Rising Foreign Ownership in Sovereign Bonds

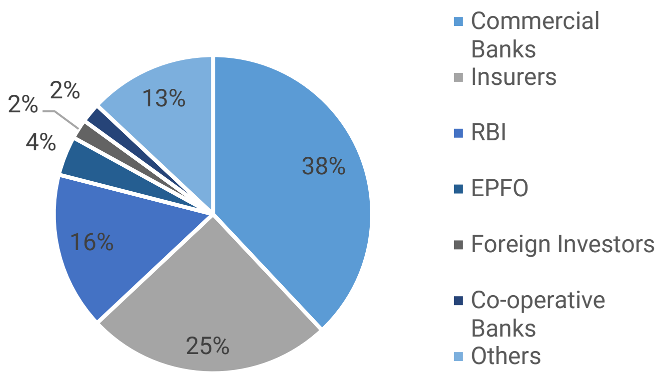
September, 2021

Why India Government Bonds (IGBs) are likely to be listed in the Global Bond Indices soon

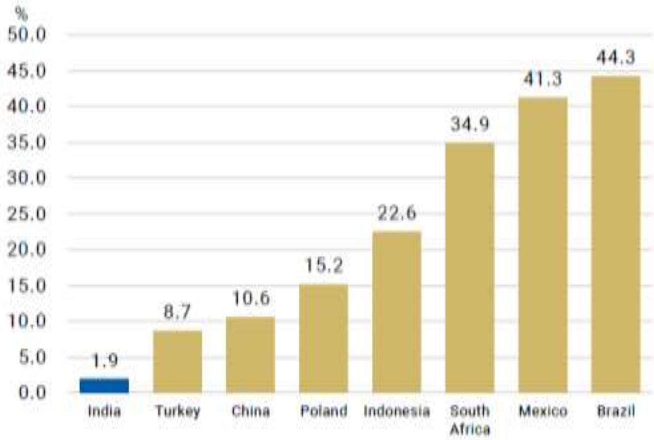
Unlike the Indian equity market, which was fully opened to foreign investors in 1993, the Indian bond market had limited foreign ownership since the past two decades. However, that situation is likely to change soon because of the Government's keenness to get IGBs listed in the global bond indices.

IGBs have been historically owned by domestic investors with foreign ownership being at a meagre ~2% of the total. This is very low when compared to the foreign ownership of central government bonds of other EM and DM countries.

Current IGB Ownership Pattern

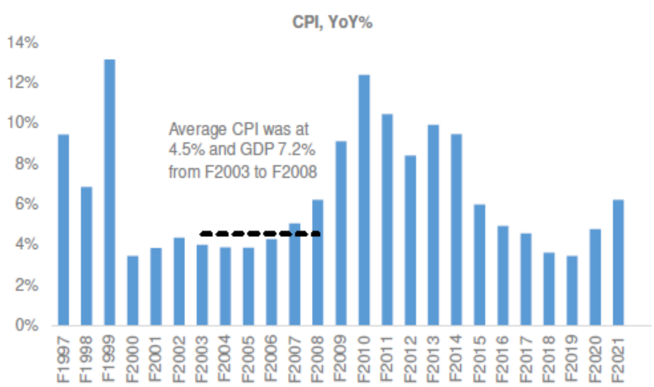


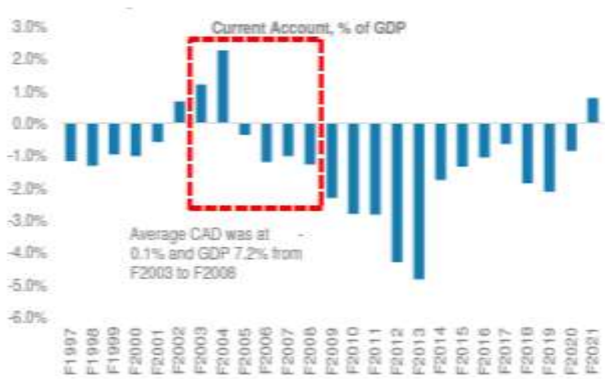
Foreign Ownership of Central Government Bonds



Source: RBI; Treasury; CEIC; Morgan Stanley Research

In the recent years, lower current account deficit, higher FX reserves, flexible inflation targeting, and a stable Government at the Centre have all set the stage for higher foreign ownership of IGBs. In further efforts to include IGBs in the global bond indices, the RBI, under direction from the Central Government, had established the FAR (Fully Accessible Route) program in 2020 which removed the cap on foreign holding of specified Government bonds.



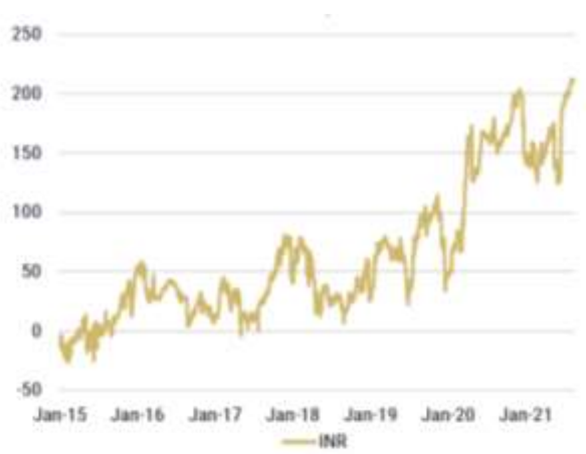


Source: CEIC; Morgan Stanley Research

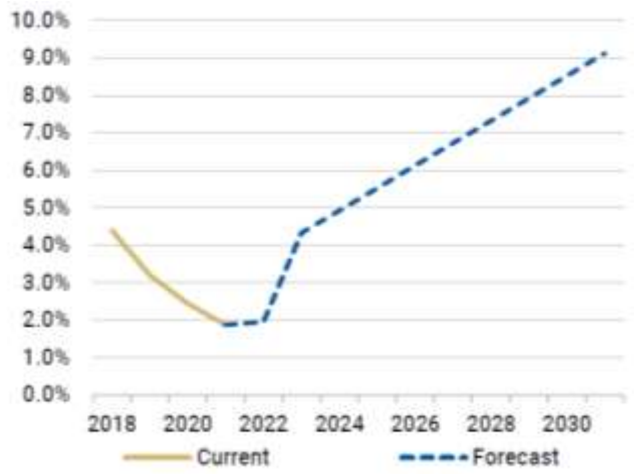
What are the implications of welcoming foreign inflows into IGBs?

It is expected that IGBs, when listed in the global bond indices, will attract significant foreign participation raising their ownership from 2% to 9% by 2031 at an estimated valuation of US$ 190 bn in the base case scenario.

Steepening of the IGB Yield Curve



Rise in Foreign Ownership (2031E)



Source: RBI; Treasury; Morgan Stanley Research

Injection of liquidity and higher bond supply have led the RBI to cut rates and have contributed to the gradual steepening of the IGB yield curve. While this is a firm trend among other EM countries, still India has witnessed one of the steepest bond curves. In our opinion, this additional foreign inflows into IGBs coupled with RBI's continued support through its GSAP program could significantly flatten this bond curve in the medium term.

An increased foreign participation into IGBs could also have a spill over effect on India's onshore corporate bond market which offers great depth and high quality-high yielding credit, but otherwise remains forgotten to the foreign investors. As these foreign investors get comfortable with the IGBs, their risk tolerance towards India might increase leading their attention to these higher yielding corporate bonds. NBFCs and HFCs with strong parentage and robust balance sheets will also benefit from additional sources of funding and lower cost of borrowing.

At the macro-economic level, higher foreign ownership of IGBs is a net positive for growth. It will diversify the source of funding and add more G-Sec buyers, thus improving the supply-demand dynamics and indirectly lowering the cost of capital. The current account, though, may continue to remain in deficit given the Government's desire to pursue productive growth. However, higher flows into the capital account should push India's balance of payments into a structural surplus zone and augment its FX reserves. This will further enable the Government to achieve fiscal consolidation despite pushing investment rates higher. The only concern remains on the inflation front driven by domestic liquidity which, we expect the RBI to counterbalance through prudent and timely measures

Final thoughts…

We expect the rate reversal cycle to begin in the next few years with growth back to the long term trend. Currently, we suggest investors to focus on AAA-rated bonds maturing in five to ten-year bucket because yields at the short-end are suppressed and does not provide sufficient carry or superior risk-adjusted returns. In that regard, Edelweiss MF has a range of target maturity and roll down debt funds with longer maturities that can be considered to avoid possible interest rate risk, should the yields soften. That ways investors are able to invest in a diversified portfolio of high quality bonds and hold them till maturity to earn superior returns.

Key risks to our view emerge from the following factors:

- Sudden spike in inflation, primarily driven by unexpected rise in commodity prices.
- Government turning back on key reforms.
- Slowdown in growth momentum.
- Volatility in INR caused by index inclusion of IGBs
- Uncertainty in taxation on foreign ownership of IGBs.