Pension Fund, Pension Fund Regulatory Development Authority, PFRDA, State Bank of India

Written by Harish Damodaran , George Mathew | New Delhi | Mumbai | Posted: December 1, 2014 1:13 am

On September 23 — a week before the Reserve Bank of India's (RBI) last monetary policy review — 10 state governments together raised Rs 8,100 crore of 10-year market loans at cut-off yields ranging from 8.9 per cent to 8.99 per cent.

Last Tuesday, 14 states managed to mop up Rs 15,225 crore again through 10-year paper. But this time, the yields were between 8.43 and 8.46 per cent.

What changed in these two months? Well, RBI did not bring down its overnight lending ("repo") rate, which remains at 8 per cent. Yet, state governments have seen their borrowings costs fall by 50-odd basis points.

Since RBI's last bi-monthly review on September 30, yields on the Centre's benchmark 10-year security have dropped from 8.51 to 8.09 per cent. It is even more against the peak of 9.1 per cent on April 7. Then, too, the repo rate was 8 per cent.

But it isn't just government bonds.

Since September 30, rates on corporate borrowings against one-year commercial paper — basically unsecured promissory notes — have come down by roughly 40 basis points to 8.9 per cent-levels.

Banks, likewise, are now mobilising funds through one-year tradable certificates of deposits at around 8.6 per cent, which is also a dip of 40 basis points.

Simply put, interest rates are falling without RBI doing anything. While even until two months ago the pressure to reduce policy rates was mainly from the finance ministry or CII and Ficci, today this is coming from the financial markets that are seemingly telling the RBI it has no option but to cut.

A good indicator of the market cues is the huge investor demand for bonds issued at high coupon rates. The expectation of interest rates falling has pushed up their prices and correspondingly driven down yield-to-maturity (YTM) to even below the original coupon levels.

Thus, a two-year non-convertible debenture of Larsen & Toubro issued on August 22 at 9.15 per cent is currently trading at an annualised YTM of 8.45 per cent on the

National Stock Exchange.

Another indicator is bond spreads — the difference between yields on government securities and corporate bonds of similar maturity. These have declined from about 65 basis points to 40 basis points since September 30, which point to reduced risks associated with investing in bonds.

The question being asked is: even if RBI continues to ignore the rants of North Block or industry associations, can it ignore the markets that are clearly betting on rate reductions happening sooner than later?

Rana Kapoor, MD & CEO of Yes Bank, expects a 50 basis points cut in the repo rate in December itself.

DR Dogra, managing director of CARE Ratings, feels a rate cut is unlikely now and “RBI may choose to defer the decision for the policy review in February”.

Ashish Vaidya, executive director and head of trading at DBS India, notes that “a softening bias on rates” was apparent, but also believes that RBI will initiate cuts only from February.

“Inflation, both core and headline, seems to be coming down faster than anticipated. India is one of the few countries now offering 2 per cent positive real interest rates and that is a huge return for investors in the present world economic scenario,” Vaidya added.

The biggest driving factor behind the marked change in interest rate outlook in the last two months has been global oil prices.

Since May 26, when the Narendra Modi-led government was sworn in, the average price of crude imported by Indian refiners has plunged from $108.05 to $72.51 a barrel. And almost two-thirds of this has taken place post September 30.

According to Sajjid Chinoy, Chief India Economist at JP Morgan, inflation risks have no doubt reduced, but RBI would need to be sure whether the current dynamics endure: “Any monetary easing will only commence when the central bank has a firmer conviction of meeting its 6 per cent inflation target.”

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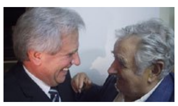

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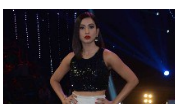

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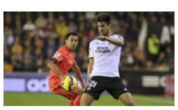

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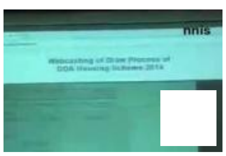

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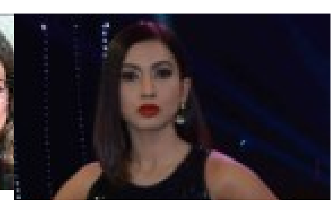

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