Interest Rates Monthly

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Rates Themes – settling into higher yield ranges

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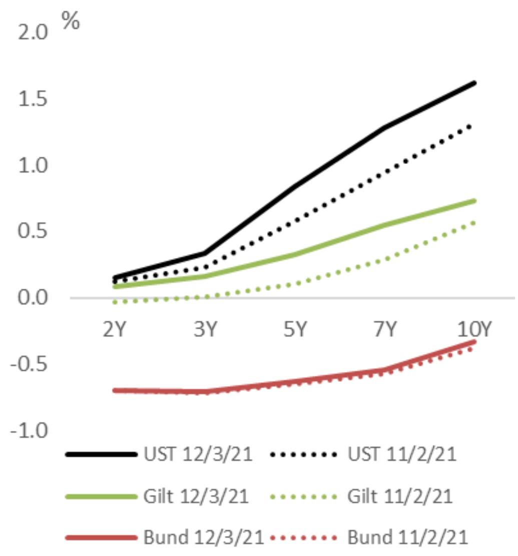
- Reflation has remained the name of the game in the past month, which is further supported by economic data and the passing of the US fiscal stimulus package. Real yield, while having moved higher, is still negative at the range of -65bp to -75bp, leaving little room for nominal yields to fall unless there is a reversal in inflation expectation. The combination of recent price actions and auction results suggests that market has settled well into higher ranges for yields. We remain of the view that it is unlikely to be a straight upward trajectory for yields, but yields are expected to trade in higher ranges, at 1.50-1.75% for 10Y UST on a multi-week horizon.

- Major central banks appear to be adopting varying reaction functions in the face of higher yields. There have been pockets of upsized purchases from the RBA and the RBNZ; ECB surprised on the dovish side by committing to a step-up in its weekly PEPP; the Fed appears comfortable with the higher yield levels thus far, probably relating market movements to fundamentals, and as yields have been oscillating higher rather than moving on a straight line.

- There have been somewhat contradicting comments from various BoJ MPC members regarding a potential policy tweak in the targeted range for yields. So far the market seems to put more weight on Governor Kuroda's opinion that "it is neither necessary nor appropriate to expand the band". The recent bouts of rapid upticks in yields may risk a policy tweak being interpreted as a greenlight to higher yields; but precisely because of the volatility in yields, the absence of a tweak may render the yield curve control less effective going forward. The likely scenario will be no outright tweak in the target range, but there can be more flexibility in their actual purchases going forward. JGB outperformance over UST is likely to continue, should absolute yields rise further.

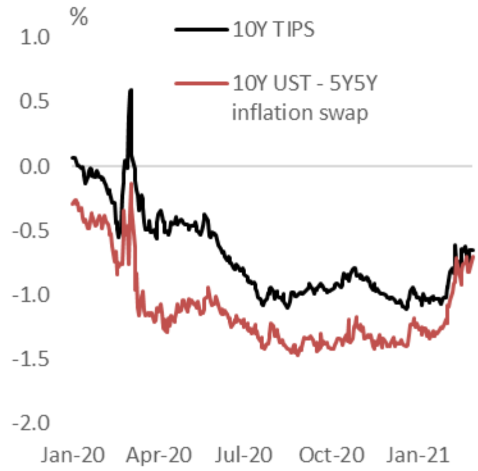
- The market may be coming to a tipping point when investors start to re-focus on real yield differentials rather than FX volatility, which will benefit Asian LCY bonds. The shift in focus is premised on a sustained recovery in the risk sentiment. Real yield differentials over USTs are supportive for IndoGBs, MGS and ThaiGBs; while asset swap flows into MGS and KTBs are also viable.



Source: Bloomberg, OCBC

USD:

Real yield is still negative at around -65bp to -75bp, not a particularly high level albeit already having risen from the lows seen earlier in the year. Inflation expectation is already well ahead of the curve, but the risk is, without further pick-up in inflation expectation, nominal yields may still face a mild upward bias.



Source: Bloomberg, OCBC

That said, market pricing of the first Fed rate hike is already fairly aggressive, and it appears difficult to be brought forward further in the near term, while longer-end rates are driven by inflation expectations and supply headwinds. The 2s5s10s fly is likely peaking and faces downward risk from here.

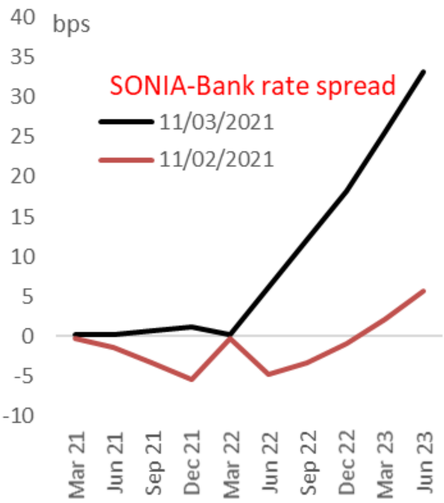
Near-term market watches 1/ whether the Fed will adjust the IOER and/or RRP rates in view of the flush liquidity; the odds of this policy action has fallen as the bill supply reduction has been lagging much behind the Treasury's own forecast, while the USD1.9trn fiscal stimulus has been passed; 2/ any extension to SLR exemption; swap spread compression suggests the market has partially adjusted its SLR expectation but risk remains for a disappointment which may hurt bond market sentiment.

EUR:

The ECB expects "purchases under the PEPP over the next quarter to be conducted at a significantly higher pace". This gave market a relief, especially after seeing data pointing to reduced purchases in recent weeks. The market was also assured that 10Y yields are on the central bank's dashboard gauging financial conditions and hence in its reaction function. With around EUR970bn left in the existing PEPP envelope, which is supposed to run till March 2022, the flexibility easily allows for a step-up to the north of EUR20bn per week. This shall sustain the outperformance of core EGBs over USTs.

GBP:

SONIA futures are pricing in around 18bp of hike by end-2022 and 25bp of hike by March 2023. Recent BoE comments focus on the slack in the economy, and on how stimulus measures will be maintained for many more months. The risk is, there may be little pushback from the central bank with the current market pricing of rate hikes, and that there may be little clue from the upcoming MPC meeting on whether and how the BoE will react should market become yet more hawkish.



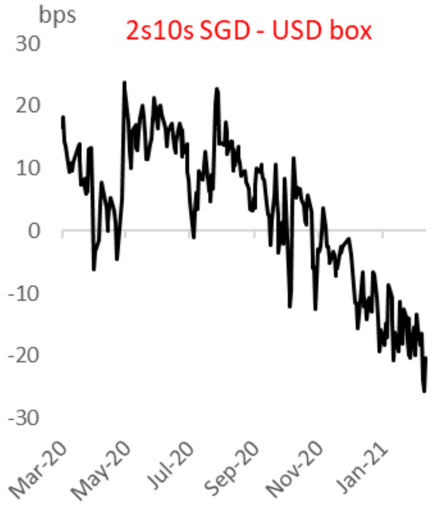
Source: Bloomberg, OCBC

Meanwhile, the bigger fiscal package is fuelling both growth and inflation expectations, and also points to more issuance. Market reaction however may be mitigated by continued BoE bond purchases, with the real test coming only next year assuming no further extension to bond purchase amount. 10Y Gilt yield is trading around 82bp – a recent high, with upward momentum; while any retracement shall pause at 76bp – the level seen a few days after market digested the UK fiscal budget.

SGD:

The SGD IRS curve has steepened a lot with the 2s5s and 2s10s segments more than 2 standard deviations wider than 6M averages. However, the SGD curve is flat vis-à-vis its USD counterpart. We acknowledge specific reasons – mainly the respective liquidity situation in the two markets – are currently at play. Looking ahead, we expect the SGD IRS curve to play some catch-up. First, front-end USD rates may not be further compressed: reduction in bill supply has been lagging Treasury's own forecast, while the 1.9trn fiscal package has already been passed, hence after all there may not be that much bill supply reduction. Second, there is limited room for SGD depreciation expectation to build up, which will help mitigate the upward pressure (arising from the mildly tight SGD liquidity) on the forward points and hence front-end SGD rates.

SGS shall stay relatively resilient, not facing much supply pressure compared with the US and some regional peers; MAS has said issuances of SGS (Infrastructure) – SINGA bonds - and SGS (Market Development) will be planned together calibrating to meet market demand; this shall not exert any meaningful pressure on supply. From here, we expect SGS to outperform USTs.

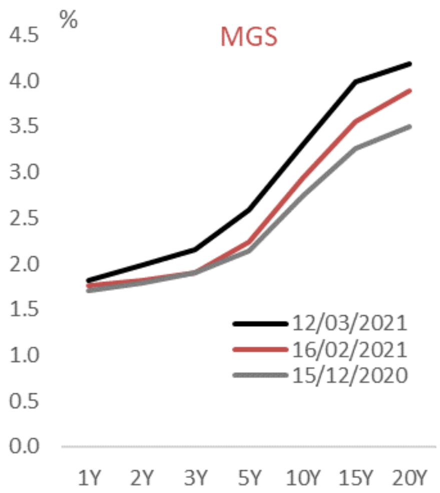


Source: Bloomberg, OCBC

MYR:

MGS did not usually have a high beta response to UST movement; but currently domestic bonds are facing a less favourable supply-demand outlook with uncertainty over potential EPF withdrawals. The take-up rate of the unconditional withdrawals is anyone's guess. The decent return at the fund hopefully will encourage members to keep their balances. On balance, we see a mild upward pressure on yields, but investors may be tempted to take advantage of the steep curve and extend their duration.

We expect Malaysia will at worst just stay on the watchlist at the upcoming FSTE WGBI review, given improvement in market accessibility, with a chance of being removed from the watchlist as investors will reasonably expect a decision from the two-year long review. A re-weighting due to China bond inclusion later in the year is estimated to translate into a manageable USD0.5-0.6bn of passive outflows for Malaysia – these are likely to be offset by other allocation given favourable real yield differentials and viable asset swap investment.



Source: Bloomberg, OCBC

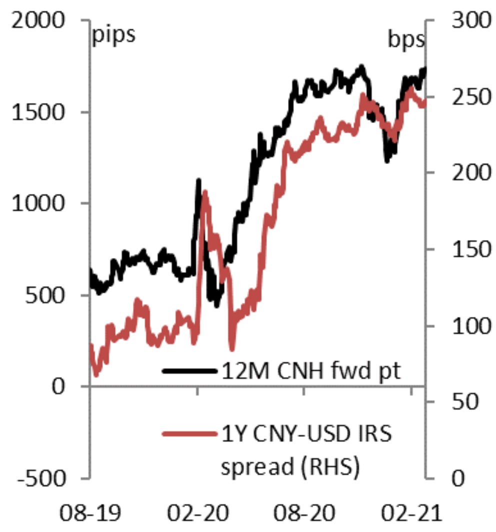
IDR:

IndoGB yields have risen by 20-60bp across the curve over the past month, but shown signs of stabilization of late. We are waiting for a tipping point when investors start to re-focus on real yield differentials rather than FX volatility – and this shall benefit IndoGBs. This shift in focus is premised on a sustained recovery in the risk sentiment, which is key given the positive correlation between USD/IDR and local yields. The government has indicated that they would be able to reduce issuance on surplus fund from last year, which has supported market sentiment to some extent. This surplus fund, at IDR120trn as of January, is not particularly huge compared with the initial financing plan of IDR1200trn, and considering the potential and actual magnitude of bond outflows. Nevertheless, the government, despite reduced issuances at a slew of auctions, is so far on track with its financing plan. Latest greenshoe result suggests that market levels may be converging gradually with yields that are acceptable by the government. 10Y IndoGB yield looks to be capped at the 6.75-6.80% region for now.

CNY / CNH:

CGBs have been fairly resilient during the latest bouts of global bond sell-off, despite a bigger-than-expected issuance plan. CGBs benefit from domestic asset rotation at times of heighted risk aversion, while foreign inflows may be further encouraged when the risk sentiment fares better. On balance, CGB yields shall be less volatile than most of the regional peers. Bond inflows shall continue on favourable real yield differentials and index inclusion induced allocations. Asset swap trade is not appealing at the moment; that said, the low, and sometimes mildly negative correlations between USD/CNY and local yields suggest that CGBs can be seen as a safe-haven asset and a candidate for portfolio diversification. On the monetary front, any tightening or deleveraging is likely to be targeted, exerting somewhat neutral impact on the money and bond market. The 10Y yield is likely capped at the 3.3-3.4% area on a multi-week horizon.

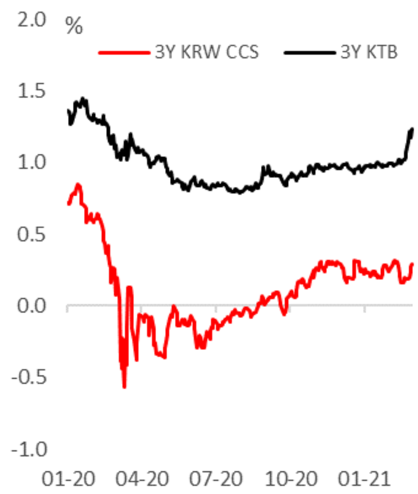
Recent equity flows under the StockConnect point to a smaller CNH pool, rendering CNY points sticky downward. If this trend in the equity market continues, the spread between CNH points and CNY points may widen, before corporate flows come in.



Source: Bloomberg, OCBC

KRW:

KTB is one of the safe havens in the region. Correlation between USD/KRW and local yields are low to mildly negative. An added advantage is the suppressed KRW CCS, which render asset swap pick-up appealing. This favourable condition for foreign investors is likely to continue, with outward FDI flows including those from shipbuilders likely keeping KRW basis/CCS at low levels. The presence of foreign central banks among foreign investors is another stabilizing factor on flows. The onshore bond market received a hefty KRW9trn of inflows during February. We expect further outperformance in KTBs over USTs. Front-end KRW rates appear overly hawkish in pricing monetary policy; we see limited upside there.



Source: Bloomberg, OCBC

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