

Interest Rate Outlook & Strategy

US Bond Market Snapshot

After fund injections from the Fed over the last several days, the US money market seems to be normalizing. Short-term Libors are falling back toward more normal levels. Still, the front end of the Treasury curve (from 1-month to 2-year tenors) continues to benefit from heavy flight to quality buying (Chart 1).

Three month Treasury bill yields fell another 20bps basis points last night to 3.86% and are now down 68bps from Friday and 108bps over the past ten days. This ten day drop equals the 108bps drop following the 9/11 attack (then, 3M T-bill bill yields fell from 3.26% on September 10 to 2.19% on September 19). Flight to quality, accentuated by a sell-off in commercial papers, has taken 2Y Treasury yields to 4.18% currently (Chart 2).

Liquidity in the CP market is becoming tighter as companies are forced to tap other sources of financing. Fed data show that the decline in outstanding CPs over the last several days has surpassed the decline following the 9/11 attacks.

Two-year UST yields at 4.18% might look low but this is consistent with 3M Eurodollar future implied yields of 4.5% by Mar08 (Chart 3). In short, both markets are pricing in 75-100bps of Fed easing over the next eight months, which is not wildly out of line with DBS' forecast for 50bps of cuts on that time horizon. Market expectations for Fed easing are significantly more aggressive than they were six weeks ago (when no hikes were priced in by end-06) and on 4Dec06 and 21 Mar07, when ED3 implied yields were at 4.83% and 4.76% (Chart 4).

So far, the Fed has stayed its course, with official rhetoric asserting that there has been little evidence of fallout on the real economy and, presumably therefore, little justification for rate cuts that the market is pricing in. But market sentiment can damage fundamentals which means the Fed may have to act as markets currently expect. In the meantime, judging from yesterday's rate movements, the market is taking little comfort in the Fed's patience. Investors are likely to remain nervous in the near-term as the Fed remains on hold.

For the Treasury market that means a trend reversal in the near-term is unlikely. Expectations for Fed easing are likely to remain fairly aggressive, which should allow Treasuries to retain recent gains. The 2Y/10Y curve in Treasuries, which has steepened into the bond rally, is likely to remain steep as short-dated Treasuries remain well-supported and investors stay away from duration.

In fact, the rally at the front end could continue were the Fed to cuts rates. Two-year UST yields sit 130bps below 3m Libor, still less than the 150bps spread seen in Oct-98 and Jan-01(Chart 5).

Chart 1: Short-term USD Rates

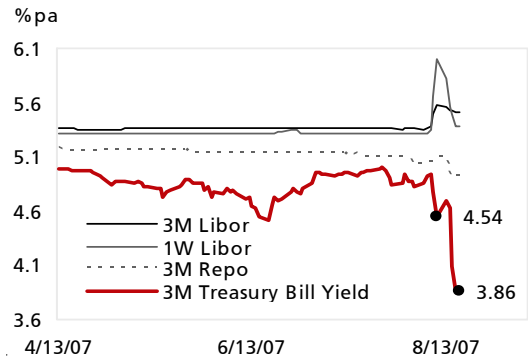


Chart 2: 2Y UST Yield

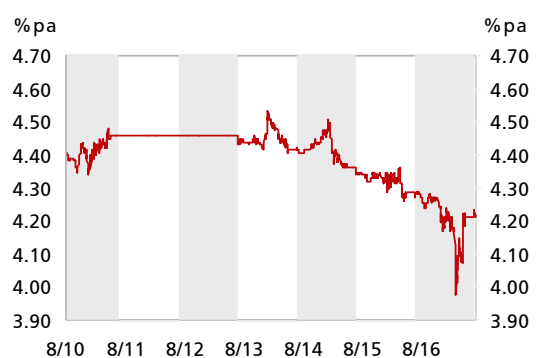


Chart 3: 2Y UST Yield vs ED3 Implied Yield

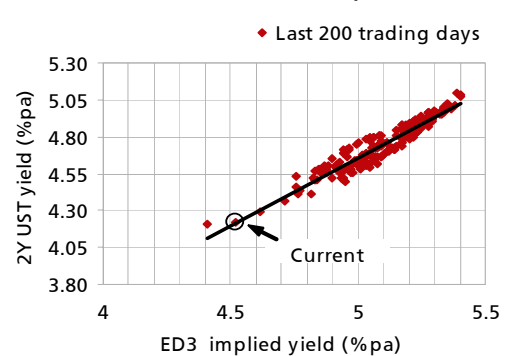


Chart 4: Generic ED3 Implied Yield



A continuation of the rally would probably steepen the 2Y/10Y curve by another 10-15bps, which would take the 10Y yield to about 4.40% from 4.64% currently and the 2Y yield to 3.8% (Chart 6).

We maintain our forecast of 50bps Fed easing before year end, followed by steady rates in 2008, but risks have increased of late that the Fed lowers its policy rate by more than 50bps before all is said and done.

Chart 5: UST 2Y - Libor 3M

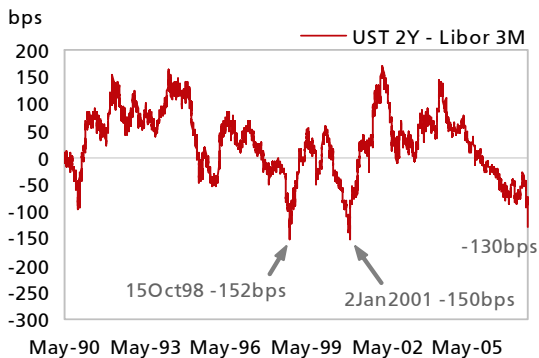
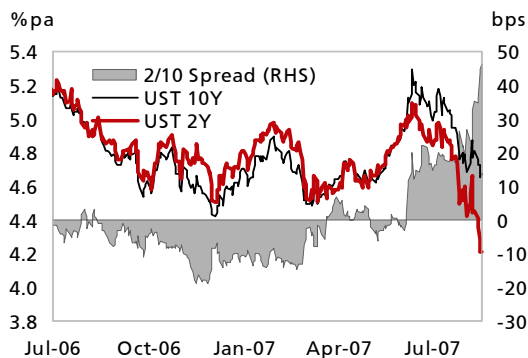


Chart 6: UST 2Y, UST 10Y & Spread



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