PGIM
India Mutual Fund

Fixed Income Weekly Update

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The global monetary tightening cycle has ended

Indian Markets:

The week gone by was all about the reinforcing of the strong underlying macroeconomic fundamentals of the Indian economy as Inflation came in line with expectations and Industrial production was stronger than expected. Indian Inflation came in line with market expectations at 5.10% with core inflation coming in at 3.50% within striking distance of the record low of 3.40% touched in October 2019.

The momentum of core Inflation also remains favourable at annualised rates of 2.60% and 3.10% on 1 month and 6 month basis, respectively. Food Inflation continues to stay elevated at 7.60% with RBI governor reiterating the risk of elevated food Inflation and the resolve to bring Inflation down.

International weather agencies are forecasting a higher probability of La Nina next year which brings good rains and augurs well for food inflation, if it materialises. Industrial Production data came in better than expected and reinforces the strong growth impulse as shown by the first advance estimate of GDP growth of 7.30%.

India's trade deficit for January 2024 came in at USD 17.50 bn. Imports were softer across the board while growth in exports remained positive. Current Account Deficit is expected to be between 1.00% to 1.30% of GDP for FY24. The economic data coming in reinforces the narrative of the Indian economy being in a goldilocks scenario amidst a very stable macroeconomic backdrop.

The bond market gave up some of its exuberance after the budget and the MPC policy on the back of higher global bond yields but remained bullish with the longer end of the curve outperforming decently. The benchmark 10yr bond yield ended the week 1bps lower at 7.10%. Overnight rates eased a bit as RBI actively intervened in the money market and government spending increased and short term money market rates up to 1 month were lower by 10-15 bps. Crude was largely stable ending the week at 83.50.

The Overnight Index Swap curve (OIS) curve inched higher on the back of higher US yields and underperformed the G-Sec curve. The 5yr OIS ended the week at 6.36%, up 5 bps during the week and the 1yr OIS was 2 bps higher ending the week at 6.71%. This month, so far, the OIS curve and the sovereign curve have moved in a divergent fashion with the benchmark 10yr bond yield down by 5bps whereas the 5yr OIS higher by 22 bps. This is largely owing to the fact that the OIS curve tends to get influenced more by the US yield curve.

Apart from the divergent movement in the G-Sec–OIS curve, the sovereign curve has flattened this month with the shorter end of the curve underperforming the longer end and the curve flattening aggressively with the 1yr T-Bill yield and the 40yr yield almost flat. The yield curve up to 5yrs has underperformed as yields have risen in this segment and the longer end yields have come down.

International Markets:

Global bond yields were higher during the week as US Inflation surprised on the upside. This miss on Inflation was on top of a stronger employment report at the start of the month. US CPI and PPI both surprised on the upside. The benchmark 10yr US treasury yield was higher by 10 bps through the week.

The US bond market is currently pricing in about 80bps of rate cuts thorough the year end compared to around 140 bps of rate cuts at the start of the year. The current pricing of rate cuts by the bond markets is more in line with the US Fed's forecast. In some other key international developments, Japanese economy unexpectedly slipped into recession after shrinking for a second straight quarter due to weaker domestic demand which prompted a push back on expectations of an end to the negative interest rate policy of the Bank of Japan.

Japanese GDP contracted by 0.40% in the last three months of calendar 2023 following a revised 3.30% retreat in the quarter prior to that. Japan's economy slipped to the fourth largest economy in the world in US dollar terms with Germany now the third largest though India is expected to overtake both these nations later this decade.

The OIS curve in Japan in now pricing in a 63% probability of an end to the negative rate policy down from 73% prior to the release of the data. There is speculation that the Reserve Bank of New Zealand might look for another rate hike given the hawkish talk from the central bank with respect to anchoring Inflation expectations.

Our View

The global monetary tightening cycle has ended and we think that we are in for a long pause. RBI will also be on a long pause and though we expect rate cuts only in Q3 of CY2024, RBI can change its monetary policy stance to "Neutral" before the commencement of rate cuts. The yield curve has flattened and can continue to stay flat given the positive demand/supply dynamics and rate cut prospects going into FY25.

Bond yields tend to move in advance of rate action and investors can look to increase allocation to Fixed Income as we expect long bond yields to keep drifting lower and expect the benchmark 10yr bond yield to go lower towards 6.50% by Q2/Q3 CY24.

Investors with medium to long term investment horizon can consider funds having duration of 5-6yrs with predominant sovereign holdings as they offer a better risk-reward currently. Investors having an investment horizon of 6-12 months can look at Money Market Funds as yields are attractive in the 1yr segment of the curve. Dynamic Bond Funds and Gilt Funds are also likely to do well with fall in long end bond yields in anticipation of rate cutting cycle starting later this year.