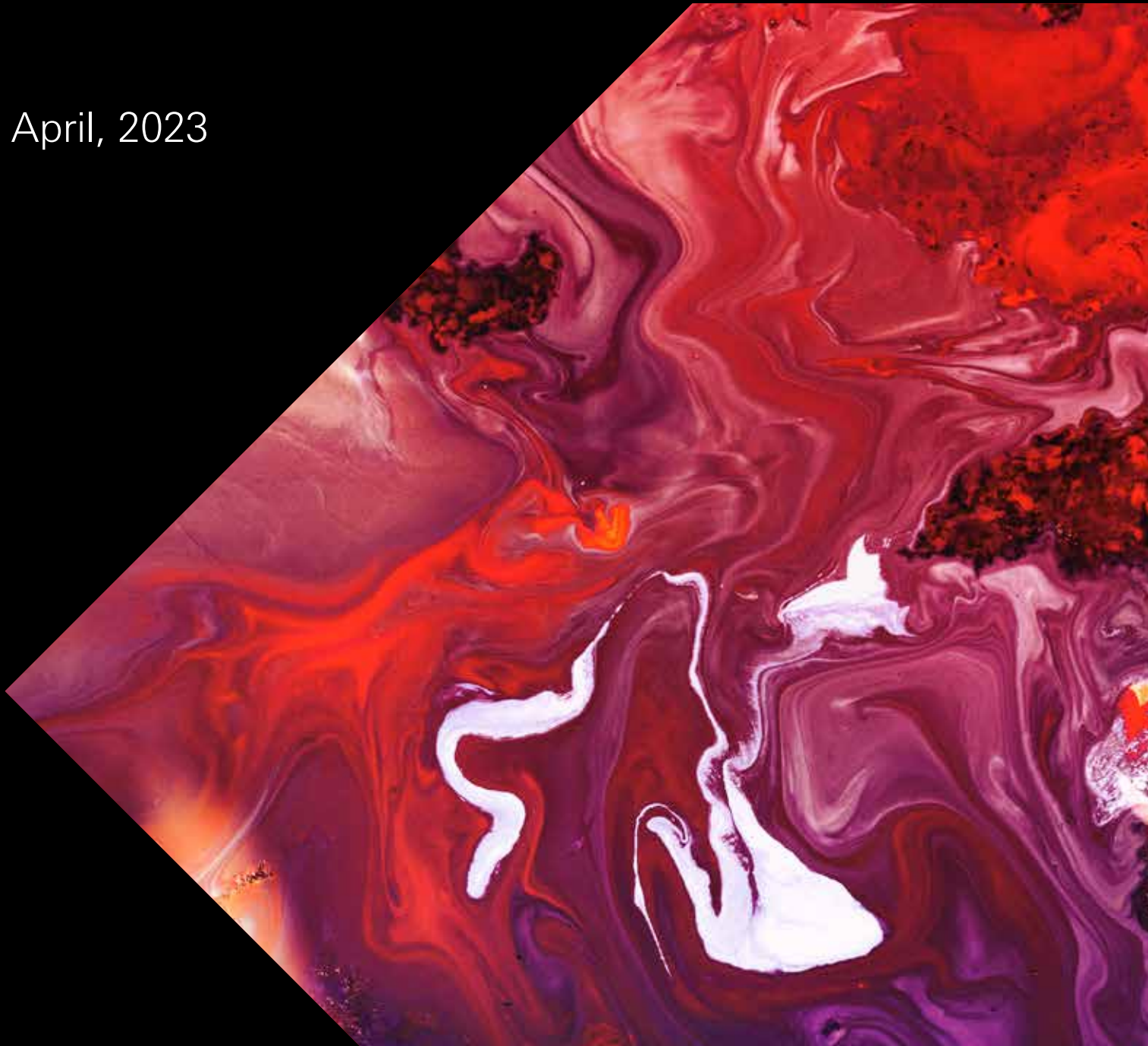


Debt Market Review

April, 2023



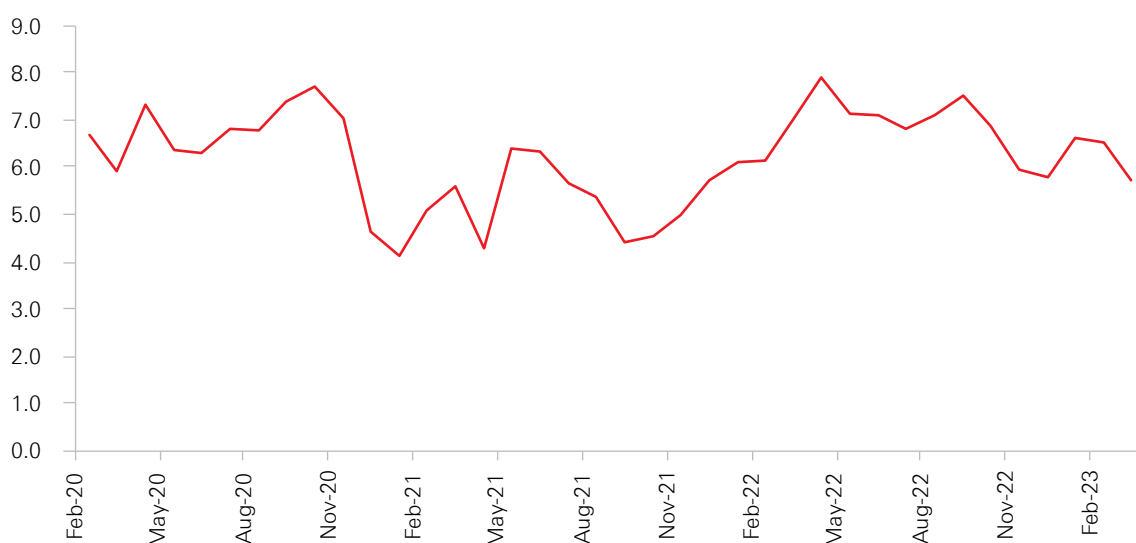
The FOMC in its meeting on May 03, 2023, raised the policy rates by 25 bps to 5.00%-5.25%. The significant change was in the accompanying statement where the Fed dropped its earlier reference to “further policy firming may be appropriate”. The Federal Reserve Chair indicated that future rate actions would be data dependent but reiterated the commitment to bringing inflation back down to 2%. The Fed Chair also mentioned that they have raised rates sharply over the past year and would note how data evolves, leaving the option open for a pause in the next meeting. Post the Federal Reserve meeting, the markets now expect the Fed Fund rates to have peaked out with around 4 rate cuts over the next one year. The US Treasury curve continues to remain inverted with the 2 yr / 10 yr spread currently at 40-45 bps post the Fed meeting vs ~60 bps at the end of April. The ECB also raised policy rates in early May by 25 bps, with possibility of further tightening going forward.

The month of April saw some amount of stability in global markets. US CPI inflation moderated to 5.0% in March 2023 vs 6.0% in the previous month. Core CPI, however, continues to remain sticky at 5.6%. Eurozone and UK CPI remained elevated at 7.0% and 10.1% respectively. 10 yr US Treasury yields stayed range bound between 3.30% and 3.60% during the month. Crude prices were volatile during the month, with a surprise OPEC production cut leading to a sharp spike to ~USD 87/bbl early in the month—prices moderated towards the end of the month closing virtually flat for the month at ~USD 80/bbl, and is currently trading even lower at ~USD 73/bbl.

The MPC met in early April and voted unanimously for maintaining the repo rate at 6.5%, contrary to consensus expectations of a 25 bps hike. The MPC also voted with a 5:1 majority for continuing with “withdrawal of accommodation”. The Governor emphasized that the decision to pause on rates is only for this meeting, leaving the door open for future rate hikes if required.

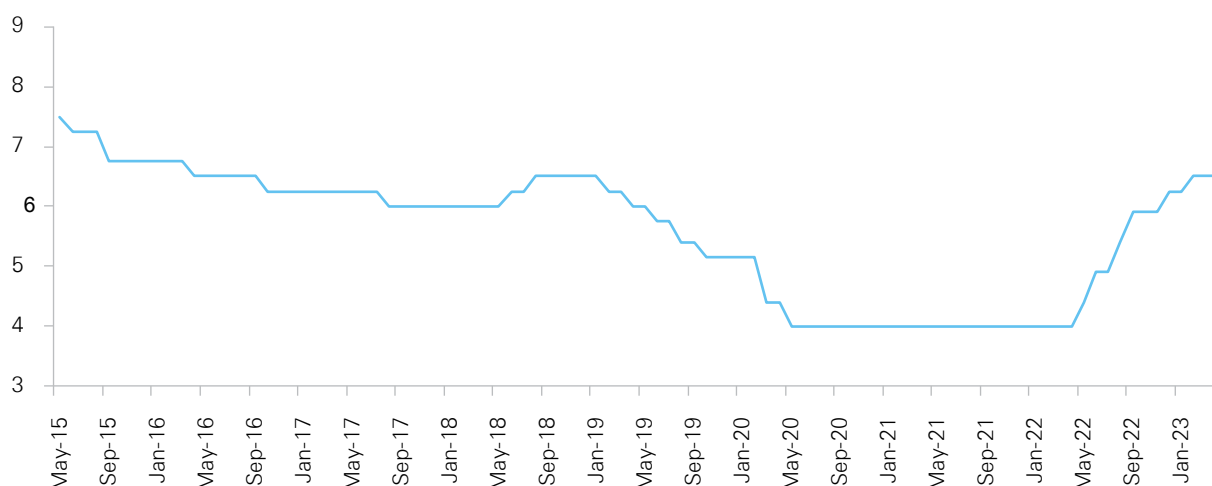
On the domestic macro front, CPI inflation moderated to 5.66% in March 2023 (vs 6.44% in Feb) given moderation in food prices and decline in core inflation to 5.8%. WPI inflation declined to a 29-month low of 1.34% in March 2023 (vs 3.85% in Feb). PMI numbers continued to be strong with Services PMI at a multi-year high of 62.0 (vs 57.8 in previous month). GST revenues remain buoyant, clocking an all-time high in of INR 1.87 Lakh Crs in April 2023 and credit off-take ended FY2023 on an upbeat note. IIP remains steady at 5.6% in Feb 2023 (vs 5.5% in Jan 2023). Trade deficit for Mar 2023 stood at USD 19.7 bn. Cumulatively for FY2023, trade deficit widened to USD 267 bn vs USD 192 bn in FY2022.

CPI Inflation (%)



Given RBI maintaining repo rate at 6.5% instead of consensus expectation of a 25 bps hike, domestic yields across the yield curve inched lower during the month. CD levels moved lower by ~10 bps benefiting from reduced supply in April as compared to March. 3yr to 10yr G-Sec yields inched lower by close to 15-20 bps. Corporate bond yields across the yield curve also eased by 15-20 bps while OIS levels were lower by ~20-25 bps across segments. Yields post the month end have further rallied by 5-10 bps.

Repo Rate (%)



Outlook

Given the 300 bps+ move in overnight rates over the past year, the MPC decided in the previous policy to assess the impact of past actions and keep an eye on the global financial stability situation over the coming months. A strong external sector and robust growth momentum (especially compared to rest of the world) gives enough space to the RBI to wait and take calibrated measures in the future if needed.

With the Fed having signaled a pause (and a likely end) to its rate hike, the probability that our rate hiking cycle has ended and 6.50% is the peak Repo Rate in this cycle has meaningfully increased. Having said that, it would still be critical to monitor incoming data pertaining to inflation and growth over the coming few quarters, to see if any nasty surprises force the Fed or the RBI to embark on a fresh round of tightening. Hence, a nimble footed approach would be apt in our portfolio strategies to adapt quickly to such events (if they do unfold).

The game now clearly shifts to the timing, magnitude and pace of rate cuts that are likely over the next year or two. The US bond markets are aggressively pricing in 100 bps of rate cuts over the next year, with the easing starting as early as July / September 2023. Domestically too, with the sharp rally in yields over the past month, markets are now effectively pricing in rate cuts starting in Q4 of this fiscal year.

Outlook (contd.)

The speed at which markets have turned around to price in rate cuts now vs hikes earlier has been sharp and quick, but not surprising as at the peak of a rate hiking cycle (with Repo Rate higher by 250 bps and Overnight rates higher by over 300 bps), it is always difficult to predict exactly when the markets turn and often such turnarounds tend to be sharp and dramatic. This is precisely the reason why we have been advocating a constructive view on bond markets over the last couple of months. Despite the sharp rally in yields over the past month, we continue to remain positive with a 1-2 year investment horizon, during which bond markets are likely to benefit from a likely rate cutting cycle and a gradually more accommodative RBI stance.

Based on the above outlook above, we believe the below mentioned strategies make investment sense:

- ◆ With 6-12-month CD space now yielding close to 7.30%-7.50%, this makes a compelling case for investors to get into investment products like Money Market Funds which invest predominantly in the 6-12-month CD space. As the gap between deposit and credit growth narrows over the coming few quarters, we believe CD rates are likely to stabilize and start moving lower.
- ◆ For investors willing to take some risk – with volatility being high and markets likely to swing from one narrative to the other during the course of the next few months, we believe dynamically managed Duration and Gilt Funds can provide more opportunities to add alpha through duration changes to take advantage of these movements.
- ◆ And for the next level of alpha seeking investors, adding an element of measured credit risk to these strategies (through products such as Medium Duration Fund), can become a rewarding proposition.

Source: Bloomberg, HSBC Mutual Fund. Data as of 30 April 2023

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