

WHAT WENT BY

Bonds remained rangebound in May'21 as rising commodity prices and improving global demand conditions buoyed by rapid vaccination progress were offset by downside risks to local growth outlook due to the vicious second wave and expectations of continued RBI intervention to keep bond yields in order. The 10-year government bond benchmark traded in a narrow range of 5.97%-6.02%. Apart from open market operations, RBI also tried to modulate bond market through its actions in the primary auctions, especially on the 10 year benchmark. It rejected bids for the 10 year benchmark on auction dated 14th May'21 while devolving Rs. 74.36 billion on primary dealers on 28th May'21.

Headline CPI inflation for April'21 declined to 4.29% YoY from 5.52% YoY in March'21, primarily driven by a favourable base effect from the national lockdown last year. Food inflation cooled to 2.02% YoY in April'21 from 4.87% YoY in March'21, led principally by a sharp widening in disinflation for vegetables (led by arrivals of the rabi harvest) and sugar, while other categories which saw a moderation in inflation momentum included cereals, milk & products, pulses and spices.

Headline WPI inflation rose to a record high of 10.5% in April 2021 from 7.4% in March 2021. On an annualized basis, broad based increase was recorded in fuel, consolidated food and core (non-food manufacturing) inflation.

IIP growth surged to 22.4% YoY in March 2021, compared to a -18.7% YoY de-growth in March 2020 due to the base effect. For the whole year FY2020-21, IIP registered a contraction of 8.6% versus a contraction of 0.8% in FY2019-20.

Government of India indicated additional borrowing this year of Rs 1.58 trillion during the current fiscal year to fund the shortfall in cess collections required to compensate states. The government projected the compensation for FY22 at Rs 2.7tn, assuming nominal GDP growth at 7% for FY22. Out of this, compensation cess collections were expected to net Rs 1-1.1 trillion, with the remaining Rs 1.58 trillion raised through additional borrowing. India's revenue secretary said that the economy had not suffered as much as last year, and argued that the additional borrowing corresponded to a monthly average GST collection of Rs 1.1tn.

Real GDP growth in 4QFY21 came in stronger than expected at 1.6%YoY (consensus: 1.0%). In annual terms, FY21 real GDP growth stood -7.3%YoY, better than CSO advance estimate of -8.0%. GDP deflator rose to a 7-year high of 7%YoY, pushing nominal GDP growth to 8.7%YoY in 4QFY21 (vs 5.2% in 3Q).

On account of the 2nd wave related disruptions caused by the pandemic, Government further enlarged the scope of Emergency Credit Line Guarantee Scheme as follows:

- ▶ ECLGS 4.0: 100% guarantee cover to loans up to Rs.20 million to hospitals/nursing homes/clinics/medical colleges for setting up on-site oxygen generation plants, interest rate capped at 7.5%.
- ▶ Borrowers who were eligible for restructuring as per RBI guidelines of May 05, 2021, and had availed loans under ECLGS 1.0 of overall tenure of four years comprising of repayment of interest only during the first 12 months with repayment of principal and interest in 36 months thereafter will now be able to avail a tenure of five years for their ECLGS loan i.e. repayment of interest only for the first 24 months with repayment of principal and interest in 36 months thereafter.
- ▶ Additional ECLGS assistance of upto 10% of the outstanding as on Feb 29, 2020, to borrowers covered under ECLGS 1.0, in tandem with restructuring as per RBI guidelines of May 05, 2021.
- ▶ Current ceiling of Rs. 5000 million of loan outstanding for eligibility under ECLGS 3.0 to be removed, subject to maximum additional ECLGS assistance to each borrower being limited to 40% or Rs.2000 million, whichever is lower.
- ▶ Civil Aviation sector to be eligible under ECLGS 3.0.
- ▶ Validity of ECLGS extended to Sep 30, 2021, or till guarantees for an amount of Rs.3 trillion are issued. Disbursement under the scheme permitted up to Dec 31, 2021.

RBI transferred a surplus of Rs. 991bn substantially higher than the aggregate dividend budgeted from RBI, nationalized banks & other Public financial institutions at around INR 535 bn for FY22 and the Rs. 571.3bn that the government received from the RBI in FY21. The increase in surplus transfer was largely due to the lower risk capital provisioning this year, compared to last year.

US CPI rose by 4.2% YoY (consensus: 3.6%) in April'21, sharpest since Sep'08 mainly on account of base effects due to unusually depressed prices last year in the initial stages of the Covid-19 pandemic. US Producer Price Index (PPI) spiked 6.2% YoY (consensus: 5.3%) in April'21, the largest increase since 2010. April'21 PCE inflation came at 0.6% MoM as vs 0.7% exp, and 3.6% YoY rising from 1.9% last month. Within this, monthly inflation was mostly driven by both food and services, while energy inflation slowed. Core PCE inflation was at 0.7% vs 0.3% exp and at 3.1% YoY vs 2.6% expected.

Outlook

Monetary policy (read our detailed note here: <https://idfcmf.com/article/4807>) seems very focused on being predictable for now, recognizing fully that there may be a considerable impact of the second wave on incomes and hence demand. Thus even as the recent evolution of global commodity prices and their local spillovers pose interpretational challenges for inflation, the guidance is unaltered and RBI's enhanced level of commitment to maintain easy financial conditions stands reaffirmed. **Our base case would remain that eventually RBI's intensity of intervention will need to get dialed back over a period of time and hence we would continue to budget for an orderly rise in yields over time. However, this by itself provides for reasonable opportunities given the current steepness of the curve even at intermediate duration points (3 - 6 years). Put another way so long as the RBI is broadly committed to containing volatility and muting the impact of excess bond supply, the steepness of the curve provides for enough cushion even if one has to give some of this away as mark-to-market losses. However, one has to be careful not to extend duration so much that potential mark-to-market losses start overwhelming the excess carry made.**

Thus local factors are unlikely to pose a significant challenge to a somewhat constructive view on intermediate duration at least for the foreseeable future. The risk is rather from the prospects of 'imported tightening' (developed market bond yields go up and that rubs off on us). One has to take this aspect as it comes and we can only note the following mitigating factors for now: 1> The US Fed is much more patient in this cycle given its revised reaction function (average inflation targeting, responding to realized rather than anticipated outcomes, and higher implicit relative importance to an equitable recovery of the labor market) 2> A rather sharp round of a reflation trade seems to already have been played as both US bond yields as well as rate hike expectations have stopped climbing since early April (although this can very easily change with incoming data) 3> The RBI's own preference for first using the forex reserve defense while persisting with pursuing easier local financial conditions to the extent required by local growth versus inflation trade-offs.

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