Invesco Mutual Fund

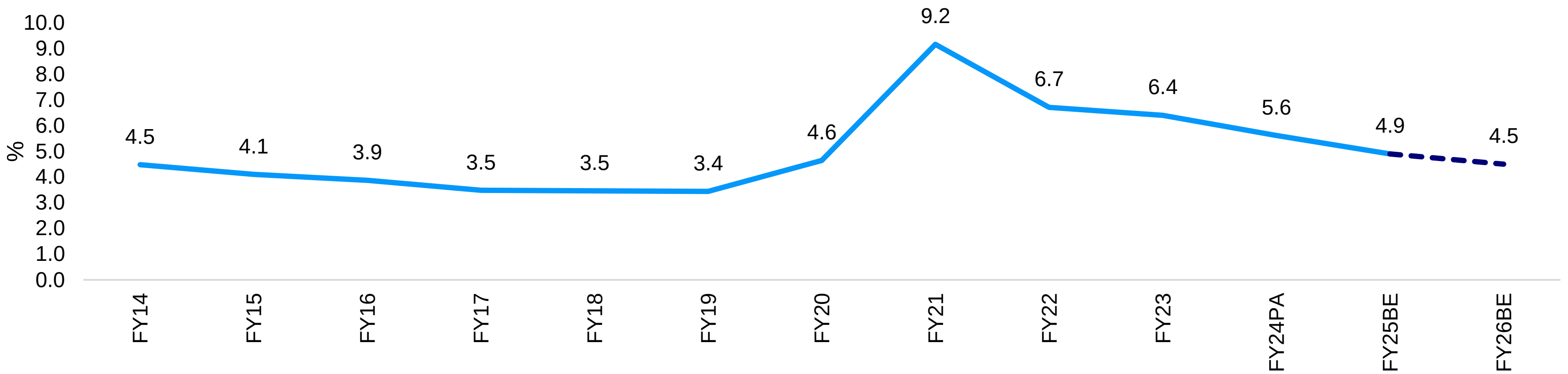
Update on Fixed Income market

FY25 Budget was critical in many ways

- First budget under the coalition Government after 10 years of single party majority Government
- Capex vs. populist measures under new political mandate
- Utilisation of RBI's record high dividend
- Funding pattern for fiscal deficit in FY25
- Fiscal consolidation approach over next few years

Government's commitment to fiscal consolidation continues

Fiscal Deficit (as a % of GDP)



- FY25 Fiscal deficit brought down further from 5.1% in interim budget to 4.9%, reflecting a y-o-y consolidation of 70 bps.
- Targeted fiscal deficit to be below 4.5% by FY 26.
- Barring the Covid impact, the Government has continued to bring down the fiscal deficit.

PA – Provisional Actuals, BE- Budget Estimates, BPS – Basis Points

Source – Budget document 2024-25

FY25 Fiscal math is a credible one

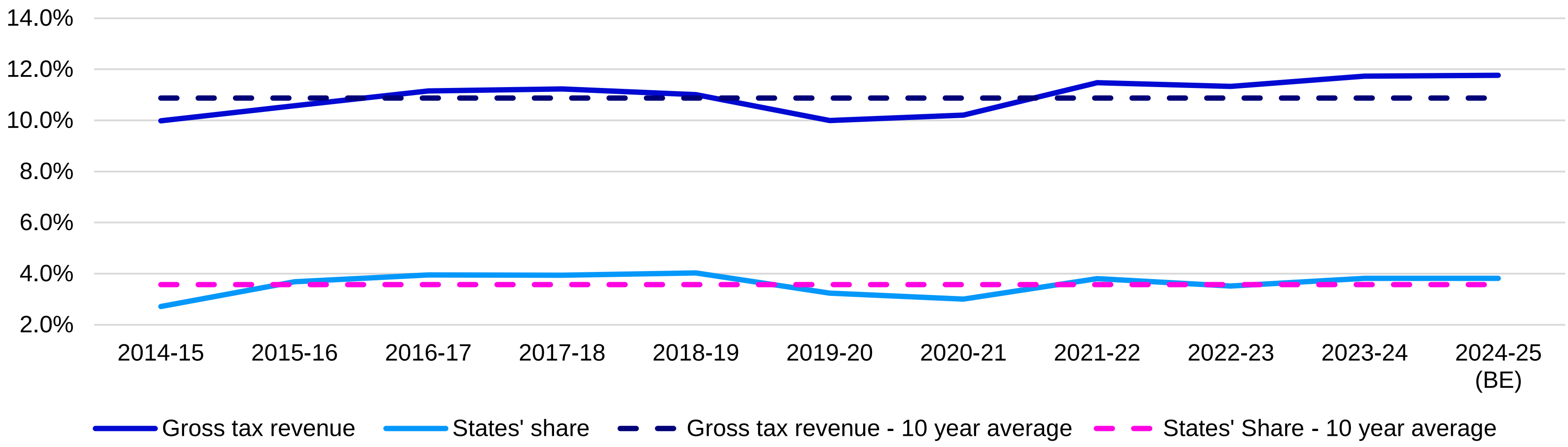
	FY24 Provisional Actual (Rs. lakh crore)	FY25 Interim BE (Rs. lakh crore)	FY25BE (Rs. lakh crore)	YoY Growth % (FY25BE over FY24)	Change over Interim BE (Rs. lakh crore)	FY24 Provisional Actual as % of GDP	FY25 Interim BE as % of GDP	FY25BE as % of GDP
Nominal GDP	295.36	327.72	326.37	11%	-1.35			
Net Tax Revenue	23.27	26.02	25.93	11%	-0.09	7.88%	7.94%	7.94%
Non Tax Revenue	4.02	4	5.46	36%	1.46	1.36%	1.22%	1.67%
Total Receipts	27.89	30.8	32.07	15%	1.27	9.44%	9.40%	9.83%
Total Expenditure	44.43	47.66	48.21	9%	0.55	15.04%	14.54%	14.77%
Revenue Expenditure	34.94	36.55	37.09	6%	0.54	11.83%	11.15%	11.36%
Capital Expenditure	9.49	11.11	11.11	17%	0	3.21%	3.39%	3.40%
Fiscal Deficit	16.54	16.85	16.13	-2%	-0.72	5.60%	5.14%	4.94%

- Marginal differences from FY25 interim budget which also reflects continuity.
- Total receipts up Rs 1.27 lakh crore or ~0.43% of GDP compared to Interim Budget estimates, largely on account of RBI's dividend. Tax revenues are reasonable and may have an upside providing cushion on shortfall on divestments / telecom proceeds, if any.
- Total Expenditure up by ~0.23% of GDP compared to Interim Budget estimates. Capex maintained at Rs 11.11 lakh crore.
- Fiscal Deficit down by ~0.2% of GDP vs. Interim Budget estimates.

BE – Budget Estimates, GDP – Gross Domestic Product. Source- Budget Document 2024-25

Tax Revenue showing structural uptrend on back of formalization of economy and better compliance. States' share in taxes remain strong

Revenue as % of GDP



Source - CMIE; Internal. BE: Budget Estimates

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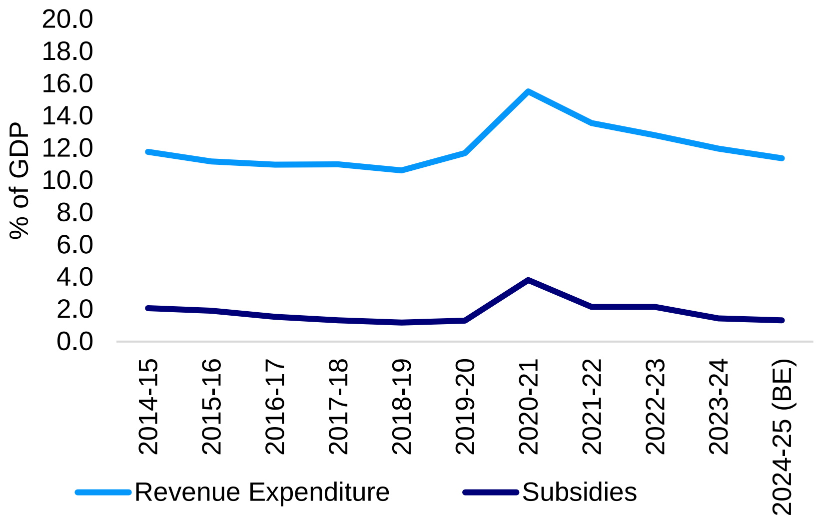
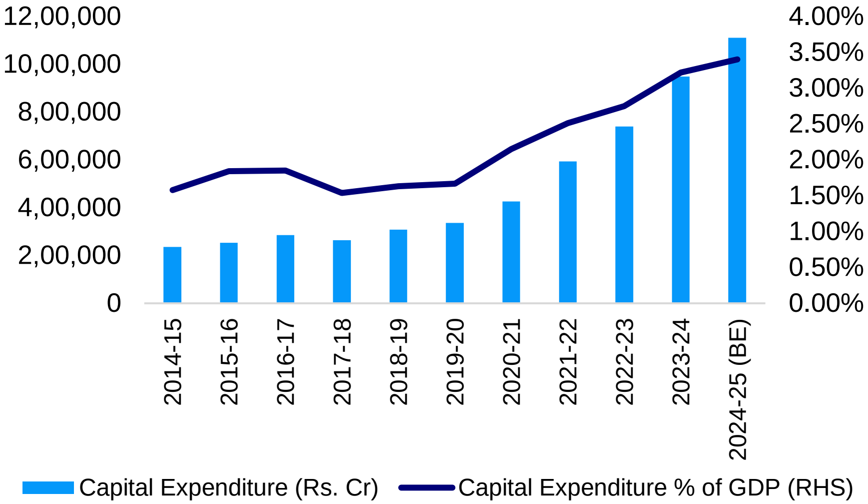
FY25 Budget continues to focus on capex spending and no populist spending

Revenue Expenditure as % of GDP



Capex as % of GDP

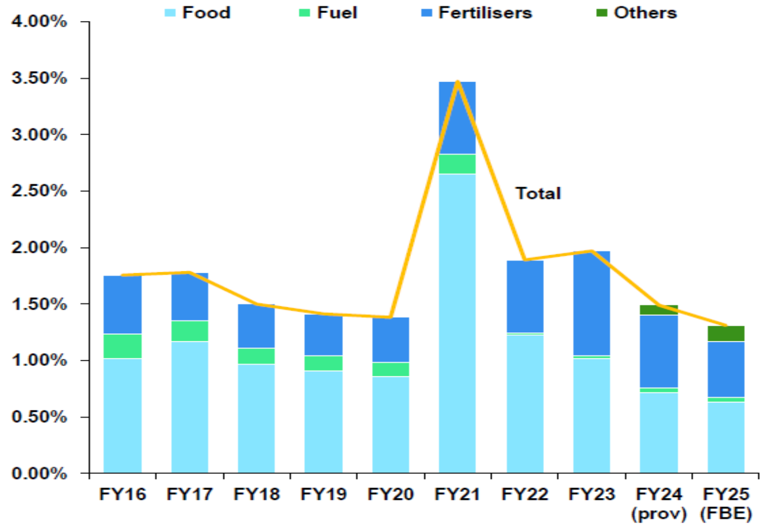


- Revenue expenditure continues to remain controlled. FY25 is budgeted at 11.37% of GDP which is 60 bps lower than the FY24
- Overall subsidies have come further down to 1.31% of GDP in FY25, similar to levels seen before pandemic.
- Capex as % of GDP is at the highest level at 3.4% in last 10 years.

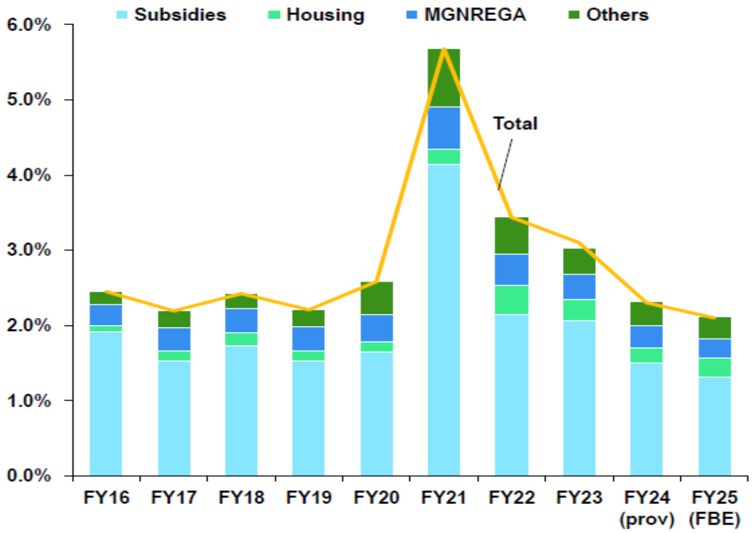
Source - CMIE; Internal. BE: Budget Estimates.

Subsidies are back to pre-pandemic levels

Subsidies are budgeted to decline in FY25 (% of GDP)



Spending on welfare schemes is now back to pre-pandemic levels (% of GDP)



Prov – Provisional Estimates, FBE – Final Budget Estimates. RHS graph- MGNREGA – Mahatma Gandhi National Rural Employment Guarantee Act, Others include farmer income support, pension support, mid-day meals, crop insurance, health and family welfare,

Source – CEIC, Budget documents, Standard Chartered Research

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Prudent funding of Fiscal Deficit for FY25

	FY24 Provisional Actual (Rs. lakh crore)	FY25 Interim BE (Rs. lakh crore)	FY25 BE (Rs. lakh crore)	Change over Interim BE (Rs. lakh crore)
T-Bills	0.53	0.50	-0.50	-1
Small Savings	4.51	4.66	4.20	-0.46
State Pension Funds	0.05	0.05	0.05	0
Others	0.83	-0.31	-0.81	-0.50
External Debt	0.55	0.16	0.16	0
Cash Drawdown	-1.72	0.04	1.40	1.36
Net Market Borrowing	11.78	11.75	11.63	-0.12
Redemption	3.63	2.38	2.38	0
Gross Market Borrowing	15.40	14.13	14.01	-0.12

PA – Provisional Actuals, BE- Budget Estimates
Source - Source: Budget document 2024-25. Internal. EPFO – Employee Provident Fund Organization

FY25 dated G-Sec borrowings not reduced much given strong demand

Expected SLR supply in FY25

SLR Supply (Rs. lakh crore)	FY25
Centre's Fiscal Deficit	16.1 (4.94% of GDP)
State Fiscal Deficit	10.1 (3.10% of GSDP)
SLR Gross supply	**24.72**
G-Sec Gross supply	14.01
SDLs Gross supply	10.71
SLR Net borrowing	**19.14**
G-Sec Net borrowing	11.63
SDLs Net borrowing	7.51

Expected SLR demand factors in FY25

Investor	Ownership	Net demand FY24 actuals (Rs lakh crore)	Net demand FY25 estimates (Rs lakh crore)
Banks	36%	7.70	5.5-5.8
Insurance Firms	26%	4.40	4.8-5.2
Provident Firms	11%	2.38	2.6-2.8
RBI	8%	-0.53	
Pension Funds	5%	1.33	1.5-1.7
FPIs	2%	1.23	1.6-1.8
Others*	12%	1.60	2.5-3.5
Total (ex-RBI)	**100%**	**18.11**	**18.5-20.8**

- SLR demand is expected to exceed the supply in FY25.
- Long investors like Insurance, PFs, Pension Funds expected to account for ~50% of demand. FY25 budget has measures to boost EPFO & NPS mobilization.
- FPIs expected to account for sizeable demand.

SLR – Statutory Liquidity Ratio, SDL – State Development Loans, EPFO – Employee Provident Fund Organization, NPS – National Pension System, GSDP - Gross State Domestic Product. *Others includes mutual funds, corporates, state governments etc.

Source- Standard Chartered Research

FPIs continue to buy the G-Sec

Foreign investments in G-Sec post JP Morgan debt inclusion announcement

FPI Buying of FAR securities	Rs. Crore
Sep 23 till Apr 24	77,164
Apr-24	-9,857
May-24	5,208
Jun-24	17,239
July MTD (till 22 Jul'24)	11,351
FYTD	**23,941**
Total since JP Morgan index inclusion announcement	**1,01,105**

Index constituents in JP Morgan index

Maturity bucket	Weight %
Upto 5 Years	21.37%
5 Years to 10 Years	40.34%
10 Years to 15 Years	13.88%
Above 15 Years	24.41%

FPI – Foreign Portfolio Investment, FAR – Fully Accessible Route
Source – LHS –CCIL, RHS – JP Morgan

Lesser T–bill supply in FY25 to create favorable demand supply dynamics

T-bill holding as on March 2024

Category Holdings (Mar-24)	Rs. Crore	% share
Commercial Banks	5,10,184	58.53
Mutual Funds	1,03,641	11.89
Financial Institution	62,411	7.16
State Governments	51,254	5.88
Others	1,44,173	16.54
Total	**8,71,662**	**100**

- Banks and financial institutions purchase T-bills to meet liquidity ratios.
- State governments buy T-bills to park their cash balances.
- Mutual funds are also required by regulations to invest in T-bills / G-Sec for meeting liquidity ratios.
- These categories hold ~83.46% of the T-bills outstanding
- Hence, if the outstanding T-Bills fall by Rs. 50,000 crore, these buyers may increase purchase of either G-Sec or Short Dated SDLs, boosting further demand in the dated securities.

Source - RBI

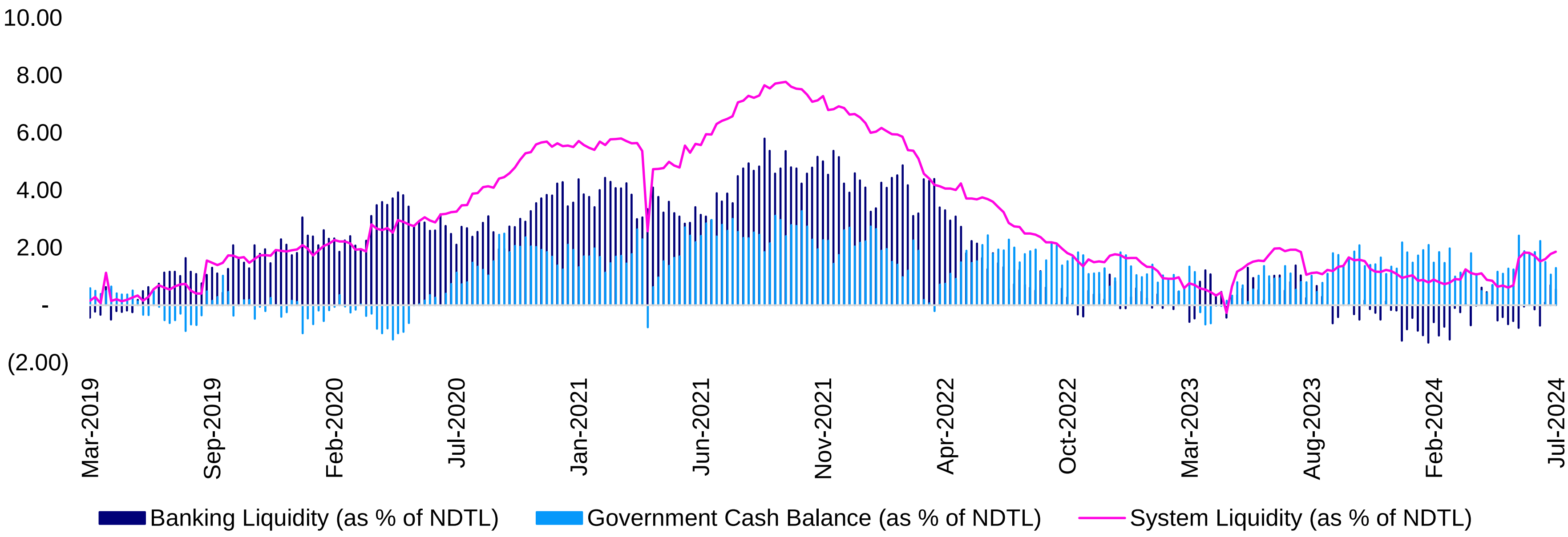
RBI’s recent draft regulations on LCR can significantly increase the SLR demand

- Additional 5% run-off for deposits linked with internet and mobile banking.
- G-Sec in Level 1 HQLA to be valued at current market value, adjusted for applicable haircuts in line
- If implemented, it will result in LCRs falling by 10% - 20% and come close to the 100% regulatory requirement.
- Incremental HQLA demand can be as high as Rs. 6-7 lakh crore to reach earlier LCR levels which are at 120% - 130%
- Even if banks were to maintain LCR of 115%, as per estimates incremental demand could still be more than Rs 3 lakh crore
- Large part of HQLA is expected to be in T-bills and short tenor G-Sec. New LCR norms will substantially increase the demand of such instruments

Note - LCR - Liquidity Coverage Ratio, HQLA – High Quality Liquid Assets. LCR is to ensure that a bank maintains an adequate level of unencumbered HQLAs that can be converted into cash to meet its liquidity needs for a 30 calendar days time horizon under a significantly severe liquidity stress scenario.
Source -Jefferies, Internal calculations
Disclaimer - It should be noted that the draft regulations on LCR are based on Basel III Framework on Liquidity Standards – Liquidity Coverage Ratio (LCR) – Review of Haircuts on High Quality Liquid Assets (HQLA) and Run-off Rates on Certain Categories of Deposit issued by RBI on July 25, 2024 and it may change or may be different upon the final issuance by the RBI. The information contained in this document is for general purposes only and not a complete disclosure of every material fact arising from the regulations. The information provided herein may include statements/data of future expectations that are based on current views and assumptions and involves known and unknown risks and uncertainties that could cause actual results, performance or events to differ materially from those expressed or implied.

Lesser T-bill supply & budgeted cash drawdown of Government's cash balance to aid in banking liquidity

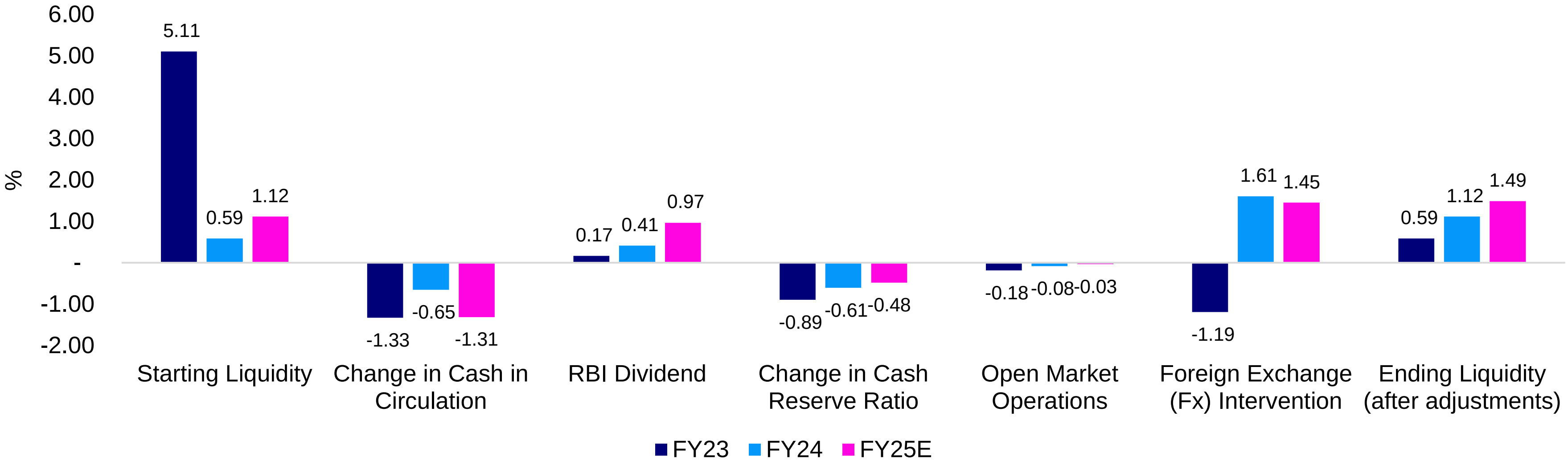
Liquidity as % of NDTL



Data till July 12, 2024. NDTL: Net Demand and Time Liabilities.
Source - Bloomberg

System liquidity to stay within RBI's comfort zone i.e. within 1.5% of NDTL in FY25

Liquidity as % of NDTL



NDTL – Net Demand and Time Liabilities, E - Estimates
Note - Adjustments include valuation changes, hair cut on operations, adjustment for increase in NDTL during the year
Source – Bloomberg, Internal estimates

However, intermittent systemic liquidity may increase till festival season; expected to neutralise thereafter

Time period (as a % of NDTL)	Starting Liquidity	Change in Cash in Circulation (CIC)	RBI Dividend	Change in Cash Reserve Ratio (CRR)	Open Market Operations (OMO)	Foreign Exchange (Fx) Intervention	Others	Ending Liquidity
Q1FY25	1.12	-0.22	0.97	-0.11	0	0.02	-0.06	1.72
Q2FY25E	1.72	0.12	0	-0.13	-0.03	0.44	-0.05	2.08
Q3FY25E	2.08	-0.67	0	-0.12	0	0.43	-0.06	1.66
Q4FY25E	1.66	-0.55	0	-0.12	0	0.55	-0.05	1.49
Total	**1.12**	**-1.32**	**0.97**	**-0.48**	**-0.03**	**1.44**	**-0.22**	**1.49**

- Liquidity expected to increase in Q2FY25 due to inflow of CIC into banking system, and start of Fx flows from JP Morgan index inclusion
- Liquidity expected to normalizes from Q3FY25 onwards as CIC outflows start with onset of festive season

E – Estimates. CIC – Cash in Circulation
Source – Bloomberg, Internal estimates
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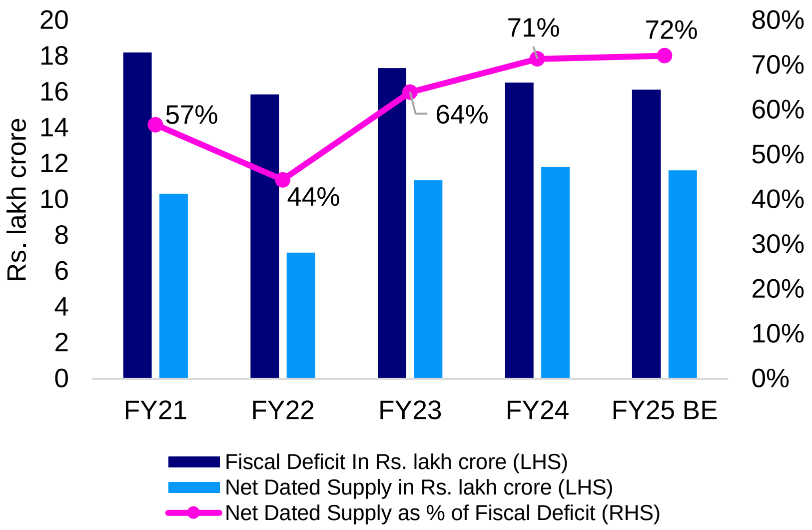
Looking beyond FY25; FY26 G-Sec supply is expected to be lower

Funding of Fiscal Deficit through dated securities

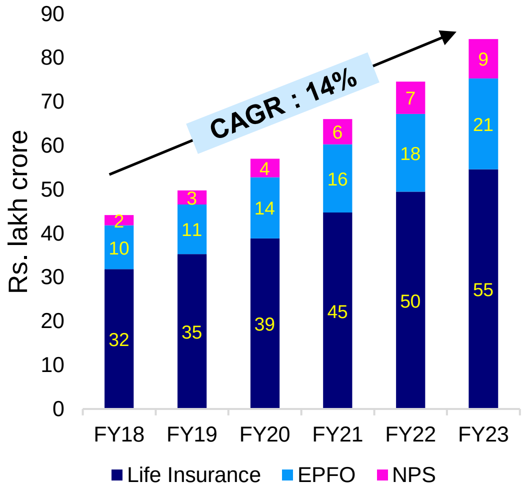


- In FY25, 72% of Fiscal Deficit has been funded by dated government securities and same trend is expected to continue.
- FY26 fiscal deficit in absolute terms is expected to be lower than that in FY25.
- Subsequently, assuming a conservative 70% funding through G-Sec, absolute G-Sec supply in FY26 is expected to be lower.
- Lower T-bill issuance & mobilization budgeted through National Small Savings Fund provides further cushion to lower FY26 G-Sec borrowings

BE – Budget Estimates
Source –Budget documents

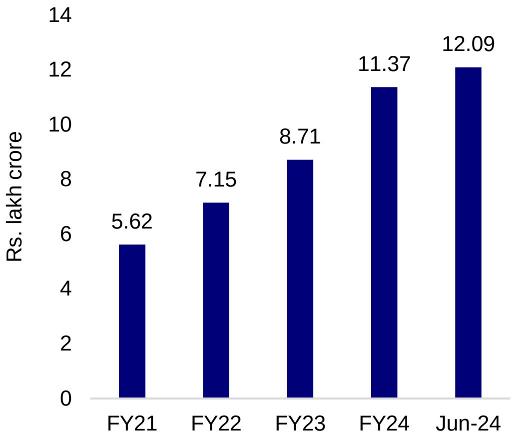
While the investors demand is expected to be substantially higher

AUM of long investors (Rs. lakh crore)



Source – IDFC Research

NPS AUM (Rs. lakh crore)



Source – NPS

Participant Category (dated SLR)	FY24
Commercial Banks	36%
Insurance Companies	26%
Provident Funds	11%
Pension Funds	5%
Other Participants	22%
Total	**100%**

Source – RBI

- Government major initiatives on skilling program is positive for organized work force which will further add to the EPFO AUM growth.
- Earlier NPS limit of 10% of basic salary has been increased to 14%. This will be NPS AUM accretive.
- This a notable measure as EPFO / NPS have now become sizeable investors in G-Sec.

EPFO – Employee Provident Fund Organization, NPS – National Pension System

Budget 2025 is overall positive for fixed income market across the yield curve

Short end of the yield curve

- Net T –bill supply is negative Rs. 50,000 crore in FY25, thereby lowering the supply by Rs. 1 lakh crore.
- Additionally, Government has budgeted to draw down Rs 1.37 lakh crore from its cash balance which is largely on account of the fiscal saving achieved in FY24.
- This will help in releasing banking liquidity and will drive down the short end yields.

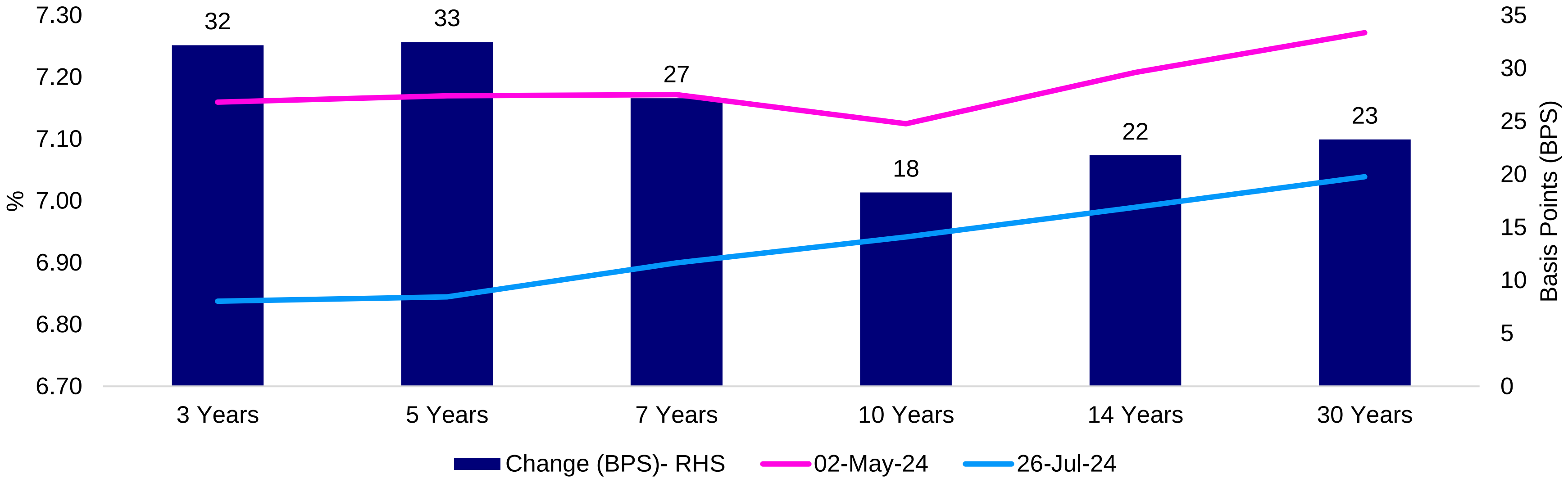
Long end of the yield curve

- Finance Minister has clearly laid out a fiscal consolidation path over next few years. While the Government had much more room to reduce the dated G-sec borrowing in FY25, they have prudently opted for a lower reduction given the huge G-sec FPI demand from JP Morgan Debt index inclusion this year.
- Adequate cushions are there in the funding of fiscal deficit. For instance, funding from Small Savings scheme have been considered lower by ~Rs 46,000 crore from interim budget. Any upside here may result in lower dated G-sec borrowing for FY25 towards the year end.
- Demand supply was already favorable in FY25 on the back of JP Morgan debt index inclusion and domestic demand. Longer end demand gets further boost now with higher expected mobilisation in NPS / EPFO which normally invests in longer end. With this budget, even FY26 seems comfortably placed on demand – supply dynamics.

EPFO – Employee Provident Fund Organization, NPS – National Pension System
Source - Budget 2024-2025 Speech; Internal.

G-Sec yield curve has steepened post Budget due to lesser T-bill supply & LCR draft norms

G-sec yield curve



Source – Bloomberg

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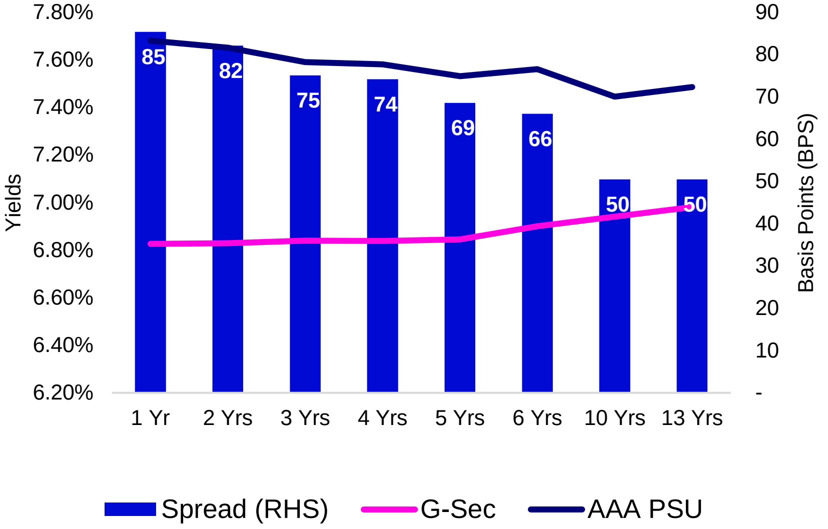
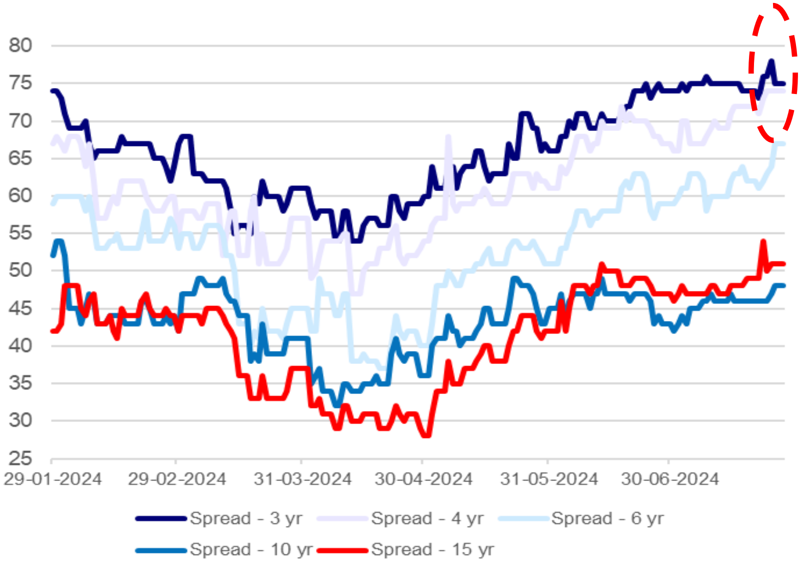
Corporate bond spreads have expanded; looking favourable in the shorter end

Yield Curve (28-Jul-2024)



AAA PSU spread over G-Sec bps (tenor wise) as on 28-Jul-2024



Source – Valuations by CRISIL & ICRA and Invesco Research

Disclaimer - The purpose of above chart is only to explain spread between G-sec and AAA PSU corporate bonds. Currently. AAA PSU corporate bonds are trading at higher level than G-sec at the shorter end. 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 an investment advice to any party.

Market Outlook

Indian Fixed Income Market remains in a sweet spot

Domestic Inflation trajectory

- FY 2025 inflation to moderate further to 4.5% from ~5.4% in FY2024 on the back of broad-based decline in core inflation basket.
- Higher food inflation is expected to come down as monsoon progresses and government measures help.
- Inflation decline has been broad-based with higher number of items increasing by < 0.35% on month-on-month basis.

Monetary Policy

- As FY25 inflation recedes to ~4.5%, current policy rate at 6.5% leaves the positive real policy rates at an elevated 200 bps.
- This should give sufficient room to MPC to cut down the policy rates towards end of 2024.

Fiscal demand-supply

- Fiscal consolidation to continue with FY25 fiscal deficit ~ 4.9% down from ~5.6% in FY24 and further to below 4.5% in FY26.
- FY25 budget avoided populist spending and instead focused on quality of spending with eye on fiscal consolidation.
- Inclusion in JP Morgan global debt index is expected to bring inflow of ~USD 20-25 bn in FY25 which can absorb close to 15% of fiscal supply in FY25.

External factors

- FDI / FPI inflow are expected to remain healthy in FY25 with robust domestic fundamentals.
- Healthy foreign exchange reserves of ~USD 660 bn[1] provide meaningful cover to absorb global volatilities.
- Global central banks have started to cut interest rates with US FOMC also expected to cut rates in September 2024.

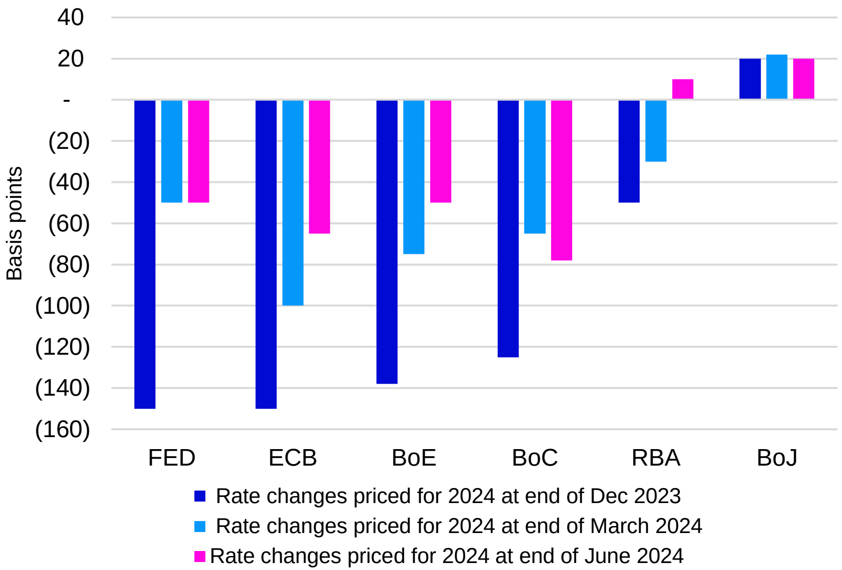
Risk factors

- Global energy prices (read as crude prices) led by geo-political risk or further cuts in oil production by OPEC+.
- Supply side disruptions again caused by geo-political risks which can change the expected course of inflation moderation and thus the monetary cycles.

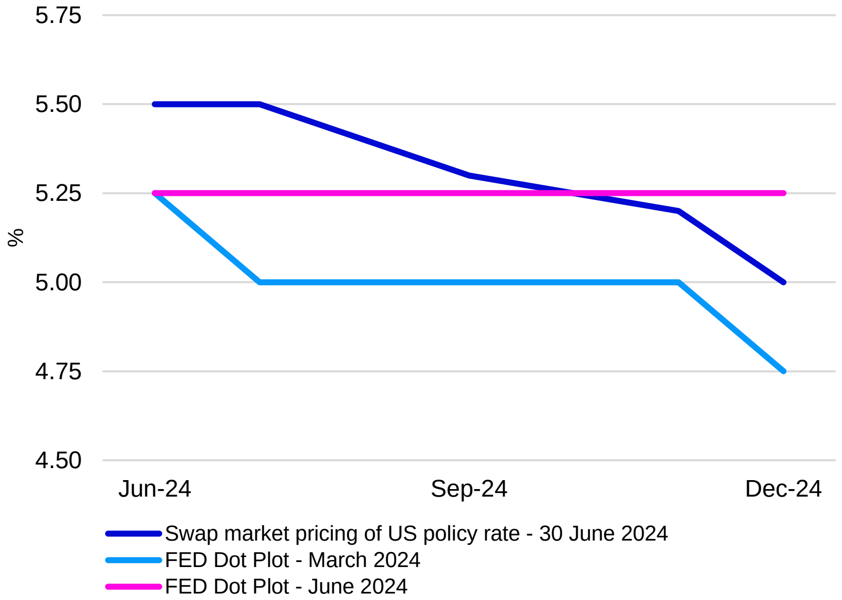
FY – Financial Year, MPC – Monetary Policy Committee, Bps – Basis Point, FOMC - Federal Open Market Committee, FDI - Foreign Direct Investment, FPI - Foreign portfolio investment, Fx – Foreign Exchange, OPEC+ It is a group of 23 oil exporting countries which meets regularly to decide how much crude oil to sell on the world market. At the core of this group are the 13 members of OPEC (Organization of the Petroleum Exporting Countries), which are mainly Middle Eastern and African nations. [1]Foreign exchange data is as on 30 June 2024

FED Dots were revised higher in June FOMC with only 1 rate cut for 2024. Markets are pricing extra rate cut above FOMC projections for 2024

Market pricing of policy rate changes – change in bps



Swap markets and FED expectations on policy rates



Source: Bloomberg data as at 30 June 2024. FED: US Federal Reserve, ECB: European Central Bank, BoJ: Bank of Japan, BoE: Bank of England. RBA : Reserve Bank of Australia, BoC: Bank of Canada

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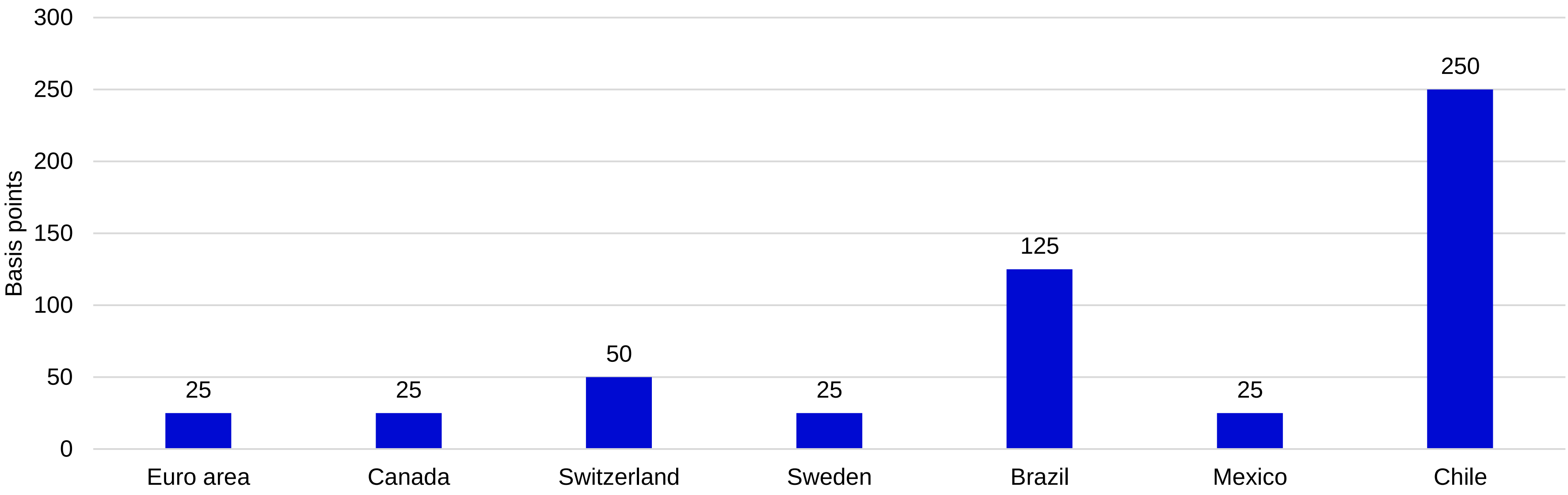
Interest rate cuts have started in many developed as well as emerging market countries

Rate cuts since December 2023

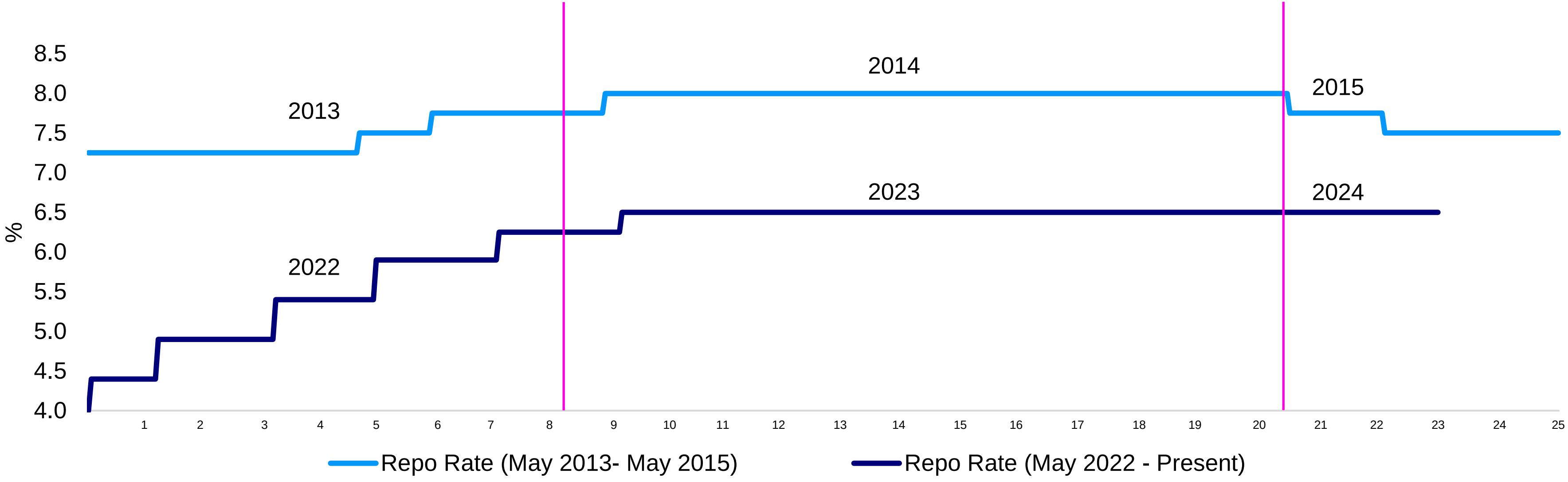


Source: Spark Capital. Data as at 30 June 2024.

India is expected to embark upon the rate cuts, possibly in 2HFY25

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

Policy rate cycle



Note – On X-axis, 1 represents month of May, 2 represents June & so on for the period under analysis. In the above chart we are showing the repo rate movement in the aforementioned periods. In 2013, there were 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 the year 2024 is expected to see the start of the rate cut cycle.

Source – Bloomberg.

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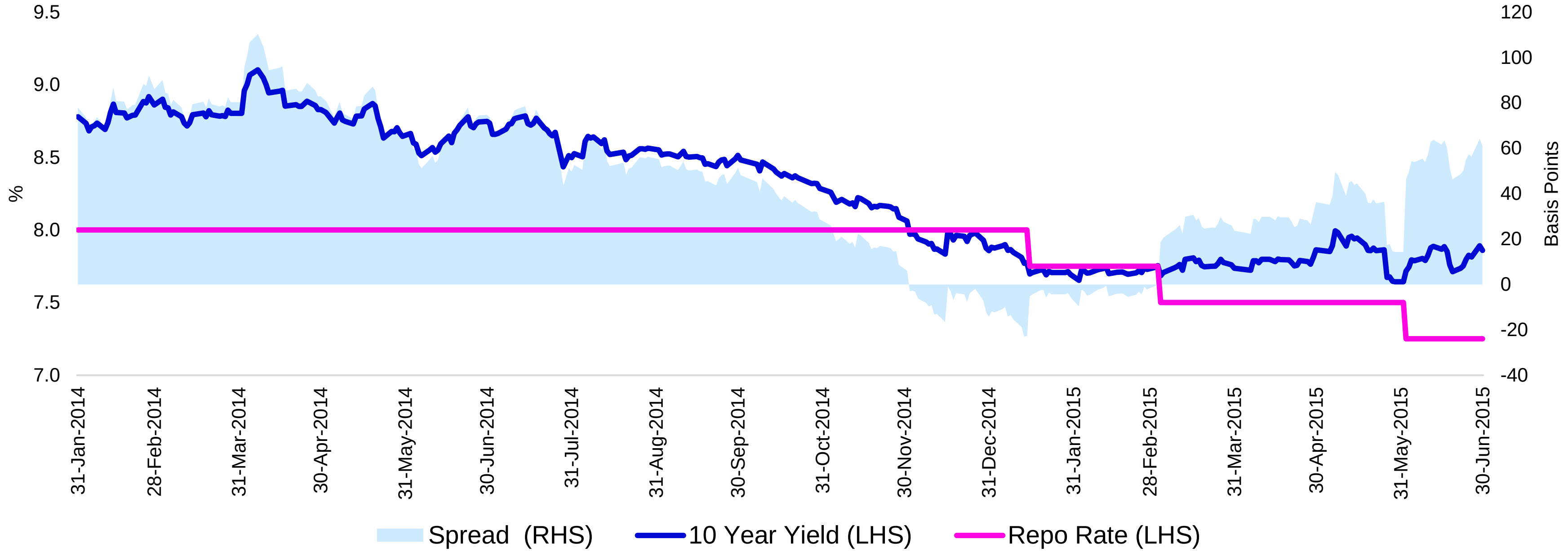
What happened in previous rate cut cycle?

#1 Interest rate rally happened much earlier than the beginning of rate cut cycle

10 Year G-sec vs. Repo rate - Spread



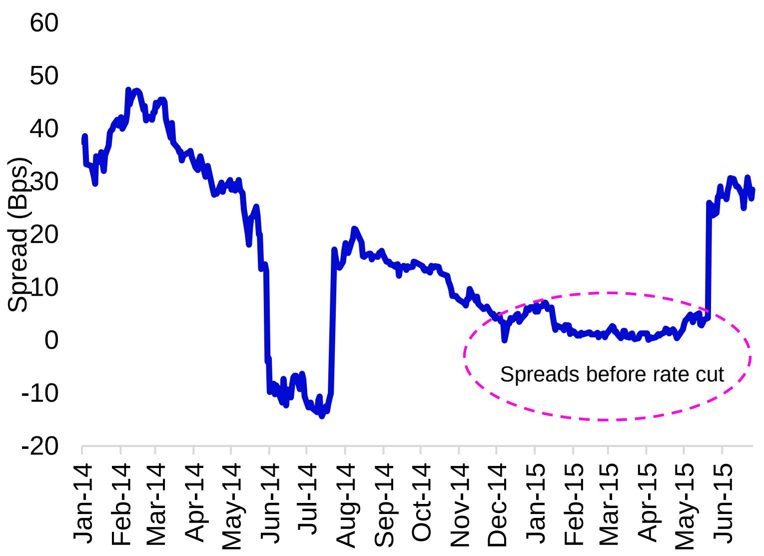
Source – Bloomberg

Note – The above chart shows the movement of 10 year G-sec, repo rate and the spread between them during 2014 & 2015.

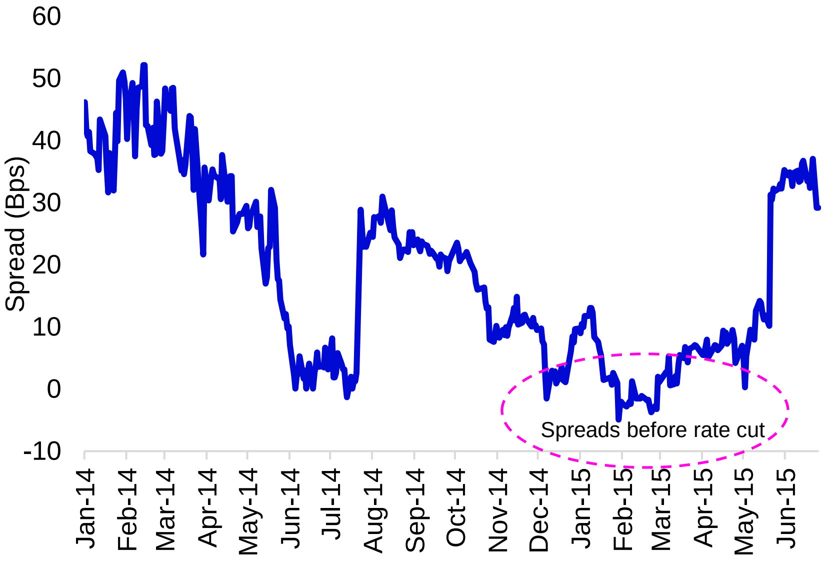
What happened in previous rate cut cycle?

#2 G-sec yield curve saw higher spread compression in the longer end before the rate cut

Spread between 10 years & 14 years G-sec



Spread between 10 years & 30 years G-sec



Source - Bloomberg

Note – The above chart shows the spreads between 10 year & 14 year G-sec and 10 year & 30 year G-sec.

Disclaimer

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