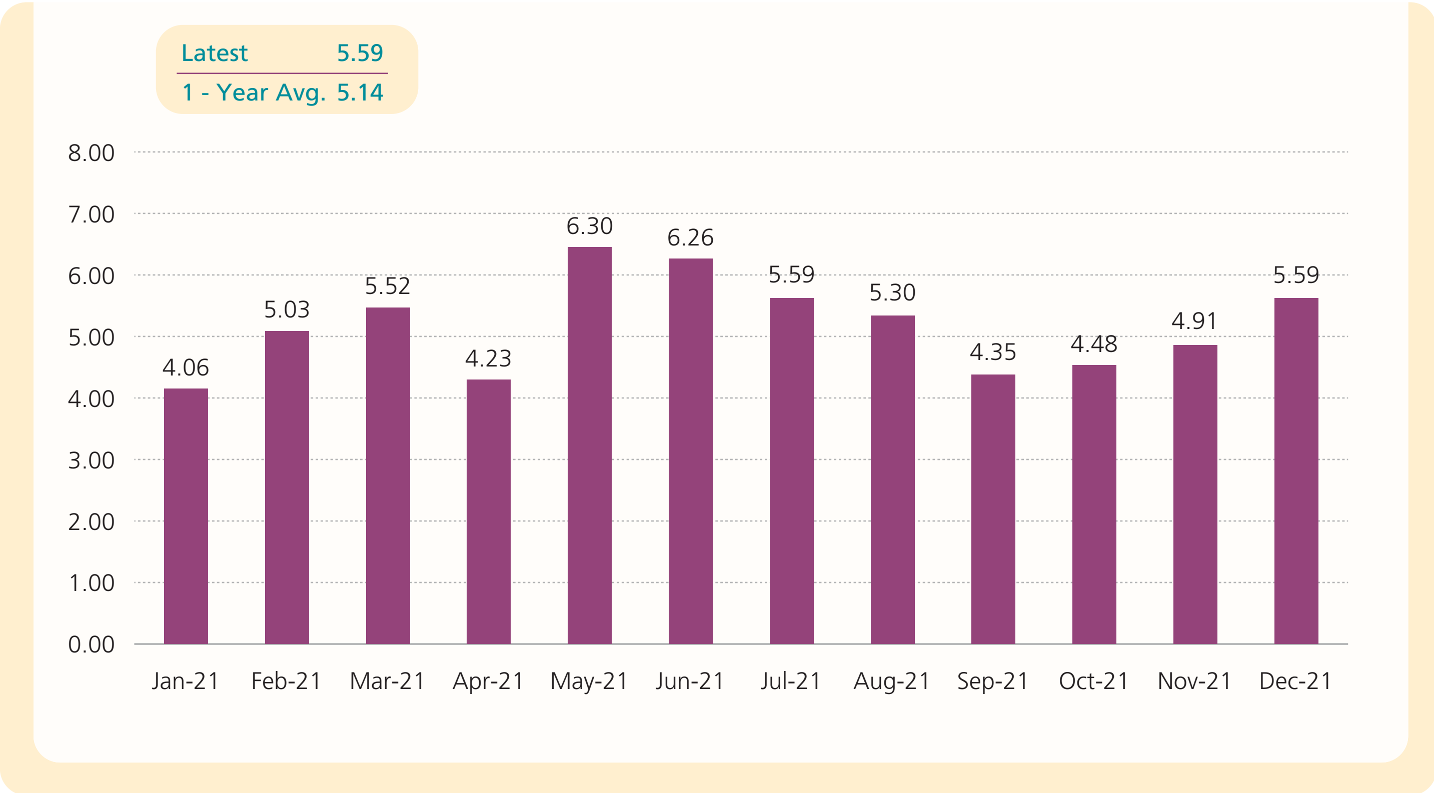
As inflationary pressures across the globe turned out to be more entrenched, Central Banks have been pushed to exit from ultra-easy monetary policies. Crude prices soaring above USD 90/bbl have only added to inflation woes. CPI print in the US for December 2021, came in at almost a 4-decade high print of 7.0%, with core CPI also at multi-year high levels of 5.5%. Against, this backdrop, the FOMC in its January meeting provided a strong hawkish guidance. Quantitative Easing (QE) in the US is expected to end by early March 2022, with the commencement of the rate hiking cycle most likely from the March policy. FOMC also provided guidance that Quantitative Tightening (QT) will begin later this year. Markets are now expecting almost 100 bps of rate hikes by the FOMC in 2022. Among other major economies, The Bank of England raised policy rates by 25 bps to 0.5%, after a 15 bps hike in December 2021. South Korea's Central Bank also raised policy rates by 25 bps to 1.25%. The 10-year US Treasury yields traded in the 1.60%-1.90% band over the month while Crude prices remained above USD 80/bbl throughout the month.

On the domestic front, CPI inflation for December 2021 came in at 5.59% (vs 4.91% in November), slightly lower than expectations, with marginal easing in Core inflation. WPI inflation continued to remain high at 13.56% due to higher food inflation (although slightly lower than the November print of 14.23%). IIP data for November 2021 however slowed down to 1.4% (vs 4.0% in October 2021) due to deceleration in consumer durables and capital goods. Exports continue to remain robust, however, imports have also been steady with a pick-up in domestic demand and rising Crude prices, pushing estimates of Current Account Deficit higher than previously estimated.

CPI Combined (YoY)



Variable Rate Reverse Repo (VRRR) auctions have been used by the RBI as a tool to manage high surplus liquidity, and markets continue to witness various tenor (between 3-day to 28-day) VRRR auctions, the cut-offs of which are coming almost at the Repo rate, with most auctions not being able to garner the full size. The RBI also conducted Variable Rate Repo Auctions (tenors between 1-day and 3-day) during the month to provide adequate liquidity to the system, when overnight rates tightened sharply due to GST payments. With pick up in Bank CD issuances and higher borrowing through 6-month and 12-month T-Bill auctions, money market rates beyond March have inched higher by 20-30 bps. With a sharp rise in US Treasury yields and Crude prices and an increasing risk-off sentiment globally, demand in G-Sec auctions have also been weak, with benchmark securities in all the four weekly auctions being partially devolved on Primary Dealers. G-Sec, SDLs and longer tenor corporate bonds have moved higher by 15-20 bps during the month.

MARKET PERFORMANCE

The 10-year benchmark G-Sec yield closed at 6.68%, up by 23 bps from its previous close of 6.45% while that on the short-term 1-year bond ended 15 bps higher at 4.50%.

In the corporate bond segment, yields rose across the yield curve over the month. The 10-year AAA bond yield ended 14 bps higher at 7.10%, while the short-term 1-year AAA bond yield ended 15 bps up at 4.85%.

The spread between 1-year and 10-year AAA bond widened. Within the short-term segment, the yield on 3-month commercial paper (CP) was up 15 bps to 3.95% while 1-year CP yield was up 10 bps at 4.80%.

10-Year G-Sec

Past performance may or may not be sustained in the future.

BUDGET FY23 – RUDE SHOCK FOR BOND MARKETS!

The Union Budget for the year FY23 presented by the finance minister is a growth-oriented budget where the focus is on reviving and sustaining economic growth through thrust on capital expenditure, with an increase of 25% over FY22.

For FY22, the revenue projection (Direct and Indirect taxes) was over achieved due to the economy largely coming back to pre-pandemic levels while the divestment targets were underachieved. The additional revenues were broadly diverted towards additional capital expenditure which is good for the overall economy in creating jobs and long-term growth. For FY23, the revenue projections are realistic, while the capital expenditure targets are ambitious and how effectively the Govt achieves it will have to be seen. Overall given the impetus to growth in this budget, the targets look achievable in absence of any further variants of virus and the economy should move to a path of inclusive growth.

With no major change in direct and indirect taxes to fund these additional expenditures, the fiscal consolidation is lower than market expectations and to that extent, the Government of India will have to borrow more from the market to fund the deficit. Fiscal deficit is targeted at 6.4% for FY23 from 6.9% for FY22, but net market borrowings through Govt bonds will increase from 7.75 trillion to 11.2trillion. **In absence of any new class of buyer for the additional borrowing, the pressure of higher supply will be felt on the market and yields are likely to head higher as we go into FY23.**

FOCUS NOW SHIFTS TO RBI MPC

The first task for RBI will be to normalise the pandemic driven extraordinary loose policies i.e. bringing the reverse repo rate to 3.75% from 3.35% (a 40 bps increase) and then over FY23 they would be resorting to increasing the repo rate to curb demand led inflation. Markets are clearly looking towards the central bank for some support, in an environment where globally yields are heading higher, domestic inflation is also in the uncomfortable territory and now the demand-supply mismatch for government bonds is at an unprecedented level. For RBI, it will be a tough year ahead in terms of balancing out its various mandates – managing the growth inflation trade-offs, managing the government's borrowing programme smoothly, and all this while still maintaining its hard earned credibility.

While near-term momentum is clearly towards higher yields, **we believe over the next few months bonds will start looking quite attractive as India is one of the very few countries which offer positive real rates on the longer end of the curve.** Also, the opportunity cost of carrying cash (at sub 4%) is a painful penalty when compared to investing in various segments where yields have moved significantly higher over the past few months. But for now, we remain cautious in our positioning across our actively managed funds till further clarity emerges on RBI's tolerance levels for yields before they come in to support the markets, and also clarity on the extent to which they can come to support without compromising their position too much.

Source: MOSPI, Internal, Bloomberg