Is this Time Different?

Cyclical

Or Structural

Interest Rates: Cyclical vs. Structural

Interest rates is a **monetary policy** tool available with the Central Banks in order to move economic growth towards its potential

Negative Output Gap

Growth < Potential

Rates are Cut

Positive Output Gap

Growth > Potential

Rates are Hiked

Balanced Output Gap

Growth = Potential

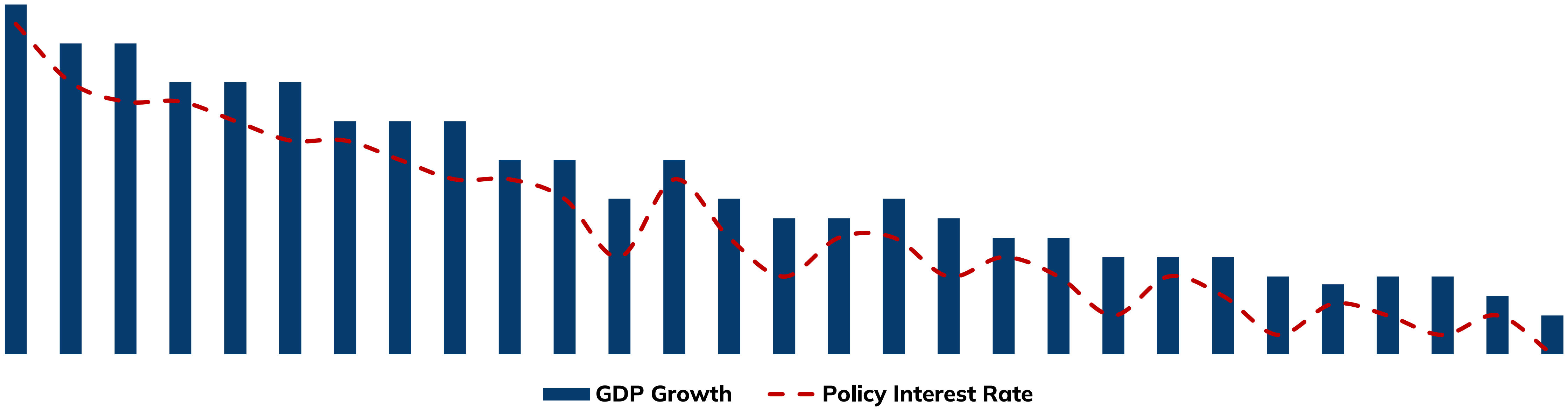
Rates are Unchanged

The graph is for illustrative purposes only

The Structural Rate Argument

Over the long term, changes in the growth potential changes the neutral real rate of interest (R*).

Higher potential growth ideally means higher R* and therefore higher interest rates. Vice-versa, lower potential growth means lower R* and therefore lower interest rates.



The graph is for illustrative purposes only

The Structural Rate Argument

So, What Influences R*?

Demographics – Improving working age population will increase potential growth and therefore increase the R*

Productivity – Technological developments and reforms can lead to higher productivity and therefore higher R*

In the short term, R does not change. The interest rates are determined looking at the output gaps in the economy. A central bank cannot observe the R*, but can only focus on the output gaps in the short term to set monetary policy.*

India: Structural Rate Arguments for Lower Rates

If one believes that fall in bond yields in India is structural, then the fall would give rise to the following questions:

1. Is long term potential growth going down for India?
2. Is demographics working against us?
3. Have we achieved the level of per capita income which suggests that the economy will now generate excess savings over investments on a continuous basis?

If the answer to the above questions is NO, then interest rates CANNOT be shifting down structurally. If its not structural and it's cyclical, then where are we in the cycle?

India: Cyclical Rate Arguments and Where we Stand

We are in a mid cycle of economic growth

Healthy Balance Sheets
- Government
- Financial System
- Corporates
- Households

With Growth getting broad-based; increased participation from SME's & Rural sectors

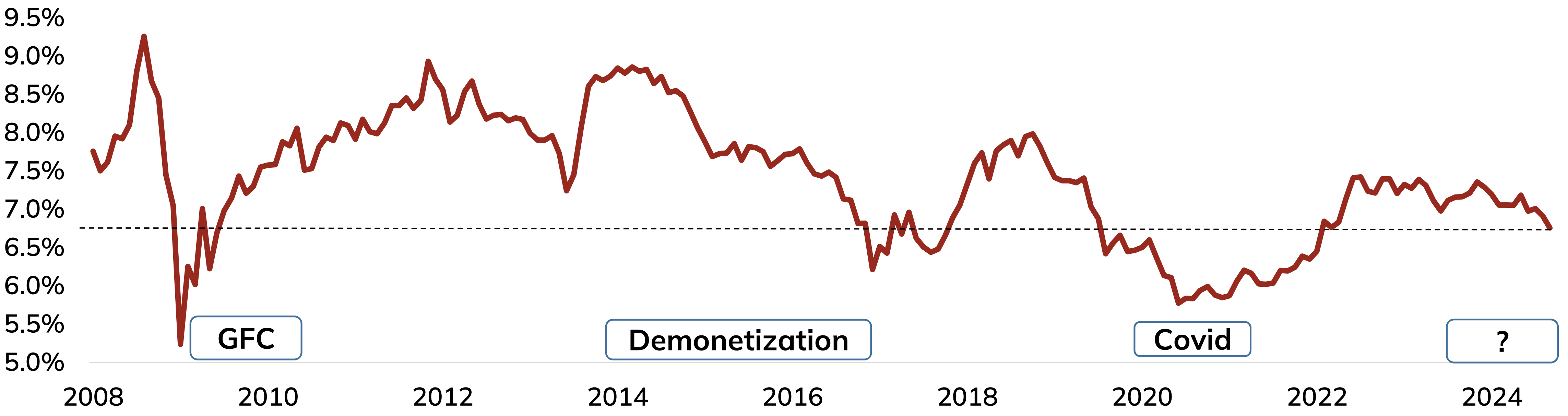
Real Estate Cycle on a Strong Footing

Output gaps have closed and capex getting broad-based;

The Key Question to ask –

Are bonds expensive today? Is the economy in crisis?

India 10 Year G-Sec Yields (%)

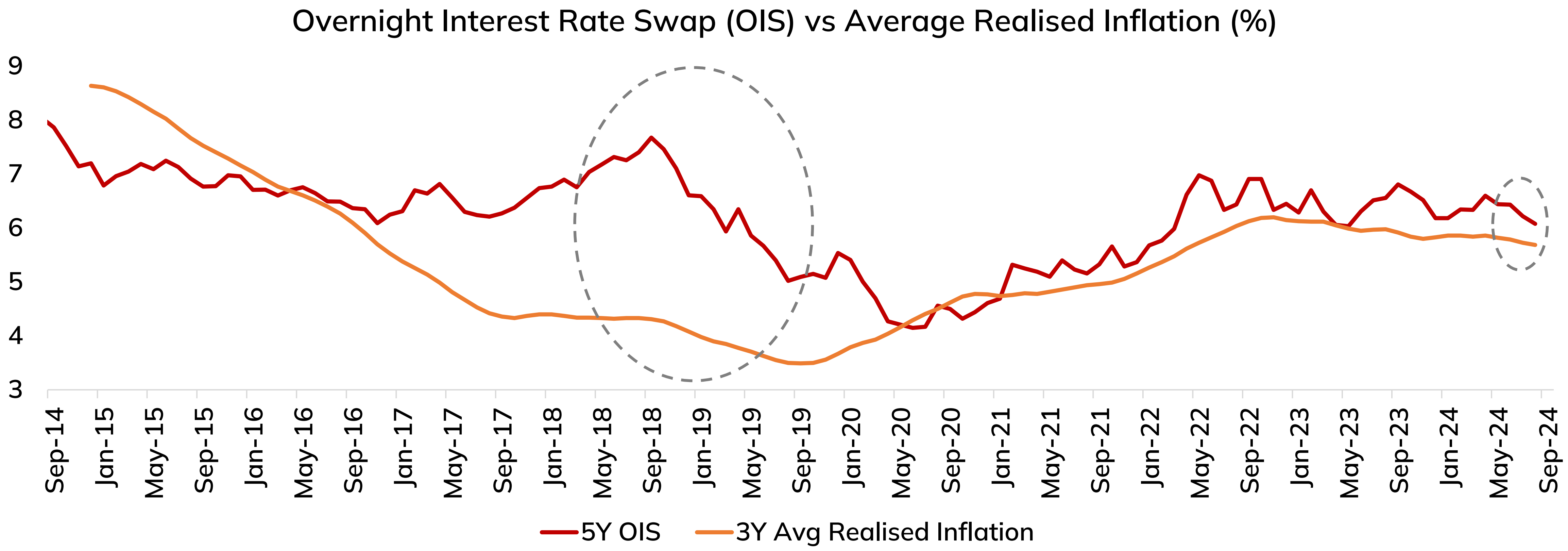


Source: RBI. Data as on Sept 25, 2024

We have traded below the current levels of 10 year G-sec yields only during a recession or during a crisis. There is no such emergency today.

The Key Question to ask –

Is Inflation Structurally Lower?



The chart of a 5 year OIS rate vs 3 year average realized inflation highlights that unlike FY 2018-19, interest rates in India are not restrictive.

Now, some argue that..

And, FPIs are investing heavily

Fiscal deficit is declining, the current account is in surplus & inflation is moderate

Many central banks are cutting rates, so the RBI will follow, too.

The US Dollar is weakening, so will benefit Emerging Markets

Let us break these myths..

MYTH

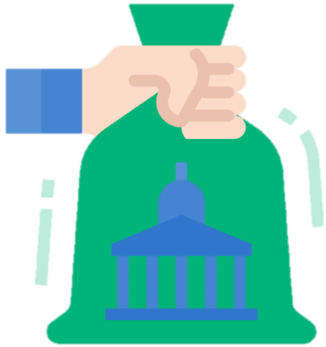
India: It is a Structural Bull Market in Fixed Income

1

Current Account has structurally improved

2

Savings pattern has permanently shifted towards long duration assets



3

Government is reducing fiscal deficit structurally

4

Dollar weakening, Index Inclusion should lead to higher external flows permanently.

Current Account – Is the change structural?

Domestic Economy	Trade & External Financing Perspective

Current Account Surplus = Excess of Savings - Investments

Is the level of investments high enough to leave us with a permanent excess of savings over investments?

Current Account = Exports - Imports

1. Commodities at cyclical low. But will it stay low forever?

2. Can gains in service exports stay permanent or will it require support continuously?
- Trade-weighted real effective exchange rate (REER) rose to 107 from 103 in 6 months, indicating losing currency competitiveness.
- Can we continue to keep skilled labor costs low to gain permanent advantage?

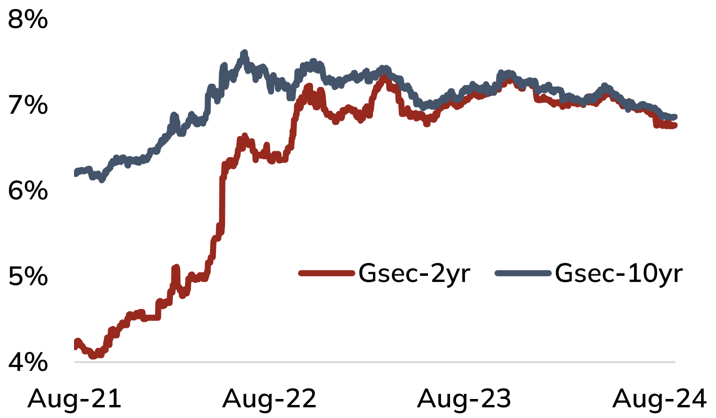
India: It is a Structural Bull Market in Fixed Income

Has Savings Pattern Permanently Shifted to Long Duration Assets?

Absent Term Premium

Earlier, the gap in yields in long and short dated G-secs was large and attractive. But now, the spread is negligible.

Eroding Term Premium (10Y-2Y)



Source: RBI

Competition from Banks

The gap between Bank bulk deposit rates and G-sec yields now are very low. This is opposite of the Covid-19 period when the G-sec was at 6.75% - 7% and bulk deposits were at 4% - 4.5%.

Phase	Yield Difference
COVID Phase (30Y Gsec – 2Y Deposit)	3.0% - 3.5%
Today (30Y Gsec – 2Y Deposit)	0.20%-0.25%

Life Insurance Surrender Norms

The gap between Bank bulk deposit rates and G-sec rates are impacting the demand for traditional insurance products.

Also, given the change in surrender value norms starting Oct 2024, the demand for long-dated G-secs by life insurers may reduce.

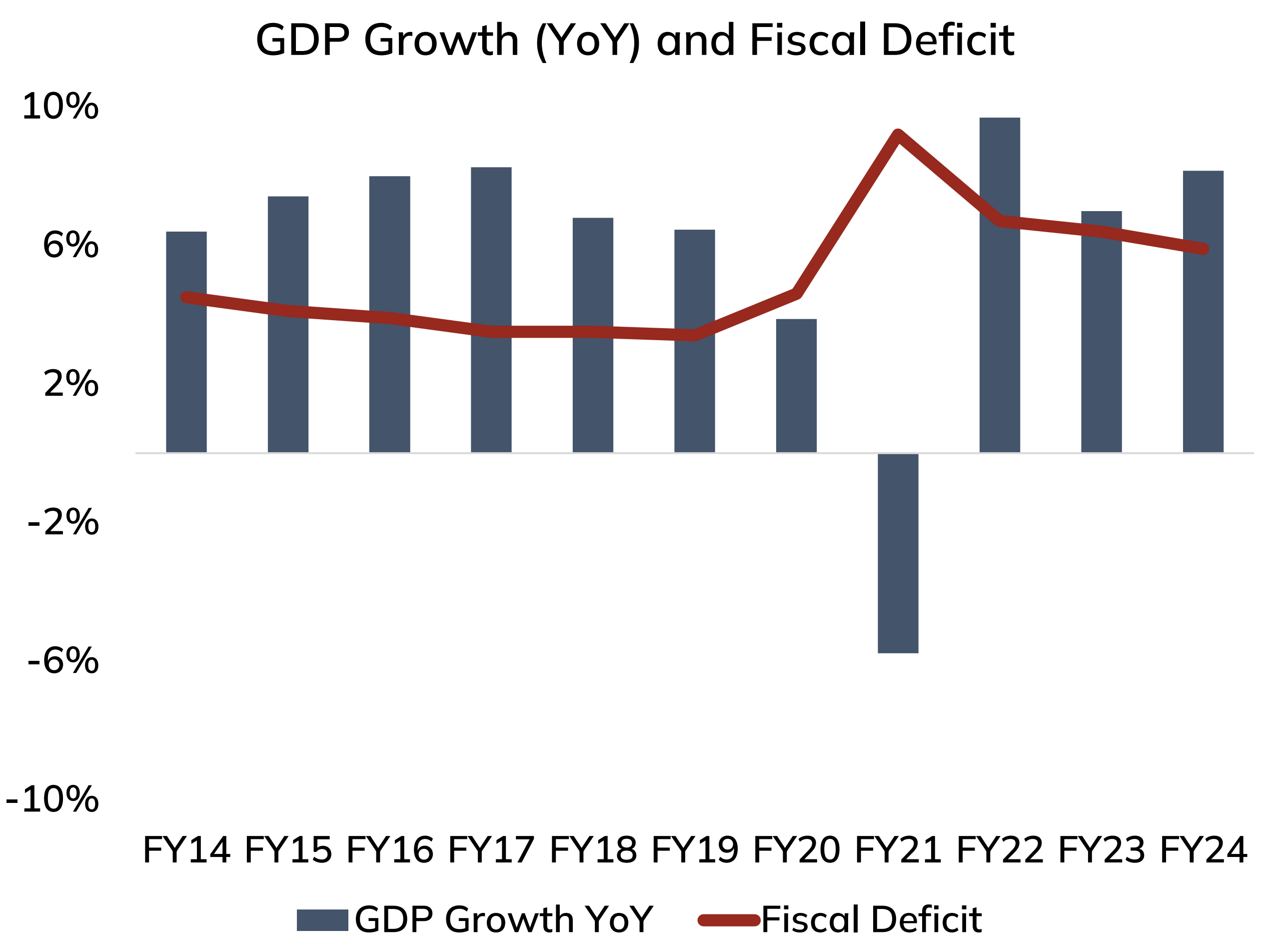
Reflexivity has led to all investors piling up on the long duration assets. Investors duration positioning is at an extreme. For some time, reflexivity feeds on itself before it does not.

India: It is a Structural Bull Market in Fixed Income

Is Reduction in Fiscal Deficit Structural?

- It is a cyclical phenomena that in a good growth environment, government revenues improve and it helps in fiscal deficit reduction. In addition, positive asset cycle (equity market, real estate) add on to the government revenues. These are automatic adjustments to the fiscal policy.

- In a good growth environment, the reduction in fiscal deficit is substituted by private sector demand. Currently, private sector demand is clearly visible through the improved industrial credit demand and robust demand for mortgages.

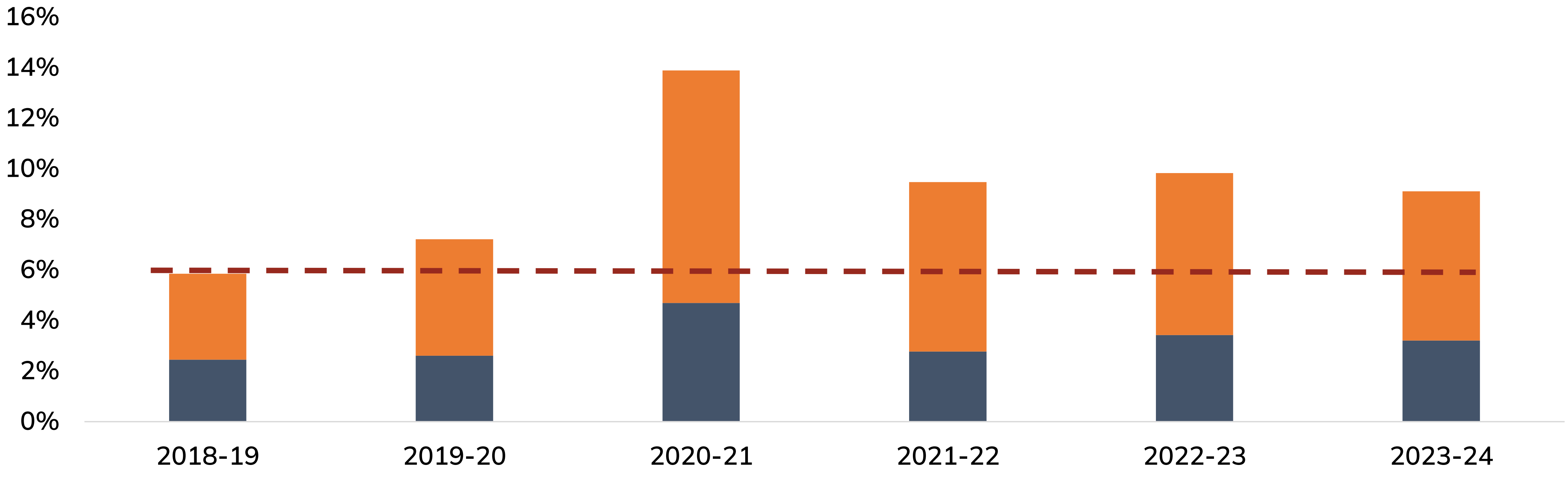


Source: Indiabudget.gov, PIB

Is Reduction in Fiscal Deficit of Govt. Structural?

While the Centre is consolidating its budget deficits, states have continued to struggle. The combined deficits of Centre and State are still higher than the pre-Covid-19 period.

Centre and State Govt. Fiscal Deficit Trend



Source: RBI

Weakening of the US Dollar

- Emerging economies (excluding India) are at their worst due to a strong dollar. Given more rate cuts from Fed in the pipeline, a weak dollar should support Emerging Market (EM) economies to stimulate growth.

- At the same time, we are seeing commodity prices bottoming out as most commodities trade close to their cost curves. Improvement in EM growth can support commodity demand, shift capital to EM's and push commodity prices higher.

- Within Emerging markets (ex India), Equities look far more attractive than Bonds. We believe, yields in a lot of EMs are already pricing in multiple rate cuts. Therefore a weak dollar may not draw as much money in EM bonds as EM equities.

- We have already seen ~19 billion USD FPI flows in India since index inclusion announcement (Source: NSDL). How much of it is up-fronted demand?

MYTH

If Fed Cuts, RBI Cuts

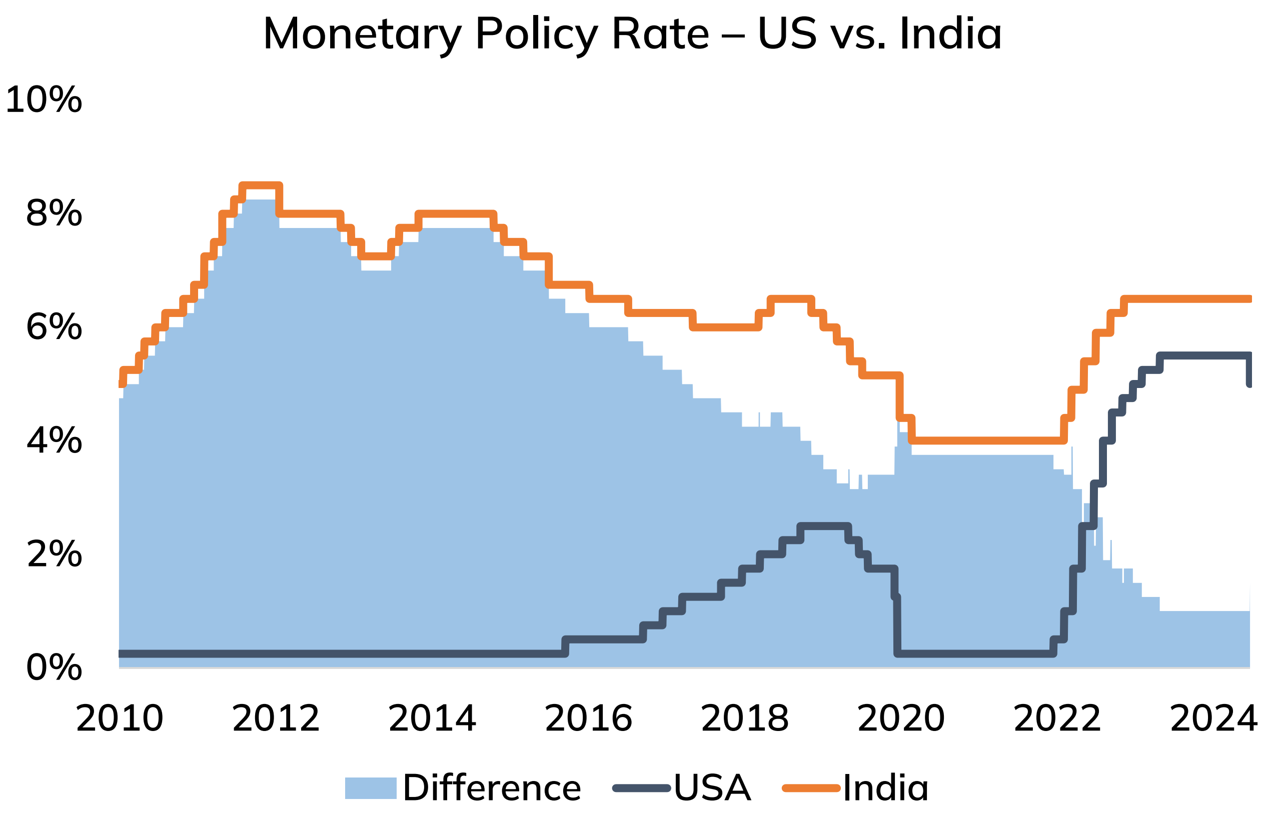
ICICI PRUDENTIAL MUTUAL FUND

- India has earned independence in terms of monetary policy setting. The macro economic stability allows RBI to run an independent monetary policy.

- The policy goals are different - Fed is neutralizing its restrictive policy, India is already at neutral and not restrictive rates.

- There have been several occasions when India and US have diverged from their policy actions. Spread between India and US 10 year was at its lowest. There is scope for a decent mean reversion.

- The recent memory of the market is - synchronized rate cuts and then rate hikes globally during Covid. Covid was a global event (like GFC) which impacted everyone simultaneously and therefore the response was synchronous.



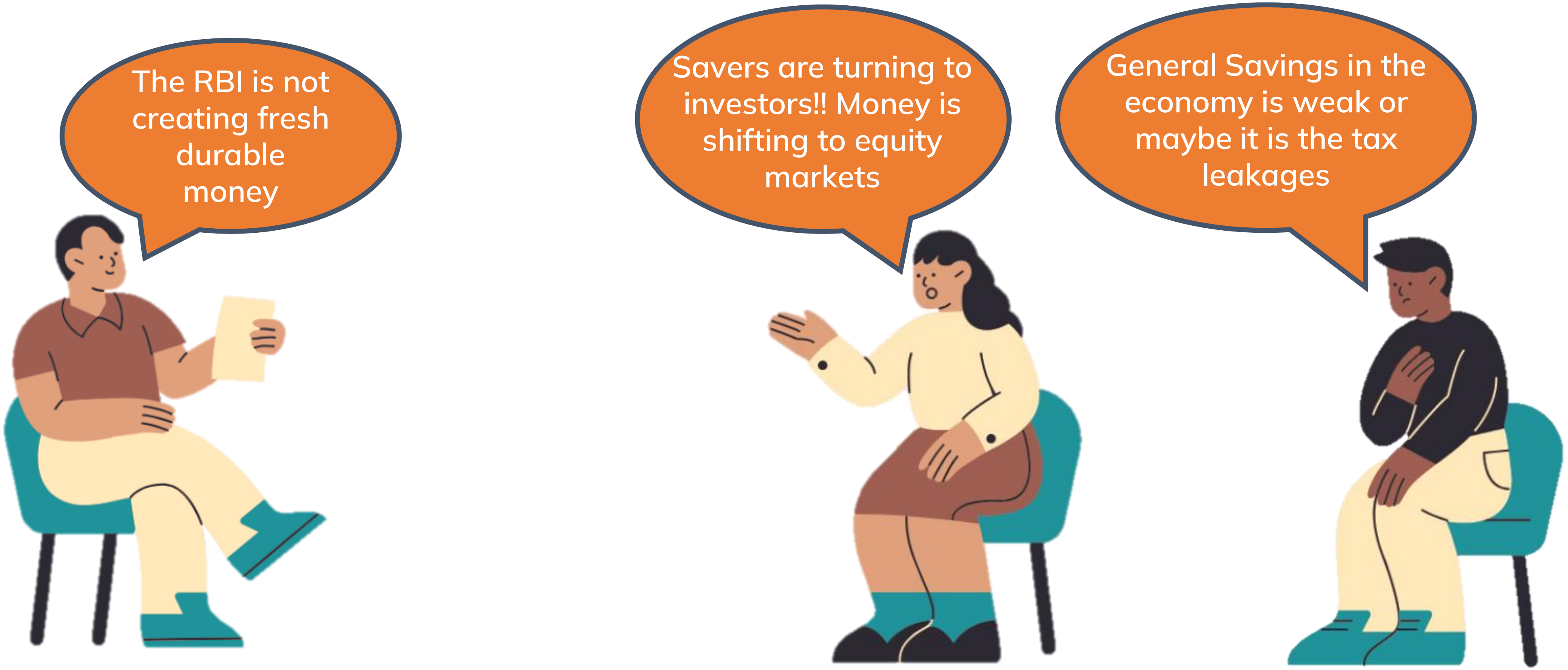
The RBI governor has reiterated several times that domestic growth inflation dynamics will determine monetary policy in India, not Fed actions.

MYTH

Lagging Deposit Growth

ICICI PRUDENTIAL MUTUAL FUND

Too many views on deposits today. Popular arguments are around..



Lagging Deposit Growth

Low Money Creation by the RBI

- **The M0 (Monetary Base) or the size of RBI's balance sheet is determined by the currency in circulation and the reserves held by the banks with RBI.**

- The Liquidity Preference Theory states that **"the demand for money is influenced by transaction motive, speculative motive or precautionary motive. The transaction demand for currency notes is influenced by the habits of the households."** With the UPI, there is a change seen in the habit of individuals, which earlier had modified the relationship between M0 and M3 (Broad Money).

- When monetary policy rates are set by the Central Bank, they have to ensure that call money rates/ overnight rates are closer to the policy rates. Banking system liquidity should be enough to ensure this objective. (**Weighted Average TREPS Rate has been closer to the repo rate over the last one year**).

- The level of deposit growth in the banking sector is largely dependent on the credit growth and the fiscal deficits i.e. growth of the lending and investment book. **Credit growth growing @ 13.6% YoY (as on Aug 23, 2024) is healthy for an economy growing nominally at ~11%.**

There is no reason to believe that M0 growth is hurting credit growth and therefore deposit growth. Hence, to use earlier relationships of M0 to M3 and draw hypothesis that M0 is hurting deposit growth is incorrect.

Lagging Deposit Growth

Depositors are becoming Investors; Money is shifting to Equity Markets

ICICI PRUDENTIAL MUTUAL FUND

- **Banking Aggregates do not change by the Choice of Asset Allocation.** Buying or selling equity stock is only a transfer and does not impact Banking Aggregates.
- It does, however, **impact the quality of deposits for the banking system; shifting from retail to bulk deposits.** Retail deposits are considered stickier than bulk deposits. Therefore Liquidity Coverage Ratio (LCR) are much lower for retail deposits compared to bulk deposits.

Consistent Banking Aggregates

The correct analysis is - household asset allocation has shifted to equities over bank deposits. This changes the underlying quality and cost of the deposit (from retail to bulk), but does not change overall banking aggregates.

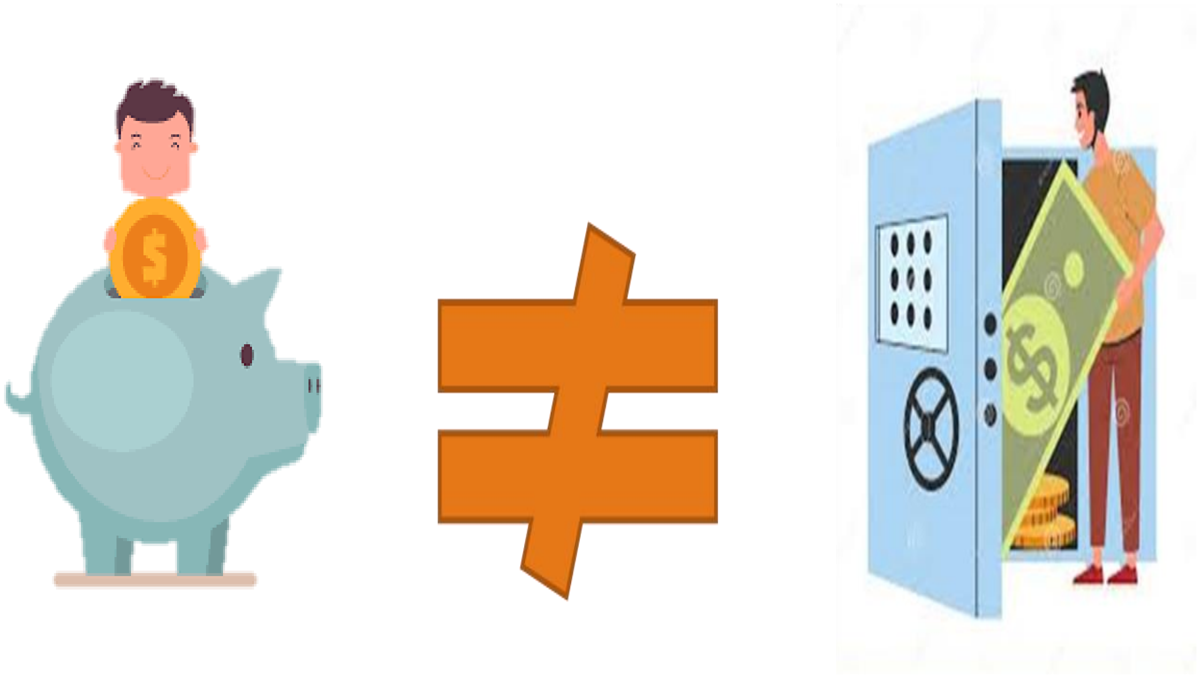
General Savings in the Economy is Weak

- **To consider Deposits as Savings is incorrect!**

- In the earlier sections, we discussed lower current account deficits. If current account deficits are lower in an economy, how can savings in the economy be weak?

- **Level of savings depends on the level of income. Since GDP growth has improved, absolute savings in the economy has been higher.**

- **Deposits are in the nature of financial asset/liabilities while Savings is an economic term.**



Tax leakages impact deposit growth!

- **The hypothesis is "Tax Deducted on Deposits gets Leaked out of Banking System."**

- Taxes have to be looked from at from a fiscal deficit lens and should not be looked at from a point of instance individually! What Government collects as taxes, spends as expenditure. While taxes reduce deposits, government expenditure creates deposits.

- Therefore, it is incorrect to single out and view the impact myopically as a leakage.

What Influences Bank's Capacity to Lend?

ICICI PRUDENTIAL MUTUAL FUND

The amount of capital available with the banks determines their capacity to lend.

Assets		Liabilities	
Reserves with RBI	INR 10 million	Capital	INR 15 million
Government bonds	INR 20 million	Deposits	INR 85 million
Loans	INR 70 million		

The cost of deposits determines the profitability and not the capacity for banks. Every incremental credit creates deposits.

- Higher capitalization can lead to higher competitiveness as each bank fights for its market share. This impacts profitability of the sector, as each bank wants to maximize its share of both loans and deposits.
- Given very comfortable capital adequacy ratios, there is no constraint to credit growth
- Liquidity Coverage Ratio (LCR) ratios are better measure of ALM risk, not Loan to Deposit (LDR) ratios.
- Incremental LDR ratios mean revert over cycles. If Incremental LDR ratios in the past have been very low, future incremental LDR ratios can be very high.

Our View

- We believe in cyclicality of Interest Rates and Interest Rates follow business cycles.
- We continue to believe that economy is in the mid cycle phase.
- We expect RBI to keep the Interest Rates unchanged.
- The bond market look expensive.
- We expect bank deposit growth to improve by itself and RBI to maintain comfortable liquidity conditions.
- We expect Emerging Market equities (ex-India) and commodities to benefit from Fed easing.
- We recommend investors to focus on accruals rather than duration.

Disclaimers

Mutual Fund investments are subject to market risks, read all scheme related documents carefully.

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