PNB GILTS LTD

Volume 03/2021-22
3rd May 2021

ECONOMY & GILT WATCH

PNB GILTS LTD
(Subsidiary of Punjab National Bank)

INSIDE THIS ISSUE:

FOMC Meet: No Taper Talk Yet

The US central bank, Federal Reserve announced its policy verdict on 28th April, delivering no surprises as it kept the policy rates unchanged and maintained the bond buying program steady at USD 120 billion. More than the policy verdict, it is the Fed's views on inflation, labour markets and cues on tapering, that the market was keenly anticipating. Fed also upgraded its assessment of economy on account of progress in vaccination and strong policy support. In the current milieu of a stronger than expected rebound in the US economy, the Fed has yet again refrained from initiating any discussion on the tapering of the bond purchase program. While this was largely on expected lines, the booming US economic indicators, such as job gains, housing market, retail sales etc. and more importantly the consistent rise in inflation, has raised doubts and fears if Fed is right in overlooking the "transient" spike in inflation.

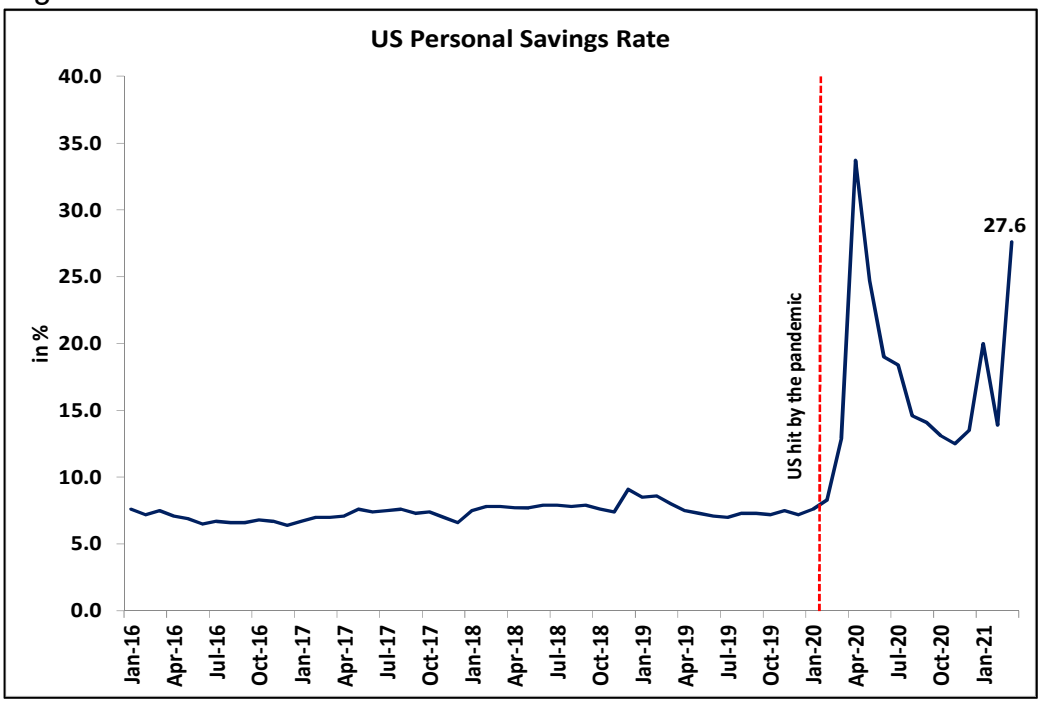
A lot is at stake as Fed continues with its stance of maintaining an ultra-lose policy even as the US economy gathers pace. With its decision to stay "behind the curve", Fed is clearly traversing unchartered territories in policy making, which has a substantial bearing on not only the US economy but also others, with emerging economies being especially vulnerable. The fear of taper tantrum spooked the markets in early March this year, after Fed triggered the talk of tolerating higher inflation and yet continuing with an easy policy stance. In this edition, we try to analyse the reasons why Fed is doing what it is doing and why it is important to keep a close watch on the macro economic developments in the US economy.

Is the US economy really heating up?

The recent economic data releases indicate a sharp rebound in economic activity. The massive USD 1.9 trillion stimulus has worked in

the right direction, giving a significant boost to consumption demand as reflected in sharp growth seen in retail sales and personal spending data. While this is largely attributable to the stimulus paychecks part of the pandemic rescue package announced in the month of March, the same has also boosted personal income as well as savings rate. While one may argue that the spike in consumer spending may be temporary, one cannot ignore the fact that the personal savings rate (which is personal savings as a percentage of disposable income) has soared significantly, thanks to cut back in spending and stimulus fed boost to personal income. This may prove to be succour for sustaining consumer spending in the coming quarters. Wages have also witnessed a rise, as indicated by the quarterly US employment cost index, which rose to its highest in a decade.

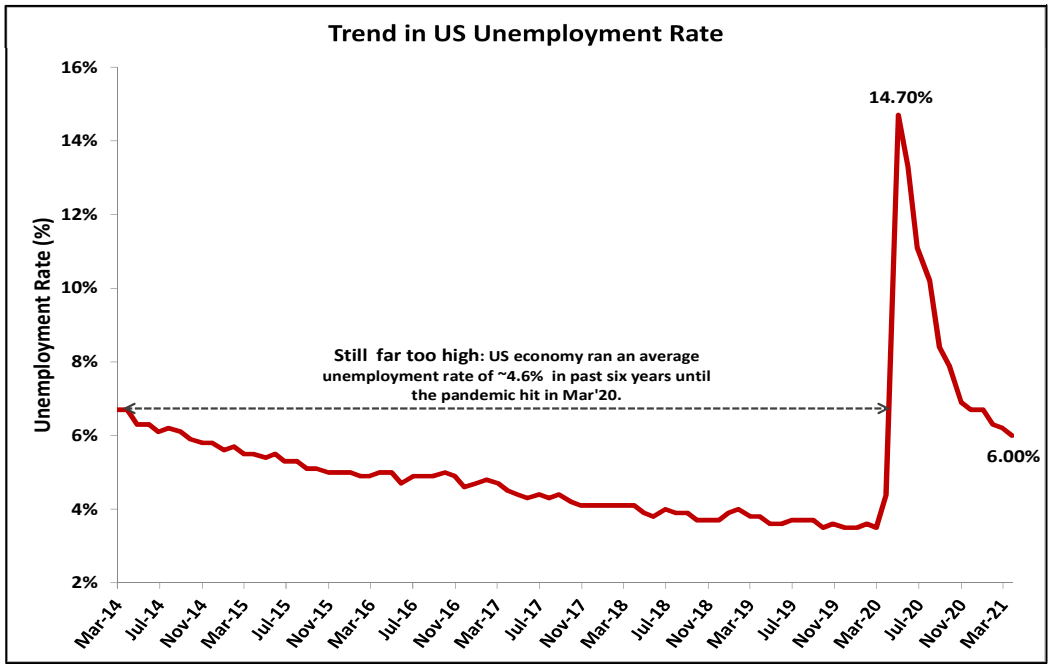
Likely tailwind for future spending: The massive fiscal boost and forced cut back in spending has pushed the US personal savings rate in post pandemic era

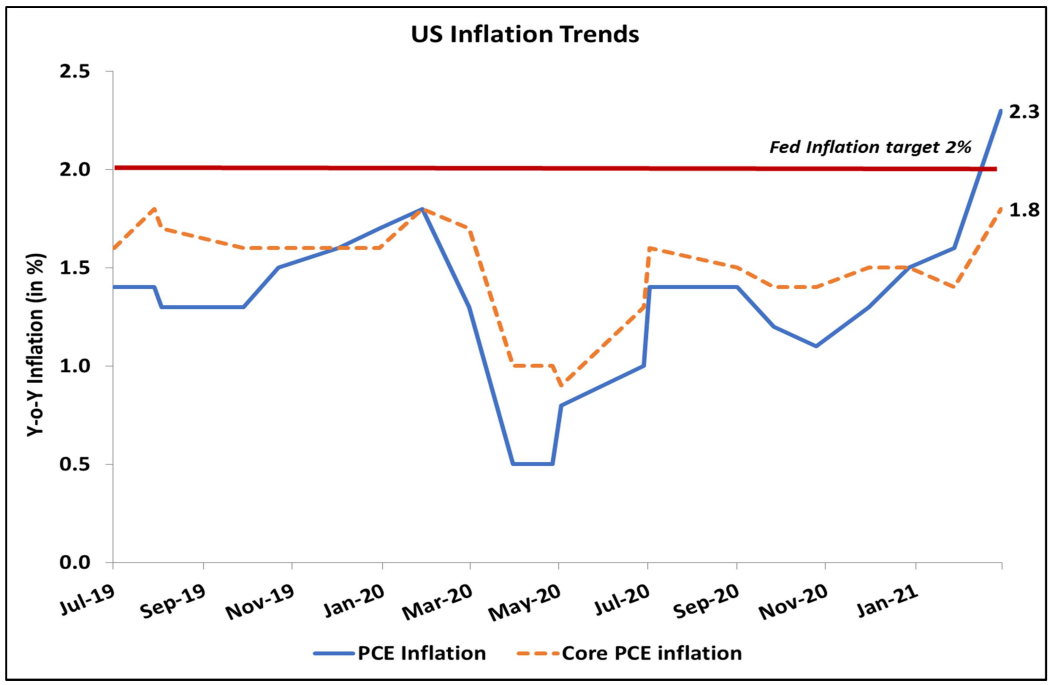


Why Fed is reluctant to talk taper

While the preliminary data does point towards a significant shift in the US economy, the Fed is reluctant to talk about unwinding yet. Besides being mindful of the disruptive impact of the unwinding of the stimulus and ultra-lose policy, Fed cites reasons behind its patient approach towards inflation and economy switching back into high gear. While the jobs have scaled back significantly, they are still far from being back to the pre pandemic levels, indicating that the labour markets are yet to recover completely. Unlike his predecessors, Fed chief Powell, places much more

emphasis on maximizing employment. While inflation is the chief mandate of any central bank, Fed has been successively underplaying the clamour surrounding price pressures. While they expect inflation to move up, they do not expect the price pressures to result in an adverse shift in inflation expectations in the economy. With labour market still remaining in relatively weak spot, inflation expectations are unlikely to change in any significant manner in Fed's manner of thinking.





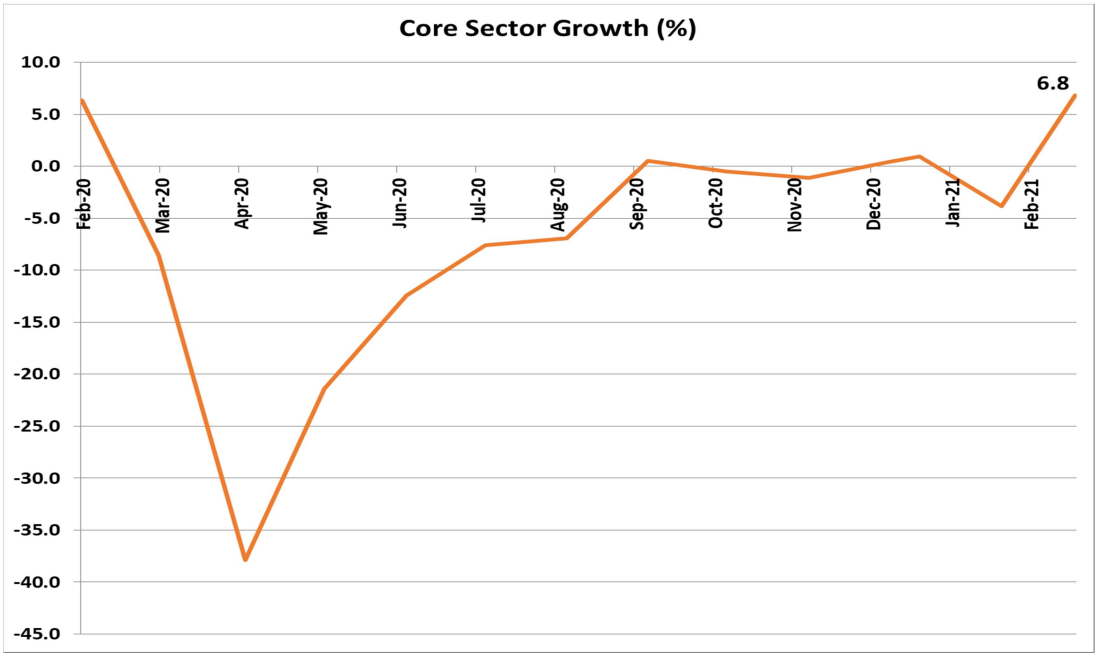
The post pandemic period has marked an important shift in US policy making, as subdued inflation over the years gives Fed ample room to focus on employment, which has turned out to be its overriding concern

As stated earlier, these are unchartered and new territories for the Fed as well as the market and it will be crucial to keep a close watch on the US data prints. The pace of vaccination will also be key data to be monitored as the same is expected to bring further normalcy in economic activities especially the contact intensive services sector which has been a laggard courtesy the pandemic. With global markets & capital flows hinged on to the Fed policy, one could only bet that Fed's bet goes right!

Macro Monitor

Core sector growth surges on base effect

India's core sector output surged sharply in the month of March, registering a y-o-y growth of 6.8%, helped by a low base (core sector growth in March'20 at (-)8.56%) and an increase in cement (32% y-o-y growth), steel (23% y-o-y growth) and electricity output (22% y-o-y growth) during the month. On the other hand, coal production witnessed steep decline, with a contraction of 22% over the previous year. During the pandemic stricken FY 2020-21, the core sector witnessed a contraction of 7%. With the plunge in economic activity seen in Q1 of previous year, the upcoming core sector and industrial output growth numbers shall be accentuated on a negative base and hence do not warrant any serious considerations. Conversely, economic activity seems to have taken a hit due to localized lockdowns and restrictions on non-essential activities, which is expected to upend Q1 growth expectations. High frequency indicators of economic activity such as fuel demand, auto sales etc. have dipped amidst the ongoing second wave of the pandemic.



Fixed Income Outlook

Fundamental View

April was a cruel month. India suffered in mammoth proportions due to the pandemic raging across the length and breadth of the country. We believe and hope that May brings relief on continuous and sustained basis. Now that there is too much fear in the general public and more alertness and urgency on the part of government (s), we can hope to see the pandemic peak soon and start decreasing thereafter steadily. The only good news if we can call it good news is that despite the pandemic being far larger in proportion to that of last year's, the impact on the economy is not as severe.

Coming back to our domain i.e the bond markets. It's becoming repetitive to say that the bonds are in a range due to RBI actions. But that's how it is. The gone fortnight also witnessed RBI cancelling the auction of Rs. 11,000 crores of 5 year paper in the first week of fortnight-thus again giving a steely counter response to the market's demand for higher yields. This resulted in a sharp rally in upto 5 year segment across. Other maturities also rallied though not as much. However more interesting development happened at end of last week. First RBI announced an unexpected special OMO (operation twist) of Rs. 10,000 crore on the eve of Friday's auction. And most surprising was the result of the weekly auction. The auction seems to have been cornered in both 2 yr (with only 7 bids mopping up the entire auction amount) and 10 yr segment (weighted cut off yield at 6.02%) Obviously this defies the logic and fear of devolvement under the current market conditions.

The powers that be are in no mood to tolerate the higher yields. The message is loud and clear. Cash balances of central and state governments have also helped till now along with RBI's resolve. The question is till when? Given that the pandemic is not as severe globally as it is in India right now and even in India we may see the peak shortly, the macros are bound to catch up in bond markets, “later than sooner” (pun intended). Till then we recommend investors to keep the portfolio light at close to 6% and bide the time. Traders can play ball along with RBI for some more time and try to catch any upticks in 10 year yield to 6.10%, till RBI has more ammunition left in its armory.

Technical View

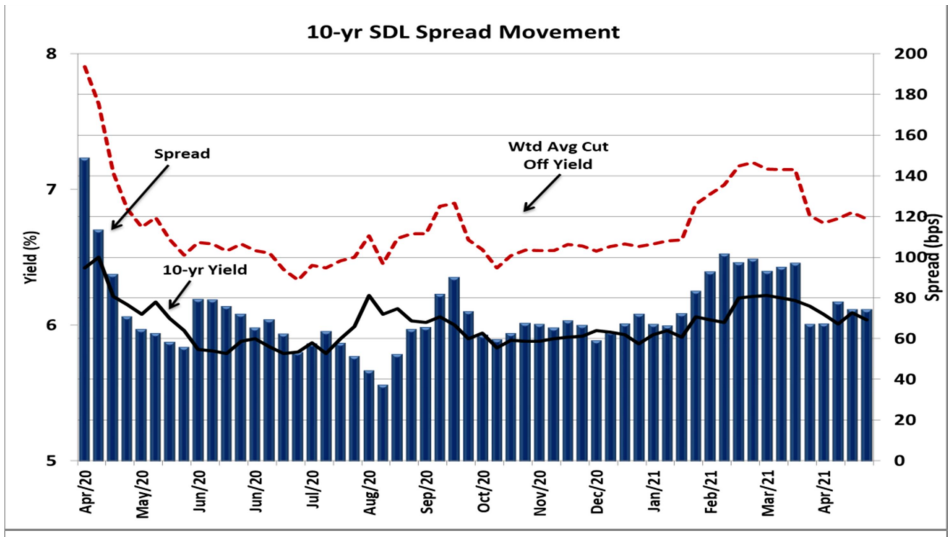
5.85% G-Sec 2030 Yield settled at 6.00% on Monday's session. Last fortnight benchmark Yield headed south and traded broadly in 6.10%-6.00% range.

Momentum oscillator RSI is currently placed around 36 level and seems heading towards 30 zone. Current chart pattern indicates yield may again test the crucial support zone of 5.96%-5.97% which also coincide with lower Bollinger band and on higher side 6.08% will act as crucial resistance zone. For coming fortnight, we believe benchmark may trade between 5.96% to 6.08% zone.

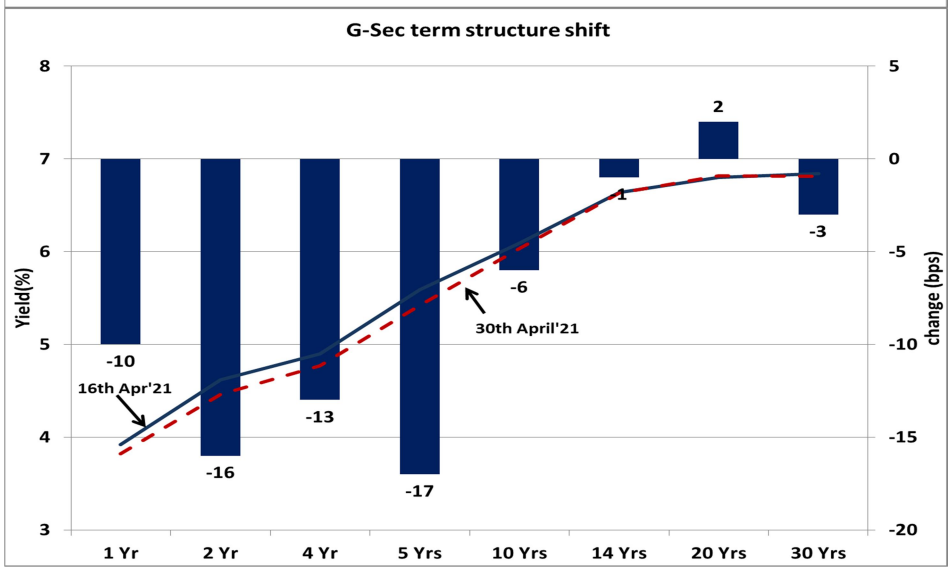
Current chart pattern indicates yield may again test the crucial support zone of 5.96%-5.97%

Source: Tickerplant

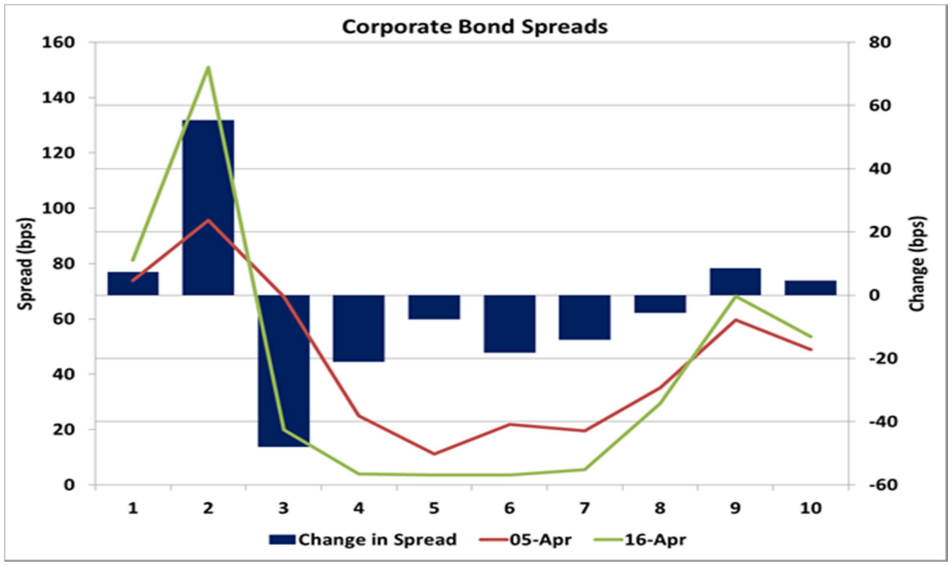
Spread Monitor



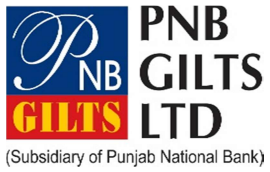
SDL spreads remained largely unchanged amidst subdued supplies in the primary market



Cancellation of 5 year paper auction, led to a rally at the short end of the curve



Corporate bond spreads eased during the fortnight



PNB GILTS LTD.
5, Sansad Marg
New Delhi
110001

Phone 011-23325759
For Fixed Income retail queries: 011-23321568
E Mail:
marketing@pnbgilts.com
For other queries:
research@pnbgilts.com

We're on the Web!

www.pnbgilts.com

PNB Gilts Ltd, a renowned and preferred name in the Indian debt market was one of the first entities to be granted the Primary Dealership License by the Reserve Bank of India. The company is also a subsidiary of one of the largest Indian commercial banks, Punjab National Bank. Company has played a pivotal role in strengthening of the domestic fixed income markets and is a dominant player, marking its presence with significantly high market share in the overall trading turnover.

Disclaimer