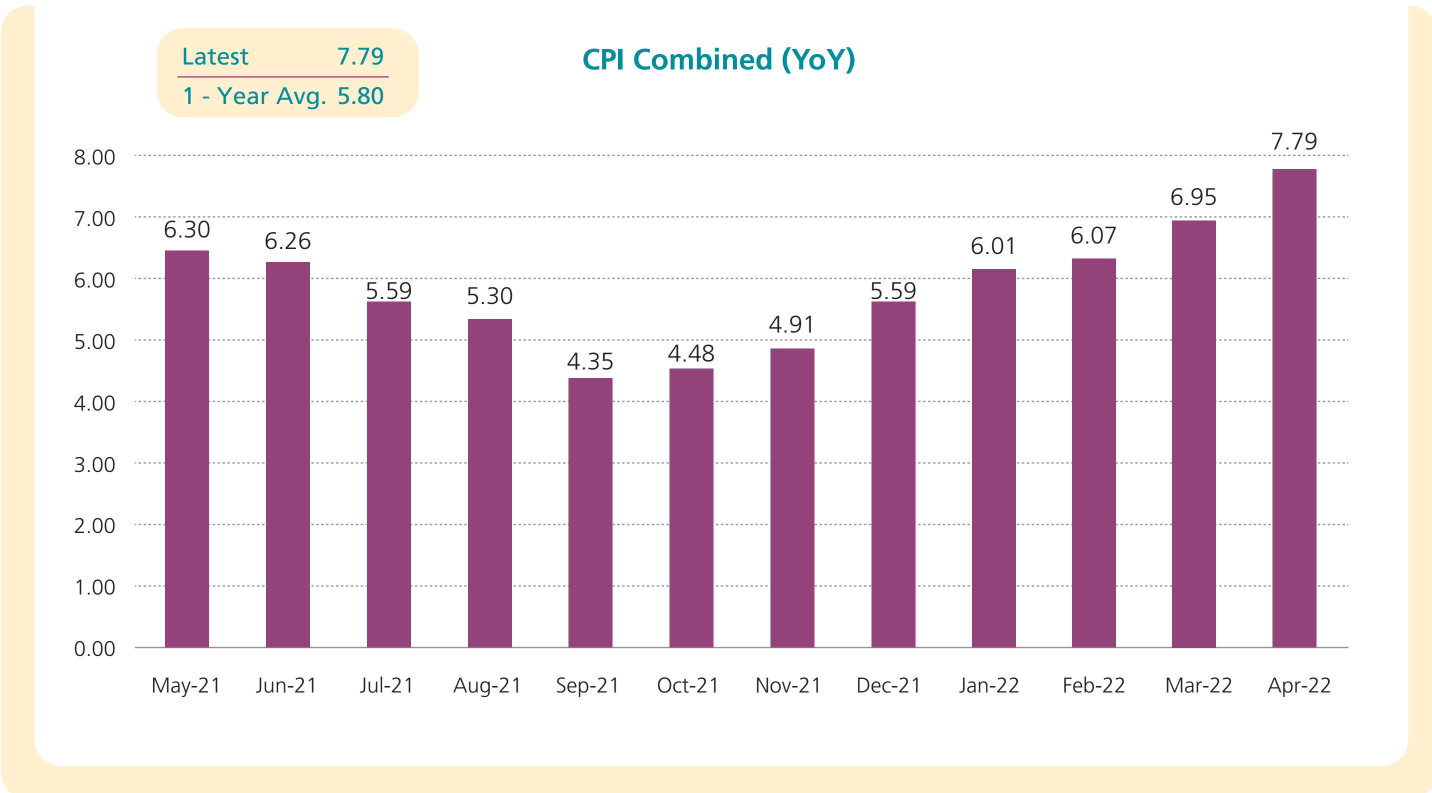
The Federal Open Market Committee (FOMC) in its July meeting hiked policy rates by 75 bps, taking the federal funds rate to 1.50%-1.75%. The pace of Quantitative Tightening remained unchanged. The dot plot indicated that the federal funds rate will move to 3.4% by December 2022 and 3.8% by December 2023 before moving lower to 3.4% by December 2024. Inflation continued to remain the main source of concern with expectations of inflation becoming broad based. Inflation (PCE) projections for 2022 were revised higher and are expected to remain above 2.0% throughout 2023 and 2024. Meanwhile, estimates of the Unemployment rate were moved higher whereas real GDP growth expectations were revised lower from the March 2022 projections. The FOMC Chair indicated that the future course of rate hikes will remain dependent on incoming inflation prints and although at the current juncture a 50-75 bps hike is likely in the July meeting, hikes of 75 bps thereafter are not expected to be common. The Bank of England (BOE) also hiked policy rates by 25 bps to 1.25%. This is their fifth consecutive rate hike. The BOE expects inflation to remain above 9.0% over the upcoming months before moving to above 11.0% later this year. US CPI for May 2022 came in at 8.6% (vs 8.3% in April) with Core CPI marginally lower at 6.0% (vs 6.2% in April). US 10-year Treasury yields remained volatile and traded above 3.0% for most of the month, while almost touching 3.5% before the FOMC meet. Crude prices during the month traded in the range of USD 110/bbl to USD 120/bbl. However, with talks around a possible recession gaining ground, Crude prices are now trading closer to USD 100/bbl and correspondingly US Treasury yields have fallen below 3.0%.

On the domestic front, CPI inflation for May 2022 moderated to 7.04% from the previous month's high print of 7.79%. Core inflation also eased to 6.10% (vs 7.00% in April). Although inflation is expected to have peaked in April, the trajectory to below 6.0% is most likely to be gradual. WPI inflation continued its upward trajectory clocking 15.88% in May 2022 (vs 15.08% in April) led by higher vegetable prices and fuel index. IIP data for Apr 2022 increased to 7.1% (vs 2.2% in March). Trade deficit for May 2022 widened to USD 24.29 bn (vs USD 6.53 bn last year). Exports grew at ~20% y-o-y, however, imports on a y-o-y basis increased by more than 60%, with oil imports up by more than 100%. For FY2022, the Current Account Deficit (CAD) came in at USD 38.7 bn (1.2% of GDP), against a surplus in FY2021. Higher oil prices continue to put pressure on the import bill, resulting in markets now penciling in higher CAD estimates for FY2023. PMI numbers have been encouraging with Manufacturing PMI at 53.9 and Services PMI at 59.2 in June 2022.



The Government levied special additional excise duty of INR 23,250/ton on domestic production of petroleum crude, and additional excise on exports of petrol, diesel and ATF at INR 6/litre, INR 13/litre and INR 6/litre respectively. These measures would help in offsetting the shortfall in revenue due to the excise cut done earlier. The Government also increased the import duty on gold from 10.75% to 15% to curb imports. In order to boost FX inflows and stem further depreciation of the Rupee, the RBI announced a slew of measures, including exemption from maintenance of CRR and SLR on incremental FCNR(B) and NRE deposits, removal of short-term limits for FPI investments in debt instruments of less than one-year maturity and increase in limits for ECBs under automatic route.

The T-Bill and SDL auction calendars for Q2 FY2023 were announced, with gross T-Bill issuance in Q2 FY2023 at INR 2.73 Lakh Crs (weekly auctions of INR 21,000 Crs vis-à-vis INR 33,00 Crs in Q1) and gross SDL issuance in Q2 FY2023 at INR 2.12 Lakh Crs (vis-à-vis actual borrowing of INR 1.1 Lakh Crs in Q1).

On a month-on-month basis (as on June 30, 2022), money market rates moved up by 20-30 bps while 2-3 year G-Sec rose by 5-10 bps. Yields in the 5-10 year segment have also moved up by 5-10 bps. Although 1-year OIS levels moved higher by 15 bps m-o-m, 5-year OIS closed 10 bps lower from the previous month's closing.

10-Year G-Sec

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

OUTLOOK

Central Banks globally have been on a tightening path with most economies witnessing frontloading of rates due to soaring inflation. However, discussions around possible recessionary impact globally have picked up recently. This has resulted in softening of Crude prices and a corresponding rally in rates. Domestic rates have also seen a correction with the 10-year benchmark moving lower by around 25 bps from the recent highs. Pressure on the external sector and thereby Rupee continues to remain a key monitorable. However, the recent measures by the Government and RBI might help in alleviating further worries. The RBI Governor has abstained from giving any guidance on the future course of rate actions, leaving it completely data dependent. Against this backdrop, global growth parameters, inflation trajectory and Crude prices remain key factors going forward.

We had previously mentioned that the terminal rate is expected to be in the range of 6.0%-6.5%, implying a positive real rate. The 2-4 year part of the yield curve was pricing in a higher terminal rate than this and we had highlighted that this segment offers good relative value vis-à-vis other points on the curve. Given the policy actions taken so far by the MPC and in the event of Crude prices staying below the MPC's baseline assumption, the easing of inflation might happen sooner than expected. ***We continue to believe that the 2-4 year part of the curve offers good value for investors who are looking at a medium-term investment horizon. However, we remain cautious in our outlook on the longer end of the yield curve as the supply demand dynamics remain still uncertain and yields need to become much more attractive to justify adequate relative value versus the 2-4 year space.***

Source: MOSPI, Internal, Bloomberg