Fixed Income Outlook for 2022

As I write this year end note, I feel a sense of ***Déjà vu.*** Exactly a year ago, around this same time, we were showing signs of economic rebound and victory over Covid. Unfortunately, we were hit by the second wave that not only impacted human lives extensively but also extended the uncertainty and volatility in market across asset classes.

Analyzing high frequency indicators, trade deficits, price pressures (both input and output prices), and buoyancy across sectors in festive season, we feel that the economic cycle is almost back to pre Covid levels. But at the same time there is noise about a new variant "Omicron" and we are again witnessing bouts of uncertainty and volatility.

With uncertainty still glooming, decision making for central banks and investment options for investors continue to remain challenging.

Quick recap

Major themes which played out last year were:

1) ***Central banks in H1 across failed to spur growth*** on account of Covid uncertainty and are still grappling with economic uncertainty despite flooding the markets with liquidity and easy monetary policies
2) ***Government deficits continued to widen*** to support growth & economy
3) ***Inflation fears started rising especially in H2*** on account of supply bottlenecks and lack of investments
4) ***Credit cycle showed massive improvement*** especially for good operating companies where we observed credit spreads compression
5) ***Risk On and High Risk asset classes delivered good returns, wealth impact among wealthy investors increased leading to higher propensity to consume***
6) ***Central banks starting to face issues of communication to reverse the rate cycle*** in rising inflationary environment as markets use to the Central bank steroids

Summary of quick macro data trends and changes over the last 12 months

	Macro Trends		
Macro data	2020	2021	Trend
GDP % Y-0-Y	0.40%	8.40%	
CPI India	4.50%	5.20%	
INR	73.3	75.5	
10 year Gov Bonds %	5.85	6.35	
5 Year Gov Bonds %	5.05	5.7	
3 year AAA %	4.75	5.5	
1 year Tbills %	3.5	4.15	
Banking durable Liquidity (In Rs Trillion)	8.5	11.2	
Trade Deficit (Monthly trend)in $	15.5 Bn	23.5 Bn	
FX reserves in $	580 Bn	640 Bn	
Brent in $	50$	75$	
UST 10 year %	0.90%	1.50%	
Vaccination rate (2 doses)	-	40%	
Credit Spreads			
AA over AAA for 3 year (in bps)	110	75	

A over AAA for 3 year (in bps)	~300	~275	

What is macro saying?

GDP for full year would be upwards of 9% in real terms and the trend for next year too would be ~6%. Macro data has started showing massive improvement; what needs to attract attention is the ***growing trend of Trade deficit, increased trend in local trade data (proxy of consumer demand) over the festive season, petroleum products consumptions, PMI trends, improving trends in gross fixed capital formation and increasing capacity utilization levels.***

Inflation has started to become a worry across all economies including India

Major signs of concern for inflation are:

1) ***Bottoming out of food inflation globally***
2) Rising and ***persistent commodities inflation which impacts core*** inflation
3) ***Service inflation trends showing uptrend***, services like telecom, GST increases etc will lead to uptick in services inflation
4) Supply side deficits can keep inflation high for long

We believe that ***CPI (Consumer Price Index) for CY 22 would be higher than RBI projections and would put pressure on RBI to be faster in reversal in rate hikes then communicated now***.

INR had been a stellar performer over last many years (FX reserves 450 Bn 2019 to 650 Bn 2021). We believe that with the US economy growing and worsening trade data, INR appreciation looks very difficult and in fact ***we can see marginal depreciation in INR which can also be a worry in rising trade deficits trends***.

Fiscal support from the Government over the last 2 years have supplemented India's recovery well. In fact, fiscal impetus (excess spending over the revenue shortfall over the last 2 years) would very well be the reason for near term positive surprise in the Growth cycle for India. We had a significantly higher than expected fiscal for the year @6.8% **(likelihood to go above 7%)** which led to bond yields, especially long bonds to be under pressure for most part of the year. ***We believe that in the next year too, government will refrain from a big fiscal consolidation and we expect fiscal to be ~ 6% -6.2% of GDP***. In fact, it would continue to be fiscally expansionary which will continue to be positive for the Growth cycle and keep continued pressure on bond yields.

Banking liquidity though the absolute durable liquidity has shown an uptick Y-O-Y from INR 8.5 trillion to INR 11 trillion. We believe that ***abundant liquidity is a mirage as*** RBI (through its liquidity glide path) has started to absorb most of surplus liquidity through long 14 & 28 days VRRR (Variable Reverse Repo Rate) auctions and accordingly the operative rate would start moving towards 3.75% without RR (Reverse Repo Rate) hikes.

Global Macro had mixed macro data trends across the world with the US showing signs of strong growth and inflationary pressures, most of Europe and China showing macro weakness, and some EM's showing rising inflation trends and currency pressures and commodities and Covid showing volatile trends.

What will RBI do?

RBI has done a stupendous job of managing Growth- inflation dynamics along with ensuring no pressures on external sector for last 2 years. We feel central banks across will face challenges in 2022 and RBI too will be a party to the same

Major challenges for RBI are as under:

1) Economy has started showing ***persistent price pressures*** which can impact CPI headline and core and RBI MPC can be forced to move the rates higher faster despite uncertainty of Covid

2) ***Improved growth outlook would add to credit cycle*** and crowd out government borrowing which would put pressure on bond yields
3) Growth drivers can also put pressures on import data and ***widening trade deficits can impact currency***
4) ***Rising inflationary trends will also put pressure on RBI to return to normalization quicker and absorb huge surplus durable liquidity*** which RBI has already showed the glide path
5) ***Quicker than anticipated reversal of monetary policies by Fed*** and other global central banks would add pressure on RBI to move the rates quicker

We believe that despite a very dovish guidance from RBI MPC and new Covid strains (Omicron), RBI still might be forced to fasten both normalization and rate hike process than their current guidance. Unless the new variant shows wide spread impact and leads to severe lockdowns, growth won't be impacted. Hence persistence price pressures (inflation) would lead to faster pace of reversal. ***We pencil in normalization to 25 bps narrow corridor by April 2022 and 2-3 repo rate hikes by end of 2022. Operative rate to move to 4.50-4.75 % by Dec 2022***.

Impact on Markets

We believe that for major part of the last year "***Carry***" was the theme. This year, the theme would be ***curve flattening (spreads and term premium across would compress).*** Gradual liquidity withdrawal with hikes in RR (Reverse Repo Rate), along with pick up in credit growth and high fiscal deficits will lead to yields trending higher across the curve with sell off ore in short end and hence curve would flatten.

Inclusion of sovereign bonds in Global indices should happen in CY 22 and can lead to some tactical rallies of 15-20 bps in long Govt bonds beyond 5 years. Any delay in inclusion would continue to add pressure on long bonds yields

Last year we witnessed yields across the curve move up by 70-75 bps in short end and 30-50 bps in long end. ***This year too we expect short end (1-3 year) to move upwards by 75-100 bps and long bonds (5-15 year) by 30-45 bps. We can see the GOI 10 year yields ~6.60-6.75%. Corporate bonds spreads to widen across tenures is what we anticipate as we believe that credit cycle will pick up and would see large corporate bond issuances next year.***

What should investors do?

Curve flattening i.e. technically Barbell strategy with lower duration products to protect investors return would be best theme to invest in 2022. ***Use of floating rate bonds and accrual funds would also provide a hedge against rising interest rate cycle.***

What can go wrong? (Risks to the view)

1) Wide spread of the new variant Omicron and consequent lockdowns in India and across the world can lead to tactical rallies and steepness in the curve against expectations of curve flattening
2) Global meltdown especially in China which can put a lid on commodities inflation and give some breathing space to RBI for reversal of rates
3) Fiscal consolidation might lead to lower than anticipated borrowing especially on long bonds which can lead to some rally in long bonds and can have a negative impact on growth cycle
4) No Booster shots announced and substantial reduction in immunity which makes the world vulnerable to strains of Covid again can lead to slower reversal of rates cycle by central banks

Source: Axis MF Research

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