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Interest Rate Outlook

Mixed tone of MPC minutes reinforces our view of 60 bps of repo hikes in Q2 FY2023; interest rates set to rise across the spectrum

JUNE 2022

Highlights

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With a mixed tone of the MPC minutes, we continue to expect policy rate hikes of 35 bps and 25 bps, respectively, in the Aug 2022 and Sep 2022 policy meetings

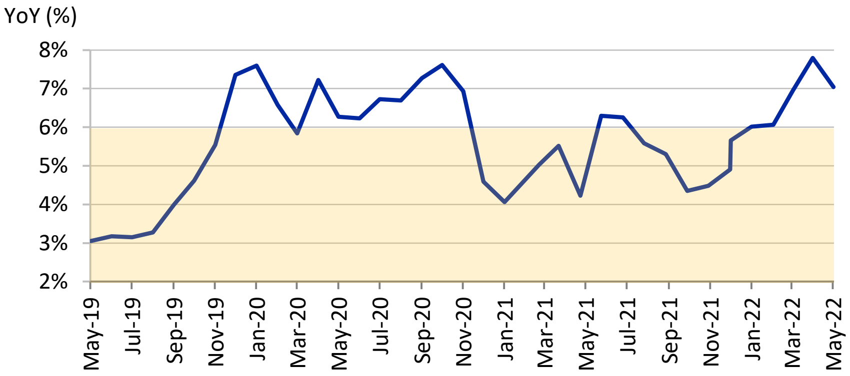
We project the 10-year G-sec yield to range between 7.5-8.0% in H2 CY2022, amid a large Government borrowing programme for FY2023

- The MPC hiked policy rates by 90 bps in May-June 2022 following the surge in inflation readings. Amidst the mixed tone of the MPC members' minutes, we continue to expect additional, front-loaded policy rate hikes of 35 bps and 25 bps in the Aug 2022 and Sep 2022 policy meetings, respectively, followed by an extended pause to gauge the impact on growth.
- As a percentage of NDTL, net systemic liquidity surplus has eased to a 32-month low of 1.2% as on June 22, 2022 from ~4.4% in early-April 2022. The rapid drop is quite surprising given the RBI's assurances of a calibrated normalisation in liquidity. Although the gap between the repo rate and the WACR has narrowed, it remains high, indicating that liquidity conditions are comfortable.
- The 10-year Government of India (GoI) security (G-sec) yield has risen by ~56 bps during FY2023 so far, amidst the rate hikes by the MPC and the US Fed. We expect the 10-year G-sec yield to range between 7.5-8.0% in H2 CY2022, amidst the large Government borrowing programme for FY2023. While the GoI's fiscal deficit for FY2023 is expected to modestly overshoot the BE, a hike in interest rates on small savings schemes could limit the need for additional market borrowings.
- The spread between the 10-year and 5-year G-sec has narrowed in Q1 FY2023, following expectations of measures by the RBI to cap longer tenure yields. While corporate bond yields have touched the highest levels in 3 years, spreads over the 10-year G-sec remain lower than the average levels seen over the last 5 years. With the likely rise in G-sec yields, market borrowings for corporates are also set to become dearer soon.
- Given the expectations of rate hikes by the US Fed envisaged from the 'dot plot', the US rate hike cycle is likely to be much steeper than India's rate hike cycle, resulting in a further compression of the 10-year spread.
- India's yield curve is likely to shift further upwards over the next quarter, following front-loaded rate hikes. The RBI's measures to support the GoI's borrowing programme would determine the extent of the upmove across various tenors, and how much the yield curve flattens.
- Amidst the global headwinds, we expect the INR to trade between 77.0-80.0/US$ in the remainder of H1 FY2023. The RBI's large forex reserves, notwithstanding the recent dip, and outstanding forward book position, is likely to prevent a disorderly depreciation of the INR.

MPC: Monetary Policy Committee
BE: Budget Estimates
NDTL: Net Demand and Time Liabilities
WACR: Weighted Average Call Rate

MPC has hiked the repo rate by 90 bps since May 2022 amidst a sharp 100 bps increase in its CPI inflation projections

EXHIBIT: YoY trends in headline CPI inflation



Source: National Statistical Office (NSO); CEIC; ICRA Research

EXHIBIT: MPC's GDP growth and CPI inflation forecasts*

YoY (%)	CPI Inflation*		GDP Growth (at constant 2011-12 prices)	
MPC Policy Review	April 2022	June 2022	April 2022	June 2022
Q1 FY2023	6.3%	7.5%	16.2%	Retained at the April 2022 levels
Q2 FY2023	5.8%	7.4%	6.2%	
Q3 FY2023	5.4%	6.2%	4.1%	
Q4 FY2023	5.1%	5.8%	4.0%	
FY2023	5.7%	6.7%	7.2%	

**The MPC has assumed an average crude oil price (Indian basket) of US$105/bbl; Source: RBI; ICRA Research*

- After the 40 bps rate hike in the off-cycle policy meeting in May 2022, the MPC voted unanimously to raise the policy repo rate by 50 bps while remaining focused on withdrawal of accommodation, in its second scheduled Bi-monthly policy review meeting for FY2023 held in June 2022.
- The MPC revised its inflation projections for FY2023 upwards quite sharply by 100 bps to 6.7%, slightly higher than our expectations of 6.5% (with upside risks).
- The CPI inflation subsequently eased to 7.0% in May 2022 from the 95-month high of 7.8% in April 2022, implying an average of 7.4% during the first two months of Q1 FY2023. In order to meet the MPC's inflation projection of 7.5% for Q1 FY2023, the CPI inflation would need to print at 7.7% in June 2022 – this is well above our projections of ~7.0% for the month and appears unlikely given the full first round, and partial second round impact of the excise cuts on petrol and diesel. Consequently, we expect the MPC's CPI inflation projections for Q1 FY2023 (and perhaps Q2 FY2023) to be undershot.

MPC minutes reveal a mixed tone; ICRA continues to foresee repo rate hikes of another 60 bps over the August and September 2022 policy reviews

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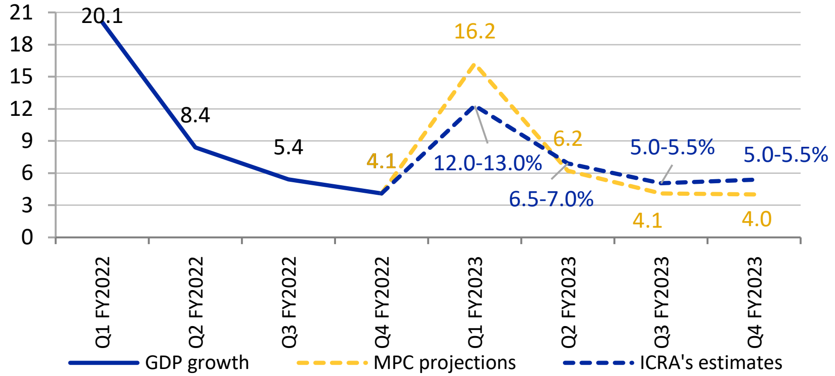
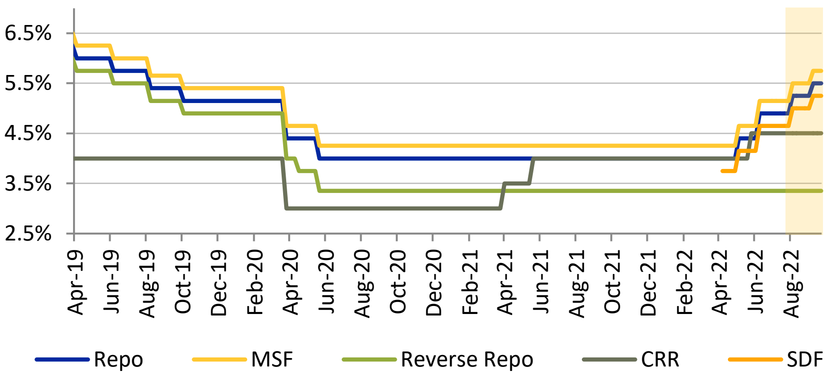
EXHIBIT: Real GDP growth (YoY %)



Source: NSO; ICRA Research

EXHIBIT: Movement in Key Rates and ICRA's projections for Jul-Sep 2022



**Values for Jul-Sep 2022 are based on ICRA's expectations; Source: RBI; ICRA Research*

- While the growth projections for FY2023 were retained at 7.2% in the June 2022 policy review, in line with our expectations, the quarterly projections differ from our forecasts: we foresee a somewhat lower growth relative to MPC's projections in Q1 FY2023, and higher than the same in Q2-Q4 FY2023. Nevertheless, growth projections for H2 FY2023 are tepid at best, amid expectations of an uneven growth will likely prevent a severe policy tightening by the MPC.
- As per the minutes of the June 2022 policy meeting, the MPC members differed in terms of their tone, the extent of concern regarding future inflation outcomes, and the growth supportiveness that may be warranted. If the CPI inflation in FY2024 moderates to 4%, as alluded to by Dr. Patra, then our expectation that the additional repo hikes in this tightening cycle will be limited to 60 bps, will yield a positive real rate of 1.5%.
- We continue to anticipate additional policy rate hikes of 35 bps and 25 bps, respectively, in the Aug 2022 and Sep 2022 policy meetings, with a resultant repo rate of 5.5% by end-September 2022 (higher than the pre-pandemic level of 5.15%). This is likely to be followed by an extended pause to gauge whether the currently uneven growth is broad basing.

Inflation concerns have sparked a hawkish outlook from the US Fed; additional 175 bps rate hikes expected in 2022

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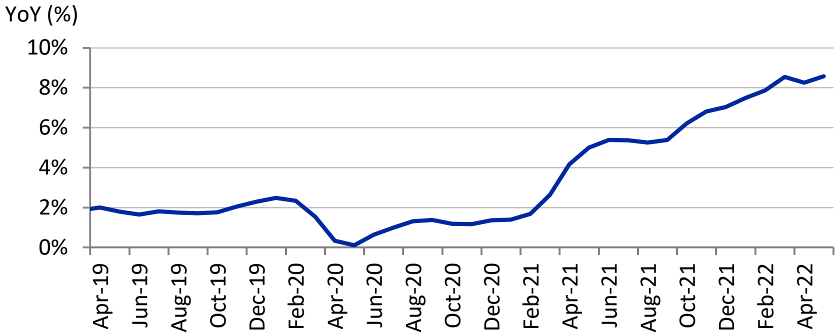
EXHIBIT: Trend in US CPI inflation



Source: US Bureau of Labor Statistics; ICRA Research

EXHIBIT: FOMC participants' assessments of the federal funds rate

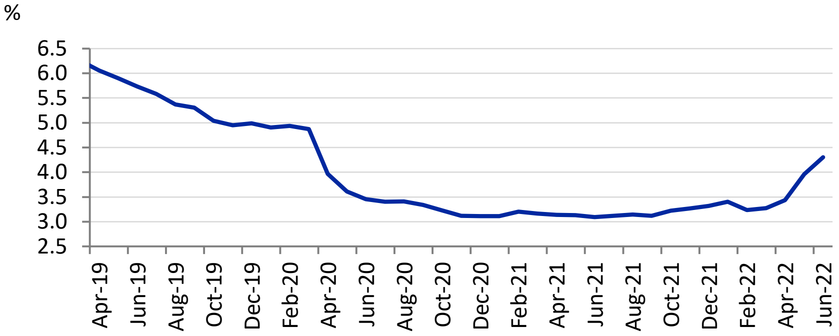
% rate	Median^				Range*			
	2022	2023	2024	Longer run	2022	2023	2024	Longer run
March 2022 Policy	1.9	2.8	2.8	2.4	1.4–3.1	2.1-3.6	2.1–3.6	2.0-3.0
June 2022 Policy	3.4	3.8	3.4	2.5	3.1–3.9	2.9-4.4	2.1–4.1	2.0-3.0

*^For each period, the median is the middle projection when the projections are arranged from lowest to highest. When the number of projections is even, the median is the average of the two middle projections; *The range for a variable in a given year includes all participants' projections, from lowest to highest, for that variable in that year; Source: FOMC; ICRA Research*

- The US CPI inflation surged to 8.6% in May 2022, the highest since December 1981, from 8.3% in April 2022. The Russia-Ukraine conflict and the associated surge in global commodity prices has led to a tempering of expectations around the anticipated base effect led moderation in the US CPI inflation in 2022.
- In its June 2022 policy meeting, the FOMC hiked the Fed Funds Rate by 75 bps to the 1.5% -1.75% range. Moreover, the 'dot plot' was revised upwards with the median Fed member expecting that the Fed Funds Rate will move to 3.4% by December 2022, 3.8% by December 2023 and then lower to 3.4% by December 2024. Further, the inflation projections were revised sharply higher for 2022 (to 5.2% from 4.3% in the March 2022 policy) and inflation is expected to remain above the 2% threshold over 2023 and 2024. GDP growth projections for 2022, on the other hand, were pared to 1.7% from 2.8% in the March 2022 policy.
- Overall, we expect India's rate hike cycle to be relatively shallower vis-à-vis the Fed, given the uneven domestic economic recovery, a relatively larger output gap relative to pre-Covid levels (after adjusting for India's higher potential growth vis-à-vis the US) and higher inflation tolerance levels.

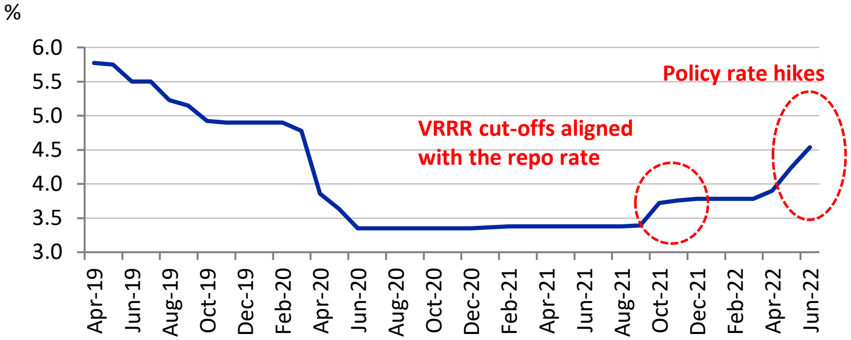
WACR surged by 90 bps during May-June 2022 mirroring the hike in policy rates; effective reverse repo rate has risen by 110 bps since September 2021

EXHIBIT: Trends in WACR



Data for June 2022 is available till June 22, 2022; Source: RBI; CEIC; ICRA Research

EXHIBIT: Trends in the effective reverse repo rate (%)



Effective reverse repo rate is the weighted average rate of the VRRR and FRRR/SDF; Data for June 2022 is available till June 22, 2022; Source: RBI; CEIC; ICRA Research

- Following the rate hikes by the RBI in May and June 2022, the WACR rose from 3.4% in April 2022 to 4.0% in May 2022, and further to 4.3% in June 2022 (till June 22, 2022). Nevertheless, it continues to trade below the policy repo rate, given the overhang of excess liquidity in the system.
- The effective reverse repo rate - the weightage average rate of VRRR and FRRR/SDF - rose gradually from 3.4% in Sep 2021 to 4.2% in May 2022, and further to 4.5% in June 1-22, 2022; this is higher than the increase in the policy rates in the current tightening cycle. VRRR cut off-yields had aligned with the repo rate in October 2021 (as against the reverse repo rate earlier), pushing up the effective reverse repo rate well before the policy rate hikes started.
- Given our expectations of a hike in policy rates over the next two policy meetings, we expect the WACR to and the effective reverse repo rate to rise further through the next quarter.

Liquidity absorption halved by June 2022 compared to levels seen in early-April 2022; SDF accounts for bulk of liquidity absorption in June 2022

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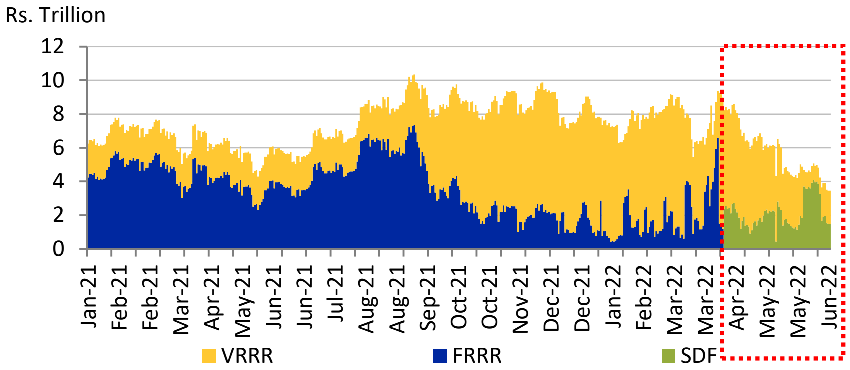
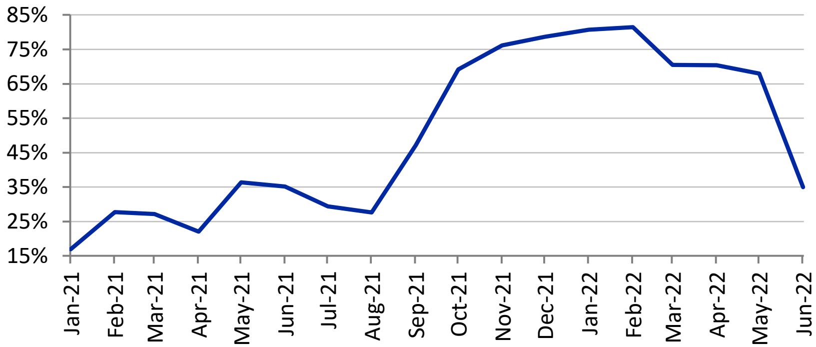
EXHIBIT: Liquidity absorption under VRRR, FRRR and SDF



Source: RBI; CEIC; ICRA Research

EXHIBIT: Share of VRRR in total liquidity absorption (%)

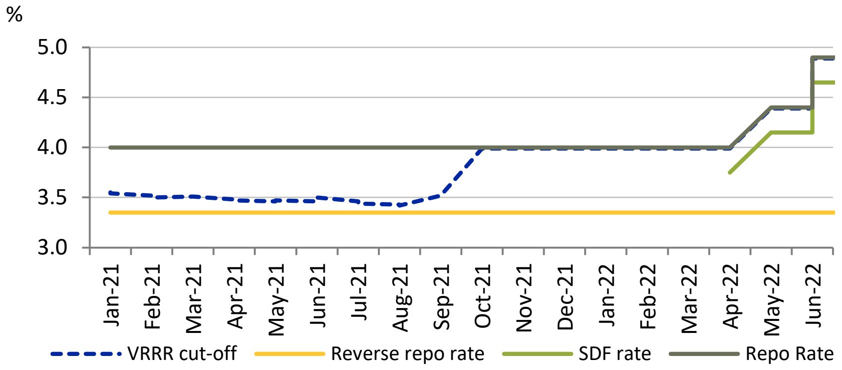


Data for June 2022 is available till June 22, 2022; Source: RBI; CEIC; ICRA Research

- Liquidity absorption has fallen quite sharply since April 2022, with the total absorption (through FRRR, VRRR and SDF) easing from Rs. 7.4 trillion during April 8-30, 2022 to Rs. 5.5 trillion during May 2022, and further to Rs. 4.4 trillion in June 1-22, 2022. The decline is largely in the amount absorbed through VRRRs.
- Post the introduction of the SDF in the April 2022 policy meeting, it has become the key tool of liquidity absorption; the daily average amount parked under the SDF has increased to Rs. 2.9 trillion during June 1-22, 2022 from Rs. 1.9 trillion during April 8-30, 2022 (and Rs. 1.8 trillion in May 2022).
- Given the higher rates offered at the VRRR auctions (closer to the repo rate) relative to the FRRR, a bulk of the liquidity surplus was absorbed under the former in H2 FY2022. However, the share of liquidity absorbed under VRRR declined quite sharply from ~69% in April-May 2022 to just 35% in June 1-22, 2022.

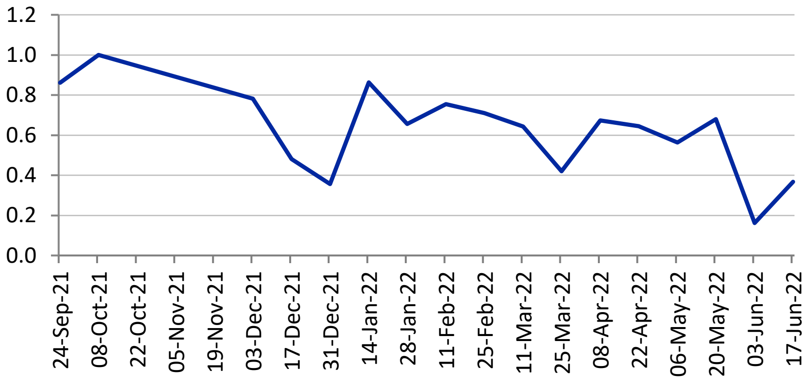
VRRR cut-offs have risen in line with the repo rate; however, bid-cover ratio of the 14-day VRRR auctions declined sharply in June 2022

EXHIBIT: Trends in VRRR cut off yields, repo rate, reverse repo rate and SDF rate



Source: RBI; CEIC; ICRA Research

EXHIBIT: Trends in bid-cover ratio of 14-day VRRRs

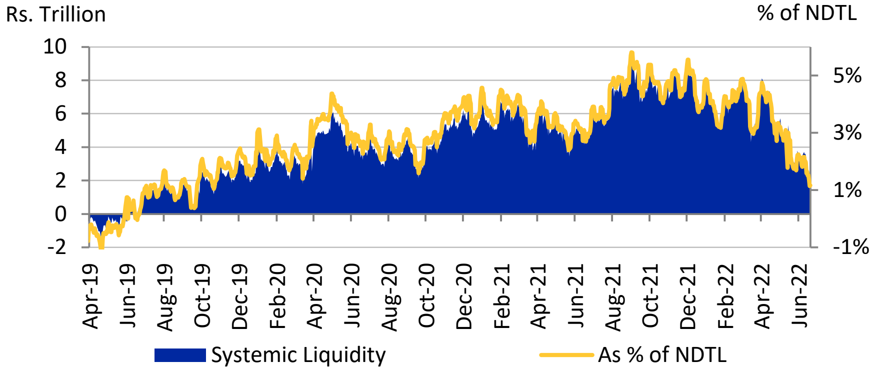


Source: RBI; CEIC; ICRA Research

- The average cut-off yields of VRRR auctions across tenors had gradually risen from 3.99% during March-April 2022, to 4.39% during May and further to 4.89% in June 2022 (till June 22, 2022), in line with increase in the repo rate. The VRRR cut-offs have aligned with the repo rate since October 2021, when the market first started to pencil in the expectation of policy rate hikes.
- Notwithstanding the higher cut-off yields in the VRRR auctions (with rates now exceeding the SDF rate), the bid-cover ratios of the 14-day VRRR auction dipped in June 2022 relative to April-May 2022, reflecting the decline in surplus liquidity.

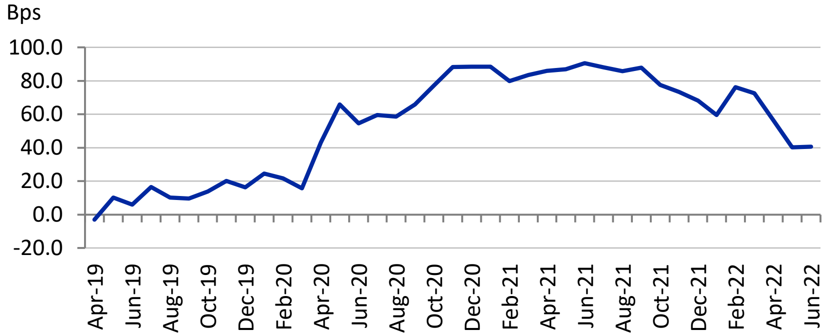
Systemic liquidity surplus has fallen quite sharply despite RBI's assurances of a calibrated normalisation; gap between WACR and repo rate continues to narrow

EXHIBIT: Systemic liquidity (Rs. trillion) and as % of NDTL



Systemic liquidity = Repo + MSF + SLF - Reverse Repo – SDF – excess reserves; Source: RBI; CEIC; ICRA Research

EXHIBIT: Spread between Repo rate and WACR (bps)

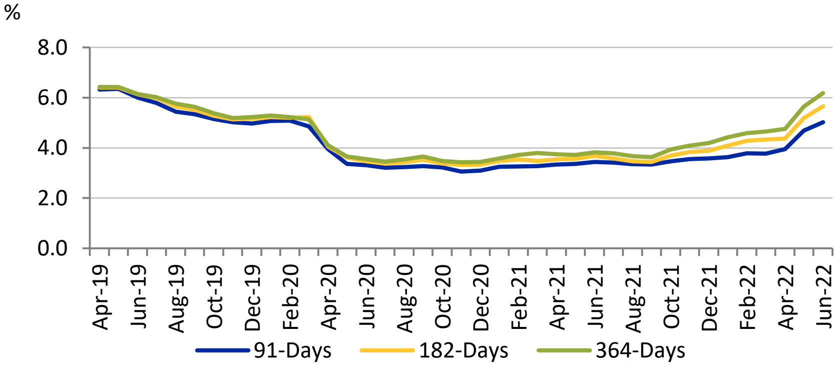


Data for June 2022 is available till June 22, 2022; Source: RBI; CEIC; ICRA Research

- As a percentage of NDTL, net systemic liquidity surplus has eased to a 32-month low of 1.2% as on June 22, 2022 from ~4.5% in early-April 2022. The rapid drop is quite surprising given the RBI's assurances of a calibrated normalisation in liquidity; ICRA views the moderation in liquidity in consonance with the central bank's move to neutral conditions.
- Durable liquidity surplus has also fallen sharply to Rs. 6.2 trillion in early-June 2022 from Rs.7.2 trillion in early-April 2022 and over Rs. 10 trillion in end-December 2021.
- The WACR inched closer to the repo rate, with the gap between the two narrowing to ~41 bps in June 2022 (till June 22, 2022) from 76 bps in Feb 2022. Nevertheless, the gap remains high, indicating that liquidity conditions are comfortable, albeit tighter than what was prevailing previously.

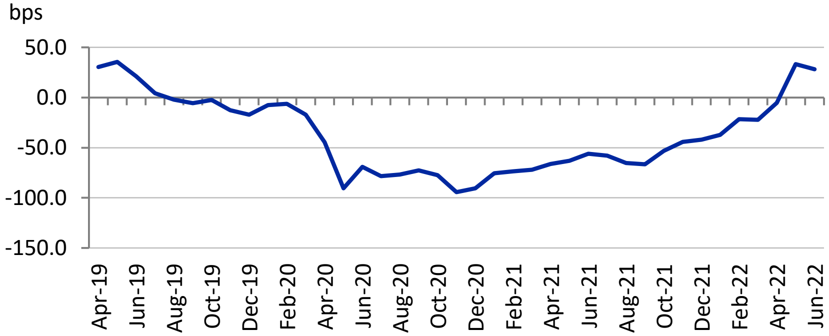
T-bill yields surged by ~100-140 bps since April 2022, following the policy rate hikes and increase in cut-off yields of the VRRR auctions

EXHIBIT: Trends in T-bills yields



Data for June 2022 is upto June 22, 2022; Source: RBI; ICRA Research

EXHIBIT: Spread between 3-month T-bill yield and the repo rate



Data for June 2022 is available upto June 22, 2022; Source: RBI; ICRA Research

- The average rates for the 91-day T-bills, 182-day T-bills, and 364-day T-bills rose gradually from 3.9%, 4.4% and 4.8%, respectively, in April 2022, to 4.7%, 5.2% and 5.6%, respectively, in May 2022, and further to 5.0%, 5.7% and 6.2%, respectively, in June 2022 (till June 22, 2022), following increase in cut-off yields of VRRR auctions.
- The spread between 3-month T-bill yield and the repo rate turned positive in May 2022, at 33 bps before inching lower to 28 bps in June 2022 (upto June 22 2022). Overall, the increase in spreads in May-June 2022, is indicative of expectations of further policy rate hikes.

10-year G-sec yield up sharply by ~56 bps during FY2023 so far; ICRA expects the new benchmark security to be issued in July 2022

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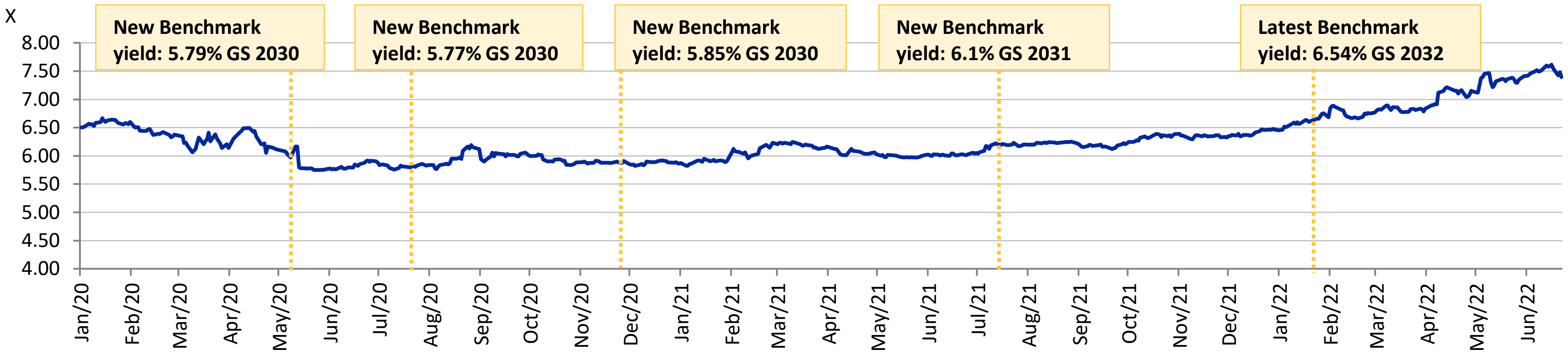
EXHIBIT: Trend in India 10-year G-sec yield

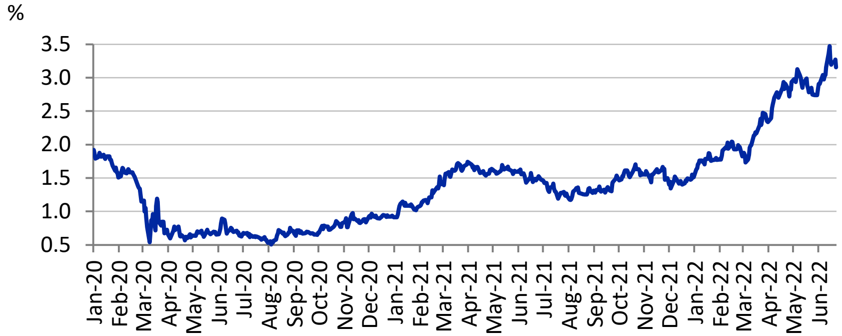


Source: RBI; Bloomberg; ICRA Research

- The G-sec yield soared to 7.62% on June 16, 2022, its highest since Feb 2019, after the MPC raised the repo rate in its June 2022 policy meeting. Moreover, concerns about faster rate hikes by the US Fed, amid inflationary pressures, have put upward pressure on G-sec yields. Thereafter, the 10-year G-sec yield cooled off to touch 7.40% on June 22, 2022, implying an increase of ~56 bps during FY2023 so far.
- As on June 22, 2022, Rs. 1.04 trillion has been issued in the benchmark 6.54 GS 2032. We believe that the GoI may issue three additional tranches of Rs. 140 billion each of 6.54 GS 2032, taking the total to Rs. 1.46 trillion. This may be completed by July 22, 2022, after which a new benchmark 10-year security may be issued.

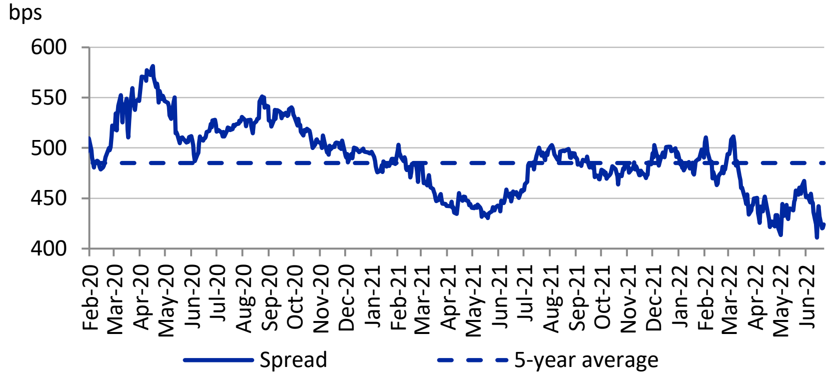
Spread between the 10-Year G-Sec and US Treasury yield may fall below 400 bps

EXHIBIT: Trend in US 10-year Treasury yield



Source: Bloomberg; CEIC; ICRA Research

EXHIBIT: Spread of Indian 10-Year G-Sec yield and US 10-year Treasury yield



Source: Bloomberg; CEIC; ICRA Research

- The 10-year US Treasury yield surged to 3.47% on June 14, 2022, the highest in 11 years, amid concerns of surging inflation pressures and steeper rate hikes by the US Fed. However, it has pulled back thereafter to 3.16% on June 22, 2022.
- As a result, the 10-year G-sec-UST spread eased to 424 bps on June 22, 2022 (450 bps on March 31, 2022) and is appreciably lower than the average of 485 bps seen during the last five years.
- Given the expectations of rate hikes by the US Fed envisaged from the ‘dot plot’, the US rate hike cycle going ahead is likely to be much steeper (175 bps) than India’s rate hike cycle (60 bps). Accordingly, the spread between the US and Indian 10-year yield may fall below 400 bps.

Elevated crude oil prices are expected to exacerbate the impact of large FY2023 market borrowings of the GoI on G-sec yields

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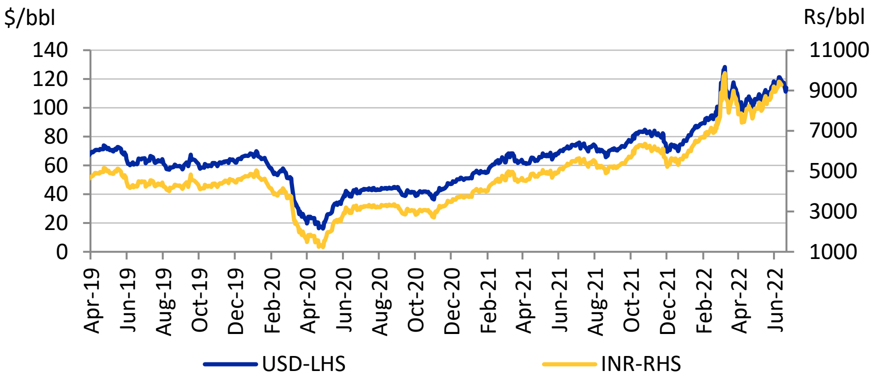
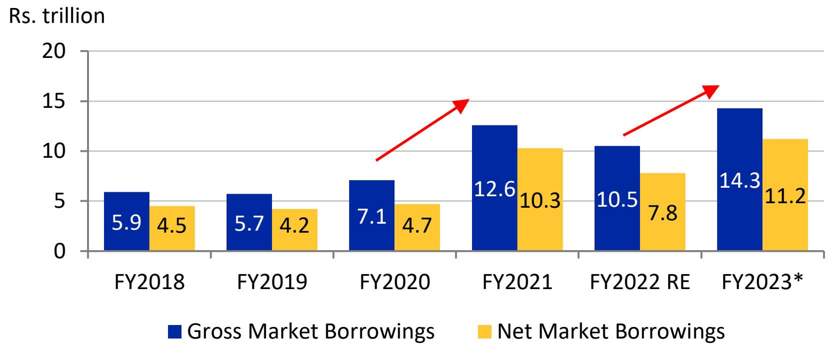
EXHIBIT: Crude Oil Price Movement of Indian Basket



Source: PPAC; CEIC; ICRA Research

EXHIBIT: Trends in GoI's gross and net market borrowings



**Adjusting for switch of G-sec of Rs. 0.63 trillion on January 31, 2022, the redemptions and gross borrowing would be Rs. 3.1 trillion and Rs. 14.3 trillion, respectively; RE: Revised Estimates; Source: GoI Budget Documents; ICRA Research*

- The international price of crude oil crossed the US$120/bbl mark on June 9, 2022 (Indian basket), given the improved demand outlook following the reopening of Chinese cities, besides rising concerns regarding the supply increases amid fresh sanctions by EU countries on Russian oil. While oil prices have pulled back slightly since then, they continue to remain elevated at US$ 114/bbl as on June 21, 2022.
- Overall, the international crude oil price of the Indian basket increased from US$102.9/bbl in April 2022 to US$109.3/bbl in May 2022, and further to US$117.0/bbl in June 1-21, 2022.
- The GoI's market borrowings have seen a significant increase in the post-pandemic period. While they eased in FY2022 RE, they are budgeted to rise quite sharply in FY2023 to touch record levels. Besides, any fiscal slippage may put further pressure on the GoI's market borrowings.

Additional spending to exceed GoI's revenue upside by Rs. 1.0 trillion

EXHIBIT: Factors that will impact the GoI's budgeted fiscal deficit for FY2023

Positives

- **Low nominal GDP assumption:** The nominal GDP for FY2023 assumed in the FY2023 Union Budget (Rs. 258.0 trillion) is only 9.0% higher than the NSO's Provisional Estimate for FY2022 (Rs. 236.6 trillion). We expect it to expand by 14-15% in FY2023.
- **Modest growth assumed in tax revenues:** As per the FY2022 Prov. data, the gross tax revenues in FY2022 were pegged at Rs. 27.1 trillion, exceeding the RE level by Rs. 1.9 trillion. This is only marginally lower than FY2023 BE of Rs. 27.6 trillion, implying that the growth embedded for FY2023 is conservative. We foresee a considerable upside to non-excise tax revenues in FY2023, relative to the BE, in spite of the margin pressure for Corporates created by the elevated commodity prices.
- **Spillover of inflows from LIC IPO to FY2023:** The spillover of the LIC IPO to FY2023 would augment the GoI's non-debt capital receipts in this fiscal.

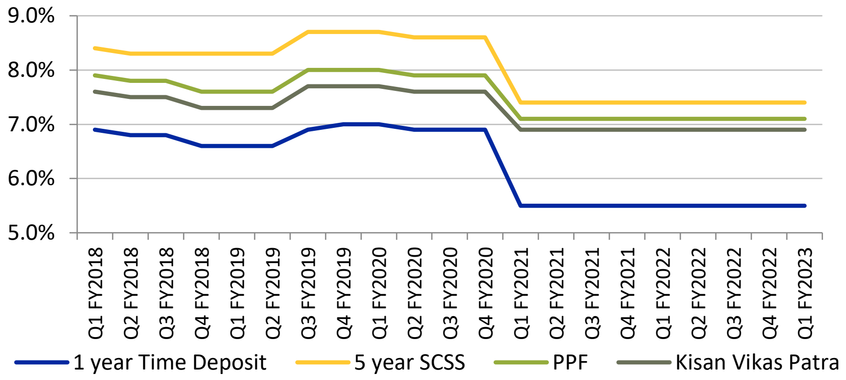
Negatives

- **Revenue losses related to excise duty cuts:** The revenue loss to the Centre in FY2023 from the recently announced excise duty cut is estimated at Rs. 860 billion for the rest of FY2023.
- **Lower-than-budgeted RBI surplus transfer:** The recently announced surplus transfer of Rs. 0.3 trillion appears to be a modest Rs. 0.3-0.4 trillion lower than the budgeted amount for FY2023.
- **Higher spending on subsidies:** Given the surge in input costs, ICRA pegs the fertiliser subsidy requirement for FY2023 at 2.0 trillion, Rs. 1.1 trillion higher than the budget estimate (BE). Moreover, the free foodgrain extension under the PMGKAY until Sep 2022 will cost Rs. 800 billion to the GoI, pushing up the outgo for food subsidy.
- **LPG subsidy and reduction in customs duties:** The GoI announced a subsidy of Rs. 200 per gas cylinder up to 12 cylinders (cost of Rs. 61 billion) and has also reduced customs duty on coking coal, coke, semi-coke, naptha, PVC, etc.

PMGKAY: Pradhan Mantri Garib Kaylan Ann Yojana; LIC; Life Insurance Corporation; Source: ICRA Research

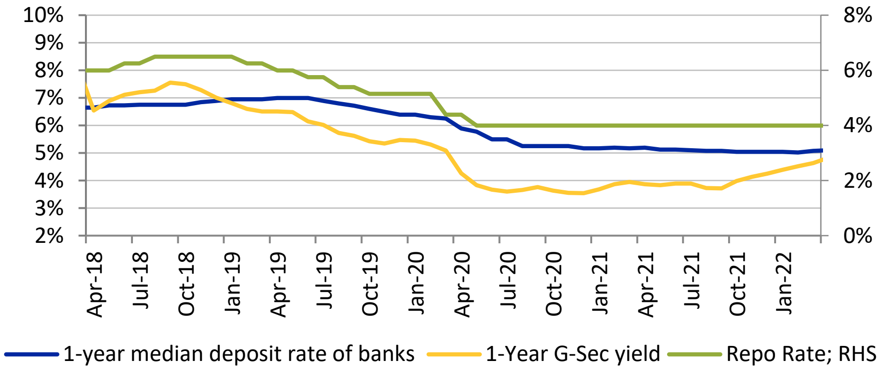
Hike in interest rates on small savings schemes could limit the need for extra market borrowings arising on account of modest fiscal deficit overshoot

EXHIBIT: Trends in Interest Rates on Selected Small Savings Schemes



Source: Ministry of Finance, GoI; RBI; CCIL; CEIC; ICRA Research

EXHIBIT: Trends in Repo Rate, 1-year G-sec Yield and 1-year Median Deposit Rate

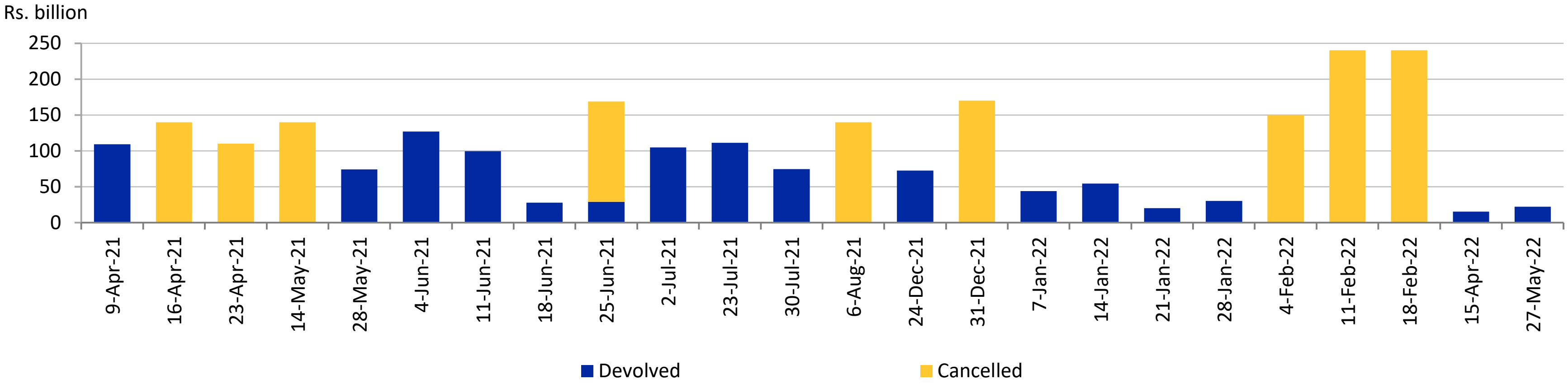


Source: Ministry of Finance, GoI; RBI; CCIL; CEIC; ICRA Research

- Interest rates on various small savings schemes have not been changed for the last eight quarters since Q1 FY2021. Rates for the small savings schemes for Q2 FY2023 are set to be announced in end-June 2022.
- The average month-end G-Sec yields for one-year, two-year and 5-year bonds have increased substantially by 138 bps, 93 bps and 79 bps, respectively, during Mar 2022- May 2022, following an increase of 38 bps, 31 bps and 31 bps, respectively, during Dec 2021-Feb 2022.
- Accordingly, we expect the interest rates on small savings schemes to be hiked for Q2 FY2023, given the sharp increases seen in the G-Sec yields of various maturities, to which such rates are linked. An increase in small savings rates could lead to higher flows into such schemes, limiting the need for additional market borrowings on account of the overshooting of fiscal deficit.

ICRA expects 10-year G-sec yield to range between 7.5-8.0% in H2 CY2022; measures announced by RBI will determine where yields settle

EXHIBIT: Cancellation and Devolvement of G-secs in weekly auctions in FY2022 and FY2023 so far



Source: RBI; ICRA Research

- Cancellations and devolvement played an important role in providing respite to G-sec yields in FY2022.
- In FY2023 so far, there have been no cancellations and devolvements have been limited to Rs. 37.9 billion in Q1 FY2023.
- Given the expectation of 60 bps of rate hikes from the MPC over the next two policy reviews, and with a large borrowing programme for FY2023 reducing the likelihood of repeated cancellations, we expect the 10-year G-sec yield to range between 7.5-8.0% in H2 CY2022.

India's yield curve has shifted upwards, with larger moves seen at the shorter end of the curve vis-à-vis the longer end; further upward shift likely in near term

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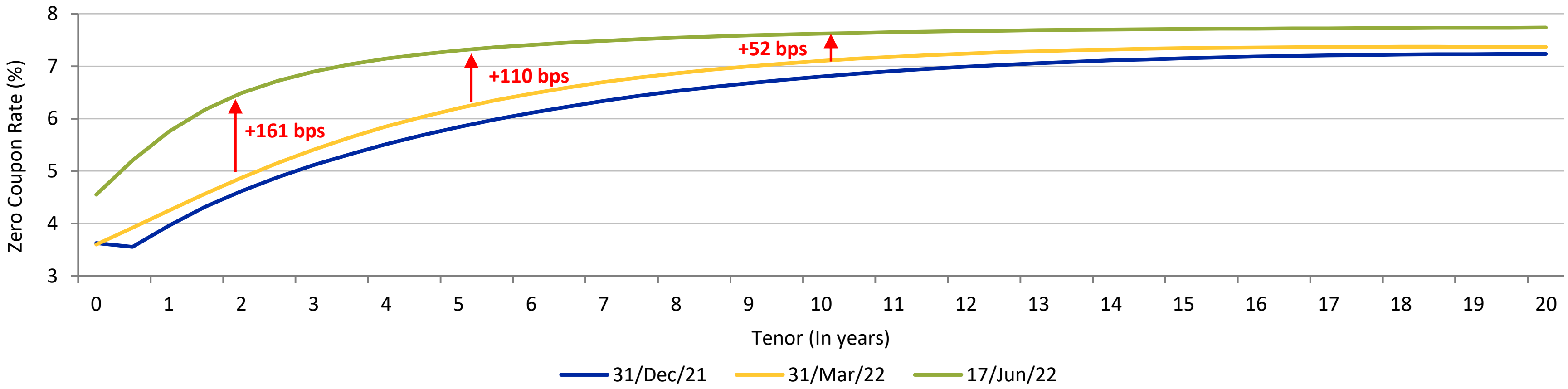
EXHIBIT: Trends in India's yield curve*



**Zero coupon yield curve; Source: CCIL, ICRA Research*

- India's yield curve has moved up quite sharply between June 17, 2022 and March 31, 2022. However, the increase has been much larger at the shorter end of the curve vis-à-vis the longer end of the curve.
- The yield curve is likely to shift further upwards over the next quarter, following front-loaded rate hikes. The RBI's measures to support the Government borrowing programme would determine the extent of the up-move across various tenors, and how much the yield curve flattens. In the event of a sizeable Operation Twist, the yield curve is likely to flatten further, with a relatively larger increase at the shorter end of the curve vis-à-vis the longer end.

Spread between 10-year and 2-year G-sec yields narrowed sharply in May-June 2022 following rate hikes by RBI

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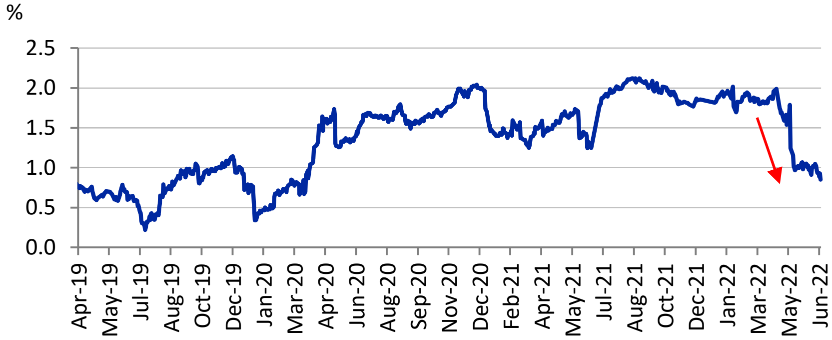
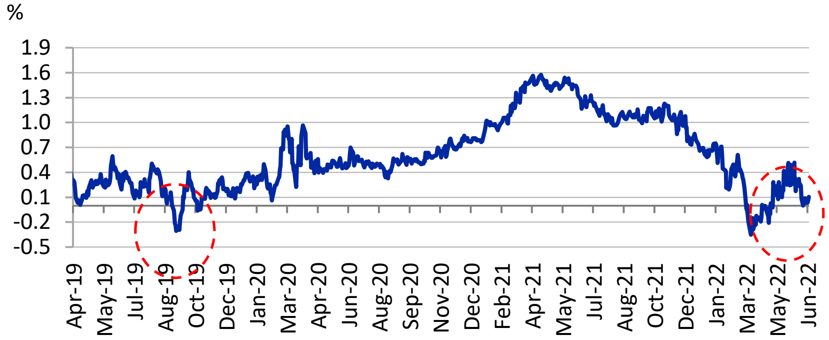
EXHIBIT: Gap between the yields of the Indian 10-year and 2-year G-secs



Source: Bloomberg; ICRA Research

EXHIBIT: Gap between the yields of the US 10-year and 2-year Treasury securities

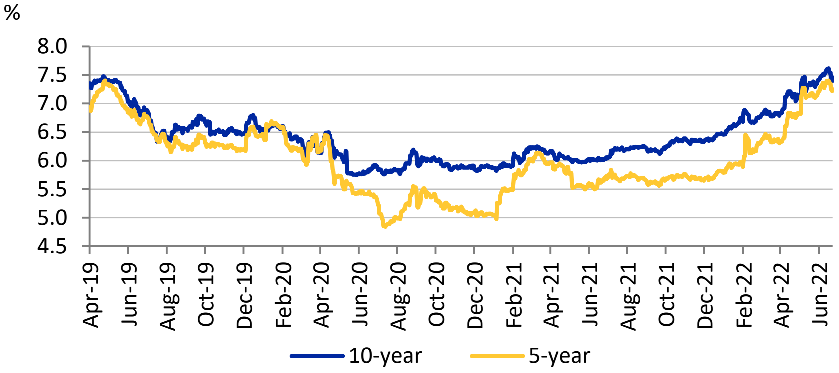


Source: Bloomberg; ICRA Research

- The rise in India's 10-year G-sec yield has been much lesser than the hardening in the shorter end yields (2-year), compressing their spread from 186 basis points on March 31, 2022 to 85 basis points on June 22, 2022, implying that the yield curve has flattened, partly due to expectations of future actions by the RBI to cap longer tenure yields.
- Meanwhile, the US 2-year Treasury yields rose above the 10-year yields in March-April 2022, resulting in the inversion of the yield curve. Thereafter, the US 10-year yield rose at a faster pace than the 2-year yield, resulting in an increase in their difference from -35 bps on March 21, 2022 to +24 bps on June 9, 2022. However, the difference narrowed again to +10 bps on June 22, 2022, amidst increased expectations of a recession in the US as a fallout of the aggressive rate hikes expected from the US Fed.

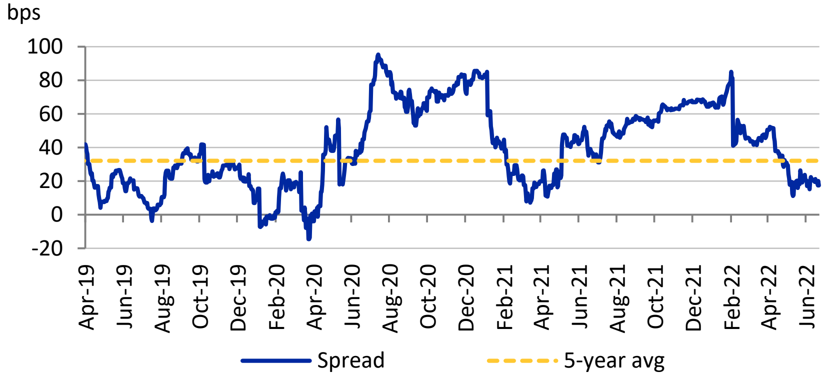
Spread between 10-year and 5-year G-sec yield narrows sharply in Q1 FY2023, dipping below the 5-year average

EXHIBIT: Trend in India 10-year and 5-year G-sec yields



Source: Bloomberg; ICRA Research

EXHIBIT: Spread between 10-year and 5-year G-sec yield

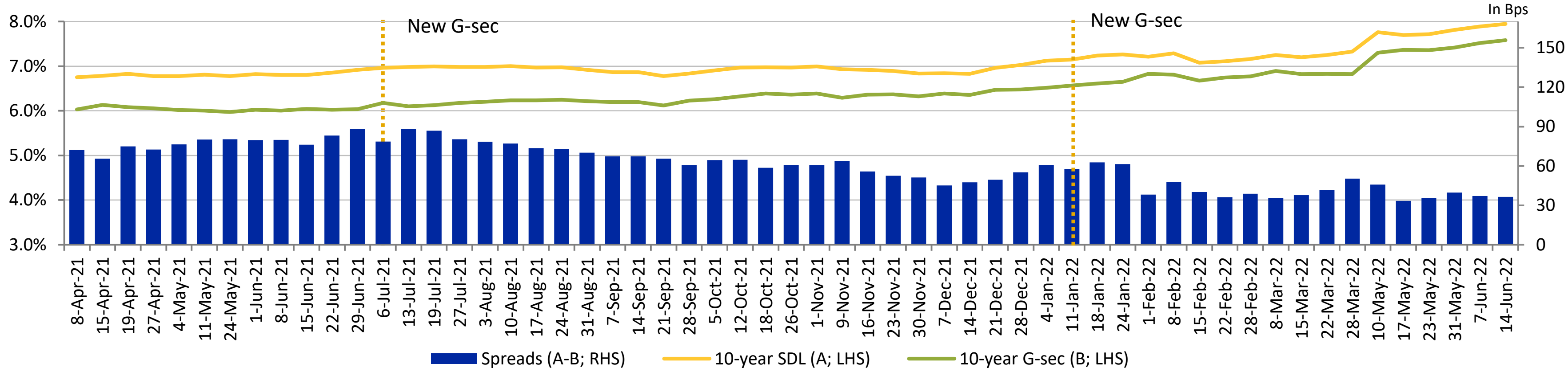


Source: Bloomberg; ICRA Research

- The yield on the 10-year G-Sec (6.54% GS 2032) increased by 56 bps from 6.84% on April 1, 2022 to 7.40% on June 22, 2022, while the 5-year G-sec yield increased by a steeper 89 bps from 6.33% to 7.22%, during the same period, due to expectations of measures by the RBI to cap longer tenure yields.
- Accordingly, the spread between the two narrowed sharply from ~50 bps on April 1, 2022 to ~17 bps on June 22, 2022, slipping below the five-year average.

Spread between the 10-year SDLs and G-sec remained below 40 bps in the recent weekly auctions of Q1 FY2023

EXHIBIT: Closing yield of 10-year G-sec, weighted average cut-off of 10-years SDLs and the spread between the two



Source: RBI; ICRA Research

- The weighted average cut-off of the 10-year SDLs rose by 62 bps to 7.95% on June 12, 2022 from 7.33% on March 28, 2022; this was relatively lower than the 76 bps increase in the 10-year G-sec yield (from 6.82% to 7.58%) seen during the same period.
- The spread between the weighted average cut-off of 10-year SDLs and G-sec has largely remained below 40 bps since February 22, 2022, auction, partly reflecting lower than indicated SDL issuance in this period, following a combination of factors such as large Central tax devolution as well as a delay in some states' receiving their borrowing permissions for FY2023 related to the recent changes in borrowing norms.

Corporate bond yields have risen by 70-120 bps in FY2023 so far, exceeding their pre-pandemic levels; likely to rise further over the next 2-3 months

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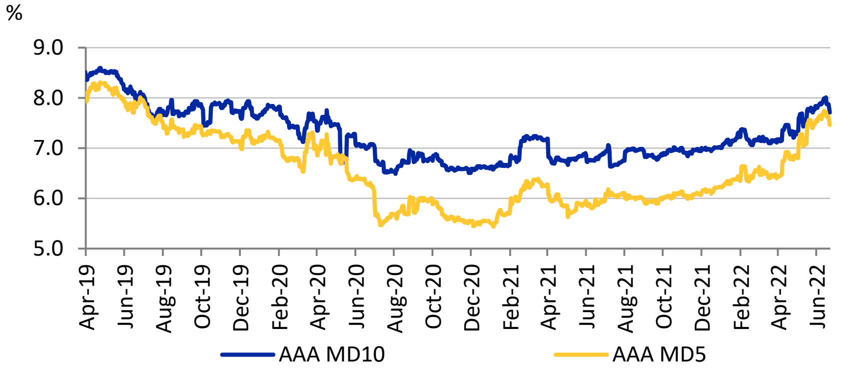
EXHIBIT: Trend in India's Corporate AAA bond yields (MD 10-year and 5-year)



Source: Bloomberg; ICRA Research

EXHIBIT: Trend in India's Corporate AA+ bond yields (MD 10-year and 5-year)

Source: Bloomberg; ICRA Research

- Corporate bond yields have risen sharply by 70-120 bps during FY2023 so far, for AAA and AA+ bonds with 5-year and 10-year tenures, touching the highest levels in three years. Corporate bond yields have risen by a larger extent than the G-sec yields.
- With expectations of policy rate hikes over the next two policy meetings and an increase in G-sec yields, we expect corporate bond yields to rise further over the next 2-3 months.
- The 5-year corporate bond yields have risen by much more than their respective 10-year counterparts. This is in line with the compression in term premium in G-secs due to expectations of future actions by the RBI to cap the longer-term G-sec yields.

Corporate bond spreads have surged in FY2023 so far, but remain below their respective 5-year average

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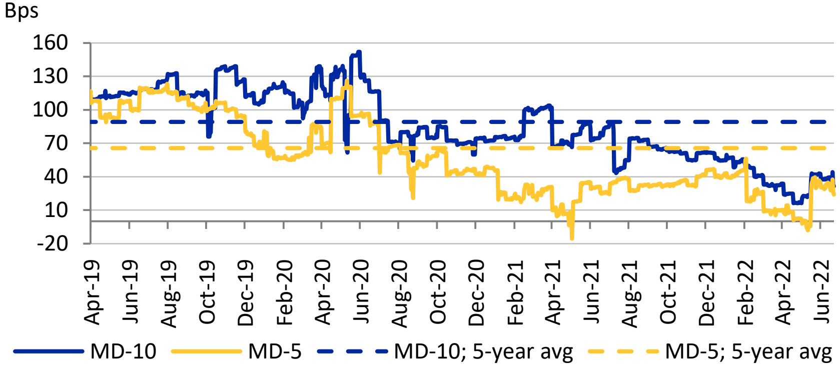
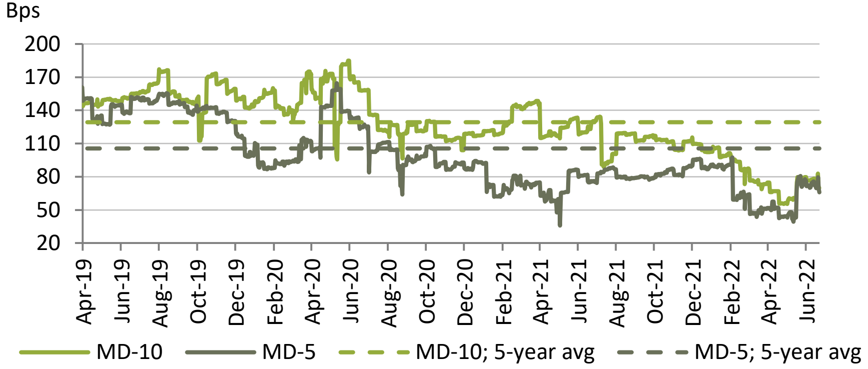
EXHIBIT: AAA Corporate Bond Spreads



Source: Bloomberg; ICRA Research

EXHIBIT: AA+ Corporate Bond Spreads

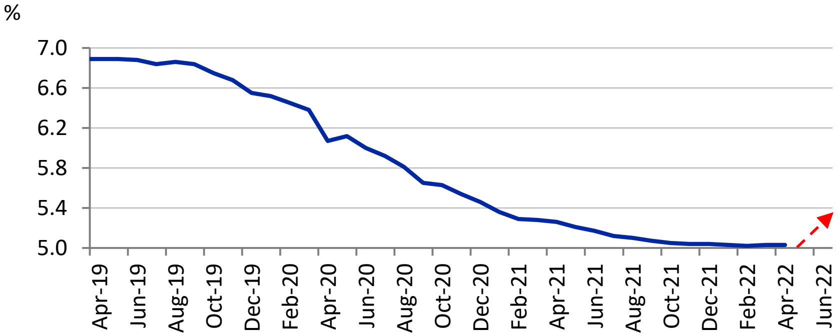


Source: Bloomberg; ICRA Research

- While the 10-year G-sec yield has risen by ~56 bps in FY2023 so far, the AAA and AA+ 10–year corporate bond yields have hardened by a larger 80-82 bps. This is largely due to market expectations of a cap on the 10-year G-sec, given the possible actions by the RBI and may not entirely reflect an increase in risk premia.
- Further, the widening of spreads has been somewhat larger for the shorter maturity (5-year) corporate bonds , at ~25 bps, during FY2023 so far.
- However, the corporate bond spreads over G-sec yields are still lower than their pre-pandemic levels as well as their respective 5-year averages.

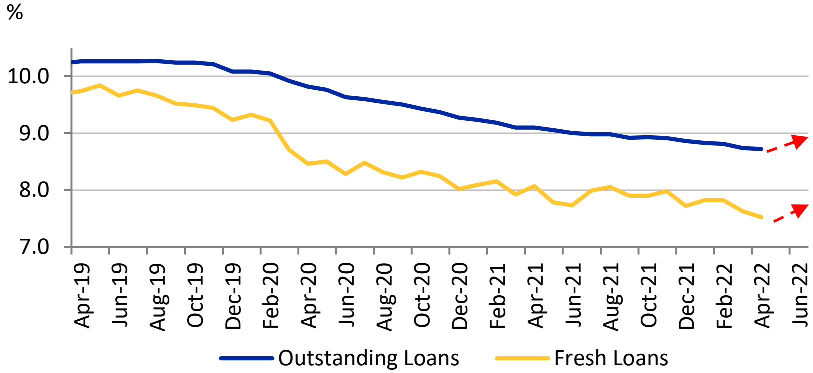
Term deposit rates likely to continue to edge up in the near term; transmission to lending rates expected to be faster in upcycle

EXHIBIT: Trends in weighted average term deposit rates



**Complete data for May-June 2022 is not available yet; Source: RBI; ICRA Research*

EXHIBIT: Trends in weighted average lending rates



**Complete data for May-June 2022 is not available yet; Source: RBI; ICRA Research*

- Both the weighted average term deposit rates and weighted average lending rates eased by 150 bps each between Jan 2020 to April 2022, post the emergence of Covid-19. Following cumulative 90 rate hike by the RBI in May 2022 and June 2022, several banks have hiked deposit rates of various tenures by 20-35 bps in FY2023 so far. With expectations of further rate hikes over the next to policy meetings and the normalisation of systemic liquidity, we expect deposit rates to rise further through the remaining part of FY2023.
- Banks have also started hiking lending rates, with the MCLR across various tenors rising by a mild 10-15 bps in April-May 2022. Going forward, we expect the transmission by banks to the lending rates to be faster in the upcycle vis-à-vis the deposit rates.

INR crossed the 78-mark against the US$; global policy tightening, elevated crude oil prices and rising DXY to impart depreciating bias to the INR

EXHIBIT: Movement in USD/INR exchange rate

Source: Bloomberg; RBI; ICRA Research

EXHIBIT: Movement in Dollar Index (DXY)

Source: Bloomberg; RBI; ICRA Research

- The Dollar index had touched a 20-year high of 105.5 on June 14, 2022, driven by rising US treasury yields, protracted geopolitical tensions, elevated commodity prices, heightened volatility in global financial markets, and uncertainty amid fresh waves of Covid-19.
- Subsequently, the INR plunged to an all-time low 78.38 on June 22, 2022, following the rise in US treasury yields. While the Indian currency had hovered between 77.5 and 78.0 between May 16, 2022 and June 10, 2022, it seems to have decisively broken the 78-mark since June 13, 2022.
- Going forward, global monetary policy tightening, elevated crude oil prices and general risk aversion towards EM assets would continue to put an upward pressure on the USD/INR pair. The policy tightening by the US Fed amid the risk aversion environment is expected to strengthen the US Dollar, thereby imparting a depreciating bias to the INR against the US$.

ICRA expects US$/INR to trade between 77.0-80.0/US$ in remainder of H1 FY2023; large forex reserves to prevent a disorderly depreciation of the INR

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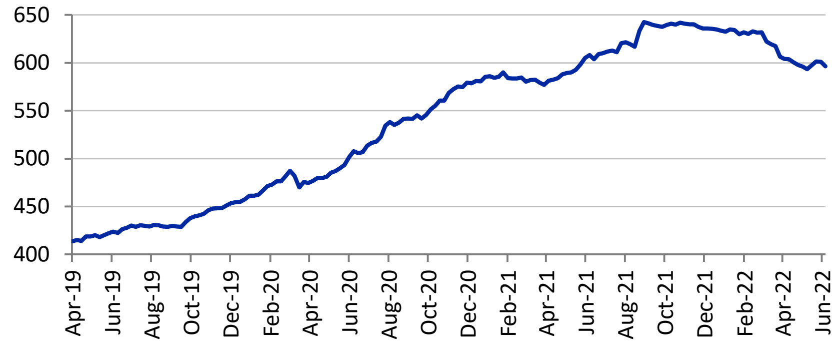
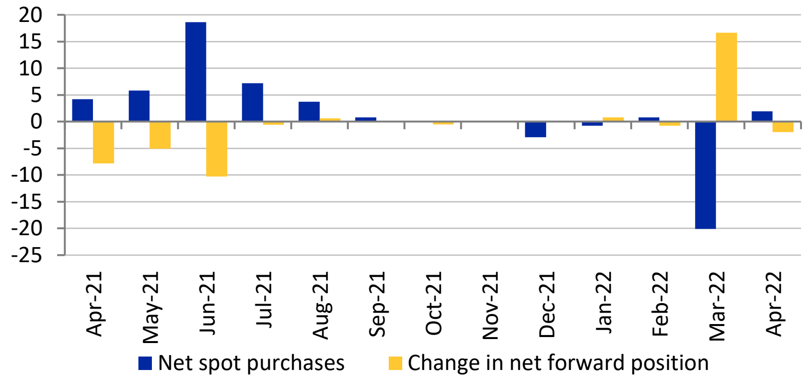
EXHIBIT: Trends in India's forex reserves (US$ billion)



Source: RBI; ICRA Research

EXHIBIT: Trends in RBI's net spot purchases of the US dollar and outstanding forwards (US$ billion)



Source: RBI; CEIC; ICRA Research

- India's foreign exchange reserves eased from US$633.6 billion as on Dec 31, 2021 to US$596.5 billion as on June 10, 2022, on account of a decrease in foreign currency assets, with the RBI likely to have sold dollars to ease the volatility in the INR.
- The RBI's large dollar sales in March 2022 (US$20.1 billion) were partially matched by the increase in the RBI's outstanding forward position (+US$ 16.7 billion) in the month. Overall, large forex reserves, notwithstanding the recent dip, and the RBI's outstanding forward position, at US$63.8 billion in April 2021, are likely to prevent a disorderly depreciation of the INR despite the global headwinds. Nevertheless, a further run-up in crude oil prices from current levels poses a significant risk to the INR.
- **Amidst the global headwinds, we expect the INR to trade between 77.0-80.0/US$ in the remainder of H1 FY2023.**

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