PNB GILTS LTD
(Subsidiary of Punjab National Bank)

25th August 2020 Vol: 12/2020-21

Economy & Gilt Watch

INSIDE THE ISSUE

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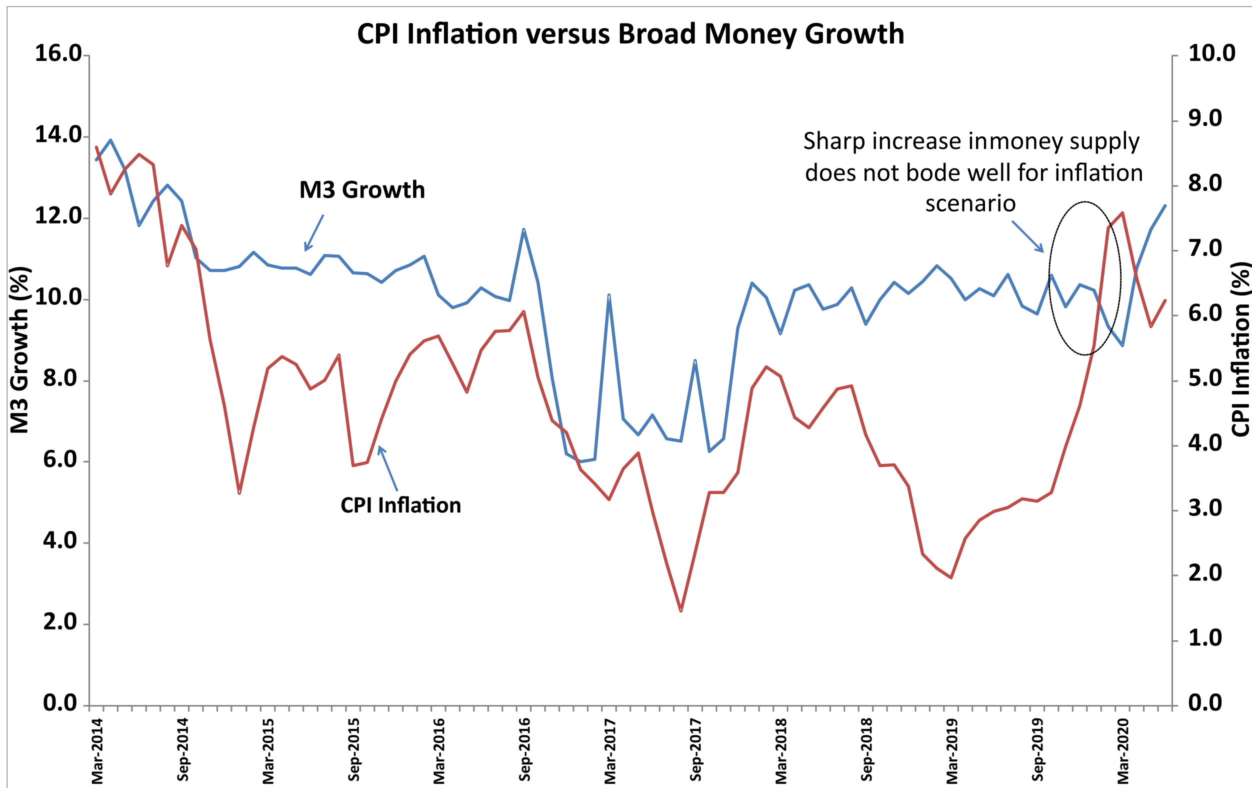
Inflation: Worst feared coming true

The worries over inflation got loud and clear as the central banks across the world have started to ring the alarm bells over inflation in the latest string of policy meets held. On one hand is the Fed, which is expected to target a moderately higher inflation in order to spur economic activity in the forthcoming Jackson Hole meeting scheduled on Thursday this week. While in India, CPI running higher than the target rate in the new FY has caused severe discomfort which was quite evident from the statements of the policy members released in the MPC minutes in the previous week. The MPC expressed deep concerns almost to extent of being hawkish in the minutes, due to which there was a unanimous vote for a status quo in the last policy meet. And it is evident that the RBI is unlikely to reduce the policy rates any further until there is a "durable" reduction in inflation. While RBI accepts that there indeed is space available to adhere to its commitment of reviving growth, the persistent inflation has tied RBI's hands in continuing with this resolve.

Uncertainty Galore

RBI is clearly perturbed about the uncertainty prevailing in the economy. Some members have highlighted that the current crisis will lead to "hysteresis", which implies permanent damage to potential output. The damage to the output cannot be recovered as despite opening up of the economy, the public shall remain reluctant in resuming spending which were prevailing at the pre covid levels. However, the main concerns relate to inflation and all the members have been extremely vocal about it in the minutes. Members expressed concerns over both the uncertainty of the future path of inflation as well as the reliability of the imputed numbers released for the months of April and May. The comments of internal member Dr. Patra were particularly hawkish as he talked about taking "remedial measures" in form of an immediate response to ward off inflationary pressures and prevent it from getting generalised.


CPI Inflation versus Broad Money Growth
M3 Growth (%)
CPI Inflation (%)
M3 Growth
CPI Inflation
Sharp increase inmoney supply does not bode well for inflation scenario
Mar-2014
Sep-2014
Mar-2015
Sep-2015
Mar-2016
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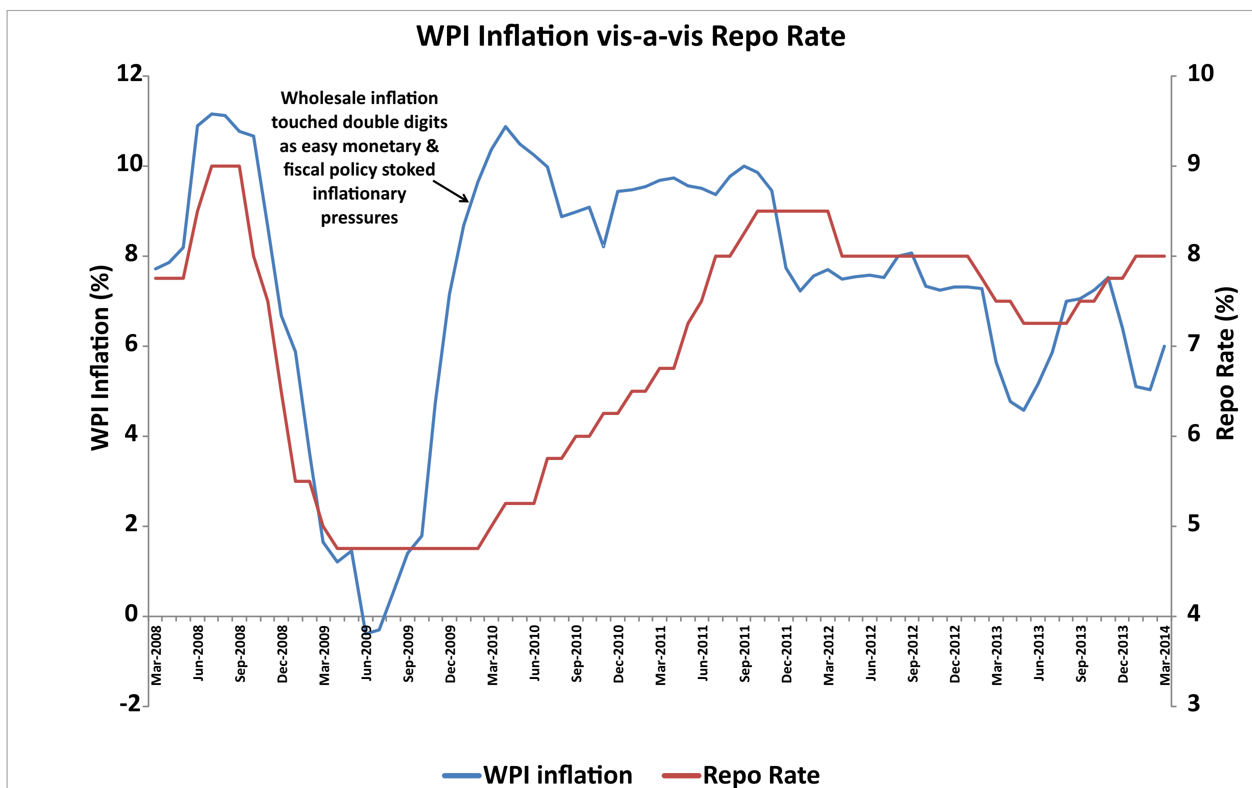
Mar-2017
Sep-2017
Mar-2018
Sep-2018
Mar-2019
Sep-2019
Mar-2020


WPI Inflation vis-a-vis Repo Rate
WPI Inflation (%)
Repo Rate (%)
Wholesale inflation touched double digits as easy monetary & fiscal policy stoked inflationary pressures
WPI inflation
Repo Rate

What Lies Ahead

It could be clearly inferred from the minutes reading that RBI is done with the easing cycle. However, a stubborn inflation at this juncture will only increase RBI's dilemma over growth inflation trade off. Even though, one may argue that monetary policy is less effective in tackling supply side induced inflationary pressures, it is important to note that in the Indian context, food inflation has led to generalised inflationary pressures in the economy in the past. One could also draw inference from the post 2008-09 era when monetary and fiscal easing had resulted in inflation turning painful which could not be controlled even by a series of rate hikes. RBI too would be extremely wary of such a scenario repeating itself as the sharp contraction in output would only make matters worse causing irreparable damage to the economy.

Fixed Income Outlook

Fundamental View

Domestic bond markets came under sharp pressure in the previous fortnight as the hawkish tone of the minutes left the market disappointed. Yields shot up sharply with the 10-yr yield rising to the levels last seen in March'20. Yields have retraced back after RBI announced Operation Twist to be conducted in two tranches for an aggregate amount of Rs. 20,000 crore. Going forward, though RBI has shown its intent to cap sharp rise in yields as that would be counterproductive at this juncture and would undermine the monetary easing done so far. However, with rise in inflation and RBI's discontent with the same, the range for yields may have shifted upwards. The upper trading band for the 10-yr yield now seems to have moved upwards to 6.15%-6.20% levels from 6% levels earlier. Market movement is now largely hinged on to special OMOs which if conducted on a sustained basis can soften the yields from here on.

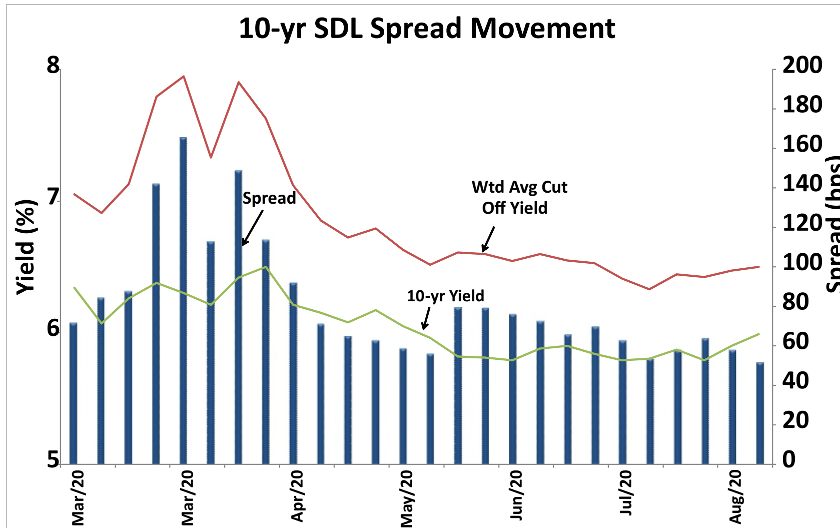
Technical View

Analyst1: 5.79% GOI 2030 yield settled at 6.22% on Monday's session. Last fortnight, benchmark Yield headed higher as it witnessed a breakout above 5.91% level. Momentum oscillator RSI is trading in highly overbought zone at 86, indicating strong surge witnessed in momentum in previous week. However, going forward this momentum may ease out a little and we may witness yield's consolidating, with higher side capped around 6.27%-6.30% levels and on any dip 6.08% will act as crucial support zone.

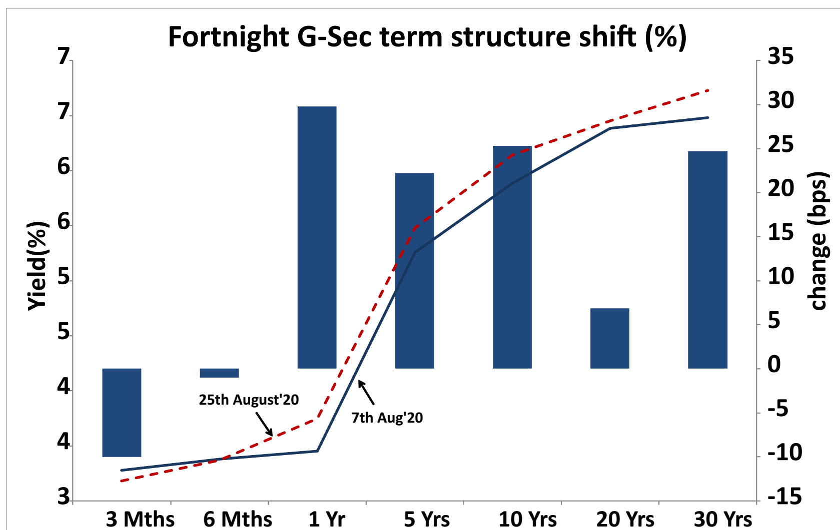
Chart source: TickerPlant

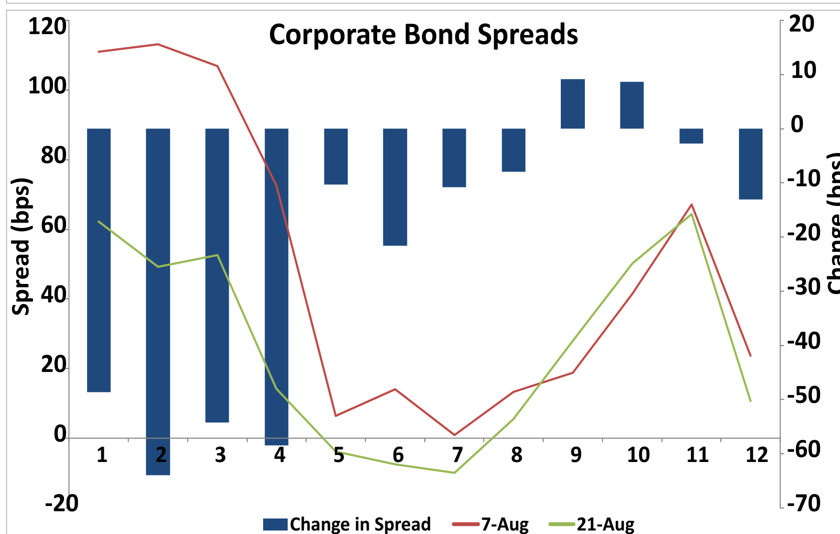
Analyst 2: 5.79 GOI 2030 is having a strong uptrend in yields after the MPC minutes got released. The most important level of 6.12% got broken swiftly on the upside , confirming the strength of the bearish trend. The view is to stay bearish as long as 5.79 GOI 2030 stays above 6.12%. Any closure below 6.12% would trigger the stop loss.

SPREAD MONITOR



Sovereign yields witnessed a sharp spike as the hawkish tone of the MPC minutes turned sentiments cautious





Corporate bond spreads witnessed contraction during the fortnight as the impact of sharp rise in G-sec yields is still to be reflected in the corporate bond markets

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