Debt markets

The month of July was volatile for Money Markets. Two month CD rates which were around 6.80% in June fell to 6.55% levels. Similarly one year CD rates also rallied to 7.90% from the last month's 8.15%. However this rally could not sustain and yields rose back in second half of the month due to negative liquidity in the system. This along with high demand for short term money for equities market public issues resulted in sharp spike in money market yields and at peak two months bank CD rates moved up by 30-40bps to 7.25% at month end.

The 10 year Government benchmark yield opened the month at 7.90%. The rates remained in a narrow band of 7.87-7.90 for first 10 days in line with crude prices. Crude prices have been driving the benchmark rate throughout the month. However, as the crude prices fell from $ 77 per barrel to $71 per barrel the 10yr benchmark yield also rallied by 15-20 basis points to 7.72% and remained in narrow range of 7.75% to 7.80% before closing the month at 7.77%.

Liquidity turned negative in the month of July at average Rs -0.13 trillion from previous month's average of Rs 0.11 trillion (Rev Repo-Repo-Marginal Standing Facility-Standing Liquidity Facility + term repo/re-repo).

Domestic Macro Factors

Industrial Production

India's Industrial production growth weakened to 3.2% y-o-y in May versus 4.8% (revised from 4.9%) in April. This was lower than market expectation of 4.4%. The weakness in Industrial production was mainly due to slow pace growth in consumer non-durables, infrastructure and intermediate goods. Consumer non-durables sector declined to -2.6% in May vs. 7.9% in April. Infrastructure and Intermediate goods growth declined to 4.89% and 0.9% in May vs 7.03% and 1.7% respectively in April. Manufacturing activity growth declined to 2.8% y-o-y in May from 5.3% in April. Mining and electricity growth accelerated at 5.7% and 4.2% in May from 4.0% and 2.1% respectively in April. Primary goods rose to 5.7% in May vs. 2.8% in April. In terms of use based classification, Capital goods production declined to 7.6% in May vs 11.9% in April. The consumer durables category remained constant at 4.5% y-o-y in May from 4.3% in April.

External Trade

India's external trade deficit widened to a 61 month high of $ 16.6 bn in June vs. $ 14.6 bn in May. This was above market expectation of a deficit of $ 14.4 bn. Exports growth rose to 17.6% y-o-y in June vs. 20.2% in May. Exports printed at $ 27.7 bn in June from $ 28.9 bn in May. Imports rose to 21.3% in June vs. 14.9% in May. Imports printed at $ 44.4 billion in the month of June. Oil imports increased to $ 12.73 bn in June vs. $ 11.5 bn in May. Gold imports decreased to $ 2.39 bn in June Vs. $ 3.5 bn in May. Non-oil, non-gold imports increased to $ 31.6 bn in June vs $ 28.5 bn in May.

INR traded in the range of 68.46 to 69.05 during the month of July and finally closed the month at 68.5475/$ vs 68.4700/$ in June. India's forex reserves reduced to $404.1 bn as on 3rd August from $407.81bn in June.

The GST collection for the month of July touched Rs 96,483 crores, slightly higher than Rs 95,610 crores collected for the month of June. GST collection for the month of July is higher than the monthly average collection of Rs 89,885 crores for last fiscal.

Inflation

Headline CPI inflation remained flattish at 5.00% y-o-y in June from 4.87% in May. This was below market expectation of 5.28%. The primary reason of stability in headline CPI was mainly contributed by lower food price inflation. Food inflation moderated to 2.9% in June vs 3.1% in May. Core CPI (i.e. CPI ex food & fuel) remained a concern as it rose to 6.6% in June from 6.3% in May. Fuel & light inflation increased to 7.14% y-o-y in June from 5.8% in May. Housing Inflation remained constant at 8.45% in June vs. 8.40% in May.

WPI inflation increased to 5.57% in June from 4.43% in May. This was above the market expectation of 5.23%. It remained the highest wholesale inflation since March 2017 beating the previous month's figure. This was largely due to rise in manufactured products, food and fuel prices. Primary articles inflation rose to 5.3% in June vs. 3.16 % in May. Fuel and power inflation rose to 16.2% in June from 11.2% in May. Core WPI Inflation (manufactured product ex food inflation) rose to 4.8% y-o-y in June from 4.4% in June. Coal mining inflation remained constant at 4.7% in June vs. 4.6% in May. Electricity inflation rose drastically to 7.5% in June vs. 2.5% in May.

Outlook

The US Federal Open Market Committee (FOMC) kept policy rates unchanged in line with market expectation. However, the commentary appeared a bit hawkish. This has brought back the 4 rate hike narrative for those expecting a hold in their next quarterly policy. On the language front, the noticeable change was "...economic activity has been rising at a strong (from solid) rate."

European Central Bank (ECB) in line with consensus expectation kept its policy rates unchanged and maintained its commitment to keep rates unchanged through the summer of 2019. ECB also kept the QE unwind schedule unchanged i.e. net asset purchase at the monthly pace of Euro 30 billion until September 2018 and Euro 15 billion post that until December 2018. It further indicated that while recent economic indicators and surveys point towards a stabilisation and ongoing solid and broad-based economic growth, it maintained that an ample degree of monetary accommodation is still necessary.

RBI Monetary Policy Committee (MPC), in line with market expectation, increased repo rate by 25 basis points to 6.50%. However, MPC retained its neutral stance. MPC revised its inflation forecast for H2FY19 to 4.80% from 4.70% forecasted in June. GDP forecast for FY19 was retained at 7.40%. Furthermore MPC revealed its forecasts for Q1 FY20. CPI Inflation at 5.0% which is much above its long term target and hence explains the rate hike. Similarly GDP growth rate for Q1FY20 was forecasted at buoyant 7.50%, shows MPC's optimism on future growth.

The policy statement noted that domestic economic activity has continued to sustain momentum and the output gap has virtually closed. Further it noted uncertainty around domestic inflation needs to be carefully monitored in the coming months. The Governor in its post policy press briefing indicated that the risks are evenly balanced around inflation and that retaining neutral stance gives them the flexibility to move either side depending on the incoming data.

RBI outlook will be shaped by several factors like trends in crude oil prices, uncertain global financial market conditions and rise in household inflation expectations that could impact actual inflation, monsoon risks especially from the perspective of regional distribution, fiscal slippages – both at the Central and the State levels, uncertainty on MSP hike depending on its implementation. On the flip side some sobering of the higher input cost faced by manufacturers could come from a sustained dip in the global commodity prices and the recent reduction in the GST.

RBI retains its FY19 growth forecast at 7.4% with risks evenly balanced. While higher MSP is likely to boost rural demand, investment activity has held up well despite some tightening in the financing conditions. Rising trade tensions, however, remain an adverse risk to the growth projections.

We believe that until unless there is some adverse global event we don't expect the MPC to waver from its durable 4% inflation target and that could prompt MPC to hike at least once more in this fiscal and probably end up with neutral repo rate of 7.00%. The growth for now remains robust giving MPC to act on emanating inflationary pressures. We believe as the global liquidity turns negative we will see liquidity deficit increasing in emerging markets like India prompting the RBI to inject durable liquidity. Money market rates are likely to head higher in H2 depending on domestic liquidity conditions.

We continue to recommend short duration funds with accrual focus for investors with 9 to 12 months focus while we recommend mid duration and systematic deployments in long duration funds for investors with 36 months and greater investment horizon.