

Debt Market Review



Mr. Marzban Irani, CIO - Fixed Income

Market Review

The month of February was eventful considering we had two very important events, Union Budget and MPC. Both were critical considering it was to be seen what measures GOI undertakes to spur growth and how RBI tackles the twin problem of high Fiscal Deficit and Rising inflationary expectations. The FY2022 union budget rightfully focuses on growth and has accordingly, relaxed the government's medium-term fiscal consolidation targets. The government has rationalized expenditure from high FY2021 levels, while providing meaningfully higher support versus FY2020 levels. The government's bigger focus remains on supply-side reforms with the objective of kick-starting the investment cycle, critical for India's medium-term growth prospects. Though the Union budget takes commendable steps to stimulate growth, it fails to highlight the source of funds for financing the huge fiscal deficit, considering the debt market has never such levels of gross fiscal numbers. Some of the key announcements from debt market perspective are as follows,

- ➔ Fiscal Deficit of 9.5% for FY21, 6.8% for FY22
- ➔ Expected gross Borrowing for FY22 of 12 lakh crore
- ➔ Additional Borrowing of 80k crore in Feb- March 2021

The RBI MPC's decision to keep policy rates unchanged was as expected. Policy statements on growth and inflation indicated that the rate cut cycle is over. Even as headline inflation trends lower, with economic recovery being underway, services gradually starting to open up, and pricing power coming back in some segments, core inflation will likely see some upside pressure through the year. The MPC kept the repo rate unchanged and retained its accommodative stance. To allay heavy bond supply concerns, the RBI acknowledged that gradual phasing out of CRR would allow for liquidity injection via market friendly tools. While we do not expect liquidity withdrawal measures to be undertaken immediately, the policy normalization of bringing the operating target rate towards the repo rate would play out during FY2022. Some of the key announcements are as follows,

- ➔ Status Quo-Repo Rate at 4 % and Rev. Repo Rate at 3.35 %.
- ➔ Accommodative Stance Retained
- ➔ TLTRO on Tap Scheme – Inclusion of NBFCs
- ➔ CRR level to be restored from 3% to 4% in two phase
- ➔ Extension of HTM and MSF measure

The announcements was in line with market expectations with focus on growth and managing yield curve with various monetary policy measures. However RBI didn't announce any OMO calendar or other concrete measures considering huge government borrowing program. Hence 10 year benchmark curve shot up to 6.20-6.25%. MPC highlighted that while inflation had stabilized recently, emergent risk through core group remained, leading to an increase in Q2 FY22 forecast for headline CPI to 5% from 4.6%.

Oil prices edged past \$70 / barrel to their highest in almost 2 years as supply cuts by major producers, optimism over fuel demand recovery and hopes for further U.S. economic stimulus measures support energy markets. It also presents significant risks to INR and fiscal deficit going ahead.

January GST collections, collected in February, exceeded the Rs1 tn mark for the fifth consecutive month supported by economic recovery and improved compliance. Based on the PIB release, total GST collection was at Rs1,131 bn for January (7.4% yoy) compared to Rs1,198 bn in December. Gross GST collections up to 11MFY21 were at Rs10.1 tn—contraction of 9.9% over 11MFY20.

CPI inflation in January moved lower on the back of falling vegetables prices. CPI inflation moderated to 4.06% in January as against 4.6% in December amid falling momentum. Food and beverages inflation moderated to 2.7% (3.9% in December) led by vegetables (-15.8%) and cereals (0.1%). Meanwhile, fuel and light inflation rose to 3.9%. Core inflation (CPI inflation excluding food, fuel and pan, tobacco) remained unchanged from December at 5.2% and was led by inflation in personal care (10.6%) and transport and communication (9.3%). Prices of petrol (12%), gold (25%), and diesel (14%) were some of the major contributors to core inflation. WPI inflation in January increased to 2% (1.2% in December). While food inflation was at (-)2.8% ((-)1.1% in December), core manufacturing WPI inflation rose to 5.2% (4.3% in December) on the back of rising inflation in textiles (5.2%), chemicals (3.6%), and basic metals (14.5%).

Outlook

The last two policy statements and the minutes suggest that while in the near term the MPC members will remain focused on supporting growth through accommodative stance and ample liquidity, they remain concerned on risks of increasing inflation and financial stability. Given the nascent stage of recovery with further risks emanating from the increasing infection rates and lower inflation prints, the MPC may get some further leeway to remain accommodative in the near term. We expect rates to move upwards as borrowing target at 12 lakh crore is more than expected. The bond supply pressure is likely to resurface in FY2022 given the restricted ability of the RBI to infuse liquidity through outright OMO purchases. However, the special OMOs could continue to cap sharp upside risks. Based on our fiscal estimates, we expect the 10-year yield in the range of 6.10-6.30% in the near term. Minutes from the Federal Reserve's January policy meeting indicate that the FOMC officials see the economy "far from" the central bank's goals. The meeting summary indicates it will likely "take some time for substantial further progress to be achieved", highlighting that the policy is unlikely to change soon. FED Chair Powell adds that the discussion on tapering is "premature"; indicates that "substantial further progress" towards the FOMC's goals of labor market recovery and inflation of at least 2% is required for changing the asset purchase guidance.

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For further details, please refer to the Scheme Information Document, Statement of Additional Information & Key Information Memorandum cum Application forms, available on our website www.licmf.com and at the official points of acceptance of LIC Mutual Fund Asset Management Ltd.

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