Nippon India Mutual Fund
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Fixed Income

Market Outlook

February 2025

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Fixed Income Market Update and Outlook

Market Update

Fiscal Consolidation, Active Liquidity Management and Moderating Inflation risks

January'25 saw sharp rise in geo-political risk, hardening US Treasury Bonds (USTs) and strong U.S. Dollar Index (DXY) driven by tariffs fears. This in turn had strong implications on global yields, currencies and capital flows movement. Major central banks have adopted gradual easing path - driven by the domestic factors as well as global concerns.

In India, the Jan'25 saw inflation easing towards 5% mark and growth moderating to 6.4% levels. While Economic Survey focused on the need to accelerate medium term growth drivers, Union Budget sticked to fiscal consolidation path. Sharp decline in liquidity led RBI to infuse liquidity via temporary and durable measures on war footing indicated the RBI's whole-hearted support to keep liquidity neutral.

India

Union Budget:

FY26 Union Budget revised downwards fiscal deficit (% of GDP) estimate for FY25 at 4.8% (BE: 4.9%). This, despite, moderation in nominal GDP. Further, for FY26, the government has budgeted fiscal deficit at 4.4% aided by - compression of revenue expenditure and buoyant tax receipts, while keeping capex (capital expenditure) as % of GDP intact. This is in line with the government's medium-term glide path (FY21-26) to bring fiscal deficit below 4.5% by FY26. Union Budget also gave medium term glide path for fiscal consolidation (to bring down Central govt's debt/GDP ratio ~50 (Current: 57%) over next five years). Dependence on market borrowing for funding budget continues to remain elevated in FY26 (at 74% vis-à-vis pre-pandemic average of 66-68%).

Monetary Policy:

In the recent February policy (7th February 2025), the RBI cut the policy rate by 25 bps, while keeping stance neutral. The move was in line with the consensus. In the policy, RBI projected Indian economy to grow at 6.7%y/y in FY26, while it estimated inflation at 4.8%y/y and 4.2%y/y in FY25 and FY26 respectively. In his statement, RBI governor asserted to use flexibility embedded in inflation targeting framework to improve macro-economic outcomes, while responding to evolving growth-inflation dynamics. While the RBI has been undertaking proactive measures to provide liquidity since Dec policy, the governor promised to proactively take measures to ensure orderly liquidity conditions.

Economic Growth:

According to the first advance estimate of the National Statistical Office (NSO), the Indian economy grew at 6.4%y/y (lower than 8.2%y/y in FY24 & RBI's expectations of 6.6% y/y). While private consumption is expected to improve, muted government consumption spending from demand side and mining & manufacturing growth from supply side kept the growth lower. Net exports contributed positively to growth.

Inflation:

CPI inflation eased to 5.2%y/y in Dec'24 (Nov 2024: 5.48% y/y, Dec'23: 5.69%y/y). This was in line with the consensus (5.2-5.3%y/y). Although, the base effect was adverse, the sequential decline in monthly food & housing prices and muted momentum in clothing & miscellaneous/services prices helped in bringing down the inflation. Core inflation decline further to 3.58%y/y (Nov 2024: 3.64%y/y; Last year same period: 3.89%y/y).

While Food inflation continued to remain elevated at ~7.7% lvls (Sep through Nov 2024: average 8.8%y/y), all other subindexes continued to remain below/~ 4%y/y lvls. Further, the fuel index is in deflation for the sixteen consecutive months. Excluding veggies, headline inflation rose marginally to 3.67%y/y (Previous month: 3.64%y/y; Dec 2023: 4.48%y/y).

Fiscal:

April-Dec 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 muted on account of record higher devolution to states. Record high RBI dividend resulted in sharp spike in non-tax receipts. During same period, expenditure growth was muted. While the revenue expenditure was modest YTD, capex has picked up recently. As a result, Fiscal deficit stood modest at 57% of budget estimates (Previous year similar period: 55%). January GST print was second highest in fiscal year at Rs. 1.95 trn, although Apr-Jan FY25 GST growth was muted at 9.4%y/y.

External Sector:

Dec'24 Trade deficit moderated to ~US$22 bn (Nov 24: US$32 bn), on muted imports. While the Apr-Dec 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 5.2%y/y driven down by muted core import growth. Dec 2024 net service exports grew robust at 19%y/y and Apr-Dec 2024 growth was robust at ~13%y/y.

After witnessing modest inflows in Dec 2024 (US$3 bn), there were net FPI outflows in Jan'25 (US$9 bn) driven down by equity. With this, Apr 2024-January 2025 witnessed tepid US$1.6 bn inflows (mainly through debt) driven down by global cues.

Global cues (Strong DXY, elevated UST, global risk-off) continued to put pressure on currency for fourth consecutive month and INR depreciated by ~2% during the month. In January, Rupee stood on average 86.64 against dollar (Dec: 84.99; Nov: 84.36; Oct: 84.03; Sep: 83.81). YTD FY25 rupee has depreciated by ~4%, with major depreciation occurring during Oct-Jan period (3.4%)

Liquidity:

After remaining positive (Rs. 1.3 trn) from July through November, system liquidity on an average turned negative in Dec 2024 (-ve Rs. 65,000 cr) and deteriorated further in January (-ve Rs. 2 trn) on back of RBI's forex intervention and seasonal demand for cash. Average Government balances improved to Rs. 1.9 trn in January as against Rs. 1.6 trn in Dec. Further, from the recent peak 4.9 trn at the start of Oct, the core liquidity (system liquidity + Government balances) has sharply declined to ~Rs.72,000 cr by Dec end and -ve Rs. 57,000 cr by mid-January - on RBI's aggressive forex actions. While RBI's CRR cut in Dec policy (~Rs. 1 trn) did not help much in shoring up system and core liquidity, RBI has come out with slew of measures on war footing to infuse the liquidity since then. Through the measures like OMO (secondary market + Primary market), forex swaps and long-term variable repo, the RBI has planned to infuse liquidity to tune of Rs. 1.7 trn

Yield Levels & Spreads:

Fixed income market yields eased during second half of the month on RBI's OMOs announcement. While g-sec yields were range-bound during the first half of month, 10-year G-sec yield eased post OMO calendar announcement (Rs. 60,000 cr) & aggressive G-sec buying by RBI through secondary market (Rs. 30,000 cr). 10 year G-sec yields moved in the range of 6.68%-6.84% during the month (Dec 2024: 6.68%-6.79%;). 10 yr G-sec closed the month lower at 6.69% (Dec 2024: 6.77%). Average 10-year term premia decreased to average~9 bps during the month (Dec 2024: 15 bps).

Like G-sec, 10-year SDL yields eased in second half and moved in the narrow range of 7.06%-7.14% in January (as against 7.05%-7.14% in December) to close the month lower at 7.09% (Dec 2024: 7.11%). January SDL primary issuances stood at Rs.86,944 cr (Dec 2024: Rs. 1,13,291cr). The average spread between 10 yr SDL over G-sec stood at 36 bps during the month (Dec: 34 bps; Apr-Jan FY25 average: 34 bps).

AAA bonds were range bound during the month. 10 yr AAA PSU moved in the range of 7.22%-7.32% (Previous month: 7.18%-7.32%). It closed the month at 7.22% (Dec 2024: 7.20%; Nov 2024: 7.31%).

Global

Monetary Policy:

Jan'25 saw global central banks' actions driven by domestic requirements. While US Fed left policy rate unchanged, ECB, Bank of Canada and Riksbank of Sweden continued to cut during the month, Bank of Japan hiked the policy rate by 25 bps in line with expectations. Going forward, the policy outlook of most Central Banks (CBs) is expected to remain data-dependent, and CBs are likely to prefer gradual rate cutting cycle on back of sharp rise in global uncertainties.

Financial Markets:

Amid the rising uncertainties, US treasury yields continued to harden further during month of Jan'25. While it rose further in runup to US President taking office, it eased thereafter in expectations of gradual increase in tariffs. US 10 Yr Treasury bond (UST) yield moved in the range of 4.52%-4.79% (as against 4.15%-4.62% in Dec 2024) and closed the month flat at 4.58% (Dec 2024: 4.58%, Nov end: 4.18%; Oct end: 4.28%; Sep 2024: 3.81%).

After appreciating sharply by 1.8% and 1.2% m/m in Nov/Dec respectively, the dollar index (DXY) continued to appreciate further by 1.4%m/m in January 2025 on elevated UST yields and risk aversion on global risk-off backdrop.

Market View

- FY26 Fiscal deficit of 4.4% is likely to be viewed positively by the markets, since it indicates that the government is committed to remain on fiscal consolidation path. Government's Medium-term glide path (FY2026-2031) to reduce debt-to-GDP to 50% is step forward in this direction and a big positive for market and rating agencies

- Market continues to remain positive on duration due to RBI's Open Market Operations (OMO) auctions. Especially RBI's buying of 10 yr paper is positive for benchmark.

- Going forward, growth focussed Economic survey, consumption boost via tax cut yet fiscally prudent Budget and RBI's dovish monetary policy is likely to bode well with growth-inflation dynamics and thereby may be positive for fixed income yields. Further, RBI's assurance to ensure orderly liquidity conditions provides further comfort.

- 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. Recent RBI actions provide cues that RBI is likely to remain liquidity supportive.

Common Source:

RBI, CSO, FAO, CEIC, NSO, JP Morgan, US Federal Reserve, US Treasury department, ECB, Bank of Canada, Riksbank of Sweden, Bank of Japan, Budget Documents, Commerce Ministry of India, NIMF Internal Research