PGIM
India Mutual Fund

Fixed Income Weekly Update

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Dynamic Bond Funds and Gilt Funds are likely to do well this year

Indian Markets:

The first month of FY25 has, so far, been weak for the bond markets contrary to expectations of solid beginning given the favourable underlying fundamentals. FY24 had ended on a positive note with the central government borrowing calendar for H1 being lower than anticipated but with RBI not giving any hints of a change in the monetary stance and the firming up of US bond yields amidst the escalation in middle east conflict has led to bond yields firming up in India. The benchmark 10yr bond yield has firmed up by 17 bps in this month reaching a 3 month high.

Though bond yields have risen, the underlying macroeconomic fundamentals remain strong with headline and core inflation remaining benign.

Trade deficit for March 2024 narrowed to USD15.6bn from USD 18.7 bn in February. Current account deficit for FY24 is expected to be in the vicinity of 1%. FPI inflows into bonds reversed for the first time in last 7 months as a mix of rising crude prices, strong USD and higher US bond yields led to almost INR 10000cr outflows from Indian bonds over the last 3 weeks.

The MPC minutes showed continued caution on part of the members while drawing comfort from the moderation in "Core" inflation. The RBI Governor and other members of the MPC noted that given the uncertainties emanating from supply side shocks due to adverse weather conditions and geopolitical tensions, the monetary policy actions should tread the last mile of disinflation with extreme care.

INR ended the week at 83.47 marginally better than the all-time low of 83.54 touched during the course of the month.

Money Market yields came off with easing of interbank liquidity conditions with June maturity CDs trading between 6.85% to 6.90% and Feb/Mar 25 CDs trading around 7.50%. Brent came off from its highs but stayed elevated and ended the week at 87.29.

The Overnight Index Swap curve (OIS) yields also rose in consonance with firming bond yields with 1yr OIS ending the week at 6.91%, up by 5bps on the week and 16 bps in this month while the 5yr OIS ended the week higher by 7bps at 6.63%. It has gone up by 30 bps in this month.

International Markets:

Global bond yields continued their upward march with the benchmark US 10yr bond yield rising 10bps over the week and 40 bps in the month. Higher than expected inflation, robust growth and repricing of rate cut expectations from the US Fed not only led to higher yields but also a stronger dollar index. DXY crossed 106, ending the week at 106.15, up 1.60% in this month.

As the spate of stronger economic data continued along with higher inflation, Fed speakers reiterated that there was no rush to cut rates, with some speakers talking about the possibility of a rate hike also. Currently, the bond markets in US are pricing in 35 bps of rate cuts by end of CY24

Our View

The recent flare up in US inflation and the consequent rise in US bond yields is putting pressure on global bond yields including Indian bond yields with FPI outflows from Indian bonds happening for the first time in last 7months and INR coming under pressure in spite of strong underlying fundamentals. We continue to believe that the global monetary tightening cycle has effectively ended and the bar of further rate hike in US remains pretty high despite the hawkish posturing by some FOMC members.

The Indian OIS curve is now not expecting any rate cuts in India and the yield curve remains flat. We continue to think that scope for rate cuts in India is there on account of high real positive rates and the need to encourage private investment, 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.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 few months and to drift lower over the next one year. We expect the benchmark 10yr bond yield to go lower towards 6.50% by Q3 of FY24.

Investors with medium to long term investment horizon can consider funds having duration of 5-6yrs 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.

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