Monthly Debt Market Update

June 07, 2023 I Economics

Global Overview

US

- US Treasury yields remained volatile over the last month, largely driven by uncertainty over debt ceiling negotiations and the release of macroeconomic data that put the Federal Reserve in a tough spot. The 10-year yield traded within a wide range of 3.35-3.82% over the last month. A funding deadline of June 1 raised fears of a default and/or sovereign downgrade that spurred safe-haven demand. On the other hand, stronger-than-expected data raised bets of a hike at the June meeting. Market expectations were however tempered after key Fed officials opined that a pause in rate hike in June could be accompanied by hawkish guidance of raising interest rates later if required. Officials believed that skipping a rate hike could allow policymakers to see more data before making a decision. According to CME FedWatch Tool, there is now a 75% probability of a pause in June and a 50% chance of a 25 bps hike in July.
- On the data front, an upward revision of Q1 GDP (to 1.3% from the initial release of 1.1%), sticky core inflation (0.4% m-o-m in April unchanged from previous month), higher-than-expected PCE (4.4% y-o-y in April vs 3.9% expected), and strength in the labour market (nonfarm payrolls at 339K in May vs 190K consensus) supported calls for a rate hike in June. However, the internals of the labour market data painted a mixed picture as wage growth slowed (4.3% y-o-y in May vs 4.4% prior) and unemployment rate rose above estimates (3.7% in May vs 3.5% consensus).
- With concerns over the debt ceiling limit out of the way, we believe US Treasury yields would continue to be driven by incoming data ahead of the June policy meeting. The CPI reading for May will be released a day prior to the FOMC meeting. While a higher-than-expected print may not change the June policy decision, we could expect hawkish guidance if the central bank opts for a pause in June. Market forecasts for CPI and core CPI are seen unchanged at 4.9% and 5.5% y-o-y, respectively, in May. That said, with the debt ceiling removed until January 2025, debt auctions of new securities are now set to swell, further tightening liquidity conditions, and weighing on bonds.

Europe (ex-UK)

- Incoming macroeconomic data drove European bonds over the last month. While ECB lowered the quantum of a rate increase to 25 bps in May, the central bank expects a larger impact of its tightening cycle on inflation only in 2024, suggesting there may be room for further rate hikes. Meanwhile, recent inflation prints have supported bets of another 25 bps rate hike in June. CPI rose 10 bps to 7% y-o-y in April, while core CPI eased 10 bps to 5.6% y-o-y, from a month ago. Additionally, the economy averted a contraction, with Q1 GDP rising 0.1% q-o-q, albeit from 0.3% in the previous quarter. Moreover, the unemployment rate fell to 6.5% in April, from 6.6% in the previous month. Hawkish commentary by ECB officials too supported the upside in yields. That said, lead indicators such as PMI, and confidence surveys by IFO and ZEW are currently pointing to a grim growth outlook.
- With Germany, the largest economy in Europe slipping into a recession and other key economies such as France, Spain and Italy reporting softening of inflationary pressures, we believe the June rate hike of 25 bps could be the last one in the current tightening cycle. While markets are currently expecting another 25 bps rate hike in July, we believe the impact of ECB's decision to stop asset purchase program (APP) reinvestments from July would further help in tightening lending conditions going ahead. As a result, European bond yields could move higher in the short term, with deteriorating growth prospects limiting the upside.

UK

- UK gilt yields rose sharply over the last month, with the 10-year yield rising to its highest level since October 2022. Higher-than-expected inflation and a strong labour market added to bets that the Bank of England would continue hiking interest rates, taking terminal rate expectations to 5.5% from the current bank rate of 4.5%. CPI eased to 8.7% y-o-y in April from 10.1% in the previous month but remained higher than BOE's forecast of 8.4% for the month. Moreover, with May CPI expected at 8.4%, it is likely that inflation could overshoot BOE's Q2 forecast of 8.2%. More notably, core CPI rose 6.8% y-o-y in April, above market forecasts of 6.2%. On the growth front, Q1 GDP came in line with market expectations at 0.1% q-o-q. Meanwhile, the labour market continued to exhibit resilience. Wage growth improved marginally (6.7% in April vs 6.6% prior), while employment additions beat forecasts (182K in the three months ending March vs 160K expected), adding to upside pressures for core inflation. The unemployment rate moved slightly higher to 3.9% from 3.8% in March.
- With another 25 bps rate hike on the cards in June, we believe UK gilt yields could move higher from current levels in the near term, with the interest-rate sensitive short-term yields rising faster. However, we expect the BOE to pause earlier than the current market pricing as the UK could enter a mild recession in the coming months. Markets are pricing in a total of 100 bps (including the June hike) by December 2023, followed by a pause at the February 2024 MPC meeting.

Japan

- Comments from Bank of Japan Governor Kazuo Ueda and incoming data were in focus over the past month. Ueda stated that changing the central bank's policy target to the 5-year bond from the current 10-year zone would be amongst options if it were to tweak its yield curve control policy. However, market expectations of a continued accommodative policy stance remained in place given BOJ's expectations of inflation easing sharply on account of falling raw material costs.
- Incoming data painted a mixed picture. CPI rose 3.5% y-o-y in April (vs 3.2% prior) while core CPI accelerated 3.4% y-o-y in April (vs 3.1% prior). In fact, the hike in household electricity tariffs effective June suggests overall inflation could take longer to fall to the 2% target. Meanwhile, wage growth missed market expectations (0.8% in March vs 1.1% estimated). The unemployment rate dipped lower to 2.5% in April from 2.8% in the previous month. GDP growth in Q1 2023 however rose 0.4% q-o-q beating forecasts of a 0.1% rise. PMI surveys, particularly the services component (55.9 in May vs 55.4 prior), too indicated that the economy remained resilient, possibly contributing to the acceleration in core inflation going forward.
- Any adjustments in the YCC policy at the June meeting seem unlikely as the review of the policy announced in April is still underway. If inflation, wage growth and GDP continue to surprise on the upside, we may see a revision in terms of widening the yield cap or shortening the target maturity in July or September. An abrupt end to the YCC policy is however unlikely.

India Overview

- India's 10-year benchmark bond yield traded in a range of 6.96-7.12% over the last month, with a downside bias on yields largely on account of a favourable liquidity landscape. The banking system saw an average monthly surplus of around Rs 72,000 crore in May largely on account of government spending and maturity of government securities. In the first two months of the fiscal year, total G-sec redemption amounted to Rs 1.45 lakh crore. RBI's transfer of Rs 87,416 crore as surplus to the central government for the accounting year 2022-23, is also a positive for liquidity. The surplus transfer however fell short of market expectations (Rs 90,000-1,00,000 crore). The withdrawal of Rs 2000 currency notes could also bode well for liquidity in the short-term. According to a CareEdge BFSI report, an infusion of Rs 1-1.8 lakh crore can be expected in the June-September period. Overall, due to excess liquidity, weighted average call money rates declined from around 6.70% at the start of the month to as low as 6.10% as on June 2. Given that Rs 13,156 crore worth of G-sec redemptions are due in June, it is likely that RBI would continue to withdraw excess liquidity via reverse repo auctions.
- Easing domestic inflation has given confidence that RBI's rate hike cycle has come to an end, while better-than-expected FY23 GDP pushed back expectations of policy easing. The downtrend in inflation convinces us that the RBI would leave the repo rate unchanged at the June monetary policy. Moreover, neither do we

foresee a change in policy stance to neutral as the RBI could prefer to maintain flexibility given uncertainty over weather-led disruptions due to El Nino. With growth expected to moderate and inflation seen above 4% in FY24, we believe RBI would keep the repo rate unchanged in 2023. That said, the ongoing economic momentum evident from expansion in manufacturing and services PMI, robust services exports, and recovery in rural demand, has prompted us to maintain an upside bias on our initial FY24 GDP forecast of 6.1% for FY24.

- Going ahead, incoming bond sales and climate-related risks could cap the recent rally in Indian bonds. We foresee the 10-year benchmark bond yield in the 7-7.2% range by end-FY24.

Financial Market Performance

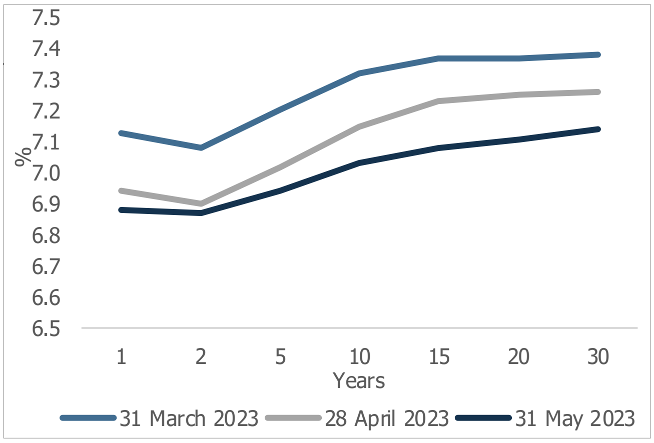
	Close	MOM	YOY
Global indices			
S&P 500	4,146	0%	5%
Nasdaq	12,560	4%	12%
Dow Jones	33,056	-2%	4%
FTSE 100	7,763	-2%	4%
Euro Stoxx	459	-1%	12%
DAX	15,992	0%	11%
CAC40	7,379	-3%	18%
Nikkei 225	30,958	8%	16%
Hang Seng	19,099	-5%	-11%
Sensex	61,982	4%	15%
NIFTY	18,348	4%	14%

	Close	MOM	YOY
Treasuries		**(bps)**	**(bps)**
10-yr UST	3.7%	24	65
10-yr Bund	2.4%	11	103
UK 10-yr Gilt	4.2%	47	201
10-yr JGB	0.4%	1	19
India 10-yr G-sec	7.0%	-2	-51
Currencies			
DXY	104.1	3%	2%
EUR/USD	1.1	-3%	0%
GBP/USD	1.2	-2%	-1%
USD/JPY*	139.8	4%	6%
USD/CNY*	7.1	3%	7%
USD/INR*	82.6	1%	6%
*(+) indicates weakening and (-) denotes strengthening			
Commodities			
Gold ($/Oz)	1,962	-3%	6%
Silver ($/Oz)	24	-8%	7%
Brent ($/bbl)	76	2%	-38%
WTI ($/bbl)	71	1%	-41%
Aluminium($/mt)	2,165	-6%	-22%
Copper($/mt)	8,334	-3%	-14%

Source: CEIC, Refinitiv (Closing values are as on June 06)

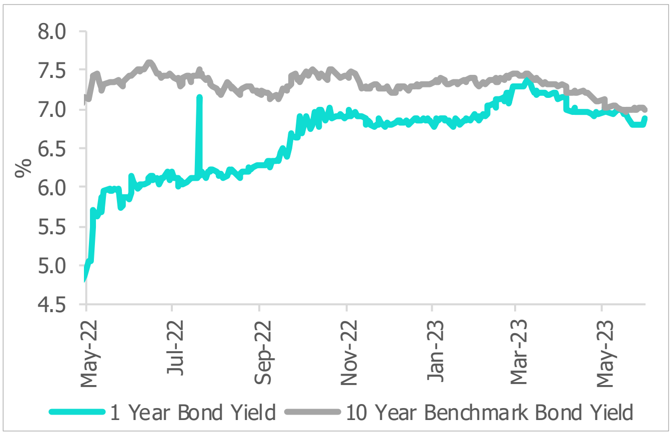
Indian Debt Market Chartbook

Bond Yields Ease



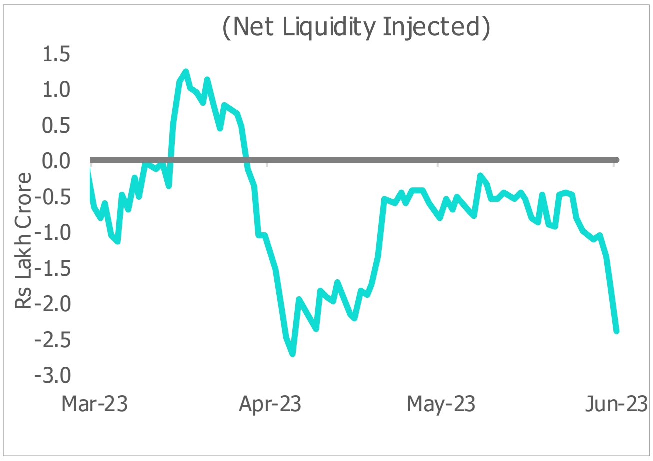
Bond yields eased on account of surplus liquidity in the banking system and reduced prospects of future rate hikes by RBI.

G-Sec Spreads Widen Marginally



With relatively sharper fall in short-term rates, the spread between the 10-1 year bond widened marginally to 12 bps as on June 2, from 6 bps a month ago.

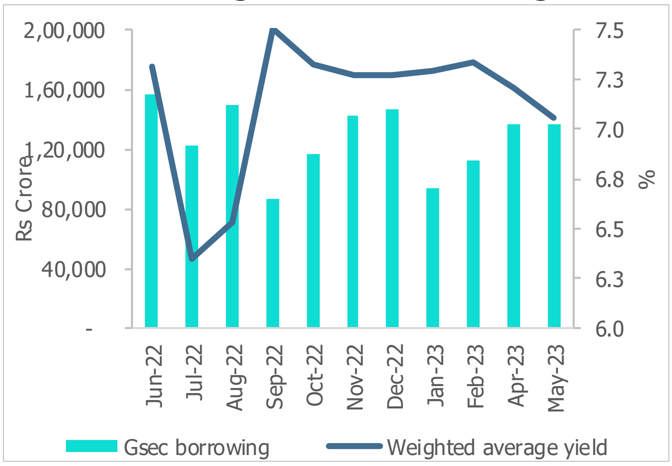
Banking System Liquidity Remains in Surplus



(+ indicates deficit/- denotes surplus)

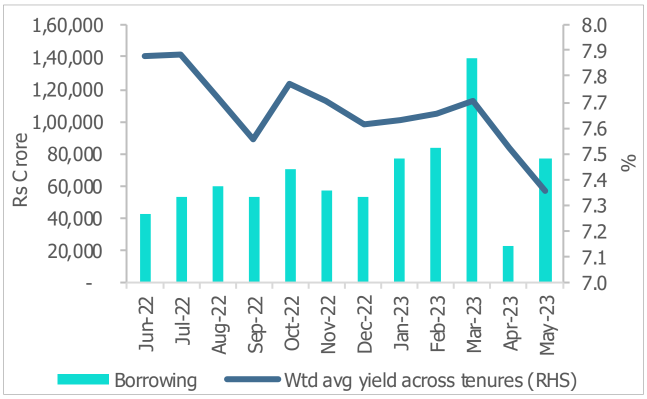
The banking system saw an average monthly surplus of around Rs 72,000 crore in May, with the surfeit largely triggered by government spending and G-sec redemption of Rs 1.45 lakh crore. Going ahead, RBI is expected to conduct reverse repo auctions to manage liquidity conditions.

G-Sec Borrowing Meets Calendar Target



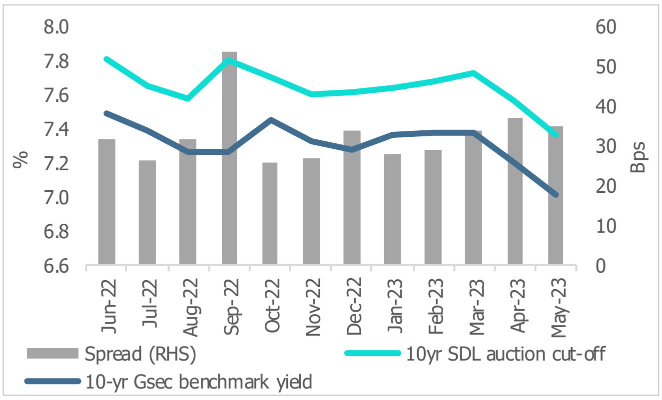
The government met its market borrowing target of Rs 1.36 lakh crore for May. The 5-year segment witnessed strong demand at the auction this month, with the bid-to-cover ratio rising from 1.8 to 2.3.

SDL Borrowing and Weighted Average Yields



SDL issuances rose nearly four-fold in May to Rs 77,500 crore amidst a sharp decline in states' borrowing costs.

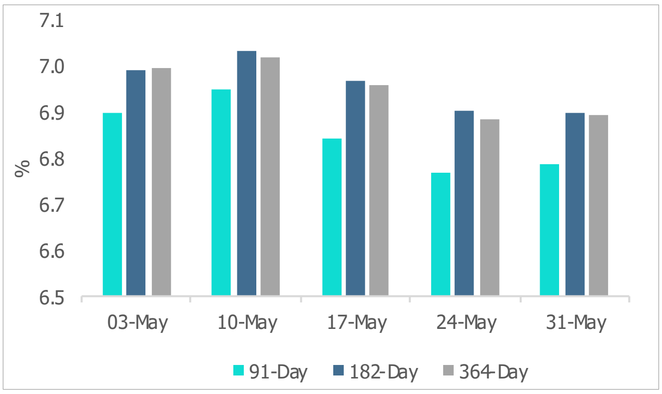
10-year SDL-G-sec Spread Steady



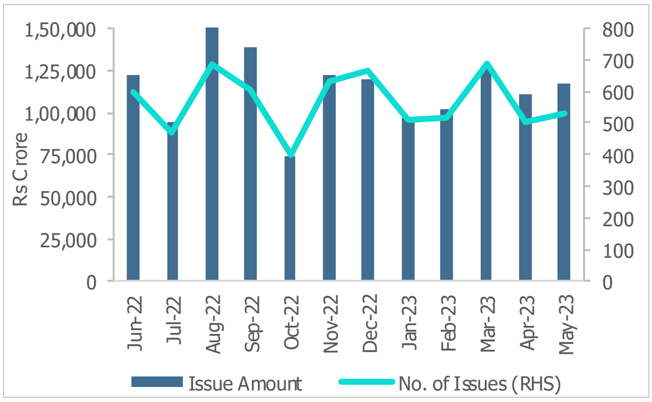
State governments' borrowing costs eased further in May. The spread between 10-year SDL and comparable G-sec yields stood at 35 bps in May, slightly lower than 37 bps a month ago.

91-day T-bill Borrowing and Yields

T-bill Yields at Auction in May

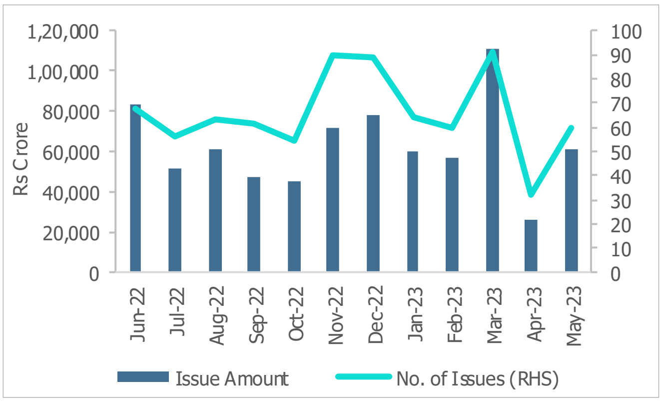


CP Issuances Rise Marginally



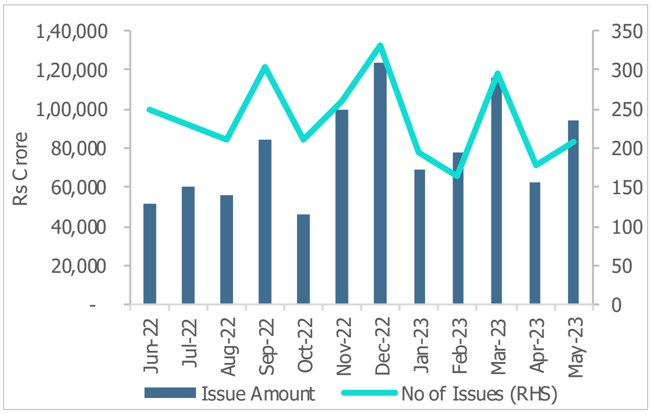
CP issuances rose 5% from the previous month to Rs 1.2 lakh crore in May. From a year ago, issuances were higher by over 4%.

CD Issuances Pick Pace to Meet Funding Gap



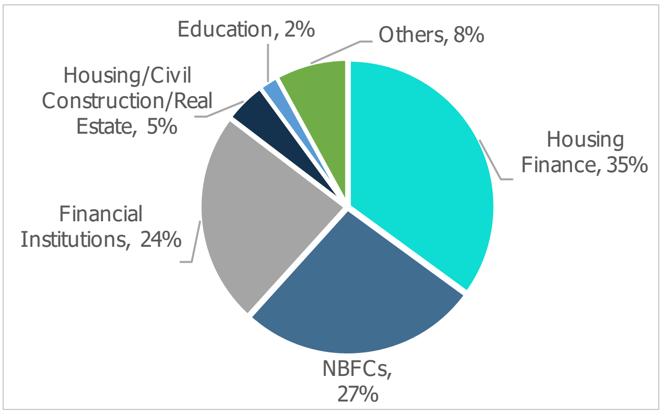
CD issuances more than doubled to Rs 60,000 crore in May. Banks' need to meet the funding gap on account of rising deposit costs and still-strong credit demand led to a surge in CD issuances.

Corporate Bond Issuances on the Rise



Private placement of corporate debt amounted to Rs 94,000 crore in May, rising 50% from the previous month.

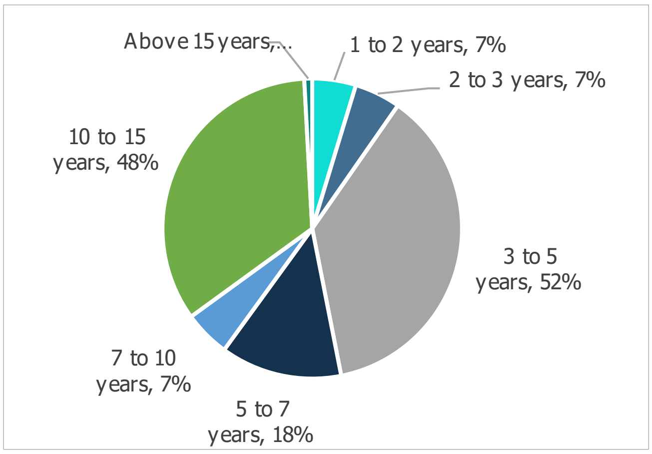
Corporate Bond Issuance by Industry - May



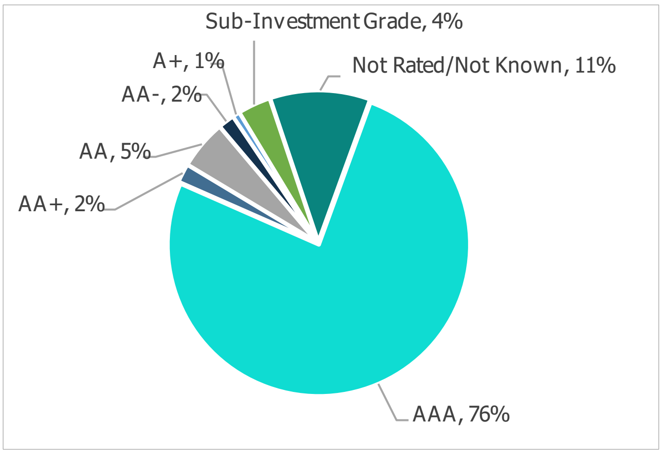
(Others include financial institutions, hotels & tourism, etc)

As per Prime Database, NBFCs, financial institutions and housing finance companies made up over 90% of the issuer base in May. However, in terms of the number of issuances, out of a total of 215 issuances, 113 were of financial institutions, followed by housing/civil construction/real estate (31 issuances), and housing finance (20 issuances).

Tenor-wise Corporate Bonds - May (% Share)

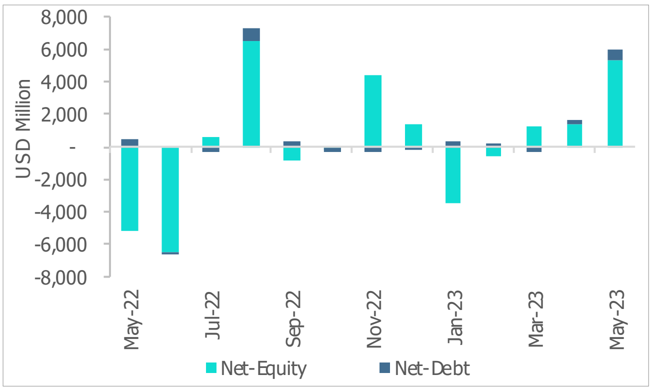


Corporate Bond Issuance by Rating- May



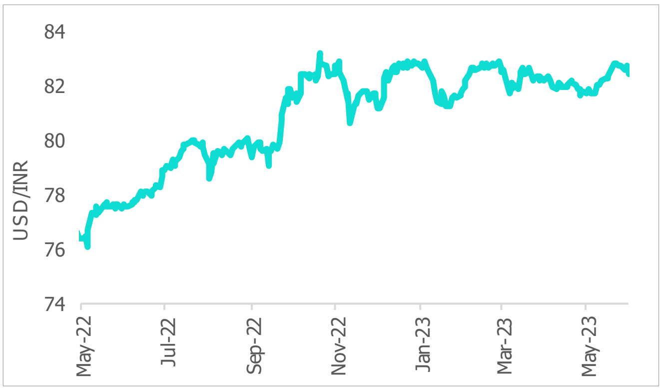
(Sub-Investment Grade includes bonds rated below A+)

Net FPI Inflows Climb to 9-Month High in May



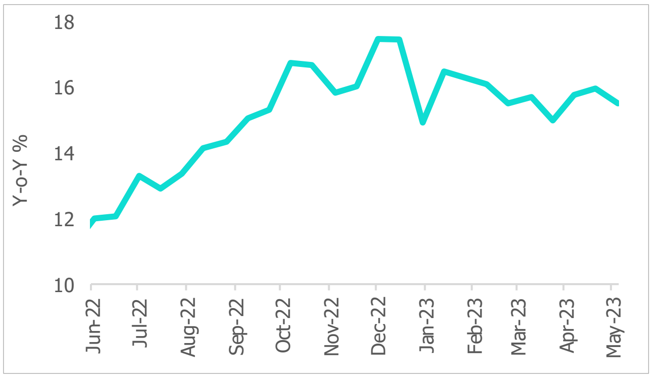
Net FPI inflows rose to a 9-month high of USD 5.8 billion in May, amidst a rise in both equity and debt segments. Going ahead, stable rupee, positive real rates and improved growth prospects are likely to sustain overseas investment.

INR Trades Rangebound on RBI Intervention



Rupee has been trading in a tight range of 81-83 since September 2022, with RBI aggressively protecting these levels via FX intervention. We expect rupee to remain within this range by end-FY24, with an upside bias on account of prospects of narrowing CAD.

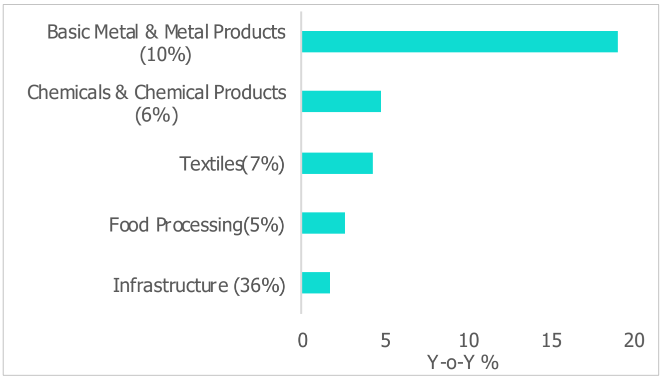
Bank Credit Growth Remains Steady



(Data for May 2023 as of the fortnight ending May 05)

Non-food bank credit rose 16% y-o-y in April, compared to 11% a year ago. Credit growth was steered by the services segment (22% y-o-y growth), retail (19%) and agricultural activities (17%). Credit to industries grew 7% y-o-y, from 8% a year ago.

Bank Credit Growth by Industry – Top 5



(Data as on April 21, 2023; Note: Figures in bracket represent % share in total industry credit)

Among major industries, healthy credit growth was recorded in metals (21% growth), chemicals (5% growth) and textiles (4% growth).

Weekly Average AAA Corporate Bond Spread Over Comparable G-Sec (bps)

Maturity Buckets	Week ended April 28, 2023	Week ended May 26, 2023
<= 1 year	53	66
>1 year -<= 2 years	79	81
>2 year -<= 3 years	84	68
>3 year -<= 5 years	59	59
>5 year -<= 7 years	47	19
> 7 years	46	57

Source: Data for this report is sourced from RBI, CCIL, CEIC, CMIE, PRIME DATABASE, WSJ

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