Fixed Income Outlook

Debt markets

Government 10 year benchmark bond yields shifted the trading band upwards to 7.63% - 7.79% during the month. There were no fresh triggers for markets, but heavy supply and an increased possibility of a rate hike in the December Fed policy led to volatility. The benchmark closed at 7.79% with a selling bias.

In the money markets, short term yields did not move much and stayed in the range of 6.95% - 7.10% as liquidity remained easy and banks remained reluctant to issue CDs as a lack of credit growth provided inadequate deployment opportunity to banks. The rate cut by the RBI had resulted in a fall of 45-50 bps in near end rates at start of the month.

Foreign Portfolio investment flows observed outflows in both equities as well as debt during the month. Debt outflows were US$ 0.55bn as against inflows of US$ 2.41bn in the last month. Equities observed outflows of US$ 1.15 bn against the outflows of US$ 0.80 bn seen in October.

Domestic Macro Factors

Real GDP growth for Q3 2015 printed at 7.4% y-o-y from 7.0% in Q2, marginally above market expectations of 7.3%. This was driven by a pick-up in fixed investment growth (6.8% versus 4.9% in Q2). However, private consumption growth decelerated to 6.8% in Q3 from 7.4% in Q2, likely owing to weak rural demand.

Meanwhile, gross value added (GVA) growth also rose to 7.4% y-o-y from 7.1% in Q2 against market expectations of 7.3%. Agriculture output growth edged up (2.1% vs 1.9% in Q2), while industry growth picked up sharply to 8.3% in Q3 from 6.4% in Q2 2015, led by strong growth in manufacturing and utilities. However, services growth slowed to 8.0% from 8.6% in the previous quarter owing to a deceleration in the trade and transport sectors.

Index of industrial production (IIP) growth decelerated to 3.6% y-o-y in September vs. 6.3% (revised down from 6.4% printed earlier) in August, this moderation was contributed by higher base effect. This was lower than market expectations of 4.8%. In terms of use-based classification, deceleration in IP growth was driven by slowdown in the consumer and capital goods. Capital goods production grew 10.5% against 21.8% in August. Consumer goods production also slowed down to 0.6% from 6% in August 2015. Manufacturing output growth decelerated in September to 2.6% vs 6.6% in August, mining growth also decelerated to 3% from 4.2% in August however electricity growth printed higher at 11.4% compared to 5.6% in August.

However IP series has become volatile over the past couple of months, so it should be seen in conjunction with other growth indicators. We expect industrial production will continue to improve in the coming months, supported by stronger discretionary consumer demand, increased government spending and the government's efforts to debottleneck investment and policy reforms.

India's external trade deficit narrowed significantly in October to USD 9.8 bn vs USD 10.5bn in September. Export growth fell further to -17.5% in October against (-24.3%) y-o-y in September, marking the 11th consecutive month of decline. Imports also continued to decline at (-21.2% y-o-y) in October compared to (-25.4% y-o-y) in September due to drop in gold and oil imports. Oil imports were (-45.3% vs. -54.5%) y-o-y in September whereas gold and silver imports contracted by 58.4% against an expansion of 41.5% in September. Non-oil, non-gold imports growth turned positive in September and grew at 0.8% against a decline of 5.3% in August. This drop was mainly due to an increase in import of capital goods, pearls and precious metals, chemicals and pulses.

The rupee depreciated by 2.15% from last month and closed at 66.67/$. India's forex reserves are close to $351.62bn in the week ending November 27, 2015.

Inflation

Headline CPI inflation accelerated to 5.0% y-o-y in October from 4.4% in September, and this was largely in line with market expectations of 4.9%. The pickup in headline CPI inflation was due to higher food prices and unwinding of favourable base effect. Food inflation rose to 5.2% from 3.9% in September and core CPI Inflation remained stable at 4.1% in October (same as September).

WPI inflation fell by 3.8% y-o-y against 4.5% fall in September, this is twelfth consecutive month of decline. Food inflation rose by 2.4% in October compared to a rise of 0.7% seen in September. The current trend in WPI inflation suggests that it's bottoming out as the high base effect has started waning and going into next quarter we can see WPI turning positive. However, given the global commodity prices trend, we expect WPI to remain subdued.

Outlook

The month of December has begun with the European Central Bank delivering a lesser than expected stimulus in its monetary policy meeting. This fuelled a global risk-off sentiment, as markets were disappointed with Draghi who was widely expected to over-deliver on measures.

US Fed officials' hawkish statements have driven the dollar to eight-year highs, signalling an imminent rate hike in December. In anticipation of a rate lift-off, financial markets across emerging economies have witnessed downside pressures, with their currencies moving lower. Going forward, global market volatility would pick up further as we approach the day of the US FOMC meeting on December 16.

India is likely to witness bouts of volatility but ample Forex reserves, including favourable economic fundamentals should help cushion the impact. The recently released GDP print suggests that a gradual economic recovery is indeed underway. The measures of GDP (market prices and GVA) indicate that a business cycle recovery is underway, led by steady discretionary demand, public Capex, lower commodity prices and the gradual transmission of lower interest rates.

On the fiscal front, 7th Pay Commission report released in November has put the focus on the viability of the fiscal consolidation path for FY17. For the FY17 Union Budget, the total financial implications of the 7th CPC is projected to be INR 736 bn (0.49% of GDP; ex railways), with the government likely to face a tightrope maintaining public spending.

We expect that RBI will wait for some time and see the pass though of recent rate cuts into lending rates, developments in global macroeconomic environment, impact of unwinding of easy monetary policy in USA, domestic factors such as growth and inflation etc. before taking any further action on monetary policy. Further the focus will soon shift to inflation target of 5% for Year 2017 as current year target of 6% look within reach.

We believe that the present level of 10 years G-sec at 7.79% looks attractive and investors in long duration funds like gilt & income funds can remain invested for a better exit opportunity. Incremental investments can be done at these yields with the investor having long term horizon as volatility emanating from global events can keep rates elevated temporarily. The case for long term rates is also supported by the existing spread between overnight rate and ten year G-Sec yields. This spread is currently at 100-110 bps, however history shows median spreads have been around 45bps giving cushion to traders and investors to absorb intermittent volatility.

We also recommend investments in short to medium duration products like ultra-short term fund, income plus, short term bond fund with 3 to 9 month's Investment horizon.

Fixed Income Desk