PGIM India Mutual Fund

Fixed Income Weekly Update

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Sovereign holdings offer a better risk-reward at this juncture

Indian Markets:

Bond yields stabilised this week after the US Fed induced rally of last week. In the absence of any major triggers, there was profit booking and bond yields were marginally higher in the week. The benchmark 10yr bond yield ended the week at 7.19% up 3 bps from last week's closing.

The minutes of the MPC meeting were released and Prof. Varma and Dr. Ashima Goyal were dovish in their outlook as has been the case earlier also. Other members of the MPC mentioned that any change in stance at the current juncture may send wrong signals as growth remains strong along with risks of spill over of food inflation, which may negatively influence Inflation expectations. External members of the MPC voiced concern on rising real rates and we believe that if food Inflation behaves well over the next couple of months then we can see the MPC stance changing to "Neutral" in the April 2024 Policy.

In a lacklustre week for the Bond markets, RBI's intervention in the FX market made headlines as the IMF, in its annual review, re-classified India's foreign exchange policy from floating to stabilised arrangement on account of excessive intervention by RBI since Dec 23 onwards. RBI strongly rebuked this observation suggesting that the time frame concerned was too short to make an assessment and any policy needs to be seen over a longer time frame of 3 to 5 yrs. Going by the numbers as released in RBI's monthly bulletin, it seems RBI has been intervening pretty heavily in the FX market.

RBI's gross intervention (buy and sell combined) was the highest ever in October standing at USD 73bn with US 36bn intervention both on buy and sell. RBI's intervention in the FX futures and forward market has risen and RBI's forward book went into negative zone at USD14 bn, the first negative forward position after more than 3yrs. This shows that the preference of RBI's intervention in the FX market has shifted from spot to forwards and futures.

The interbank liquidity remained tight with the overnight lending rate remaining closer to the MSF rate of 6.75%. RBI conducted VRR auction for an enhanced amount of Rs 1.75 trn against the amount of Rs 1 trn last week.

Money Market rates remained elevated with 3 month CD's around 7.40-7.45% and 1yr CD at 7.85-7.90%. Banking sector credit continues to grow at a healthy rate of 16.40% against deposit growth of 12.70%. The Rupee marginally depreciated by 15 paise, ending the week at 83.15.

The rebound in crude continued as shippers shunned the red sea route (between Europe and Asia) taking the longer route via the cape of good hope, which is 40% longer.

The Overnight Index Swap Curve (OIS) curve was little changed during the week. The 5yr OIS was flat week on week ending the week at 6.20% whereas the 1yr OIS closed the week at 6.64% up 2 bps from last week's closing of 6.62%.

International Markets:

Global bond were also stable after the sharp fall over the previous few weeks. The benchmark US 10yr yield has come down from 5% to 3.90% in 40 trading sessions and we expect some consolidation going ahead. Yields may retrace a bit going ahead.

Inflation came in below expectation in UK and US though economic data continues to hold up especially in US. Markets are keeping up with a scenario of a soft landing. US bond markets are now pricing in 125 bps rate cuts in 2024 compared with the Fed dot plot of 75bps rate cuts. The dollar index continues to weaken ending the week at 101.70, down by 1%. While the rate hiking cycle has ended, global markets may again be turning a bit optimistic on the pace of rate cuts and we would be mindful of any recalibration in markets expectation of easing in monetary policy if incremental economic data remains strong especially in US.

Meanwhile..

In what can be described as an irony, Inflation has forced the new head of Turkey's central bank to move back into her parents' house as she could not afford a house as housing has become prohibitively expensive in Istanbul due to Inflation.

Our View

As the global monetary tightening comes to an end with the US Fed's pivot last week, we are in for a long pause in the rate cycle. RBI will also be on a long pause and though we expect rate cuts only in Q2/Q3 next calendar year, 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 allocating to 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 couple of months.

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