PGIM
India Mutual Fund

Fixed Income Weekly Update

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Positive demand/supply dynamics will continue to favour bonds

Indian Markets:

Bonds traded rangebound during the week and the 10yr benchmark bond yield was down 3bps as sentiment turned positive following the announcement of the buyback of Gsec worth Rs. 4000 crore by the Government of India. Though the buyback is not a yield signal like an OMO purchase by RBI, it infuses near term liquidity in the banking system and can lower the overnight lending rates. The buyback, which happened on 9th May, was not a success and resulted in only Rs.10000 crore worth of securities being accepted. Government announced a bigger buyback of the same set of securities worth Rs. 60,000 crore and as mentioned earlier it does not impact the longer end of the curve albeit for the sentimental value.

The benchmark 10yr bond yield ended the week at 7.12%, down 3 bps over the week. Inter Bank liquidity remained tight with 3 month bank CD rates touching 7.35% amidst an estimated Government of India surplus cash balance of around Rs.3 lakh crore. The buyback being conducted will reduce the surplus of the Government and infuse liquidity in the baking system but we will have to wait and see the success of the buyback. Nonetheless the intention of the government is clear that they would not want an unnecessarily tight liquidity in the banking system due to lacklustre government spending till the formation of the government after the elections and we believe that if the upcoming buyback next week in not very successful like the first one then RBI may intervene through VRR to ease banking sector liquidity.

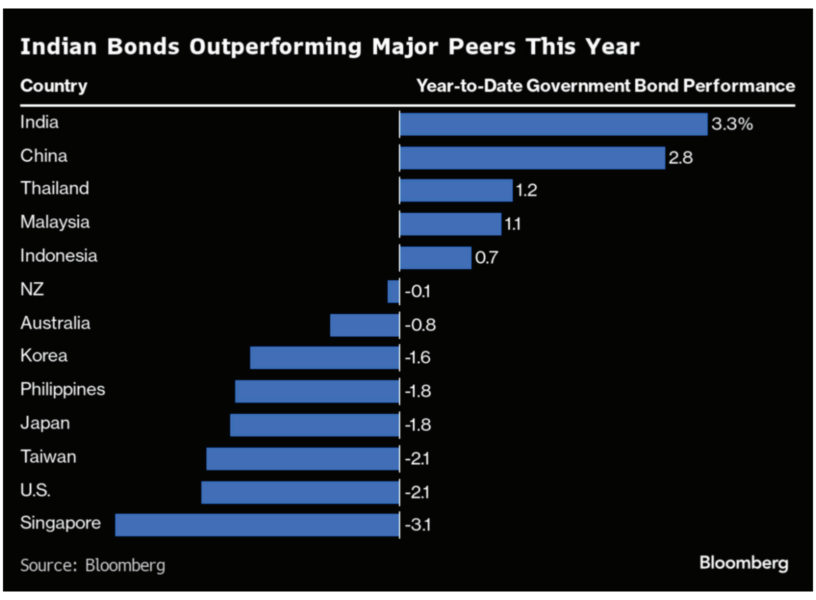
Continuing with its proactive approach towards agriculture produce, onion export ban was lifted on robust crop prospects and a minimum export price of USD 550 per ton has been determined. A 40% export duty on staple vegetables has also been introduced. The estimated rabi crop (2024-25), which has a share of around 60% of the total annual output, is projected at around 19.1mn tons, which is ‘reasonably comfortable’, considering monthly domestic consumption of around 1.7mn tons.

Real rural wages have contracted in 25 of the 27 months up to February 2024, suggesting that the recovery in the hinterland could take longer than expected. February saw the rural wages contract by 3.1%.

Agriculture credit has surpassed target, rising 15% to Rs 24.83 trillion in FY24. Regional disparity exists; over INR 12.5 tn (50.5%) was disbursed to five southern states — Andhra Pradesh, Telangana, Karnataka, Tamil Nadu and Kerala while the region had only 17% of the gross cropped area of the country.

INR ended the week at 83.50 depreciating marginally by 7 paise over the week even as Brent crude remained stable at 83. FPI flows into bond market for this month remained negative (excluding VRR) but improved as compared to last week standing at Rs.1600 crore of outflows. Debt VRR inflows stand at Rs. 2,000 crore so far for this month.

The Overnight Index Swap curve (OIS) yields came off marginally in line with bond yields with 1yr OIS ending the week at 6.82%, down by 3bps over the week and the 5yr OIS ended the week at 6.49% down by 2bps. Bolstered by the strong underlying macro-economic fundamentals Indian Bonds have outperformed across the board ahead of the impending inclusion in the JP emerging market Bond Index.



International Markets:

Global and US bond yields have came off from their highs after a relatively softer jobs report and a relatively dovish FOMC meeting. US bonds were stable during the week with the benchmark US 10yr bond yield ending the week almost flat at 4.50%. DXY rose marginally 105.30 from 105 last week.

US consumer sentiment softened with the University of Michigan Sentiment Index falling to a six month low at 67.4 from 77.2 while inflation expectations came in higher than expectations, thus strengthening the stagflation narrative but it is difficult to come to a conclusion just yet.

US jobless claims surprised on the upside, rising by 22k to 231k, the highest increase since August. Earlier, the UK central bank kept rates on hold in a 7-2 decision, as expected. The most significant takeaway from the meeting was their signal to data-dependency, alongside increased confidence in the economy’s progress. While the incremental will be the key, it’s clear each meeting going ahead will be viewed as ‘live’.

Its very likely that ECB and BOE will start rate cuts earlier than the US Fed. Australia’s Central Bank (RBA) raised its outlook for inflation and removed any chance of a rate cut for its forecast this year. This is a departure from its earlier stance in February.

Gold has been pretty strong and Chinese gold consumption (retail public) and investment by its central banks are the key reasons. Chinese gold consumption rose 6% in the first quarter on heels of a 9% rise last year. Investment in gold in China has picked up after traditional investments like real estate have turned lacklustre in China. Besides increase in retail consumption, the Chinese central bank has continuously added to its gold reserves for a 17th straight month. Last year it had bought more gold than any other central bank in the world adding more to its reserves than it had in nearly 50 years.Chinese central bank has been reducing its holdings of US treasuries for the last 10yrs and as of march end China had about USD 775bn of US debt down from about a USD1.1 trn in 2021.

Our View

The recent flare up in US inflation and the consequent rise in US bond yields has put pressure on global bond yields including Indian bond yields with FPI outflows from Indian bonds happening for the first time in the last 7 months and INR also coming under some pressure in spite of pretty strong underlying fundamentals.

We continue to believe that the global monetary tightening cycle has effectively ended and the bar of further rate hikes in US remains pretty high despite the hawkish posturing by some FOMC members and strong economic data along with sticky Inflation. The Indian OIS curve is now not expecting any rate cuts in India this year and the yield curve remains flat.

We continue to think that scope for rate cuts in India is on account of high real positive rates and the need to encourage private investment and that 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. Positive demand/supply dynamics will continue to favour bonds with the inclusion in the JP Morgan EM Bond Index kick starting from end June.

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 stabilise over the next couple of months after the sharp uptick over the course of last one month and expect yields to drift lower over the course of the next one year.

We expect the benchmark 10yr bond yield to go towards 6.50% by Q3/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. Dynamic Bond Funds and Gilt Funds are also likely to do well this year.