HSBC Mutual Fund

Fixed Income Outlook

2023 – A year of changing narratives!

January, 2023

2023 is probably going to be that type of year. As investors, we may need to keep our foothold weak and an optimum strategy could well be to keep shifting views and altering investing strategies as the year goes by and incoming data gives more clarity on the future trajectory. Through most of 2020 and 2021, global central banks' as well as the RBI's pandemic-driven approach of doing "whatever it takes" gave a somewhat secular narrative to the interest rate backdrop, while 2022, for the most part has been a one-way street of central banks making up for past follies and frantically raising interest rates to gain control over the inflation genie. As we head into 2023, the year promises to be interesting with a high level of confidence that the end of rate hikes across most countries is almost in sight, however with much lower confidence levels of the path that lies beyond. That path, in our view, is still very hazy and likely to make various markets swing from one side to the other as 2023 goes by, requiring a nimble approach from investors.

Let's take a look at a few dominant questions which are likely to impact our bond markets as we lay down our thoughts on those, with a frank and clear disclaimer at the outset that many of these views are indeed fickle and more likely than not, will undergo changes through the course of 2023.

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1. Outlook For The Fed And US Interest Rates

Market is currently expecting the US Fed to raise rates to just below 5% from 4.25-4.5% currently, and then from mid-2023 onwards, do an about-turn and start cutting rates almost thrice (~75 bps) by Jan 2024. The pendulum on this one has swung a few times already. From a 5.25-5.50% projected peak rate just a few months ago, markets are now pricing a peak below 5%. More interestingly, despite various Fed speakers, including Chair Powell, repeatedly telling the markets that rates need to remain at the peak levels for a longer period to achieve their inflation objective, bond markets continue to price in a Fed buckling down under recession worries and reversing course to rate cuts after just a few months post the last rate hike. We believe as the year goes by, bond markets may come closer to where the Fed currently is rather than the other way around, which does mean that US interest rates could have an upward bias as and when the markets get more convinced of the higher for longer Fed messaging.

2. Outlook For India's Growth And Inflation

India's growth outlook for FY24 is somewhat hazy, with forecasts for GDP growth ranging from as low as 5% to an impressive 7% as well. In an environment of a global growth slowdown, the crucial determinant of growth would be the intrinsic strength of the domestic economy being able to weather the external headwinds. While various fast indicators of growth are all over the place and can be used to justify either side of the growth spectrum, in our view – the economy may turn out to be more resilient than market expectations and from a bond market perspective, less of an influencer in making RBI do a volte-face in its rate trajectory.

3. RBI MPC

The markets are currently pricing in another 25 bps hike from 6.25% to 6.5%, a pause thereafter, and then expectations of rate cuts into the second half of FY2024. In our view as well, the MPC is likely to hike rates to 6.50% and then pause to gauge the impact of past tightening. However, we do think the MPC is unlikely to cut rates in the latter half of 2023 or even early 2024. Whether rate cuts do materialize so soon or not, would be an important determinant of investment strategy, especially with regard to the need to worry about re-investment risks or on the merits of duration extension.

The other risk scenario to not lose sight of, even if the low probability, is that of the RBI being forced to continue hiking rates beyond 6.50% due to the Fed forcing their way well beyond 5% on the Fed funds rate. However, delinked we may like to believe India is, maintaining a minimum interest rate differential between our rates and the US would be warranted to ensure macro and currency stability.

4. Banking Balance Sheets

This, we believe, is probably the most crucial variable not just for government security yields but also crucially for credit spreads. With credit growth likely to remain in the mid-to-high teens in FY24, the pressure to grow their deposit base is likely to intensify in the banking sector, thereby keeping the overall level of interest rates high in our economy. This bodes well for the gradual resurgence of deposit flows into the banking sector, but given the long lead time needed to achieve that, there is likely to be transition effects that the bond markets may need to deal with, viz., government bond yields remaining elevated to ensure their relative attractiveness versus commercial credit, and secondly, banks pricing credit risks more prudently, leading to higher costs for borrowing from the banking sector. This would hopefully in our view, finally lead to increased corporate issuance and importantly, a widening of credit spreads in our bond markets as well, something that mutual fund investors have been waiting for some time now!

Based on the outlook above and the high level of uncertainty surrounding them, a few strategies that in our view, make a lot of investment sense are:

- **Take advantage of the banking ALM mismatch:** Heading into the Jan-March quarter, bank FD and CD rates are likely to trend higher, from current levels of 7.50-7.60% to 7.75-8%. 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.
- **G-Sec oriented rolldown / index funds in the 4-5 year space:** With G-Sec yields trading at ~7.25% and AAA corporate bond spreads still fairly unattractive in this space, conservative investors are better off locking into **G-Sec Oriented Index Funds** targeting the 2026-2027 segments, especially keeping 3 year taxation benefits in mind.
- **Active funds could finally make a comeback:** So far, passive / index funds investing in G-Secs and SDLs have made the most sense and has been the only category to attract investor flows, but we believe this could change going forward. 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 (which we believe is likely in 2023), investors would be able to better optimize their overall returns over a 3 year period, instead of being locked passively only into just sovereign bonds.

- **Carry - the main game and not capital gains:** If, as we expect, rates remain elevated for longer, without a rate cutting cycle beginning in 2023, we could expect interest rates to consolidate around the 7.00-7.50% range (for 10-year G-Sec yields), 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 2023, 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.

To sum up, the bands of uncertainty around the interest rate outlook are high and many of our assumptions and outlooks may indeed change as we navigate 2023, but we do believe a nimble approach open to change, and able to optimize portfolio strategies, is probably the best way to play 2023 and beyond.