The bond yields in domestic markets, despite continued volatility in global bond yields, higher global commodity prices and concerns over cost push inflation, rallied in the range of 10-25bps across the curve, due to interventions by the Reserve Bank in various forms - like announcement of G-SAP bond buying program, cancelling the government bond auctions, auction devolvement on primary dealers, asymmetric Operation Twists. Further, the increasing possibility that unwinding of easy monetary policy may get pushed by a one or two quarters due to second wave of pandemic also helped the rally.

The yield on 10-year benchmark yield remained range bound and hovered between 6.03% and 6.12% in April. It opened the month at 6.12% and closed at 6.03%, down by 14 basis points (bps) from the March month's close of 6.17%.

Banking system liquidity in the month of April averaged around Rs. 5.5 trillion which was higher from previous month's average of Rs. 5.1 trillion (Rev Repo-Repo-Marginal Standing Facility-Standing Liquidity Facility + term repo/re-repo).

INR traded in the range of 73.30/$ to 75.46/$ and closed at 74.08/$ in April vs 74.11/$ in March. India's forex reserves reduced marginally to $588 bn in last week of April as compared to $580 bn a month before.

Domestic Macro Factors

Industrial Production

The Index of Industrial Production (IIP) for February contracted by -3.6% y-o-y vs. -0.9% in January. The moderation in IIP was broad based and across the sectors except for capital goods, this fall was mainly due to the unfavorable base effect of last year. However, on month on month seasonally adjusted basis industrial production saw positive momentum and current industrial activity has almost reached pre-pandemic levels. Other industrial activity indicators such manufacturing PMI numbers also continues to be in expansion mode since the last 9 months, despite some moderation in March manufacturing PMI printing at 55.5 compared to 57.5 in February.

External Trade

India's external trade deficit widened to $15.2 bn in April from a deficit of $13.9 bn in March. Exports grew by 197 % in April compared to 60.3% in March and Imports rose by 166 % y-o-y in April compared to 53.7% y-o-y in March. This sharp rise in y-o-y numbers was due to exceptionally favorable base effects. Non-oil exports and non-oil non-gold imports both continued to showed growth on month-on-month basis.

Tax Revenue

The Goods and Services Tax collection for April rose to all time high of Rs. 1.41 lakh crores vs. Rs. 1.23 lakh crores in March. The Rs. 1.41 lakh crore collected includes Central GST of Rs. 27,837 crores, State GST of Rs. 35,621 crores, Integrated GST of Rs. 68,481 crores and Cess of Rs .9,445 crores.

Inflation

Headline CPI inflation for March rose to 5.52% vs. 5.03% in February, driven by an unfavorable base as well as rise in food and fuel prices. The Core CPI Inflation (CPI ex-food & beverages, fuel) moderated marginally to 5.9% in March compared to 6.0% in February. Within core, while communications and transport continue to show upward prices, personal care items showed some reprieve due to fall in gold prices. Going ahead given the favorable base and moderate food prices we expect CPI print between 4%-4.5% for the next couple of months.

WPI inflation for March spiked to 7.39% compared to 4.17% seen in February and market expectation of 6.16%. The rise was broad based and largely driven by fuel price with contribution from food and manufactured goods prices and unfavorable base of last year.

Outlook

The FOMC maintained a status-quo on policy rates and the pace of asset purchases was kept unchanged. The FOMC members acknowledged an uptick in economic activity owing to the fiscal support and progress on vaccinations. The policy reiterated that 'substantial further progress' would have to be made toward its goals of full employment and average 2% inflation before it could consider tapering the asset purchases.

The Fed is willing to let the economy run hot and tolerate actual inflation above 2% to support the rise in inflation expectations that would be consistent with sustained 2% PCE inflation target. The idea is that if inflation shows signs of moving out of the tolerance band, along with growth in wages and upward movement in inflation expectations, then it can always fall back on strong policy tools to handle such a risk. The focus for now is to avoid the prospect of economy remaining in a low inflation and low growth matrix for long time.

In India, the second wave of Covid-19 continues to intensify, the daily new cases have reached 4.0 lacs from around 70k/day at the end of March. Recoveries have also picked up in last two weeks of April and crossed 3.0 lacs/day. The total active cases now stand at 36.44 lacs as of 6th May compared to 6.1 lac on 2nd April. The daily new cases growth rate has slowed with absolute numbers stabilizing around 4 lacs/day. However, the positivity rate (positive cases/samples tested) continues to rise and has reached ~21% from ~7% at the start of the month. This could mean that the recent fall of the growth rate might be contributed by insufficient testing. Till last month the epicenter of spread was Maharashtra, Chhattisgarh, Madhya Pradesh, and they imposed restrictions, now it is spread across the country and almost all large states have some restrictions. Vaccination drives have also been impacted due to supply constraints as daily vaccination which was 3.3 mn per day in the 1st week of April has now dropped to 2.5 mn as of 6th May.

The RBIs control on markets firmed up through market intervention and forward guidance. The rates saw a significant drop across the curve from already lower base as RBI deftly used cancellation of the government bond auctions, auction devolvement on primary dealers and asymmetric Operation Twists for market signaling on the back of already announced G-SAP program. Any apprehension regarding an untimely reversal of an overly accommodative policy was relieved by forward guidance and then minutes of last MPC meeting. The minutes highlighted that despite the committee's concerns on inflation and the possible imbalances that overly accommodative monetary policy could trigger, it continues to give higher weightage to growth.

The potency of these yield management tools of RBI have increased significantly as these are happening on back of already committed balance sheet by RBI in form of G-SAP and resurgence of second wave of covid, which has pushed back the market's expectation on normalization of policy accommodation by couple of quarters. We expect RBI to continue to be successful in achieving the objective of orderly evolution of the yield curve through use of these tools. However, risk to this can emanate from extension of the second wave beyond market expectation which can hurt Government finances and increase the dependence on market borrowing as Government would then be under pressure to unleash countercyclical fiscal policies.

We believe the RBI will go back to the normalization theme only when it is convinced that the growth headwinds due to successive covid waves have been reasonably tackled. We believe the economic uncertainty in wake of the devastating second covid wave would be enough to make sure that the RBI does not change anything in its policy stance in the next policy (or couple of policies) even if growth picks up in this quarter as expected and the second wave starts to flatten. However, beyond that towards end of FY 21 when large parts of the population would have been vaccinated or have developed indirect protection in form of herd immunity and growth has found firm footing is when we should expect significant changes in policy stance and normalization.

In this backdrop, a fixed income strategy needs to be built up for various investment horizons, considering that we are somewhere very close to the bottom of the rate cut cycle and rates in various buckets are at multi year lows, we should be cognizant of the duration risk and ensuing volatility risk.

In this environment, we suggest investors match up their investment horizon with portfolio duration and select strategies which offer lower inherent risk in the portfolio viz. roll down strategies and active duration strategies in lower duration buckets. As the curve is steep and longer maturities offer substantial spread and inherent protection to the investor on yield rise, a systematic investment in longer duration buckets is suggested for an investor with a longer investment horizon. These ideas can be executed when investing in our funds like Sundaram Ultra Short Term, Low Duration, Short term Debt Fund, Sundaram Banking & PSU, Sundaram Corporate Bond Fund depending on the risk-return objective of the investors.