



In Focus: Indian Government Bond Outlook

06 September 2022

India's sovereign yields remained almost flat over last one month. Between beginning of August to 01 September, the 10-yr G-Sec yield for India came down by about 2 basis points. On the other hand, the US 10-yr yield between beginning of August to 01 September hardened by about 62 basis points. The central banks globally have remained hawkish to tame multi-year high inflation. The US Fed since March 2022 has increased the policy rate by 225 basis points to take it to the range of 2.25-2.50%. As per the Fed's latest dot plot, the median Fed Fund rate is projected to be at 3.38% in 2022 and 3.75% in 2023. Post Jackson Hole Symposium that concluded last week, the US 10-yr yield increased by about 15 basis points as US Fed Chair Powell gave very hawkish guidance and was categorical in stating the FOMC's focus would be to bring inflation within its target of 2%. Yields soared across the globe with UK 10-year yield moving up by about 30 basis points since the Symposium. Similarly, German 10-year yield was about 20 basis points up. However, Chinese yields remained more or less unchanged due to the stimulus it has been receiving from its government and central bank. China cut its key lending rates in August 2022. 1-year and 5-year prime lending rates were cut by 5 and 15 basis points to 3.6% and 4.3% respectively.

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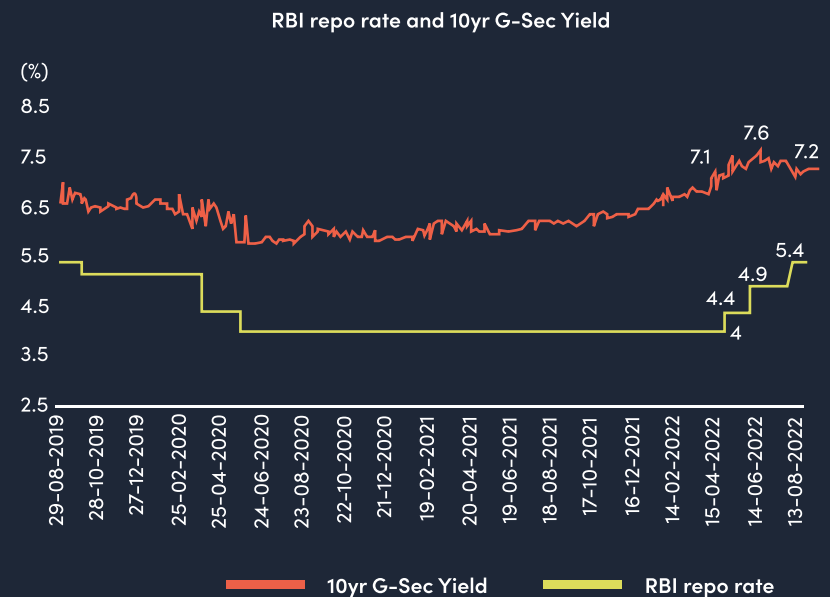
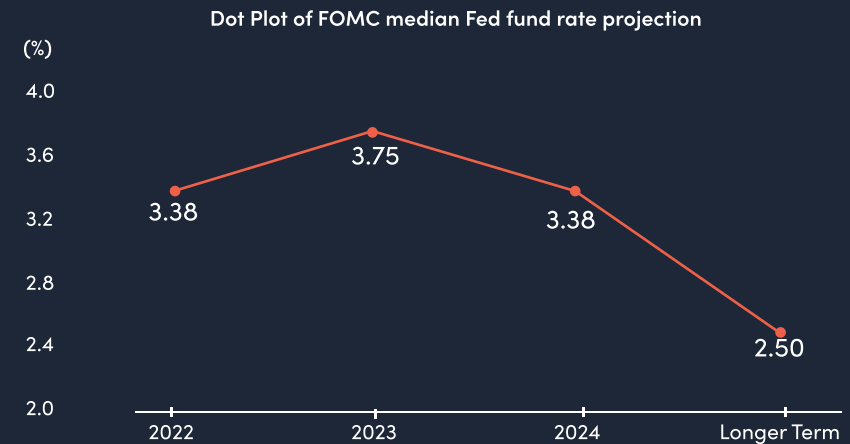
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In contrary to many countries that have seen yields hardening in the recent times, Indian government yields have softened in the recent times due to several factors.

Factors contributed in softening of G-Sec yield

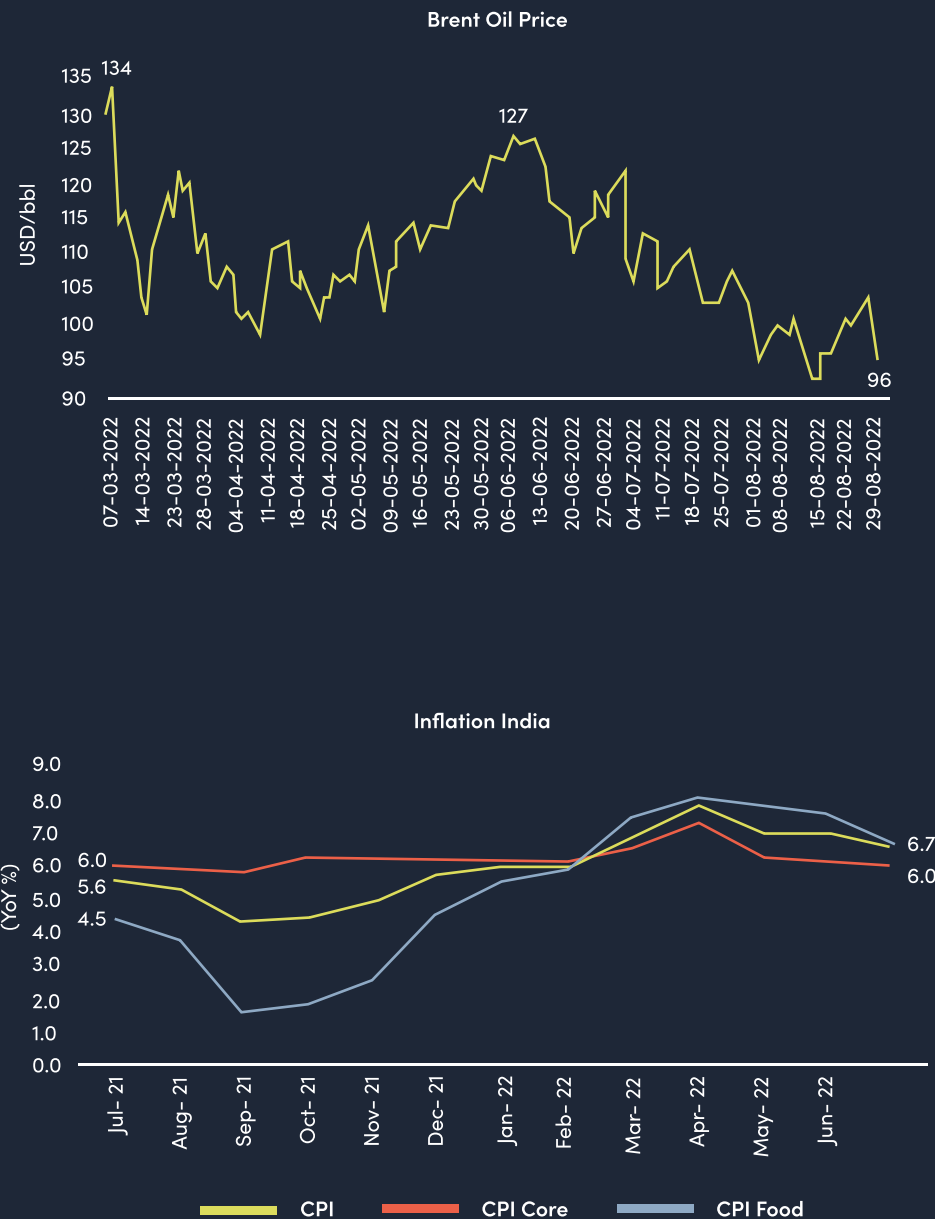
- 01 Expectation of moderating inflation from H2FY23 from its peak in April 2022
- 02 Fall in crude oil prices from its peak and correction in commodity prices
- 03 Statements from MPC members that inflation is well anchored in India
- 04 Expectation of India's inclusion in global bond indices

Domestic inflation peaked in April to 7.79% YoY with higher prices across the board. The core inflation was very high at 7.24% YoY and food inflation was at 8.1%. Since then inflation has shown signs of moderation. The central government has taken various measures that helped in ebbing inflation. The government announced excise duty cuts in petrol and diesel. It also announced reductions in custom duty on import of raw materials for steel.

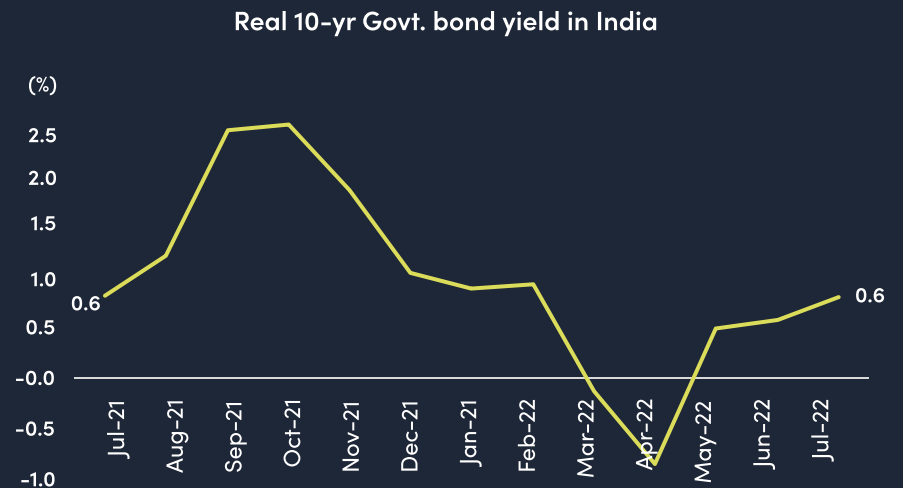
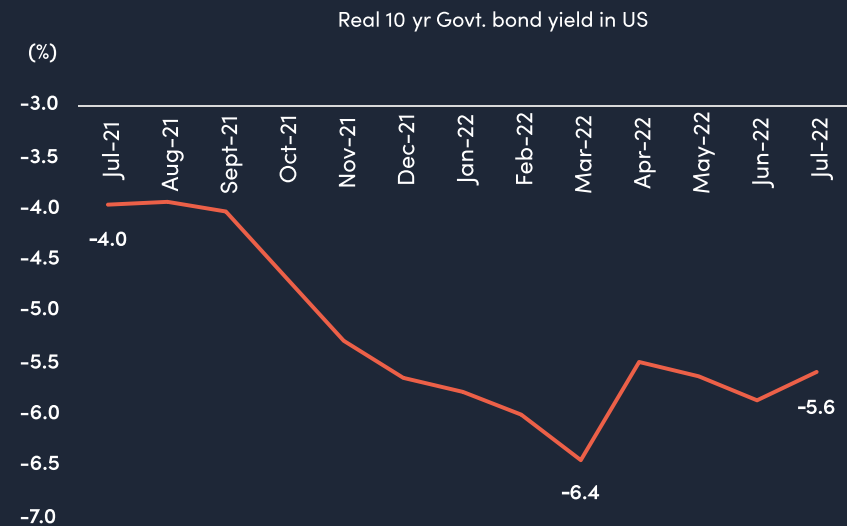


Inflation has come down to 6.7% YoY in July 2022. Food inflation also moderated to 6.7% in July from 8.1% in April. Core inflation (excluding food and fuel) is at 6% now. Going forward, we believe that inflation will moderate on the back of softening of commodity prices, global growth slowdown that will impact demand, and easing of supply side disruptions. The softening of inflation from its peak and RBI's anchoring of inflation expectations have contributed to softening of yields. We expect inflation to average at ~6.5% in FY23 which is higher than MPC's upper tolerance limit of 6%.

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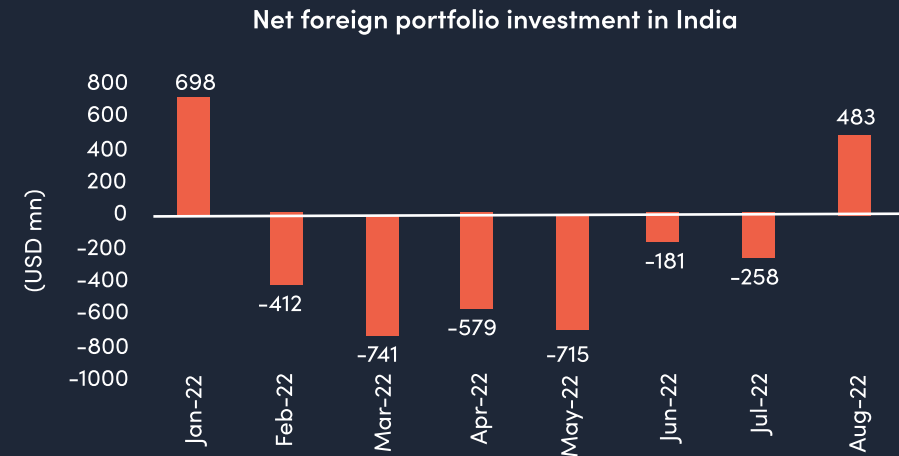


Crude oil prices have corrected from its peak since the Russia-Ukraine war broke out. Brent touched below USD 100/bbl several times recently. Between 01 June to 01 September, crude oil price declined by about 20%. Oil prices have fallen as there are growth concerns among the major economies in the globe. Also recently talks of a nuclear deal between Iran and other world powers could lead to easing of sanctions on Iran that might add to global oil supply. However, on 05 September in the OPEC+ meeting it was decided to cut output by 100,000 barrels per day which is about 0.1% of global demand for October. Risks to higher oil prices could manifest from further output cut and any intensification of geo-political tensions. Forward prices of copper and aluminum also corrected by about 14% and 19% respectively during this period. Correction of crude and other commodities had cooling off impact on India's bond yields since this will help reduce imported inflation and secondly it is positive for the government's fiscal. Earlier, government announced reduction in excise duties in petrol and diesel to protect the pump prices. Cut in excise duties along with higher subsidies on food and fertilizer will put additional pressure on government budget.



Hawkish guidance and rise in interest rates by the central banks of developed markets led to outflow of FPIs from India as risk adjusted returns on investments increased in developed markets. There was a net outflow of FPI capital from the debt segment for six months in a row between February 2022 to July 2022 due to heightened global uncertainty on account of geo-political tensions, elevated crude prices, concerns of global slowdown, etc. even though real or inflation adjusted yield in India on government papers were higher than that of US. This had put pressure on the domestic G-Sec yields. However, in August there has been net inflows of portfolio investment in India's debt segment with softening of crude prices and other commodities. This inflow has also helped reduce yields on domestic government papers. Inflation in US has been multi-year high. Inflation in July in US was 8.5%. This is much above the Fed's target of 2% inflation.

The demand for government securities have also increased due to recent statements by RBI that inflation is well anchored. The RBI Governor Shaktikanta Das recently said that inflation is likely to fall in the coming months. He added that "considering the global situation, we can say that inflation in India peaked in April but is now gradually declining". Additionally, media reports of talks on India's inclusion of global bond indices will increase demand



for government papers and will reduce the upward pressure on yields. Inclusion in global bond indices will attract FII as it makes investment decision easy. There will also be an increase in investment by passive funds. It will increase confidence on domestic currency and ensure a sustained inflow of dollars in India.

The RBI has been mopping up excess liquidity from the system. It introduced standing deposit facility (SDF) in April 2022 to give banks an option to park excess liquidity with RBI. The system liquidity surplus came down to ~INR 950bn in the beginning of September but again increased above ~INR 2tn. We expect system liquidity to be around ~0.5-1.0% of net demand and time liabilities (NDTL) of the banking system. Government has excess balance with the RBI to the tune of about ~INR 1.8tn. We expect this excess liquidity to come to the banking system as the government accelerates its spending on capex and subsidies. The depreciation of INR against USD has made RBI constantly intervene in the forex market. RBI's forex reserve has come down to USD 561bn during the fortnight ending 26 August 2022 vis-à-vis USD 564bn during the previous fortnight as INR breached psychological mark of 80 per USD. RBI's forex intervention has also reduced rupee liquidity in the system. Additionally, with the onset of festive seasons the currency in circulation (CiC) will increase which will drain liquidity from the system further.

The Monetary Policy Committee (MPC) of RBI had started its rate hiking cycle post pandemic by delivering an off-cycle hike in May 2022 by 40 basis points. Since then it raised policy repo by a total of 140 basis points to take it to 5.40%. The G-Sec yields inched higher with the start of rate hiking cycle as the MPC prioritised inflation over growth. We expect MPC to continue its front loading of rate hikes and take the terminal repo rate to 6% by December 2022 by raising rates by 35 and 25 basis points in September and December meetings respectively. This will take the real rate marginally positive in Q4FY23 as we expect inflation to stay a little below 6% during that quarter. We expect 10-yr G-Sec to average ~7.10-7.40% in the medium-term. However, yield movements will depend on volatility in crude oil prices. Any material development towards India's inclusion in global bond index will raise the demand for government papers.

Key indicators and their expected levels by end of FY23

10-yr G-Sec (average)	7.10-7.40%
CPI Inflation (average)	6.50%
Repo Rate	6.00%



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