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ECONOMY & GILT WATCH

PNB GILTS LTD
(Subsidiary of Punjab National Bank)

INSIDE THIS ISSUE:

RBI Monetary Policy Minutes

Re-emergence of the hawk

The RBI monetary policy minutes released on 20th August'21, were keenly awaited post release of the August MPC decision, which was announced on 6th August'21. Reason being, the first voice of dissent (Prof. Jayanth Varma), ever since the MPC embarked on the ultra-loose and accommodative policy in February last year. The dissent against continuation of accommodative stance by MPC had created quite a ruffle, and the minutes tell that the dissent was remarkably a strong one. All other members while acknowledging the persistence in inflation with varying degrees of concern, continued to remain tilted in favour of maintaining a growth supportive policy stance as long as necessary. The RBI minutes were preceded by the Fed policy minutes, which also highlighted a split over the bond buying taper timeline, with some members advocating continuation of an aggressive monetary policy to fix the labour markets, while some members pressed that the monetary policy may not add any further value to revival of business and household sentiments. The discord amongst members of Central banks is only natural, given the highly complex macroeconomic environment, which still continues to be threatened amidst rising Delta variant cases.

Criticism in dissent

The commentary by Prof. Jayanth Varma is not merely hawkish, but also critical of the continuation of the accommodative stance despite persistent inflationary pressures. Prof. Varma had raised the flag in June policy meet that India's monetary policy committee must be watchful of inflation expectations becoming entrenched. However, in the August policy, he has out rightly questioned the continuation of the accommodative stance and the highlighted fact that "it is stimulating asset price inflation to a greater extent than it is mitigating the distress in the economy." The argument is a far cry from the stance and language adopted by the MPC hitherto, more importantly the "whatever it takes" stance of the Governor. Comments by Dr Mridul Saggar on markets getting "opiated to slush liquidity" too resonate with the concerns raised by Prof. Varma around likely asset price bubbles.

The moot point of his exhortations is that the monetary policy has its limitations while dealing with a non-economic crisis, and with resurgence of infections despite high level of vaccination in several nations, it is not possible for policy to remain accommodative indefinitely. He warns that inflationary expectations are getting entrenched, because RBI has signaled that it will support growth, come what may. He says it's therefore time to normalize the interest rate corridor and raise the reverse repo rate, to keep RBI's credibility intact as an inflation targeting central bank. Such a move according to him would "anchor expectations, reduce risk premia, and sustain lower long term interest rates for longer, thereby aiding the economic recovery". These are indeed very strong statements, coming at a time when the RBI is seen to be strongly focused on reviving growth.

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Other members, continue to remain tilted in favor of maintaining a growth supportive stance. Dr. Goyal termed the rise in fuel taxes to be at odds with inflation targeting, but does not expect inflation expectations to be de anchored due to the reputation and responsiveness of the inflation targeting regime and supply side response by the government. On normalisation, however, she is of the view that the process can begin even in an accommodative stance. Dr Saggar on the other hand also remains growth supportive and his view on normalization resonates with that of Dr. Goyal, calling for gradual adjustments within the accommodative stance. Dr. Patra remains strongly inclined towards the growth revival narrative, calling it RBI's highest priority and the price that has to be paid is higher inflation but within the tolerance band.

Between Rock and a Hard Place

The August policy and the minutes released clearly highlight the dilemma that RBI faces at the current juncture. The July inflation numbers and the recent claw back in crude oil prices along with the resurgence & persistence of the pandemic in various advanced and emerging economies may give some breathing space to the committee as overheating concerns are allayed. On the domestic front, government's resistance to slashing fuel taxes, despite continuous exhortations by the central bank and a sharp fall in the international fuel prices, however, will continue to keep RBI between a rock and a hard place going forward.

Macro Monitor

Headline inflation softens to 5.6% in July, Core inflation at 5.8%

Headline inflation softened more than expected, for second consecutive month, easing below the 6% mark in the month of July to 5.6% largely on back of a favourable base effect and softening of prices of some food items such as edible oil, cereals, fruits and pulses. On a segment wise basis, food & beverages inflation eased to 4.46% (5.58% in June), fuel & light inflation eased to 12.38% (12.61% in June) and miscellaneous items inflation softened to 6.71% (7.21% in June). On the other hand, inflation in housing segment hardened to 3.86% in July from 3.75% in June, whereas clothing inflation rose to 6.46% in July from 6.14% in June. Inflation in pan and tobacco also increased to 4.71% from 3.98% in the previous month. Core inflation also declined, mirroring the overall decline in inflation rate. For the month of July, core inflation stood at 5.8% as against 6.1% in the month of June. Going forward, CPI inflation may witness an uptick in the month of August compared to the surprise fall posted in the month of July, as favourable base effect wears off slightly and on back of rise in prices of food items such as vegetables, fruits and certain edible oils.

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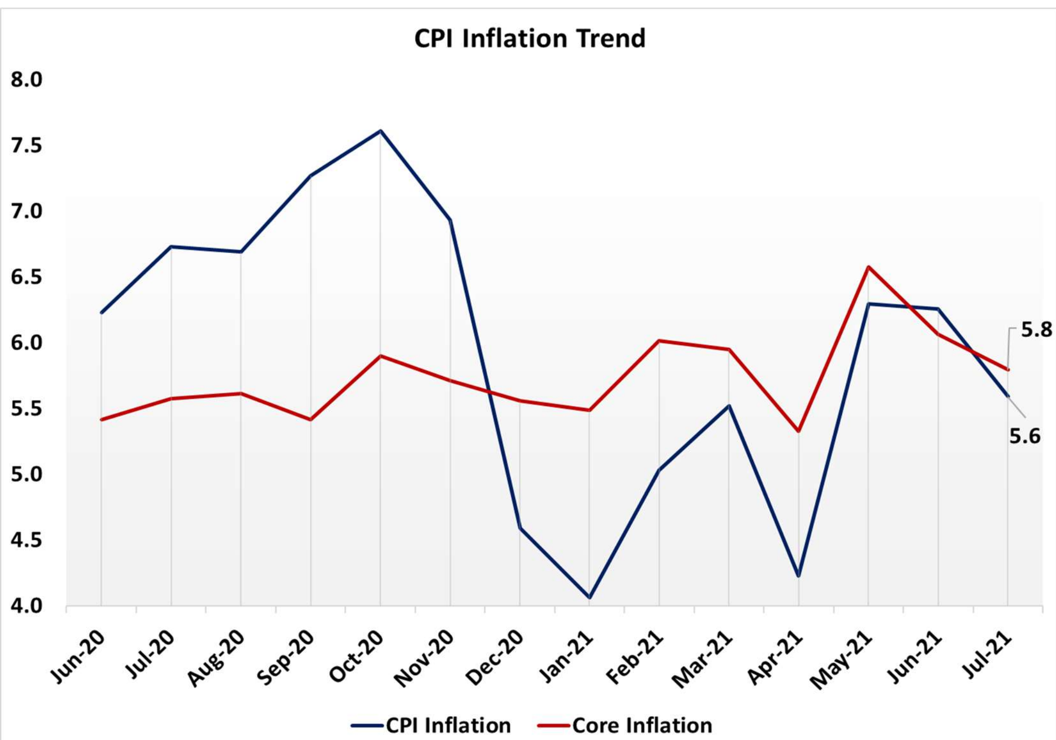


Fixed Income Outlook

Fundamental View

The policy normalization would also mean that economy is back on track, which augurs well for the government finances outlook.

The much awaited MPC minutes are out and with no big surprises on either side. Besides the known fact that Prof. Varma has turned hawkish on basis of inflation and Governor Das remains dovish supporting growth, there were no major surprises and minutes are unlikely to affect the market much per se. Yet the big take away from both Fed and RBI latest meetings is that the time for tapering/normalization is closer than ever. It could still be several months before the first step is taken and that too a baby step, but markets would prepare for this eventuality before the central banks actually act. However, the normalization would also mean that economy is back on track, which augurs well for the government finances outlook. The government finances have already started to show some traction and as of now we don't see why this won't continue except for a widespread recurrence of pandemic. Therefore, the next market theme could be gradual withdrawal of liquidity amidst an improving fiscal position. With the assumption of this combination playing out in coming months, we believe that the term premia in India markets are attractive at current levels. Even with onset of normalization, the Indian 10 year bond could settle in the range of 6.30%-6.40% eventually.

Last fortnight also saw some correction in risk assets like equities and commodities globally. It is difficult to fathom whether this is unwinding of any excesses or is it risk off trend. One should look at currency movements for any further cues while looking for solving this puzzle. For the short run, we reiterate the upper band of the 10-yr yield to stay intact at 6.25%. The shorter dated papers may remain stable but any further lowering of yields in short dated papers looks unlikely, even though the last fortnight saw the yields on such papers coming down. INR has been in a tight range for quite some time now while USD has gained strength recently versus major currencies globally. A depreciation in INR is a palpable risk to the above stated view of investing in longer dated papers and one needs to keep an eye on currency movement.

Technical View

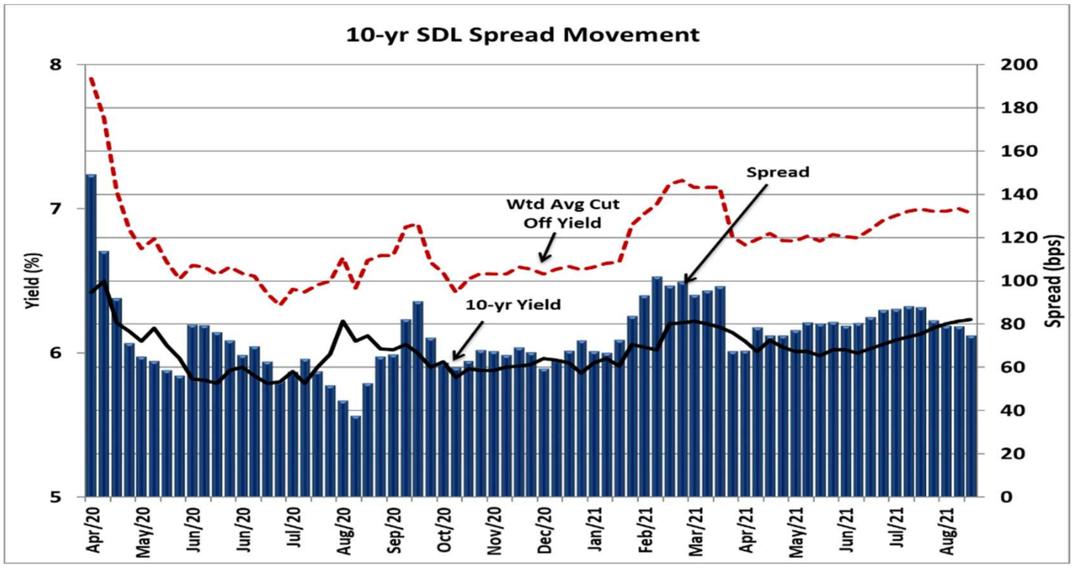
6.10% GOI 2031: 6.10% G Sec 2031 yield settled at 6.23% on Friday's session. Passing fortnight benchmark traded range bound between 6.21% to 6.24% zone. Since inception 6.10% GS 2031 is making Higher High-Higher Low formation stating hardening of yields. However, last week it has witnessed a pause and traded in small range, indicating resistance around 6.25% zone. Current chart pattern indicates further rise possible if and only if it sustains and close above 6.25% level else it may skid towards lower range of the band i.e. 6.21%.

Source: Tickerplant

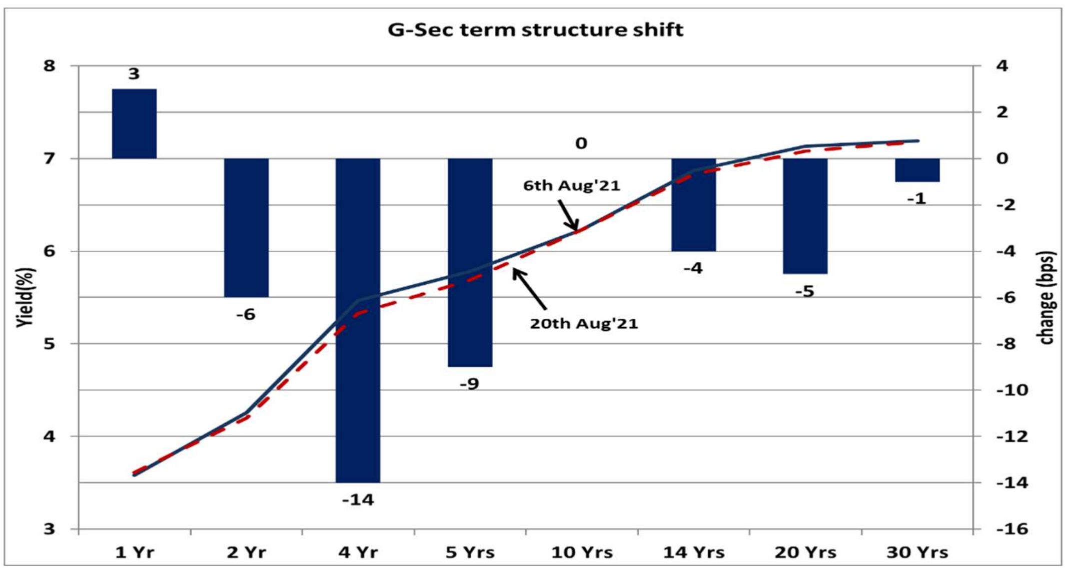
5.63% GS 2026: 5.63% GS 2026 has exhausted its quick rally after marking a high price of Rs. 100 (5.6281%). The price correction that has begun is expected to touch Rs. 99.54 in prices (5.7425%). Hence, the view is to go long in this paper at 5.74% with a stop loss of 5.78% and a take profit of 5.67%.

Spread Monitor

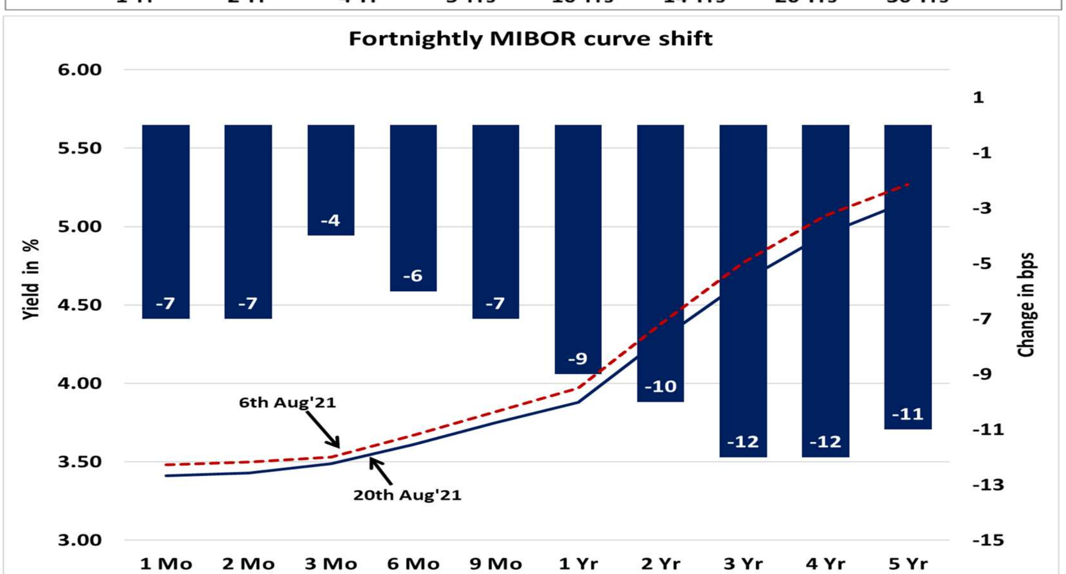
SDL eased during the previous fortnight as the outlook for government finances remains largely stable, amidst buoyant revenues



Short dated yields may remain stable but any further lowering of yields in short dated papers looks unlikely, given the rising talks of normalisation of monetary policy



Decline in US treasury yields and crude oil prices at the global level and of inflation at the domestic level, push OIS rates down during the fortnight



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