17th February 2020

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PNB GILTS LTD (Subsidiary of Punjab National Bank)

ECONOMY & GILT WATCH

Unconventional tools for unconventional times

The main highlight of the 6th bi monthly review of RBI's monetary policy held on 5th February2020 was not the policy outcome but the novel tools that the central bank deployed as part of its "Statement on Developmental and Regulatory policies" to target the monetary transmission process in the economy. So, a policy which was largely expected to be a non event with no change in policy rates surprisingly turned out to be a major event, leaving the market much enthused as the out of the box measures doled out by RBI only emphasize its deep concern for the ongoing slowdown in the economy. Prior to this, RBI resorted to unconventional tools like Operation Twist in December wherein it swapped long tenor securities with short dated securities in order to bring down the term premia. This time, RBI made a host of important announcements which include a) a revised liquidity management framework, b) Long term repo operations (LTRO), c) CRR exemptions to banks for lending to specific sectors with important multiplier effects.

New Liquidity Framework: Managing liquidity at the macro level

With the revised framework, RBI intends to streamline the current liquidity operations by doing away with day to day liquidity operations, while at the same time assuring the market that the liquidity will be duly managed though at a macro level. According to the new framework, RBI shall now conduct fortnightly Repo ***or*** Reverse Repo operations (as warranted by the state of liquidity in the system) through variable rate auctions as against the daily fixed Repo ***and*** Reverse operations conducted till now. This 14 day operation shall be the main tool for managing frictional liquidity in the system it will be supplemented with *discretionary* fine tuning operations which could be overnight and/or longer, to address any unanticipated liquidity changes. **While in the current situation of excessive surplus liquidity (along with the forward guidance of maintaining an accommodative stance), the fortnightly operations may not lead to significant reactions in the money market, the same may result in uncertainty in times of liquidity deficit and we may witness increased fluctuations in the WACR which is the operating target rate.**

INSIDE THE ISSUE

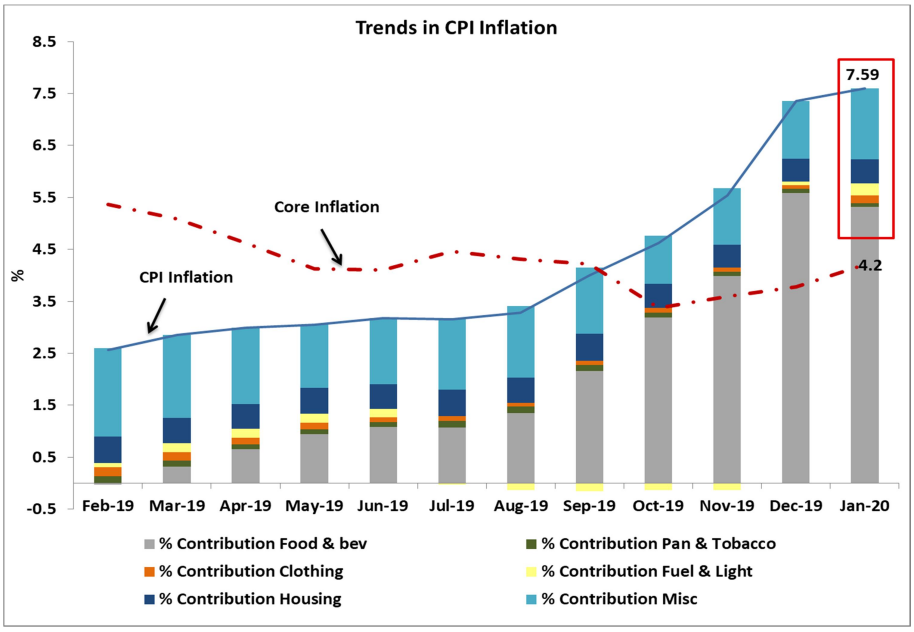
LTRO: A push to credit creation

The announcement of LTRO was received with much vigour by the markets as it implies RBIs intent to keep the interest rate scenario benign for an extended period to support economic recovery. According to the scheme, RBI shall provide durable liquidity in the system by extending 1 year and 3 year loans to banks upto Rs. 1 lakh crore at a pre-defined rate which is the prevailing policy rate. With this, RBI aims to expedite monetary transmission in the economy by providing assured funds to banks and thereby give a push to credit off take. While the funding push to banks will feed into lower rates at the short end of the sovereign curve, it is also likely to lower yields on corporate bonds, deposit rates and lending rates for banks. Additionally banks have been incentivised by way of NDTL exemption on incremental retail loans to automobiles, residential housing, and loans to micro, small and medium enterprises. RBI has also extended the scope of external benchmark linked loans and restructuring benefits for MSMEs and commercial real estate which is expected to open credit channels to these sectors. Broadly, by announcing these measures RBI has once again taken the onus to revive economic growth in a non-traditional way. Whether the steps will help meet the end objective of credit creation and triggering demand in the economy will be seen in the days to come.

Economic Data Update

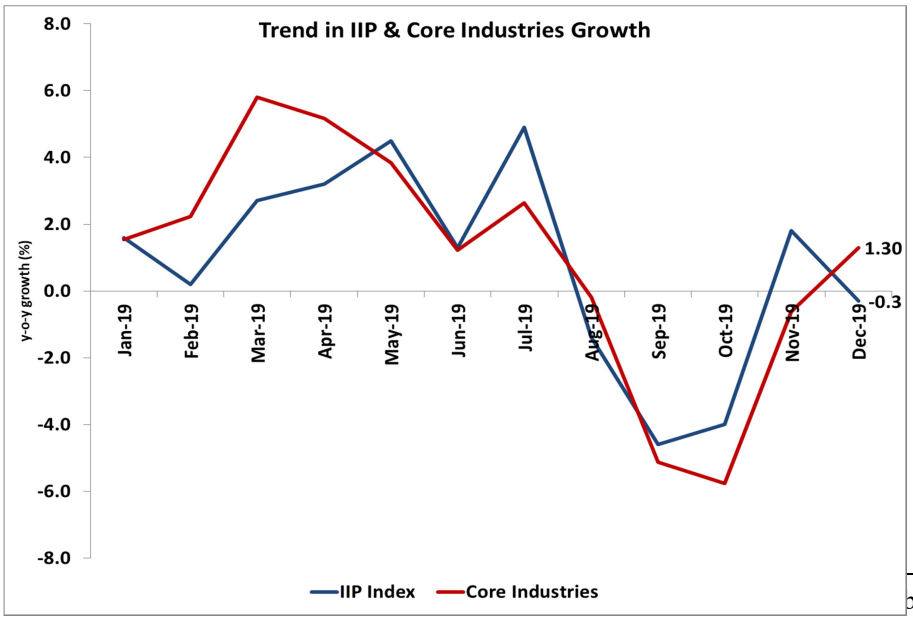
CPI inflation surges to 7.59%, IIP shrinks by 0.3%

Economic data continues to display discomfiting trend with CPI inflation surging to a 68 month high in the month of January mainly driven by an uptick in core inflation even as food inflation continues to remain at elevated levels. Core inflation recorded y-o-y rise of 4.2% vis-à-vis 3.8% in December driven by transport and communication, personal care, clothing and footwear etc. Food price inflation for January 2020 stood at 13.63% modestly down from 14.19% seen in December 2019. In food basket, vegetable prices continued to show the highest growth in prices with an inflation rate of 50.19%, followed by pulses and products at 16.71%. Costs for protein products like meat, fish and eggs also remained above 10% during January 2020. Interestingly, rural inflation at 7.73% exceeded urban inflation at 7.39% for the first time in 19 months which hints towards green-shoots in demand in the rural economy. Going forward, though CPI inflation has likely peaked, cooling off of food prices is likely to be offset by broad based rise in prices of other food items which is expected to keep CPI inflation above the 6% mark in the coming months.

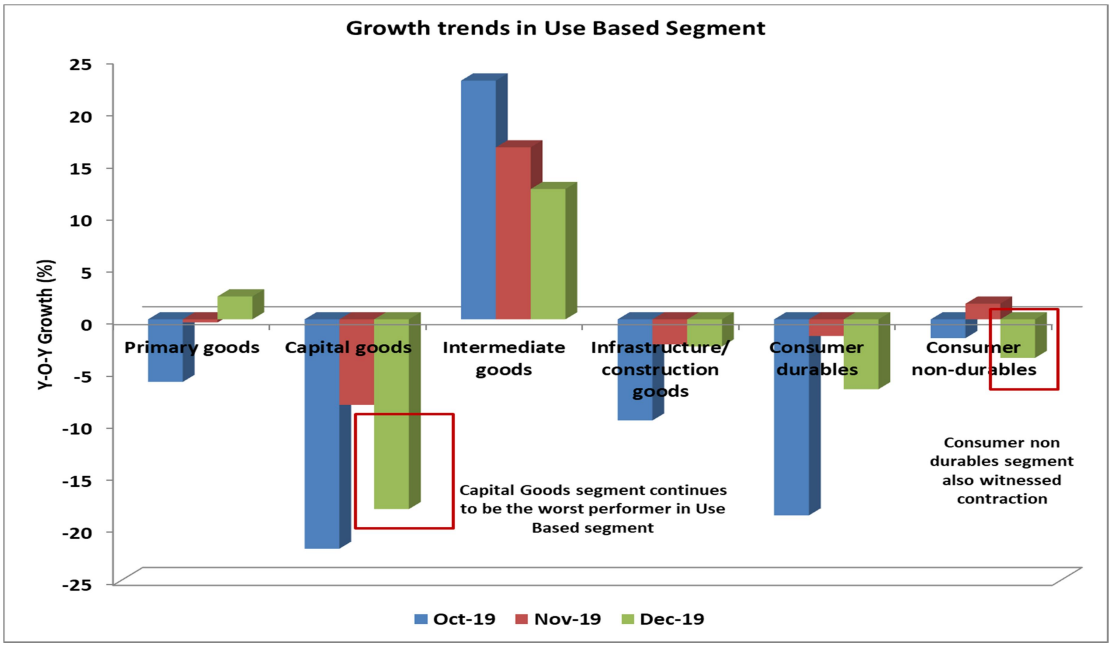


Rising contribution of miscellaneous items and rising core inflation vindicate fears of inflation becoming generalised in nature.

On the other hand IIP growth slipped back into the negative territory showing a contraction of 0.3% in the month of December pulled down by manufacturing (-1.2% growth in December). The output of 16 of the 23 industry groups in the manufacturing segment – which makes up over 75% of the index – contracted in December 2019. Mining sector on the other hand witnessed a growth of 5.4% while the contraction in electricity generation narrowed down to -0.1% vis-à-vis -5% in the month of November. Trends in used based segment continue to reflect a sobering picture of consumer and investment demand in the economy. Growth in capital goods segment contracted by 18.2%, while growth in intermediate goods segment slowed to 12.5% in December as against 16.5% in November. Consumer durable and non-durable goods segments also witnessed contraction of 6.7% and 3.7% respectively.



Contraction in IIP growth driven by continued broad based decline in manufacturing activity continues to remain a cause for concern. The on-going risk aversion due to spread of Coronavirus also does not bode well for domestic manufacturing.



Fixed Income Outlook

Fundamental View

The previous fortnight saw bond markets rallying sharply as RBI took additional steps to bring down interest rates and expedite the monetary transmission process in the economy. Bond markets reacted instantly with short term yields coming off sharply as RBI's intent to keep interest rates "lower for longer" became even more apparent with announcement of LTRO. A global risk off scenario emanating from continued gloom over Coronavirus contagion further added to the positive sentiments in the bond market. There was substantial FPI buying aggregating to Rs. 12,663 crore in the last fortnight. Going forward, bond market is expected to remain buoyant in absence of any supply even as continued uncertainty over the impact of Coronavirus is expected to keep oil prices depressed and demand for safe haven assets elevated. The 10 yr paper is expected to outperform the market in the coming fortnight and is likely to trade in the range of 6.32% to 6.42%.

Technical View

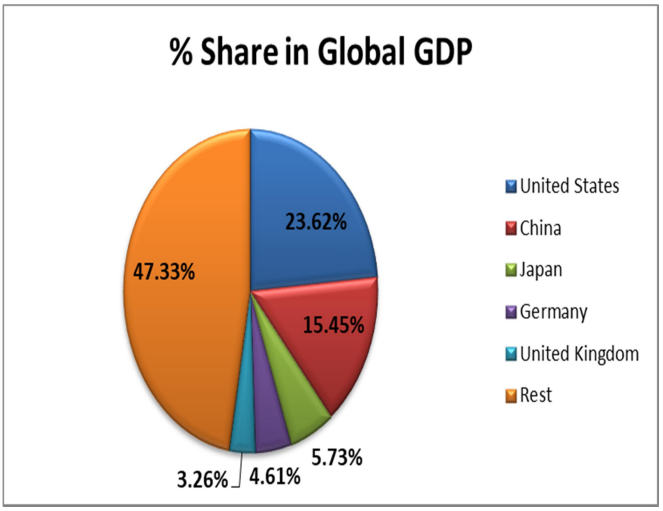
Yield on 6.45% GS 2029 settled at 6.37% on Friday's session. As discussed in last newsletter any sustainability below 6.48% can lead to target of 6.40% and below. The same was witnessed in last fortnight as benchmark moved swiftly towards the mentioned level. Currently 10 yr yield is trading around lower Bollinger band with RSI on verge to enter into oversold territory. Going forward till benchmark yield is trading below 6.40% we may see

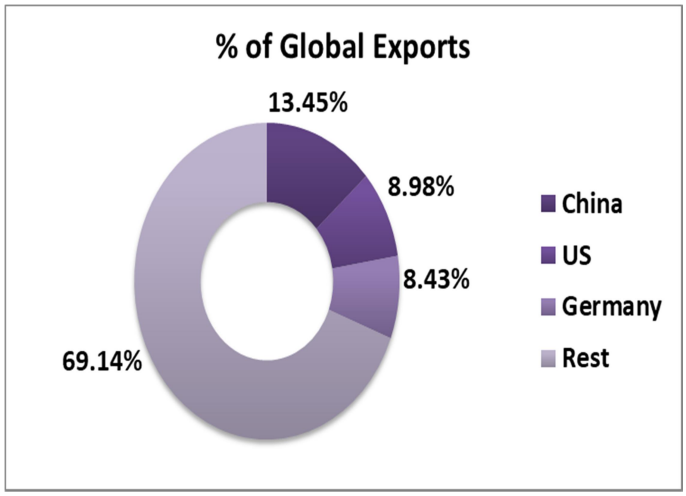
further slide towards 6.34% and 6.25% levels. On higher side 6.40%/6.45% will act as crucial resistance zone from here on.

Chart source: Investing.com

China in Global Economy:

- China's contribution to GDP few decades earlier: 4-5%.
- Did not play a major role in Global supply chains
- At present, contribution of China to Global GDP: 17-18%
- A major exporter of raw materials to Electronics, White goods, Power sectors and others.





Coronavirus Impact on China:
Production, Logistics, Retail and Services Sectors are heavily impacted; Factories and companies have been shut down

India and China Linkage:

- China is India's second largest trading partner
- China's exports to India: 13.7% of India's total Imports
- India's exports to China: 5.1% of India's total exports

Coronavirus Impact on India:

- *Advantages:* Accelerate Make in India, develop manufacturing sector rather than just assembly system, work towards ease of business and lower labour costs and encourage export
- *Disadvantages:* Dependence on China's raw materials in electronics, white goods and power sectors. Q1 will not be impacted as companies have stocked up due to Chinese New Year Holidays in Feb. But Q2 may see supply and manufacturing disruptions.

Coronavirus: Contagion Effect

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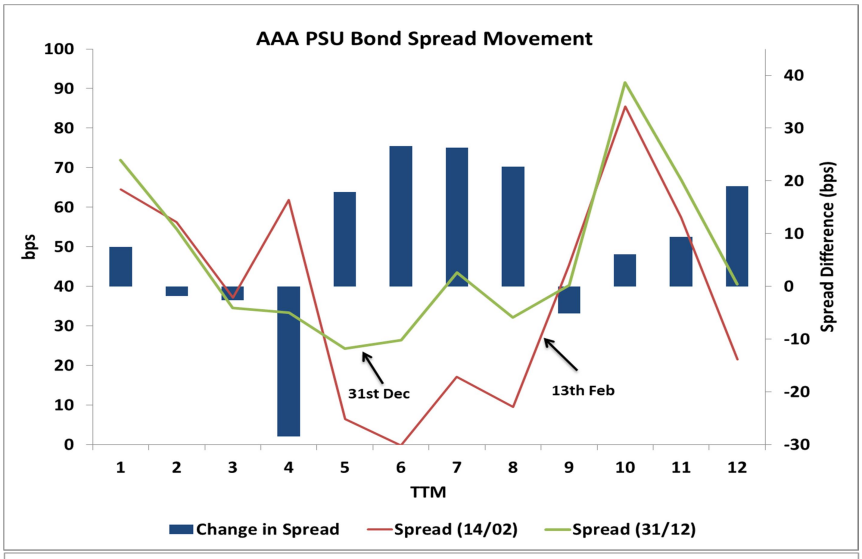
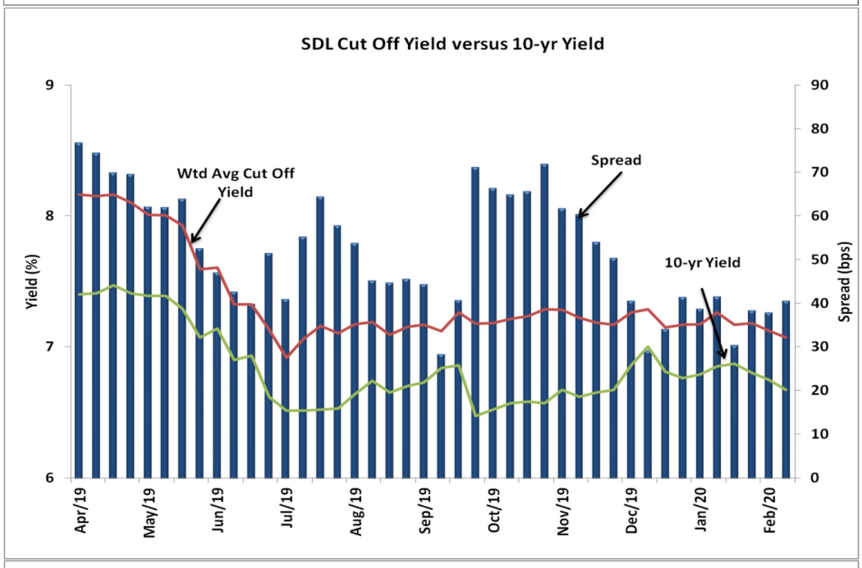
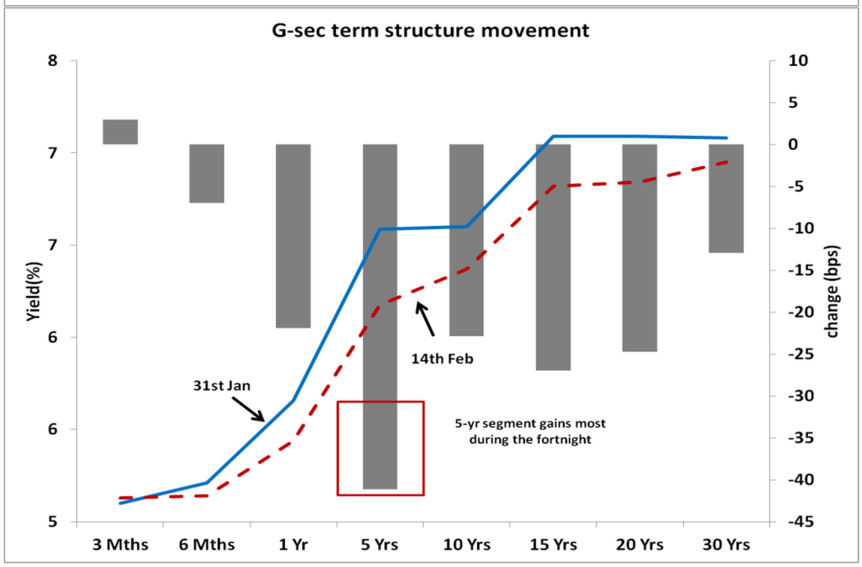
SPREAD MONITOR







The rally in the G-sec market is expected to extend to the SDL and corporate bond segments and we may see compression of spreads going forward.

With RBI's intent to keep interest rates "lower for longer" becoming even more apparent with the introduction of LTRO, the term structure is likely to see further flattening in coming days. A favourable global scenario also bodes well for the domestic bond markets.

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