PNB GILTS LTD

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ECONOMY & GILT WATCH

(Subsidiary of Punjab National Bank)

INSIDE THIS ISSUE:

Why Fed will do a Status Quo

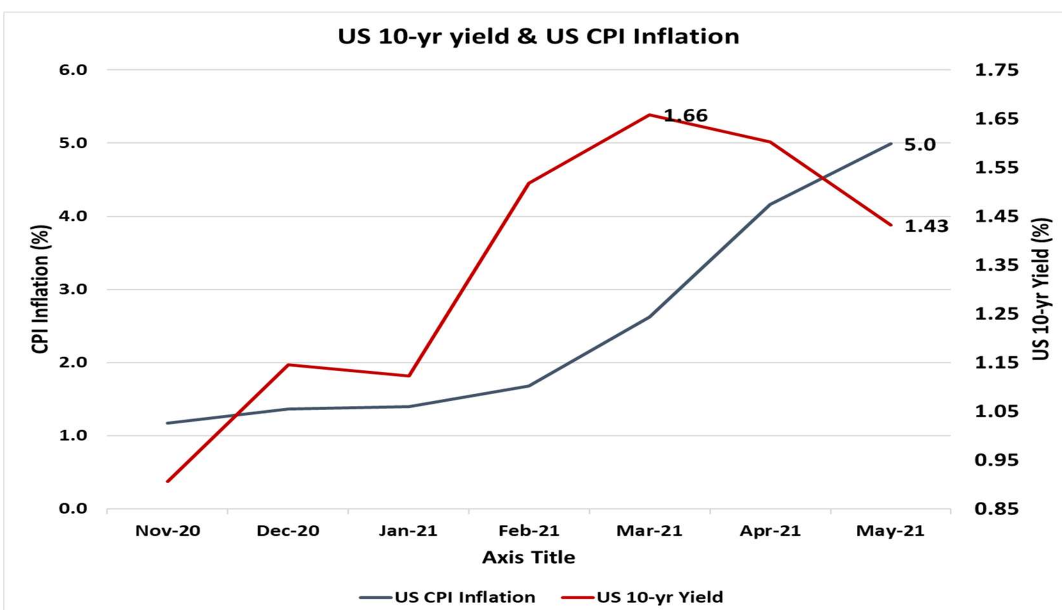
The past fortnight saw very interesting and counterintuitive developments in the global markets driven by the mother market, i.e. the US market. The 10-yr yield in the US bond markets retreated sharply from the highs of 1.75% that it touched in March'21 and the broad level of 1.60% witnessed since then, to below 1.45% despite US CPI inflation surging to a 13 year high. The US consumer price inflation came in at 5% for the month of May as against 4.2% reported in April, higher than an expectation of ~4.7%. Core CPI inflation, which strips out volatile items like food and energy, also paced up to rise by 3.8% in May on an annual basis, after a 3% rise in April. In response to the latest set of inflation figures, equity markets continued to rally, while bond markets finally shed its reluctance and seem to be falling in line with the Fed's narrative of current bout of inflation being a "transitory" phenomenon. While the equity markets have remained buoyant, largely complying to Fed's view on inflation, it is the reaction of the bond markets that has evoked much interest. Though a large part of the decline in yields is attributed to market positioning, i.e. covering of short positions, the easing of yields if sustained could actually reinforce the confidence in the view on inflation that the Fed has consistently stuck to.

Why the latest US CPI inflation failed to stir markets?

The discussions around inflation have been a central driver for global markets as Central Banks around the world continue to maintain lose policies, amidst gradual scaling back of demand in the economies and rising supply side constraints which skew the overall inflation dynamics in the global economy. The latest US CPI inflation at 13 year high should have flared up concerns sharply, but markets reacted contrary to expectations. While a low base effect did certainly lead to a sharply higher print in the month of May, the surge in inflation is also attributed to rise in prices in segments, which were severely dented during the pandemic such as new and rental cars, trucks, household furnishings, apparels, airfare, hotel stays etc. Adding to this, is the interplay of

The latest US CPI inflation at 13 year high should have flared up concerns sharply, but markets reacted contrary to expectations, with the 10 yr yield plunging to three-month lows

consumer demand which has rebounded sharply on back of higher savings amassed during the pandemic period and consequent release of pent up demand. It could be deduced that the spurt in consumer demand will likely normalize which shall have a soothing impact on inflation. The latest US consumer expectation survey also seems to be indicating the same as on one-year inflation expectations fell to 4.0% in June from 4.6% in May, while its five-to-10-year inflation outlook dropped to 2.8% from 3.0% in May. While this gives some comfort, it is the supply side constraints and passing of higher input prices to the consumers that is raising red flags, which are hard to ignore. Unless these supply bottlenecks are resolved, inflation shall continue to remain elevated. Another important factor, which has ramifications for the inflation expectations, is the labour market conditions. The US labour market conditions continue to display puzzling trends as new job additions trailed market expectations. In the month of May, US Non-farm payrolls rose less than expected by 5,59,000 which though better than last month's reading, was still lower than expectations of 6,50,000. Lower job creations despite opening up of the economy, is attributed to employers having difficulties in filling up positions due to likely mismatch of skills, while state sponsored unemployment benefits also are understood to be constraining the labour supply as potential employees remain on sidelines. However, the expiry of these benefits will augur well for labour force participation rate, which declined to 61.6% in May. While shortage of labour and opening up of the economy make a perfect recipe for the much-feared wage price spiral, Fed has successfully kept these fears in check by reiterating its transient inflation theory.



Will Fed change its language?

The latest set of employment data falling short of market estimates sets the stage for another dovish policy by the Federal Reserve, which shall release its decision on 16th June. Even though inflation at 13 year high is discomfiting, Fed's unwavering focus on full recovery in the labour markets, will likely lead us to witness yet another dovish policy with a status quo on stance. However, the data on labour markets and inflation will have to be closely monitored for any signs that would challenge what the Fed has been vouching for till now.

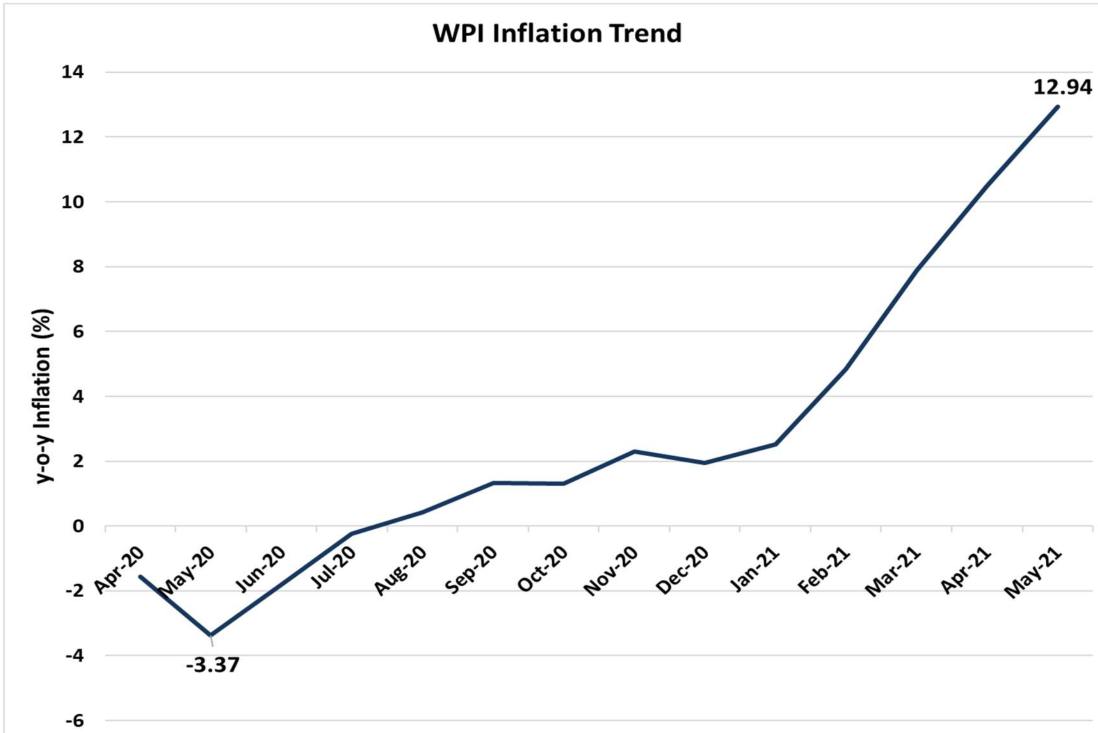
Macro Monitor

WPI Inflation Surges 12.94% in May

Wholesale price inflation continued to rise unabated, with the index posting 12.94% rise y-o-y in the month of May versus 10.49% in April. While much of the rise in WPI inflation can be explained because of the negative base of the previous year (WPI inflation at -3.37% in May 2020), the WPI inflation was also driven by an uptick in fuel and power inflation both on sequential as well as annual basis. Fuel and power inflation rose to a staggering 37.61% during May, exacerbated by a low base effect. Month on month the fuel & power index rose by 1.75%. Manufactured products inflation also witnessed a spike during the month, rising to 10.83% as against 9.01% in the previous month, with a month on month rise of 1.24%. Under manufactured products, inflation in different categories of edible oil witnessed a y-o-y rise of almost 52% as prices of international edible oil have seen a sharp increase over the last few months.

The WPI inflation is likely to have peaked as base effect improves going forward, however, rising international crude oil prices & a weakness in rupee shall keep WPI inflation firm.

On the other hand, primary articles inflation stood at 9.61% year-on-year in May against 10.16% in April. Month-on-month, it contracted by 0.86% largely on easing vegetable prices. WPI inflation may have likely peaked with the May reading, as the base will gradually rise after hitting a trough of -3.37% in May 2020. The continued rise in international crude oil prices and a depreciating rupee will likely keep WPI inflation firm.


WPI Inflation Trend
y-o-y Inflation (%)
14
12
10
8
6
4
2
0
-2
-4
-6
12.94
-3.37
Apr-20
May-20
Jun-20
Jul-20
Aug-20
Sep-20
Oct-20
Nov-20
Dec-20
Jan-21
Feb-21
Mar-21
Apr-21
May-21

Fixed Income Outlook

Fundamental View

The clear winner: Central Banks across the world. This round certainly goes to all the Central Banks including RBI in India and Federal Reserve in US. Despite deteriorating macros (in terms of inflation and fiscal deficit, the two most important macro points for bond yields) the strong and unwavering hand of the Central Banks has held the fort. After a scare in the initial part of the year, RBI has been able to contain the yields, despite the strong tailwinds. The 10-yr yield has been hovering near 6% mark mainly due to RBI's active intervention. It would be foolhardy to stand against the strong conviction of the RBI and call for a market bottom atleast in the short run. The short dated papers saw an excellent rally in last few weeks as RBI galvanized expectations amongst the market of an extended pause and availability of ample liquidity for longer period of time. In the fortnight gone by, RBI devolved a major part of the 5 year and 10 year paper in auctions on underwriters ie. Primary dealers, in order to reinforce the message to the market. Under normal market conditions such huge devolvement would have usurped market sentiments severely, however now they have become a signal of RBI's confidence in itself. Once again the question to be asked is till when yields can be managed in such a strong manner and we still don't have any answer except that eventually it has to give up unless the macros start supporting the action.

Looking forward it seems that short dated papers shall remain in flavor for longer period and longer duration paper shall remain well anchored in near term.

Looking forward it seems that short dated papers shall remain in flavor for longer period and longer duration paper shall remain well anchored in near term. Though it's a matter of time that longer dated papers will catch up with the macros but as we discussed the central bank's hand has been heavy enough to contain the yields and it is not advisable to take a bet against their well communicated intention. A new 10-yr benchmark may also be in the offing soon enough, the announcement of which could end the premium awarded to the on the run 10 yr paper and anchor other papers to the new papers. It will be interesting to see the level of the new 10-yr benchmark paper in the current context of RBI keeping a sharp eye on the 10-yr yield and the overall yield curve. These are very different times and past history won't be any guide for deciding the debut levels of the new benchmark paper.

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, as it traded in narrow band of 6.03%-5.97%.

Momentum oscillator RSI is currently placed around 47 zone. Current chart pattern indicates 6.04% to act as a crucial resistance level, also upper Bollinger band level is placed at 6.04% level, indicating crucial resistance zone, on lower side 5.98% and 5.95% to act as immediate support level for the benchmark yield. Going forward, Yield may continue to trade between 6.05%-5.95% zone. However, with Bollinger band width trading near 6month low, sustainability either side of the Bollinger band squeeze may trigger swift move in that direction.

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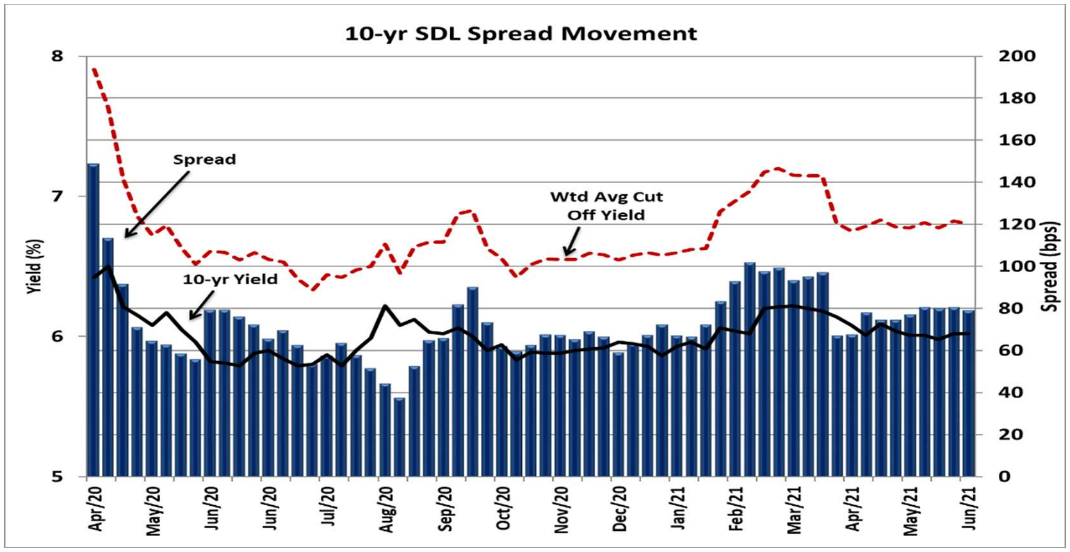
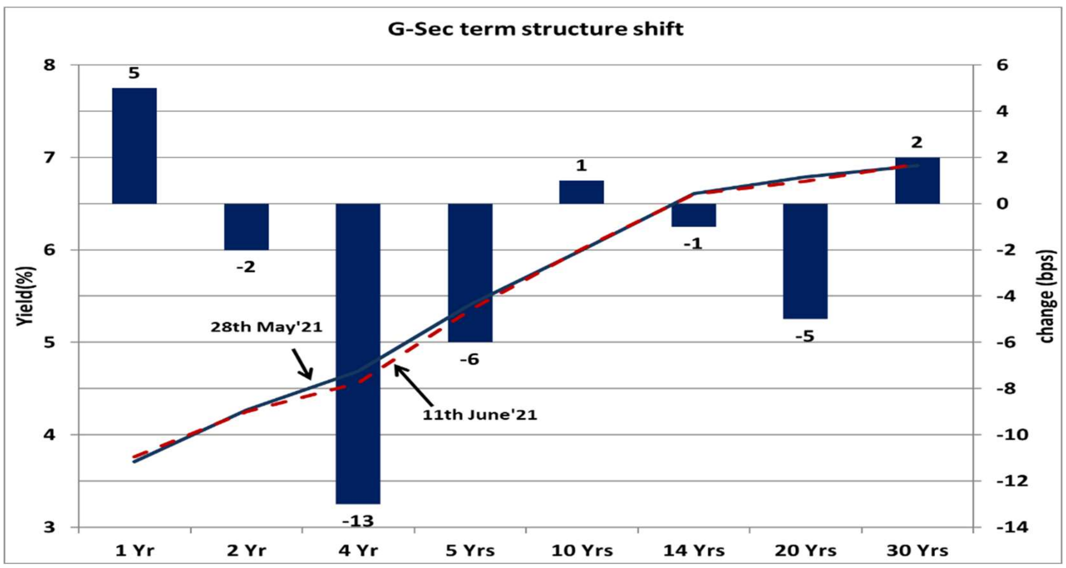
Source: Tickerplant

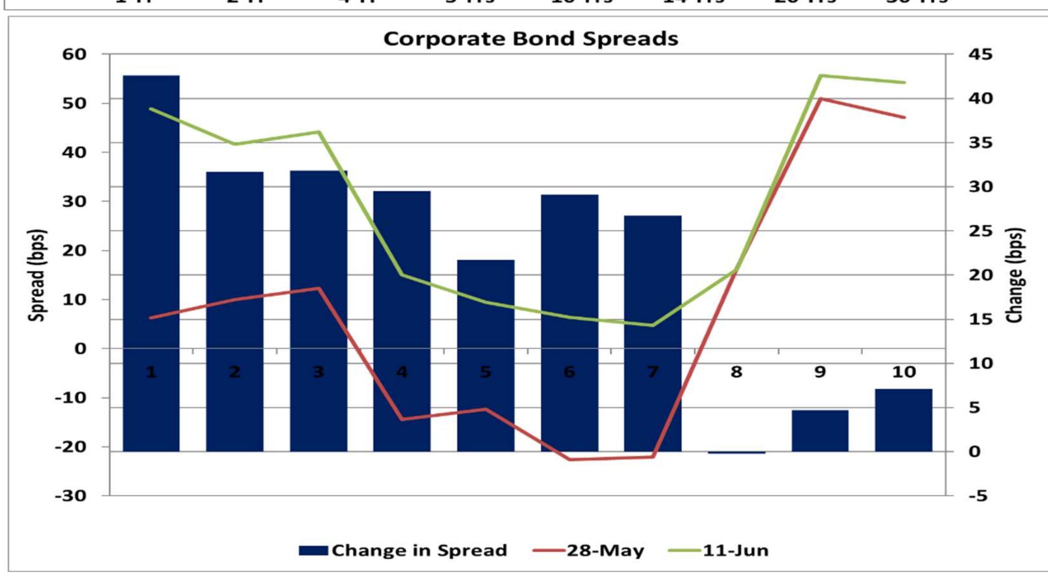
Spread Monitor



SDL spreads are expected to remain largely stable amidst genial conditions in the underlying market and continuous supplies through fresh SDL issuances



With RBI strongly reiterating its accommodative stance in a bid to support economic recovery, short end of the curve witnessed softening



Corporate bond spreads rose during the previous fortnight

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