Debt market Outlook

Markets continued to remain volatile across asset classes, as Central Banks globally stuck to their path of monetary tightening to bring down inflation. The FOMC, BOE, ECB continued to raise rates albeit in smaller quantum, with most Central Banks now having reached the fag end of their sharp monetary tightening cycle. Central Banks will now look to monitor the impact of the rate hikes undertaken, as it unfolds over the next few quarters.

In an environment of global growth slowdown, India's growth story looks promising. The Government's push on growth through increased capital expenditure over the last two Budgets is showing results. Various fast indicators of growth have remained buoyant. The MPC expects GDP growth to be at 6.5% for FY2024. The intrinsic strength of India's domestic economy is expected to weather external headwinds. In our view, the economy will remain resilient, and will be less of an influencer in determining the rate trajectory.

Inflation, which remained stuck at the higher end of the tolerance band, has finally started trending lower across various sub-segments. As per RBI estimates, CPI is expected to remain marginally above 5% for FY2024. The MPC will remain cognizant of any risks on the inflation front (vis-à-vis uncertainty around monsoon, international commodity prices, geopolitical tensions, etc.) and is expected to remain unwavering in aligning inflation with the target.

The biggest surprise for India has been the external sector, which has seen a sharp turnaround in the last few months. Merchandise Trade deficit numbers have narrowed on the back of a sharper decline in imports than exports and are expected to remain benign going forward. FPI inflows are picking up led by equity flows. Markets were expecting a Current Account Deficit (CAD) in excess of 3% few months earlier, expectations have fallen significantly now. Markets are now expecting a CAD below 2% in FY2024. Currency has remained stable and foreign exchange reserves are comfortable, keeping India's external sector resilient.

Going forward

Given the 300 bps+ move in overnight rates over the past year, the MPC has enough room 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 rest of the world) gives enough space to the RBI to wait and watch - global central bank actions as well as growth & inflation trends over the coming few quarters.

The game has now clearly shifted to the timing, magnitude and pace of rate cuts that are likely over the next year or two. The US bond markets, which were earlier pricing in 3-4 rate cuts over the next year, are now pricing in only 1 rate cut. Domestically too, with the sharp rally in yields over the past few month, markets are now effectively pricing in a rate cut 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, 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 few months, we continue to remain positive with a 1-2 years' investment horizon, during which bond markets are likely to benefit from an expected rate cutting cycle and a gradually more accommodative RBI stance.

Following the recent amendment in tax rules, taxation of capital gains for investors in funds which have less than 35% of their AUM in domestic equities would be classified as STCG irrespective of their period of holding. While this has dealt a blow to the relative attractiveness of debt funds, we believe this is more right for Index Funds/ETFs where investors came in predominantly for the indexation benefit, and not so much in case of open ended debt funds. With policy rates at or close to its peak, we believe that there is a fairly good probability that policy rates will indeed be lower than current levels over the next year or so. And when that does happen, it will be accompanied by a sharp steepening of the yield curve. All this means that yields in the 1 to 5 years' part of the curve could also move down sharply, aiding funds that invest in these segments. With markets likely to remain volatile over the course of the next few months, we believe dynamically managed Duration and Gilt Funds can provide opportunities to add alpha through duration changes to take advantage of these movements.

Corporate bond spreads are widening, and with Credit growth remaining robust, incrementally corporates will tap the bond market (this can already be seen and will only increase going forward). This will provide opportunities for investors to lock in higher corporate bond spreads through products which can switch between assets. And for the next level of alpha seeking investors, adding an element of measured credit risk to these strategies can help generate better portfolio yields, thereby reducing some of the pain from the recent tax changes.

Source – Bloomberg, RBI, HSBC MF, Data as on 10 June 2023

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