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PNB GILTS LTD (Subsidiary of Punjab National Bank)

ECONOMY & GILT WATCH

Waging an Economic War on China

We are witnessing unprecedented times, to say that, would be an understatement. The economy is in acute distress as the ongoing battle against Covid19 intensifies with every passing day. While on the other hand, actual battle lines have been drawn as we see the geopolitical scenario worsening between India and China, with latter imposing military might not seen since the Indo China war of 1962. Whether, it is increasing dominance over the South China Sea, passing of the new security law in Hong Kong, slapping high tariffs on Australia for demanding investigation into the origin of Coronavirus, or the ongoing trade war with the US, China is clearly asserting itself in a manner never seen before by using both economic and military might. Coming back to the ongoing border dispute with China, there has been a huge clamour for boycotting of Chinese goods and imposing trade barriers with China. But it has to be seen, whether retaliations to defence provocations through trade bans will really cause any tangible harm to China or will it backfire on the Indian economy, which has significant reliance on Chinese imports.

Heavy reliance on China

China's growing dominance in world trade is proved by the fact that it has usurped the US from its position of world's largest trading partner. The two countries have been at the helm of a trade war since 2018 and despite having a symbiotic relationship with each other, have failed to reach common ground as far as trade terms are concerned. Chinese's sphere of influence in global trade continues to grow as its role in global value chains has become deeply entrenched covering raw materials, intermediates and finished goods. On top of that, China is making serious attempts to further cement its role in global trade through the One Belt One Road project which will help in creating new markets and trade routes for

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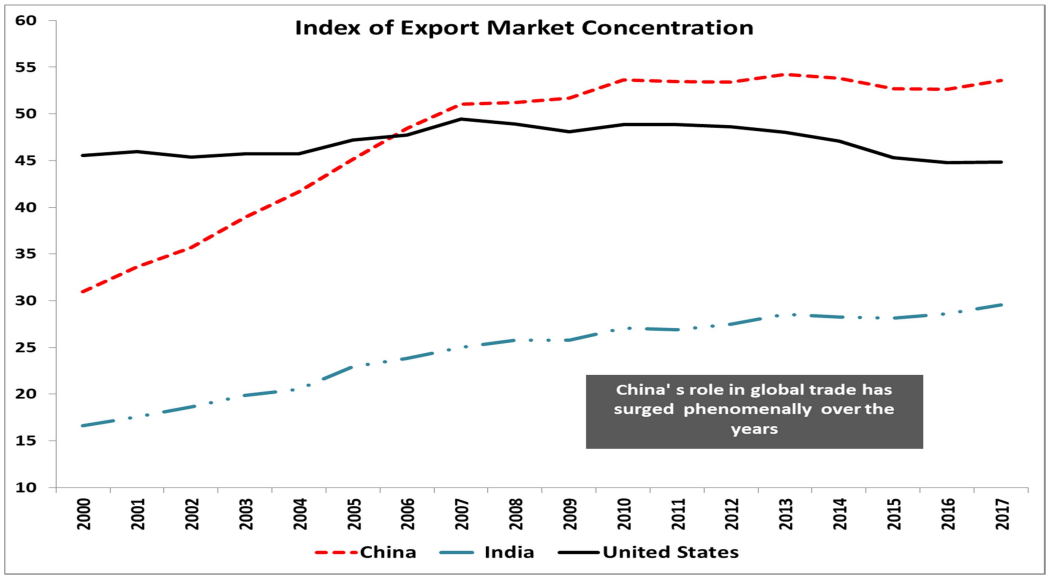
Chinese goods. In the Indian context, the heavy reliance on Chinese imports is well known. India imports not just finished goods from China, but also important inputs in form of intermediate goods and raw materials which are used to produce final goods by Indian manufacturers to be sold in domestic and global markets. Apart from trade, China has also been an important source of FDI in India with large scale investments in a plethora of sectors such as IT, electronics, startup companies, automobiles etc. During 2015-2019, FDI from China stood at USD 1.8 billion.

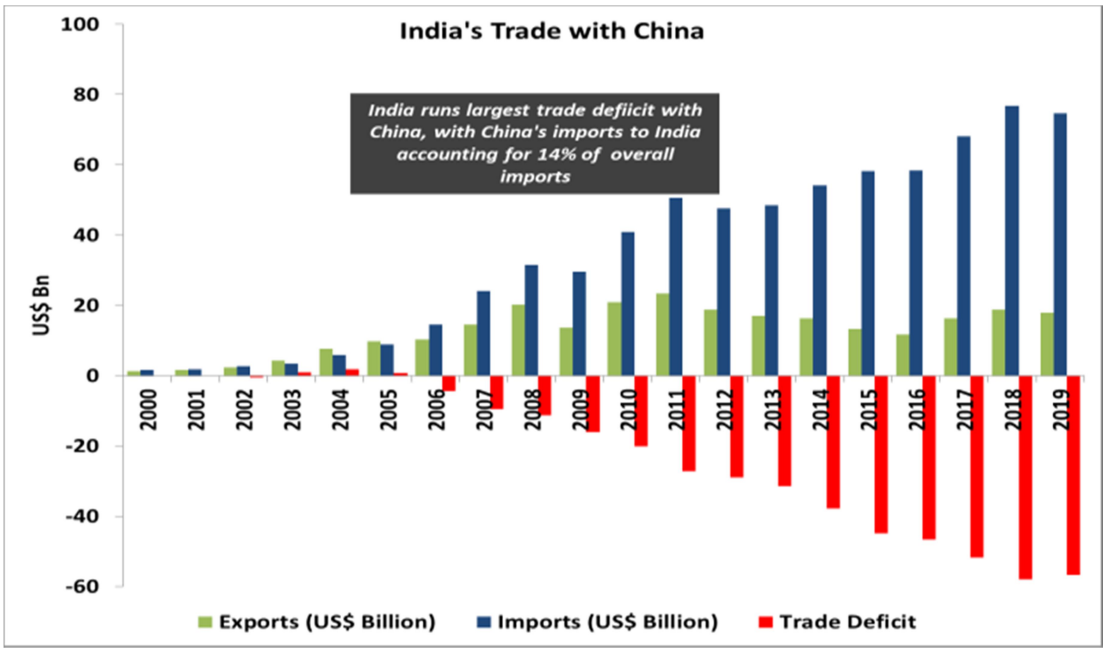


Data Source: wits.worldbank.org

Can we afford to have a trade war with China?

The question has to be seen in the context of impact that it will have on both the countries. China is well diversified when it comes to its markets and India is a relatively smaller market for Chinese exports. For perspective, India accounts for just 3% of China's total exports and1% of its total imports. The trade deficit with China, though has begun to narrow, still is significantly high. Abrupt changes in trade dynamics with China may be a losing proposition for India, especially in the current scenario when businesses are already under acute distress as supply and demand chains are far from being normal. Moreover, calls for import substitution or replacement of China as a supplier may result in increase in cost and lowering of efficiency atleast in the short term. Slapping high tariffs on Chinese products would again be inconsequential and will only lead to an increase in prices and reduced alternatives for Indian consumers and businesses, which does not augur well

given the current state of the economy. So shutting out China completely at this juncture may well be a policy hara-kiri for India.



Building domestic capacity and global competiveness

Despite Chinese centrality in global trade, the Covid crisis has dented economic activity in China. The economic activity in China is yet to return to pre Covid levels and global demand remains doomed as we may see significant shifts in consumer behavior and subdued consumption in post Covid era. Countries are also looking forward to diversifying away from China and there have been talks about India being an alternative to foreign markets. Attracting foreign markets and reducing our dependence on Chinese imports will need serious policy recalibrations and creation of domestic capacity in all sectors. Though there has been increasing policy reorientation towards self-reliance and protectionism in several countries, but the importance of trade cannot be undermined as the interconnectedness between economies continues to remain high. In the current scenario, it is imperative that India makes serious attempts to ease out domestic bottlenecks when it comes to infrastructure, law & regulations, land and labour etc. Creation of capacity would offer the twin benefit of attracting foreign markets and shoring up of the domestic investment cycle while turning away from the demographic disaster that the country is currently staring at, as the whole process leads to large scale employment generation. To conclude, rather than launching skirmishes, its time that we

scale up our capacity and competitiveness on a war footing to stand up against the Chinese economic might.

Industrial activity battered down in April

The index of industrial activity contracted by 55.5% in April as economic activity came to a grinding halt due to Covid induced lockdown measures. Sector wise data showed that manufacturing was the worst hit with output contracting sharply by 64.3% as against contraction of 22.4% in March. Mining and electricity generation also posted double digit contractions of 27.4% and 22.6% respectively. Use based classification showed that the capital goods, infrastructure and consumer durables goods sectors as the worst hit as demand upended completely during the lockdown period. With the phased easing of lockdown in different parts of the country, economic activity has begun to resume as indicated by different indicators such as revival in fuel and electricity consumption etc. However, any meaningful revival in industrial production is unlikely as the Covid crisis is expected to continue having a negative bearing on demand for a prolonged period of time.

Fixed Income Outlook

Fundamental View

Bond markets continue to remain in an extended period of lull in absence of significant triggers. Yields are still holding and are not witnessing any spike despite the significant weakening of rupee and change in rating outlook by Fitch to negative. The broader outlook for bonds continues to remain stable on persistent demand for safe haven assets. As on 5th June'20, the SLR maintained by banks stands at 27.97% of NDTL as against the mandated level of 18%, which indicates that banks are preferring to park funds in government securities in milieu of weak economic activity and heightened risk aversion. In the coming fortnight we expect the new 10-yr paper to trade in the range of 5.80% to 5.95%. Upside risk to yields entail from likely escalation of Indo-China border face-off.

Technical View

Analyst1: 6.45% GOI 2029 yield settled at 5.99% in previous session. Last fortnight, benchmark Yield traded range bound between 5.95%/6.05% zone and settled below 6%. Momentum oscillator RSI is placed at 45 and is trading flat from past 2-3 weeks. Adding to it, we are witnessing narrowing of Bollinger Band's, indicating consolidation phase in the markets. Going forward, till yield is trading below 6.04% it may trade range bound between 5.95% to 6.04% zone with downward bias and any sustainability below 5.95%

could attract further downside, on the flip side if it sustains above 6.04% then surge towards 6.15%/6.20% can't be ruled out.

Chart source: TickerPlant

Analyst 2: 6.45% GOI 2029 is trying to form a symmetrical triangle wherein the range of the yield bands are getting compressed. The recent third band has a yield range of 6.05% to 5.96%. Hence, the stop-loss for existing long view can be brought down to 6.05% from the previous 6.12%. Although the breakout direction in a symmetrical triangle is typically unknown, as the long term waves are in favor of long position, one may continue to stay long. The ultimate take profit remains unchanged at 5.75%.

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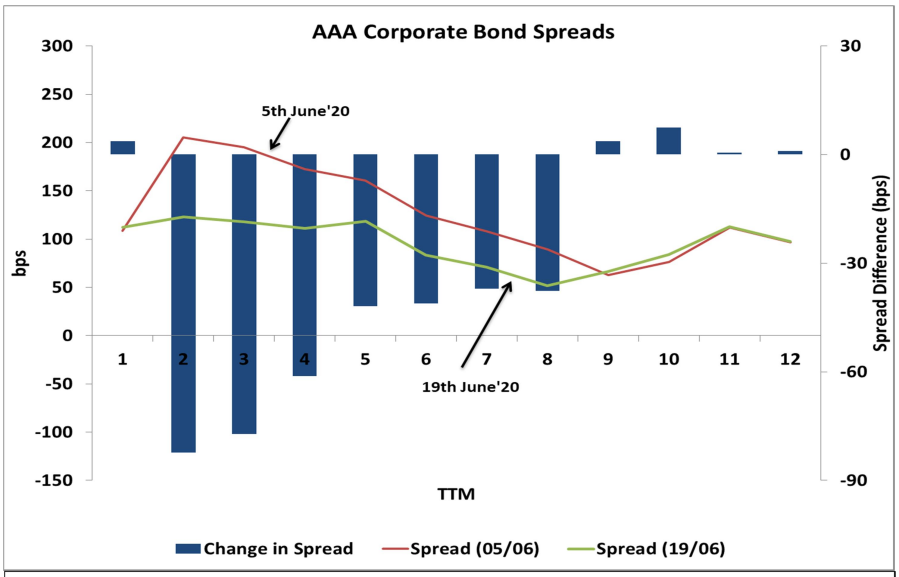
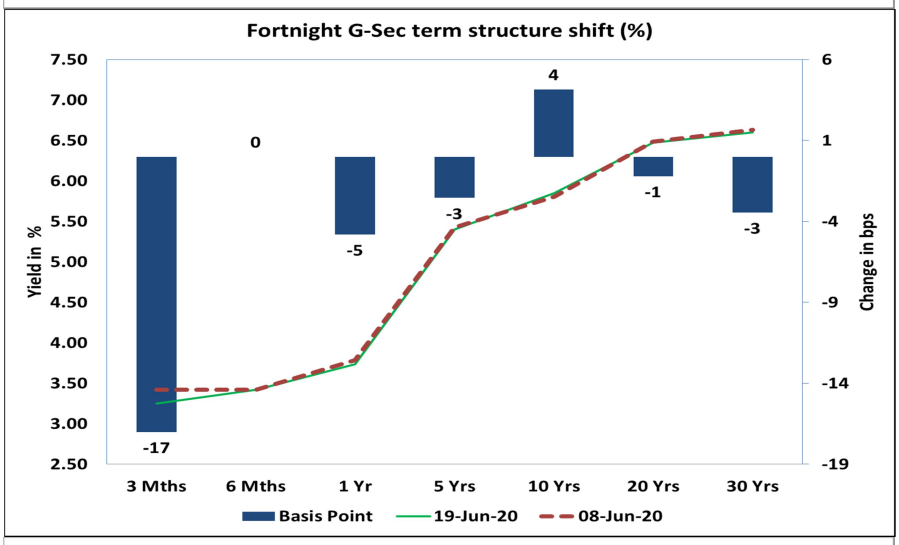
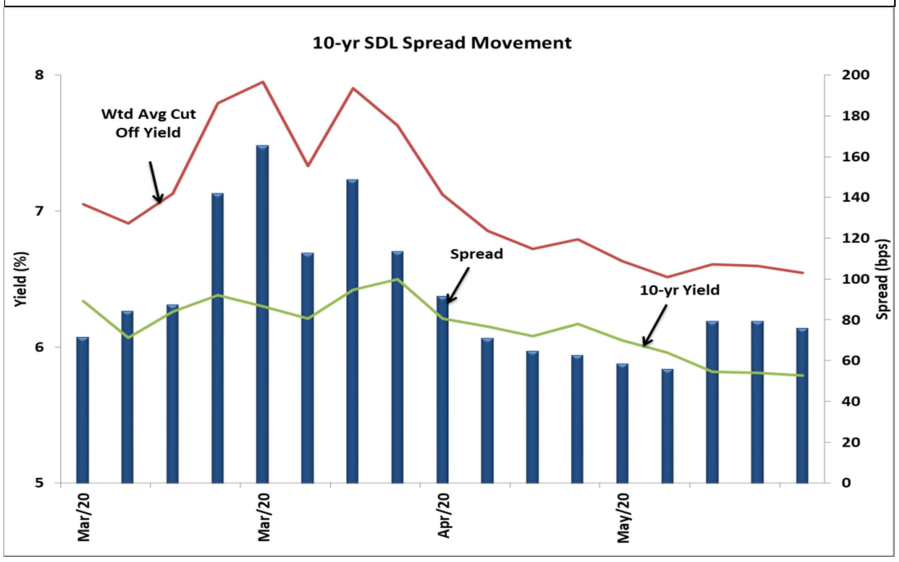
SPREAD MONITOR



Corporate bond spreads have eased on pick- up in demand from mutual funds.



G-sec yields have remained in an extended period of lull, trading in a narrow band during the previous fortnight



SDL spreads are expected to widen on supply concerns

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