PGIM India Mutual Fund

Fixed Income Weekly Update

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Indian Markets:

Indian Bond yields remained largely stable during the week though the curve flattened further with short end (2-3yrs) yields rising by 3-5 bps while the longer end bond yields stable or lower by couple of basis points. Bond yields have retraced lower from their highs touched a couple of weeks back as global yields cooled on back of mixed economic data. Monsoon worries are back as the month gone by has become the driest August since 1901. August 2023 now has the unique distinction of not only being the driest August recorded since 1901 but also being the hottest August recorded in India. August rains have recorded a deficit of 36% with cumulative rainfall deficit reaching 10% from June to August though sowing area is broadly in line with past patterns at 98%. Pulses sowing is lagging, which causes lingering worries on food inflation. Government has been proactive in managing food inflation particularly with respect to cereals, pulses and vegetables with policy intervention having an impact as seen in tomato prices which are down 60-70% from their peak among other things. Nonetheless the progress of monsoons is critical to the outlook on food inflation and September rains will be important. Given that that the earlier heavy rains in certain parts of the country and the current dry spell is a clear sign of EL Nino, which is expected to last till early 2024, meaning that uncertainty will continue to linger on in food inflation and governments policy steps will need to remain proactive and nimble. Meanwhile growth momentum continues to be decent with the Q1FY24 GDP growth coming in line with expectations at 7.80% and manufacturing PMI for august coming in at 58.6, higher than last month's 57.7.

Low base and lower deflator (due to negative WPI) may have played a role in the strong Q1 FY24 GDP numbers. Digging into the details show that services surprised to the upside and investment was better than consumption. While the government is sticking to its 6.50% GDP growth for FY24 led by private investment and revival in rural growth, market analysts are not so sanguine with most of the estimates forecasting growth in FY24 to be around 6%. Nonetheless deficient monsoons and global growth are the two variables to watch out for.

Money market rates moderated as government spending increased banking sector liquidity with 3-month CD rates trading around 7%. INR was stable during the week ending the week at 82.72 compared to the last closing of 82.65.

Brent crude can pose a threat to all the calculations as it continued its upward trajectory to close the week at 88.50 up 4% on the week. Dollar Index remained above 104.

The overnight index swap curve (OIS) curve also fattened more with the 5yr OIS, down 7bps on the week while the 1yr OIS was down 4bps.

International Markets:

Global Bond yields were broadly stable though staying elevated as economic data continues to present a mixed picture. The US jobs report was the key data to be released this week which confirmed the soft-landing narrative as inflation as shown by wage growth moderated while jobs added showed a broad-based growth. Market is expecting the Fed to hold rates in the September meeting. We do not expect further rate increases by the Fed despite various Fed speakers still sounding caution on the level of inflation. The US 10yr yield ended the week at 4.18% down 6 bps on the week but up 8 bps from an intra week low yield of 4.10%. The high supply of US treasuries due to the high fiscal deficit is one of the factors keeping yields elevated. Technically, the level of 4.34% is a significant level to watch out for as a monthly closing above 4.34% can herald further increase in yields.

Meanwhile…. Never in the 250-year history of the US has the 10yr US treasury returns been negative for 3yrs in a row. Currently, 10-year US treasury is on course for 3rd consecutive annual loss -0.3% so far in 2023 after -17.0% in 2022 and -3.9% in 2021.

Our View

We believe that global monetary tightening is on its last legs and central banks globally will be on a long pause. RBI will also be on a long pause with government taking fiscal steps to manage inflation. We think that the broad range of the benchmark 10yr bond yield will be between 7.10% to 7.35% over the next one month. Given the recent rise in yields which has pushed back the expectations of rate cuts, yields are entering attractive territory and investors can look to increase allocation to Fixed Income as growth is expected to slow down towards the end of the year.

Investors with medium to long term investment horizon can look at funds having duration of 3-4yrs 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.