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Bonds Wrap

Global bond yields edged down as markets are now expecting that Fed is probably nearing its terminal rate, as it got breather from softening of core PCE data. Macro prints in the US still remained weaker, thus the timing of pause remains crucial from the perspective of soft/hard landing. OIS rate are pricing in another 50bps hike in the current cycle. On domestic front, India's 10Y yield inched up ahead of the Union Budget. We expect pressure on long end yields to continue as centre is expected to borrow above Rs 16.5-17 lakh crore. Apart from this, repayment pressure of Rs 4.5 lakh crore is also there in FY24. Any demand side measure to be announced in the budget will also be cautionary call for inflation, as core still remains elevated. We expect India's 10Y yield to remain in the range of 7.3-7.4% in the current month. We also expect some correction in short end yields as RBI is approaching end of its rate hike cycle, post the Feb'22 policy. System Liquidity is likely to remain under pressure as currency in circulation would pick up both in Q4 and FY24 ahead of the general election and widening of credit-deposit gap would persist on account of relatively stable domestic demand conditions.

Global yields edged down in Jan'23:

- Sovereign 10Y yields again reversed its direction in Jan'23. In comparison to Dec'22, where global yields broadly rose following anticipation of an above 5% terminal Fed fund rate, the situation reversed in Jan'23.
- Yields of major economies such as US, UK and Germany showed sharp moderation. Markets are now anticipating a slower pace of rate hike of 25bps by Fed, post some softening in the core PCE data. Even the recent Q4 GDP data of US, showed that personal consumption had moderated. The 1Year ahead inflation expectation data of University of Michigan has also edged down. Thus we expect that Fed is almost nearing its terminal rate and thereafter a pause cannot be ruled out considering that domestic macros are still on a weaker footing. For ECB and BoE, another 50bps rate hike is awaited in the coming policy.

Table 1. 10Y Yields globally inched down, India's 10Y yield firmed up

Countries	10Y sovereign yield, 30 Dec 2022	10Y sovereign yield, 30 Jan 2023	Change in 10Y yield in Jan/Dec, bps
China	2.84	2.92	8
India	**7.33**	**7.4**	**7**
Japan	0.42	0.48	6
Thailand	2.64	2.5	-14
Indonesia	6.94	6.76	-18

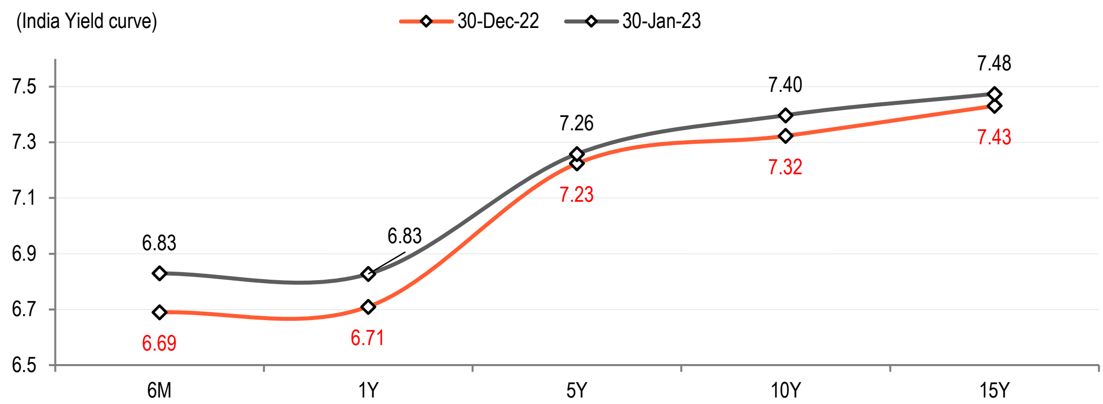
Countries	10Y sovereign yield, 30 Dec 2022	10Y sovereign yield, 30 Jan 2023	Change in 10Y yield in Jan/Dec, bps
Germany	2.57	2.32	-25
UK	3.67	3.34	-34
US	**3.87**	**3.54**	**-34**
Bloomberg Barclays EM USD Aggregate Yield to worst	7.52	7.05	-47
Korea	3.74	3.24	-50

Source: Bloomberg, Bank of Baroda Research

Domestic 10Y yield traded in the range of 7.29-7.40% in Jan'23 compared to 7.21-7.33% in Dec'22 against 7.26-7.48% in Nov'22. Some pressure is visible ahead of the Budget.

Gap between long end (15Y paper) and short end (6 months paper) was reduced to 65bps in Jan'23 from 74bps in Dec'22. This is on account of slight increase in yield of long term paper, not observed in past months. Going forward, we expect some degree of steepening of yield curve. This will be on account of inching of long end yield with disclosure of borrowing plan of FY24. We expect gross borrowing to be around Rs 16.5-17 lakh crore, which is likely to keep long end yields elevated. Further, some correction in short end yields may happen as RBI is nearing its end of the rate hike cycle, post the Feb'23 meeting.

Figure 1: Gap between long and short end yields fell in Jan'23 compared to Dec'22



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 slightly in Jan'23 compared to Dec'22. However, for central and state government papers it remained stable as borrowing calendar is nearing its end.

Table 2. Cost of borrowing for Tbills rose slightly

Type of Papers	Cut off yield as on 30 Dec 2022	Cut off yield as on 27 Jan 2023
Central Government Securities	7.30	7.32
SDL	7.64	7.65
Tbills	6.65	6.75

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

Liquidity tightening would prevail:

- On an average, system liquidity surplus fell to Rs 57,800 crore in Jan'23 compared to Rs 63,100 crore in Dec'22. Liquidity went into deficit for 4 days in Jan'23. Notably in Feb and Mar'23, long term and targeted long term repo of around Rs 1.35 lakh crore is expected to mature, which will keep system liquidity under pressure.
- Government cash balance has moderated to Rs 2.5 lakh crore as on 30 Jan 2023 compared to Rs 3.6 lakh crore as on 30 Dec 2022. This is because of higher spending ahead of the budget to meet the targeted level. Durable liquidity in Jan'23 has remained around Rs 2.9 lakh crore compared to Rs 2.8 lakh crore in Dec'22. This was supported by US$ 8.2bn accretion in foreign currency assets in Jan'23 mainly due to valuation gain, on account of falling global yields.
- Going forward, some pressure on liquidity cannot be ruled out. Till now in FYTD23 (till 20 Jan 2023) accretion in currency in circulation (CIC) has been Rs 1.4 lakh crore compared to Rs 1.7 lakh crore in the same period of previous year. In the coming months with rising currency demand ahead of the election, liquidity drain out would persist. Credit growth is still at a double digit pace of 16.5% and deposit growth is at 10.6%. So in the near term as well, a gap of around 5-6% cannot be ruled out. Further if budget is going to announce some growth centric measures it will further spur credit demand and widening of the gap cannot be ruled out. We expect liquidity to remain under pressure. However, RBI would continue to comfort through fine tuning operations to some extent.

Major players in the month

As per Bloomberg data, maximum buying for government securities in Jan'23 has been from PSBs and PVBs. On the other hand, MFs and FBs have been sellers.

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. Post Budget rally is likely to impact yield movement. A higher quantum of gross borrowing and a repayment of Rs 4.5 lakh crore, are likely to keep yields under pressure. Also growth stimulating measures might be cautionary for inflation, where pressure on the demand front (core inflation) still persists. Hence upside risks to yield persist. RBI's policy will also be closely watched where we expect around 25bps rate hike.

Table 3: OIS rates have inched up, while corporate spreads have fallen slightly

	As on 30 Dec 2022	As on 30 Jan 2023
OIS Rates		
1M	6.32	6.46
Corporate Spreads 10Y		
AAA	30	29
AA+	70	66
AA	107	106

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

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