primarily be reflected through upside in the CFETS RMB Index. Meanwhile, the USD-China pairs are likely to grind lower only in a very contained fashion.

Summary of views (Rates):

Policy backdrop:

- Fed asset purchase is likely to cease sooner than the FOMC's initial "illustrative path" implies. This would give the Fed more flexibility when it comes to rate hike decisions.
- Two rate hikes in 2022 after taper is completed does not represent a packed schedule. Chance is for the Fed's dot-plot to shift upward, closing partially the gap with market expectations.
- Most Asian central banks will try to resist tightening pressure, but this task will become more challenging going into H2-2022.

Markets:

- **We expect the 10Y UST yield to rise, on the back of stable/mildly higher inflation expectations and higher real yields.** The curve is likely to steepen during the early part of 2022, as front-end has already priced in monetary tightening, before flattening back near/upon the start of the hiking cycle in the second half of the year. We expect the 10Y UST yield to reach 1.85% by end Q2-2022.
- SONIA futures pricing a "terminate rate" at around 1% by the March 2023 contract looks overly hawkish. This pricing is likely to be adjusted.
- There is room for Bunds to outperform USTs given the divergence in the monetary policy outlook.
- Two factors that will likely lead to heightened volatility in yields from time to time: headlines surrounding the virus situation and border opening/restrictions, and adjustments in market expectations versus CB stances.

Summary of views (Rates):

Markets:

- **In Asia, relatively wide real yield differentials act as a buffer** for selected local-currency markets against expectedly rising USD rates. Investors may however not put too much weight on this indicator when yields stay volatile. Over the course of 2022, there is scope for Asian LCY government bonds to outperform USTs. We look for narrowing in a number of spreads, including 10Y SGS yield vs UST yield, SGD SORA vs implied rates from USD SOFR, 3-5Y MGS yields vs UST yields, CGB yields vs UST yields, front-end HKD IRS vs USD IRS.
- **IDR**: 2022 issuance may be front-loaded, allowing for flexibility to support the bond market should the US rate hiking cycle start later in the year.
- **MYR**: the 3Y and 5Y MGS shall be relatively resilient on the curve, in the absence of BNM hawkishness
- **SGD**: 10Y SGS-UST yield spread to narrow, on light supply pressure, supportive real yield differentials, and in the absence of direct QE withdrawal/rate hike impact. The SGD SORA curve to revert gradually to what is implied by the USD SOFR OIS curve.
- **CNY / CNH**: supportive policy stance shall lead to CNY rates outperformance over USD rates. Net additions to the CNH pool may not be huge; the CNH DF curve is likely to mostly track the onshore CNY DF curve.
- **HKD**: additional bill issuances cannot be ruled out, but interbank HKD liquidity shall remain flush. As absolute rate levels increase, bias is for front-end HKD-USD rates spreads to narrow.

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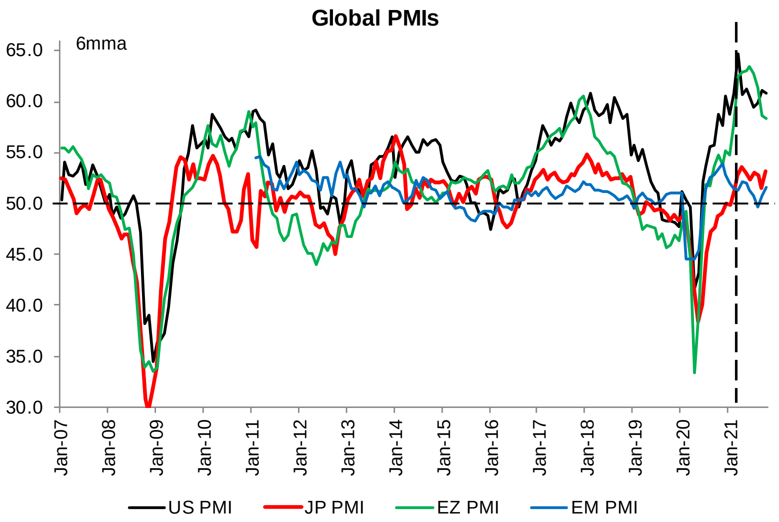
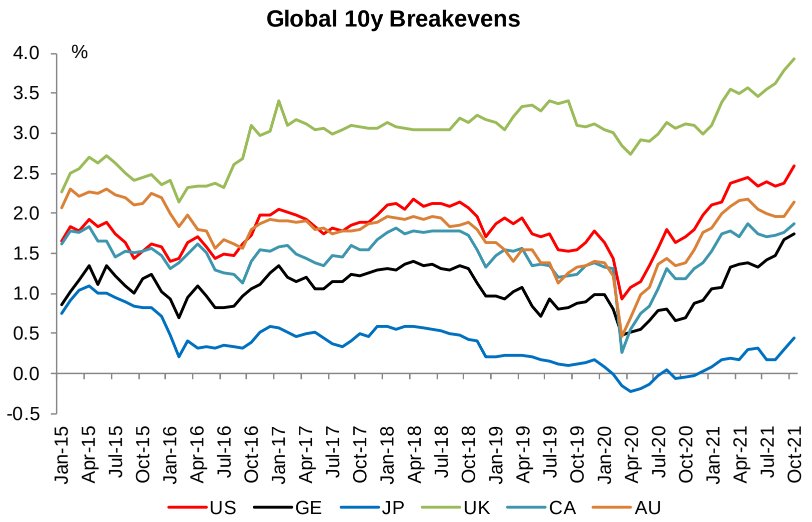
Growth-inflation divergence will lead to a convoluted macro environment in 2022

- Broadest cut economic indicators, such as the PMIs, peaked in 2Q 2021. The subsequent slowdown is arguably not a concern as it is natural for recoveries to taper off as they age. There is risk for new COVID-19 variants to further disrupt the recovery – yet, the macro impact of these variants should fade over time as the world enters an endemic phase.
- **The more pertinent, complicating factor is a persisting series of supply-chain disruptions that have kept price pressures elevated even as the pace of recovery tapers.**





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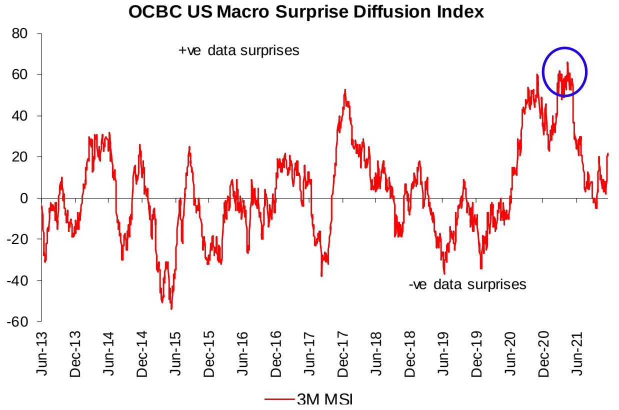
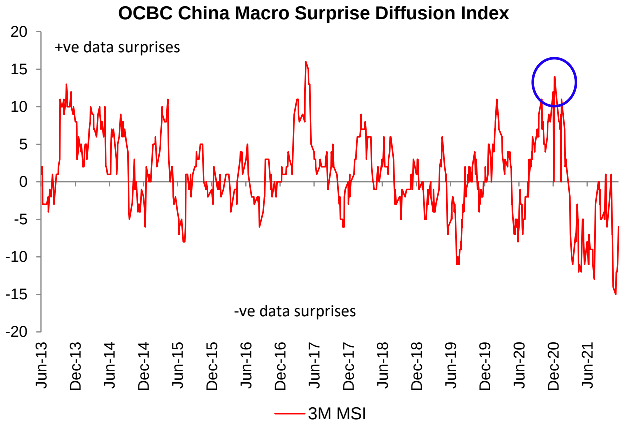
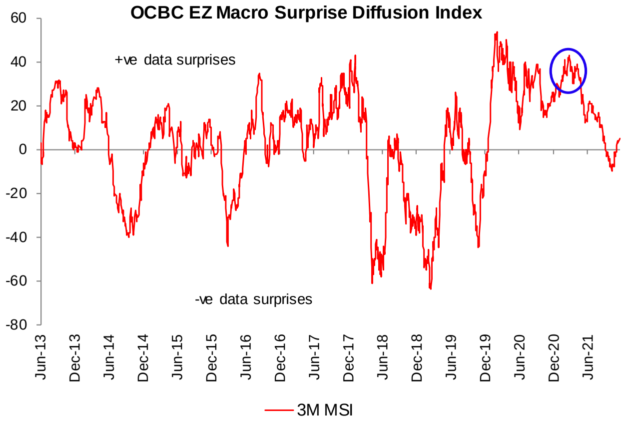
Source: Bloomberg, OCBC

Slowdown is coordinated across major economic blocs, but not facing a recession just yet

- The Chinese slowdown started in 1Q 2021. By 2Q 2021, the recovery momentum in the US and EZ also started to see slowdown.
- However, with the exception of China, the Macro Surprises Index (MSI) for the US and EZ are not in negative territory, suggesting that the growth is not excessively compromised. **The stagnation portion of "stagflation" is perhaps overblown for now.**
- However, these high-level macro indicators brush aside the more divergent outlooks between the major economic blocs.







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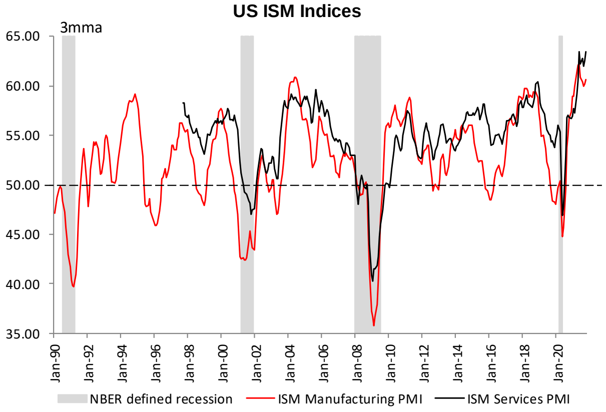
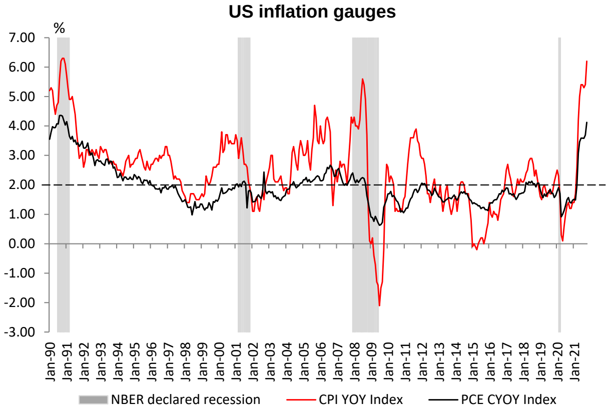
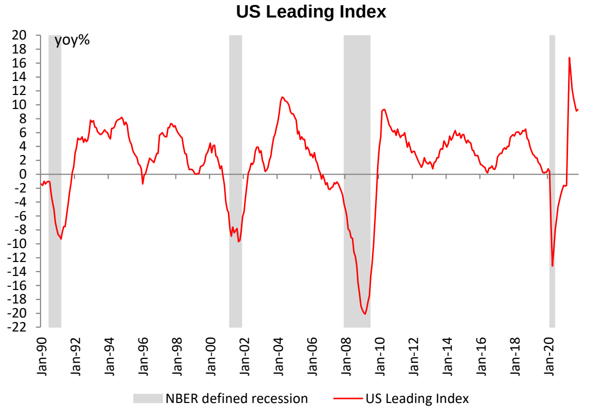
Source: Bloomberg, OCBC

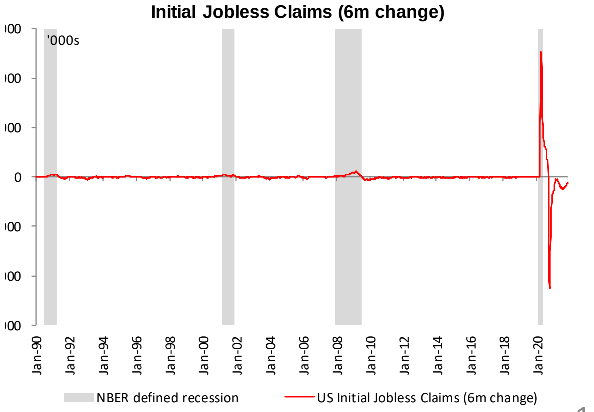
The US labour market likely to be at full employment by end-1H 2022; well-placed to absorb rate hikes

- Robust fiscal support and the paced reopening of the US economy have boosted aggregate demand. The supply side faced issues with coping, with the direct outcome being supply-induced increases in price pressures.
- Labour market is also improving, with the other condition for Fed to hike – full employment – expected to be achievable within 1H 2022.
- **Overall, the US economy looks sufficiently resilient to pull through the expected withdrawal of stimulus without being overly impeded.**









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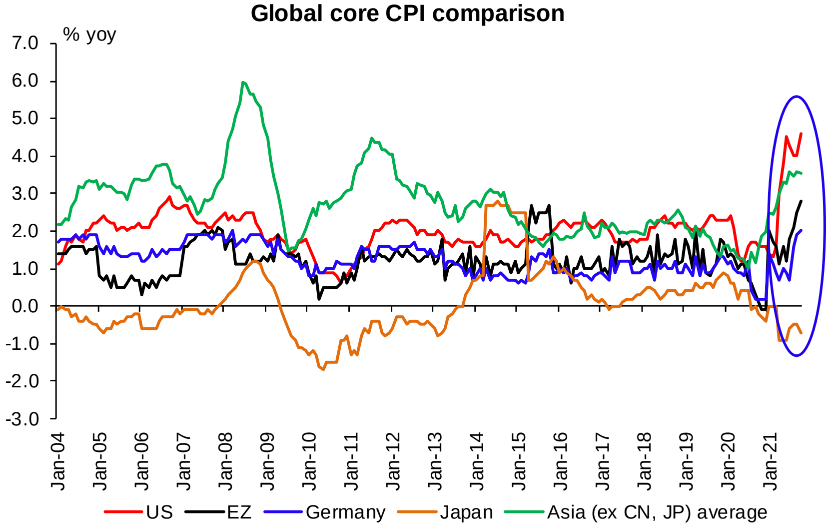
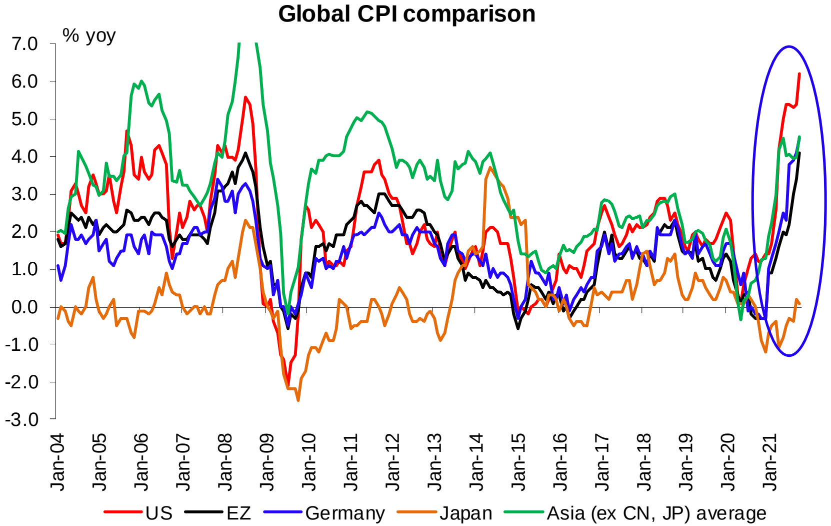
Source: Bloomberg, OCBC

Higher inflation is a global phenomenon, but note the US exceptionalism here

- The issues faced by the US supply chain is replicated almost globally. Increases in price pressures are noted even in traditionally very flat economies like the Eurozone.
- **Less talked about is that the US is leading the way in terms of inflation metrics, even in comparison to the EM Asian economies.**





Source: Bloomberg, OCBC

FX in 2022: The central banks' response to growth-inflation divergence will be the main driver

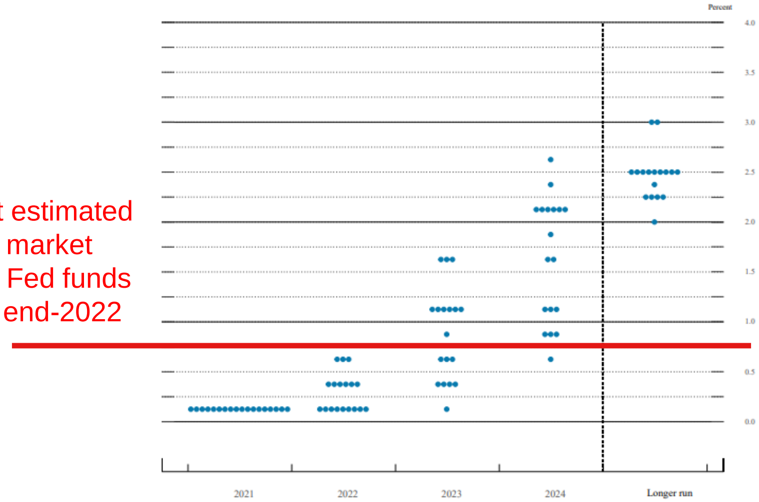
- Ultimately, **the rise in inflation and inflation expectations will compel the major central banks to turn even more neutral, if not outright hawkish**. However, the implementation of rate hikes will not be straightforward because:
    1. Inflation has slumbered for a (very) long time and policy-makers may be less adept at dealing with such threats
    2. Dealing with growth-inflation divergence with demand side policies (like monetary policy) has been traditionally and academically tricky
- Thus, we look to examine any action by the central banks through the following lenses:
    1. **At which point is the central bank in the hawkish-dovish spectrum following the action?** This is inherently the easier part. Expect currencies of the central banks nearer the hawkish end of the spectrum to outperform.
    2. **What is the impetus for the action, and its impact on growth?** This is where the growth-inflation divergence factor in most heavily. The scope for policy mistakes is significant. A central bank can be forced into policy tightening by inflationary pressures at the detriment of growth. Similarly, an over-emphasis on growth may lead to inaction, with inflation running unconstrained. Expect these to be negative for the relevant currency.

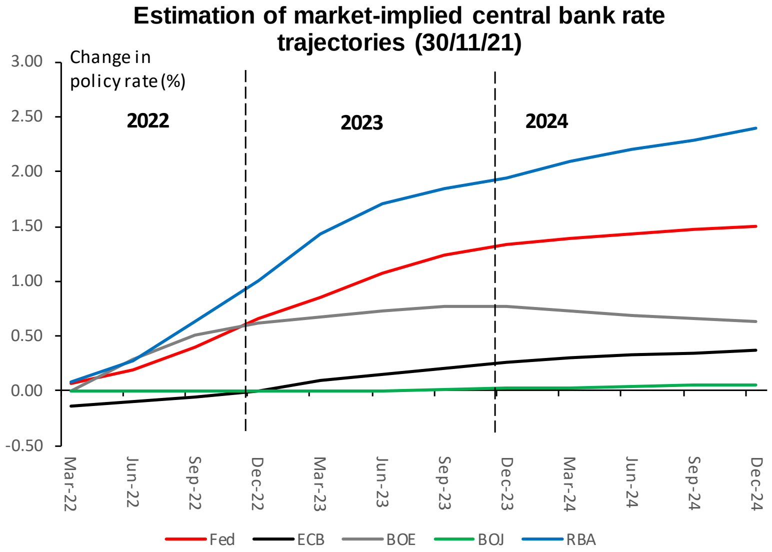
- **We expect the Fed to be comfortable on both counts, leaving the USD well-placed to appreciate amid a hawkish-Fed backdrop. The other major central banks will face their own trade-offs.**

Hawkish Fed still the main assumption, and that keeps the USD on the front foot

- As far as the Fed is concerned, the “transitory inflation” argument is all but buried. Into 2022, the Fed narrative is on increasing the pace of tapering, with confirmation potentially coming as early as the Dec FOMC. A late-1Q / early-2Q completion of the tapering process will compel the market to price in more rate hike expectations through 2022.
- **Scope for the Fed dot plot to catch up to the curve in terms of rate hike guidance.**

Current estimated level of market implied Fed funds rate by end-2022





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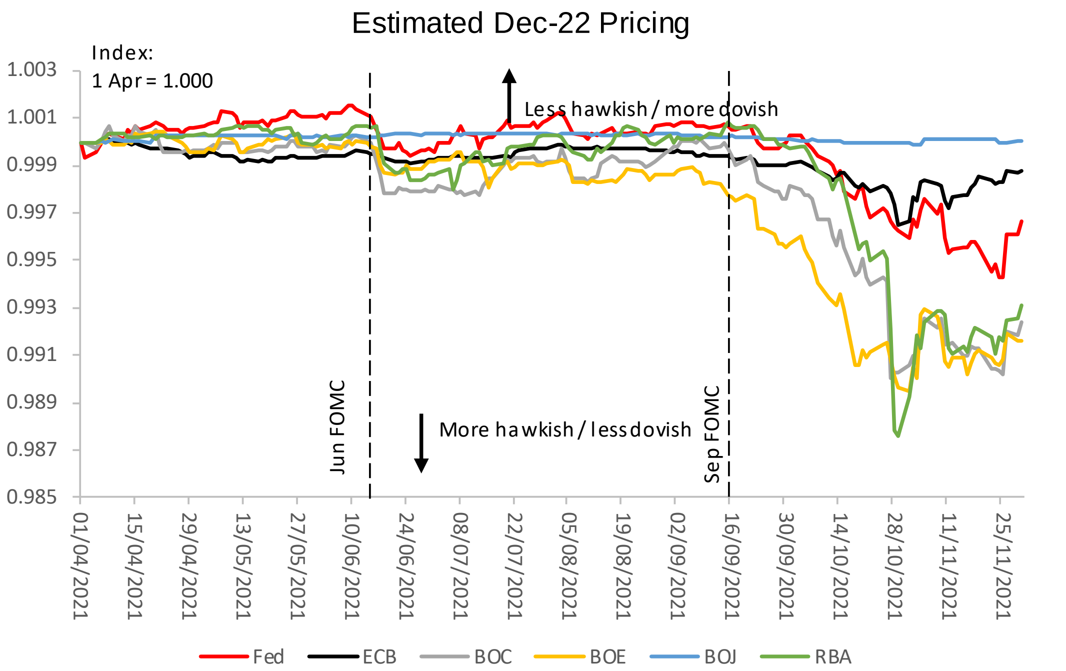
Source: Bloomberg, US Federal Reserve, OCBC

Market-implied Fed rate hike expectations not excessive, and no immediate threat of sharp pullbacks

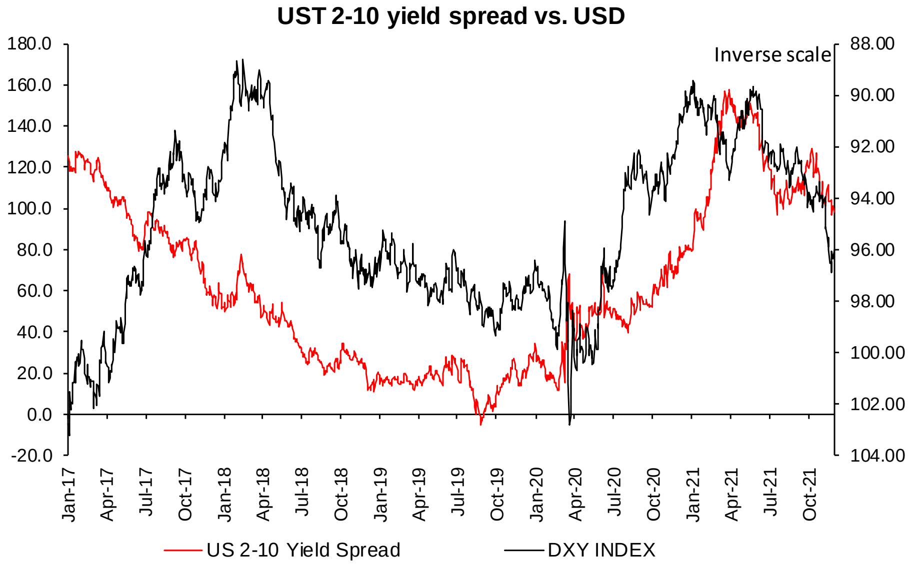
- Fed rate hike expectations did not accelerate as quickly as RBA and BOE rate hike expectations in Oct. The first rate hike is priced for Jun 2022 – still a distance away. Overall, no imminent risk of disappointment.
- The market-implied number of rate hikes is now around 2.5 hikes through 2022, with the first hike priced in for June. **This is not considered excessive at this juncture, and further extension towards 3 hikes through 2022 cannot be ruled out. The risk of a sharp retracement is not on the books for now.**

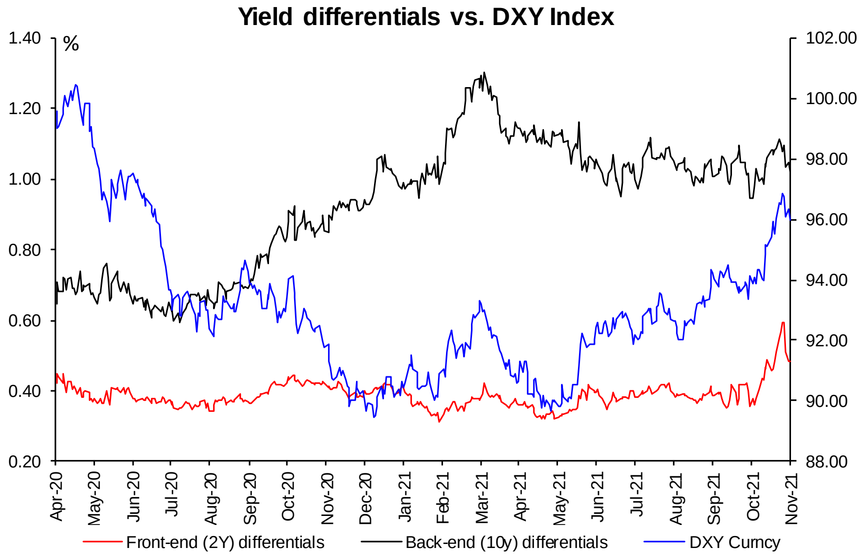


Source: Bloomberg, OCBC

Fed stance keeps the UST yield environment supportive of the USD

- Back-end (10y) US-G10 yield differentials have been sideways. **The front-end yield differentials have stayed supported, with the broad USD responsive to this yield differential advantage this year.**
- 2-10 yield spreads also narrowing, with the positive correlation with the broad USD intact.

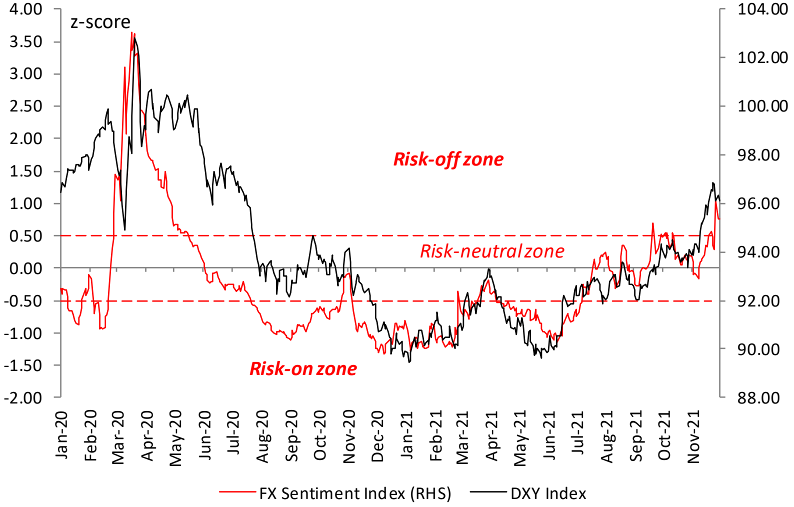


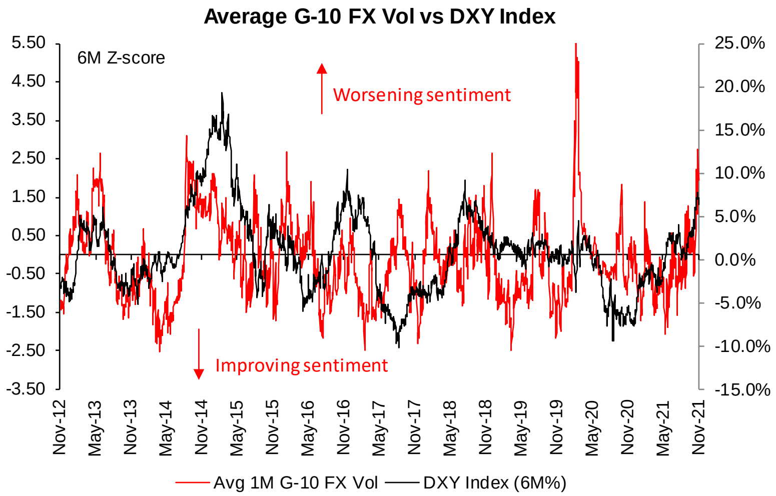


Source: Bloomberg, OCBC

Bouts of risk-off sentiment could provide an additional haven demand

- The FX Sentiment Index (FXSI) has been on a multi-month climb since Jun 2021, suggesting that the monetary accommodation-led risk-on default is well and truly over. Going forward, slowdown in the recovery, pull-back in monetary stimulus and potential COVID-19 shocks – **condition is ripe for episodic risk-off in 2022**.
- **The broad USD remains a good proxy for the risk-on/risk-off dynamics**, with good correlation with the FXSI.





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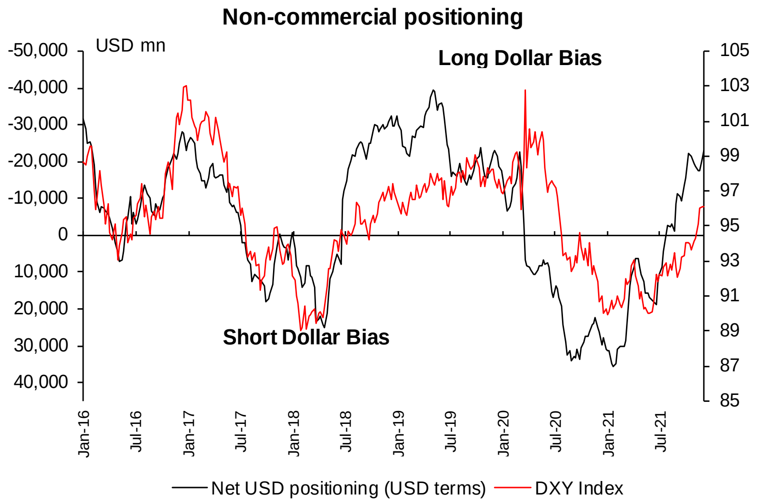
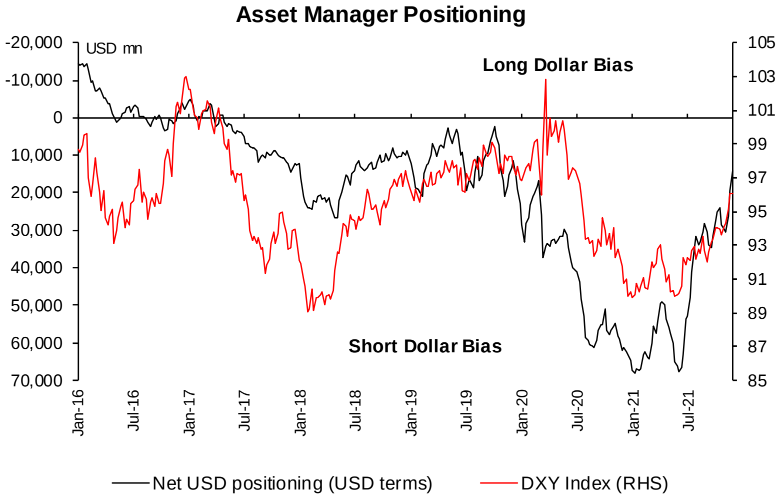
Source: Bloomberg, OCBC

Investment community moving in favour of the USD, with scope for further extension

- Both the short- and long-term players in the investment community have moved consistently in favour of the USD this year. Net implied short USD positioning within the non-commercial accounts peaked in 1Q 2021, and eventually turned net long in Aug 2021. Long-term asset managers now hold the smallest net short USD position since the start of the COVID-19 pandemic.
- **Long USD positions within the investment community not stretched. There is still room to extend.**





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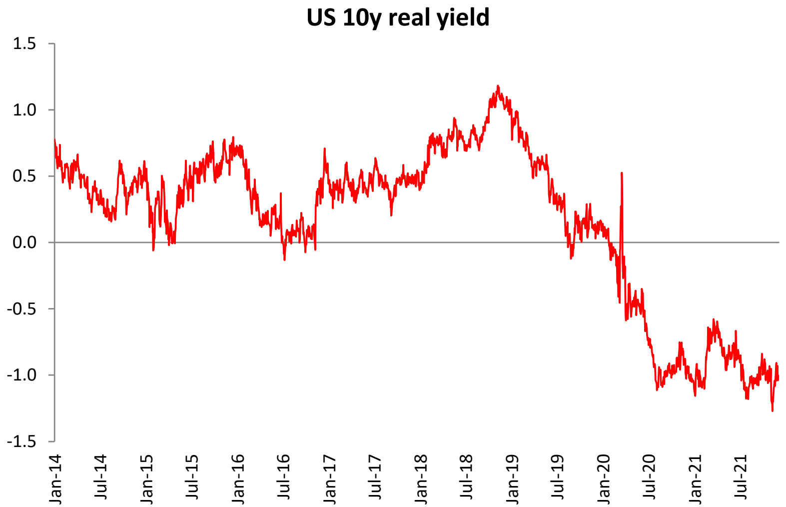
Source: Bloomberg, CFTC, OCBC

Risks to the USD: Different Fed policy assumptions and depressed real yields

- The current Fed policy assumption is a paced catch-up to the current market implied number of rate hikes through. In that context, a 2-hike or even 3-hike Fed may well be regarded as within expectations. Such a pace is already quick by historical standards. Any sign of a runaway inflation may compel this trajectory to steepen further, translating into a sharp, front-loaded USD appreciation amid heightened volatility.
- The flipside is also relevant – should the Fed come across as consistently behind the curve and leaving room for the likes of the ECB to catch up in terms of policy tightening, the USD appreciation pressures will dissipate.
- For what it is worth, real yields in the US are still near historically depressed levels.

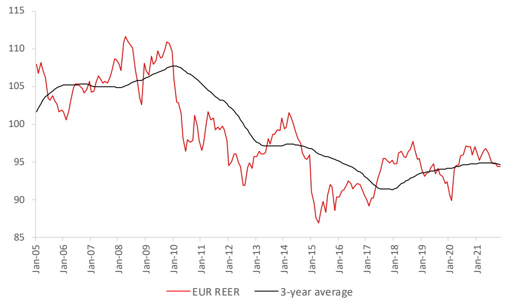


Source: Bloomberg, OCBC

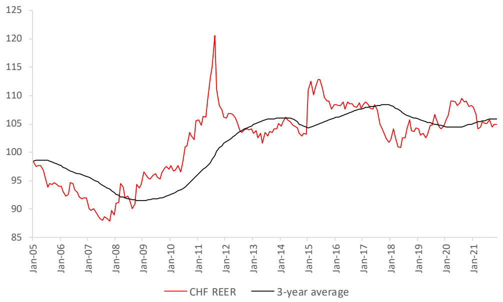
G10 currencies (save JPY) are not undervalued on REER terms despite being under pressure against the USD

- Other major currencies have mostly weakened on an REER basis through 2021. However, most are still in-line or over-valued on a historical basis – still room for major currencies, especially the GBP, to weaken further.

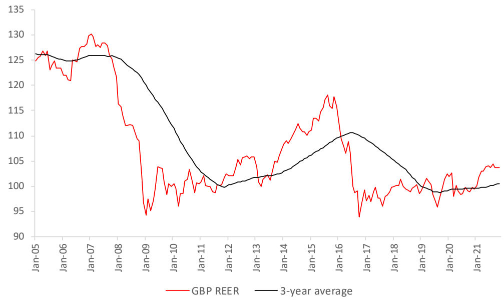
EUR REER



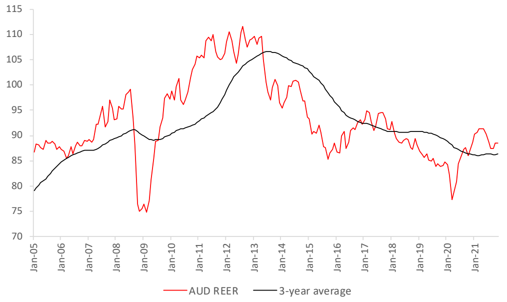
CHF REER



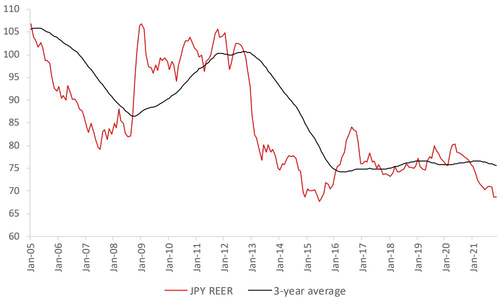
GBP REER



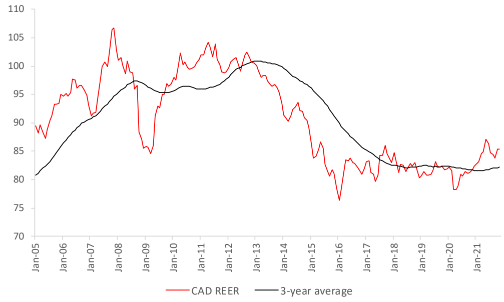
AUD REER



JPY REER



CAD REER



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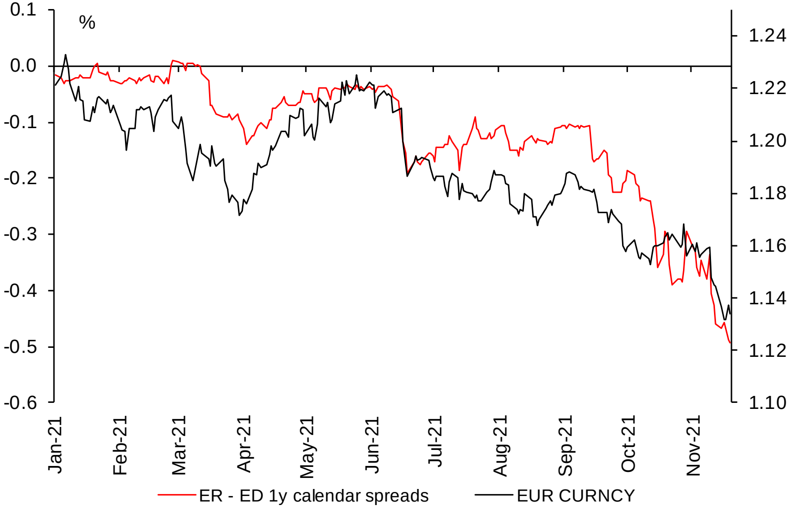
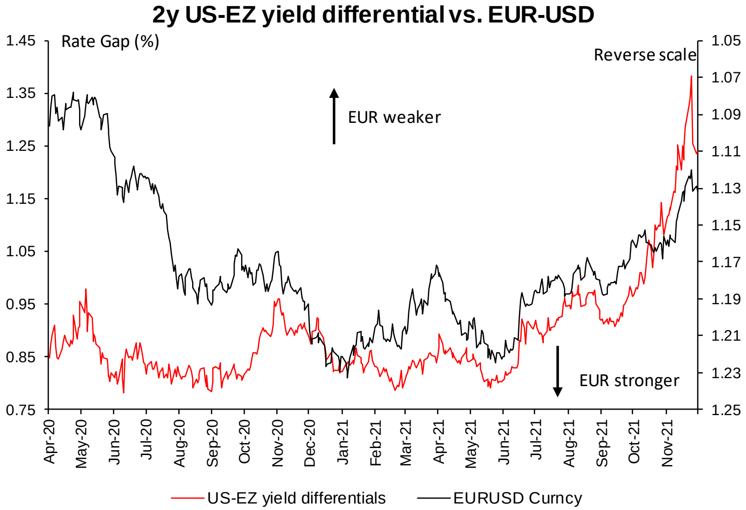
Source: BIS, Bloomberg, OCBC

EUR-USD: Fed-ECB divergence the main driver for the pair’s downside impetus

- Divergence between a hawkish Fed and an ECB that is seeking optionality in reducing asset purchases is in plain sight, and it will be the main driver of the EUR-USD’s downside trajectory.
- **Front-end yield dynamics best reflects this Fed-ECB divergence, and is USD-supportive.** Note strong correlation between the EUR-USD and 1Y calendar spreads and 2y government bond yield differentials. These front-end dynamics are not expected to change until there is a turn in Fed and ECB rate trajectories.





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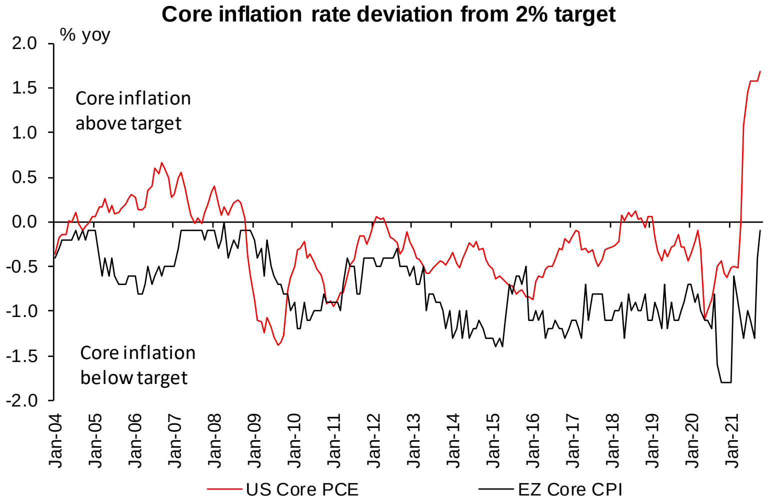
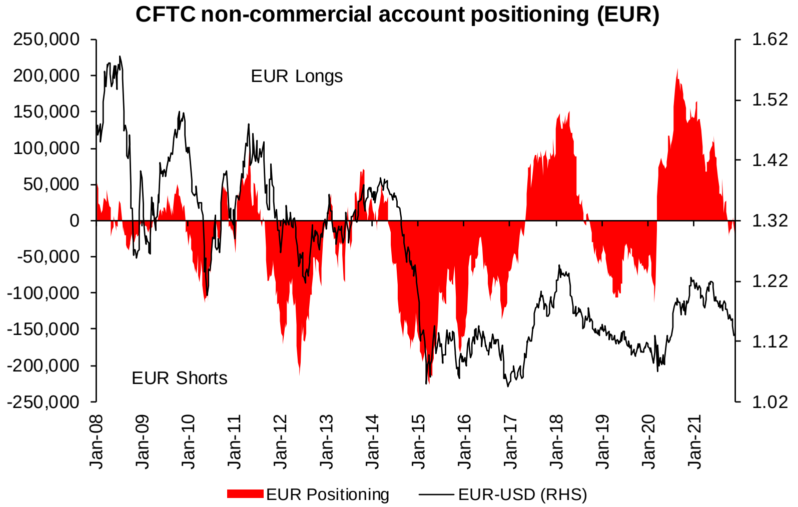
Source: Bloomberg, OCBC

EUR-USD: Can the ECB realistically be expected to catch up in the tightening race?

- The clear risk to the bearish EUR-USD view would be an ECB that is suddenly turns proactive in pulling back stimulus. However, expect this to be a low-probability event, with the key power-brokers within the ECB GC decidedly dovish. **Structurally tame price pressures also make it difficult for them to deviate from the transitory inflation theme.**
- Long-EUR positions were consistently eroded through 2021, and now stands at a small net-short. There is room for further EUR-shorts to build. **Overall, the short EUR-USD downside is our favoured long-USD expression.**





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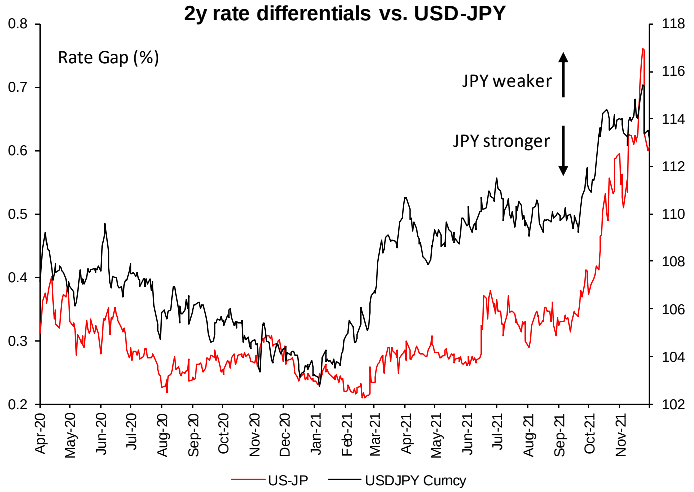
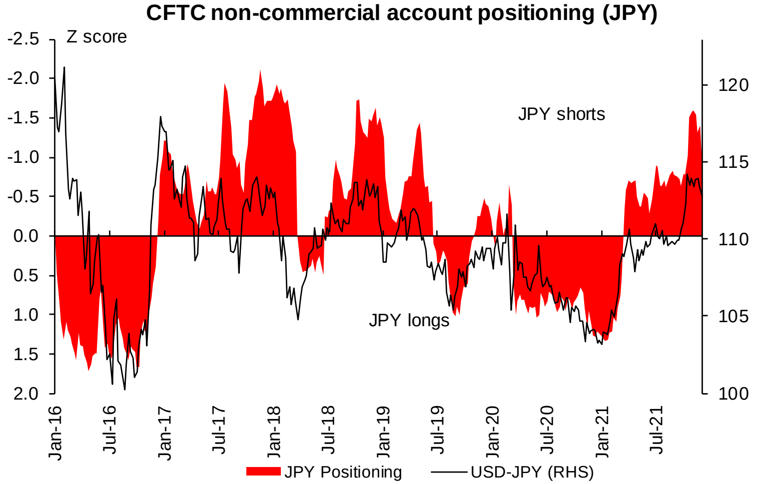
USD-JPY: Central bank dynamics not favourable for JPY, watch front-end yield differentials

- The BOJ remains in a perma-easing mode. **So long as a hawkish Fed is the central assumption, the Fed-BOJ divergence should translate to front-end yield differentials favouring USD-JPY upside.** Any risk-driven declines in the USD-JPY will be an opportunity to enter structural longs.
- **However, short-JPY positioning is now near historically elevated levels, with a clear risk of a sharp short-squeeze. The JPY is also cheap in historical REER terms.** These factors may slow down USD-JPY advance, and leaves us preferring EUR-USD downside as the favoured expression of Fed-led USD strength.





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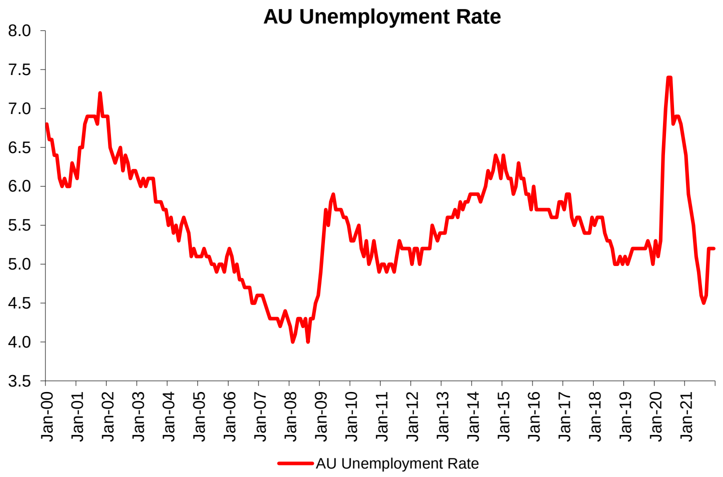
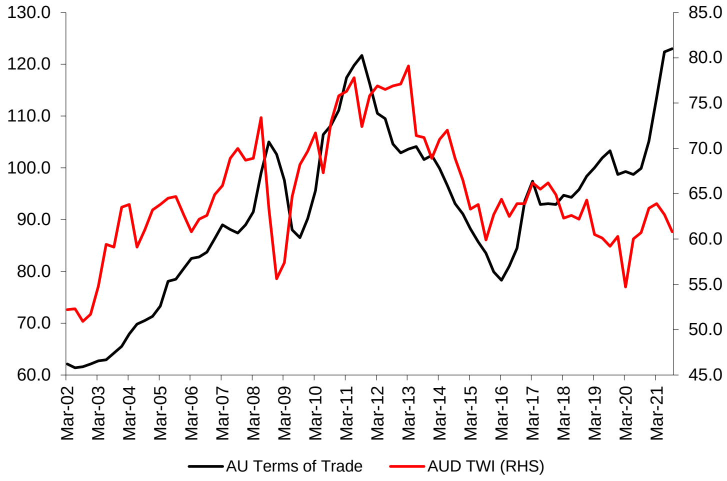
AUD-USD: Australian macro fundamentals not as weak as expected, should hold up to withdrawal of stimulus

- The Aussie external sector has been strong through the pandemic, with border closures and elevated commodity complex providing the support. Domestically, the labour market recovery since the 2H 2020 has been rapid. Should this flow through to stronger wage inflation, the case for the RBA to stay dovish may be weakened. The dovish RBA is one of the reasons why the AUD has diverged from the performance in the commodity complex and its external sector.
- **There is scope for the official RBA guidance, which has signaled 2024 hikes for most of 2021, to converge towards more hawkish market-implied and analyst expectations.**





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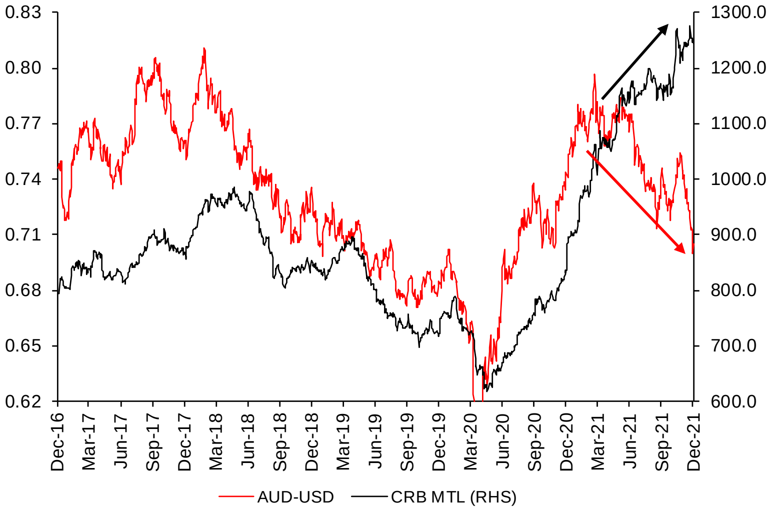
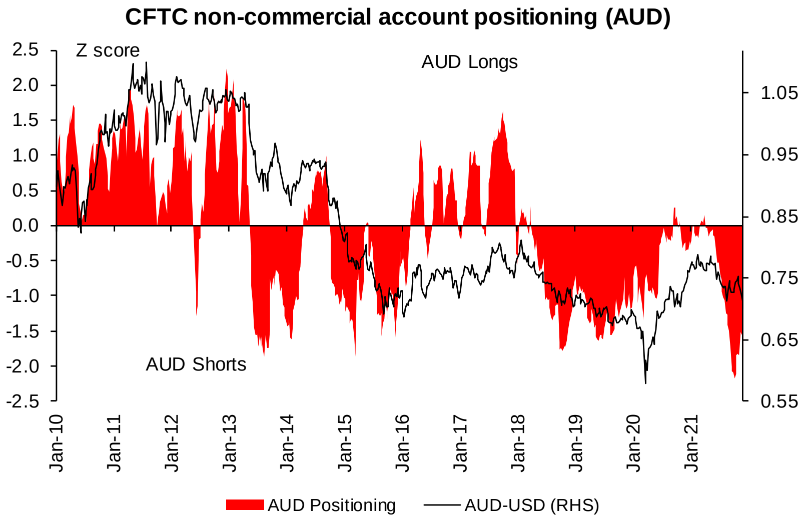
AUD-USD: Cheap by some valuation models; commodities may finally pull their weight with RBA less dovish

- **The RBA has started to deviate from its extreme dovish stance** – the 2024 reference was dropped and the asset purchase progress is expected to end earlier than expected. **Coupled with the still-elevated commodity complex, the medium term environment for the AUD should be less negative.**
- Any reversal of the record AUD short positioning could also spur the AUD-USD higher.

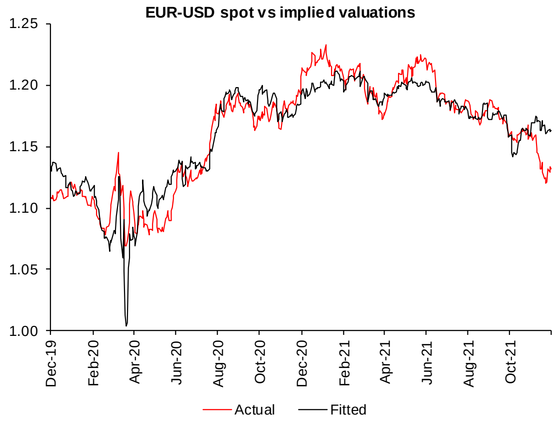


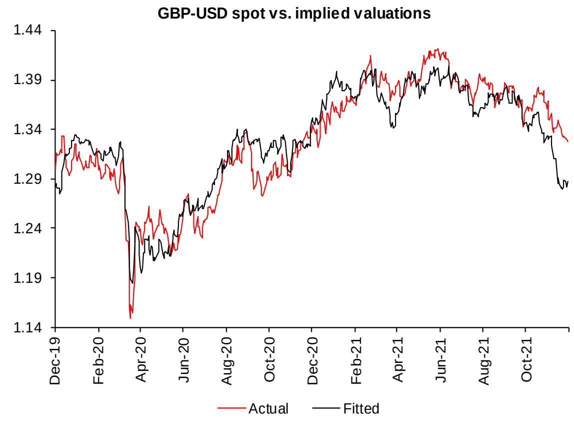


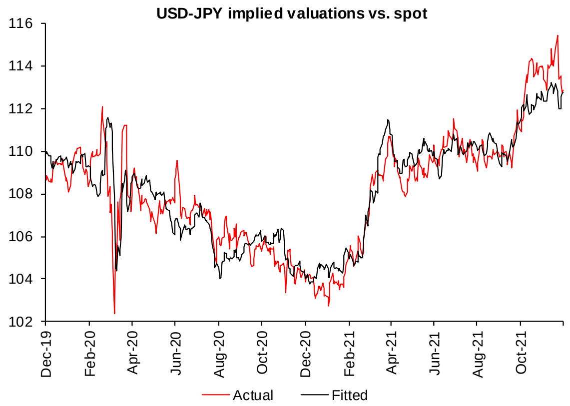
OCBC Bank

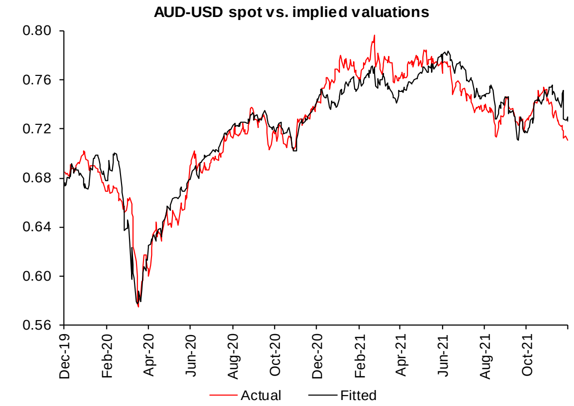
G10-USD summary: Selectively long-USD based on Fed arguments

- Fed-led USD-positive arguments are best reflected against the EUR and JPY, where the ECB and BOJ are structural laggards in terms of pulling back monetary accommodation.
- The BOE is likely ahead of the Fed in implementing the first rate lift-off, but the ongoing Brexit struggles and the niggling market doubt that any BOE tightening is a policy mistake keeps the GBP under pressure.
- Medium term downside expectations for the AUD should be reined in. The RBA might just have sufficient room to lean more neutral without overly impinging on the macro outlook. Sentiment shifts are the biggest risk.







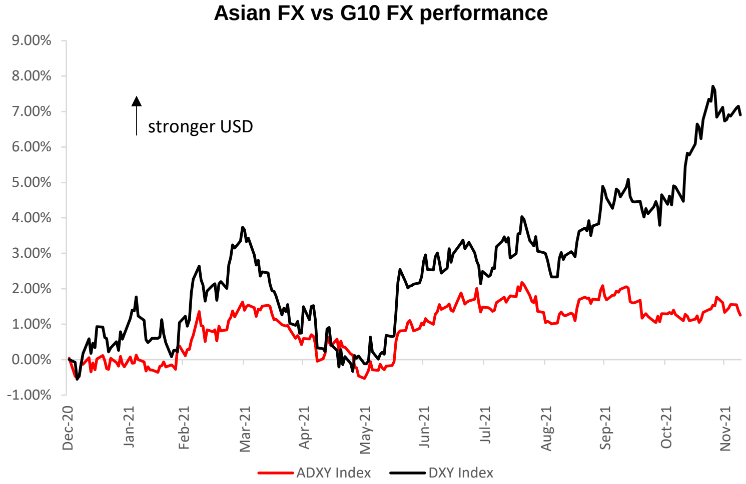


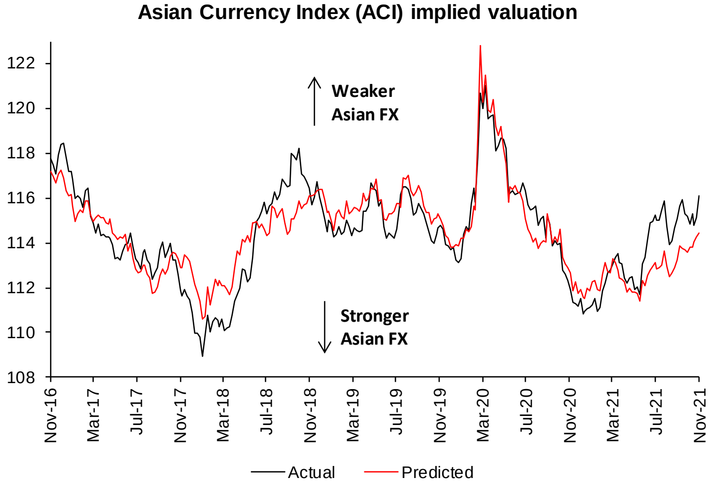
OCBC Bank

Source: Bloomberg, OCBC

Asian FX not the focus of USD strength in 2021, but that may change in 2022

- Asian currencies have broadly outperformed their G-10 counterparts in 2021. Yet, our short-term implied valuation model shows that Asian currencies are leaning cheap since 2H 2021. This suggest that the underlying fundamentals for Asian currencies are robust.
- **Asian currency strength is undergirded by a balance of payments improvement for most economies amid the pandemic.** Asia has benefited from a trade surplus expansion and good portfolio inflows. However, this dynamic may start to shift into deeper into 2022.



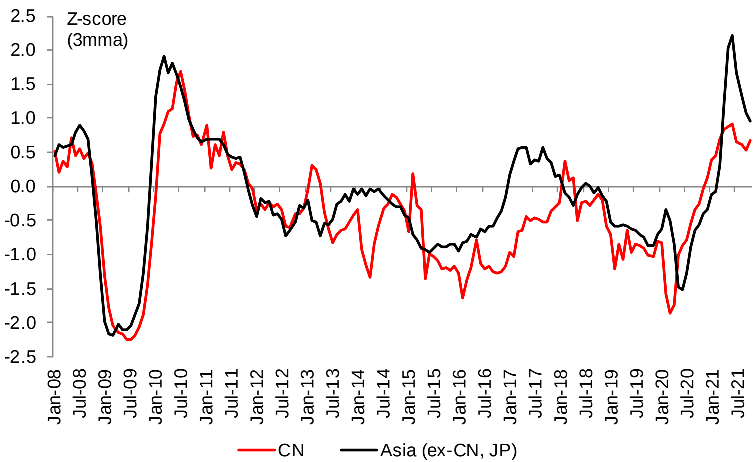


Source: Bloomberg, OCBC

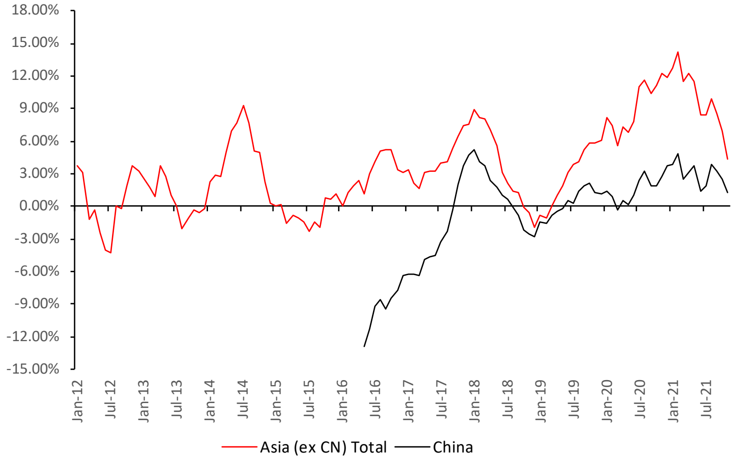
Asian BOP improvements may dissipate in 2022 as the pandemic situation fades

- The peak of the Asian export boom has likely occurred in 2Q 2021, and has faded as the rest of the world start to reopen. With ongoing normalization in terms of domestic consumption, the import sector should also start to pick up in 2022. On net, the trade surplus may start to fade.
- Factors affecting other components of the BOP, such as portfolio and FDI flows, and commodity prices, may also see shifts. **Overall, the BOP support has persisted since the start of the pandemic, but ongoing normalization should see that positive impact fade**.

Asian aggregate (Exports)



yoy% change in total foreign reserves



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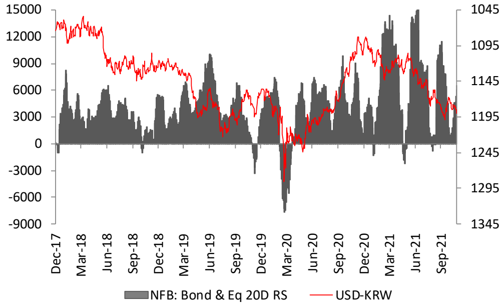
Source: Bloomberg, CEIC, OCBC

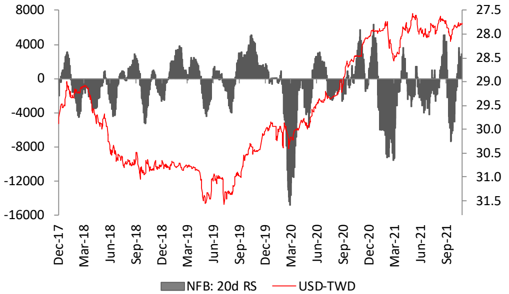
Portfolio flow environment may see a shift in 2022 as DM monetary tightening takes hold

- EM Asian real yield advantage should support EM Asian assets. Yet, this advantage may likely be crimped into 2H 2022 as DM real yields rise on policy tightening. The flow advantage for Asian currencies may not be sustainable.

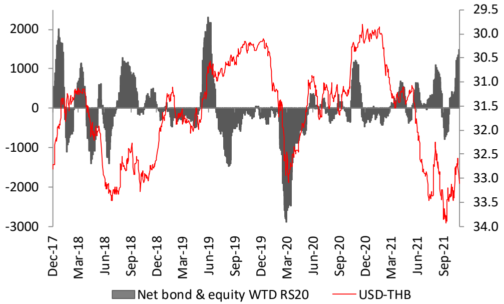
South Korea



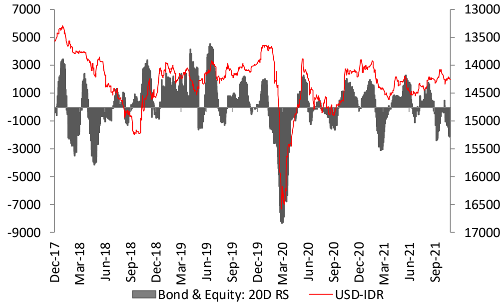
Taiwan



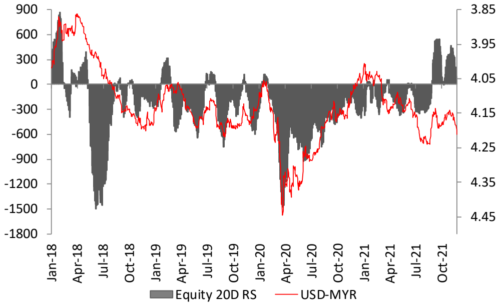
Thailand



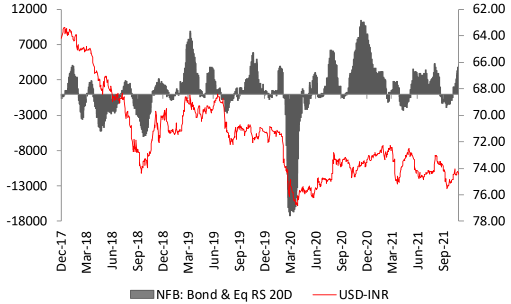
Indonesia



Malaysia



India

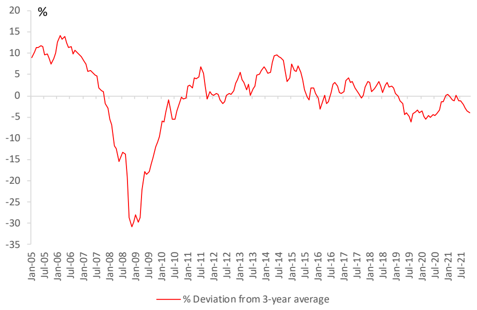


Source: Bloomberg, CEIC, OCBC

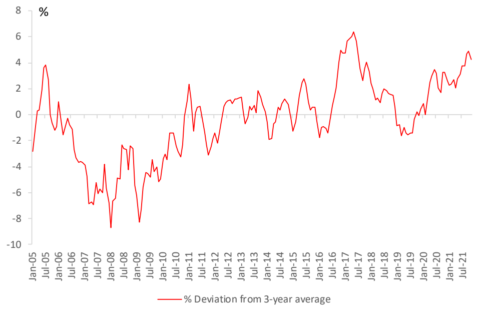
Asian FX mixed in terms of REER valuation: Focus on THB and MYR undervaluation in Southeast Asia…

- … while the IDR is in-line with historical valuation. Note undervaluation in KRW despite the fundamental positives.

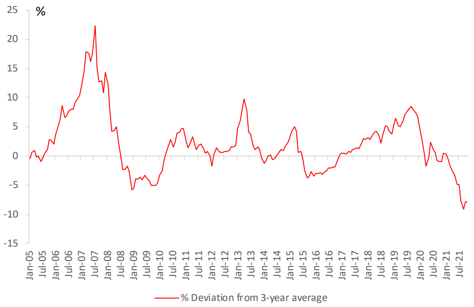
KRW REER: Deviation from average



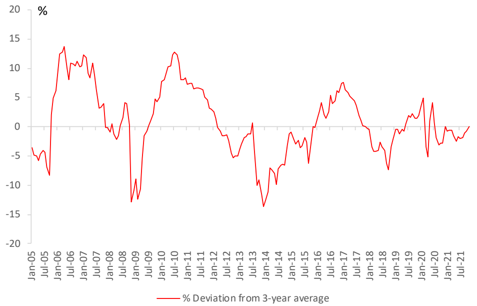
TWD REER: Deviation from average



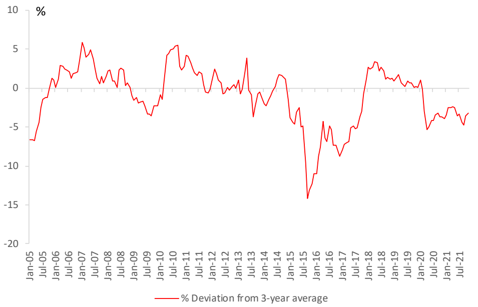
THB REER: Deviation from average



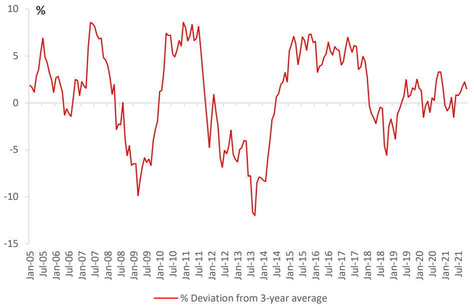
IDR REER: Deviation from average



MYR REER: Deviation from average



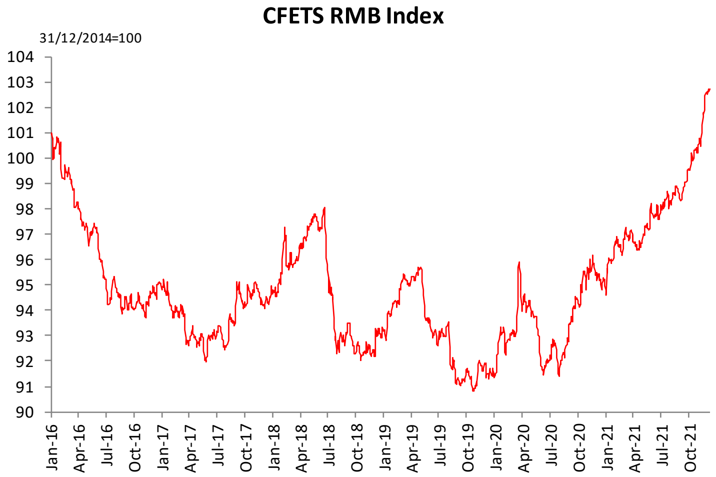
INR REER: Deviation from average

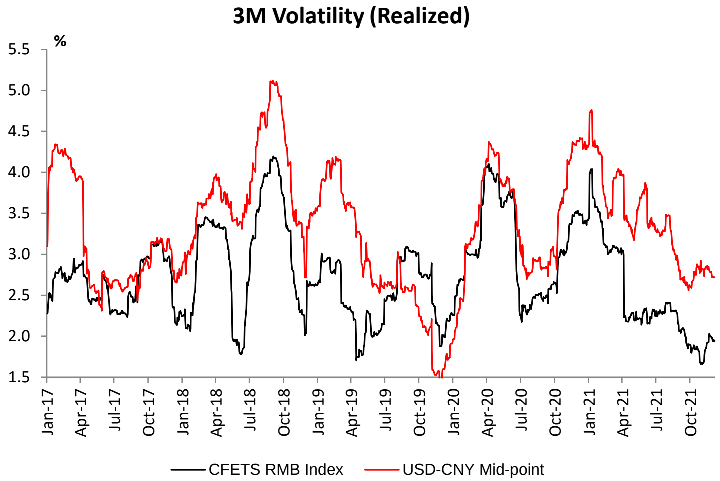


Source: Bloomberg, BIS, OCBC

RMB: Low vol, strengthening environment may persist early in 2022

- The RMB has experienced a low vol, strengthening environment for 2021, with the CFETS RMB Index as the main conduit. The USD-CNY and USD-CNH mostly grinded lower in a contained fashion, offset by USD strength and potential sensitivities around the spot level of the pair.
- **The supportive BOP dynamics could still persist in early 2022. Thus, we continue to expect the RMB complex to stay supported, primarily reflected through the CFETS RMB Index and CNH crosses.** These dynamics may only start to shift by mid-year.



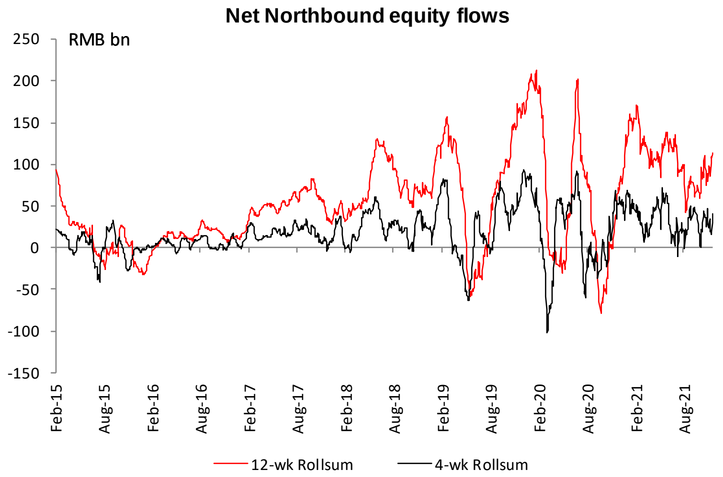


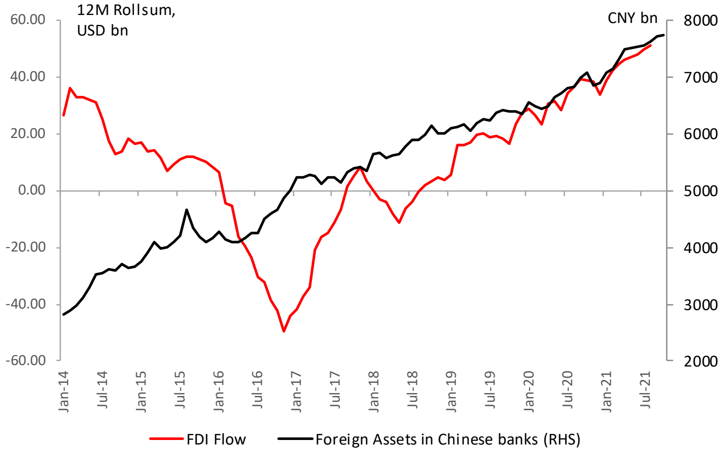
OCBC Bank

Source: Bloomberg, OCBC

RMB: BOP dynamics should support, but watch for potential shifts with ongoing normalization

- Equity inflows and FDI inflows continued to be robust despite the growth slowdown and the regulatory upheavals. This reinforces the export boom and further underlies the external health of the Chinese economy. The services deficit also stayed at reduced levels due to closed borders.
- **These RMB-supportive dynamics will fade over 2022, but the changes will be mostly gradual** – ongoing normalization and monetary tightening in the DM space could see inflows slow down. What could turn more rapidly is the services deficit, but that will need the government to reopen borders, something that may not happen until late 1Q.



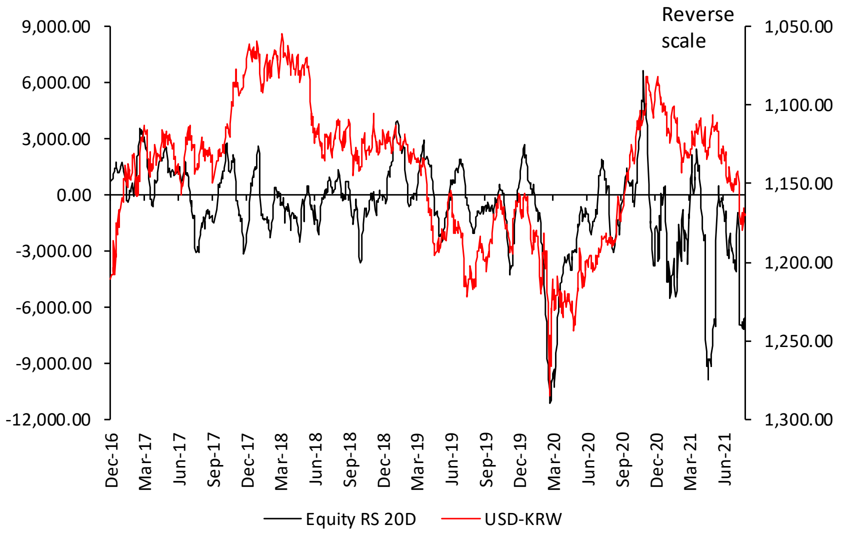


OCBC Bank

Source: Bloomberg, OCBC

KRW: Frustration as macro resilience and hawkish BOK offset by other negative factors

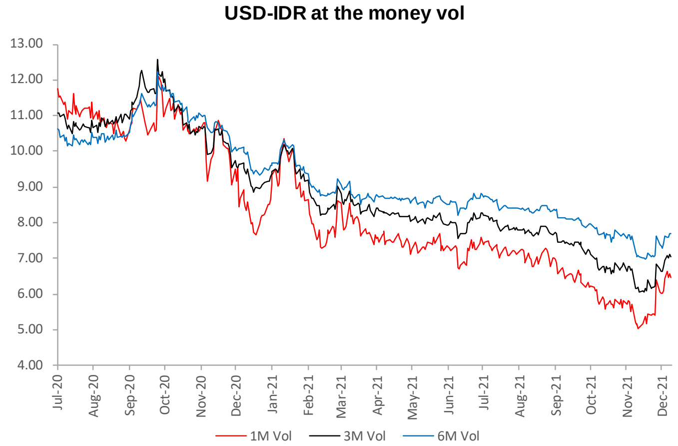
- South Korea arguably has the most resilient macro foundations in 2021, and the Bank of Korea is also leading the way in terms the pull-back of monetary stimulus. Yet, this is overshadowed by secular equity outflows that is comparable to the worst periods of the COVID-19 pandemic. A small positive here is that outflows have eased and the same extent is unlikely to be repeated in 2022.
- Trade surplus supports the BOP and the KRW, but its impact could ease in 2022 as the export sector has likely peaked in 2021, and imports may start to pick up speed. **Overall, the KRW leans cheap on an REER-basis and that should limit excessive weakness, but a clear appreciation theme have yet to present itself. Expect further depreciation against the CNH in early 2022.**

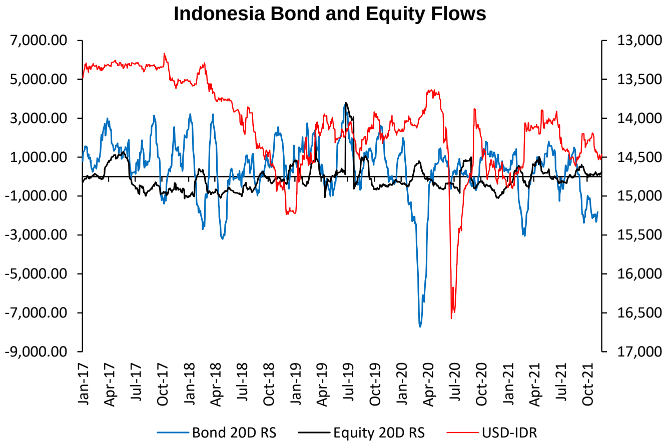


Source: Bloomberg, CEIC, OCBC

IDR: Low vol environment has benefited the IDR and IDR assets; may change in 2022

- The IDR assets have benefited from a low and decreasing implied and realized vol environment in 2021. In 2022, the baseline expectation is for monetary tightening in DM economies. This could translate to higher USD-IDR vol and a reduced attractiveness of IDR assets. The early signs of this – uptick in USD-IDR vols and bond outflows – are already underway. This dynamic could worsen by the 2Q 2022.
- The flipside to that argument is that IDR asset enjoy a nice real yield advantage that may cushion any increase in DM real yields. A pipeline of tech IPOs early in 1Q 2022 may afford some equity inflows offset to the potential bond outflows. **These factors may keep the IDR relatively more supported compared to other South-east Asian currencies.**



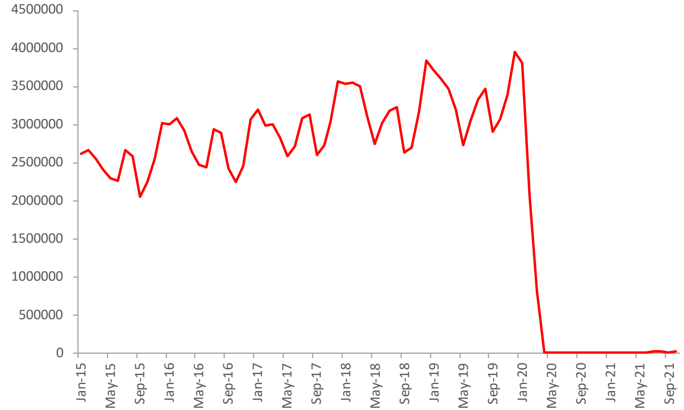


Source: Bloomberg, CEIC, OCBC

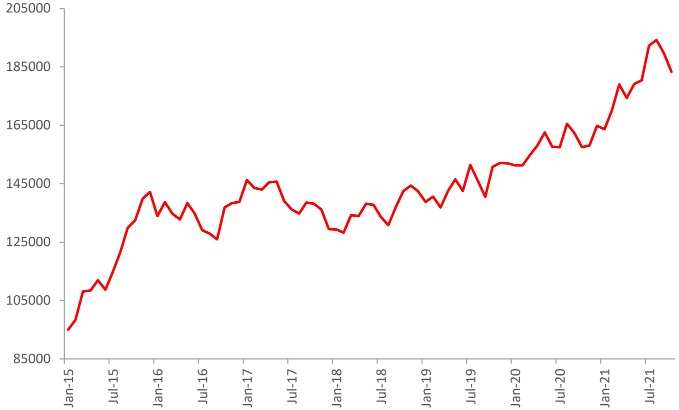
THB: Tourists desperately needed to balance the BOP
MYR: Only clear winner in SE Asia from higher oil prices

- **THB:** Thailand is perhaps unique in that the pandemic has sharply worsened the BOP situation, instead of the improvement seen in most other Asian economies. Elevated commodity complex also has a negative impact on the current account. All eyes on tourist arrivals, without which it is next to impossible to construct a structural THB-positive thesis beyond short-term speculative surges.
- **MYR:** As a net exporter of oil, Malaysia is one of the rare beneficiaries in Asia from the higher commodity complex. Outright appreciation pressure is still missing though. Foreign currency assets are accumulating in the banking system – a clear catalyst for conversion would be needed for the MYR to move into a stronger appreciation path.

Thailand: Monthly Tourist Arrivals



Malaysia: Total Foreign Currency Deposits



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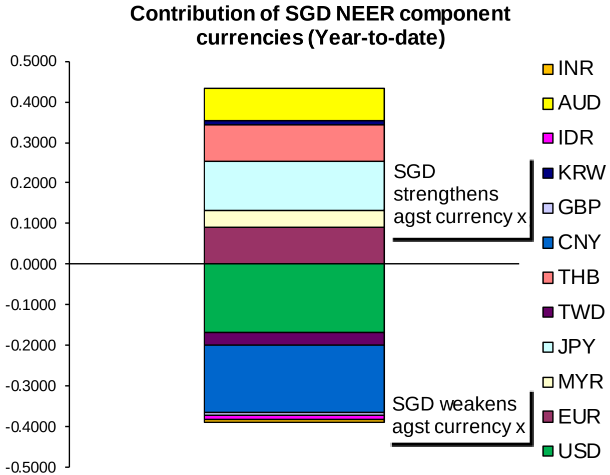
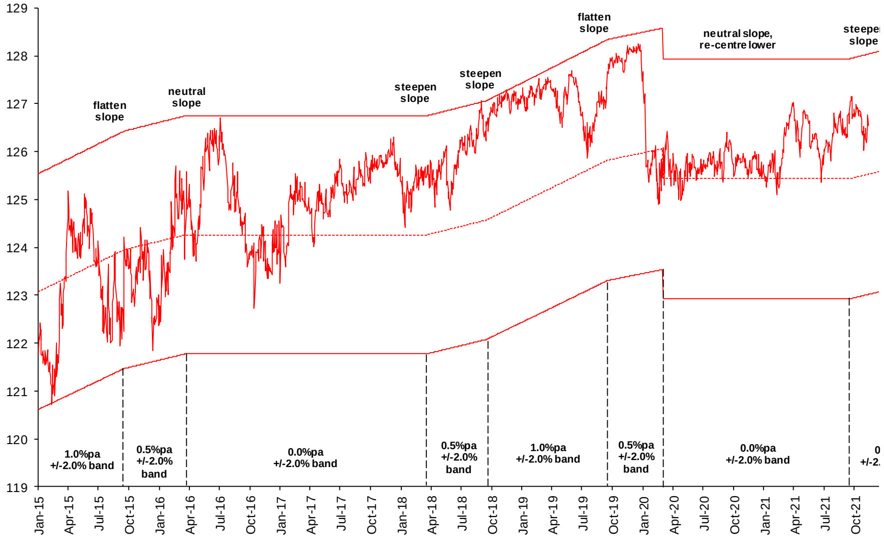
Source: Bloomberg, OCBC

SGD NEER: Heavy into the year-end, but still expect it to edge higher in 1Q 2022

- The domestic outlook in Singapore looks positive on balance, with growth estimates and MAS rhetoric painting a net optimistic picture after the surprise slope steepening move in Oct 2021. With core inflation expected to grow firmer next year, we expect another slope-steepening move come April 2022.
- **Notwithstanding the recent dip in the SGD NEER, expect the index to enter a higher plane around to +1.00% to +1.50% above parity in the run-up to the April 2022.** This implies some upside bias for the SGD on a basket basis from current levels.





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Source: Bloomberg, OCBC

2022 Rates Outlook

14 Dec 2021

Treasury Research & Strategy
Global Treasury

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Summary of rates views:

Policy backdrop:

- Fed asset purchases is likely to cease sooner than the FOMC's initial "illustrative path" implies. This would give the Fed more flexibility when it comes to rate hike decisions.
- Two rate hikes in 2022 after taper is completed does not represent a packed schedule. Chance is for the Fed's dot-plot to shift upward, closing partially the gap with market expectations.
- Most Asian central banks will try to resist tightening pressure, but this task will become more challenging going into H2-2022.

Markets:

- **We expect the 10Y UST yield to rise, on the back of stable/mildly higher inflation expectations and higher real yields.** The curve is likely to steepen during the early part of 2022, as front-end has already priced in monetary tightening, before flattening back near/upon the start of the hiking cycle in the second half of the year. We expect the 10Y UST yield to reach 1.85% by end Q2-2022.
- SONIA futures pricing a "terminate rate" at around 1% by the March 2023 contract looks overly hawkish. This pricing is likely to be adjusted.
- There is room for Bunds to outperform USTs given the divergence in the monetary policy outlook.
- Two factors that will likely lead to heightened volatility in yields from time to time: headlines surrounding the virus situation and border opening/restrictions, and adjustments in market expectations versus CB stances.

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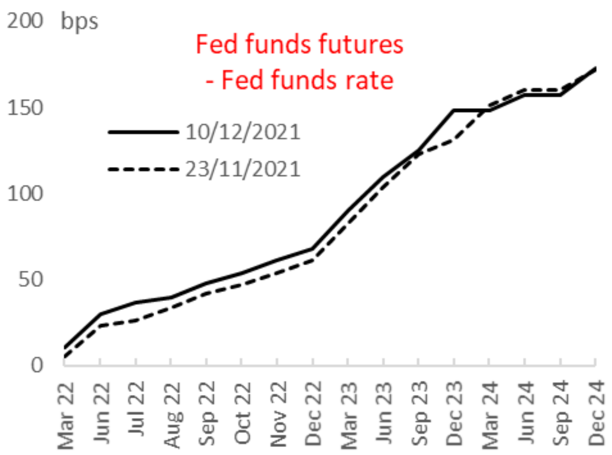
Summary of rates views:

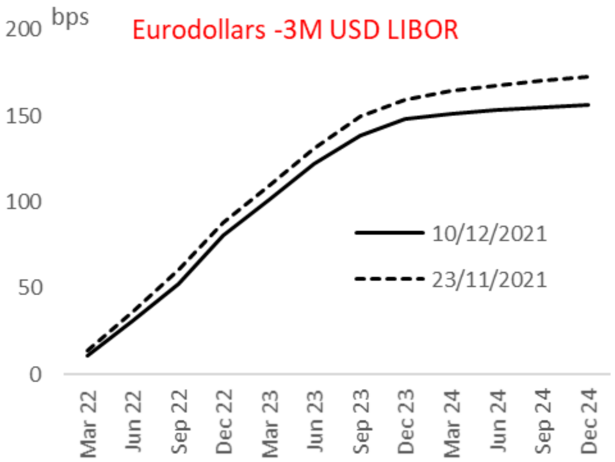
Markets:

- **In Asia, relatively wide real yield differentials act as a buffer** for selected local-currency markets against expectedly rising USD rates. Investors may however not put too much weight on this indicator when yields stay volatile. Over the course of 2022, there is scope for Asian LCY government bonds to outperform USTs. We look for narrowing in a number of spreads, including 10Y SGS yield vs UST yield, SGD SORA vs implied rates from USD SOFR, 3-5Y MGS yields vs UST yields, CGB yields vs UST yields, front-end HKD IRS vs USD IRS.
- **IDR**: 2022 issuance may be front-loaded, allowing for flexibility to support the bond market should the US rate hiking cycle start later in the year.
- **MYR**: the 3Y and 5Y MGS shall be relatively resilient on the curve, in the absence of BNM hawkishness
- **SGD**: 10Y SGS-UST yield spread to narrow, on light supply pressure, supportive real yield differentials, and in the absence of direct QE withdrawal/rate hike impact. The SGD SORA curve to revert gradually to what is implied by the USD SOFR OIS curve.
- **CNY / CNH**: supportive policy stance shall lead to CNY rates outperformance over USD rates. Net additions to the CNH pool may not be huge; the CNH DF curve is likely to mostly track the onshore CNY DF curve.
- **HKD**: additional bill issuances cannot be ruled out, but interbank HKD liquidity shall remain flush. As absolute rate levels increase, bias is for front-end HKD-USD rates spreads to narrow.

USD rates: front-end pricing

- **Pricing of between two and three hikes for 2022 does not look overly aggressive**.
- While the end of taper does not automatically translate into a rate hike, the flexibility it provides appears good enough to sustain market expectations. If taper is to be completed around or before mid-2022, a two-rate hike profile in 2022 does not represent a packed schedule.
- Market is not pricing in an imminent rate hike, which means there is a lack of platform – such as a near-term FOMC meeting - for a dovish surprise, barring a U-turn in Fed stance.
- Some dovish triggers are required for market to scale back monetary tightening expectations.



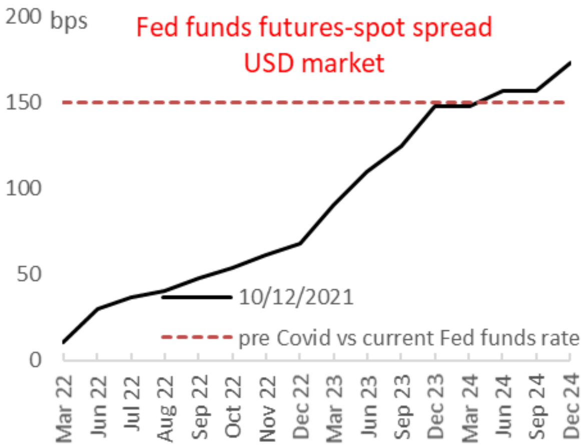


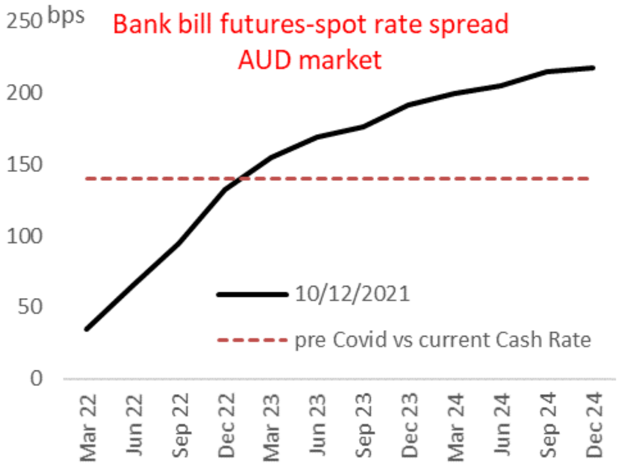
Source: Bloomberg, OCBC

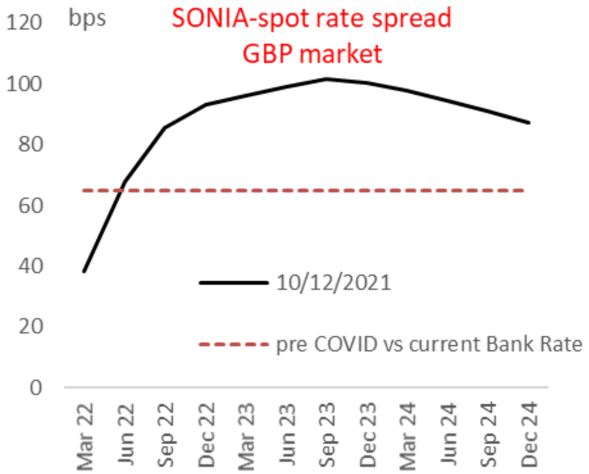
OCBC Bank

Pricing comparisons

- **Monetary pricing in the USD market is not the most aggressive, compared to the GBP or the AUD markets**.
- The upper end of the Fed funds target rate was 1.75% before COVID hit, 150bp higher than the current level; Fed funds futures is pricing a cumulative increase of around 66bp by end-2022.
- BoE Bank Rate peaked at 0.75% in the last cycle; SONIA futures are pricing in a terminal rate of around 1% and expect this to be reached at around end-2022/early 2023.





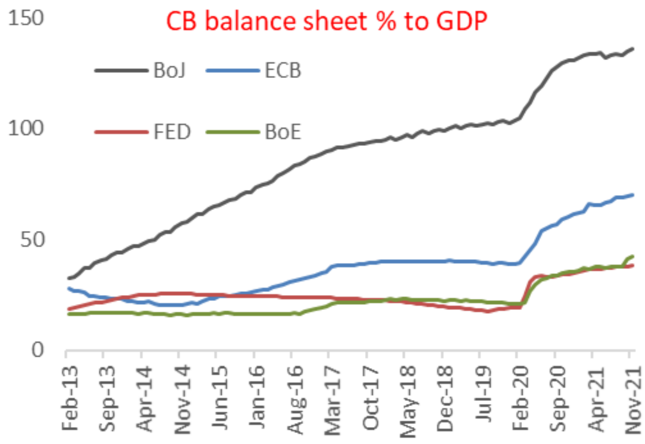


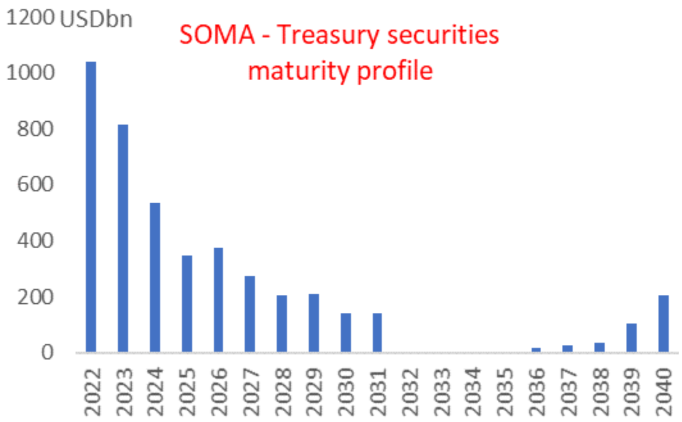
OCBC Bank

Source: Bloomberg, OCBC
*Calculations are on the expected changes in the underlying rates, not necessarily the policy rates
*Calculations ignore the numbers of days before and after the MPC meeting in the relevant month

Withdrawal of stimulus – what is the sequence?

- CB balance sheets are still expanding, for now. Some are tapering, some programs are ending.
- **The decision to shrink the balance sheets has yet to be made**
- Some members at the Fed and BoE have flagged thoughts about stopping reinvestment – so the balance sheets will shrink passively



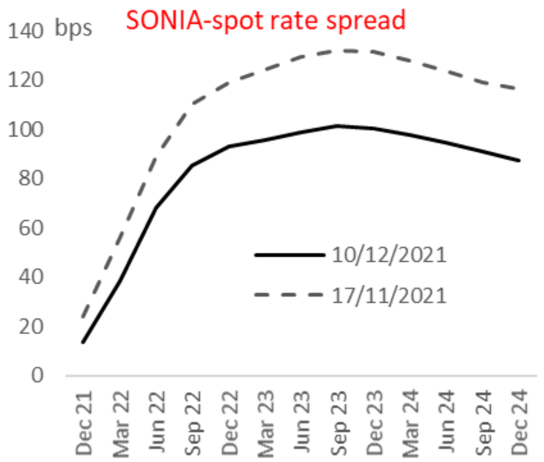


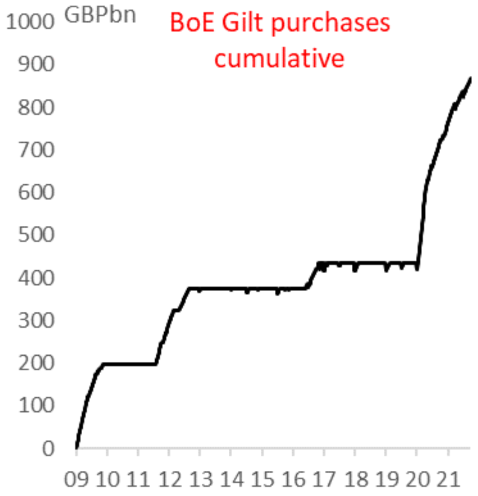
OCBC Bank

Source: Bloomberg, New York Fed, OCBC

BoE – sequence of monetary policy tools

- BoE has mentioned that it intended to reduce the stock of purchased assets by ceasing to reinvest maturing assets when the Bank Rate has risen to 0.5% (and if appropriate given the economic circumstances).
- The MPC will consider actively selling its holdings “only once Bank Rate has risen to at least 1%”. **This seems a distant future to us, given the Bank Rate peaked at 0.75% during the previous cycle.**
- Market is however pricing in a “terminate rate” at around 1% by the March 2023 SONIA futures contract. This pricing is likely to be adjusted down the road.



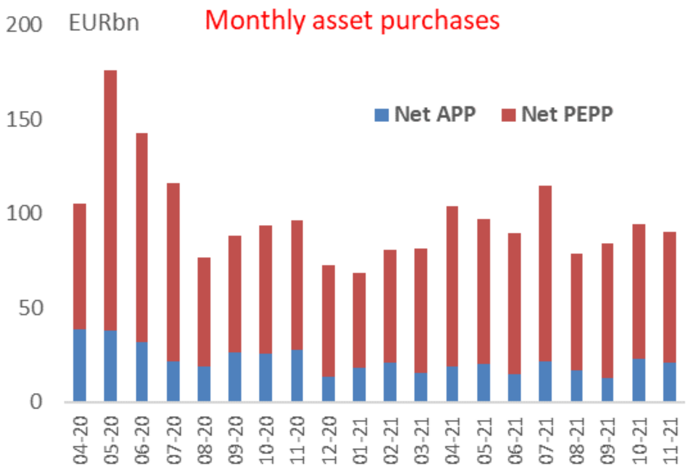


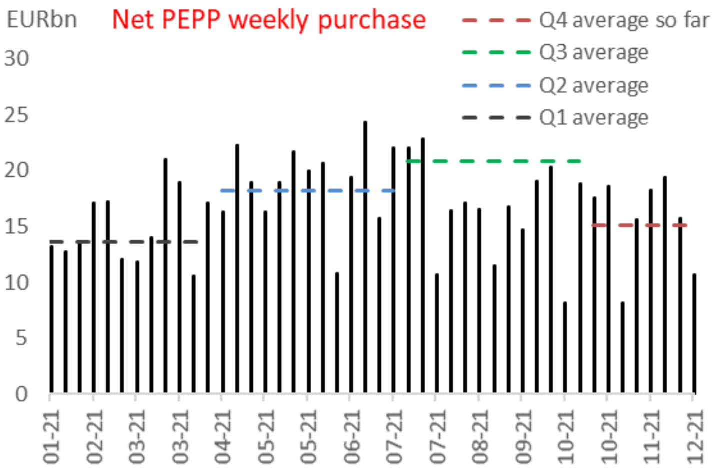
OCBC Bank

Source: Bloomberg, OCBC

ECB – PEPP and APP

- Focus at upcoming MPC meetings is on the announcement of **a successor to PEPP and/or any change to APP**.
- The run-rate for the existing PEPP envelope to be fully utilized by end March 2022 is around EUR18-19bn per week. Reinvestment is expected until end-2023.
- The plan has been for APP to end shortly before the first policy rate hike.
- There is **room for Bunds to outperform USTs** given the divergence in the monetary policy outlook, despite that the 10Y UST-Bund yield spread is already relatively wide compared to recent history.

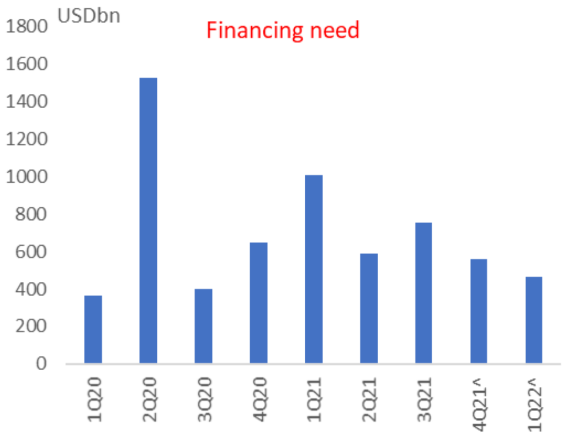


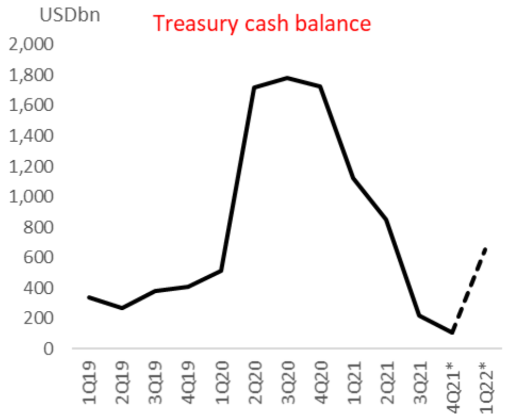


Source: Bloomberg, OCBC

USD rates: taper impact

- Fed asset purchases are likely to cease after the March/April round or the February/March round of buying, earlier than the original schedule.
- The rationale for a faster taper is **to provide the Fed with more flexibility** when it comes to rate hike decision; this flexibility is desirable especially with heightened uncertainty on the inflation outlook.
- While an end to asset purchase does not automatically translate into a rate hike, this prospect may be good enough to sustain current market expectation on rate hikes.
- When taper is completed, that means there is **a removal of quarterly demand of USD240bn** for Treasury securities. This is not insignificant compared to supply.
- Meanwhile, upon a resolution to the debt ceiling, US Treasury shall be looking to rebuild its cash balance, adding to supply.





Source: US Treasury, OCBC
^US Treasury's estimates
*latest for 4Q21, Treasury target for 1Q22

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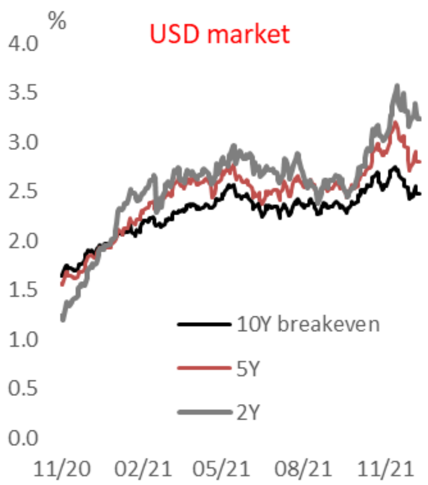
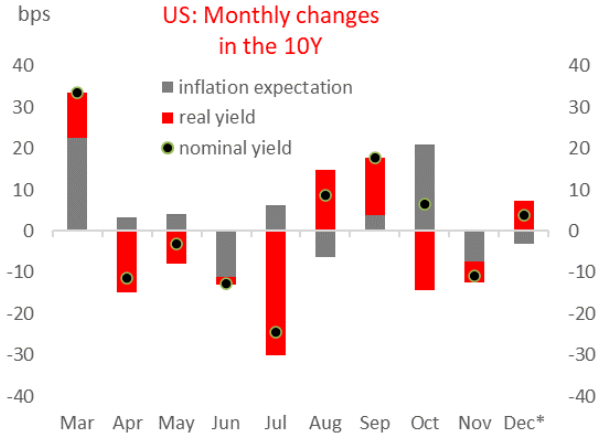
US 10Y yield: decomposition of nominal yields

- We decompose nominal yield movement into breakeven (inflation expectation) and real yield (proxy for growth expectation) changes.
- Breakevens have eased from the peaks around mid-November; curve stays inverted albeit less so. Real yield is more negative than during Q1-2021 when vaccines were not readily available.
- From here, **bias is for inflation expectations to be sustained/go mildly higher, while there is potential for the deeply negative real yield to rise** to align with economic fundamentals, pushing nominal yields higher.





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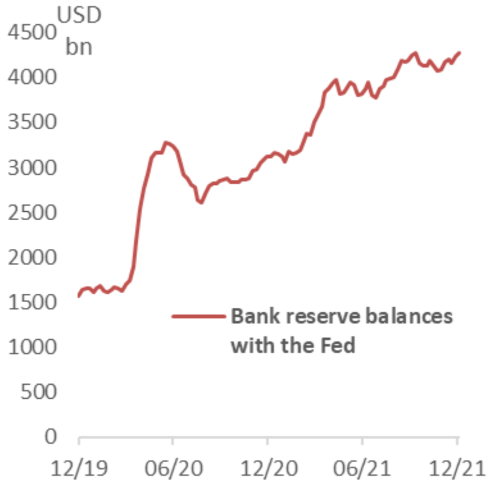
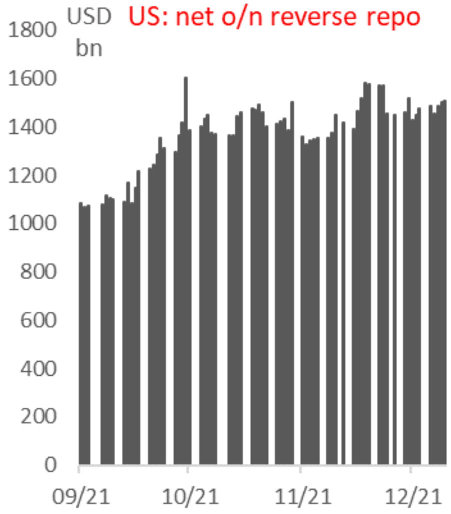
Source: Bloomberg, OCBC *as of 10 December

USD liquidity

- US Treasury's cash balance with the Fed (GTA) has been falling rapidly from the high of USD1.66trn in early February, to the latest USD118bn. Meanwhile, Fed's asset purchase has continued, adding to banks' reserve balance.
- The **USD liquidity situation shall normalize gradually** (as in becoming less flush) as taper is in progress, and on an expected resolution to the debt ceiling.
- Upon a likely increase in the US debt ceiling, **Treasury shall be looking to replenish its cash balance**, towards its target of USD650bn.

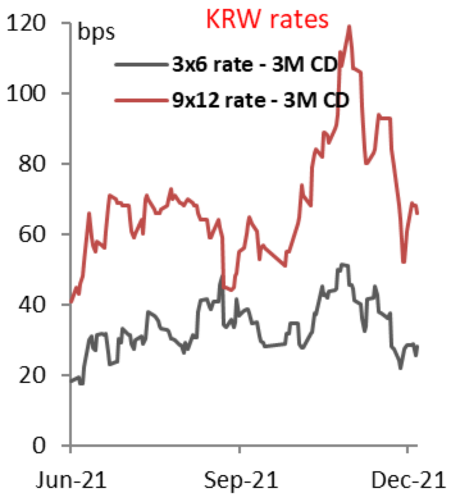


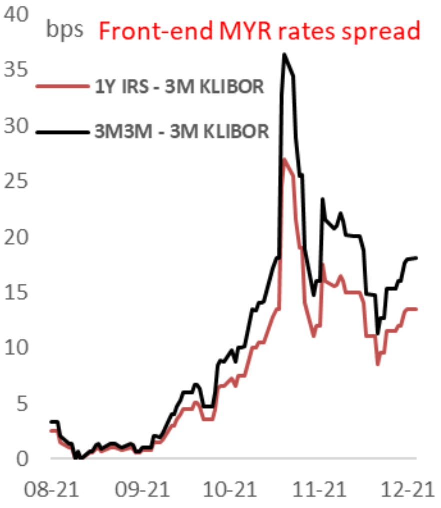


Source: Bloomberg, OCBC

Asian central banks

- Most Asia central banks will **likely try to resist hiking rates**, to sustain economic recovery. It may become a more challenging task when the Fed starts to hike rate potentially in H2-2022.
- Bank of Korea is the exception, putting more emphasis on financial (in)stability.





Source: Bloomberg, OCBC

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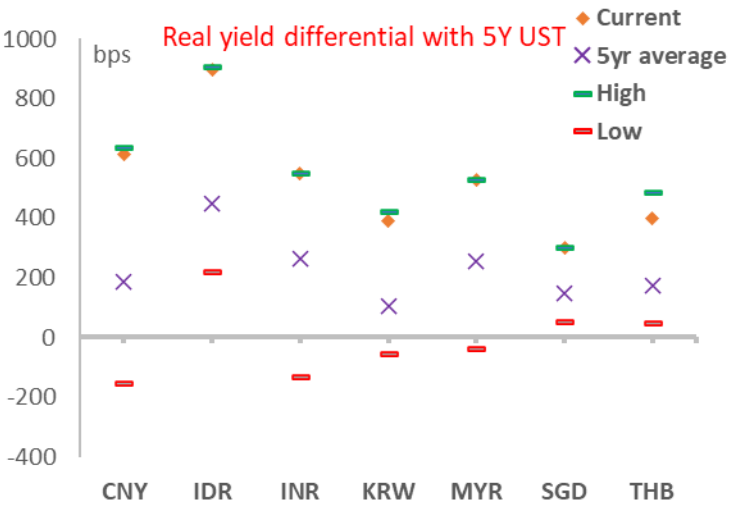
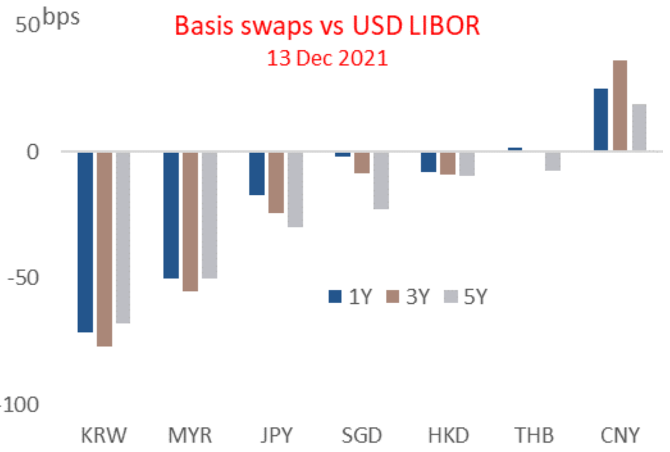
Asia: real yield differentials

- Real yield differentials for most local currency markets in Asia are near the upper end of multi-year ranges.
- **Real yield differentials act as a buffer against expectedly rising US yields.**
- Investors may not put too much weight on real yield differentials if global yield movement stays volatile, but over the course of 2022, **there is scope for Asian LCY government bonds to outperform USTs**, probably more obviously during the second half of the year.
- **One caveat is the highly uncertain inflation path**. There is a trade-off between using past averaging inflation and inflation expectations in this model. 1Y inflation expectation in the US, for example, is much lower than multi-month CPI averages. However, inflation expectation gauges are not readily available in most Asian markets.
- On top of yield differentials, the current suppressed basis swaps/well-behaved implied rates mean asset swaps into KTBs and MGS are relatively appealing compared to regional peers.





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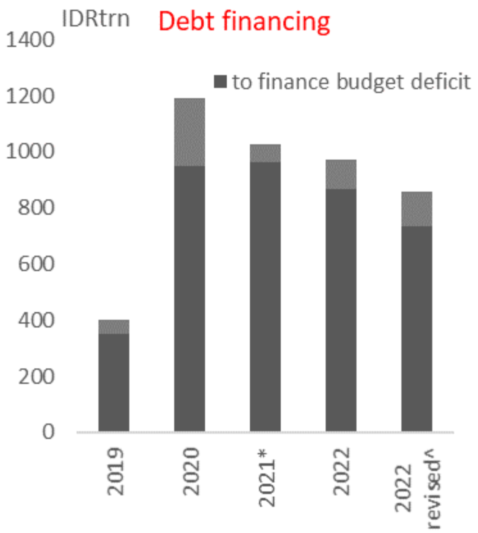
Source: Bloomberg, OCBC
As of 10 December 2021

IDR: fiscal consolidation

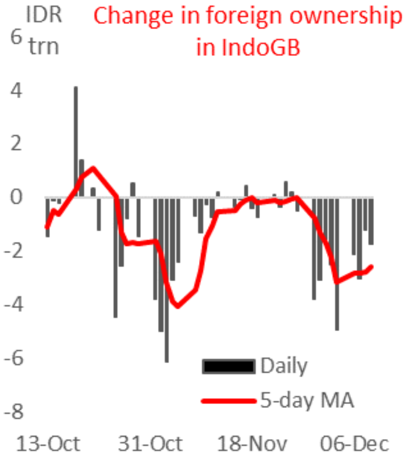
- Budget 2022 has expenditure planned at a tad higher than the revised estimate for 2021. Nevertheless, with projected higher revenue and economic growth, and unspent cash, 2022 budget deficit has been revised to 4.10% to GDP – from the 4.85% that was earlier set in the national budget. 2021 deficit has been further revised downward to “the lower end” of the 5.1-5.4% range.
- If the Finance Ministry’s outlook for revenue pans out, 2022 net supply will be at around 15% less than that in 2021.
- **Issuance may be front-loaded** if the authorities would like to take advantage of the still low yield levels, and to **allow for the flexibility to support the market** with reduced issuance towards the latter part of the year when the Fed is expected to hike the Fed funds target rate.

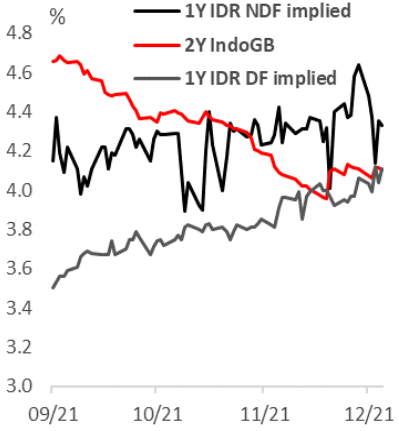


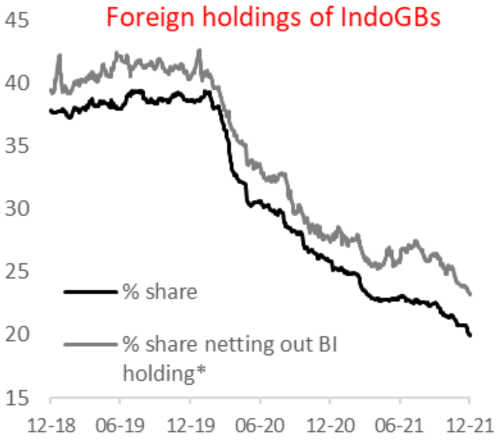
Source: Ministry of Finance, OCBC
*revised estimates for 2021
^ revised figures for 2022 budget, and OCBC estimates

IDR: foreign flows

- There have been outflows from IndoGBs for most of the days since the trend started in early September, as foreign investors turned more cautious amid the volatility in global yields, and the subdued risk sentiment of late; there were incentives to take profit following the previous IndoGB outperformance.
- Foreign holdings as a % to outstanding has fallen steadily over past quarters, **rendering the IndoGB market less vulnerable to foreign flows, although foreign investors can be the marginal buyers or sellers affecting short-term market momentum.**
- Foreign investors may not make a strong comeback when global yields stay volatile. Past liquidation of holdings nevertheless means lighter positions to start with. When investors re-focus on real yield differentials, inflows shall rebound. A stable Rupiah and/or support from DNDF will be helpful given that implied IDR rates are not low.







Source: Bloomberg, CEIC, OCBC
*not including BI holdings via private placement

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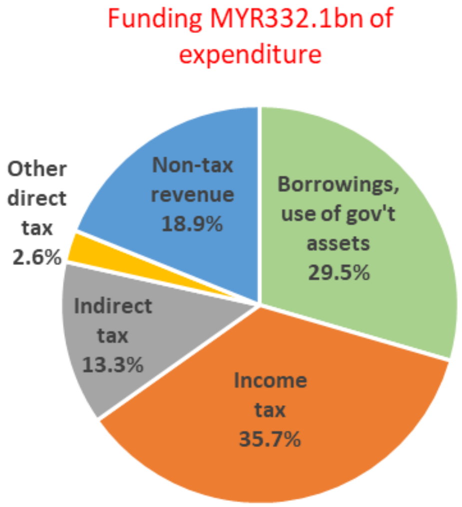
MYR: fiscal position

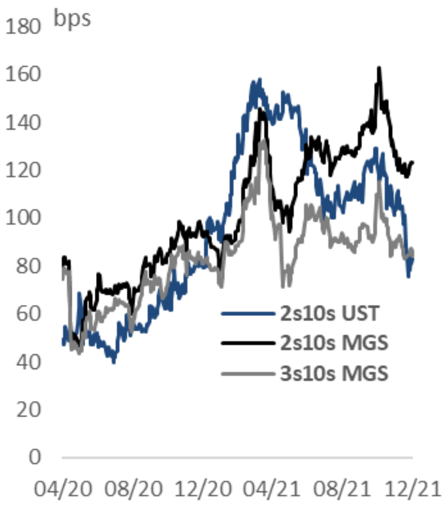
- 2022 budget deficit is planned at 5.95% of GDP, narrower than the estimated 6.52% for 2021, mainly as nominal GDP is expected to expand by 8.1%; the deficit amount is planned at MYR97.5mn, not far away from 2021 estimate of MYR98.8bn.
- Assuming most of the deficit is funded by domestic debt, then **net issuance of MYR government securities is likely to be similar to that in 2021**.
- There are risks regarding the final amounts of issuances, namely potential need for additional fiscal stimulus (which can no longer be via NPF withdrawals given small individual balances), and revenue shortfall.

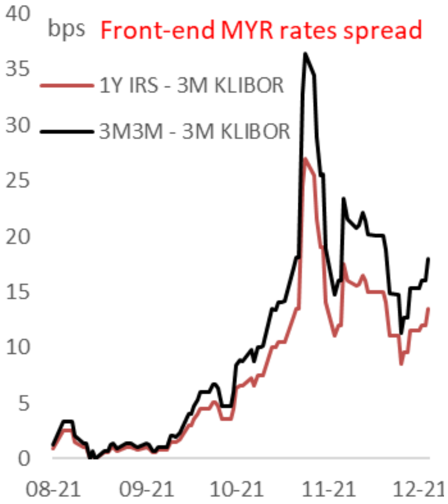


Source: Ministry of Finance, OCBC

MYR rates

- The MGS curve has followed the UST in the flattening move, despite a lack of hawkishness from BNM itself.
- **The 3Y and 5Y MGS shall be relatively resilient on the curve**. First, the domestic monetary policy outlook is not hawkish. Our baseline is for BNM to keep its OPR unchanged throughout 2022, though the Fed fund rate outlook is a challenge. Second, front-end MYR pricing had eased over the past couple of months, while bonds had underperformed swaps.
- We look to fade the flattening move across the 3s10s segment.

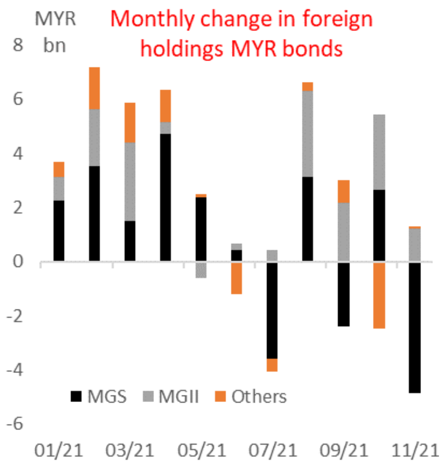


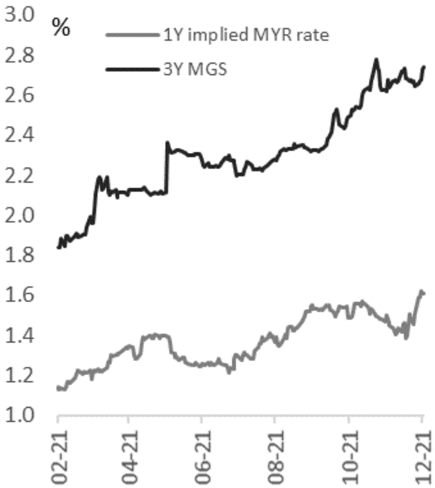


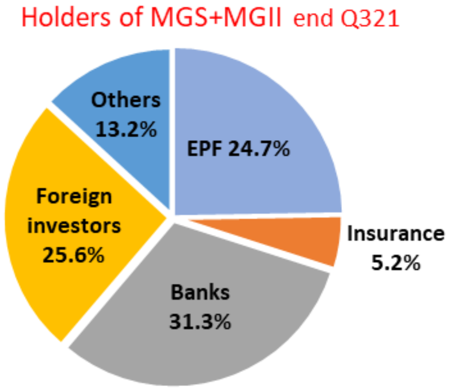
Source: Bloomberg, OCBC

MYR: foreign flows

- MGS and MGII together registered MYR25.5bn of inflows in the first eleven months of 2021. Foreign investors held one-fourth of outstanding MGS and MGII combined.
- **The flow outlook is constructive**. Estimated passive outflow because of FSTE Russell re-weighting is USD14.5mn per month, or roughly MYR740mn a year which is negligible.
- Asset swap trade stay appealing with the well-behaved implied MYR rates. Real yield differentials are supportive as well.







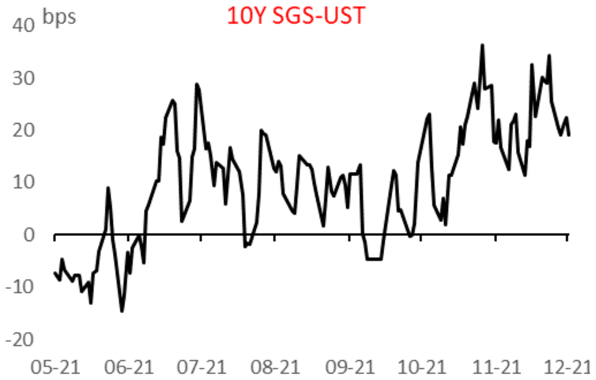
Source: Bloomberg, CEIC, OCBC

SGD: SGS supply

- The 2022 issuance schedule is light at the long-end. First, the two 30Y auctions in 2021 are to be replaced by a reopening of the 30Y SGS (Infra) and one potential new long-tenor SGS (Infra) via syndication. Second, there is no 15Y or 20Y bond auction in 2022, versus a total of two in 2021.
- An 8% increase in outstanding SGS - the average growth rate over the past 5 years – means net supply at around SGD12bn in 2022. This translates into a gross supply of SGD27bn. Allowing for some adjustments at individual auctions, we expect gross issuance at SGD26.5bn-30.0bn, which is the usual range and is likely to be well manageable.
- **10Y SGS shall outperform 10Y UST in 2022**, on light supply pressure, supportive real yield differentials, and in the absence of direct QE withdrawal/rate hike impact. First target is for the spread to move towards par.

Number of auctions (and syndication)*
SGS(MD) and SGS(Infra)

	2021	2022
2Y	2	2
5Y	3	4
10Y	2	2
15Y	1	nil
20Y	1	nil
30Y/long-tenor	2	2
Mini (optional)	1	2



Source: MAS, OCBC
*actual for 2021; planned for 2022

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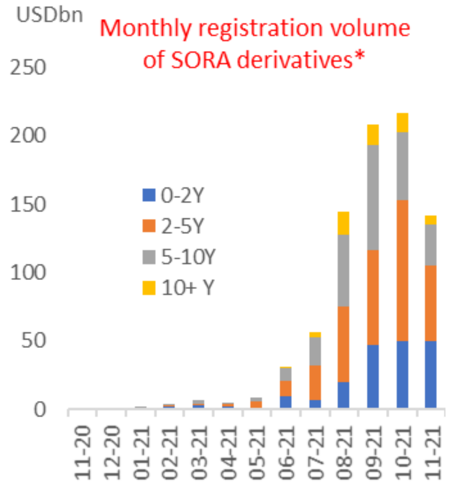
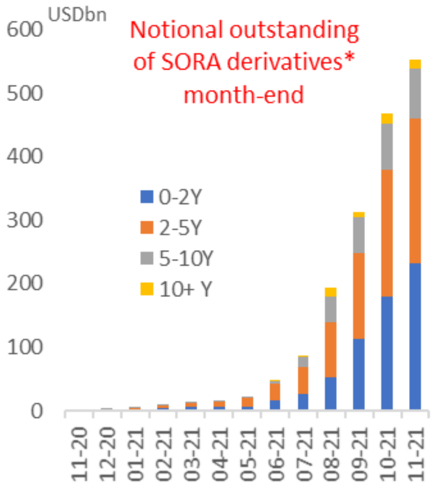
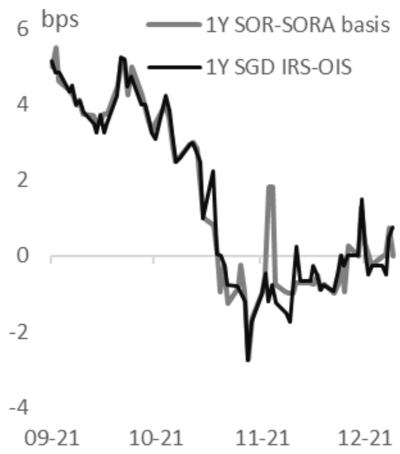
SORA transition

- SORA derivatives including SORA OIS and SOFR-SOFR CCS are available for market participants to hedge against SORA exposures. Meanwhile, as liquidity moves gradually from SOR derivatives to SORA derivatives, **it will become less manageable for market participants to hedge against their SOR exposures.**
- SOR-SORA basis swap serves as a useful starting point for discussions on transitioning SOR contracts to SORA contracts. When most transitions from SOR-referenced to SORA-referenced contracts are completed, **trading activities at SOR-SORA basis will start to fall and diminish over time**.



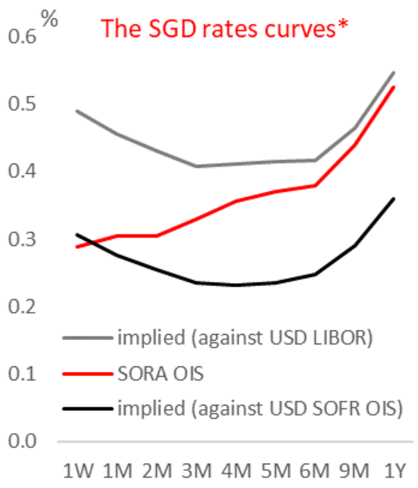


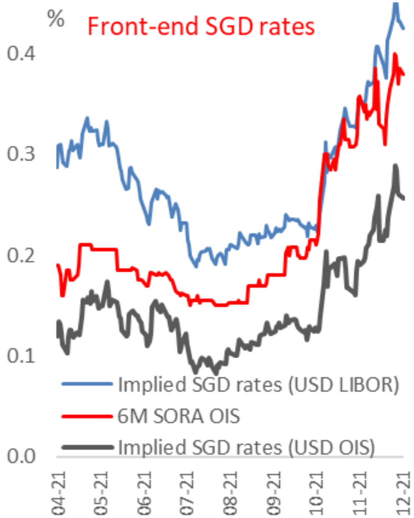


Source: LCH, OCBC
*OIS and basis swaps only

Analyzing SORA

- While SORA is a fundamentally different interest rate benchmark from SOR, market participants may nevertheless look at implied SGD rates from FX swaps to gauge fair value at the front-end, as a funding cost comparison.
- Indeed, front-end SGD SORA OIS has been trading mostly between the implied SGD rates from the USD SOFR OIS and the USD LIBOR curves.
- As **FX swap remains an important reference for front-end SORA OIS**, MAS policy shall also affect SORA OIS in the same direction as it has affected SOR, although SORA itself is not derived from FX swaps.
- Front-end SORA is elevated compared to what is implied by USD SOFR OISs. **We expect the SGD SORA curve to revert gradually to what is implied by the USD SOFR OIS curve**.





Source: Bloomberg, C
*13 December 2021

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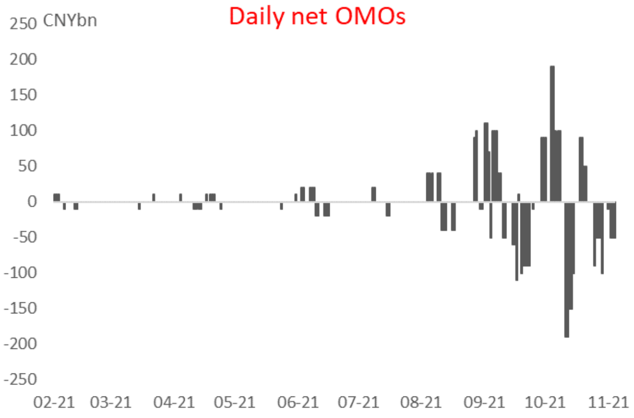
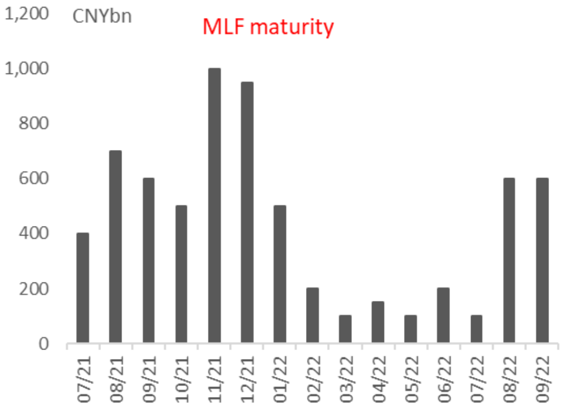
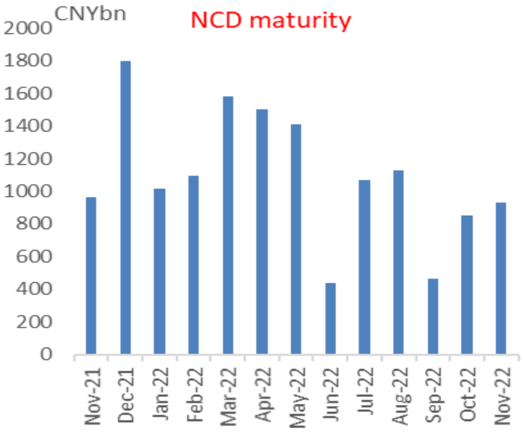
CNY rates: liquidity

- The PBoC has been supportive of liquidity, via OMOs, MLF rollover, and RRR cuts; other structural easing measures and fiscal measures are in place to support growth.
- The MLF maturity profile is getting lighter after December 2021.
- **While the PBoC is unlikely to flood the market, the supportive stance shall still lead to CNY rates outperformance over USD rates.**
- Absolute rates and yields levels however appear to have bottomed, as long as policies continue to be targeted and focus on promoting credit expansion. The 10Y CGB yield shall see 2.8% as the floor in the current cycle.







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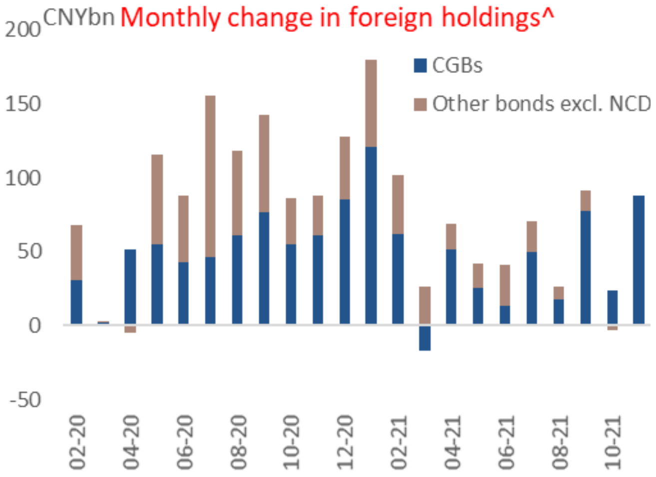
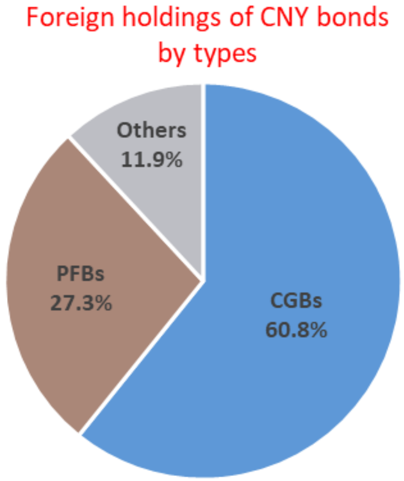
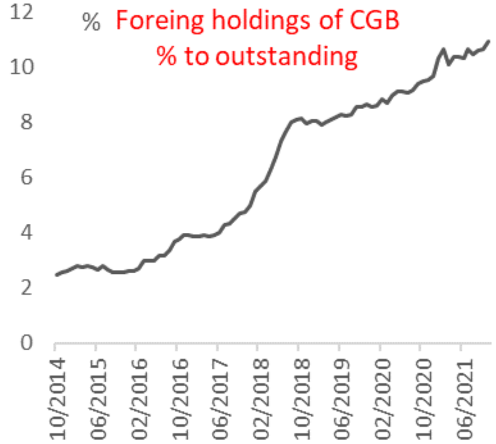
Source: CEIC, OCBC

CNY rates: foreign flows

- CGBs outperformed regional peers, acting as an avenue for portfolio diversification. **Foreign inflows are likely to be sustained, on portfolio diversification needs while real yield differentials are supportive.**
- The latest round of index-induced flows may not be as rapid as during 2019/2020 though. Inclusion into the FSTE WGBI started in October 2021; the passive flow amount is at the order of CNY23-24bn per month if placed evenly over the next 36 months.
- Most of the foreign flows headed towards CGBs and PFBs, a trend that is likely to continue.



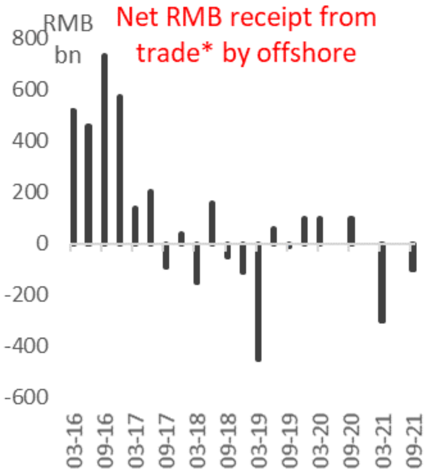


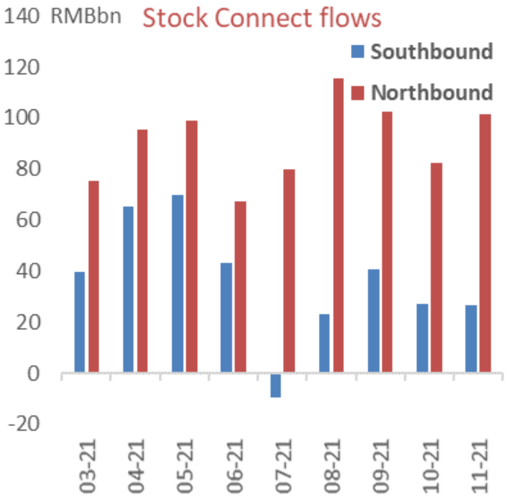


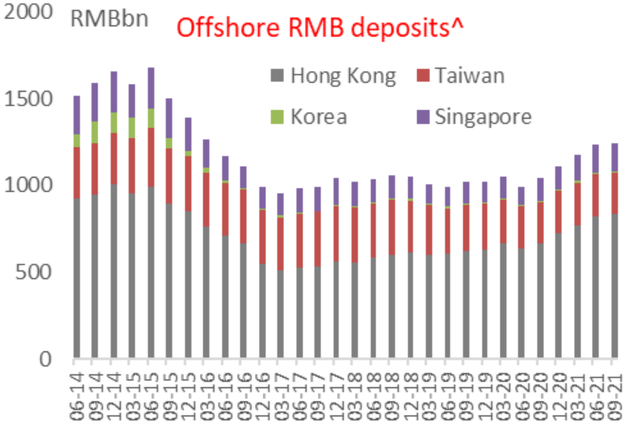
Source: CEIC, OCBC
^exclude NCDs; on Chinabond and Shanghai Clearing

CNH liquidity

- **Channels for cross-border RMB flows**: Stock Connect, Bond Connect, Wealth Management Connect, the trade/direct investment account on the balance of payment
- Net additions to the offshore CNH pool have not been huge: Northbound Stock Connect flows have continued to outweigh Southbound flows; trade and direct investment no longer brings in CNH; WMC flows are yet to become significant.
- **Against such liquidity backdrop, the offshore CNH DF curve is likely to mostly track the onshore CNY DF curve**, and unlikely to fall meaningfully vis-à-vis the onshore curve.







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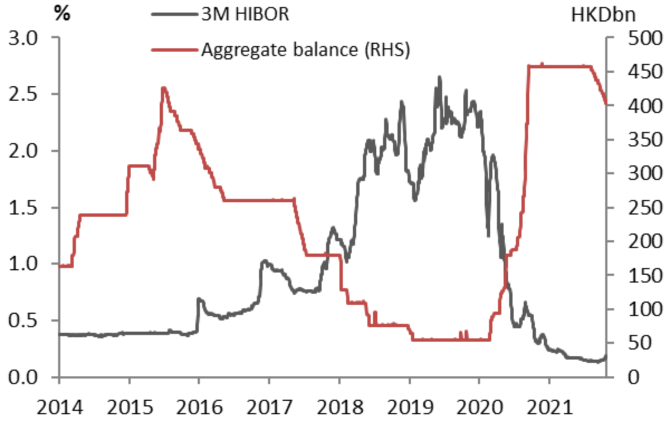
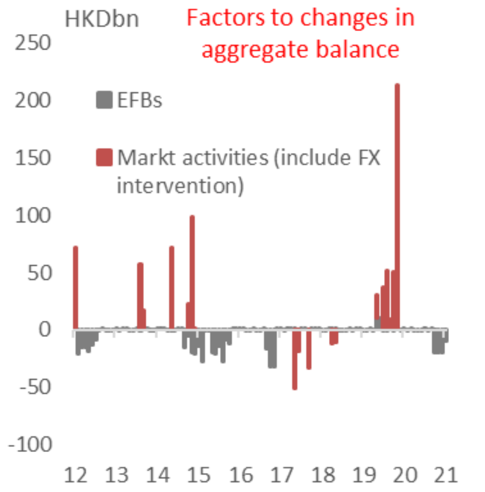
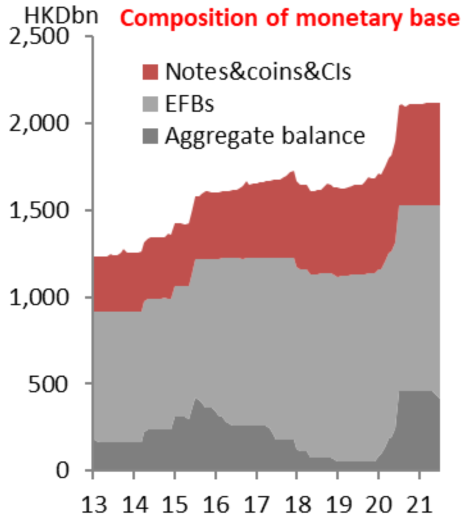
Source: Bloomberg, CEIC, OCBC
*trade and direct investment under the BoP ^ "09-21" or latest

HKD liquidity

- HKMA has been issuing additional EFBs to move liquidity from the interbank market to the bills market, **to meet bill demand and probably to prevent HKD rates from staying too low** when USD rates start to rise.
- The withdrawn amount so far is comparable to that during the 2013 taper. HIBORs shall still be relatively insensitive to changes in the aggregate balance after these withdrawals as interbank liquidity remains flush.
- Additional EFB issuances cannot be ruled out, especially amid the Fed's rate hiking cycle.
- If there is any abrupt reversal in market sentiment/needs, there is flexibility to move liquidity from the bills market back to the interbank market.







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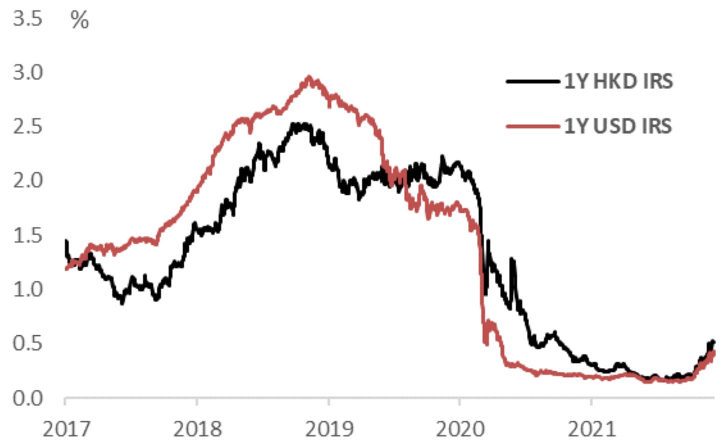
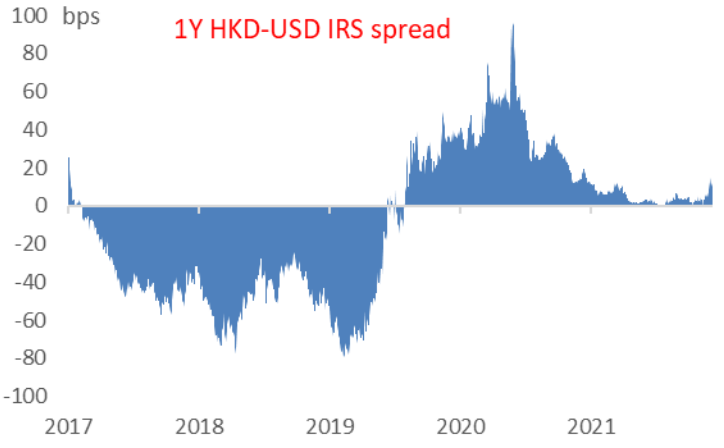
Source: Bloomberg, CEIC, OCBC

HKD-USD rates spreads

- **As absolute rate levels increase, there is room for HKD rates to further outperform USD rates**, as interbank liquidity is likely to stay flush in the HKD market.
- There is also an absence of direct QE withdrawal and rate hike impact on the local market despite the USD-HKD peg. Negative spreads are not uncharted.
- Hi-Li (HKD basis) have been paid up partly because of the exceptional flush USD liquidity; as USD liquidity gradually normalizes, there shall be a downward pressure on Hi-Li.





Source: Bloomberg, OCBC

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Summary of individual rates market views:

- **USD:** front-end rates pricing of rate hikes to be sustained. 10Y UST yield to rise, on the back of stable/mildly higher inflation expectations and higher real yields; expect 10Y yield at 1.85% by end Q2-2022. The curve is likely to steepen during the early part of 2022, before flattening nearer/upon the first Fed funds rate hike.
- **GBP**: pricing a "terminate rate" at around 1% by the March 2023 SONIA futures contract looks overly hawkish. This pricing is likely to be adjusted.
- **EUR**: There is room for Bunds to outperform USTs given the divergence in the monetary policy outlook.
- **IDR**: 2022 issuance may be front-loaded, allowing for flexibility to support the bond market should the US rate hiking cycle start later in the year.
- **MYR**: the 3Y and 5Y MGS shall be relatively resilient on the curve, in the absence of BNM hawkishness
- **SGD**: 10Y SGS-UST yield spread to narrow, on light supply pressure, supportive real yield differentials, and in the absence of direct QE withdrawal/rate hike impact. The SGD SORA curve to revert gradually to what is implied by the USD SOFR OIS curve.
- **CNY / CNH**: supportive policy stance shall lead to CNY rates outperformance over USD rates. Net additions to the CNH pool may not be huge; the CNH DF curve is likely to mostly track the onshore CNY DF curve.
- **HKD**: additional bill issuances cannot be ruled out, but interbank HKD liquidity shall remain flush. As absolute rate levels increase, bias is for front-end HKD-USD rates spreads to narrow.

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Thank You

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