Invesco Mutual Fund

CY 2024 turned to be a pivotal year, though volatile. Year 2025 may also see heightened global volatility.

Indian fixed income market to remain resilient & favourable

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CY2024 started on a positive note as US's Federal Open Market Committee (FOMC) took a pivotal turn in Dec 2023 by ending rate hike cycle and triggering market expectations of US rate cuts as early as Feb'24 & that too of steep 150 bps rate cut in CY2024. However, the exuberance was short lived as inflation remained elevated and US's economy defied the recession / soft landing, which forced the market to moderate rate cut expectations leading to US treasury yields surging quickly. Even though with a delay, 2024 was still a pivotal year as FOMC finally started the rate cut in Sep'24 with a significant 50 bps rate cut, followed by another 25 bps rate cut in each of the two subsequent policies. Almost all other major Central Banks including many of Emerging Markets (EM) also started the rate cut cycle as inflation moderated and supporting the economic growth became the priority. However, US's presidential results with clean sweep by the Republican Party has once again changed the tides as the market grapples with US policy uncertainty. All in all, CY2024 turned out to be a volatile period as reflected in US 10 year treasury yields oscillating by more than 100 bps and surging by ~70 bps to end the year at ~4.60%.

Indian Fixed Income market exhibited strong resilience to global spillovers and was largely driven by robust domestic fundamentals like stable political landscape, healthy growth, manageable current account deficit, robust Forex (Fx) reserves, relatively stable currency and very low foreign investors holding in domestic G-Sec. However, at the same time domestic inflation remained elevated on account of frequent food price shocks forcing RBI to remain hawkish on inflation & maintain high policy rates – possibly among one of the few large Central Banks which has not delivered any rate cut in CY2024. Banking liquidity also remained tight for most part of CY2024 thereby keeping the short end yields elevated.

Despite a hawkish Central Bank, domestic G-Sec rallied by 35-40 bps across the curve in CY2024 thereby bucking the global trend of hardening yields, on the back of favourable demand-supply dynamics. India is one the few countries going through a fast-paced fiscal consolidation which helped in reducing overall G-Sec supply, while already healthy domestic demand got further boosted by foreign investments with India's sovereign bonds inclusion in 3 global EM debt indices – JP Morgan, Bloomberg & FT Russell. Overall, CY2024 was a very special year in which domestic yields were largely driven by India specific demand-supply favourable dynamics and not much by the conventional rate-cut cycle & global factors.

Year 2025 also brings an element of global volatility as Mr. Trump takes Presidential office in Jan'25 and implement his policies of higher import tariffs, bigger fiscal spends, corporate tax cuts and anti-immigration rules. Some of these policies may have a potential of shortening US rate cut cycle, raising volatility in global financial market and more so – currency pressure for the EM countries.

We believe Indian fixed income market will remain insulated largely on the back of strong fundamental factors & be at a sweet spot in 2025 as well given favourable demand-supply dynamics for G-Sec and as RBI embarks upon the rate cut cycle over next few months with moderation in inflation. Risk to our view may emanate more from global front if US policies create elevated volatility in currency market which can force the Central Banks to turn hawkish to protect their currencies.

Some of the factors that will influence the Indian fixed income market in CY2025

1. **FY2026 inflation is expected to moderate further** from ~4.7%-4.8% in FY25 and come closer to RBI's long-term target of 4%. CY2024 saw elevated headline inflation led by regular food inflation shocks even as the core inflation remained well below 4%. FY26 is expected to see convergence of headline inflation & core inflation with elevated food prices seeing respite as healthy water reservoir levels support the Rabi crops. Base effect is also expected to be conducive. Notwithstanding, as witnessed in CY2024, any unexpected erratic weather conditions can impart food price shocks and derail the inflation moderation. Much feared US policies under Mr. Trump may result in growth-inflation diversion across countries and if EM countries growth is impacted more, it may indeed help in further moderating the domestic inflation.

2. **FY2026 growth is expected to recover** after getting impacted in 1HFY25, but it is still contingent on many factors. International Monetary Fund (IMF) has forecasted CY2025 global growth at 3.2% y-o-y, unchanged from 3.2% in the previous year, however the mix could be different with slower growth in China, India, US, offset by improved growth in Euro zone and Japan. Political uncertainty as well as US's policy fears may pose downside risk to global growth. India is expected to remain relatively better with stable political landscape, Government's strong measures on capex led reforms and recovery in domestic consumption. However, private capex needs to improve meaningfully to offset the slowing growth in public expenditure amidst Government's ongoing fiscal consolidation.

3. **Domestic rate cut cycle is expected to start from Feb 2025** although we expect a shallow rate cut cycle of 50-75 bps. Monetary Policy Committee (MPC) in its previous two policies has started easing out already, first with a policy stance change and then with a 50 bps Cash Reserve Ratio (CRR) cut. Even as unexpectedly low 2QFY25 Gross Domestic Product (GDP) growth at 5.4% necessitated a policy response, MPC opted to stay cautious in Dec 2024 policy as inflation remained elevated at 6.2% in Oct'24 and later drifted lower to 5.48% in Nov'24. Feb 2025 will be a crucial policy as growth may surprise on the downside and headline inflation is further expected to moderate in FY26, driven by receding food inflation. While the growth is expected to recover in 2HFY25, it would still be a challenge to grow at ~7% as RBI's projection (6.8% in 3Q and 7.2% in 4Q) amidst weaker fiscal impulse, global growth overhang and currently prevailing tight monetary policy. RBI has projected 4% inflation in 2QFY26 and we expect RBI in its Feb 2025 policy to project close to 4% inflation for FY26. As the targeted inflation comes in sight and growth surprises on downside, we expect MPC to deliver its first rate cut in Feb 2025. However, we expect a shallow rate cut cycle of 50-75 bps as global uncertainty may remain high which could put pressure on INR thereby restricting MPC's ability to deliver deeper rate cuts.

4. **Fiscal demand-supply dynamics to stay favourable for yet another year & remains comforting factor** as India continues to reap the benefit of a fast-paced fiscal consolidation and strong domestic as well as foreign investor's demand. For FY2025, Government is expected to achieve a better fiscal deficit against the budgeted 4.9% on healthy tax collections and lesser than budgeted Capex spend. Government's commitment to reduce central fiscal deficit to below 4.5% in FY26 has credence as the Government didn't compromise on consolidation path even during political pressures and FY26 is relatively light on key state elections. Foreign Portfolio Investment's (FPI's) demand is expected to remain robust as index weight of sovereign bonds in JP Morgan global EM index increases from 7% to 10% by March 2025 and even further as sovereign bonds get included in two more debt global EM indices – Bloomberg from Jan 2025 and FT Russel from Sep 2025 onwards.

5. **External factors to remain healthy but INR may become more volatile.** CY2024 proved to be a year of strong resilience of Indian financial markets as they bucked the global trend and INR emerged as one of the most stable currencies on strong domestic factors and as RBI also intervened. Albeit moderating, fundamental factors remain healthy marked by robust economic growth driven by domestic factors, manageable current account deficit in FY26 with support from net service exports, healthy import cover of more than 11 months, moderating inflation, fiscal consolidation, relatively stable credit environment and most importantly - political stability. Even if Emerging Countries come under pressure due to global uncertainties, India is expected to be a standout investment destination. With these strong fundamental factors, we expect INR to depreciate in FY26 at a lower than historical run rate (of 3%-3.5%) against USD during FY26. Nonetheless, INR may become relatively more volatile, not only as USD reacts to US's new policies under Mr. Trump and US rate cut expectations, but also on account of lesser intervention by RBI during the year with moderation in Fx reserves to ~USD 640 bn from the highs of ~USD 705 bn and as Chinese yuan (CNY) depreciates relatively more with US's tariff policy concerns.

6. **Risk factors to watch out are mostly global.** US's FOMC delivered a hawkish rate cut in Dec 2024 while adopting a data dependent approach as economy continues to remain healthy and disinflationary trend moderates. Trump's policies can be inflationary & fiscal expansionary thereby shortening US's rate cut cycle which can keep the US rates elevated and US dollar to strengthen. Many EM Central Banks may find themselves in a fix as growth may get impacted due to excessive tariff threats requiring policy support, but currency pressures may limit the flexibility. Domestically, any erratic weather conditions resulting in deficient monsoon may delay the expected moderation in food inflation and thus the policy rate cuts.

7. **Overall, risk-reward remains favourable at current juncture** as healthy domestic demand-supply dynamics & expected rate cuts will help in bringing the market yields down. Currently, the entire yield curve is elevated amidst recent global spillovers & also tight domestic liquidity which provides an entry opportunity for investors across the yield curve. Short end of the yield curve will reap the benefit of rate cuts while the long end is expected to rally on the back of robust demand from investors like insurance companies, National Pension System (NPS), Employees' Provident Fund Organization (EPFO) in last quarter of a financial year. Any uptick in yields due to still evolving global factors should be seen as an opportunity to build further exposure as the rate cut cycle commensurate over next few months. On global front also, given the fact that US Treasury yields have hardened by ~100 bps from CY24 lows despite a 100-bps rate cut & still more rate cuts are expected, suggests that many of President Trump related policy risks are already priced in. If the US policies are gradual & lesser disruptive or if some of the ongoing geo-political issues are resolved, it may trigger a global risk rally and EMs will be the beneficiary.

8. **Critical to position appropriately on G-Sec & Corporate bonds yield curve.** G-Sec yield curve is steep and is expected to flatten with long end yields coming lower on excessive demand. We expect 10 year G-Sec to move down during CY2025 and spread between 30 year and 10 year G-sec to compress from current levels. Corporate bond yield curve on the other hand, is inverted and might flatten, but with short end 1- 5 year yields coming lower. Depending upon the risk appetite, investors can look to increase duration through categories like Gilt Fund and Long / Medium Duration Fund to benefit from expected G-Sec rally in longer end. Other categories like Corporate Bond Fund, Short Duration Fund, Banking & PSU Fund provide a good mix of long tenor G-Sec and short tenor Corporate Bonds capturing opportunities on both the ends. We believe that large part of capital

gains will be upfronted in 2025 with G-Sec rally first and then followed by corporate bond spread compression in 1- 5 year segment. 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.

Data source – Bloomberg

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