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Bonds Wrap

Global yields were mixed in May'24 amidst a changing narrative on the future course of global monetary policy. US 10Y yield eased as soft macro data has once again reignited expectations of a Fed rate cut in Sep'24. On the other hand, rate cuts by ECB and BoE are facing hurdles from a resurgence in inflation in the respective regions. On the domestic front, India's new benchmark security has shown a considerable degree of softening bias in May'24 and eased below the 7% mark. RBI's bumper surplus, FPI inflows and an outlook upgrade by S&P were the primary drivers of the exuberance seen in the government bond markets in May'24. Going forward, we expect India's 10Y yield to remain in the range of 6.95%-7.05% in Jun'24, led by lower US yields and further FPI investment in debt securities ahead of index inclusion.

Movement in global yields in May'24:

- There was significant variation in movement in global yields in May'24 within advanced economies. While 10Y yield in US, Korea and UK eased, yields in Japan and Germany inched up.

Table 1. 10Y yield movement globally

Countries	10Y sovereign yield, 30 Apr 2024	10Y sovereign yield, 31 May 2024	Change in bps (MoM)
Japan	0.88	1.07	19
Germany	2.58	2.66	8
Thailand	2.76	2.81	5
China	2.31	2.32	0
UK	4.35	4.32	-3
Singapore	3.43	3.35	-9
Korea	3.65	3.56	-9
US	4.68	4.50	-18
India	**7.19**	**6.98**	**-21**
Indonesia	7.25	6.92	-32

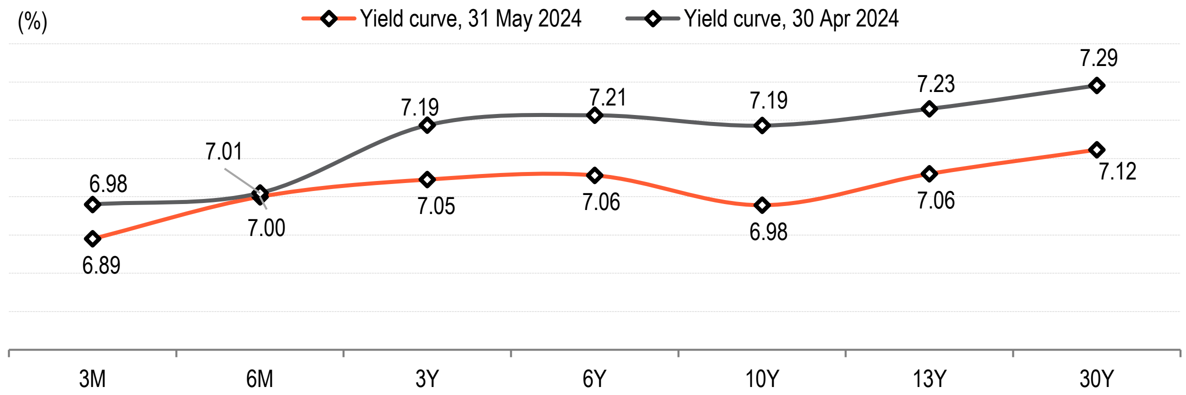
Source: Bloomberg, Bank of Baroda Research

- US 10Y yields ended May'24 lower by 18bps. Macro data including a cooler than expected CPI reading for Apr'24, further weakening momentum in labour market conditions have led to increased expectations for a rate cut in Sep'24. On the other hand, Fed officials continued to advise caution with respect to lowering rates. Weak demand in treasury auctions led to some upward momentum in US yields during the month, which was short-lived. Downward revision to US Q1 GDP, moderation in consumer spending and a softer than expected core PCE reading reaffirmed expectations that the Fed is likely to cut rates in Sep'24. The probability of a Sep'24 rate cut stood at 47% up from about 43% in Apr'24, as per the CME FedWatch Tool.

- Monetary policy divergence between global central banks is likely in the near-term as countries grapple with their domestic challenges. In the UK, the possibility of a rate cut has been delayed as inflation once again proved to be a tough challenge to tackle. On the other hand, growth continues to languish and with a surprise election announcement, the outlook looks murky.
- In EU, while a Jun'24 rate cut has been fully priced in, a recent uptick in Germany as well Eurozone's CPI reading has led to a rejig in investor expectations. Investors now expect a slower pace of rate cuts from the ECB going forward.
- Amongst major economies, 10Y yield in Japan rose sharply by 18bps in May'24. This was buoyed by new reports indicating a slower pace of bond purchase by BoJ.

India's 10Y yield declined by 21bps in May'24, with the new benchmark security trading below the 7% mark, for the first time since Jun'23. The decline in India's 10Y yield was due in a large part to the bumper RBI surplus transfer to the government. The surplus is expected to aid the government's fiscal consolidation plan and reduce dependence on market borrowings. Apart from this, considerable front-loading by FPIs in debt segment (inflows of Rs. 8,761 crores versus outflows of over Rs. 10,000 crores in Apr'24) also aided in the dip. In fact, FPI limit utilization in 19 out of the total 38 FAR eligible securities has increased between Apr and May'24. India's outlook upgrade by S&P, and expectations of a gradual rating upgrade also led to renewed interest in government bonds pushing yields lower.

Figure 1: Movement in India's yield curve



Source: Bloomberg, Bank of Baroda Research

India's yield curve shifted further downward in May'24 (Figure 1), with the longer end of the yield curve trending significantly lower. The shorter end of the curve (less than 1 year) was supported by RBI's liquidity management operations. *Interestingly, the spread between 30Y and 3-month paper has declined further to 23bps compared with 31bps in Apr'24.*

What auctions in the domestic market reflect?

There has been a slowdown in government borrowing in May'24. Amount raised by through auctions by both Centre and states has been lower, bringing down the cost of borrowings. On the other hand, due to the tight liquidity situation, yields on T-bills have inched up marginally.

Table 2. Cost of borrowing

Type of Papers	Amount raised (In Rs. crores)		Cut off yield (%)	
	Apr'24	May'24	Apr'24	May'24
Central Govt.	1,24,000	1,08,000	7.22	7.17
SDL	51,200	42,800	7.47	7.40
91-day Tbill	82,110	51,600	6.87	6.99
182-day Tbill	33,260	30,074	7.02	7.04
364-day Tbill	32,451	31,906	7.04	7.06

Source: Bank of Baroda Research | Note: Average cut off yield is taken to arrive at borrowing cost|Auction dates might differ

Liquidity situation:

- From a surplus of Rs. 20,000 lakh crores in Apr'24, average system liquidity slipped into a deficit of Rs. 1.42 lakh crores in May'24. A decline in government spending due to elections has been weighing on the liquidity situation. It must also be noted that there has been some moderation in banking system liquidity surplus (defined as incremental deposit-incremental credit-incremental investment) to Rs. 50,000 crores (as of 17 May 2024) compared with Rs. 1.35 lakh crores in Apr'24.
- Due to a shortage of funds, banks have been resorting to VRR auctions for funding their operations. There has been a significant demand for funds in VRR auctions with the RBI injecting Rs. 9.2 lakh crores in May'24. Out of a total of 12 VRR auctions conducted by the RBI in May'24, the bid amount was higher than the notified amount in 9 of these. The cut off yields in the auction ranged between 6.49% to 6.70%.

Outlook on 10Y yield for the next 30days:

- *India's 10Y yield is expected to trade in the range of 6.95-7.05% in the current month*. A lower than Budgeted fiscal deficit in FY24 (5.6% of GDP versus 5.8% BE) will be a huge tailwind for the bond market. Apart from this, results of the General Elections followed by the RBI policy will set the tone for markets at the beginning of the month. While the RBI policy is likely to be a non-event with no change in either rates or stance, markets will look for any forward guidance on the future course of policy rate.
- FPIs are also likely to increase their investment in government bonds ahead of India's planned inclusion into JP Morgan's global bond index which is set to commence from the end of Jun'24. The increased demand for domestic securities will keep a further lid on yields.
- Movement in US 10Y yield will also be a key factor. We expect further comfort for domestic yields on this front as well. With a moderation in US core PCE and soft GDP print, expectations of a Sep'24 rate cut have once again come alive. Barring any rude surprise in the US CPI and jobs report, a Sep'24 rate cut is on the table which will keep treasury yields lower.

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