Debt Market Update

CareEdge RATINGS

December 27, 2023 | Economics

Recent Key Developments

Over the past month, the **10Y UST yield** has retreated by ~100bps from its highest level in 16 years and is currently trading around 3.9%, a level last seen in July 2023. This sharp pull-back in the yield can be primarily attributed to a dovish Fed.

Following a less hawkish November meeting, the FOMC unanimously maintained the fed funds target range at 5.25-5.5% for the third consecutive time in December and retained its previously announced plans for quantitative tightening. While this aligned with market expectations, the changes made to the policy statement and the forward guidance were more dovish than anticipated. Notably, the policy statement acknowledged, for the first time, that "inflation had eased over the past year" and highlighted a slowdown in the economic activity from the robust growth in Q3. Further, the phrase "any additional policy firming", which was absent in previous policy statements, suggested that the Fed might be done with rate hikes.

FOMC projections indicated the potential for a soft landing. The real GDP forecast for 2023 was revised upward by 50bps to 2.6%. FOMC members do not see the U.S. entering a recession between 2024 and 2026. Inflation forecasts were revised downward, with the core PCE inflation (Fed's preferred inflation measure) projected at 3.2% in 2023, 50bps lower than the earlier projection. Core PCE inflation is projected to decrease to 2.4% in 2024 and 2.2% in 2025 and reach the Fed's 2% target in 2026.

The FOMC projections suggest 75bps of rate cuts in 2024, which is more aggressive than the 50bps indicated in the September meeting. Additionally, another 100bps of rate cuts are projected in 2025, followed by 75bps of rate cuts in 2026. The fed funds rate is projected to settle at 2.5% in the long run, indicating higher for longer interest rates.

Market expectations have shifted from pricing 100bps of rate cuts in 2024 starting May before the policy meeting to a more aggressive stance of 150bps of rate cuts in 2024 starting March after the policy announcement. Consequently, the 10Y UST yield has fallen by ~30bps post the policy announcement as markets cheer the possibility of the end of Fed rate hikes and the imminent rate cuts.

Crude oil prices have displayed volatility. At the beginning of the week ending December 15, Brent crude oil prices were hovering near 6-month lows of ~USD 73 per barrel amidst scepticism about OPEC+ production cuts, high U.S. crude oil output and global demand concerns. However, they closed the week around ~USD 80 per barrel, marking their first weekly gain in two months amidst a weaker dollar and a dovish Fed. Furthermore, issues related to the supply side, such as lower Russian exports and Red Sea ship attacks, continue to weigh on crude oil prices.

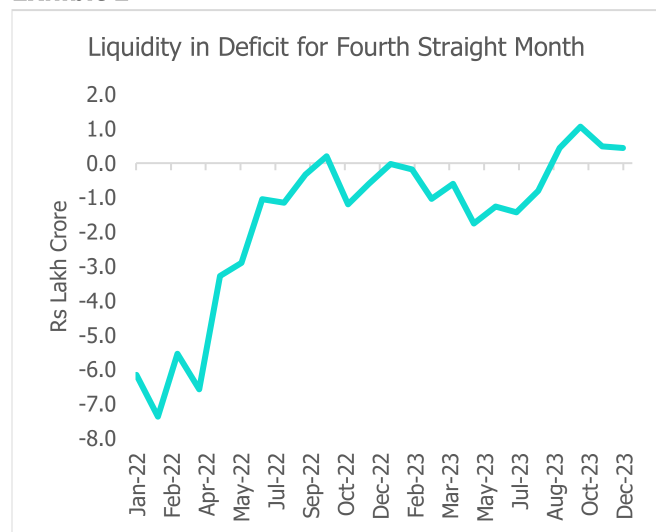
On the domestic front, the **RBI MPC** unanimously voted to keep the repo rate at 6.5% for the fifth consecutive time at its December meeting and maintained its stance of "withdrawal of accommodation." The RBI expressed optimism about the growth trajectory and revised its FY24 growth forecast upward by 50bps to 7%. Inflation

projections for FY24 were kept unchanged at 5.4%. The RBI Governor expressed confidence in the softening of core inflation, which has moved closer to the RBI's 4% target. However, he acknowledged the potential risks to headline inflation from volatile food prices. Notably, the policy language exhibited a less hawkish tone compared to the October statement. Despite this, the Governor sounded a note of caution, underscoring the importance of additional economic data in determining the future direction of monetary policy. We anticipate the RBI to start rate cuts after Q1 FY25 when quarterly inflation is projected to approach the 4% target. However, this rate-cut cycle is likely to be shallow.

Banking System Liquidity

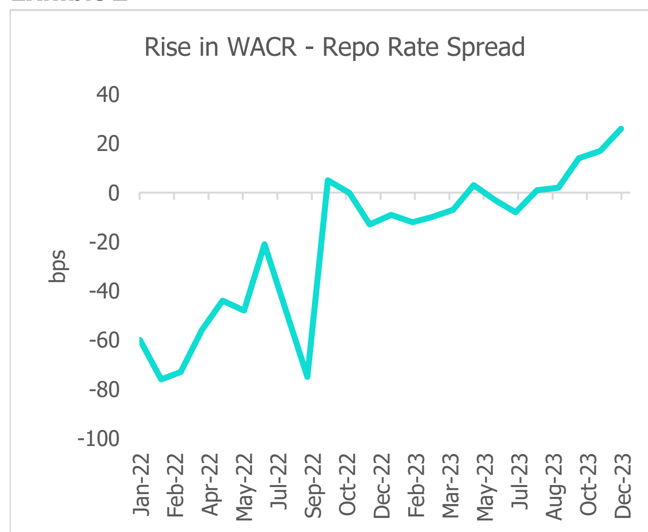
System liquidity has moved to a deficit from a surplus of ~Rs 7 lakh crore at the beginning of the current tightening cycle in May 2022, aligning with RBI's monetary policy stance of "withdrawal of accommodation" (Refer to Exhibit 1). Since September 2023, system liquidity has been in deficit due to forex interventions, currency demand during the festive season and outright OMO sales. As a result, the weighted average call rate (WACR) spread over the repo rate has risen (Refer to Exhibit 2). In the near term, advance tax-related outflows and GST payments are expected to keep liquidity in deficit. While government spending and FPI inflows may ease liquidity conditions, the RBI is likely to maintain tight liquidity in accordance with its "withdrawal of accommodation" stance. Although the RBI has not conducted any OMO sales since November 1, 2023, it may consider using them as a liquidity management tool in the future as required.

Exhibit 1



Source: CMIE. Note: Positive values imply liquidity deficit

Exhibit 2



Source: CMIE, CareEdge Calculations

Monetary Policy Transmission

Various segments of the financial market have witnessed varying degrees of monetary transmission during the current tightening cycle (Refer to Table 1). The policy repo rate has increased by 250bps in the current tightening cycle. Concurrently, money market rates have increased by 298 to 353bps over the same period. The benchmark 10Y GSec yield has remained unchanged amidst a fall in UST yields and crude oil prices. Consequently, the yield curve has flattened due to a rise in short-term rates while long-term rates have remained steady. The 3Y corporate bond yields have, on average, increased by 149bps across AAA and AA instruments in the current tightening cycle. Monetary policy transmission is still working its way through the deposit and lending rates of scheduled commercial

banks (SCBs). The Weighted Average Domestic Term Deposit Rate (WADTDR) on fresh and outstanding rupee deposits has increased by 228 and 173bps, respectively, during the current tightening cycle. The Weighted Average Lending Rate (WALR) on fresh and outstanding rupee loans has risen by 199bps and 110bps, respectively, over the period.

Table 1: Monetary Policy Transmission

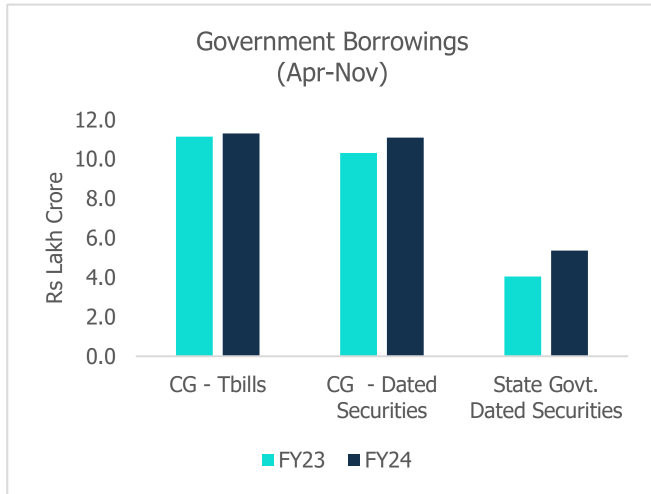
	Apr-22	Mar-23	Sep-23	Oct-23	Nov-23	Dec-23	Total Change in Current Tightening Cycle
	(Month-end*, %)						(bps)
Policy Rate							
Repo Rate	4.0	6.5	6.5	6.5	6.5	6.5	250
Money Market Rates							
WACR	3.4	6.4	6.5	6.6	6.7	6.8	332
3M TBill	4.0	6.8	6.8	6.9	6.9	6.9	298
CP – Low Rate	3.7	6.9	6.8	6.9	7.0	-	330
3M CD	3.9	7.2	7.0	7.4	7.4	7.4	353
Government and Corporate Bond Yields							
10Y GSec	7.1	7.3	7.3	7.4	7.3	7.2	2
3Y AAA	6.5	7.8	7.7	7.8	7.8	7.9	150
3Y AA	7.1	8.4	8.4	8.5	8.5	8.6	148
Deposit and Lending Rates of SCBs							
WADTDR -Fresh	4.0	6.5	6.3	6.3	-	-	228
WADTDR - O/s	5.0	6.2	6.7	6.8	-	-	173
WALR - Fresh	7.5	9.3	9.4	9.5	-	-	199
WALR - O/s	8.7	9.7	9.8	9.8	-	-	110
1Y Median MCLR	7.3	8.6	8.7	8.7	8.7	-	145

Source: CMIE, RBI, CareEdge Calculations. CP: Commercial Paper; CD: Certificates of Deposit; SCBs: Scheduled Commercial Banks; WADTDR: Weighted Average Domestic Term Deposit Rate; WALR: Weighted Average Lending Rate; MCLR: Marginal Cost of Funds based Lending Rate. *Data for Dec-23 is latest as available on December 16.

Government Borrowings

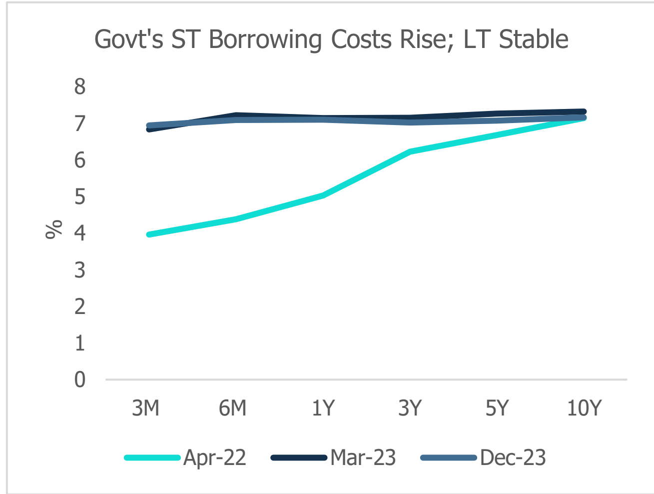
The central government has borrowed ~Rs 11.3 lakh crore through TBills during 8MFY24. This marks a ~1% increase over the corresponding period in FY23 (Refer to Exhibit 3). Additionally, the central government has borrowed ~Rs 11.1 lakh crore through dated securities in the same period, reflecting an 8% rise from FY23 and equivalent to 97% of the borrowing calendar for 8MFY24. State governments have borrowed ~Rs 5.4 lakh crore, showing a 33% increase from FY23 and reaching 91% of planned borrowings for 8MFY24. The combined borrowings of central and state governments (excluding TBills) totalled ~Rs 16.5 lakh crore during 8MFY24, a 15% rise from the corresponding period in FY23.

Exhibit 3



Source: CMIE, CareEdge Calculations. CG: Central Govt

Exhibit 4



Source: CMIE. ST: Short-term; LT: Long-term

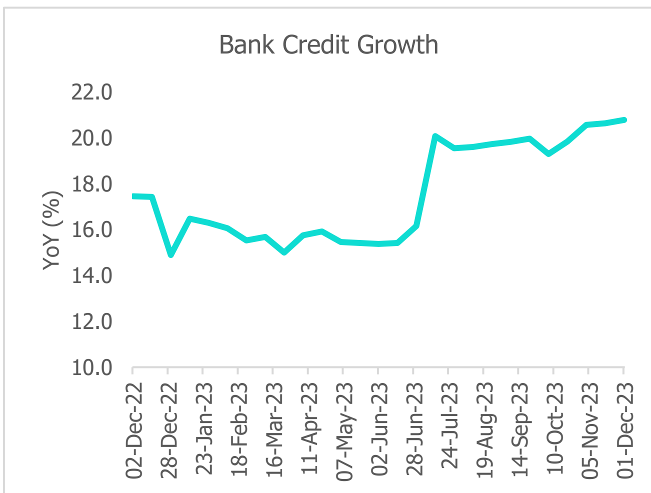
Bank Credit

Credit offtake continued to grow, increasing by 20.8% year on year for the fortnight ending December 01, 2023 (Refer to Exhibit 5). This surge is due to the impact of HDFC's merger with HDFC Bank along with the festival season and growth in personal loans. If we exclude the impact of the merger, credit grew at a lower rate of 16.4% year-on-year fortnight compared to last year's growth of 17.5%.

Primary Issuances

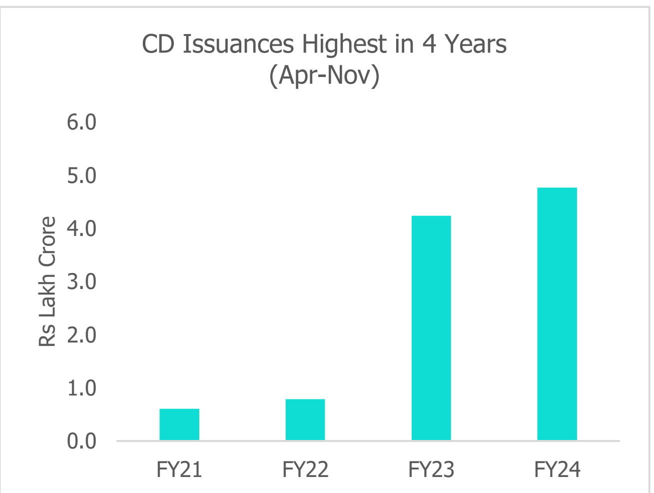
Certificates of deposit (CD) issuances in 8MFY24 amounted to ~Rs 4.6 lakh crore, marking the highest figure in four years and indicating a ~10% increase from the previous year (Refer to Exhibit 6). The preference for raising funds through CDs is likely to have grown due to healthy credit growth and tightening liquidity in the banking system. Commercial paper issuances totalled ~Rs 8.9 lakh crore in 8MFY24, marking a ~4% decrease compared to the corresponding period in FY23 (Refer to Exhibit 7). Conversely, corporate bond issuances in the same period amounted to ~Rs 5 lakh crore, reflecting a ~28% increase from FY23 levels.

Exhibit 5



Source: CMIE

Exhibit 6

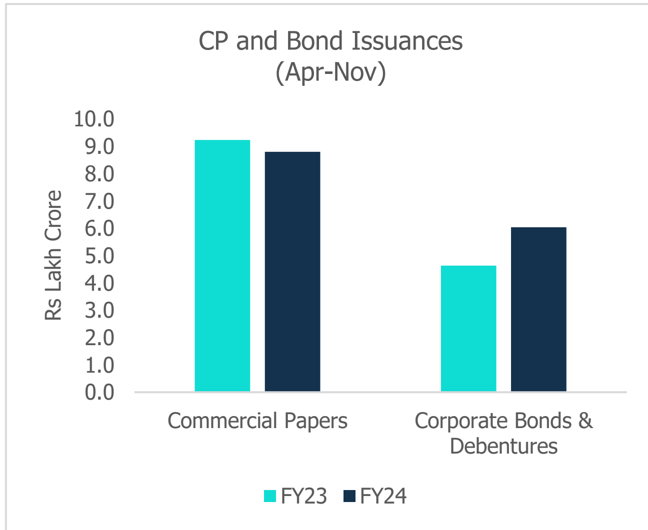


Source: Prime Database, CareEdge Calculations

External Commercial Borrowings (ECBs)

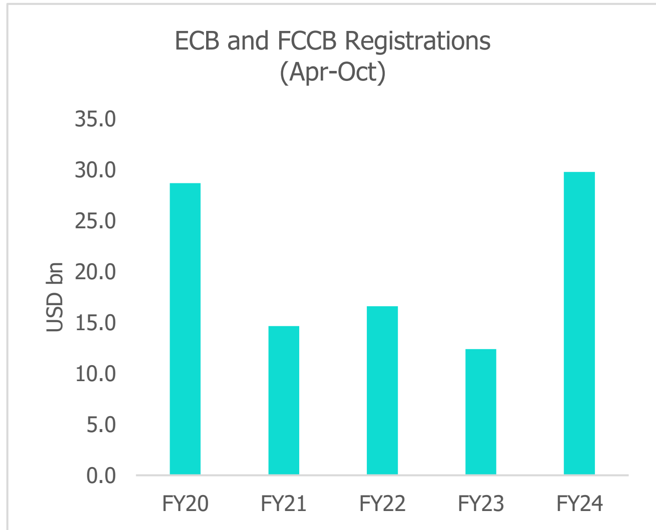
ECB registrations in 7MFY24 stood at ~USD 30bn, marking the highest level in five years (Refer to Exhibit 8). This represents a significant 140% increase compared to the ECB registrations in the corresponding period of FY23. As per RBI Bulletin, most of the newly raised ECBs were earmarked for capital expenditure.

Exhibit 7



Source: Prime Database, CareEdge Calculations

Exhibit 8



Source: CMIE, CareEdge Calculations

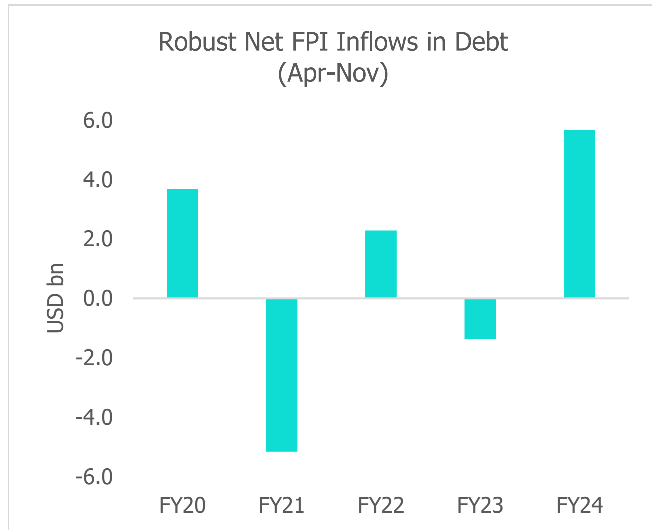
Net FPI in Debt

In the first eight months of FY24, net FPI inflows into debt reached ~USD 5.7 billion (approximately ~Rs 46,900 crore), marking the highest level in five years (Refer to Exhibit 9). Around 47% of these inflows occurred after the announcement of India's inclusion in JP Morgan's Global Bond Index – Emerging Markets next year. Expectations that interest rates have peaked in the U.S. have also resulted in net FPI inflows.

Debt Assets Under Management (AUM) of Mutual Funds (MFs)

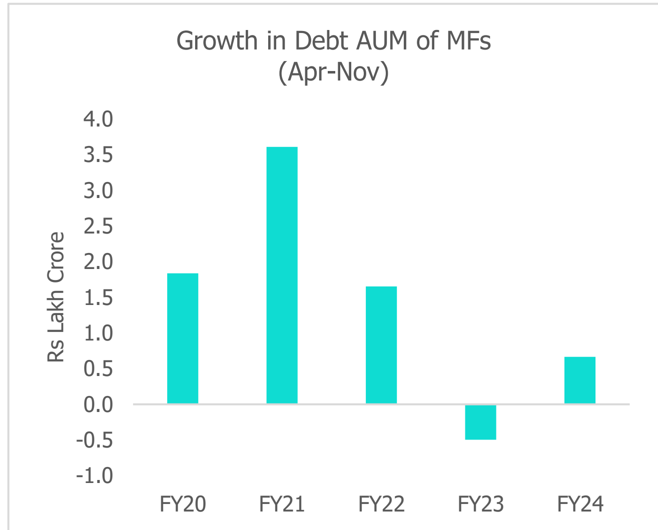
Debt AUM of MFs has increased by ~Rs 66,400 crore in 8MFY24 (Refer to Exhibit 10). MF exposure to PSU debt and government securities has risen by about ~Rs 80,800 crore during this period. In contrast, exposure to corporate debt has decreased by ~Rs 28,000 crore, and to money market instruments by ~Rs 21,000 crore.

Exhibit 9



Source: NSDL, CareEdge Calculations

Exhibit 10



Source: CMIE, SEBI, CareEdge Calculations

Outlook

In the near term, liquidity conditions are anticipated to stay tight, maintaining a flat yield curve. Robust foreign capital inflows into debt are expected to support G-Sec yields. The outlook for bank credit offtake remains positive for FY24. Unsecured personal loans and NBFC segments could witness a certain level of cooling off due to the recent RBI notification on risk weights.

An unfavourable base is expected to push CPI inflation higher around 5.8-6% in December. However, with the arrival of fresh crops in the market between January and March, headline inflation could ease to 5.1% by the end of FY24. We anticipate the RBI to start rate cuts after Q1 FY25 when quarterly inflation is expected to approach the 4% target. The 10Y benchmark yield is expected to trade between 7.00 and 7.25% in the near term, gradually moving towards the lower boundary. Nevertheless, market volatility related to expectations of the Fed's future interest rate trajectory and oil prices poses risks to the outlook.

Contact

Rajani Sinha	Chief Economist	rajani.sinha@careegde.in	+91 - 22 - 6754 3525
Sarbartho Mukherjee	Senior Economist	sarbartho.mukherjee@careedge.in	+91 - 22 - 6754 3483
Mihika Sharma	Associate Economist	mihika.sharma@careegde.in	+91 - 22 - 6754 3538
Mradul Mishra	Media Relations	mradul.mishra@careedge.in	+91 - 22 - 6754 3596

CARE Ratings Limited

Corporate Office: 4th Floor, Godrej Coliseum, Somaiya Hospital Road, Off Eastern Express Highway, Sion (East), Mumbai - 400 022
Phone : +91 - 22 - 6754 3456 | CIN: L67190MH1993PLC071691

Connect:

Locations: Ahmedabad | Andheri-Mumbai | Bengaluru | Chennai | Coimbatore | Hyderabad | Kolkata | Noida | Pune

About Us:

CareEdge is a knowledge-based analytical group offering services in Credit Ratings, Analytics, Consulting and Sustainability. Established in 1993, the parent company CARE Ratings Ltd (CareEdge Ratings) is India's second-largest rating agency, with a credible track record of rating companies across diverse sectors and holding leadership positions in high-growth sectors such as BFSI and Infra. The wholly-owned subsidiaries of CareEdge Ratings are (I) CARE Analytics & Advisory Private Ltd previously known as CARE Risk Solutions Pvt Ltd, and (II) CARE ESG Ratings Ltd, previously known as CARE Advisory Research and Training Ltd. CareEdge Ratings' other international subsidiary entities include CARE Ratings Africa (Private) Limited in Mauritius, CARE Ratings South Africa (Pvt) Ltd, and CARE Ratings Nepal Limited.

Disclaimer:

This report is prepared by CARE Ratings Limited (CareEdge Ratings). CareEdge Ratings has taken utmost care to ensure accuracy and objectivity while developing this report based on information available in public domain. However, neither the accuracy nor completeness of information contained in this report is guaranteed. CareEdge Ratings is not responsible for any errors or omissions in analysis / inferences / views or for results obtained from the use of information contained in this report and especially states that CareEdge Ratings has no financial liability whatsoever to the user of this report.