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Bonds Wrap

Global bond yields fell sharply in Mar'23 following the banking crisis. The Fed's recent policy gave a slight dovish hint. This led US 10Y yield fell by 45bps on MoM basis. Other major global yields followed suit. India's 10Y yield fell by only 12bps. The yield on long end papers have remained broadly stable. What stands out in the yield picture is the flattening of India's yield curve. If we compare the 31 Mar 2023 yield curve with 31 Mar 2022, there is a sharp contrast. The current borrowing plan have finely managed issuances with major concentration towards the long end segment. Despite this, we expect the flattening of yield curve to continue. Liquidity deficit would further aggravate in Apr'23 with Rs 61,131crore maturity of TLTROs. Increased currency demand in the election year, fairly robust credit demand will also impact flows. Thus correction in short end papers is unlikely in near term. However, long end curve would get comfort from slightly softening inflation print in Mar'23 due to falling vegetable prices and favourable base. Discomfort to short end curve would further aggravate if the 25bps rate hike is materialised by RBI in the coming policy.

Global yields moderated in Mar'23:

- Sovereign 10Y yields moderated in Mar'23. This was following the banking crisis in the global space on account of asset liability mismatches, dried up liquidity situation, regulatory factors and also faulty lines with regard to risk management practices. US Fed in its recent policy also removed the statement of 'ongoing increases in the target range'.

- Recent high frequency data point in the US such as industrial production, consumer sentiment index (U. Michigan), personal spending and the PCE deflator also reflect some degree of slowdown.

- The 1-year inflation expectation (U. Michigan) has also dropped to 3.6% from 3.8% earlier. The US OIS 2month curve is also trading at 4.9%, signaling terminal rate to hover around that level. Traders are pricing in a pause with 51.6% probability attached to the outcome. Thus, US 10Y yield fell the most by 45bps and other major global yields followed suit.

- It is interesting to note how in FY23, yields have completely reversed their direction. Here tightening rate cycle, elevated inflation prints and liquidity squeeze resulted in sharp increase in yields globally.

Table 1. 10Y Yields globally moderated in Mar’23, on MoM basis, but firmed up in FY23

Countries	10Y sovereign yield, 28 Feb 2023	10Y sovereign yield, 31 Mar 2023	Change in 10Y yield in Mar/Feb, bps	Change in 10Y yield in FY23, bps
China	2.92	2.86	-6	7
Indonesia	6.90	6.79	-11	5
India	**7.43**	**7.31**	**-12**	**48**
Japan	0.51	0.35	-15	13
Thailand	2.59	2.43	-16	17
Bloomberg Barclays EM USD Aggregate Yield to worst	7.54	7.36	-18	174
UK	3.83	3.49	-34	188
Germany	2.65	2.29	-36	174
Korea	3.76	3.36	-40	40
US	**3.92**	**3.47**	**-45**	**113**

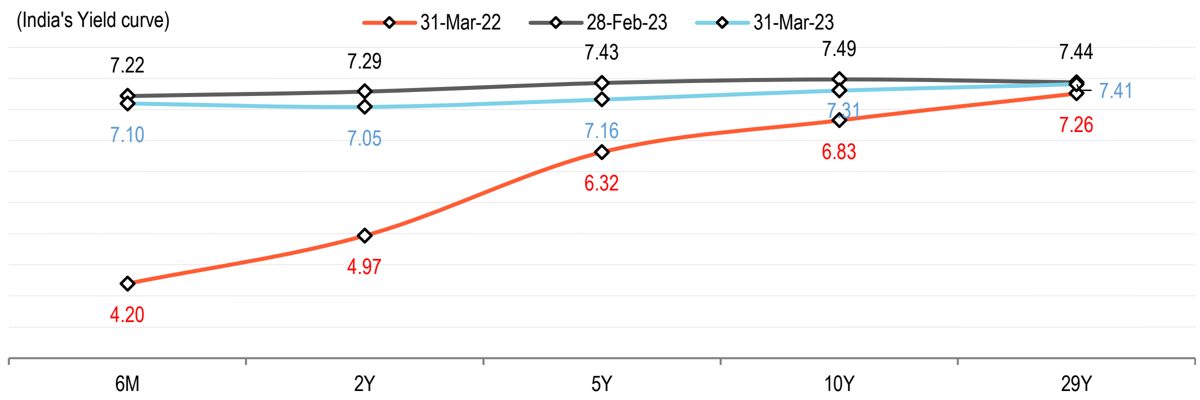
Source: Bloomberg, Bank of Baroda Research

Domestic 10Y yield traded in the range of 7.29-7.43% in Feb’23, almost stable compared to previous month. Some downside risk was instead visible due to increased appetite for sovereign asset class supported by risk off sentiment.

Gap between long end (29Y paper) and short end (6 months paper) was reduced to 31bps in Mar’23 which was 60bps in Jan’23. In FY23, yield curve has exhibited considerable degree of flattening. Going forward, we do not foresee much correction in India’s yield curve. Though in the short end, supply of papers have moderated (share of 2-5 year papers have gone down to 18% in H1FY24 from 20% in H1FY23), and for long end papers (10-40Y papers), the share increased markedly to 51.2% in H1FY24 from 43.1% in H1FY23, several factors will come into play which will contribute to a flattening yield curve of India in the coming few months.

Most importantly, all eyes will be on RBI’s upcoming policy. OIS curve is somewhat pricing in a 25bps hike. Apart from this, widening deficit in the system level liquidity will continue to exert pressure on the short end curve which is more responsive to policy rate change at least in the current cycle.

Figure 1: Yield curve has flattened considerably in Mar'23 compared to the same period of previous year



Source: Bloomberg, Bank of Baroda Research

What auctions in the domestic market reflect?

In Mar'23, no extra borrowing of the centre was scheduled. But if we compare the cut off yields seen in Mar'22 with Mar'23, a clear picture which emerges is the sharp increase in yield of T-bills.

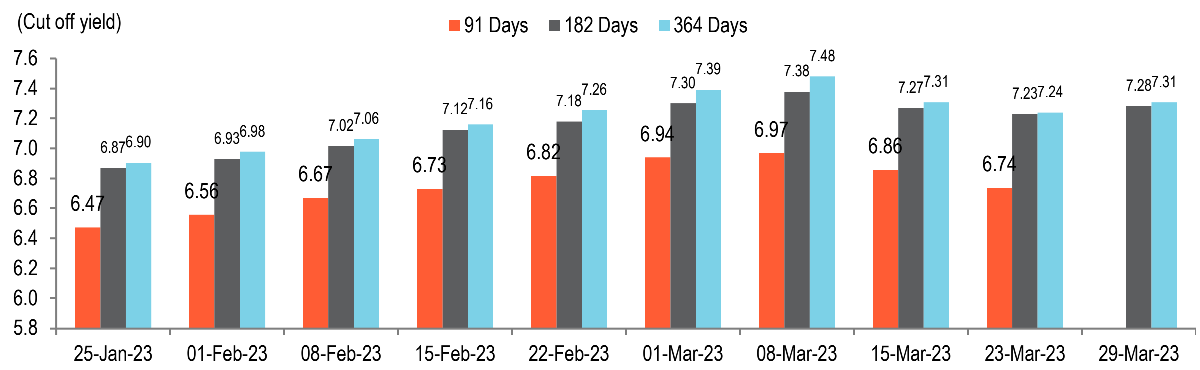
Table 2. Cost of borrowing for Tbills rose sharply

Type of Papers	Cut off yield as on 31 Mar 2022	Cut off yield as on 28 Feb 2023	Cut off yield as on 31 Mar 2023
Central Government Securities	6.35	7.41	-
SDL	7.26	7.69	7.71
T-bills	**4.23**	**7.08**	**7.29**

Source: Bank of Baroda Research, Note: Average cut off yield is taken to arrive at borrowing cost, Auction dates differ, The cut off yield for central government securities is as of Feb'23, hence Mar'23 is left black as no auction is scheduled

Even in Mar'23 as well, the cut off yield for 182 and 364-days TBill have remained considerably elevated.

Figure 2: Cut off yield for TBill have risen sharply



Source: RBI, Bank of Baroda Research, Note in the last auction the YTM of 91-day TBill is not available

Liquidity conditions remained tighter:

- System liquidity deficit averaged to Rs 5,000 crore in Mar'23 compared to Rs 5,400 crore deficit seen in Feb'23. Liquidity remained in deficit for 12 days in Mar'23, due to pressure on account of maturity of TLTROs. In Apr'23 as well TLTROs of Rs 61,131 crore is due to be matured. Recently RBI conducted Rs 75,000 crore 5 day VRR on 24 Mar, which comforted the month end liquidity numbers, which faced additional pressure from government's year end fiscal spending as well as pressure from tax outgo.
- Durable liquidity has moderated sharply to Rs 1 lakh crore as on 31 Mar 2023 from 1.4 lakh crore as on 28 Feb 2023. This could have been even sharper but was somehow comforted by falling US treasury yields and accretion in foreign currency assets in Mar'23 to the tune of US$ 13.8bn.
- Going forward, we expect liquidity to remain in deficit. However any deficit above Rs 1 lakh crore might be supported by RBI's fine tuning operations. Once the rate cycle comes to a pause and if currency demand picks up as it is an election year, widening liquidity deficit will be comforted by RBI's OMO operations.

Major players in the month

As per Bloomberg data, buying has been supported by foreign banks and mutual funds.

Outlook on 10Y yield for the next 30days:

- *India's 10Y yield is expected to remain in the range of 7.3-7.4% in the current month*. Even with increase in supply of papers in the long end segment, yields in this segment have remained broadly stable. In Apr'23, India's 10Y yield will got further breather as inflation might soften slightly due to an elevated base and sharp fall in vegetable price in Mar'23.

Table 3: OIS rates have inched down slightly, corporate spreads remained broadly stable in Mar'23

	As on 28 Feb 2023	As on 31 Mar 2023
	OIS Rates	
1M	6.73	6.69
2M	6.75	6.71
	Corporate Spreads 10Y	
AAA	36	38
AA+	73	71
AA	109	108

Source: Bloomberg, Bank of Baroda Research, Note: data as on the mentioned time point

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