

ECONOMY & GILT WATCH



(Subsidiary of Punjab National Bank)

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RBI MPC Surprise

RBI delivered an outsized 50 bps cut at the June MPC, above the market consensus of 25 bps cut. What was surprising was the change in stance to neutral followed by a 100-basis CRR cut. Market reading of the policy points towards an end of cut cycle basis the commentary indicating a strong conviction towards front loading of rates. The sentiment since has turned bearish in bond markets.

With the dust finally settling, the rationale for the triple whammy of policy decisions seems confusing. Particularly concerning is the fact that all the three major decisions that have been taken are unexpected and in normal course of action are unlikely to work in tandem to support the growth inflation dynamics as targeted by the RBI. Stance change at such a pace gives a signal of a confused RBI rather than a central bank nimble in its approach. Monetary policies to have an impact on the economy need to be given a stable run else they are likely to remain ineffective.

The CRR cut on the other hand is most likely going to serve the rupee dry up caused by the near tenor maturities of RBI's forward dollar sales. On paper, this is a good idea but with reserves artificially supported by the forward sale figures the maturities are going to put pressure on the forex kitty. While the forex reserves are abundant, there are growing geopolitical risks in a multi-polar world that can erode the reserve buffer rather quickly.

Coming on to the stance change, the move was erratic at best and signifies much confusion in the efficacy of RBI's own measures and the reading of economy. RBI having established a reputation of being a clear communicator risks putting the above in question by a stance change. In any case, a changed stance leaves no room for the much-needed monetary action if needed in the future and now RBI has essentially bet everything on the policy transmission.

Market has reacted very aggressively to the MPC decisions with sell off across tenors. Curve steepening was playing out well before the...

RBI MPC Surprise

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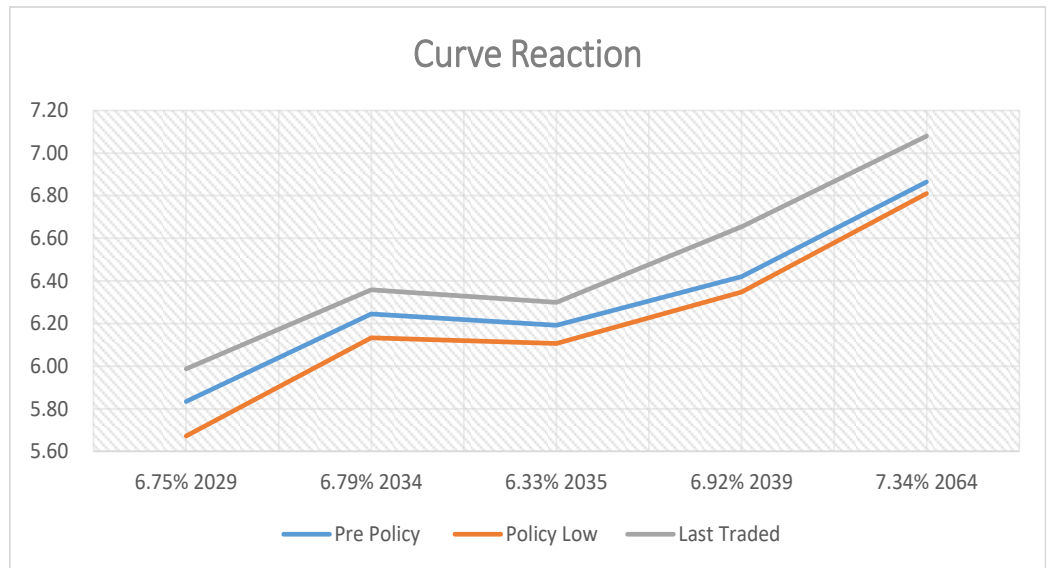
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policy decisions, it was the post policy stopping of VRR that spooked the market further and accelerated selling pressure. The curve shift during and post MPC has been significant with duration coming under immense pressure.

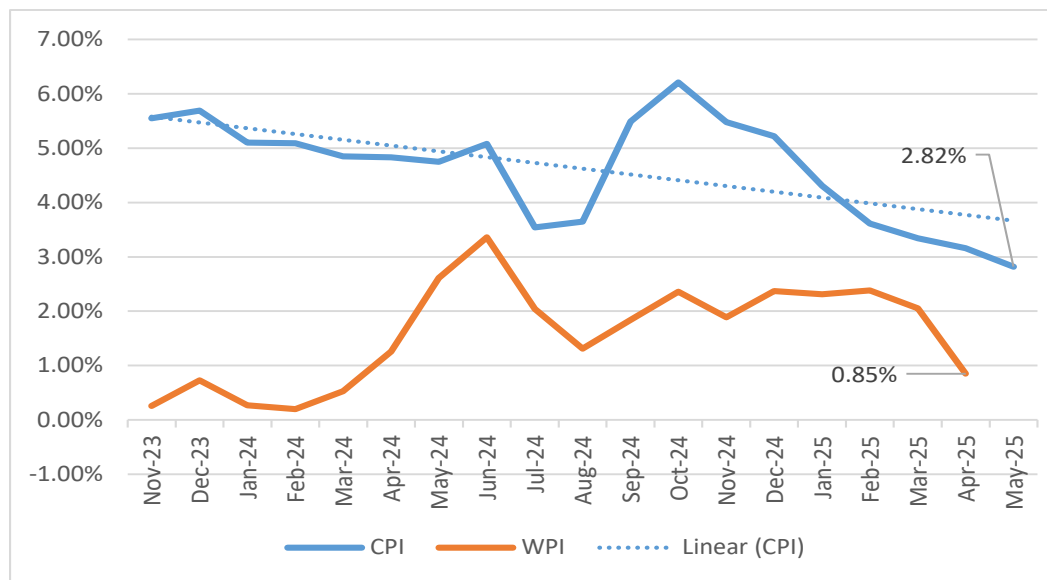
RBI is expected to remain data driven



Inflation Update:

CPI touched a 75-month low of 2.82% for the month of May with low food inflation the key driver. This marks the 4th consecutive month where the inflation has stayed below RBI's 4% percent threshold.

Falling inflation trend continues



Fixed Income Outlook

Fundamental View

Indian bonds are expected to trade with a bearish bias going forward with RBI in full control and actively managing liquidity. The 10Y paper is likely to trend lower finding a ceiling at 6.35% in yield terms. In case of RBI acting cautiously going forward, markets are likely to turn from sideways to a bearish sentiment. Things look bright on the growth-inflation dynamic front but unease in Global Bond Markets pose serious challenges going forward. With Middle East conflict scaling fresh highs, the panic can now spread across the curve considering weak fiscal positions.

Yields to remain stuck here

On the global front, weak commodities prices continue to support the inflation at home and the deficit figure. Weakening of dollar has lifted sentiment for INR with RBI having replenished its reserves having faced a 10 percent drawdown. Going forward, both bonds and currency are likely to remain stable with risks arising out of external factors to be managed proactively by RBI with increased buffer of currency reserves.

SDL Overview

Last fortnight, CG benchmark 10 Yr traded in a range of 6.10% -6.33%, whereas, the 10Y SGS got dealt in the range of 6.60%-6.86% i.e. the SDL spreads vis-a-vis their CG counterpart remained in the range of 48-54 bps. We had a RBI Policy where we had a massive 50bps cut, 100bps CRR cut in four tranches starting from H2 of this FY. Alongside, these positive measures RBI changed its policy stance from Accommodative to Neutral, illustrating limited monetary policy space to support from here on. This triggered a massive sell-off across the yield curve with longer duration bonds borne the maximum brunt of it. This repricing was reflected in cut-offs of 20+ year SGS as well, where the cut-offs were as high as 7.145%. This massive steepening of curve highlights the lack of demand in spread papers post policy.

SDL spreads can widen

States so far in this Q1, has borrowed a sum of Rs. 1,65,149 Crores against the notified sum of Rs. 2,18,955 Crores (~75.4% of calendar amount). We expect the spreads for 10 Yr SGS over CG in the coming fortnight to widen further and remain in the range of 50-60 bps, and the spread of duration (20yr+) SGS to widen further in the range of 85-90bps over the liquid 10 Yr CG, as states are expected to increase their issuance size towards quarter end and investor demand is expected to be tepid.

Technical View

Technical Synopsis 6.79% GS 2034 Yield

6.79% G Sec 2034 paper settled at 6.3584% at closing bell on Friday. Passing week post the MPC Benchmark inched higher, & broadly traded in the range of 6.13% to 6.40%.

As hinted in last Newsletter with Divergence between Yields and RSI, spike possible if sustains above 6.30% level and the same was witnessed in previous trading days. With shooting star candle formation near resistance level of 6.40%(Upper Bollinger Band) we may see pause to the current spike in yields, However, 6.32%-6.33% on lower side will act as crucial support levels for coming days. To conclude, resumption of uptrend to continue if sustains above 6.40%-6.42% zone and on lower side major respite for Bond traders only if sustains below 6.32% on closing basis.



1D chart: 10 yr Source: Tickerplant

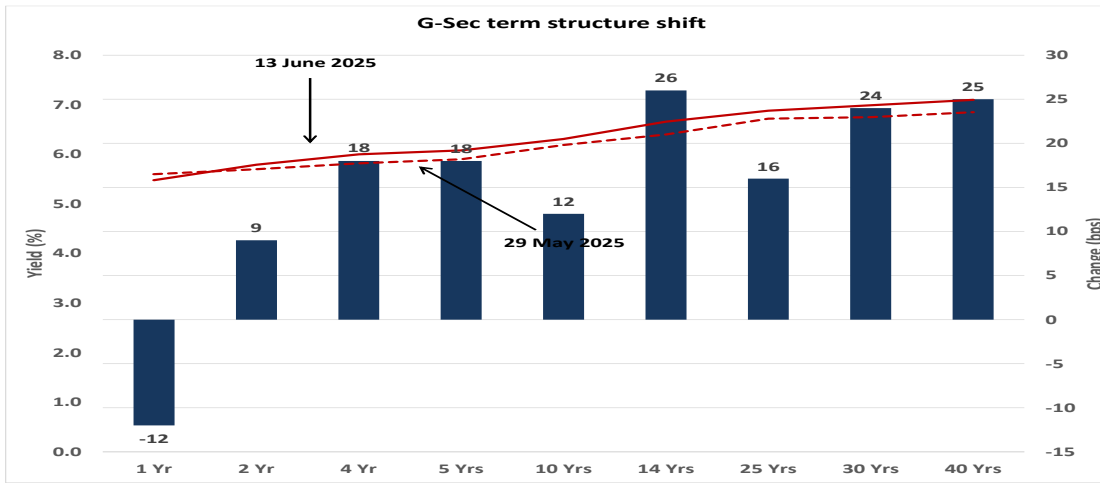
Liquidity

The System liquidity has been in surplus and liquidity conditions are likely to remain abundant with the CRR cut now in place. Risks remain from FX swap maturities and VRRRs.

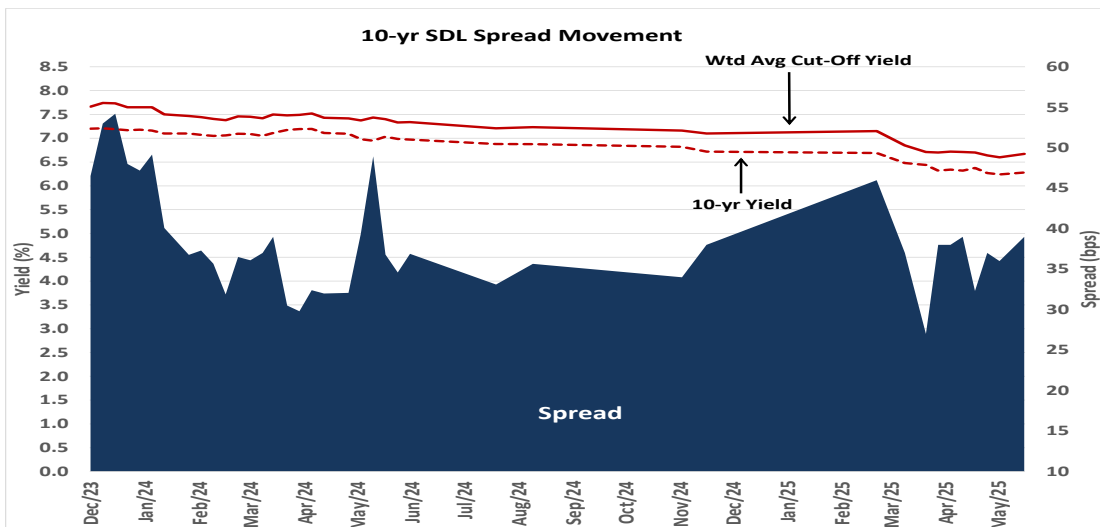
Bearish bias persists

Liquidity remains abundant

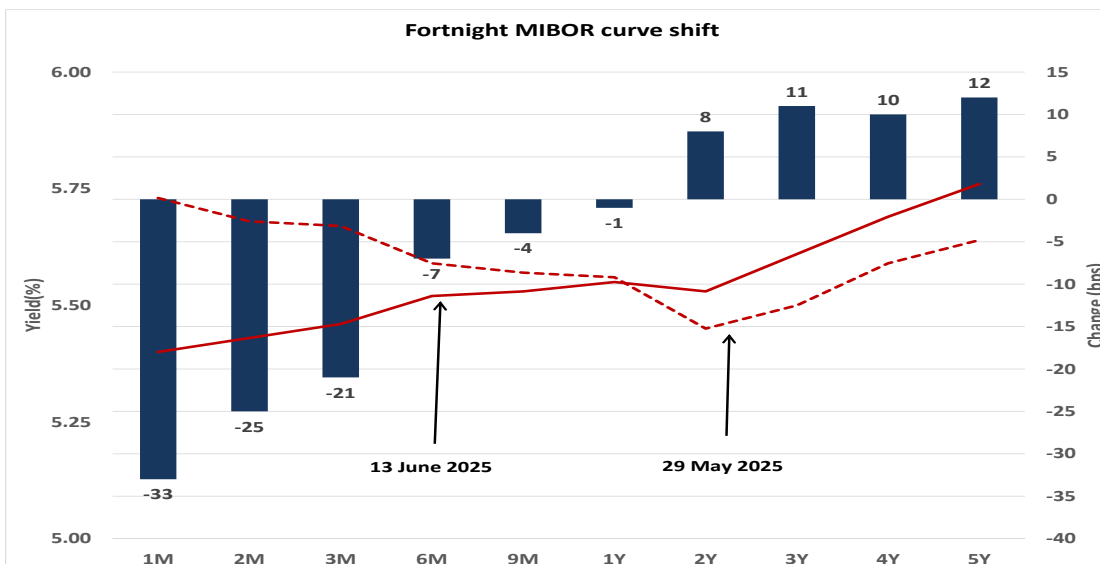
Spread Monitor



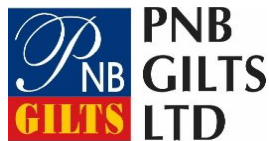
Curve has shifted upwards



SDL Spreads to remain high



OIS spike in >1Y



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