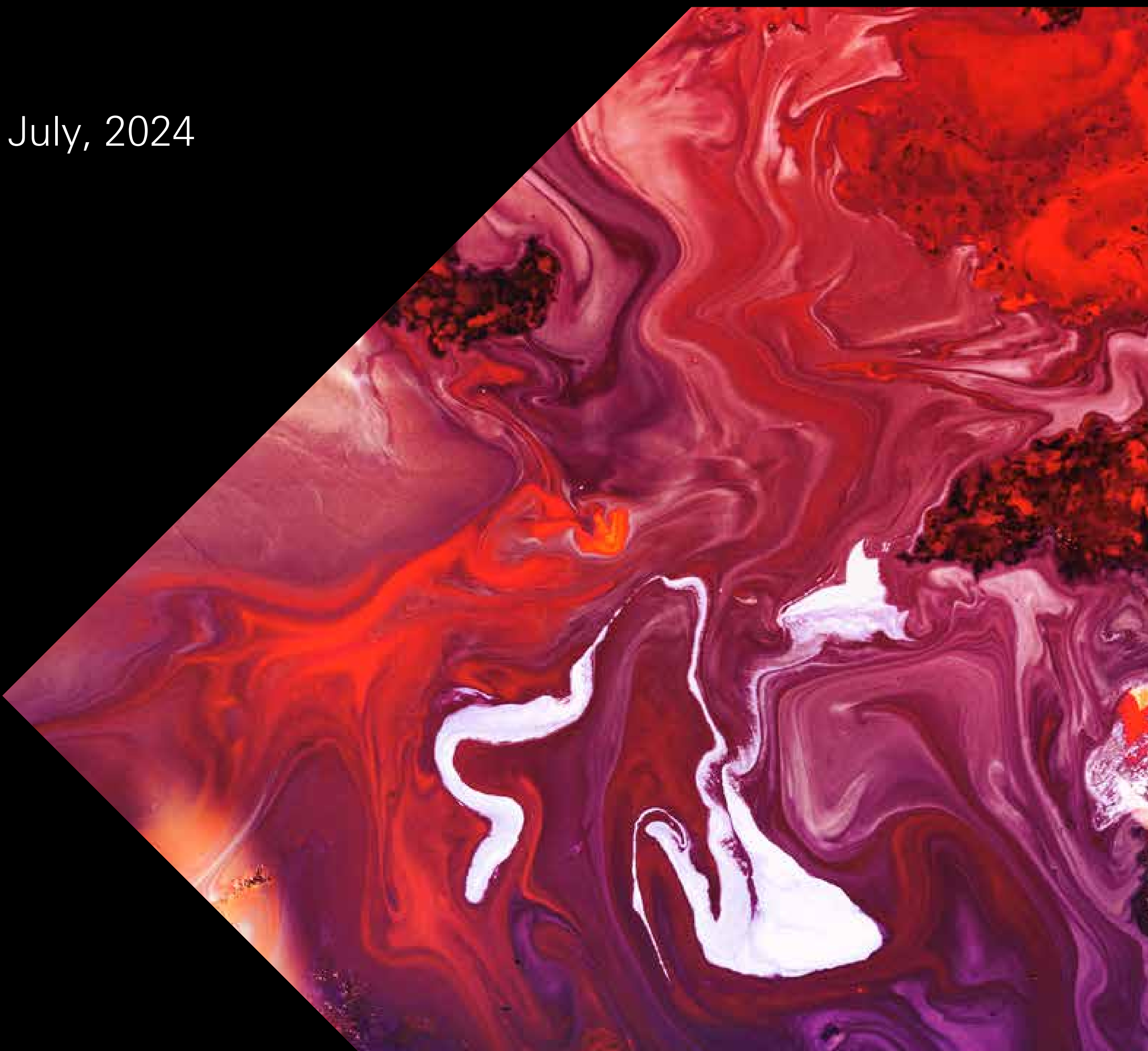
HSBC Mutual Fund

Debt Market Review

July, 2024



Stage set for a rate easing cycle across economies…

July remained an eventful month, both globally and for domestic markets, with key events and data points setting the tone for the evolution of the interest rate trajectory over the next few months. One key theme that emerged was the softening of data in the US. On one hand, markets saw an easing in inflation data with US CPI and PCE printing at 3.0% and 2.5% respectively, while on the other hand labour markets showed broad based weakening with payrolls coming in significantly lower than expectations along with a sharp rise in the unemployment rate to 4.3%. This has set the tone for the commencement of easing policy rates by the Fed in the September policy, which was also hinted at the recently concluded FOMC meeting.

US Treasuries, which had been witnessing a steady fall in yields over the last few days, saw an even sharper fall post the payrolls data, with the 10-year US Treasury closing at 3.79% (as of Aug 02, 2024). Markets are now increasingly pricing in possibility of a 50 bps rate cut in the September policy, and a cumulative easing of 125-150 bps by January 2025.

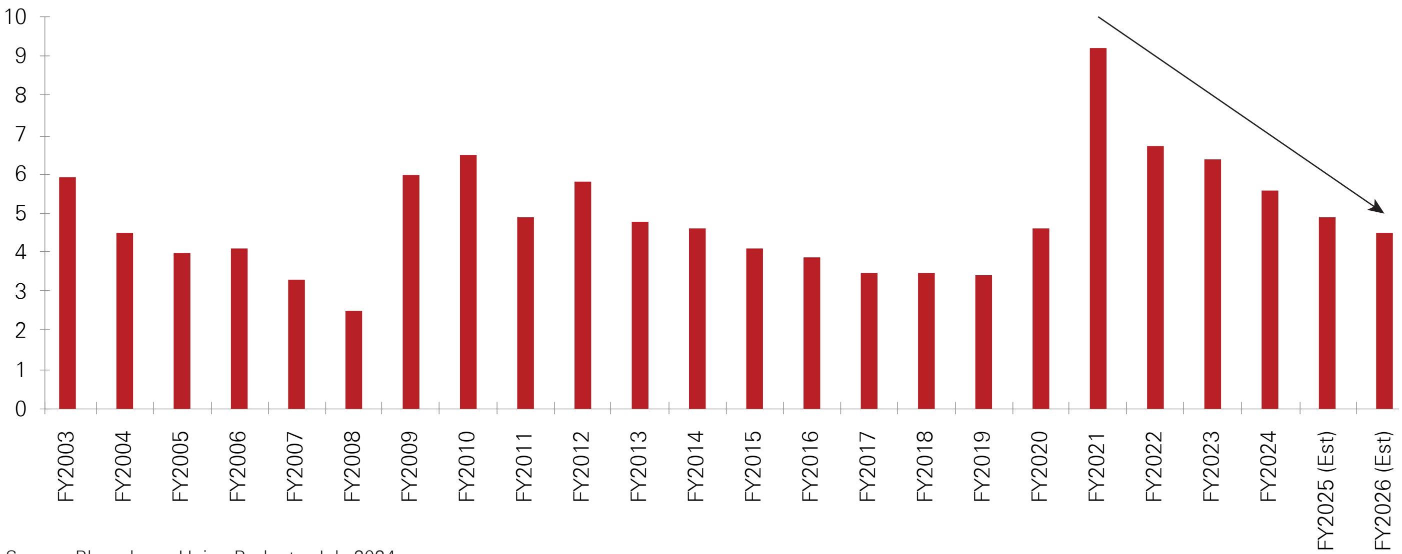
Among other major economies, BOE cut policy rates by 25 bps while hinting that future rate actions would be data dependent. The BOJ, on the other hand, hiked policy rates from 0-0.1% to 0.25% and decided to reduce their purchase of JGBs. This has resulted in sharp strengthening of JPY along with broad Dollar weakening.

Union Budget demonstrated Government's continued focus towards fiscal consolidation…

On the domestic front, the Union Budget was announced on July 23, 2024. One key theme that emerged from the Budget was the focus on job creation and employment over the next five years. There were some fears that the Government might deter from their path of fiscal consolidation, given that they could not win a complete majority. However, the Government continued its focus on fiscal consolidation and Capex, allaying any market fears surrounding it.

The budget surprised positively on the Fiscal Deficit number which came in at 4.9% (vs. market expectations of 5.0% and interim budget estimates of 5.1%) with a target to bring Fiscal Deficit to below 4.5% by FY2026. Assumptions around revenue targets, tax growth and nominal GDP looked realistic and achievable. Gross borrowing for FY2025 was marginally cut from INR 14.13 trn to INR 14.01 trn, with net borrowing correspondingly at INR 11.63 trn along with reduction in financing through small savings. T-Bill borrowing has been reduced by INR 1 trn (vs interim budget estimates), along with cash drawn down of INR 1.4 trn implying an easing in short term rates.

India's Fiscal Deficit (% of GDP)



Source: Bloomberg, Union Budget – July 2024

Draft Liquidity Coverage Ratio (LCR) norms: Further reinforcing the bond market momentum…

The other key event was the draft changes to the Liquidity Coverage Ratio (LCR) norms for Banks which the RBI came out on July 25, 2024. The RBI is essentially trying to proactively address the issue that due to increased usage of technology in banking, users now have the flexibility to make instantaneous bank transfers/withdrawals which can lead to liquidity risks during periods of stress.

The key impact of the proposed changes are: **(a)** LCR could get impacted by 10%-20% depending on the retail-to-wholesale deposit mix of each bank, **(b)** Increased pressure on deposit generation, **(c)** Lower NIMs for Banks or slowdown in growth to conserve NIMs, and (d) Increase in demand for HQLA assets, primarily G-Sec, SDLs and eligible corporate bonds.

While Banks have multiple options to tackle this impact, namely **(a)** Maintain lower LCR and run on tighter LCR buffers, **(b)** Increase deposit rates and push for higher deposit generation, and **(c)** Slowdown in growth, given the limited ability to meet all the proposed requirements using just the above three options, we believe that it is highly likely that they will have to add to their current base of HQLA assets. If the current LCR buffers are maintained, our broad calculations suggest that there will be an incremental demand of INR 3-5 trn of such assets.

Alternatively, if at a system level, they maintain slightly lower LCRs of ~115%, we believe it could still mean incremental buying of INR 1.5-2 trn of HQLA assets. There could be some marginal revisions in the final circular for this draft and there is still some time to go before the implementation date -– April 01, 2025. The Banks' strategies may use a combination of all the options available, however, if HQLA requirement increases which is likely here, we believe that there will be an uptick in incremental demand for G-Sec going forward.

Macro data, positive liquidity and market movement…

Here are the key data points from domestic perspective:

- CPI came in marginally higher at 5.08%, due to an increase in vegetable prices. IIP registered a 5.9% growth, continuing on the positive momentum.
- Trade Deficit came in at USD 20.98 bn. PMI numbers continued to remain robust and GST collections were buoyant at INR 1.82 trn.
- FPIs continued to pour money into IGBs, with the cumulative purchase since the JP Morgan index announcement at close to USD 14 bn.
- RBI has been conducting OMO sales in the secondary market, with almost INR 100 bn worth of G-Sec sold by the RBI over the last few weeks. While this is a small number and might not impact markets significantly, any announcement pertaining to an OMO sales calendar will remain a key monitorable.
- Additionally, in a surprise move, RBI announced exclusion of new 14-year and 30-year Government securities from FAR (eligible for FPI purchase), while existing securities to continue to remain in FAR. This resulted in a sell-off in long end G-Sec resulting in further steepening of the yield curve.

Liquidity remained positive during the month. Post elections, accelerated spending by the Government along with G-Sec maturities aided liquidity. Government cash balance which was around INR 5 trn has come down to close to INR 3 trn, while net durable liquidity is around INR 4 trn. Impact of build-up of FX reserves by RBI has been liquidity positive (FX reserves at USD 667 bn) and markets continue to see FPI inflows.

CIC has also reduced a bit which has added to liquidity and is expected to come off further. We believe Government spending will continue and along with lower T-Bill borrowing will impact liquidity positively. Easing in liquidity will also likely result in compression of corporate bond spreads in the up to 5-year segment, benefitting funds which are predominantly invested in corporate bonds.

Market movement during the month..

- T-Bill rates fell by around 15 bps
- G-Sec levels up to the 5 year segment were lower by 15-20 bps, 10 year G-Sec was lower by 9 bps while the 30 year segment was broadly unchanged
- Corporate bonds up to the 5 year segment were lower by 10-13 bps
- OIS levels moved sharply lower by 15-20 bps during the month

Present Outlook

We continue to have a positive outlook on interest rates, based on various favorable factors:

a) Global markets turning positive

b) Record RBI dividend to the Government

c) Reduced Fiscal deficit number of 4.9%

d) Favorable G-Sec supply demand dynamics

e) Incremental G-Sec purchase by Banks to increase HQLA assets

f) FPI index related inflows

g) Soft core inflation along with expectations of a better than normal monsoon, and finally

h) Soft signals by Government and RBI on liquidity

Taking this into an overall context of recent events and developments, we believe the below four ongoing factors over the next 12 months are expected to be supportive of the respective segments:

Factors impacting the market	Maturity segments likely to benefit
Expected improvement in liquidity over the next 6-12 months	Upto 3 years
Implementation of revised draft LCR norms	3-7 year segment
FPI inflows following the index inclusions	7-14 years
Expected rate cuts by the RBI	Across the segments

Impact of the factors on HSBC fixed income funds

Fund	Breakup of portfolio holdings (maturity wise)	Expected favorable impact of factors on various funds			
		Liquidity Improvement	LCR norms	Index flows	RBI rate cuts
HSBC Banking and PSU Debt Fund	100%	✓			✓
HSBC Short Duration Fund	45% 55%	✓	✓		✓
HSBC Corporate Bond Fund	10% 90%		✓		✓
HSBC Dynamic Bond Fund	20% 40% 40%		✓	✓	✓
HSBC Gilt Fund	30% 25% 45%		✓	✓	✓

Source: HSBC MF Factsheet - Indicative maturity breakup based on portfolios dated July 31, 2024

HSBC Mutual Fund

Maturity Buckets for the breakup in table above:

	<3 yr
	3-7 yr
	7-10 yr
	10+ yr

As highlighted above, our different high-quality funds are positioned across various maturity buckets, and the favorable impact of the four factors may benefit these segments. Investors can look at the specific fund category as per their investment horizon and risk appetite.

Present Fund Positioning

- **HSBC Banking and PSU Debt Fund** is predominantly invested in assets maturing in the 1.5-2 year segment. With liquidity easing through this quarter and expectations of rate cuts getting priced in over the next few months, the fund may benefit from market expectations of softening in short end yields along with compression in spreads of Corporate bonds.
- **HSBC Short Duration Fund** and **HSBC Corporate Bond Fund** may be considered for investment with a medium-term horizon and slightly higher appetite for interest rate risk. These funds are primarily invested in the 2-6 year part of the curve. Liquidity easing and pricing of rate cuts along with implementation of revised LCR norms could result in (a) softening of yields in this segment, (b) steepening of the yield curve and (c) compression in spreads of Corporate bonds. Both these funds may benefit from these developments.
- **HSBC Dynamic Bond Fund** and **HSBC Gilt Fund** are primarily invested in the 7-10 years and 10+ years part of the curve, while also having some allocation to the shorter maturity to opportunistically benefit from favorable moves in those segments. The duration of the funds is actively managed. With index inflows continuing in IGBs in an environment where demand supply dynamics is favorable and rate cut expectations get built in over the next few months, these funds may provide an opportunity to generate alpha for investors looking to play the duration theme.

Abbreviations:

IGB: Indian Government Bond
JGB: Japanese Government Bond
FOMC: Federal Open Market Committee
BOE: Bank of England
BOJ: Bank of Japan
CPI: Consumer Price Index
PCE: Personal Consumption Expenditures
HQLA: High Quality Liquid Assets
FPI: Foreign Portfolio Investment
CIC: Currency in Circulation
OMO: Open Market Operations

Scheme name

HSBC Dynamic Bond Fund
HSBC Corporate Bond Fund
HSBC Gilt Fund
HSBC Banking & PSU Debt Fund

Potential Risk Class

Potential Risk Class			
Credit Risk → / Interest Rate Risk ↓	Relatively Low (Class A)	Moderate (Class B)	Relatively High (Class C)
Relatively Low (Class I)			
Moderate (Class II)			
Relatively High (Class III)	A-III		

A relatively high interest rate risk and relatively low credit risk.

Scheme name

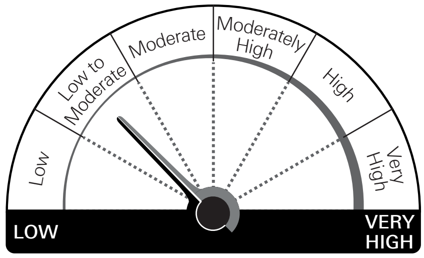
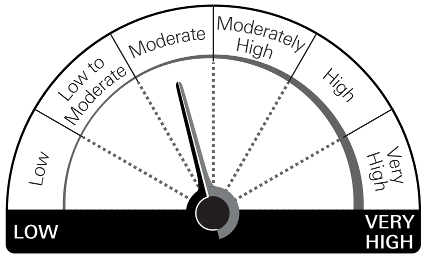
HSBC Short Duration Fund

Potential Risk Class

Potential Risk Class			
Credit Risk → / Interest Rate Risk ↓	Relatively Low (Class A)	Moderate (Class B)	Relatively High (Class C)
Relatively Low (Class I)			
Moderate (Class II)	A-II		
Relatively High (Class III)			

A Moderate interest rate risk and Relatively Low Credit Risk

Product Labels

Scheme name and Type of scheme This product is suitable for investors who are seeking#	*Riskometer of the Scheme
HSBC Banking and PSU Debt Fund (An open ended debt scheme primarily investing in debt instruments of banks, public sector undertakings, public financial institutions and municipal bonds. A relatively high interest rate risk and relatively low credit risk.) • Generation of reasonable returns and liquidity over short term • Investment predominantly in securities issued by Banks, Public Sector Undertakings and Public Financial Institutions and municipal corporations in India (Benchmark: NIFTY Banking & PSU Debt Index A- II)	Riskometer  Investors understand that their principal will be at Low to Moderate risk
HSBC Dynamic Bond Fund (An open ended dynamic debt scheme investing across duration. A relatively high interest rate risk and relatively low credit risk.) • Generation of reasonable returns over medium to long term • Investment in Fixed Income Securities (Benchmark: NIFTY Composite Debt Index A-III) **HSBC Short Duration Fund** (An open ended short term debt scheme investing in instruments such that the Macaulay Duration of the portfolio is between 1 year to 3 years (please refer to page no.16 of SID for details on Macaulay's Duration). A Moderate interest rate risk and Relatively Low credit risk.) • Generation of regular returns over short term • Investment in fixed income securities of shorter-term maturity. (Benchmark: NIFTY Short Duration Debt Index A-II) **HSBC Corporate Bond Fund** (An open ended debt scheme predominantly investing in AA+ and above rated corporate bonds. A relatively high interest rate risk and relatively low credit risk) • Generation of regular and stable income over medium to long term • Investment predominantly in AA+ and above rated corporate bonds and money market instruments (Benchmark: NIFTY Corporate Bond Index A-II) **HSBC Gilt Fund** (An open ended debt scheme investing in government securities across maturity. A relatively high interest rate risk and relatively low credit risk.) • Generation of returns over medium to long term • Investment in Government Securities (Benchmark: NIFTY All Duration G-Sec Index)	Riskometer  Investors understand that their principal will be at Moderate risk

#Investors should consult their financial advisers if in doubt about whether the product is suitable for them.

Please refer notice cum addendum available on website of HSBC Mutual Fund for updates on riskometer/product labeling of the scheme. Riskometer is as on 28 June 2024.

Source: Bloomberg & HSBC MF Research estimates as on July 31, 2024 or as latest available

Note: Views provided above are based on information in public domain and subject to change. Investors are requested to consult their financial advisor for any investment decisions.

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Mutual Fund investments are subject to market risks, read all scheme related documents carefully. CL1702