

Economy & Gilt Watch

Tantrum before Taper

The recent move in global markets has brought back memories of 2013 taper tantrum, with US treasury yields seeing a secular rise towards the levels seen last year. The surge in US treasury yields has sent jitters in the equity markets as investors pull out funds from emerging market assets. The emerging markets remain in tenuous position under such circumstances as rise in US bond yields hurts the appetite for their assets. In this article we shall look at the reasons for the rise in US treasury yields, its comparison with the 2013 taper tantrum and how it is likely to impact India.

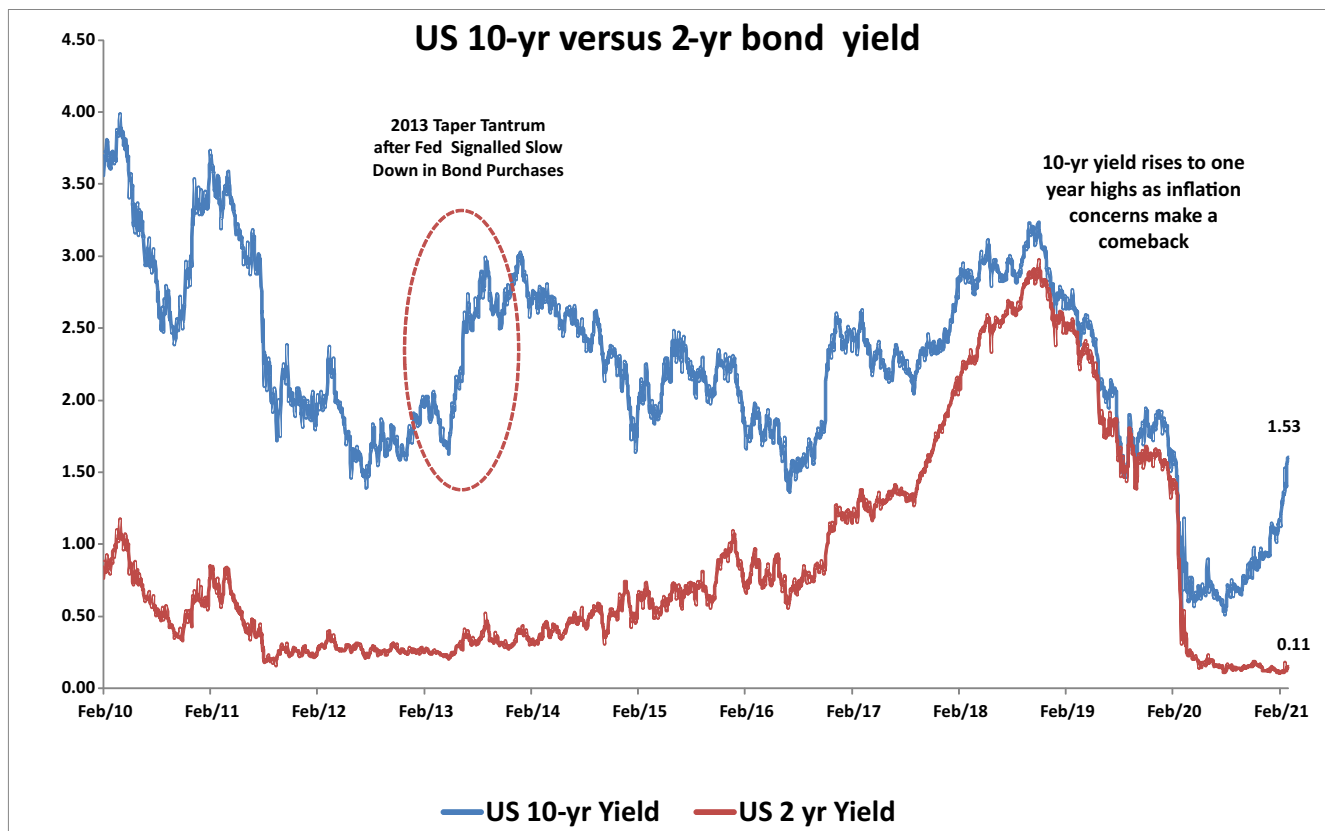
Why Fed wants inflation back

US bond yields remain at the centre of the latest developments in the financial markets triggered by Fed Chairman's stance about inflation. Fed Chairman stance over inflation is in contrast with the general convention. It is highly unusual for a central bank to concede that inflationary pressures shall rebound and at the same time affirm maintaining an ultra-loose monetary policy. The new found tolerance for higher inflation by the US Fed stems from the worries of low inflation and inflation expectations getting deeply entrenched in the economy. As inflation becomes too low or negative (as was the case with Japan), monetary policy becomes an ineffective tool in reinvigorating the economy. Currently the PCE inflation (which is the target inflation rate) is at 1.5% and has averaged at 1.4% over last one year. To cut this risk, Fed wants inflation to run above its target of 2%, so that the average inflation comes near around the Fed target of 2% mark. But have the markets over reacted in expressing their concern over Fed's comfort with inflation running higher than its target? There are arguments that would validate this extreme fear being exhibited by the markets. First, the new fiscal package of USD 1.9 trillion that was recently passed by the Senate along with the pick-up in vaccination drive and gradual reopening of the economy is expected to give a leg up to consumer demand. The fiscal stimulus is considerably large and targets the higher spending part of the US

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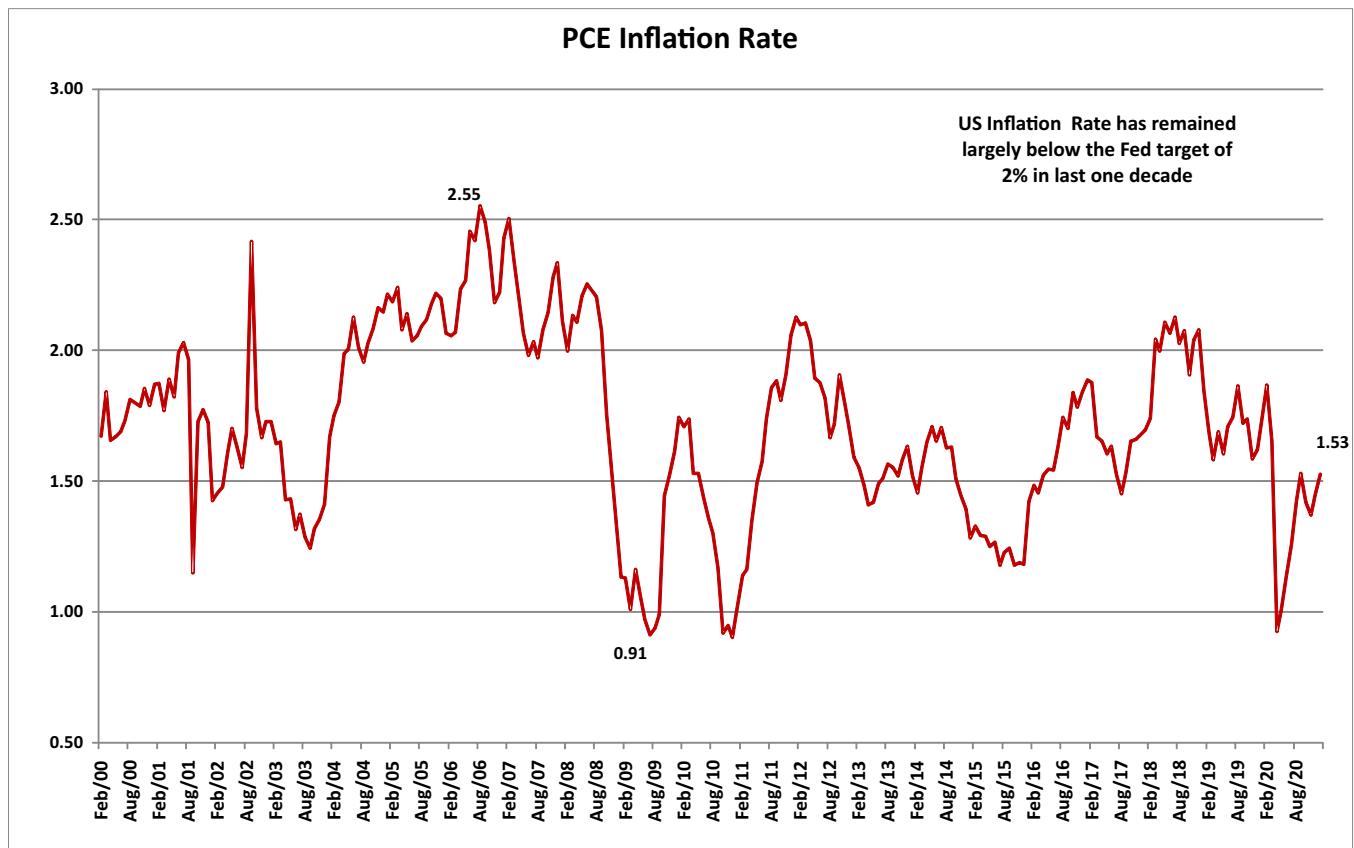
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population which means a higher multiplier effect. Secondly, cost push pressures also seem to be a risk as prices of key commodities witness a spike which is leading to increase in input cost for businesses. However, inflation dynamics are not entirely determined by these factors alone. In last two decades, US inflation has remained close to 2% even though GDP growth remained above potential, while the unemployment rate has remained low, which is conventionally a perfect recipe for higher rates of inflation. However, market seems to be clearly pricing in a sharp rise in inflation, which can be seen from the steepening of the yield curve. So while the short end rates remain anchored, the longer term rates have taken a significant hit as market demands higher premiums to protect returns on longer terms bonds. The US 10-yr yield has returned to pre pandemic levels touching a high 1.62% while the 2 year yield continues to remain steady near the lows witnessed during the pandemic year. The surge in yields have led markets to draw parallels with the rise in yields witnessed in year 2013. However, the economic scenario and monetary guidance remains starkly different. While the economic scenario still remains clouded and uncertain, the monetary guidance has been extremely clear and unambiguous, with Fed reiterating its dovish & supportive stance. However, markets are fearful and the recent bout of rise in yields seems to be discounting the error that Fed might make in its expectation on inflation & growth.



What all this mean for Indian debt market

The recent turbulence in the mother of bond markets has spooked EM markets and its impact was seen in the India markets too. India remains on a weak footing on a macroeconomic basis (high CAD, Fiscal deficit, higher inflation & subdued growth) and is highly vulnerable to the foreign fund flows. The rise in US yields hurts the domestic bond markets through foreign fund outflows and weakening of rupee. On the other hand, a stronger USD pushes up the import bill and domestic price pressures. The domestic set of factors remains adverse to bonds, as market is reeling under the pressure of heavy supplies slated for the next year. The turnaround in global markets only makes matters worse for the domestic bond markets. Nonetheless, the global developments need to be tracked closely, given the large bearing on the domestic market. As the old maxim goes, “When US sneezes, the world catches cold.”



Fixed Income Outlook

Fundamental View

In our previous edition, we discussed how the global developments and supply overhang in the Indian bond markets are weighing and shall continue to weigh on the domestic bond yields. It was discussed that a range of 6.00% to 6.20% is high probability range with the possibility of expansion towards 6.30% in the current fiscal. The 10-yr yield for the major part of the last fortnight remained in this expanded range touching a high of 6.28%, just short of 6.30%. With the global factors (US bond yields and crude prices) continue to turn adverse, the game for Indian bond markets is also getting murkier. RBI has been lending major support to the markets which has kept the 5yr and 10-yr yield under check. While the 5 & 10 yr yields have remained rather well behaved, the losses in other maturities and segments have been rising steadily. These points on the yield curve continue to remain richly valued. GOI is expected to have a cash surplus by end of March due to better advance tax revenues and lower expenditure, which has raised hopes of cancellation of one or two scheduled auctions in the last month of the fiscal. This may help cool down yields by around 10-12 bps and we could see 6.10% levels on the 10-yr again. There are also talks of reduction in domestic fuel prices through a cut in duties. However, it is a double edged sword for the bond markets as on one hand it helps cool down inflation, but reduced govt. revenues.

We reiterate the earlier range of the 10-yr yield at 6.00% to 6.30% for the month of March. Any extraordinary efforts by the central bank and the government to bring the yields down can be an opportunity to lighten portfolios and wait for better opportunities.

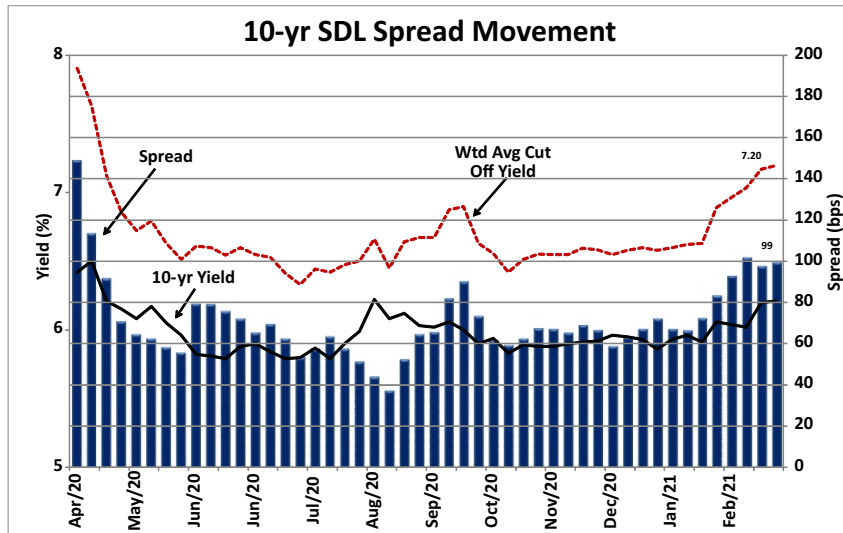
Technical View

Analyst 1: 5.85 GS 2030 which has been exhibiting continuous drop in prices is expected to reach 6.29%. With a closing stop loss of 6.34%, we may look to enter long at 6.29%. The take profit for this long trade is at 6.15%.

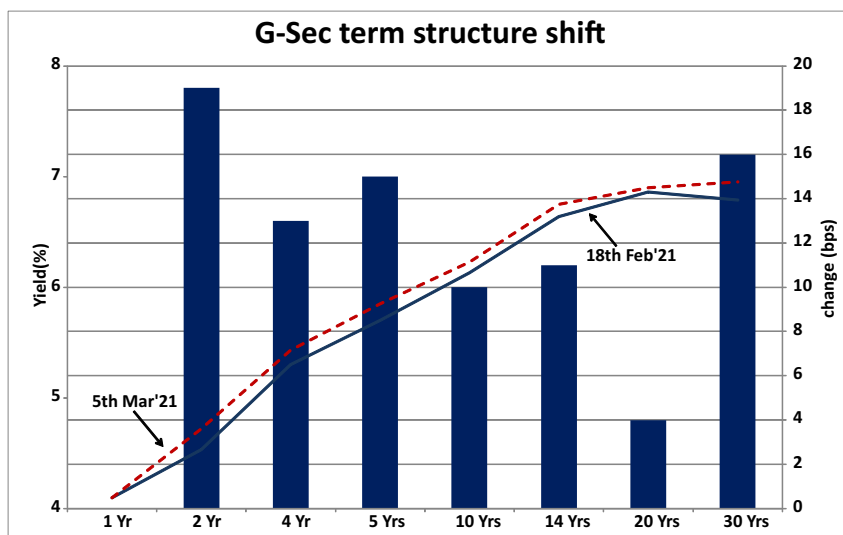
Analyst 2: 5.85% G-Sec 2030 Yield settled at 6.23% on Friday's session. Last fortnight, benchmark Yield traded range bound between 6.13%-6.26% zone. After breakout witnessed on 1 Feb'21, benchmark yield is making Higher High, Higher Low formation indicating northward directions in yield, However, Momentum indicator RSI is showing marginal divergence on EOD chart, indicating pause to the current strength. Going forward any sustenance below 6.20% may led to small pullback towards 6.13% zone and on higher side any sustenance and closing above resistance level of 6.25% level may led to further surge towards 6.35% level.



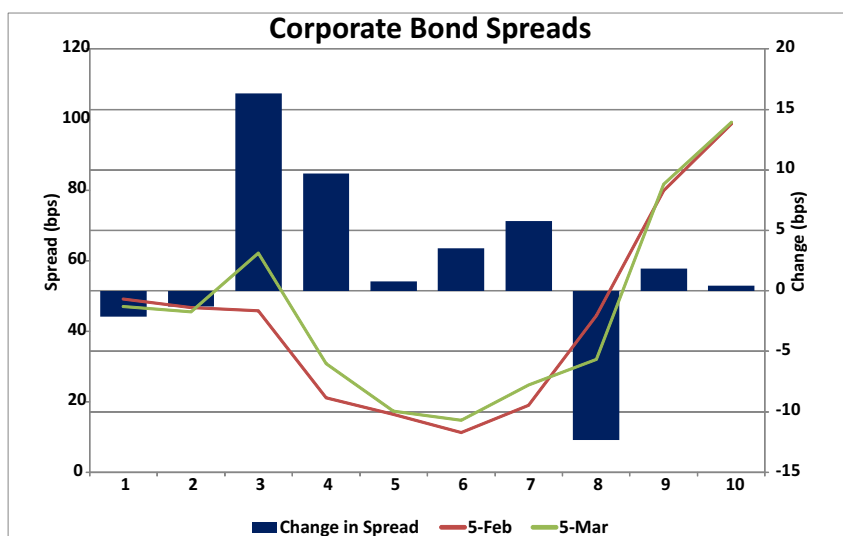
SPREAD MONITOR



SDL cut off yields continue to rise as underlying sentiments in the bond market remain weak



Domestic G-sec yields surge as appetite continues to remain weak amidst heavy supplies and firm US bond yields



Corporate bond spreads trade with flat to firming bias during the fortnight

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