

ECONOMY & GILT WATCH



(Subsidiary of Punjab National Bank)

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Currency Risk: Yen

The markets have been moving sideways for some time now despite geopolitical risks and ever resilient data coming in from the US. It is in this context that; most asset classes have either been trading sideways or have been on the uptrend. Equities and Gold **rallying** at the same time give enough evidence of markets being in an indecisive state. But what might be missed in all this confusion is the looming risk of Global Currency meltdown potentially being triggered by the **unwinding** of the most favoured trade of them all, the **Yen Carry Trade**.

Recent Bank of Japan policy decision did not help deter the market participants from **crowding this trade** further which has **pushed USDJPY higher** and higher this year with JPY depreciating more than **10% on a YTD** basis. While the BoJ is cognizant of macro fundamentals underlying this JPY carry trade. 30 years of Quantitative Easing in Japan meant **borrowing in JPY** and investing elsewhere was the **cheapest funding** mechanism out there. While a slow decline is understandable, the **increased participation of speculators** has fuelled the sudden slump in Yen's value against Dollar.

Yen Carry Trade Unwind: Barring late entrants in the JPY carry trade, most investors use the trade to **borrow in JPY to invest elsewhere** in Equities, Bonds, etc. Higher yielding US Treasuries being a large chunk of such investments, the investors are currently **sitting on huge MTM losses**. Couple that **with long JPY trades** used to **hedge Yen appreciation** risk at the time of investment which have soured in an unprecedented fashion with **JPY losing** close to **50% value since 2021**. In such an environment when the investments and FX hedge both are bleeding, the unwinding is likely to have catastrophic implications for the **broader fixed income** given Japanese insurers, Pension Funds being one of the largest holders of US Treasuries. In case a sell off is to materialise, it won't be long before panic sets in financial markets with a strong case of **correlated Bond-Equities markets sell off**. The quantum of slump in Yen's value since Covid is what makes the unwind scenario concerning for asset classes.

One way to counter the above is that **BoJ hikes rates** which is **not feasible** considering the **unsustainable Debt/GDP ratio** for Japan accumulated at almost no cost. At the same time Partial unwind and pain in the markets cannot be rules out. Sustainable and feasible response to tackle the above would be require Fed **to cut rates aggressive-**

Currency Risk: Yen

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INR being an EM currency, any FX turmoil will have spill over impact on Indian Bond markets

ly before the contagion risk out of Japan becomes too large. While US cutting rates **might lead to mild stagflation** conditions, the turmoil caused by **upending of currency markets** should be the avoidable risk.

Another approach is a **coordinated response by Fed and BoJ to buy time** and indicate a data driven approach while gradually shifting the stance to a more **accommodative stance for the Fed and a hawkish stance by the BoJ**. Today India is better positioned to weather such a storm thanks to post-Covid prudent management by RBI and the large buffer of Foreign Exchange reserves which are at all-time highs. It would be wise to keep track of global currency market developments given the **sensitive levels at which USDINR** is already trading which can cause pain in with spill over in Bond markets.



USDJPY 5 Year Chart; Source: Refinitive

FOMC Highlights:

- Holds key rates unchanged at 5.25-5.50% for 6th straight meeting
- Lack of progress on inflation front pointed out
- Slows pace of quantitative tightening via Balance Sheet reduction
- Starting in June, the Fed will reduce its monthly cap on Treasuries to \$25 billion from \$60 billion
- Overall the FOMC had a dovish tone while maintaining a cautious data driven approach

FOMC sounded dovish, ruling out stagflation

Fixed Income Outlook

Fundamental View

During the last fortnight, benchmark yields remained range bound. FPI related flows remained benign as the USDINR currency pair remained under pressure in the 83.30-83.50 range prompting caution from investors. In absence of major domestic cues market looks to remain range bound going forward and react to data points. While a fall in benchmark yields looks unlikely considering uncertain and subdued investor appetite around currency and ongoing elections. As far as benchmark yield is concerned, the edge case scenarios currently point towards upside with potential shocks coming in currencies or geopolitical flare-ups.

With markets talking about a potential Yuan devaluation and the speculative frenzy with which Japanese Yen is being shorted, a currency meltdown contagion can pose significant risks for Indian bond markets in the near term. Apart from structural macro driven risk as pointed above, geopolitical flare-ups can send the yields souring as we saw on 19th April which fortunately turned out to be a false alarm. With fed turning dovish in its policy, markets are expected to remain more or less stable with a slight downward bias on yields.

The market will remain sensitive to global cues and to some extent to developments around Yen and Yuan devaluation

SDL Overview

In last fortnight, CG benchmark 10 Yr was traded in the range of 7.11-7.19, whereas, the 10Y SGS got dealt in the range of 7.40-7.54 i.e. the benchmark 10Y G-sec yield spread widened and traded in the range of 33 - 38 bps, despite lower actual issuance by states vis-à-vis their notified calendar. Stated had borrowed a sum of Rs. 51,200 Crores vs their scheduled figure of Rs. 98,140 Crores (47.8% lower). This highlights the dampening of demand from investors specially in spread papers which could be corroborated further by weaker demand witnessed in Longer dated CG auctions as well. We also expect states to come up with bigger SDL issuances than seen in the month of April and with weaker demand from investors, we see spreads of 10Y SGS vs benchmark 10Y G-sec to widen from current levels and trade in the range of 36 - 42 bps during the coming fortnight.

SDL spreads came down slightly in the last fortnight

Technical View

Technical Synopsis 7.18% GS 2033 Yield:

7.18% 2033 G-sec settled shop at lower range of the zone of around 7.16% on Monday's session. As discussed in last newsletter, Benchmark may inch higher towards 7.25% and trade within range of 7.16% to 7.25%, the same was witnessed in passing Fortnight.

Momentum oscillator RSI is currently valued at 52. Going forward, 7.14%-7.15% i.e. Trend line level will act as crucial support zone on lower side, which also coincide with 30EMA level and 38.2% retracement level of recent swing high/low. We believe, till Benchmark is holding above 7.14% we may see range bound trade to happen in coming week with important resistance level now placed around 7.22%.

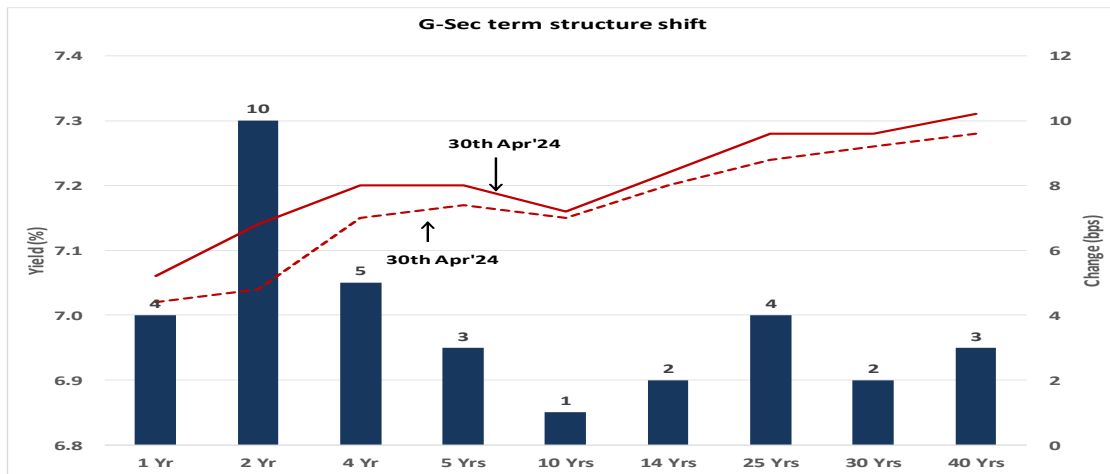


Running Chart GOI 10yr Daily. Source: Tickerplant

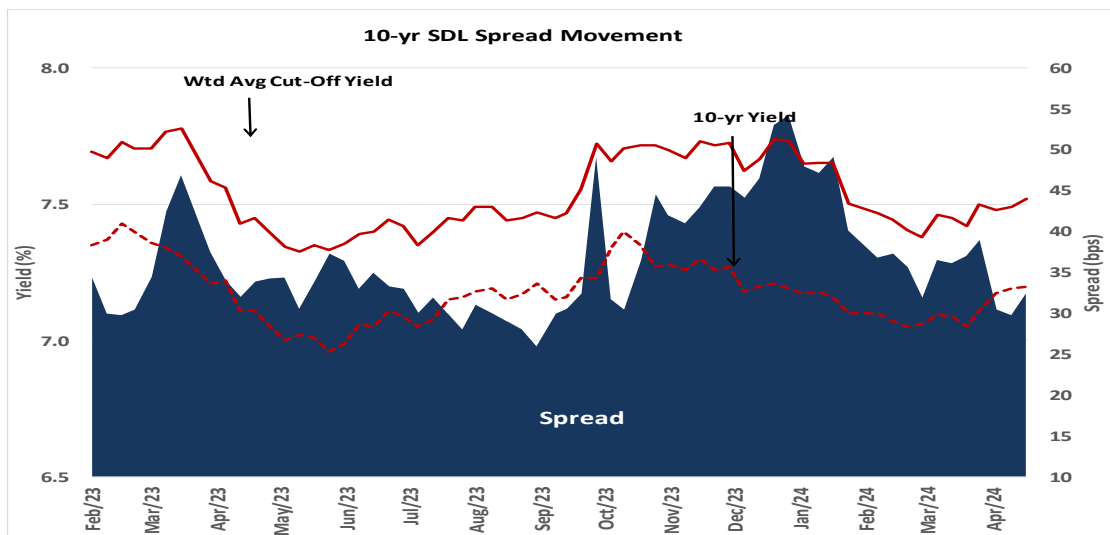
Liquidity

Liquidity remained in surplus mode for first 19 days in April, thereafter; it turned into deficit mode because of GST outflow. This month highest level in MIBOR was 6.80% and monthly average remained at 6.66%. With government spending picking up towards month end, we might see some easing in money market rates. RBI had injected/absorbed liquidity proactively through main and fine-tuning operations, in both repo and reverse repo window during the month.

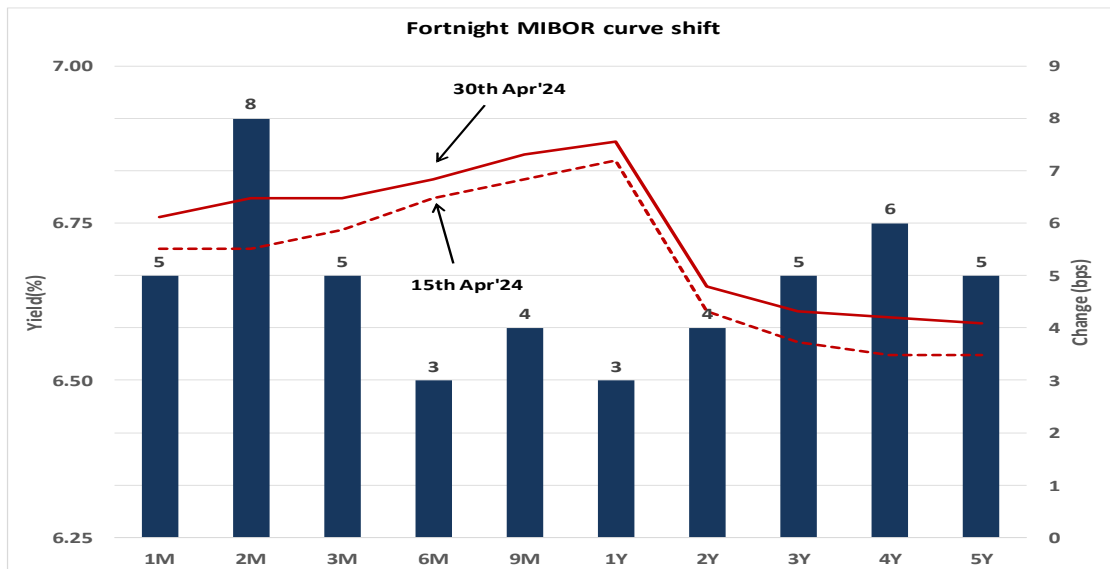
Spread Monitor



G-Sec yields trended slightly upwards tracking higher UST levels



SDL Spreads came down owing to low supply



UST in 4.60+ territory pushing OIS higher



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