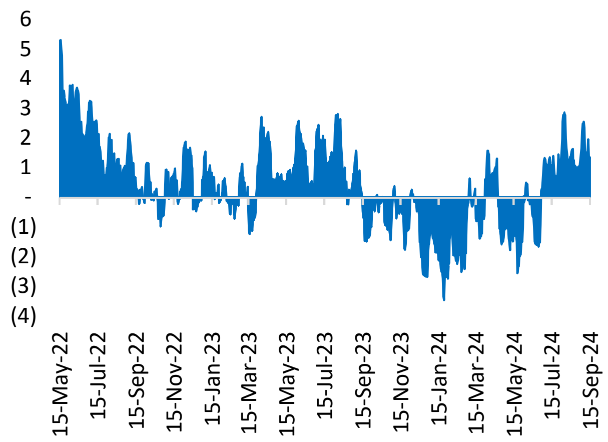
17th Sep 2024

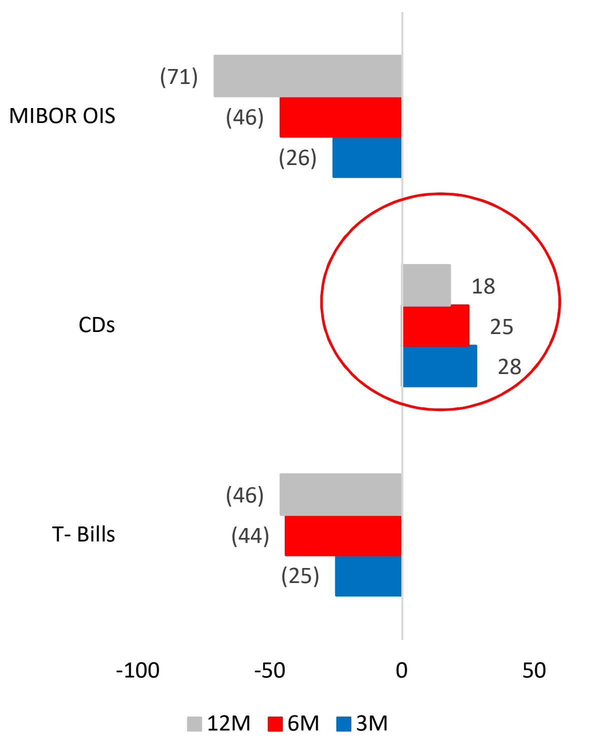
The US CPI print cooled to 2.5% in August as against an estimate of 2.6% and 2.9% in July. The recent trend is encouraging, while still above the FED's target of 2%. Currently, the CME FEDWatch tool shows 67% probability of 50 bps rate cut in September meeting which was 30% a week ago. During the week, US 10-year yield touched a low of 3.60% and the 10Y-2Y spread stayed positive. Indian benchmark 10 year yields have broken out of the range 6.84%-6.88% and presently trading at 6.77% amid continuous flows in debt segment due to JP Morgan Index inclusion.

Fig.1: Systemic Liquidity continue to remain in surplus; (Rs. In Lakh Crore)



Source: RBI, CEIC, UBI Research

Fig.2: In past 1 year, T-Bills and MIBOR OIS have softened whereas, CD rates have hardened; (change in bps)



Source: FBIL, UBI Research

Fed rate cut cycle likely to begin in this week

- The US CPI is trending lower, while it is still above the FED's ideal target of 2%. August CPI rose by 0.2% MoM on a seasonally adjusted basis and cooled to 2.5% YoY against EST. of 2.6% and 2.9% in July.
- The US 10-year touched a low of 3.60% and the 10Y-2Y spread is becoming positive indicating steepening of yield curve. Since late last week, the market probability of 50bps reduction in September FOMC meeting has spiked to 67% from 30% previously, a media article titled (The FED's rate cut Dilemma: Start Big or Small) in The Wall street Journal suggesting that the decision is close call.
- Dollar index currently trading at 100.40 which is below the last week's low of 100.87 showing signs of further weakness.

G-Sec yields broke below key resistance levels

- 10-year benchmark yield finally broke out of the 6.82%-6.84% range last week and closed at 6.76% on 16th Sep'24 showing signs of further softening (*Fig.3*).
- India CPI Aug'24 clocked 3.65% against our expectations of 3.3% while consensus was at 3.47%. Food CPI was the key driver of data surprise, coming in at 5.3% (UBI: 4.7%) while core inflation was broadly in line with our estimate. More importantly, CPI ex vegetables continues to remain subdued at 3.1% (lowest in 5 years) and hence signals that food prices, especially vegetables remain the mainstay of inflation trends. The moderation in headline inflation is due to favorable base effect which shall fade in Sep'24, thus, it doesn't align with the RBI target of 4%. This was asserted by the RBI Governor as well in the latest media interaction, that "we still have a distance to cover (towards 4% target) and cannot afford to look the other way".
- Even with market divided on the timing of the start of the rate cut cycle, we still hold our view on no possibility of rate cuts this fiscal. In specific, in October, we do not see any change in stance as well, with the RBI Governor emphasizing that "India's monetary policy will be governed primarily by domestic conditions and the RBI will make its decision irrespective of moves made by the US Fed". We continue to remain positive on long duration bonds based on favorable demand supply dynamics amid positive FPI flows in debt segment during FY25.

Liquidity in surplus still aberration in money market persists

- The system liquidity is consistently hovering in surplus zone which has gone upto Rs.2.5 lakh crore as of 05th Sept'24 and presently at Rs.1.35 lakh crore as of 15th Sep'24 (*Fig.1*). We expect further reduction in liquidity on account of GST & advance tax payouts due this month.
- The RBI has continued its OMO sales for 9th consecutive week with a total sale of Rs.695 Crore in the week ended 06th Sep'24 and a cumulative of Rs.18,950 Crore to absorb surplus liquidity.
- Over last one year (Sept'23 to Sept'24) the money market instruments like T-Bills and MIBOR OIS of less than 1 year tenor have softened from 25 bps to 71 bps, whereas Certificate of Deposits (CD) rates have gone up, specifically, 28 bps in 3 month segment which is higher than 18 bps in 12 months segment (*Fig.2*). The overall yield curve has been shifting downwards on favorable demand supply dynamics, however, banks are raising funds at higher spreads over T-Bills.
- Despite surplus systemic liquidity, the fight for deposits during end of quarter may continue to drive higher the already elevated spreads between Certificate of Deposits (CD) over T-Bills (~65bps in 3months, ~80bps in 6months and ~95bps in 1 year). It may be pertinent to note that the spread for 1 year T-bills to CD levels is close to 98 bps, last seen in Jan-23, a key level from where it receded (*Fig.4*).

T-Bills supply cut amid surplus liquidity is another positive

- RBI has cancelled T-Bill auctions scheduled on 18th & 25th Sep 2024 worth Rs.20,000 crore each. This is probably motivated by persistence of high government balance with RBI. Advance tax and GST flows in Sept'24 may push the government balance higher (Balance in Sep'23 went upto ~Rs.3.95 lakh crore).
- The T-Bill auction cut is more of a cash management measure by the government and may not have fiscal implications, in our view. Govt. may borrow via T-Bills in the second half of the year to make up for this reduction in borrowings. The aforesaid announcement shall help improve banking system liquidity during advance tax / GST outflow period and likely drive further easing in Tbill yields.

Fig.3: T-Bill supply cut further provides scope for Yield curve steepening; (%)

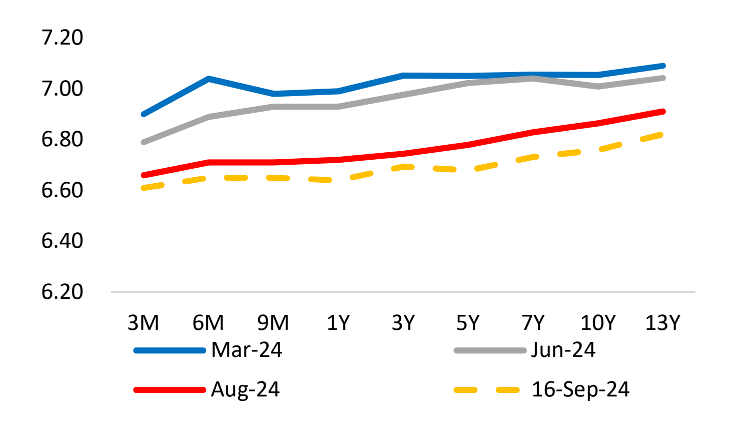
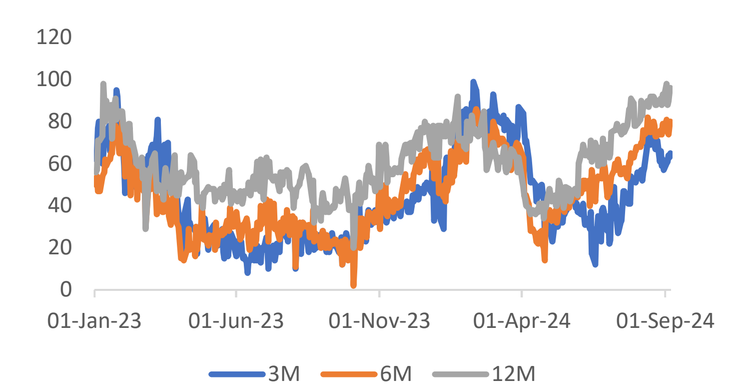


Fig.4: Spreads between T-Bills and CDs at Jan-2023 highs; (bps)



Source: Bloomberg, CCIL, FBIL, UBI Research

By:
Kanika Pasricha
kanika.pasricha@unionbankofindia.bank

Dhiraj Kumar
dhirajkumar@unionbankofindia.bank

Banking Research Team	
Kanika Pasricha **Chief Economic Advisor**	**kanika.pasricha@unionbankofindia.bank**
Suneesh K	suneeshk@unionbankofindia.bank
R Gunaseelan	gunaseelan@unionbankofindia.bank
Nidhi Arora	nidhiarora@unionbankofindia.bank
Rajesh Ranjan	rajeshranjan@unionbankofindia.bank
Jovana Luke George	jovana.george@unionbankofindia.bank
Amit Srivastava	asrivastava@unionbankofindia.bank
Rohit Yarmal	rohitdigambar@unionbankofindia.bank
S. Jaya Laxmi	s.jayalakshmi@unionbankofindia.bank
Dhiraj Kumar	dhirajkumar@unionbankofindia.bank
Akash Deb	akash510@unionbankofindia.bank
Shreyas Bidarkar	shreyas.bidarkar@unionbankofindia.bank