PNB GILTS LTD

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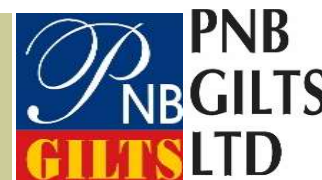
ECONOMY & GILT WATCH



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Q2 GDP Review
Deeba Hasan
Vice President
deeba.hasan@pnbgilts.com

Macro Monitor
Lavisha Wadhwani
Associate Vice President
lavisha.wadhwani@pnbgilts.com

SDL Outlook
Anshul Arora
Sr. Vice President
a.arora@pnbgilts.com

Technical Outlook
Rajavageesh Ramaiah
Vice President
rajavageesh.ramaiah@pnbgilts.com

Q2 GDP Review: Strong Upside Surprise

The Indian economy posted robust gains in the second quarter of FY 2023-24, driven by a sharp rebound in the industrial sector activity. The real GDP growth for the second quarter stood at 7.6 per cent, standing significantly higher than RBI's projection of 6.5 per cent for the quarter. With this, the real GDP growth for the first half of the year stands at 7.7 per cent, implying that the economy stands on a rather firm footing, despite external headwinds and higher interest rates prevailing currently. The annual growth in GVA stood at 7.4 per cent during the quarter as against 5.4 per cent in the corresponding period of last year. While the industrial sector provided a sharp fillip during the quarter, agriculture activity underwhelmed, while services sector activity moderated as elevated prices of essentials possibly hit discretionary spending. Expenditure side numbers revealed subdued private consumption momentum, strengthening of capital formation and pick up in government expenditure during the quarter.

Trends by Production: Manufacturing Steals the Show

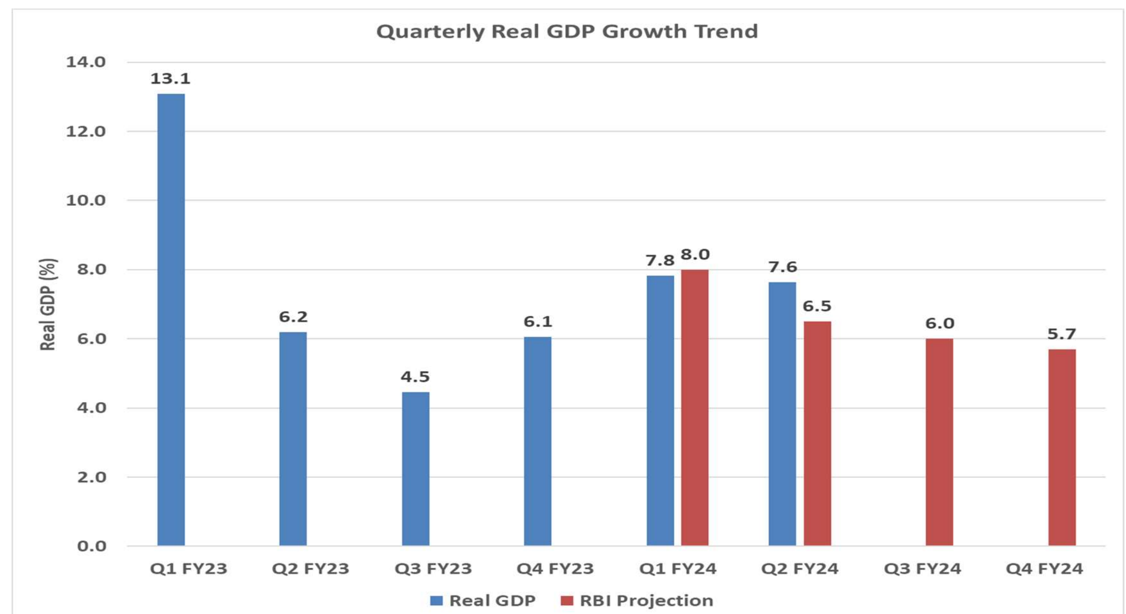
Production side numbers indicate the agriculture sector activity weakened, with uneven rainfall affecting the timing of sowing of kharif crops. During the quarter y-o-y growth in agriculture sector came in at 1.2 per cent vis-à-vis 3.5 per cent in Q1 FY 2023-24 and 2.5 per cent in Q2 FY 2022-23. Agriculture sector activity is expected to remain muted in FY 2023-24 as El-Nino induced weather anomalies continue to impact sowing and harvesting of key crops. As per the first advance estimates of production of major kharif crops 2023-24, the expected kharif production for key kharif crops like rice and pulses is trailing the targets set for the year. This is also impacting rural consumption, which is getting reflected in rather muted trends in private consumption. Industrial sector on the other hand, was the bellwether of economic activity in Q2, growing at a robust annual pace of 13.2 per cent, with the three segments (manufacturing, mining and electricity), clocking double digit growth during the quarter. While, part of it can be explained by a favourable base effect (industrial sector witnessed contraction of 2.5 per cent in corresponding quarter of last year), buoyant urban demand and below normal rainfall helped manufacturing and mining activity make significant gains during the quarter. Softer commodity

prices and hence lower cost of production, also seem to be likely contributors towards the higher GVA witnessed for the industrial sector. Services sector growth on the other hand cooled down with construction and PADOS being the key drivers of services activity. Construction activity witnessed y-o-y growth of 13.3 per cent partly due to a favourable base effect and due stepping up of capital expenditure by the government ahead of the elections. Trade, hotels, transport and financial and real estate services, the two largest contributors in GDP, slowed during the quarter, pulling down overall services sector growth to 6.7 per cent vis a vis 10 per cent in the previous quarter.

Trends by Expenditure: Government spending quickens, private consumption squeezed

Private consumption growth at 3.1 per cent stands significantly lower than 7 per cent average growth in the current GDP series (until FY 2019-20)

On the expenditure side, Private Final Consumption Expenditure (PFCE), which is the single largest contributor in GDP, clocked a muted growth of 3.1 per cent with rural economy remaining under continued duress amidst weak agriculture output. The share of private consumption also declined to 56.8 per cent during the quarter as against 57.3 per cent in the previous quarter. Government expenditure and capital formation remained the key drivers of economic growth, both driven by government led expenditure, with Government Final Consumption expenditure (GFCE) rising by 12.4 per cent and Gross Fixed Capital Formation (GFCF) rising by 11 per cent during the second quarter. In terms of percentage share in the overall GDP, the share of GFCF held at series high of 35.3 per cent, while the share of GFCE was 8.9 per cent. Net exports improved marginally as exports growth bounced back in positive territory, reducing the drag of net exports on overall growth. Exports grew by 4.3 per cent during the quarter as against a de-growth of 7.7 per cent in the previous quarter.



What the GDP data implies for monetary policy

The outlook for economic activity has strengthened and any doubts what so ever on underlying weakness have been squashed with the release of the surprisingly strong Q2 GDP growth, if we look at the headline number. However, persistent weakness in rural demand, agricultural growth and softening momentum in services growth, along with tapering of government expenditure is likely to result in softening of growth in the coming quarters. Nonetheless, the high frequency indicators, foretell continued buoyancy in economic activity in the third quarter as well for now. A robust growth number gives RBI ample comfort to continue with the tightened monetary policy stance. RBI has been maintaining liquidity in deficit to keep overnight rates firmly at the upper end of the LAF corridor. The softening of headline inflation is also unlikely to last owing to a low base effect along with an uptick in prices of food items such as vegetables, pulses, cereals in the month of November, which will prompt RBI to remain pat on rates and stance in the upcoming monetary policy (due on 8th December). On a medium terms basis, in absence of demand led pressures in the economy, which can be seen in benign core inflation and private consumption growth, along with a likely US Fed policy pivot, domestic policy expectations may also turn softer.

A robust growth number gives RBI ample comfort to continue with the tightened monetary policy stance

GVA at basic prices from (at constant prices)	FY 2022-23	FY 2023-24		
	Q2	Q1	Q2	H1
Agriculture & allied activities	2.5%	3.5%	1.2%	2.4%
Industry	-2.5%	4.6%	13.2%	8.8%
Mining & quarrying	-0.1%	5.8%	10.0%	7.6%
Manufacturing	-3.8%	4.7%	13.9%	9.3%
Electricity, gas ,water supply etc.	6.0%	2.9%	10.1%	6.4%
Services	8.9%	10.0%	6.7%	8.3%
Construction	5.7%	7.9%	13.3%	10.5%
Trade, hotels, transport, comm & broad	15.6%	9.2%	4.3%	6.6%
Financial, real estate & prof. srvcs	7.1%	12.2%	6.0%	9.0%
Public Admin, Defence & Other srvcs	5.6%	7.9%	7.6%	7.7%
GVA at Basic Price	5.4%	7.8%	7.4%	7.6%
GDP	6.2%	7.8%	7.6%	7.7%

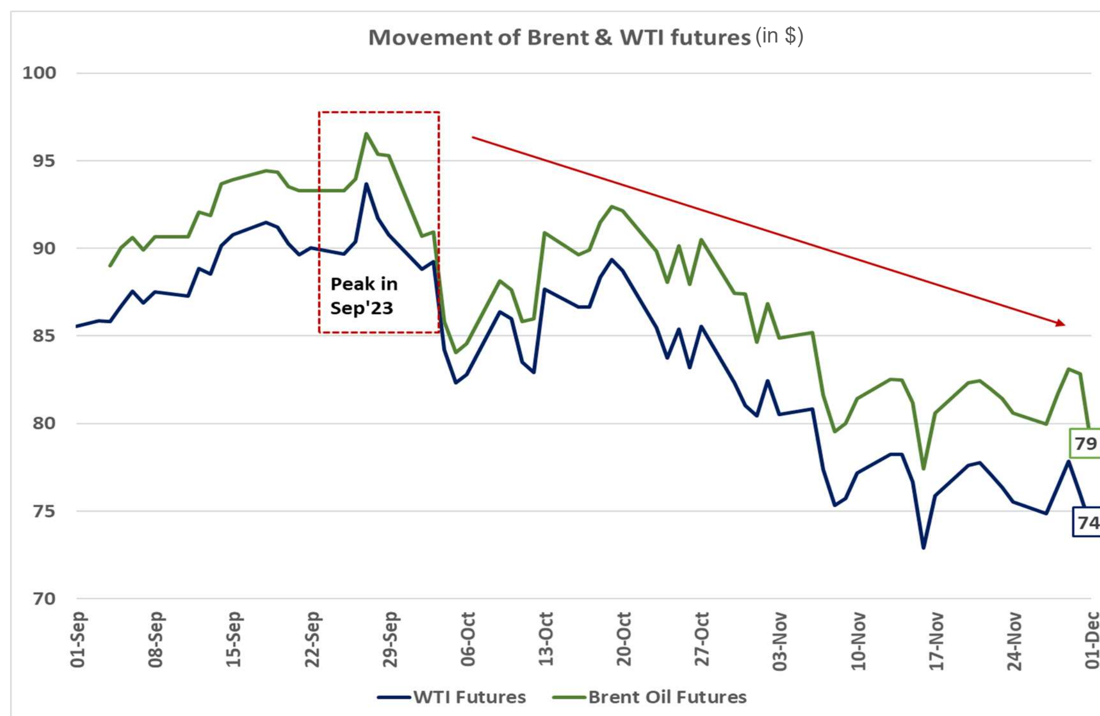
Macro Monitor

Skeptic market response on OPEC+ output-cut

The oil prices have observed a weakening bias for two straight months, from their peak highs in September, majorly on the back of record production levels of crude by the US and diminishing oil demand. With China being a major crude oil importer, slowdown in the economy took a big hit on the oil demand. In an attempt to restore price stability and demand-supply balance, OPEC+ agreed on voluntary supply cut of 0.9 mn barrels per day w.e.f. January 2024 for the first quarter. This voluntary pledge comes in addition to the existing curbs implemented by Saudi and Russia of 1 mn barrels per day and 0.3 mn barrels per day respectively. The markets responded to this move with skepticism as the size of cuts are 'voluntary' and not part of formal quota of the agreement, therefore, compliance may prove to be just on paper and not result in as much removal of barrels effectively from the market.

OPEC+ agreed on an additional voluntary supply cut of 0.9 mn barrels per day w.e.f. January 2024 for the first quarter.

Nevertheless, the diminishing of 2.2 mn barrels per day could manage to address the oversupplied markets atleast for the quarter, unless any further deterioration in demand outlook is witnessed. According to the forecasts, a surplus of 0.3 mn barrel per dollar will turn to a deficit of 0.3 mn barrel per day in the first quarter, which would provide support to falling crude oil prices.



Fixed Income Outlook

Fundamental View

Domestic bond yields traded in a range bound manner in the previous fortnight, despite a sharp fall in US treasury yields, with US 10-yr yield softening by almost 30 bps to end the fortnight at three months of 4.21 per cent. While the global cues have been largely positive with markets pricing in a Fed pivot, despite Fed's reluctance to indicate the end of rate hikes, domestic cues have not been so bond positive. A much higher than expected GDP growth number and resurgence in prices of staple vegetables such as onion and tomatoes are expected to keep RBI firm in its guidance in the upcoming policy. In the policy review, RBI is expected to revise the GDP forecast upwards, post sharply higher Q2 GDP data release and continue to voice concern over repeated food price shocks. However, weakness in underlying demand in the economy along with softening global policy expectations, do not warrant a change in policy rate trajectory going forward, which will keep bond prices supported, despite a status quo in the forthcoming policy review. Markets will also track US yield movement closely, which in turn will be driven by the Fed guidance in the policy review due on 13th Dec 2023. Until now, the Fed has been reluctant to concede to the end of the rate hike cycle, with caution stemming from large deviations between projected and actual inflation in the past. In the coming policy review, we expect Fed to continue to remain vigilant and wait for further softening of labour markets and a persistent easing of inflation before indicating the peaking of the rate cycle.

The coming fortnight will witness two key events, viz, RBI and US Fed monetary policy reviews

SDL Outlook

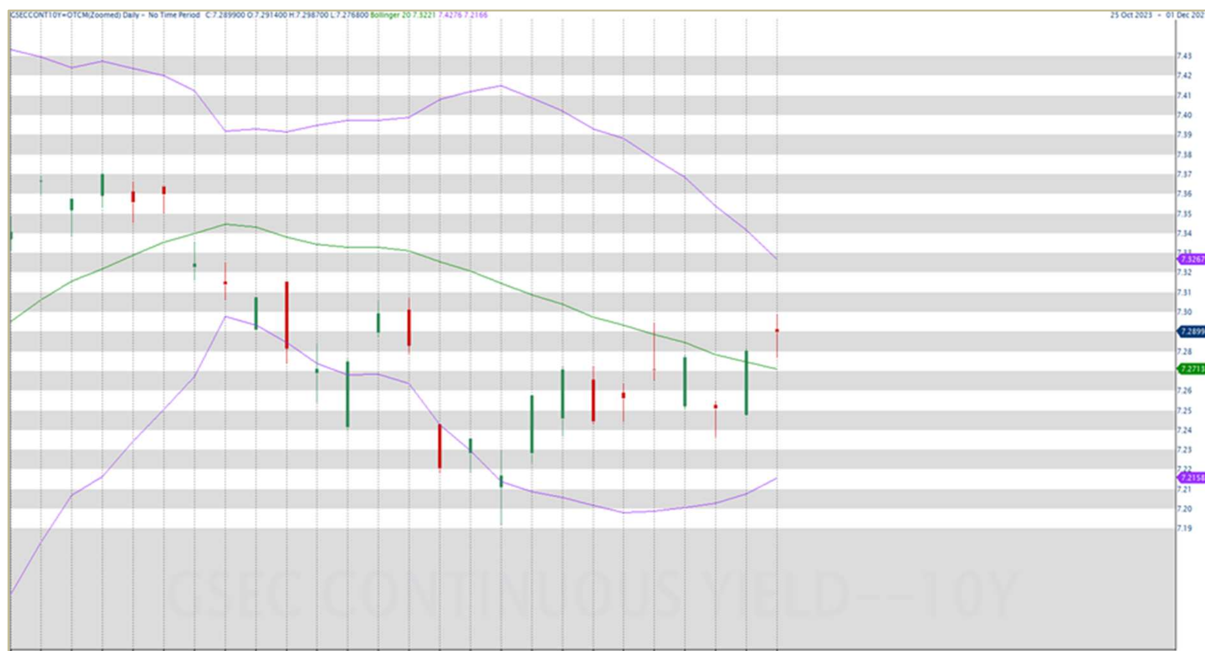
During the last fortnight, 10 Yr. State Loans traded in the broad range of 7.60%-7.77%, whereas the 10 Yr. CG benchmark, remained in the range of 7.22%-7.30%. So far, in the Q3, the amount raised by state governments has been **18% higher** than the indicative amount (Rs. 1,78,309 Cr vs Scheduled figure of Rs. 1,51,042 and this has led to the widening of the spread between the 10-year SGSs and the benchmark 10-year government bond to (**40 - 47 bps**) over the entire month of November. We expect, the trend of States continuing to come up with heavier issue size than the scheduled calendar amount coupled with subdued investors demand. We expect the spread between 10 Yr SGS and CG to remain the same and trade in the range of ***40 - 47 bps*** in the next fortnight and the spread of Long End SGS over their CG counterparts to remain in the band of ***20 -25 bps***.

Market always closed below 50% retracement level of 7.295% between 7.40%-7.1925% the high and low yields made post October policy

Technical View

<u>Technical Synopsis 7.18% GS 2033 Yield:</u>

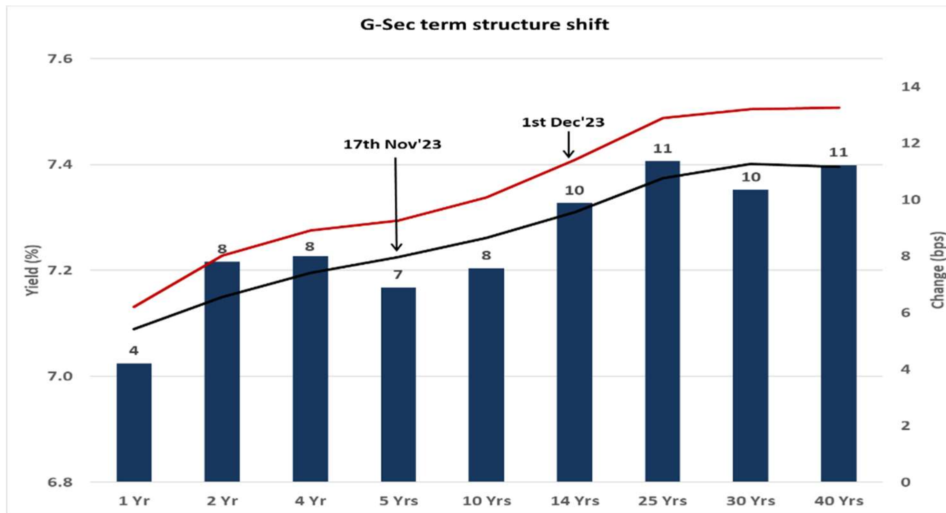
7.18% GS 2033 closed at 7.2899% last fortnight. The benchmark paper hovered in the range of 7.22% to 7.30% during the period. The narrowing Bollinger during the period indicated the lowering volatility is prices despite supportive US Treasury moves. At the same time, the market always closed below 50% retracement level of 7.295% between 7.40%-7.1925% the high and low yields made post October policy. With upcoming monetary policy opening up opportunities for more volatility, any move towards 7.32% should evince buying interest while benchmark's inability to break below 7.22% should be regarded as sell signal.



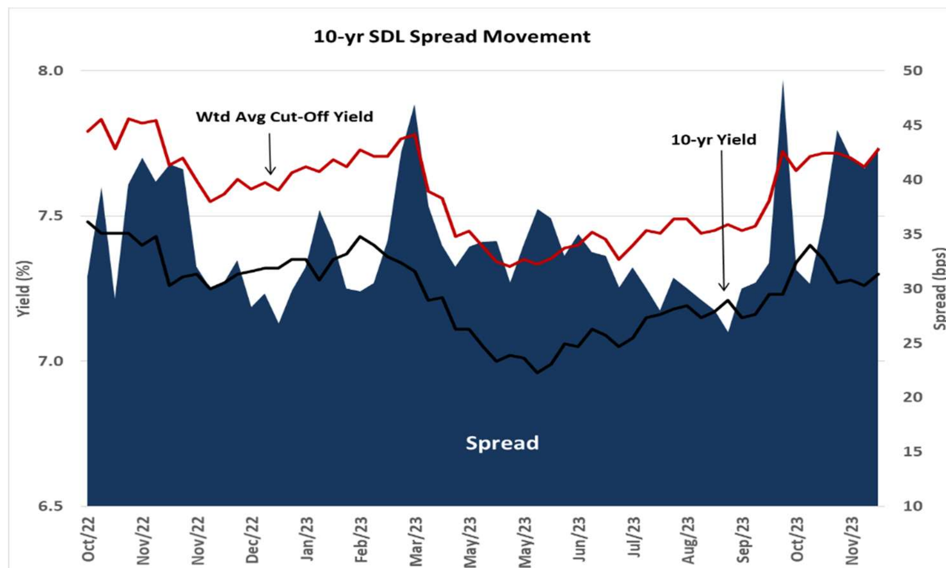
Running Chart GOI 10yr Daily.

Source: Cogencis

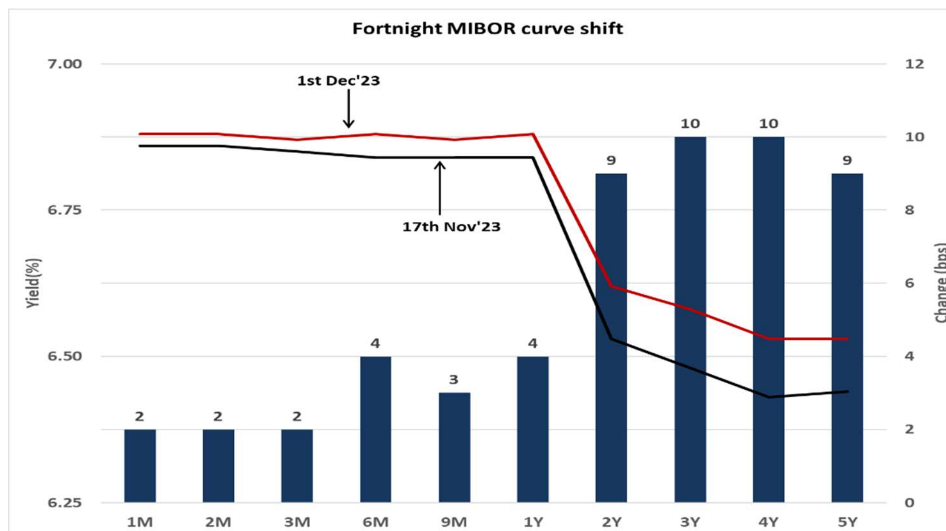
In Graphs



G-sec yields hardened during the fortnight despite a fall in US yields



The spread between 10 Yr SGS and CG is expected to trade in the range of 40 - 47 bps in the next fortnight



Overnight indexed swap rates firm up on lack of fresh cues

PNB GILTS LTD.
5, Sansad Marg
New Delhi
110001

Phone 011-23325759
For Fixed Income retail queries: 011-23321568
E Mail: marketing@pnbgilts.com
For other queries:
research@pnbgilts.com

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