PGIM
India Mutual Fund

Fixed Income Weekly Update

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The global monetary tightening cycle has ended

Indian Markets:

Bond yields turned a bit volatile during the week though the 10yr bond yield ended flat from last week's closing at 7.18%. Yields came down at the start of the week on the back of good inflation numbers but the rally fettered out on back of rise in US and global bond yields as markets recalibrated their expectations about rate cuts.

The RBI Governor, in an address, highlighted the resilience of the Indian economy by stating that for FY25, they were expecting a growth of 7% along with fall in Inflation though its likely that Inflation will remain above 4% and that monetary policy should continue to be on a disinflationary path.

Money market yields up to 2 months inched higher as government continued to run surplus of around Rs.3 lakh crore putting pressure on the banking sector liquidity even as RBI stepped up efforts to infuse liquidity by announcing two consecutive repo auctions. Proactive intervention by RBI to manage banking sector liquidity suggests that money market yields may stabilise around current levels though the trajectory of short end money market curve will depend a lot on the pace of government spending and the rise in currency under circulation (CIC). Trade deficit for December came in at USD 19.8bn, lowest since April 2023 as imports fell and export increased marginally.

The Rupee depreciated marginally to end the week at 83.07 from 82.92 last week, on the back of higher volatility in the equity markets. Crude oil was little changed despite the Red sea crisis and stayed below 80 ending the week at 78.56, little changed from last week's closing of 78.26.

The Overnight Index Swap curve (OIS) curve steepened a bit with the 5yr OIS ending the week at 6.24%, up 4bps from last week's closing whereas the 1yr OIS was flat at 6.64%, broadly tracking the movement in the US treasuries curve.

International Markets:

Global bond yields inched higher during the week as Fed speakers talked down on the possibility of bigger and/or faster rate cuts given the continued resilience of the US economy amid still higher than target Inflation.

Retail sales came in stronger than expected and given the resilience of the labour market and sticky core inflation, bond yields took a breather with yields retracing a bit. The benchmark 10yr bond yield was higher by18bps during the week. Given the still elevated CPI and resilient growth, the US bond markets pricing of rate cuts looks optimistic and if there is no discernible slowdown in growth and Inflation over the next couple of months, then probably the bond market will continue to recalibrate its future expectations of rate cuts.

The Dollar Index strengthened to 103.29 from 102.40. While the global rate hiking cycle has ended, rate cuts might still be sometime away with central banks on a longish pause. We will be mindful of any recalibration in markets expectation of easing in monetary policy if incremental economic data remains strong especially in US. Next week's Bank of Japan meeting will be important with respect to any change in stance on negative rate policy.

Meanwhile China's population in 2023 shrank for the second straight year even as the Chinese government increases incentives for having more babies. This comes at a time when Chinese debt to GDP ratio has risen to a record 286%.

Our View

The global monetary tightening cycle has ended. Going ahead, we are in for a long pause in the rate cycle for at least next two quarters. RBI will also be on a long pause and though we expect rate cuts only in Q3 of CY2024, RBI can change its monetary policy stance to "Neutral" in the Feb/April MPC policy meeting as core Inflation is in a falling trend and is below 4%. 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 consider 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 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 later this year. We expect the benchmark 10yr bond yields to continue to fall and come down below 7% over the next couple of quarters.