Debt markets

Bond markets were volatile during the month where the New series 10 year government benchmark (issued during the month) made some gains initially, which tapered off immediately due to concern overs fiscal slippage. The benchmark yield closed at 7.43% which had set a cut off of 7.17% at the time of issuance.

Liquidity remained positive in the month of January at average Rs0.33tn from previous month's average of Rs0.30tn (Rev Repo-Repo-Marginal Standing Facility-Standing Liquidity Facility + term repo/re-repo). However it was volatile throughout the month, even turning negative on a few occasions, mainly due to increase in currency in circulation, tax collection and tighter movement spending.

Domestic Macro Factors

Industrial Production

India's industrial production series printed at 8.4% y-o-y in November versus 2.2% in October and this surprised the market positively which was penciling in 4.4%. Growth was broad based across sectors - manufacturing activity accelerated to 10.2% y-o-y in November (2.5% in October), mining and electricity also showed growth and printed at 1.1% and 3.9% in November from 0.2% and 3.2% respectively in October. In terms of use based classification, Capital goods production grew to 9.4% in November vs 6.8% in October, Consumer durables growth turned positive in November at 2.5% vs -6.9% in October. Other segments like Intermediate goods and consumer non-durables segments also showed good growth.

External Trade

India's external trade deficit increased to $14.88bn in December vs. $ 13.82bn in November, higher than market expectation of $13bn deficit. Exports growth moderated to 12.4% yoy in December after increasing by 30.5% in November. Oil exports printed at 25.1% in December compared to 47.7% in November. Non-commodity exports growth accelerated by 29% in December vs 9.8% in November. Imports increased by 21.1% in December vs. 19.6% in November. Oil imports remained strong although at slightly lower rate at 34.9% YoY in December vs. 39.1% YoY in November. Gold imports increased marginally to $ 3.4bn in December against $ 3.3bn reported in November. Non-oil, non-gold imports moderated at bit but stayed robust at 12.9% in December vs 19.1% in November. This suggests that there is strong domestic demand in the economy.

INR traded in the range of 63.37 to 64.04 during the month and finally closed the month at 63.58/$ vs 63.87/$ in January. India's forex reserves are more than $417 bn in the week ending February 02, 2018.

Inflation

Headline CPI inflation accelerated to 5.21% y-o-y in December from 4.88% in November, marginally higher than market expectation of 5.1% due to higher vegetables and housing inflation. Food inflation rose to 5.0% in December from 4.4% in November and core CPI (i.e. CPI ex food & fuel) also increased to 5.1% in December from 4.9% in November.

WPI inflation eased to 3.58% in December from 3.93% in November, below the market expectation of 4%. This downward movement was largely due to easing food & fuel prices.

Outlook

In its latest budget the government missed the FY18 fiscal deficit target (3.5% of GDP vs. budgeted 3.2%) and projected a slower pace of fiscal consolidation to 3.3% of GDP in FY19. It re-iterated its medium-term fiscal consolidation commitment but pushed the fiscal deficit target of 3% of GDP out to FY21.The decision on linking minimum support prices (MSP) to a minimum of cost plus 50% raised some concern due its fiscal and inflationary impact. The other apprehension is government's aggressive tax revenue (GST) assumptions which could undershoot if tax compliance fails to pick up.

US Federal Reserve in its monetary policy meeting kept the benchmark interest rates unchanged after its first policy meeting of 2018. It continues to expect inflation to go in upward direction hinting at faster rate hikes in this year. Later strong wage growth data pushed US 10 year benchmark yield also rose to high of 2.88% from 2.45%.

Bank of Japan also in its monetary policy kept policy rates unchanged and it expects to reach its inflation target of 2% by fiscal 2019. The officials also said that it would continue with the quantitative monetary easing. However, they also announced that they would slightly reduce their purchase of long dated Japanese Government bonds.

ECB in its monetary policy meeting kept rates unchanged. ECB maintained its stance of continuing to make net asset purchases under the asset purchase program at a monthly pace of Eur30 billion, until the end of September 2018.

The focus now has shifted from budget to development in global markets. Globally Financial markets have become volatile due to uncertainty over the pace of normalisation of the US Fed monetary policy. The January payrolls data showed rapidly accelerating wage growth and better than expected employment .Consequently Bond yields in the US have hardened sharply with concomitant rise in bond yields in other economies.

RBI left the repo rate unchanged at 6.00%, as expected by markets and flagged upside risks to inflation, but maintained its "neutral" policy stance. It expects while inflation may overshoot in the near term, it expects end-FY19 inflation at ~4.5%.

Going ahead, a host of domestic and global factors have triggered risk to inflation projections. Crude oil prices have firmed up sharply in last few months, driven by both demand and supply side factors while a pick-up in global growth may exert further pressure on crude oil and commodity prices with implications for domestic inflation.

Domestic inflation will be under pressure from rising input costs resulting from improving economic activity, impact of HRA increases by various state governments, proposed revision of the minimum support prices for kharif crops and impact of fiscal slippage.

The 10 year Gsec yields has risen by almost 100bps to 7.70% in this financial year. In addition to above factors the Demand -Supply equation of GSec has played a role in this sharp movement of yields. For last couple of quarters we have been advising investors with shorter horizon to invest in accrual products like Ultra short term Fund and Income Plus. We now believe that investors with a longer term outlook can start investing in a calibrated fashion in mid duration products like Bond Saver, Banking PSU and Flexible Income Plan.