23rd March 2021 Vol: 27/2020-21

PNB GILTS LTD
(Subsidiary of Punjab National Bank)

Economy & Gilt Watch

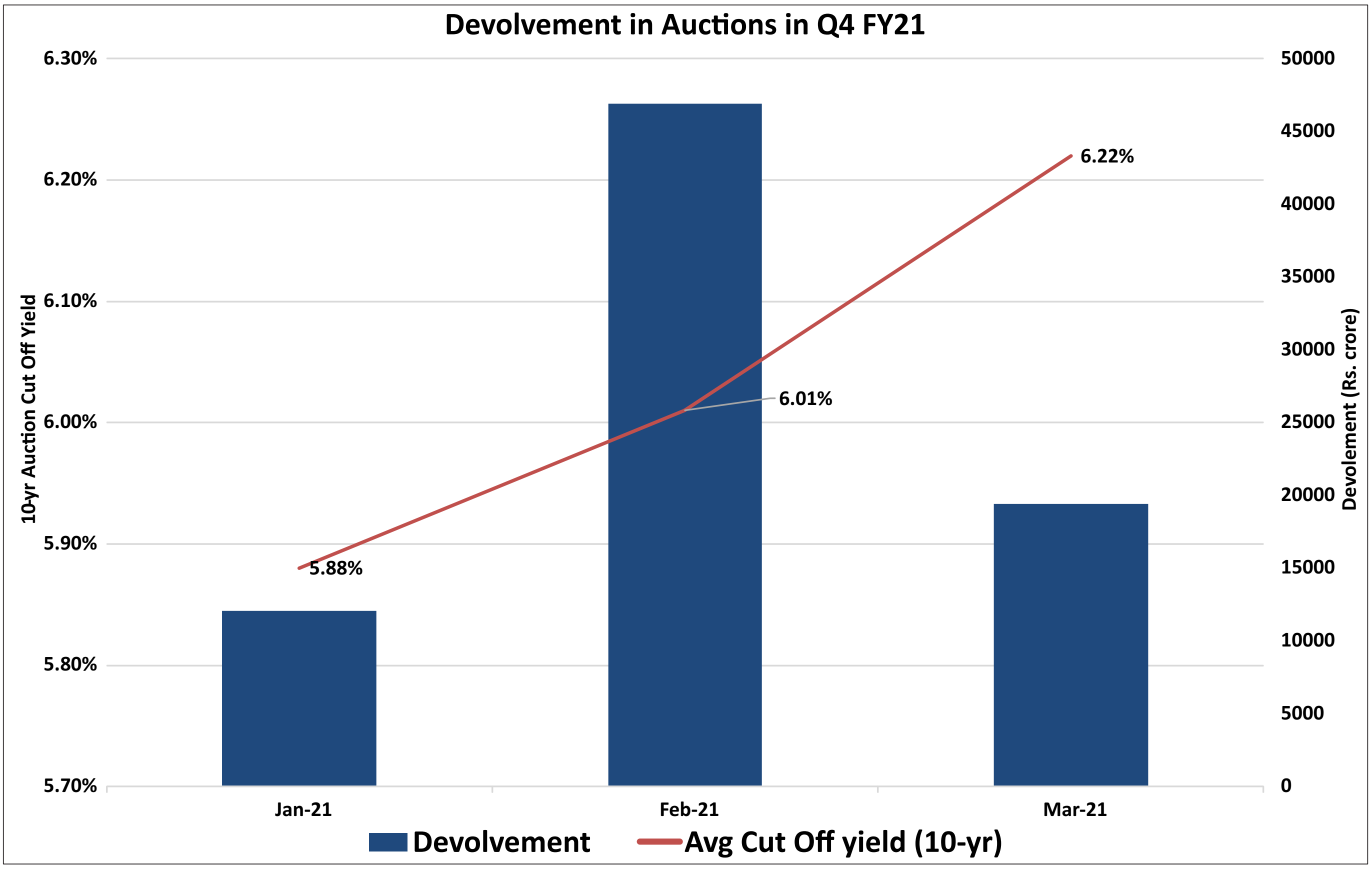
INSIDE THE ISSUE

A Rebuke to the Bond Markets

In what seems to be an open admonishment of the Indian bond markets, RBI has come down heavily in its monthly bulletin, blaming the "bond vigilantes" for driving yields higher, undermining economic recovery & unsettling the financial markets. The bond market seems to have fallen in line, with yields retracing somewhat from the recent highs seen recently (10-yr yield at 6.25%). RBI and the bond markets have remained in tug of war over yields, with former making strong efforts towards containing the same, while the latter, demanding higher yields over fears of inflation. Since February, markets have clearly shown their apprehension over inflation fears fanning out of a loose monetary and fiscal policy, which are perfect ingredient for stoking price pressures in the economy. The ongoing vaccination drive and normalization of economic activity only adds to this "heady cocktail" in RBI's words, giving much confidence to the bond vigilantes. Globally too, Fed tried to douse fears of taper tantrum, stating that inflation would ease after witnessing a temporary rise and that the accommodative stance shall be continued till 2023. That central banks are ready to look through inflation is something which bond markets are not used to, hence causing much upheaval in the bond markets across the world.

Don't Fight Us

The message to those trying to fight RBI is loud and clear, don't be an adversary, instead do what it takes to stall the effects of the pandemic, as the economy in its current state "cannot withstand high interest rates." RBI has persistently provided extremely clear forward guidance time and again to the bond markets to ensure a smooth sailing of the GOI borrowing program. However with markets still not behaving in the desired manner (as seen in continuous devolvements in last few auctions), RBI has subtly warned the markets that they could engage in more "aggressive actions" to cap the rise in yields, which could actually take those who are trying to exploit the market conditions in for a surprise. It goes on to say that, "there is much sense in what the Reserve Bank of India is doing in striving to ensure an orderly evolution of the yield curve", but RBI alone cannot effect this without cooperation from the bond markets. These assertions by the regulator certainly warrant a relook at bearish sentiments that have been built up in the bond market, as RBI clearly is in no mood to tolerate higher yields as they shall stand in way of economic recovery.



The State of the Economy

On the state of the economy, RBI highlights the recovery in economic activity and aggregate demand as seen from various high frequency indicators. It goes on to state that investment demand which has remained underwhelming till now, is now beginning to show signs of recovery. It lists a number of evidences in favour of its claim that "the capex cycle is uncoiling and turning." RBI states that central government capital expenditure has made a sharp turnaround, while States' cap-ex has returned to pre-pandemic levels. As regards, private investment activity, infrastructure firms are seeing an expansion in their order books and there is revival in real estate & construction activity. Investment in machinery and equipment is also seen recovering, as seen from imports and capital goods production figures. The traction in the sector is also gauged by the fact that foreign portfolio investors (FPIs) allocations to the capital goods sector are now at a three-year high.

At the same time, RBI expresses several concerns, which could stand in the way of full recovery. The recent pick up in COVID infections has raised worries of a second wave and RBI emphasizes on the need to speed up the vaccination drive. The second concerns that RBI points out is that of inflation, with core inflation remaining sticky and headline inflation testing the upper band of the target. The rise in input prices of businesses poses a dilemma, as a pass on to consumer shall lead to higher inflation, while holding back the same may lead to erosion of business profitability and hence gross value added to the economy. Though confidence is seen returning to households and businesses, and a better debt profile of the Indian government (in terms of debt servicing, refinancing risks & external debt position) puts India on a better pedestal than other emerging economies, another outbreak & consequent lockdowns "will get unbearable in spite of learning from the initial experience of living with the virus." RBI concludes on a strong note stating that, "Central banks will go beyond their conciliatory open mouth operations if their stated stances are challenged." Will the bond markets take the message and fall in line, will be seen in days to come.

Fixed Income Outlook

Fundamental View

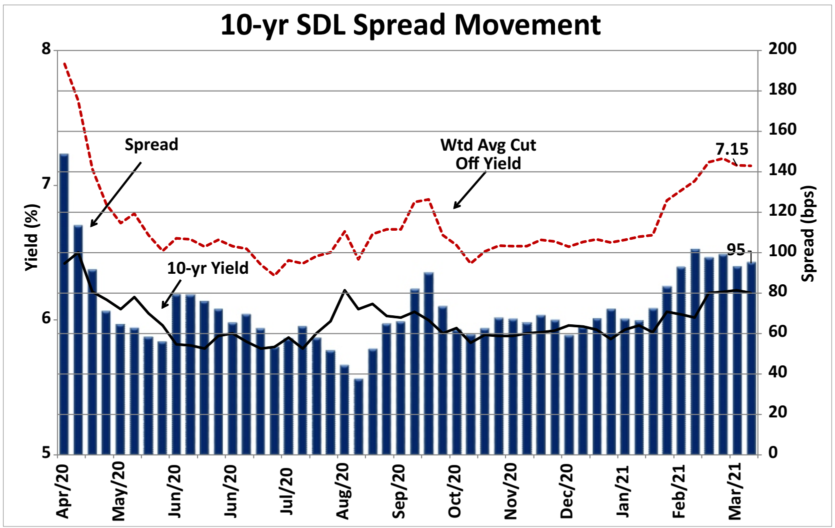
In continuation to our last report, wherein our stance was mildly bullish till year end, the bond markets did well in the last week. The liquid Central G-sec points (5 yr and 10 yr) were managed well by RBI through OTs and auction management. Illiquid papers & SDLs also recovered sharply. It was broadly an investor driven rally that we saw in the last week. The other factors that helped in yield retracement were sharp resurgence in COVID infections in India, (raising doubts over quick economic recovery) and US Fed's resolve of not raising rates till 2023. The expectations of auction cancellation also crystallized as RBI announced that the last auction of the year (Rs. 20,000 crore) stands cancelled, and we could witness a rally on account of that. While a further retraction in yields cannot be ruled out, this opportunity could be utilized by investors to offload some of the portfolio and wait for better levels for re-entry in the new financial year. The risk to the view however is that if COVID spreads further and farther, yields for once could even slide sharply with 10-yr likely to re touch sub 6% levels. The probability of this move however seems low and we believe that the bottom for the rally could be anywhere between 6.08% to 6.12%.

Technical View

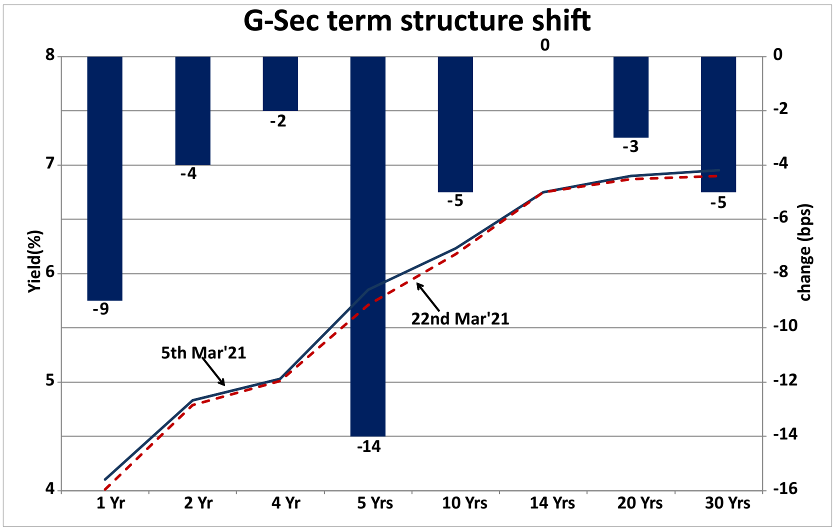
As on Tuesday morning (23.03.21) 5.85% G-Sec 2030 Yield is trading at 6.14% level. Last fortnight, benchmark yield northward journey was capped as it faced stiff resistance around 6.25% zone. As discussed in last newsletter, we are witnessing a divergence in Oscillators and yield movement and hence possibility of a pause with a pullback towards 6.13% can't be ruled out. Going forward, the current chart structure indicates 6.13%(38.2% retracement) to act as a crucial support level for benchmark, which also coincides with lower Bollinger band giving strength to the level. On higher side 6.20%/6.25% will act as pivotal resistance for coming fortnight.

Source: Tickerplant

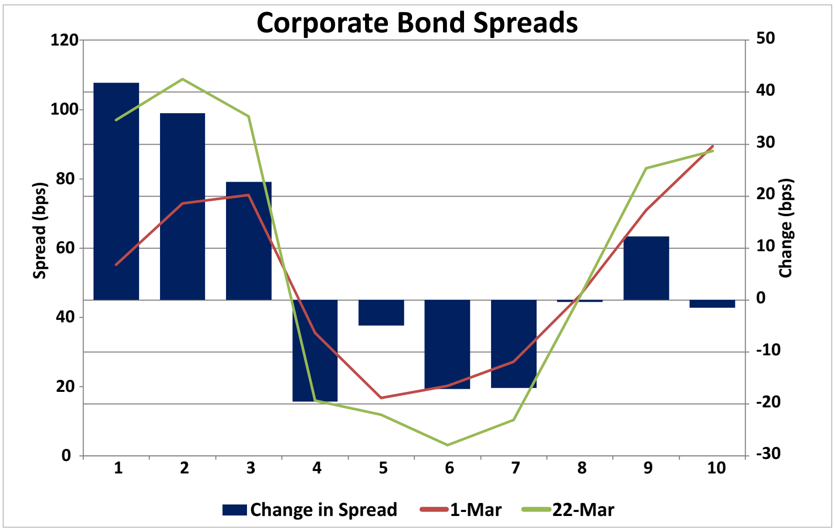
SPREAD MONITOR



SDL spreads are expected to narrow on value buying amidst positive sentiments in the G-sec market



G-sec yields ease with 5 yr & 10 yr segment witnessing the sharpest fall on RBIs OT



Short end Corporate Bond spreads firm up during the fortnight

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