Attractive Short Term Yields

Puneet Pal
Deputy Head – Fixed Income

Bond Market Investors, over the last six months, have been caught on the wrong foot by the steep rise in yields, especially short term yields and are currently in a wait and watch mode pondering over the optimal investment choices.

In our view, which we will try to explain in this note, it is in fact a good time to invest into short term bond funds especially high quality portfolio's which do not have a portfolio duration of more than 2yrs.

Currently the short term yields are factoring in 50 bps rate hike by RBI during the course of this financial year along with liquidity tightness.

The current spread of the 2yr AAA bond with the Policy rate is 225 bps which is almost 75 bps higher than the median spread of 150 bps (over the last 10yrs).

Spread between AAA PSU bond with the Repo Rate

Apart from the relative spread the expected return on an absolute basis also looks quite attractive at the current yield of 8.50% for a 2yr bond. Even on a real rate adjusted basis, the yields are attractive. Assuming a worst case scenario of 6% Inflation, still the real yield of a 2yr AAA will be 250 bps positive. The spread between the 2yr AAA and Gsec is also the highest in the entire curve at 90 bps.

Short Term yields are predominantly influenced by

1. Expectation of Future Rate Hikes
2. Expectation of the Liquidity in the banking system

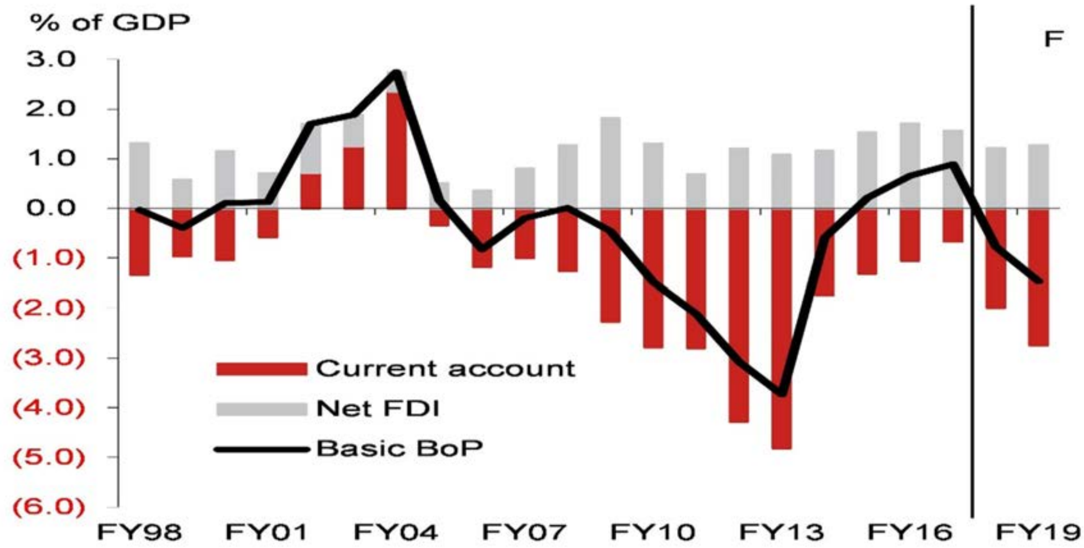
Interest Rate Outlook

Currently the market is pricing in 50 bps of incremental rate hikes by RBI for the remainder of FY19 and it is in consonance with the neutral stance of RBI, which indicates data dependency. The risk of more than 50 bps rate hike in FY19 is low given the fact that RBI has taken into account the rise in oil prices and the risk of higher MSP's . The path of rate hikes by other major central banks across the world is also pretty much clear and markets seem to have discounted it. The major risk to higher and aggressive rate tightening in India remains the movement of crude Oil Prices.

Outlook on Liquidity

Structurally we expect liquidity to remain tight as the current account deficit is widening with portfolio outflows which means that the BOP surplus will shrink this year. Also the currency in circulation (11.6% of GDP) has gone up to be almost at the same level as before demonetization (12% of GDP).

Fig. 8: Basic balance of payments



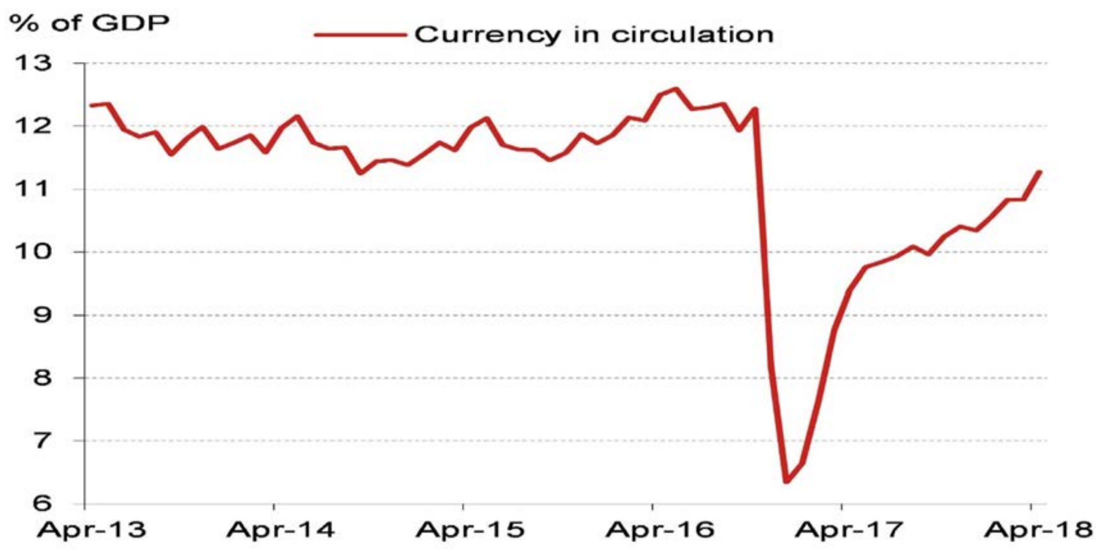
Source: Nomura Global Economics estimates

Fig. 7: Balance of payments projections

	USD bn	FY16	FY17	FY18F	FY19F
A	**Current Account**	(22.2)	(15.3)	(51.7)	(77.2)
1	**Merchandise**	**(130.1)**	**(112.4)**	**(165.1)**	**(201.0)**
	Exports	266.4	280.1	307.8	330.8
	Imports	396.4	392.6	472.8	531.8
2	**Invisibles**	**107.9**	**97.1**	**113.4**	**123.8**
	Services	69.7	67.5	76.8	82.2
	Transfers	62.6	56.0	63.0	69.3
	Income	(24.4)	(26.3)	(26.4)	(27.7)
B	**Capital Account**	**41.1**	**36.5**	**88.0**	**72.9**
3	Foreign Direct Investment (net)	36.0	35.6	31.6	36.0
4	Portfolio Investment	(4.1)	7.6	21.2	3.0
5	Loans	(4.6)	2.4	18.9	21.5
6	Banking Capital	10.6	(16.6)	14.0	10.0
7	Rupee Debt Service	(0.1)	(0.1)	(0.1)	(0.1)
8	Other Capital	3.3	7.6	2.4	2.5
C	**Overall Balance**	**17.9**	**21.6**	**39.1**	**(2.4)**
	Current account (% of GDP)	**(1.1)**	**(0.7)**	**(2.0)**	**(2.7)**

Source: CEIC and Nomura Global Economics estimates.

Fig. 1: India: Currency in circulation (% of GDP)



Source: Nomura Global Economics estimates

The other big factor which is negative for liquidity is US$ strength and the fiscal stimulus at a record unemployment rate along with contraction in the FED Balance sheet. This can cause a lot of US$ liquidity to flow back to the US putting at risk emerging market liquidity.

The reduction in the FED Balance sheet

RBI is cognizant of this fact, as highlighted by the RBI Governor in his column recently, and has eased up the norms for FII flows into the bond markets by removing the restriction on the criteria of minimum residual maturity and also easing the norms on group investments and single security limit.

The good part of the story is that India remains one of highest growth countries in the world and with an Inflation targeting central bank which endeavors to maintain a positive real rate of interest, flows both FDI and portfolio will find its way into India. RBI has already conducted two OMO purchases to alleviate liquidity tightness and we expect INR 1 trn of incremental OMO purchases in FY19.

Our View

We expect RBI to be proactive in its liquidity management though Global dollar liquidity remains a risk.

On a relative risk reward basis, we believe that the short end of the curve is attractive for Investment from a 18 months and beyond time horizon.

To capture this attractive yield we intend to follow a simple strategy of carry and roll down i.e. rolling down the duration of the portfolio so that the returns are close to the YTM of the portfolio.

We have also done a scenario analysis wherein we have shown that even if the short term yields were to rise from current levels, the Investor stands to make a decent return.

2 yr AAA Portfolio Return Scenario

Sr no	2 Year AAA Bond	No Change in Yields (current yields are assuming an incremental RBI rate hike of 50 bps in FY19)	50 Bps Increase in Yields	100 bps Increase in yields	50 bps Decrease in yields
A	Current YTM (annul.)	8.50	8.50	8.50	8.50
B	Residual Duration after 1yr	0.90	0.90	0.90	0.90
C	Current yield of 1yr	8.10	8.60	9.10	7.60
D	Capital Gain/Loss = B*(A-C)	0.36	-0.09	-0.54	0.81
F	**Expected Returns (A+E)**	**8.86%**	**8.41%**	**7.96%**	**9.31%**

Assumptions

1 Current 2 yr AAA Yield - 8.50%

2 Current 1 yr AAA Yield - 8.10%