Economics

DBS Flash

Asia Rates 2022: Growth Priorities vs Fed Concerns

Strategy/Rates

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2021 Review and 2022 Outlook

2021 was a difficult year for the total returns performance of Asia local currency government bonds, especially compared to 2020. There were multiple headwinds throughout the year. In 1Q, we had US rates volatility post-Georgia state election outcome and resultant expectations of significant US fiscal stimulus. In 2Q, several Asian economies were hard-hit by the Delta variant spread. In 3Q, regulatory tightening in China weighed on risk sentiment in the region. And in 4Q, the Fed shifted away from its "transitory" stance on inflation and signalled a faster taper. The Omicron variant also began to spread across the globe, raising growth recovery worries.

Looking ahead, the macro backdrop is likely to stay difficult in 2022, at least for 1H. The **combination of a weaker global outlook due to Omicron and a hawkish and faster-moving US Fed will prove to be a challenging setup for Asia bonds.** Historically, Asia bonds do not perform in a Fed hiking cycle, especially if the global outlook is not particularly strong.

From an economic perspective, Asia has been harder hit by the pandemic due to slower vaccinations, less resilient healthcare facilities, and harsher restrictions. Asian economies will continue to recover in 2022 but the growth momentum will be weaker than the US. Asia is unlikely to close the growth gap just yet because of more downside risks from Omicron.

With the economic recovery on a weaker footing and inflation much more benign in Asia, Asia central banks could also be less keen to match the US and global pace of policy normalization and rate hikes.

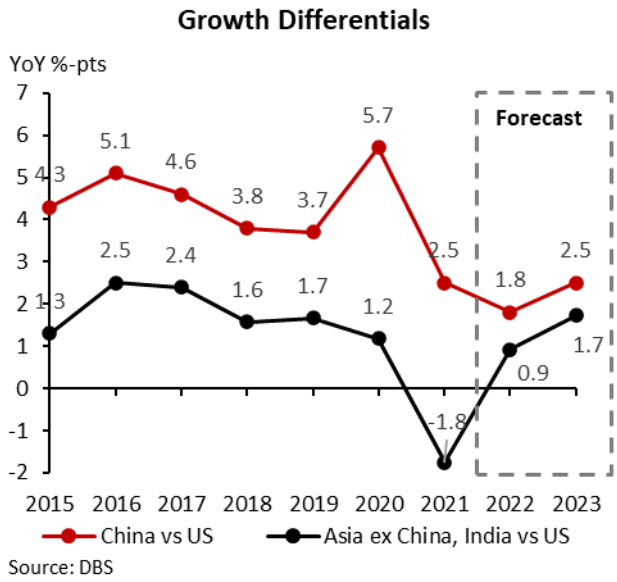
Therefore, in 2022, we expect developments to be more challenging in 1H before bottoming and turning around in 2H. From an EM rates perspective, the most welcome outcome in 2022 will be a moderation in US inflation. That would allow markets to price for a more measured path of Fed tightening. This would go a long way towards easing some of the external pressures on EM/Asia rates and bonds.

			2021 Returns				2020 Returns			
	Yield	Duration	Price	Coupon	FX	Total	Price	Coupon	FX	Total
S.Korea	2.10	9.54	-5.2%	2.2%	-8.7%	-11.4%	-1.3%	2.3%	6.3%	7.5%
Thailand	1.84	9.00	-7.7%	2.7%	-10.2%	-14.9%	0.3%	2.8%	0.1%	3.2%
China	2.74	7.27	2.6%	3.2%	2.6%	8.7%	-0.7%	3.2%	6.5%	9.3%
Malaysia	3.46	7.03	-5.1%	3.9%	-3.4%	-4.8%	3.4%	3.8%	1.7%	9.2%
Philippines	4.21	5.43	-8.5%	4.6%	-5.8%	-9.8%	7.8%	4.7%	5.6%	19.1%
Indonesia	5.91	6.23	-1.7%	6.9%	-1.4%	3.9%	6.6%	7.3%	-0.1%	13.3%
India	6.39	6.73	-4.0%	6.8%	-1.7%	1.0%	5.4%	6.9%	-2.4%	10.3%
Poland	3.66	4.16	-12.8%	2.3%	-7.5%	-17.5%	4.0%	2.5%	1.6%	8.4%
Hungary	4.31	5.46	-13.8%	3.0%	-8.4%	-18.7%	-1.9%	3.2%	-0.3%	0.6%
Mexico	7.46	4.96	-10.7%	7.2%	-2.6%	-6.5%	6.6%	7.1%	-4.8%	8.5%
Russia	8.26	4.52	-11.4%	6.8%	-1.5%	-6.4%	1.4%	6.7%	-15.5%	-9.0%
Brazil	10.86	2.19	-8.3%	3.8%	-6.4%	-11.2%	4.1%	3.9%	-22.4%	-16.2%
South Africa	9.63	6.61	-1.5%	9.2%	-7.8%	-0.5%	-1.4%	9.4%	-3.2%	3.1%

Asia Macro in 2022 (A Rates Perspective)

Growth

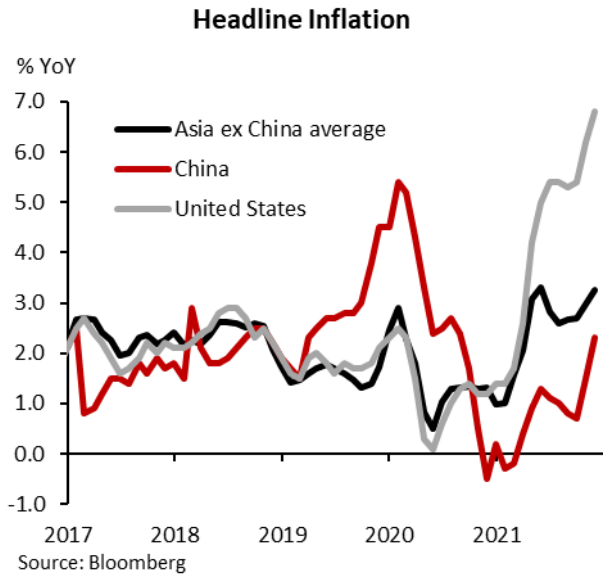
Expect above-trend growth in Asian economies in 2022, though recoveries to pre-pandemic paths are likely to stay incomplete. From an Asian bond investor's perspective, **Investors of Asian bonds will consider Asia's growth differentials against the US as low relative to recent historical averages, suggesting that inflows may remain tepid in the short term.**



Note: For Asia ex China, India grouping, GDP shares are based on the purchasing-power-parity valuation of economies' GDP.

Inflation

In 2021, price pressures across Asia had been much more benign/subdued compared to the rest of the world. While inflation in the US and other parts of EM have been printing at elevated levels, inflation across Asia has been much lower and closer to central bank target levels/bands. A key reason for the different inflation experiences could have been Asia's sizeable negative output gaps as the region was harder hit by the Delta variant. Relative to other EM regions, the depreciation of Asian currencies had also been negligible, likely resulting in a smaller passthrough to imported inflation.



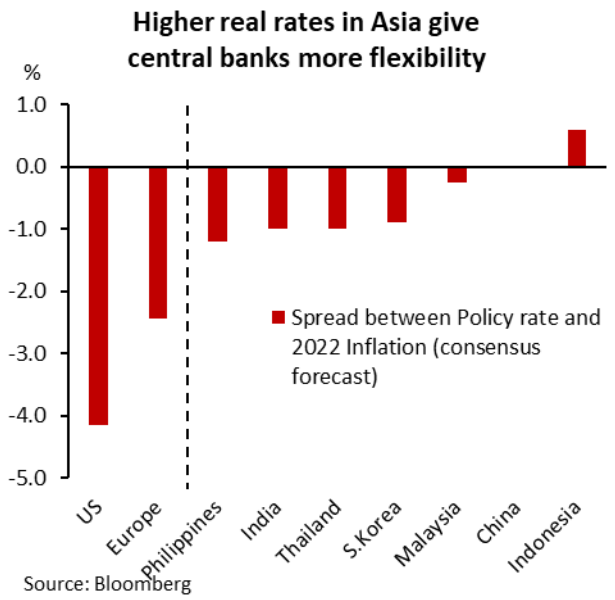
Coming into 2022, easing supply constraints and a slower pace of increase or some stabilization in energy prices would argue for downside risks to inflation. On the other hand, continued reopening and recovery in labour markets and economic growth would support the demand-side push for higher inflation. In aggregate, we think that the risks around Asia inflation are well balanced in 2022; we continue to expect inflation prints to come in close to central bank targets generally.

On its own, lower and contained inflation across Asia would support Asia rates. Asia central banks may not need aggressive rate hikes to contain inflation risks. However, as we saw in 2021, historically high inflation in the US could negatively spill over onto Asia rates via

the pricing of aggressive Fed hike cycle and higher long-term US breakevens.

Monetary

Asia central banks, as a group, have lagged in terms of policy normalization, whether its shifting to a less dovish stance or delivering actual policy rate hikes. So far, only the Bank of Korea and the Monetary Authority of Singapore have been able to achieve rate lift-off (in MAS's case, slope of the SGD NEER). This is in sharp contrast to other EM regions such as Latam and CEEMEA where many central banks have been hiking rates aggressively (some to restrictive territory). Even in DM, central banks such as the Bank of England and the Reserve Bank of New Zealand have hiked rates while the US Fed and the Bank of Canada turned decidedly more hawkish in signalling that lift-off is approaching.

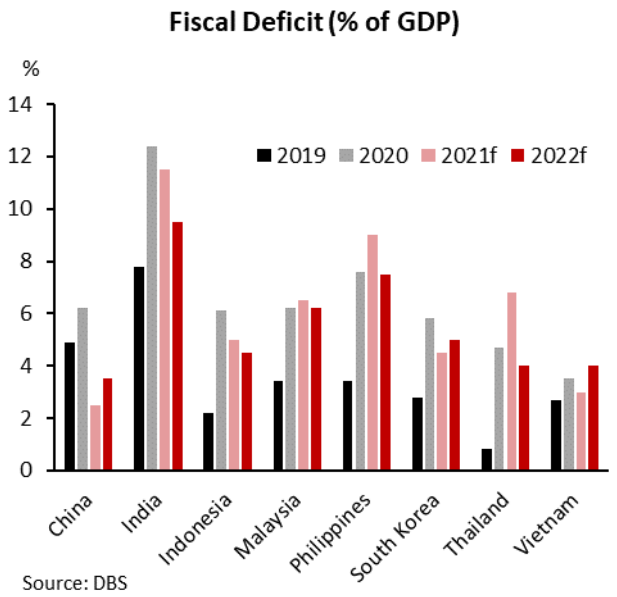


The underlying causes for Asia's slower progress towards monetary normalization will extend through much of 2022. Growth recoveries across the region remain uneven and incomplete with Asia central banks preferring to delay rate hikes until recoveries become more durable and broad-based. Compared to global peers, the favourable macro factors for Asia have been relatively contained inflation and lower external financing risks, which have given Asia central banks the flexibility to stay accommodative for longer.

For 2022, while we expect policy rates in Asia to normalize (higher), aggressive hike paths are unlikely. From a rates perspective, to the extent that Asia has some catching up to do on monetary normalization, Asia rates and bonds could underperform other EM peers.

Fiscal and Bond Issuances

Most Asian governments are expected to make further progress on fiscal consolidation. The exceptions are China, South Korea and Vietnam where we are forecasting an increase in fiscal deficit (as % of GDP) from 2021. Even as fiscal deficits narrow this year, deficit levels will stay elevated relative to pre-pandemic (2019).



The linkage between fiscal deficits and government bond issuances can sometimes be limited. A smaller fiscal deficit does not

necessarily mean smaller bond issuances. To a large extent, it would depend on the GDP base, individual government's financing strategy/mix (bond issuances vs other modes of financing) and size of maturing bonds.

For 2022, issuances in most Asian bond markets are projected to be stable or even rise slightly from 2021 sizes. Given that bond supply pressures will continue to be heavy this year, we would need to monitor possible demand gaps as central banks and domestic banks pull back on their bond purchases. The one exception is South Korea, where bond issuances are projected to decline by 10% for gross issuances and 23% for net issuances.

Liquidity

Besides rate hikes, Asia central banks will also be unwinding pandemic-easing of liquidity. Since the onset of the pandemic, Asia central banks have deliberately ensured financing and interbank liquidity conditions stayed easy to support growth recoveries. Higher private savings coupled with weaker private consumption and investments have led bank deposits to expand much more than loans/credit. Hence, interbank liquidity has been extremely flushed over the last several quarters.

As a result, Asia money market rates have been trading at low levels relative to policy rates (sizeable discounts in some markets) and government financing costs have been largely capped despite much larger fiscal deficits and bond issuances.

In 2022, by a combination of rebound in private credit growth and increased central bank absorption (e.g. reverse repo operations, hikes to reserve requirement ratios, increased issuance of central bank bills e.t.c.), we are likely to see interbank liquidity tighten and become less flush across Asia.

There would be two key implications for Asia rates. 1) Money market rates and by extension, swap fixing rates would rise relative to policy rates. 2) Banks' capacity to support government financing will decline and Asia bond yields could face upward pressures from weaker banks' demand, particularly in the shorter 0 to 5Y tenor where banks focus their buying.

Balance of Payments

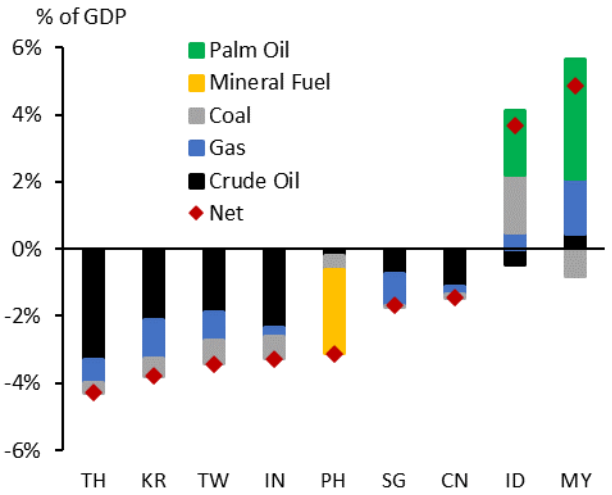
In 2022, we expect a general deterioration in Asia's balance of payments (BOP) profile leading to a more muted total returns profile for Asia govvies.

On current accounts, pandemic-driven improvements have likely peaked in 2021 and are expected to reverse in 2022. Key exporters like China and South Korea could see their exports strength and trade surpluses moderate ahead, alongside the continuing global rebalancing from goods demand to services demand. Across the region, rising vaccination coverage and more durable economic re-openings would support the normalization of domestic demand and consequently, drive higher imports. We see this in economies like India and the Philippines where trade deficits have been progressively widening for several months and could extend through 1H.

Our Commodity Analysts are also forecasting oil prices to stay higher for longer (Brent to average USD75-80/bbl in 2022 and USD85-90/bbl in 2023). And with most of Asia being net

energy importers (Indonesia and Malaysia are exceptions), elevated energy prices will be a key factor weakening terms-of-trade and amplifying the worsening of current account balances.

Energy Trade Balance (% of GDP), 3Q20-2Q21



Source: CEIC / Note: India's Gas balance is for 2Q20-1Q21

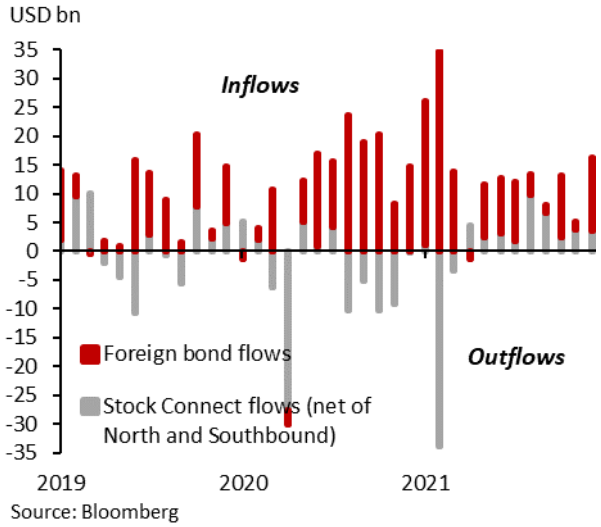
Aside from the above downside risks to current accounts, we see some upside risks from the global reopening of international borders, which would benefit economies with significant tourism exposures such as Thailand and Malaysia. However, the recovery timeline for the tourism sector will likely be much more drawn-out, and therefore, support to current accounts will be relatively limited in the near term. **On balance, we think that risks to Asia's current accounts are skewed to the downside.**

Shifting to Asia's capital accounts, we hold a more neutral outlook for 2022. With Fed expected to complete taper and start hiking rates this year and considering Asia' weaker economic recoveries relative to the US, we find it hard to be bullish or expect capital inflow prospects to materially improve in 2022.

That said, there will be substantial dispersion. For example, equity portfolio investment outflows, by both locals and foreigners, have been a significant trend for South Korea in 2021 and may persist in 2022, considering that some of the drivers are structural in nature. For Thailand and Malaysia, overseas equity investments by locals have also been rising, though the extent of outflows has not yet been as severe as South Korea's.

In contrast, we expect foreign inflows into Chinese equities and bonds to stay robust. Equity markets of India and Indonesia could see greater inflows on a strong pipeline of IPO listings.

Foreign inflows into China equities and bonds



Source: Bloomberg

Broadly speaking, we think **Asia's current account balances will be weaker for most economies. Capital inflow prospects will comparatively be more differentiated across the region and will either partially offset or augment the downward impact on BOP.**

Key Theme 1: Drawing on the experiences of past Fed hike cycles

Every Fed hike cycle, together with the accompanying global macro setup at that point in time, can be very different. And as a result, how Asia local markets react and perform can vary from one Fed hike cycle to the other. **In general, a Fed hike cycle together with US growth outperformance are typically quite bearish for Asia local markets.** On the other hand, a strong global outlook (where growth in the rest of the world is also strong) can provide a substantial cushion against the headwinds posed by the Fed hike cycle (higher US rates, lower USD liquidity).

In the last 20-30 years, there have been only four Fed hike cycles, namely 1994, 1999, 2004 and 2015 (start dates). We can look at how Asia local markets performed during those four cycles to glean some insights. We start by breaking down each Fed hike cycle into three stages, where we believe Asia local markets could exhibit varying behaviour in each of the three stages. **Stage 1 represents the six months before the first rate hike.** Typically, forward US rates (e.g. 1y1y USD IRS) will start pricing for the Fed hike cycle around six to nine months before lift-off. **Stage 2 represents the time between the first hike and the peak in hike pricing (i.e. peak in forward US rates). Stage 3 represents the time between peak in hike pricing and the last hike**, where overshot hike expectations get recalibrated lower.

For the Fed hike cycles that started in 1994 and 1999, there is a lack of reliable price data for market interest rates and so we excluded performance computations.

2015

	Change in FX (%)			Change in 5Y Rates (bps)		
Stage	1	2	3	1	2	3
S. Korea	-5.2%	5.1%	-0.6%	-15	16	-25
Thailand	-7.1%	8.9%	0.5%	-5	13	-27
Singapore	-4.9%	2.3%	0.2%	35	-11	-41
China	-4.3%	-7.1%	0.6%	-28	56	-11
Malaysia	-15.2%	3.6%	-0.4%	8	-19	-4
Indonesia	-5.4%	-3.3%	0.7%	28	-97	-3
India	-3.8%	-8.6%	2.9%	-40	49	-80

2004

	Change in FX (%)			Change in 5Y Rates (bps)		
Stage	1	2	3	1	2	3
S. Korea	3.5%	17.1%	-0.3%	-40	27	-2
Thailand	-3.2%	6.2%	0.1%	-5	197	2
Singapore	-0.8%	6.9%	0.5%	-20	106	2
China	0.0%	3.4%	0.0%			
Malaysia	0.0%	3.0%	-0.1%	-33	23	0
Indonesia	-10.9%	0.6%	-0.3%	-24	92	-8
India	-1.2%	-0.7%	0.2%	170	88	4

1999

	Change in FX (%)			Change in 5Y Rates (bps)		
Stage	1	2	3	1	2	3
S. Korea	4.3%	3.7%	0.0%			
Thailand	-0.3%	-6.9%	0.0%			
Singapore	-2.6%	-1.9%	0.0%			
China	0.0%	0.0%	0.0%			
Malaysia	0.0%	0.0%	0.0%			
Indonesia	17.2%	-28.0%	0.0%			
India	-2.0%	-1.4%	0.0%			

1994

	Change in FX (%)			Change in 5Y Rates (bps)		
Stage	1	2	3	1	2	3
S. Korea	-0.2%	2.7%	0.3%			
Thailand	-0.8%	1.3%	0.1%			
Singapore	1.3%	8.7%	0.2%			
China	-50.6%	2.9%	0.1%			
Malaysia	-8.5%	8.1%	-0.2%			
Indonesia	-0.9%	-3.8%	-1.0%			
India	0.5%	0.3%	0.0%			

Based on the experiences of the last four Fed hike cycles, we make the following empirical observations. **Asia FX tends to be weakest in Stage 1 where markets start to price for the Fed hike cycle and rate differentials are likely**

moving against Asia. After the Fed makes the first hike (Stage 2 and 3), Asia FX performance tends to be mixed. **For Asia local rates, performance tends to be the weakest in Stage 2 when the Fed is hiking with markets still uncertain when the hike cycle will complete.**

The above observations have implications for our Asia Rates strategy (we are currently in Stage 1). **First, while Asia rate hike pricings are elevated (relative to our forecast) but it is likely too early to position for a unwind (by receiving). Hike pricings could still overshoot because market participants may still want to pay rates for insurance.** We should look to receive only when we are closer to the end of Stage 2. **Second, up to the first Fed hike, Asia bond investors may want to consider asset-swapping to USD to protect FX downside**, especially if there is a yield pick-up from swapping.

Key Theme 2: China diverges (again!) on growth trajectory and policy bias

Since the onset of the pandemic, financial markets have had to constantly trade around the major theme of China's divergence from the rest of the world. In the first phase (2H20 - 1H21), China, on the back of its first-in-first-out advantage, enjoyed a V-shaped growth recovery and was thus able to tighten/normalize fiscal and credit growth quite quickly. This was at a time when recovery in the rest of the world was still weak and global governments and central banks were still in easing mode.

Now, in the current second phase (2H21 onwards), the tables have turned. Chinese growth momentum has slowed considerably in recent months, in large part due to policy-induced shocks (regulatory clampdown in tech and education sectors, tightened measures on property financing, controls on energy consumption, e.t.c). To help shore up growth, policymakers are signalling stepped-up fiscal and monetary support in 2022, particularly to be front-loaded in 1H. Last month, the finance ministry issued CNY1.46tn in 2022 advance quota for local government special bonds while the central bank (PBOC) did a broad-based 50bps cut to reserve requirement ratio. In contrast, for the rest of the world (e.g. the US and the rest of Asia), growth recovery continues to gain momentum and governments are expected to consolidate on fiscal and central banks to begin their rate hike cycles in 2022 (if they did not already started in 2021).

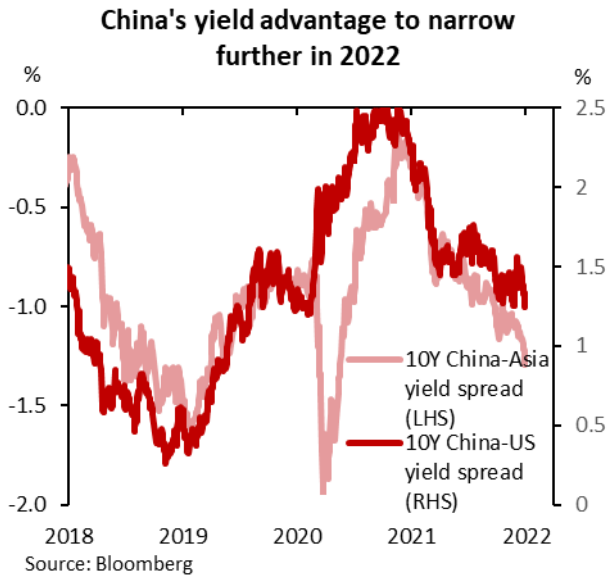
In the current second phase, **China's weaker growth trajectory and easing policy bias will have nuanced implications for Asia macro and our outlook on Asia interest rates.** So far, weaker Chinese growth has had limited economic and financial spillovers (negative) onto the rest of Asia and our base case expects it to stay that way. China's external sector (trade and exports) continues to be well-supported by global demand and domestic production capacity does not appear to be materially constrained by local mobility restrictions. While weaker Chinese domestic demand could presumably weigh somewhat on imports from the rest of Asia, there does not appear yet to be an evident and material negative impact on growth in the rest of Asia. That said, select economies dependent on tourism and with large exposures to Chinese

tourist arrivals, such as Thailand, are likely to see their recovery prospects be disproportionately affected by China's zero-COVID policy and associated border controls.

In terms of implications for interest rates, we expect China's divergences on growth trajectory and policy bias to be fully reflected in the outperformance of CNY rates in 2022, relative to global and regional rates.

Expectations for the PBOC to maintain accommodative liquidity conditions, stable funding costs and hold an easing bias should see CNY rates be more stable with upside pressures capped. If prospects of more dovish easing, in the form of rate cuts to OMO or MLF, were to increase in the coming months, we should see CNY rates rally.

Our outlook for CNY rates to be stable-to-lower is fundamentally divergent from our outlook for global and regional rates to rise on rate hikes and more hawkish central banks. Hence, the relative outperformance of CNY rates is one of our conviction views for 2022.



On tail risk scenarios, we think a much sharper-than-expected deceleration in China's growth or systemic and disorderly fallout in the property sector could significantly weigh on risk sentiments towards Asian assets and by extension, drive pricing of larger risk premium in Asia rates and bonds.

Key Theme 3: Low valuations and low foreign ownership in Asia bonds are bright spots

Based on our bottom-up models and various metrics, valuations in Asia rates and bonds appear to be cheap across both short and long tenors. Foreign ownership in most Asia bonds is also low, despite the large amount of liquidity injection by DM central banks since the onset of the pandemic. **In our view, the generally cheap valuations and low foreign ownership levels in Asia bonds could help provide some extent of cushion against the expected challenging environment for EM fixed income in 2022, especially in 1H.**

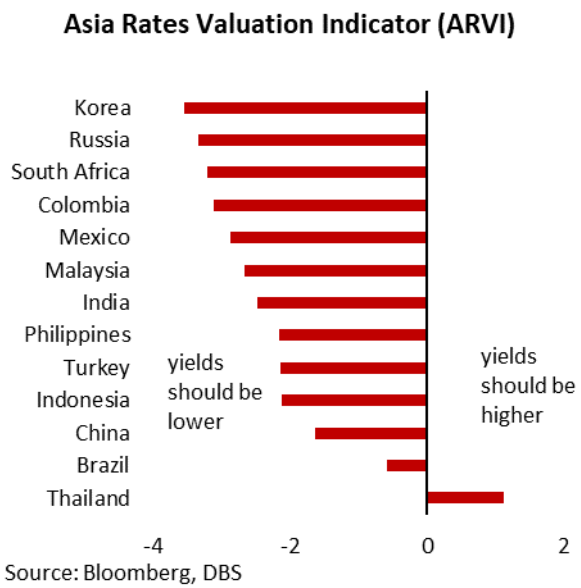
When we look at rate hike pricings in short-term Asia interest rate swaps, markets' pricing appears to be much more hawkish than consensus and our forecast. This is nothing too unusual, as markets' hike pricing tends to be more aggressive going into a hike cycle, due to the significant uncertainty around hike pace and terminal policy rates that is typical in the early stages of hike cycles. Though market pricing appears overly hawkish, pricing can remain elevated or overshoot for some time, and therefore, we don't advocate

indiscriminately taking outright receive positions across Asia swaps just yet.

When we look at valuations in longer-term Asia bond yields, based on our bottom-up models, valuations appear to be closer to the lower end of historical ranges. I.e. Bond yields are high relative to model variables. Ultimately, last year (2021) was a difficult year for Asia bonds, with many bonds suffering large losses on the back of volatility in US rates, strength in US dollar and various other macro and flow trends. **In large part because of last year's cheapening, there is now a significant risk premium that is priced into Asia bonds that can provide buffer against economic or financial shocks in 2022.**

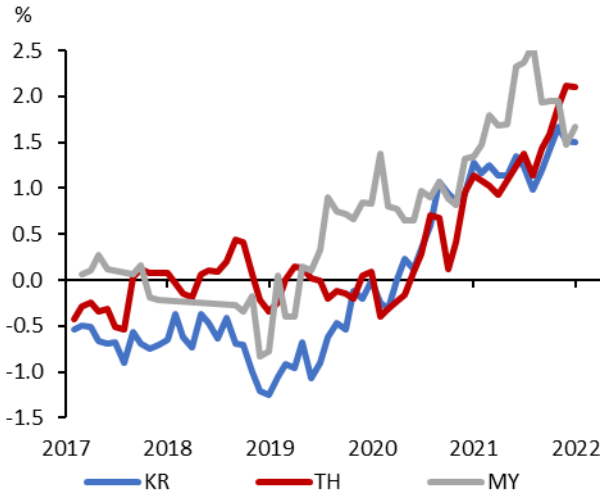
The first valuation model we consider is our Asia Rates Valuation Indicator (ARVI). Primer - Introducing the Asia Rates Valuation Indicator. This indicator benchmarks Asia-US nominal yield differentials against macro factors such as Asia-US inflation differentials and Asia external funding needs (current accounts). Fundamentally, the model works on the basis that higher Asia inflation and weaker Asia current account balances would need to be compensated by higher Asia bond yields.

Our latest ARVI values show that 10Y Asia bond yields are currently high relative to model. I.e. **Though Asia inflation has been lower (relative to US) and Asia current account balances have improved in recent quarters, Asia-US yield differentials have not compressed to sufficiently reflect the extent to which model factors have moved in Asia's favour.** Taking a more forward-looking approach, if we assume current Asia-US yield differentials to be fair, that will imply that markets expect inflation differentials and Asia current account balances to considerably deteriorate (against Asia) in 2022, which is not something we expect.



The second valuation model we look at takes a yield decomposition approach to assess if excess risk premia embedded in Asia bonds are attractively high and thus, Asia bonds can be considered cheap relative to US Treasuries. From 10Y Asia nominal bond yields, we subtract 10Y US real yields (real risk-free rate), 12-months ahead domestic inflation consensus forecast (inflation) and 5Y sovereign CDS spreads (sovereign credit spread). The residuals would then represent excess risk premia, which also compensates Asia bond investors for idiosyncratic risks and currency depreciation risks.

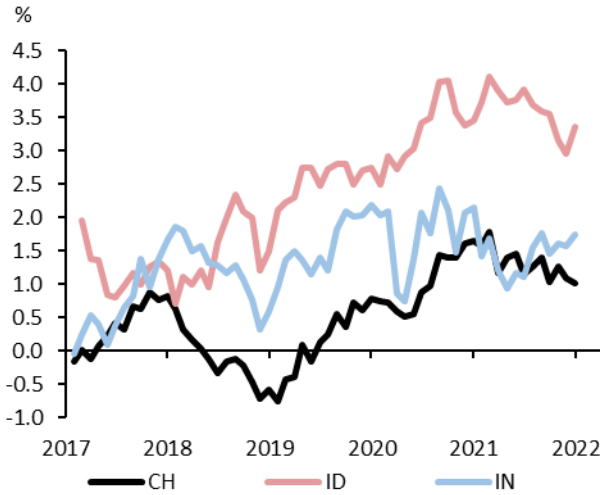
Estimate of Excess Risk Premia in Asia Bonds



Source: Bloomberg

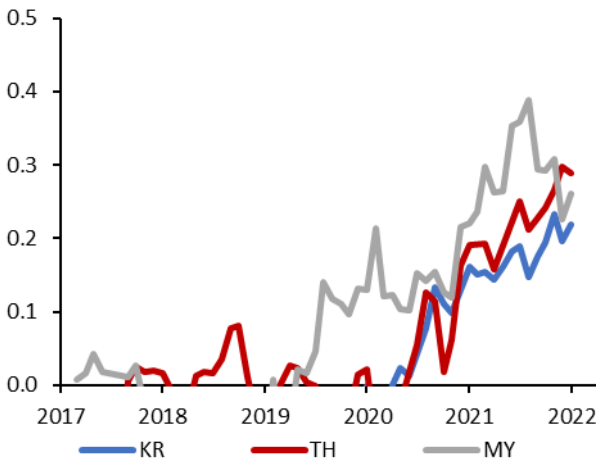
To judge if excess risk premia are high as a direct result of greater expectations of Asia currency depreciation, we express our estimate of excess risk premia as a ratio over Asia FX vols. We find that those ratios are close to 5-year highs. **Therefore, though broad US dollar strength could persist (our forecast is for the US dollar to peak only in 3Q), it appears that Asia bonds already offer some yield concession to compensate. From this perspective, there may be opportunities to go long once Asia and USD rates have adjusted to a tighter monetary regime.**

Estimate of Excess Risk Premia in Asia Bonds



Source: Bloomberg

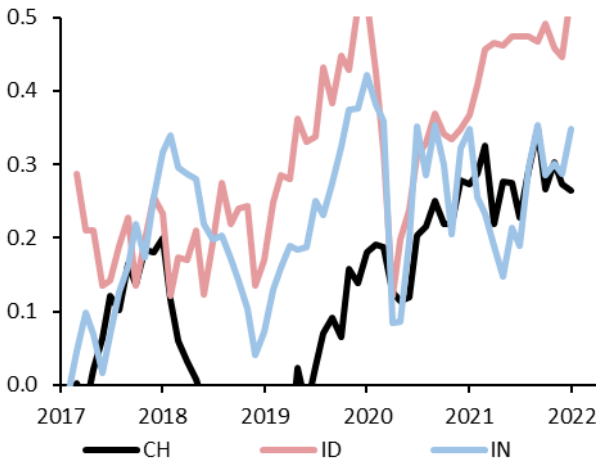
Excess Risk Premia as a ratio over FX Vol



Source: Bloomberg

Comparing against recent historical values, it appears that South Korea, Thailand, China and Malaysia bonds currently embed higher-than-average excess risk premia and thus, bonds are likely cheap. On the other hand, excess risk premia in India and Indonesia bonds are closer to historical averages and thus, yields are likely close to fair value.

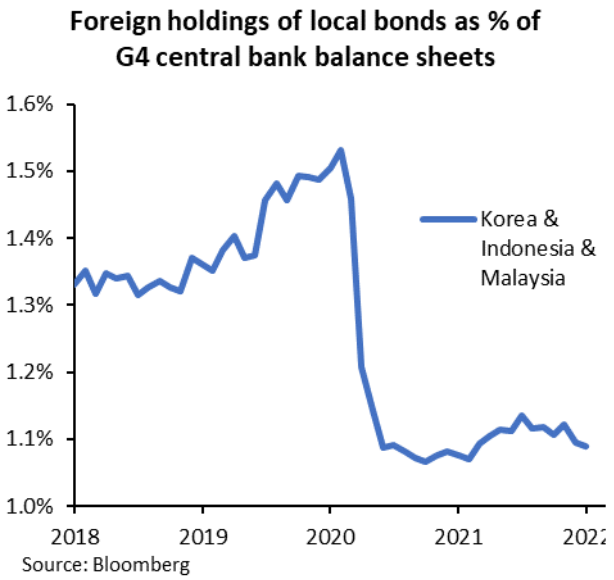
Excess Risk Premia as a ratio over FX Vol



Source: Bloomberg

Over the last two years, the bulk of foreign bond inflows has gone to China bonds. Inflows into South Korea and Malaysia bonds have been relatively robust as well. For the rest of the region, however, bond inflows have been much more subdued.

Considering the large amount of liquidity injections by DM central banks post-pandemic, we think that Asia bonds could be relatively under-owned. We use foreign holdings of South Korea, Indonesia and Malaysia bonds (these are the Asia bonds typically more popular with foreign investors) and express these foreign holding sizes as a percentage of G4 central bank balance sheet sizes. That percentage had fallen from 1.5% to 1.1% around the onset of the pandemic (February - April 2020) and have stayed at 1.1% ever since. **If Asia bonds are indeed under-owned (based on our proxy), Asia bond outflows should be a smaller risk for this upcoming Fed hike cycle.**



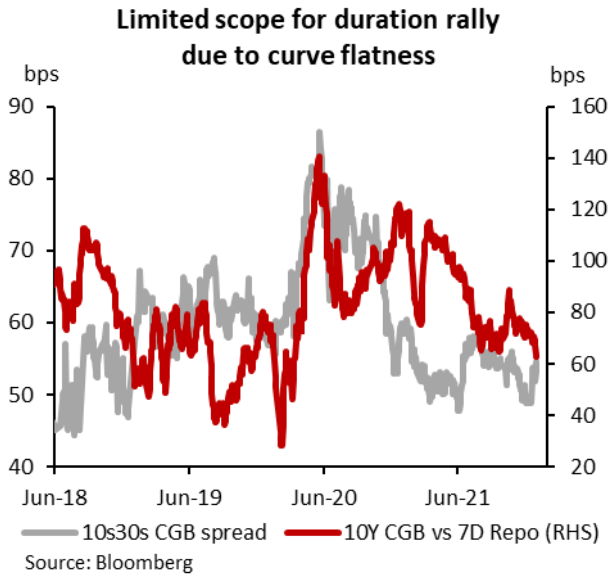
Country Sections

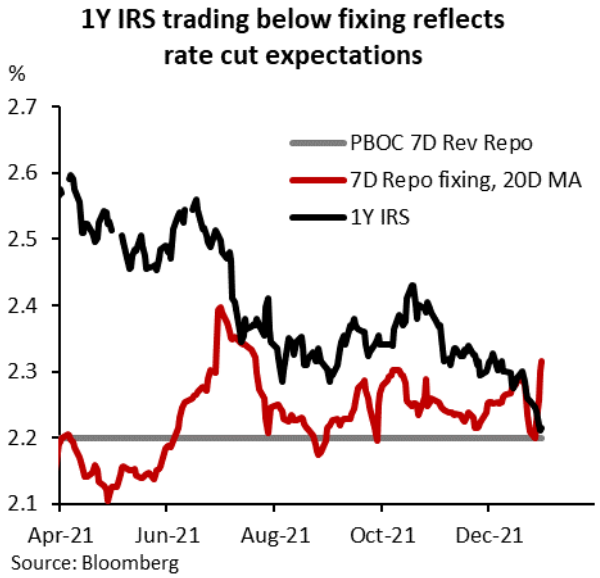
China

In the tough fixed income environment of 2021, CNY rates (IRS/NDIRS) and bonds (CGB) have been much more resilient relative to core and Asia peers. China CGBs returned +8% in total returns, significantly superior performance to the -5 to -15% returns in many EM bonds and -2% in US Treasuries.

Looking ahead through 2022, we expect CGB returns to continue to stay on top. As written in our Key Themes section, our rates thesis is that China's weaker growth trajectory and easing policy bias will act as a strong anchor for CGB yields, while in contrast, we expect global and Asia bond yields to rise this year on rate hikes and more hawkish central banks. From a total returns perspective, we acknowledge that there are some investor concerns around likely moderation in the current account and portfolio investment balances in 2022. But, ultimately, China's balance of payments is still going to stay quite strong and will be a key source of resilience against the external pressures (e.g. US dollar strength) we foresee in 2022.

Despite our bullish view on China CGB, we want to point out that absolute total returns in 2022 are likely to be smaller than 2021's +8%. Coming into 2022, the CGB curve is already quite flat relative to historical, both at the front-end (10Y CGB vs 7D reverse repo) and the back-end (30Y CGB vs 10Y CGB). As a result, even though financing costs have been extremely stable of late, brokers/dealers and fund managers etc may not be highly incentivized to extend duration and/or earn carry. **In this context, even if we get more liquidity injections ahead (from more RRR cuts), scope for curve spreads to compress and duration to rally are quite limited. For CGB price to rally, we ultimately need lower funding rates (more than quantitative measures like RRR cuts). I.e. we need the PBOC to cut the OMO (7D reverse repo) rates.**





That said, cuts to OMO rates are already partially priced in. With R007 swap fixings around 2.23-2.28% levels, and factoring in some term premium in short-term CNY rates, 1y (2.23%) and 1y1y (2.37%) CNY IRS rates suggest that markets have already priced in 5-10bps in cuts to OMO rates.

Therefore, investors should not expect the same kind of outsized duration rallies achieved in 2021. For 2022, CGBs should be seen as offering good carry (stable yields) with very limited scope for duration rallies and also quite importantly, a valuable diversifier against the global trend of rising bond yields. We initiate a receive 5Y CNY NDIRS vs pay 5Y USD IRS to express that view.

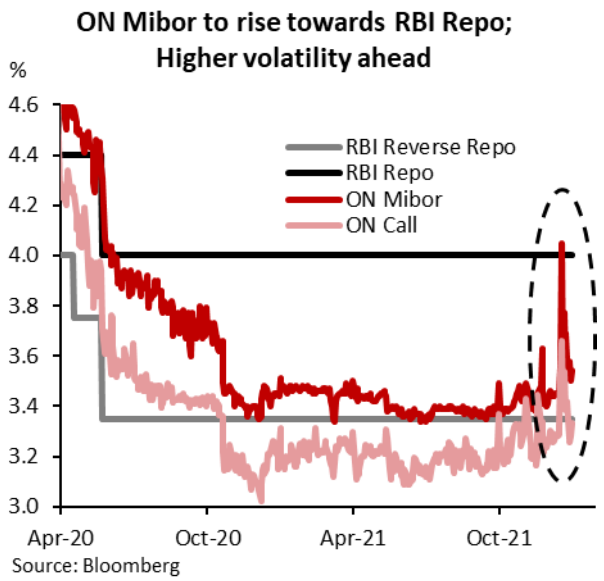
We also continue to hold onto our long 30Y CGB idea (initiated in 2021) to hold out for a cut to OMO rates. We keep our receive 1Y vs pay 5Y CNY NDIRS idea (initiated in 2021) to act as a partial hedge against expected bond supply pressures in 1Q from front-loading of local government bond issuances.

There are two key risks to our overweight stance on CGBs. One, at some point in 2022, China's growth trajectory could stabilize and with it, monetary easing expectations would peak and by extension, CNY rates would bottom. That would be our cue to exit our long 30y CGB idea. Two, the risk scenario where the mode of policy easing in 2022 is heavily skewed towards fiscal and credit tools, rather than monetary, would be less bullish for CGB.

India

With increasing sizes of variable rate reverse repo (VRRR) auctions to absorb more surplus liquidity at higher rates, coupled with lower liquidity injections via Reserve Bank of India (RBI)'s GSec purchases and FX operations, it is clear that the 2022 trend is for tighter liquidity and higher cost of funding. Therefore, overnight call and repo rates should be expected to rise within the rate corridor and towards the policy repo rate.

For the broader INR rates space (OIS/NDOIS, GSec), markets' perception of RBI's policy reaction function will determine the pace of rate hikes priced, and by extension, how fast INR rates can rise in 2022. Markets will be constantly trying to interpret how RBI will trade-off between supporting growth and



fighting inflation, as well as the weight given to external factors such as the Fed cycle. **Uncertainty around the pace of policy normalization will mean higher volatility in INR rates in 2022**, compared to 2020 or 2021.

We saw some evidence of that in late December when RBI unexpectedly announced 3D and 4D VRRR auctions to shift more surplus liquidity to the variable rate liquidity adjustment facility.

Looking at OIS swaps' pricing of the upcoming RBI hike cycle, we think the quantum of priced hikes seems reasonable, but the pace is probably too front-loaded. Our expectation is for RBI to be more gradual in normalizing policy settings, at least until domestic growth is more broad-based and durable. Our forecast sees the policy repo rate at 4.50% at the end of 2022, lower than the current market pricing of 5.30-5.40%.

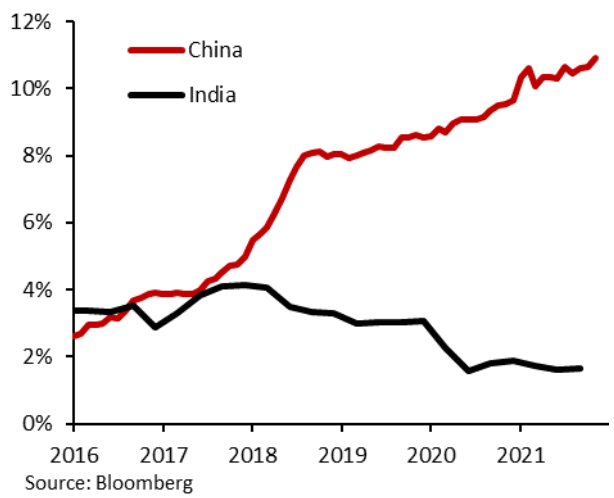
In 1H, there could be good potential for the OIS curve to re-steepen, if RBI pushes back or under-deliver against markets' aggressive hike expectations. We therefore initiate a receive 1Y1Y vs pay 5Y INR NDOIS idea, which has a positive carry of around 3bps per month. The key risk to our idea would be a faster-than-expected shift in RBI's focus from supporting growth to containing inflation.

Transition from G-Sec Acquisition Programme (GSAP) to ad-hoc Open Market Operations will create much uncertainty around the extent of RBI's support for GSec bonds. In fact, the last time RBI conducted a sizeable (>INR100bn) outright purchase or twist operation was in early October. We think RBI could be comfortable staying on the side-lines, unless there is excessive GSec yield volatility that would be disruptive for government financing. **In addition to tighter liquidity, RBI's newfound passivity should argue for greater GSec yield volatility and wider term premiums in 2022.**

Possible inclusion into BBGA and GBI-EM bond indices is a key tail event that could make us turn bullish on GSecs. In the event of inclusion, foreign investors can be expected to partially fill the bond demand gap from reduced GSec purchases by banks (due to tighter banking liquidity) and RBI (due to suspension of GSAP). **Considering the current wide dispersion amongst market participations on the timing of inclusion, there is likely to be an outsized knee-jerk rally in GSec, if and when inclusion is confirmed - 10Y GSec yields could fall by as much as 10-30bps.**

Potential index-tracking inflows from inclusion are estimated to be around USD30bn, roughly 3% of current GSec outstanding. Non-index inflows would also be drawn in and could bring total foreign ownership of GSec from the current 1.8% to as much as 8-10% by the end of the inclusion process. We will be monitoring inclusion prospects in 2022, and if a positive announcement (by Bloomberg or JPM) starts to look imminent, we could initiate a GSec-OIS compression idea to pre-position.

Foreign Ownership of Central Govt Securities



Source: Bloomberg

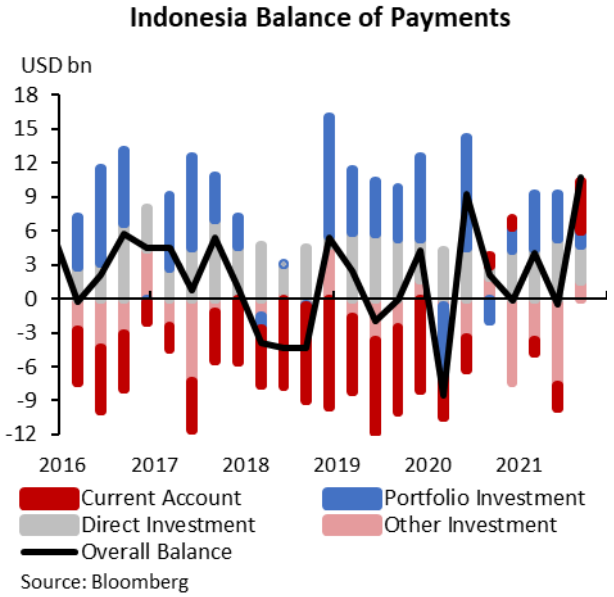
Indonesia

We have been holding a constructive outlook on Indonesia government bond (IndoGB) since 3Q of 2021, and now carry forward that stance into 2022. We however want to point out that external conditions are expected to deteriorate and domestic factors likely to gradually turn less supportive ahead, and thus, absolute return prospects would be weaker in 2022 relative to 2021. **On a relative basis, against other Asian bonds, we expect IndoGB to outperform due to superior buffer from lower inflation risks, higher nominal yields (to offset price losses from higher global yields) and support from Indonesia's much-improved external balances.**

IndoGB investor concerns seem to revolve around the pace of the Fed hike cycle - IndoGB, fundamentally, can be quite sensitive to sharp increases in short-term US rates and tightening in US financial conditions (including wider US credit spreads).

Recognizing the risks around a more hawkish Fed, Bank Indonesia (BI) has recently signalled that the focus of monetary policy will tilt towards being more "pro-stability", which includes ensuring currency stability, as well as containing inflation risks. Therefore, **a faster-moving Fed would put some pressure on BI to move faster on its own rate hike cycle, so as to pre-empt potential sell-off in local bonds and currency.**

That said, **compared to past Fed hike cycles, Indonesia is coming into this Fed hike cycle with better defenses.** Trade and current account balances are in large surpluses, boosted by surging export prices in coal and crude palm oil. We expect some stabilization in prices and higher imports ahead to eventually return the current account into a deficit, but our forecasted 2022 deficit of 0.5% of GDP would be quite manageable and less of a vulnerability compared to the 2-3% deficits prior to the pandemic. On inflation, though we expect higher prints in 2022, our 2022 forecast of 3.0% would still be within BI's target range of 2.0-4.0%.

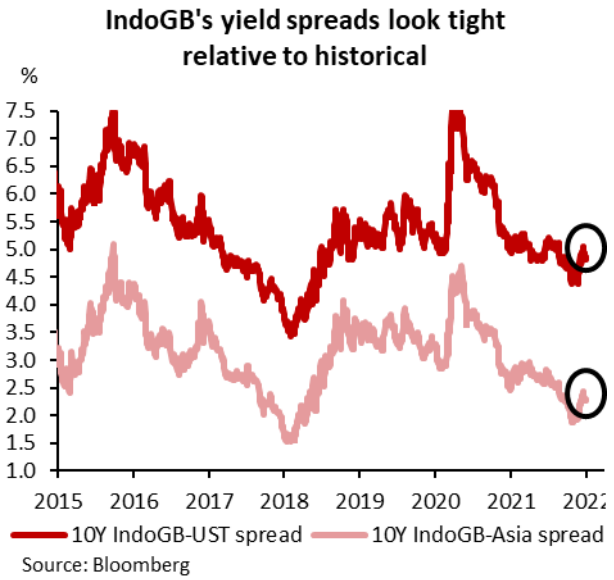


Therefore, we do not expect BI to normalize liquidity and hike rates in an aggressive manner that would drive significant volatility in IndoGB. However, in the event that we are wrong, 3 to 5Y tenors would be more vulnerable on the IndoGB curve, as these tenors have a higher beta to hike cycle and have disproportionately benefitted from flush interbank liquidity.

Possible bond demand gaps may be one underappreciated risk. Gross government issuances in 2022 are projected to be around IDR1,300tn, higher than IDR1,145tn in 2021. At this juncture, there is some uncertainty around

bond demand. In a year where many DM central banks are expected to hike rates and global liquidity injection is fast decelerating, we are attaching a low-to-moderate likelihood to the return of large foreign inflows into IndoGB. For local banks, less flush banking liquidity (from potential BI normalization measures) and a sustained recovery in credit growth could see their bond buying capacity decline. **Under the burden-sharing arrangement, BI has committed to purchasing IDR224tn of bonds in 2022. But the ability to fully utilize that envelope is to some extent, dependent on investor sentiments and currency stability.** In 2022, possible bond demand gaps could lead to episodic surges in IndoGB yields, that would then require BI to intervene to calm yields.

Current 10Y yield spreads between IndoGB and US Treasury, as well as yield spreads between IndoGB and peer EM high-yielders, are in the lower half of recent historical ranges. In our view, the lower yield spreads are partly justified by improvements in Indonesia's macro fundamentals (lower inflation risks, stronger policy credibility, more resilient external position, e.t.c.) and do not necessarily suggest that IndoGB valuations are rich. **That said, it would be prudent to await better entry levels so that investors get more yield buffer against the expected challenging environment for EM fixed income in 2022. We will look to re-engage in IndoGB longs if 10Y yields move closer to 6.75%-7.00% range.**

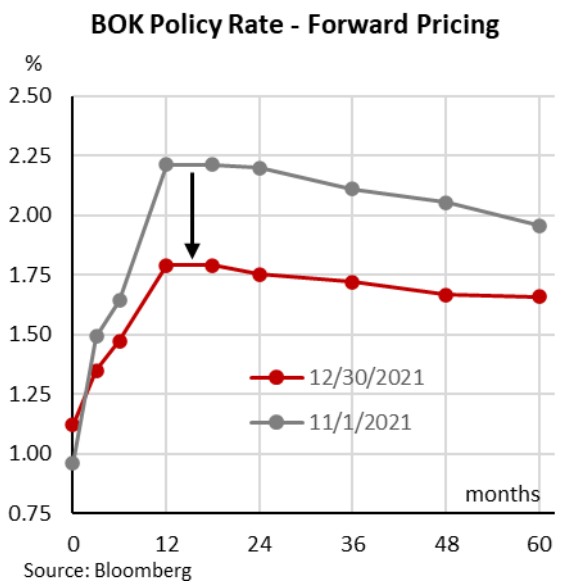


South Korea

Bank of Korea (BOK) is expected to continue with its hawkish communications and proceed with more hikes in 2022. Hike justification could shift from containing financial stability risks (property prices, household debt) to restraining upside risks in inflation and inflation expectations. The main uncertainty is around the number of hikes we get. At present, BOK is priced to hike three more times in 2022 and essentially conclude its hike cycle by the end of 2022 with a terminal policy rate of 1.75%. In the near term, COVID resurgences and possible re-tightening of restrictions could suggest a possible temporary delay in further BOK action.

There have been notable changes in market pricing over the last couple of months. Total priced hikes in 2022 have dropped from four to three, presumably due to the recent sharp rise in COVID daily infection rates posing downside risks to the growth outlook. The priced terminal policy rate has also fallen from 2.25% to 1.75%. What has been interesting was that at the prior 2.25% priced terminal rate, KRW swaps were also pricing for some prospects of subsequent

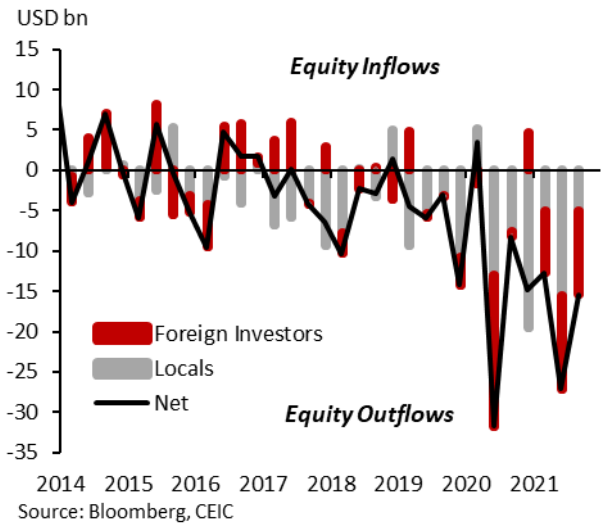
BOK cuts, in 2023 and 2024. But for the current priced terminal rate of 1.75%, there is no such cut pricing for after policy rates peak. I.e. **Swap markets seem to think that Korea's neutral policy rate is around 1.75%.**



Our policy rate forecast is more dovish and gradual compared to the market's hike pricing - We expect one hike in 2022 and one hike in 2023. Our thesis is that inflation will peak in 1Q of 2022 and then ease toward 1% in 4Q, therefore, raising the real policy rate and removing some urgency for BOK to hike to reduce accommodation.

Though our forecast is more dovish relative to market pricing, we do not favour going outright receive on KRW IRS/NDIRS rates as it is highly uncertain when the gap between our forecast and market pricing will close. Furthermore, our expectations of a hiking-Fed and a still-hiking BOK in 2022 could bring general upward pressures on KRW rates. **Therefore, we prefer to express via a 1Y1Y vs 5Y KRW NDIRS steepener idea as we think a couple of the priced 2022 hikes could be pushed out into 2023 and there could be more term premium built onto the IRS curve. We also initiate a receive 2Y KRW NDIRS vs pay 2Y MYR IRS idea as a relative-value idea, and also to remove some of the exposure to the direction of core rates.**

From a total returns perspective, Korean Treasury Bond (KTB) was one of the worst underperformers in 2021, recording total returns of around -11%. The linkage between KTB performance and macro factors (e.g. BOK's earlier normalization of policy, Korea's stronger growth recovery) had been weak. Instead, to a greater extent, KTB performance had been decided by flows. Equity portfolio investment outflows by both locals and foreigners had been especially large in 2021 (comparable to the size of Korea's current account surplus) and had weighed heavily on total returns.



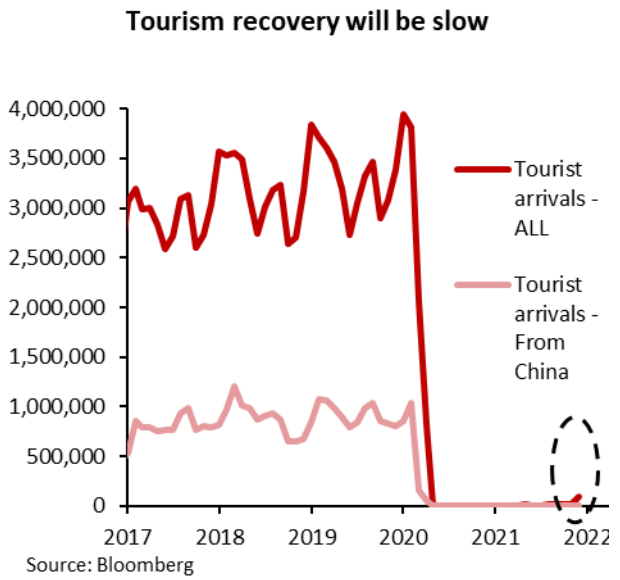
Looking ahead through 2022, we attach a low likelihood to positive absolute returns this year, but think that KTB could outperform within Asia by virtue of its larger valuation discount (based on our ARVI measure). Yield spreads between KTB and US Treasury are also

wide and therefore, KTB is likely to outperform its historical beta to higher US rates.

On the key factor of Equity portfolio outflows, we recognize that outflows by the National Pension Fund are structural in nature, but think that outflows by other locals should ease and foreign inflows could return in 2022. The presidential elections would be one key event to watch, as the outcome could have major fiscal and debt implications.

Thailand

Within Asia, Thailand's growth recovery from the pandemic is expected to be relatively slow and would take longer to converge with the pre-pandemic path. A key cause is the economy's outsized exposure to the tourism sector (11-12% of GDP) which has been especially hard-hit by the pandemic and slow to normalize.



On 1 November of 2021, Thailand re-opened itself to quarantine-free travel for vaccinated tourists, only to suspend the program in late December when concerns arose over the local spread of the Omicron variant. Prior to suspension, arrivals were tracking about 100k per month, less than 4% of pre-pandemic numbers. **Besides new variants weighing on global travel appetite, outbound travel restrictions in many countries (especially China which accounted for close to 30% of tourist arrivals pre-pandemic) suggest that full or close-to-full recovery of tourist arrival numbers will be slow and may not be possible within 1H.**

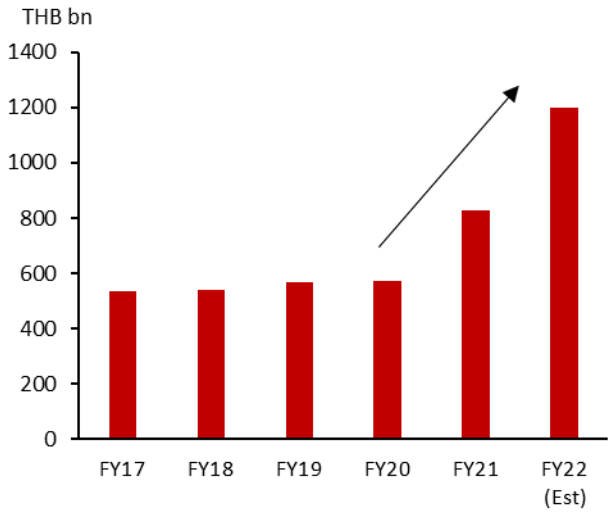
On inflation, recent prints have been rising but core inflation is still at benign levels. **We think that Thailand's weaker recovery and benign inflation mean that the Bank of Thailand (BOT) is likely to be a laggard, relative to US Fed and Asia central banks, in terms of hiking rates.** Our economists see BOT achieving rate lift-off only in 2Q of 2023, while rest of Asia is expected to start hiking in 2H of this year.

Against market pricing for 50bps hike this year and 50bps hike in 2023, we initiate a receive 1Y1Y THB NDIRS idea. We think that the risks of BOT turning more hawkish in their communications is quite low in the near-term, and therefore, short-term THB swap rates (1y1y, 2y) are likely to be better anchored and the scope for overshoot would be small relative to regional swap rates.

While we are bullish on short-term THB swap rates, we are bearish on the performance prospects of long-term Thai Loan Bonds (ThaiGB), due to concerns around expected pressures on Thai duration and unfavourable flows profile.

We are cautious around Thai duration given that we expect 10Y UST yields to end 2022 at around 2.30% (60-70bps from current levels) and long-term ThaiGB yields track 10Y UST yields quite closely. ThaiGB duration supply pressures are also a worry. The Public Debt Management Office's financing plans for FY22 (October 2021 - September 2022) indicate significantly larger ThaiGB issuances relative to prior years. Gross ThaiGB issuances are projected to amount to THB1100-1300bn in FY22, which would represent a 45% increase over FY21 (THB827bn) and 110% increase over FY20 (TH571bn). The weighted average maturity of issuances will also be re-lengthened (larger proportion of longer-tenor issuances) as part of the normalization of financing strategy and will inflict disproportionate upward pressures on longer-tenors and strong steepening pressures on the curve.

Auction Issuances of ThaiGB



Source: Bloomberg

In the near term, we also expect Thailand's current account and other flows to continue to weigh on ThaiGB total returns. The current account has been weighed down by the slow recovery in tourism inflows, elevated oil prices (Thailand has one of the larger energy trade deficits in Asia) and high freight costs. At this juncture, there is low visibility on the timing of a return to surplus balance. The intensified trend of domestic capital outflows in the form of locals purchasing overseas equities and shifting to foreign deposits have also been another headwind. A turnaround in flows profile, being highly dependent on tourism recovery, may be some way out, possibly in 2H at the earliest.

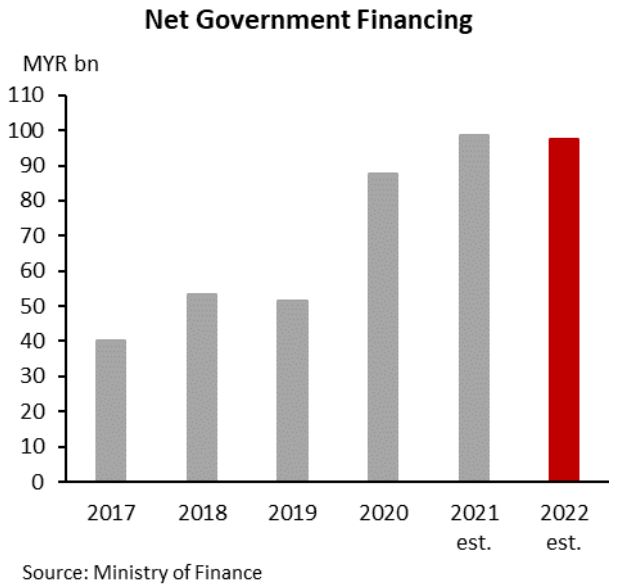
The ongoing benchmark transition from 6M THB FIX (FX-implied rate) to THOR (Overnight repo rate) should set volatility in THB swaps on a declining trend. Historically, 6M THB FIX can deviate far from the BOT policy rate due to BOT hike/cut expectations or swings in onshore FX liquidity. On the other hand, THOR tends to track the policy rate quite tightly.

Malaysia

Our economists expect Malaysia's economic recovery momentum in 2022 to be one of the stronger ones within the region. High vaccination rates and transition to endemic living should mean relatively lower risks of re-tightening of restrictions and by extension, limited downside risks to growth outlook, should more variants surface. **Unlike many peer economies in the region, both fiscal and monetary policies are also expected to continue to focus on supporting growth.** Fiscal will remain quite expansionary with the record expenditures planned under Budget 2022. Monetary is expected to stay accommodative in the near term, and a pivot to a less dovish stance may only occur closer to 2H. Our economists are therefore pencilling in a first BNM hike in 3Q of 2022, followed by two more hikes in 1Q of 2023 and a pause thereafter for the rest of 2023.

Compared to Asian peers, Malaysia's growth prospects are stronger, and its fiscal consolidation process is expected to be slower and the timeline more dragged out. This, in our view, is a recipe for relative underperformance of MYR rates, especially in the shorter tenors where hike pricing could have more room to rise. We thus initiate a relative-value idea against KRW rates where we think BOK hike pricing for 2022 is overly aggressive and should be faded - Pay 2Y MYR IRS vs receive 2Y KRW NDIRS.

A slower fiscal consolidation process means that government financing needs are likely to stay elevated for longer. 2022 net government issuances are projected to be MYR97.0bn, very close to 2021's size of MYR98.8bn. Compared to 2021, duration supply pressures would in fact be higher in 2022 due to likely lower reliance on financing via Treasury Bills.



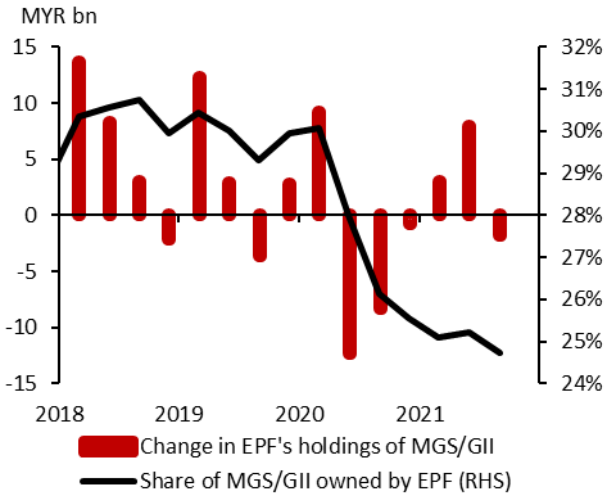
On bond demand dynamics, there is much uncertainty at this juncture. As the economy continues to reopen, lending growth (to the private sector) would be expected to recover and consequently weigh on banks' demand for bonds. That said, it is difficult to forecast the timing and strength of such a recovery. Foreign buying would also be highly dependent on the global macro and liquidity backdrop in 2022, though MGS's much improved FX-hedged yields should provide some marginal support for foreign interest.

The one positive development we see on bond demand relates to the Employee Provident Fund (EPF). EPF's bond buying capacity was constrained in 2020 and 2021 by more than MYR100bn of aggregate member withdrawals (associated with withdrawal schemes to support household consumption). In 2022, we expect that there will be no new withdrawal schemes introduced. Normalization of the

pension contribution rate to 11% around mid-year and stronger economic growth this year should result in a fast rebuild of EPF assets and consequently, a pronounced rebound in EPF's buying of long-duration Malaysia Government Securities (MGS).

As a result, we think that a turnaround in EPF's demand will be the dominant factor anchoring long-duration MGS (e.g. 15Y and 20Y) and those bonds should outperform on the curve. Together with shorter-term MYR rates that are likely to rise with BNM hike pricing and weaker bond demand by banks, we think MYR rates curves will exhibit a clear flattening trend in 2022. To express this view, we initiate a long 20Y MGS vs pay 5Y MYR IRS.

Expect a 2022 rebound in EPF's bond demand



Source: Bloomberg, CEIC

List of Asia Rates Ideas

Entry

		Entry			
		Date	Level	Stop-Loss	Take-Profit
1	Rec 5Y CNY NDIRS vs Pay 5Y USD IRS	6-Jan-22	0.9351	1.45	0.55
2	Pay 5Y vs Rec 1Y1Y INR NDOIS	6-Jan-22	-0.0613	-0.40	0.35
3	Pay 5Y vs Rec 1Y1Y KRW NDIRS	6-Jan-22	-0.1165	-0.40	0.10
4	Rec 2Y KRW NDIRS vs Pay 2Y MYR IRS	6-Jan-22	-0.6175	-0.30	-1.25
5	Rec 1Y1Y THB NDIRS	6-Jan-22	1.0732	1.50	0.75
6	Long 20Y MGS vs Pay 5Y MYR IRS	6-Jan-22	1.082	1.70	0.50

Running

		Entry					Current			Performance (in bps)	Adjusted for carry/roll
		Date	Level	Stop-Loss	Take-Profit	Report	Date	Level	Report		
1	Long 30Y CGB	30-Mar-21	3.720			link	5-Jan-22	3.343		+38	+38
3	Pay 5Y vs Rec 1Y CNY NDIRS	30-Sep-21	0.215	0.100	0.400	link	5-Jan-22	0.240		+3	-1
									Aggregate	+40	+37

Closed over last 12M

		Entry					Exit			Performance (in bps)	Adjusted for carry/roll
		Date	Level	Stop-Loss	Take-Profit	Report	Date	Level	Report		
1	Rec 1Y CNY NDIRS	23-Mar-21	2.570			link	3-May-21	2.452	link	+12	+16
2	Rec 1Y KRW NDIRS	23-Mar-21	0.830			link	3-May-21	0.813	link	+2	+4
3	Long 5Y MGS vs Pay 5Y MYR IRS	30-Mar-21	-0.052			link	3-May-21	-0.133	link	+8	+8
4	Rec 1Y INR NDOIS	23-Mar-21	3.830			link	19-May-21	3.720	link	+11	+20
5	Rec 2Y INR NDOIS	23-Mar-21	4.220			link	19-May-21	4.100	link	+12	+24
6	Pay 5Y INR NDOIS	19-May-21	5.110	4.800	5.500	link	18-Jun-21	5.305	link	+19	+14
7	Pay 2Y CNY NDIRS	7-Jul-21	2.523	2.350	2.700	link	29-Jul-21	2.350	Hit SL	-17	-19
8	Pay 2Y THB NDIRS	18-Jun-21	0.475	0.300	0.700	link	4-Aug-21	0.300	Hit SL	-18	-21
9	Pay 5Y MYR IRS	6-May-21	2.640	2.450	2.850	link	6-Oct-21	2.850	Hit TP	+21	+11
10	Pay 10Y KRW NDIRS vs Rec 10Y THB NDIRS	6-May-21	0.169	0.000	0.500	link	27-Oct-21	0.500	Hit TP	+33	+37
11	Long 10Y INDOGB	2-Sep-21	6.085	6.400	5.800	link	6-Dec-21	6.400	Hit SL	-32	-32
12	Pay 5Y vs Rec 1Y INR NDOIS	28-Oct-21	1.260	1.050	1.550	link	7-Dec-21	1.050	Hit SL	-21	-12
									Aggregate	+31	+51

Rates Forecast

		2022				2023			
		Q1	Q2	Q3	**Q4**	Q1	Q2	Q3	**Q4**
US	3M SOFR OIS	0.10	0.17	0.17	**0.67**	1.17	1.17	1.17	**1.25**
	2Y	0.75	0.88	1.07	**1.22**	1.50	1.55	1.60	**1.65**
	10Y	1.80	1.90	2.00	**2.10**	2.15	2.20	2.25	**2.30**
	10Y-2Y	105	102	93	**88**	65	65	65	**65**
Japan	3M TIBOR	0.07	0.07	0.07	**0.07**	0.07	0.07	0.07	**0.07**
	2Y	-0.10	-0.10	-0.10	**-0.10**	-0.10	-0.10	-0.10	**-0.10**
	10Y	0.15	0.15	0.15	**0.15**	0.18	0.20	0.20	**0.20**
	10Y-2Y	25	25	25	**25**	28	30	30	**30**
Eurozone	3M EURIBOR	-0.50	-0.50	-0.50	**-0.50**	-0.50	-0.40	-0.30	**-0.20**
	2Y	-0.60	-0.60	-0.60	**-0.60**	-0.60	-0.50	-0.40	**-0.30**
	10Y	-0.15	-0.05	0.00	**0.00**	0.05	0.10	0.10	**0.10**
	10Y-2Y	45	55	60	**60**	65	60	50	**40**
Indonesia	3M JIBOR	3.63	3.63	3.65	**3.90**	4.15	4.40	4.65	**4.70**
	2Y	4.00	4.05	4.20	**4.55**	4.80	4.90	5.05	**5.10**
	10Y	6.00	6.05	6.10	**6.35**	6.50	6.50	6.55	**6.60**
	10Y-2Y	200	200	190	**180**	170	160	150	**150**
Malaysia	3M KLIBOR	1.97	1.99	2.26	**2.28**	2.80	2.82	2.84	**2.86**
	3Y	2.75	2.80	3.00	**3.10**	3.30	3.30	3.25	**3.20**
	10Y	3.65	3.75	3.85	**3.90**	3.90	3.95	4.00	**4.05**
	10Y-3Y	90	95	85	**80**	60	65	75	**85**
Philippines	3M PHP ref rate	1.50	1.50	1.65	**1.90**	2.20	2.45	2.50	**2.50**
	2Y	2.80	2.90	3.05	**3.15**	3.15	3.20	3.20	**3.25**
	10Y	5.50	5.70	5.90	**5.90**	5.85	5.80	5.80	**5.85**
	10Y-2Y	270	280	285	**275**	270	260	260	**260**
Singapore	3M SORA OIS	0.15	0.15	0.15	**0.67**	1.09	1.09	1.09	**1.13**
	2Y	0.90	0.98	1.12	**1.22**	1.35	1.45	1.45	**1.50**
	10Y	1.75	1.80	1.85	**1.95**	1.97	2.00	2.03	**2.08**
	10Y-2Y	85	82	73	**73**	62	55	58	**58**
Thailand	3M BIBOR	0.62	0.62	0.62	**0.62**	0.62	0.87	0.87	**1.12**
	2Y	0.65	0.70	0.80	**0.85**	0.95	1.05	1.05	**1.10**
	10Y	2.00	2.05	2.10	**2.15**	2.25	2.35	2.40	**2.50**
	10Y-2Y	135	135	130	**130**	130	130	135	**140**
China	1Y LPR	3.85	3.85	3.85	**4.05**	4.05	4.25	4.25	**4.45**
	2Y	2.45	2.45	2.50	**2.60**	2.70	2.80	2.90	**3.00**
	10Y	2.90	2.95	3.00	**3.05**	3.10	3.15	3.20	**3.25**
	10Y-2Y	45	50	50	**45**	40	35	30	**25**
Hong Kong, SAR	3M HIBOR	0.25	0.32	0.32	**0.82**	1.09	1.09	1.09	**1.17**
	2Y	0.65	0.78	0.97	**1.12**	1.30	1.35	1.40	**1.45**
	10Y	1.45	1.55	1.65	**1.75**	1.80	1.85	1.90	**1.90**
	10Y-2Y	80	77	68	**63**	50	50	50	**45**
Korea	3M CD	1.45	1.45	1.40	**1.40**	1.70	1.70	1.65	**1.65**
	3Y	1.90	1.95	2.00	**2.05**	2.15	2.20	2.20	**2.20**
	10Y	2.50	2.65	2.80	**2.85**	2.85	2.85	2.85	**2.85**
	10Y-3Y	60	70	80	**80**	70	65	65	**65**
India	3M MIBOR	3.90	4.00	4.20	**4.40**	4.65	4.90	5.00	**5.10**
	2Y	4.60	4.70	5.00	**5.20**	5.35	5.60	5.60	**5.60**
	10Y	6.45	6.50	6.60	**6.70**	6.75	6.80	6.80	**6.80**
	10Y-2Y	185	180	160	**150**	140	120	120	**120**

%, eop, govt bond yield for 2Y and 10Y, spread bps

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