Debt Market Review

L&T Financial Services
Mutual Fund

January, 2020

Indian sovereign bond ended 5 bps higher to 6.60%. Markets reacted to the measures taken by the government in Budget for opening up domestic bond markets to overseas investors, including the idea of inclusion of Indian bonds in global bond indices.

Market Performance

The 10-year benchmark G-Sec yield closed at 6.60%, up by 05 bps from its previous close of 6.55% while that on the short-term 1-year bond ended 05 bps higher at 5.35%. In the corporate bond segment, yields rose across the yield curve over the month.

The 10-year AAA bond yield ended 02 bps higher at 7.54%, while the short-term 1-year AAA bond yield ended 15 bps up at 6.25%. The spread between 1-year and 10-year AAA bond narrowed. Within the short term segment, yield on 3-month commercial paper (CP) was up 45 bps to 5.60% while 1-year CP yield was up 15 bps at 6.20%.

Key Highlights Of The Budget

- FY20 Fiscal Deficit has been restated to 3.8% of GDP (versus targeted 3.3 % of GDP), with FRBM exit clause being triggered allowing a 50 bps leeway
- No additional borrowing likely in FY20, with small savings collections helping to bridge the gap with targeted collections at INR 2.4 lakh crore versus BE of INR 1.3 lakh crore
- FY21 Fiscal Deficit target has been set at 3.5% of GDP. Total gross borrowing of INR 7.8 lakh crore for FY21, and net borrowing of INR 5.44 lakh crore
- More credible assumptions and projections on tax revenue side for FY21, with nominal GDP growth of 10% and gross taxes growth of 12% and net taxes growth of 8.7%
- Aggressive assumptions include the INR 2.10 lakh crore disinvestment target (with LIC and BPCL accounting for the lions share) and the INR 2.4 lakh crore small savings collection to fund 30% of FY21 deficit. Any downside risks here can lead to significant shortfall

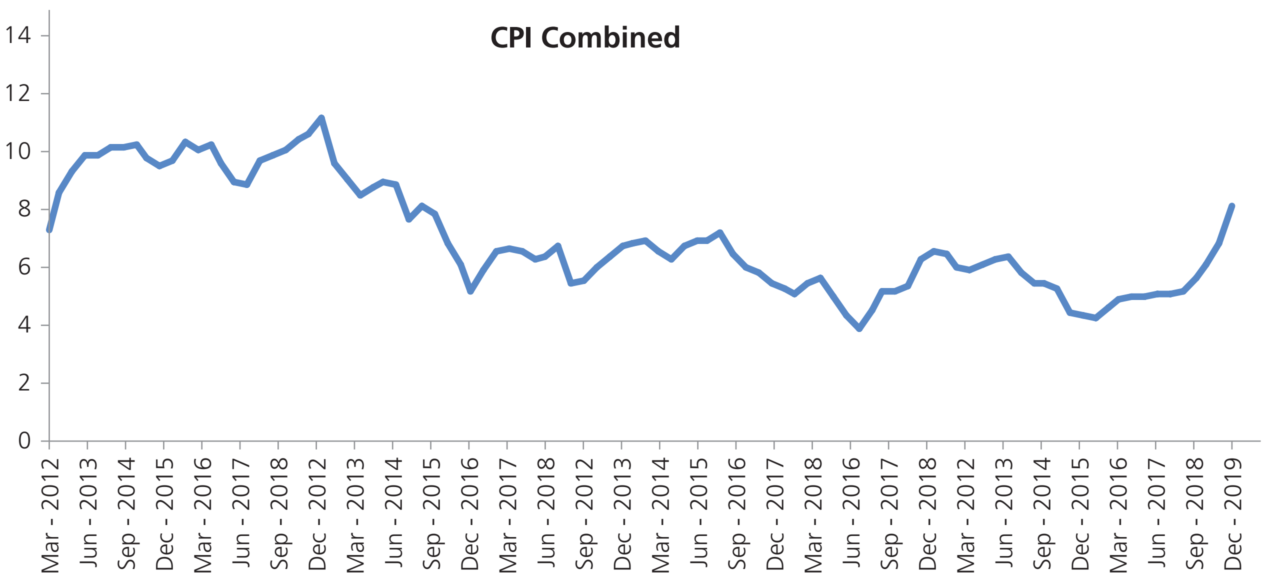
- Dispute resolution scheme for past direct tax disputes could lead to some positive collections in FY20 and FY21
- Other key announcements include the removal of Dividend Distribution Tax (DDT), and instead taxed at the marginal rate of the recipient. Also, change in slab rates for personal income tax, with tax payers' having the choice to move to the new lower tax rates with the provision that beneficiaries give up on the various exemptions and deductions
- Move towards getting India included in international bond indices, with a new series of bonds without restrictions on FPI participation. While more details are awaited, it does appear that some ground work has already been done and this measure could result in a potential inclusion in such indices sooner than market expectations

Market Impact And Outlook

While the Union Budget was received quite negatively by the equity markets, it has been received with a big sigh of relief by the bond markets. Bond markets were worried about an INR 30,000 crore - 50,000 crore extra supplies this year and the possibility of INR 8 lakh+ crore numbers for next year's borrowing, on the back of a big-bang stimulus announcement. However, no extra borrowings in this year, next year's borrowings broadly in line with expectations and potential for inclusion in global bond indices are all positive factors for the bond market.

10 year G-Sec yield is lower by about 8-10 bps, trading at 6.50-6.52%. With the budget now behind us, a big overhang for the markets has been alleviated. ***Market participants have a more comfortable outlook on the demand-supply situation for Government securities and some of the risk premium that was priced into the yield curve is likely to get unwound.***

Market attention will now turn to the Monetary Policy Committee (MPC) meeting outcome due on February 6, 2020. With CPI at 7.35% and significantly above the 4-6% band targeted by the MPC, it will be interesting to see how the various MPC members view their mandate in the context of high inflation and slower growth.



We expect the RBI MPC to keep policy rates on hold. While there is a risk of MPC stance changing from accommodative to neutral, on balance, however, we believe that MPC will choose to continue with the accommodative stance, given the still weak growth outlook. ***We also expect RBI to keep the system in surplus liquidity mode, in an attempt to have further monetary policy transmission through lower lending rates.***

Economic growth trends over the next few quarters will continue to be lackluster in our view, especially without any meaningful fiscal stimulus in the Budget. Chronic issues in the Real Estate and NBFC sectors, and risk aversion in the banking sector, are likely to remain headwinds to a speedy recovery.

In such an environment, with weak credit growth trends and a positive liquidity backdrop, ***we expect short end yields to remain well anchored with 1 year CDs hinging around the 6% level. With carry being relatively attractive in the 2-5 year part of the AAA curve, we expect flows into short term and banking & PSU funds to remain strong, thereby, keeping yields there well supported.***

From a near term perspective, longer end government securities are likely to continue to be well bid with potential for rates to move lower, as markets get more clarity on the global bond index inclusion. However, as the supply calendar kicks off from April, we expect yields to back up and trade in the 6.5-7% range in first half of FY21. ***With AAA spreads at the longer end at 80-100 bps, the carry offered by 8-10 year AAA bonds is relatively attractive, and offer sufficient cushion to deal with the volatile environment facing our bond markets.***

Source: MOSPI, Internal, Bloomberg