6th January 2020

Vol: 7/2019-20

PNB GILTS LTD (Subsidiary of Punjab National Bank)

ECONOMY & GILT WATCH

INSIDE THE ISSUE

Global Bond Index: Is India ready?

The story so far

At the Bloomberg Global Economic Forum held in the month of September, Bloomberg offered to guide India in inclusion of Indian bonds in the global bond indices. This is not the first instance that the possibility of inclusion of domestic bonds in global bonds indices is being deliberated upon as the government has previously gone back and forth on the much debatable step of further opening up of the sovereign debt market to foreign players. Currently, with burgeoning government debt, an ambitious growth target set for the economy, decelerating domestic savings and investments, the talks of being a part of the global indices have once again taken the centre stage.

Why are global bond indices important?

A bond index is nothing but a benchmark that measures the performance of fixed-rate, local currency, investment-grade sovereign bonds. What makes these indices important is the fact that they are used in both active and passive fund management strategies in financial markets. While in active fund management, the index is used as a benchmark to measure performance, passive fund management entails replicating the performance of the index by tracking the specific market which is a part of the index. In other words, when a fund 'tracks' an index, it tries to converge its performance with that of the benchmark while minimizing the tracking error which can arise due to duration mismatches, transactions costs or liquidity consideration. This would ensure that the member country would get the allocations in accordance with its weight in the index. Amongst the important global indices are, Merrill Lynch Global Bond Index, JP Morgan Emerging Market Bond Index, Bloomberg Barclays Bond Index, Citi World Broad Investment-Grade Bond Index. Assets tracking the Bloomberg Barclays Bond index could be anywhere between USD 2 trillion to USD 2.5 trillion. The humongous money tracking the indices at a time when real yields are low to negative, makes a strong case for making domestic bonds a part of the global bond index. China has already set precedence in this case with the Chinese bonds being included in the Bloomberg Barclay Global Aggregate Index earlier in April this financial year. The inclusion will eventually take China's weight in the index to 6.03 percent in a phased manner till December 2020 and in response, the Chinese bond markets have seen nine successive months of net foreign inflows.

The advantage of being a part of global bond index at this juncture cannot be overstated as India looks forward to finance its growing debt even as it can boast to offer one of most compelling returns amongst global economies. The government's plan to give a INR 100 lakh crore of infrastructure spending push to the economy over a period of five years would require a large absorptive capacity for funding of the government debt. The domestic ability to finance such a huge debt certainly stands constrained in the face of declining domestic savings, making it imperative to explore alternative sources of financing. On the face of it, being party to the global bond index does sound like a panacea to India's economic problems, ranging from funding of the twin deficit, deepening of the corporate bond markets, raising the credibility of India as an investment destination etc. However, the rewards come with risks and riders that can have grave impact on the domestic economy. Firstly, to be a part of the bond index comes with meeting stringent prerequisites. The local currency debt market must be classified as investment grade, the currency must be freely tradable, convertible, hedge-able and free of capital controls etc. India meets some of these criterion including having a rule based monetary and fiscal policy framework, adequate levels of foreign exchange reserves and low external debt. However, in order to attract foreign inflows in a sustained way, serious reforms are required over a period of time such as easing of quotas on bond investments, greater transparency in financial markets and taxation laws etc.

Weighing the cons

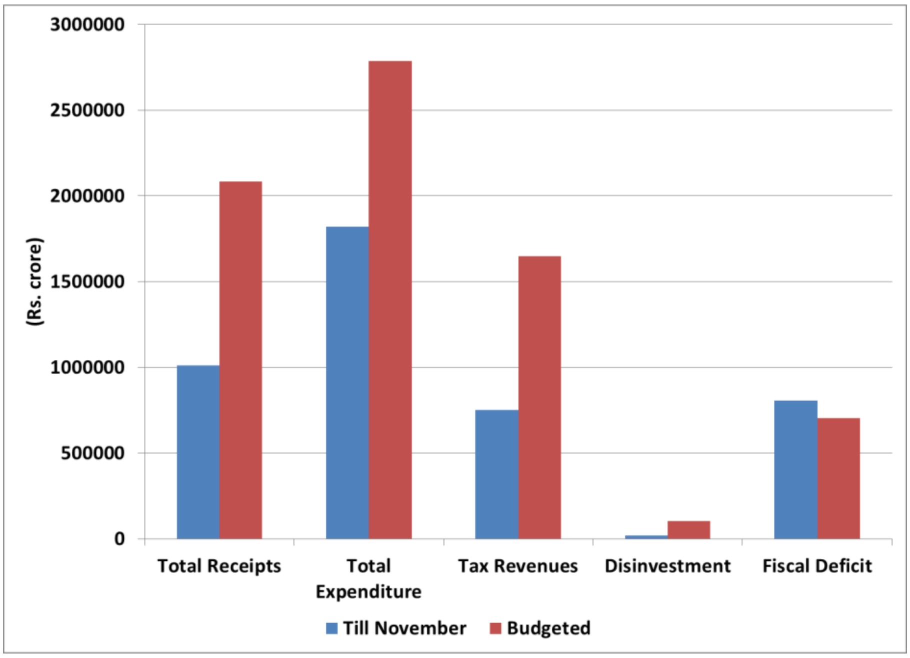
Talking about the risks that come with inclusion in the global bond indices, we need to note that foreign flows are hot money chasing high yielding assets and being a part of an index does not ensure permanency of such flows into the domestic markets. The volatility of flows can have severe repercussions on the currency and current account front as a depreciating INR will inflate the import bill leading to widening of the current account deficit. Further, one of the inclusions rules is full convertibility of rupee. Whether India is ready for full convertibility of rupee, is a serious policy matter with important implications for the economy. Emulating its Chinese peer in this case will not be easy given the structural differences in the two economies. China has the comfort of a current account surplus and a humongous forex reserve of USD 3.5 trillion. Also a pegged currency gives China more control over its financial system and does not leave it to the mercy of the volatile foreign flows.

Nonetheless, the idea of being included in the global bond index is the one that needs to be weighed with great considerations despite the risks and trade-offs. In the current context, attracting global investors requires sustained reforms and easing of restrictions and the same can facilitate the ambitious growth target and bold economic goals that India has set for itself for the coming years.

Fiscal Deficit at 114% of the target, CAD shrinks to 0.9%in Q2

The government finances continue to remain in a precarious situation as we approach the close of the financial year and the announcement of the Union Budget for the upcoming fiscal. As per the data released for the month of November, the fiscal deficit is already at 114% of the budgeted figure for FY20 as tax collections trail the projections by a sharp 52%. On y-o-y basis, the gross tax revenues have grown by a meagre 0.81% in the eight months till November as against projected y-o-y growth of 18%. The non tax revenues are also under stress as 84% of the disinvestment target is yet to be realised with a delay in the BPCL strategic stake sale likely to worsen the revenue side. The expenditure on the other hand was robust as government compensates for falling private expenditure in order to anchor economic growth. Both revenue and capital expenditure have met more than 60% of the year's budget. With a gaping hole on the revenue side and a slash in expenditures being counter- productive to the efforts towards fuelling growth, government is left with little options for managing its fiscal deficit situation.

On the other hand, the CAD showed an improvement declining to 0.9% of GDP in the second quarter of the fiscal year ending March 2020 from 2.9% in the same period a year ago. The contraction was primarily on account of a lower trade deficit at $38.1 billion as compared with $50.0 billion a year ago. Decline in trade deficit is mainly attributable to imports falling at a faster rate than exports due to weak manufacturing activity and lower imports of raw materials and capital goods.



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Fixed Income Outlook

Fundamental View

The announcement of three back to back special OMOs by RBI has given much needed breather to the bond markets. RBI has been successful in correcting the term structure to some extent and we may see further correction going forward with RBI targeting the 5-7 year segment also through OMOs apart from the 10-year segment. However, there has been an adverse turn of events in the geo-political outlook with US-Iran tension leading to a sharp spike in crude oil prices. The market would be on a wait and watch for further cues on the US-Iran front, while in the short run, the yield movement would be largely driven by OMO induced optimism. We expect the 10 year yield to trade in a range of 6.50% to 6.62% with an upward bias.

With regard to inflation, we expect the December CPI to come in at 6.70%. The pick-up in the food prices over the last month has been broad based. The trend which began with a spike in onion prices has spread over the entire food basket. With oil prices also firming up and hike in telecom tariffs kicking in, it looks like the firmness in prices is here to stay. Unfavorable base-effect is expected to add to the woes.

Technical View

Yield on 6.45% GS 2029 settled at 6.51% on Friday's session. Last fortnight yields traded weak as it slipped below previous breakout level of 6.56%. However, in last trading session 10 Year yield has formed bullish engulfing candle post a doji candle, indicating strength to commence above 6.52% level.

Momentum indicator RSI witnessed bounce, post touching important support of 40 and Bollinger's lower band is placed around 6.44% which also coincide with crucial support zone, as indicated in the chart. Going forward, if 10 Year yield sustains and close above 6.56% level, we may see range shift from 6.56%-6.49%/6.44% to 6.49%-6.62% zone.

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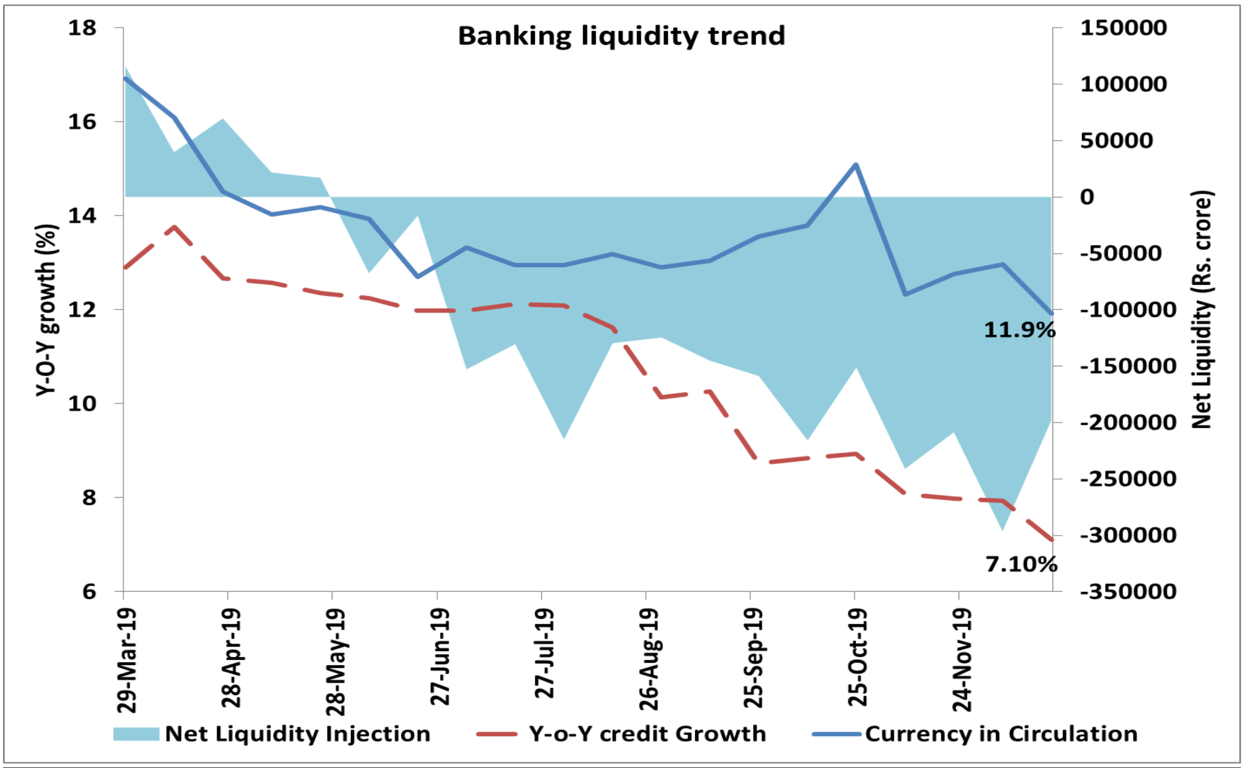
DATA CHECK

Key Events: Upcoming Fortnight		
Date	**India**	**US**
10-Jan	FX Reserves, USD	Unemployment Rate (Dec)
	Industrial Production YoY (Nov)	
	Manufacturing Output MoM (Nov)	
12-Jan	CPI YoY (Dec)	
14-Jan	WPI YoY (Dec)	CPI YoY (Dec)
15-Jan		PPI YoY (Dec)



Banking system is likely to remain flush with liquidity amid weak credit off-take and risk aversion. Redemption of government bonds has further increased the surplus leading to reverse repo absorptions of over Rs.4 lakh crore. We may see further rise in surplus with another tranche of government bonds (worth Rs.74,000 crore) due for redemption in the coming fortnight.

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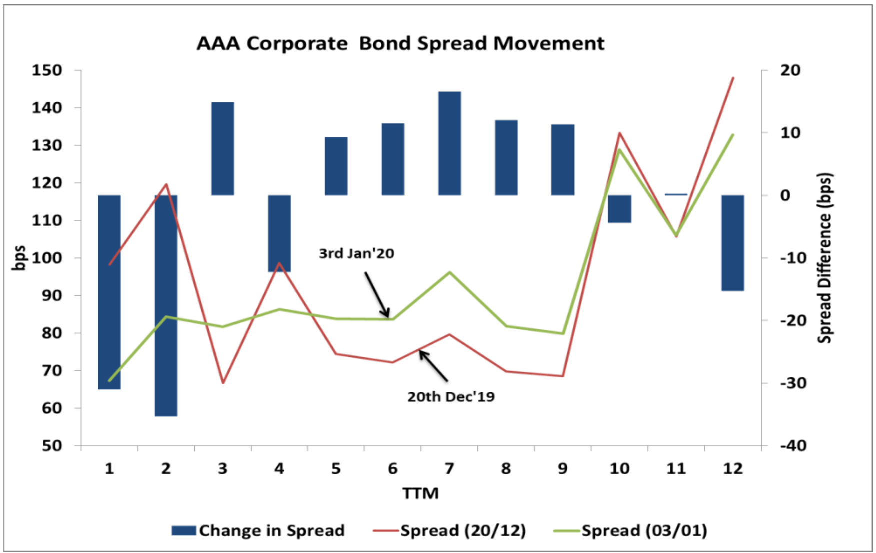
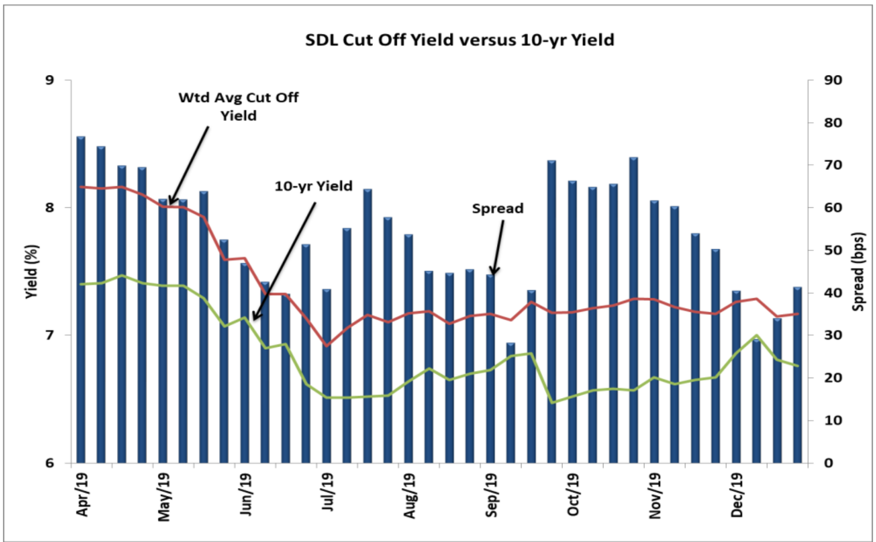
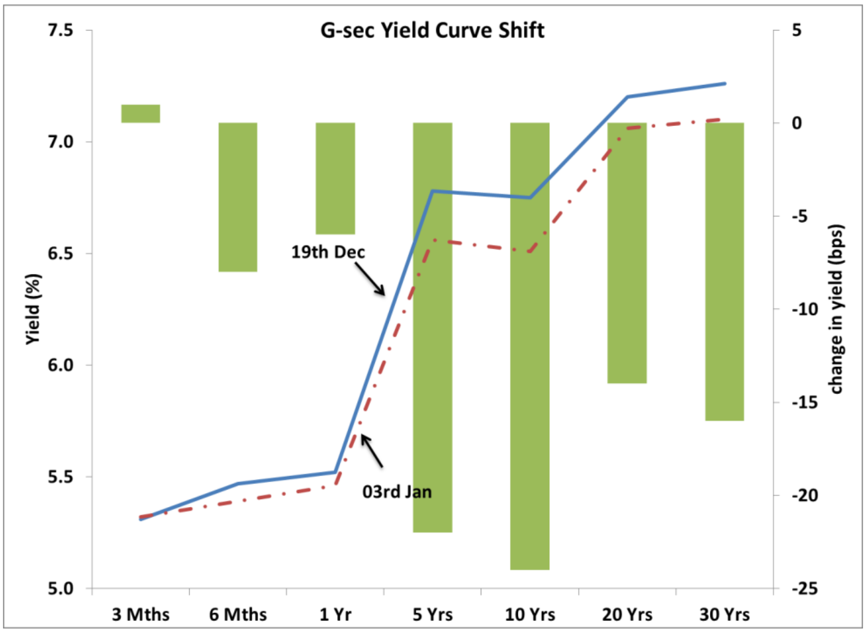
SPREAD MONITOR



Corporate bond spreads firmed up mildly while persistent demand in case of SDLs will keep spreads capped at around current levels.





Medium and long tenor yields have retraced as RBI announced three successive OMOs. Ample liquidity will keep short term rates sustained at lower levels, while OMOs will pull down the medium and long tenor yields further.

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