OCBC TREASURY RESEARCH

Interest Rates Monthly

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Rates Themes – Supply the key headwind

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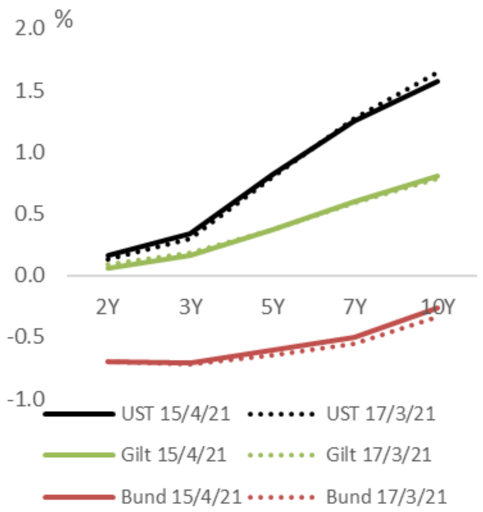
- Bond supply is likely the key driver for US yields in the coming months, while inflation expectations appear peaking for now. Every auction will be scrutinized to assess if supply can be readily absorbed without pushing yields higher. Meanwhile, the still negative real yields leave little room for nominal yields to fall unless there is a reversal in inflation expectations. Our expected range for the 10Y yield in the coming weeks is 1.55-1.75%.

- Supply mostly emanates from the budgeted fiscal deficit, which covers the USD1.9trn fiscal stimulus plan. The US infrastructure plan, on the other hand, is impacting the market through economic optimism, rather than a direct bearing on supply – given that it is a long-term project spanning over eight years and a large part of it is planned to be financed via tax hikes.

- 10Y TIPS breakeven and the 5Y5Y inflation swap have been trading at the 2.3-2.4% range for weeks. The more likely dynamics from here, shall be for data points confirming higher inflation to push nominal yields higher catching up with the already elevated inflation expectations, leading to higher (less negative) real yields.

- US Treasury's cash balance has continued to fall, albeit at a slower pace than initially planned. Bill auctions yielding near zero have been well received; net reverse repo operations have continued as there is excess liquidity in the market to be absorbed. Risk of front-end yields dipping into negative territory keeps the possibility alive that the Fed may hike the IOER and/or o/n RRP.



Source: Bloomberg, OCBC

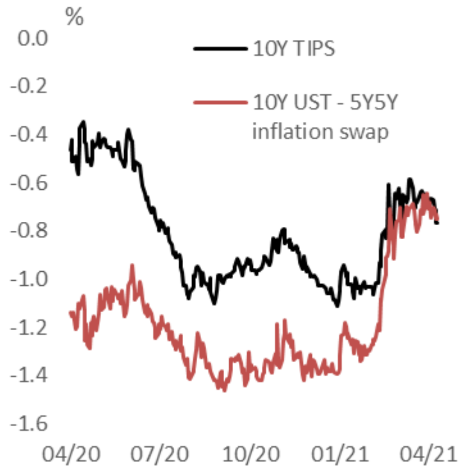
- Bias is to the upside to core EGB yields, as PEPP stepped-up purchase is digested, while nominal yields are lagging inflation expectations. With lower absolute yield levels, core EGB yields may still increase less rapidly than UST yields, but this outperformance may become less pronounced going forward.

- Real yield differentials over USTs stay fairly supportive of a number of local currency markets in Asia, including CGBs, IndoGBs, KTBs, MGS and ThaiGBs. For some, market awaits a tipping point when investors start to re-focus on this medium-term consideration, rather than FX volatility and short-term carry.

- Opportunities in Asian rates: potential for further narrowing in front-end SGD-USD rates spreads, when the USD liquidity dynamics change; MGS curve can flatten when market gets more clarity on EPF withdrawal pattern; back-end CNY points are likely to fall further as a catch-up with CNY-USD rates spread; CGBs shall stay resilient but there is upside risk to yields amid supply – nevertheless we continue to see 10Y CGB yield capped at 3.3%.

USD:

USTs have been consolidating in the past weeks, benefiting from relatively light supply and continued dovish Fedspeak. Fed fund futures have scaled back its aggressive pricing but stays hawkish for the December 2022 contract and beyond; the 2s5s10s fly fell back after transiently trading above zero.



Source: Bloomberg, OCBC

Our view remains that supply headwinds is the key driver for yields (to go higher). Meanwhile, the still negative real yields leave little room for nominal yields to fall unless there is a reversal in inflation expectations. Our expected range for the 10Y yield in the coming weeks is 1.55-1.75%.

Two potential policy actions that the market watches out for are: 1/ whether the Fed will adjust the IOER and/or RRP rates in view of the flush liquidity. The FOMC minutes revealed that the potential for an inter-meeting tweak to the IOER was discussed. A situation of negative front-end rates across instruments is unlikely to be sustained, as the Fed will likely react to such situation. 2/ a permanent recalibration to SLR. The market did not move much in response to cessation of the SLR exemption, as expectation has been quickly guided by Fed comments onto a more permanent fix.

EUR:

Bias is to the upside to core EGB yields, as PEPP stepped-up purchase is digested, while nominal yields are lagging inflation expectations. ECB minutes confirmed that there is a quarterly joint assessment to determine the pace of PEPP, meaning that the step-up decision is not automatically extended beyond this quarter – and speaking of this quarter the step-up has not been spectacular. On the prospects of the pace of purchase beyond this quarter, ECB comments have been mixed; while speculation on when and how the ECB will withdraw injections has heated up of late.

Source: Bloomberg, OCBC

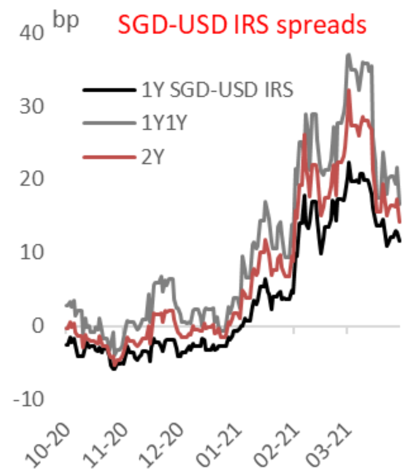
Meanwhile, inflation expectation has moved further higher, when nominal yields were little changed, leaving real yields more negative. There is room for nominal yields to play catch-up. With lower absolute yield levels, core EGB yields may still increase less rapidly than UST yields, but this outperformance may become less pronounced going forward.

GBP:

SONIA pricing is little changed don the month, staying hawkish for the Dec 2022 contract and beyond. Easing lockdown restrictions and subsequent prospect of recovery in economies activities shall sustain economist optimism, setting a floor to Gilt yields. The 10Y bond faces resistance at 71bp while support sits at 80bp and then 87bp.

SGD:

SGD IRS had retraced lower on the month, partly as the liquidity situation normalised and partly as a preparation for the MAS April meeting. This saw front-end SGD-USD rates spread narrowed markedly, in line with our view. The MAS MPS *per se* is not hawkish enough to exert much additional downward pressure on SOR and front-end SGD rates. MAS tried to balance growth optimism and inflation pressure, citing the negative output gap and expectation that "inflation in Singapore is projected to rise at a more gradual pace in H2 2021".

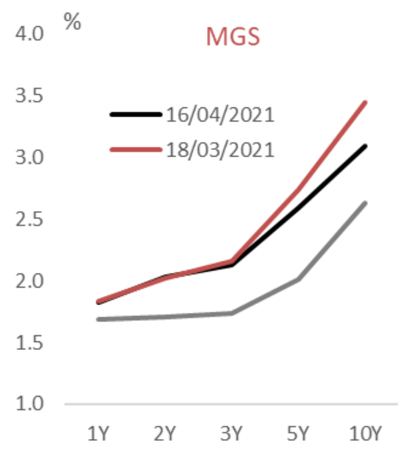


Source: Bloomberg, OCBC

Beyond MAS decision, there is scope for further narrowing in front-end SGD-USD rates spreads – in particular the 1Y1Y and the 2Y spreads; this will require a change in the USD liquidity dynamic, while SGD liquidity continues to normalise. For upward pressure on front-end USD rates to materialise, the reduction in Treasury's cash balance (the GTA) needs to be reversed, which may happen when the latest fiscal stimulus kicks in.

MYR:

With the FSTE WGBI review out of the way, MGS shall revert to a lower beta response to UST movement. The remaining uncertainty in the domestic supply-demand dynamics is EPF withdrawals. Our view remains that the impact of potential EPF withdrawals on MGS is well manageable. The MGS curve is not as steep as before the recent adjustment lower in long-end yield; the steepness is around 6M average across the 2s10s and 3s10s segments. The 10Y is facing resistance at the 3% handle near-term; and the 3s10s segment is likely to trade in the 85-95bp range. Looking further ahead, when more clarity comes regarding the EPF withdrawal pattern, market sentiment shall improve further and by then there will be another leg of compression in the curve shape.

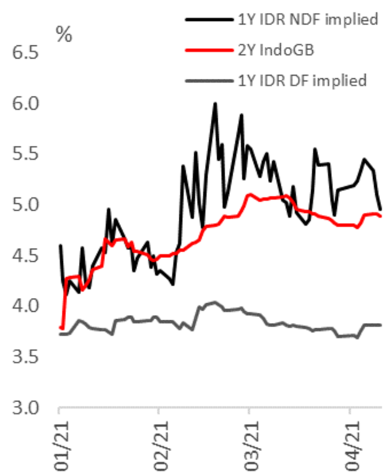


Source: Bloomberg, OCBC

IDR:

IndoGB benefited from an improved risk sentiment and lower US yields in the past month, with pockets of foreign inflows registered as well. Despite the lowered local yields, real yield differentials remain fairly supportive. FX stability will be key to sustaining foreign inflows; BI support via DNDF is important, in providing an affordable hedging alternative.

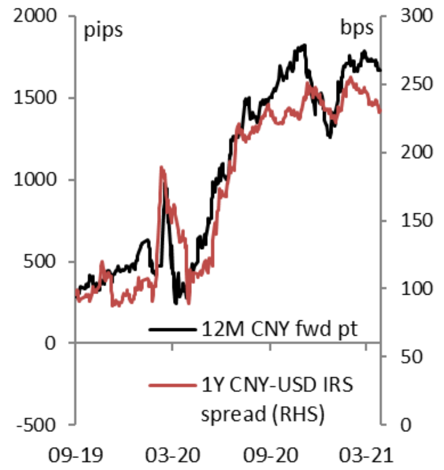
As local yields have adjusted lower, the yields acceptable by the government may be more aligned with market levels now; market waits to see if more bonds will be sold at the auctions, reducing the reliance on the greenshoe option. The 10Y yield is likely to trade in a lower range of 6.40-6.65% in the coming weeks, barring unexpected deterioration in the general risk sentiment.



Source: Bloomberg, OCBC

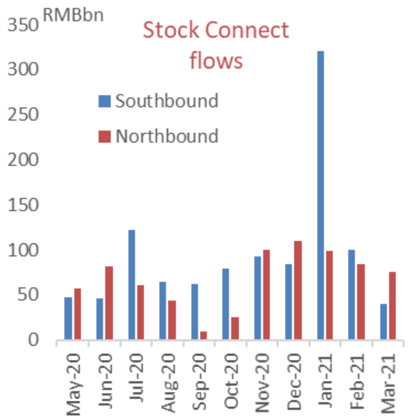
CNY / CNH:

Recent PBoC comments suggest that the near-term goal is to ensure LGB supply is readily absorbed. Money market liquidity shall stay supported, with any tightening or deleveraging is likely to be targeted. Front-end CNY IRS has edged lower over the past weeks, compressing CNY-USD rates spread, deviating from the forward points. Back-end points have started to adjust and shall face further downward pressure, while any liquidity tightness due to tax payment may be reflected more at the front-end, potentially leaving the curve flatter across the 1-12M and/or 3-12M segments. In offshore CNH, however, liquidity stays tight with Northbound stock flows outpacing Southbound flows of late. Offshore-onshore points spreads may widen.



Source: Bloomberg, OCBC

While CGBs shall stay relatively resilient, yields nevertheless faces some upward pressure amid a pick-up in LGB supply. Meanwhile, the inclusion into the FSTE WGBI is to be phased over 36 months, instead of the expectation of 12 months, pointing to slower inflows of USD3.6bn per month versus earlier anticipation of up to USD12.5bn per month, although expected total inflow is only mildly lower. The slower passive inflows mean CGBs will be driven more by domestic demand and active asset allocations; in this regard, real yield differentials remain supportive. On balance, we continue to see the 10Y yield capped at 3.3%.

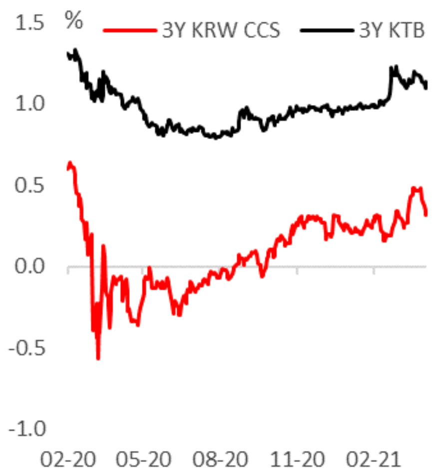


Source: CEIC, OCBC

KRW:

KTBs outperformed UST in the past month, in line with our expectations. Real yield differentials stay supportive, while asset-swap pick-up is still appealing. Outward FDI flows including those from shipbuilders are likely to help cap KRW basis/CCS. The onshore bond market received a hefty KRW9.1trn of inflows during March. We expect further outperformance in KTBs over USTs.

The BoK kept its policy rate unchanged as widely expected. The KRW rates market had priced in a status quo as well, and as such market reaction was muted. KRW rates were paid up mildly following the press conference as the central bank highlighted financial instability – albeit that this has always been under their radar. Current front-end pricing appears fair to us.



Source: Bloomberg, OCBC

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