Debt markets

Crude prices continued to dip further and closed at $53.8 /barrel i.e 13% drop in a month. This relief on external front, RBI's downward revision of inflation projection and escalated OMOs resulted in a bond market rally of 25 bps as 10 year yield closed at 7.37%

Though liquidity turned significantly negative yet there was no effect on short term rates as there remained healthy demand for top rated papers post credit squeeze .Three month CD rates dropped to 6.95% as market remained anchored to RBI's liquidity guidance.

Liquidity remained negative in the month of December at average Rs -1 trillion from previous month's average of Rs -0.82 trillion (Rev Repo-Repo-Marginal Standing Facility-Standing Liquidity Facility + term repo/re-repo) mainly due to advance tax outflow and increase in currency in circulation.

Domestic Macro Factors

Industrial Production

India's Industrial production growth accelerated to an 11 month high of 8.1% y-o-y in October vs. 4.5% in September. This was higher than market expectation of 6%. The acceleration was mainly due to a favorable base effect. In terms of sectorial classification, mining activity rose to 7.0% in October vs. 0.1% in September. The activity in manufacturing and electricity sector also picked up to 7.9% and 10.8% in October vs. 4.6% and 8.2% in September respectively. In terms of use-based classification, capital goods production increased to 16.8% in October vs 6.5% in September. The consumer durables category rose drastically at 17.6% in October from 5.2% in September. Consumer non-durables sector growth rose marginally to 7.9% in October vs. 6.1% in September. Infrastructure and intermediate goods growth printed at 8.71% and 1.8% in October vs 9.34% and 1.5% respectively in September.

External Trade

India's external trade deficit narrowed to $ 16.7 bn in November vs. $ 17.1 bn in October. This was higher than market expectation of a deficit of $ 15.1 bn. Import growth decelerated to 4.3% in November vs. 17.6% in October. The moderation in imports was in both oil and non-oil segments. Export growth slowed to 0.8% y-o-y in November vs. 17.9% in October. Imports moderated marginally to $ 43.2 bn in November vs $ 44.1 bn in October. Oil imports moderated to 41.3% in November from 53.1% in October. Gold import growth increased to $3.3 bn in November vs $ 1.7 bn in October. Exports printed at $ 26.3 bn in November from $ 27 bn in October. Oil exports rose 42.7% in November vs. 49.4% in November. Non-oil exports declined by 5.9% November vs. 13% in October.

Fiscal

The GST collection for the month of December decreased to Rs 94,726 crores, from previous months collection of Rs 97,637 crores. The Rs 94,726 crore collected includes Central GST of Rs 16,442 crore, State GST of Rs 22,459 crore, Integrated GST of Rs 47,936 crores and Cess of Rs 7,888 crores.

Inflation

Headline CPI inflation printed at a 17 month low of 2.33% in November from 3.38% in October (revised from 3.77%) mainly due to lower food and core inflation. This was below market expectation of 2.58%. Core inflation slowed down to 5.7% in November vs. 6.2% in October. Food inflation further contracted -2.6% in November vs -0.9 in October. Fuel inflation moderated at 7.4% in November vs. 8.5% in October. The core inflation (CPI ex-food & beverages, fuel, petrol, diesel and housing rent) inched up to 5.7% in November from 5.6% in October.

WPI inflation eased to 4.64% in November from 5.28% in October. This was in line with market expectation of 4.64%. It was the lowest WPI since August. This was largely due to decrease in food prices and slow rise in fuel prices and manufactured products. WPI food inflation printed at -3.31% in November vs. -1.49% in October. Fuel and power sector combined inflation printed at 16.3% in November from 18.4% in October. Core WPI Inflation (manufactured product ex food inflation) softened to 4.8% in November from 5.1% in October.

Outlook

The emerging markets rates and currency markets had a tough time for a large part of the year 2018. Four consecutive rate hikes and start of reversal of QE at a time when US Govt is borrowing more than ever to fund budget deficits led to tighter liquidity globally. Add on to that the trade wars, tax breaks in USA and geopolitical tensions meant many Emerging market Central bankers had to deploy measures including rate hikes to protect extreme currency volatility. Domestically INR depreciated to an all-time low but still RBI eschewed defensive rate hikes and kept monetary policy hinged on inflation trajectory. Govt. took many measures outside Monetary policy like bilateral swaps to curb volatility in currency which turned out to be effective.

For India as growth picked up it meant higher imports of not only oil at higher prices but non-oil imports too. However exports couldn't pick up similarly. Crude prices maintained an upward trajectory till it touched a peak of $ 85/barrel leading to CAD widening to 2.7% from 1.9%in FY2018. As the output gap closed it started to put pressure on core inflation even though headline CPI remained subdued and undershot RBI projection due to exceptionally low inflation in food items. This meant a shallower rate hike cycle for 2018 than market had expected originally.

The last few months saw a quick reversal in crude prices as US approved Iran crude imports for many countries to continue even after overall sanctions kicked in. This along with increase in supply in expectation of harder sanctions created excess supply in the market. For countries like India with dependence on oil the year ended on a positive note and earlier concerns on external account have diluted. However fiscal concerns remain intact as indirect tax collections have been trailing mainly on account of lacklustre GST collections and the net GST shortfall for FY19 is expected to be around Rs 500 bn. Other than this cut in excise duty on petrol/diesel during the year has added to the fiscal pressure. We expect the Govt. either to largely meet fiscal deficit target through curtailed expenditures, interim dividend from RBI and dip in to small saving schemes. The game changer in bonds market rates has been RBIs choice of OMO purchase as liquidity inducing instrument. This has titled the demand supply dynamics in favour of Government bonds. It has brought down the level of overall long term rates but bigger beneficiaries have been G-sec leading to widening of corporate bond spreads.

We expect MPC to change stance from calibrated tightening to neutral in coming policies in line with inflation trajectory. Inflations numbers have regularly undershot RBI's projection. There are a number of risk factors like the shrinking of G3 central bank liquidity, possible escalation of trade war and reversal in crude prices due to OPEC cuts. Domestically markets will keenly look at policy announcements for alleviating farm distress and its impact on FY20 fiscal position especially in an election year. But as growth-inflation dynamics remains positive for bonds we feel they should evince interest from medium-long term investors. We continue to recommend Liquid, Money market and Low duration funds for shorter holding periods. 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.