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Fixed Income

Market Outlook

January 2025

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Fixed Income Market Update and Outlook

Market Update

Rising UST, Dollar Strength and Hawkish Fed Cut

December'24 saw sharp rise in geo-political risk, hardening USTs and strong DXY, which in turn had strong implications on global yields, currencies and capital flows movement. With most major central banks half-way through rate cut cycle, their forward guidance indicates gradually further policy actions dependent on evolving data.

In India, the Dec'24 saw inflation easing below 6% mark, supported fiscal, depreciating INR, RBI's forex intervention, liquidity supported by CRR cut.

India

Monetary Policy:

In early December'24 policy, the RBI left the policy rate unchanged, while cutting the cash reserve ratio (CRR) by 50 bps to 4%. Both these measures were in line with consensus expectations. In the policy, RBI sharply revised downward FY25 growth forecast to 6.6% (earlier projection: 7.2%), although 1H FY26 is expected to pick up to ~7.1%. RBI also revised upward FY25 inflation projection to 4.8% (Previous projections: 4.5%), while 1H FY26 expected to moderate to 4.3%.

Inflation:

CPI inflation eased to 5.48%y/y in November (Oct 2024: 6.21% y/y, Last year same period: 5.55%y/y). This was in line with the consensus (5.5%y/y). Favourable base effect and sequential decline in monthly food (read: veggies, fruits, pulses, sugar, meat) and fuel prices helped in bringing down the inflation. Core inflation decline marginally to 3.64%y/y (Oct 2024: 3.67%y/y; Last year same period: 4.11%y/y). While Food inflation continued to remain elevated at ~8% lvls (Previous month: 9.7%y/y), all other sub-indexes continued to remain below/~ 4%y/y lvls, with fuel index in deflation for last fifteen consecutive month. Excluding veggies, headline inflation rose to 3.65%y/y (Previous month: 3.57%y/y; Nov 2023: 4.77%y/y). Apr-Nov 2024 avg CPI inflation was lower at 4.9%y/y (Last yr same period: 5.45%y/y).

Fiscal:

April-Nov 2024 gross tax receipts grew robustly by ~11%y/y - driven by buoyant direct tax collections and resilient indirect taxes. However, net tax receipts growth was flattish on account of record high devolution to states YTD. Record high RBI dividend resulted in sharp spike in non-tax receipts. During same period, expenditure growth was muted, While the revenue expenditure has picked up in recent months, capex continues to contract by double-digit. As a result, Fiscal deficit stood modest at 53% of budget estimates (Previous year similar period: 51%). December GST print was fourth highest in fiscal year at Rs. 1.77 trn, although Apr-Dec FY25 GST growth was muted at 9%y/y.

External Sector:

Nov'24 Trade deficit accelerated to ~US$38 bn (Oct 24: US$27 bn), on record high gold imports. While the Apr-Nov 2024 exports growth was muted due to drag from oil exports, core exports (excludes oil and gold) grew at resilient 9%y/y. Similarly, import growth was modest at 8.4%y/y driven down by muted core import growth. While Nov 2024 net service exports was flattish at 2.5%y/y, Apr-Nov 2024 Net services exports growth was robust at ~12%y/y.

2Q (Jul-Sep) FY25 current account deficit rose marginally to 1.2% of GDP as against current a/c surplus 1.1% in 1Q FY25. Rise in deficit was attributed to higher trade deficit. In the capital account, while FDI flows contracted, all other segments (especially FPI, banking capital and short-term capital flows) were buoyant. As a result, BoP inflows were robust to US$18.6 bn during the quarter from modest US$5.3 bn in previous quarter.

After witnessing record outflows in Oct-Nov, there was modest FPI flows in Dec 2024 to the tune of US$3 bn (Oct-Nov 2024: outflow of US$14 bn) driven by debt and equity. With this, Apr-Dec 2024 witnessed US$11 bn inflows (mainly through debt).

Rupee continued to depreciate for third consecutive month on strong dollar bias, although RBI's active intervention in forex market helped reduce volatility. In December, Rupee stood on average 84.99 against dollar (Nov: 84.36; Oct: 84.03; Sep: 83.81).

Liquidity:

After remaining positive on monthly average Rs. 1.3 trn from July through November, system liquidity was negative on an average of Rs. 65,000 cr on account of seasonality (advance tax and GST payouts) in second half of fortnight. Average Government balances improved to Rs. 1.62 trn in Dec'24 as against Rs. 0.85 trn in Nov'24. Further, From the recent peak 4.9 trn at the start of Oct'24, the core liquidity (system liquidity + Government balances) has sharply declined to ~Rs.0.68 trn by Dec 14, 2024- on RBI's forex actions and festive season cash demand. That said, RBI's CRR cut in second fortnight of December'24 helped in shoring up core liquidity to Rs.1.14 trn by Dec 20, 2024.

Yield Levels & Spreads:

Fixed income market yields remained range-bound during the month, although it picked up a bit in second half of the fortnight on strong dollar and hardening USTs. 10-year G-sec yield moved in the range of 6.68%-6.79% during the month (Nov 2024: 6.75%-6.85%;). 10 yr G-sec closed the month marginally higher at 6.77% (Nov 2024: 6.75%). Average 10-year term premia decreased to average~15 bps during the month (Nov 2024: 21 bps).

Taking cues from G-sec, 10-year SDL yields moved in the narrow range of 7.05%-7.14% as against 7.09%-7.16% in November to close the month lower at 7.11% (Nov 2024: 7.14%). December SDL primary issuances stood higher at Rs.1,13,291 cr (Nov 2024: Rs. 55,006 cr). 3Q FY25 issuances stood at robust Rs. 2.53 trn (2Q FY25: Rs. 2.40 trn; last year same quarter: Rs. 2.45 trn). The average spread between 10 yr SDL over G-sec stood at 34 bps during the month (Nov 2024: 32 bps; Apr-Dec FY25 average: 34 bps).

AAA bonds were range-bound with 10 yr AAA PSU moving in the band of 7.18%-7.32% (Previous month: 7.26%-7.32%). It closed the month lower at 7.20% (Nov 2024: 7.31%; Oct 2024: 7.26%, Sep 2024: 7.24%; Aug 2024: 7.40%).

Global

Monetary Policy:

December-24 saw global central banks' actions driven by domestic requirements. While US Fed and ECB continued to cut during the month, Bank of England and Bank of Japan preferred to be on hold. That said, the policy outlook of most Central Banks is to remain data-dependent and prefer gradual rate cutting cycle. In fact, US Fed has revised down the CY2025 rate cuts projection by 50 bps.

Financial Markets:

US treasury yields continued to harden further during December. It rose sharply post US Fed hawkish cut. US 10 Yr Treasury bond (UST) yield moved in the range of 4.15%-4.62% (as against 4.18%-4.44% in Nov 2024) and closed the month much higher at 4.58% (Nov end: 4.18%; Oct end: 4.28%; Sep 2024: 3.81%; Aug 2024: 3.91%).

After appreciating sharply by 1.8%m/m in Nov'24, the dollar index (DXY) appreciated further by 1.2%m/m in Dec'24 on high UST yields and risk aversion (CY2024 YTD: +7.1%) on global risk-off backdrop.

Market View

» Going forward, Indian bonds are likely to be supported by domestic growth moderation, expectations of easing inflationary pressure in coming months and improved demand (bond inclusion). That said, the sharp rise in geo-political uncertainty (US Tariffs & fiscal dynamics, strong dollar resulting in pressure on INR, China stimulus, commodities including crude oil, war etc) is likely to keep financial markets volatile in near term.

» RBI Policy focus is likely to be growth, while trying to align inflation around its medium-term target (4%).

» We expect RBI's next move to be rate cut, as there may be more clarity on growth trajectory (FY25 advance GDP estimates), inflation trends (Dec'24 print will be out, with estimates for Jan'25 print), fiscal consolidation (Budget FY26) and some stability on foreign flows and INR by that time.

» That said, movement in DXY and UST along with global uncertainty is likely to have major implications on Indian currency outlook, inflation, RBI's currency & rate management and core system liquidity trajectory.

» Active Liquidity Management is likely to remain crucial given the uncertainty related to currency volatility.

Common Source:
RBI, CSO, FAO, CEIC, NSO, JP Morgan, US Federal Reserve, US Treasury department, Commerce Ministry of India, NIMF Internal Research