Economics
DBS Flash

Top-10 investment strategies for 2019: #8 India govvies curve to steepen

Group Research

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Eugene Leow
Strategist

Radhika Rao
Economist

Please direct distribution queries to
Violet Lee +65 68785281 violetleeyh@dbs.com

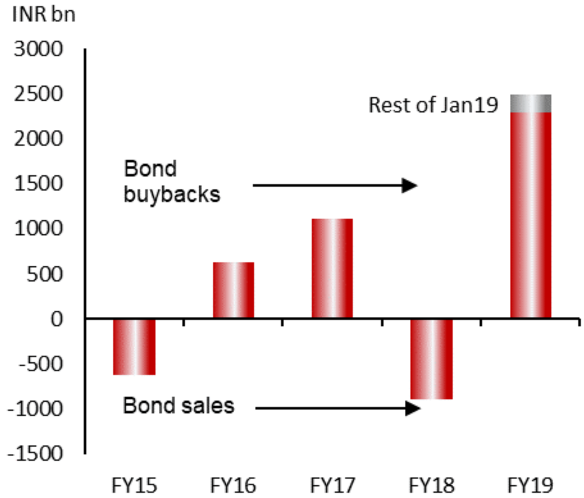
#1 Bet on more rate hikes by the Fed
#2 Looking for USDSGD to hit 1.40
#3 Long Indonesian equities
#4 Support for high grade credit, especially BBB
#5 Bullish 10Y China govvies
#6 Short AUD
#7 We like short-dated Chinese BBs for carry

- *Underpinnings of this call lies in the divergence between fiscal and monetary policies*
- *While we flag risks of only a small miss in the FY19 fiscal deficit, incoming news flow on an expansionary fiscal boost will keep investors on the edge*
- *The RBI panel's commentary on 7 February will be the next trigger for the short-end of the curve*
- *A bull-steepening scenario is on the cards*

The India sovereign curve has steepened in recent weeks and more is yet to come. Underpinnings of this call lies in the divergence between fiscal and monetary policies underway at this juncture.

We think that the rally in longer-term bonds, since 4Q18, may be limited. Besides a 30% decline in global oil prices, much of the correction in 10Y yields (generic) since highs of 3Q18, has been on the back of a surge in open market operations by the central bank. In addition to INR2trn bond purchases by December 2018, the RBI plans to purchase INR500bn in January. This will total OMOs to INR 2.5trn in a month's time, absorbing close to half of this year's gross bond supply. Recent RBI remarks that liquidity conditions were being monitored closely and that it was not in favour of a surplus balance, suggests that the pace at which bond purchases were carried out in the last two quarters is unlikely to continue.

RBI continues to provide strong liquidity support



Source: Bloomberg, DBS Group Research

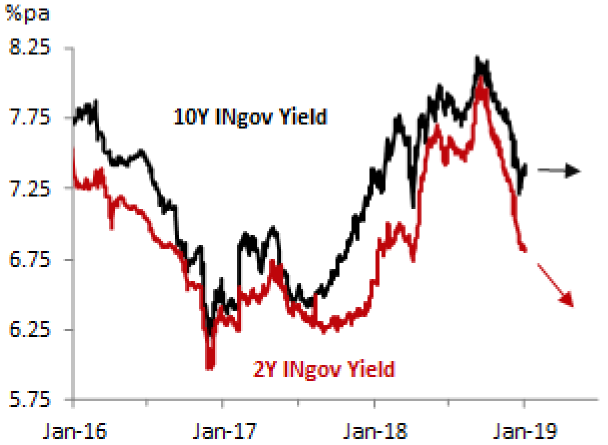
Add to this, the market is also focused on the fiscal outlook (see here), upcoming interim budget and India's general election. While we are flagging risks of only a small miss in the FY19 fiscal deficit, incoming news flow on an expansionary fiscal boost will keep investors on the edge. The likelihood of welfare-oriented measures directed at the farm and rural sector, ahead of elections, are risks to the FY20 fiscal math. Depending on the scheme announced, the fiscal impact could be in the range of 0.5-1.5% of GDP, even as implementation risks are aplenty. Besides, the centre, market borrowings from states will not only be heavy in 2HFY19 but might also entail an increase in FY20 borrowings.

Thereby, a mix of a pullback in OMOs coupled with modest fiscal miss (if not accompanied by RBI's dividend contribution to the state's coffers) is likely to draw the brakes on the 10Y rally. We see the 2Y/10Y spread widening towards 100bps, from 55bps currently.

Outperformance in the front-end of the curve will come on the back of receding rate hike expectations. Inflation has been downbeat this year; CPI inflation fell from 4.9% YoY in April-May 2018 to 2.2% in December, mainly due to disinflation in the food segment. Apart from benign inflation of 2.0-3.0% in the coming months, the remarks of new Governor Das and a commitment to keep the fiscal deficit close to its FY19 target of -3.3% of GDP (at the interim budget announcement on 1 February) will be closely watched for a shift from ‘calibrated tightening’ to a ‘neutral’ stance at next RBI review on 7 February. Markets have accordingly squeezed out rate hike expectations, with the implied rates pointing to cuts over a year. In this regard, the RBI panel’s commentary in early-February will be the next trigger for the short-end of the INR bond curve. Dovish commentary, in our view, will lay the ground for further downside in the 2Y yields (generic).

The external environment has also become more supportive for Asian government bonds in general. To be sure, risk taking sentiment is still negative. However, with global growth concerns likely to dominate, further Fed tightening will be much more muted in 2019, removing a considerable headwind for emerging market bonds.

Shorter-term yields should be anchored as the market bets on an end to the tightening cycle



Source: Bloomberg

Key risks to our scenario include a sharp jump in oil prices and surge in global rates, which increase macroeconomic risks for the economy. Upside risks to inflation will diminish rate easing expectations, putting a floor for the short-end of the curve.

Group Research

Economics & Strategy Team

Taimur Baig, Ph.D.
Chief Economist - G3 & Asia
+65 6878-9548 taimurbaig@dbs.com

Nathan Chow
Strategist - China & Hong Kong
+852 3668-5693 nathanchow@dbs.com

Ma Tieying, CFA
Economist - Japan, South Korea & Taiwan
+65 6878-2408 matieying@dbs.com

Masyita Crystallin, Ph.D.
Economist – Indonesia & Philippines
+ 62 21 2988-4003 masyita@dbs.com

Radhika Rao
Economist - Eurozone & India
+65 6878-5282 radhikarao@dbs.com

Joanne Goh
Regional equity strategist
+65 6878-5233 joannegohsc@dbs.com

Irvin Seah
Economist - Singapore, Malaysia, & Vietnam
+65 6878-6727 irvinseah@dbs.com

Neel Gopalakrishnan
Credit strategist
+65 6878-2072 neelg@dbs.com

Duncan Tan
Rates/FX Strategist - ASEAN
+65 6878-2140 duncantan@dbs.com

Eugene Leow
Rates Strategist - G3 & Asia
+65 6878-2842 eugeneleow@dbs.com

Samuel Tse
Economist - China & Hong Kong
+852 3668-5695 samueltse@dbs.com

Chris Leung
Economist - China & Hong Kong
+852 3668-5694 chrisleung@dbs.com

Philip Wee
FX Strategist - G3 & Asia
+65 6878-4033 philipwee@dbs.com

Sources: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations).