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Fixed Income Weekly Update

13th May - 17th May 2024

Investors can consider increasing allocation to Fixed Income at every uptick in yields

Indian Markets:

The week gone by was all about inflation and liquidity as bond yields continued to drift lower as "core inflation" hit an all-time low in India. The CPI inflation came in at an 11 month low of 4.83% and the 10yr benchmark bond yield ended the week at 7.09%, down by 3bps. WPI inflation picked up to 1.26%, the strongest since March 2023 influenced by global commodity trends.

The buyback of short maturity G-secs again failed as bids of only Rs. 2,069 crore were accepted. This is the second time that this buyback operation has failed and following the failure of the second buyback, the government decided to reduce the amount of Tbill auctions by Rs 60,000 crore till June end, which will have a direct impact on banking sector liquidity. The government backed up this announcement by again announcing a buyback of Rs. 60,000 crore for next week, thus making it pretty clear that they want to reduce the growing government surplus and increase banking sector liquidity.

As highlighted earlier in our weekly writeups, government does not want this temporary government surplus buildup to impact banking sector liquidity and the short term rates negatively. We do not think this is a yield signal and construe this measure as a liquidity management exercise. The 3 month bank CD yields came down by 5 bps. Trade deficit for the month of April widened to USD 19 bn from USD 15.6 bn in March, which can very well be seasonal in nature. This does not materially change the outlook for the current account deficit, which is expected to be in the vicinity of 1% for FY25.

The INR ended the week at 83.33 appreciating 17 paise over the week as Brent crude remained stable at 84. FPI flows into bond market for this month turned positive (excluding VRR) and the CYTD inflows into debt stand at USD 5.44 bn.

The Overnight Index Swap curve (OIS) yields came off with 1yr OIS ending the week at 6.81%, down by 1bps over the week and the 5yr OIS ended the week at 6.41%, down by 8 bps.

International Markets:

The US and global bond yields came off after the release of the US inflation report with the benchmark US 10yr bond yield ending the week 8bps lower at 4.42%, DXY came down to 104.44 from 105.30. Although the CPI numbers enthused the markets, one needs to watch if this trend continues and inflation continues to soften or whether this month's data was just a flash in the pan.

In all likelihood, the ECB and the BOE will cut rates before the US Fed while Riksbank and SNB have already cuts rates among the G10.

Our View

The latest US CPI inflation report and the continuous falling trend of our "core" inflation, which hit an all time low of 3.20%, should support bond yields and we expect yields to continue to drift lower.

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 continuous hawkish posturing by some FOMC members.

The scope for rate cuts in India is on account of high real positive rates and the need to encourage private investment and there is a fair probability of rate cuts in 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 couple of 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 look at Dynamic Funds having duration of 6-7yrs 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.