OCBC

GLOBAL MARKETS RESEARCH

Interest Rates Monthly

23 July 2024

Central banks in action

- **USD rates.** Recent UST performance is in line with our medium-term view for yields to go lower in a steepening manner. After recent rapid adjustment, the 10Y UST yield may be sticky downward in the near term. Long-term breakeven mildly above 2% looks fair while further downside to real yield would require more data showing softness in the US economy. Range for 10Y yield is seen at 4.10-4.30%, before the next catalyst. Next quarterly Treasury refunding documents are to be released on 29 July; we expect additional bills issuances at around USD200bn which shall be well manageable.

- **JPY rates**. We expect the BoJ to tighten monetary policy further via a 10bp hike in its target rate at its July meeting, and via starting passive QT. The BoJ may tweak its monthly purchase guidance of JPY6trn to around JPY4trn – with this the balance sheet run-off would still be slow. We continue to see the next support for the 10Y JGB at 1.15-1.25% in terms of yield.

- **IndoGBs** underperformed USTs in the recent rally, improving yield differentials. The mild easing in SRBI rates of late may add to the view that peak rate has been reached and the next move is more likely to be a rate cut. That said, given the policy intention to stabilise FX via SRBIs, we suspect SRBI rates will not follow entirely our expected BI rate cuts in Q4 and Q1-2025.

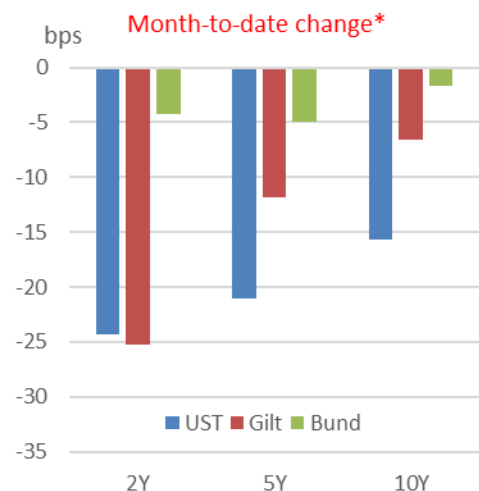
- **MGS.** The rally in MGS was timid compared to UST moves, reflecting the usual stability of the domestic bonds. Swap rates appear low compared to bond yields; bias is for bond swap spreads to widen mildly from here. Auctions thus far this year suggest that there has been investor appetite for duration.

- **SGD rates** mildly underperformed USD rates in the recent down move, in line with historical pattern. Still, SGD rates are likely to stay meaningfully below USD rates before USD rates fall more rapidly, especially with a positive S$NEER slope. Next focus is the reopening of 15Y SGS which shall be readily absorbed amid asset swap pick-up and potential appetite for duration.

- **CNY rates**. PBoC cut 7-day OMO reverse repo rate by 10bps. We maintain a steepening bias on the CGB curve and expect the 5s30s part to play some catch-up in the move.

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

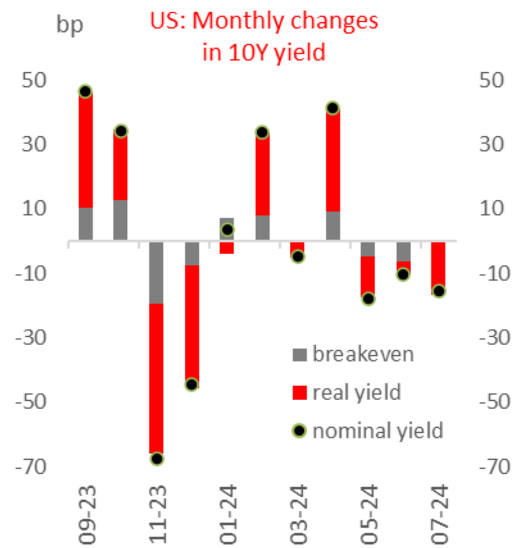
Global Markets Research and Strategy



Source: Bloomberg, OCBC Research *as of 19 July

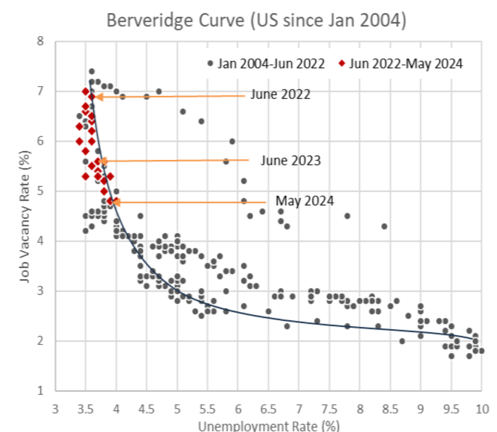
USD:

The UST curve bullish steepened over the past month, as investors added to rate cuts expectation. This performance was in line with our medium-term view for yields to go lower in a steepening manner. After recent rapid adjustment, the 10Y UST yield may be sticky downward. We continue to see long-term inflation expectation mildly above 2% as fair; downside is limited to 10Y breakeven which was last at 2.3%. It has been our view that *downside to nominal yield would require real yield to go lower*. 10Y real yield has fallen by a cumulative 20bps since the recent high on 1 July. We next wait for short-end USTs to catch up in rally to add to the steepening momentum on the curve. Our base-case is a total of 50bps of Fed funds rate cut by year-end. Range for 10Y yield is seen at 4.10-4.30%, before the next catalyst.



Source: Bloomberg, OCBC Research *as of 19 July

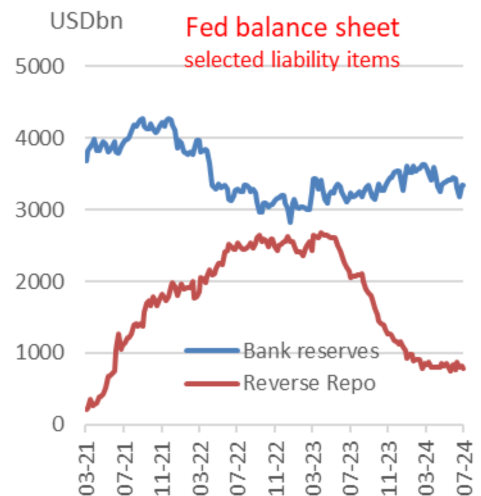
Inflation and the labour market. June CPI outcome is encouraging; yoy core services inflation, rent of shelter inflation, and services less rent of shelter inflation all eased. We turn a bit cautious against the potential for core good price inflation to go further deeper into deflation in the months ahead though. Further easing in services inflation is key, which likely requires the labour market to cool. Six-month average of non-farm payroll change was last at 222k (as of June 2024), similar to the 200K+ levels in the years 2013-2019 before COVID. In comparison, Fed funds target rate ranged between 0.25% and 2.50% in those years. Furthermore, some FOMC members observed that "the monthly increase in employment consistent with labor market equilibrium might now be higher than in the past because of immigration". In addition, as mentioned by Fed's Daly citing the Beveridge curve, we are probably near the point where further falls in job vacancies would translate into adjustments in actual employment itself. All in all, Interest rates are restrictive – or probably overly restrictive - vis-à-vis economic fundamentals.



Source: Bloomberg, OCBC Research

Trump trade? This is not our thesis. We reviewed movements in the 2Y and 10Y UST yields before and after past US elections (please refer to *OCBC 2H 2024 FX and Rates Outlook*). Past movements in 2Y yield were mostly attributable to the prevailing monetary policy cycle, which was in turn based on the then economic fundamentals and these did not change within a short period of time. We do not automatically assume inflation would be materially wider, or fiscal deficits would be materially wider, under a Trump victory. Wide fiscal deficits are here to stay, regardless. For one, the largest contributor to the latest upward revisions in US fiscal deficits through to 2034 was the recently enacted legislation, which included emergency supplemental appropriations that provided aid to a number of countries. Meanwhile, mandatory spending represents a significant share of fiscal outlays; these expenditure items can be fairly rigid.

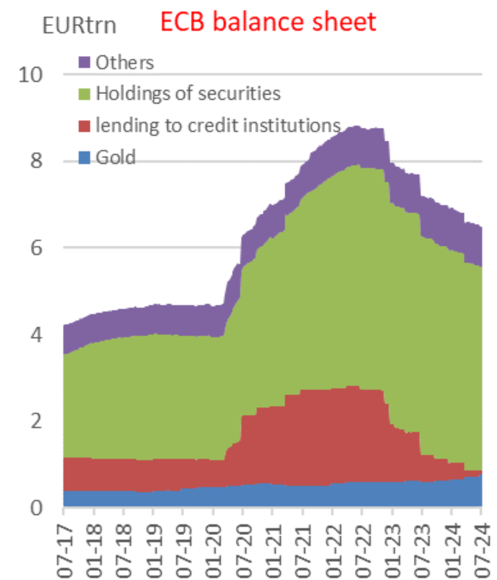
Treasury refunding. We assume additional funding for the wider deficit estimates to come mainly from bill issuances which shall be manageable in the next couple of quarters. First, the liquidity condition has stayed largely supportive with bank reserves last at USD3.33trn and reverse repos at USD790bn (as of 17 July). Second, TGA balance is on the high side at USD767bn (17 July) and there is room for US Treasury to adjust its target (USD850bn for 3Q24) lower. Third, QT taper per se shall lead to some downward adjustment to refunding needs; QT via Treasury securities will amount to USD175bn for the June-December period, instead of USD331bn, in our estimates, which leaves a headroom of USD156bn. The next quarter refunding documents are to be released on 29 July. We expect additional bills issuances at around USD200bn. Coupon bond auction sizes shall be left little changed.



Source: Bloomberg, OCBC Research

EUR:

ECB kept policy rates unchanged as widely expected; the decision was unanimous. Balance sheet adjustment via APP and PEPP stays with plan, averaging EUR32.6bn per month in 2H-2024 which is similar to the EUR30.6bn in the first half; with balance sheet run-off via expiring lending having mostly run its course, **overall balance sheet run off is at a slower pace and well manageable**. When asked about potential policy rate decision at the September meeting, Lagarde stayed non-committal and said the decision "is wide open". Our base-case remains for additional 50bps of rate cuts before year-end. Still elevated wage growth is a risk to our base-case, but ECB's assessment has it that profits helped to "offset the inflationary effects of higher unit labour costs", and that due to the way in which employment relationships are organised, wage is playing catch-up and "the highest numbers that you have are in '24". If the ECB is confident enough in their view that wage growth will return to levels that are "perfectly compatible with [their] target of 2% in the course of '25", another two rate cuts this year shall be on the cards in our view. EUR OIS pricing was little changed, seeing 44bps of rate cuts by year-end, which looks roughly fair.



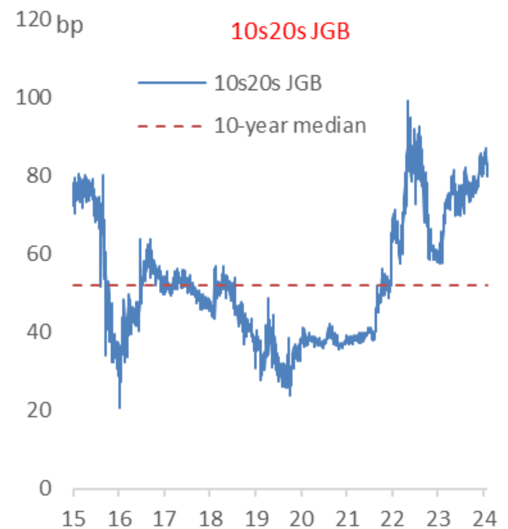
Source: Bloomberg, OCBC Research

JPY:

Recent data has added to the prospects of a virtuous cycle between inflation and wage growth being formed, and hence for inflation to stay sustainably around the 2% target. June core CPI and core core CPI edged up to 2.6%yoy and 2.2%yoy respectively, staying above the 2% market. Q2 Tankan survey was solid, especially at large enterprises and non-manufacturers. Fixed investment plan was revised up across large, medium-sized and small enterprises. Inflation outlook was revised mildly higher; for output prices, 1-year inflation outlook at 2.8% (previous 2.7%) and 3-year inflation outlook at 4.1% (previous 4.0%). Expectation for general prices has also stayed firmly above 2.0%. Schedule full-time pay accelerated to 2.7%YoY – in line with the expectation for

the *Shunto* results to be reflected in wage statistics in following months.

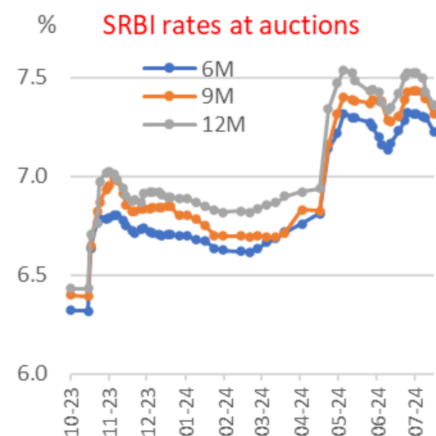
The macro backdrop is constructive for BoJ to go ahead with monetary policy tightening in terms of both the policy rate and its balance sheet. Our base-case is a 10bp hike in the BoJ target rate at the July MPC; JPY OIS priced around a 5bp cut at this meeting. Meanwhile, to achieve "a sizeable reduction in the purchase amount" of JGBs, we **expect the BoJ to tweak its monthly purchase guidance of JPY6trn to around JPY4trn.** There are some JPY15-19trn of JGBs held by the BoJ maturing in each quarter. A monthly purchase pace of JPY4trn would translate into QT of around JPY22trn on a one-year horizon counting from this quarter, which still represents a slow pace of balance sheet run-off given the balance sheet size of JPY754trn. The BoJ will probably feel comfortable to start with such pace. We continue to see the next support for the 10Y JGB at 1.15-1.25% in terms of yield.



Source: Bloomberg, OCBC Research

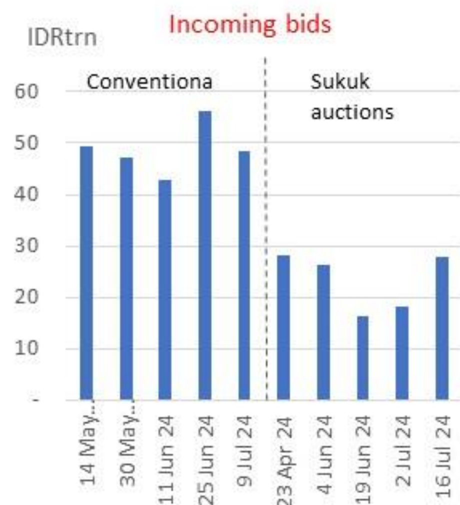
IDR:

IndoGBs underperformed USTs in the past months, as the UST rallies were driven by Fed funds expectation. Domestically, Bank Indonesia kept its policy rate unchanged at 6.25% as widely expected. The near-term policy focus is Rupiah stability, which is not surprising. BI said it would continue to use SRBI as a tool to stabilize the Rupiah. The 12M SRBI rate fell by a cumulative 16.5bps between the auction on 3 July and that on 19 July. The mild easing in SRBI rates of late may add to the view that peak rate has been reached and the next move is more likely to be a rate cut rather than a rate hike. That said, given the policy intention to stabilise FX via SRBIs, **we suspect SRBI rates will not follow entirely our expected BI rate cuts** in Q4 and Q1-2025. Meanwhile, any interim easing in SRBI rates will hinge on market movements.



Source: Bank Indonesia, OCBC Research

Demand at recent auctions was fair to solid. The sukuk auction on 16 July garnered incoming bid amount of IDR27.7trn, higher than those at the previous five auctions. Earlier, the conventional bond auction on 9 July had incoming bid of IDR48trn which was fair. Next conventional auction size has been announced at IDR22trn, smaller than the previous IDR24trn. If MoF continues with a IDR22trn/10trn combination through the quarter (we had earlier assumed IDR22trn/12trn), then total issuance amounts may be mildly below the quarter-target of IDR215trn.

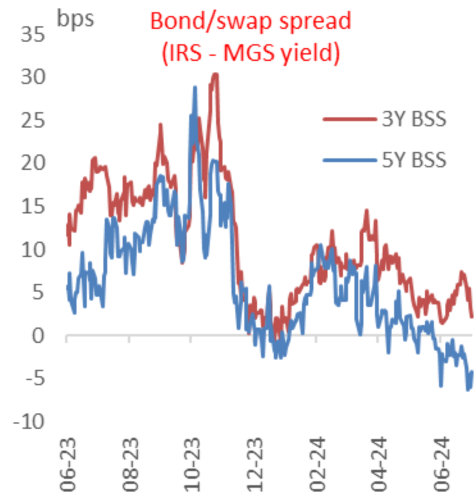


Source: DJPPR, OCBC Research

Month to 15 July, domestic banks reduced holdings of IndoGBs (including bills) by IDR77trn; non-bank domestic investors holdings barely changed; BI and foreign investors increased their holdings by IDR47trn and IDR4.6trn respectively. Foreign holdings have been gradually built up over the past couple of months, as IndoGB-UST yield differentials improved. Stronger comeback of foreign demand probably requires USD rates to fall further.

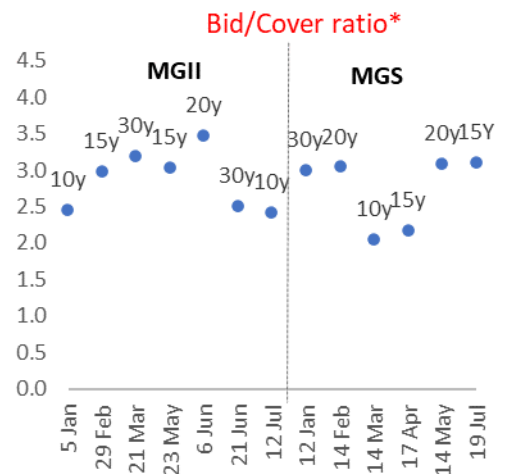
MYR:

MGS rallied by 5-8bps over the past month, in a timid manner compared to UST movements, reflecting the more stable nature of the domestic bonds which is in line with our view. MYR IRS have been offered down to a larger extent, resulting in narrower bond/swap spreads (IRS – bond yields), which were negative for some tenors e.g. -4bps at the 5Y. Our view remains for BNM to keep OPR steady throughout the rest of the year. **Swap rates appear low compared to bond yields; bias is for bond swap spreads to widen mildly** from here.



Source: Bloomberg, OCBC Research

Auctions thus far this year suggest that there has been investor appetite for duration. Bid/cover ratio averaged 2.86x for MGII of 10Y or longer tenors; bid/cover ratio averaged 2.74X for MGS of 10Y or longer tenors. The most recent 15Y MGS auction on 19 July garnered a bid/cover of 3.10x, probably as the lower rate-view had become more entrenched. This appetite, together with our steady OPR view, may mean any steepening move in the MGS curve will not be strong.

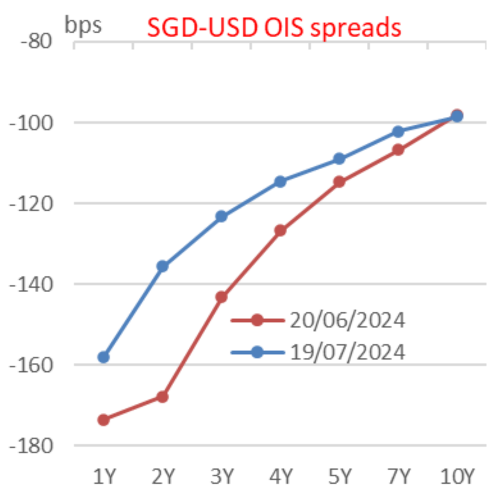


Source: BNM, OCBC Research *include auctions of long-tenors only

The bond supply-demand matrix stays neutral to mildly favourable. Key swing factors for supply are outstanding bills, and the fiscal outcome itself. Net bills issuance was virtually flat year-to-date, versus a reduction of MYR11.5bn in 2023 – if there is no bills reduction it would be marginally beneficial to the bond supply outlook. On demand, we expect EPF demand to stay steady with organic growth. Withdrawals from incoming contributions shall be manageable but adding in potential front-loading then withdrawal could be bigger. In any case, the impact on MGS+MGII holdings can be buffered with the option to reduce % allocation to foreign assets and/or money market instruments.

SGD:

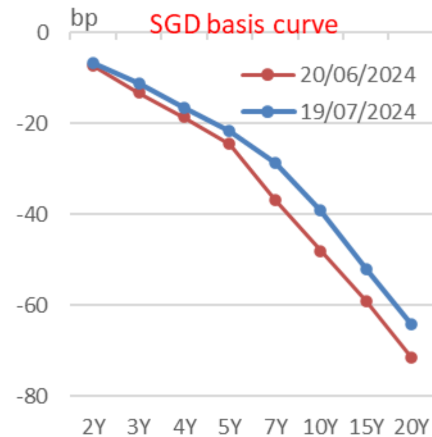
SGD OIS underperformed USD OIS over the past month at tenors 1Y to 4Y on the downward move, which is in line with historical pattern. That said, the underperformance was mild. Our medium-term view is for short-end SGD rates to underperform USD rates. But in the near-term, **before USD rates embark on a more sustained and rapid downtrend, a positive S$NEER slope likely means short-end SGD-USD rates differentials will stay deeply negative** – i.e. SGD rates to stay meaningfully below USD rates. A positive S$NEER slope *per se* tends to exert a downward pressure on front-end SGD rates through the FX swap dynamics. And we expect MAS to maintain current S$NEER policy settings including the positive slope (our model assumes 1.5%) at the upcoming MPC meeting later this month.



Source: Bloomberg, OCBC Research

Cut-offs at MAS bills and T-bills have been edging lower over recent auctions, in line with the lower FX swap implied SGD rates. Front-end SGD rates have already adjusted to around our end-Q3

targets – e.g. 6M SGD OIS was last at 3.42% versus our expectation of 3.40%. We expect some consolidation in front-end rates near-term, and some further downside of 10-20bps towards year-end.



Source: Bloomberg, OCBC Research

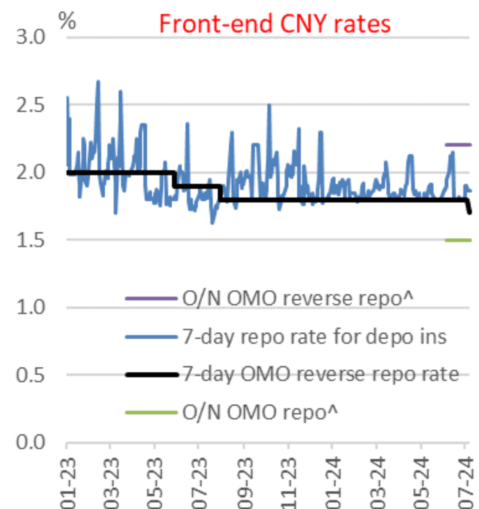
Next focus is the reopening of 15Y SGS on 29 July, the size of which is to be announced on 23 July. We expect the bond sales to attract some foreign demand on asset swap pick-up. Pick-up has generally narrowed over the past month, but remained decent at the long end, which was last at around SOFR+75bps (before bid/offer spread) at 15Y SGS, and at around SOFR+90bps at 20Y SGS. On the SGS curve itself, there is a small kink at the 15Y compared to the 10Y and 20Y; but the kink is very mild which will likely be reflected as concession at the auction. There may also be an increase in preference for duration if the lower rate-view becomes more entrenched.

CNY:

The CGB curve has steepened further, across various segments, amid expectation for and materialization of some form of monetary policy support. Meanwhile, bond supply and policy makers' guidance are curbing rallies in long-end bonds. The upward adjustments in longer-end yields have been slow, not least because of the subdued risk sentiment leading to safe-haven flows to bonds. We **maintain a steepening bias on the curve and expect the 5s30s part to play some catch-up** in the move; after all, additional supply is of ultra-long end tenors, while front-end bond yields may be sticky downward given that the 2Y bond yield is very near the floor of the interest rate corridor.

Source: Bloomberg, OCBC Research

PBoC announced on 8 July that it will conduct temporary repo or reverse repo depending on market conditions on working days at 1600-1620 local time. We wrote earlier on 1 July that "OMO reverse repo rate (and decade back, OMO repo rate) has been effectively serving as a policy rate. PBoC injects liquidity via reverse repos and as such the OMO reverse repo rate acts as the cap of an interest rate corridor. **If OMO repos were to be conducted, then OMO repo rate could serve as the floor**." Subsequently, PBoC cut the 7-day OMO reverse repo rate by 10bps to 1.7%, effectively moving the interest rate corridor down by the same magnitude to 1.5-2.2%. **Next to watch is a potential RRR cut**. We note CNY401bn of MLF matures in August, and another CNY591bn mature in September, which may provide an option for the PBoC to replace some of these liquidity with more permanent one via an RRR cut.



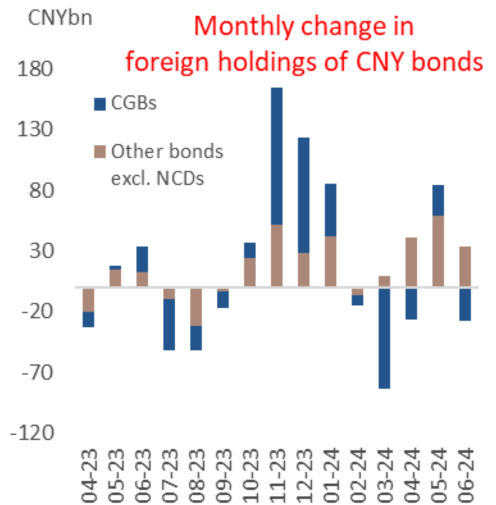
Source: Bloomberg, OCBC Research

^to be conducted depending on market conditions

PBoC considers long-end yields as too low; to counteract the spillover from rate cuts to long-end bonds, PBoC may finally pull the triggers on bond selling under monetary operations. But monetary operation alone is unlikely to exert a lasting impact on the bond market, hence PBoC also tries to facilitate market selling of bonds. In this regard, PBoC announced it would loosen the

collateral requirement for MLF so that market participants can sell the bonds (PBoC specifically mentioned medium to long end bonds) they hold if need be. Overall, the policy backdrop shall add to our CGB curve steepening view.

CGBs saw outflows of RMB28.1bn in the month; year-to-June outflows from CGBs amounted to RMB78.1bn. Some meaningful widening in the much-compressed CGB-UST yield differentials is needed before foreign investors stage a strong comeback, and this would in turn require UST yields to fall further and CNY rates to bottom out and rebound. While we have been looking for CNY rates to bottom out, a strong rebound in CNY rates is not in sight yet. Meanwhile, inflows into NCDs remained hefty, at RMB81.7bn in June after the RMB88.0bn in May. Asset swap into NCDs remained appealing, thanks to the low implied CNY rates. This window of opportunity has not closed yet, but investor positions are likely heavy which may slow additional flows going forward.



Source: CEIC, OCBC Research

KRW:

Bank of Korea kept its policy rate unchanged at its July MPC meeting as widely expected. The vote was unanimous, but the rhetoric turned a tad more dovish: 1/ today's statement has it that "inflation will gradually converge on the target level", instead of the previous "it is premature to be confident that inflation will converge on the target level"; 2/ following this assessment, today's statement added that "the Board will examine the timing of a rate cut."

The KRW IRS market has added to rate cut expectations over the past weeks, to become in line with our base-case of 50bps of rate cuts by year-end. Room for further downward adjustment in front-end KRW rates may be limited from here. KTBs may continue to trade on the firm side, given hope remains for bond index inclusion. Passive inflows are estimated at up to around USD50bn upon index inclusion, expected to be paced out over either 18 months or 24 months. Short-end KRW basis have been trending higher over the past months, narrowing asset swap pick-up, which may affect inflows into short-end bonds to a small extent. Pick-up was last at around SOFR+60bps at 3Y KTBs, compared to around SOFR+80bps in late 2023.

Source: Bloomberg, OCBC Research

*implied rate

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
Credit Research Analyst
ezienhoo@ocbc.com

Wong Hong Wei
Credit Research Analyst
wonghongwei@ocbc.com

Chin Meng Tee
Credit Research Analyst
mengteechin@ocbc.com

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