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Bonds Wrap

UK and US 10Y yields' noticed quite a sharp upturn in May'23. In UK, more than expected public borrowing, favourable growth indicators and inflationary concerns resulted in inching up of its yield. In the US, higher than expected PCE index, tighter labour market conditions and uncertainty surrounding US debt limit deal, kept yields elevated. Now with the passage of the deal in the House, some comfort on global yields might be visible. India's 10Y yield on the other hand was comforted due to softening of headline CPI print and comfortable liquidity conditions. RBI's announcement of withdrawal of 2000 rupee notes also raised hopes of a favourable durable liquidity number in the near term. Post the announcement (19 May'23), reserve money balances have fallen and bank deposits increased. Our analysis suggests that If 50% of the total INR 2000 notes (Rs 3.62 lakh crore) are deposited then we can expect bank deposits to go up by Rs 1.8 lakh crore. This will further put downward pressure on yields in the near term. We expect India's 10Y yield to remain in the range of 6.95-7.05% in the current month. Any cautionary call by RBI against inflation can however result in some volatility.

Global yield: UK's 10Y yield noticed sharp uptick

- Sovereign 10Y yield in UK and US firmed up sharply on MoM basis in May'23. For UK, better than expected industrial production, modest improvement in consumer confidence, higher than expected CPI reading and pickup in BRC shop price index; all pointed towards firming up of growth and inflation numbers. This was reflected in inching up of its yield by 46bps.
- In the US, inflationary concerns remain elevated with core PCE QoQ as well as the PCE deflator remaining stickier than anticipated. Even labour market conditions remained tighter with JOLTS job opening firming up. Other than this, uncertainty over US debt limit deal also kept its 10Y yield elevated, which rose by 22bps. However, with the passage of the deal in the House and the next lies with the Senate; post that we can expect some moderation in yields, on account of higher supply of securities.
- On Fed fund rate, market is in a fix with 57.6% probability for a pause and 42.4% probability for a rate hike of 25bps. Even mixed macros of the US (retail sales excluding auto and gas and new home sales pointing to revival, whereas flash manufacturing PMI and consumer confidence remained disappointing), also enumerate bit of confusion. The commentary of Fed officials also gave conflicting signals with Minneapolis Fed President and St. Louis Fed President signaling more rate hikes, while Fed Governor Phillip Jefferson and Philadelphia Fed President speaking of pause.
- In China, moderation in CPI, retail sales, fixed assets and manufacturing PMI all point towards some degree of slowdown in the economy. Thus, its 10Y yield fell by 7bps.

Table 1. 10Y Yields globally traded mixed in May'23 over Apr'23

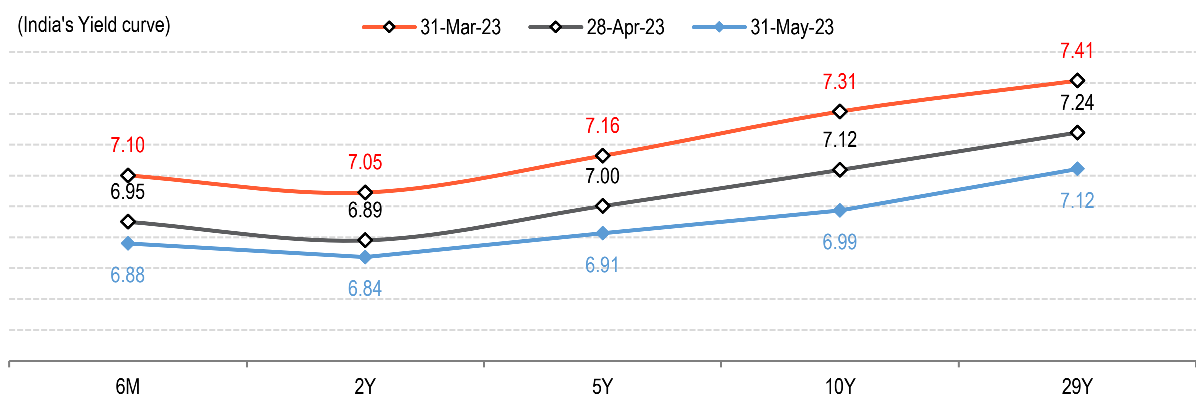
Countries	10Y sovereign yield, 28 Apr 2023	10Y sovereign yield, 31 May 2023	Change in 10Y yield in May/Apr'23, bps
UK	**3.72**	**4.18**	**46**
US	**3.42**	**3.64**	**22**
Bloomberg Barclays EM USD Aggregate Yield to worst	7.32	7.54	22
Korea	3.37	3.52	15
Japan	0.39	0.44	4
Germany	2.31	2.28	-3
Thailand	2.53	2.49	-4
China	2.78	2.71	-7
India	**7.12**	**6.99**	**-13**
Indonesia	6.53	6.37	-16

Source: Bloomberg, Bank of Baroda Research

Domestic 10Y yield fell by 13bps and traded in the range of 6.96-7.09% in May'23 from 7.10-7.31% in Apr'23. Downside pressure to yield was visible as inflation continued to inch down in Apr'23 as well. Apart from this, RBI's decision to withdraw 2000 rupee notes from the system has also resulted in moderation of yields. This is because, fall in currency in circulation in circulation will improve durable liquidity of the system, thus supporting yields.

Notably, post the announcement of withdrawal of 2000 rupee notes, reserve money has fallen by Rs 38,146crore, which can be attributed to exchange and subsequent withdrawal of. Our analysis suggests that If 50% of the total INR 2000 notes (Rs 3.62 lakh crore) are deposited then we can expect bank deposits to go up by Rs 1.8 lakh crore. This will further put downward pressure on yields in the near term.

Figure 1: Yields fell across all tenor papers



Source: Bloomberg, Bank of Baroda Research

What auctions in the domestic market reflect?

In May’23, cut off yields moderated across the board with central government papers’ cut off yield noticing quite a drop. Notably, the bid to cover ratio of 7.26% GS 2033 security has risen sharply to 2.72 in May’23 compared to 1.83 in the previous auction, reflecting stronger appetite.

Table 2. Cost of borrowing for central government papers fell considerably

Type of Papers	Cut off yield as on 31 Mar 2023	Cut off yield as on 28 Apr 2023	Cut off yield as on 31 May 2023
Central Government Securities	-	**7.20**	**7.09**
SDL	7.71	7.40	7.36
Tbills	7.29	6.93	6.86

Source: Bank of Baroda Research, Note: Average cut off yield is taken to arrive at borrowing cost, Auction dates differ, The cut off yield for central government securities is as of Feb’23, hence Mar’23 is left black as no auction is scheduled

RBI’s fine tuning supported liquidity conditions:

- System liquidity deficit averaged to Rs 72, 590 crore in May’23 compared to Rs 1.5 lakh crore in Apr’23. RBI conducted 14-day Variable Rate Repo auction of Rs 50,000 crore where Rs 46,790 was received. Whereas for reverse repo the amount received was far lower at Rs 8,447 crore compared to notified amount of Rs 50,000.
- Durable liquidity rose to Rs 89,697 crore as on 31 May 2023 compared to Rs 79,885 crore as on 28 Apr 2023. Some comfort on this front was provided by accretion in foreign currency assets to the tune of US$ 5.5bn (19 May’23 over 28 Apr’23).
- However, some pressure on liquidity might emanate from maturity of Rs 0.13 lakh crore of securities in Jun’23.

Major Player of the month

As per Bloomberg data, buying has been supported by foreign banks.

Outlook on 10Y yield for the next 30days:

- *India’s 10Y yield is expected to remain in the range of 6.95-7.05% in the current month*. Downward bias exists as headline CPI in May’23 would also benefit from favorable base. Even commodity prices are softening. Apart from this, with the base case of a debt limit deal in the US, fall in global yields cannot be ruled out as there would be excess supply of papers in the market. This indeed would push downward pressure on yields.
- RBI’s commentary on growth and inflation would be closely watched in the Jun’23 policy, where a pause in rate is most likely. However any cautionary tone against inflation or guidance on future course of action will shed light on the trajectory of domestic 10Y yield.

Table 3: OIS rates indicate pause on RBI's front, corporate spreads have inched up marginally

	As on 28 Apr 2023	As on 31 May 2023
OIS Rates		
1M	6.58	6.51
2M	6.59	6.54
9M	6.62	6.58
Corporate Spreads 10Y, bps		
AAA	38	42
AA+	75	80
AA	110	113

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

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