

Bonds Wrap

Global sovereign 10Y yields have shown steepest increase, post Jackson Hole conference. Fed Chair's speech focusing on reducing inflation and hinting trade off with regard to growth, led yields soaring. CME Fed watch tool data which attached 50% probability for 75bps rate hike in the Sep'22 policy, now is pricing in 75bps rate hike with 72% probability. Even US OIS 1Y rate rose by 14bps post Fed Chair's speech. Not only in the US, even in the Eurozone record high inflation was witnessed in Aug'22, and exerted pressure on Germany's 10Y yield. UK's 10Y yield registered monthly increase of 94bps in Aug'22 which is the sharpest since Sep'86. This is despite fears of sharp slowdown in growth as is reflected in PMI of major economies. India and China have shown anomalies. China's 10Y yield closed a tad lower supported by government and central bank's stimulus measures. On the other hand, sharp drop in oil prices and comments from central bank officials about inflation getting anchored, have lend support to domestic yield.

India's 10Y yield closed 10bps lower in the current fortnight. What has been an interesting observation in the current fortnight is volatility at the short end of the curve continue reflecting frontloading of rates. Going forward, we expect India's 10Y yield to trade in the range of 7.20-7.30% in the coming fortnight. Upside risk remain on account of global financial tightening and downside risk emanate from growth slowdown. Liquidity conditions are likely to be tighter and we are looking at 0.6-1% of NDTL, contingent on how RBI's forex intervention would pan out in the wake of pressure on currency.

Signal of aggressive global policy tightening impacted yields:

Sovereign yield for the current fortnight ending 31 Aug 2022, noticed sharp upswing. The sharpest jump in yield happened in the last 5 days since 26 Aug 2022, post Fed Chair's speech. Comments such as 'reducing inflation is likely to require a sustained period of below-trend growth'; reflected some trade off in growth on the back of price stability. Notably CME Fed watch which showed a probability of ~50% a week before the Jackson Hole conference, is now pricing a 75bps rate hike in Sep'22 policy attaching a 72% probability to the outcome.

Elsewhere, inflation still remained a concern. Eurozone inflation rose to its record high of 9.1% in Aug'22. A survey conducted by British Retail Consortium (BRC) and market research firm NielsenIQ showed that UK shop price inflation in Aug'22 rose to its highest since Sep'08. Notably the current 94bps monthly jump in UK 10Y yield is the sharpest increase since Sep'86. Inflation fears also prompted Central Bank of South Korea to raise policy rate by 25bps to 2.5% and even inflation forecast was revised sharply upward to 5.2% for CY22 (highest since CY98).

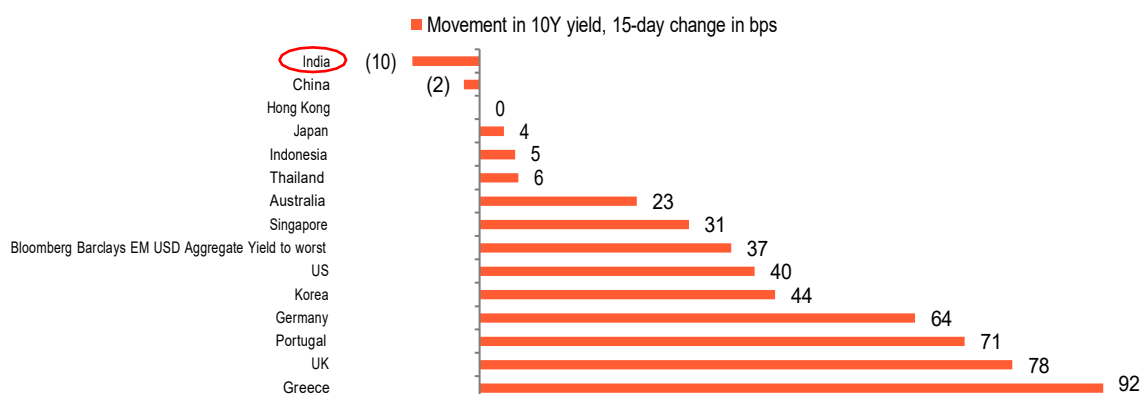
Amongst major economies, UK's 10Y yield rose at the sharpest pace by 78bps. Traders are also betting faster pace of rate hike from BoE as its 1Y OIS rate rose sharply by 76bps in the current fortnight.

Germany's 10Y yield also rose by 64bps as market is pricing in a 75bps rate hike by ECB in the upcoming policy. In fact, ECB minutes clearly signaled normalization of rates in the wake of inflationary pressure.

Only outlier in this rising yield spectrum has been India and China. For China, stimulus measures such as central bank's lowering of benchmark lending rate, government's likely support in terms of a special developer loans worth US\$ 29.3bn, to deal with the property woes, supported its 10Y yield.

Domestic 10Y yield traded in the range of 7.19-7.29% in the current fortnight. Sharp moderation was led by comments from major central bank officials. Governor in a recent interview said that inflation has passed its peak and is 'increasingly getting anchored'. Further Prof Varma-one of the MPC member also spoke of higher inflation not becoming the norm. This also comforted yields. Apart from this, news reports of India's inclusion in the global bond index and possibility that it might constitute 10% of the index, also boosted demand for sovereign securities.

Figure 1: Globally yields are rising sharply, India's 10Y yield fell by 10bps against 3bps decline in the previous fortnight



Source: Bloomberg, Bank of Baroda Research, as of 31 Aug 2022

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

Auction results reflected that borrowing cost went down in the current fortnight. Except for short term papers (stable), borrowing cost for both central government securities and SDL went down.

Another important thing which the past four auctions witnessed has been the cancellation or devolvement of GOI floating rate bonds as appetite remained weak for these papers.

Table 2. Cost of borrowing is moderating

Type of Papers	Current fortnight	Previous fortnight
Central Government Securities	7.23	7.31
SDL	7.70	7.77
Tbills	5.92	5.92

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

Liquidity to remain in the range of 0.6-1% of NDTL:

System level liquidity surplus moderated to Rs 931bn in the current fortnight against Rs 1.6tn in the previous fortnight. For Aug'22 as well the level is lower at Rs 1.2tn against Rs 1.9tn in Jul'22. Liquidity is likely to hover between 0.6-1% of NDTL, in this withdrawal cycle.

Going forward, pick up in currency in circulation (currently at Rs 619bn in FYTD23 against Rs 852bn in the same period of last year), and RBI's Fx intervention (as is evident from the decline in forex reserves by US\$ 5.8bn for the week ending 19 Aug 2022), will impact the system level liquidity. Interestingly, post Jackson Hole conference when dollar started strengthening, the INR forward premia curve have shown a fall in rates for 3M, 6M and 9M papers, reflective of the fact that RBI's intervention is on swing.

Government's cash balance is currently nearing Rs 3tn as on 31 Aug 2022 against Rs 3.4tn in the previous fortnight and compared to Rs 3.9tn as on 31 Jul 2022. In the next 14 days, reverse repo of Rs 703bn is also due for maturity, which will again provide comfort to the net LAF numbers.

Major players in the fortnight

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

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 CPI print. We expect some moderation as crude prices declined by 7% to average around US\$ 98/bbl in Aug'22 against US\$ 105/bbl in Jul'22. However, major high frequency price indicators is still showing some upside risk. Even for cereals, risks in the future remains as sowing data has not been impressive, especially for rice. We expect India's 10Y yield to trade in the range of 7.20-7.30% in the coming fortnight.
- Both upside and downside risks remain. On the downside, already global PMI indices are reflecting growth slowdown (Asian economies), which is likely to keep domestic yields depressed too. On the upside, ECB policy is due in the coming week. Any rate hike above the expected 75bps will also provide discomfort to yields. US payroll numbers are also due and any higher than expected change in the wage print, will further worry Fed.
- Going forward, we believe, short term yields are going to be far more volatile compared to the longer tenor papers. As any frontloading of rates is expected to push the short end rates at a faster pace in the event of ongoing shocks to growth.

Table 3: Short end yields have inched up, yield for longer tenor papers are lower

	Current fortnight	Previous fortnight
OIS		
9M	6.09	5.94
1Y	6.22	6.12
Corporate Yield-10Y		
AAA	7.62	7.70
AA+	8.03	8.16
AA	8.35	8.44
AA-	9.01	9.05
A+	9.46	9.50
A	10.24	10.27
A-	11.01	11.05
BBB+	11.70	11.73
BBB-	12.07	12.11

Source: Bloomberg, Bank of Baroda Research Note: Average yield for the fortnight taken

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