PGIM
India Mutual Fund

Fixed Income Weekly Update

18th March - 22nd March 2024

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The yield curve has flattened and can continue to stay flat

Indian Markets:

There was plenty of action in the global bond markets led by central bank policy actions in the week gone by though the Indian bond markets were impacted more by the dynamics of the financial year end and the much higher than scheduled state bond auctions.

Yields rose during the week led by the longer end of the curve with state bond supply and liquidity tightness impacting the yield curve. The SDL auction announced for next week was Rs.60000 cr almost double of the scheduled auction of Rs. 30000cr. This is on back of Rs. 740000 cr of SDL borrowing done in the last one week. This higher supply led to hardening of yields at the longer end of the curve.

Apart from the much higher supply of state government bonds, yields also came under pressure as INR weakened to an all-time low against the US dollar on the last day of the week.

INR weakened to an all-time low against the US dollar even as India's FX reserves rose to an all-time high. Most of the Asian currencies were weaker on back of weakness in the Chinese currency and INR also came under pressure as a result. Even though INR weakened because of exogenous factors, one needs to watch out for the monthly and quarterly closing of INR next week as technically its important. It will be interesting if INR continues to weaken given that India's external position remains comfortable with rising flows and higher growth along with stable and low Inflation. The flash PMI rose to the highest in 8 months.

The benchmark 10yr Bond yield ended the week at 7.09% up 3 bps on the week. Money Market yields inched higher in the last couple of days as money market liquidity tightened after advance tax and GST outflows. The 1yr CDs are trading between 7.65%-7.70% and 3 month CD yields are at 7.70%. Brent stayed elevated above 85.

The Overnight Index Swap Curve (OIS) curve yields also rose with the 1yr OIS ending the week at 6.77% higher by 3bps and the 5yr OIS ended the week higher by 7bps at 6.39%.

International Markets:

Global bond yields edged lower as the US Fed played to the script indicating 3 rate cuts this year even as it increased both its inflation and growth projections for the year. Growth projection for CY24 was increased to 2.1% from 1.4% and core inflation to 2.60% from 2.40% earlier.

The decision on the forecast for three rate cuts this year was a close one as it was a 10/9 decision. Bank of Japan ended the negative rate policy as was being anticipated though JPY weakened. There was a surprise SNB rate cut and markets are pricing in rate cuts from the ECB and BOE going ahead.

The benchmark US 10yr treasury yield came down by 11bps during the week, closing the week at 4.20%. US growth indicators continue to be strong and certain segments of the market remain sceptical to the projection of rate cuts by the US Fed. There are contradictions in the way the projection of the three rate cuts was retained while increasing the forecast for both growth and inflation. Even the unemployment rate forecast was reduced to 4% from 4.1% earlier by the end of the year. This can make the US treasury curve steeper going ahead. Gold rose to a record high on back of a dovish Fed even as the dollar strengthened to 104.43 up by 1% this week.

Our View

The global monetary tightening cycle has ended and the developed market central banks are sounding dovish even as growth holds up leading to a scenario of a soft landing. Indian growth is holding up pretty strong but with core inflation at multiyear lows gives RBI room to cut rates later this year. The yield curve has flattened and can continue to stay flat given the positive demand /supply dynamics and rate cut prospects going into FY25.

Bond yields tend to move in advance of rate action and investors can look to increase allocation to Fixed Income as we expect long bond yields to keep drifting lower and expect the benchmark 10yr bond yield to go lower towards 6.50% by Q2/Q3 CY24.

Investors with medium to long term investment horizon can look at 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 look at 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 with fall in long end bond yields in anticipation of rate cutting cycle starting later this year.