Debt markets

The relief rally which started in October with drop in crude prices intensified as prices continued to slide. Brent crude prices dropped from a peak of US$85pb to around US$60pb, a drop of around 42% in a couple of months. Further as the RBI made no changes to its monetary policy rates and was persuaded by recent changes to revise its inflation projection downwards, the ten-year benchmark yield which closed at 7.60% from 7.85% of last month dropped to 7.40% in December.

The activity in the money market segment picked up pace as continued focus by the RBI on liquidity led to a sense of normalcy in the market after last month's credit squeeze in the NBFC sector. Three month CD rates dropped 10-15 bps as markets got a sense of possible status quo in the upcoming policy. NBFC CP rates dropped even more, ~30 bps, from their previous elevated levels.

Liquidity remained negative in the month of October at an average of Rs -0.80 trillion from previous month's average of Rs -0.57 trillion (Rev Repo-Repo-Marginal Standing Facility-Standing Liquidity Facility + term repo/re-repo) mainly due to increase in currency in circulation due to festive season and State elections.

Domestic Macro Factors

Industrial Production

India's industrial production growth moderated to 4.5% y-o-y in September vs. 4.7% (revised from 4.3%) in August. This was higher than market expectation of 4.3%. The moderation was mainly due to deceleration in manufacturing growth from 5.1% to 4.6% despite Mining and Electricity growth increasing to 0.2% and 8.2% in September from -0.5% and 7.6% in September. In terms of use-based classification, capital goods production decreased to 5.8% in September from 9.3% in August. The consumer durables category fell marginally to 5.2% in September from 5.3% in August. Consumer non-durables sector growth also slowed down to 6.1% in September from 6.5% in August. Infrastructure and Intermediate goods growth printed at 9.5% and 1.4% in September vs 8.0% and 2.8% respectively in August.

External Trade

India's external trade deficit widened to $ 17.1 bn in October vs. $ 14 bn in September. This was much higher than market expectations of a deficit of $ 16 bn. Import growth accelerated to 17.6% in October vs. 10.5% in September. The acceleration in imports was in both oil and non-oil segments. Export growth jumped to 17.9% y-o-y in October vs -2.15% in September. Imports rose to $ 44.1 bn in October vs $ 41.9 bn. Oil imports accelerated to 52.6% in October from 33.6% in September. Gold imports growth moderated to $1.7 bn in October vs 2.6bn in September. Exports printed at $ 27 bn in October from $ 27.95 bn in September. Oil exports rose by 42.7% in October vs. 26.8% in September. Non-oil exports rose by 36.9% October vs. 11.2% in September.

Fiscal

The GST collection for the month of November decreased to Rs 97,637 crores, from previous month's collection of Rs 100,710 crores. GST collection in October had witnessed an uptick due to festive demand and anti-evasion measures. The Rs 97,637 crores collected includes Central GST of Rs 16,812 crores, State GST of Rs 23,070 crores, Integrated GST of Rs 49,726 crores and Cess of Rs 8,031 crores.

Inflation

Headline CPI inflation printed at a 13 month low of 3.31% in October from 3.70% in September (revised down from 3.77%) mainly due to stable food prices. This was below market expectations of 3.66%. Core inflation edged higher to 6.2% in October vs. 5.8% in September. Food inflation declined 0.9% in October vs. growth of 0.5% in September. Fuel inflation remained high at 8.5% in October from 8.6% in September. Core inflation (CPI ex-food & beverages, fuel, petrol, diesel and housing rent) also increased to 5.4% y-o-y from 4.9% in September.

WPI inflation rose to 5.3% in October from 5.1% in September. This was above market expectations of 4.90%. This was largely due to higher fuel prices. WPI food inflation printed at -0.3% in October vs. 0.5% in September. Fuel and power sector combined inflation printed at 18.4% in October from 16.6% in September. Core WPI Inflation (manufactured product ex food inflation) further hardened to 5.1% in October from 4.8% in September.

Outlook

A host of factors both domestic and global have brought macroeconomic risk under control and respite to interest rate markets. The sustained fall in oil prices, resulting appreciation in rupee, stepped up OMOs by RBI, deceleration in CPI and a softer Fed view has resulted in a significant drop in long term rates. The 10 year yield has dropped in November by 25 bps to 7.60%. Further as RBI made no changes to its monetary policy rates and also lowered its inflation projection, this led to 10 year G-sec rates dropping to 7.40%. Even as RBI highlighted some upside risks to inflation, the forecast for H2FY19 as also Q1FY20 were lowered. Inflation outlook for H2FY19 has been revised down to 2.7-3.2% from 3.9-4.5% earlier. Q1FY20 inflation forecast was lowered to 3.8% Vs 4.8% earlier while Q2FY20 is now forecasted at 4.2% Vs 4,6%.The upside risk to inflation made MPC to retain the "calibrated tightening" stance.

The liquidity deficit widened, led by increase in currency in circulation due to festival related demand and upcoming state elections. However it was not enough to push short term rates higher as rates have already been high in expectation of upcoming events and credit squeeze of NBFCs. In fact short term rates also dropped as expectation of rate hike went out of the window and concern over NBFC refinancing risk diluted as market participants reckon that the RBI is proactive in addressing the problem.

The distressing conditions of H1FY19 have now given way to a much more comfortable external scenario, mostly due to a sharp fall in the crude prices. Given that oil payments form a significant chunk of overall import bill, this has also led to an appreciation of the Rupee and rekindle FPI investor's interest in the debt segment as interest carry for India remains positive.

Inflation has remained below RBI's target for some time now largely with the help of subdued food inflation. Crude and core inflation have remained key risk to inflation. We expect MPC to be extremely data dependent. We expect rates to remain range bound in short term as fiscal risk remains but continued OMOs help soothe the markets. However if the crude oil surprises on upside as OPEC may decide to lower its supply then volatility will increase.

We continue to recommend Liquid, Money market and Low duration funds for short 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.