FRANKLIN TEMPLETON

Fixed Income Market Snapshot

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Global long-term bond yields across several major economies moderated in May 2021 as investors' fears over higher inflation reduced despite continued expectations of strong economic recovery driven by global vaccination programme. Although economies across several regions continued to grow with the relaxation of pandemic related restrictions, the recovery has shown signs of weakness in some of them amid emerging problems due to supply chain challenges and increase in raw material costs. This led to an increased demand for government securities leading to moderation in the yields.

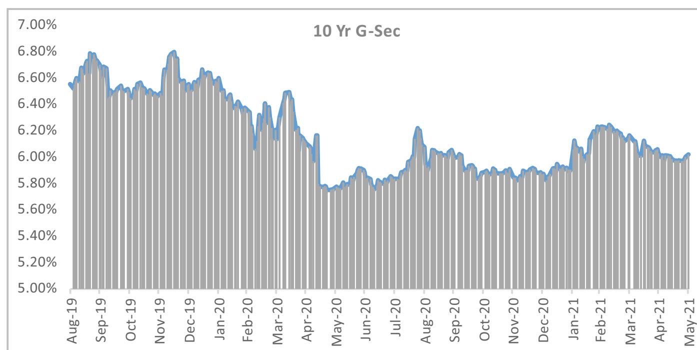
The US treasury yields were marked by fluctuations in May. It rose during the first half of the month on concerns over building price pressures. Yields retreated after the Federal Reserve reiterated that it would maintain an accommodative monetary policy stance for an extended period. The likelihood of continued bond purchases by the Federal Reserve outweighed investor expectations of a rise in inflation. Also, the slowing pace of growth of various economic indicators coupled with the emerging economic uncertainties supported demand for risk free US Treasuries pushing down their yields. At the same time, the improving risk appetite with expectations of a rebound in demand following the vaccination programme and concerns over high public debt put upward pressure on yields. In China, the decline in bond yields has primarily been on account of the continued foreign inflows into the domestic bond markets. The higher interest rates of Chinese debt securities and the limited nature of pandemic stimulus programmes have been boosting inflows into the Chinese debt markets.

Domestic Market Scenario

Monetary Policy Review FY22

The Monetary Policy Committee (MPC) of the RBI voted unanimously in favour of keeping the policy repo rate unchanged and agreed to continue with the accommodative stance for as long as necessary to revive and sustain growth on a durable basis and continue to mitigate the impact of COVID-19 on the economy, while ensuring that inflation remains within the target going forward.

Yields: In May, the 91-day treasury bill yield was up by 8bps while the 10-year government securities' yield was down by 2bps. The decline in the benchmark bond yields, despite the huge supply of government securities, can be attributed to the RBI's G-sec acquisition or G-SAP 1.0 programme in conjunction with the regular open market operations, aimed at limiting the rise in bond yields. Concerns over the domestic economic outlook stemming from a surge in COVID-19 cases in the country, underlying inflationary concerns with the firming of global commodity prices led to safe haven buying of government securities, thereby limited the fall in yields.



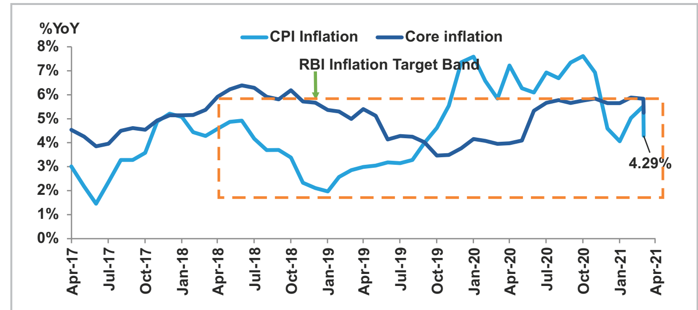
Source: Bloomberg

Forex : In May 2021, the INR appreciated by 2.6% against the USD and 1.6% against the Euro. On a YTD basis, INR has appreciated 0.6% against USD and appreciated 1.4% against Euro. The dovish stance of US Federal Reserve and the less aggressive intervention of RBI in the forex market has supported the rupee. The INR traded in the range of 72.39 to 73.84 per USD on a daily closing basis in May 2021. Foreign exchange reserves inched up to USD 598 billion as on May 28, 2021 compared to USD 588 billion as on April 30, 2021.

Liquidity : The outstanding liquidity surplus was at INR 4.6 trillion in May 2021 as against the surplus of INR 5.4 trillion in the preceding month. The surplus continues to be sizeable even as the RBI undertook the phased restoration of the CRR (from 3% to 3.5% on March 27, 2021 and thereafter to 4% from May 22, 2021).

Macro

Inflation: CPI inflation came at 4.29% in April 2021 (against 5.52% in March 2021). It softened primarily on account of fall food prices and favourable base effect.



Source: Bloomberg

Core inflation eased to a 10-month low of 5.25% in April 21 (against 5.82% in March). Core inflation continues to be at elevated levels, reflective of the underlying price pressures. We expect to see a marginal uptick in inflation in the coming months due to renewed pandemic restriction across the country, higher crude oil prices and the firming of global commodities prices.

Fiscal Deficit: The Central Government finances were severely impacted in FY21 following the outbreak of the COVID-19 pandemic leading to lower revenue collections and higher expenditure. The fiscal deficit to GDP ratio is estimated at 9.2% of GDP (based on provisional FY21 GDP estimates of INR 197.45 trillion), double of 4.6% witnessed in FY20.

Outlook:

India's Q4FY21 GDP growth came in at 1.6% (Q3FY21 at 0.5%). The growth was stronger than expected and was led by manufacturing, construction, and investment activity. The FY21 GDP contracted by 7.3% and was expectedly better than the NSO's second advance estimate of -8%.

In line with our expectation, the RBI's MPC unanimously voted to keep the policy rate unchanged for the sixth consecutive time, while maintaining its accommodative policy stance.

RBI revised its FY22 GDP growth projection down to 9.5% from earlier 10.5% after taking into consideration disruption caused by second wave of pandemic, ongoing vaccination drive, fiscal stimulus, and increased traction around the PLI scheme. RBI noted that, although favorable monsoons are expected to support rural demand, rise of infections in the rural areas poses key downside risks. GDP is a long way from pre-COVID levels, and which is why RBI is likely to fend off upward pressures on domestic interest rates from US Fed tapering, domestic inflation and fiscal uncertainty. On the inflation front, RBI expects the inflation to inch up due to firming global commodity prices and supply-side bottlenecks. However, weak demand and normal monsoon may keep inflation from going above RBI's target range.

Another operation under G-SAP 1.0 for purchase of G-Secs of INR 400 billion will be conducted on June 17, 2021. Of this, INR 100 billion would constitute purchase of State Development Loans (SDLs). RBI reasserted its emphasis on maintaining adequate liquidity in the system. In this regard, the RBI announced G-SAP 2.0 in Q2FY22 to the tune of INR 1.2 trillion. RBI also indicated that G-SAP may include SDL securities as well. The G-SAP and other liquidity infusion measures of the RBI are expected to anchor bond yields going forward. However, with emerging inflation risks, partial lockdowns, and continued supply strains in bond markets, we believe that these measures alone may not be sufficient to flatten the yield curve, which is currently steep.

We believe that the RBI may embark on a gradual exit from the prevailing loose monetary policy stance once the current pandemic wave subsides, and the vaccination drive reaches critical mass during H2FY22. We expect RBI may increase the reverse repo rate in H2FY22. We expect RBI to gradually move from the easy liquidity measures in H2FY22, as indicated by introduction variable rate reverse repo (VRRR) and other measures.

We believe that the yields in the short to mid part of the curve are reasonably priced with modest duration. Even with yields tending to inch up, the higher accrual should provide a buffer to mitigate some of the erosion in price. Investors may consider investing in funds that offer such exposure along with lower volatility. Investors may also consider floating rate funds as they provide a hedge against a rise in interest rates.

	30-Apr-21	31-May-21
1 year G-sec	3.81%	3.77%
3 year G-sec	4.80%	4.70%
5 year G-sec	5.42%	5.59%
10Y Benchmark: 5.85% GS 2030	6.04%	6.02%
1 year AAA	4.18%	4.25%
3 year AAA	5.10%	5.27%
5 year AAA	5.90%	5.90%
10Y AAA	6.80%	6.83%
Call rates (WAR)	3.21%	3.18%
Exchange rate	74.08	72.62