Interest Rates Focus

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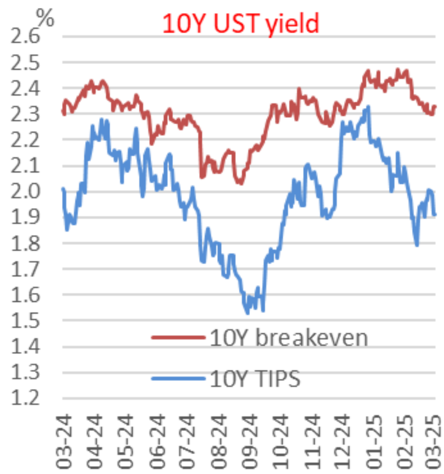
USTs consolidate; Fed QT slowdown; BoE split votes

Frances Cheung, CFA
FX and Rates Strategy
FrancesCheung@ocbc.com

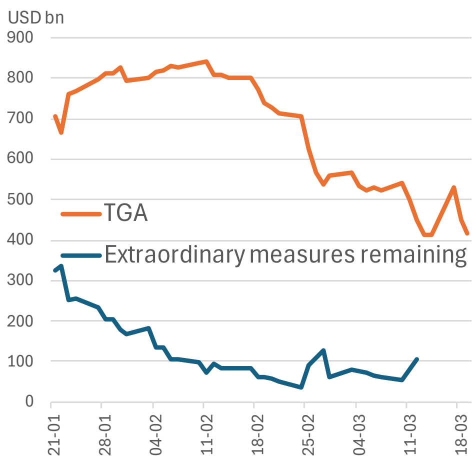
- **March FOMC**. The FOMC kept the target range of the Fed funds rate unchanged at 4.25-4.50% as widely expected. A few things that we have hoped for panned out nicely, **underpinning our view that UST yields are likely to fluctuate within the current lower ranges** (compared to levels observed in January).

  1/ The median dot stayed at where it was, i.e. pointing to 50bps of cuts this year, although some of the individual dots shifted higher by one notch. The dot-plot outcome is the scenario of "an unchanged median dot (with or without some upward adjustments in individual dots)" which we had expected to give the greenlight for markets to maintain rate cut pricings (around 59bps then). Fed funds futures even added mildly to rate cut expectation following the March decision, pricing in 66bps of cuts for this year.
  2/ GDP growth forecasts have been revised downward, more so for 2025 (from 2.1% to 1.7%); granted, inflation forecasts have been revised upward but that had been expected with Committee members' comments in the run-up to the March meeting having focused on inflation impact of tariffs, while there had been little touch on the growth impact. The GDP revisions represent an acknowledgement of downside growth risk.
  3/ QT pace will slow; the monthly redemption cap on Treasury securities will be reduced from USD25bn to USD5bn starting 1 April (cap on MBS stayed the same at USD35bn).

  Near-term range for 10Y UST yield remains at 4.20-4.34%; only when the yield breaks decisively on either side we will be eyeing a new range. We have long seen 10Y breakeven in the range of 2.2-2.4% as fair; movements in nominal yield have been more driven by real yield, which may remain so. For Fed funds rate, our base-case remains for a total of 75bps of cuts this year; we have pencilled in one 25bp cut each in Q2, Q3 and Q4.



Source: Bloomberg, OCBC Research



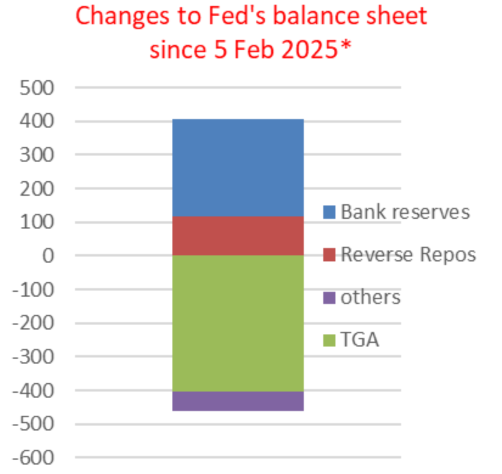
Source: Bloomberg, US Treasury, OCBC Research

- **Fed QT**. The QT slowdown is understood to be in reaction to the debt ceiling issue, which was flagged in the FOMC minutes for the January meeting. With monthly maturities of Treasury securities over the coming months higher than the previous cap of USD25bn (i.e. that is a binding cap), the effective reduction in the size of run-off will equal the reduction in the cap, i.e. USD20bn per month – there is no indication as to whether there will be a re-acceleration of QT upon resolution of the debt ceiling before the next decision to end QT. For now, the buffer for re-funding is at USD20bn per month. TGA balance fell to USD416bn as of 19 March from the recent peak of USD842bn on 11 February, as bill issuances are constrained by the debt ceiling. Meanwhile, the amount of remaining extraordinary measures has been estimated at USD106bn as of 12 March.

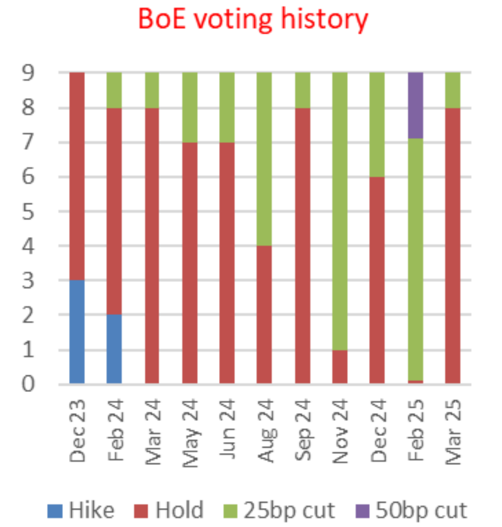
- The Fed might have put more weight on the potential impact of keeping QT pace for too long on the volatility in money market rates. The rationale goes that if they keep the pace of balance-sheet runoff when the debt ceiling situation is yet to be resolved, the risk would be that upon resolution of the debt ceiling, bank reserves could decline rapidly as US Treasury ramp up bill issuances. Bank reserves stood at USD3.47trn and reverse repos (all tenors) at USD571bn as of 19 March. The higher bank reserves resulted from limited bill issuances and the subsequent drawdown in TGA balance, which more than offset the shrinkage in the overall balance sheet; this is expected to reverse once the debt ceiling issue is resolved. For now, NY Fed's conclusion (February update) from their estimates of Reserve Demand Elasticity (RDE) is still that "the elasticity of the federal funds rate to reserve changes is very small and statistically indistinguishable from zero" and this "suggests that reserves remain abundant". There will be net bills paydown of USD51bn next week, after the net paydown of USD94bn this week; this may keep front-end yields anchored near-term.

- **BoE.** Bank of England kept its Bank Rate unchanged at 4.5% by an 8-1 vote. The status quo decision had been widely expected, while the 8-1 vote was marginally less dovish. Gilts initially did not react much to the 8-1 vote at BoE decision, but yields rose as Governor Bailey's comments hit the wire. Bailey suggested a wait-and-see mode, as "there is a lot of economic uncertainty". Nevertheless, he added that he thought "interest rates are on a gradually declining path". GBP OIS pared back rate cut expectation to 46bps for the rest of this year, versus 53bps priced before the decision. On balance, **we believe one 25bp cut per quarter remains consistent with the "gradual and careful" approach** to the further withdrawal of monetary policy restraint. The uncertainty Bailey mentioned refers to both inflation and growth, which does not sound as hawkish to us as interpreted by the markets. In terms of the split of votes, it has tilted marginally to the less dovish side; that said, the votes reflect more of the views at a particular meeting (which did move the markets as we had expected), rather than representing a strong forward guidance.

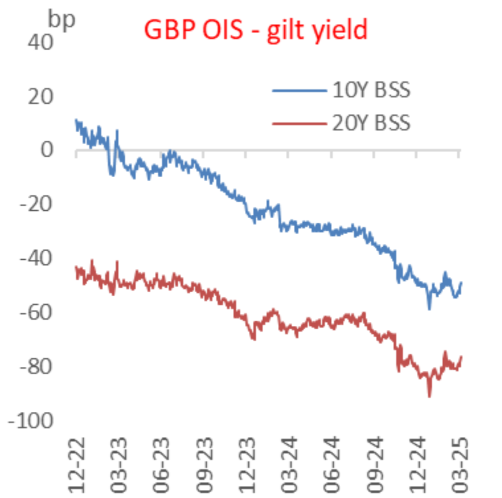
- However, the risk is that the BoE may delay rate cuts in view of upside risk to inflation in the near term. The MPC currently focus on two risks, which are "greater or longer-lasting weakness in



Source: Bloomberg, OCBC Research
*recent peak in TGA balance on 5 Feb 2025 (using weekly data); data as of 19 March 2025



Source: BoE, OCBC Research



Source: Bloomberg, OCBC Research

demand relative to supply…which could push down on inflationary pressure in the medium term", and "more persistence in domestic wage and prices…additional second-round effects related to the projected near-term increase in CPI inflation". In short, the risks seen are near-term upside inflation risk and medium-term downside inflation risk. The minutes added "there was no presumption that monetary policy was on a pre-set path over the next few meetings", which hints at the risk of a longer pause in rate cuts.

- After BoE's decision, the next key event for the Gilt market is the Spring Statement 2025, to be released on 26 March. Long-end bond/swap spreads showed signs of stabilisation of late, with current spread levels probably seen as providing some support to Gilts for now, when markets gave the benefit of doubt to the notion that defence-spending will be deficit neutral.

Macro Research

Selena Ling
Head of Research & Strategy
lingssselena@ocbc.com

Tommy Xie Dongming
Head of Asia Macro Research
xied@ocbc.com

Keung Ching (Cindy)
Hong Kong & Macau Economist
cindyckeung@ocbc.com

Herbert Wong
Hong Kong & Taiwan Economist
herberthtwong@ocbc.com

Lavanya Venkateswaran
Senior ASEAN Economist
lavanyavenkateswaran@ocbc.com

Ahmad A Enver
ASEAN Economist
ahmad.enver@ocbc.com

Jonathan Ng
ASEAN Economist
jonathanng4@ocbc.com

Ong Shu Yi
ESG Analyst
shuyiong1@ocbc.com

FX/Rates Strategy

Frances Cheung, CFA
Head of FX & Rates Strategy
francescheung@ocbc.com

Christopher Wong
FX Strategist
christopherwong@ocbc.com

Credit Research

Andrew Wong
Head of Credit Research
wongvkam@ocbc.com

Ezien Hoo, CFA
Credit Research Analyst
ezienhoo@ocbc.com

Wong Hong Wei, CFA
Credit Research Analyst
wonghongwei@ocbc.com

Chin Meng Tee, CFA
Credit Research Analyst
mengteechin@ocbc.com