26th May 2020

Vol: 05/2020-21

PNB GILTS LTD (Subsidiary of Punjab National Bank)

ECONOMY & GILT WATCH

RBI steps in after fiscal dampener

In a second unscheduled policy move, RBI slashed the policy rates by 40 bps on 22nd May, almost two weeks ahead of the bi monthly MPC meet that was due on 5th June'20. The policy statement clearly spells out that the "acute stress" in the economy warrants front loading of the incremental rate cuts, while at the same time keeping some head room for supporting economic recovery as and when it takes place. With the reduction in the policy rates, the repo & reverse repo rate now stand at 4% and 3.35% respectively. The MPC stance continues to remain accommodative in order to revive economic growth. Taking cognizance of the continued stress in the economy, RBI announced a slew of fresh policy measures to ease the pain in the financial system.

Growth & inflation outlook: Precarious & uncertain

RBI's outlook for growth is sobering and once again it has refrained from providing any projections on both inflation as well as growth numbers. However, the RBI Governor has pointed out in his speech that that GDP may contract in FY 21. RBI expects economic activity to pick up not before Q3 and gain momentum in Q4 as the base effect kicks in along with probable easing of lockdown measures. Of course any revival in economic activity is strongly hinged onto demand and supply chains being restored to normalcy while downside risks to domestic growth remain significant. On the inflation front, the outlook continues to remain hazy as price dynamics pivot around probable supply side disruptions and slowing demand in the economy. The headline inflation number is expected to stay below the MPC target in the second half of FY21 on likely easing of supply side disruptions.

INSIDE THE ISSUE

Covid measures 3.0

Covid measures 3.0 reinforce RBI's commitment to support normal functioning of the financial system and easing the buildup of financial stress due to Covid disruptions. As per the third round of measures, the moratorium period on term loans outstanding as on 31st March'20 has been extended by another three months till August'20. Further, with respect to interest on WC facilities sanctioned in form of cash credit/ overdraft, lending institutions have been allowed a deferment of another three months. The accumulated interest on such WC loans shall be converted into a funded interest term loan which shall be repayable by the end of the current financial year. As was done earlier, the moratorium availed by the borrowers will not result in an asset classification downgrade. The 90-day NPA norm for all standard accounts which have been granted moratorium shall exclude the period of moratorium. RBI has also announced some measures to ease working capital financing such as reduction of margin and recalculation of drawing power till 31st August 2020.

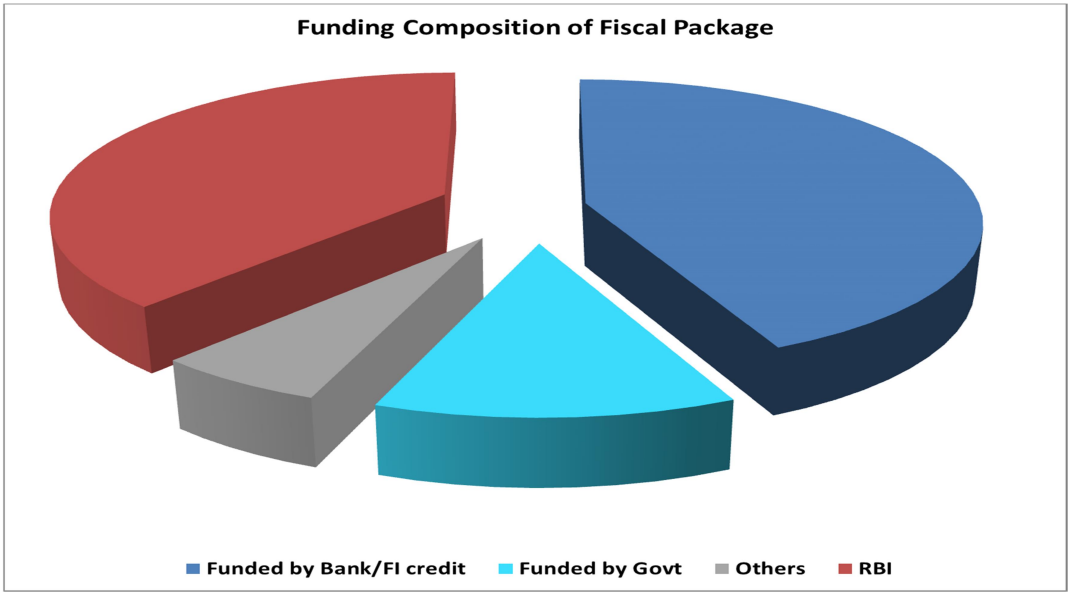
RBI also took some more steps to ease constraints on market participants and enhance liquidity flow in the economy. Under this, the 90 day refinance availment period for SIDBI for ₹ 15,000 crore has been allowed to be rolled over by another 90 days. Relaxation has also been provided to FPIs for investment under the Voluntary Retention Route and now FPIs can fulfill the condition of investing 75% of the allotted limits in a period of six months as against three month prescribed earlier. RBI has also taken some measures to provide support to the sagging exports by permitting an increase in the maximum permissible period of pre-shipment and post shipment export credit sanctioned by banks from existing 1 year to 15 months for all the disbursements made up to 31st July, 2020. RBI has decided to extend a line of credit of ₹ 15,000 crore to EXIM bank for 90 days (with a rollover of maximum 1 year) for facilitating US dollar swap to meet foreign exchange requirements.

Finally, in order to ease the stress on State finances, RBI relaxed withdrawal norms related to the Consolidated Sinking Fund or the CSF with immediate effect till 31st March 2021. State governments maintain CSF with RBI as a buffer for repayment of their liabilities. As per the scheme, State governments can contribute 1-3% of the outstanding market loans every year to the fund. These relaxations to states will release an additional amount of about ₹13,300 crore. Together with the normally permissible withdrawal, this measure will enable the states to meet about 45% of their redemptions due in FY 2020-21 through withdrawal from CSF.

Summing Up

RBI has been proactively using monetary and non-monetary tools to offset the collapse in economic activity. The lowering of interest rates assumes

even more importance as a major part of the fiscal measures announced by the government are being routed through bank and FI credit to different sectors of the economy. However, from bond markets' perspective, a depreciating rupee and low interest rates do not augur well, as higher hedging costs and lower returns reduce the attractiveness of Indian bonds for foreign investors. As such, we have seen heavy selling by FIIs in the bond markets with FIIs offloading Indian debt by ₹ 32,000 crore in FY21. Nonetheless, RBI has explicitly stated in its policy statement that the fiscal measures will play an important role in revival of the economy and the central bank shall support smooth completion of borrowing program for both Centre and the States which should give comfort to the bond markets.



Fixed Income Outlook

Fundamental View

In the last fortnight, bond markets were surprised by yet another unscheduled policy move by RBI in which the policy rates were reduced further by 40 bps. The reaction was however slightly muted as the rate cuts offer little solace amidst concerns of heavy G-sec supplies. Nonetheless, the scenario for bond markets remains positive as RBI projects an extremely gloomy picture of the economy for the current financial year and the central bank is widely expected to support the government borrowing program and prevent any disruptions in the bond markets. Continuous selling by FIIs will be a reason for worry for the bond markets which could be further exacerbated with depreciation of rupee. We expect yields to trade with an easing bias with yield on 6.45% GS 2029 to trade in the range of 5.80% to 6.00%.

Technical View

Analyst1: 6.45% GD 2029 yield settled weak at 5.96% on Friday's session. Last fortnight 10 year yield traded with downward bias, as it sustained below crucial support level of 6.06%. However, in last trading session 10 Yr yield has formed a hammer candle, indicating pause to the current downward bias, if it holds above the immediate resistance level of 6.00%/6.03%. Momentum indicator RSI is showing slight divergence on EOD charts, indicating markets may renter into consolidation phase if it sustains above 6.03% zone. Major support level is placed at 5.92%. Going forward, more the 10yr yield will spend time below 6%, greater the probability of it touching further lows.

Chart source: Investing.com

Analyst 2: In our previous fortnight view, we have mentioned that any downside retracement from 6.30% in 6.45% GOI 2029 should be considered as a buy signal. The paper has instead touched 6.28% and swiftly travelled down without giving much scope to buy around 6.30% to 6.25% levels. Now post the RBI's rate action on Friday, 6.45% GOI 2029 managed to touch a low of 5.85% intraday and closed towards 5.96%. This weekly closure below 6% is a good signal for bulls and as per technicals, now 6.45% GOI 2029 has the potential to move towards 5.75% (first support level at 5.89%) with an ultimate stop-loss at 6.12%.

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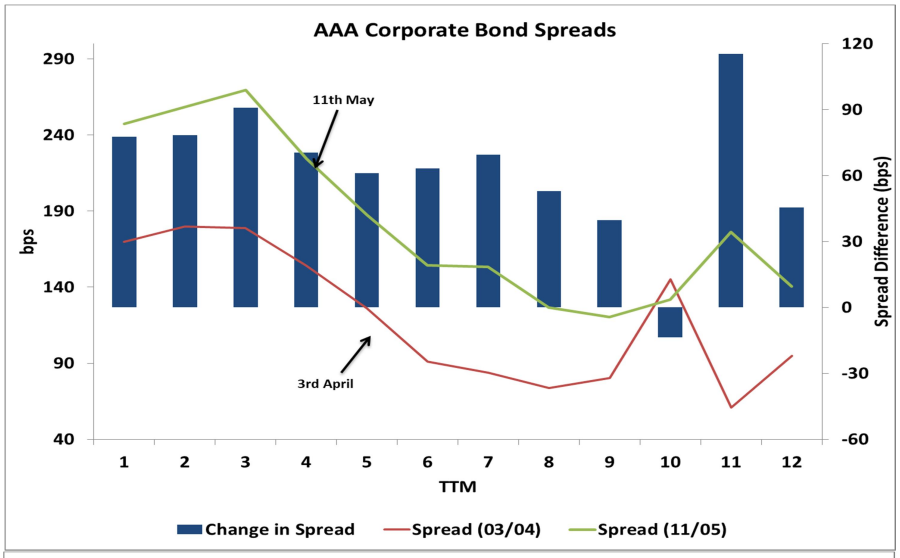
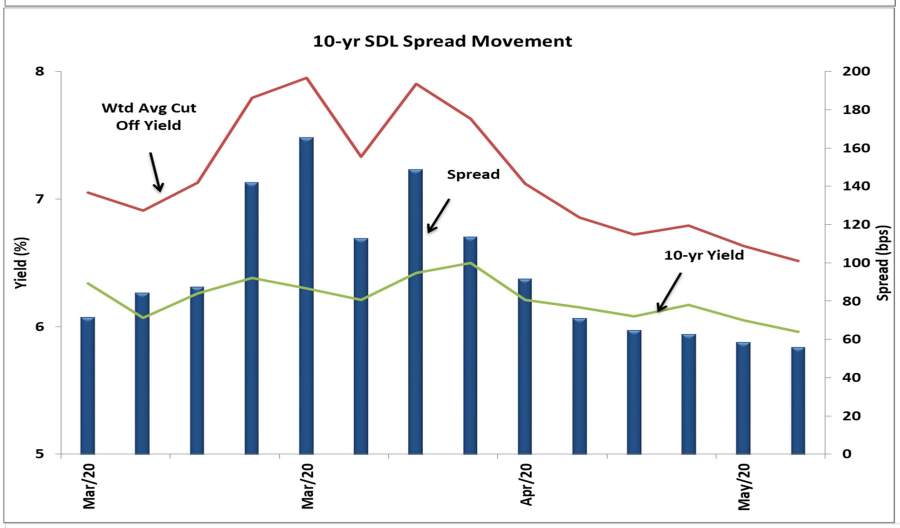
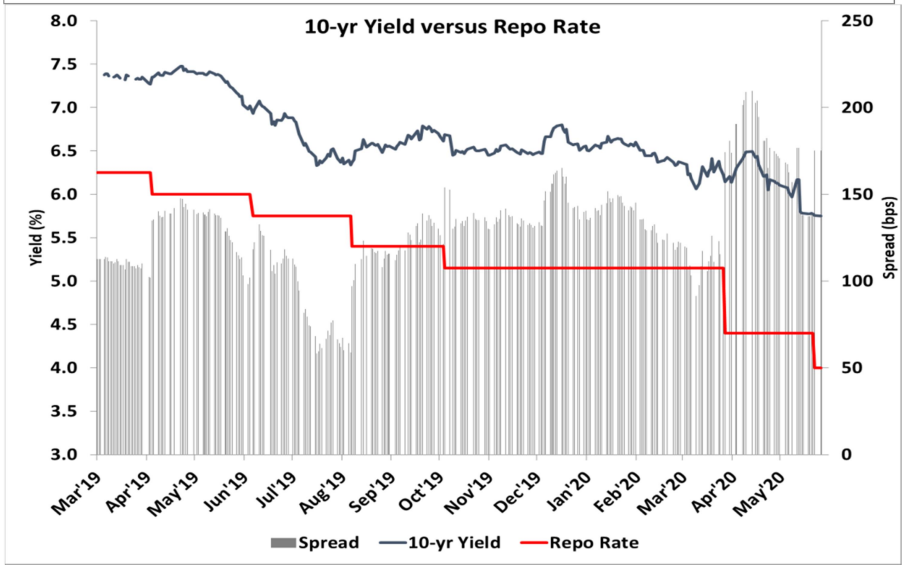
SPREAD MONITOR



Corporate bond spreads are expected to see upward pressures on expectations of rise in delinquencies in different sectors



States have got some respite in borrowing cost with decline in sovereign yields. Spreads are expected to compress on measures taken by RBI to support state finances



With the repo rate standing at two decade lows and expected to be brought down further, 10-yr & Repo spread is currently trading at attractive levels

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