### Summary:

- **Global risk aversion intensified** after the Federal Reserve provided a dovish message and Euro-zone economic indicators continued to disappoint raising concerns about global growth prospects.
- The net result has been a sharp downtrend in global yields witnessed across markets and a flattening bias in yield curves driven by increased concerns about the global growth environment.
- We see the USD and JPY remaining bid in an environment of falling global yields and weakness in global equity markets. There is a possible upside potential in store with regards to the USD/EM pack in the near-term.
- On the domestic market front, the bit of good news is that the government has exceeded its disinvestment target for FY2019.
- In the local markets, the main focus will be on the scheduled auction of the USD/INR buy/sell swap that is due to take place for 26-March-2019.
- The main events for the week ahead are:
  1. **German IFO surveys: (25-March-2019):** After a weaker reading of PMI surveys, investors will scrutinize the IFO surveys to assess the state of business sentiment in the region given that the industrial sector appears to be in a technical recession.
  2. **RBI auction: (26-March-2019):** The RBI will auction the quantum under the USD/INR buy/sell swap for USD 5 bn. The recent moves in the forwards, OIS and the MIFOR suggests that it has been priced in. However, there could be some knee jerk reaction if the final outcome deviates from expectations.
  3. **Government borrowing calendar H1FY2020 (26-March-2019):** The RBI will announce the government borrowing calendar for H1FY2019 with markets expecting ~55%-60% of borrowing as percentage of total borrowings for the fiscal year to be announced. We suspect that the impact will be felt more on the shape of the curve depending on the maturity wise issuance that gets announced.
  4. **US GDP Q42018 (28-March-2019):** There could be a downward revision in the US GDP reading for Q42018 to 2.4% from a previous reading of 2.6% reflecting lower net exports and government spending.
  5. **US PCE core deflator (29-March-2019):** The core PCE deflator is expected to come in at around the 1.9% mark that is unlikely to have a substantial impact on the markets.
The Fed turns more dovish pushing US real yields lower: The main message from the recently concluded FOMC meeting is that US monetary policy is turning more dovish than was previously expected. The changes to the ‘dot plot’ showed that it is in no hurry to hike rates further. Additionally, the dot plot seems to have indicated that the terminal fed funds rate (2.6%), the rate that the Fed plans to end its tightening cycle, is expected to remain well below the estimated long-term neutral rate (2.8%) over the 2019-2021 period implicitly indicates that the Fed wants to keep its monetary stance more accommodative in the medium to long-term to support the real economy. The net result of this was a sharp fall in US yields driven by a sharp correction in US real yields and an inversion in the US yield curve in some segments of the curve. Chart 1 illustrates the underlying drivers of the US 10-year sovereign yield that has been split into its two components: real rates and breakeven inflation. Hence, the decline in the UST 10 year has taken place reflecting movements in the real yields. The current move lower in real rates is a function of a build-up of concerns about the US economy and a re-pricing of US monetary policy expectations over the medium-term. The break-even inflation rates have moved higher and is being influenced by crude price developments but could soften if risk aversion pushes crude price lower.

**Chart 1: US 10 year yield has fallen sharply**

![Chart](image)

It is worth noting that in previous communication, the FOMC has emphasized that it will give greater weight to the developments in the UST 10 year and UST 3-month T-bill spread as a possible recession indicator than the spread between the other segments of the yield curve such as the commonly tracked UST 10 year and 2 year spread. Hence, an inversion of this curve suggests that market concerns about US growth prospects have picked up considerably. At the current juncture the slew of US data releases continues to emphasize that growth is weakening but that a recession or recession like conditions are still not in place. Hence, there could be some correction that could kick in later on in the year as the shorter-end could move lower in the medium-term once the Fed ends its balance sheet run-off that in turn results in an improvement in liquidity conditions in the local US markets. However, for time being an inversion of the yield curve is likely to remain a concern and stoke apprehensions about growth prospects.

But the USD recovered after an initial reaction: A dovish Fed accompanied by a substantial flattening to inversion in certain segments of the yield curve should have in theory resulted in a broad-based correction in the USD. Indeed, the USD did weaken in a knee-jerk reaction to the FOMC meeting. However, it recovered sharply a day after primarily because global risk aversion returned with a vengeance. The main catalyst for this was a much weaker than expected Euro-zone and German manufacturing PMI data that reinforced expectations that growth in the non-US world remains fairly weak and benign. Besides, investor concerns had already picked up post the FOMC lowering its growth projections for 2019-20 and raising the unemployment rate forecasts for 2019. The net result was that global bond yields fell sharply and that DM yield curves flattened considerably reflecting investor concerns about global growth prospects. Hence, the simultaneous fall in global yields and flattening in yield curves resulted in the USD regaining most of its lost ground post the FOMC meeting. The capitulation in yields was most prominently visible in the German bund markets as the 10-year yield on German bunds fell to a 29-month low of -0.013% and is currently trading at around the -0.025% mark.
The persistence of risk aversion has even pushed USD/EM currency pairs higher even as the global monetary environment remains fairly accommodative. Going forward, the FX environment is likely to become a tussle between lower US yields and global growth concerns. As long as investor concerns about growth prospects remains in place, we think that there is limited downside potential in the USD even if the Fed continues to send dovish messages to the market.

India government exceeds disinvestment target: There was some favourable news on the domestic fiscal balances front with the government announcing that it has exceeded its target of INR 800 bn for FY2019 raking in INR 850 bn. This was accomplished by fifth tranche of the CPSE ETF and REC-PFC deal respectively. Hence, concerns about domestic fiscal balances could diminish and work out as a net positive for the domestic fixed income markets.

‘Brexit’: The dust has not cleared: The EU granted the UK an extension to the 29-March-2019 deadline but the duration was a lot lower than the three months that was requested for by the UK PM. The UK has been granted upto 12-April-2019 to decide on whether to accept the current ‘withdrawal agreement’ that is in place, provide fresh guidance in terms of its plans for the way forward or leave with a ‘No-Deal’ Brexit scenario.

The date was chosen also because the UK will also have to decide on whether it wants to participate in the EU elections so as to organize itself in time for 23-26-May-2019. It means that by 12-April-2019 the UK will have to make a choice between leaving with no-deal (which MPs have rejected) or requesting for a further extension and subsequently participate in EU elections. Media reports indicate that the UK PM intends to hold a third and final vote on her ‘Brexit’ deal early this week possibly even later on today. However, she will first have to convince the UK Speaker that she has made substantial alterations to the bill, perhaps including some of the wording that she agreed with EU Head Juncker. Even if she is able to put her bill for vote in the Parliament, it will most likely fail. The road ahead after this remains uncertain with several possibilities in store that could force the UK PM May to hold the ‘so-called indicative votes’ on alternatives in the Parliament. The UK MPs could then take over the process and proposed various options such as a permanent customs union, the Norway type agreement, hold a second referendum to revoke Brexit and call for fresh elections. Whatever the final outcome, we expect substantial volatility in the GBP to persist. Markets are still not positioned for a ‘No-Deal’ Brexit outcome.
Asset market update: Risk aversion could keep the USD supported

**USD: Not falling as yet:** The Fed’s dovish message and implicit indications that it expects its policy rate to remain well below the level of the long-term neutral rate might have paved the way for the USD to come under pressure. However, we maintain that there will be limited downside potential given that concerns about the Euro-zone remain in place. The flattening bias in yield curves is likely to mean that risk aversion remains prominent. During the course of the week a number of FOMC members are due to speak at various forums, investors will seek some clarity on the rationale behind the sharp revisions made to the economic projections. There are also tier two data in the form of housing and US consumer confidence that is due over the week but that is unlikely to work as a substantial trigger. We maintain our near-term trading range of 96.00-97.00. US treasury yields are likely to continue trading with a downside bias driven by growth concerns and as US real yields continue to correct lower reflecting a much lower fed funds rate profile in the medium term.

**Domestic assets: Trapped in the global risk-off environment:** Even as the global monetary environment remains fairly accommodative, we see limited downside potential in the USD/INR pair in the near-term given that global growth concerns remain prominent at the current juncture. Hence, we see a mild upside potential emerging with a possible range of 68.50-69.50 in the week ahead. Domestic bond yields are likely to respond primarily to the borrowings calendar and the buy/sell swap auction. On balance, we see prospect of continued downtrend in domestic yields to persist in line with the global trend.

**EUR/USD: More downside potential remains in place:** On the data front, the main release was the Euro-zone PMI surveys that continued to show that the manufacturing sector remains in stress. The PMI manufacturing survey declined to 47.6 (expectations: 49.5) in March-2019 that was the lowest reading since 2013 and the German PMI manufacturing sector plunged to 44.7 level consistent with a substantial contraction. However, the Euro-zone PMI services continues to show that private demand is still expanding even as the pace of expansion is moderating. The PMI services came in at 52.7 above the break-even expansion level of 50. Nevertheless, the PMIs continue to show that the Euro-zone industrial sector remains in a possible recession and is still being adversely affected by uncertainty about the ‘US Protectionist’ stance. We see more downside potential in store especially if Euro-zone data flow continues to surprise to the downside. The ECB President Draghi is due to speak on 27-March-2019 and is expected to reinforce the accommodative framework of the ECB. We see a possible range of 1.1250-1.1400 to persist in the near-term.

**GBP/USD: Tracking ‘Brexit’ developments:** The pair is likely to remain volatile tracking developments in the UK Parliament. Any indications that the UK is moving away from a no-deal outcome could induce an upward bias in the pair. Last week, the Bank of England maintained status quo on rates and the size of its balance sheet that was a unanimous decision among the members of the monetary policy committee (MPC). The decision and tone was in line with ours and the consensus expectations and was similar to the previous policy meeting. The main message from the policy statement and the minutes was that the BoE is waiting for the final ‘Brexit’ outcome before taking a decision on the way forward. We see two scenarios:

1.) ‘Soft-Brexit: Some monetary tightening in the medium-term:’ The UK leaving the UK with a deal that results in a rebound in investment spending and growth that could in turn push core inflation pressures higher. Hence, demand could outstrip supply forcing the BoE to resume tightening possibly in Q42019. The GBP could rally on a trade-weighted basis that could in turn limit the ability of the BoE to tighten aggressively.

2.) A ‘no-deal’ Brexit: Induces a recession forcing the BoE to turn accommodative: An adverse outcome of a no-deal could induce a possible recession. We expect the BoE to look through the possibility of a weaker exchange rate and possibly cut its policy rates by 25-50 bps. A decision to resume QE would depend on the magnitude of the growth shock.

**USD/JPY: Risk aversion could pull it lower:** The USD/JPY pair has broken lower driven by risk aversion and falling US yields. We expect this trend to persist as the downside bias in US yields persists given that investors are still digesting the outcome of the latest FOMC meeting. We see a downside possibility of109 emerging in the near-term for the pair.
Chart 3: Asset market performance over the previous week

<table>
<thead>
<tr>
<th>FX Market performance</th>
<th>15-Mar-19</th>
<th>22-Mar-19</th>
<th>Change over the week (%)</th>
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<tr>
<td>DXY</td>
<td>96.52</td>
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<tr>
<td>USD/INR</td>
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<td>EUR/USD</td>
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<td>USD/CNY</td>
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<td>USD/THB</td>
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<td>USD/INR</td>
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<td>USD/SGD</td>
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<td>USD/RUB</td>
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<th>Rates market overview</th>
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<th>Change over the week (bps)</th>
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<td>UST 10 yr</td>
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<td>INR 1 year</td>
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<td>EUR 2 YR</td>
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<td>JPY 2 yr</td>
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<td>JPY 10 yr</td>
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<td>GBP 2 yr</td>
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<td>AUD 10 yr</td>
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<td>CAD 2 yr</td>
<td>1.621</td>
<td>1.532</td>
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<tr>
<td>CAD 10 yr</td>
<td>1.714</td>
<td>1.595</td>
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Note: EUR 2 yr and EUR 10 yr refer to the German yields respectively.
Source: Bloomberg & ICICI Bank Research
Treasurer Research Group
Economics Research

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Treasurer Desks

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