Debt markets

The major event for the month of October was the MPC meeting. MPC voted for a 25bps Repo rate cut by a 5:1 vote with a dissent vote being cast in favour of a larger cut of 40bps. The focus of the MPC increased risks to growth as it revised down its projected GDP for the year by 80bps to 6.1%. MPC has also guided for a continuation of its accommodative stance "as long as it is necessary to revive growth". It came following the series of pro-growth measures announced in earlier months by GoI and this was backed now by MPC doing its bit by giving a 25bps rate cut. The trigger for this was continued weaker than expected growth data. Weaker PMIs and later contraction in IIP continued the trend of weaker data in recent past. Bonds rallied initially after the rate cut. However mounting fiscal pressures resulted in a range bound market at the longer end. However, high-quality short-term bonds and money market securities continue to benefit from the rate cut and closed the month 30-40bps lower than the previous month. Fall of GST collections to nine month lows on top of corporate tax cuts added to worries.

The 10-year benchmark yield gyrated in the range of 6.60% to 6.70% and finally closed the month at 6.67%.

Banking system liquidity for the month of October increased to an average of INR 1.96 trillion from previous month's average of INR 1.20 trillion (Rev Repo-Repo-Marginal Standing Facility-Standing Liquidity Facility + term repo/re-repo). The increase in system liquidity was largely due to higher government spending and dollar buying by the RBI in the forex market.

INR traded in the range of 70.88/$ to 71. 54/$ and finally closed the month at 70.9287/$ in October vs 70.8688/$ in September. India's forex reserves rose to $442.58 bn as on 25th October from $433.59 bn in last week of September.

Domestic Macro Factors

Industrial Production

India's industrial production growth surprisingly declined to -1.1% in August vs. 4.6% (upwardly revised from 4.3% earlier reported) in July. This was well below the market expectation of +1.7%. The moderation in industrial production was broad based as the growth in all sectors declined. In terms of sectoral classification, growth in mining activity decreased to 0.1% in August vs. 4.8% in July. The activity in the manufacturing sector moderated to -1.2% in August vs. 4.5% in July. The activity in the electricity sector weakened to -0.9% in August vs. 4.8% in July. In terms of used-based classification, activity in primary goods slowed to 1.1% August vs. 3.5% in July. The growth in consumer durables and non-durables declined respectively at -9.1% and 4.1% in August vs. -2.7% and 8.4% in July. The activity in Infrastructure and Intermediate goods sector also moderated respectively to -4.47% and 7.00% in August vs. 3.53% and 14.7% in July. The capital and primary goods sector growth declined respectively to 21.0% and 1.1% in August vs. -7.2% and 3.5% in July.

External Trade

India's external trade deficit reduced to $10.86 bn in September vs. $13.45 bn in August. This was below the market expectation of a deficit of $12.9 bn. Imports contracted by -13.8% y-o-y in September vs. -13.4% in August. Imports decreased to $36.89 bn in September vs $39.58 bn in August mainly due to decline in purchase of coal, coke & briquette, petroleum, crude & products, pearls, precious & semi-precious stones and organic & inorganic chemicals. Export growth also contracted by -6.06% in September vs. 6.0% in August mainly due to lower sales of gems and jewelry, engineering goods and petroleum products. Exports moderated slightly to $26.03 bn in September from $26.03 bn in August.

Fiscal

The GST collection for the month of October increased to INR 95,380 crores, from the previous month's collection of INR 91,916 crore. The INR 95,380 crore collected includes Central GST of INR 17,582 crores, State GST of INR 23,674 crore, Integrated GST of INR 46,517 crores and Cess of INR 7,607 crores.

Inflation

Headline CPI inflation rose to 3.99% in September vs. 3.28% in August. The uptick was mainly due to increase in food price inflation particularly in vegetable prices. This was slightly above the market expectation of 3.80%. Core inflation (CPI ex-food and fuel inflation) remained stable at 4.2% in September vs 4.2% in August. The core-core [SJN-SM1] inflation (CPI ex-food & beverages, fuel, petrol, diesel and housing rent) moderated to 4.53% in September from 4.51% in August. Inflation for food and beverages combined rose to 4.70% in September vs. 2.96% in August. Housing inflation in September moderated slightly at 4.75% vs. 4.84% in August. Fuels and lighting inflation moderated further at -2.18% in September vs. -1.70% in August. Other miscellaneous inflation combined moderated to 4.45% in September vs. 4.71% in August.

WPI inflation moderated to 0.33% in September from 1.08% in August. This was below the market expectation of 0.84%, mainly led by slow rise in food prices and decline in manufacturing and fuel prices. This was the lowest wholesale price inflation since June 2016. Inflation for primary articles combined moderated to 5.54% in September vs. 6.43% in August. Food and non-food articles inflation printed respectively at 7.5% and 2.2% in September vs. 7.7% and 4.8% in August. Inflation for Fuel and power sector combined moderated to -7.1% in September vs. -4.0% in August. Manufactured goods inflation moderated at -0.4% in September vs. 0.0% in August.

Outlook

The US-China trade deal continues to overshadow the global demand and growth outlook. The recent developments suggest that a partial deal before a full trade agreement can take place in November itself. The US Federal Reserve Bank, in its October meeting, in line with the market expectation delivered the third rate cut of 25bps. The policy statement in forward guidance indicated towards a pause or "wait and see mode" for now. In addition, the Fed will continue to purchase $60bn Treasury bills every month till Q2 2020 to improve liquidity.

In Europe, the macro data out of Eurozone especially Germany continues to be weak with PMI manufacturing moving deeper into contraction zone and close to recession. The ECB will resume buying of eurozone government bonds at a rate of □20 billion per month. Further the uncertainty on Brexit continues to add on to the risk off sentiments.

In domestic markets the growth data for October '19 remained weak with continued slowdown in consumption, capex and external demand. High frequency growth indicators like non-oil non gold imports, capital goods imports and exports continued to contract. The domestic PMI's remained in contraction mode in October. GST collections also continued to undershoot the budgeted number, collection for October was INR 0.95 tn. This raises the worries of fiscal slippage and additional borrowings by the Government.

On the back of deteriorating growth and comfortable inflation data, *Monetary Policy Committee (MPC)*, in its October policy decided to cut the repo rate by 25bps. The policy statement mentioned that the MPC is willing to keep policy stance accommodative as long as it is required to revive the growth, while ensuring the inflation remains within the target. Later in the minutes of the meeting it was evident that most of the committee members were concerned about deteriorating growth and transmission of rate cuts delivered so far.

We believe that the comfort that the MPC members have drawn so far from lower inflation is likely to be challenged in the coming months with recent inflation prints already hovering around RBI's target of 4%. MPC will have to weigh in whether the potential downside risks on growth outweighs the upside risks on inflation. We believe that growth risks will outweigh inflation at target and the MPC will deliver another 15-40bps of rate cuts in FY20. However, rising inflation expectations and risk of fiscal slippage will keep the rate cut possibilities under check. Hence, RBI will focus more on transmission of earlier rate cuts by liquidity and guidance.

Money Market rates have started to adjust to policy rates in expectation of a rate cut and on the back of easy liquidity in the system. The current term spreads are still on the higher side than what we have seen in the recent times. This is largely due to risk aversion among market participants and poor demand supply dynamics in bonds. Going ahead, we believe that higher system liquidity should result in steepening of the rate curve i.e. front end of the rate curve getting better aligned with repo rate compared to the long end rates. Accordingly, we expect short term bonds to deliver better risk adjusted returns compared to long bonds. We recommend short duration funds like Money Market Fund, Banking and PSU Debt Fund, Short Term Debt Fund and Corporate Bond Fund as they offer better risk adjusted opportunities, while we recommend mid duration and systematic deployments in long duration funds for investors with 36 months and greater investment horizons.