Monthly Debt Market Update

October 10, 2023 | Economics

Global Overview

US

- The 10-year US Treasury yield rose to levels last seen in 2007 following hawkish comments from Fed officials, the central bank's upward revision to growth and inflation forecasts, and better-than-expected jobs data.

- On the data front, nonfarm payrolls posted their largest gain since January, rising 336K in September, well above forecasts of 170K. Meanwhile, the unemployment rate held steady at 3.8%. Headline numbers for both CPI and PCE came slightly above expectations, while core inflation of both indicators showed signs of moderation, reflecting the impact of the recent rise in global food and energy costs. Other high-frequency indicators such as retail sales, PMI, and industrial production also beat market forecasts. More notably, the Fed's upward revision of GDP and inflation forecasts further reinforced optimism over the strength of the US economy. 2023 real GDP and PCE inflation forecasts were seen at 2.1% and 3.3%, respectively, from 1% and 3.2% estimated in June. Further, Fed policymakers including Loretta Mester, Thomas Barking and Michelle Bowman opined that the restrictive policy needed to stay for longer, with Mester supporting the case of one more hike.

- The recent upside in the 10-year bond yield is unlikely to sustain as the economy is expected to slow, given that the full impact of the total 500 bps of rate hikes is yet to play through. Although signs of slack have begun emerging (i.e. cooling housing and labour market, dwindling savings, tightening bank credit conditions), there may still be some time before these signs of weakness reflect on the broader economy. That said, every incoming data that surprises on the upside will continue to keep yields elevated. The upside will however be contained as the US government's temporary stopgap funding bill runs out in November, in the run-up to which, could be the source of continued political chaos and uncertainty in the near term. According to the CME FedWatch Tool, the Fed is expected to be done with rate hikes, and expectations of rate cuts have been pushed back to July 2024.

Europe (ex-UK)

- Hawkish comments by the European Central Bank (ECB) officials and revision of GDP and inflation forecasts at the September policy meeting amidst a 25bps rate hike weighed on European bonds, with the 10-year German bund yield rising over 40 bps in the last month.

- Although the ECB raised the policy rate by 25 bps to a record high of 4% at the September policy meeting, the Governing Council signaled that it is likely done tightening. Forecasts for 2023 GDP growth were seen lower at 0.7% (from 0.9% estimated in June), while average inflation was now seen higher at 5.6% (from 5.4% forecasted in June). However, policymakers remain divided over the future course of action amidst stubbornly high price pressures and rising recession fears. Separately, central bank officials including chief Christine Lagarde, Philip Lane, Frank Elderson and Isabel Schnabel have expressed concerns over inflation, favouring keeping rates restrictive for longer than initially expected. Lane and Elderson support the case for more rate hikes.

- On the data front, Q2 GDP growth fell below expectations, rising 0.1% q-o-q against market bets of a 0.3% rise. CPI rose 4.3% y-o-y in September (vs 5.1% expected), even as core inflation moderated to 4.5% (from 5.3% prior). Meanwhile, the labour market continued to exhibit signs of resilience, as the unemployment rate dropped to 6.4% in August from 6.5% in the previous month, and Q2 wage growth remained healthy at 4.6%. Amongst other high-frequency indicators, the contractionary trend in industrial production and retail sales persisted in August, signalling that pockets of economic slack have begun emerging. More importantly, the major European economies- Germany, France, Spain and Italy saw shrinking activity in August, especially that of the services sector.

- Going ahead, we believe that the ECB would choose to keep rates on hold in the upcoming policy meeting in October while remaining watchful of inflation given that services inflation is a big contributor to price pressures and that low gas prices are unlikely to sustain. As a result, the sell-off seen in European bonds could take a breather from its multi-year highs. While the market probability of another 25-bps rate hike is low at 23%, it is worth noting that rate-cut bets have now shifted to the second half of 2024.

UK

- The 10-year gilt yield eased from multi-year highs of 4.75% seen in August after the Bank of England decided to leave interest rates unchanged at its September MPC meeting, marking a pause in its tightening cycle that began in December 2021. However, markets remain divided on whether this is a pause, or the end of rate hikes given that economic activity has avoided a contraction and inflation has been falling faster than estimated. The MPC was split 4-3 in favour of keeping rates on hold.

- Inflation data was influential in BOE's September decision as price pressures that were expected to firm on the back of higher energy costs instead moderated. CPI rose 6.7% y-o-y in August, falling below consensus estimates of 7%, while core inflation softened to 6.2% y-o-y, 40 bps below expectations. Meanwhile, Q2 GDP rose 0.2%, in line with market forecasts, putting its growth ahead of economies like Germany and France. Further, wage growth improved to 8.5%, beating estimates of 8.2%, with a higher-than-expected rise in employed persons in August (1K as against expectations of 17K).

- We believe UK gilt yields could move lower from current levels in the near term as BOE could prefer to keep rates on hold in the upcoming meeting. Nevertheless, the possibility of one more rate hike in December cannot be ruled out if strength in the labour market and services inflation make it difficult for BOE to achieve its 2023 inflation target of 5%.

Japan

- The 10-year Japanese bond yield hit its highest level in a decade and nearing Bank of Japan's hard cap of 1%. The rally in yields was driven by the hawkish minutes of the September meeting, which reignited expectations that the central bank is slowly laying the groundwork for the end to negative interest rates. The sharp rise in yields, however, prompted BOJ to announce additional bond buying. BOJ surprised markets with the unscheduled announcement that it will buy USD 2.01 billion (300 billion yen) of five to 10-year bonds.

- While some in the nine-member board stressed the need to maintain monetary easing, few policymakers opined that an end to its bond yield control and negative interest rate policy "must be tied to the success" of hitting the bank's price goal, the summary showed. The central bank sees the second half of the current fiscal year, ending in March 2024, to be an "important period" in determining whether the BOJ's price target will be achieved. Apart from the clear change in tone, the summary also reveals heightened wage rise expectations amongst board members.

- On the data front, Japan's economy grew 4.8% in Q2, down from a preliminary estimate of 6.0% growth and below market forecasts for a revised 5.5% expansion. Growth prints raised doubts over the central bank's expectations that domestic demand would spur economic recovery, lowering chances of an early exit from its ultra-loose monetary policy. Meanwhile, retail inflation eased 10bps to 3.2% y-o-y in August, while core inflation remained sticky at 3.1% y-o-y. The labour market, however, showed signs of slack as wage growth slowed to 1.3% in July, missing estimates of 2.4%. Other data points such as industrial production, retail sales and export growth however beat expectations.

- Looking ahead, we believe Japanese bond yields would continue to test the 1% cap, especially if incoming macro data supports the narrative of policy tightening. That said, a worsening of the growth outlook could postpone the timing of an exit. Currently, markets expect BOJ to hike its policy rate by 10 bps to 0% at the January 2024 meeting. However, the review of the yield curve control (YCC) policy is expected to conclude only by April 2024, before which, a rate hike seems unlikely.

India Overview

- The 10-year benchmark bond yield remained elevated at multi-month highs following a hawkish RBI MPC meeting amidst a sharp rise in US yields and crude oil prices. Although RBI left the repo rate and policy stance unchanged at the October MPC meeting, bond markets witnessed a sell-off in reaction to the central bank's hints of open market operation (OMO) sales auction of government securities to mop up any build-up of excess liquidity.
- Outflows due to advance tax and GST, amidst healthy credit demand led to deficit liquidity in the banking system. Average monthly banking system liquidity slipped to a deficit of Rs 13,000 crore in September compared to a surplus of around Rs 12,000 crore in the previous month. As a result, overnight call rates rose as high as 6.82% during the month and remained well above the repo rate for most of September. With call money rates firming, banks also resorted to borrowing from the MSF window instead to fulfil their liquidity requirements. Banks borrowed around Rs 40,000 crore via the MSF window in September. Due to tightening liquidity conditions, the 2–10-year yield curve witnessed mild inversion. Given the pressure on the rupee and underlying inflationary risks, it is likely that RBI would prefer to keep liquidity tight and intervene via variable rate auctions mainly to ensure credit offtake does not get hampered.
- On the inflation front, headline inflation rose 6.8% y-o-y in August, compared to a high of 7.4% in the previous month, moderating below market expectations of 7%. The softening was largely on account of waning food inflation, particularly vegetables. Nevertheless, other items in the food basket i.e. cereals, milk and spices continued to remain elevated. We expect inflation to miss RBI's Q2 FY24 forecast of 6.2% and average around 7% while remaining wary about risks emanating from higher crude oil prices and lower agricultural output. Moderation in core inflation has nonetheless been comforting.
- Meanwhile, the announcement of the market borrowing calendar for H2FY24 was on expected lines and was a non-event for bond yields. The government left its H2FY24 borrowing plan unchanged, aiming to issue bonds worth Rs 6.55 lakh crore or 42% of its total borrowing in the October-March period. The tweak however was the introduction of bonds with ultra-long tenors of 50 years considering increased demand from investors such as insurance and pension funds. While the borrowing plan has not altered our outlook on fiscal balances as yet, it is worth noting that there have been signs of GST collections dwindling, which along with higher crude oil prices and moderating exports could pose a threat to tax collections.
- On a positive note, India's inclusion in JP Morgan's emerging market index effective June 2024 could bode well for bond yields and the local currency in the medium to long term. Markets expect the staggered 10% weightage for India over 10 months to attract overseas inflows of around USD 20-30 billion. While this would be favourable for Indian bond yields in the long term, we expect US yields, inflation and crude oil prices to dictate bond yield trends in the near term. We expect the 10-year benchmark bond yield to trade within the 7-7.2% range by the end of FY24.

Financial Market Performance

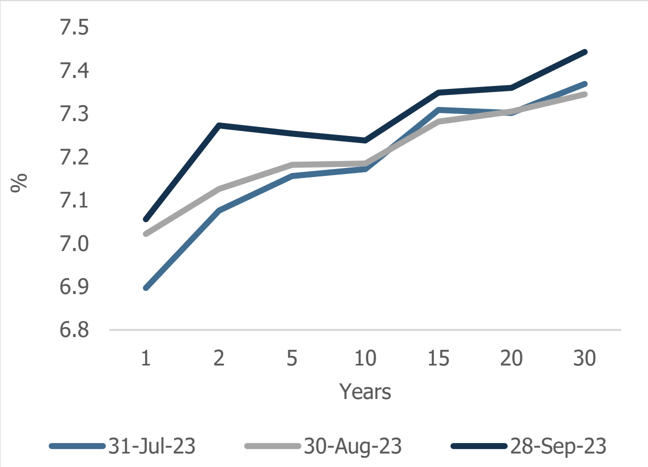
	Close	MOM	YOY
Global indices			
S&P 500	4,309	-4%	15%
Nasdaq	14,973	-3%	30%
Dow Jones	33,408	-3%	12%
FTSE 100	7,495	1%	7%
Euro Stoxx	436	-3%	16%
DAX	15,230	-3%	22%
CAC40	7,060	-2%	19%
Nikkei 225	30,995	-7%	13%
Hang Seng	17,486	-5%	-3%
Sensex	65,996	0%	13%
NIFTY	19,654	0%	13%

	Close	MOM	YOY
Treasuries		**(bps)**	**(bps)**
10-yr UST	4.72%	45	89
10-yr Bund	2.95%	37	93
UK 10-yr Gilt	4.61%	15	59
10-yr JGB	0.81%	15	56
India 10-yr G-sec	7.21%	1	-24
Currencies			
DXY	106.0	3%	0%
EUR/USD	1.1	-2%	6%
GBP/USD	1.2	-5%	1%
USD/JPY*	149.3	4%	9%
USD/CNY*	7.3	1%	8%
USD/INR*	83.1	1%	4%
*(+) indicates weakening and (-) denotes strengthening			
Commodities			
Gold ($/Oz)	1,832	0%	-4%
Silver ($/Oz)	22	1%	-7%
Brent ($/bbl)	85	4%	-6%
WTI ($/bbl)	83	5%	-5%
Aluminium($/mt)	2,205	0%	3%
Copper($/mt)	7,971	0%	-5%

Source: Refinitiv (Closing values are as on October 06)

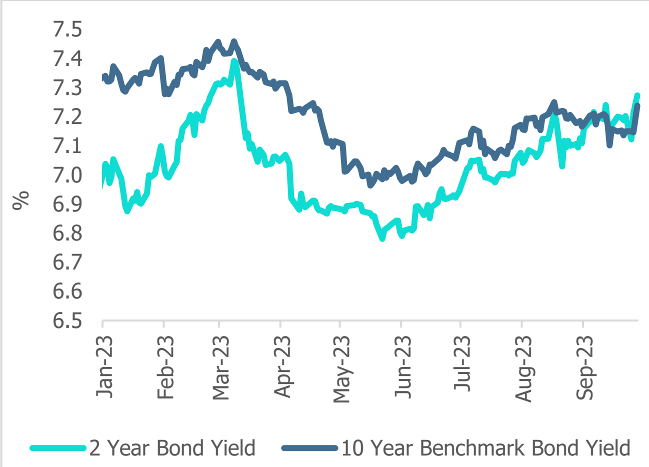
Indian Debt Market Chartbook

Bond Yields Move Higher



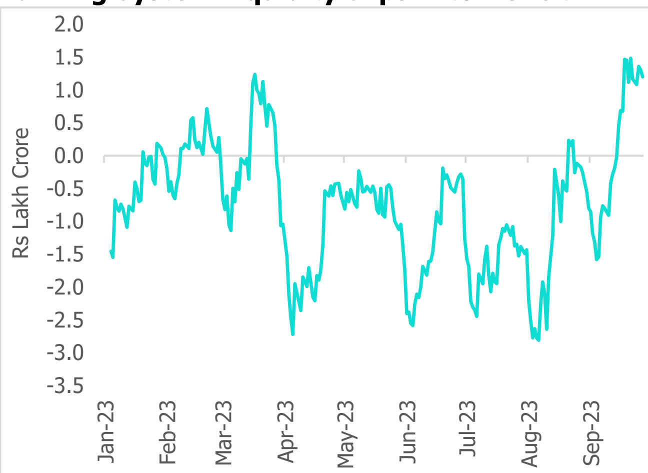
The 10-year benchmark bond yield traded within the 7.10-7.34% range over the last month, with the upside led by prospects of OMO sales, higher US yields and crude oil prices.

10-2 Year Yield Curve Sees Mild Inversion



The 10-2 year bond spread inverted as much as 7 bps in the last month, from a positive premium of around 20 bps a month ago, after tightening liquidity saw short-term yields rise at a faster pace.

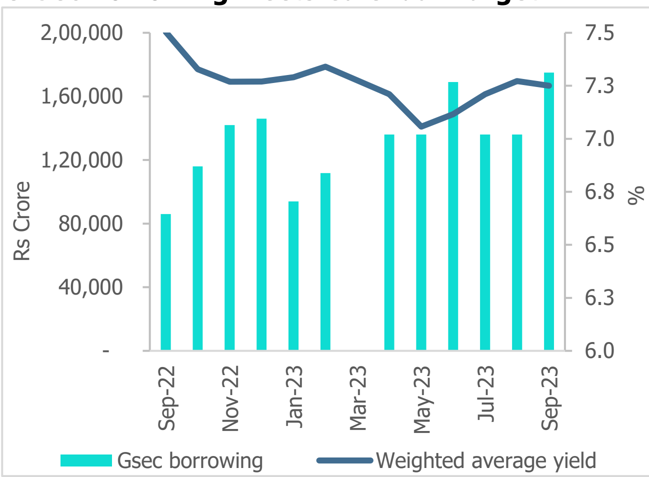
Banking System Liquidity Slips Into Deficit



(+ indicates deficit/- denotes surplus)

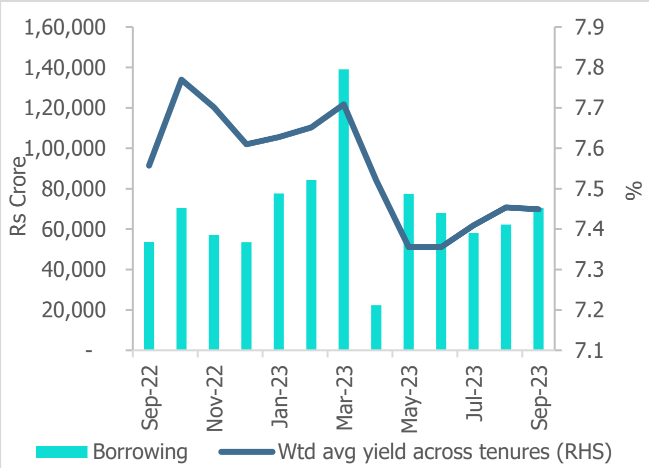
Average banking system liquidity stood at a deficit of Rs 13,000 crore in September, compared to an average monthly surplus of ~Rs 12,000 crore. GST and advance tax outflows, healthy credit offtake and RBI's FX intervention led to a tightening of liquidity conditions.

G-Sec Borrowing Meets Calendar Target



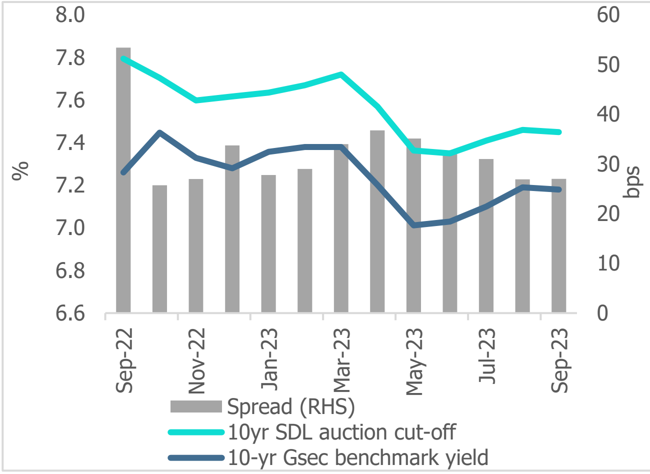
The government raised Rs 1.75 lakh crore in September through its market borrowing programme, in line with the amount set out in the indicative calendar.

SDL Borrowing and Weighted Average Yields



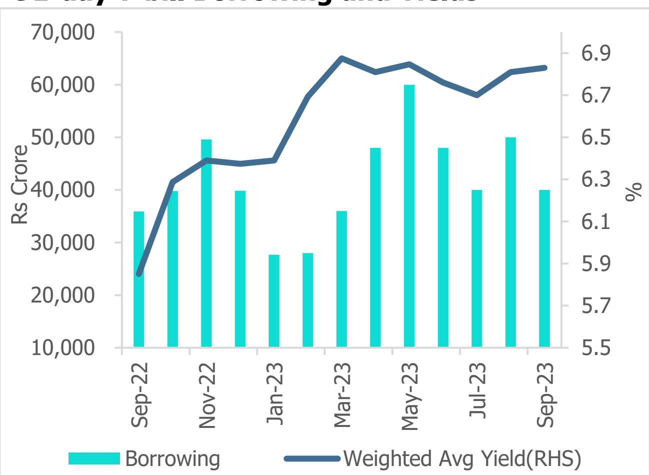
SDL issuances rose 13% from a month ago to Rs 70,523 crore in September, while borrowing costs remained unchanged at an average of 7.45%. The issuance is however 9% lower than that initially scheduled. For the October-December quarter states are expected to borrow ~ Rs 2.37 lakh crore via SDLs.

10-year SDL-G-sec Spread Steady

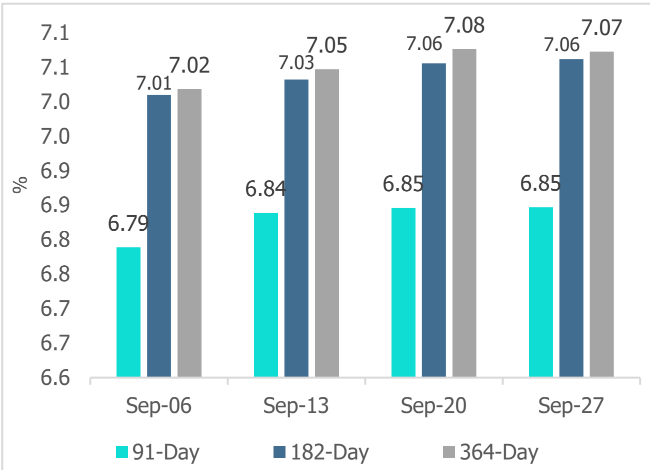


The yield spread between the 10-year SDL and comparable G-sec remained unchanged at 27 bps in September.

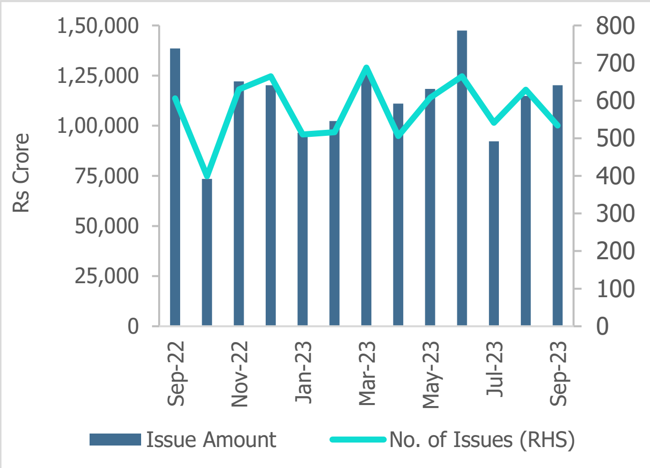
91-day T-bill Borrowing and Yields



T-bill Yields at Auction in September

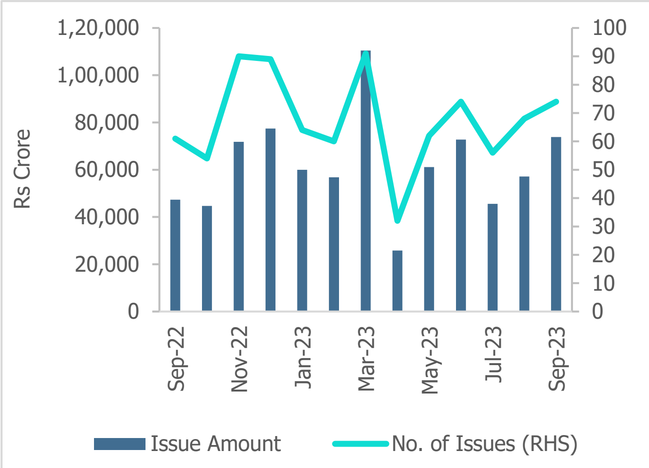


CP Issuances Pick Pace



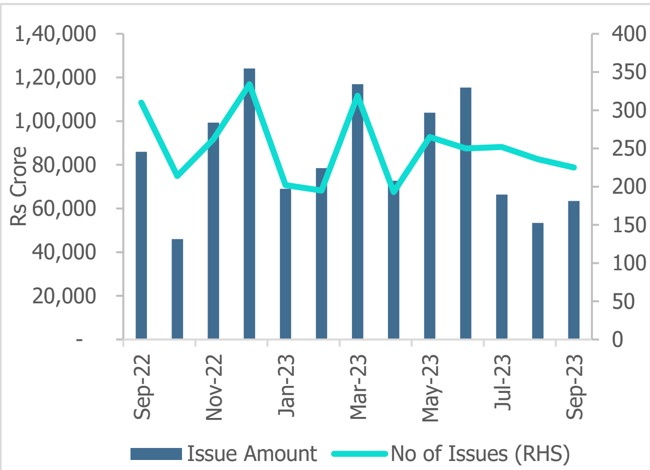
Fundraising through commercial papers (CP) rose in September. CP issuances rose 5% from the previous month in September to Rs 1.2 lakh crore.

CD Issuances Climb to 6-Month High



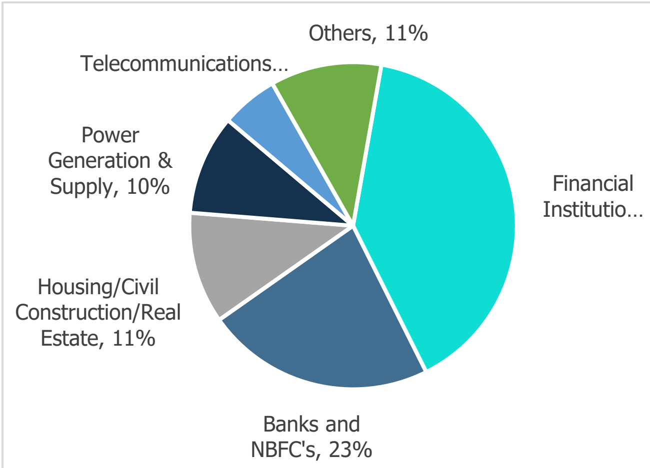
Certificate of Deposit (CD) issuances rose 29% from a month ago to Rs 73,852 crore in September, its highest level since March 2023. The preference for raising funds via CDs is likely to have risen amidst healthy credit growth and tightening liquidity in the banking system.

Corporate Bond Issuances Rise



Corporate bond issuances amounted to Rs 63,486 crore in September, up nearly 20% from the previous month. In the first six months of the fiscal year that began in April, private debt placements totalled Rs 4.75 lakh crore, nearly 50% higher than the same period a year ago. The increase during H1FY24 can be attributed to an increase in credit demand, rising bank loan rates and higher overseas borrowing costs.

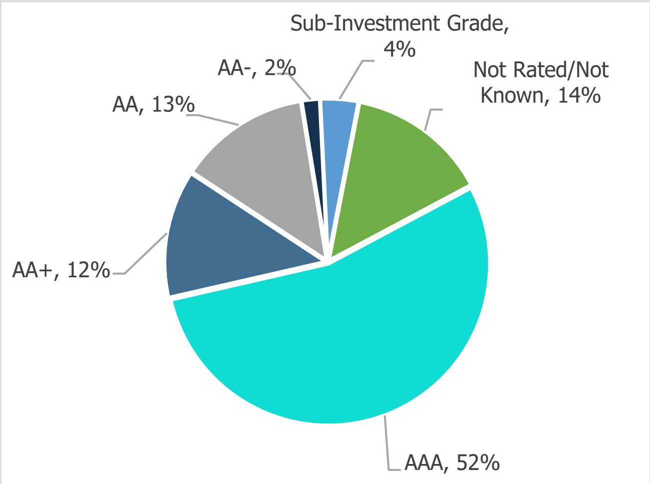
Corporate Bond Issuance by Industry



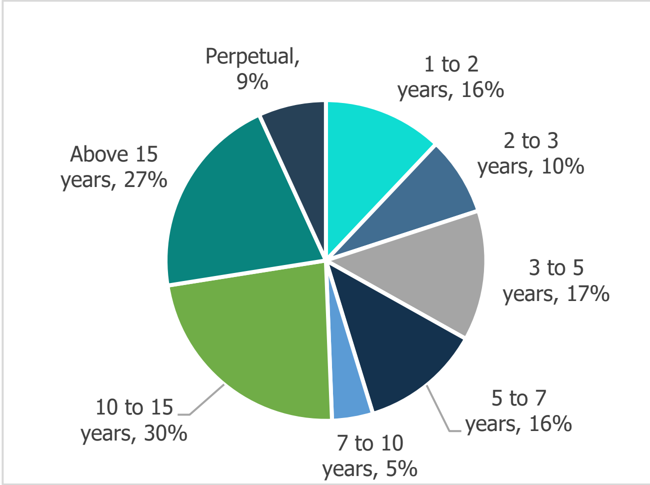
(Others include housing finance, travel & transportation, etc),

In terms of value, Financial Institutions and Banks & NBFCs and Housing/civil construction/real estate made up nearly 75% of the issuer base in September.

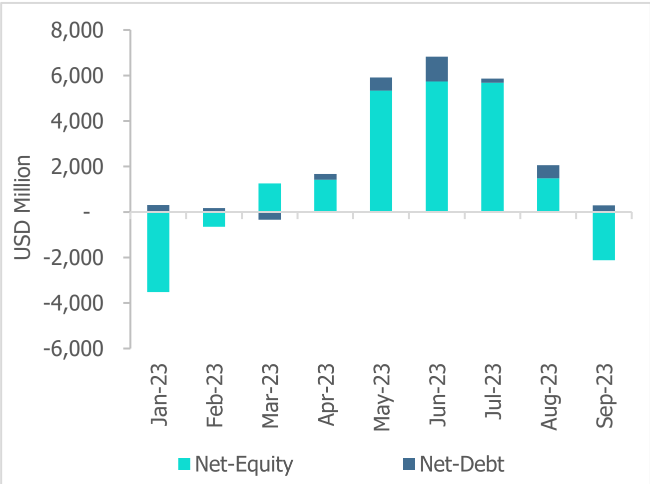
Corporate Bond Issuance by Rating-September



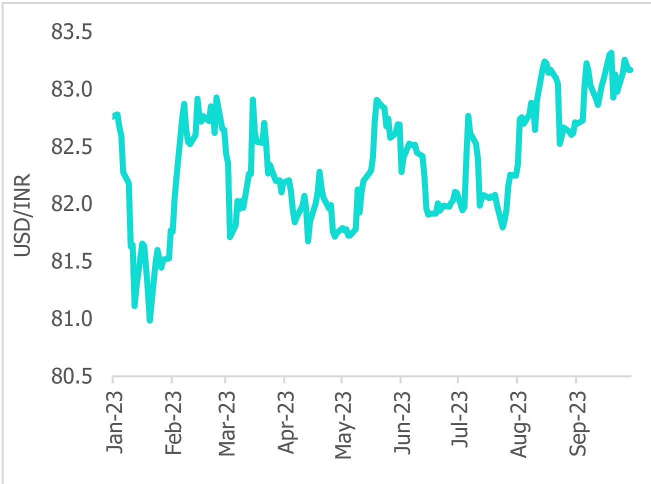
Corporate Bond Issuance by Tenor-September



Net FPI Flows Turn Negative in September



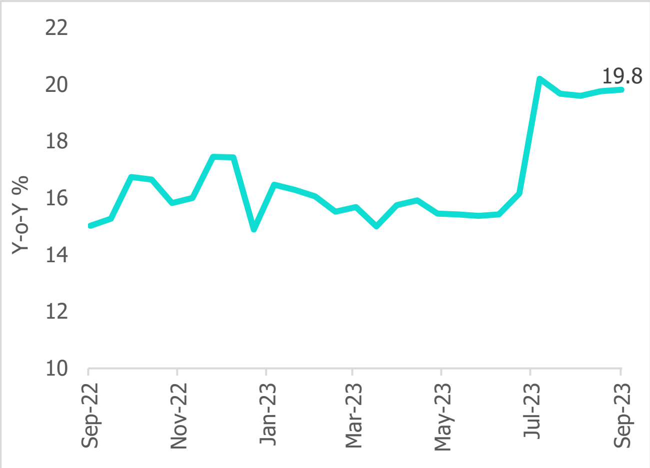
INR Falls to Record Low



Net FPI flows turned negative last month, registering the largest outflows since the start of the year. FPI's sold a total of USD 1.8 billion in September, with sharp outflows from equity markets. Debt markets however attracted inflows worth USD 289 million. In the year so far however, FPI flows stood at USD 18 billion, as against an outflow of USD 23 billion in the same period a year ago.

The rupee depreciated to a fresh record low of 83.31 in September, amidst a sharp rise in the dollar index, moderation in FPI inflows, and a rise in crude oil prices. RBI intervention via dollar selling is however likely to have curtailed the depreciation.

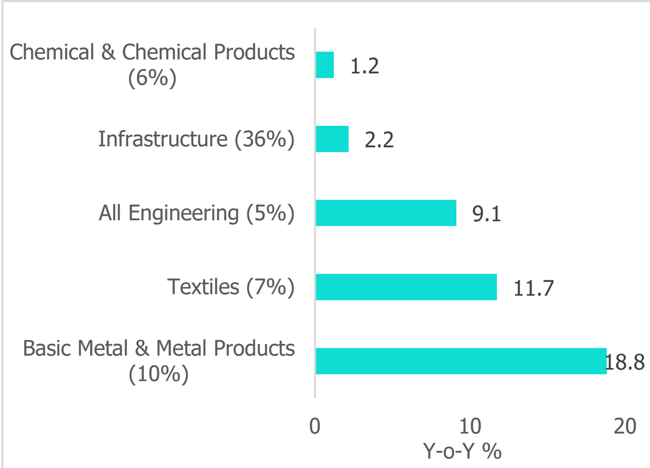
Bank Credit Growth Remains Healthy



(Data for September 2023 as of the fortnight ending Sep 08)

Non-food bank credit rose 15% y-o-y in August. Credit to industry registered a growth of 6% y-o-y in August 2023 as compared with 12% a year ago. Meanwhile, the credit to services sector grew 21% in August, from 17% a year ago.

Bank Credit Growth by Industry – Top 5



(Data as on Aug 25, 2023; Top 5 in terms of share in total industry credit; Figures in bracket represent % share in total industry credit

Among major industries, credit growth accelerated for basic previous year.metal and metal products (19%), engineering textiles (12%) and engineering (9%) as compared to the corresponding month of the

Source: Data for this report is sourced from RBI, CCIL, CEIC, CMIE, Refinitiv and Prime Database.

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