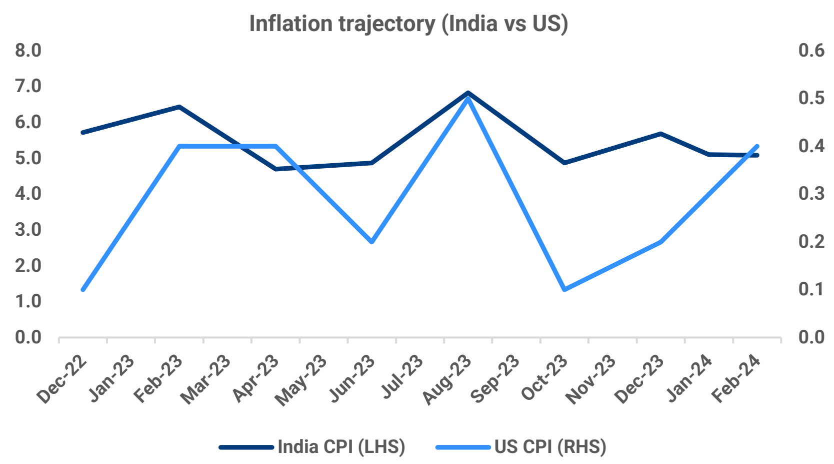
Time to go long on bonds

March 2024

In the last three years, 10Y benchmark IGB has hardened by more than 100 bps. But we expect this trend to reverse very soon considering multiple factors like favourable demand supply dynamics, lower market borrowing in the upcoming financial year and softer core inflation readings amid moderating growth.

Strong and resilient economic data may induce RBI to cut rates faster than Fed.

Historically, there has been a strong correlation between IGB and UST yields. But in the recent times, we have seen a low beta relationship between them and expect this trend to continue. This is caused by a gradual decoupling of the Indian and US economy backed by consistent and positive economic indicators from India against conflicting data points emanating from the US. Both US CPI and PPI inflation reading for February came in stronger than expected – indicating that inflation will likely be sticky for longer than feared earlier. Services PMI, home sales and Fed's commentary downplaying exuberance around aggressive easing this year – all together aided the upside in yields. To add to that, political activity calendar suggests that Fed has very little time to take a rate action while India is in a much stronger footing to cut rates to induce economic growth.

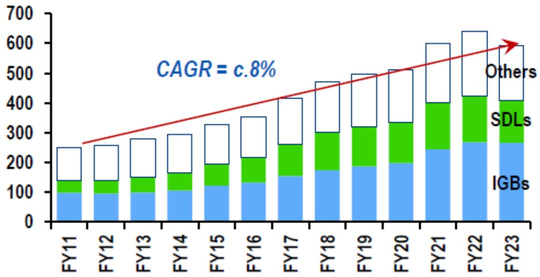


Source: US Bureau of Labor Statistics; Bloomberg

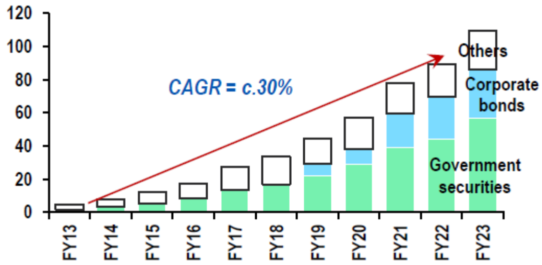
Robust demand for IGBs to continue.

IGB supply is predominantly absorbed by domestic banking sector, insurance companies and provident funds. While banking sector's ownership of IGB's is on a decline, the same is being replaced by rising ownership from the insurance sector. This change in ownership pattern is primarily driven by supportive Regulations which mandate insurance company portfolios to have a certain percentage of its investments into Government bonds. Further, Employee's Provident Fund (EPFO) and National Pension Scheme (NPS) remain key participants in purchase of IGBs. We can witness significant growth in the investment portfolio of insurance companies as well as sharp uptick in NPS which makes us believe that demand for IGBs will continue to stay elevated.

Organisation/sector	Allocation to IGBs, SDLs, govt. guaranteed debt, IGB MFs (≤5%)
EPFO	45% - 65%
Life Insurance	≥ 50%
General Insurance	≥ 50%
Pension/General Annuity	≥ 40%
NPS	25% - 65%



Insurance companies' portfolio growth

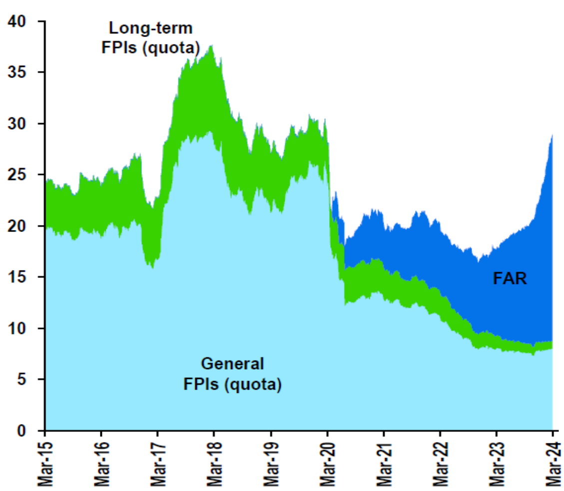


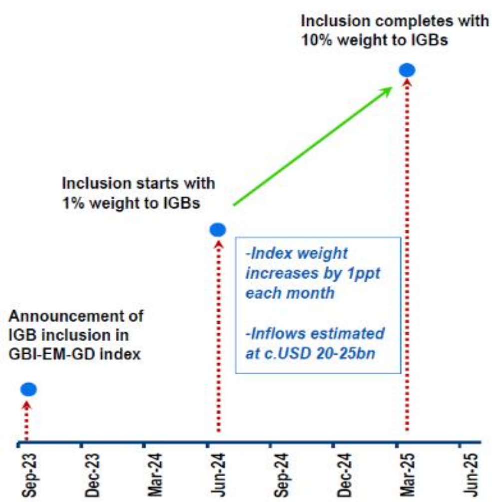
Growth in NPS

Source: IRDA; EPFO; NPS; Standard Chartered Research

IGB inclusion in Global EM Bond Indices augur well for its demand.

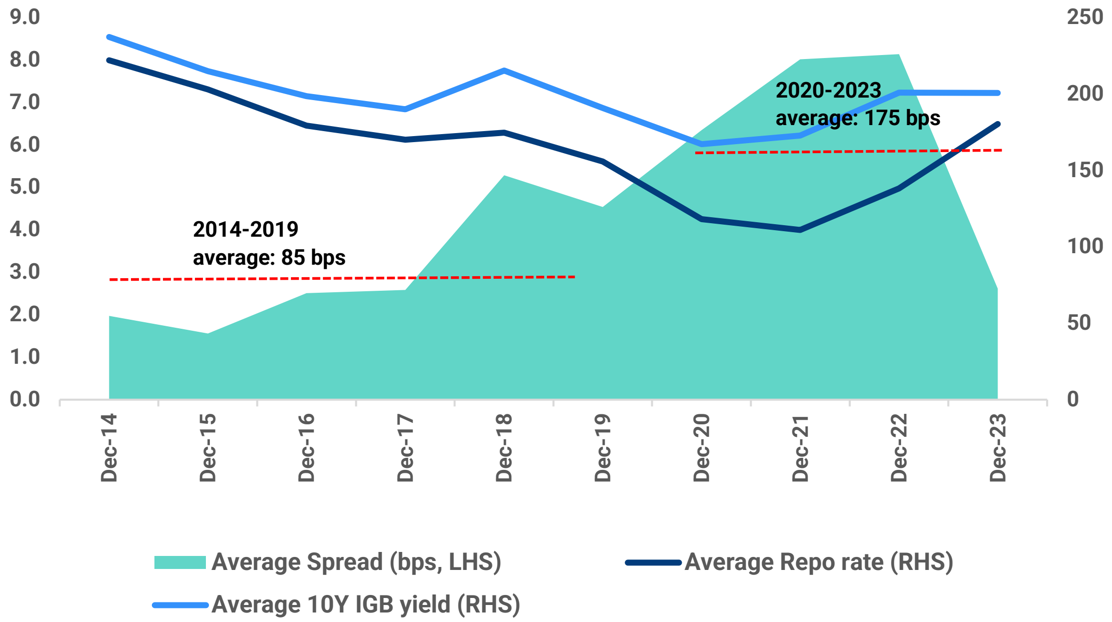
FPI activity in IGBs has amplified since the announcement of IGB inclusion in Global EM Bond indices. We could already see US $ 6 Bn worth of FPI inflows into IGBs on a YTD basis. Beginning June 2024, we estimate a combined inflow of ~US $ 30 Bn in the next 16-18 months starting with JPM index inclusion which will end in January 2025 and followed by Bloomberg Barclays which will complete its index inclusion by October 2025. Assuming current Fx rates, this translates to demand for INR ~ 2.5 trillion worth of IGBs being absorbed in the Global EM Bond indices. In our view, Government of India will have no option to remove the cap currently associated with FPI purchase of IGBs through various routes to accommodate this flourishing demand.





Source: JP Morgan; Standard Chartered Research

Hence, IGB spread compression is likely in the next 12M -18M considering historical average.



Source: RBI; Bloomberg

Current 10Y benchmark yield is pegged at about 7.10%. If we expect headline inflation to trend lower, it will lead RBI to progressively cut policy rates. In such a scenario, it is our view that 10Y IGB yield has the room to soften by 50 bps from its current levels for the term spread vis-à-vis repo to be in line with its long-term average.

Simulation – Impact of interest rate movements

- IGB 3 year holding period returns under different interest rate scenarios.
- Indicates significant upside in case our hypothesis holds good.

Yield Movement	Current YTM	Revised YTM	3Y Accrual	MTM Profit/ Loss	Total Abs Return	CAGR Return
-1.00%	7.10%	6.10%	19.44%	6.71%	26.15%	8.05%
-0.75%	7.10%	6.35%	20.3%	5.03%	25.32%	7.81%
-0.50%	7.10%	6.60%	21.1%	3.36%	24.49%	7.58%
-0.25%	7.10%	6.85%	22.0%	1.68%	23.67%	7.34%
0.00%	7.10%	7.10%	22.8%	0.00%	22.85%	7.10%
0.25%	7.10%	7.35%	23.7%	-1.68%	22.03%	6.86%
0.50%	7.10%	7.60%	24.6%	-3.36%	21.22%	6.63%
0.75%	7.10%	7.85%	25.4%	-5.03%	20.41%	6.39%
1.00%	7.10%	8.10%	26.3%	-6.71%	19.61%	6.15%

Note: We have considered 10Y benchmark IGB (7.18% GS 2033) as the proxy for the simulation; The base assumption for this simulation is that the fall in yields happen as on Mar 20, 2024; The above table is only to show the impact of interest rates and should not be assumed as returns of any scheme.

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