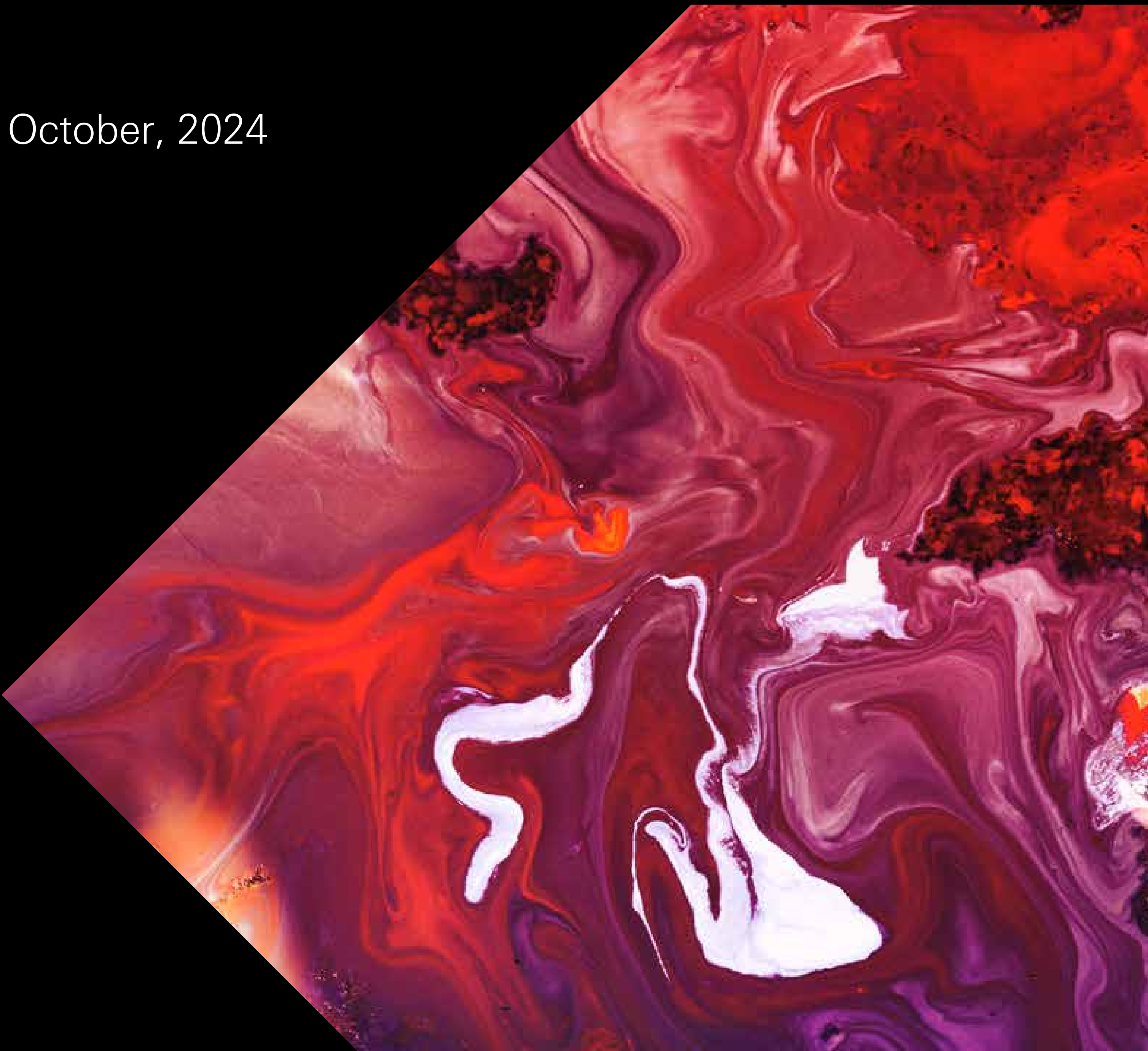
HSBC Mutual Fund

Debt Market Review

October, 2024



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Brace up for volatility!

The FOMC minutes for the September policy indicated that the decision to cut rates by 50 bps (instead of 25 bps expected by most Economists) was largely deliberated between the members, and what possibly tilted the FOMC to ease by 50 bps was the weak labour market data. The members gained confidence that the inflation trajectory was moving towards the target of 2%. This also hinted a subtle change in the thought process of Committee members, which prioritizes labour market conditions over inflation while framing monetary policy going forward. The minutes also acknowledged that the FOMC was not a pre-set course of rate easing, and decision making would remain data dependent. What transpired post the FOMC meeting was a series of sightly stronger economic data, which resulted in repricing of the earlier aggressive cuts expected by the markets. US Treasury yields saw a sell-off pushing yields above 4%. With US elections taking center stage, and both parties' fiscal mandate seemingly expansionary, US Treasury yields sold off further, closing the month at 4.29%. From a low of close to 3.60% just prior to the FOMC meeting, yields have shot up by around 65-70 bps in the last month and a half.

The markets are now pricing in (as of Oct 31, 2024) close to 2 rate cuts in 2024 (similar to dot plot), 3 rate cuts in 2025 and pretty much nothing thereafter (against 4 rate cuts in 2025 and 2 rate cuts in 2026 as per the dot plot). This would result in a terminal rate close to 3.5% (significantly higher than what was getting priced in a month back). The more recent data prints, however, have been relatively benign, with the October Non-farm payroll dropping sharply to 12,000 (much lower than consensus) due to impact of hurricanes and worker strikes. The unemployment rate remained unchanged at 4.1%. The GDP print for Q3 CY2024 came in slightly lower than market expectations at 2.8%. The inflation data continued on its downward trajectory with the Sep 2024 CPI and PCE inflation printing at 2.4% and 2.1% respectively.

The ECB eased policy rates in their October meeting for a third time, taking the deposit rates to 3.25%. The BOJ maintained status quo on rates and will continue to evaluate incoming data to decide future course of action. The recent CPI print in the UK came in at 1.7%, which will enable BOE to ease policy rates in November.

MPC minutes sounded balanced

The major domestic event was the MPC minutes that was published on Oct 23, 2024. Markets were waiting for the minutes to gauge the thought process of the 3 new external members and the RBI members which led them to change the policy stance to neutral. The key observations were:

- Tone of the members appeared balanced, with comments from RBI members indicating a shift in narrative on inflation, while growth remaining strong
- The RBI members sounded lesser worried about volatility from higher vegetable prices in the medium term, which is a change in tone from the earlier MPC meetings. They also attributed weakness in high frequency data to be driven by one off-factors. The comments indicated that the MPC members were willing to look through any upward surprise in inflation in near term as they anticipate it to align to expectations in Q4, and likewise ignore any near-term weakness in growth as they expect it to pick up in the subsequent quarters
- Although the tone of the minutes seemed balanced, it has left markets divided on expectations around timing of first rate cut (Dec 2024 or Feb 2025). Given the uncertainty around US elections and fear of a high CPI print, markets are increasingly pricing out a Dec rate cut. However, we would still not completely rule out that possibility. A weaker Q2 GDP print along with a lower headline inflation number than market expectations can tilt the balance in favour of a Dec rate cut

Possibility to undershoot on Fiscal Deficit target

India's Gross Tax Revenue saw a 12% (YoY) increase at INR 18.1 trn in H1 F20Y25. Direct tax collections grew at 14% y-o-y and Income tax revenue rose at an impressive 25% (YoY). Corporate tax growth, however, was subdued at 2% (YoY). This is probably due to slightly weaker corporate results impacting profitability and tax collections. Indirect tax collections were in line with budget targets of 10% (YoY) growth led by robust GST collections. Non-tax revenue saw significant growth due to a bumper RBI transfer of INR 2.1 trn to the Government in May 2024.

Government expenditure has been subdued at INR 21.1 trn in the first six months of FY25. This is primarily because of subdued growth in capital expenditure, which is at INR 4.1 trn (less than 40% of full year target). The shortfall is predominantly due to a significantly lower capex spend in Q1 owing to general elections, which raises the possibility that the Government might not be able to meet the capex target for the full year.

India's fiscal deficit for H1 FY2025 reached INR 4.75 trn (29% of full year estimates, compared to 39% in H1 FY2024). In an environment where public capex has been lagging and private capex has not picked up, it makes the outlook for investment weak, putting a downside risk to RBI’s growth estimate of 7.2% for FY2025.

From a fiscal math perspective, this is a positive. Given, that capex for full year is likely to undershoot and robust income tax collections is likely to compensate for the shortfall in corporate taxes, there is an increasing possibility of undershooting the fiscal deficit of 4.9% by 10-30 bps.

Indian Government Bonds (IGBs) add another feather to the cap

Another major development during the month was the inclusion of IGBs in FTSE Emerging Markets Government Bond Index (EMGBI). The inclusion will be done in a phased manner on a monthly basis over a six-month period starting September 2025. As per a few market reports, the index tracks an AUM of around USD 45-50 billion, resulting in index related flows of around USD 4-5 bn into India.

Domestic macro-economic factors and data points

- Inflation for Sep 2024 came in higher than market expectations at 5.49% due to a pick-up in vegetable and edible oil prices resulting in a sharp rise in food inflation. Core CPI increased marginally to 3.50%. Given the recent price trends, headline inflation for Oct 2024 is expected to remain high. However, a normal monsoon along with higher kharif acreage for certain food items augers well for food inflation outlook going forward
- IIP for the month of Aug 2024 saw a contraction (first time in 22 months) of 0.1%, partly due to high base effect. Electricity and mining sector reported contraction on a YoY basis
- Trade deficit narrowed to a 5-month low of USD 20.78 bn led by lower gold imports
- GST collections continued to remain strong at INR 1.87 trn

Liquidity continues to remain comfortable

Liquidity remained positive during the month, ending at INR 1.54 trn as of Oct 31, 2024 and is expected to increase further as month end Government spending picks up. Additionally, G-Sec maturity of INR 1.5 trn in the first fortnight of Nov 2024, will further add to liquidity. Oct 2024 saw CIC outflows to the tune of around INR 50,000 Crs due to festive season and is likely to continue till State elections. Overall, liquidity is expected to be in a comfortably positive zone through November and mid of December, till advance tax outflows.

Summary and key takeaways

- From a global markets perspective, we have been in a period of high volatility, which will continue till the outcome of the elections are clear. Having said that, it is important to understand that a fair bit of negativity is already priced in the US rates, given 10 year US Treasury yield is close to 4.30%. However, in the near term we can expect some more volatility in domestic G-Sec and OIS rates as well as currency
- India's currency markets have so far been less volatile compared to other EM currencies. We continue to believe that RBI will remain very active to manage any unforeseen volatility in the currency market. Once, volatility subsides, RBI will continue to add back to their FX reserves
- The fiscal deficit number for H1 shows that public spending has been lagging, and we believe there is downside risk to budgeted fiscal deficit target of 4.9%
- G-Sec supply demand dynamics which remains at the core of the fundamental factors, continues to remain favourable, and if the LCR norms do kick in it will further benefit G-Sec demand
- We have seen a bit of sell off by FPIs in October, with unwind of a few TRS trades, but index related flows are expected to continue
- Growth indicators have been mixed. PMI numbers have softened lately, PV sales numbers have also moderated. Credit growth is also showing signs of slowing. Economists are expecting a below 7% print this quarter, which will make the full year RBI estimate of 7.2% fairly difficult to achieve
- Inflation in the near term can continue to be a cause of worry, with the October print expected to remain elevated. However, food prices should cool off over the next couple of months, given the better than normal monsoon and good kharif sowing this year
- The MPC decided to look through the near-term inflation volatility while changing the policy stance to neutral, as they expect food prices to cool off from Q4. Although a December cut is getting priced out, the Q2 growth number before the Dec MPC meeting and expected CPI print for Nov, can tilt the MPC either side depending on how the data evolves

Market Outlook

While near term volatility can be expected across asset classes due to global factors, we believe Indian bond markets are much better placed than other emerging market economies to absorb any sudden shocks. Once the dust settles on the US election results, Indian markets would fall back on domestic macro factors and fundamental drivers like demand and supply, which can continue to remain favourable. Growth inflation dynamics is also flipping as is evident from some of the commentary from MPC members. With inflation expected to ease after some near time spikes and growth increasingly likely to disappoint, we believe there is room to cut rates by 75-100 bps.

Fund Strategies

- Although some volatility is expected in G-Sec rates in the near term, we believe the longer end of the curve is likely to remain supported as end investor demand might remain strong. Hence, we believe that any further corrections, can be looked at as an opportunity to cautiously add duration. **HSBC Gilt Fund** is primarily invested in the 10 years and 10+ years part of the curve, and seems adequately positioned to provide an opportunity to generate alpha over medium to long term for investors looking to play the duration theme
- With liquidity expected to remain comfortable and expectations of rate cuts getting priced in going forward, we believe the corporate bond spread compressions story is there to be captured

- **HSBC Banking and PSU Debt Fund** is predominantly invested in assets maturing in the 1.5 year segment, it can provide an investment opportunity for investors looking at a short-to-medium term investment horizon
- **HSBC Short Duration Fund** and **HSBC Corporate Bond Fund** are positioned in the 2-6 year part of the curve and may be considered for investment with a medium-term horizon and slightly higher appetite for interest rate risk. Both these funds are appropriately positioned to benefit from these developments

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Abbreviations:

FOMC: Federal Open Market Committee
ECB: European Central Bank
BOJ: Bank of Japan
BOE: Bank of England
GDP: Gross Domestic Product
MPC: Monetary Policy Committee
G-Sec: Government Securities
LCR: Liquidity Coverage Ratio
AUM: Assets Under Management
HQLA: High Quality Liquid Assets
TRS: Total Return Swap
FPI: Foreign Portfolio Investment
IGB: Indian Government Bond
CPI: Consumer Price Index
PCE: Personal Consumption Expenditure
CIC: Currency in Circulation
OIS: Overnight Index Swap

Scheme name

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

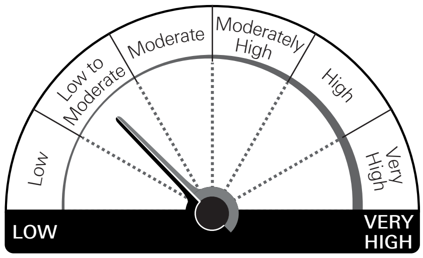
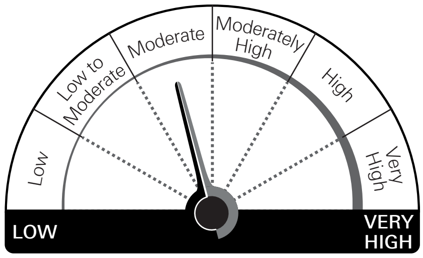
HSBC Short Duration Fund

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.) • Generation of reasonable returns and liquidity over short term. • The portfolio will primarily be invested in debt and money market instruments consisting predominantly of securities issued by entities such as Banks, Public Sector undertakings, Public Financial Institutions (PFIs) and Municipal Bonds..	Riskometer  Investors understand that their principal will be at Low to Moderate risk
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. A moderate interest rate risk and moderate credit risk.) • Generation of regular returns over short term • The Scheme will Invest predominantly in debt and money market instruments such that the Macaulay duration of the portfolio is between 1 year to 3 years. **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 • The Scheme will invest predominantly in corporate debt securities rated AA+ and above **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 • The Scheme as per the asset allocation pattern has to invest a minimum of 80% in Government Securities and Treasury bills.	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 31 October 2024.

Source: Bloomberg & HSBC MF Research estimates as on October 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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