HSBC Mutual Fund

Debt Market Review

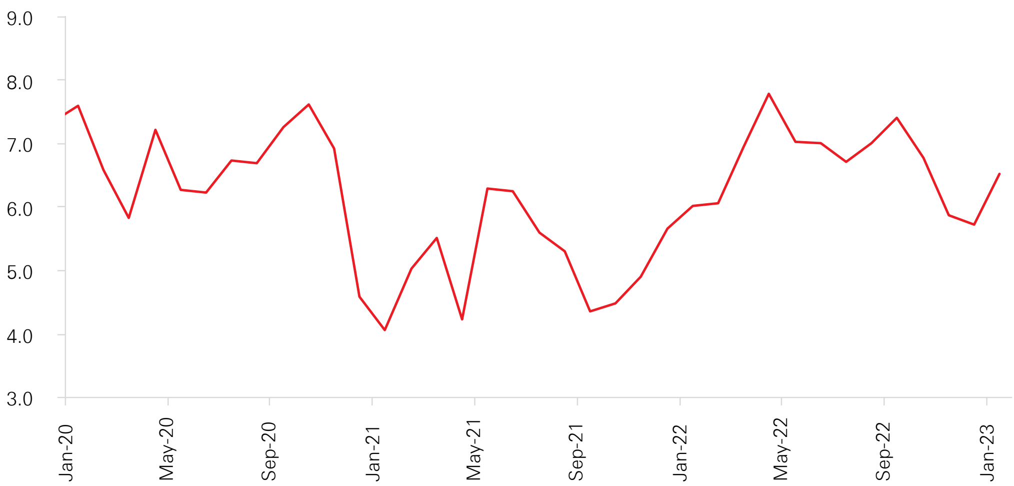
February, 2023

The Federal Open Market Committee (FOMC) minutes indicated that there was consensus among members to continue with a restrictive policy, in light of possible upside risks to inflation and tight labor market conditions. Few members hinted at a 50 bps increase to fast-track inflation's trajectory to the targeted level. Fed is most likely expected to continue with the restrictive policy through 2023. This has pushed US Treasury yields higher and along with strong employment and inflation data, bond markets are now catching up with what the Fed has been saying in their dot plots i.e., higher for longer. Markets will keep a keen watch on incoming data to assess the pace of growth slowdown and whether the Fed would indeed buckle down and come to the economy's rescue sometime through the year. US bond markets are now pricing a peak rate of 5.40%-5.50%, and barely one rate cut in the next 1 year. Going forward, we are likely to see incremental growth and employment data gradually reflect the slowdown impact of past rate hikes.

Macro-Economic Developments

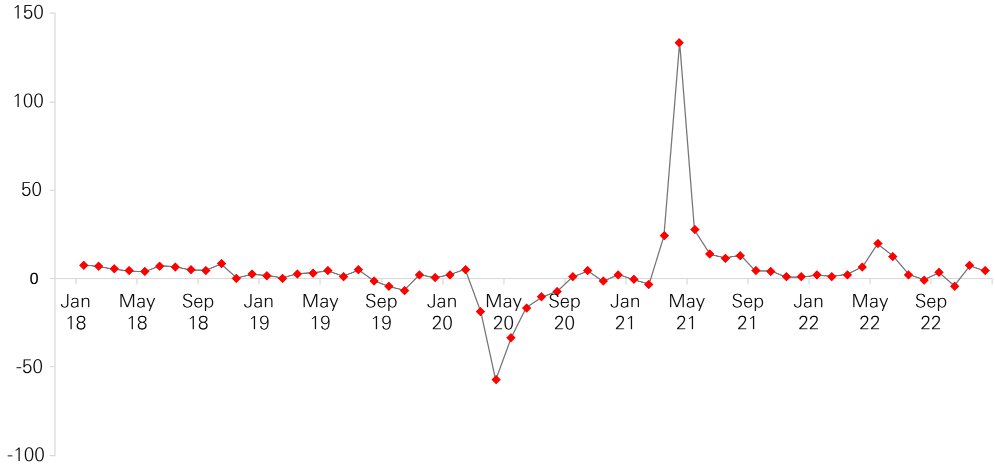
US inflation print for Jan 2023 came in similar to the previous month with CPI at 6.4% and Core CPI at 5.6%. Inflation in UK and Eurozone continue to remain high with the recent CPI prints at 10.1% and 8.5%, respectively. 10-year US Treasury yield has moved from 3.40%-3.50% level to 3.90%-4.00% levels during the month. The UST yield curve continues to remain sharply inverted with the 2-year vs 10-year spread at almost 90 bps. Crude prices remained range bound during the month, trading between USD 80/bbl to USD 90/bbl.

CPI Inflation (%)



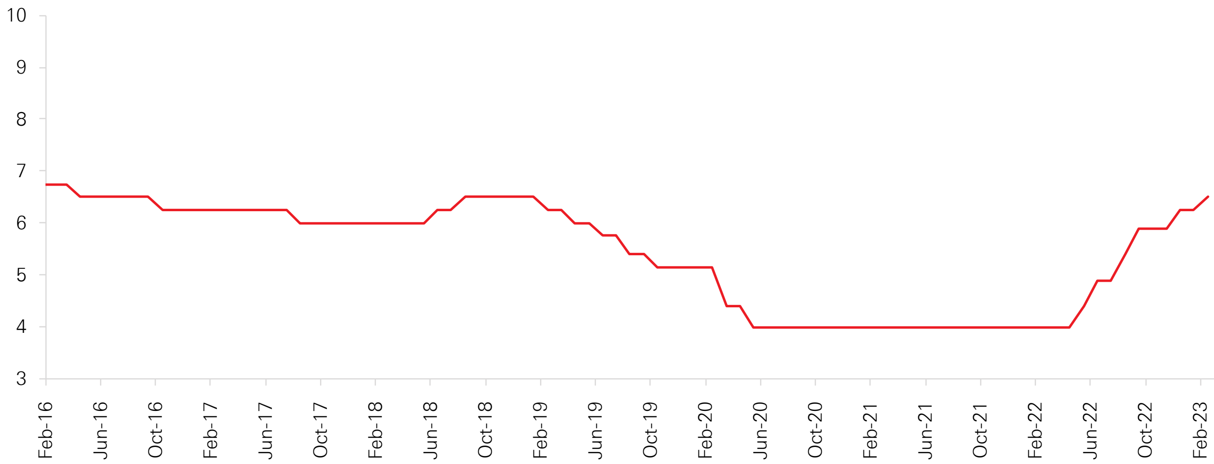
On the domestic front, CPI inflation for Jan 2023 came in higher than expectations at 6.52% (vs 5.72% in Dec 2022), led by a rise in cereal inflation. Core CPI continues to remain sticky around ~6.1%. The trend of moderating inflation was seen on the WPI side, with Jan 2023 WPI print at almost a 2 year low of 4.73%. IIP data for Dec 2022 came in at 4.3% (vs 7.3% in Nov 2022). Trade Deficit for Jan 2023 moderated to USD 17.75 bn driven by a YoY fall in both exports and imports. High frequency data continues to be robust, with Manufacturing and Composite PMI at 55.3 and 59.4, respectively. GDP growth for Q3 FY2023 came in lower expected at 4.4%. However, the full year GDP growth estimate has been retained at 7.00%. During the month, GOI cancelled all pending gilt switch auctions for the remaining of the financial year. In line with market expectations, RBI announced INR 50,000 Crs of additional T-Bill borrowing to be conducted in Mar 2023. With liquidity conditions tightening, RBI announced a Variable Rate Repo auction worth INR 50,000 Crs to support markets.

Index of Industrial Production (IIP)* new series data



Domestic interest rates have been moving higher over the past few weeks, influenced by the US Treasury moves, tightening liquidity conditions and importantly by the most recent MPC meeting and its minutes. Markets which were expecting a dovish tilt from the RBI have been disappointed with RBI reiterating continuation of its Arjuna's eye on inflation and its determination to see it sustainably lower. This has resulted in yields moving higher across the curve. T-Bills moved higher by 35-40 bps during the month, money market papers moved up by up to 25 bps. G-Sec in the shorter end moved up by 20-30 bps while the 10-year segment rose by 10 bps. OIS levels also saw a sharp move, increasing by 30-40 bps.

Repo Rate (%)



Outlook

This up-move in interest rates provides attractive opportunities for investors to take advantage of. Markets, which were earlier pricing in a 6.50% and a possible pause thereafter, have moved up sharply to now price in not just the next 25 bps rate hike (taking repo rate to 6.75%), but also to a large extent the subsequent move to 7% as well. In our view, this adequately prices in the adverse risk scenarios that the markets are now grappling with.

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To sum up – in our view

- The next few years are likely to be favorable for fixed income investors given that interest rates across the maturity spectrum are now well above 7%
- While markets will continue to assess growth vs inflation risks, both globally and in India, we believe we are close to the peak of the rate hiking cycle with risks of RBI hiking rates above 7% being fairly low
- In our view, the waiting game for fixed income investors is now over with the risk–reward turning 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:

- With 6-12 month CD space now yielding close to 7.70%-7.90%, this makes 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 ~7.30%-7.45%, 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
- 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 bonds when spreads become more attractive, investors would be able to better optimize their overall returns
- If rates remain elevated, without a rate cutting cycle beginning in 2023, we can expect interest rates to consolidate, reducing 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 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 Funds**), can become a rewarding proposition.

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