

# Debt Market Review

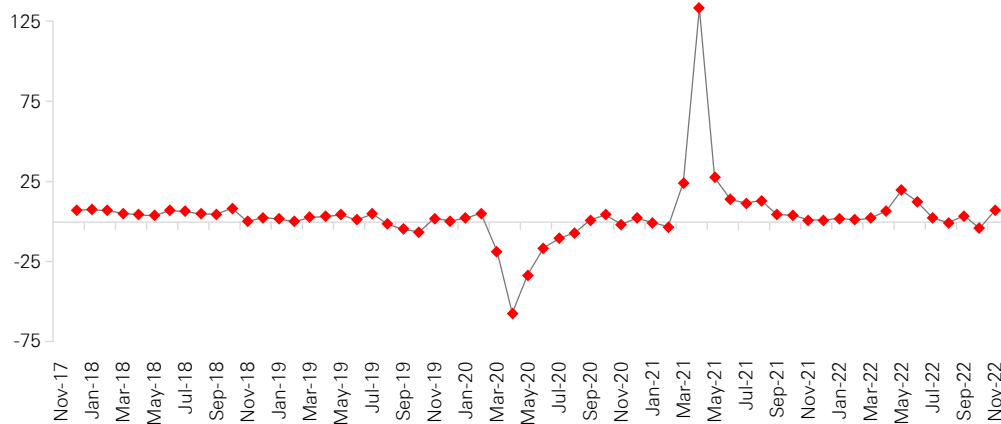
January, 2023

There were further signs of moderation in inflation in developed markets with US December CPI inflation (released in mid-January) dropping to 6.5% v/s 7.1% in November. In this backdrop, the Federal Reserve in its recent meeting on 1st February decided to increase rates by 25 bps v/s 50 bps in December. The ECB and the Bank of England, however hiked rates by 50 bps each in their monetary policy meetings in early February.

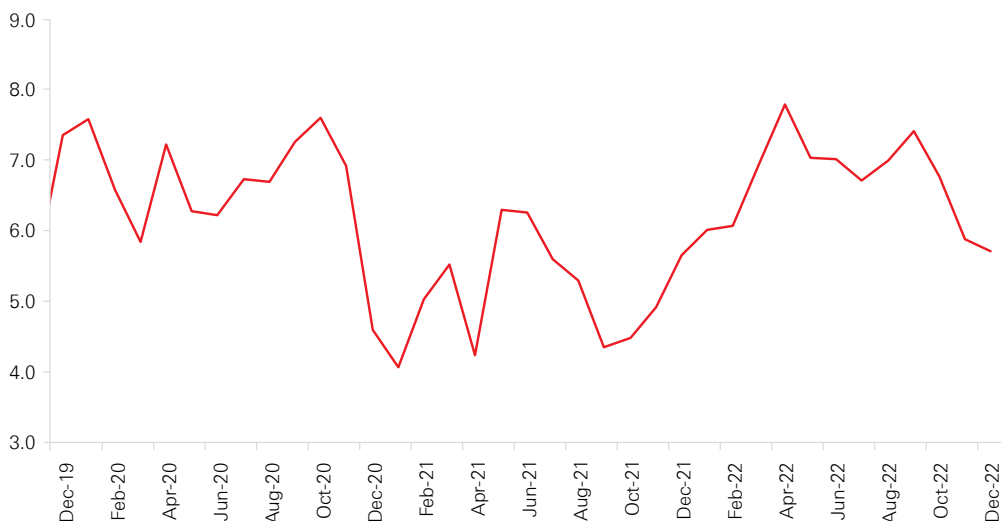
US Treasury (UST) yields rallied during the month of January, with the 10-year UST moving to ~3.50% at the end of January v/s 3.85%-3.90% at the end of December. The UST yield curve remains inverted with a 2-year v/s 10-year spread at 70 bps. Crude prices stayed around the USD 85/bbl mark.

On the domestic front, CPI inflation continued to stay below the 6% mark for the second month, dropping to 5.72% and was below market expectations. This was largely driven by a drop in food inflation. Core CPI, however continues to stay elevated and inched slightly higher to 6.1% v/s 6% in the previous month. The trend of moderating inflation was seen on the WPI side, with December WPI moderating to 4.95% v/s 5.85% in November.

## Index of Industrial Production (IIP)\* new series data



## CPI Inflation (%)



High-frequency data continues to be robust - Composite PMI was at a decadal high of 59.5 in December though moderating to 57.5 in January. The Index of Industrial Production (IIP) recovered sharply in the month of November to 7.1% v/s a contraction of 4.2% in October, partly on base effects. All sub-segments showed positive growth. On the external front, trade deficit continued to stabilize and was at USD 23.8 bn in December v/s USD 22.6 bn in November; both exports and imports declined y-o-y by ~12% and ~4%, respectively.

**On a month-on-month basis (as on Jan 31, 2023)**, short term rates moved higher given tighter liquidity conditions and in line with seasonality - 3m CD rates were at 7.20%-7.25%, higher by 55 bps from the previous month. The G-Sec curve was range bound during the month and eventually closed 1-2 bps higher across various points on the curve. Corporate bond spreads inched up marginally by around 5-10 bps across the curve as they underperformed G-Sec during the month. On the OIS curve, the 1-year closed largely flat while the 3/5-year OIS closed ~10-15 bps lower.

## Budget FY2024

The government of India continued to balance the twin priorities of growth and fiscal consolidation in the budget presented on 1st February. FY2023 Fiscal target of 6.4% was maintained. Though the total receipts of INR 24.3 trn (revised estimates) were higher than budgeted estimates, the total expenditure was also higher by ~INR 2.5 trn, given a significant increase in subsidy expenditures which overshoot the budget estimate by nearly INR 2 trn. Overall the Fiscal Deficit for FY2023 (RE) remained at 6.4%, given the higher than expected nominal GDP.

Going forward in FY2024, the Fiscal Deficit is budgeted at 5.9%. Government has stuck to the fiscal roadmap of targeting a deficit of 4.5% by FY2026. The budgeted deficit numbers are based on reasonable assumptions, with nominal GDP expected to grow at 10.5% and tax revenues by a similar number. Overall receipts are estimated at INR 27.2 trn. The expenditure is budgeted at INR 45.0 trn in FY2024 v/s INR 41.9 trn in FY2023 (RE), with the large increase coming from capital expenditure which is estimated to increase to INR 10.0 trn in FY2024 (RE) from INR 7.3 trn in FY2023 (RE). Subsidy expenditure is expected to fall sharply in FY2024. For FY2024, states have been allowed to run a Fiscal Deficit of 3.5%, which includes 0.5% strictly based on power sector reforms. Gross market borrowing is at INR 15.4 trn with net borrowing (net of redemptions) through dated securities at INR 11.8 trn. The budget factors in a higher than expected borrowing through small savings (NSSF) at INR 4.7 trn.

Overall the budgeted estimates appear achievable. The sharp projected increase in capex, per budgeted estimates, offers scope for curtailing expenditures if needed, without compromising on the growth push, to offset any minor shortfall in revenue.

## Outlook

Based on the outlook above, few strategies that in our view make investment sense are:

- ♦ Heading into March 2023, pressure on Banks to raise funds will push CD rates further higher. This creates a compelling case for investors to get into investment products like **Money Market Funds** which invest predominantly in the 6-12 month CD space
- ♦ With 4-5 year G-Sec yields trading at ~7.10%-7.20%, conservative investors can look at locking into **G-Sec Oriented Index Funds** targeting the 2027-2028 segment, especially keeping 3-year taxation benefits in mind

## Outlook (contd.)

### 10 Year G-Sec



- ◆ Active funds such as **Short Duration Funds**, which can invest in Government Securities for now, but with the ability to actively and dynamically shift strategy towards AAA corporate and PSU Bonds when spreads become more attractive (spread widening has begun), investors would be able to better optimize their overall returns over a 3 year period, instead of being locked passively into just Sovereign Bonds
- ◆ If rates remain elevated for longer, without a rate cutting cycle beginning in 2023, we can expect interest rates to consolidate, reducing the scope for capital gains to add to portfolio returns. However, 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 have a lot more opportunities to add alpha through meaningful duration changes to take advantage of these swings. 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 Funds**) can become a rewarding proposition

Source: MFI Explorer, HSBC Mutual Fund

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