16 July 2022

Dipanwita Mazumdar
Economist

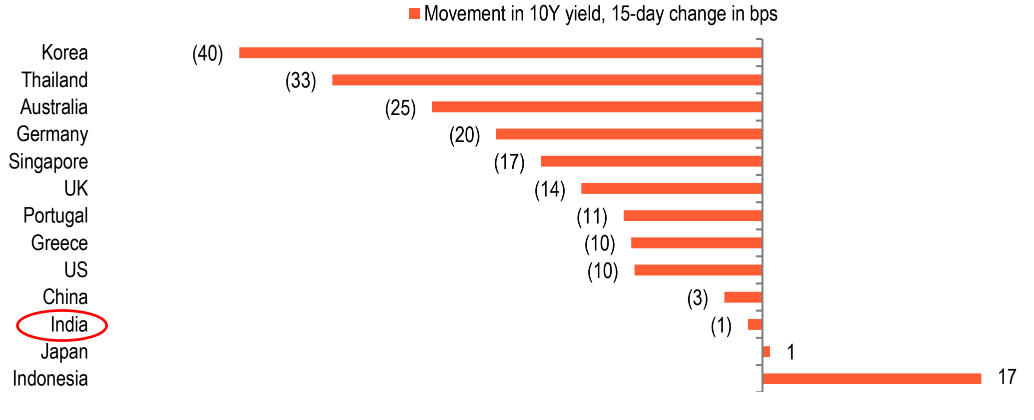
Bonds' Wrap

Global sovereign 10Y yields have shown moderation across the board as recession fears outweighed inflationary concerns. However, central banks kept in mind price stability and went on with aggressive rate hikes. India's 10Y yield has only fallen a tad in the current fortnight. Average borrowing cost for central government securities, SDLs and TBills have remained unchanged or fallen a tad compared to the previous fortnight. Even for corporate paper as well yields have shown moderation. Durable liquidity is still at an elevated level which is supporting yields apart from risk off sentiment due to aggravated growth concerns. We expect India's 10Y yield to trade in the range of 7.40-7.50% range in the next fortnight with risks remaining on the upside. Major event will be the Fed policy meeting. As per CME Fed watch, 71% traders are anticipating a 75bps rate hike. However, 100bps cannot also be ruled out. If this happens domestic yields might inch upward in line with global yields. Also any devolvement in the auctions will put pressure on yields as seen in 15 Jul 2022 auction. Even depreciating currency also poses upside risk to domestic yield outlook in terms of FPI debt outflow. Another notable development of late is that OIS-1Y swap rate is trading at 6.35% which is reflective of the fact that repo rate might be raised by another 150bps in the next 12 months. However, we expect 50-75bps hike in the current cycle.

Lower risk appetite increased demand for sovereign yields:

Sovereign yield movement for the current fortnight ending 15 Jul 2022, was driven by impending risks to global growth. Fears of recession were clearly visible in the muted global PMI print, tighter labour market conditions in the US and recent inversion of its yield curve (2Y and 10Y paper), China's less than expected GDP data print for Q2CY22 and its declining home sales (10 month in a row till Jun'22) data. This led increased demand for sovereign asset class, due to risk off sentiment. Even major central banks' aggressive policy rate hike (New Zealand: 3rd 50bps hike, Korea: first 50bps hike against previous level of 25bps hike) and higher inflation print (US: CPI-41year high and China CPI-23month high), hardly impacted yields.

Figure 1: Globally yields are falling, India's 10Y yield fell a tad by 1bps



Source: Bloomberg, Bank of Baroda Research, as of 15 Jul 2022

How has US and India's cycle moved?

For US, in the current rate hike cycle which started from 16 Mar 2022, Federal fund rate has been raised by 150bps whereas its 10Y paper rose by 77bps during the same period. For India, the current cycle began on 4 May 2022 and rate has been increased by 90bps, whereas its 10Y yield has risen by only 32bps.

Reason for recent moderation in domestic yield:

- Domestic yields got comfort from government's supply side measures (excise duty cut on petrol, diesel and measures on edible oil prices front) to check inflation. The current Jun'22 inflation reading also got slight comfort from those measures.
- Oil prices have fallen by 11.9% in the current fortnight, and by 18.1% from its high of US$ 124/bbl seen in 8 Jun 2022. This has comforted domestic yields on account of expectation of lower burden in terms of inflation.

What auctions in this fortnight reflect?

Auction results also reflected that cost of borrowing have broadly remained stable looking for cues from global policy responses and its spillover impact on major domestic macro prints.

Table 1. Cost of borrowing in the current fortnight

Type of Papers	Current fortnight	Previous fortnight
Central Government Securities	7.31	7.32
SDL	7.86	7.88
Tbills	5.68	5.73

Source: Bank of Baroda Research, Note: Average implicit yield at cut off taken for average cost of borrowing calculation

- Another factor for stable borrowing cost may be that durable liquidity is still at an elevated level of +Rs 6tn. This is despite a significant pace of system liquidity normalization that has happened (average system liquidity surplus has fallen to Rs 2.9tn in Jun'22 from Rs 4.3tn in May'22 and currently lower at Rs 2.5tn). This is probably comforting yields.
- However due to seasonal nature, currency demand picks up in the second half at a faster pace. This coupled with RBI's FX intervention to support the currency, will definitely witness depletion of liquidity. So we expect that withdrawal of liquidity to put further pressure on yields in the near term.

Major players in the fortnight

As per Bloomberg data, maximum buying for government securities in this fortnight has been from mutual funds, private banks and PDS.

Outlook on 10Y yield for the next 15-days:

- The main factor which is going to impact India's 10Y yield movement in the next fortnight is the Fed Policy, scheduled on 26-27 Jul 2022. CME Fed Watch tool data shows 71% traders are anticipating a 75bps rate hike. However, 100bps cannot also be ruled out, considering price stability.

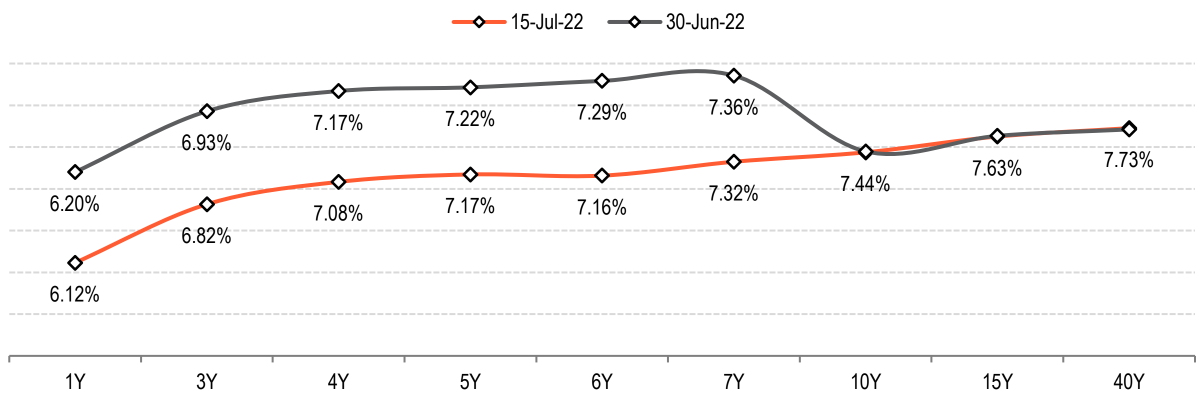
- We expect India's 10Y yield to trade in the range of 7.40-7.50% in the next fortnight with risks remaining on the upside. Any devolution as seen in the latest auction (Rs 29bn for the GOI FRB 2028) might also push yields higher. Further depreciation of INR also poses upside risk to yield in terms of FII outflow in the debt segment. Only comfort comes in if oil prices drop sharply due to growth concerns.
- The table below shows yields across different papers. *The OIS 1Y paper is trading at +6.3%, indicative of the fact that policy repo rate may be raised by another 150bps in the next 1 year.* However, we expect repo rate to increase by another 50-75bps in the current cycle.

Table 2: Yields for different papers

Average yields across spectrum	Current fortnight	Previous fortnight
OIS		
1Y	6.30	6.41
3Y	6.59	6.90
5Y	6.67	7.04
Corp Yield-10Y		
AAA	7.72	7.82
AA+	8.11	8.21
AA	8.43	8.54
AA-	9.15	9.29
A+	9.60	9.74
A	10.37	10.52
A-	11.15	11.29
BBB+	11.84	11.98
BBB-	12.21	12.36

Source: Bloomberg, Bank of Baroda Research

Figure 2: India's yield curve shows 1-7Y rates have moderated, however long end rates have remained stable



Source: Bloomberg, Bank of Baroda Research

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For further details about this publication, please contact:

Economics Research Department
Bank of Baroda
+91 22 6698 5143
chief.economist@bankofbaroda.com