1 August 2022

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# Bonds Wrap

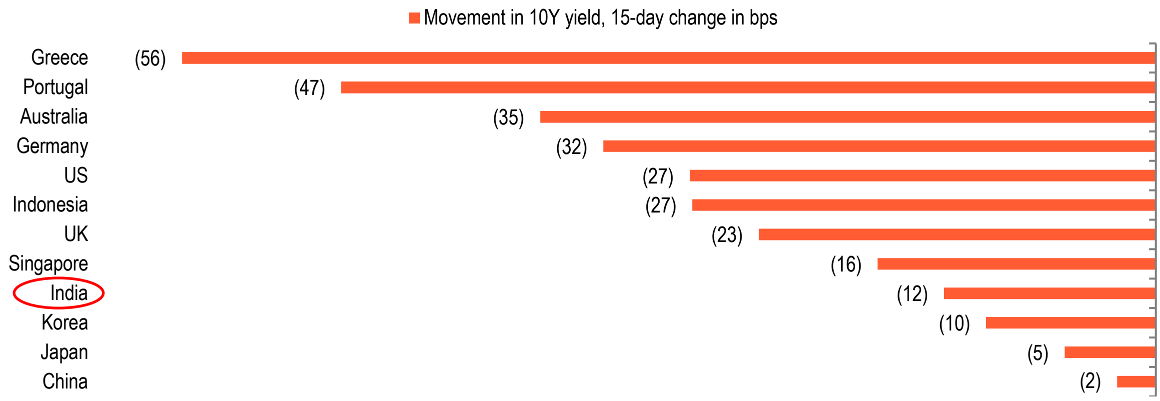
*Global sovereign 10Y yields have moderated in the current fortnight with Germany and US 10Y yield falling as much as 32 and 27bps respectively. Fear of recession improved demand for sovereign securities. India's 10Y yield also fell by 12bps against only a tad decline in the previous fortnight, led by concerns of a spillover impact of global financial tightening and growth slowdown. However, the most notable fact in the current fortnight has been the significant jump in yields of short end papers which has reduced the yield gap (10Y and short end papers). This has made the yield curve considerably flatter compared to the previous fortnight. Importantly, in the 22 Jul 2022, auction, 91-day TBill borrowing cost rose to its 3-year high. This happened primarily on account of reduction in surplus liquidity in the system. It is worth mentioning that system level liquidity surplus reached its lowest since 23 Sep 2019 remaining between Rs 492-499bn (0.3% of NDTL) on 26th and 27th Jul. RBI's conduct of 3-day variable day repo auction of Rs 500bn (last conducted on 21 Jan 2022) was also to support the liquidity in the system. The sudden reduction in liquidity surplus was on account of higher credit demand, RBI's forex intervention and seasonal upshot of government's cash balance (Rs +5tn against +Rs 3tn seen in the previous fortnight). Going forward in the next fortnight, we expect India's 10Y yield will trade in the range of 7.35-7.45%, with upside risks on account of withdrawal of liquidity. All eyes will be on RBI's policy and its forward guidance. We expect a 25bps rate hike against market consensus of 35-50bps. Even CPI print scheduled next week will also impact bond yield trajectory. We expect some softening of the print on account of moderation in commodity prices.*

**Growth concerns led to sharp drop in yields globally:**

Sovereign yield movement for the current fortnight ending 29 Jul 2022, was driven by risks of recession as indicated by muted industrial production, 26-month low flash composite PMI reading and rising unemployment benefits for the 3$^{rd}$ straight week in the US. Even in the Eurozone, flash composite PMI print was at its 17-month low. Germany's IFO business climate index dropped to its more than two month low. Most importantly, the latest World Economic Outlook update of IMF also sharply downgraded (compared to Apr) global growth forecast by 40bps and 70bps respectively in CY22 and CY23. The most notable downgrade was observed for AEs led by US (140bps downgrade in growth forecast in CY22). Even for China, growth forecast has been trimmed down by 110bps in CY22. For India, the downgrade was of 80bps with growth estimated to be at 7.4% in FY23 and at 6.1% in FY24.

**Domestic 10Y yield** traded in the range of 7.31-7.45% in the current fortnight. Sharp moderation was led by a risk off sentiment on account of global growth concerns.

**Figure 1: Globally yields are falling, India's 10Y yield fell by 12bps against only a tad decline in the previous fortnight**




Source: Bloomberg, Bank of Baroda Research, as of 29 Jul 2022

**Table 1. Euro area has the maximum probability of hitting recession as per Bloomberg Survey**

| Region | Recession Probability |
|---|---|
| Euro area | 45% |
| UK | 45% |
| US | 42% |
| Canada | 40% |

Source: Bloomberg Survey

### Central banks continued its rate hike spree

Since last fortnight, major developments have been the 1) 50bps hike of policy rate by ECB (first time in past 11-years) to anchor inflation expectations. ECB President also signaled 'further normalization of interest rates' in the upcoming policies. 2) US Fed raised policy rate for the 2nd straight month taking the total rate hike to 225bps in the current cycle and reiterated its statement of being "highly attentive to inflation risks." As per CME Fed watch tool data, 72% probability is attached for a 50bps hike in its Sep'22 meeting. 3) Minutes of Australia central bank reflected that the current policy rate is far below neutral rate. 4) Bank of England (BoE) Governor also hinted at 50bps rate hike.

### What auctions in the domestic market for the current fortnight reflect?

Auction results reflected that borrowing cost through Tbill cost went up sharply. *Notably in the 22 Jul 2022, auction 91-day TBill borrowing cost rose to its 3-year high*. For the current fortnight, there has been a sharp jump of 22bps for borrowing through the TBill route as against earlier fortnight. This is primarily on account of 1) tightening liquidity conditions (explained later) and 2) tightening of financial market conditions globally.

**Table 2. Cost of borrowing for TBills rose sharply**

| Type of Papers | Current fortnight | Previous fortnight |
|---|---|---|
| Central Government Securities | 7.30 | 7.31 |
| SDL | 7.93 | 7.86 |
| Tbills | 5.90 | 5.68 |

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

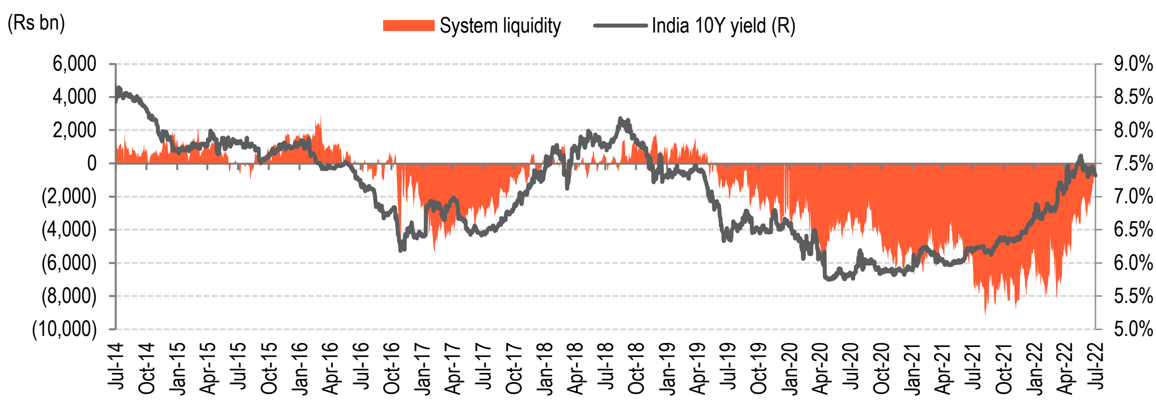
**Liquidity tightening is evident:**

System level liquidity surplus reached its lowest since 23 Sep 2019 remaining between Rs 492-499bn (0.3% of NDTL) on 26th and 27th Jul. Thus RBI conducted the 3-day variable day repo auction of Rs 500bn on 26 Jul 2022. Notably, variable rate repo was last conducted on 21 Jan 2022. On an average, system liquidity surplus has averaged Rs 1.3tn in the current fortnight compared to Rs 2.7tn surplus seen in the previous fortnight.

So what are the underlying dynamics? 1) RBI's forex intervention to support currency, as visible in the forward premia data (Bloomberg) for 1month and 3months where the increase in premia is less compared to the previous fortnight. Decline in foreign currency assets of US$ 1.5bn for the current week ending 22 Jul 2022, also hinted at some intervention. 2) Credit accretion is happening at a faster pace. As per RBI data, incremental credit deposit ratio is far higher at 113.1 as on 15 Jul 2022 against 99.2 as on 1 Jul 2022. 3) Another factor which resulted in sudden reduction of liquidity was net outflows on account of GST and also increase in government cash balance. Notably, government cash balance rose to Rs 5.0-5.5tn between 21 Jul 2022 and 28 Jul 2022 against Rs 3.4tn as on 30 Jun 2022.

Going forward, we expect government cash balance would normalise to its +Rs 3tn level. However, faster pace of currency demand in H2 post-harvest and widening credit deposit gap might put pressure on liquidity front and a level close to neutrality may be observed. To comfort yields, RBI might resort to VRR auction. Also, OMO might be another route going forward.

**Figure 2: Generally, liquidity overhang comforts yield as seen historically**




Source: CEIC, RBI, Bank of Baroda Research

**Major players in the fortnight**

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

**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 RBI Policy, scheduled in the current week. We expect 25bps hike in policy rate against market expectation of35- 50bps hike. WE believe that as inflation has more or less stabilized at the higher level of 7% will invoke a smaller rate hike. There do not appear to be any imminent threat of inflation increasing sharply at this time.. We expect some moderation in headline CPI due to falling commodity prices.

- 10Y yield might trade in the range of 7.35-7.45%, with upside risks on account of withdrawal of liquidity and also global central banks' policy decision (Bank of England and Australia) which are expected to be hawkish.

**Table 3: Yields for different papers**

| | Current fortnight | Previous fortnight |
|---|---|---|
| | **OIS** | |
| 9M | 6.09 | 6.03 |
| 1Y | 6.30 | 6.30 |
| | **Corporate Yield-10Y** | |
| AAA | 7.76 | 7.73 |
| AA+ | 8.13 | 8.11 |
| AA | 8.47 | 8.44 |
| AA- | 9.16 | 9.15 |
| A+ | 9.61 | 9.60 |
| A | 10.38 | 10.38 |
| A- | 11.16 | 11.15 |
| BBB+ | 11.85 | 11.84 |
| BBB- | 12.22 | 12.22 |

Source: Bloomberg, Bank of Baroda Research Note: * Spreads with the corresponding GSec yield

**Table 4: Yields for short term paper rose sharply thus reducing the gap with the corresponding 10Y GSec and making yield curve considerably flat**

| Spreads (10Y Gsec- different tenor papers), bps | Fortnight ending 29 Jul 2022 | Fortnight ending 15 Jul 2022 |
|---|---|---|
| 3M | 175 | 222 |
| 6M | 142 | 170 |
| 1Y | 121 | 132 |
| 5Y | 28 | 27 |
| 6Y | 17 | 28 |
| 7Y | 9 | 11 |
| 14Y | -16 | -13 |
| 15Y | -22 | -19 |
| 30Y | -36 | -30 |
| 40Y | -37 | -29 |

Source: Bank of Baroda Research, Note: Red highlighted ones reflect yield across short term paper has increased significantly

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