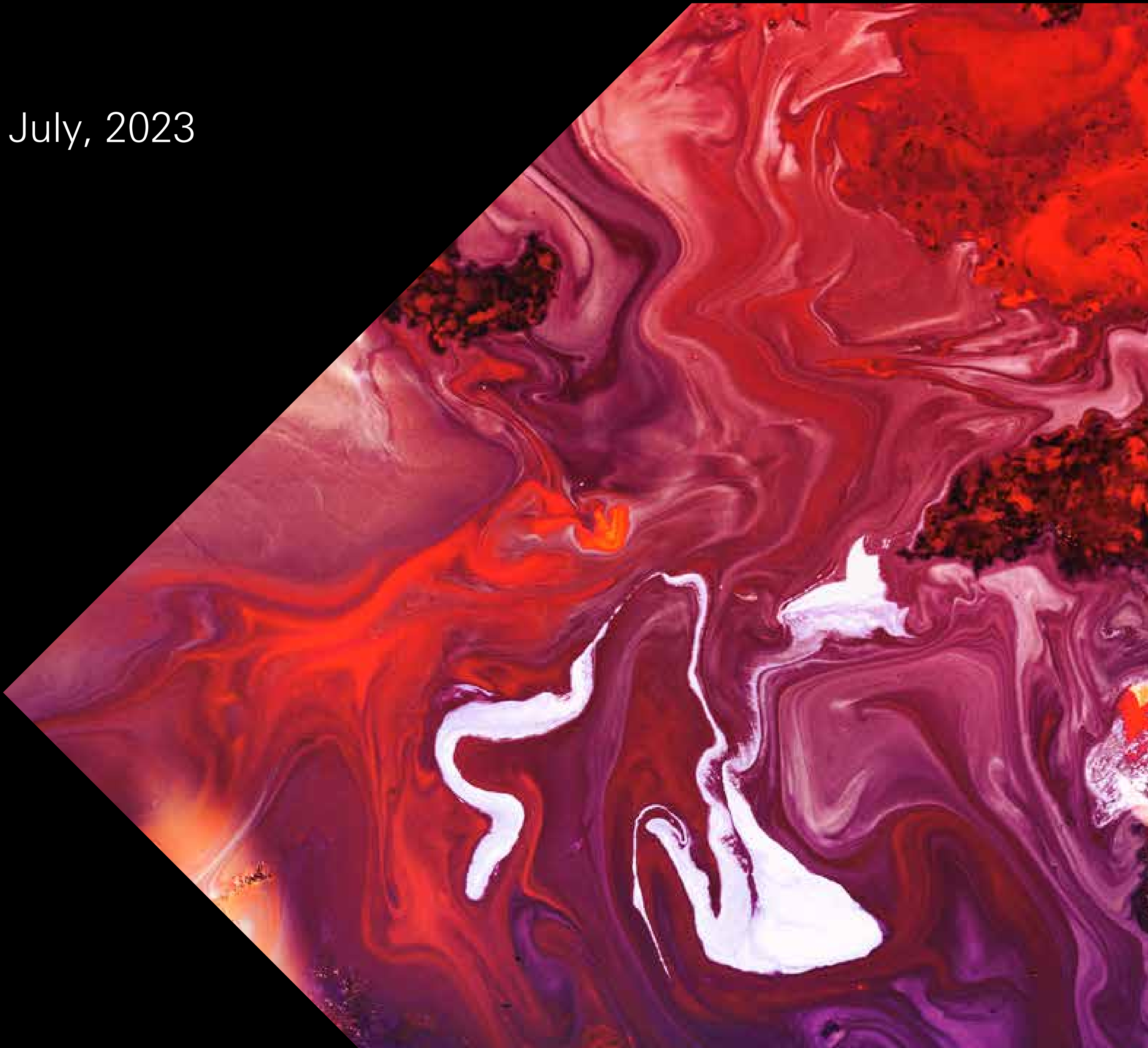
HSBC Mutual Fund

Debt Market Review

July, 2023



Economic data in the US continued to point to strong growth with preliminary Q1 GDP estimates coming in at 2.4% vs 2.0% in Jan-March quarter. On the inflation side, US CPI moderated to 3.0% in June vs 4.0% in May. In the backdrop of growth remaining strong and inflation easing somewhat, the Federal Reserve Open Market Committee (FOMC) met in end July and delivered a 25 bps hike taking the Fed Funds rate to 5.25%-5.50%, which was on expected lines. In its statement, the FOMC maintained that it remained highly sensitive to inflation risks. In his press conference, the Fed Chair Powell did not commit to further policy tightening and emphasized that no decisions had been taken regarding future meetings and that the Fed would set policy on a meeting-by-meeting basis. Elsewhere, the ECB also raised policy rates by 25 bps (their 9th consecutive rate hike). The Bank of Japan, while holding its short-term interest rates at -0.1%, tweaked its yield curve control policy, allowing greater flexibility on the upper and lower bounds of the target range of yields.

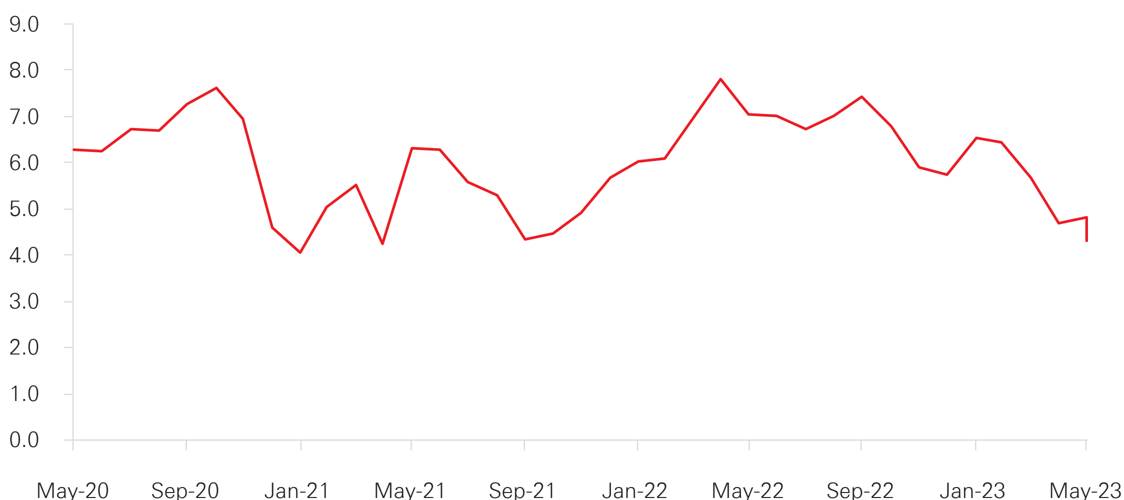
In early August, we saw a surprise downgrade of USA sovereign rating to AA+ from AAA by Fitch. With this downgrade, the USA is now rated AAA by Moody's only. Post this downgrade, we saw UST yields inch higher by ~10 bps.

Overall given this backdrop globally, UST yields have inched higher to 4.10%-4.20% band in early August as against 3.96% in end July from 3.82% in end June. The UST curve remains inverted with the 2 yr / 10 yr spread at ~90 bps in end July (vs 106 bps in end June). Brent crude prices inched higher reaching ~USD 85/bbl in end July (vs USD 75/bbl in end June).

Macro-Economic Developments

- Inflation rose in June driven by a spike in food prices, especially vegetable prices, leading to CPI inflation moving to 4.81% in June vs 4.31% in May. Vegetable prices have continued to rise further and stayed elevated in July which could lead to a further increase in CPI inflation

CPI Inflation (%)



- On the growth front, PMI and IIP numbers continue to reflect a robust growth environment with May industrial production at 5.2%, July Services PMI at a 13 year high of 62.3 (vs 58.5 in June) and Manufacturing PMI was stable at 57.7 vs in 57.8 in June
- July GST collections remain robust at INR 1.65 Lakh Crs, up 11% (YoY)
- On the external front, trade deficit for June 2023 moderated further to USD 20.1 bn from USD 22.1 bn in May 2023
- Liquidity stayed comfortable for most of July given increased government spending

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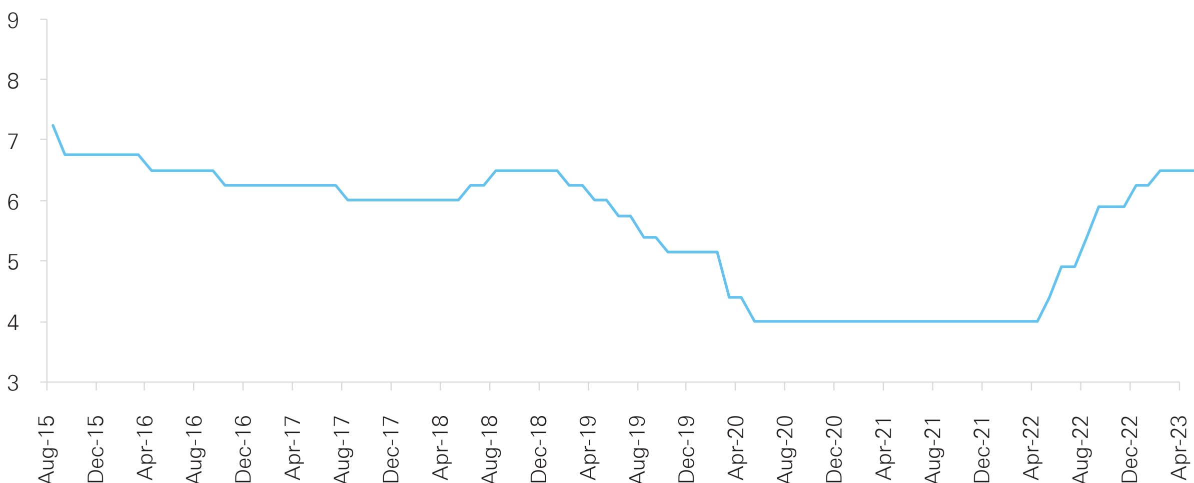
MARKET MOVEMENTS

- In terms of market movements, during the month, 10-year G-Sec inched higher and settled 6 bps higher at 7.17% in end July. 3 to 5-year G-Sec were also higher by 7-12 bps
- Corporate bond yields inched higher marginally by 1-5 bps across various points on the curve
- OIS rates moved higher across the curve with 1-year OIS moving up by 13 bps, 2-year OIS moving up by 17 bps and 5-year OIS moving higher by 21 bps
- 6–12-month CD rates were at 7.20-7.45 and were higher by ~ 7 bps for the month

Repo Rate (%)



Outlook

Global bond yields have been moving sharply higher over the past week, with the narrative once again moving towards higher for longer on the US rates front. While inflation has trended lower and is likely to provide some comfort to the Fed, other growth and employment indicators continue to indicate an economy far from recession. This has re-ignited fears that inflation may remain stubbornly above the Fed's target of 2% and more tightening may be required to be done by the Fed over the coming few meetings before the fight against inflation can be declared as over.

While so far Indian bond markets have been somewhat de-linked from the volatile US Treasuries market, correlation between the two can potentially increase going forward– especially given the recent spike in food inflation, as well as oil prices. Domestically India's CPI inflation could move above RBI's 6% (4% +/- 2) target in the month of July, driven by a sharp spike in vegetable prices.

In such a backdrop, our bond markets could see sentiment turning negative, with yields possibly inching higher over the coming few months. Such an upmove in yields, if it were to materialize, would be an opportunity to add duration in our view and for investors also, provide a good entry point into longer duration bond funds.

With food prices likely to mean revert later in the year following usual seasonality, RBI is likely to look through this volatility in inflation prints but it may continue to sound hawkish and reiterate its commitment to bringing down inflation closer to the 4% mark. The RBI MPC meeting in August will be held in this backdrop and its outcome and commentary will provide further cues to the markets.

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Outlook (contd.)

From a medium term perspective, despite some volatility in bond yields over the coming few months both globally and in India, we continue to believe we are at the peak of the rate hiking cycle. In our view, the risk–reward has turned in favor of careful deployment into certain areas which offer the best risk adjusted returns.

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

- If yields do move higher over the coming few months, investors can look at bond funds in the 2- 5 year maturity segment. **Corporate Bond Fund** and **Banking & PSU Debt Fund** can provide more opportunities in these segments
- 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 Fund and Gilt Fund** 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

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