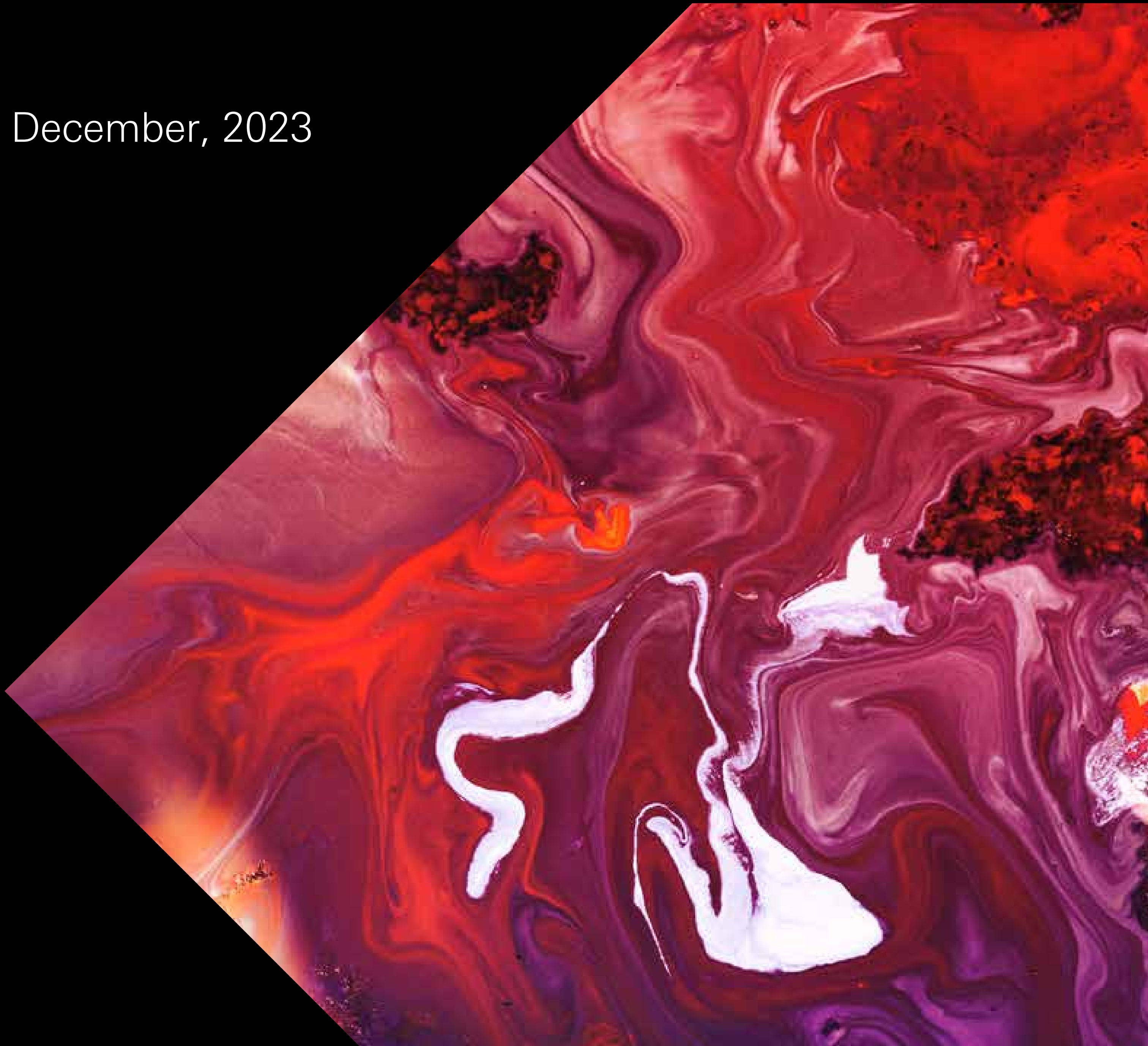
HSBC Mutual Fund

Debt Market Review

December, 2023



2024 is starting off on a good note for fixed income markets the world over, and also here in India. In the US, bond yields peaked in October with the 10-year US Treasury hitting 5%, before rallying sharply all the way down to 3.80% in the last week of December. Fed fund futures are now pricing in almost 5-6 rate cuts in CY2024, with a high probability of the first one being delivered as early as March. While the volatility in global bond yields may continue and market expectations of the timing and quantum of rate cuts may keep shifting, 2024 is clearly likely to witness an easing cycle across most developed and emerging economies.

While we do expect India to also join the easing cycle at some stage, the situation is quite different here with growth holding up much better than other countries. With RBI increasing its FY24 GDP projection to 7% (from 6.5% earlier), and the outlook for FY25 also appearing to be positive, the need for RBI to support the economy through any dramatic monetary easing measures is much less. We believe the RBI MPC is likely to take a measured approach to see how the easing cycle progresses in the developed world and its impact, while keeping a keen eye on domestic growth prospects.

Accordingly, we believe our easing cycle is likely to start later- in the second half of the calendar year. It is also likely to be a shallow rate cutting cycle for us, with possibly two rate cuts taking the policy rate to 6% by March 2025. Prior to the first rate cut, however, RBI is likely to gradually shift the liquidity deficit into a surplus, consistent with an easing cycle. Hence, despite a potential rate cut of only 50 bps, the overnight rates are likely to move down by 75-100 bps on account of the reversal of liquidity conditions, and overnight rates flipping from the top to the bottom of the rate corridor. As and when RBI does start its easing cycle, the yield curve is likely to steepen with shorter maturity rates coming down more than the longer end.

Unlike the swaps curve which is almost entirely pricing in the above scenario, the cash (G-Sec) bond curve is currently not pricing any rate cuts, with the 1 year forward rate curve above 7% over the next few years. Even though JP Morgan Government Bond Index-Emerging Markets (GBI EM) Index inclusion is slated to start from June 24 onwards, we are already seeing significant pre-buying by FPIs with Rs 30,000 cr of buying seen over the past two months. Total index flows of USD 20-25 bn are likely to remain a supportive tailwind for government securities through the course of the coming year. While RBI is likely to hold the line and ensure that market's rate cut expectations remain under check through their hawkish communications, **we may observe that there may be a relatively favorable case to add duration to investor portfolios with a 1.5-2 year investment horizon for reasons mentioned below.**

- Global interest rates have peaked; any growth or financial stability concerns can see yields fall further
- CPI is likely to track RBI expectations (5.4% for FY 2024) and gradually move to 4.5% in FY 2025
- Fiscal deficit is on consolidation track with FY 2024 @ 5.9% of GDP and FY 2025 likely at 5.4% of GDP
- CAD is likely to be below 2% for FY 2024/2025, with BoP surplus adding to RBI reserves
- Inclusion of IGBs in global indices to result in USD 25-50 bn of inflows
- RBI is likely to shift to an easing bias in Q2/Q3 FY 2025 with two rate cuts by March 2025
- Unlike OIS, cash bonds are not pricing in any rate cuts

Source: Bloomberg & HSBC MF estimates as on Dec 2023 end or as latest available

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