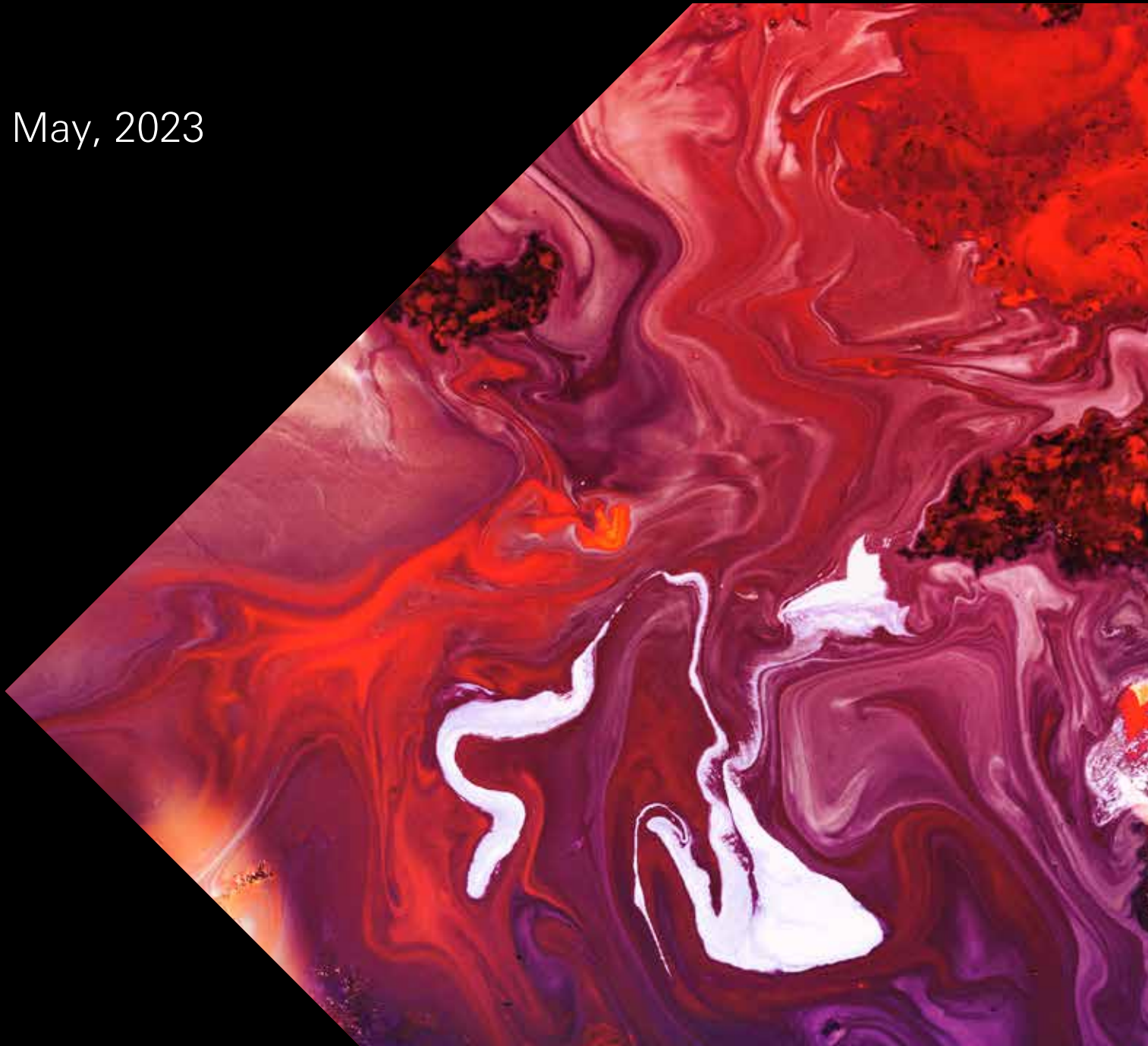


Debt Market Review

May, 2023



The month of May was marked by concerns over the US government borrowing approaching the debt ceiling levels, the breach of which would have forced the US Treasury to suspend payments from early June onwards. Eventually, a bipartisan deal was reached, which resulted in the debt ceiling being suspended until January 2025, thereby easing concerns on this front.

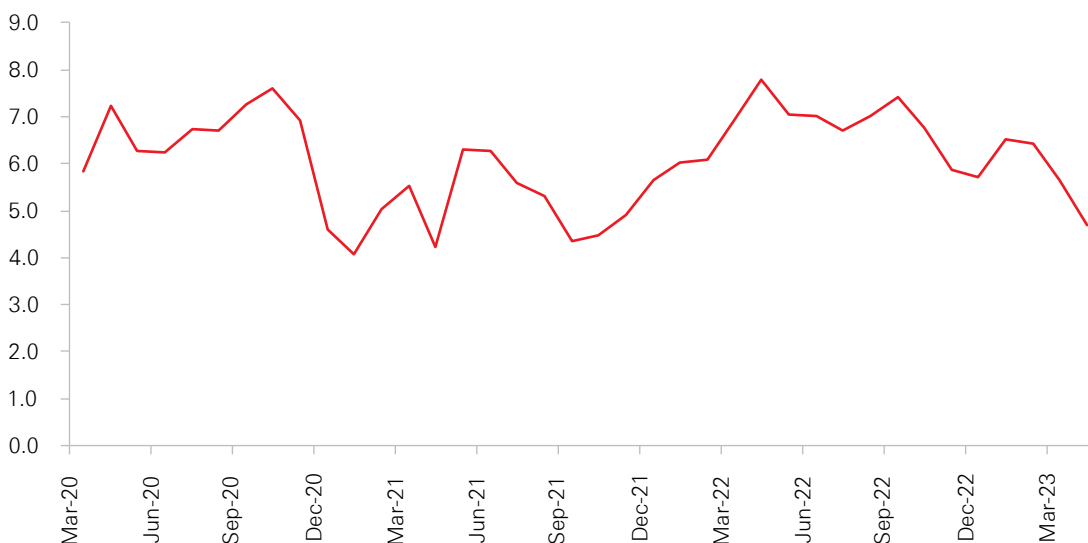
The Federal Open Market Committee (FOMC) minutes for May Fed meeting (where the Fed had raised rates by 25 bps), indicated that members were divided on the need for further rate hikes, with the FOMC participants expressing uncertainty about how much policy tightening may be appropriate. While the FOMC members concurred that inflation had reduced, some members judged the progress in reducing inflation as slow, while other members expressed concerns on the slowing economic growth, and hinting that further policy firming post the meeting may not be necessary. Among other economies, the ECB and Bank of England also raised interest rates by 25 bps, during their meetings in early and mid-May respectively.

The UST curve continued to invert further with the 2-year / 10-year spread currently at ~80 bps vs ~60 bps at the end of April and vs a low of around 40 bps post the Fed meeting in May. The UST 10-year yield after touching ~3.35% early in the month, inched higher for most of the month and closed May at 3.65% vs 3.43% at the end of April after briefly crossing 3.80% during the month. Brent crude prices drifted lower to USD 73/bbl in end May vs USD 80/bbl at the end of April but have since rebounded to USD 77/bbl on OPEC+ production cuts.

On the domestic macro front, GDP growth surprised significantly to the upside, at 6.1% in Q4 FY2023 vs 4.5% in Q3 FY2023. Q4 FY2023 GVA growth also was higher than expected at 6.5%. For the full year FY2023, GDP growth came in at 7.2%. The robust growth trends also continued to be reflected in PMI numbers with May manufacturing PMI at 58.7, a 31-month high vs 57.2 in April. Services PMI stayed robust at 61.2 in May. May GST collections also stayed strong at INR 1.57 trn, up by 12% (YoY), but lower on a month-on-month basis.

On the inflation front, April CPI inflation moderated further to 4.70% vs 5.66% in March 2023, driven by a favorable base with core inflation also moderating from ~5.2% from 5.8% in the previous month. WPI moved into negative territory at -0.92% vs 1.34% in March. On the external front, trade deficit for April 2023 moderated further to USD 15.2 bn vs USD 19.7 bn in March 2023.

CPI Inflation (%)



RBI announced the withdrawal of INR 2,000 denomination notes from circulation. The notes could be exchanged with notes of lower denominations till 30th September or could be deposited with banks. This is expected to have some positive impact in terms of liquidity over the next few months as some of these notes get deposited which could result in currency in circulation reducing while banking system deposits increase. RBI announced a transfer of surplus amounting to INR 87,416 Crs to GOI for FY2023, against a Budget estimate of INR 48,000 Crs. The Fiscal Deficit for FY2023 was maintained at 6.4% of GDP.

In terms of market movements, during the month, 10-year G-Sec inched lower and settled at 6.99% in end May vs 7.12% at the end of April. 3-year to 5-year G-Sec also moved lower by 7-10 bps while corporate bonds inched lower by ~2-3 bps in the 2-3 year segment and by ~8-12 bps in the 5-10 year segment. 1-year/5-year OIS inched lower by ~3 bps. CD rates also moved lower benefiting from improved liquidity conditions with 3-month and 1-year CD rates lower by ~15 bps and ~10 bps, respectively.

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 the rest of the world) give enough space to the RBI to wait and take calibrated measures in the future if needed.

The game now clearly shifts to the timing, magnitude and pace of rate cuts that are likely over the next year or two. With the sharp rally in yields over the past two months, markets are now effectively pricing in rate cuts starting in Q4 of this fiscal year. 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. 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 6-9-month CD space now yielding close to 7.10%-7.30%, this makes a compelling case for investors to get into investment products like **Money Market Fund** which invest predominantly in the 6-9-month CD space.
- ◆ 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 May 31, 2023

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