27th July 2020

Vol: 10/2020-21

PNB GILTS LTD

ECONOMY & GILT WATCH

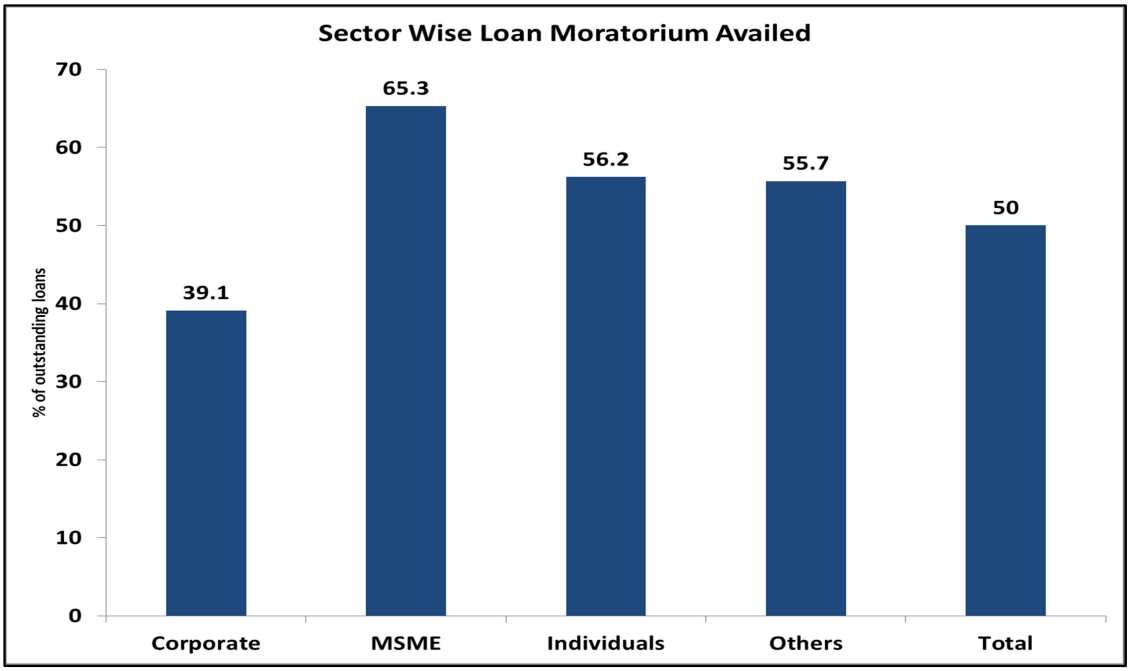
Financial Stability Report: Review

The 21st edition of the Financial Stability Report (FSR) by RBI was released last week. In the milieu of the ongoing economic crisis, the report provides RBI's assessment of the key challenges and risks that face the financial system. The message one can clearly draw from the report is that the financial sector faces serious challenges in the near period and their resilience remains of top most priority given the increasing inter connectedness between different financial entities, intermediaries and the real economy. The report is divided into three parts, the first one is dedicated to macro financial risks, the second part evaluates the soundness and resilience of different financial institutions based on stress tests and sensitivity analysis. While the final part, details the key regulatory measures taken so far at both global and domestic level.

INSIDE THE ISSUE

End of Moratorium, Beginning of Pain

According to the RBI report, the proportion of borrowers availing the moratorium facility is significantly high. Nearly half of the customers accounting for around half of outstanding bank loans opted to avail the benefit of the relief measures which will end on 31st Aug'20. The impact of moratorium on the health of the banking sector is uncertain but it will be certainly be impinged by the sheer size of the borrowers who have availed the facility and the widespread distress prevailing in the economy. The NBFC sector in particular remains vulnerable as the moratorium availment in different segments is high. The liquidity issues faced by small, medium and lower rated NBFCs only amplifies these vulnerabilities and consequently the systemic risks as NBFCs remain the largest borrower of funds from the financial system.



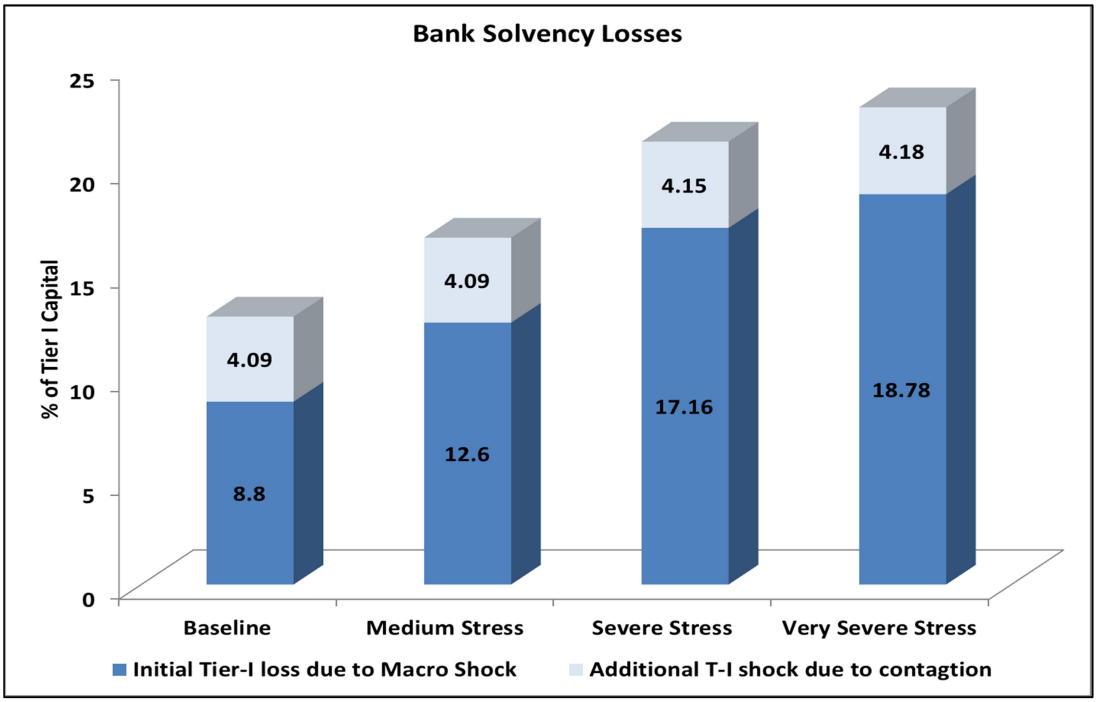
*as a % of sectoral loan outstanding (As on 30th April'20)

Risk Aversion on the Rise

The report says that banks (Both PSB and PVB) have shown clear signs of risk aversion as indicated by analysis of lending behavior. There has been contraction in PSB credit to all categories except AA and above in the last three years and also moderation in credit growth driven by private banks. The risk aversion prevailing in the system is also indicated by the fact that the deployment of debt AUM in G-Secs as a proportion to total debt AUM has been on a rising trend since March 2019 while the proportion of liquid securities (G-sec/ T-bills/ CBLO) in overall debt AUM reached an all-time high in April 2020. The Systemic Risk Survey singles out risk aversion as a major impediment to economic revival while stating that monetary transmission is still inadequate and that the flow of funds to productive sectors (including NBFCs/HFCs) remains a challenge. The response to the Systemic Risk Survey carried out by RBI indicates that the risk perception with respect to global & domestic growth and government's fiscal health has deteriorated significantly. And a majority of the respondents expect that the banking sector shall be adversely affected due to asset quality concerns, slow recovery, lower interest margins and higher provisioning requirements.

Testing the Resilience

The various stress tests and scenario analysis carried out by RBI on aggregate and individual bank level, vindicate the concerns surrounding the banking system as a whole. Macro-stress tests for credit risk indicate that even under the baseline scenario, gross nonperforming assets (GNPA) ratio of Schedule Commercial Banks are likely to increase from 8.5 per cent in March 2020 to 12.5 per cent (14.7 per cent in a very severe stress scenario) by March 2021, whereas the system-level capital to risk-weighted assets ratio (CRAR) may fall from 14.6 per cent in March 2020 to 13.3 per cent (11.8 per cent in a very severe stress scenario) by March 2021. These stress tests do not take into account data upto March 2020 as RBI expects that the actual impact of the moratorium on the asset quality to play out gradually in the coming period. On the other hand, on a slightly positive note, RBI points out that a shrinking inter-bank market with higher capitalization has moderated the overall inter-bank contagion risks. Nonetheless the stress tests and scenario analysis give a subtle warning about the vulnerabilities of the financial system, as macro shocks and contagion may lead to significant erosion of bank capital and bank default in terms of capital requirement of different magnitudes under various scenarios.



*Source: FSR

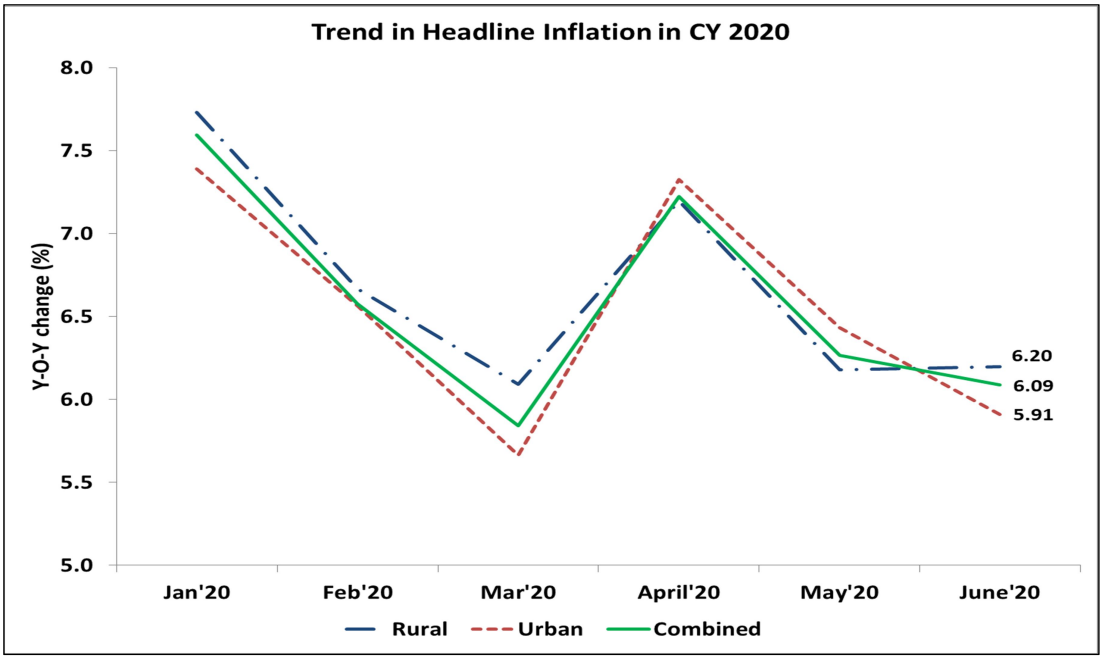
Way Forward

The way forward is laden with uncertainties as the economy still grapples with the crisis and in milieu of such an economic environment, RBI accepts that the stress on the financial system is inevitable even though the regulatory measures taken hitherto have ensured stability and resilience until now. The outlook on asset quality is extremely clouded and public sector banks are treading in murky waters as capital adequacy remains a huge worry. RBI's has not been able to provide much clarity on these fronts as it awaits the actual impact of the moratorium on the bank books to play out completely even though the report does highlight the need of capital augmentation. With regard to the regulatory initiatives, RBI highlights the need for an "exit plan" from the forbearance regime while stating that in the post pandemic period the challenge would be to establish normalcy without disrupting markets and the health of financial intermediaries.

Key Economic Data Prints

CPI Inflation Stays Elevated at 6.09% in June, Rural Inflation higher

The retail inflation for the month of June came in at 6.09% even as the economic activity stayed in limbo amidst fast paced rise in Covid cases. Government also released the index data based on imputation methodology for the months of April and May. CPI inflation for May and June as per the imputed data stood at 7.22% and 6.27% respectively. Food inflation remained high at 7.29% as inflation in certain food items hovered in double digits. Inflation in the 'meats and fish' segment was at 16.22%, 'oils & fats' at 12.27%, pulses at 16.68% and spices at 11.74% in the month of June. The inflation data released using the imputation methodology is suspected to bring in distortions and is not reflective of the true inflation picture. The imputation method simply extrapolates the overall CPI trend to different categories for which prices could not be collated. Another key observation from June's inflation data is the higher rural inflation compared to urban inflation. As we discussed in the previous newsletter, rural sector is a bright spot, the rise in inflation can be seen as a sign of revival in rural demand. From policy perspective, the higher inflation figures are unlikely to outweigh the growth concerns and RBI is likely to continue with the accommodative stance in the upcoming policy meet.



Fixed Income Outlook

Fundamental View

The G-sec market traded largely range bound during the previous fortnight with mild uptick seen in yields post release of higher than anticipated inflation figure for the month of June. The inflation numbers may not be truly reflective of the actual price situation in the economy, largely due to imputation, supply constraints and the recent surge in commodity prices do not augur well from inflation perspective. Nonetheless, the paucity in demand, buoyant monsoons keep short term outlook of inflation stable. Bond markets also await the outcome of the RBI policy meet to be held between 4th to 6th August. While, RBI is widely expected to continue with the calibrated lowering of interest rates, a breather from the rate cutting cycle cannot be ruled out at this juncture as RBI has done significant front loading of the monetary measures. Markets will also closely watch for measures related to the banking sector specifically restructuring, moratorium etc. The bond markets have shown some fatigue in absence of major cues & further moves in yields in the forthcoming fortnight will be contingent on policy expectation build up and the actual policy outcome.

Technical View

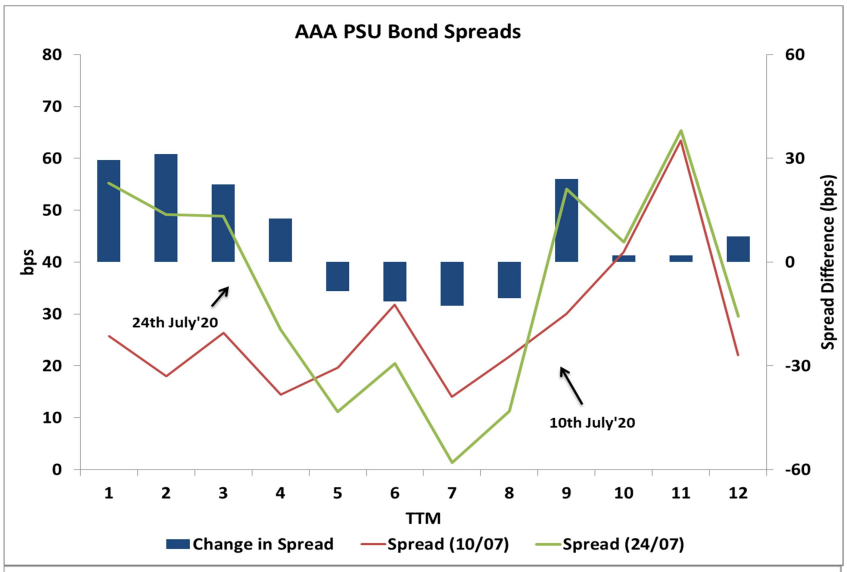
Analyst1: 5.79% GOI 2030 yield settled at 5.82% on Friday's session. Last fortnight, benchmark yield headed higher as it touched the middle band of Bollinger (i.e. 20 SMA level) and traded in small range thereafter. Momentum oscillator RSI is placed around 50 level. From here on, any sustainability above immediate resistance levels of 5.84%-/5.85% may led to range shift from 5.74%-5.84% to 5.79%-5.91% zone. However, our broader view still remains sideways to weak in case of benchmark yield.

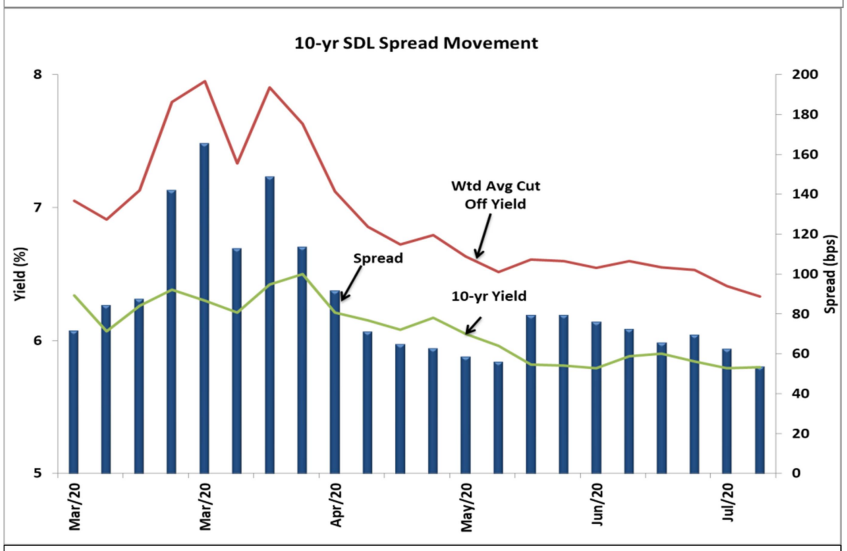
Chart source: TickerPlant

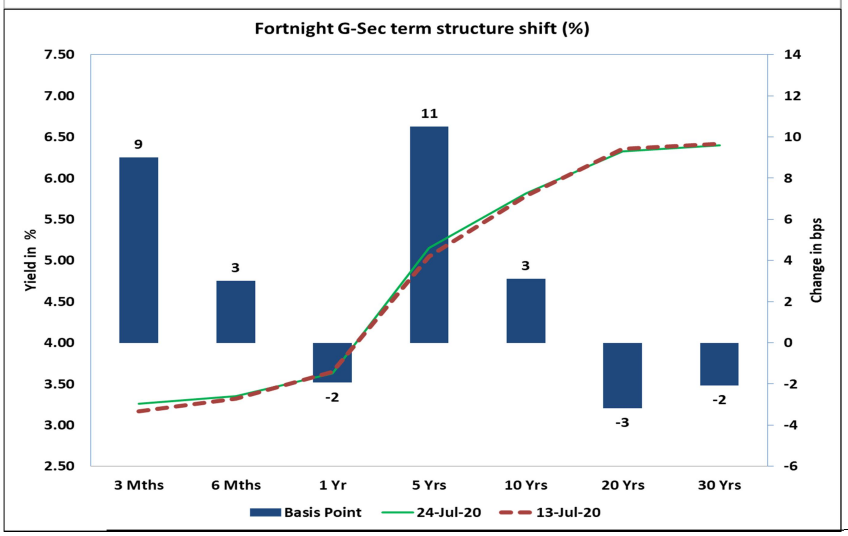
Analyst 2:.5.79% GOI 2030 has been on a range bound price action for the last two weeks. Since the paper has not given any breakout on the either side, it is difficult to infer the direction of the potential breakout in prices. As the view remains long, the idea is to buy either after an upside breakout in prices or to buy after a price reversal from the technical bottom level. Hence, one may go long in 5.79% GOI 2030 on a downside breakout below 5.78%. Else, one may look to buy if market touches and retraces from 5.86%. Any closure above the stop loss level of 5.86% should trigger the stop loss.

27th July 2020

SPREAD MONITOR







Short term PSU bond spreads rose during the previous fortnight, however the overall spread outlook for higher rated papers remains stable on adequate demand

In the G-sec segment, the five year yield rose the most during the previous fortnight as the expectation of rate in the August Policy meet weakens a tad bit post release of June inflation number which was higher than estimates and above the RBI target band

PNB Gilts Ltd

CIN: L74899DL1996PLC077120

5, Sansad Marg, New Delhi-110001

Ph. No: 011-23325759, 23325779

Company Website: www.pnbgilts.com

Research Mail ID: research@pnbgilts.com

For Fixed Income retail queries, kindly contact at:

Ph. No: 011-23321568, 23736586

Mail ID: **marketing@pnbgilts.com**