PGIM
India Mutual Fund

Fixed Income Weekly Update

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Rate cuts are still some time away

Indian Markets:

Indian Bond yields followed the action in the global bond markets as yields fell sharply after the US Fed meeting. The dovish stance of the Fed meeting has effectively ended the rate tightening cycle and can thus be considered as the long awaited PIVOT in the global monetary tightening cycle.

Indian Bond yields, which have been inching higher after MPC meeting last week got a leg down after the Fed meeting. Earlier in the week, headline CPI inflation came in lower than expected at 5.55% and the trend of lower core Inflation continued as the core Inflation printed at 4.10%, a 44 month low though food inflation went up especially in pulses. WPI came in higher than expected at 0.26% led by food Inflation.

The trade deficit narrowed to USD 20.60bn for November compared to USD 29.90bn in October. Imports declined whereas exports remained steady. Current account deficit is expected to remain in the vicinity of 1.60%. The benchmark 10yr Bond yield came down by 11 bps to end the week at 7.16% from last week's closing of 7.27%. RBI announced a 7 day variable rate repo (VRR) of INR 1trn to ease the expected tightness in liquidity due to advance tax outflows. The interbank liquidity remained tight throughout the week with the operating overnight lending rate remaining at 6.75%, the MSF rate. Money market rates continue to be elevated with 3 month CD rates hovering at 7.40%. INR appreciated and ended the week at 83.00 following the slide in the dollar index. Crude rebounded to end the week at 76.55.

The overnight Index swap curve (OIS) curve moved down more than the bond curve. The 5yr OIS was down by 26bps ending the week at 6.20% from 6.46% last week and the 1yr OIS was also down by 23 bps ending the week at 6.62% from last week's closing of 6.85%.

The bond market, with the move in the last couple of days has started to price in a more benign liquidity environment going ahead and we think that liquidity is likely to move to neutral from deficit from January 2024 onwards but given the strong growth and some concerns on food Inflation, we do not expect any RBI easing to precede global monetary easing. We expect status quo on rates for a longish period though long end yields can start to come down in anticipation of easing aided by FPI inflows.

International Markets:

The global bond yields fell sharply after the dovish Fed meeting where the Fed was as dovish as it can be in the current environment. The benchmark US 10yr bond yield fell below 4% to end the week at 3.91% down 31 bps on the week and more than 1% down from its peak of 5% just a couple of months backs. All markets rallied reinforcing its bets on 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. Inflation came in line with expectation.

The dollar index fell to 102.55 down by 1.37% on the week after the Fed policy. Markets are pricing that other major central banks will also toe the dovish line after the Fed's pivot this week. While the rate cutting cycle has ended, we believe that rate cuts are still some time away and are likely to see some retracement in yields as markets are already pricing in 125 bps rate cuts for 2024.

Our View

As the global monetary tightening has come to an end with the Fed's pivot this week, we are in for a pause in the rate cycle over the next couple of quarters. RBI will also be on a long pause. Investors can look to increase allocation to Fixed Income as the next move of central banks is going to be rate cuts but bond yields have already reacted and are expected to react more.

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 consider 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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