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Bonds Wrap

Global bond yields rose sharply following expectation of a higher terminal Fed Fund rate. Market is now pricing it at 5.5% against earlier expectation of 5%, as visible in the money market rates. India's 10Y yield has also reflected global yield movements to an extent. However, underlying domestic macros such as elevated inflation pressure and tighter liquidity conditions have also contributed towards the same. Interestingly, the correction in short term papers which was seen in the past month, was reversed. Feb'23 witnessed an increase in yield of short term papers with cut off rising sharply. This was visible in considerable flattening of the yield curve. The gap between 15Year and 6months paper fell sharply to 27bps in Feb'23 against 60bps in Jan'23. The 2-month OIS curve of India is now at 6.75%, going by that logic another 25bps rate hike by RBI might be translated. Adding to this, has been the liquidity situation which went into deficit on an average basis in Feb'23. Durable liquidity fell sharply, so did government cash balances, due to month end spending to meet the budgeted level. Going forward pressure on liquidity would aggravate with maturity of LTROs and TLTROs and possible increase in spending by States. All these would put pressure on India's 10Y yield in the near term which is expected to trade in the range of 7.4-7.5% in the next 30-days.

Global yields inched up in Feb'23:

- Sovereign 10Y yields rose significantly globally, in Feb'23, following slew of economic data releases in the US which pointed towards 'soft landing' of the economy. These range from better services activity and home sales, core capital goods orders and personal spending data. Most importantly, core PCE data which is the Fed's official inflation indicator rose more than anticipated. Even payroll data showed tighter labour market conditions. Money market is now pricing terminal rate of ~5.5%, which translates to another 75bps rate hike by Fed in the current cycle.

- Fed minutes highlighted that FOMC members are comfortable keeping Fed fund rate in the restrictive territory. Fed officials such James Bullard, Loretta Mester and Philip Jefferson hinted at faster pace of rate hike to control inflation.

- This was reflected in the direction of US 10Y yield which rose by 41bps in Feb'23, on MoM basis compared to 37bps decline seen in Jan'23. Yield in other major economies followed suit. ECB officials also hinted at raising rates beyond Mar'23 as well, to bring inflation to the targeted level. Market is now pricing 4% terminal rate for the region, post the hot inflation print in France and Spain. Germany's 10Y yield firmed up by 37bps in Feb'23, on MoM basis.

Table 1. 10Y Yields globally firmed up

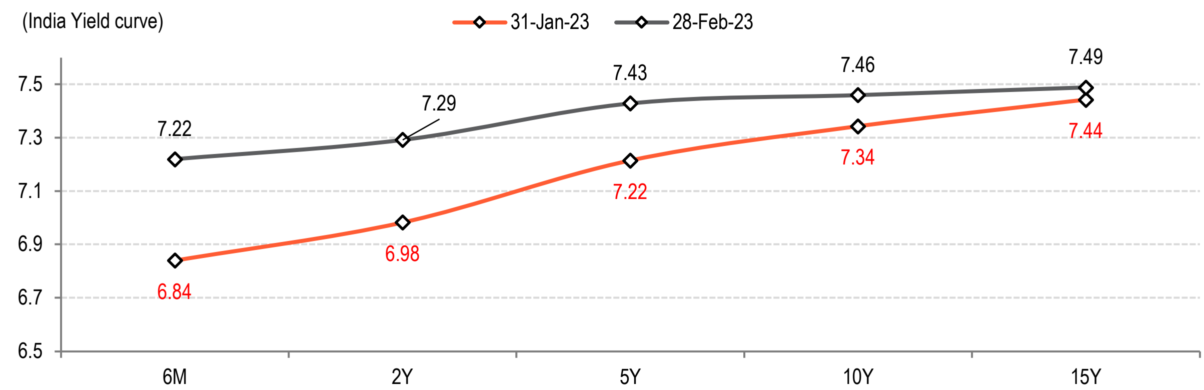
Countries	10Y sovereign yield, 31 Jan 2023	10Y sovereign yield, 28 Feb 2023	Change in 10Y yield in Feb/Jan, bps
Bloomberg Barclays EM USD Aggregate Yield to worst	7.02	7.54	52
UK	3.33	3.83	49
Korea	3.28	3.76	48
US	3.51	3.92	**41**
Germany	2.29	2.65	37
Indonesia	6.71	6.90	19
India	**7.34**	**7.46**	**12**
Thailand	2.54	2.59	5
China	2.90	2.92	1
Japan	0.50	0.51	1

Source: Bloomberg, Bank of Baroda Research

Domestic 10Y yield traded in the range of 7.28-7.46% in Feb'23 range against 7.29-7.40% in Jan'23. Some upside risk was visible due to evolving liquidity conditions and inflationary pressure.

Gap between long end (15Y paper) and short end (6 months paper) was reduced to 27bps in Feb'23 compared to 60bps in Jan'23. This is on account of sharp pace of increase in yield of short end papers. Notably, 3M-1Y GSec paper rose in the range of 38-42bps in Feb'23. On the other hand, pace of increase in yield of long term paper was comparatively lower.

Figure 1: Gap between long and short end yields fell sharply in Feb'23 compared to Jan'23



Source: Bloomberg, Bank of Baroda Research

What auctions in the domestic market reflect?

Auction results reflected that borrowing cost (measured by Cut-off price / Yield) for short term papers rose sharply in Feb'23 by 33bps, while for centre it has risen by 14bps. For state government papers, it remained stable.

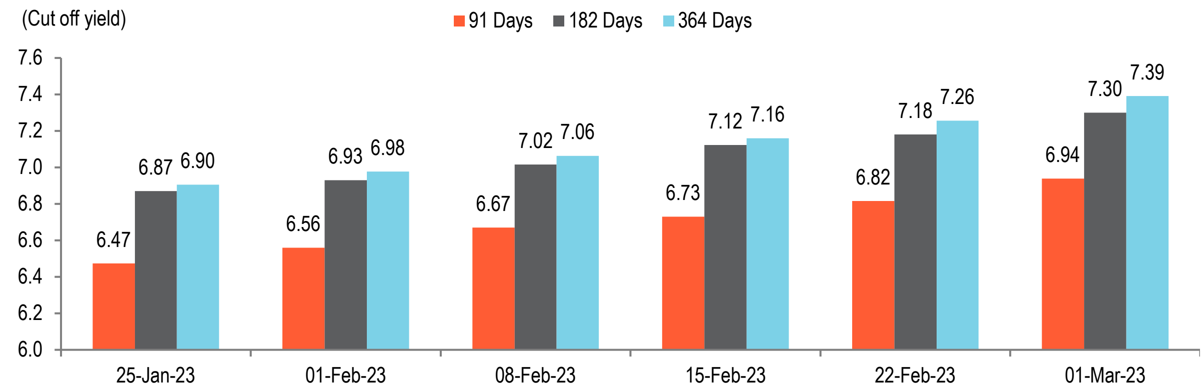
Table 2. Cost of borrowing for Tbills rose sharply

Type of Papers	Cut off yield as on 31 Jan 2023	Cut off yield as on 28 Feb 2023
Central Government Securities	7.27	7.41
SDL	7.68	7.69
TBill	**6.75**	**7.08**

Source: Bank of Baroda Research, Note: Average cut off yield is taken to arrive at borrowing cost, Auction dates differ

Short end yields have again started inching up, a phenomenon which was noticed when RBI started its rate hike cycle. The recent increase in cut off yield of short end papers can be attributed to crunch in liquidity situation. Also it may be reflective of the fact that RBI may go for another 25bps rate hike. Also the 2month India OIS curve is trading at 6.75% and indicates the same.

Figure 2: Cut off yield for TBill have risen sharply



Source: RBI, Bank of Baroda Research

Liquidity conditions remained tighter:

- Liquidity remained in deficit for 17 days in Feb'23. On an average, system liquidity went into deficit of Rs 5,400crore in Feb'23 compared to Rs 55,900 crore surplus in Jan'23.
- Government cash balance has moderated sharply to Rs 1.4 lakh crore as on 28 Feb 2023 compared to Rs 2.5 lakh crore as on 31 Jan 2023. Durable liquidity in Feb'23 has also fallen sharply to Rs 1.6 lakh crore from Rs 2.5 lakh crore in Feb'23. This was on account of US$ 4.5BN weekly fall in foreign currency assets, due to valuation loss, on account of rising US treasury yields.
- Going forward, further pressure on liquidity will be visible. Around Rs 13,018 crore LTROs and TLRO are due to be matured in Mar'23. Apart from this, government cash balances will also be under pressure to boost capex cycle. *To ease liquidity pressure, RBI may conduct Variable rate repo of longer tenor in the coming days.*

Major players in the month

As per Bloomberg data, foreign and private banks have reduced their holding of government securities in Feb'23, while some support has been from mutual funds.

Outlook on 10Y yield for the next 30days:

- *India's 10Y yield is expected to remain in the range of 7.4-7.5% in the current month*. Some degree of volatility can be noticed as the volume of the 2033 paper picks up. Interestingly, in the 17 Feb 2023 auction, the 7.26% GS 2033 paper got devolved (devolved amount was Rs 8,254 crore against Rs 12,000 crore auctioned amount). Apart from this, inflationary pressure which is still visible in vegetable prices, risks from heat wave on cereal inflation, would further mire the inflation outlook. This will indeed put upside risk on outlook of yields in the near term. Tightening liquidity condition is also an added risk to interest rate outlook.

Table 3: OIS rates have inched up, even corporate spreads have risen in Feb'23

	As on 31 Jan 2023	As on 28 Feb 2023
OIS Rates		
1M	6.47	6.73
2M	6.65	6.75
Corporate Spreads 10Y		
AAA	30	36
AA+	66	73
AA	106	109

Source: Bloomberg, Bank of Baroda Research, Note: data as on the mentioned time point

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