



PNB GILTS LTD

HO: New Delhi

July 26, 2010

**Debt Market Update
(For the week ended 23rd July'10)**

WPI Inflation

Food inflation eased to 12.47% for the week ended 10th July'10 vis-à-vis 12.81% recorded in the previous week as prices of vegetable, wheat and pulses declined. The decline is also partly attributed to the high base effect of the previous year. The primary articles inflation, however, rose to 16.48% as against 16.25% in the previous week, while fuel inflation was flat at 14.27% unchanged from previous week's level. The steep upward revision in fuel prices in the month of June may impact inflation numbers in the coming weeks. However better monsoons this year may lead to good harvest which augurs well for food inflation. Nevertheless, RBI is expected to continue with the monetary tightening as the overall inflation figure is still at elevated levels much above the central bank's year's target at 5.5%.

Money Market

Money market rates remained at elevated levels hovering above the Repo rate during the week as liquidity condition continues to be tight in absence of considerable inflows in the system. Government has been slow with its spending in order to avoid putting further pressure on inflation. During the week, RBI injected liquidity to the tune of Rs. 64,360 crore on a daily average basis. Call rate ended the week at 5.63% vis-à-vis previous week's close of 5.50%, while CBLO rates ended the week at 5.49% vis-à-vis previous week's level of 4.70%.

G-sec Secondary Market

Bond yields opened lower snapping four days of continuous rise in the previous week on rising optimism that buoyant monsoons may boost agricultural productivity. However the level could not be sustained and yields treaded upwards to the highest level in a week as lower liquidity in the system curbed demand for G-sec. Yields climbed further to one month highs as traders turned cautious ahead of first quarter monetary policy review. Rise in US treasury yields further exerted upward pressure on domestic yields. Trading volumes remained thin as players preferred to stay sidelined ahead of crucial policy meet. During the week 10-yr yield rose by 4 bps to close at 7.68%.

Crude Oil

Crude oil opened the week on a rising note tracking the rally in equity markets on better than expected results of companies. Tropical wave in the Caribbean region further exerted upward pressure on oil prices. Though an unexpected rise in US stockpiles snapped the rise in prices briefly, better than estimated financial results of companies in the US and higher manufacturing and services growth rates in the Euro

region pushed prices up again above USD 79 a barrel after a gap of 10 weeks. Weakness in dollar too boosted demand for crude oil. However the 10-week high level could not be sustained on speculation that the Tropical storm “Bonnie” may not be strong enough to disrupt production in Gulf of Mexico. Oil closed the week at USD 78.98 a barrel as against USD 76.01 a barrel in the previous week.

US Treasury Market

US treasury yields hovered near record low levels in the beginning of the week as stocks declined and builders’ confidence declined. With Housing starts falling to the least level since October last year, yield on 10-yr bond eased to touch 3-week low level. Weak housing data raised apprehensions of economy witnessing a double dip recession keeping buying interest in treasuries intact. In keenly awaited address to congress, Fed chief stated that the economic outlook is unusually uncertain and that the Fed is ready to take further actions as needed. However, yields firmed up towards the end of the week as higher-than-expected corporate profits eased concern the Federal Reserve may have to consider more stimuli to help sustain the U.S. economic recovery. On the last trading day, reports of 7 banks in Europe failing the stress test turned market sentiments cautious. Yield on 10-yr benchmark paper ended the week at 2.99% as against 2.92% during the previous week.

Forex Market

Rupee weakened in the beginning of the week on concern investors will cut holdings of emerging-market assets after the latest reports on U.S. consumer confidence and inflation signaled the global economic recovery is faltering. Release of weak export growth data further dampened the market sentiments. However, recovery in stock markets towards the latter half triggered capital inflows. Foreign investors bought rupee to raise holdings in local stocks and bonds. Speculations of RBI increasing key policy rates in the upcoming policy review helped rupee strengthen further as the move will make local assets more attractive to investors seeking higher yields. Rupee closed the week at 46.98/USD as against 46.78/USD in the previous week.

Outlook

Bond market is expected to open on a cautious note ahead of RBI policy meet due on 27th July’10. Market has already discounted 25 bps hike in the key policy rates and any steeper hike in the rates may lead to sharp surge in yields. Market shall also take cues from RBI’s stance in the policy meet on inflationary and growth expectations. Liquidity conditions may ease on back of redemption of more than Rs. 30,000 crore on 28th July’10.

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