17th March 2020

Vol: 12/2019-20

PNB GILTS LTD (Subsidiary of Punjab National Bank)

ECONOMY & GILT WATCH

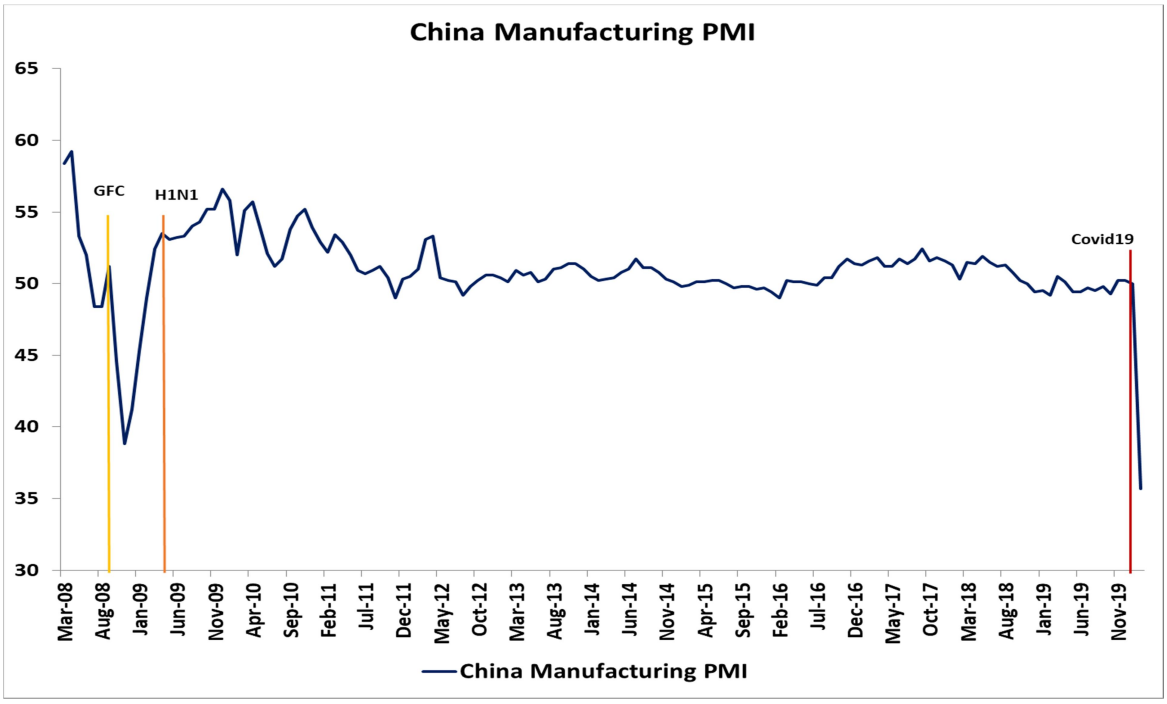
Economic Fallout of a Virus Contagion

The world is going through unprecedented times. All countries are in grip of a flu trying to fight it off with a monetary pill. Financial markets across the world are bleeding and the volatilities have returned to the levels last seen during the GFC. The Federal Reserve slashed its benchmark rate by a full percentage point to near zero in yet another emergency move on Sunday. It has also announced a massive asset purchase program of USD 700 bn comprising of treasuries and mortgage backed securities. Synchronizing its move with the Fed, Australian central bank joined in by pumping extra liquidity into a strained financial system while, the Bank of Japan stepped in by easing monetary policy further in an emergency meeting, ramping up purchases of exchange-traded funds and other risky assets. Such extraordinary monetary measures are clearly reminiscent of the monetary expansion undertaken during the GFC.

A Real Sector Crisis

The risk of a medical contagion hitting the real sector with such a magnitude was to a large extent unforeseen. The crisis has impacted the economies at several points inducing both supply and demand side shocks. China, which is the epicentre of the ongoing crisis, has an important place in the global supply chain especially in the electronics, automobiles, machinery and other capital goods. With production coming to a halt in China, the supply chains have been disrupted which will have a negative spill over impact on the rest of the economies. Further, there will be negative externalities of the containment measures being undertaken across the world in order to restrict the spread of the virus. This will be felt through thinning supply of labour and consequent reduction in capacity utilisation.

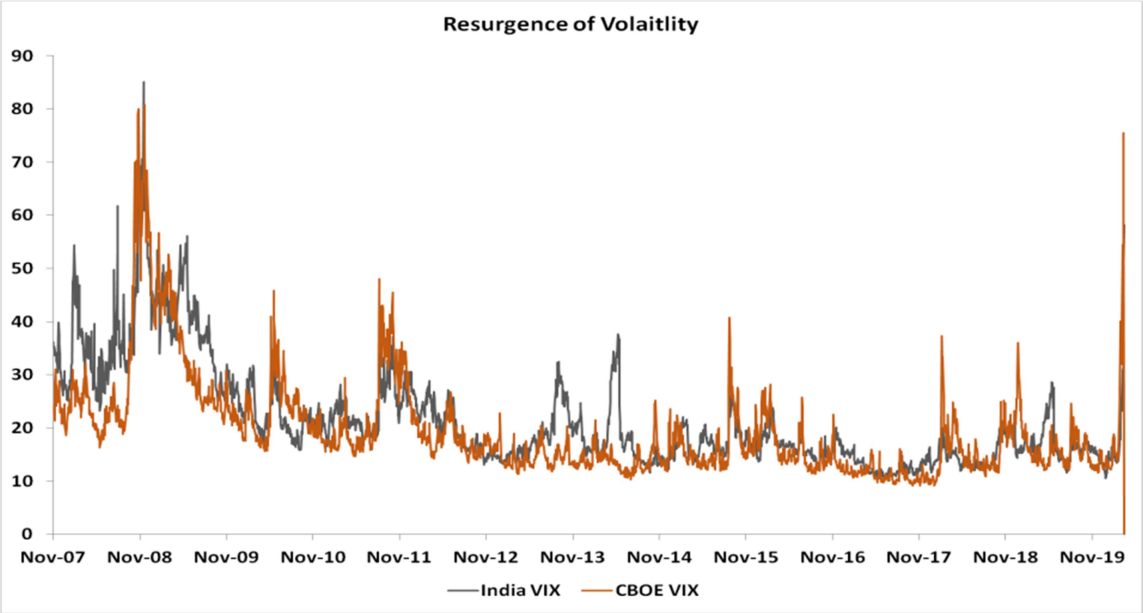
INSIDE THE ISSUE



On the other hand, the demand side will also see shocks emanating from income uncertainties and a general wait and watch behavior which will lead to restricted household and business spending. This behaviour is clearly reflected by a sharp drop in travel and hotel bookings. Leading indicators like the Purchasing Manager Indices (PMIs) for both manufacturing and services are also significantly down. This worsening of consumer and business sentiment can push the global economy in the vicious circle of poor investment and demand thereby causing protracted stagnation.

Spillover to the Financial Sector

The reaction in the financial markets has been sharp and ruthless as they portend the crisis to spill over to the financial sector. The household and corporate distress may result in tightening of credit which will further exacerbate the demand and supply shocks in the economy. Banks will likely face deterioration of credit quality as business cash flows become increasingly uncertain leading to rise in borrowing costs. The domestic demand shocks can further, through international trade and financial linkages lead to a synchronized downturn in the global economy.



How will monetary & fiscal response help?

The coordinated response of the global central banks is a testimony to the fact that this crisis can have prolonged impact on the global economy. Whether the spread of the virus is transient or stretched, it is important to keep the confidence alive by assuring flow of money in the economy and arresting distress in the financial sector. Additionally there could be direct measures such as cash transfers, tax breaks, income support to offset job losses to support affected businesses and households.

What it means for the Indian economy?

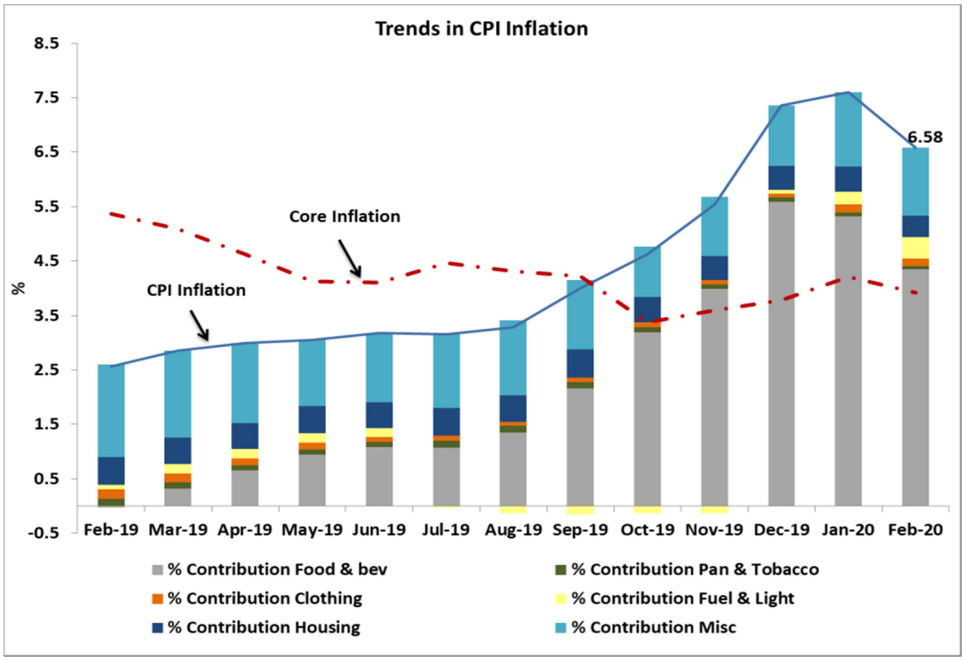
India is by no means immune to the current pandemic and the economic spillovers of the ongoing crisis. Though India's link with the global economy is limited due to low reliance on exports, the crisis has hit at a time when domestic economy was stuttering amid weak investment and consumer demand. The spread of the virus in India has remained contained till now, but there is a palpable decline in consumer confidence even as supply side has started to see the strain in some sectors such as pharma, chemicals, electronics etc. On the monetary front, the dramatic fall in crude oil prices will keep inflationary expectations in check, opening space for rate cuts. RBI has already announced yet another leg of long term repo operations in order to maintain ample liquidity in the system. On the fiscal front, albeit

there is limited space, but a fiscal response will become crucial in order to cutback the knock on effects of the crisis on the real economy.

Economic Data Update

CPI inflation softens to 6.58%, IIP growth posts a rebound to 2%

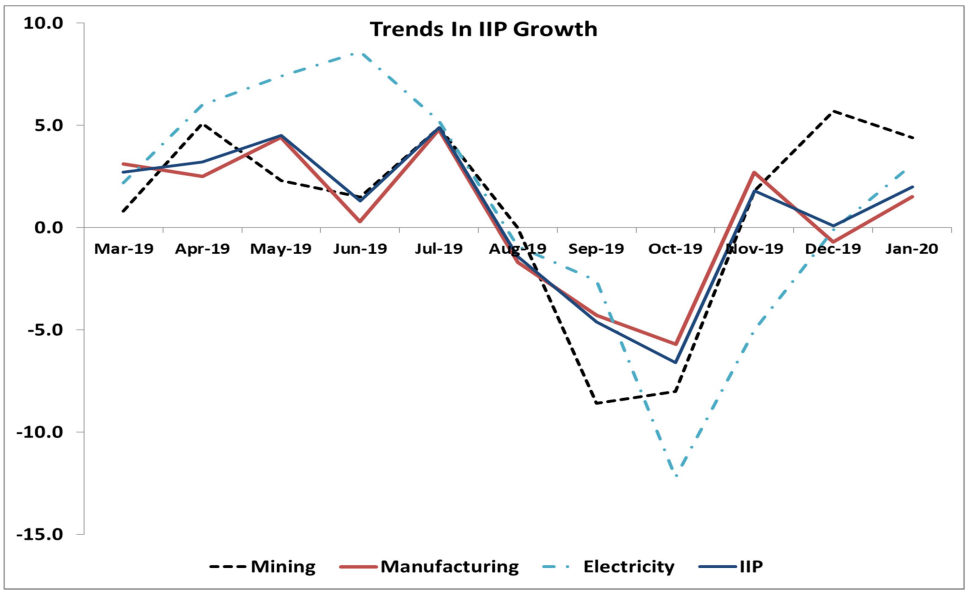
The CPI inflation eased from a 68 month high to 6.58% in February largely on account of decline in food prices. Inflation for food & beverages segment, which has the highest weight in the CPI basket declined to single digits (9.5% in Feb as against 11.7% in Jan) as prices of vegetable came off substantially even as protein based food items witnessed some contraction in prices. Miscellaneous items also witnessed softening of price pressures with inflation in the segment easing to 4.5% in Feb as against 4.7% in Jan. On the other hand core inflation remained steady at 4%. Going forward, the outlook for inflation seems likely to have taken a turn as the ongoing crisis starts to have a dampening effect on demand while decline in food and fuel prices will further have favorable impact on overall inflation scenario.



CPI inflation falls for the first time in seven months as food prices cool off in January. Further easing of inflation is likely on account of waning of demand pressures & the recent fall in oil prices

The IIP growth data surprised on the upside, posting y-o-y growth of 2% in January mainly driven by an uptick in electricity and manufacturing output. In January, electricity output grew by 3.1% and manufacturing recorded a growth of 1.5%, while growth of mining stood at slightly lower at 4.4%. However the used based segment data continues to remain discouraging as capital & infrastructure goods and consumer durable & non durable goods segment exhibit a contractionary trend. The outlook for industrial production remains bleak despite the mild revival witnessed in the month of January as uncertainty in the global investment scenario, disruption in global supply chains and likely waning of consumer

demand amidst the ongoing Covid19 crisis induce a knock on effect on the domestic manufacturing.



Fixed Income Outlook

Fundamental View

The previous fortnight saw the 10-yr yield plunge to 11 year lows as the ongoing Covid crisis wrecked havoc in financial markets pushing US 10-yr yield to historic lows. While the crude oil markets also roiled due to triggering of oil price war between the two largest oil producers. The period was also marked with synchronized monetary measures by central banks of Developed Economies led by the US Fed which slashed its benchmark rate by 150 bps to near zero levels apart from announcing massive asset purchase program. There has been sharp increase in volatilities across financial markets as global economic scenario turns increasingly uncertain with the rising Covid contagion. RBI too held an emergency meet on 16th March and announced another leg of LTRO for Rs. 1 lakh crore but refrained from announcing an inter policy rate cut. The G-sec market in the current scenario will witness volatility swaying between expectations of rate cut and a likely fiscal stimulus to contain the negative impact of the crisis. The market has already priced in a rate cut as a decline in inflation and depressed crude oil prices open space for monetary easing. Going forward, volatility is likely to remain high and yields can move sharply in either direction triggered by domestic and global cues.

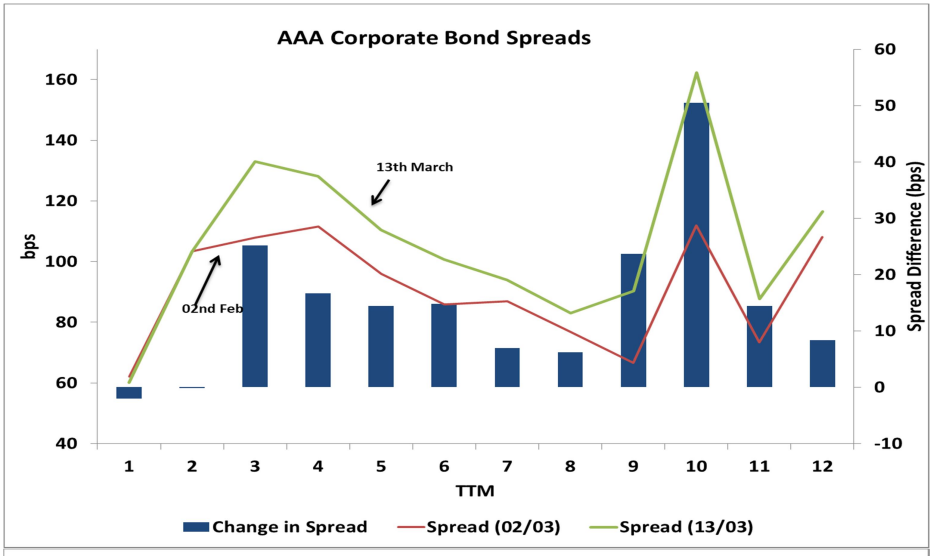
Technical View

6.45% GS 2029 Yield settled at 6.21% on Monday's session. Last fortnight benchmark Yield resumed its lower low, lower high formation and touched lows of 5.995%. However, soon thereafter sharp pull back was witnessed in it, as it tested recent breakdown level of 6.34%.

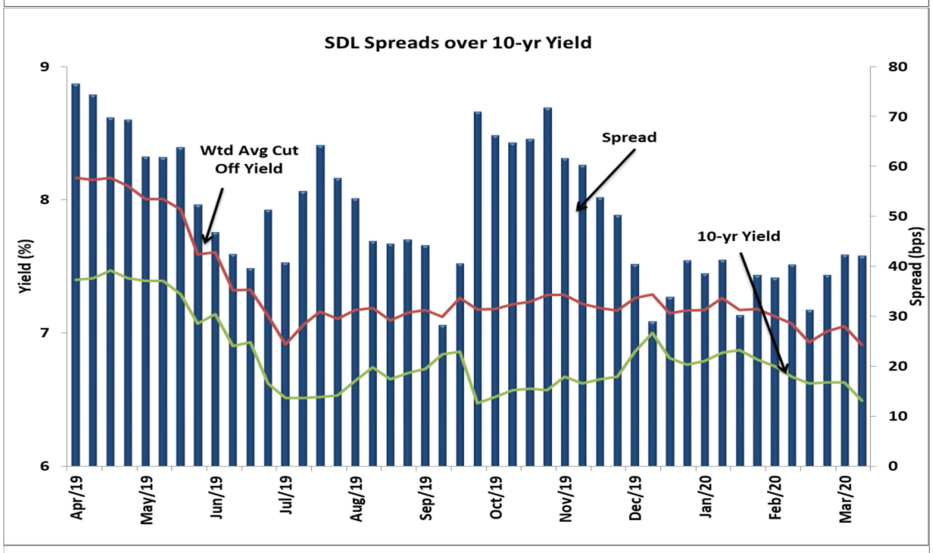
Momentum indicator RSI bounced back from oversold zone and currently hovering around 40 level. Short term resistance is placed at 6.34-6.35%, which coincide with 30 EMA zone indicating crucial supply/resistance zone from hereon. On lower side 6.10% will act as an immediate support area. Going forward, till benchmark is trading below 6.35%, bears will dominate the trend and they will try to take yield towards 6.10% and lower.

Chart source: Investing.com

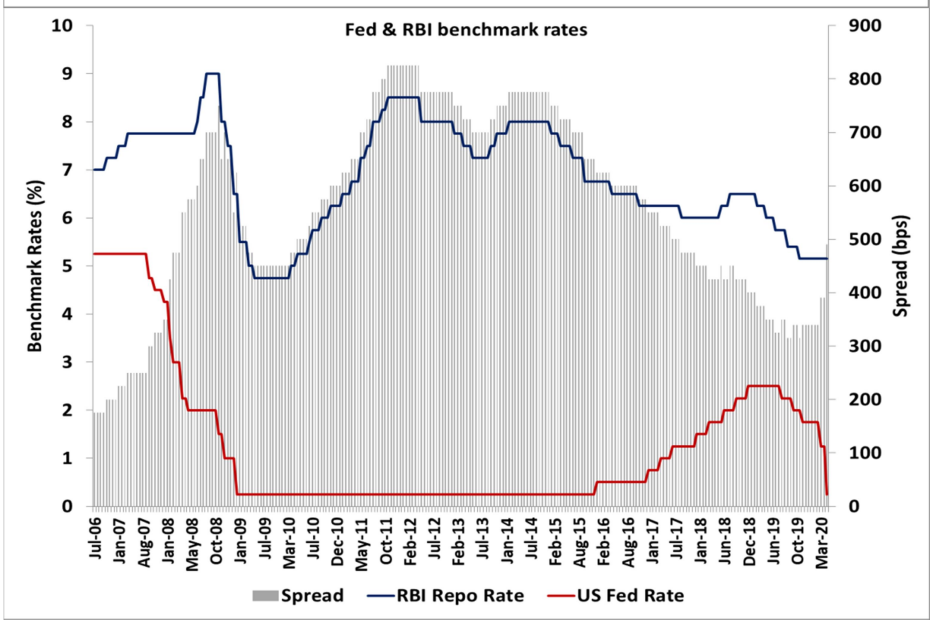
SPREAD MONITOR



Corporate Bond spreads have witnessed a spike as deteriorating growth outlook and global uncertainty raises concerns of corporate balance sheets coming under stress



A worsening scenario for state finances and additional borrowing concerns is likely to exert upward pressure on spreads on State Development Loans



Further intensification of the on-going Covid crisis is likely to entail monetary response by RBI

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