Let's Bond with Bonds

In the June 2022 edition of the Debt Market Observer – **Looking Beyond FED**, we made a case that the inflation narrative has peaked. Market developments since then have made us more convinced about the endgame of inflation.

Commodity Crack

Commodity prices have been softening for the last 2-3 months due to moderation in the global growth outlook. Lockdown in China and fear of recession in the US and Europe accelerated the pace of decline in the last 4-6 weeks. Prices of most of the industrial as well agricultural commodities are down upto 50% from their recent peaks.

Table – I: Commodities off-peak on recession fears

	% Price Change from the Peak	% Price Change year till date
Thomson Reuters Core Commodity CRB Index	-13%	23%
S&P GSCI Agriculture Index	-22%	7%
Brent Crude Oil	-17%	37%
Bloomberg Industrial Metals Subindex	-39%	-16%

Source – Bloomberg, Quantum Research, Data as of July 18, 2022

Our inflation estimates were not based on the highest level of commodity prices, so this drop in prices may not materially change the inflation numbers immediately. However, **the upside risk to the inflation estimate this year has gone down significantly.**

If commodities prices stabilize, India's CPI inflation should come below the RBI's upper threshold of 6% by early next year from the current 7% plus. Given the synchronized global monetary tightening and slowing global growth, this seems the most plausible outcome.

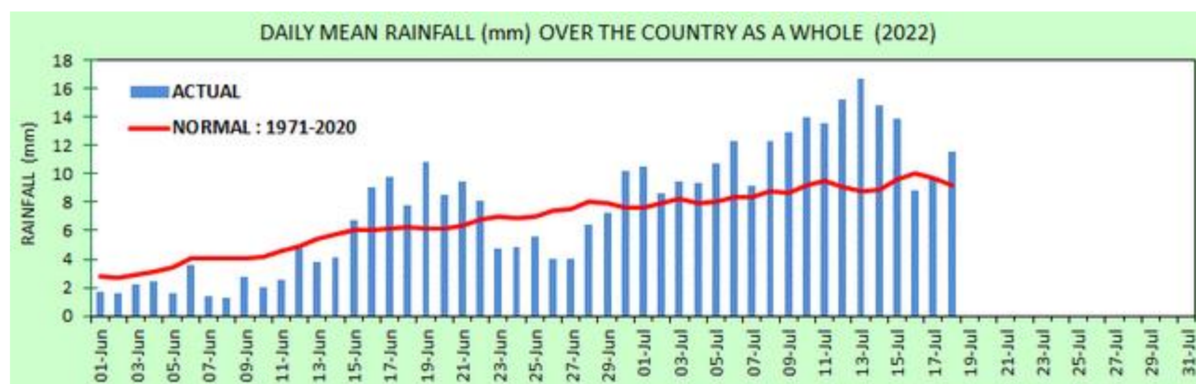
Monsoon on Track

Domestically also things have improved for inflation to cool off. After initial delays, the monsoon has now picked up. Total rainfall between June 1, 2022 to July 18, 2022 is 13% above the long term average rainfall during this period. However, the spatial distribution of monsoon is a bit concerning as the monsoon activity is concentrated in the western and southern regions of the country while the north and east parts are still in deficiency.

Table – II: Total rainfall in surplus; but spatial distribution is poor

Seasonal Rainfall (in mm) since 01 June 2022 till 18 July 2022

Region	Actual	Normal	% Departure from Long Period Average
EAST & NORTHEAST INDIA	500.7	581.0	-14%
NORTHWEST INDIA	175.3	191.3	-8%
CENTRAL INDIA	464.1	348.3	+33%
SOUTH PENINSULA INDIA	383.1	276.9	+38%
COUNTRY AS A WHOLE	365.2	323.1	+13%



Source – India Meteorological Department; data as of July 18, 2022 (https://mausam.imd.gov.in/imd_latest/contents/weather_report.php)

The sowing of kharif crops has also picked up along with the southwest monsoon; though total acreage is still lagging in Rice compared to its last 5 years' trend. Much of the rainfall in the current monsoon season has come in the last two weeks. So, the sowing activity should pick up sharply from here on.

Table – III: Kharif sowing picked up; still lagging in Rice

Crop	Normal Kharif Sowing Area (In Million Hectares)	Area Sown (In Million Hectares)		
		2022	2021	% Year-on-Year Change
Rice	39.7	12.8	15.6	**-17.9%**
Pulses	14.0	7.3	6.7	**9.0%**
Course-cum-Nutri Cereals	18.4	9.4	8.7	**8.0%**
Oilseeds	18.4	13.4	12.5	**7.2%**
Sugarcane	4.7	5.3	5.4	**-1.9%**
Jute & Mesta	0.7	0.7	0.7	**0.0%**
Cotton	12.6	10.3	9.7	**6.2%**
Total	**108.5**	**59.2**	**59.3**	**-0.2%**

Source – GOI Department of Agriculture & Farmers Welfare; Data as of July 8, 2022 (https://agricoop.nic.in/en/weather-watch)

Globally, agricultural commodity prices have started to soften. **A healthy monsoon season should help in easing food prices** in the domestic market as well.

Government's inflation fight

Another notable development during the last one month is the government's move to impose export duties on petrol and ATF at the rate of Rs. 6/litre each and on diesel at the rate of Rs. 13/litre. It also slapped a windfall tax on domestic crude production of Rs. 23,250 per tonne. This would discourage the export of petroleum products and increase the fuel supply in the domestic market.

These measures are estimated to generate Rs. 1.2 trillion in government revenues which could be used to further reduce taxes on fuel items - effectively putting a cap on the petrol and diesel prices or even cutting their prices.

Indian CPI basket has close to 5% weight in petroleum fuel items and around 46% weight in food items. Thus, a reduction in food and fuel prices could sharply bring down the inflation.

Inflation losing Momentum

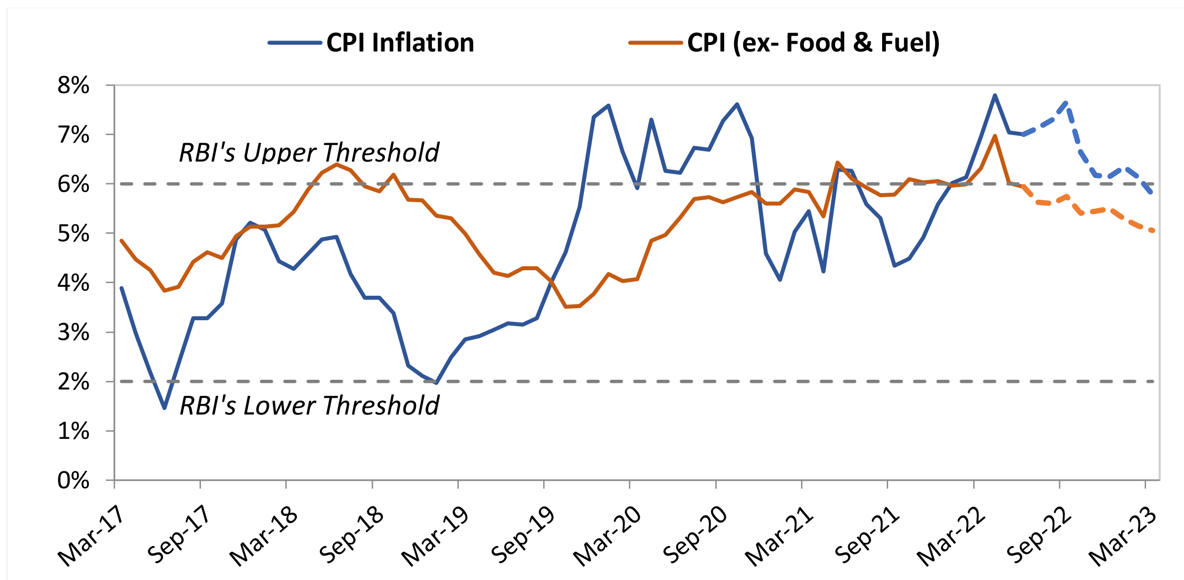
In June 2022, CPI inflation grew at 7.01% YoY, posting the third consecutive month of decline in the headline CPI from 4.05% in May 2022 and 4.8% in April 2022. We found some green shoots in the inflation internals.

Sequential momentum across various high-weightage items like Cereals, Meat & Fish, Spices, Prepared meals and clothing & footwear have softened in June. Prices of Oil & Fats came down due to a drop in global edible oil prices and a reduction in import duties by the Government. While the transport and communication index came down due to an earlier reduction in fuel taxes. Another positive sign was the moderation in the sequential momentum in some of the key services like health care and recreation.

We expect the headline CPI inflation to move up again between July – September 2022 due to the lower base effect from the last year and a seasonal uptick in the vegetable and fruit prices. However, it should come down sharply in the second half of the year.

In the August meeting of the RBI's monetary policy committee, it may deliver another 50 basis points of rate hike to take the repo rate above its pre-pandemic level to 5.40%. However, easing of inflation momentum should take off some pressure and allow the RBI to slow down the pace of rate hikes in the second half of the year. **The RBI may still take the Repo rate to 5.75%-6.00% by early next year to take the short-term real interest rates into positive territory.**

Chart -I: Inflation Elevated; But Likely to Slide Lower

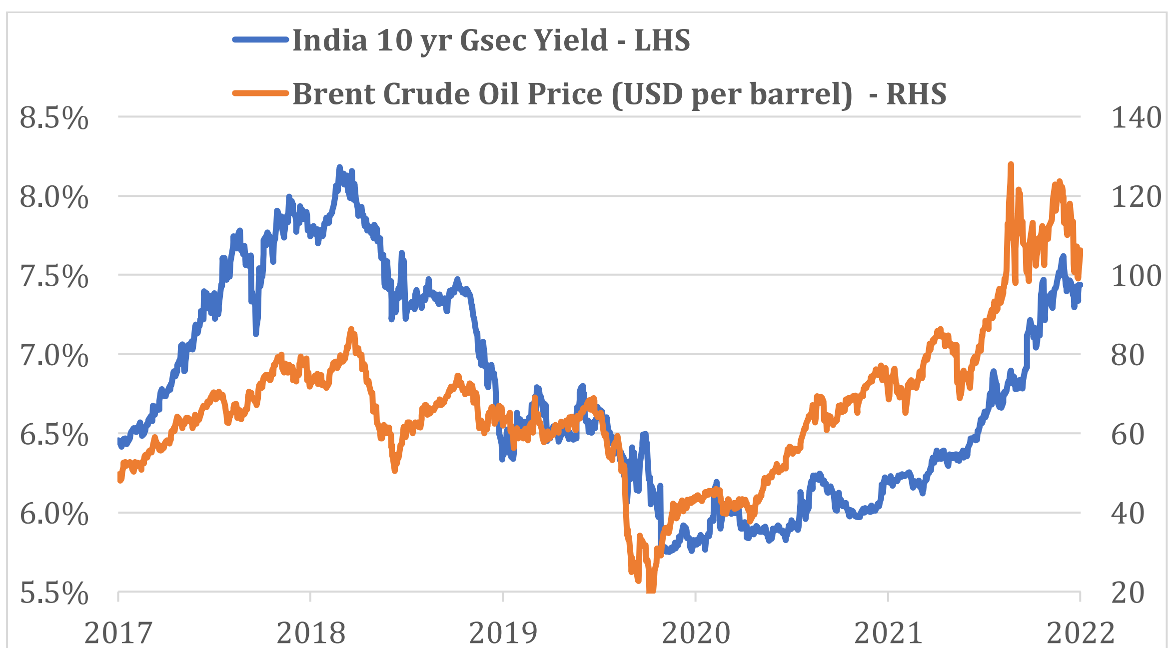


Source – MOSPI, Quantum Research
@Actual Data upto June 2022. Data between July 2022 to December 2022 is based on Quantum Fixed Income Team's Estimates and may or may not turn out the same.

What does this mean for the Bond Market?

Bond yields have come down sharply in the last 4-5 weeks in response to falling commodity prices and falling US Treasury yields. The 10-year Indian government bond yield peaked at 7.60% on June 13, 2022. Currently, on July 18, 2022, the 10-year Indian government bond is trading at a yield of 7.44%.

Chart – II: Moderating Commodity Prices to Cap Indian Bond Yields

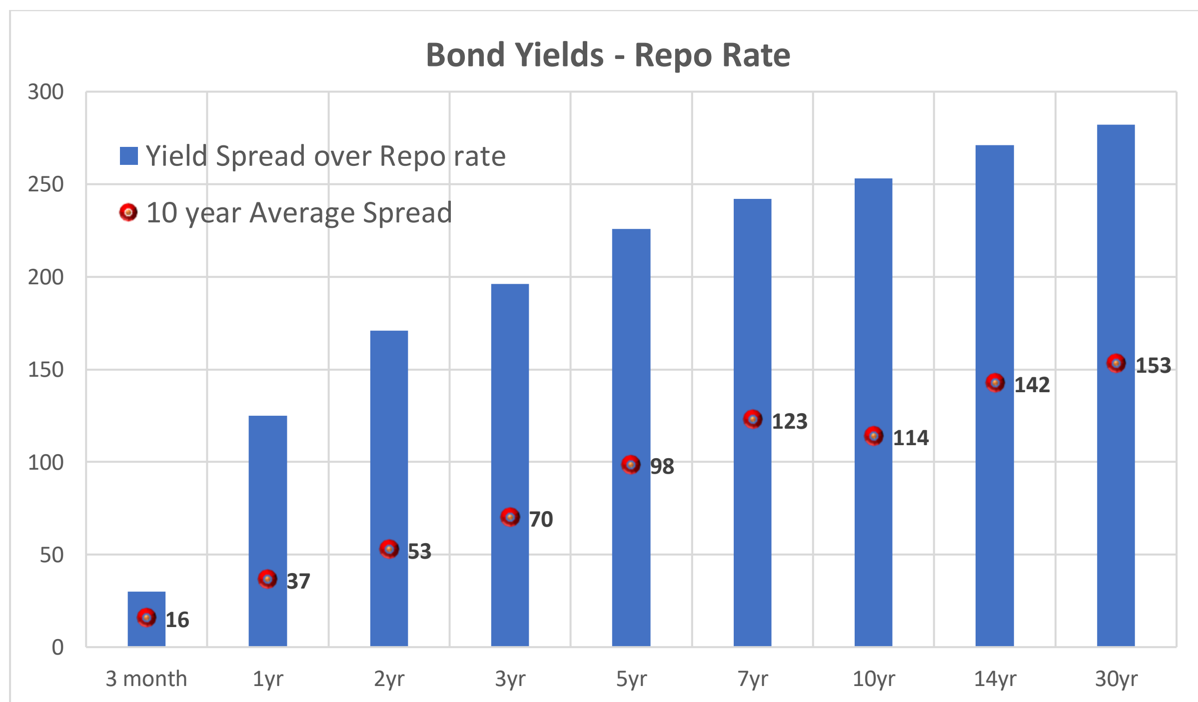


Source – Refinitiv, Quantum Research; Data as of July 18, 2022
Past Performance may or may not sustain

Last month, we wrote to investors that the prevailing valuations at the medium to long maturity bonds had built in a significant uncertainty premium (**Looking Beyond FED**). The recent drop in the bond yields and the consequent compression of yield spread on medium to long duration bonds over the repo rate, has lowered the uncertainty premium somewhat.

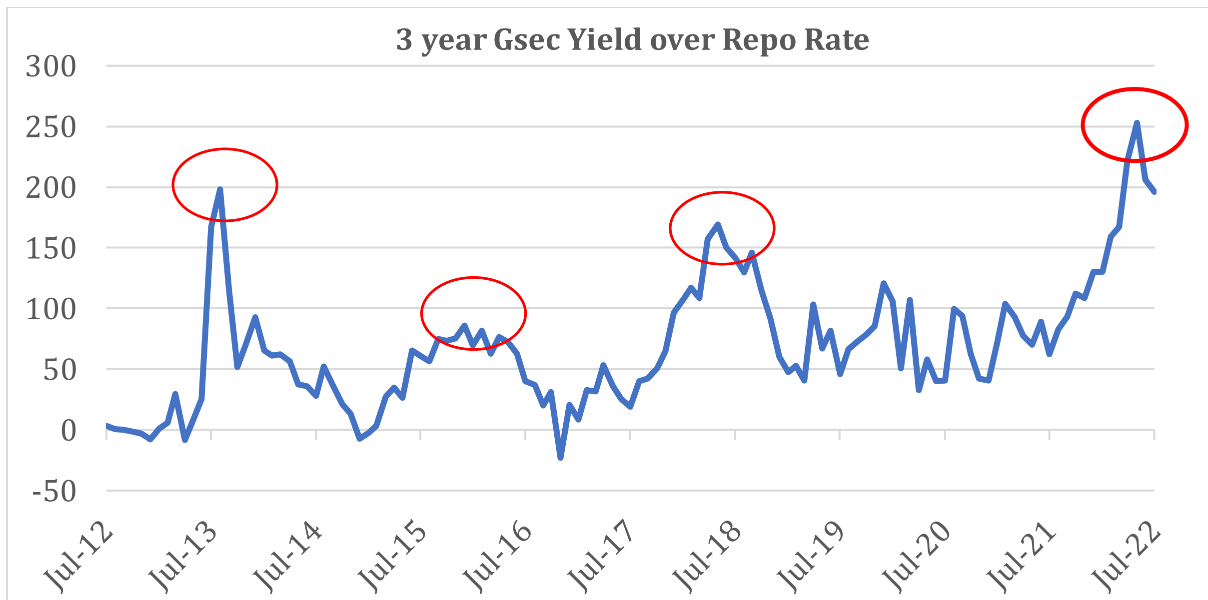
However, term spreads (yields on long-term bonds over shorter maturity bonds or the repo rate) are still significantly higher than their long-term averages. At 6.88% yield, the 3-year government bond is currently trading at about 200 basis points above the policy repo rate of 4.90%. The long-term average of this spread in a tightening interest rate environment is ~80 basis points.

Chart – III: Yield Spreads over Repo Rate are significantly above their long term averages – pricing for potential rate hikes, demand-supply imbalance and other uncertainties.



Source – Refinitiv, Quantum Research; Data as of July 18, 2022
Past Performance may or may not sustain

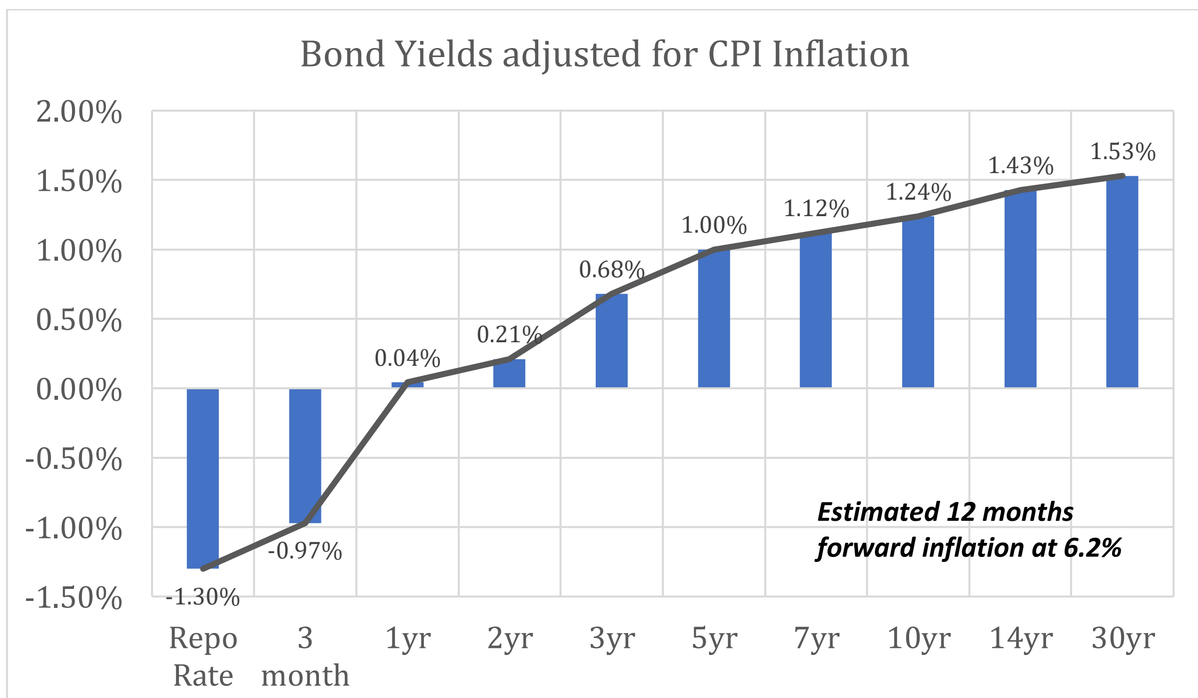
Chart – IV: Bond Valuations have built-in significant uncertainty premium



Source – Refinitiv, Quantum Research; Data as of July 18, 2022
Past Performance may or may not sustain

Even in terms of real rates (interest rates/bond yields – expected inflation rate), the yield on government bonds beyond 1 year maturity is now above the average 12 months' forward inflation estimate. Our estimate of 12 months average forward inflation (simple average of expected monthly inflation estimates from July 2022 till June 2023) is around 6.2%.

Chart –V: Real rates are now in positive territory beyond 12 months term



Source – Refinitiv, Quantum Research; Data as of July 18, 2022
@ Real rates are calculated based on forward 12 months CPI inflation as per the Quantum Fixed Income Team's Estimates; Future estimates may or may not turn out the same.
Past Performance may or may not sustain

Outlook

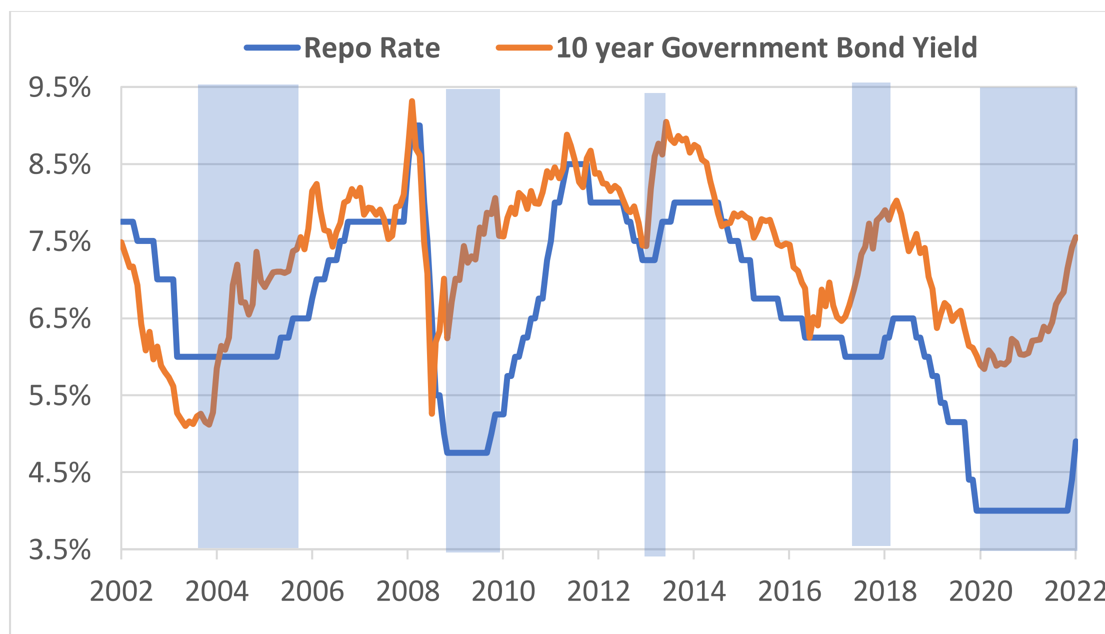
Markets tend to pre-empt policy moves. Yields on medium to long term bonds had moved up over the last 12 months to price for the rising inflationary risks and potential rate hikes by the RBI.

At current valuations, much of the potential rate hikes are already priced in the medium to long duration bonds. **<u>Thus, the bond market may not be too sensitive to RBI's rate hikes going forward.</u>**

<u>As the RBI delivers on the expected rate hikes, short-term interest rates – yield short-term treasury bills etc. should move higher proportionately. However, long term bond yields may remain in a tight range or move up only marginally.</u>

We found a similar trend in past. In all the previous rate hiking cycles, maximum jump in yields had happened up until the first-rate hike. Thereafter, yields moved up only marginally or got stuck in a narrow range.

Chart – VI: Bond Market has run ahead of the Policy rates; Much of the potential Rate Hikes are already Priced



Source – Refinitiv, Quantum Research; Data as of July 18, 2022
Past Performance may or may not sustain

There is still a risk of yields moving up due to an unfavorable demand-supply balance. Long-term bonds (above 5 years maturity) are more exposed to this risk as their prices are more sensitive to interest rate changes. When market interest rates rise, long term bond prices fall more compared to prices of shorter maturity bonds.

Since we are in a rising interest rate environment, at this stage our goal should be to have higher accrual with a lower maturity/duration. In our opinion 2-5 year maturity bonds offer this critical balance between accrual (interest income) and duration (price changes).

Portfolio Positioning

In the Quantum Dynamic Bond Fund (QDBF), we have been avoiding long-term bonds for some time due to our cautious stance on the markets. The defensive positioning helped the portfolio ride through the market sell-off over the last 6 months.

The bulk of the QDBF portfolio is currently positioned in the 1-3 years maturity bonds. We continue to like the 2-5 year segment of the bond market and maintain our cautious stance on the above 5-year maturity bonds.

However, we would remain open and nimble to exploit any market mispricing by making a measured tactical allocation to any part of the bond yield curve as and when the opportunity arises.

We stand vigilant to react and change the portfolio positioning in case our view on the market changes.

What should Investors do?

The interest rate on short-term treasury bills has jumped about 160 basis points (1.6%) in the last 6 months. With more rate hikes coming, short-term treasury bill rates are expected to move higher in the coming months. This suggests higher potential returns from investments in liquid and debt funds going forward.

Since the interest rate on bank saving accounts are not likely to increase quickly while the returns from liquid funds are already seeing an increase, investing in liquid funds looks more attractive for your surplus funds. Investors with a short-term investment horizon and with little desire to take risks should invest in liquid funds which own government securities and do not invest in private sector companies which carry lower liquidity and higher risk of capital loss in case of default.

Investors with more than 2-3 years holding period can consider dynamic bond funds which have the flexibility to change the portfolio positioning as per the evolving market conditions.

Medium to Long term interest rates in the bond markets are already at long-term averages as compared to fixed deposits which remain low. With higher accrual yield (interest income) and relatively lower price risk (compared to the last two years), dynamic bond funds are appropriately positioned to gain.

However, investors in debt fund dynamic bond funds or any other medium to long-term debt funds should be ready to tolerate some intermittent volatility associated with the movement in the market interest rates.

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