PNB GILTS LTD

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ECONOMY & GILT WATCH

PNB GILTS LTD
(Subsidiary of Punjab National Bank)

INSIDE THIS ISSUE:

RBI Monetary Policy: Review

RBI released its monetary policy decision on 6th Aug'21 after three days of deliberations beginning 4th Aug'21. In the policy announcement RBI maintained status quo on the policy rates and continued with accommodative stance as long as necessary. While the policy verdict is on expected lines, there was build-up of expectations for August policy to be a pivoting point in terms of the language and guidance on inflation, with economy facing continuous price pressures. The policy excerpts and the statement of the Governor indeed point towards a mild turn in the language used, which is less dovish, but not anywhere close to being hawkish. Another key fact to be noted is that one Monetary policy committee member, Prof Jayanth R Varma dissented in RBI's resolution on accommodative stance, with four member favouring continuation of accommodative stance. It must be noted that Prof. Varma had expressed concerns on inflation as per the June policy minutes, stating that India's monetary policy committee must be watchful of inflation expectations becoming entrenched. Another key highlight was upward revision of the CPI inflation projection for FY 2021-22, and clear but non-hawkish signals by RBI that it is keeping a watch on the evolving inflation dynamics. The GDP growth estimate for FY 2021-22 was retained at 9.5 per cent though, there are changes in quarterly projections. In all, the policy struck a balance between keeping its focus on growth revival, while also making it clear that it remains committed to anchoring inflationary expectations as well.

More optimism on growth; Inflation back under the scanner

RBI sounds more optimistic on domestic growth, expecting rural demand to be resilient and expects investment demand to also pick up as capacity utilisation, steel consumption, imports of capital goods show encouraging trends. Buoyant external demand is also expected to support aggregate demand. GDP projection is however retained at 9.5% for FY 2021-22 as vulnerabilities still exist. There is a definite change in tone and expectation on inflation, with CPI projection being revised upwards to 5.7% for FY 2021-22, 60 bps up from June projection of 5.1%.

RBI also highlights the importance of anchoring inflation expectations and the fact that it is conscious of this objective. However, at the same time it downplays inflation fears by highlighting the fact that inflation is supply driven and demand is slack and that pre-emptive policy response to such build up inflationary pressures at this juncture may disrupt the recovery process. Nonetheless, we feel that RBI may not chose to look through the inflation numbers going forward and the forthcoming inflation numbers shall be critical in determining the timing of exit from the current easing cycle.

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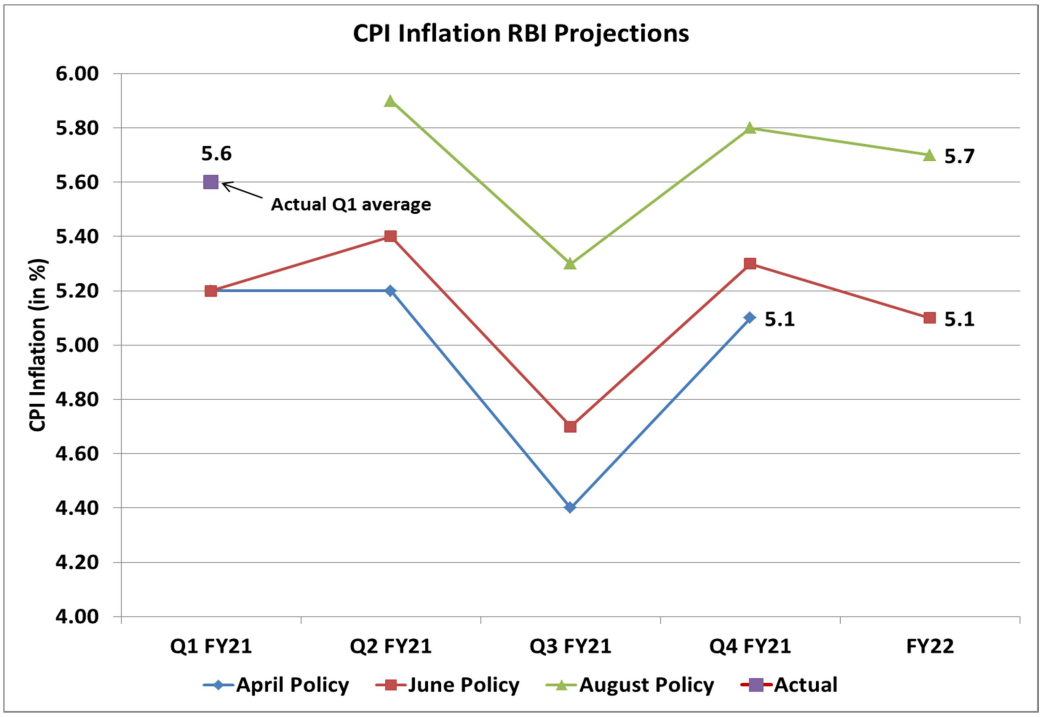


Other Key Announcements

Other key announcement pertains to the increase in VRRR auction amount. RBI has announced to increase the VRRR auction amount in a calibrated manner starting from Rs. 2.5 trillion on 13th Aug'21 and increasing by Rs. 50,000 crore each fortnight till 9th Sep'21. RBI emphasizes that the enhanced VRRR amounts do not indicate reversal in accommodative stance. It should be noted that the absorption under the reverse repo window has seen a steady increase June onwards and has topped Rs. 8 trillion in August (including VRRR of Rs. 2 trillion). And with the upcoming GSAP auctions (of Rs. 25,000 crore each on 12th & 26th August 2021), the systemic liquidity is expected to rise further.

Given this, the increased VRRR auction amount should not be seen as a destabilizing factor, infact it will help liquidity stay normal and hence avoid unnecessary distortions in the yield curve.

Beginning of a tight rope walk?

Overall, the policy continues to be driven by the overarching objective of ensuring durable economic recovery, with RBI reviving its focus back on inflation and acknowledging that inflation expectations getting unhinged can have undesired ramifications on policy credibility and ultimately on the markets. While that stands true, the path of policy normalization may have to be treaded with great caution as the tradeoff between growth and inflation is likely to widen in the coming period.

Macro Monitor

Household Inflation Elevated, Consumer Confidence Continues to Remain Subdued

The household expectations survey released by RBI on the policy day, i.e. 6th August 2021, showed that Households' median inflation perception for the current period stood elevated at 10.3% in July compared with 10.2% in May. Whereas, median inflation expectations for three months and one year ahead period hardened by 50 basis points and 60 basis points to 11.3% and 11.5% respectively. Respondents to the survey, largely expect prices of food, non-food products and services to remain high. The consumer confidence survey showed that consumer sentiment for the current period continues to remain weak with the Current Situation Index at around all time low levels (48.6), driven by reported lower levels of incomes and higher price levels. On the other hand, the one year ahead scenario improved somewhat, driven by significant improvements in the outlook for general economic situation and employment scenario after the waning of the second wave of the COVID-19 pandemic. The Future Expectations Index revived to 104 in July 2021 vis-à-vis the index trough of 96.4 witnessed in the month of May 2021. The survey outcomes on income and spending expectations also remain largely muted with a higher percentage of respondents expecting a decrease in income as per current perception on income, and a contraction in non-essential spending as per both current perception and one year ahead expectation.

Fixed Income Outlook

Fundamental View

The impact on market of a divided vote in RBI Policy is right now unknown and we would advise to wait for the minutes of MPC meeting to be released and analyzed for further cues

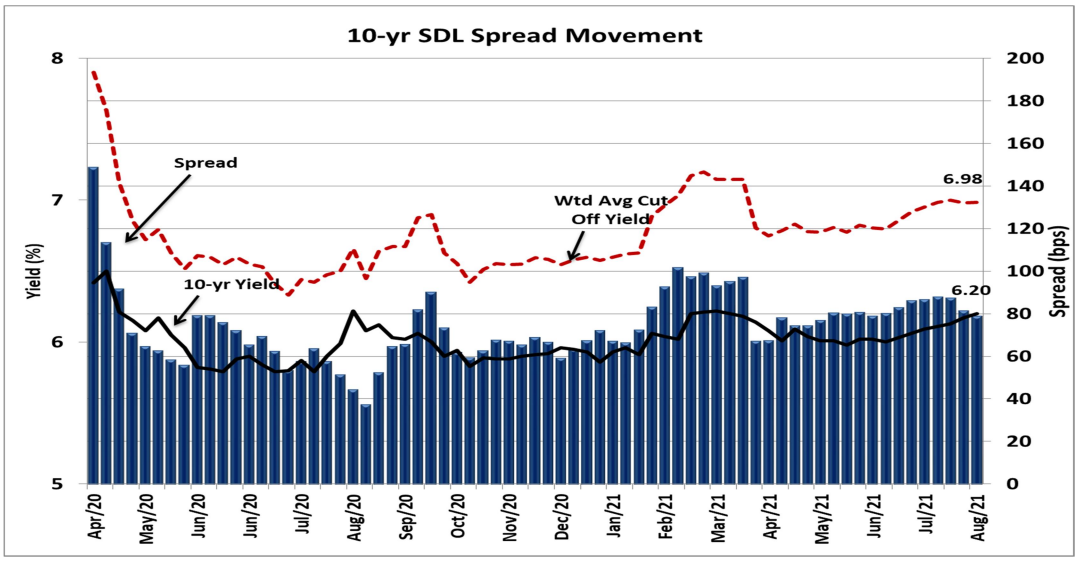
The last fortnight witnessed two main events: Fed meet and RBI MPC decision. Fed meeting outcome had no surprises and resultantly the markets also remained well behaved after the meeting outcome was announced. Even RBI MPC meeting outcome was on expected lines albeit with one surprise. Even though the MPC voted to keep status quo on accommodative stance, the vote wasn't unanimous as one member (Prof. Jayanth Verma) didn't vote along with the rest of the committee on maintaining an accommodative stance as long as necessary. This was a major deviation from last time as well as from the market expectations. Rest of the commentary like revising the inflation target upwards by 60 bps and giving a roadmap for temporary liquidity absorption through VRRR was also taken a negatively by the markets. However the impact on market of a divided vote is right now unknown and we would advise to wait for the minutes of MPC meeting to be released and analyzed for further cues. The MPC minutes this time (to be released on 20th August) would make for an interesting read. Are there more members who are also now waiting on borderline for crossing over to 'change the status quo' zone? How strong were the arguments of the dissenting member? All this and more will be clear only after minutes are released. Till then, we may expect the 10-yr yield to continue trading in the range of 6.20% to 6.25%, shorter duration papers may remain under pressure till there is further clarity on MPC deliberations through policy minutes.

Technical View

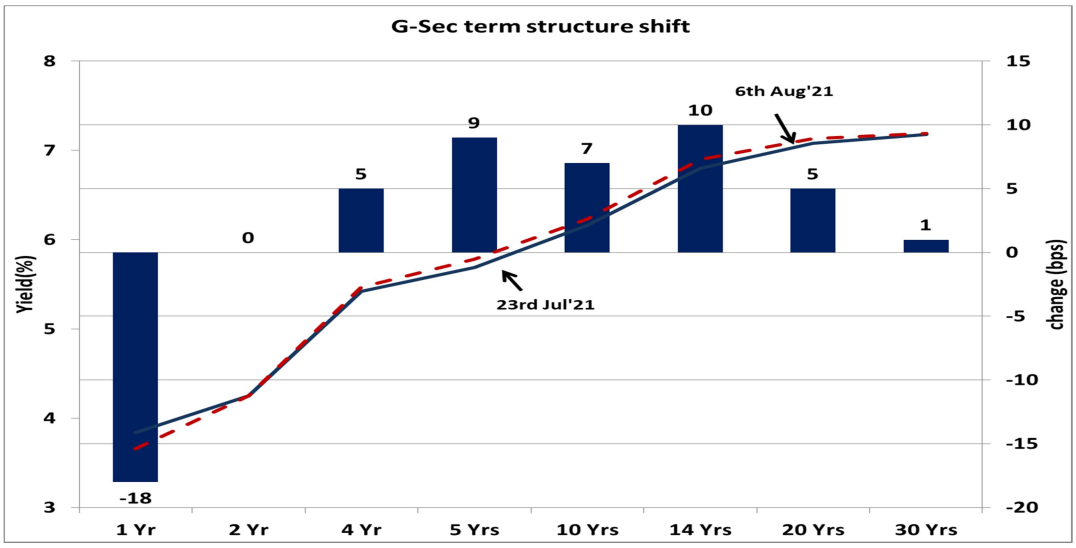
6.64% GOI 2035: The correction in 6.64% GS 2035 which has initiated from 100.73 has exhausted its correction phase after making an intraday low of 97.57 on the day of August policy. Hence, there may be buying opportunities in the paper 6.64% GS 2035 at 97.82 levels with a closing stop loss of 97.65 and a take profit of 98.30.

Spread Monitor

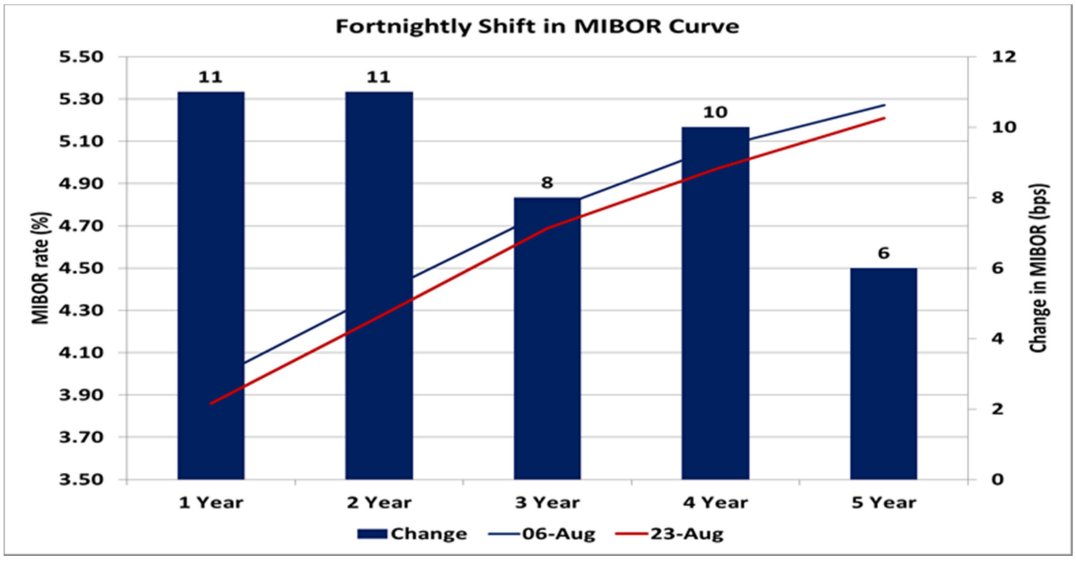
SDL spreads are expected to remain stable at current levels, as robust tax collections augur well for overall state government finances

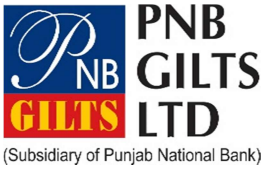


Bond markets witnessed a sell off post RBI policy verdict, however long dated yields remained largely anchored as broader cues such as oil prices, tax collection trend, and global cues remained positive



OIS yields firmed up sharply over the previous fortnight as RBI policy outcome turned out to be bearish for interest rate markets





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

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