PGIM
India Mutual Fund

# Fixed Income Weekly Update

15th July - 19th July 2024

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## There is a fair probability of rate cuts in the second half of FY25

### Indian Markets:

Bond markets remained stable and yields were lower by 2-4 bps across the curve during the week in the run up to the Budget next week. The benchmark 10yr bond yield ended the week at 6.96%, down 3 bps over the week.

Monsoons stabilised with overall good temporal and spatial trends and sowing remains good, showing an increase of 10.30% YOY increase though vegetable prices continue to stay elevated. RBI, in its Monthly Bulletin, reiterated the need to continue the focus on 4% inflation target amid continuous uncertainty of food price inflation. A separate study done by RBI staff, published in the Monthly Bulletin, has put India's neutral or natural rate of interest (the interest rate at which an economy can grow at full capacity without fuelling Inflation) in a range of 1.40% -1.90% currently, from 0.80%-1.00% in Oct-dec 2021. This does not necessarily reflect RBI's view.

The RBI Governor, in his address, emphasised that RBI needs to unambiguously focus on Inflation as growth is holding up and also mentioned that the neutral rate cannot determine monetary policy and that the neutral rate is a theoretical concept. He also mentioned that the current economic activity remains very robust even at the current interest rates. He also expressed concern on the continuous disparity between credit and deposit growth rates of the banking system. The next trigger for the Bond markets will be the Union Budget on 23rd, wherein the market is expecting the government to stick to its fiscal deficit target of 5.10% while some sections of the market are hopeful of a lower fiscal deficit. Some states, including Maharashtra, have announced some populist schemes and it remains to be seen how the central government utilises the extra revenue on account of higher RBI dividend.

We expect the central government to stick to its fiscal deficit of 5.10% with 30% probability of a slightly lower fiscal deficit of 5.00%.

For the week ending 12th July, RBI has sold Gsec worth INR 3,400 cr.

FPI inflows into debt continued to come in at a steady pace with USD1.6bn during the week (till 19th July) bringing the cumulative inflows into debt at USD 9.89 bn in CY2024.

The OIS curve continued to come down in line with domestic and global cues with the 1yr OIS ending the week 3bps lower at 6.71% while the 5yr OIS was down 6bps ending the week at 6.30%. INR was an outlier, depreciating a tad and ending the week at 83.66, driven mostly by global cues even as FX reserves touched a new peak of USD 667bn. To put things in perspective on a YTD basis the Dollar index (DXY) has gained 2% while INR has depreciated by 0.4% supported by RBI intervention and the FX reserves have risen by USD 58bn over the last one year.

Import cover as of end June 2024 was at 11.4 months compared to 10.30 months as of June 2023 and the external debt has decreased a tad to 18.70% of GDP as of March 2024 from 19% as on March 2023.

Money market yields were stable as banking sector liquidity remained in surplus with RBI ensuring that the overnight lending rates remained close to the policy repo rate by conducting frequent VRRR's. September maturity Bank CD yields trading around 7.00% almost flat from last week.

### International Markets:

US yields were broadly stable during the week though the benchmark 10yr bond yield ended the week a bit higher at 4.24% even as data continues to come in soft with bond markets fully pricing in 50 bps rate cut by the end of CY24 and a 50% probability of a third rate cut. DXY gained a bit towards the end of the week closing the week at 104.40 gaining 0.30% from last week's closing of 104.09. China's growth rate was below expectations while the ECB held on to rates and kept options open for future. Australian bonds yields were higher after a better than expected employment data.

## Our View

We expect Indian bond yield curve to remain flat amidst favourable demand supply dynamics at the longer end of the curve though the progress of monsoons will be a key factor to access the trajectory of food Inflation and subsequently RBI's stance on the monetary policy. 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.



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