Debt Market Review

L&T Financial Services
Mutual Fund

March, 2020

Indian sovereign bond ended 23 bps lower at 6.14% in March, due to liquidity concerns in a volatile environment, amid COVID-19 pandemic.

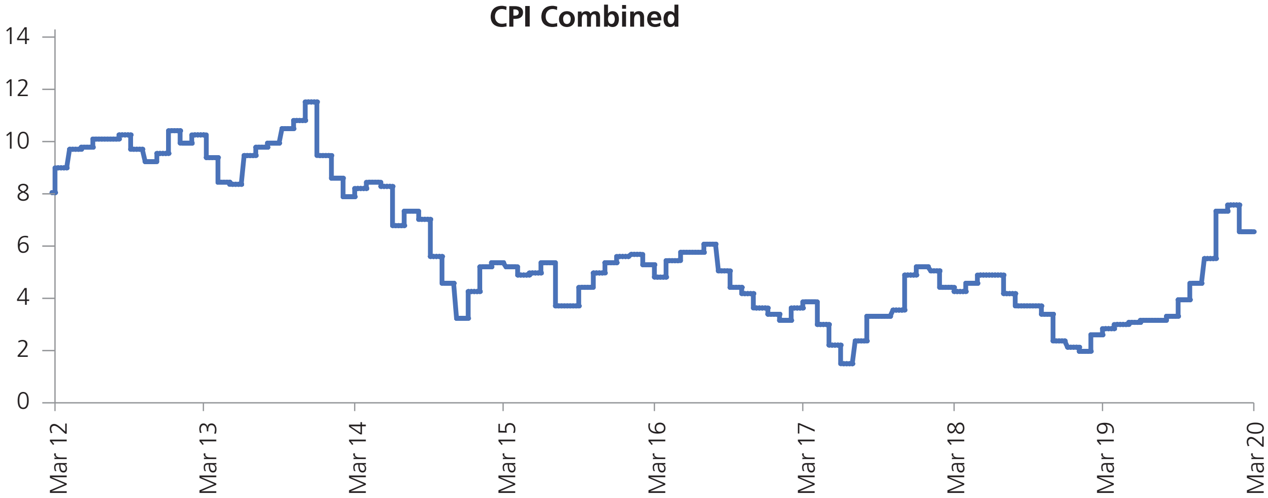
String of measures like cutting the repo and the reverse repo rates, reducing the CRR by 100 bps, injecting liquidity of Rs 3.74 lakh crores in the system etc. announced by the RBI on March 27, were a much-needed solution.

In March, RBI has done two tranches of dollar-rupee swaps of $2 billion each, as the rupee was falling sharply against the US dollar.

Macro-Economic Developments

IIP & Inflation: Industrial production rose 2% in January, as manufacturing recovered slightly from contraction in December. Wholesale Price Index inflation eased to 2.26% in February from 3.1% in January, helped by a sharp decline in food inflation. Consumer Price Index slipped down to 6.58% in February.

PMI: The manufacturing Purchasing Managers Index (PMI) softened modestly in February 2020 to print at 54.5, from an eight-year high of 55.3 in January 2020. In contrast to the manufacturing PMI, the Services PMI surged to a seven-year high of 57.5 in February 2020, rising for the fifth consecutive month from 56.1 in January 2020, due to a spike in business orders, renewed export demand and strengthening business confidence.



Market Performance

The 10-year benchmark G-Sec yield closed at 6.14%, down by 23 bps from its previous close of 6.37% while that on the short-term 1-year bond ended 17 bps lower, at 5.00%.

In the corporate bond segment, yields fell across the yield curve over the month. The 10-year AAA bond yield ended 10 bps lower at 7.10%, while the short-term 1-year AAA bond yield ended 20 bps down at 6.00%.

The spread between 1-year and 10-year AAA bond narrowed. Within the short term segment, yield on 3-month commercial paper (CP) yield was down by 35 bps at 5.25%, while 1-year CP yield was down 15 bps at 5.95%.

Outlook

We start FY 2021, amidst never-before seen turmoil in the real economy and extreme volatility in markets, as the world and India continue with their fight against the rapidly spreading COVID-19 virus and its deadly impact. Central banks across the world have reduced policy rates and have resorted to liquidity like they did during the Global Financial crisis in 2008-2009.

Here in India too, although with a bit of delay, the RBI has swung into action, with the seventh bi-monthly RBI Monetary Policy statement announced on March 27, 2020, ahead of schedule, in view of the COVID-19 pandemic:

- The MPC reduced repo rate by 75bps from 5.15% to 4.40% and reverse repo rate by 90bps from 4.90% to 4.00%.
- The RBI will conduct auctions of targeted long term repos of up to three years, for amount of up to ₹ 1,00,000cr linked to the policy repo rate. Liquidity, availed under the scheme by banks,, has to be deployed in investment grade corporate bonds, commercial paper and non-convertible debentures, over and above the outstanding level of their investments in these bonds, as on March 25, 2020.
- The RBI reduced CRR by 100bps from 4% to 3% for a period of 1 year.
- The RBI announced various steps to mitigate the burden of debt servicing caused by disruptions, on account of COVID-19 pandemic. These measures include moratorium on term loans; deferring interest payments on working capital; easing of working capital financing; deferment of implementation of the net stable funding ratio; and the last tranche of the capital conservation buffer.

The RBI has so far stayed away from any announcements about the size of its Open Market Operations (OMO) program as well as any hints about whether it will directly monetize the government's deficit. Markets will be watching for further updates about the fiscal stimulus package, following which some clarity on RBI's stand on these issues may emerge.

We enter FY21 where the entire country is in lockdown and economic activity is almost zero, barring essential services. The first challenge for the whole country is to contain the COVID-19 virus and come out of it with minimum damage to human life. Once we are able to successfully come out of the danger posed by the virus to human life, the challenge will be to bring the economy back to its potential, through the year. The government along with the states,in spite of their weak finances, will have to increase deficits and do the heavy lifting to protect the weaker sections of the economy and also relax policies so as to ensure that companies and sectors survive and come out of this situation.

It will be extremely essential that the economy is not dragged into a prolonged deflation and recession. External forecast are projecting a 2% growth with a risk to downside. While we await action from the Government of India on the fiscal side, it is now amply clear that the RBI will do whatever it takes, which not only includes reducing interest rates but resorting to other innovative ways, to ensure financial stability, as it has done throughout the year.

Now that the RBI's intent and ability to stabilise the bond markets has been clearly demonstrated, yields across the G-Sec and AAA curve have moved back to the February levels, although policy rates are now 75-90bps lower, post the MPC cut. Further actions from policymakers, we believe, will set into motion a sense of stability and gradual decline in yields across various high quality segments will make it an attractive environment for fixed income investors.

The impact of COVID-19 on companies will make the credit environment even more difficult in the coming year. Rating agencies have already indicated negative outlooks for many sectors due to lockdowns and the coming year is likely to see more downgrades than upgrades. The need to actively monitor credit exposures, position portfolios away from the vulnerable issuers and sectors and take quick pre-emptive action, wherever new risks emerge is now paramount to ensure capital protection, while still benefitting from the move to lower interest rates.

Source: MOSPI, Internal, Bloomberg