PGIM
India Mutual Fund

Fixed Income Weekly Update

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We expect Indian bond yield curve to remain flat amidst favourable demand supply dynamics

Indian Markets:

The last day of the week marked a big event for the Indian bond market as Indian government FAR bonds got formally included in the JP Morgan EM Bond Index. Since the announcement of the inclusion, more than USD 11bn have come into Indian bond markets and more is expected to come. Incremental flows over the next one year is expected to be in the range of USD 15-20bn on account of the Index inclusion.

Good and stable macroeconomic variables with positive real yields make Indian bonds an attractive investment. Beyond the Index inclusion, the week started with the news of the current account turning into surplus for the quarter ended March 2024. The current account recorded a surplus of 0.60% of GDP for QE March 2024 compared to a deficit of 1% of GDP for QE December 2023. Current Account Deficit is expected to be in the vicinity of 1% in FY25.

The Reserve Bank of India, in its Financial Stability Report, reiterated the resilience of the Indian financial system with NPAs at decadal low levels and even under extreme stress GNPA and CET1 for the banking system will be 3.40% and 10.80%, respectively, compared to the current levels of 2.80% and 13.80%. Personal loans and credit card delinquencies have gone up and there is stress in the less than Rs. 50,000/- loan category.

After RBI increased the risk weightages last year, bank lending to the NBFC sector has moderated to 14.6% in April 2024, from 18.90% in November 2023. The central bank remained optimistic on growth while being concerned about food inflation. The report also highlighted rising financial liabilities of household sector with overall savings dropping to 18.4% of GDP in FY2023 compared to an average of 20% in the previous 10yrs.

The yield curve remained flat during the course of the week though there was some profit booking towards the end of the week as the benchmark 10yr bond yield inched up a bit to end the week at 7.01%. In another classic - buy the rumour and sell the news trade as profit booking happened on the last day of the week as the Index inclusion formally happened. INR was steady despite the strength of the Dollar Index and ended the week at 83.39.

FPI inflows into debt continued to be positive at USD1.88bn during the course of the this month. Money Market yields went higher due to quarter end tightness in banking sector liquidity, with the 3 month bank CD yields are trading around 7.15-7.20%.

The Overnight Index Swap curve (OIS) was higher with the 1yr OIS ending the week at 6.82%, up by 4bps and the 5yr OIS was up by 8 bps as it ended the week at 6.44%.

International Markets:

US yields were higher over the week despite some good news on the Inflation front as the Fed's favoured inflation gauge - the "core personal consumption expenditure price index", the PCE rose less than expected to the smallest advance in six months.

The last few weeks data in US has been soft though markets will wait for the employment data next week for further confirmation on the trajectory of the US economy. Canada and Australia reported higher than expected Inflation with some analysts expecting a rate hike in Australia.

The US benchmark 10yr bond yield ended the week at 4.40%, up 15bps over the week with the US swap curve pricing in around 40bps rate cut by the end of the year. Yen continued its weakening trend, ending the week at 160.78 even as Japanese officials reiterated their stance to curb any outsized moves in the currency. DXY strength continued as it briefly went above 106 but ended the week flat from last week's closing of 105.80.

Interesting Concept : Siegel's Exchange Rate Paradox

The best way to explain this concept is through an example. In last 5yrs, the USDJPY has gone from 110 to 160, which shows around 45% appreciation of the US Dollar against the Japanese Yen. However, if we take the JPY/USD quote, the exchange rate went from 0.0091 to 0.0063, representing a 31% depreciation of the Yen against the US dollar. This is counterintuitive at first glance as one would expect that the rate of change of the dollar against the yen would be the same as the yen against the dollar, but because of a convexity effect, this paradox arises which some people refer to as the Siegel's exchange rate paradox.

Our View

We expect Indian bond yield curve to remain flat amidst favourable demand supply dynamics though a lacklustre start of the monsoons can put some short term pressure on yields. The scope for rate cuts in India is on account of high real positive rates and the need to encourage private investment and there is a fair probability of rate cuts in second half of FY25 though any rate cuts in India will follow rate cuts in advanced economies and will not precede them.

Bond yields tend to move in advance of rate action and investors can look to increase allocation to Fixed Income at every uptick in yields. We expect long bond yields to continue to drift lower over the next couple of quarters. We expect the benchmark 10yr bond yield to go towards 6.50% by Q4 of FY25.

Investors with medium to long term investment horizon can look at Dynamic Bond Funds having duration of 6-7yrs, with predominant sovereign holdings as they offer a better risk-reward currently. Investors having an investment horizon of 6-12 months can consider Money Market Funds as yields are attractive in the 1yr segment of the curve also.