PGIM India Mutual Fund

Fixed Income Weekly Update

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RBI can change its stance to Neutral by April MPC policy meeting

Indian Markets:

Bond yields came down during the week as value buying emerged after yields had risen during the last couple of weeks. CPI inflation came in at 5.69%, slightly below expectations, while core Inflation moderated to under 4% coming in at 3.90%, the lowest level since December 2019. Core Inflation has been on a moderating trend even as food inflation remains volatile. This moderation in core Inflation at a time when growth has been resilient underscores the current goldilocks scenario of the Indian economy.

The 10yr benchmark bond yield came down by 5bps ending the week to 7.18%. Money Market yields also came off during the week with march maturity CD yields coming down by 5 -10bps. NBFC yields maturating in March came down by 15 bps as relatively higher yields attracted buyers. RBI also announced an enhanced amount of Rs 1.75 lakh crore VRR auction which helped cool the overnight lending rates on the last day of the week.

News reports suggested a possible 50 bps reduction in the fiscal deficit for FY25. The RBI governor called upon the banking system to take pre-emptive steps to mitigate risks. This is in line with central banks focus on risk management in the financial sector. The banking sector deposits have touched Rs.200 lakh crore doubling since 2016, reflecting a CAGR of 9.50%. Term Deposits make up majority of the deposit base standing at Rs 176 lakh crore.

The net direct tax collection stood at 81% of the FY24 target growing at 19.4% YOY. Given the red sea crisis, government is looking at ways to insulate Indian trade from this as it can lead to significant cost escalation for Indian businesses.

The INR appreciated and strengthened to a 4 month ending the week at 82.92, appreciating by 24 paise during the week. Crude oil was stable despite the crisis in red sea and stayed below 80 ending the week at 78.29 little changed from last week's closing of 78.86.

The Overnight Index Swap Curve (OIS) curve was lower on the week with the 5yr OIS ending the week at 6.20% down 10bps from last week's closing whereas the 1yr OIS closed the week at 6.64% down 4 bps from last week's closing of 6.68%.

International Markets:

Global bond yields also came down during the week despite higher than expected CPI inflation in US. In US, both the headline and the core Inflation came in higher than expected though it did not have much impact on the US yield curve. The bond market in the US is factoring in 150 bps rate cuts in US in 2024, double of what the Fed dot plot is indicating. Given the still elevated CPI and resilient growth, the US bond markets pricing of rate cuts looks optimistic and if there is no discernible slowdown in growth and Inflation over the next couple of months, then probably the bond market will recalibrate its future expectations of rate cuts.

The benchmark 10yr bond yield ended the week at 3.94%, down 11 bps on the week. The Dollar index was stable at 102.40. While the global rate hiking cycle has peaked, rate cuts might still be sometime away with central banks on a longish pause. We will be mindful of any recalibration in markets expectation of easing in monetary policy if incremental economic data remains strong especially in US.

Our View

The global monetary cycle has peaked with the US Fed pivot's in last month's meeting. We think that we are in for a long pause in the rate cycle for at least next two quarters. 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" by the April MPC policy meeting. Bond yields tend to move in advance of rate action and thus we believe that with the rate cutting cycle on the horizon investors can look to increase allocation to Fixed Income.

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 consider Money Market Funds as yields are pretty 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 next year. We expect the benchmark 10yr bond yields to continue to fall and come down below 7% over the next quarter.