

Economy & Gilt Watch

When US Goes to Election

The US Presidential election is the biggest political spectacle and is closely watched for the geo political and economic ramifications it has on the rest of the world. What makes the US election even more interesting this year is the unprecedented and dramatic backdrop with issues ranging from the US-China trade war, the pandemic induced economic crisis, shunning of multilateral institutions/pacts such as WTO, WHO, Trans Atlantic Trade and Investment Partnership etc. Going into the final days of the election, the markets across the world have been rattled with sharp sell-off seen in the risk assets. The outcome of the election will have different implications on the financial markets

A Battle of Ideologies

The closely contested US Presidential elections is a battle of ideologies with the contesting parties (i.e. Democrats and Republicans) seen as left and right leaning respectively. The Republicans believe in the policy of “laissez faire”, implying lower regulations and taxes on businesses and freer markets. Under the leadership of the current incumbent Donald Trump, US policies turned increasingly mercantilist and protectionist with policies focused on bringing jobs and manufacturing back to US, lowering of taxes on corporates & individuals and relaxing regulations on businesses. The stance on China was stiff as we saw a series of trade wars and negotiations mainly intended to reduce US dependence on China. On the other hand, Democrats starkly differ in their trade and economic policies. They advocate progressive taxation (higher taxes on businesses and higher income individuals), higher government spending on social programs such as healthcare & minimum support, multilateralism and fair trade policies with trading partners. To surmise, Republicans are traditionally considered to be more market friendly vis-à-vis their Democrat counterparts as they advocate minimum government interference. However, the actual performance of the economy is affected by several other factors, besides the parties underlying philosophy on economic policies.

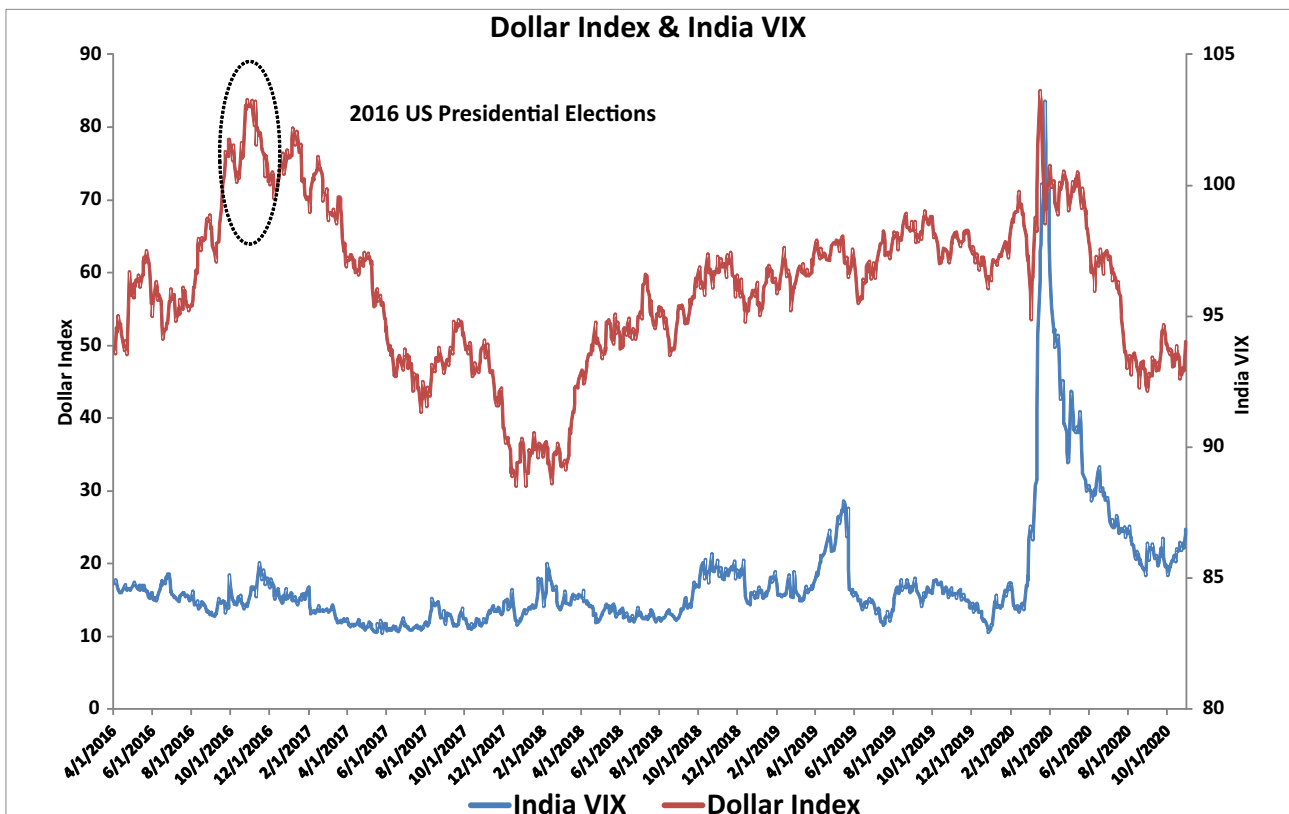
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Likely Outcomes

Though this year the expected election outcomes are harder to predict, given variables such as higher proportion of mail in votes and likely scenario of Trump not conceding to a Democrat win and initiating a legal battle, a Democratic sweep could be one of the likely outcomes that may materialize. Under a normal scenario, a Democrat win is considered to be detrimental for the equity markets & Dollar strength as increase in taxation and government regulations make a comeback on the table. However, it needs to be noted that the Democrat policies are expansionary (higher public spending) and in the current period of economic stress, a Democrat win shall open way for a big ticket fiscal stimulus which may translate into higher jobs and income growth in the economy. So, though Dollar may see a sell off in the short term on lower demand for safe asset (on account of a more balanced policy stance and lower geo-political risks), stimulus fed growth may help Dollar gradually strengthen in the medium to long term as the economy recovers lost ground.

A Stalemate Scenario: Another plausible scenario, which is a mixed outcome (Democrat candidate Biden winning the Presidency and Republicans retaining the Senate majority or vice versa) may lead to an extended period of policy impasse even as the US economy remains far from full employment. The scenario does not augur well from the risk asset perspective as the outlook on growth shall remain more or less muted amidst a policy environment which shall remain gridlocked.



What it means for our economy and market

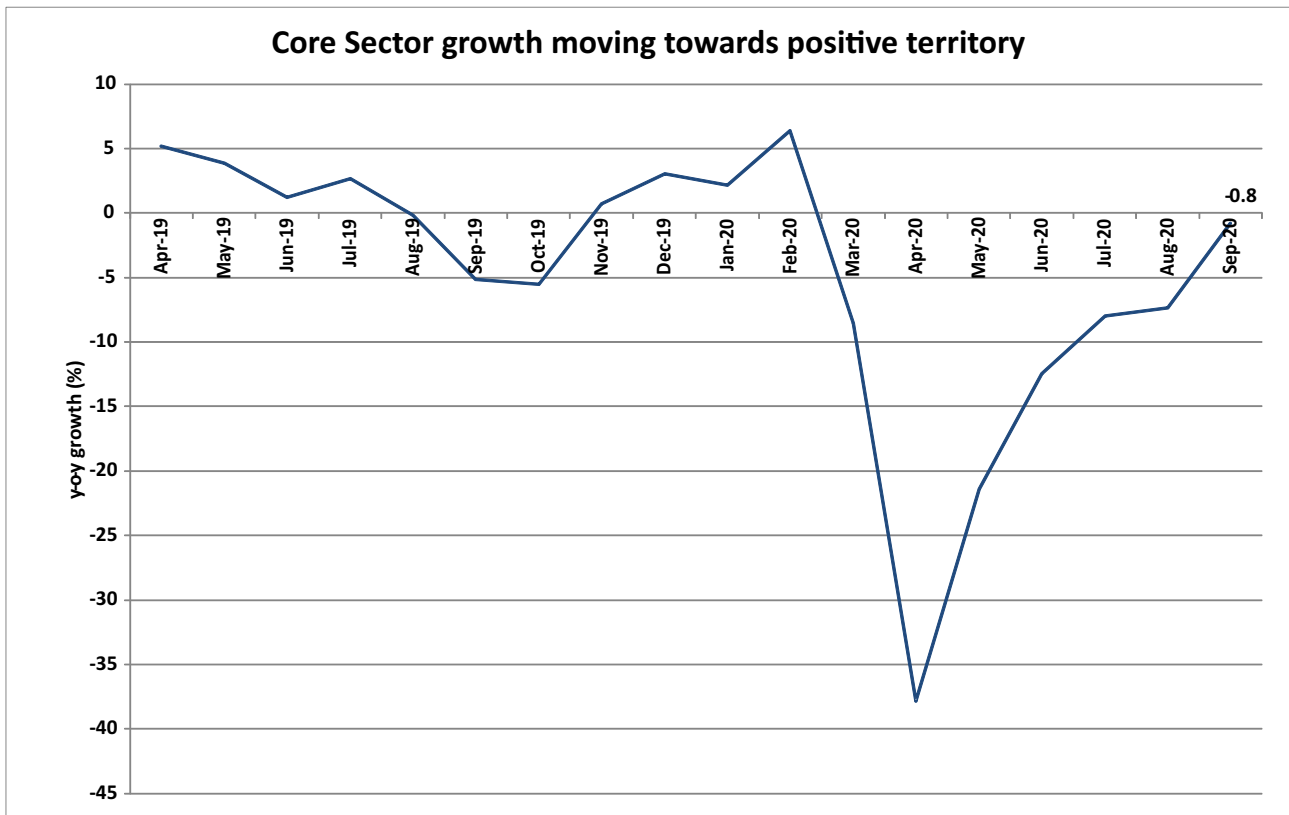
The final counting of votes and declaration of the US Presidential election results shall be done on 6th January'21 and markets may continue to witness volatility until then. While a status quo on election outcome will likely stabilize the markets, a Democrat sweep in the elections may actually turn out to be a positive for the Indian markets and other emerging economies on a) looser fiscal policy, b) a favorable trade policy, c) and a stable geo political outlook (which is important for crude oil price stability). A Democrat win also means greater autonomy for the Federal Reserve, which again augurs well for the interest rate outlook in the medium term. A less than favourable scenario on the other hand, of Trump taking up the legal battle against the Democrat win, or Republicans holding the senate majority, shall be negative scenarios for the emerging markets. All in all, the US elections continue to lend uncertainty and despite the narrative of economies turning inwards gaining ground, the US elections continue to pose a substantial event risk to the global markets.

Macro Monitor

Core Sector contraction narrows substantially in September

Data released by the industry department showed that in September, the core sector which constitutes 40% of the index of industrial production (IIP) shrank for the seventh consecutive month, with only coal (21.2%), steel (0.9%) and electricity (3.7%) registering positive growth while performance of fertilisers (-10.6%) and natural gas (-0.3%) worsened. The core sector shrank just 0.8% in September on a year-on-year basis, recording the lowest contraction since March 2020 on account of a favourable base effect and a strong rebound in coal production. The upward momentum in the core sector is expected to spill over to the next month riding on low base and a modest pick up in demand in the economy.

The manufacturing PMI corroborates the upward trend in manufacturing as the index rose to 58.9 in October as firms increased production in response to the bounce back in sales in the ongoing festive season and lowering of containment measures. However, sustainability of the pick-up in demand remains in question as the pent up demand plays out in the ongoing festive season and runs the risk of running out of steam eventually.



Fixed Income Outlook

Fundamental View

Last fortnight saw yields easing with long end of the curve benefitting the most from the recent developments in the bond market. State Loans also witnessed sharp easing of yields overall factors remain supportive for the bond market (regular and sizeable OMOs). The coming fortnight shall witness the US elections which may keep the market on a cautious footing. The outcome of the election is highly unpredictable and risk assets may witness sharp volatility which may have negative bearing on the INR and crude oil prices. Overall, the trade in the upcoming fortnight would be driven taking into consideration the US election which is a key event risk for all asset classes. We expect the 10 yr yield to trade in the range of 5.80% to 5.95%.

Technical View

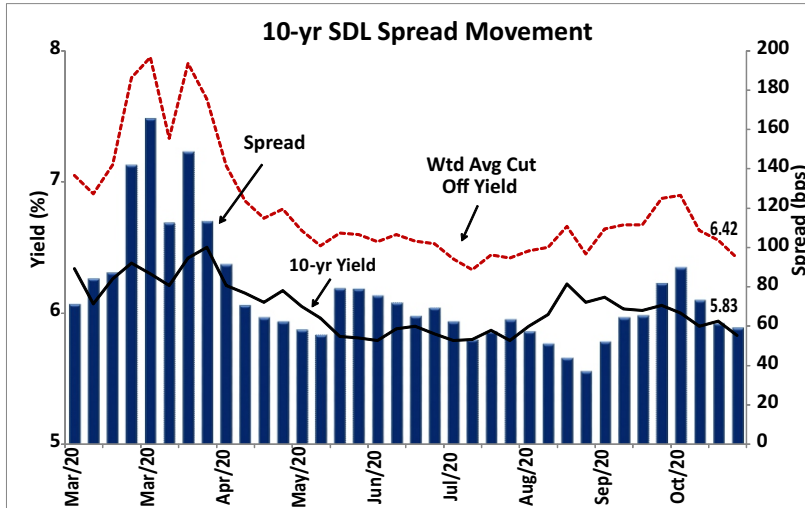
Analyst 1: 5.77% G-Sec 2030 yield settled at 5.88% on Friday's session. Last fortnight, the benchmark yield traded with downward bias and touched low of 5.79%.

Momentum oscillator RSI touched lows of 30-31 and witnessed a bounce back thereafter. As discussed in last newsletter, any sustainability below 5.88% could take benchmark towards 5.80% level, the same was witnessed in last week. Current chart pattern indicates yield may try to touch middle Bollinger Band level of 5.91%, which also coincide with downward sloping trend line(as shown in the chart), indicating crucial resistance zone going forward. From here on, till 10 yr is sustaining below 5.91%-5.92% level we may see yield trading range bound between 5.92% to 5.80% zone.

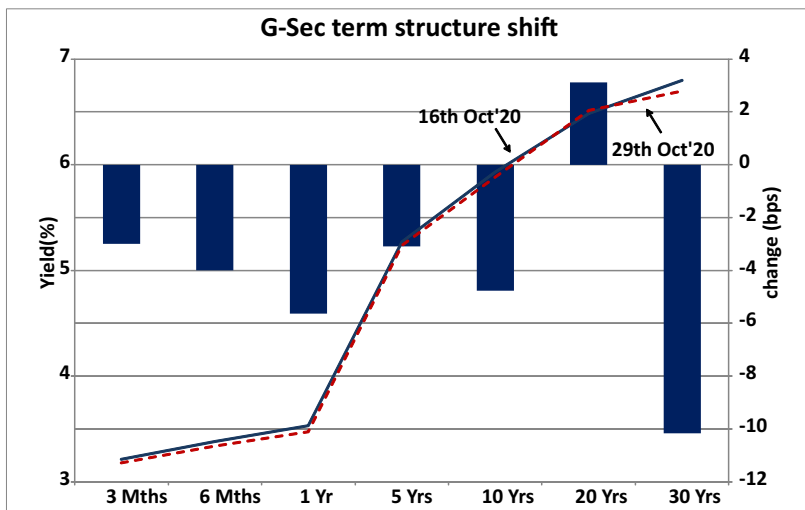


Analyst 2: After assuming long view at 5.94%, the market swiftly rallied closer to our take profit of 5.75%. It almost touched 5.79% and had a trend reversal towards 5.89%. Here, the view is to stay long, with the revised closing stop loss of 5.94% and the take profit remains at 5.75%.

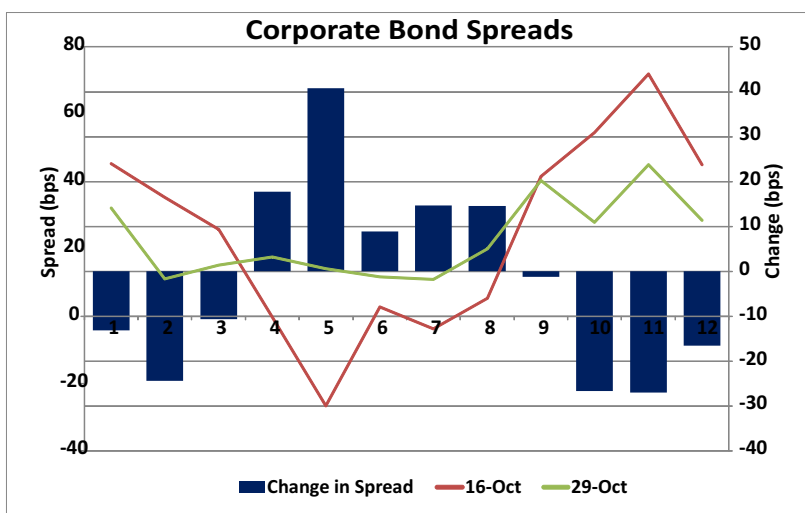
SPREAD MONITOR



SDL yields continue to decline, benefitting from the OMO auctions in the segment by RBI



As expected, G-sec curve witnesses mild flattening as long dated papers attract demand



Corporate bond spreads widen in the five year bucket in the previous fortnight

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