Debt markets

The upward movement in Money Market rates continued in the first half of May due to tight liquidity in the system and higher issuance pressure from Corporates. The rate hike expectation also led to higher rates overall. Three month CD rates touched a high of 7.75% which were at 7.05% at the beginning of the month. One year CD rates also rose to 8.10% from the last month's rate of 7.60%. However, in the last week of the month Money Market rates fell by 20-30 bps due to liquidity induced by increased Government spending.

The 10 year Government benchmark yield opened the month on a flat note at 7.73% & rallied up to 7.58% on the back of announcement of Open Market Operation (OMO) purchase auction by RBI. However, market could not sustain the rally and yields soared back up to 7.90% as crude prices touched almost $80 per barrel and Rupee started to depreciate. Later during the month as crude prices pulled back from peak of $80/bbl to $75/bbl and rupee stabilized at Rs. 67/$ the Benchmark yield rallied by 10-12 bps towards the end of month and closed the month at 7.82%.

Liquidity remained positive in the month of April at average 0.12 trillion from previous month's average of 0.42 trillion (Rev Repo-Repo-Marginal Standing Facility-Standing Liquidity Facility + term repo/re-repo). This was mainly because of the increase in currency in circulation and step up of sale of foreign exchange by RBI to support the fall in rupee.

Domestic Macro Factors

Industrial Production

India's Industrial production weakened to a five month low of 4.4% y-o-y in March versus 7.1% in February. This was lower than the market expectation of 6.2%. The consumer durables category fell drastically to 2.5% y-o-y in March from 7.5% in February. On sectorial basis manufacturing activity also declined to 4.4% y-o-y in March from 8.5% in February. Mining and electricity growth picked up and printed at 2.8% and 5.9% in March from -0.4% and 4.5% respectively in February. In terms of use based classification, Capital goods production disappointed and fell to -1.8% in March vs 19.5% in February. Other segments like Intermediate goods and Consumer Non-Durables segments printed at 2.1% & 10.9% in March vs. 3.7% and 7.3% in February.

External Trade

India's external trade deficit remained flat at $ 13.72 bn in April vs. $ 13.69 bn in March. This was below market expectation of a deficit of $ 15 bn. Exports growth rose to 5.17% y-o-y in April vs. -0.7% in March. Exports printed at $ 25.91 bn in April from $ 29.11 bn in March. Oil exports printed at -4.5% in April as compared to 13.4% in March. Imports moderated to 4.6% in April vs. 7.2% in March. Oil imports growth increased to 41.4% y-o-y in April vs. 13.9% in February. Gold imports declined marginally to -33.1% in April Vs. -40.3% in March. Non-oil, non-gold imports decreased at -0.1% in April vs 12.2% in March.

INR traded in the range of 66.6 to 68.4 during the month of May and finally closed the month at 67.4100/$ vs 66.6613/$ in April. India's forex reserves reduced to $412.82 bn as on 1st June from $423.5 bn in April.

Inflation

Headline CPI inflation increased to a 3 month high of 4.58% y-o-y in April from 4.28% in March. This was higher than the market expectation of 4.42%. The increase in headline CPI was mainly contributed by higher prices of housing, clothing and footwear. Food inflation was almost flat at 3% in April vs 3.01% in March. Core CPI (i.e. CPI ex food & fuel) rose to 5.9% in April from 5.3% in March. Fuel & light inflation moderated to 5.24% y-o-y in April from 5.73% in March. WPI inflation increased to 3.18% in April from 2.47% in March. This was above the market expectation of 2.82%. It was the highest wholesale inflation since December 2017. This was largely due to rise in prices of manufactured products and fuel prices. Primary articles inflation rose to 1.41% in April vs. 0.24 % in March. Fuel and power inflation rose to 7.9% in April from 4.7% in March. Core WPI Inflation (manufactured product ex food inflation) remained neutral at 3.6% y-o-y in April from 3.6% in March.

GDP for January to March 2018 quarter printed at 7.7% YoY vs. 7.00% in previous quarter, which was above the market expectation of 7.30%. The quickening in GDP was mainly driven by a pickup in investment activity and Government consumption expenditure. GDP growth for the full year was revised up from an earlier estimate of 6.6% to 6.7%. Gross Value Added growth rose to 7.6% YoY in January to March quarter vs 6.6% (revised from 6.7%) in previous quarter. The manufacturing sector grew at 9.1%% as compared to 6.9% in previous quarter. The mining and quarrying sector grew at 2.7% vs. 1.4% in previous quarter. The Electricity, Gas and Water Supply growth accelerated to 7.7% in January to March quarter from 6.1% in previous quarter. Construction sector grew to 11.5% from 6.6% in previous quarter. Trade, hotels, transport & communication and services growth moderated to 6.8% vs. 8.5% in previous quarter. General Public administration activity grew to 13.3% from 7.7%.

Outlook

In Global markets, the US Federal Open Market Committee (FOMC) kept policy rates unchanged in line with market expectations. However they highlighted the upward trend in inflation. The Committee members unanimously voted for status quo. The Committee deemphasized the potential concerns about inflation moving above its 2% target. Also, they dropped their longstanding statement that the Committee was "monitoring inflation closely." This suggests that the Committee is not going to act in haste even if inflation moves somewhat higher. However, with no major changes it seems that June hike is on its way.

The ECB which will have a meeting this month had taken a small step towards normalization as it removed commitment to increase asset purchase in its March meeting. However, the recent volatility has brought into question whether the ECB will end its three year bond buying programme in September, or extend it amid concerns over liquidity.

In domestic markets:

RBI Monetary Policy Committee in its second meeting for FY19 on 6th June decided to hike the repo rate by 25bps to 6.25% and consequently reverse repo to 6% and Marginal Standing Facility rate to 6.50% from 5.75% and 6.25% respectively. The RBI's policy statement revealed that this policy action was primarily triggered by the surprise hardening of core inflation in April, and escalation of crude oil prices. Hence in line with this policy outlook, the RBI has revised up its CPI inflation forecast to 4.8-4.9% y-o-y in H1FY19 (from 4.7-5.1%) and its H2 projection to 4.7% (from 4.4%). While the GDP growth projection has been retained at 7.4% for FY19, (year-ending March 2019), the H1 projection has been raised to 7.5-7.6% (from 7.3-7.4% previously) and the H2 projection tightened to 7.3-7.4% (from 7.3-7.6%), with risks evenly balanced. However, what was more puzzling for markets was, first the decision to hike was taken unanimously and second that the RBI retained it neutral stance despite a pre-emptive rate hike.

In our view, the RBI's decision to hike rates but leave its stance unchanged sends an important signal. The reluctance to change stance suggests that the MPC believes interest rates are closer to neutral and that it is not about to embark on a significant tightening cycle unless global conditions change materially. Hence, the RBI remains data dependent.

In the coming days we expect that the positive effects of remonetisation and a lower base effect of last year will continue to support a strong cyclical recovery in the next one to two quarters. However, beyond that the current growth recovery will depend on bank's bad-asset resolution, private sector investments revival and pickup in net exports. This will give the fact that resolution of bad bank assets can take some time and tighter financial conditions and weaker investment activity ahead of the elections can be challenging.

On inflation, food price inflation remains subdued currently, but the Government's impending decision to raise Kharif (summer) MSPs to at least 1.5x production cost is a clear upside risk to this. In the near term, core inflation momentum is also likely to remain elevated due to the closing output gap and the adverse effects of higher oil prices and a weaker currency. However if oil prices stabilise around current levels, good monsoon rains and MSP prices are increased moderately, inflation may remain within RBI's comfort zone.

We believe that, the RBI will need to consider tightening beyond this stage if oil prices move above $80/bbl sustainably, if the Government embarks on populist policies that entail fiscal slippage, sharp depreciation in rupee and if BOP pressures re-emerge. We expect the RBI to remain in wait-and-see mode. With this view we advise investors with shorter horizon to invest in accrual products like Low Duration Fund and Short Term Credit Risk Fund. Investors with a medium term investment horizon can invest in short to mid duration products like Short Term Debt Fund, Banking & PSU Debt Fund, Medium Term Fund and Corporate Bond Fund.