Rates Themes – await tapering details, and tapering, before rate hikes

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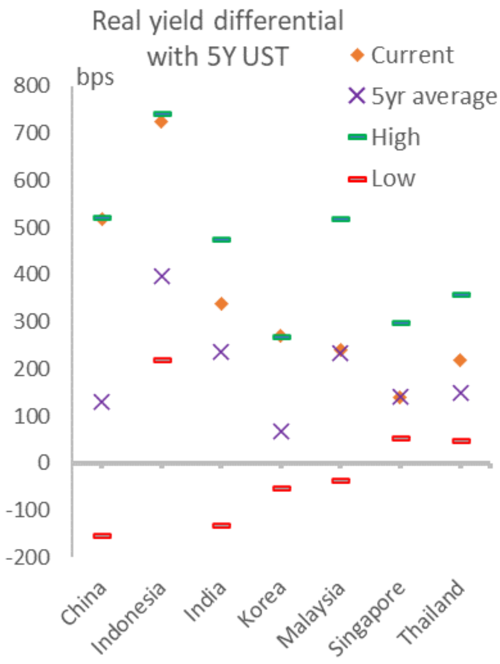
- The hawkish FOMC flattened the UST curve as expectedly sooner rate hikes led to some scaling back of inflation expectations, while pre-FOMC positioning had probably exaggerated the move. Breakevens fell, partly reflecting lower nominal yields and partly higher real yields. The flattening move looks a bit excessive. As the front-end have already adjusted to reflect a more hawkish rate hike expectation, while the tapering narrative shall become more explicit down the road, the curve shall be biased to steepening from here. We expect the 10Y yield to mostly trade in a range of 1.40-1.60% on a multi-week horizon, with an upward bias.

- Upon the hike in the O/N RRP rate, the usage at the facility went to fresh record high. While the higher RRP rate appears effective in absorbing more liquidity, the high usage also plainly reflects the flush liquidity situation. A resolution of the US debt ceiling (expected before end-July), and a tapering in the Fed's asset purchase longer-term, will address the root causes to flush USD liquidity.

- The ECB maintained the "significantly higher" pace of PEPP for the coming quarter. Weekly PEPP was at EUR17.6bn during Q2 so far, which already represented a step-up from Q1. The run-rate for the existing envelope to be fully utilized by March 2022 is EUR17.2bn, and hence there is room for a continued step-up. The divergence between the Fed and ECB may point to a re-widening in UST-Bund yield spreads, although the still viable asset swap may slow the move.

- We highlighted the IndoGB, MGS and CGB curves for a steepening bias in our last monthly. This steepening view panned out well in the IndoGB and MGS curves. From here, our bias remains for a steepening in the MGS curve, but likely at a slower pace; we have turned neutral on the IndoGB curve; the CGB curve shall play some catch-up, where we see the steepening move being delayed as LGB issuances were short of expectation.

- A re-visit at real yield differentials: differentials over USTs are favourable for a few markets in Asia, at the upper end of 5-year ranges for CGB, IndoGBs and KTBs, and above 5-year averages for G-Sec and ThaiGB across the 2Y, 5Y and 10Y tenors. The differentials are around 5-year averages for MGS and SGS. These shall be conducive to foreign inflows in general, with room for a narrowing in the differentials via Asian LCY bond outperformance.



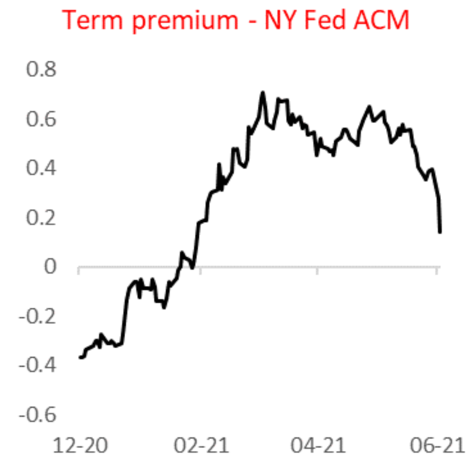
Source: Bloomberg, OCBC

USD:

Hawkish surprises from the June FOMC came on two fronts. The main surprise was the dot plot, which now shows two rate hikes expected in 2023, versus none previously. On top of this, 7 out of the 18 members predict the first rate hike to come in 2022. On tapering, although Powell described it as still in the stage of "talking about talking about", it nevertheless means the plan is forthcoming. More details – timing and pace – are likely to be unveiled at the July or September meetings. Assuming it takes 12 months to bring asset purchases to zero, then tapering may come around end 2021 or early 2022.

Source: Bloomberg, OCBC

The UST curve flattened as expectedly sooner rate hikes led to some scaling back of inflation expectations and hence reversal of reflation trade, while pushing up front-end rates. Eurodollar futures have also adjusted further; rate implied from the March 2023 contract through the December 2023 contract went up by almost a full rate hike cumulatively from the low in early June. As the front-end have already adjusted to reflect a more hawkish rate hike expectation, while the tapering narrative shall become more explicit down the road, the curve shall be biased to steepening from here. Our expected range for the 10Y yield in the coming weeks is 1.40-1.60% with an upward bias.



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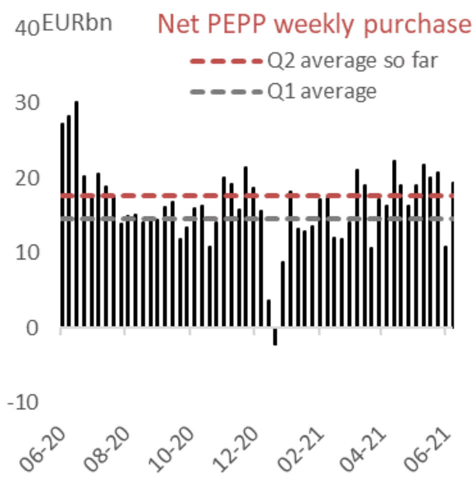
EUR:

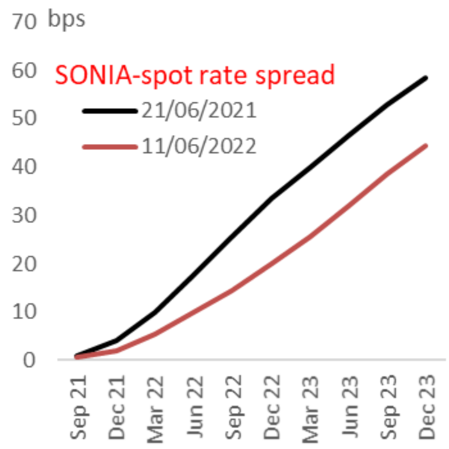
The ECB maintained the "significantly higher" pace of PEPP for the coming quarter. However, there was debate on the pace of purchases in view of the usually thin market liquidity during the summer, hence the decision was only "broadly agreed" on and not unanimous. The economic assessment has also turned mildly more upbeat, that the central bank now sees the risks to economic growth as "balanced". Weekly PEPP was at EUR17.6bn during Q2 so far, which already represented a step-up from Q1. The run-rate for the existing envelope to be fully utilized by March 2022 is EUR17.2bn, and hence there is room for a continued step-up. The divergence between the Fed and ECB may point to a re-widening in UST-Bund yield spreads, although the still viable asset swap may slow the move.



Source: Bloomberg, OCBC

GBP:

SONIA pricing turned more hawkish over the past week, upon the high prints of core and headline CPIs, while the BoE again voiced concerns over the size of its balance sheet. The first expected rate hike has been brought forward to the September 2022 contract. This pricing looks hawkish enough, although other comments from BoE officials also erred on the hawkish side – "risk that demand gets ahead of supply and that will lead to a more generalized pick-up in inflationary pressure", by Deputy Governor Ramsden; "we as policy makers should be more ready to withdraw our stimulus", by Chief Economist Haldane. Resistance for the 10Y Gilt is at 72bp, while support sits at 79bp and then 84bp.

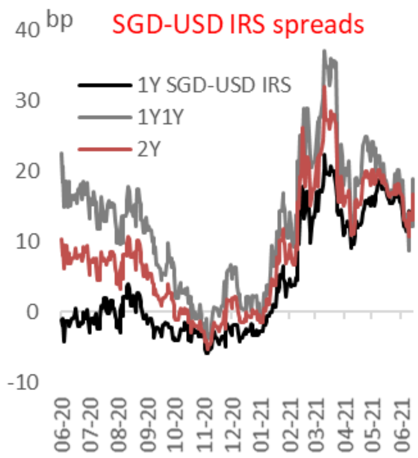


Source: Bloomberg, OCBC

SGD:

Spot and short-dated forward front-end SGD-USD rate spreads have narrowed over the past month amid flush SGD liquidity, before the widening of late. Further narrowing hinges on USD liquidity, which is exceptionally flush currently but may normalise somewhat upon a resolution of the US debt ceiling, expected by end-July. Front-end SGD-USD spreads shall gradually grind towards par by then.

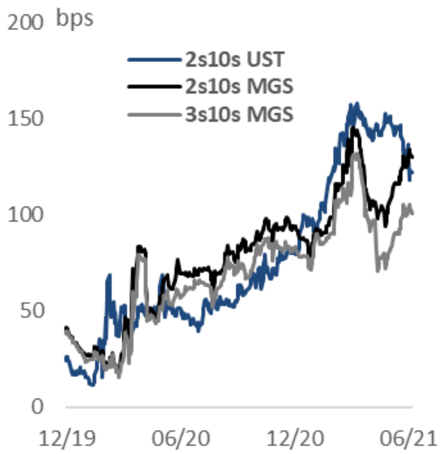
On bond side, 10Y SGS yield had stayed below 10Y UST yield for most of the time prior to FOMC; it rose above its UST counterpart transiently upon the rally in 10Y UST. The 10Y SGS yield is likely to revert to trading below the 10Y UST yield – when yields are rising there is scope for SGS to outperform UST. SGS issuance so far this year is on track with annual estimates of SGS (Market Development). The first batch of SGS (Infrastructure) is likely to come in November, when SGS (Market Development) issuances are finished, while there is no long-end supply in Q4. There is every flexibility to adjust the size of each issuance to cater for demand if needed. Not facing much supply pressure, and being highly rated, SGS shall stay resilient.



Source: Bloomberg, OCBC

MYR:

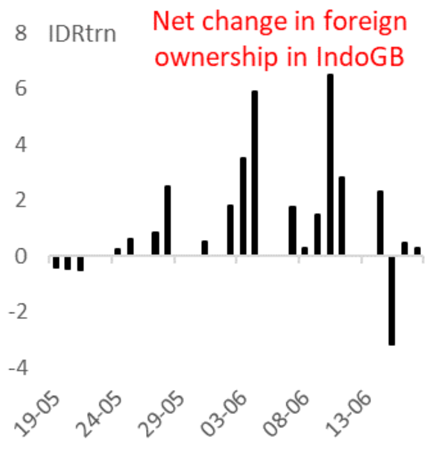
Our MGS curve steepening view panned out well in the past month, with the 3s10s segment having widened by 18bp since our last monthly report. As the curve has caught up partially with the UST curve – which flattened over the same period, further steepening in the MGS curve may be slower, but shall remain as the bias. Upon renewed lockdown measures, rates spreads at the front-end – 6M, 3M3M or 1Y MYR IRS versus 3M KLIBOR – have narrowed over the past couple of weeks. Market has scaled back some of the economic optimism built earlier this year, and instead been erring on easing expectations. OCBC economists expect a 25bp policy rate cut in Q3. Front-end rates shall stay better anchored on monetary policy expectation, while risk of additional fiscal support shall keep investors cautious towards duration.



Source: Bloomberg, OCBC

IDR:

Recent bond auctions went well, attracting decent incoming bids yet with only small or no upsize, supporting market sentiment. Government reassurance that there will be no major impact on fiscal position from stimulus also came as a relief. Foreign inflows into IndoGBs since 24 May has amounted to IDR28.4trn, with total foreign holdings at IDR981trn as of 17 June. Real yield differentials of IndoGBs over USTs are favourable, near the upper-end of 5-year ranges across the 2Y, 5Y, and 10Y tenors. Foreign interest is likely to be sustained, as long as USD/IDR volatility is capped. The IndoGB curve has steepened by 39bp across the 2s10s segment since our last monthly report; this segment is currently at more than 2 standard deviations above 6M average and we have turned neutral from a steepening view.

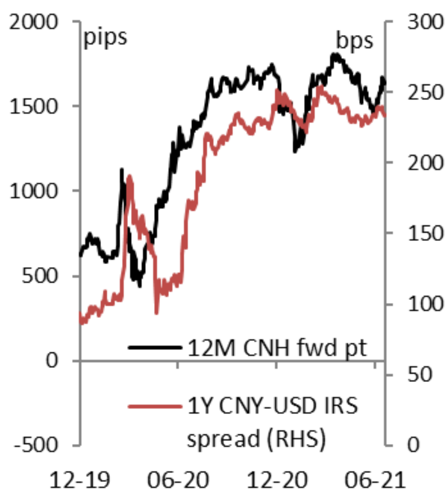


Source: Bloomberg, OCBC

CNY / CNH:

The CGB curve flattened over the past month, as LGB supply still fell short of expectations while bonds were supported by real yield differentials. The latest aggregate financing data for May showed government bond issuance did pick up, but not representing a particularly heavy month compared with some months in 2020. The market shall still brace for higher supply ahead, if the issuance quota is to be utilized. The curve shall steepen from here, with the 10Y CGB yield trading in the range of 3.0-3.3% in the coming months.

There are signs that back-end CNH points may be peaking. First, while inflows to onshore are expected to continue, thereby tightening CNY liquidity in the absence of PBoC operation, the latest expansion in the PBoC's balance sheet gives market some comfort. Second, back-end CNH points have started to diverge with CNY-USD rates spreads again. Third, back-end CNH points are mildly above onshore points. Fourth, although recent addition to the CNH pool has stayed minimal, CNH liquidity shall improve when the Wealth Management Connect and the southbound trading under Bond Connect kickstart later in the year.



Source: Bloomberg, OCBC

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