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PNB GILTS LTD

ECONOMY & GILT WATCH

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Monetary Policy Preview

After announcing a slew of measures in an inter policy statement to address the deteriorating macro-economic conditions amidst a vicious second wave of the pandemic, RBI is set to announce the outcome of the MPC deliberations on 4th June 2021. In the interim meet, RBI committed that it shall remain in a "battle ready" mode in order to ensure orderliness in financial markets, however the moot question is what all we can expect RBI to further do in its bid to reboot the economy, which has lost traction considerably in the ongoing quarter. The prospects of the economy recovering on a durable basis in FY 2021-22 have been dented significantly, as we lose one quarter of the year to a health crisis, which seems to have debilitated the confidence of the public, the impact of which will continue to be felt in the ensuing quarters.

Unlike last year, when we saw the release of pent up demand in the third quarter, cushioning the economic activity, this year may not see similar release of pent up demand as consumer demand is expected to remain subdued on second successive shock to employment & rise in income uncertainty, drained out finances to meet health expenses, and caution in anticipation of a third pandemic wave. Much of the economic recovery was expected to ride on the pace and success of the vaccination drive, which is also trailing in absence of continuous supplies of vaccines, hence raising serious doubts over sustainability of economic activity. With only 3% of the total population being fully vaccinated, there is a long way to be covered in immunizing a substantial proportion of our population, which is critical in averting future waves. Nonetheless, the supply side dynamics remain more stable compared to the first wave, though rising business input costs at a time of weakened consumer demand will put pressure on business margins and profitability. In the existing macroeconomic milieu, which is fraught with uncertainties, RBI is expected to remain inclined towards maintaining an accommodative stance for a prolonged period even if inflation risks face upward risks owing to factors such as surging commodity prices and supply chain disruptions.

The GDP growth projection for FY 2021-22 has been maintained at 10.5%, with RBI expecting a capital expenditure push by the government, rising capacity utilization and the turnaround in capital goods imports to support growth

Takeaways from the Annual Report

In its Annual Report for FY 2020-21, released on27th May 2021, RBI highlights the uncertainties plaguing the Indian economy which can act as a deterrent in the immediate period. Barring the citing of these uncertainties, broader stance on growth remains positive as RBI expects the Indian economy to remain resilient on account of a strong rabi season, gathering momentum of activity in several sectors of the economy till March, especially housing, road construction and services activity in construction, freight transportation and information technology (IT). The GDP growth projection for FY 2021-22 has been maintained at 10.5%, with RBI expecting a capital expenditure push by the government, rising capacity utilization and the turnaround in capital goods imports to support growth. The emphasis is on increase in public spending, which will help crowd in private investments, which are in turn essential for a sustained rebound in growth. Yes, the economic woes can only be addressed through a strong fiscal response, but a déjà vu situation has already started to play out with respect to government finances. In anticipation of a sharp shortfall in the GST collections in the first quarter of the year, the government has announced to borrow Rs. 1.58 trillion on similar lines like the last year, through back-to-back loans to compensate the states. With borrowings at record high for both the Centre and states, the fiscal headroom is highly constrained to provide a meaningful spending push.

On the inflation situation, RBI highlights the wedge between wholesale and retail price inflation during the year and attributes it to the persistence of supply-side bottlenecks and higher retail margins, underscoring the importance of supply management. It expects inflationary pressures to persist as the second wave leaves markets less competitive and impacting the supply chains while rise in global commodity prices further adding to the cost-push pressures.

What to expect from RBI policy

By announcing measures in an inter policy meet, RBI has indicated that supporting the recovery in economy remains its prime priority. Though there isn’t much room on the interest rate front, RBI would continue to use indirect measures to keep interest rates low. However, as we get back into the loop of slower growth, decimated revenues and higher government borrowings once again like the previous year, RBI’s job of keeping interest rates (yields) anchored will be a challenging task.

Adding to this challenge is a global macroeconomic environment, which is on a firmer footing and expected to gather pace led by AEs. Nonetheless, in the upcoming policy meet, RBI will likely reiterate its bias towards maintaining a growth supportive stance, while keeping its projections on GDP growth and inflation unchanged. In the face of rise in borrowings, RBI may announce its plan to conduct G-SAP 2 in order to soothe the frayed nerves of the bond market. G-SAP 1 is still to be completed with Rs. 40,000 crore out of the total Rs. 1 lakh crore announced in the April policy. We may also expect measures to ease the pandemic related distress in the economy with some measures focused on the rural economy, which has been hit hard in the second wave.

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Macro Monitor

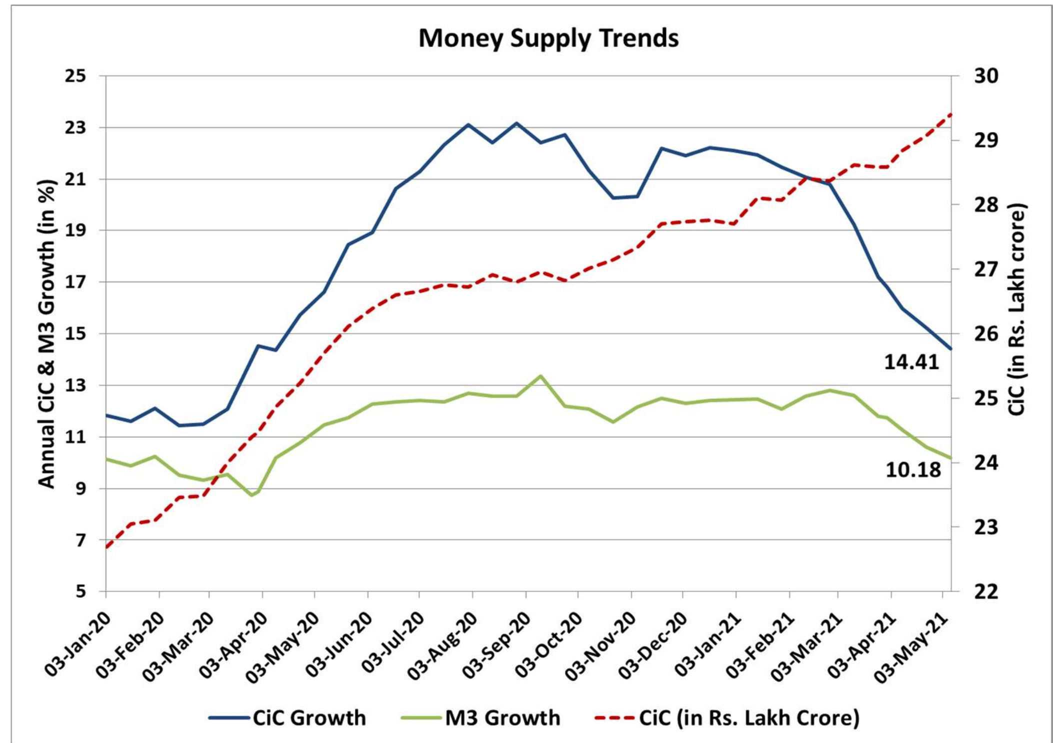
Money supply growth moderates

A look into the money supply data reveals a moderating trend in y-o-y growth of broad money supply as well as currency in circulation in FY 2021-22. In the week ended 7th May 2021, Currency in Circulation or CiC grew at 14.41% slipping from 16.81% as on 31st March 2021. A large part of this slippage in CiC growth can be attributed to base effect of the previous year, which witnessed a sharp spike in currency demand amidst a nationwide lockdown and physical disruptions. Year to date growth trends also reflect slowing of growth as CiC grew by only 2.8% in FY 2021-22 (till 7th May 2021) so far as compared to 5% growth witnessed in the corresponding period of last financial year.

Broad money supply continues to grow albeit at a slower pace, reflective of a weak credit growth. The money multiplier as per RBI's Annual Report stood lower at 5.4 in FY 2020-21 as against an average of 5.5 during the period 2011-2020. Slowing of forex inflows may have also contributed towards slowing of money supply unlike the previous year which witnessed heavy inflows resulting in addition of rupee liquidity to the system. Another key aspect with regard to M3 growth is that time deposits which form more than 70% of the broad money supply, have witnessed a sharp slow down in the new financial year. On YTD basis, time deposits grew by 1.8% till 7th May 2021 as against 3.6% in the corresponding period of last year. This could be attributed to loss of income or dipping into savings by the public to meet health expenses which have been a big drain on finances in the second wave.

Both CiC and broad money supply growth moderated owing to a high base of the previous year. Weakness in credit growth has also attributed to slowing pace of money supply in the economy.

Even on year on year basis, the growth in time deposits have slipped into single digits from an average of 10.3% during Jan'21 to Mar'21 to 8.9% during April'21 to May'21.



Fixed Income Outlook

Fundamental View

After witnessing a rather dull period of trading with yields sticking to a narrow range largely owing to RBI's continued intervention through OMOs and devolvement's, market is now seeing new developments which may induce some volatility going forward. A major development has been announcement of additional borrowings amounting to Rs. 1.58 trillion to fund the GST cess shortfall for FY 2021-22. In a similar mechanism as followed in last financial year, shortfall in GST compensation to states shall be made good by providing back to back loans. GOI has projected the GST compensation to states at Rs. 2.7 trillion for FY 2021-22, of which Rs. 1.1 trillion shall be funded through cess collections, while the remaining Rs. 1.58 trillion is to be funded through borrowings. While additional supply is bad news for the G-sec market, the announced borrowings may still not be enough to meet the GST compensation requirement of the States given the assumption of 7% growth in revenues which seems little stretched under the current scenario. Though the additional GST related borrowings shall act as a dampener to RBI's efforts to contain yields, RBI yet again gave a firm signal in last week's auction, devolving half of the 10-yr paper at a yield of 5.99%.

In the coming fortnight, two important events shall be watched by the bond markets. First, the GDP growth estimate for the fourth quarter of FY 2020-21 shall be announced on 31st May 2021. While economy is expected to post a growth of around 1.5% to 2% in Q4 FY 2020-21, the same is unlikely to be of much importance given the disruptions that the economy has undergone in Q1 of FY 2021-22. Secondly, RBI shall announce the outcome of the MPC deliberations to be held during 2nd to 4th June 2021 on 7th June 2021. Bond markets shall keenly await more measures to timely assuage the pressures that have started building up given the deteriorating state of government finances. All macro factors (fiscal deficit, inflation, global cues etc) point out to yields trending higher, but RBI's resolve to cap them has been steely. Along with it other factors such as comfortably high levels of government cash balances, will also give much comfort to RBI to tinker with pace of CG and SDL supplies, helping it to moderate the adverse impact of additional borrowing requirements. Going forward we expect the direction for the markets to be set post policy verdict.

Technical View

5.85% G Sec 2030 Yield settled at 6.00% on Friday's session. Benchmark yield, witnessed yet another lacklustre movement in passing fortnight.

Momentum oscillator RSI is currently placed around 48 zone. As discussed in last edition, till benchmark is sustaining above 5.95% level further downside seems unlikely. Current chart pattern indicates 6.04%-6.05% to act as a crucial resistance level, adding to it, upper Bollinger band level is also placed at these level, giving weightage to the level. Going forward, yield may continue to trade between 6.05%-5.95% zone. However, with Bollinger band width trading near support level and RBI policy round the corner, any suitability either side of the range may trigger swift move in that direction.

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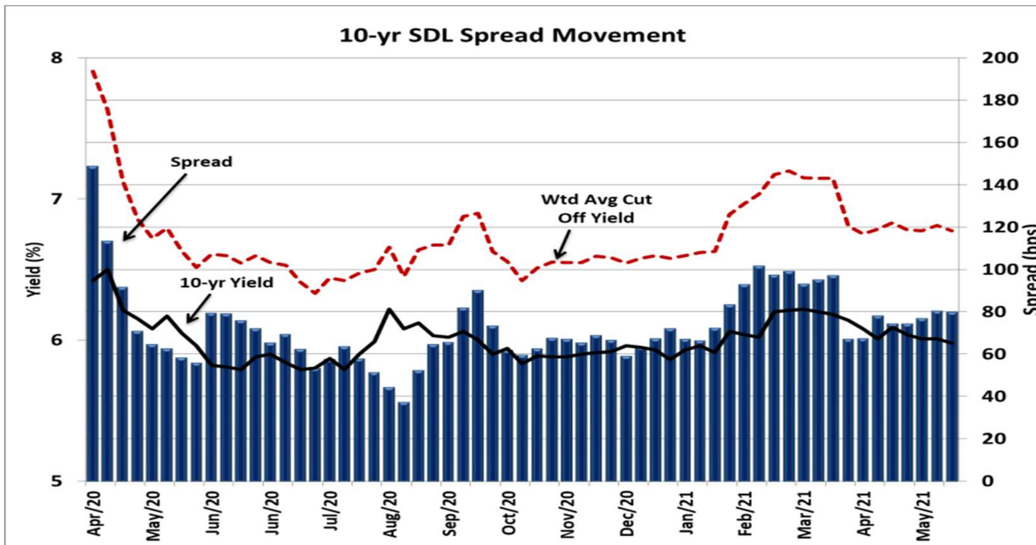
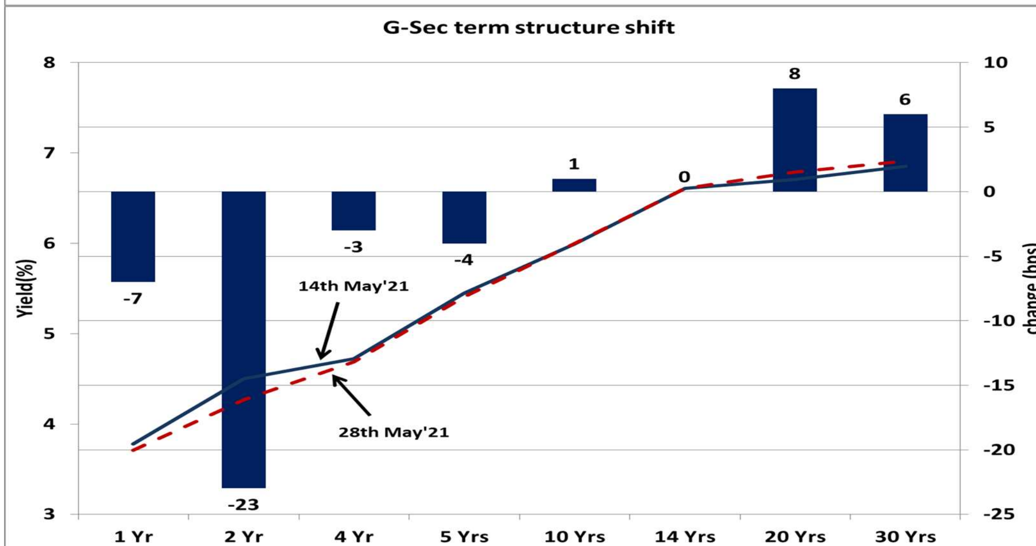
Source: Tickerplant

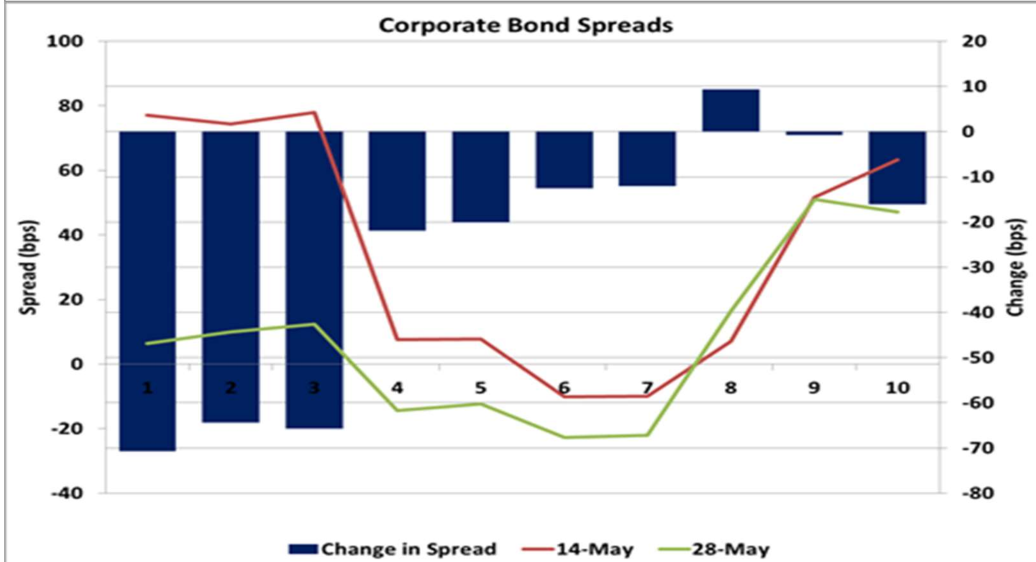
Spread Monitor



After remaining largely stable, SDL spreads may witness some widening on account of additional borrowings of Rs. 1.58 trillion announced to fund the GST cess shortfall



Yields in the 5 to 14 yrs bucket traded in a narrow range. Going ahead much of the direction of yields shall be decided by the RBI policy outcome



Corporate bonds eased at the short end of the curve during the previous fortnight

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