PGIM
India Mutual Fund

Fixed Income Weekly Update

29th April - 3rd May 2024

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We expect long bond yields to stabilise over the next few months

Indian Markets:

Global cues continued to exert their influence on Indian markets with Indian bonds reacting to global cues. Value buying picked up at higher yields and with crude oil retracing lower from the recent highs, bonds were well bid most of the week.

The benchmark 10yr bond yield ended the week at 7.15% down 4 bps over the week and almost down 10ps from the high of 7.23% witnessed a few weeks back. Inter Bank liquidity eased a bit on the back of incremental government spending and RBI infusing liquidity through VRR's (variable rate repos). Short term Money Market CD yields were down by 5-10 bps by the end of the week though 3 month Tbill yields climbed up through the week ending at 6.99%.

Government of India (GOI) announced a buyback of short maturity government securities worth Rs. 40,000 crore, which in our view, has been done to incrementally increase the banking system liquidity. RBI dividend, expected to be in the vicinity of Rs. 85,000 crore will further augment the banking sector liquidity. As highlighted in last week's market wrap, the banking system had tightened after the GST outflows and reduced government spending, which is not expected to pick up till the formation of the government after the elections. This means that while the government borrowings continue the government spending will be low, resulting in higher government surplus and tighter banking liquidity.

This buyback announcement is just to reduce the government surplus and ease banking sector liquidity. The Government probably did not expect 3 month Tbill yields to climb back towards 7%, a level seen in March which happened due to the traditional financial year end tightness in liquidity and thus the measure to increase interbank liquidity.

GST collection crossed the Rs 2 lakh crore mark for the first time, indicating both a robust growth trend and improved compliance. Manufacturing PMI came in a tad lower than last month but still printed at a healthy 58.80.

INR ended the week at 83.43 depreciating marginally by 7 paise over the week even as Brent crude fell by over 7% during the week as hopes buildup of a ceasefire in the middle east. FPI flows into bond market for the first couple of days this month remained negative registering Rs.1700 crore of outflows.

The Overnight Index Swap curve (OIS) yields came off from their highs with 1yr OIS ending the week at 6.85%, down by 4bps over the week and the 5yr OIS ended the week at 6.51% down by 8bps. OIS curve has reacted the most to the rise in global bond yields and after a substantial sell off during the course of the last one month, we are likely to see some consolidation going ahead. Currently, the 1yr OIS is not pricing in any rate cuts over the course of the year.

International Markets:

Global bond yields came down after a relatively dovish Fed meeting and a weak job report on Friday evening in US. The benchmark US 10 yr bond yield was down 16 bps ending the week at 4.51% from a closing of 4.67% last week.

The FOMC meeting held rates as expected but reduced quantitative reduction (QT) more than expected which led to lower yields. At the same time, the Fed Chairman indicated that a still tight labour market and higher inflation expectation will require a longer time frame to gain confidence to cut rates than what was previously thought. He has said that a rate hike would require data indicating that monetary policy was not restrictive and this was unlikely.

A lower than expected reduction in QT and a loose fiscal policy means that financial conditions remain relatively accommodative. The non-farm payrolls report showed a weaker than expected growth in jobs as the unemployment rate inched higher to 3.9% compared to an expectation of 3.8%. Average earnings were also lower than expected though ISM non-manufacturing prices rose to 59.3, much higher than expectations even as other data came in weaker than expected.

Overall, this indicates stickiness of Inflation along with some softening in employment. The inflation data, later in the month, will be keenly watched. DXY softened to end the week at 105 as both the bond and the equity markets cheered the data. US Bond markets have substantially repriced their expectations of rate cuts from the Fed and are currently pricing in one rate cut in CY2024 and a 33% probability of a second rate cut.

Our View

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

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 on account of high real positive rates and the need to encourage private investment and that there is a fair probability of rate cuts in the 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 with the inclusion in the JP morgan EM bond index kick starting from end June.

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 after the sharp uptick over the course of last one month and expect yields to drift lower over the course of the next one year. We expect the benchmark 10yr bond yield to go towards 6.50% by Q3/Q4 of FY25.

Investors with medium to long term investment horizon can consider funds having duration of 6-7 yrs 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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