23rd December 2019

Vol: 6/2019

ECONOMY & GILT WATCH

INSIDE THE ISSUE

MPC minutes & Operation Twist: Targeting the transmission

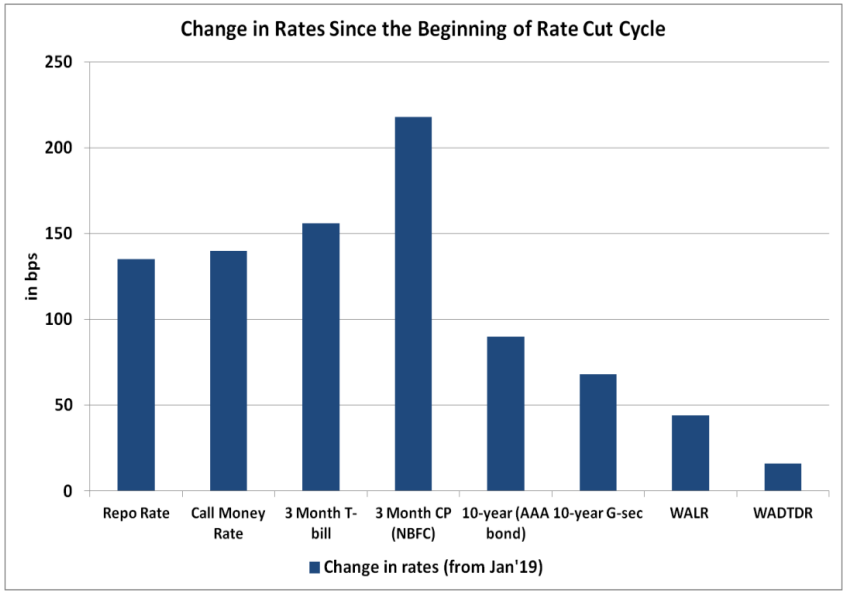
The highlights of the past week were the Monetary Policy Committee minutes and the surprise announcement of a first of its kind OMO which will see simultaneous sale and purchase of government securities for an amount of Rs. 10,000 crore. Through the OMO, RBI plans to swap the 10 year paper for short dated securities, all of which are maturing in FY 2020-21.

MPC Minutes: End of the rate cut cycle?

The policy committee members were unanimous in their view of adopting a wait and watch approach whilst the impact of fiscal and monetary steps taken so far plays out completely in the economy. The members justified their stance for a pause primarily on account of ***a) the evolving inflation scenario b) the impending transmission in the lending rates c) keeping room for future rate cuts for ensuring "optimal impact".*** With regard to inflation, RBI has remained much behind the curve and members expressed caution over food inflation becoming increasingly broad based and spilling over to other non-food items. The November CPI inflation print at 5.54% is already higher than RBI's revised projection of 4.7% to 5.1% for H2 FY 2019-20. While, the headline inflation is expected to remain north bound and breach the upper bound of RBI's 2% to 6% target in the coming months, there are potential upside risks to core inflation as well, as in the Indian context food inflation tends to become generalized by fanning overall inflationary expectations. Moreover, the recent hike in milk prices, telecom tariff rates and surge in crude oil prices, the impact of which has not been accounted for in the revised inflation projection, will further add to the inflation woes, making future rate cuts less likely in the current scenario. Pending transmission of rate cuts continues to remain a concern, though the members expect the same to be facilitated by external benchmarking of lending rates. ***Given the fact that transmission of the 135 bps rate cut is still underway, RBI clearly passes on the baton to the government for reviving growth through sustained reforms and fiscal measures.*** The upcoming Union Budget will be crucial as RBI will keenly watch out for further counter cyclical fiscal measures and going forward monetary actions seem highly contingent on further weakening of the economy.

A new 'twist' for the bond markets

After the rate pause shock in the December policy, the announcement of the special OMO by RBI has taken the bond markets by surprise. The OMO (Operation Twist in market parlance) through which RBI plans to buy the 10 year paper by selling off short dated papers is aimed at correcting the term structure without having any impact on the liquidity in the immediate term. The fact that RBI is now resorting to unconventional ways to target the transmission indicates that we may be nearing or are already at the end of the rate cut cycle. The desired impact on the term premia will however depend on RBI conducting such operations on a sustained basis. And the same should also help in arresting any shock in yields as the market gears up for the actual deficit and borrowing numbers for the year. Nonetheless, with RBI clearly endeavoring to anchor the yields, the development certainly adds a new twist to the bonds story which was already facing conflicting pulls from factors such as widening fiscal deficit, surging inflation, stalling growth and rise in global risk appetite etc.



Partial transmission of interest rates despite easy liquidity and successive rate cuts has compelled RBI to resort to unconventional ways for ensuring the transmission.

Term premia is at its highest level since 2012 as liquidity fails to find its way into longer dated securities

Headwinds to Economy Continue

IIP and Exports continue to disappoint

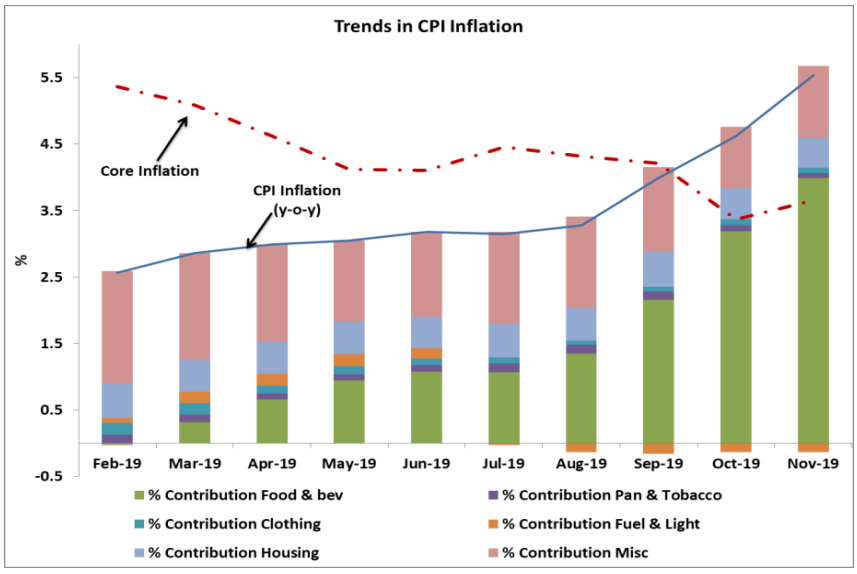
A spate of key economic data released during the last fortnight indicate continuing slump in the domestic economy. The industrial output shrank for the third month in a row, registering y-o-y contraction of 3.8% in the month of October. All the three sectors, viz, manufacturing, mining and electricity contracted by 2.1%, 8% and 12.2% respectively during the month. Different segments under use based classification also continued to witness broad based weakness except intermediate goods which posted a growth of 22.2%. Capital and consumer good segment both of which are indicators of investment and consumer demand in the economy, continued to post double digit contraction. India's trade position also continues to remain fragile as exports contracted for fourth straight month in November by 0.32% while imports declined by 12.71% on y-o-y basis leaving a trade deficit of USD 12.12 billion. Labour intensive sectors such as garments, gems & jewellery, leather and carpets and also petroleum products which are the key export sectors, posted negative growth. Imports dropped for a sixth straight month through November by 12.7% reflecting continued weakness in domestic demand.

Non-food credit growth slumps to a 2-year low

After seeing a mild uptick in the month of October largely on account of festive demand and a special loan drive conducted by PSBs, non-food credit grew by an abysmal 7.5% on y-o-y basis in the fortnight ended 6th Dec 2019.

Uptick in inflation adds to woes

Adding to the economic conundrum was the November CPI print which came in at a 40 month high of 5.54%, mainly on account of sharp surge in food inflation (10% y-o-y). Vegetable prices continue to rise unabatedly rise, touching more than three year highs on y-o-y basis even as other non-food items such as pulses, milk, spices etc saw rising price pressures on annual basis during the month. Core inflation on the other hand remained subdued, recording an annual growth of 3.6%.



Inflation is expected to breach RBI's medium target range of 2%-6%on account of persistence in food inflation and upward revision in telecom tariffs

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Fixed Income Outlook

Fundamental View

The announcement of the special OMO helped bond markets recover from the huge sell off post monetary policy announcement with the 10 year yield retracing by 15 bps at the end of the fortnight. While the announcement is definitely a positive development as it clearly indicates RBI' s intent to cap to rise in yields (the same being counter-productive to the monetary easing process), sustained buybacks are required to induce confidence in the market. In the same context, markets may witness sharp volatility as the OMO operation adds to a host of conflicting factors that have been affecting the bond yields till now. Globally, the cues remain adverse to overall bond scenario as encouraging economic fundamentals have led to a sharp rise in US treasury yields. Crude prices near three month highs on back of optimism over US China trade deal and production cuts will also keep bond markets on the watch out. We expect the 10 year yield to trade in a range of 6.52% to 6.67% with volatility adding few bps on either side.

Technical View

6.45% GS 2029 yield settled at 6.60% on Friday's session. Yields traded volatile in the last fortnight amid RBI's surprise moves. Post Monetary Policy announcement, range breakout was witnessed in yields as it touched highs of 6.83%. However, Friday's gap down opening and follow up weakness there after indicates mild weakness to prevail in yields.

Currently 10 year yield is trading around Middle Bollinger band (20Day SMA) and momentum indicator RSI is placed at 48. Immediate resistance is placed around 6.65% level and immediate support is placed at 6.56% level, which was previous breakout/resistance level. Going forward, till yield is trading below 6.65% possibility of 6.55/6.56% seems bright. However, sustainability below 6.55% is necessary for resumption of weakness in yields. On higher side any sustenance above 6.65% levels will push markets to fill the recent gap.

7.26% GS 2029

The pulling power of 61.8% Fibonacci support has finally started to play out. 7.26 GOI 2029 observed good closing support at 101.70 due to 61.8% support in this medium term uptrend. This rally in G-sec initiated by operation twist, should take 7.26% GOI 2029 towards 6.71%.

Chart Source: Tickerplant

DATA CHECK

Key Events: Upcoming Fortnight		
Date	**India**	**US**
27-Dec	FX Reserves, USD	
30-Dec	RBI Monetary and Credit Information Review	Goods Trade Balance (Nov)
31-Dec	Federal Fiscal Deficit (Nov) Current Account	
02-Jan	Manufacturing PMI (Dec)	Manufacturing PMI (Dec)

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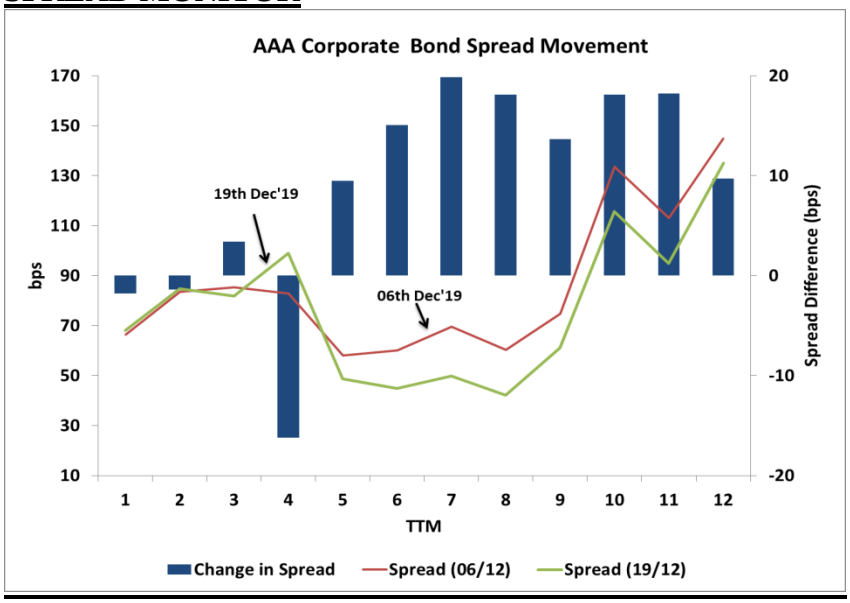
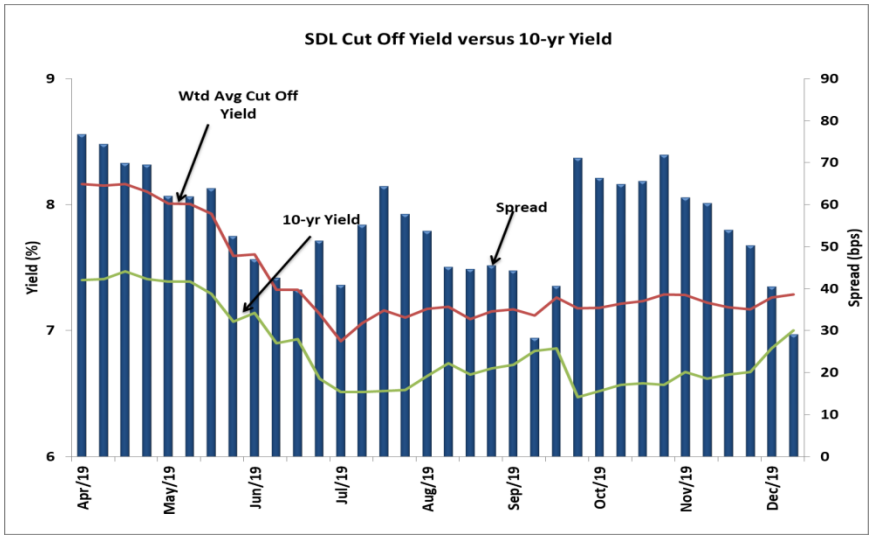
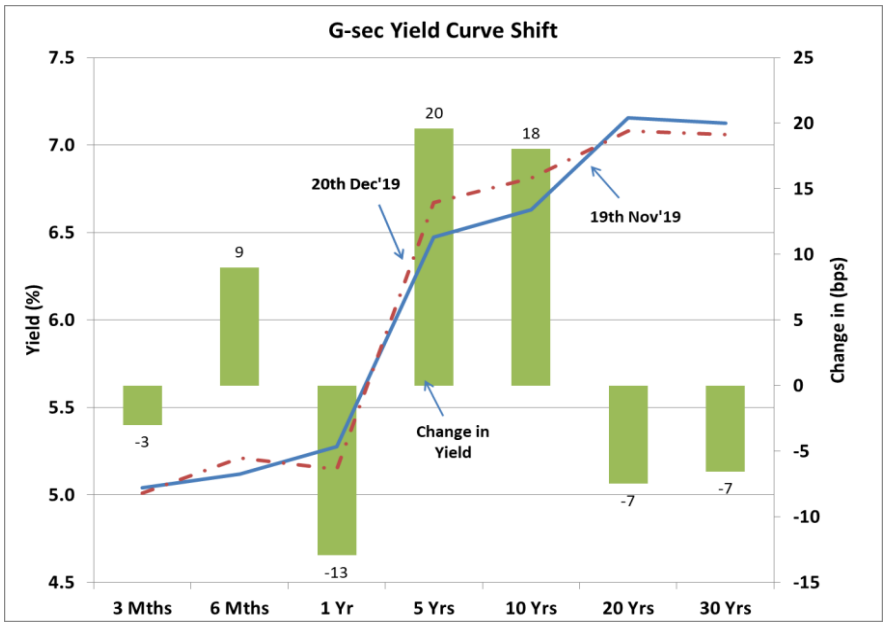
SPREAD MONITOR



Corporate bond and SDL spreads have narrowed on account of upward shift in the G-sec yield curve. Attractive valuations of SDLs are likely to cap rise in spreads.





Yield curve has remained steep despite easy liquidity conditions and RBI maintaining an accommodative stance. RBI aims to flatten the yield curve through special OMO operation.

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