

## MARKET UPDATE

### May 2021: Ferocious rise in Second wave in India, Rising uncertainty and Growth Implications

**Economic Growth:** Ferocious rise of infections in April continued into May, leading to regional lockdowns in most parts of the country. While it seems second wave has peaked somewhere by mid-May, the daily infection numbers continue to remain elevated. Most hi-frequency indicators were down to almost last June-July levels (on account of restrictions on mobility & severity of virus). While the fourth quarter (Jan-Mar 21) GDP print indicated better than expected rebound in growth, the first quarter (Apr-June) growth numbers are likely to come weather due to second wave. Most economists have revised their quarterly and FY22 estimates downwards (FY22 GDP consensus: 8%-9% on account of impact of second wave on income and lives and fear of third wave). At the same time, globally, rapid inoculation in advanced countries (especially US and UK) is leading to pickup of economic activities. In fact, 2021 global growth is likely to be driven by growth in advanced countries.

**Inflation:** After remaining elevated for most part of FY21, Headline CPI inflation eased closer to 4% mark in Apr 2021 (Mar 21: 5.52%/y/y). Decline in headline print was primarily due to favourable base effect and decline in vegetable prices and modest increase in services inflation. Core Inflation eased to 5.19% y/y (Previous: 5.76%/y/y, Average FY21: 5.32%/y/y) on favourable base effect and muted increase in services prices. Globally, the inflation is showing signs of pick-up in advanced economies driven by high commodity prices, improved growth outlook, fiscal stimulus and humungous liquidity.

**Monetary:** In June Policy, the RBI maintained status quo, with clear focus on revival of sustainable growth conditions. Inflation may play second fiddle, till it remains within tolerance levels. RBI may also continue with its hugely successful proactive approach of providing ample liquidity and managing yield expectations, which has reduced volatility and aided transmission meaningfully. RBI announced GSAP 2.0 for 2Q (Rs. 1.2 trn vis-à-vis Rs. 1 trn in 1Q). It also announced GSAP auction for SDL indicating its support to reduce borrowing cost for state governments.

Earlier in first week of May, RBI in an unscheduled meeting, came out with slew of measures to support most impacted sections (like health sector, MSMEs, small banks etc) in the backdrop of sharp spike in virus infections. Focus of RBI was to increasingly channelize the liquidity operations to support growth impulses especially at grassroot level.

**Fiscal:** FY21 fiscal deficit print came tad lower than revised estimates mainly due to better revenue receipt collections and despite clearing huge FCI (Food Corporation of India) outstanding dues with Small savings. FY21 expenditure was robust ~30%/y/y (both revenue and capex). April print shows decline in revenue expenditure probably due to second wave restrictions. Capex however was robust and so are the tax collections. Next two months prints are likely to be impacted due to strict lockdowns.

**India's external sector & Global Update:** Brent crude rallied 5%/m/m in May (average US\$68/barrel against 65 in Apr) and even breached US\$70/barrel towards end of month on strong economic data from advanced economies & weak US\$. This was broad-based rally evident in other commodities - right from industrial metals like copper, aluminium, zinc to precious metals like gold and silver.

In the bond markets, US treasury yields remained range-bound in May despite higher inflation print. This was mainly on account of Fed's indication to keep policy rates lower for longer. The US 10 Yr Treasury bond yield closed the month at ~1.61% (Apr end: 1.63% & Mar end: 1.75%). Other advanced countries and most of the emerging market countries moved in sync with US treasury yield movement. After sharply appreciating in March, Dollar Index depreciated in Apr and May.

Indian rupee (INR) exhibited appreciating trends during the month on weak US dollar. After depreciating in April, INR appreciated by 1.6% during the month to close the month at US\$72.62, with intra-month breaching 72.35 levels. The total FPI (Foreign Portfolio Investment) inflows in India for the month of May stood at small positive US\$0.4 bn (Apr: outflows of USD 1.18 bn. Over the month of May (till May 21), FX Reserves increased by ~USD 5 bn to ~USD 593 bn. YTD FY22 Forex reserves rose by US\$16 bn.

### Fixed Income Market Update

**Yield Levels & Spreads:** Month saw range-bound movement in GSECs on global cues (range-bound US treasury yield but rising crude and commodity prices) and domestic cues (dovish RBI giving clear indication growth supportive monetary policy, lower monthly inflation number).

RBI conducted second tranche of GSAP auction and has intervened to the tune of ~Rs.40,000 cr in May (YTD: ~Rs. 1 trillion).

The 10 Yr benchmark (5.85 GS 2030) closed the month tad lower at 6.02% from 6.03% at Apr end. Even the term premium (10 yr over 365 days) eased further to average ~ 229 bps (vs ~235 bps one month back).

Yields in SDL remained range-bound during the month. SDL supply through auctions improved in May (~Rs. 50,000 cr) after muted auctions in Apr (with States' machinery engaged in fighting pandemic). 10 yr SDL closed the month at 6.79% (similar as previous month).

The spread between 10 yr SDL over GSECs widen a bit from average 73 bps in Apr 2021 to 78 bps in May. AAA PSU and private corporate yields were range-bound with easing bias across maturities.

### Fixed Income Market – Outlook

- June policy had asserted RBI's support to continue for longer to ensure sustainable growth revival. While RBI revised down its overall growth forecasts owing to disruptions in the current quarter, the forecasts for the second half was revised upwards. The text of the policy seems to indicate some comfort around growth recovery once the pandemic related disruptions start easing out. The predominant focus on growth, may get more balanced, in case things start normalising faster than anticipated. But the RBI would need to be fully convinced that this revival is firmly entrenched and sustainable. Till then, it may continue to remain reasonably accommodative. Recent fall in inflation provides additional policy elbow room.
- Our base case assumptions around narrowing of Repo corridor towards the latter part of FY 22, followed by a gradual Repo normalisation at the start of FY 23 stays intact. Going forward, while RBI may be watchful of inflation trajectory, it may look through as transitory factor.
- Relatively large size of GSAP 2.0 and SDL buying through GSAP window might ensure lower sovereign risk premia ahead amid elevated borrowing.
- Centre has estimated FY22 GST related revenue shortfall for the states ~Rs. 1.58 trillion (last yr: Rs.1.1 trn). Going forward, the timing and size of these weekly GSEC borrowings and OMO intervention may be determining factors for evolution of yield curve.
- The current steepness in the yield curve along with the RBI policy may make the outlook even more constructive for most debt funds

### Recommendations

Any extreme views on market direction may be avoided. Our overall portfolio allocation may reflect a neutral bias on rates. The core portfolios of most open-ended debt schemes may operate slightly below the mid points of their duration mandates. The huge steepness in the yield curve along with some select exposures to structured high grade assets may sustain and cushion returns in this uncertain environment.

We recommend continued discipline in investor allocations, driven primarily by their holding period considerations. This tends to reduce the negative impact of interim market volatility while the investors capture the curve steepness. Moderate duration allocations may form the core for now. Roll-down strategies across the yield curve may be considered, but with a clear understanding on required holding periods.

Funds running constant duration strategies in the 1-3 years space and reducing duration strategies across the yield curve tends to offer constructive risk-return rewards. The steepness in the curve combined with select exposure to good quality AA+ and AA issuers and structures may enhance overall carry across portfolios without compromising on either liquidity or credit quality mandates of those respective schemes.

As the economic and financial system normalization gathers pace, Credit Funds may regain ground driven by higher balance sheet visibility & comfort and reasonable spreads. This may likely play out through the course of FY 22 and beyond.

**Common Source:** Bloomberg, RBI, Centre for Monitoring Indian Economy Pvt Ltd, Finance Ministry of India, NIMF Research

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