

Year 2024 is going to be a pivotal year for global fixed income market: India is in a sweet spot!



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2023 really tested the patience of global fixed income market as the growth dynamics (particularly US) and jobs market proved to be much more resilient to aggressive rate hikes & quantitative tightening undertaken by FOMC, which forced the narrative to quickly change from hard landing of US economy (in the beginning of the year) to soft landing (by mid year) leading to **"Higher rates for Longer"**. If that itself was not good enough, US government also conducted elevated fiscal borrowing, possibly at the worst time as its two of the biggest investors – China & Japan reduced their incremental buying. Middle-East geo-political tensions erupted out of nowhere and added to the jitters, though briefly only. Overall, what was expected to be a relatively less volatile year for rates turned out to be quite a roller coaster, as reflected in the US 10-year treasury, which touched 5% yield during the year and oscillated ~175 bps. Emerging Markets (EMs) were largely insulated to global mayhem and showed a clear divergence from Developed Markets (DMs) on the back of timely monetary policy actions and prudent fiscal policies.

2024 in all probabilities will prove to be a **pivotal year for global fixed income market**. FOMC has peaked on policy rates as growth-inflation dynamics and jobs market has finally started to show signs of re-balancing. US economy is expected to enter soft landing & inflation to moderate further in 1H CY24, prompting FOMC to start a rate cut cycle possibly by March 2024 thereby paving a way for series of rate cuts in CY2024. ECB has sounded hawkish as of now but is soon expected to pivot as Europe growth struggles even more and is expected to carry out more aggressive rate cuts. Other DMs are also expected to follow suit. EMs will also start the rate cut cycle although the extent of rate cuts is expected to be lesser than DMs. Bank of Japan on the other hand, may gradually start phasing out the ultra-loose monetary policy.

Indian Fixed Income market is particularly placed in a sweet spot on many counts

1. **FY 2025 inflation** is expected to moderate further to 4.5%-4.75% from ~5.4% in FY2024 on the back of global growth slowdown and broad-based moderation in domestic core inflation basket. Still concerning food inflation is expected to be better addressed by fiscal measures. Healthy correction in crude prices gives room to central government to cut down on fuel prices, especially before the General elections in May 2024. Headline inflation is expected to be meaningfully in the ~4.5%-4.75% range 2QFY25 & onwards, indicating a steady decline towards the long-term target of 4%.
2. Amidst the global rate cut cycle, India is also expected to embark upon the rate cuts, possibly in 2QFY25, as the headline inflation recedes to ~4.5%-4.75%, current policy rate at 6.5% leaves the positive real policy rates at an elevated 175-200 bps. This should give room to MPC to cut down the policy rates by cumulatively ~75 bps over a period while still keeping the policy rates restrictive enough to keep inflation expectations anchored.
3. Even before the actual policy rate cuts, MPC is expected to precede with **stance change from "withdrawal of accommodation" to "Neutral"** and maintain **relatively better systematic liquidity** conditions by 1QFY25 which has been in deficit since October 2023. This will help in reversal of a stealth 25 bps rate hike undertaken by RBI through liquidity tightening that had resulted in the operative rate at 6.75% instead of a policy rate of 6.5%.

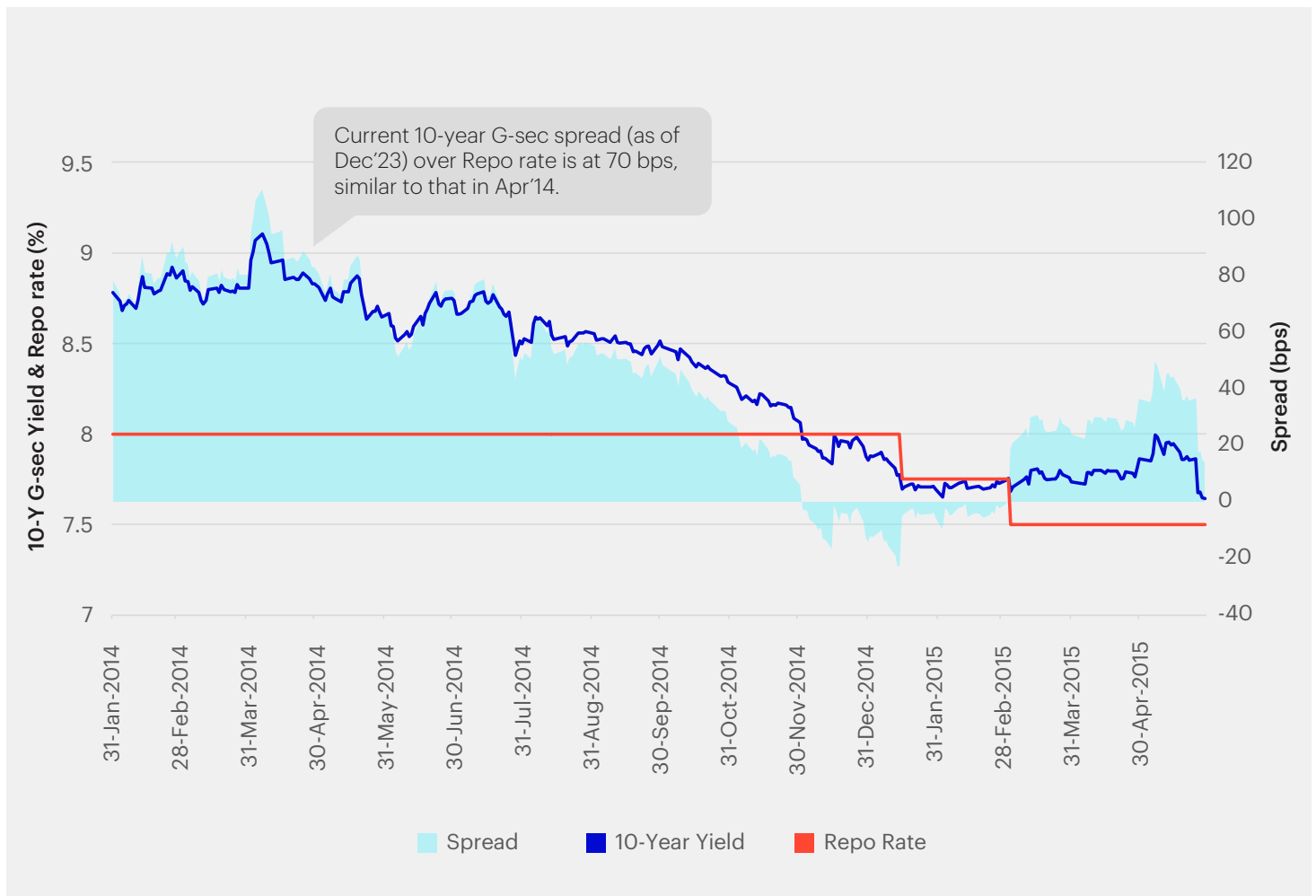
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4. **Fiscal consolidation to continue** with FY25 fiscal deficit close to 5.5% down from ~5.9% in FY24. A stable political landscape with expectation of current central government to come back in power in 2024 will help the government to stay focussed on reforms & capex-oriented budget.
 5. **Economic growth is expected to stay healthy** even as FY25 GDP growth is expected to moderate to 6.0%-6.5% from ~7% in FY24, thereby making India as one of the fastest growing countries. While the fiscal capex push may slow down with fiscal consolidation, private capex and domestic consumption are expected to remain healthy.
 6. **INR is expected to remain well supported** and remain in the range of 80-84 against USD in FY25 as USD loses strength with FOMC rate cuts and favorable growth rate & inflation differential between US & India. FDI / FPI inflow are expected to remain healthy in FY25 with robust domestic fundamentals and Current Account Deficit (CAD) at manageable levels. Healthy Fx reserve at ~USD 620 bn (as on Dec 22, 2023) provides meaningful cover to absorb global volatilities to an extent.
 7. Inclusion of Indian sovereign bonds in JP Morgan global debt index will be an **icing on the cake** with expected inflow of ~USD 20-25 bn in FY25 which can absorb close to 15% of fiscal supply in FY25. This makes Indian fixed income market far better placed on demand-supply dynamics than many others which are still struggling with elevated fiscal supply pressures. Possible inclusion in another global debt index will further enhance the inflows.
 8. **Risk factor to watch-out emanates from global energy prices** (read as Crude prices) led by geo-political risk or further cuts in oil production by OPEC+, and **supply side disruptions** again caused by geo-political risks which can change the expected course of inflation moderation and thus the monetary cycles. The BoJ which is expected to phase out its ultra-loose monetary policies may leave an impact on global fixed income if tightened too aggressively. US's fiscal policies, as it goes into presidential election in 2024, will also be critical and any major expansion can haunt the global markets again.
 9. Overall, **risk-reward has turned favorable** at current juncture with benign fundamental & elevated yields across the yield curve with maximum potential at long duration on the back of expected rate cut cycle. Currently, 2-3 yr high quality corporate bonds are yielding 7.70%-7.80% levels at a spread of 120-130 bps over Repo rate, reflecting prevailing tight liquidity. Also, 10-yr G-Sec is close to 7.20% and the interest rate differential with US 10-yr G-Sec has now widened to ~335 bps from ~240 bps in October 2023 as Indian rates have not reacted much to global rates rally. While the near-term volatility may remain high mainly coming from global factors, any large upside on yields is expected to be limited on the back of India's inclusion in global bond indices and healthy buying at current absolute levels.
 10. **Time to go long on duration** with increased allocation toward funds like Gilt fund, Dynamic bond fund, Medium duration fund, Corporate bond fund, Banking & PSU funds etc. which can provide participation in 5-yr + segment. One should not wait to see the start of actual rate cut cycle. Markets, being forward looking will react much in advance to the expected policy stance change followed by rate cut cycle thereby upfronting the returns through spread compression over policy repo rate. Active fund management is critical as uncertainties may emanate from domestic inflation, fiscal supply and global backdrop which may influence various yield curve segments differently.

Period of 2022-2023-2024 is turning out to be like 2013-2014-2015 for fixed income market -

2013 saw steep rate hikes by RBI in response to global taper tantrums followed by year of consolidation in 2014 with only one early rate hike and then rate cuts in 2015. In a similar way, 2022 saw steep rate hikes by RBI in line with global rate hikes, 2023 was a year of consolidation with only one early rate hike and now 2024 is expected to see the start of the rate cut cycle. The current 10-yr G-Sec at ~7.20% is at ~70 bps spread over Repo rate, similar to that in April 2014 and that the spread reduced & even turned negative even before the start of actual rate cut cycle in Jan 2015 (pl refer chart below) as the market moved much in advance with anticipation of rate cut cycle.

We have to see how the next 12-15 months evolve for fixed income market, but clearly the stage is set with strong fundamentals and still elevated yields for increased allocation towards high duration fixed income funds.

10 Y G-sec Yield v/s Repo Rate- Spread



Data source: Bloomberg.

Disclaimer: The purpose of the above chart is to explain how 10-year G-sec, repo rate and spread moved during the period under analysis. The information alone is not sufficient and shouldn't be used for the development or implementation of an investment strategy. It should not be construed as investment advice to any party.

Notes:

- FOMC - Federal Open Market Committee
- ECB - European Central Bank
- MPC - Monetary Policy Committee
- GDP - Gross Domestic Product
- FDI - Foreign Direct Investment
- FPI - Foreign portfolio investment
- Fx – Foreign Exchange
- RBI – Reserve Bank of India

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