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INDUSTRY OUTLOOK

IMPACT OF COVID 19 ON INDIAN BOND MARKETS

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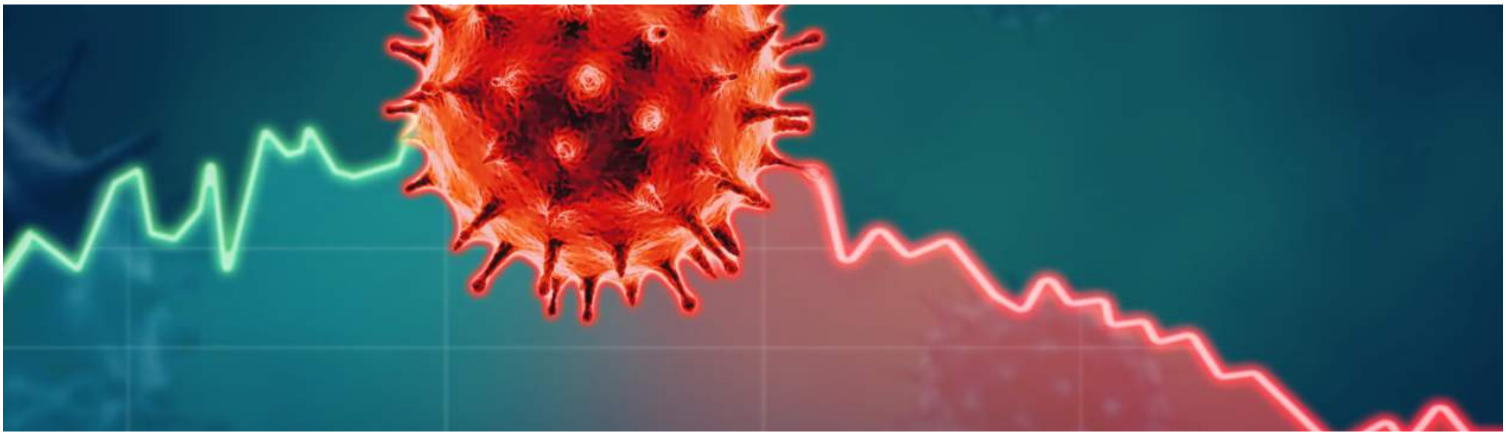
Industry Outlook

The financial markets all over the globe are broiling under the threat of COVID 19 that has unleashed havoc on the human beings. The damage caused to the global economy may be far higher than the initial estimates of USD 1 trillion and a few nations may take a longer time to resurrect after the 'pandemic' gets controlled. As nation after nation is grappling with the cascading economic problems, the slew of measures announced by the Government of India in tandem with monetary action support from RBI shall bring some respite to the financial markets, albeit at a slow pace.

Indian Bond market is dominated by institutional participants like banks, mutual funds, insurance companies, pension and super-annuation funds like EPFO, ESIC etc. Retail participation is very less except for the tax free bonds or through mutual funds. Scheduled commercial banks are driven by statutory requirement to hold Government bonds, the demand for bonds by other participants, both issued by the Government & Corporate largely depends on the nature of liquidity available with them, others are guided by their respective regulatory authorities to hold securities in their investments portfolio.

Banks have been parking funds with RBI to the extent of Rs.2.86 lakh crores from the beginning of March 2020. With RBI announcing a 1% reduction in CRR with effect from March 28,2020 resulting in an inflow of Rs.1.37 lakh crore, the amount now stands in excess of Rs.6 lakh crore as on 30.3.2020 indicating easy liquidity condition for the banks.



However, this position is not likely to continue for long as slight pick up in credit demand and need for dollars could upset the skewed liquidity position suddenly. Since most of the banks are having surplus SLR position (the growth in SLR was 11.80% against deposit growth of 9.10% in 2019-20) and further, they have been permitted to dip into MSF to the extent of 1% of the DTL for their immediate liquidity requirements, we don't foresee a major shift in demand for G Sec/ SDLs. The potential MTM losses while migrating to the new accounting standard regime is also staring at the banks.

The Rs.15,000 crore aid announced by the Prime Minister for fighting COVID 19 & the Finance Minister's announcement of welfare measures to unorganized sector especially dedicated to the urban-rural poor and daily-waged labourers, to the extent of Rs.1.70 lakh crore have raised doubts in the minds of the investors about the Government's approach on the fiscal deficit. With most of the business establishments and factories closed, the impact on GST & Income Tax collection during 2020-21, meeting revenue targets will be a major challenge for the Government. The aggregate fiscal deficit of India could slip by over 80 bps to 100 bps. Larger than expected borrowing programme by the Central Government & State Governments would lead to excess supply and in that perspective we expect a slight spike in the long term sovereign yield curve. Yes, the yield curve can steepen with the nearer term to compress by 40 – 60 bps from the current level, in consonance with the cut announced in recent monetary policy the repo/reverse repo rates. Rates of money market instruments like T Bills/ CP / CD may compress by 40 – 60 bps as stated above.

COPORATE BONDS

Except for a couple of PSU banks and private banks, Commercial banks have not been major participants in the Corporate Bond market and therefore, the excess liquidity may not find its way to this class of investment.

The ILFS & DHFL episodes have created irreparable dents in the corporate bond market - risk-averse mutual funds & insurance companies, wary investors, a fragile NBFC industry.

Mutual Funds have been the main saviors of the debt market with an incremental net investment of Rs.5,31,329 crore during the calendar year 2019 (source SEBI), while the AUM increased only by Rs.3,15,684 crore, clearly indicating the investor preference for debt . Commercial Banks' contribution to the Government Securities segment was slightly above Rs.3 lakh crore during this period.

The year saw 32 public issues of Rs.14,659 crore as against 25 issuances for Rs.36,679 crore in 2018-19. In the private placement segment, the amount raised stands similar to the previous two years. There were 1624 issues till February 2020 aggregating to Rs.5,99,294 crore against 2,706 issues in 2017-18 amounting to Rs.5,99,147 crore and 2,358 issues for Rs.6,10,318 crore in 2018-19. While the number of issues has come down, the average issue size has substantially increased to Rs. 369 crore in 2020 as against Rs. 221 crore in 2018 & Rs.258 crore in 2019.

Due to lack of quality issuances, the average AAA spread compressed to 97 bps in January 2020 from 114 bps in April 2019 while the spread for AA papers widened from 241 bps to 315 bps. For lower rated bonds, the spreads widened even higher. However, the average volume of trades reported on exchanges increased from Rs.5602 crore in 2017-18 & Rs.4,506 crore in 2018-19 to Rs.5,967 core in 2019-20.

In this pandemonium, the moratorium on Yes Bank Ltd and consequent write down of more than Rs.8,000 crore of AT 1 Perpetual Bonds has ended the prospects of lower rated banks to raise quasi equity through issue of Basel III compliant Tier I Bonds. The withdrawal of issue of such bonds by Indusind Bank Ltd is a pointer towards the same. The steep increase in the traded yields of State Bank of India perpetual bonds post the Yes Bank event indicates the challenge for public sector banks to access the market in future with the issue of AT 1 bonds. The spread on Tier II bonds issued by banks can also rise. Tier I /Tier II bonds had a captive investor base in the form of mutual funds & FPIs who may abstain from future issues. As the capital market is also on the down turn, banks may struggle to raise additional equity to maintain a healthy CRAR in the current situation.

FOREIGN PORTFOLIO INVESTORS

RBI, through its two separate notifications dated 30th March 2020, opened up avenues for higher foreign investment in Indian Debt market:

i. Fully Accessible Route (FAR) for investment by non-residents in securities issued by the Government of India, wherein FPIs, Non-Resident Indians (NRIs), Overseas Citizens of India (OCIs) and other entities permitted to invest in specified Government Securities without any quantitative limit.

ii. The limit for FPI investment in corporate bonds is increased to 15% of outstanding stock for FY 2020-21. Accordingly, the revised limits for FPI investment in corporate bonds, after rounding off, shall be as under:

Table-1: Limits for FPI investment in corporate bonds for FY 2020-21	
	(Rs. Crore)
Current FPI limit	3,17,000
Revised limit for HY Apr 2020-Sep 2020	4,29,244
Revised limit for HY Oct 2020-Mar 2021	5,41,488

When the global economy is on turmoil and the FPIs have already divested from the debt markets in India to the extent of Rs.42,357 crore in 2018-19 & Rs.48,710 crore during the current year, the above announcements look optimistic. As on March 30, 2020 the FPIs have utilized only Rs.1,73,173 crore out of the current limit of Rs.3,17,000 crore (54.63%) for corporate bonds. There is an unutilized limit of Rs.1,43,827 crore still available to the FPIs or investment in corporate bonds (source NSDL). In this context, the intent to attract forex inflows through increase in investment limit for FPI in corporate bonds also looks ambitious.

Given the current situation where the income generation of the entire population of the country is affected and the Government itself conceding a time frame of at least 3 months to recover from the fiasco, corporate / personal savings and the inflow of funds to the institutional investors may slow down while the fund starved corporates would be looking forward to raise funds from every corner. The resultant demand – supply mismatch may result in risk reward ratio in favour of the investors i.e. spreads widening for low rated papers while the spread for short term highly rated papers can compress from the current levels.

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