PGIM India Mutual Fund

Fixed Income Weekly Update

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We expect the benchmark 10yr bond yield to go towards 6.50% by Q4 of FY25

Indian Markets:

The positive undertone of the Indian bond markets continued as yields drifted lower with a steepening bias. The longer end of the curve has underperformed and the yield curve bull steepened with the shorter segment of the curve (3-5yr) outperforming in the month of June 2024. In respect of the last week, the 10yr benchmark security has outperformed this week as it ended the week at 6.89%, down 5 bps from last week's closing. Yields at the shorter end of the curve (3-5yrs) ended the week lower by 2-3 bps while yields at the longer segment of the curve (30-40yr) were up by 1-2bps.

Thus, the curve steepening trend that characterised the bond markets last month has continued for the first couple of days in this month. The curve steepening has stemmed from a couple of factors, first was the reduction in the T-bill borrowing amount, second was the higher bond switch amount (financing the buyback of shorter maturity securities by issuing longer maturity securities), which increases the supply of longer duration securities and lastly the announcement by RBI that the incremental new issuances of the 14yr and the 30yr government securities will not be eligible for FAR status.

All of the mentioned factors have contributed to the steepness of the curve, though we continue to be constructive on the longer segment of the curve given the continuous favorable demand-supply dynamics and high real positive rates. Giving a positive impetus to the bond markets has been the downward trajectory of crude with brent down almost 5% over the week.

Monsoons have picked up and till August 1, cumulative rainfall was 4.4% above long-term average while weekly rainfall was 18% above long-term average. On a cumulative basis, rainfall was excess in Central India and Southern India, normal in Northern India, and deficient in East and North-East India. Out of the 36 sub-divisions, till date, nine have received deficient rainfall, 14 have received normal rainfall, and 13 have received excess rainfall.

As of August 1, the total kharif acreage was 2.9% higher than the same period last year. Compared to same period last year, rice sowing was 5.3% higher at 27.7 mn hectares. Oilseeds acreage was 3% higher at 18 mn hectares while pulses acreage at 11.1 mn hectares was 11% higher than last year. Coarse cereal acreage was 3.2% higher at 16.6 mn hectares. Sugarcane acreage was 1% higher at 5.8 mn hectares, and cotton acreage was 8.3% lower at 10.8 mn hectares.

Basin-wise reservoir levels moved to surplus. Among major river basins, Cauvery (South), Godavari (West and South), Krishna (West and South), Narmada (Central and West), Tapi (Central and West), and West flowing southern rivers were surplus. Ganga (North and East), Indus (North India), and Mahanadi (Central and East), were deficient. Basins and reservoirs levels were around 7% above long-term average but around 8% below last year levels for week-ending August 1.

FPI inflows into debt continued with $2.67bn in July taking the CYTD 2024 inflows to $11.37 bn.

The OIS curve continue to come down in line with domestic and global cues with the 1yr OIS ending the week at 6.64% while the 5yr OIS ended the week at 6.16%. INR was an outlier, depreciating 10 paise to end the week at 83.75.

Money Market liquidity increased on the back of government spending though Money Market yields were stable, anticipating the current liquidity surge as temporary as 3 month maturity CD's were trading at 7.20% and 1yr CD's yielding 7.60%.

International Markets:

The international bond markets were all about rate cuts and dovishness except for Japan, where as anticipated, the BOJ raised rates. Bank of England cut rates and the FOMC deliberated on rate cuts. The US employment data came in much weaker than expected with the unemployment rate inching higher to 4.30% compared to expectations of 4.10%.

The Fed had also forecasted the unemployment rate steady at 4.10% till December 2024. This led the benchmark US 10yr Bond yield to end the week at 3.79%, 40bps lower than last week's closing of 4.20% and 60bps lower than the June end yield levels. US economic data has been coming in softer over the last couple of months and after the release of the employment data, some analysts are pencilling in a 50 bps rate cut in the September FOMC meeting. The geopolitical situation remains fluid especially in the Middle East, which is a tail risk for the markets.

Our View

We remain constructive on Indian bonds with favourable underlying macro-economic factors and favourable demand supply dynamics at play. 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 the second half of FY25 and RBI is also likely to draw comfort from the start of the monetary easing cycle in advanced economies.

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 consider 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 look at Money Market Funds as yields are attractive in the 1yr segment of the curve also.