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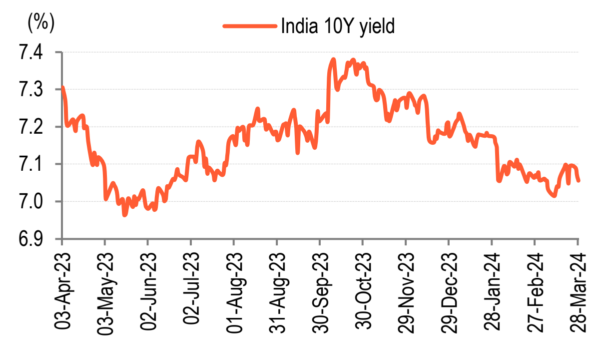
Dipanwita Mazumdar
Economist

Bonds Wrap

How India's 10Y yield have moved in FY24:

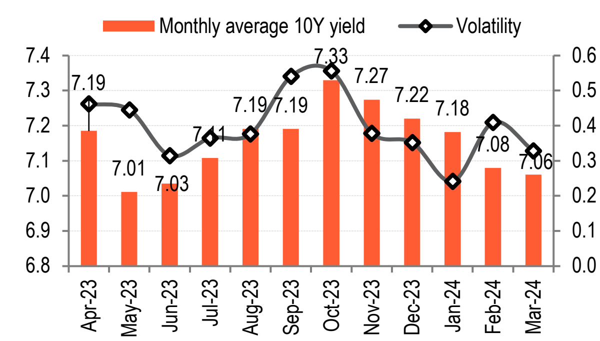
The trajectory of India's 10Y yield in FY24 has been interesting. The first decline in yield occurred in May'23 as RBI went in for a pause going against market expectation of a 25bps hike in Apr'23. This, added with comfortable liquidity conditions, has also supported yields. However, the momentum of downswing was short lived and since May'23 India's 10Y yield have risen considerably, peaking in Sep'23, where it exhibited the highest volatility amongst all the months of this current financial year. This was owing to RBI's surprise announcement of OMO sale in its policy to manage underlying liquidity conditions of the economy. But like the previous fall, even the increase was short lived and notably since Oct'23, 10Y yield has been on their downward journey. A lot of factors impacted this movement of India's 10Y yield in FY24, which is illustrated below:

Figure 1: Charting the trajectory of India's 10Y yield



Source: Bloomberg, Bank of Baroda Research

Figure 2: Volatility of India's 10Y yield



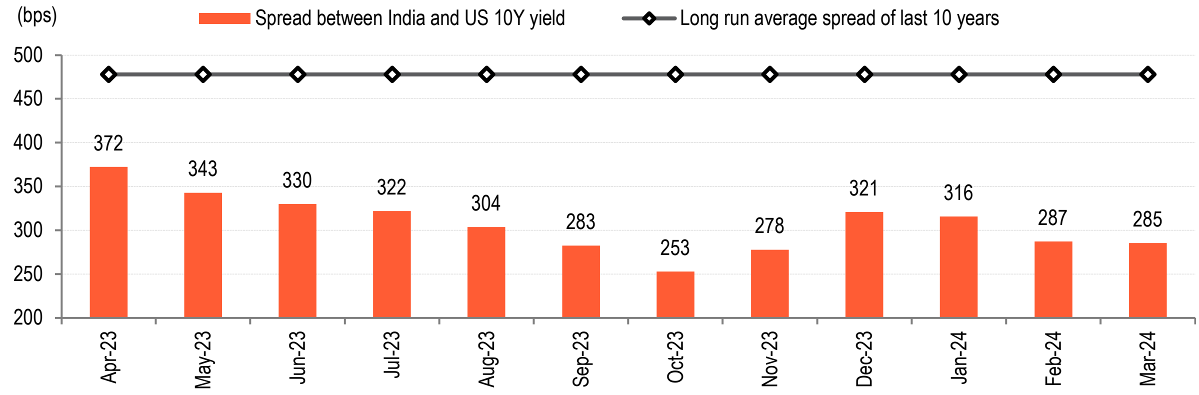
Source: Bloomberg, Bank of Baroda Research

Factors impacting India's 10Y yield:

1. **Movement of India and US 10Y yield:** Till Oct'23, the pace of increase in US 10Y yield has been far higher compared to modest movement in India'10Y yield, thus reducing the spread between India and US 10Y yield. Post Oct, with build up expectations of an easing cycle by Fed supported by some degree of softening of US inflation and labour market data, the spread between India and US 10Y yield picked up.

   However, it could not be sustained due to evolution of data driven uncertainty surrounding Fed's future course of action. Interestingly, the spread data suggests that the current level is far below the long run average. Going forward, a calibrated approach may be the desired choice for both central banks (India and US) and at least in the near term, returning to the mean reversion levels doesn't seem feasible.

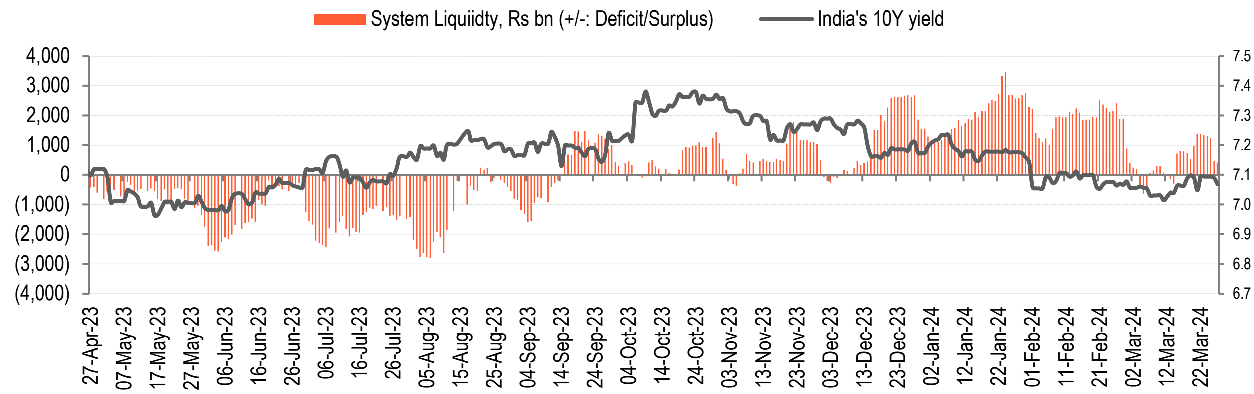
Fig 3: Spread dynamics



Source: Bloomberg, Bank of Baroda Research

2. **Movement of India's 10Y yield and domestic liquidity:** The evolution of domestic liquidity in FY24 has been interesting with RBI resorting to frequent liquidity management through its VRRR and VRR window. Till Aug'23, liquidity has been at a comfortable surplus of above Rs 1 lakh crore. But the higher pace of credit growth (with the pickup in domestic growth conditions) compared to deposit growth, has resulted in tighter liquidity conditions towards H2 of FY24, where it moved to deficit from surplus. This initially exerted pressure on yields, but RBI's nimble liquidity management approach has arrested further rise in yields. Currently, we expect liquidity deficit to remain in the range of 0.5-1% of NDTL as the divergence between credit and deposit growth (currently at Rs 1.6 lakh crore) might only be corrected in H2 with some correction in domestic growth conditions. Notably, the system liquidity deficit averaged to ~ Rs11,250 crore compared to Rs 1.6 lakh crore surplus seen in FY23.

Fig 4: Movement of 10Y yield curve with system level liquidity

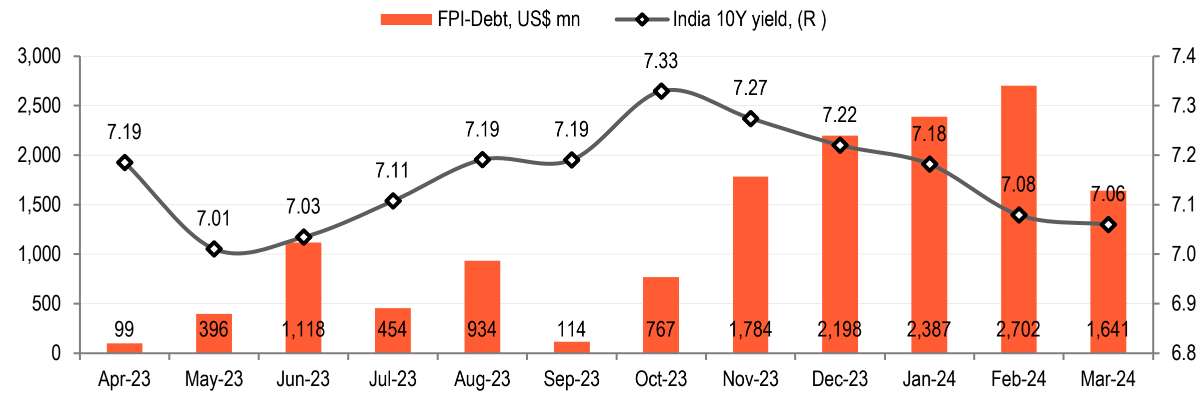


Source: Bloomberg, Bank of Baroda Research

3. **Movement of India's 10Y yield and FPI-Debt flows:** FPI debt flows have gathered momentum since Nov'23 because of sentiment buying post announcement of India's inclusion to JP Morgan Global Bond Index. Further India's buoyant growth story coupled with fiscal prudence, leveraged sentiments of foreign investors at a time when still some degree of uncertainty prevailed over outlook of global economy. Volatility in DXY and US treasury yield also act as a

catalyst for more flows into Indian debt market. Notably, AUCs in sovereign bonds as of 15 Mar 2024 stood at Rs 29.0 bn compared to Rs 17.5 bn in the same period of previous year.

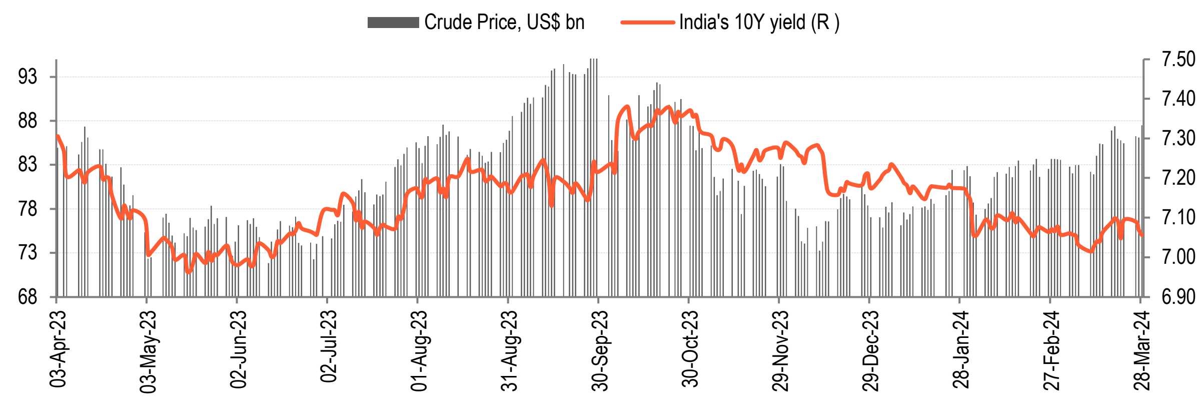
Fig 5: Movement of 10Y yield curve and FPI debt flows



Source: Bloomberg, Bank of Baroda Research

4. **Movement of India 10Y yield and international crude price:** Till Aug'23, international oil price and 10Y Gsec yield mirrors the same trend. However, since Jan'24, despite increase in oil prices, India's 10Y yield remain insulated. Going forward, some pressure on oil prices cannot be ruled out due to ongoing geopolitical tensions. However, its impact on domestic 10Y yield is likely to be limited unless it crosses the crucial US$ 100/bbl or above.

Fig 6: Movement of 10Y yield curve and international oil price:

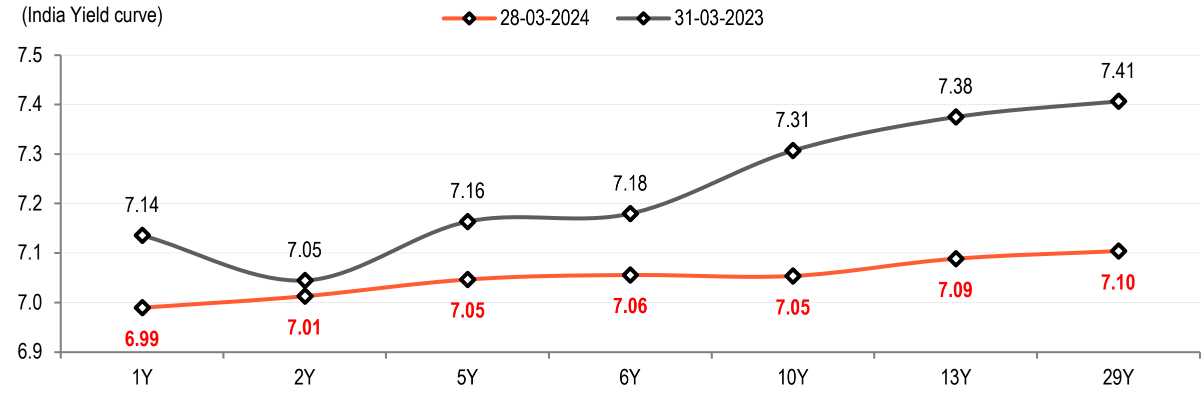


Source: Bloomberg, Bank of Baroda Research

How India's yield curve has emerged in FY24:

Fig 5. shows a point-on-point comparison between movement of India's yield curve. There has been considerable flattening of India's yield curve in FY24. In fact, the entire curve shifted downwards with significant correction happening towards the long part of the curve due to buoyant demand conditions. However, if we compare the 10Y Gsec spread on an average for FY24 with FY23 with other traded papers of different maturities, clearly what stands out is that the spread between 10Y Gsec with 2Y paper has gone down significantly.

Fig 7: Movement of India's yield curve



Source: Bloomberg, Bank of Baroda Research

Table 1: Spreads between 10Y GSec and other papers

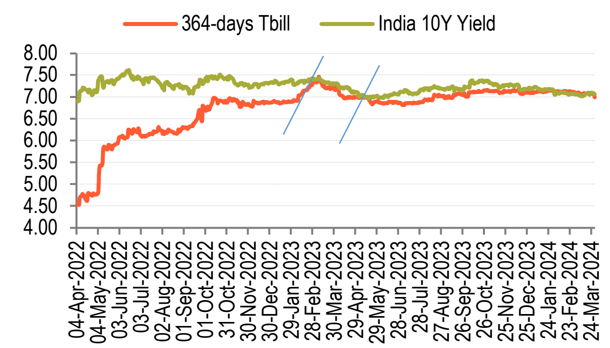
Gsec	FY23	FY24	Spread between 10Y Gsec with other papers, FY23	Spread between 10Y Gsec with other papers, FY24
2Y	6.73	7.06	60	**10**
5Y	7.16	7.12	16	3
6Y	7.21	7.15	12	0
10Y	**7.33**	**7.15**	**0**	**0**
14Y	7.45	7.25	-12	-10
30Y	7.52	7.32	-20	-16

Source: Bloomberg, Bank of Baroda Research, Note: Spreads in bps, Yields have been averaged and accordingly spreads are calculated

Spreads of 10Y Gsec with TBills:

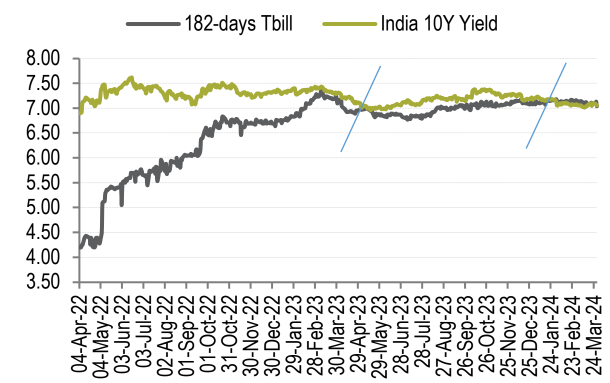
The movement of short end papers has been interesting in FY24. There has been considerable correction of yields in line with comfortable liquidity conditions towards the first part of the year. However, tighter domestic liquidity along with uncertainty surrounding the inflation trajectory has led to spreads falling and some part of the curve witnessing inversion as well.

Figure 8: Movement of 10Y yield and 364 days TBill



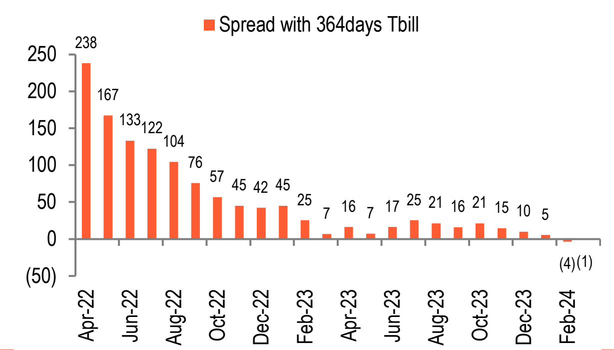
Source: Bloomberg, Bank of Baroda Research, Not: Dashed lines are the point of inversion

Figure 9: Movement of 10Y yield and 182 days TBill



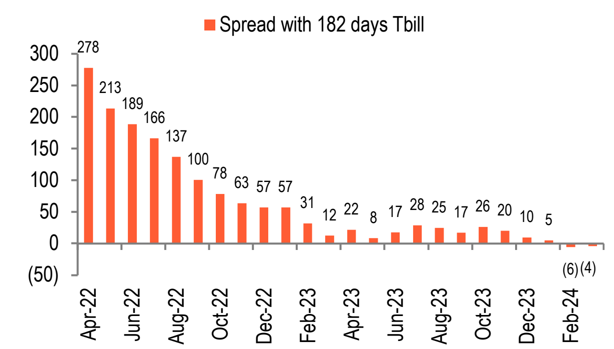
Source: Bloomberg, Bank of Baroda Research, Not: Dashed lines are the point of inversion

Figure 10: Spread data 364 days TBill



Source: Bloomberg, Bank of Baroda Research, Note: Spread calculated after averaging yields for months, Spreads in bps

Figure 11: Spread data 182 days TBill



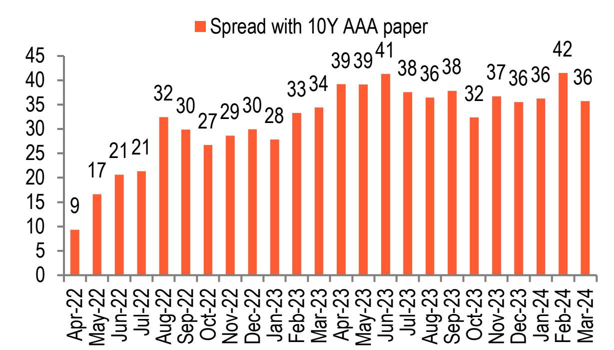
Source: Bloomberg, Bank of Baroda Research , Note: Spread calculated after averaging yields for months, Spreads in bps

(These two 364-days and 182-days have been shows as the inversion observed for these two curves have been higher compared to 91-days TBill).

Spreads of 10Y corporate papers with 10Y Gsec:

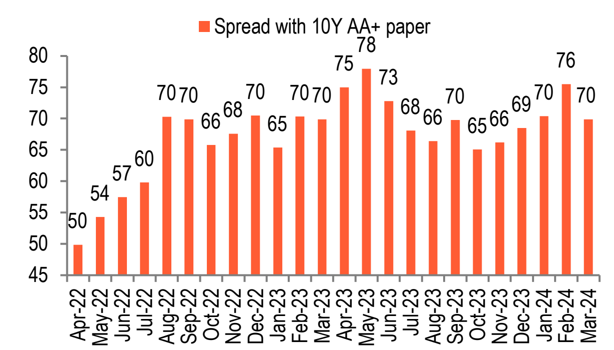
The spreads with corresponding tenor corporate papers have remained rangebound without noticing considerable correction.

Figure 12: Spread data



Source: Bloomberg, Bank of Baroda Research

Figure 13: Spread data

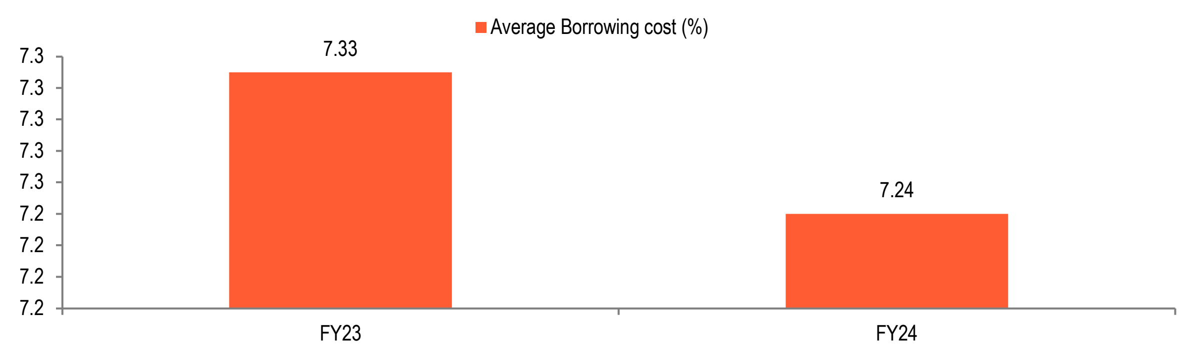


Source: Bloomberg, Bank of Baroda Research

Average borrowing cost:

As seen from the cut off yield of auction, average borrowing cost calculation as total interest expense to total amount of papers issued for the financial year, has gone down in FY24 compared to FY23.

Fig 14: Movement of Borrowing cost



Source: RBI, Bank of Baroda Research

Outlook on 10Y yield:

India's 10Y yield got support in FY24 from considerable frontloading by FPIs. India's buoyant growth condition coupled with fiscal prudence and RBI's effective liquidity management operations; all have remained positive for yields. Going forward, we expect India's 10Y yield to have a further downward bias. We do not rule out the possibility of yields reaching below 6.95% from H2 onwards when favourable growth-inflation dynamics would prompt a rate reduction by RBI. It is possible that in Jun'24, when the Fed rate cut cycle kicks in, some softening bias will prevail for India's domestic yield. Support will come from FPI flows.

If the RBI does lower the repo rate based on inflation and monsoon conditions possibly from August onwards, it would be of the order of 25-50 bps. This can lower the 10-year yield to 6.75%.

For further details about this publication, please contact:

Economics Research Department
Bank of Baroda
chief.economist@bankofbaroda.com