Fixed Income Market

The global monetary policy outlook remained challenging as growth / inflation data continued to give mixed signals. China provided yet another policy stimulus to kickstart the growth engine, which has led to some pickup in global commodity prices. Crude oil remained in a tight demand-supply zone with extended oil production cut by OPEC, and Brent crude crossed USD 90 per barrel. Food supply chain disruption & monsoon deficit on El Nino fears raised concerns about global food prices. Significant increase in fiscal supply in the US remained an overhang on interest rates.

Global rates remained volatile during August and further hardened with many countries witnessing new highs over the last 1 year, and US 10-year G-Sec crossed 4.30% levels also. Indian rates also inched up in line with the global trend, and 10-year G-Sec briefly touched 7.25% during the month. Global uncertainty, elevated crude prices & higher domestic inflation expectations led by food prices imparted upward pressure. Corporate bonds remained relatively more resilient with limited new issuances.

Outlook

The domestic rate environment has become relatively more challenging compared to the previous month, with uncertainty on the global backdrop and as domestic inflation concerns & monsoon deficit worsened. August headline inflation is expected to remain upwards of 7% after a shocking 7.75% in the previous month and is now expected to far exceed RBI's 2QFY24 inflation projection of 6.2%. Govt's fiscal response to arrest rising food prices, cut in LPG prices, and fresh crop cycle of vegetables is expected to cool off the prices, but its re-affirmation by October / November inflation print remains critical.

While the uncertainty on various fronts has increased over the last month, we believe MPC will maintain a status quo on policy rates in October and sound watchful on the inflation trajectory. Inflation is expected to cool down from October onwards and provide comfort to MPC to overlook the recent spike. MPC is also expected to decouple itself from the global rate hike cycle on the back of a comfortable situation on the external front with a healthy Fx reserve.

MPC may continue to maintain the policy stance of “withdrawal of accommodation” & reiterate its 4% inflation target to guide the market expectations towards “higher rates for longer” which also provides flexibility against any extreme negative surprises on domestic inflation. In the interim, domestic rates may remain volatile and react to the global rates as well as incoming data points, especially on the inflation front.

Interestingly, domestic rates have surged back to almost March 2023 levels when the backdrop was much more challenging with expected global rate hikes, India's relatively weaker external factors, and most importantly, almost a consensus view of the MPC rate hike in April 2023 policy. For instance, 10-year G-Sec has moved up from the sub 7% level seen in June 2023 to now at 7.20% - 7.25% and is very close to the 7.30% - 7.35% levels seen in March 2023. We believe India's current fundamental situation is much better than that in March 2023, and the recent surge in market rates provides an attractive entry point to investors, especially in the 2 to 5-year segment, as elevated yields are expected to deliver positive returns over inflation. Near-term volatility led by evolving factors, if any, is expected to be range bound and should be ignored. Over the medium term, as the market builds expectations on the rate cut cycle at some point in time, it will enhance overall returns through mark-to-market benefit. Having said that, active fund management is critical as uncertainties may emanate from domestic inflation, fiscal supply, and global backdrop, which may influence various yield curve segments differently. The credit environment remains healthy, and selective AA / AA+ rated exposure can be explored at fair credit spreads.