PNB GILTS LTD

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ECONOMY & GILT WATCH

PNB GILTS LTD
(Subsidiary of Punjab National Bank)

INSIDE THIS ISSUE:

MPC Minutes: Review

The minutes of the monetary policy meet held during 2nd to 4th June 2021, flagged concerns over rising inflation, even though the broad consensus continues to remained tilted towards supporting economic recovery. Highlighting the debilitating impact of the second wave on the nascent economic recovery that began in Q4 FY20 and disruption witnessed in Q1 FY21, the MPC makes a case of unambiguous policy choice that continues to remain accommodative. The committee members however remain divided on the risks concerning inflation, with some members advocating that the subdued demand will keep a tab on price pressures, while other members advocating a close watch on inflation, lest it becomes deeply entrenched in the economy. The headline inflation print of 6.30% for the month of May released post policy meet, merits that we take heed of these warnings rather seriously. Though it's a bit too early to draw the conclusion that normalization of policy would be kick started with policy focus shifting back to inflation management, its primary objective, the forthcoming trends in inflation and economic activity would be key in determining when that pivot point would arrive as far as the shift in policy stance is concerned. The US Fed has already set the precedence, by a swift change in its stance, forecasting two rate increases in 2023 and also revising its consumer price inflation projection to 3.4% from 2.4% projected earlier.

While Fed has taken cognizance of the rising pressures in the US economy, the question is whether RBI can afford to continue to overlook the buildup in inflationary pressures in the domestic economy? Two of the committee members, Dr Mriddul K Saggar and Prof. Jayanth R Varma wouldn't certainly agree. According to Prof Jayanth, India's monetary policy committee must be watchful of inflation expectations becoming entrenched, despite being supply driven, and to keep the credibility intact, RBI needs to be data driven, so that it can respond rapidly. On the other hand, Dr. Mridul K Saggar sounds even more wary of the rising inflationary pressures in the economy.

Even though, he highlights the fact that transmission of cost push pressures onto retail prices remain limited in the current environment of muted demand, he advocates to watch CPI very closely for signs of it becoming generalized. He also advocates that the policy may need to respond if inflation expectations are seen becoming unhinged. The concerns are valid, given that we have seen inflation becoming generalized in the past. However, in the current macroeconomic backdrop of weakened demand, loss of income and job, the risks of inflation becoming broad based and demand induced seem limited. Committee member Dr. Ashima Goyal has highlighted this contra point in her comments. She highlights the fact that fall in demand exceeds that in supply, due to which the output gap should widen, reducing demand side pressures on inflation. According to her, reduction in income, increased indebtedness and impoverishment are further expected to keep demand muted in the economy. On the globally driven commodity price pressures, she expects these pressures to be temporary with uneven recoveries in different parts of the world and uncertainties to restrain demand. On the anticipated outflows from emerging markets due to reversal in US policy stance, Dr Ashima highlights the fact that India has enough reserves to allow it to follow its own interest rate cycle rather than being directed by the US rate cycle. Other members, viz Dr. Patra and Dr. Bhide also resonate a similar view that it would be immature to withdraw policy support at this juncture, with Dr. Patra recommending taking supply easing measures to mitigate the risk posed by energy prices.

CPI Projections					
Policy Meet	Q1 FY21	Q2 FY21	Q3 FY21	Q4 FY21	FY22
April Policy	5.2	5.2	4.4	5.1	-
June Policy	5.2	5.4	4.7	5.3	5.1
GDP Projections					
	Q1 FY21	Q2 FY21	Q3 FY21	Q4 FY21	FY22
April Policy	26.2	8.3	5.4	6.2	10.5
June Policy	18.5	7.9	7.2	6.6	9.5

Will RBI be an outlier amongst emerging economies?

The minutes of the June policy meet, broadly imply that the MPC is overlooking the current build up in inflationary pressures, with 4 out of the 6 members drawing comfort from the fact that inflation is supply driven and demand is still too weak for inflation to become deeply entrenched. However, other central banks are now seen tweaking this approach in response to the buildup in price pressures. Brazil's central bank, raised its benchmark rates for third consecutive time as inflation surged to multi year highs. Russia's central bank also increased its key interest rate to 5.5% this month, increasing the cost of lending for the third time this year due to rising inflation adding that more hikes would be needed. The contrast in the policy approach towards rising inflationary pressures between India and other emerging economies is stark. While Brazil has acted with promptness to prevent inflation expectations becoming unanchored, India is in a wait and watch mode, giving economic recovery time to take roots. While the former approach entails risk of nascent recovery losing steam, the latter runs the risk of inflation running lose. The policy dilemma is indeed perplexing, but given the fact that policy transmission occurs in long lags, the need for RBI to adjust its stance sooner than later is increasingly gaining ground.

There is policy contrast between India and Brazil in tackling growth inflation trade off. While the Brazil's approach entails risk of nascent recovery losing steam, India's approach of giving time to growth to take roots runs the risk of inflation running lose

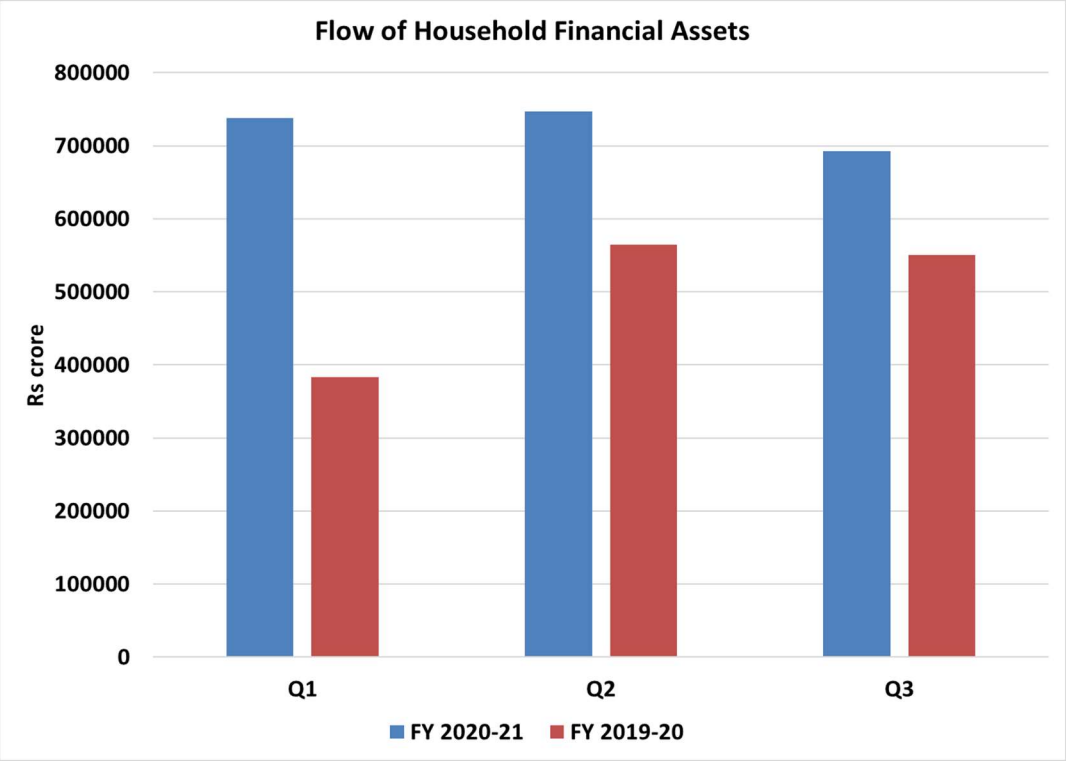
Macro Monitor

Household Finances during Q3 FY 2020-21

The quarterly data released by RBI on the state of household financial savings gives glance of the impact of the first wave of the pandemic on household finances in India. During the period Q1 to Q3 of FY 2020-21, the financial assets of households swelled to Rs. 21.78 lakh crore as against Rs. 14.98 lakh crore during Q1 to Q3 of FY 2020-21. This is indicative of the fact that households held on to savings and cash amidst the pandemic induced uncertainty, preferring not to spend their incomes. Currency holdings also increased during the first three quarters to Rs. 3.16 lakh crore as public increased precautionary holding of cash. The financial liabilities of the households witnessed a rise during Q1 to Q3 FY 2020-21 to Rs. 4.25 lakh crore as against Rs. 3.92 lakh crore during corresponding period of last year. After the first wave, the economy witnessed swift rebound in demand as pent up demand was released. However, with the

second wave being much more virulent than the first, a similar strong rebound in consumer demand seems less likely and the impact of the second wave on consumption may be continued to be felt for a protracted period.

Household financial assets swelled during the first three quarters as households held on to savings and cash amidst uncertainty



Fixed Income Outlook

Fundamental View

All the events that dominated the previous fortnight viz domestic CPI and WPI and Fed meeting were all bond negative. A *hawkishly dovish* (pun intended) Fed took the wings out of the globally most popular trade of steepener. It resulted in a selloff in the shorter end of the yield curve. As the event turned out negative, the crowded trade of buying the short dated bonds bore the main brunt. The 2-year US treasury note yield jumped from 0.14% to 0.26%. A 12 bps jump seems a very nominal rise on the face of it but when the base yield of 0.14% is taken into account, it turns out to be a substantial change.

Coming to domestic bond markets, a similar reflection was seen in India too. The impact, though, was far more pronounced and quick in "non controlled" markets like overnight index swaps (OIS) and corporate bonds while it was comparatively lesser in SLR instruments. The CPI and WPI reading shows that reflation theme is back with a vengeance. However, the support of RBI towards the government bonds market has been intact and unabated since the start of this financial year and there been no let up in their commitment. Nonetheless the disconnect between RBI's expectations of the market and the market player's expectations of the market is ever increasing with each passing day. There is no doubt that one day the fundamentals (reflecting the macro economic scenario) will prevail but when that day will arrive is anybody's guess and honestly we haven't been too successful in predicting that. All we can say that the day is closer than ever before. Market players know that even though RBI has large power to manage the markets but not an unlimited power. RBI has done OMO/OTs, cancellation of auctions, devolvement of auctions, GSAP et al to signal a stable and soft interest rate regime but market now seems to be tired of the same and RBI may have to do something new or something larger than usual, to tone down the evolving bearish sentiments, and quickly. The word quickly assumes a lot of importance here. Unless the same is done quickly, the time for manifestation of higher yields is closer than ever. Two things can defer the inevitable though - a larger than current support by RBI or resurgence of COVID pandemic (which would be unfortunate though).

The disconnect between RBI's expectations of the market and the market player's expectations of the market is ever increasing with each passing day.

Once again, looking at the yield of 10-year benchmark to judge the state of the market would be fallacious. Over the fortnight the 10 year yield hasn't shown much change but other parts of the yield curve have shown perceptible damage. It's only and only RBI that can prevent any further damage. The market participants are keenly watching the evolving economic realities which as of now are bond negative. To summarise, unless the growth inflation dynamics turns lower again or RBI uses a quick and larger action, the best days of the bond markets could be over.

Technical View

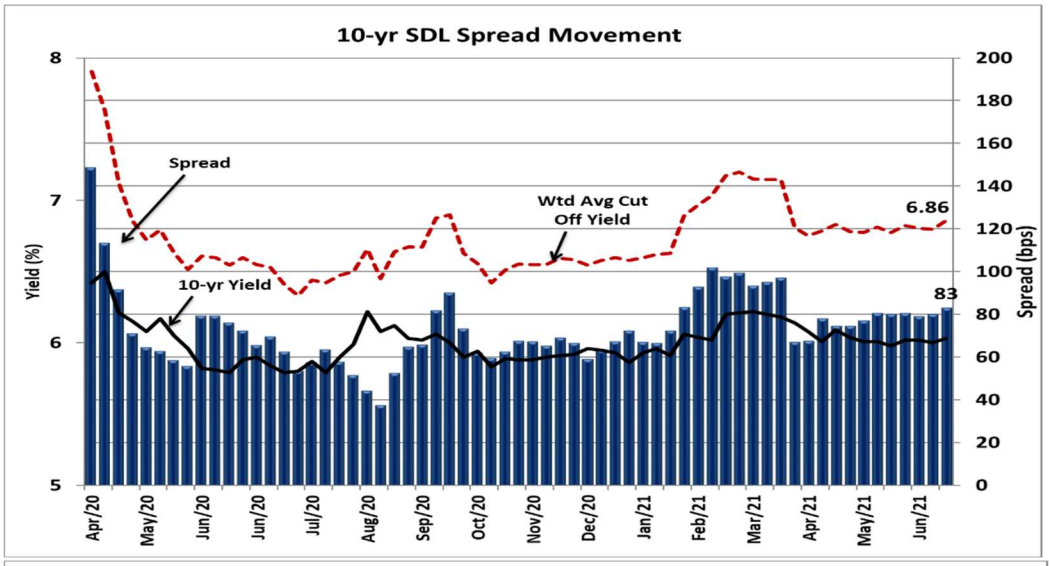
5.85% GS 2030 Yield settled at 6.03% on Friday's session. Ten year continued its dismal performance as it traded in a narrow range of 6.00% /6.06%.

Momentum oscillator RSI is placed around 55 level. The chart pattern indicates Benchmark may witness a trend line breakout if it sustains and close above 6.06% level, adding to it, with Bollinger width trading near 6months low it may further add to the momentum if the resistance is breached on higher side. However, till then it may continue to trade in above mentioned range of 6% to 6.06%.

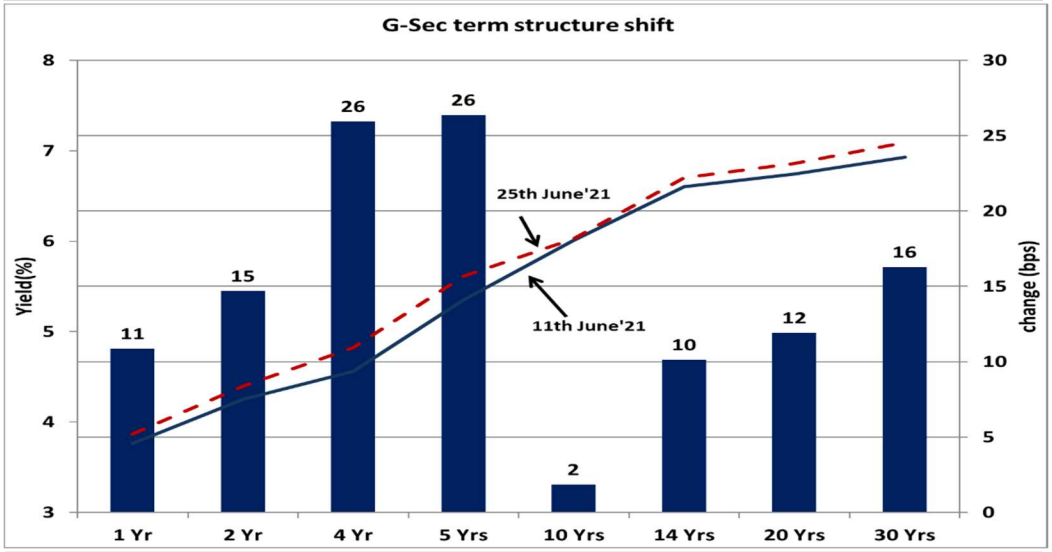
The chart pattern indicates Benchmark may witness a trend line breakout if it sustains and close above 6.06% level

Source: Tickerplant

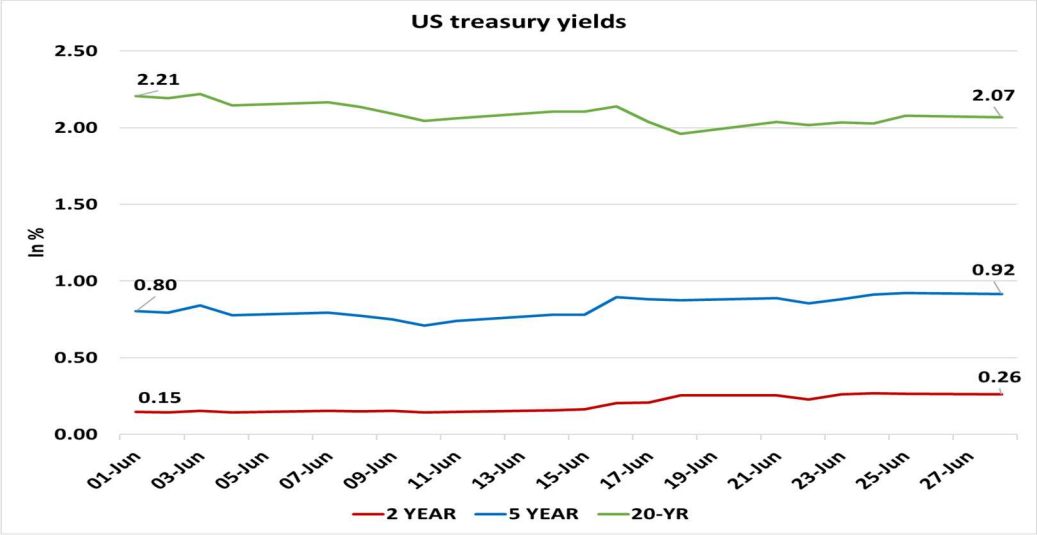
Spread Monitor



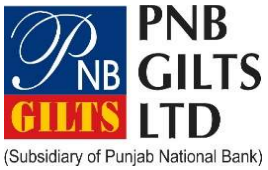
SDL spreads inched upwards during the fortnight, as supplies remain large, while the broader sentiments in the bond markets remain subdued



All the tenors on the yield curve firmed up during the fortnight barring the 10-yr point as concerns over rising inflation and reversal in Fed's stance hurt appetite



The US treasury yield curve witnessed significant flattening after US Fed signalled two rate increases in 2023



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