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ECONOMY & GILT WATCH

(Subsidiary of Punjab National Bank)

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RBI MPC Decision Review

In meet held during 8th to 10th August 2023, MPC yet again decided to maintain status quo on both policy rates as well as stance, in line with broader expectations. The policy repo rate stands unchanged at 6.50 per cent, with focus on withdrawal of accommodation. The voting on policy rate decision remained unanimous while Prof. Jayanth continued to express reservations against withdrawal of accommodation. The highlights of policy were the upward revision of the CPI projection and the announcement of incremental CRR 10 percent on NDTL accumulated during a specified time window. Without raising rates in the policy, by announcing the incremental CRR, RBI indicated that it would continue to take necessary measures to contain any upside risks to inflation and inflationary expectations. The current liquidity overhang in the system, with net durable liquidity amounting to ~Rs. 3.90 lakh crore as on 4th August 2023, poses potential upside risk to inflation, which apart from muted VRRR participation by banks, likely pushed RBI to "impound" liquidity from the banking system. The rumours of action on CRR hike came true though not entirely as the I-CRR will be reviewed and is likely to be flushed back to the banking system ahead of the festive season. To note that, a seasonal moderation in banking liquidity is expected in the festive season with increased demand for currency (and hence an uptick in currency in circulation).

Macro-Economic Projections

RBI left the growth projections untouched vis-à-vis the June GDP projections as there has not been any material change in global and domestic macro environment. As per RBI, despite external headwinds, the economy continues to exhibit resilience. The supply side witnesses a strong momentum on account of an increase in Kharif crop sowing, stable industrial activity, and pent-up service activity. The buoyancy in the manufacturing sector can be assessed by averaging of IIP to 5.5 per cent for the period of April – May 2023 and increase of core infrastructure output in June by 8.2 per cent. On the consumption side, rural and urban demand stand strong. Rising capacity utilization, improving business optimism and buyout pent-up construction activity indicates an improved pace in investment activity. Consequently, these factors along with the beginning of festive season are expected to support the demand for the next few months. RBI expects upcoming festive season to help economy gain further traction, while acknowledging weak external demand and continued geopolitical tensions posing risk to the growth outlook.

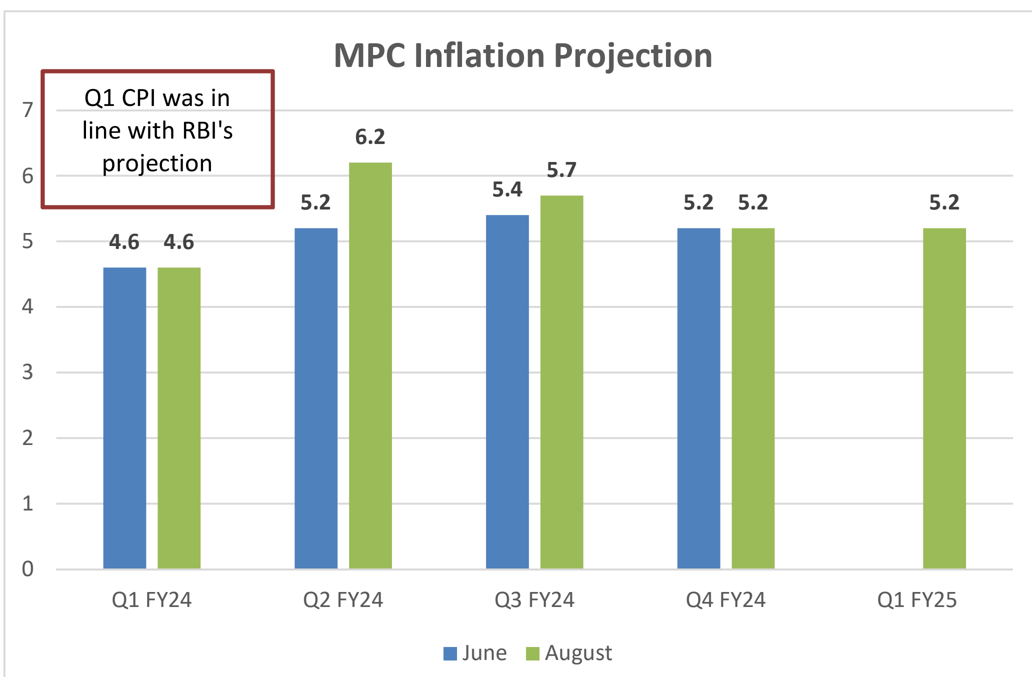
RBI kept the growth projections unchanged for all quarters of this financial year, and projected the growth at 6.6 per cent for the first quarter of FY 2025.

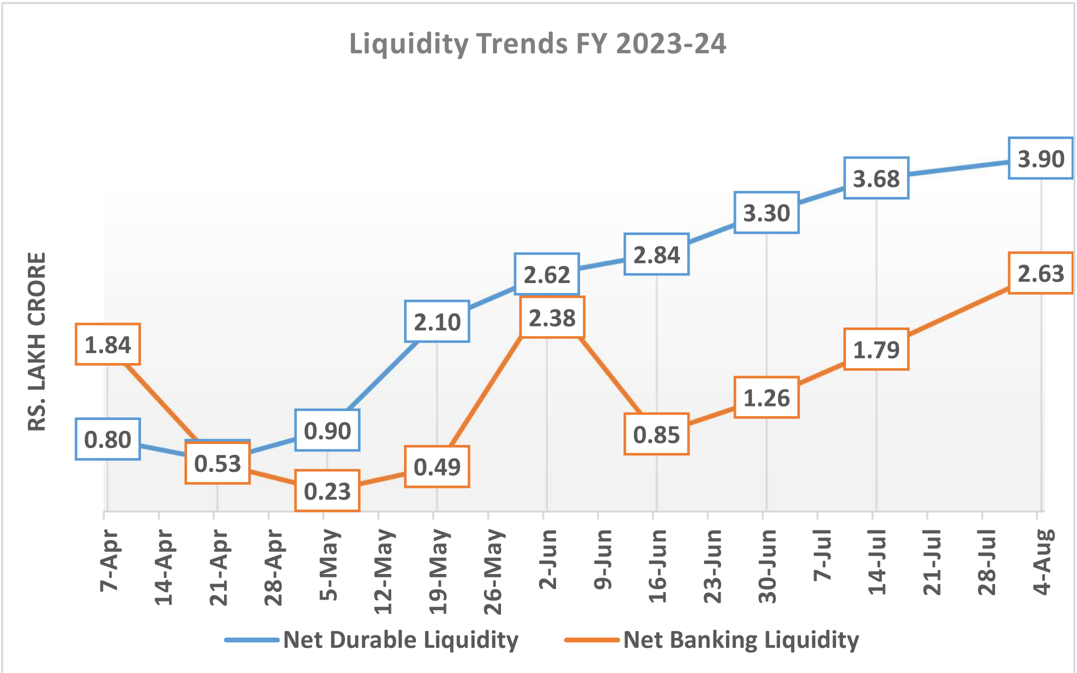
Inflation continues to be RBI's Radar

While the Q1 2023 headline inflation was in line with the Reserve Bank's projection, the recent elevation in food prices has caused some concerns over the inflation expectations going ahead. The vegetable prices hardened during the month of July following a three-fold spike in the prices of tomatoes. The pulses and cereals also witnessed surge in prices on the back of supply constraints. However, with an improvement in the south-west monsoon, the Kharif acreage is expected to go up in the coming months. Basing the historical trend, the MPC believes that the vegetable prices would also undergo corrections after a few months. This view, however, remains exposed to some upside risks from an uneven monsoon, El-Nino effects, hardening of oil prices and surging global commodity prices. The Governor's commentary on inflation was rather balanced, showing vigil towards the recent spike, while at the same time not unnerving as he talked about likely correction going forward.

Taking all the above factors into cognisance, the Committee revised the inflation forecast upwards to 5.4 per cent for FY 2023-24, with Q2 at 6.2 per cent, Q3 at 5.7 per cent and Q4 unchanged at 5.2 per cent. The Reserve Bank also revealed the headline inflation projection for Q1 FY 2025 at 5.2 per cent.

Any upending of RBI's revised inflation projection may bring back rate hike expectations back on the table



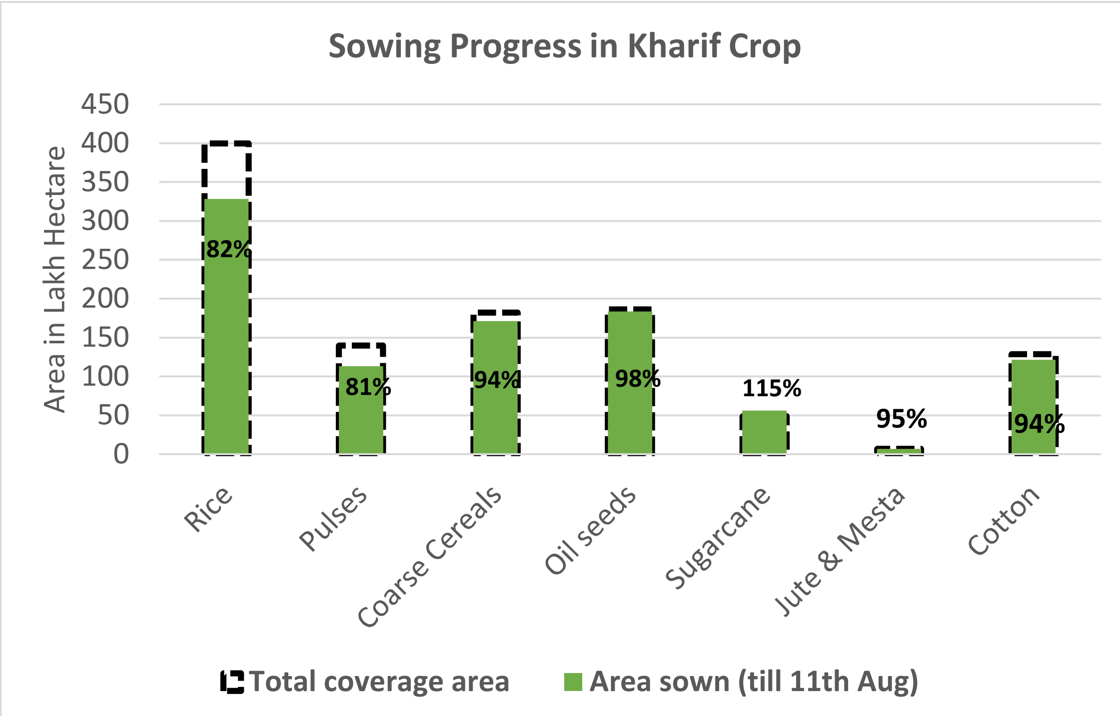


Persistence of high liquidity conditions pushed RBI to announce incremental CRR

Bottom line and Outlook

The RBI by emphasizing on the temporary nature of food price shock gave some respite to the markets, however, the Governor closed his commentary by stating that persistence of these shocks will have to be acted upon. The inflation trajectory for the coming months need to be watched closely as any overshooting of inflation over RBI's revised projection will bring back rate hike expectations on the table. The vegetable price pressures persisted in the months of July and August, with additional pressures emanating from prices of cereals, pulses and spices. Though there has been significant progress in Kharif crop sowing for cereals; rice and pulses continue to lag behind. As per the Department of Agriculture, 90 per cent of the estimated coverage area under Kharif crops has been covered till 11th August 2023. While more than 90 per cent of the area has been covered for Cereals, oilseeds, jute and cotton, rice and pulses lag behind with 82 per cent and 81 per cent area coverage respectively. The outlook for inflation continues to be cloudy with the upcoming festive demand side pressures likely to accentuate the prevailing supply side price pressures. For the month of July, we expect CPI inflation at 6.84 per cent as against 4.81 per cent for the month of June. Under such a scenario, the rate cut expectations get pushed back further and there is a need to watch the evolution of inflation trajectory especially in the second quarter as the current price pressures are likely to persist.

Upcoming festive demand may accentuate prevailing price pressures



Macro Monitor

IIP grows 3.7 per cent in June

Manufacturing sector remained a drag on the overall industrial sector performance during June

The Index of Industrial Production grew by 3.7 per cent y-o-y in June, lower than broader expectations of 5 per cent plus growth. IIP had grown by 5.2 per cent in the previous month. The IIP growth was dragged down by weak manufacturing performance which grew by 3.1 per cent y-o-y in June, after rising by a healthy 5.5 per cent in the month of May. On the other hand, mining witnessed a growth of 7.6 per cent (6.4 per cent in May), while electricity sector grew by 4.2 per cent during the month, witnessing a sharp improvement over May's growth of 0.9 per cent. Under manufacturing, apparels, wood products, computer& electronics segments witnessed double digit contraction during the month. Overall, under manufacturing a total of 14 out of 23 sectors witnessed contraction during the month. On the other hand, as per use based classification, consumer durables segment contracted by 6.9 per cent y-o-y in June, while consumer non-durables and capital goods segment also witnessed a muted growth of 1.2 per cent and 2.2 per cent respectively. Infrastructure/ construction segment on the other hand continue to perform robustly, registering y-o-y growth of 11.3 per cent in June. For the first quarter, the IIP has grown by 4.5 per cent. The upcoming festive season will be key for progress in performance of the industrial sector.

Fixed Income Outlook

Fundamental View

The bond markets witnessed firming of yields with the 10 yr benchmark yield rising to as high as 7.20 per cent as both global and domestic cues remained largely adverse. The rise in US treasury yields triggered the rise in domestic yield and the RBI policy verdict on 10th August further led to dampening of sentiments. The shorter end of the curve reacted negatively to RBI's I-CRR announcement which is expected to suck out liquidity aggregating ~Rs. 1 lakh crore. Not only this, the fact that RBI is not likely to allow liquidity conditions to ease, will keep up the pressure on the shorter end of the curve. Going forward, the CPI print for the month of July to be released on Monday (14th August) will be the next trigger for the market. Though international oil prices have surged significantly, China's uncertain economic outlook and a large build up in US inventory are likely to cap further rise. Volumes in the bond markets are expected to remain shallow in the coming holiday curtailed week.

The shorter end of the curve is expected to remain under pressure with RBI intending to keep liquidity out the system

SDL Overview

During the last fortnight, 10 Yr State Loans traded in the broad range of 7.43% - 7.47%, whereas the 10 Yr CG benchmark, remained in the range of 7.15% - 7.22%. In aggregate, State government have raised Rs. 2,22,200 Cr in this fiscal so far which is ~19.69% lower vis-a'-vis an indicated figure of 2,65,930 Cr. The spread between the 10-year State Government Securities (SGS) and Government Security (G-Sec) of corresponding maturity narrowed mildly to 27-30 bps from the previous fortnight while demand for long-term paper has gone up drastically. Since the start of this financial year, states have been borrowing less through SGSs than the amounts stated in the indicative borrowing calendar, while demand for long-term paper has gone up drastically. Additionally, the Central government has approved Rs 84,884 Cr worth of long-term, interest free loans to the states so far in FY 24, the amount released till July 31st is Rs 29,518 Cr. The amounts approved and released so far in 2023-24 represents a huge improvement from 2022-23. In the last financial year, Rs 95,147 crore had been approved, however, only Rs 81,195 crore of that amount was actually released. The timing and quantum of further release of the capex loans could lead to lower than indicated actual issuance in the remaining auction of Q2, FY24. Sighting low supply, we expect the spread between 10-year SGS and CG to trade in the range of 25-30 bps.

During the last fortnight, 10 Yr State Loans traded in the broad range of 7.43%-7.47 %

Immediate resistance is placed around 7.24% and on lower side crucial support still remains at the previous gap level of 7.14%

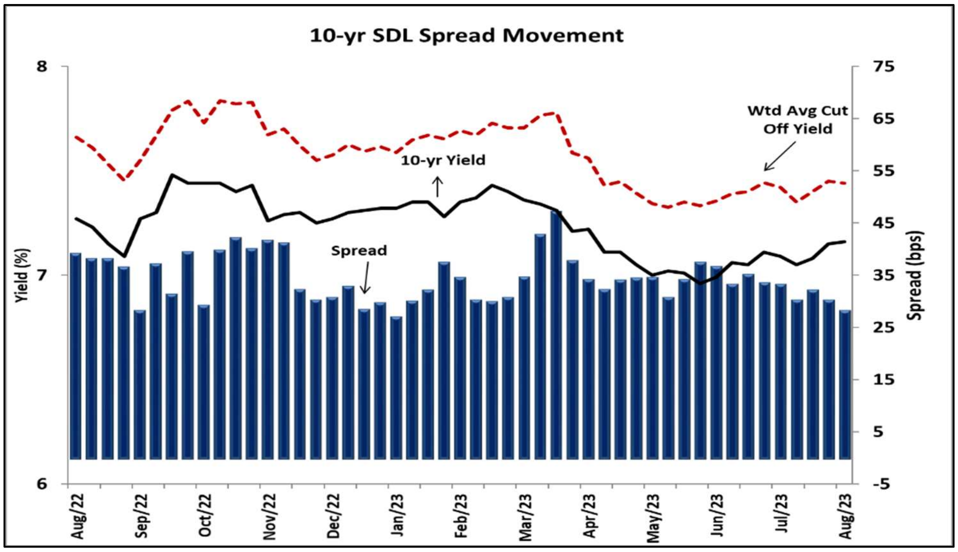
Technical View

Technical Synopsis 7.26% GS 2033 Yield:

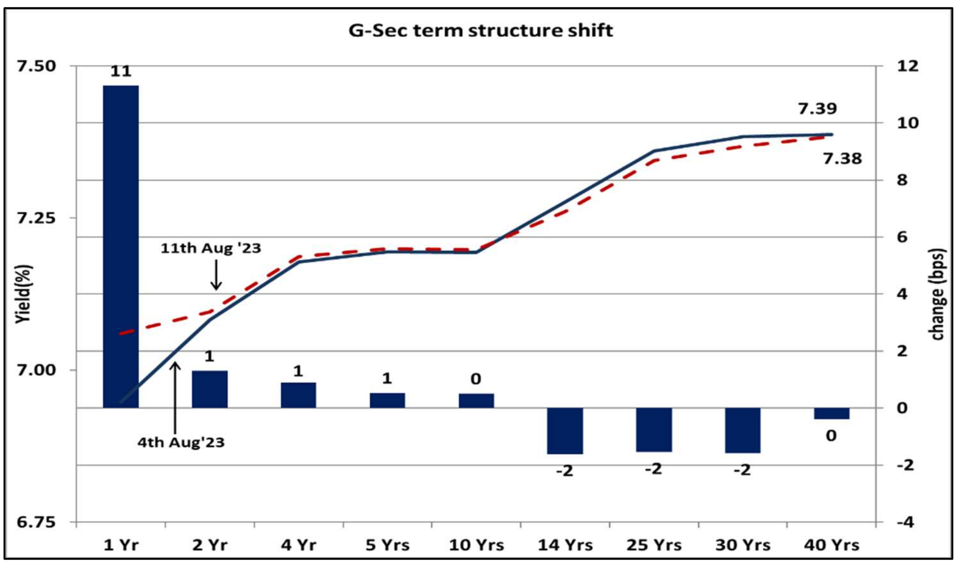
7.26% G Sec 2033 Yield settled at 7.20% on Friday's session. Post Gap up on 28th July, it is consolidating in the range of 7.14% to 7.22%, forming strong base around 7.14% zone. Momentum oscillator RSI is currently placed at 60 zone. Benchmark is slowly and steadily drifting upwards in a rising channel pattern indicating further hardening possible in coming days. On level front immediate resistance is placed around 7.24% and on lower side crucial support still remains at the previous gap level of 7.14%.

Source: Ticker Plant

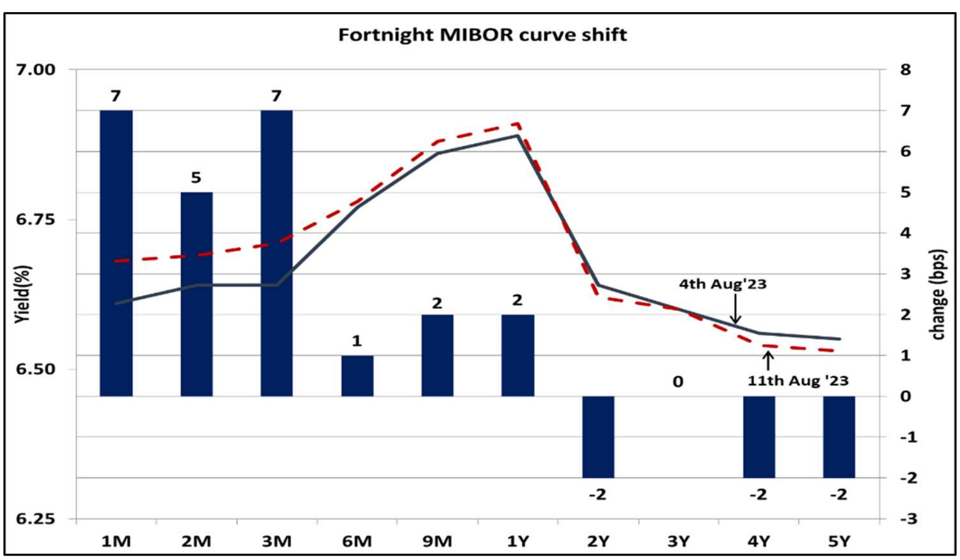
Spread Monitor



The spread between long end SGS vs CG narrowed mildly to 27-30 bps from the previous fortnight



Shorter end of the curve witnessed correction with announcement of I-CRR by RBI



Shorter end OIS rates also reacted negatively to RBI's decision to impound liquidity

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