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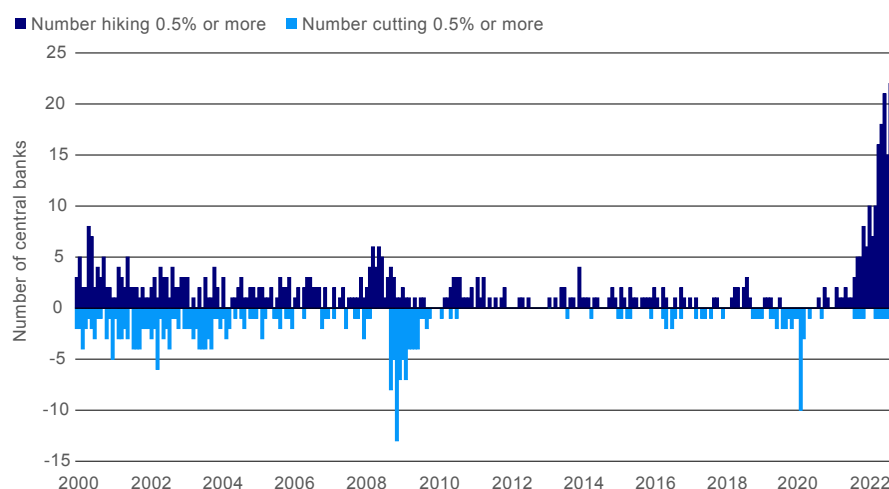


**After a painful 2022, Year 2023 is expected to bring a fresh life to Fixed Income market as risk-reward turn favourable**

## Year 2022 – one of the most painful years for Fixed Income Markets

Year 2022 proved to be yet another year dominated by unprecedented events causing heightened volatility across the global financial markets. While the year started on a positive note with many countries coming out of Covid-19 led disruptions owing to the massive vaccination drive, it was soon eclipsed by Russia-Ukraine conflict which took everyone by surprise with significant surge in global commodity prices. Many developed countries touched multi decade high inflation forcing Central Banks to embark upon one of the most aggressive rate hiking cycles. Currency market turned even more volatile as the market forces oscillated between inflation vs. recession fears in many developed countries.

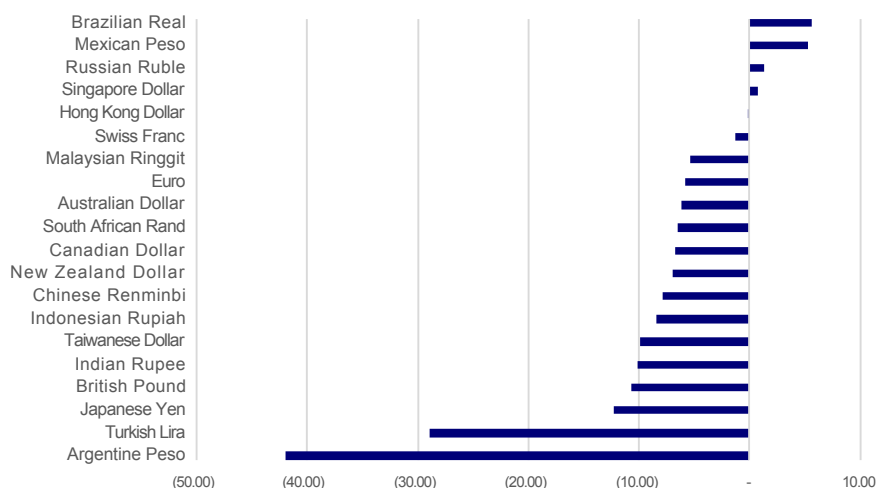
## Global Central Banks have hiked rates aggressively in 2022



Note: Number of central banks among 38 leading central banks. The number of central banks hiking or cutting rates is measured on a one-month rolling basis.

Sources: Macrobond and Bank for International Settlements, September 30, 2022.

## % Change in Major currencies in 2022

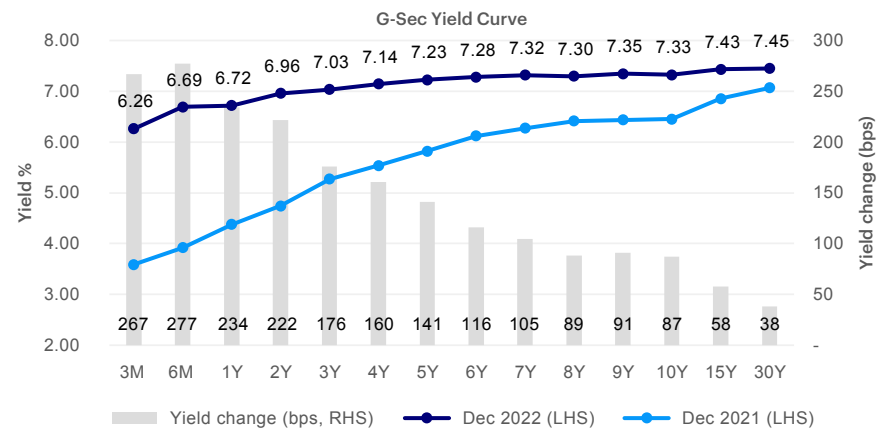


Sources: Bloomberg

India also saw a paradigm shift in interest rates during the year as RBI tightened the monetary policy aggressively in response to global factors and elevated domestic inflation trajectory. Debt investors were adversely impacted with high mark to market hit as domestic interest rates hardened sharply during the year with a flattening bias.

Few of the key themes in 2022 are worth highlighting –

- India managed the Covid-19 situation much better than many other countries.
- Healthy rebound in economic activity led by domestic strength; domestic financial stability showed resilience with no major credit defaults / worsening of asset quality.
- INR came under heavy pressure as USD strengthened sharply and as India struggled with high current account deficit & large FPIs outflows.
- Inflation became the devil forcing RBI to switch gears from growth supportive to inflation controlling measures.
- No inclusion of Indian sovereign bonds in global bond indices came as a disappointment against market-wide expectations.
- G-sec yield curve got elevated upwards by 90 – 235 bps (1 – 10 year segment) with a sharp flattening bias.
- Despite the sharp hardening of interest rates, all the debt scheme categories delivered positive 1 year return with most of the scheme categories in 3% - 5% range. Source: MFI Explorer



Sources: Bloomberg

### **Year 2023: Expected to bring a fresh life to fixed income market as risk-reward turn favourable**

2023 has commenced on a positive note with many Central Banks already starting to moderate the rate hikes from the so-called jumbo ones as the inflation trajectory has reversed. This indicates the market conditions returning to a more normal level. As the global growth slowdown / recession fears take the centre stage during the year, correction in global commodity prices, better resolution of supply chain bottlenecks and most critically - relatively stable currency market points to a benign environment for interest rates, especially as the rates are already highly elevated.

We see 2023 as a tale of two halves –

#### **First half: the peak of interest rates in current rate hike cycle**

With peak global inflation behind us and the downward trend in inflation trajectory likely to continue on back of high base effect, price correction in global commodities, demand slowdown, especially in goods & better supply chain management with China opening up, fears of global recession & large cumulative rate hikes moderating, we believe global monetary policies are towards the last leg of rate hikes. As US inflation comes below 5% by April 2023, we expect US FOMC to reach the peak policy rate of 5% - 5.25% by early 2023 before taking a pause.

Similarly in India, MPC has moderated the rate hike to 35 bps, which is also the lowest quantum in the current rate hike cycle (40-50 bps

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rate hike in last four policies). At the same time, MPC has continued to maintain its caution on inflation highlighting the sticky core inflation, higher demand-pull factors and global uncertainties that can pose upside risks to the inflation trajectory. MPC's decision to continue with "withdrawal of accommodation" stance indicates that the rate hiking cycle is not over yet. Given the current global as well as domestic indicators, we expect MPC to undertake one final rate hike of 25 bps in Feb 2023 to reach a peak policy rate of 6.5%. This may provide a safety cushion to absorb the global spillovers to an extent. India's Foreign Exchange (Fx) reserves have also improved over last few weeks which has provided some relief. Any further rate hikes beyond a policy rate of 6.5% would be more determined by the global factors than the domestic factors.

While the markets have largely factored in the peak policy rates, a marginally higher actual peak policy rate (by ~25 bps) may not be very disruptive for markets as long as it is supported with no further risk of rate hikes later. Accordingly, we expect the interest rate volatility in first half of 2023 to be much lesser as compared to the previous year.

### **Second half: Expectations on timing of rate cuts by US FOMC & subsequently by RBI**

This can turn out to be a tricky phase as the market waits for monetary policy pivot amid growth slowdown and as the Central Banks continue to maintain their resolute to bring back the inflation closer towards the long-term target.

Even as the US inflation has begun its downward trajectory, it may still maintain a gradual decline given the tight jobs market, broadened inflation basket, especially the services which are typically more persistent in nature, relatively higher energy prices fuelling the high inflation expectations and healthy corporate balance sheets to withstand the demand slowdown pressure for longer. Unlike in the past, Central Banks may be more inclined towards inflation control even if it means some sacrifice on growth, and this could warrant higher policy rates for longer as against the market wide expectations of US FED starting a rate cut cycle by early 2H CY23.

We expect India also will see a prolonged rate pause cycle well into 2024 as the inflation continues to remain elevated in the range of 5.25% - 5.50% (average of CY23) due to sticky core inflation, healthy domestic economic recovery, pass through of higher input costs to consumers, expected fiscal expansionary measures of central government and global uncertainties. RBI has sounded cautious on inflation as it has retained FY23's inflation projection at 6.7% and 1HFY24's inflation projection at 5.2% reflecting that the inflation may take longer to reach closer to the long-term inflation target of 4%. We believe RBI would maintain its tight vigil on inflation (including core inflation) and bring it below 6% as the first step and then reach closer to the long term target of 4% over a period of time.

As the market expectations get reset for a delayed start of rate cut cycle by Central Banks than what is currently factored in, it may cause some volatility of interest rates, especially in the longer tenor segment.

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### **Key investment themes for 2023**

- **Economy** is expected to witness slowdown in FY24 largely led by global factors. Nonetheless, domestic demand & fiscal measures are expected to provide support to maintain a healthy GDP growth rate of 5.75% - 6.00% in FY24 making India one of the fastest growing economies.
- **Inflation** may moderate to come within the RBI's threshold of 6% but still remain elevated in the range of 5.25% - 5.5% in CY23 and far from 4% long term target.

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- Central Govt is expected to keep the **fiscal expansionary budget** in FY24 to support infrastructure push, especially in the last budget before general election in 2024. Fiscal deficit of 5.8% - 6.0% would mean yet another year of record fiscal supply.
  - RBI to maintain **higher rates for longer** after peaking out in early 2023.
  - Even as USD gives up its strength in 2H CY23 as US slips into recession & FOMC takes a pause, **INR's appreciation bias may be capped** as India remains high on current account deficit and RBI replenish its Fx reserves.
  - **Favourable risk-reward in 1 to 5 years segment** presents an opportunity to benefit from already elevated interest rates with global & domestic rate hike cycle expected to peak in early 2023. Further 2023 is expected to be a year of **lesser interest rate volatility** as compared to 2022.
  - Delayed rate cuts as inflation may still remain elevated and yet another year of elevated fiscal supply may impart **some pain in longer – 5 yr+ segment**. G-sec yield curve in 5 - 10 years segment is already very flat (~10 bps) and SDL as well as corporate bond spreads in this segment are very narrow thereby not having much of a safety cushion against these risks.
  - **AAA Credit spreads to widen** especially in 5 to 10 years segment and non-AAA credit spreads to widen across the maturity as the issuances pickup and systemic liquidity further dries up.
  - Large part of returns will be contributed by **high accrual** with no meaningful capital gain opportunity in CY2023.

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#### **High quality investment portfolios with staggered maturity up to 5-year segment provides the best risk-reward opportunity**

Year 2023 will be the inflection point for debt investors as they would see the risk appetite returning to normal with attractive investment opportunities across the curve, especially upto the 5-year segment. Global & domestic monetary policy cycle is expected to peak out in early 2023, which provides visibility to the short - medium tenor segment. However, elevated fiscal supply, the possibility of delayed rate cuts and credit spread widening may continue to provide headwinds to the longer tenor segment.

With this backdrop, we believe actively managed and high credit quality debt schemes like Low Duration Fund, Short Term Fund, Corporate Bond Fund & Medium Duration Fund, which are largely deployed across 1 to 5 years segment as a layered approach are suitably placed to provide not only a high accrual but also the flexibility to capture upside capital gain potential over the medium term by actively managing the duration.

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#### **Active Funds may be better placed over the longer tenor passive strategies at the current juncture**

Target maturity funds have emerged as a go-to destination for debt investments especially, over last 1 – 1.5 years and rightly so as they helped the investors to mitigate mark to market risks amidst extreme volatile market conditions by exactly mapping their investment horizon with the specific target maturity funds. While we remain constructive on the target maturity funds for meeting time specific investment requirements, we believe actively managed funds provide better investment opportunities as of now as we near the peak in interest rate cycle.

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### **Healthy credit environment but non-AAA credit spreads have a long way to go up**

Credit environment remains healthy with more number of credit rating upgrades than downgrades on every month basis on the back of economic recovery, robust equity markets, lower borrowing costs and much stronger balance sheet of Banks & Corporates. Even with the rise in interest rates and expected growth slowdown, we expect improving credit trend to continue as the overall leverage of Corporate Inc has reduced considerably over last few years. To say the least, we don't expect any worsening of credit in 2023-2024. However, current narrow spreads of AA / AA+ over AAA bonds do not provide favourable risk adjusted reward opportunities as the lack of issuances over last few years have kept the credit spreads significantly lower than the historical average. With lower systemic liquidity going forward & bank's credit growth hovering at 17% - 18%, we expect non-AAA segment issuances to pickup in 2023 which will force the credit spreads to widen back to the normal levels. Accordingly, we advise investors to remain contained with high quality AAA issuers along with few select AA rated issuers and wait for better entry points once the economic recovery has become much more sustained & at better credit spreads as the issuances pick up.

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### **Risks to be watched out for, mostly global in nature**

As Central Banks undergo an aggressive rate hike and quantitative tightening cycle, the risk of global financial crisis is elevated. The potential of policy errors was exemplified by the events in UK where fiscal expansionary policy was rejected by the market and was forced to be reversed but not before causing immense global volatility. BoJ's changes in yield curve control with higher targeted yield can be one such potential event which can change the global contours thereby causing extreme volatility. China opening up trade with its infrastructure push to fast pace the economic recovery can result in flare up of prices of global commodities thereby complicating the Central Bank's fight against inflation. While Russia - Ukraine conflict has become a new normal in its current form, any fear of use or even the talk of nuclear weapons can significantly escalate the geo-political tensions thereby causing a massive flight to safety, not so positive for Emerging market assets. Any meaningful escalation in attempts of China to reunify Taiwan is expected to open a new geo-political front leading to supply side disruptions and a global risk-off. Any such global risk-off event may also inflict indirect pain to Indian fixed income market as the capital outflow picks up and current account deficit widens more with global growth slowdown thereby putting pressure on INR & hence on domestic monetary policies.

At home, we expect the domestic risks to be largely contained. Monetary policy may be more of a fine tuning as it soon closes on a peak policy rate. Fiscal policy may continue with the gliding path of consolidation (to reach 4.5% fiscal deficit by FY26) though more back ended. Credit environment looks favourable for now. A key risk to our base case of interest rates higher for longer can come from any sharp slowdown / deep growth recession forcing the Central Banks to pivot much earlier.

Macro Indicator	Expectations
Repo Rate	6.25% - 6.5% (2023 end)
GDP	5.75% - 6% (FY24)
Inflation	5.25% - 5.5% (average for CY23)
Fiscal Deficit	5.8% - 6.0% (for FY24)
Currency	82 – 85 (for CY23)
Benchmark G-Sec	7.35% - 7.60% (2023 end)
Brent Crude	85-100 (2023 end)
Gold	NA

Source: Internal, based on our views.

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