Benchmark 10Y @ 8.35%
What to expect going forward

August 21, 2013

DSP BLACKROCK MUTUAL FUND

The benchmark 10Y government bond yield had touched a high of 9.48% early in the morning on August 20, 2013 as the rupee crossed 64 and traded at a lifetime low of 64.11. Market sentiment was weak after the RBI's scheduled auction announcement late in the evening on August 19, 2013.

However, subsequent intervention in the currency market by the RBI and value buying at around 9.40-50% for the benchmark 10Y government resulted in a smart rally in the government bond market.

The benchmark 10Y government bond yield closed at around 8.90% on August 20, 2013.

Later in the evening, the RBI announced the following measures:

- Rs, 8,000 crore OMO bond purchase on August 23, 2013 and possibility of more OMOs based on their assessment of liquidity need and with an aim to contain long-term government bond yields
- Allowing banks to transfer SLR from Available for Sale (AFS) book to Hold-To-Maturity (HTM) book up to 24.5% of their deposit at lower of the cost or value as on July 15, 2013 (the date on which RBI first announced measures to reduce systemic liquidity) and spread the losses (if any) over a year
- Indication of calibration of further issuance of Cash Management Bills in order to keep money market rates at around 10.25% pa

All these measures have resulted in further improvement in sentiment on August 21, 2013 with the benchmark 10Y government bond yield touching 8.35% pa in the first-half of the day.

Overall, the benchmark 10Y government bond price has gone up by around Rs. 7 in less than 24 hours from its low of 85.45 on August 20, 2013.

What has happened?

If we carefully examine these measures, two key observations are made –

- These measures are aimed at protecting the banking system from adverse price movement in government bonds after July 15, 2013
- Fundamental issue of volatility in the rupee's level is yet to be addressed in a meaningful way

Market participants believe that the RBI will keep conducting more OMO bond purchases by buying long-term government bonds in order to stabilize the long-end of the yield curve and at the same time keep short-term rates higher in order to check the volatility in the rupee. However, the rupee continued to remain under pressure and traded as high as 64.62 in the second-half of the day on August 21, 2013.

What should an investor do?

We believe that recent fall in the yield may have provided a great opportunity to reduce risk in portfolios due to the following reasons:

- Current decline in yield (around 113 basis points for the benchmark 10Y government bond) may be an over-reaction to the above-mentioned steps by the RBI.
- The rupee continues to remain weak against the dollar. Therefore, we believe that the RBI will likely keep its current stance of tight systemic liquidity a little longer than market participants think.
- FIIs are apparently still selling Indian bonds as well as Indian equities. They have sold around Rs. 50,000 crore worth of bonds since June 1, 2013. Further selling may result in more weakness in the rupee.
- Globally, Emerging Market (EM) bonds continue to remain under pressure as flow of liquidity moves out of EM to Developed Markets (DM) due to better risk-adjusted returns and higher liquidity.
- All eyes are on the upcoming Federal Open Market Committee (FOMC) meeting on Sep 17-18, 2013 for any tapering related announcement and its impact on the dollar and US Treasury yields, which have been steadily inching up.
- The macro-economic environment in India continues to remain challenging due to a multitude of factors. These include worsening inflationary pressures on account of higher international energy prices (Brent crude @ $111 per barrel), wearing off of positive base effect in the second-half, declining trend in government revenue growth versus budgeted projections and fragile global economic environment. Moreover, supply pressure may remain high amid waning appetite.

We believe that the benchmark 10Y government bond yield may trend back towards 8.55-8.60% from a technical perspective in the near-term and may trade between 8.50% & 9% till the forex market volatility is contained.

Investors should take advantage of the recent spike in money market yields and consider investing in 1Y FMP and prefer quality & liquidity over credit & yield.

Source: RBI and Internal