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Bonds Wrap

In Dec'22, bond yields globally changed direction and went for an upswing as Federal Reserve now expects a higher terminal rate at 5.1%. Even ECB officials hinted at peak inflation might not be way past us. These moves impacted yield trajectory. On domestic front, RBI's policy remained in line with market expectation, thus 10Y yield did not exhibit much volatility. However, with ending of calendar year and a review of the yield situation compared to previous year, brings some interesting conclusion.

In CY22, sovereign 10Y yield globally as well as in India noticed considerable upward movement. Tightening policy environment amidst inflation, resulted in the same. For India, what has been a stark contrast compared to CY21 is that there has been a significant flattening of the yield curve, with rise in yield of short term papers. The short term papers were indeed more responsive to policy rate change by RBI. The gap between short and long end paper fell to 74bps in Dec'22 compared to 298bps in Dec'21.

The liquidity dynamics also changed considerably. On an average, liquidity surplus fell to Rs 3.1lakh crore in CY22 compared to Rs 6.3lakh crore in CY21. Even the drivers of liquidity noticed a shift. With rising credit deposit gap, forex depletion and constrained space for OMO (on account of rising rate cycle), liquidity surplus in the system went down. Going forward, we expect slight deficit in liquidity is going to be the new normal. The outlook for yields remain heavily contingent on the upcoming borrowing calendar of FY24. No additional borrowing in Q4 has comforted domestic yield in Dec'22. We expect fiscal deficit ratio to come down slightly to 5.5-6 % in FY24. This would support the yield. Our outlook for the next 30days is at 7.3-7.4%.

Global yields started inching up in Dec'22:

- Sovereign 10Y yields again reversed its direction in Dec'22. In comparison to Nov'22, where global yields broadly fell following the 44bps drop in US 10Y yields, the situation was quite the opposite in Dec'22. 10Y yields of major economies have risen with Germany, UK and US rising as much as 64bps, 51bps and 27bps respectively.
- **So what has been the reason behind this upswing?** 1) Major central banks such as US Fed, ECB and BoE went for an expected 50bps rate hike, yet yields firmed up. This was driven by *US FOMC's upward revision in its terminal federal fund rate forecast. It now projects terminal rate to reach 5.1% against its earlier forecast of 4.6%*. Current US OIS 1Y rate is at 4.9%. 2) ECB President also hinted that inflation peak may not be way past us on account of wage growth spiral due to government stimulus. Notably, recently, Head of Dutch Central Bank Klaas Knot remained thoroughly hawkish and hinted at "quite a decent pace of tightening". In Japan as well, 10Y yield rose by 17bps, this is quite a remarkable rise post BoJ's decision to expand its implicit cap for 10Y bond yield target to 0.5% from earlier 0.25%.

- *CY22, as well noticed quite a significant jump in sovereign 10Y yield, led firmly by economies such as Germany, UK and US. Persistently high inflation and tightening policy environment were the primary drivers contributing towards rising yields.*

Table 1. 10Y Yields globally inched up

Countries	10Y sovereign yield, 31 Dec 2021	10Y sovereign yield, 30 Nov 2022	10Y sovereign yield, 30 Dec 2022	Change in 10Y yield in Dec'22, bps	Change in 10Y yield in CY22, bps
Bloomberg Barclays EM USD Aggregate Yield to worst	4.31	7.52	7.59	-7	321
Germany	-0.18	2.57	1.93	64	275
UK	0.97	3.67	3.16	51	270
US	**1.51**	**3.87**	**3.61**	**27**	**236**
Korea	2.26	3.74	3.68	5	148
India	**6.45**	**7.33**	**7.28**	**5**	**87**
Thailand	1.89	2.64	2.72	-9	74
Indonesia	6.38	6.94	6.94	0	56
Japan	0.07	0.42	0.25	17	35
China	2.78	2.84	2.92	-8	6

Source: Bloomberg, Bank of Baroda Research

- The table gives below the responsiveness of policy rate to rising inflation. For US, the change is policy rate has been the maximum followed by UK and India. The quantum of change in inflation in CY22 for US and India might look small when compared to other economies, because of the recent moderation in inflation from their recent peaks. On the other hand, for other major emerging economies, inflation still remains elevated, which also opens the room for further tightening of these central banks.

Table 2. Policy rates moved up in response to higher inflation

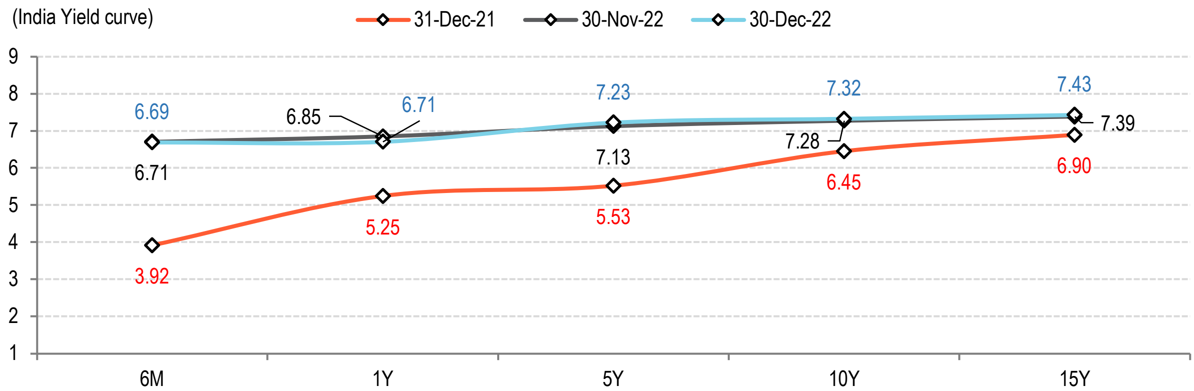
Countries	Change in policy rate in CY22, bps	Change in inflation in CY22, bps
US	**425**	**10***
UK	325	530
India	**225**	**22****
Korea	225	130
Germany	200	470
Indonesia	200	355
Thailand	75	338
Japan	0	300
China	-15#	10

Source: Bloomberg, Bank of Baroda Research Note: *If the peak of the year 9.1% seen in Jun'22 is taken, inflation has risen by 210bps in the US,** for India, if the peak of the year which was 7.8% seen in Apr'22 is considered, inflation has risen by 213bps, #for China 1Y LPR is taken

Domestic 10Y yield traded in the range of 7.21-7.33% in Dec'22 against 7.26-7.48% in Nov'22. The volatility was lower in the current month at 0.05 against 0.07 in Nov'22. Lack of fresh triggers (RBI's policy on expected lines), have hardly impacted 10Y yield movement in the current month.

A closer look at the yield curve reveals that in CY22, *considerable flattening has been observed*. This was on account of sharp rise in yield of short end papers. The yield for 6month and 1Y paper has risen by 277bps and 146bps respectively in CY22 whereas for 15Y paper, it has risen by only 54bps. This has reduced the gap between short and long end paper to 74bps in Dec'22 compared to 298bps in Dec'21. A plausible explanation could be that short end of the curve was more responsive towards policy rate change, whereas increased investors' confidence towards growth outlook of Indian economy and expectation of fiscal consolidation, kept yields at the long end stable.

Figure 1: Yield curve fairly flat in Dec'22 compared to Dec'21



Source: Bloomberg, Bank of Baroda Research Note: As of 31 Dec 2021, instead of 1Y, 3Y paper is taken, instead of 5Y, 4Y paper is taken and instead of 15Y, 14Y paper is taken due to unavailability of the same tenor papers.

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 Dec'22 compared to Dec'21. It went up by 269bps, whereas for central government papers it went up by 117bps. On MoM basis (Dec'22/Nov'22), there has not been much major change in borrowing cost.

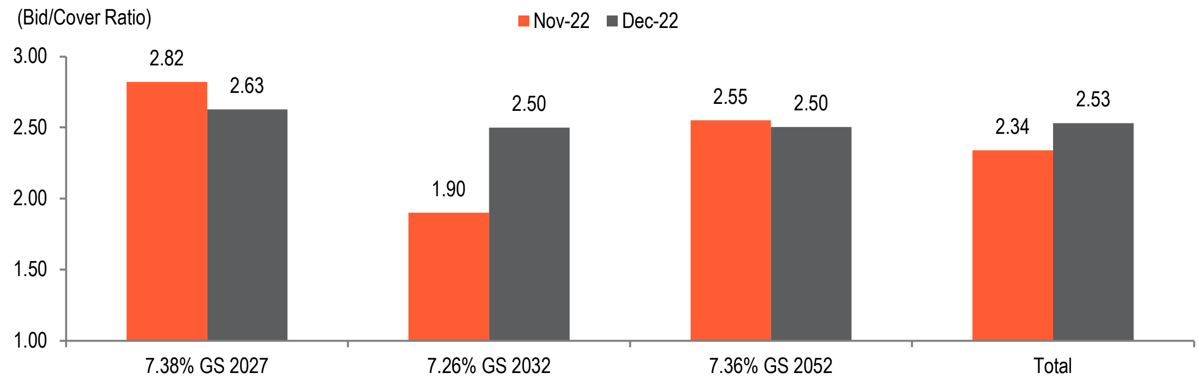
Table 2. Cost of borrowing rose the sharpest for Tbills

Type of Papers	Cut off yield as on 31 Dec 2021	Cut off yield as on 30 Nov 2022	Cut off yield as on 30 Dec 2022
Central Government Securities	6.13	7.26	7.30
SDL	7.01	7.59	7.64
Tbills	3.96	6.66	6.65

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

The demand for 10Y security remained firm in Dec'22 compared to Nov'22.

Figure 2: Bid to cover ratio across securities



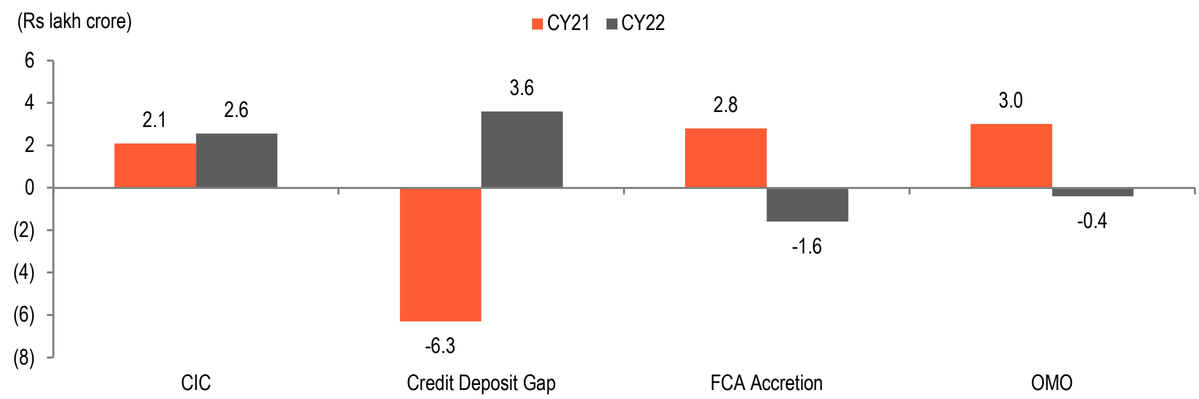
Source: RBI, Bank of Baroda Research

Liquidity tightening would prevail:

On an average, system liquidity was in surplus of Rs 63,200 crore in Dec'22 slightly higher compared to surplus of Rs 47,800 crore seen in Nov'22. On 13 days of the month (Dec'22), liquidity remained in deficit. Interestingly, durable liquidity have also risen to Rs 3 lakh crore as on 30 Dec 2022 against Rs 2.7lakh crore as on 30 Nov 2022. This is on account of RBI's less intervention in the forex market (US$ 14bn accretion in foreign currency assets). Government cash balance has also fallen to Rs 3.1tn as on 30 Dec 2022 from Rs 4tn as on 30 Nov 2022. This is on account of higher capital expenditure which stands at 59.6% of budgetary estimate against 49.4% in the same period of previous year.

If we look at the liquidity dynamics in the year, a lot of notable things come across: 1) the widening gap between credit and deposit has drawn a lot of liquidity out of the system in CY22 compared to CY21 2) Even a weaker currency has also contributed to a drawdown in liquidity surplus. 3) With a rate hike cycle on the go, RBI's support through OMO has also been constrained. Going forward, liquidity is likely to remain in slight deficit mode. However, some gap between credit and deposit is likely to narrow. With deposit rates inching up, it would garner inflows and help in reducing the gap.

Figure 3: Major drivers of liquidity



Source: RBI, Bank of Baroda Research, Note: Credit deposit gap is accounted by taking the difference of the change in outstanding numbers in the year, FCA is foreign currency assets and negative number implies depletion in reserves, OMO is net OMO=OMO Purchase-OMO sales and negative numbers should be read as net sales

Major players in the fortnight

As per Bloomberg data, maximum buying for government securities in Dec'22 has been from PSBs and foreign banks. On the other hand, MFs have reversed their buying spree.

Outlook on 10Y yield for the next 30days:

- India's 10Y yield is expected to remain in the range of 7.3-7.4% in the current month. Much fluctuation towards the long end of the yield curve is unlikely. Further, no additional borrowing in Q4FY23 has yielded support. Also, clarity in government's food subsidy program has lend support. Even short end yield is unlikely to exhibit much volatility and sooner with the clarity in government's borrowing program for FY24, we might see some correction in the yield curve. We expect fiscal deficit as percentage of GDP to be slightly lower at ~6% in FY24.

Table 3: OIS rates have inched up sharply in CY22 compared to CY21, while corporate spreads have fallen

	As on 31 Dec 2021	As on 30 Nov 2022	As on 30 Dec 2022
		OIS Rates	
9M	4.20	6.64	6.69
1Y	5.57	6.42	6.55
	Corporate Spreads-10Y		
AAA	45	31	30
AA+	91	71	70
AA	120	108	107
AA-	160	148	148
A+	310	273	273
A	335	298	298
A-	385	323	323
BBB+	435	398	398
BBB-	510	473	473

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

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