Fixed Income Update and Outlook – Mar 2021

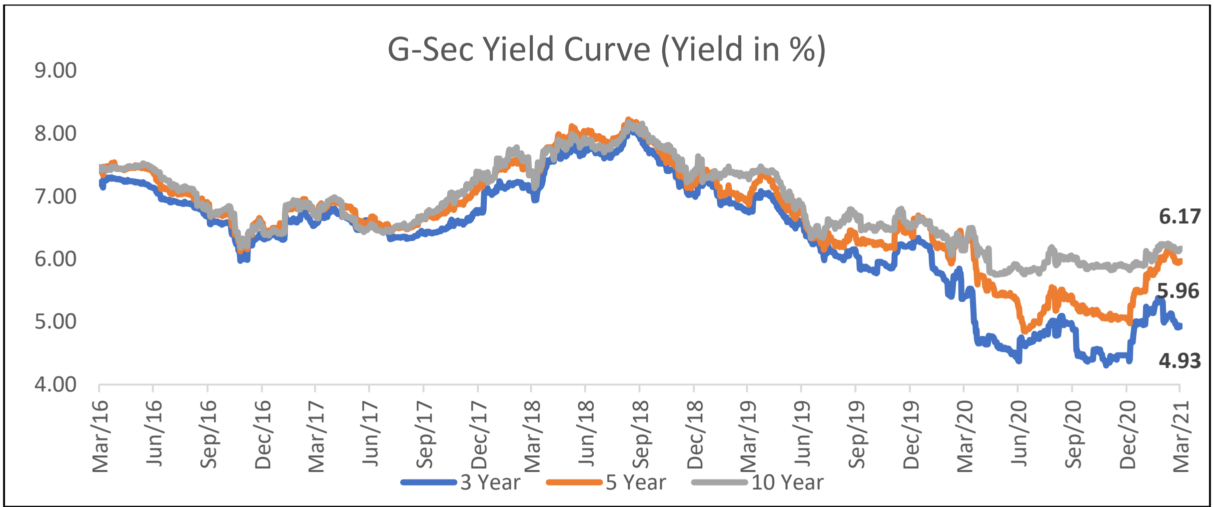
Market Commentary:

The new regulations on Bank Tier 1 and Tier 2 bonds issued under Basel III guidelines ensured markets stayed volatile right till end of March 2021. SEBI has mandated that Mutual Funds need to treat AT1 bonds as 100 year maturity bonds (over a transition period of 2 years) and has also restricted the total exposure of such bonds at both scheme and AMC level. While the new rules will definitely impact the demand of these special bonds, more importantly, it makes it difficult for funds which have lower target duration range, to take exposure in these bonds. It remains to be seen how the new rules will impact the capital raising capability of banks and what new set of investors come in to fill up the vacuum created by the new regulations.

The Central government borrowing through G-Sec auction was around Rs 88,900 Crs in the month of March 2021. The total devolvement to primary dealers in the month of March 2021 was around Rs 24,217 Crs. The State government borrowing through SDL auction was around Rs 89,800 Crs. Avg Cut-off yield in 10-year segment was 7.09%. The Gsec auction of Rs 20,000 Crs scheduled on March 26, 2021 was cancelled as the position of cash balance with central government was in surplus. This helped the 10 year benchmark to close at 6.17% which was otherwise trading in the range of 6.20 – 6.25% for most of March 2021.

Headline CPI for the February rose to 5.03% compared to 4.03% in January, as prices of oil and fats, non-alcoholic beverages and prepared meals, fuel, transport and communication continued to rise, while the pace of disinflation in vegetable prices slowed in February. Overall, the food and beverages inflation rose from 2.60% to 4.25% in February. Core CPI rose above 5.5%, due to higher inflation in transportation, fuel and lighting, clothing and recreation.

Bond Yield Movement & Spreads:



AAA PSU Term Spreads (Longer end minus shorter end) – 31st Mar 2021						
	Current Spread	**3M back**	**6M back**	**1Y back**	**5 Year Average**	**SD**
1 - 3 Year	133	82	78	38	22	23
3 - 5 Year	81	77	72	18	18	19

Common Source: Bloomberg, RBI, CEIC data

- The 3 yr. benchmark yield on the GSEC curve has been the best performer with yield cooled-off by almost ~ 35-40 bps during the month due to excessive liquidity. In comparison, the 5 yr. & 10 yr. benchmark yield has slightly improved by ~ 6 bps.
- The GSEC term premium (10 yr. – 1 yr. T-bill) now stands at ~ 241 bps, which still is relatively high from the average spread of ~ 74 bps.
- The term spread between 1-3-year AAA PSU is around 133 bps, which is relatively high from the average spread of ~ 22 bps.

Outlook:

The new SEBI regulations put up a big question mark on the future of AT1 bonds and has definitely dented the demand metrics particularly from the MF angle. As markets absorbed the ramifications of the new regulations, the AT1 bonds did experience a good amount of repricing. Going ahead, mutual funds need to declare both yield to call and yield to maturity on these bonds and calculate duration basis the specified maturity. However, investors must note that while the duration of the bonds and portfolios will change due to the new regulations, the underlying quality of the bonds have not changed and as a result the portfolio quality remains intact. Markets continue to trade these bonds at yield to call and hence, there will be limited impact on portfolio NAVs due to the new regulations.

The GOI borrowing calendar for first half FY 2021-22 was as per market expectations and as always is front loaded with 60% of the scheduled borrowing for the year. Given the second wave of Covid-19, there were some expectations that RBI may defer the CRR normalisation steps but that did not happen. The first meeting of the new financial year of Monetary Policy Committee is scheduled from April 5^{th} – 7^{th}. While at one hand the GST collections have been over 1 lac crores for 6 consecutive months signifying recovery in the economy, at the same time, the recent spurt in Covid-19 cases threatens to derail the recovery. Though we expect the guidance from the governor to be in line with the previous MPCs, the markets will take cue from the steps the central bank takes to tackle this dilemma.

Statutory Disclosures:

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Common Source: Bloomberg, RBI, CEIC data