India Fixed Income Opportunities Fund - May 2019

20 May 2019

Summary

- Debt markets take a breather after sharp gains in March following continued strength in crude prices and tighter domestic liquidity conditions.
- Headline inflation continues to remain within the Monetary Policy Committee (MPC) comfort zone. MPC reiterates the need to strengthen domestic growth impulses by spurring private investment, supporting prospects for more rate cuts in 2019.
- The Fund remains constructive on debt markets in 2019. Benign inflation expectations and their implication for high real rates, a steep yield curve and high-grade credit spreads drive our positive view on total return opportunity in debt markets.

Market update

April started on a dovish note, as the RBI aggressively cut rates by 25 bps on April 4. However, this marked the peak in bond prices as yields backed up sharply post the cut as the crude price rally held sway over bond markets.

Dated Brent prices gained for the fourth consecutive month, rallying from US$67.50/bbl end of March to an intra month high of US$74.80/bbl and closing at US$71.80/bbl. With oil consumption growing briskly and domestic output remaining stagnant, India's dependence on oil imports continues to increase and has inched up from 82.9% in FY18 to 83.7% in FY19. Going forward, any sharp move in oil will significantly impact the near-term India outlook.

The government borrowing program, announced at start of April, revealed front loading (62%) of gross market borrowing in H1 FY20. While this is in line with expectations, the turn of events did impact short term bond prices. To counter this liquidity pressure, the RBI announced an FX swap auction worth US$5bn at the start of the month. At the end of April, tighter liquidity conditions and the need for durable liquidity prompted the RBI to announce an OMO purchase of G-secs worth INR 250bn in May through two auctions of INR 125bn each. The latter move was unexpected and coincided with some relief on crude prices, providing support for bond prices.

April was otherwise light on other macro-economic news flow. CPI hardened up on expected lines to 2.86% from historic low levels on food price normalisation and remains well below the RBI's 4% target and fiscal year end projection of 3.5 to 3.8%. The minutes of April's MPC meeting reiterated increasing concerns of fading growth momentum, with GDP growth estimates for FY20 revised down from 7.4% to 7.2%.

The INR was down a modest -0.40%, on account of both crude and liquidity concerns. The Balance of Payments outlook supports the case for INR stability, led by current buoyancy in flows and Foreign Portfolio Investments (FPI) flows observed historically post elections under a stable government. Assuming conservative FPI at $10 billion for current fiscal year FY19-20, the Balance of Payment deficits breaks even at crude US$75/bbl. FPI flows through April 2019 already stand at $9.7 billion.

Performance

In April, the yields on 5-year G-Secs rallied from a high of 7.44% to 6.87%, and have retraced back to 7.35%. The yields on older series of 10-year G-Secs rallied from high of 7.75% to 7.48%, and have retraced back to 7.61%. Corporate spreads however have started moderating after touching 7-year highs on IL&FS driven stress in the financial sector. Spreads on 5 year AAA and AA rated corporate bonds have come down from 118/189 to 90/154 bps respectively. Historically, these spreads remain elevated at the higher end of the band at 50-70 bps and100-125 bps respectively. INR-US dollar rate has been steady but negative for the month at -0.40%. High coupon income helped offset the rate backup and a modest increase in credit spreads helped contain the NAV markdown to INR 0.16% and US dollar 0.56%.

Outlook

Looking forward, the Fund Managers remain constructive on debt markets. Both yields and spreads are expected to rally, contributing to positive returns.

India's real rates are quite high considering the soft inflation and slowing growth. We expect liquidity management and monetary transmission to assume higher importance this year. The RBI is in a sweet spot to use strong foreign flows and global growth slowdown concerns to address the monetary policy transmission. There are signs of aggressive moves in this area and we expect the yield curve to flatten from current levels.

Despite the GDP slowdown, we foresee a revival in corporate earnings paced by fewer slippages, a reversal in provisioning for corporate banks, easing of liquidity as monetary stimulus trickles down, normalisation in private and government consumption supported by structural demographics and an increasing private capex driven by confidence in a stable, 5-year government regime. This scenario will positively influence credit spreads for the fiscal year.

Two key risk factors counter this enthusiasm and require attention:

1. Skymet weather is guiding for a difficult monsoon season, impacted by a devolving El Nino effect. The agri-economy is the smallest share of GDP, but accounts for a sizeable share of population. Given stagnant farm incomes over past 2-3 years, this sector is garnering attention with government support in the form of either farm loan waivers, farm support income or universal basic income.
2. We are in the last leg of elections and results will be declared on May 23. Our media readings and ground feedback suggest extremely favorable odds for the incumbent BJP and alliance parties. While this is on expected lines, the relative strength of incumbents might shape the near term volatility in FPI flows and hence all asset classes at large.