



Puneet Pal
Head - Fixed Income

Fixed Income Weekly Update

31st July - 4th August 2023

Indian Markets:

Bond yields continued their northward journey this week as global yields surged led by the bear steepening in the US curve which led the 10yr US yield towards 4.20% as higher supply of treasuries spooked the long end of the US bond curve. The new month started with fresh bout of optimism on growth as the services PMI surged to a 13 year high of 62.3 led by stronger exports. Concerns on food inflation linger on with rise in wheat prices as some news reports indicating government may consider scraping import duty on wheat. Vegetable prices are sustaining at higher levels. The consensus for next week's CPI is at 6.50%. Next month also inflation is likely to be high, close to 7% before moderating in the next quarter. Though the headline inflation will overshoot RBI's target for this and the next month led mainly by vegetable prices, core inflation is likely to stay benign around 5% as seen in the last CPI print. The trend of core inflation needs to be watched closely from a policy perspective as crude price is edging higher but for now core inflation is expected to remain stable. We will also have the MPC meeting next week and we expect MPC to retain the status quo on policy rates but RBI is likely to sound hawkish given the continuing uncertainties. The relative resilience of the domestic and the global economy witnessed so far means a longer wait for rate cuts and as such we continue to expect a long pause by RBI. Money market yields trended lower during the week as banking system liquidity increased on back of higher government spending and due to the return of 88% of the outstanding Rs.2000 denomination notes to the banks.

Brent continues to inch higher crossing USD85 a barrel well above its 200-day moving average, with Saudi extending its voluntary production cut through to September and the fact that the crude demand is holding up. US total stockpile of crude is at 20yr low and there will be a time when the US will need to replenish its strategic petroleum reserves (SPR). INR depreciated 60 paise or 0.70% during the week as the dollar index jumped above 102.

The overnight Index swap curve (OIS) steepened with the 5yr OIS rising by 8bps to 6.56% while the 1yr OIS moved up by 2bps to 6.88%.

International Markets

Fitch downgraded US credit rating to AA+ more than a decade after S&P's downgrade citing fiscal concerns and now only Moody's have a AAA rating on US. Markets also seems to share some of the fiscal concerns as the US yield curve steepened sharply as the 10yr US yield traded sharply higher touching 4.19% during the week up by 25bps from the week before as both short term and medium-term supply concerns soured market sentiments ahead of the key monthly jobs report. The US Jobs report led to a sharp fall in yields as internal data suggested a cooling Job market even as the unemployment rate came in better at 3.50%. Couple of Fed speakers also sounded dovish, and yields went down. The 10yr yield went down by 14bps after the jobs data to end the week at 4.04% up 10bps from the week before. Bank of England hiked rates by 25bps and the tone was less hawkish than expected. RBA stayed put on rates. The bigger surprise came from Brazil as it cut its policy rate by 50bps which was more than the expected 25bps. Brazil was one of the first countries to hike rates as it started tightening in 2021 when other were in denial of inflation.

Japanese yields continued their upward surge following last week's surprise tweak in the YCC. BOJ announced couple of unscheduled bond buying actions to temper the increase in yields. Chinese economy continues to be sluggish even as inflation falls. We think that the synchronised global monetary tightening is in its last stages and continue to believe that the aggressive rate hikes done so far will have an impact on growth, given the lagged impact of monetary policy, slower economic growth is on the anvil by end of CY23.

Our View:

We believe that global monetary tightening is entering its last phase. RBI will be on a long pause despite higher inflation prints expected for the next couple of months on back of higher food prices especially vegetables. This quarter (July-Sept) is quite heavy on net supply and we might see some pressure on the belly of the curve, we think that the broad range of the benchmark 10yr bond yield will remain between 7% to 7.25%. Given the recent rise in yields which have pushed back the expectations of rate cuts, yields are entering attractive territory and it is the right time for investors to increase allocation to fixed income as growth is expected to slow down towards the end of the year.

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 look at the money market funds as yields are attractive in the 1yr segment of the curve.