PGIM
India Mutual Fund

Fixed Income Weekly Update

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RBI may change its monetary stance to Neutral going ahead

Indian Markets:

The interim Budget gave Indian bonds a fresh lease of life as the fiscal deficit and the gross borrowing numbers came in lower than market expectations. The fiscal deficit for FY25 has been projected at 5.1% against market expectations of 5.30% and the gross borrowing at Rs.14.13 trn against market expectations of Rs.15.2 trn.

The assumptions about the nominal GDP growth and tax revenues look realistic and the markets reacted positively post the interim Budget with the 10yr benchmark bond yield falling by 9 bps on the Budget day and down 13 bps during the week ending the week at 7.05% from last week's closing of 7.18%. The yield curve bull flattened with the longer end of the curve outperforming the shorter end of the curve.

Yields had fallen before the Budget on the back of lower global bond yields and continued to rally post the positive surprise after the interim budget. INR also reacted positively and ended the week at 82.93, appreciating 20 paise from last week's closing of 83.12.

The lower than expected fiscal deficit gives a very strong message on fiscal consolidation which reinforces the strong macroeconomic narrative which has given India a distinct advantage in the current uncertain times. The fiscal consolidation roadmap along with the decelerating trend in core inflation increases the probability of a stance change in next week's MPC meeting and we are of the view that the monetary stance will be changed to "Neutral" when the MPC meets next week though immediate rate cuts are not on the table.

Despite a probable change in monetary policy stance, we think RBI will continue to be on pause and rate cuts are still 6-7 month away. Overnight rates eased towards the end of the week as government spending increased though RBI made clear its intention of keeping the overnight rates close to the policy repo rates by announcing variable rate reverse repo to suck out surplus liquidity as overnight rates crashed to 6.25%.

The rally in crude oil frittered away and brent ended the week at 77.33, down 7.60% this week.

The Overnight Index Swap curve (OIS) curve also came down in line with fall in bond yields though the fall was muted given that the OIS curve had already moved down sharply earlier. The 5yr OIS ended the week at 6.13% down 5 bps on the week and the 1yr OIS was down by 2 bps to 6.58%.

International Markets:

Global bond yields were lower during the week though the economic data continues to come in stronger than expected. US bond yields was lower after the FOMC meeting though influenced more by the reduced borrowing plan of the US treasury for Q1 CY24.

US Treasury reduced its Q1 CY24 borrowing to USD 760bn against the market expectations of USD 850 bn and lower than its own earlier estimate of USD 816bn. Even the Q2 CY24 borrowing number stands at USD 206bn against the market expectations of USD 350bn. This led to a mini rally in US treasuries as the benchmark US 10yr yield touched a lower of 3.83% before the monthly employment data on Friday.

The US jobs report came in much stronger than market estimates leading to a decent retracement of 15bps on the benchmark 10yr bond yields which ended the week at 4.02%, still 12 bps lower than last week's closing of 4.14%. The Dollar Index continued its upward trajectory in line with the strong economic data ending the week at 103.92 from last week's closing of 103.47. The stock price of New York Community Bank (NYCB) fell 40% after its earning report which showed a loss of USD 260mn while expectations were of a gain of a similar magnitude. This re-ignited concerns of the health of small banks as this bank had acquired the collapsed Signature Bank last year.

FOMC in this week's meeting has pushed back on market expectations of early rate cuts and continues to advocate a data dependent approach.

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" in the next week's MPC policy meeting as core Inflation is on a decelerating trend and is running below 4%. 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 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. 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.