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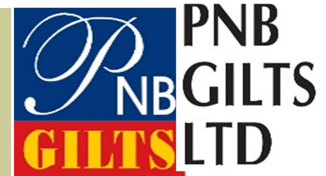
ECONOMY & GILT WATCH



(Subsidiary of Punjab National Bank)

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US Fed Policy Review
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US Fed Policy Decision: Status Quo, with a Hawkish Message

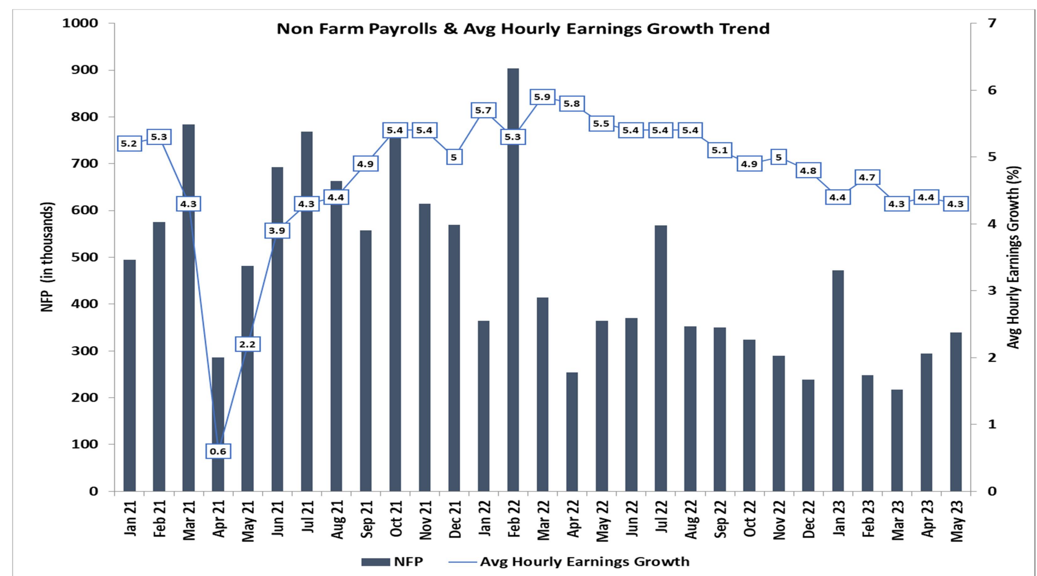
The June US Fed monetary policy verdict came in as expected with Fed pausing and maintaining the federal funds rate in the range of 5.00 per cent to 5.25 per cent with no dissent on the decision. The macroeconomic and federal funds rate projections, however underwent notably hawkish revisions, which have tempered expectations of a pivot in the policy within this year. The dot plot is particularly hawkish with median forecast for the year-end 2023 fed funds rate at 5.6 per cent vs. 5.1 per cent as per March projection, with as many as 12 members expecting rate to be at this level or higher. On the other hand, all long run projections have been kept unchanged. The policy statement reads broadly similar to May policy statement with the decision to holding rates steady attributed to the need to "assess additional information and its implications for monetary policy." Chair Powell emphasised that "it will be appropriate to raise interest rates somewhat further by the end of the year" and that "inflation pressures continue to run high and the process of getting inflation back down to 2 percent has a long way to go." Overall, the June policy turned out to be a balancing act by the US Fed, giving time for the previous actions to play out further and keeping markets tethered by maintaining hawkish rate projections.

Macro-Economic Projections

The main takeaway from the June Summary of Economic Projections is the higher fed target rate of 5.6 per cent projected for 2023, 50 bps higher than projected in the March policy. A higher fed rate projection is complemented with an upwardly revised GDP projection of 1 per cent for the year (versus 0.4 per cent as per March projections). On the other hand, core PCE inflation is also projected to be higher at 3.9 per cent as against 3.6 per cent in the March policy. Headline PCE inflation, on the other hand, was revised slightly lower, with the median participant now expecting PCE inflation of 3.2 per cent (vs. 3.3 per cent for March) this year. The underlying reason behind these revisions continue to be the labour market conditions which though are on a softening trend, have still a long way to cover. Through its revised economic projections, the Fed is increasingly making a move towards the case of softer landing for the US economy. The unemployment rate projection has been accordingly pegged lower at 4.1 per cent as against 4.5 per cent as per March projections.

The slow progress in the US labour market conditions is keeping the US Fed from bringing its guard down

Another key take away from the economic projections, is that the FOMC participants have greater confidence in the GDP projection (hence of a soft landing). A lower number of participants see downside risks to growth and uncertainty over GDP as compared to the March projections. However, a greater number of participants see upside risks to both core and PCE inflation. The dot plot correspondingly indicates two more rate hikes, with as many as 12 participants expecting the Fed funds rate to be 5.6 per cent or higher. This of course aligns well with Chairman Powell's call for greater restraint than earlier anticipated.



The trajectory of future policy moves remains uncertain, and highly data dependent. With rather optimistic projections of growth, it is likely that the US Fed may stretch a bit more in its bid to bring down inflation especially core inflation which has been rather stubborn. The rates decisions across central banks are now likely to chart their own paths with determining factors as domestic price and growth conditions. There have been divergent policy moves as slowing growth in China, forced PBOC to cut rates with expectations of further easing. On the other hand, ECB continues to remain firm on rate hike path as it battles inflation and tight labour market conditions. The Bank of Japan maintained its ultra-loose monetary policy accompanied with a dovish guidance to boost economic growth. On 8th June, RBI also kept rates unchanged accompanied with a hawkish commentary so as to keep inflationary expectations anchored. Regardless of the upcoming Fed moves, RBI is expected to manoeuvre policy according to incoming data on prices and growth.

Macro Monitor

Retail Inflation Softens to 25 Months Low

Bearing signs of convergence towards the 4 per cent inflation target, India's headline inflation brought some respite dropping to a 25-month low print since April 2021. The May CPI inflation was recorded at 4.25 per cent, as against the economists' median poll of 4.40 per cent. While the inflation level was majorly pulled down by a higher base, a part of it was also on the back of receding prices of vegetables, oil & fat, and meat & fish.

Let's talk about the monthly trend. Although, all sub-categories (excluding cereals, oil & fat and fruits) witnessed an uptick in prices, May 2023 witnessed a sharp fall in inflation as against the 4.70 per cent print of April 2023. The economy faced an period of high cereal inflation during the previous fiscal due to a shortage of supply of two major cereals – rice and wheat. Following a healthy harvest and interventions by the Food Corporation of India (FCI), wheat prices are now seen to be in check. Edible oil prices have gone down following a downtrend in international oil prices resulting in lower import duties.

During its June policy meet, the Reserve Bank had decided to continue the pause for the second consecutive time with an expectation that inflation would average at 5.1 per cent during the year. However, going forward, the performance of monsoon and a high probability for development of El Nino conditions as well as higher growth in MSPs for kharif crop may act as key headwinds for the inflation trajectory.

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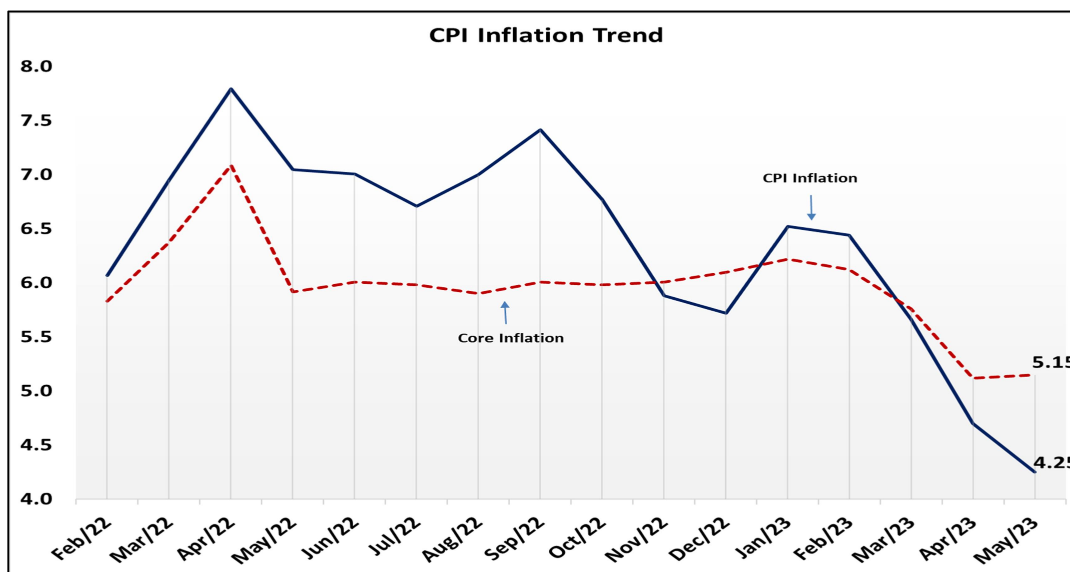

Fixed Income Outlook

Fundamental View

Recovering from the hawkish nudge given by the RBI post release of better than expected CPI inflation data, the domestic bond yields edged higher following a hawkish Fed event. With the central bank actions behind us, markets may closely track the developments on India's rating announcement by Moody's and the possibility of an upgrade may keep markets on the edge. Currently India's Moody's assigned rating stands at Baa3 with a stable outlook. Moody's assigns sovereign rating based on four broad parameters, ranging from economic strength, institutions and governance strength, fiscal strength and susceptibility to event risk. Going ahead, with reference to the bond markets, a bottom in 10 year yield seems set to be firmly placed at 6.95 per cent - 6.98 per cent range. While there is a great degree of resistance at 7.05 per cent, with incessant supply lined up and lack of any further events, there is a likelihood that the yields could trade with an upward bias. However a major sell off seems unlikely due to the fact that the market is certain that the policy rates have now peaked. The term structure may continue to steepen further and we expect the 10-yr yield to trade in the range of 6.95 per cent to 7.10 per cent.

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SDL Overview

During last fortnight, 10 Yr State Loans traded in the broad range of 7.30 per cent-7.34 per cent, whereas the 10 Yr CG benchmark, remained in the range of 6.97 per cent -7.04 per cent. In aggregate State government have raised Rs 1,40,000 cr in this fiscal so far which is 66% higher than Rs. 80,000 cr that was borrowed in the same period last year. However, the actual issuance during April to June 13, 2023 is 12 per cent lower than the indicated level of Rs 1,58,350 cr. The central government has released Rs 1,20,000 cr tax devolution to the state governments on 12th June. This amount was twice as large as the amount released in the first two months of FY 24. Despite this borrowing by states is likely to remain lower for at least in the beginning months of Q2, FY-24. The spread between 10 year SGS and G-Secs (government securities) has remained stable at 33-35 bps from the previous fortnight. The cut off for long tenure CG have moved higher by 11 bps suggesting decline in demand for spread papers while long end SGS remain subdued causing spread to widen at the Long End. We expect the spread between 10 yr SGS and CG to widen and trade in the range of 35-40 bps in the next fortnight considering increase in supply as states borrow more than the scheduled amount in the quarter end, historically.

Going forward, till Benchmark is trading below 7.06% the ongoing trend may continue and it may head towards 6.96% i.e. immediate support level.

Technical View

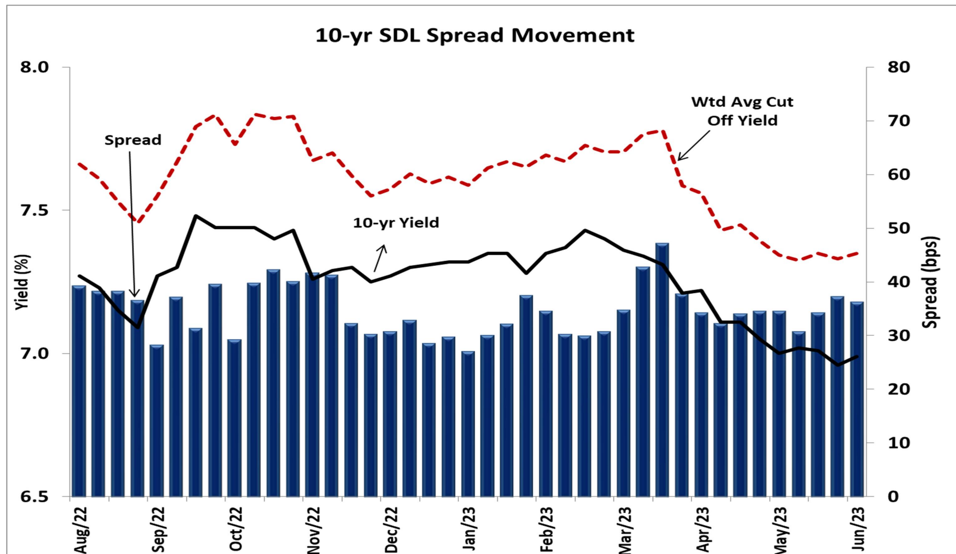
Technical Synopsis 7.26% GS 2033 Yield:

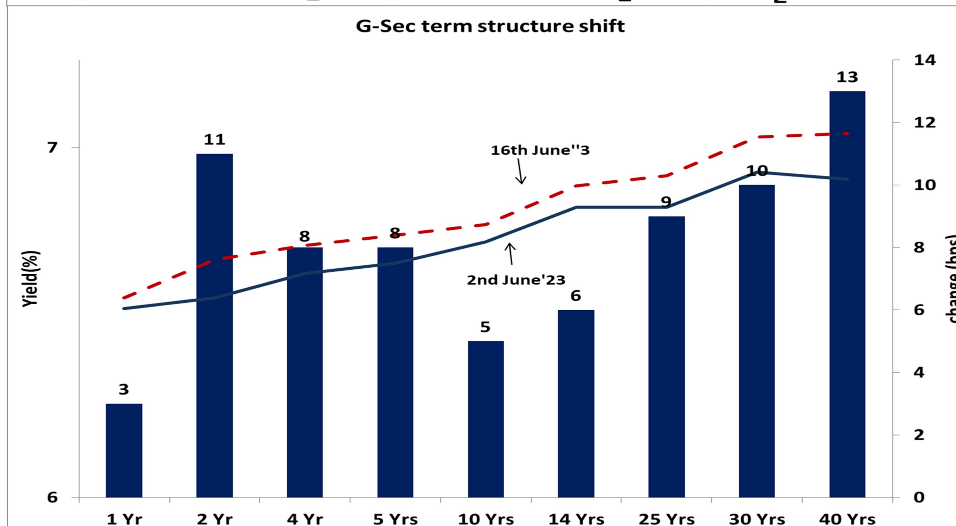
7.26% G Sec 2033 Yield settled at 7.0354% on Friday's session. Passing Fortnight Benchmark consolidated broadly in range of 6.96% to 7.06%.

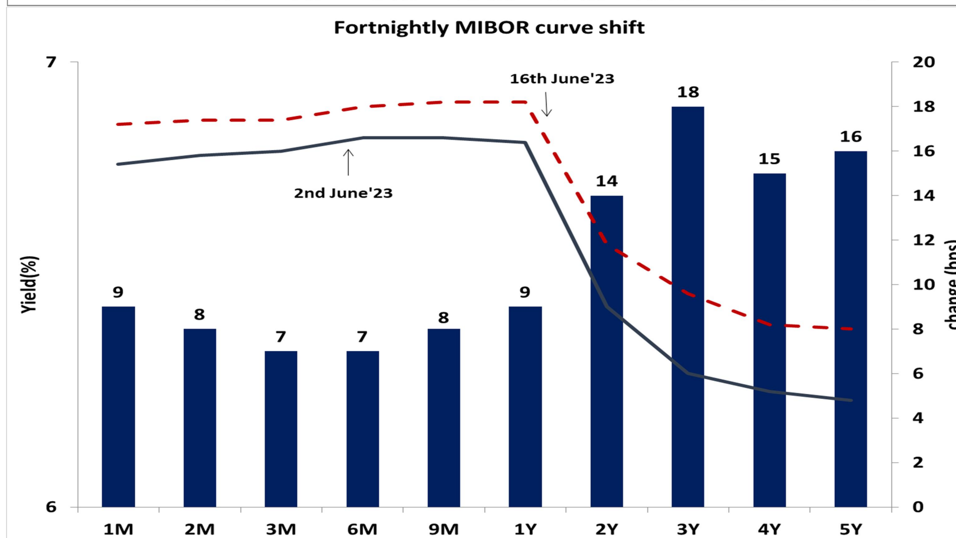
Momentum oscillator is trading around 50 level. On daily chart Benchmark has witnessed a shooting star candle at the resistance zone indicating 6.96% possible if it sustains below 7.02%. Also, 7.06% level coincide with Upper Bollinger band zone hinting towards crucial demand zone for short term. Going forward, till Benchmark is trading below 7.06% the ongoing trend may continue and it may head towards 6.96% i.e. immediate support level.

Running Chart GOI 10yr Daily. Source: Tickerplant

Spread Monitor







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G-sec term structure may witness further steepening in the coming fortnight

OIS rates edged up during the fortnight tracking higher US treasury yields

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