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PNB GILTS LTD
(Subsidiary of Punjab National Bank)

ECONOMY & GILT WATCH

INSIDE THE ISSUE

RCEP: A missed opportunity?

After much anticipation and amid fervent opposition by Indian farmers, dairy industry, trade unions as well as corporates, India dropped out of world's biggest trading block in the making, the Regional Comprehensive Economic Partnership or RCEP in the concluding rounds being held in Bangkok. The RCEP which earlier comprised of 16 nations (ASEAN, Japan, Australia, China, New Zealand, South Korea and India), will go ahead with the treaty while India opted for last minute withdrawal quoting "national interests" coming in way of being a part of the mega regional trade arrangement.

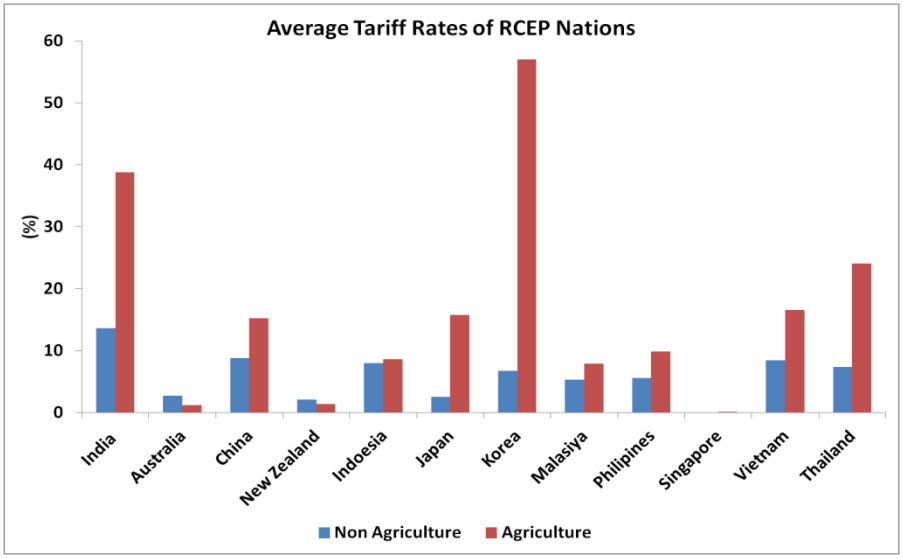
A brief background: The RCEP was pioneered by the 10 nation ASEAN and casted as China's response to the Trans Pacific partnership (TPP) initiated by the US. The round of negotiations kick started in the year 2012 with the treaty aiming to cover trade in goods and services, as well as investment, intellectual property and dispute resolution. ***The treaty is highly ambitious with regard to liberalization of trade as it aims to eliminate tariff and non tariff barriers in most goods thus achieving a "free trade area" in the true sense.*** The importance of the trading block can be understood from the fact that the 16 nations taken together account for almost one third of the world GDP and trade with potential to provide an estimated USD 260 bn in global income benefit as per ADB report.

India's Stance: India is the third largest economy in the RCEP block and has been actively involved in the negotiations ever since its inception. The withdrawal at the last stage of rounds may have come as a surprise, but the underwhelming experience of India in past Free Trade Agreements (FTAs) with ASEAN and some other RCEP members seems to be the main rationale behind India's pull out from the treaty. India currently has FTAs with 12 of the RCEP nations, i.e. ASEAN, Korea & Japan. The trade pattern with these nations indicates that India has not been able to utilize the opportunities of tapping the partner's market by entering into trade agreements. Rather, the trade deficit with these nations increased substantially due to increased access to Indian markets through these FTAs helped by lower tariffs. ***Clearly, entering into RCEP***

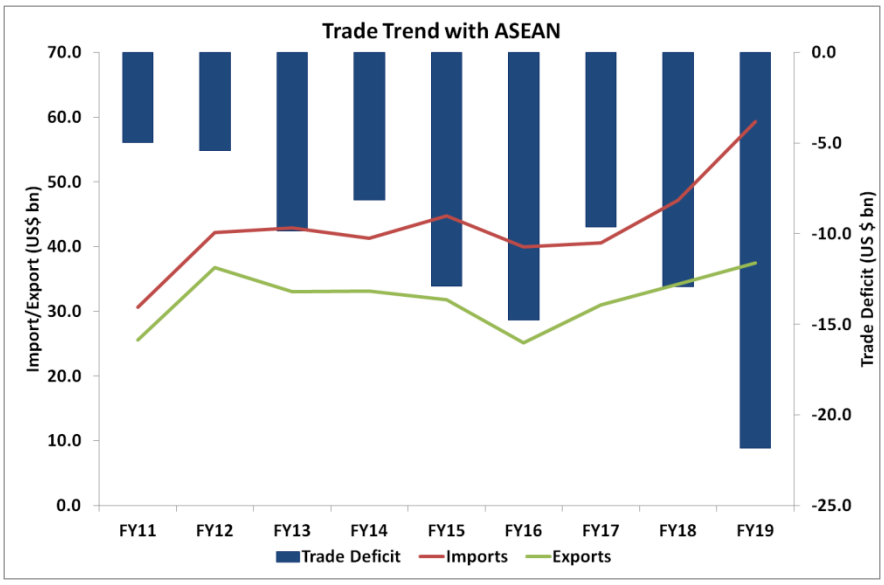
would prove to be a body blow to the India's trade position and domestic industries which have not been able to match pace with the global counterparts due to lack of policy and structural reforms. In a bid to shield the domestic players from foreign competition, the government has adopted an increasingly protectionist stance in recent times. Clearly, the government's protectionist stance and "Make in India" policy go against the very spirit of the RCEP treaty and the fact that India failed to secure conditions in its favour, the withdrawal seems to be the logical outcome of the negotiations held over the span of seven years.

Fear of the Dragon: China is a major stakeholder in the RCEP arrangement and the concerns of Chinese imports swamping the Indian markets are genuine. China has been the largest importer to India (imports comprising capital, consumer and intermediate goods), with share in imports rising from 6.4% in 2003–04 to over 16% in 2017–18. On the other hand, India's exports (mainly raw material) to China have faced multiple barriers both in terms of tariff and non tariff barriers. The RCEP pact would further open the Indian economy to the Chinese players which would certainly hurt the already vulnerable situation of domestic players.

Missed Opportunity: Amidst all the concerns and rationale justifying the Indian government's decision to not be a party to the biggest trade pact, there are also concerns of India missing out on to the long term strategic benefits of being integrated into global value chains. Global value chains (GVCs) across the world have been a key growth driver and provider of good quality jobs and high paying jobs. For realizing the goal of becoming a global manufacturing hub, it is imperative that India becomes part of the GVC, which would bring in competition driven efficiency in the domestic industries. While foreign competition continues to remain a double edged sword, it is important for the government to bring in structural reforms to provide a level playing field rather than adopting protectionist policies which would only close the Indian economy further.



India has the highest tariff rates among the RCEP nations. Rising protectionism may protect the domestic players in the short run, however, the long run ramifications may not be conducive to growth prospects.

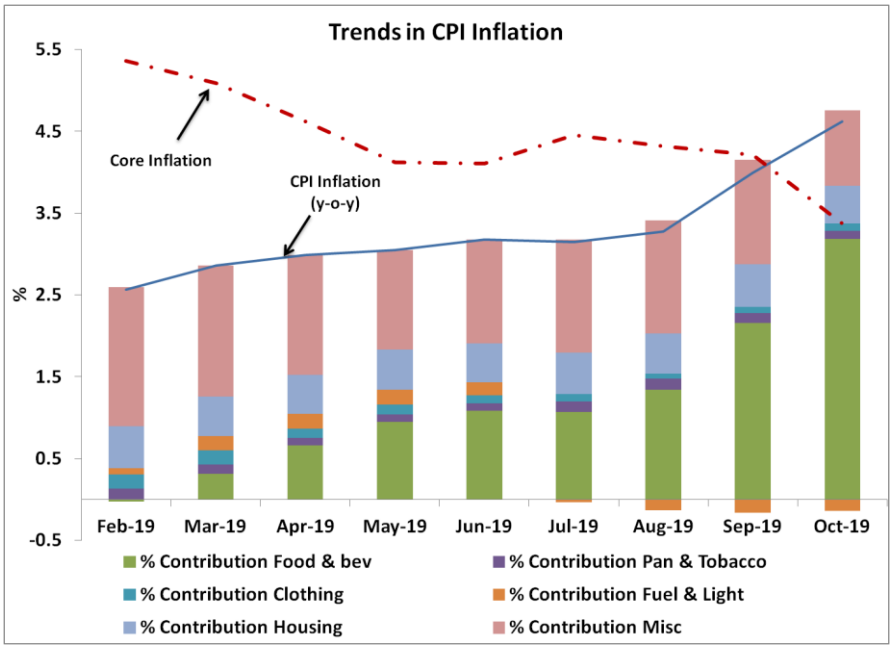


Source: dgft.gov.in

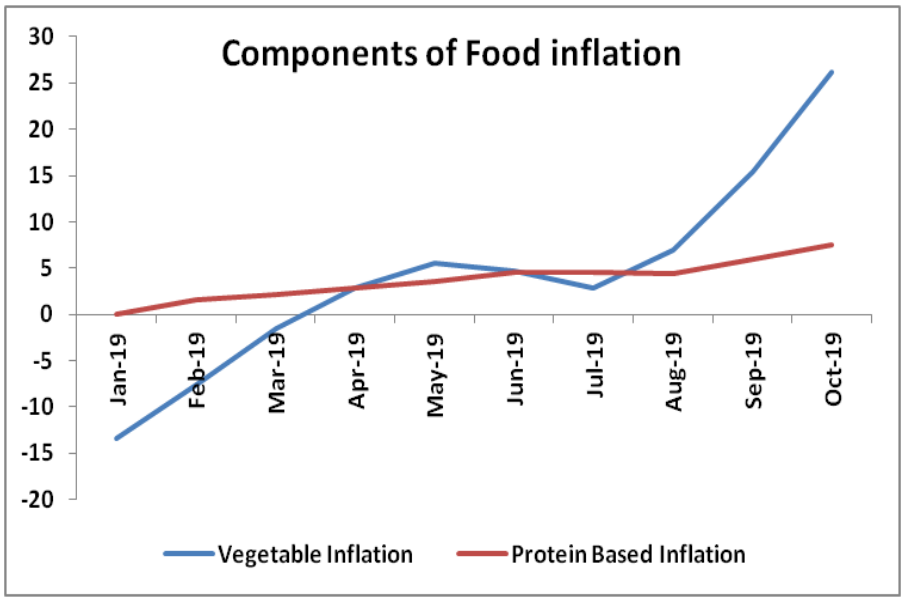
Exports to ASEAN have remained rather flat while imports have surged, leading to widening of the trade deficit. Further liberalization of trade rules is likely to hurt India's trade position further.

October CPI surges to 4.62%, Core inflation slows to below 4%

CPI print for the month of October rose well past the 4% mark on unabated rise in food prices even as core inflation mellowed down further to a fresh low of 3.4% y-o-y in the current CPI series. The surge in food inflation remains unabated as prolonged monsoon linked supply disruptions and crop damage continue to exert upward pressure on food prices. Food & beverage inflation came in at a 39 month high of 6.93% driven mainly by 26% (y-o-y) uptick in vegetable prices and 7.5% (y-o-y) rise in prices of protein based items. An unfavourable base effect further aggravated the overall level of food inflation in the month of October. All other categories under CPI inflation remained benign with fuel group showing a disinflation of 2.02% and core inflation (non food & non fuel) easing for the third time in a row. While the food prices may take some more time to cool off, core inflation trend is an offsetting factor as far as the headline inflation number is concerned. Food inflation going forward would be impacted by rabi crop prospects. ***The MSP for rabi crops was recently increased by a modest percentage and the same is unlikely to have much effect on the prices. In the current season, rabi sowing has shown a sluggish trend as there was a delay in harvesting of kharif crops. As on 15th November the area sown in current year trails by almost 12% compared to the last year, with pulses (16% lesser acreage) and wheat (22% lesser acreage) being the most affected crops.*** However, there is optimism that the record reservoir levels pan India would augur well and rabi sowing would pick up. ***Going forward, a low base effect is likely to keep the headline inflation firm above 4% in the coming months, while the core inflation may also see a mild uptick from current levels.***



More than a blip: The surge in food inflation is likely to persist as prospects of rabi crop look mixed, even as market continues to suffer from kharif supply setback. Further, waning of favorable base effect is likely to keep the headline inflation above 4% mark in the coming months.

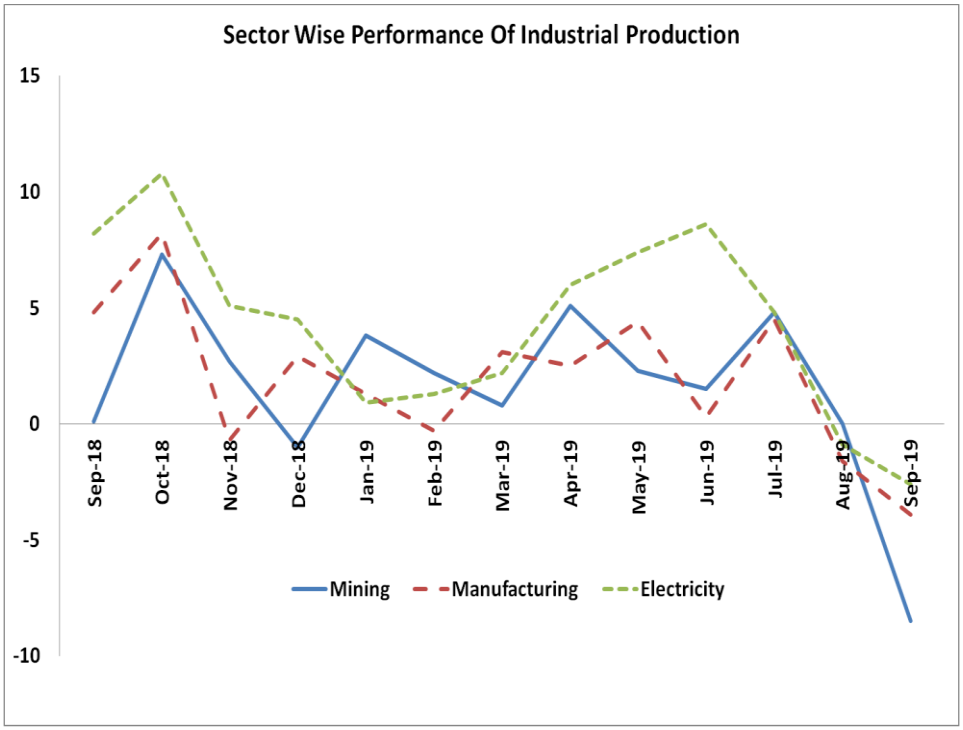


Industrial production: No signs of bottoming out

Contrastingly, the industrial production continued to weaken on a broad based basis posting a contraction of 4.3% on y-o-y basis in the month of September. Barring intermediate goods, all other sectors under used based classification posted contraction, reflecting across the board weakness in demand. The primary goods segment registered its weakest performance (-5.1% y-o-y) in more than 7 years largely due to dismal mining and electricity sector output. Capital goods segment continued to show unabated decline in output, contracting for the ninth consecutive month as investment activity shows no sign picking up. During September, capital goods output contracted by 20.7% y-o-y as against 21.4% contraction posted in

August 2019. Construction goods output also deteriorated further (-6.4% y-o-y) as the impact of heavy and prolonged monsoons continues to be felt in construction activity. However, intermediate goods continue to buck the trend posting a robust growth of 7% in September marginally up from 6.9% in August 2019. Consumer durables and non durables contracted by 9.9% and 0.4% respectively during September reflecting continued weakness in consumer demand.

Under sectoral classification, manufacturing continues to be a drag on the industrial production, posting a contraction of 3.9%. Mining and electricity output also deteriorated further, contracting by 8.5% and 2.6% respectively in September 2019. ***The outlook for industrial production remains poor amidst lack of turnaround signs in headline indicators. Protracted weakness in automobile production, electricity generation and at the consumer demand level will continue to weigh on the industrial performance going forward.***



***All in the red**: Industrial production hit a fresh series low in September' 19, in line with abysmal core industries data for the corresponding month.*

Fixed Income Outlook

Fundamental Point

G-sec yields traded in a tight band with an upward bias in the last fortnight amid factors such as contrasting economic data releases (weak IIP and firm CPI), steady rise in US treasury yields while reacting negatively to the Moody's cut in India's rating outlook from stable to negative. In the coming fortnight, the bond market shall stay geared for the Q2 GDP growth data to be released on 29th Nov'19. While the CPI inflation came in much higher than anticipated, expectations of another round of policy rate cut stay intact as GDP growth rate for the second quarter is likely to slip below the 5% mark. On the global front, any clarity on US-China trade negotiations will feed into higher demand for risky assets and commodities, which will be a negative for global and domestic yields. 10-year paper is expected to trade in the range of 6.42% to 6.55%

Technical Point

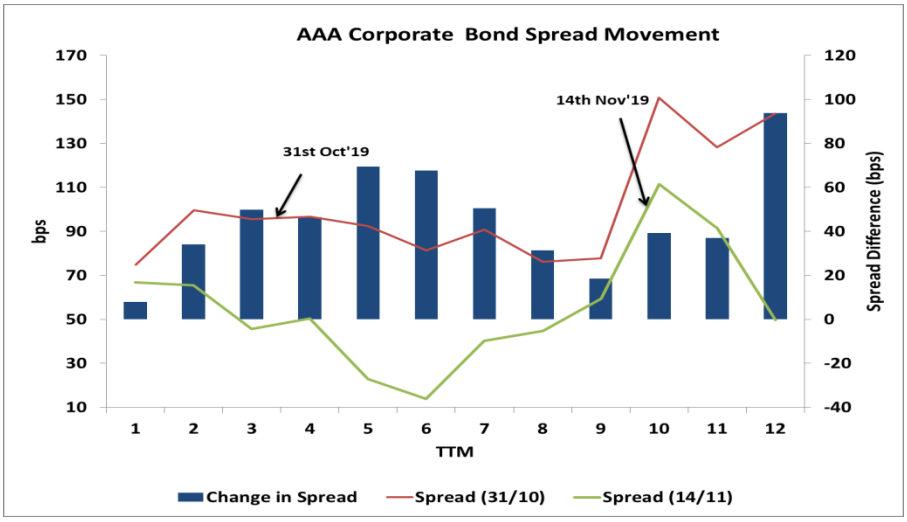
7.26% GS 2029

7.26% GS 2029 yield settled at 6.69% on Friday's session. In last fortnight, strong up move from 6.66% to 6.79% was witnessed in 10 yr yield. However, bullish momentum fizzled out soon as it re-entered the previous consolidation zone and settled below 6.73% level. Momentum indicator RSI is hovering in range of 45 to 60 from past many days, with Bollinger band width trading around lower side, indicating sideways moves. For short term resistance is placed at 6.75%, with immediate supports placed around 6.68%/6.64% zone. From here on, till yields are sustaining above crucial supports, it may continue to move sideways between 6.64% to 6.75%.

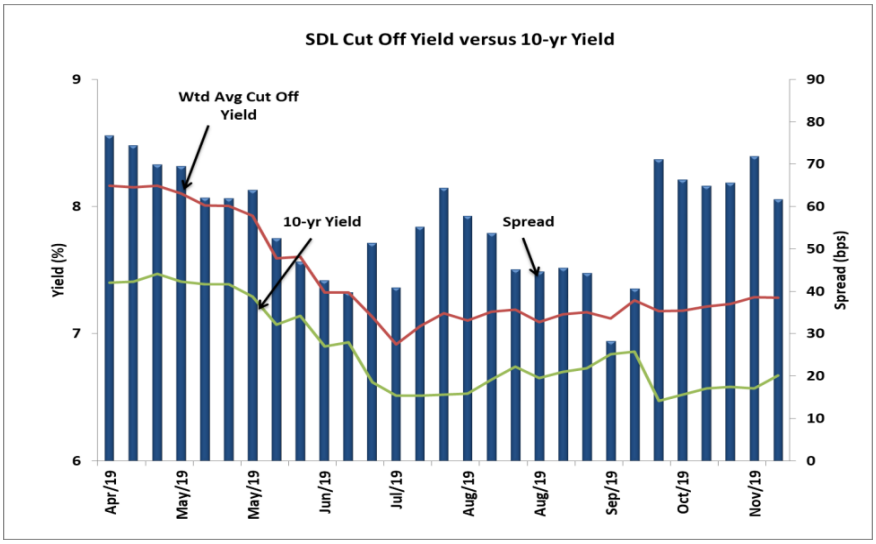
Chart Source: Tickerplant

DATA CHECK

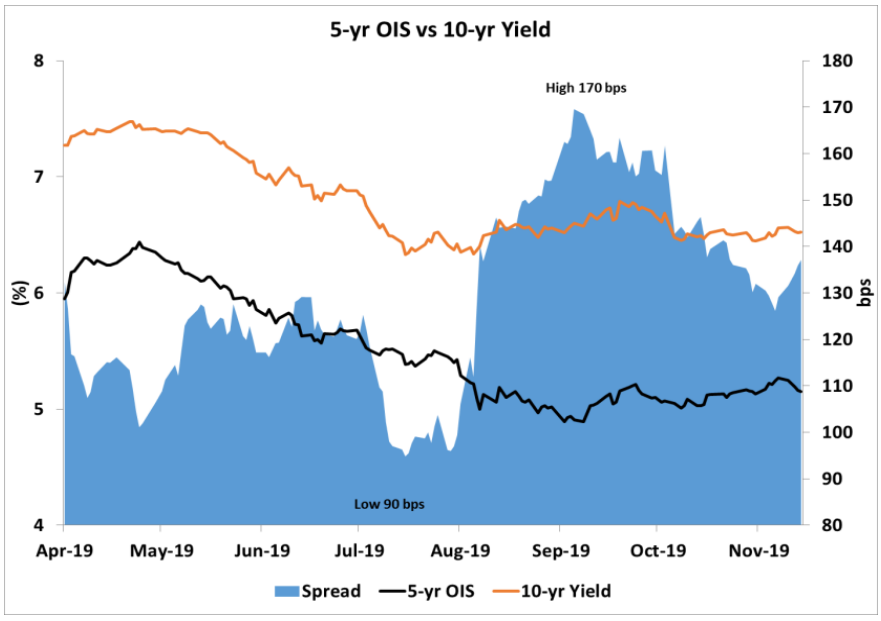
Key Events: Upcoming Fortnight		
Date	**India**	**US**
20-Nov	M3 Money Supply	FOMC Meeting Minutes
22-Nov		Manufacturing PMI (Nov)
27-Nov		GDP (Q3)
29-Nov	GDP (Q2)	



Corporate bond spreads at the shorter end of the curve continue to compress on account of surplus liquidity in the banking system.



Constant supplies are expected to keep SDL spreads at elevated levels in the intermediate run.



The spread between 5-yr OIS and 10-yr G-sec have receded from current year highs but is still above the average spread of 129 bps witnessed during the year. Spreads are likely to compress further on mean reversion.

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