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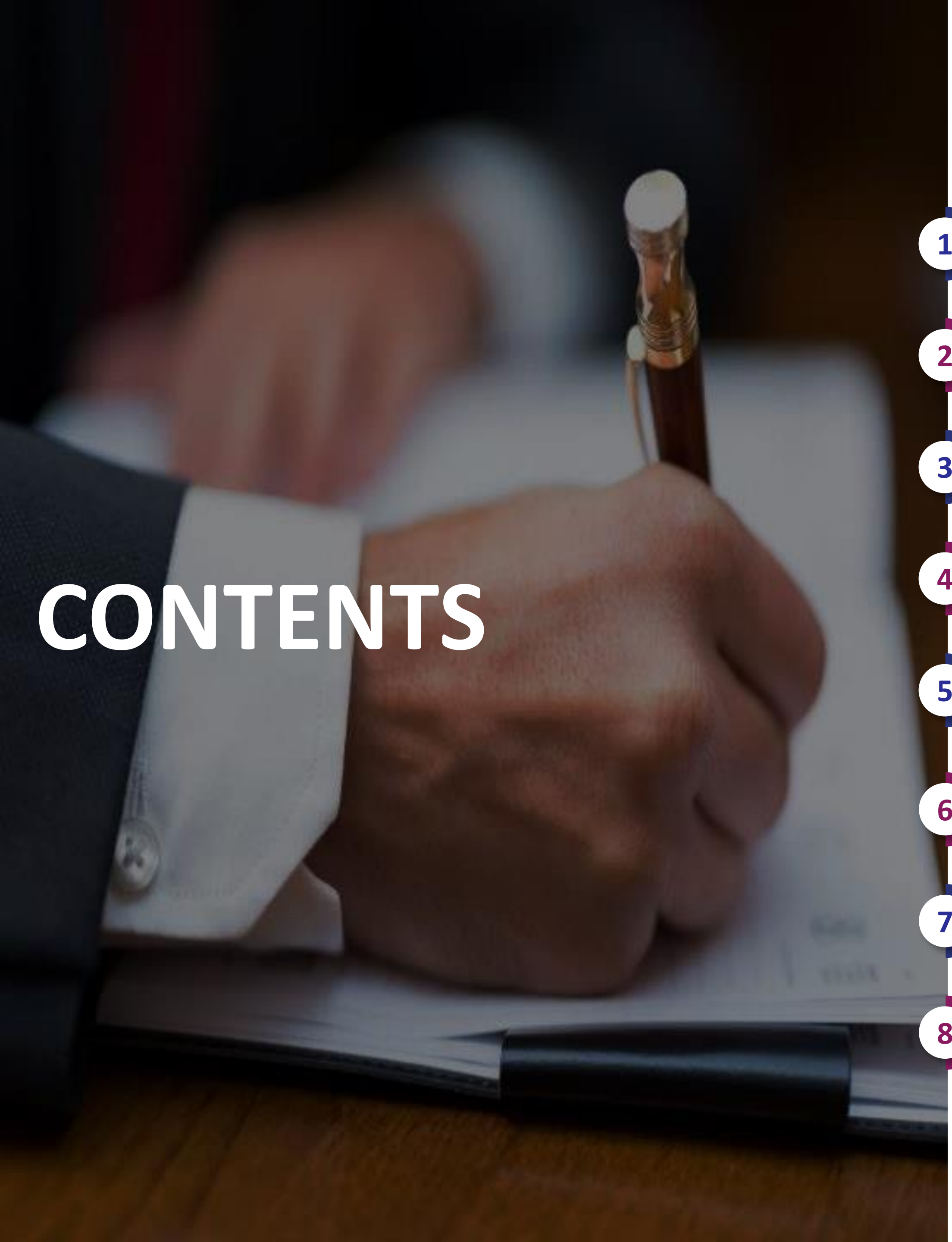
REPORT ON INDIAN BOND MARKET

WILL GLOBAL GLOOM OVERSHADOW A DOMESTIC BLOOM: A TALE OF TWO DRIVERS

June 2024



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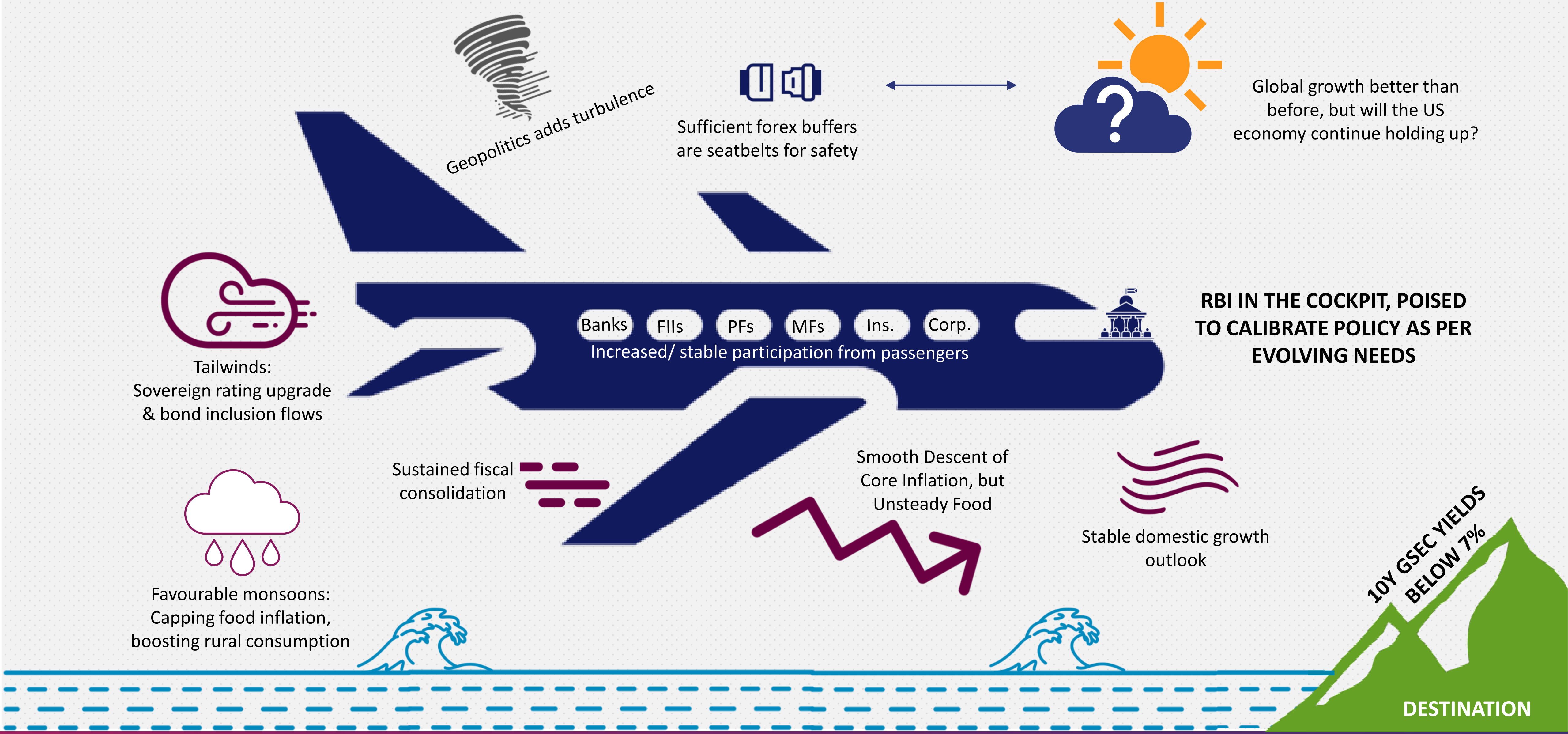
NEXT DESTINATION: A SLOW & POSSIBLY BUMPY DESCENT OF 10Y YIELDS



EXECUTIVE SUMMARY (1/2)

Bond yields are an amalgamated indicator of disparate parts of the economy – from inflation, growth, fiscal balance, and external indicators which impact policy, to supply-demand dynamics, which add another layer of complexity. It is said that Central Banks have been able to fundamentally alter the nature of business cycles in the 20th Century using rates and yields. **We stand again at a crucial point at the peak of the interest rate cycle, where not only the extent, but also the timing of actions shall have a deciding say in the future of yields (and the economy): thus, an investigation of their drivers in this Report is warranted**

Consumer inflation on a steady descent helped by ebbing Core; slow pace of reduction to ensure headline remains above RBI's target (4%) in FY25 at 4.7% y/y

- Headline inflation has been generally well-controlled since the Flexible Inflation Targeting (FIT) regime started in 2016. Barring brief periods in the COVID-19 era, Core inflation has been a downward tug on the headline in the past 5 fiscals, and has lodged itself durably below RBI's 4% target since Dec'23
- Core likely bottomed out in FY24 and FY25 could see a gradual rise owing to pent-up base effects. Revision in telecom tariffs, soaring gold and silver prices, rising costs of healthcare, and jagged shelter inflation could influence the Core upwards

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Fuel prices unlikely to be on fire bar supply shocks. Rainy relief from an above-normal monsoon critical to prevent food inflation festering

- Fuel prices have not played truant in the past few fiscals. The careful curation of duties has ensured gradual pass-through – helping cushion the outlook for FY25 with a high base. Globally, sufficient spare capacities exist with the OPEC, and volatility could mainly be induced by only geopolitical machinations
- Food inflation has exceeded headline for much of the large decade, despite an increasing base. While expectation of a good monsoon augurs well for kharif production, depressed pulses-sowing and volatile vegetables could play truant. However, policy has a limited role in leashing seasonal supply side shocks

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Global growth prospects are improving but mixed economic data from the US suggests the Fed could be stuck between soft landing and hard take off

- Global growth outlook is sunnier than before, with Europe and China joining the US and punching above their weight. Things, however, remain highly dynamic with large divergence emerging between economies, and gargantuan general government deficits amplifying risks
- Seeing the US Fed's past track raises questions about engineering a soft landing. Recent data suggest that pent-up pandemic era personal savings are running out even as the government's bloated deficit limits wiggle-room for additional stimulus

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Volatile economic variables have made the US Fed reactive rather than proactive: coupled with fickle Fedspeak, this has kept the market on its toes

- The US FOMC has kept changing its dotplot – from predicting 3 cuts in CY24 in Dec'23, it now predicts only 1 cut. The markets have also fluttered from 5-6 cuts in CY24 in Dec'24 to 1-2 cuts now. Nothing has an air of finality, however, and this could evolve rapidly depending on direction of inflation/growth prints
- Fedspeak also fluctuates with every datum and speaker. This acts as a strategic counterweight in balancing expectations between FOMC meetings sometimes but has also led to extreme volatility in US yields (US 10Y yields moved in a 120 bps range from Jul'23 till now, though rates have stayed unchanged!)

EXECUTIVE SUMMARY (2/2)

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Forex buffers shield India from minor global air pockets, but large-scale external turbulence remains a remote risk in the horizon

- The external sector is more robust than in 2013 when thin buffers coupled with rising crude precipitated a taper tantrum, forcing the RBI to raise rates to avoid sharp depreciation in the INR. While an orderly depreciation of the INR remains a possibility in FY25, we believe that sharp changes will be curbed
- Risks pertaining to high trade deficit remain in the realm of rarity, with only a combination of geopolitical shocks, distorted duty structures, and sharp global slowdown likely to make it crystallise in material measure in FY25

Steady but slow descent of inflation, robust domestic growth, and possible global risks largely mitigated by buffers, indicate rate cuts will start in Q3FY25

- The real rate (CPI – repo) is expected to reach 2.7% in Q2FY25. Though this remains below peaks reached in previous cycles, both the FY15 and FY19 cycles saw real rate peaking reaching ~2.7% around 3 months before the first rate cut, thus we expect rate cuts to start in Q3FY25
- In recent times, the Central Bank has chosen to carefully curate liquidity through several tools beyond the policy and stance, such as OMOs, buybacks, switch operations etc., which has allowed it to avoid demand side coupling of supply side inflation, while maintaining funds for productive uses

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Union's commitment to non-expansionary growth keeps fiscal consolidation in sight; increased State borrowing is a monitorable

- Blistering growth momentum has seen monotonic upward revisions to GDP estimates, and the outlook for FY25 remains robust at ~7.0% y/y real growth. The Union is likely to manage this while keeping borrowing in check, aided by a generous dividend from the RBI
- At the same time, States are expected to ramp up their gross borrowings to ~Rs. 10.5 trn in FY25, a 4% y/y rise, contrasting the declining trend in Union G-secs. This will help temper the supply side constraint

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Fresh global interest and robust growth in domestic investors in Indian G-secs is tilting the balance in favour of supply rather than demand

- Demand for Indian G-secs will see a fillip in FY25 due to inclusion in global bond indices once short-term liquidity issues in certain papers gets sorted. While this augurs well for keeping yields down, it could also induce some bouts of volatility
- Sharp credit growth from banks will ensure that demand for Union G-secs will outpace supply in FY25, just for them to maintain their SLR. The government has also altered its maturity pattern to suit patient investors such as insurers and pension funds, who form an increasingly large chunk of investor base

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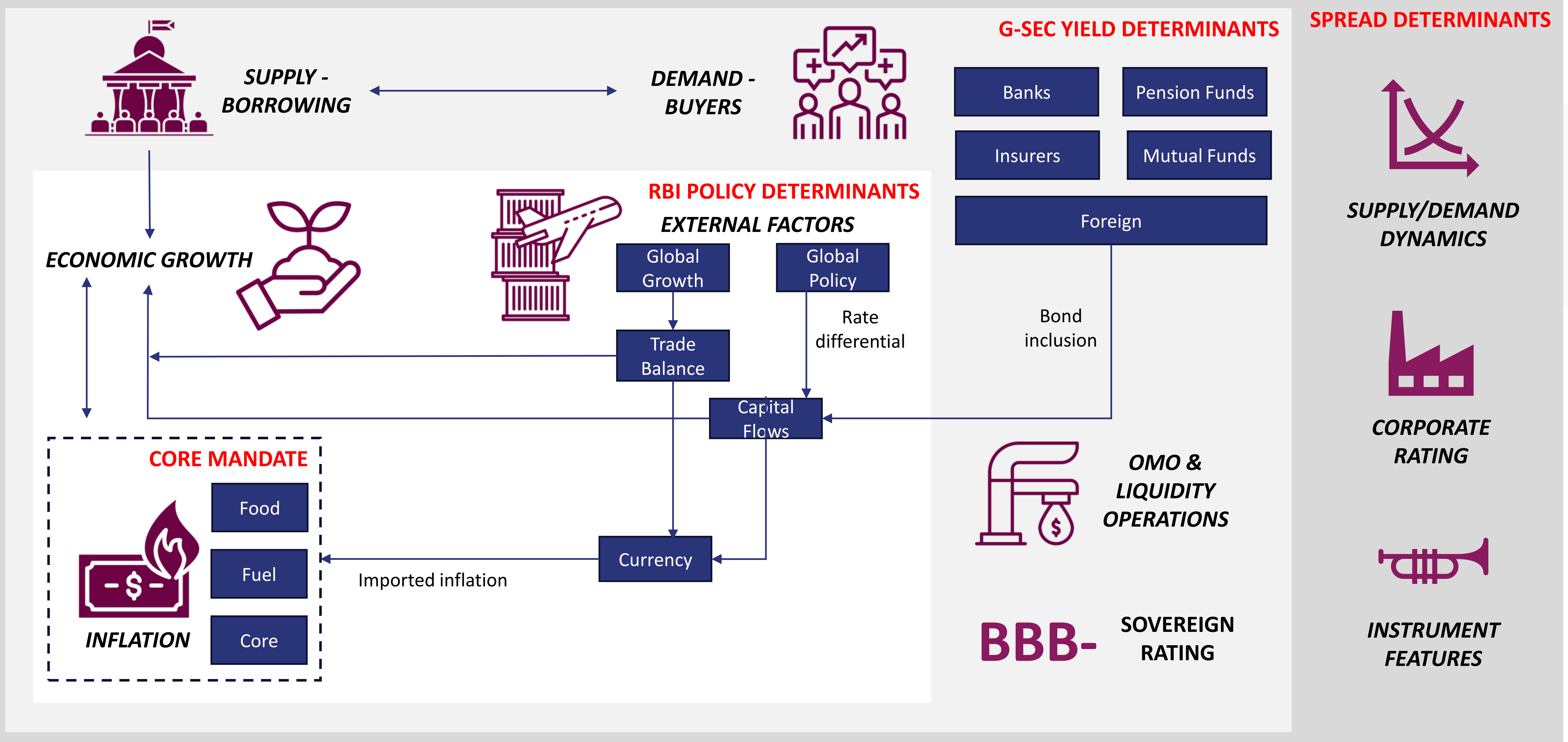
Outlook on yields is titled to the downside. Downward pressures transcend beyond policy, led by prominence of supply-demand factors. While the entire curve welcomes cuts, impact on shorter-end tend to be more pronounced & faster. 10Y Union G-sec yields have already descended below 7% and are expected to continue the descent. Additionally, we expect them to fall by 25-30 bps from current levels with the curve witnessing a bull steepener

INTRODUCTION: NAVIGATING A COMPLEX AIRSPACE

POLICY >> YIELDS >> SPREADS… A TALE OF CASCADING INTERCONNECTEDNESS



HISTORICAL YIELD MOVEMENTS REVEAL COMPLEX INTERPLAY OF FACTORS

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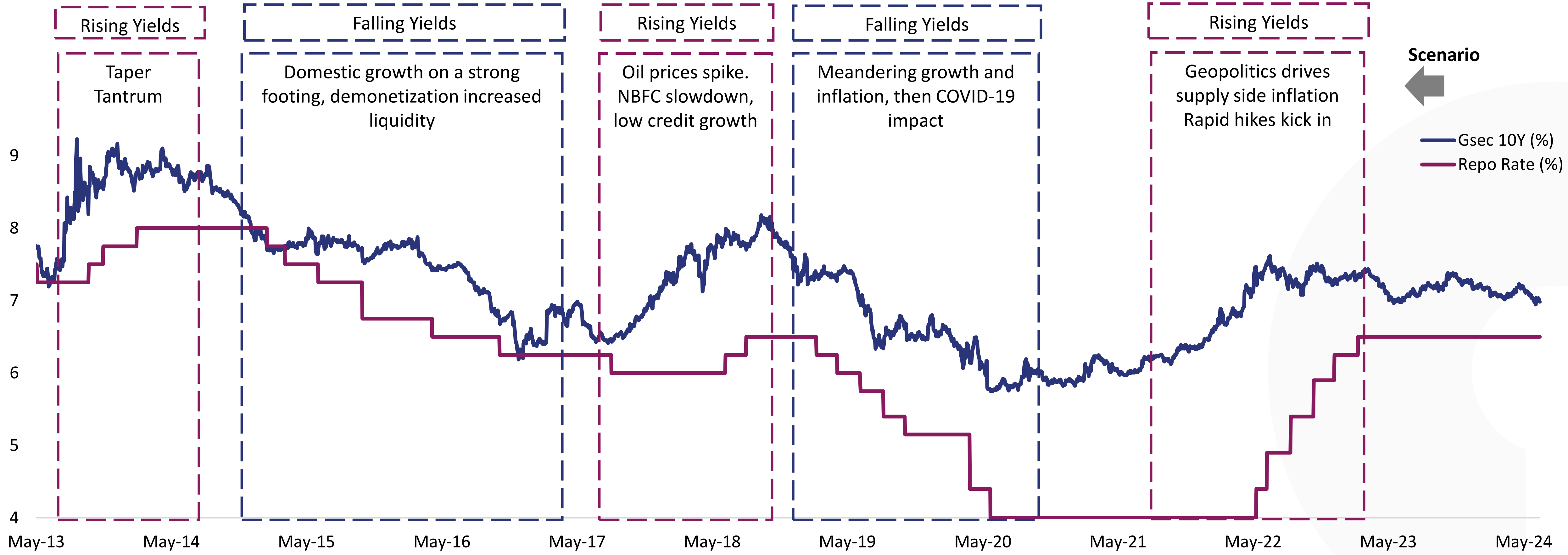


USD-INR depreciated by ~13%; High **CPI**

Currency was remarkably stable as US Fed rates remained low, and oil prices were bottoming

Crude = USD 82/ bbl (from 61); with **USD-INR** depreciate

Real growth decelerated in FY19 & FY20; then COVID-19 led fiscal & monetary stimulus

CPI at 7.8% in Apr'22, with **oil** at USD 127/bbl

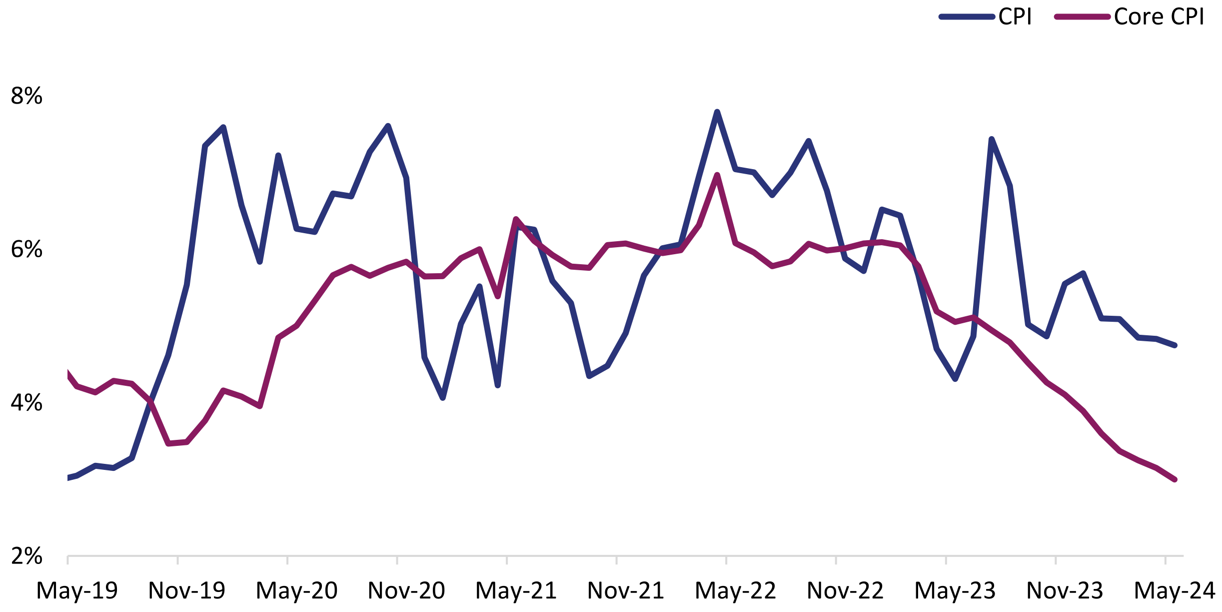
Story in Numbers

Source: Bloomberg, RBI, News Sources, SBICAPS

INFLATION: A RECEDING CORE MAY HELP RBI LAND SMOOTHLY

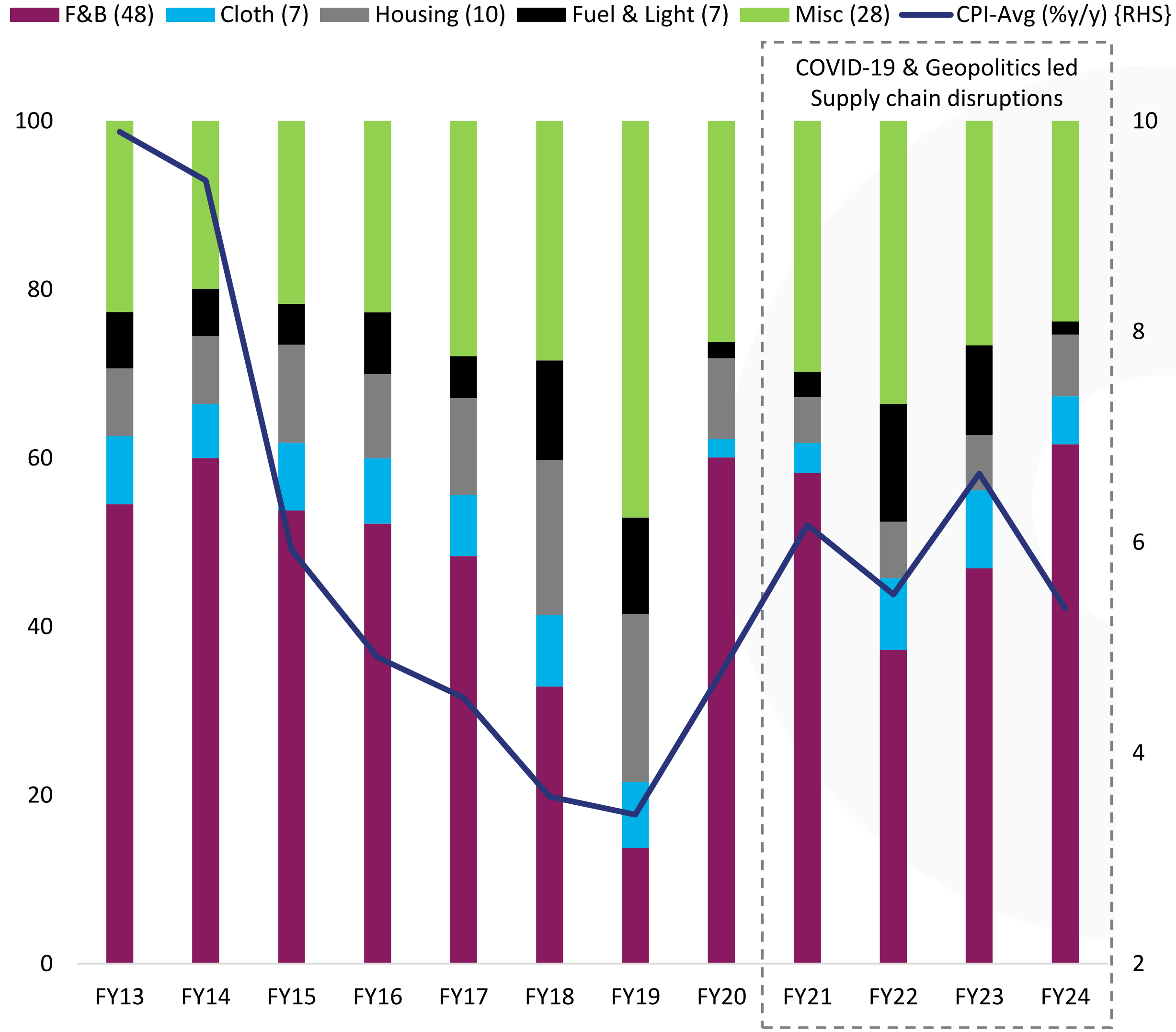
CONSUMER INFLATION GRADUALLY SLOWING, AIDED BY CORE

CPI VS CORE CPI (%Y/Y)



- Headline consumer inflation remained above 4% target of RBI in FY24. It is on a steady decline since Dec'23 and touched a 12-month low in May'24
- Factor keeping headline above target is largely food inflation: in line with historical trends – only in 3 of the past 12 years has food inflation been materially below headline
- Keeping aside the supply driven non-core, Core inflation has dipped secularly as RBI provided a policy leash to ensure demand doesn't couple with supply shock

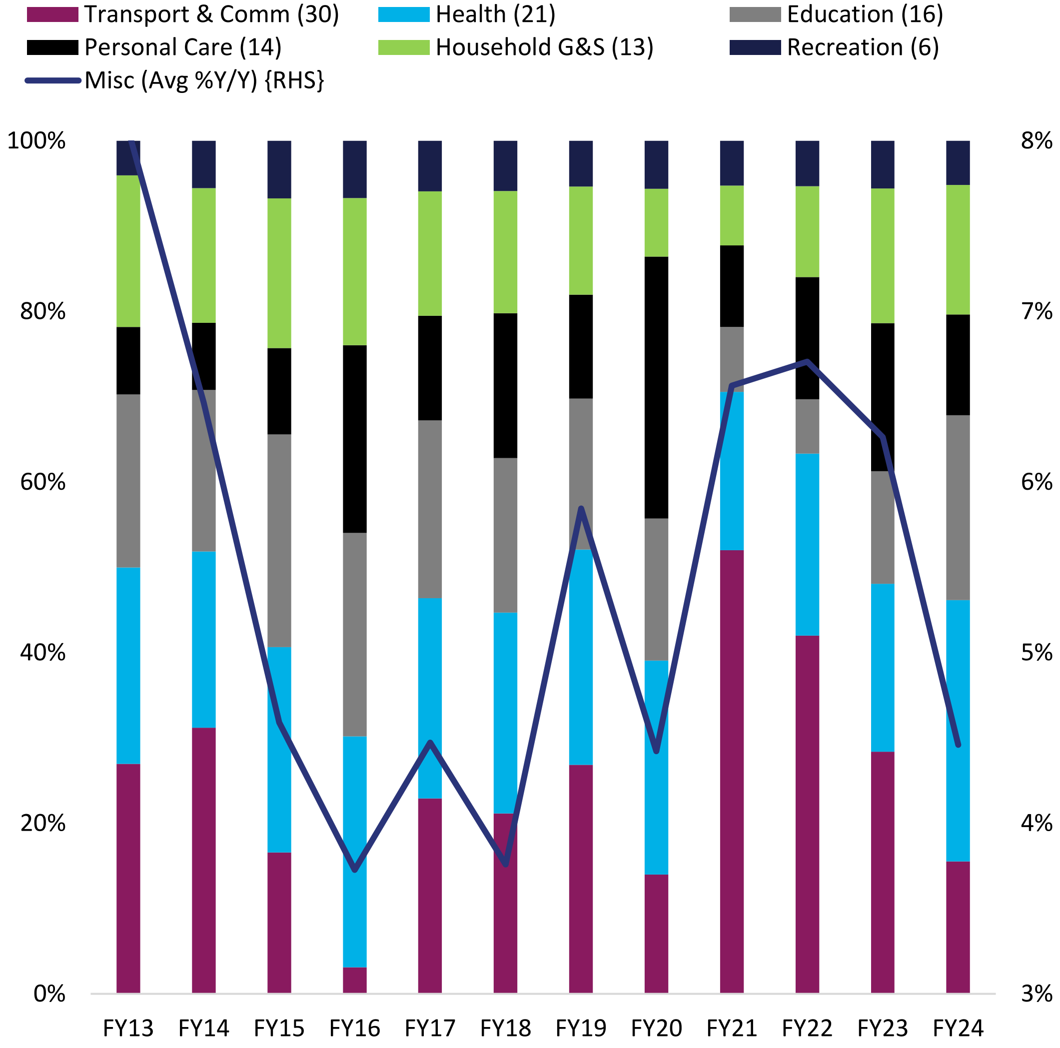
CONTRIBUTION TO Y/Y CHANGE IN CPI (%)



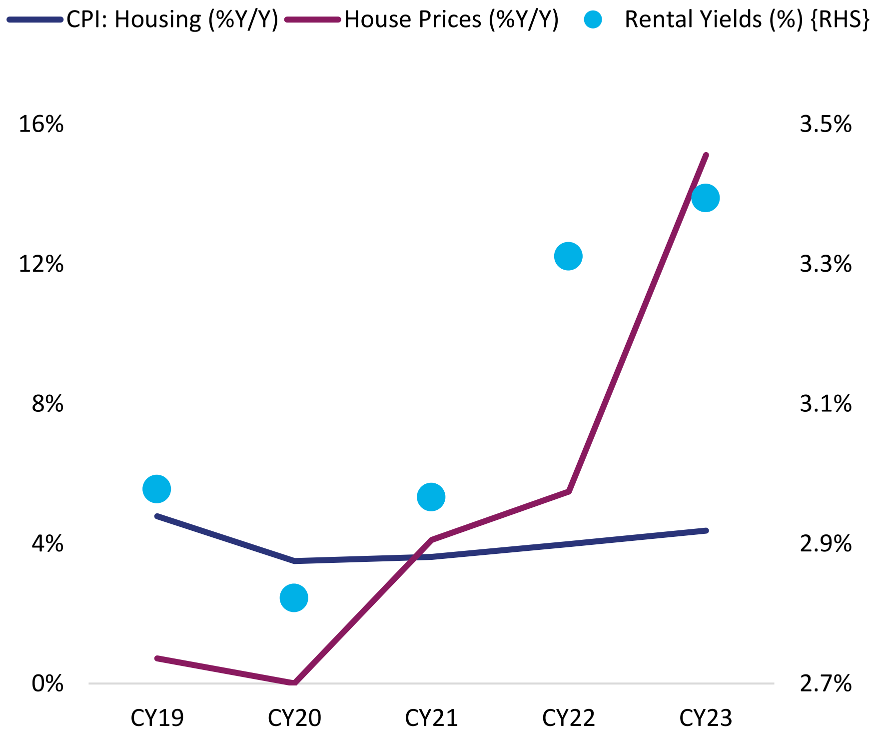
Note: F&B is Food and Beverage, and includes Pan, Tobacco & Intoxicants. Similarly, Cloth includes clothing & footwear; *Source: MoSPI, Bloomberg, SBICAPS*

CORE IN CONTROL, THOUGH NOT WITHOUT UPSIDE RISKS

COMPONENTS OF CPI:MISCELLANEOUS (%)



HOUSING PARAMETERS



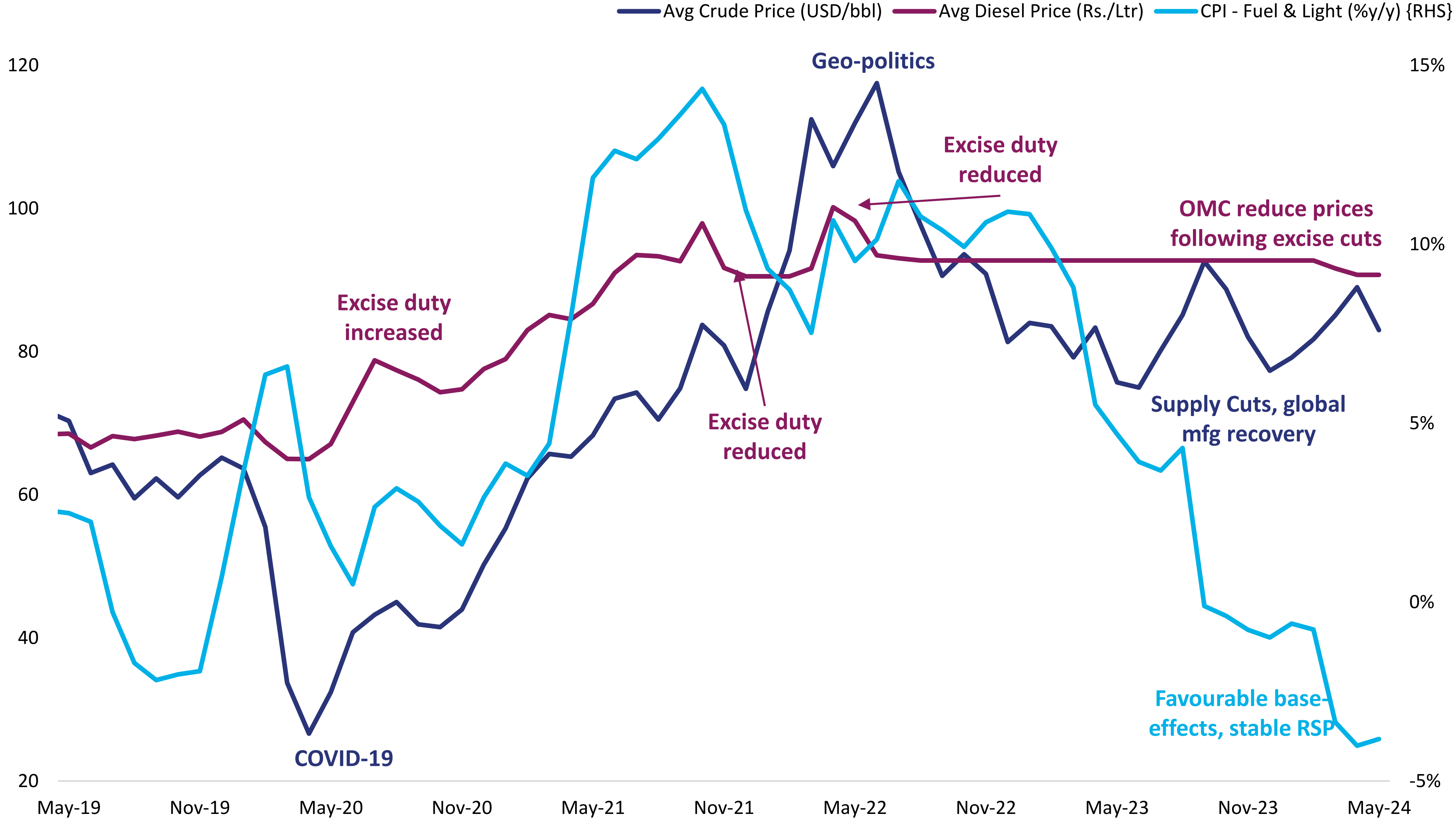
Housing Inflation increase might be higher than Core

- Subdued housing inflation significantly contributed to the containment of Core. However, recent data indicates an upward trajectory in house prices and rental yields
- While house prices are not included in CPI, adjustments in HRAs, renewal of long-term leases made during COVID-19, and forthcoming survey data may impact CPI: Housing

- Rising healthcare costs have ensured it has a contribution to inflation beyond its weight in most years
- Sharp increase in prices of gold and silver will give an upward bias to Core inflation
- Telecom tariff increase could drive up communications inflation, which had been subdued in FY24

FUEL INFLATION TO REMAIN IN CHECK AS MULTIPLE LEVERS ARE AT PLAY

CRUDE'S IMPACTS ON CPI IS MODERATED

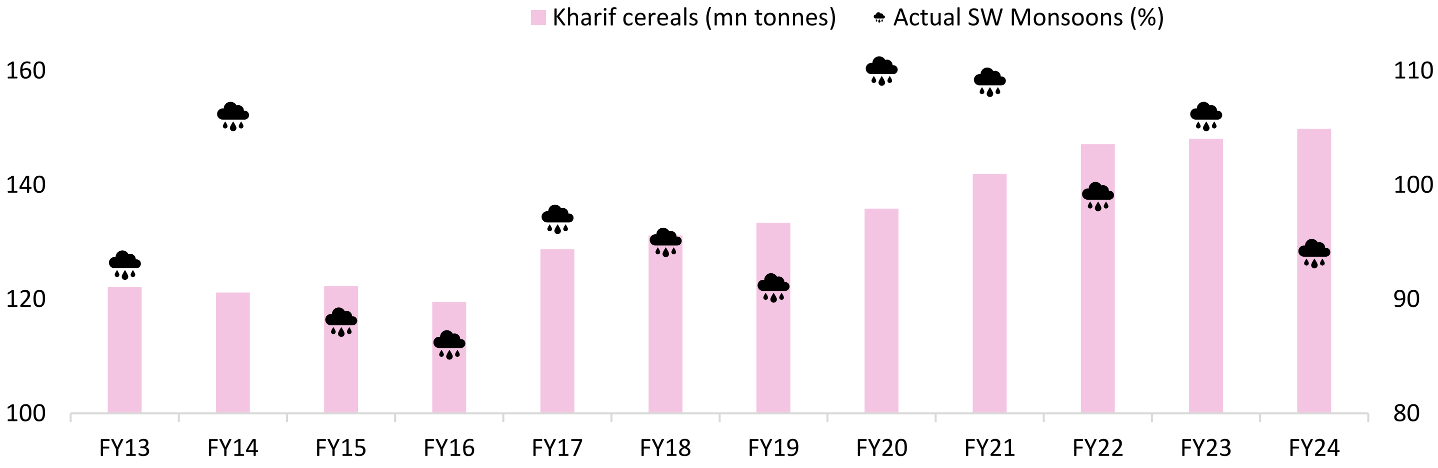


- Crude remains volatile due to supply-side machinations, chiefly OPEC+'s supply cuts and geopolitical strife. Minor supply-demand mismatches are expected as per EIA
- Pass on of global crude prices in India depends on other factors such as levies and duties at State and Union level. Currently, these duties have moderated from past highs
- CPI –Fuel & Light to remain in low single digits in FY25

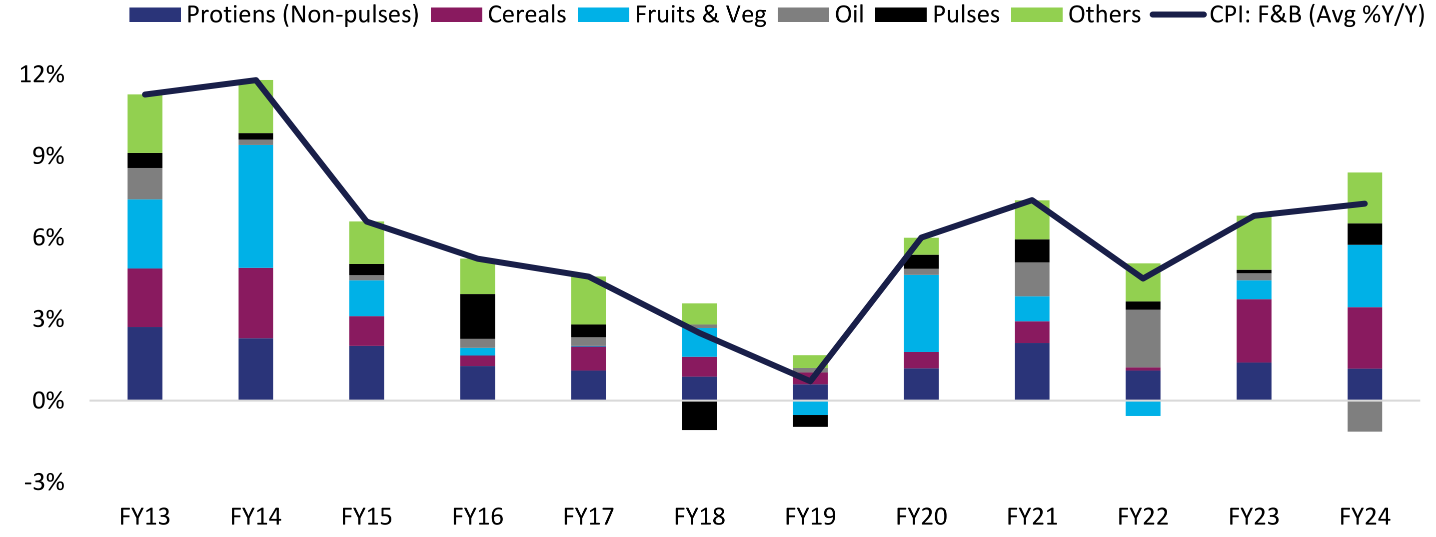
Source: PPAC, MOSPI, Bloomberg, SBICAPS

RAINY RELIEF FOR RISING CEREALS TO REIN IN FOOD INFLATION

KHARIF PRODUCTION (mn tonnes) VS. SW MONSOON (% OF LPA)



CONTRIBUTION OF COMPONENTS OF FOOD INFLATION (Y/Y)



WILL THE PLATE BECOME COSTLIER IN FY25?

Pulses

Protein inflation remains a concern with lower rabi sowing of pulses, which leads to collateral price rise in other protein sources

Fruits and Veg

Seasonal effects and unexpected rain could lead to transitory spikes

Edible Oil

Palm oil prices remain low, helped by base effects. Might impact low base

Cereals

Above avg expected CY24 SW monsoon alongwith buffers with FCI to support prices of rice, despite lower FY24 output & low southern reservoir levels. Wheat stocks may be replenished as UP receives bountiful rainfall & MP having excess reservoir levels

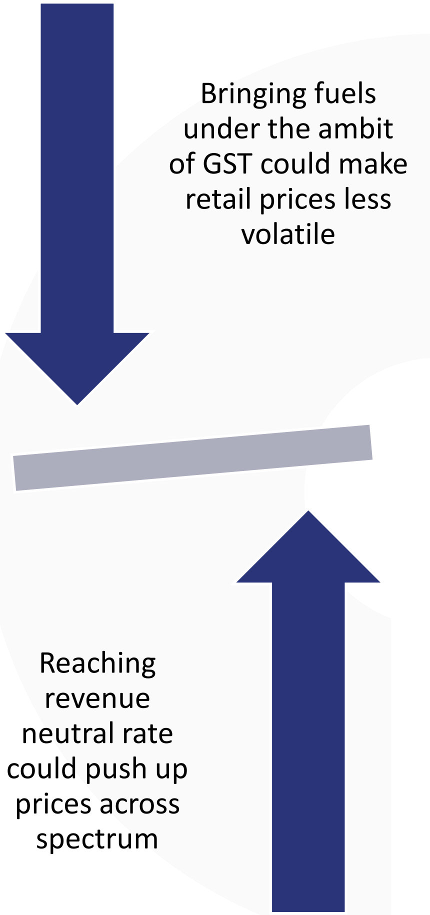
Note: Proteins (Non-pulses) include meat & fish, eggs, and milk & milk products. *Source: IMD, MoSPI, SBICAPS*

CONSUMER INFLATION TO EASE FURTHER IN FY25

OUR FY25 OUTLOOK ON HEADLINE INFLATION

NON-CORE	**Food & Beverages**	• Food inflation is expected to print lower than FY24 average (7% y/y) helped by expected above normal SW monsoon, decent FCI rice buffers, extension of PMGKAY, besides favourable base effects • Reduction in wheat import duties could be done if needed • Monthly volatility will remain if heatwave/unseasonal rain impact sown vegetables • Protein inflation to remain volatile
	Fuel & Light	• Volatility in crude oil prices is expected to be transitory, as supply-demand are expected to remain in balance, as mellow global growth meets OPEC cuts. Geopolitical tension remains a upside risk • Levers such as excise and other levies remain to manage retail fuel prices. Thus, no major increases are expected in liquid fuels or LPG
CORE	**Housing**	House prices are not included in CPI, but as HRAs adjust, longer agreements entered during COVID renew, and fresh surveys happen, housing CPI prints might be impacted
	Health	Rising healthcare costs have ensured it has contribution to inflation beyond its weight in most years. This trend is likely to continue
	Other Miscellaneous	• Expected hike in telecom tariffs after years of subdued prices could pinch transport and communication • Skyrocketing gold and silver prices will also impact inflation

THE GST QUESTION?



We expect CPI to average at 4.7% for FY25 (from 5.4% in FY24) with risks evenly balanced, though actual spatial and temporal distribution of monsoons' impact on food, and volatility induced in crude due to any renewed geopolitical tensions cloud our outlook.

GLOBAL GROWTH-POLICY DYNAMIC: AVOIDING AIRPOCKETS

GLOBAL GROWTH HAS SMOOTHLY CRUISED TILL NOW

RESILIENT GROWTH FORECASTS (% Y/Y)

	Apr-24			Apr-23		
	CY23E	CY24P	CY25P	CY22E	CY23P	CY24P
World	**3.2**	**3.2**	**3.2**	**3.4**	**2.8**	**3.0**
Advanced Markets	**1.6**	**1.7**	**1.8**	**2.7**	**1.3**	**1.4**
US	2.5	2.7	1.9	2.1	1.6	1.1
Euro-area	0.4	0.8	1.5	3.5	0.8	1.4
Japan	1.9	0.9	1.0	1.1	1.3	1.0
Emerging Markets	**4.3**	**4.2**	**4.2**	**4.0**	**3.9**	**4.2**
China	5.2	5.0	4.5	3.0	5.2	4.5
India	7.8	6.8	6.5	6.8	5.9	6.3

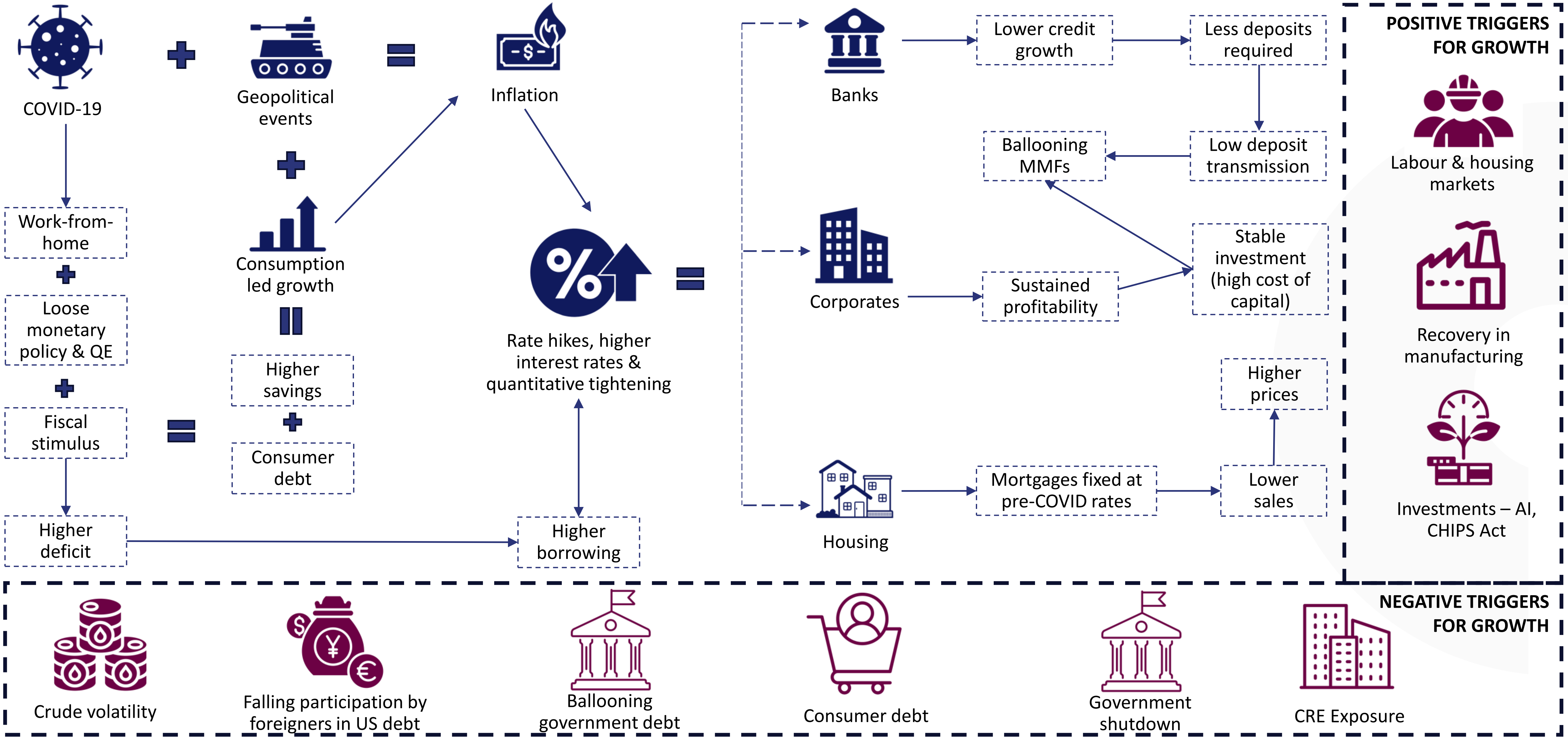
- Resilient economic activity throughout CY22–23, defied slowdown concerns, led by consumption and fiscal exuberance
- Fiscal exuberance came at a cost of higher debt amid rising rates, esp. for developing economies, already under pressure of slowing trade
- Flailing growth & decelerating inflation might lead monetary easing. Headline inflation to fall from annual average of 6.8% in CY23 to 5.9% in CY24 and 4.5% in CY25, with a front-loaded decline led by AE

30,000 FT OVERVIEW OF GLOBAL MACRO-ECONOMY

	Central Bank	Growth	Inflation	Key Driver/ Event
US	Cut expectations pushed forward	Consumption led growth stabilizing	Dis-inflationary progress slowing	Strong labour, CRE & ballooning govt debt
China	Loose policy to support growth	Expected strong recovery	Deflationary pressures easing	Housing market & local govt debt
Euro-area	Trajectory after Jun'24 cut uncertain	Out of recession, rate easing required	Easing – labour market & energy	Energy prices, and geopolitics
Japan	Negative interest rate policy removed	Weak consumption and external demand	Decelerating, below 2% target now	Wage & pay growth, currency volatility

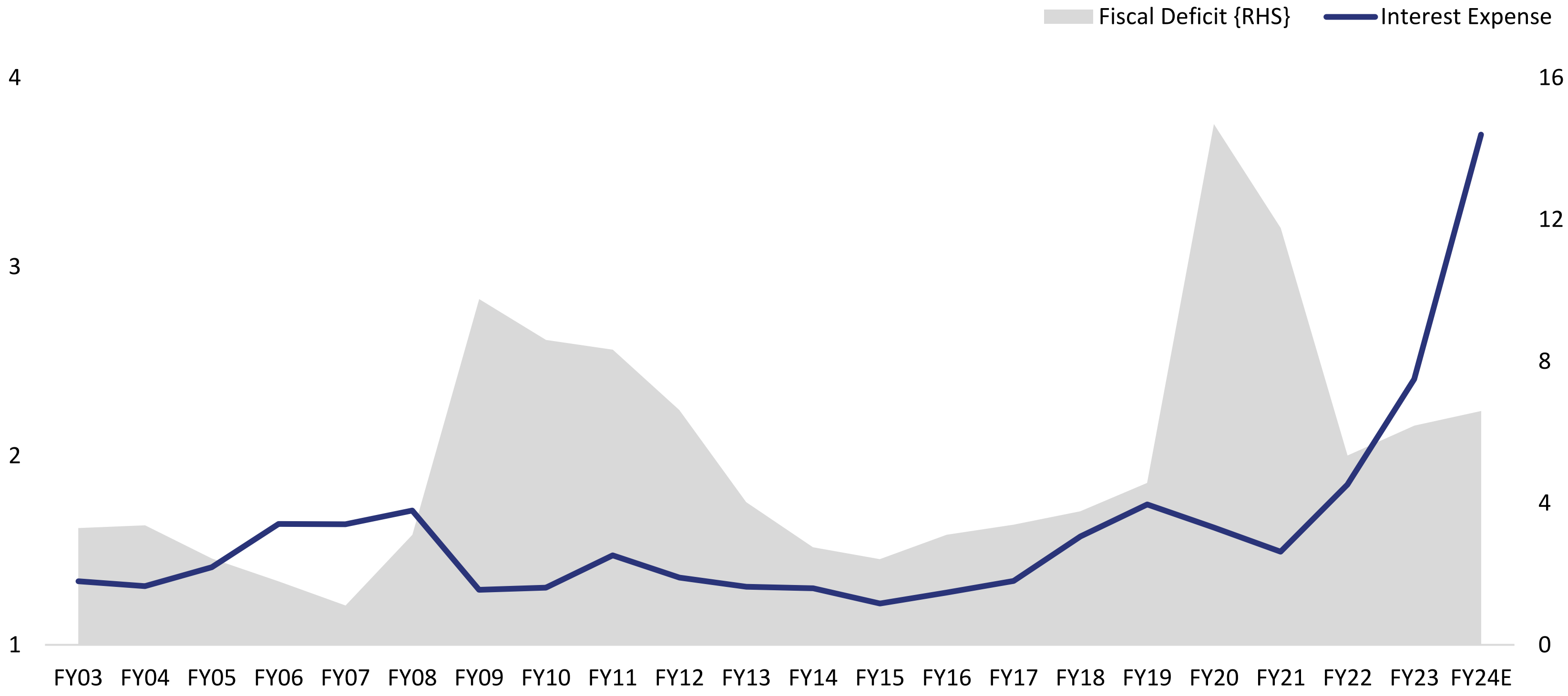
*India's growth numbers are on Apr-Mar basis. For instance, CY23 represents FY24. *Source: IMF, Bloomberg, News Sources, SBICAPS*

PENT UP SAVINGS LEND UNCANNY STRENGTH TO US GROWTH…

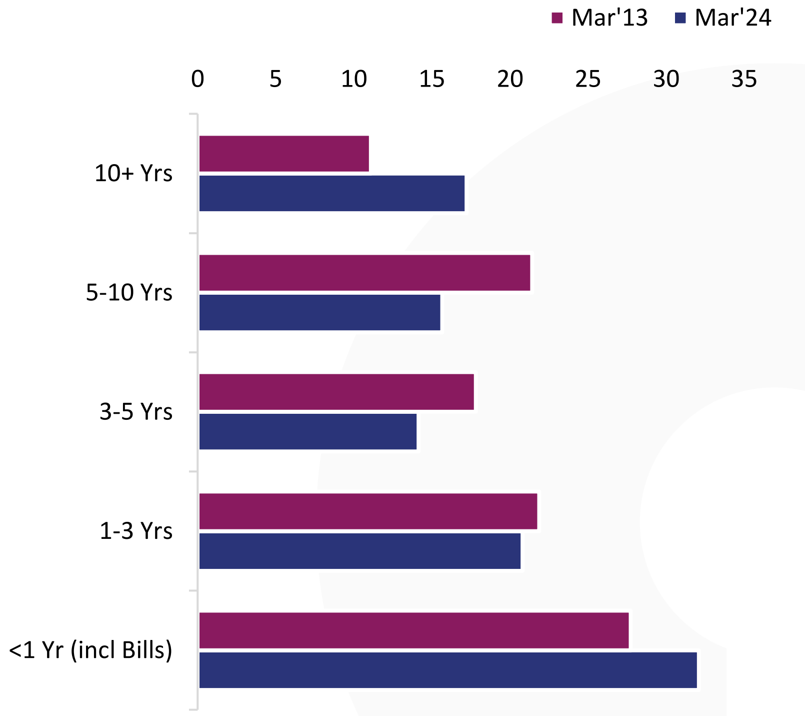


… AMIDST BALLOONING US GOVERNMENT DEBT & INTEREST COSTS…

KEY RATIOS AS % OF GDP (US)



MATURITY PROFILE OF UST DEBT O/S (%)

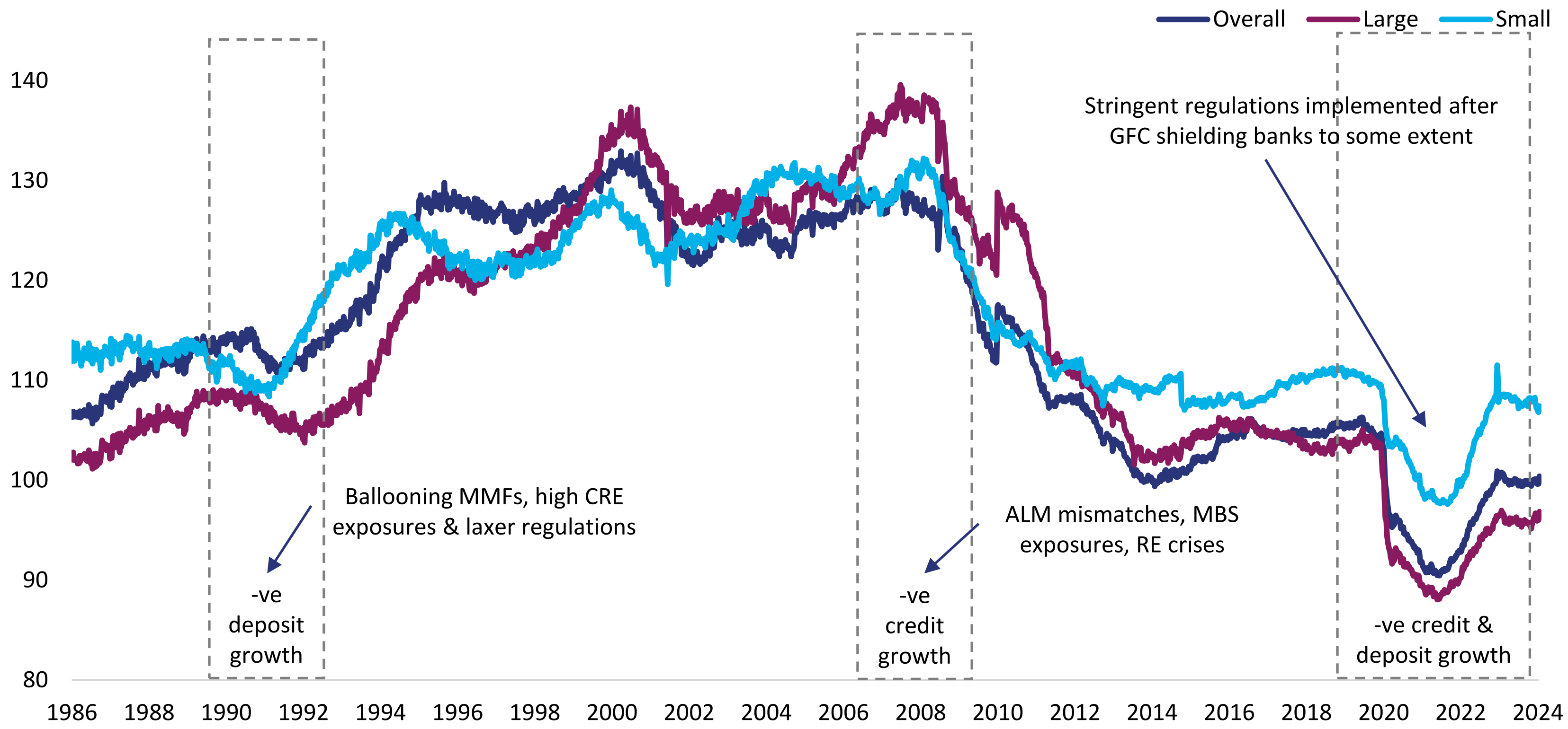


- Fiscal deficit has remained high since COVID-19, with heavy spends on net interest and social security. Deficit will rise even further in FY24 despite assumed growth in taxes (esp. personal)
- Govt. Debt stands at 122% of GDP (vs. 63% in FY07 & 84% in FY09) currently, with 30%+ debt up for refinancing at relatively higher rates even if 1-2 cuts take place
- Interest as a % of GDP stands at multi-decadal high of 3.7% in Q2FY24 and is expected to increase to 4+% in FY24, levels last seen in 1980s

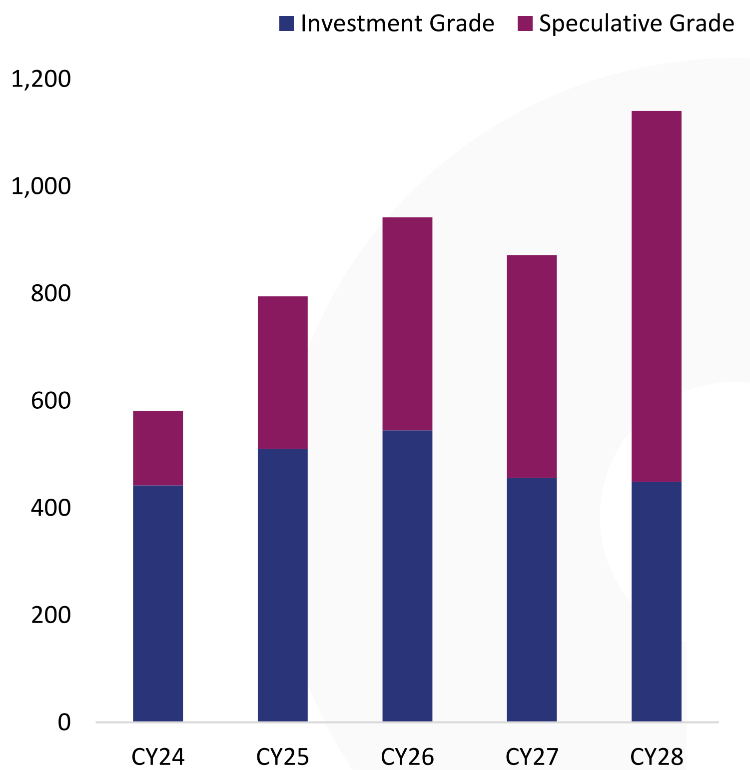
Note: FY refers to Oct-Sep period. *Source: Fred, US Treasury, SBICAPS*

…WHICH COULD SNOWBALL INTO A TWIN BALANCE SHEET PROBLEM

CREDIT-DEPOSIT RATIO OF BANKS



CORPORATE DEBT MATURITIES (USD bn.)



- Stronger regulations now vs. GFC mean that chances of a complete meltdown remain remote unless there is concurrence of multiple crises such as failure of small banks and crystallisation of stress in CRE
- Currently, banks face both low deposit and credit growth as MMFs are ballooning, and costs of capital remain high. Interestingly, small bank deposits are growing as they offer higher rates and FDIC insurance, despite having higher CRE exposures
- Growth in corporate profitability is sustained currently, led by large companies. In the lower tier, defaults have risen by 80% y/y from CY23 levels. Despite spreads remaining low amid high interest rates, a slew of corporate maturities and thereby refinancing might dent profitability and capex spends, with a lagged impact on labour markets

Source: US Fed, BEA, S&P, News Sources, SBICAPS

US INFLATION REMAINS STIFF, ADDING RISK OF STAGFLATION

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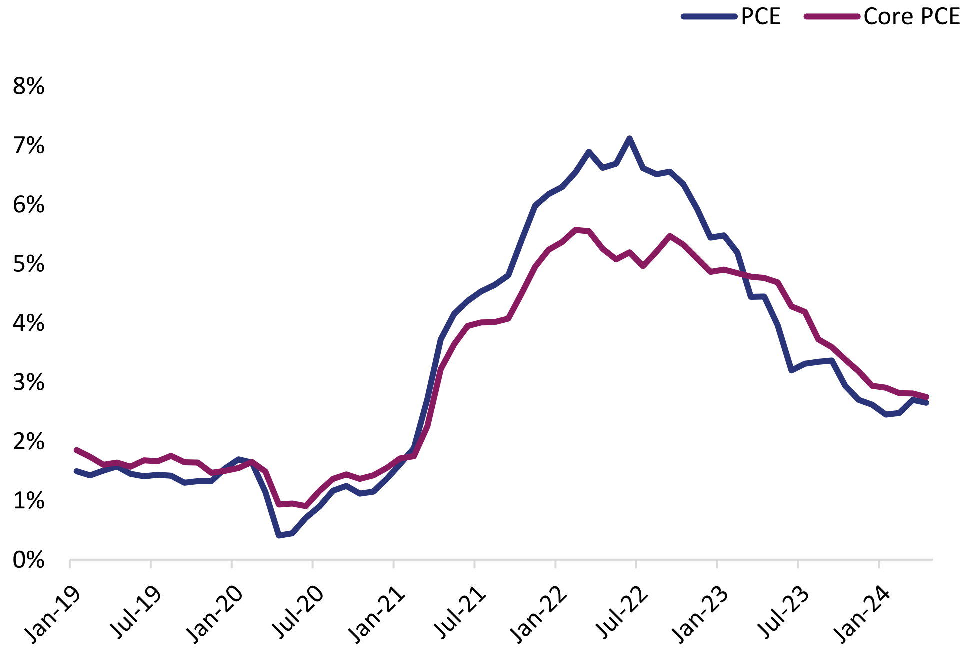
PCE VS CORE PCE (%Y/Y)



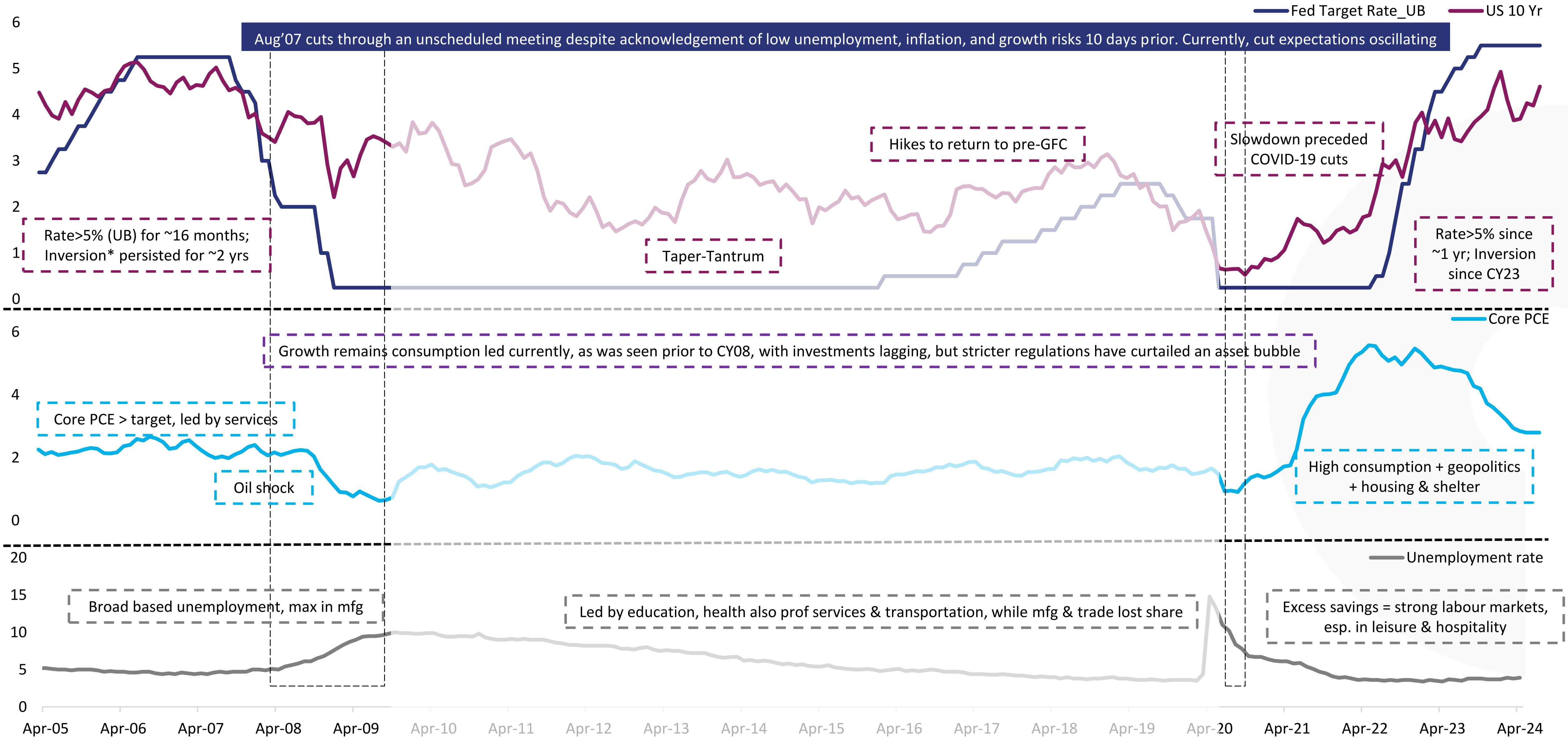
KEY COMPONENTS OF PCE

		Contributors to PCE (Avg %Y/Y)						
	Avg Wt	CY19	CY20	CY21	CY22	CY23	4MCY23	4MCY24
Energy Goods & Services	5%							
Food	8%							
Housing	16%							
PCE Excl. Housing, Food & Energy	***72%***							
Accomodation & Hospitality	7%							
Financial Services	8%							
Transport & Recreation	***14%***							
Transport Services	3%							
Recreation Services	4%							
Healthcare Services	17%							
Others	***27%***							

Note: Red indicates high contribution to PCE, while blue indicates lower/negative contribution

- US PCE index has cooled materially from the highs of Mar'22, led by dipping energy and food prices, and base effects in core categories. Core remained higher than headline for more than a year, before second round effects led to its convergence with the headline
- High housing inflation, particularly, has contributed to the stalled progress on Core. With homeowners fixing mortgage at lower rates thereby being reluctant to sell, prices and rents have remained escalated. Once labour and housing markets cool, pressures on Core are expected to abate

WILL HISTORY REPEAT ITSELF FOR US FED RATES?



Note: Dotted area represents recession. *Inversion is defined as US Fed > US 10 Yr.; *Source: Bloomberg, SBICAPS*

UNCERTAINTY PERVADES TIMELINE FOR RATE CUTS..

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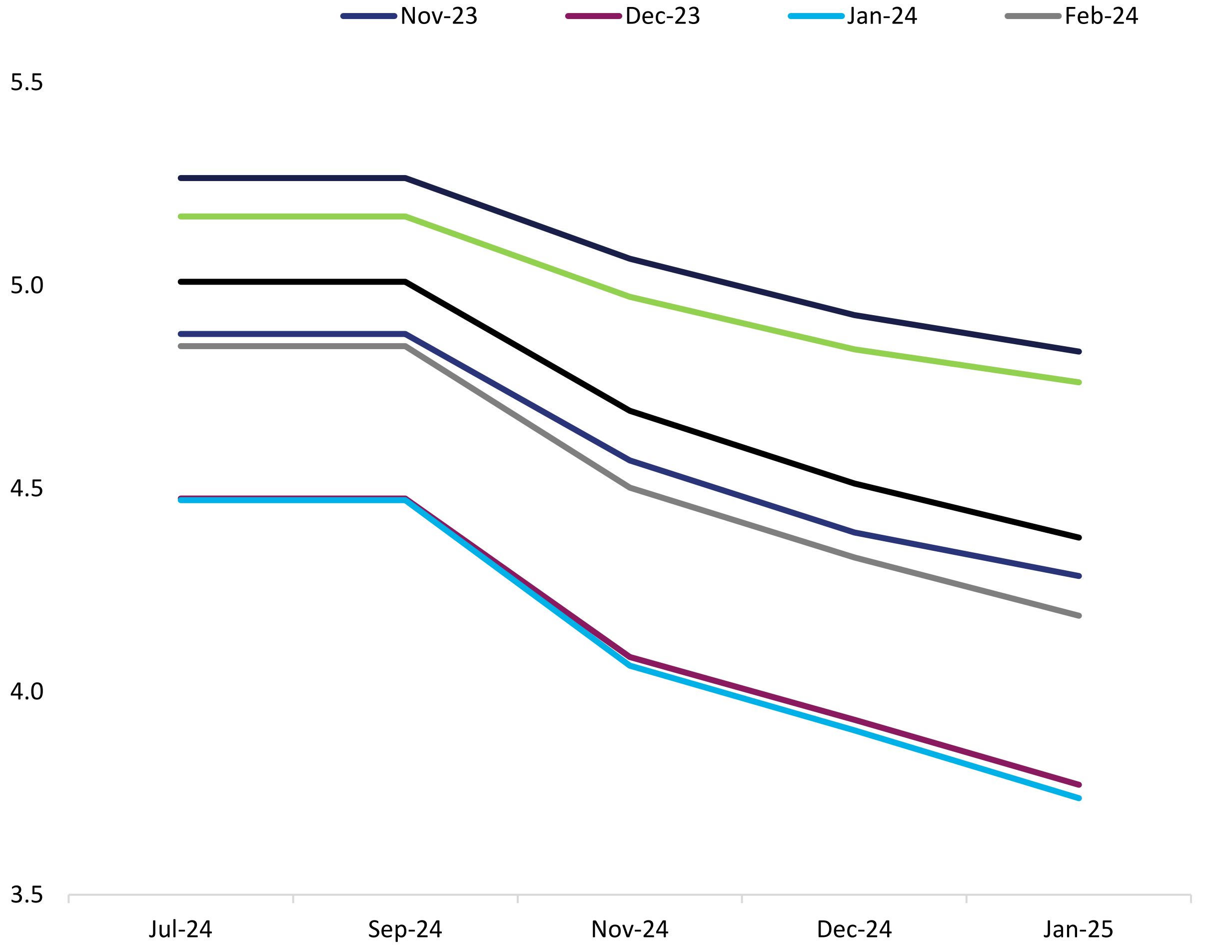
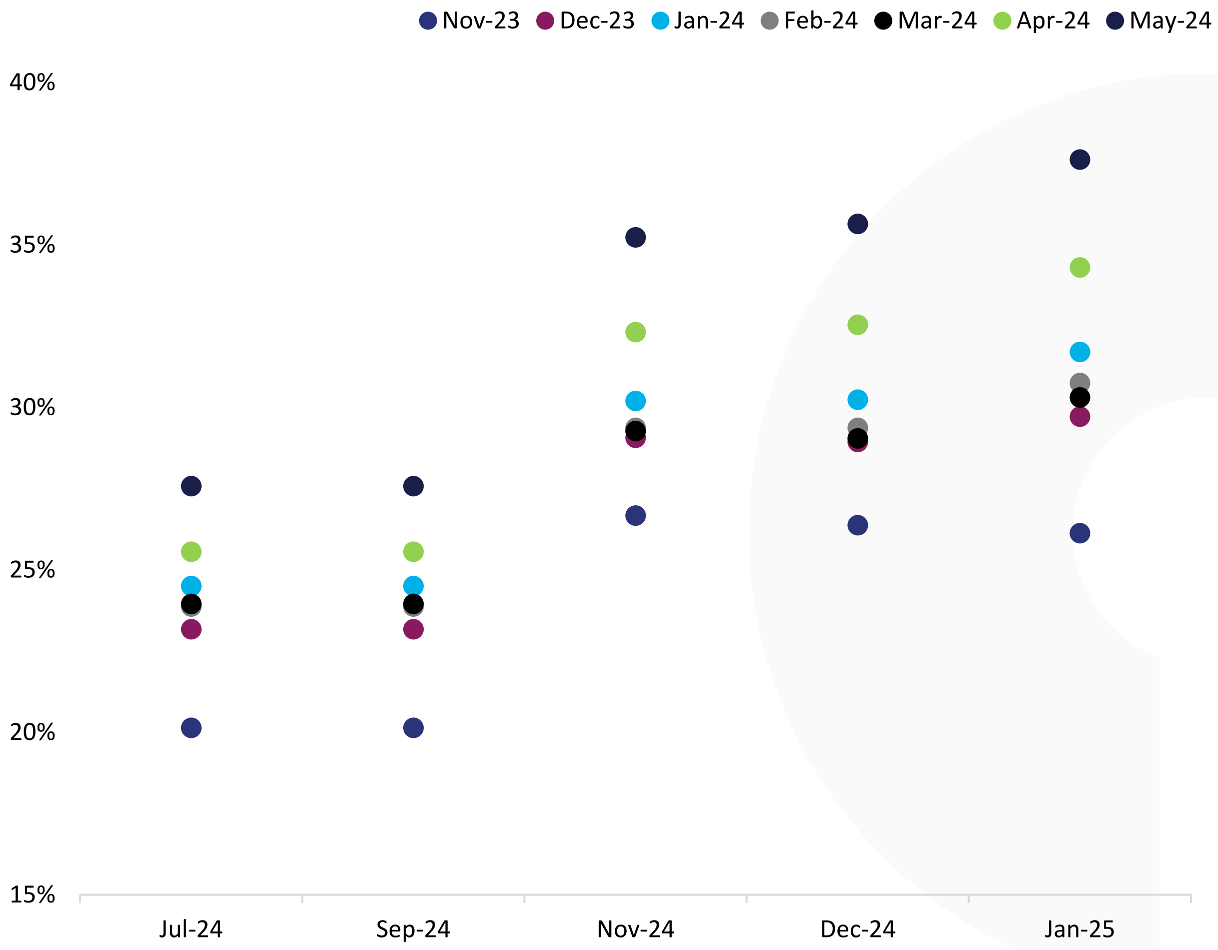
AVERAGE MARKET PREDICTION OF FED'S FUTURE POLICY PATH (%)



VOLATILITY OF MARKET PREDICTION (%)



Market expectations of cuts have not only shifted forward, but they have also oscillated rapidly. This means volatility of market expectations of Fed fund rates is not only high for later FOMCs, but it has also risen significantly over the past 6 months, more when the FOMC approaches

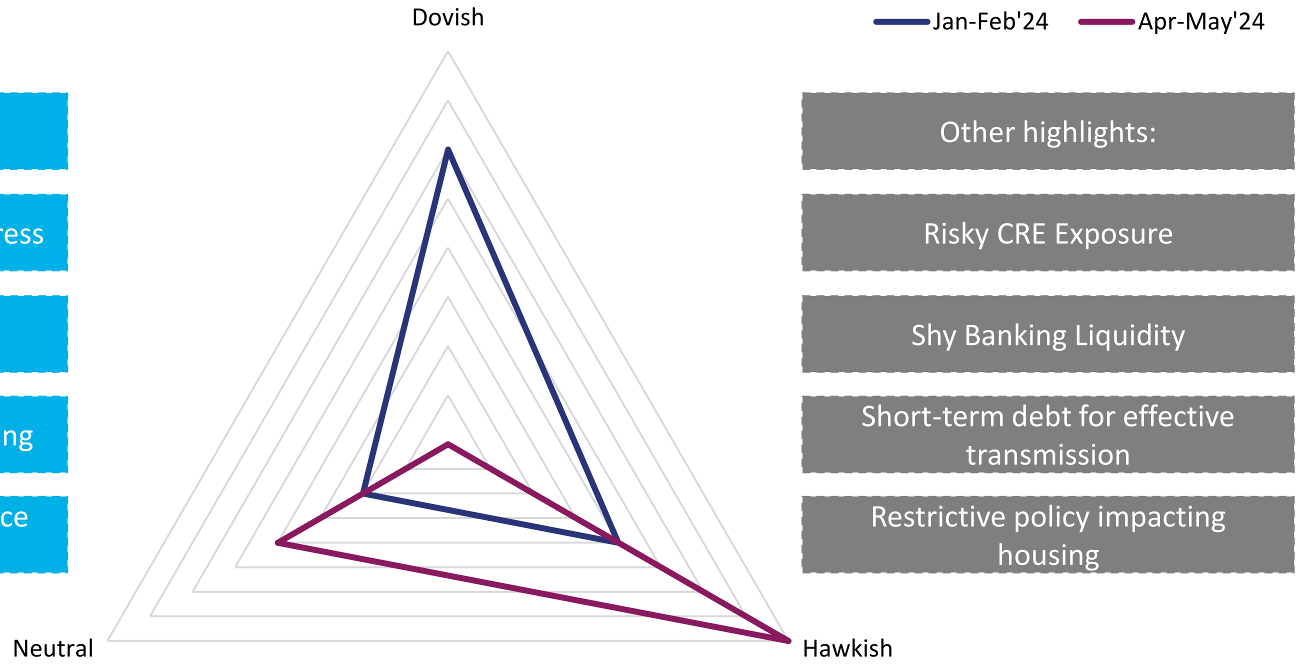
Source: Bloomberg, SBICAPS

.. AS POLICY-SPEAK AND POLICY-ACTION DIVERGE AT CRITICAL MOMENTS

POLICY SPEAK HAS TURNED MORE HAWKISH

Underlying factors:

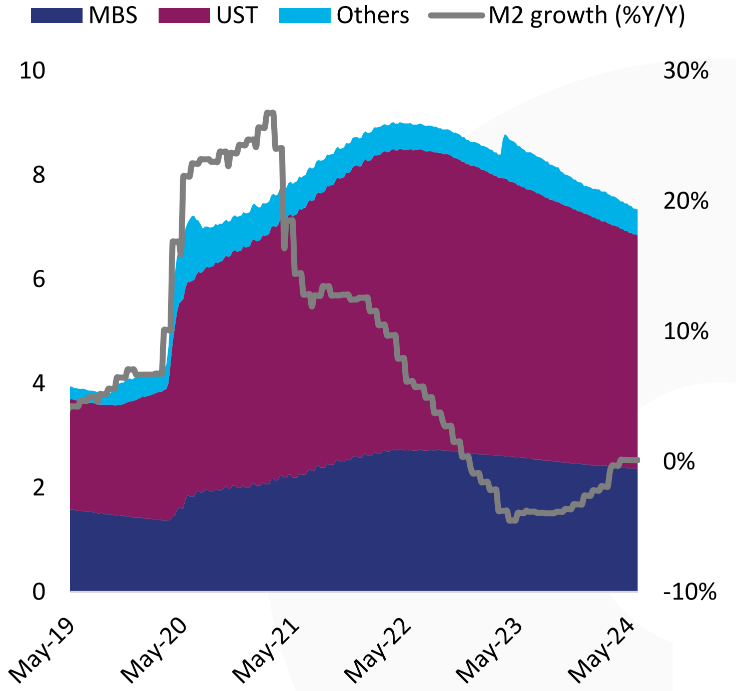
- Slowdown in dis-inflation progress
- Economy still resilient
- Labour markets pressures easing
- Contracting pace of Fed balance sheet taper-off



Other highlights:

- Risky CRE Exposure
- Shy Banking Liquidity
- Short-term debt for effective transmission
- Restrictive policy impacting housing

FED BALANCE SHEET (USD trn.)



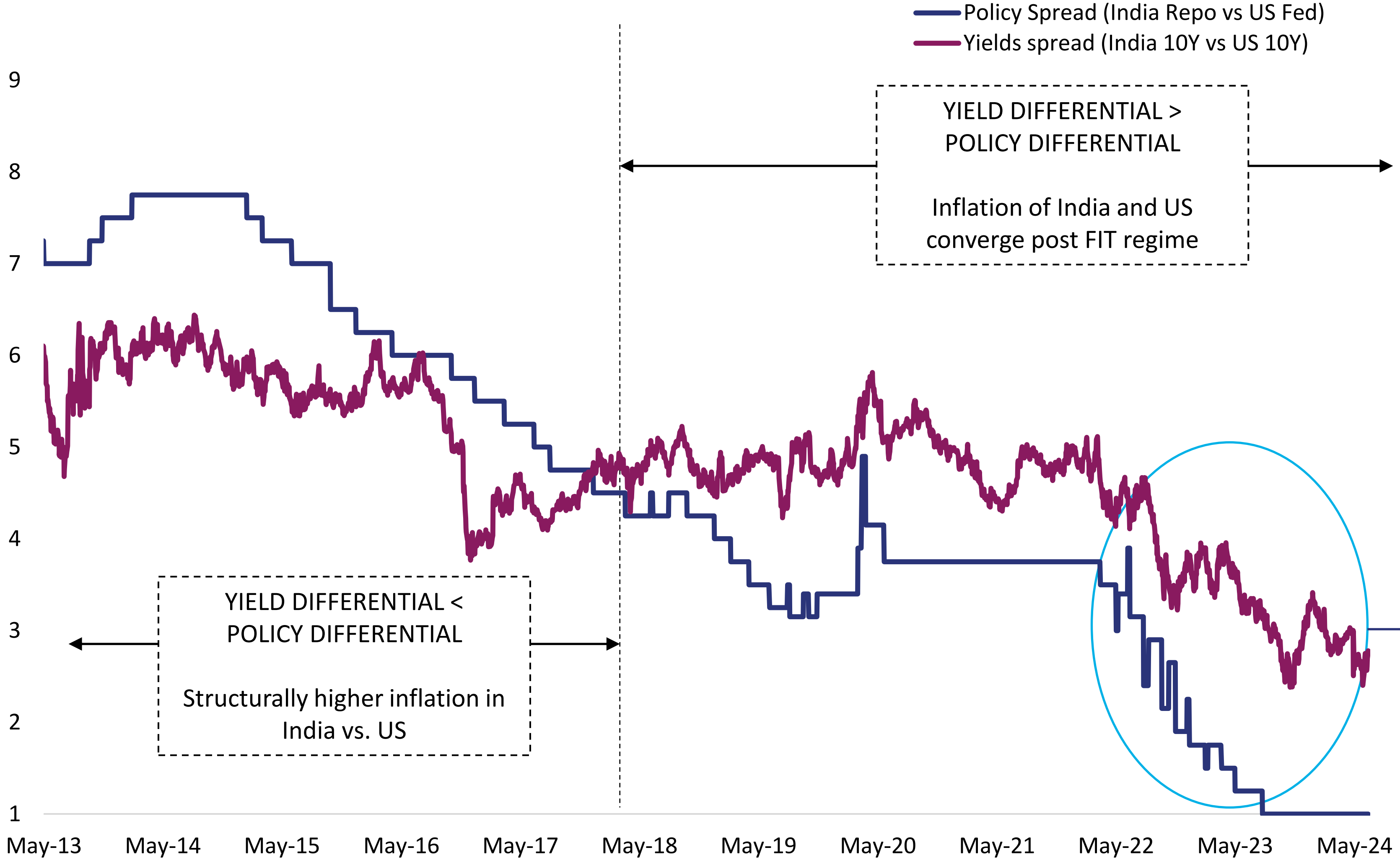
- Fed's actions and policyspeak has been quite contrasting over the recent past. While, majority of the policy-makers turned hawkish before the FOMC, announced reduction in balance sheet taper-off and signal of 'no-hikes' was perceived dovish by the markets. As evident in a positive M2 growth, after being negative since most of CY23, conditions seem to be easing
- 1-2 cuts are priced in by markets with wildly oscillating expectations, which is led by inflation prints amid conflicting actions and policyspeak. Even if Fed delivers 2 cuts in CY24, high absolute rates may pass through on mortgages and debt soon. We believe that pro-longed 'higher for longer' (despite 1-2 cuts) may lead to 'lower and faster, but later' by mid-CY25

Source: US Fed, News Sources, SBICAPS

EXTERNAL BUFFERS: TO HELP BRACE FOR IMPACT

INDIA-US YIELD SPREADS NEAR ALL TIME LOWS

POLICY AND YIELDS SPREAD (PP)



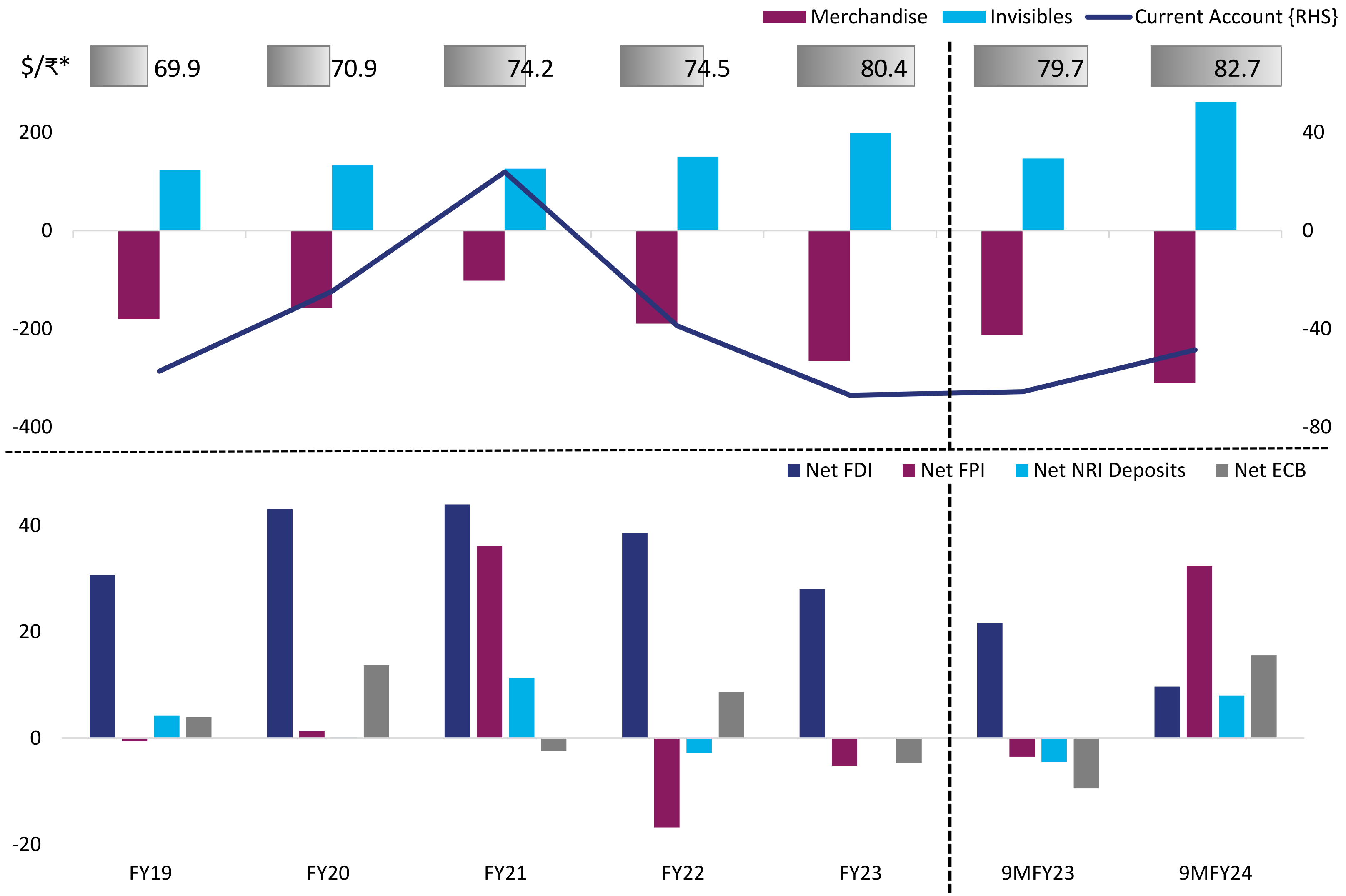
DRIVERS OF LOW SPREADS

- Strong domestic macros push risk premiums downward
- Higher inflation in US due to record fiscal deficit
- RBI's judicious use of forex reserves has lowered Indian currency volatility
- Controlled fiscal and current account deficit in India

Source: RBI, Bloomberg, News Sources, SBICAPS

EVEN SO, CAPITAL FLOWS RELATIVELY STRONGER (THAN OTHER EM), LIMITING CAD

CURRENT ACCOUNT AND KEY CAPITAL FLOWS (USD bn.)



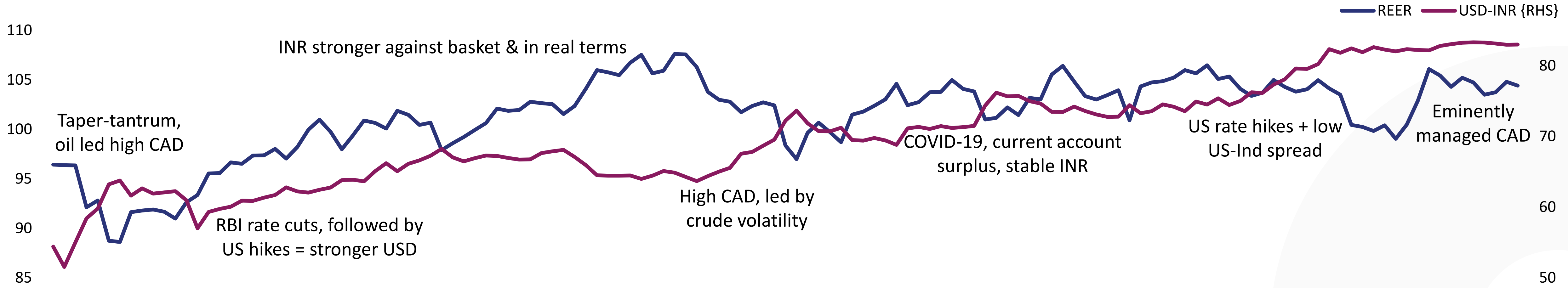
- FY24 CAD has been eminently managed, expected within ~1% of GDP vs 2% in FY23 and LTA of ~1.5%
- This was led by robust service exports, lower merchandise deficit, and positive externalities in oil
- We expect FY25 CAD closer to FY24 levels

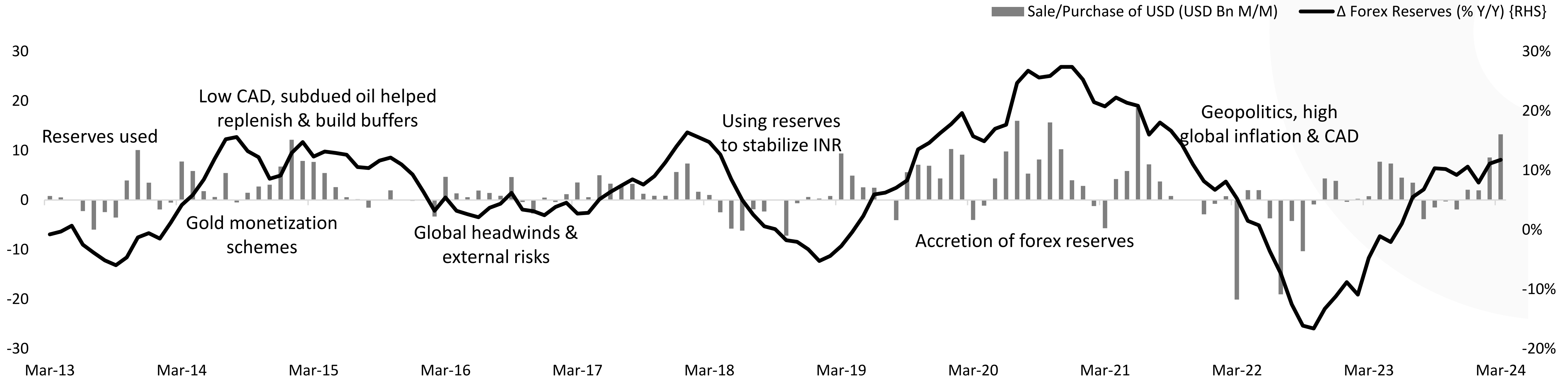
- India has outperformed other EMs with respect to FDI inflows, despite them being subdued until 9MFY24
- FPIs were also net buyers after being sellers over past couple years, led by bond inclusion & equity inflows
- Similar trend was observed in ECBs and NRI deposits, despite thin difference between global and Indian rates

Note: *The exchange rate is an average of RBI reference rate for the time-period mentioned. *Source: RBI, Bloomberg, SBICAPS*

FOREX BUFFERS SHIELD INR FROM SHARP DEPRECIATION IN CURRENT CYCLE

INR - ONE OF THE MOST STABLE OF CURRENCIES AMONG EMs, ALLOWING RBI TO CONSCIOUSLY BUILD BUFFERS FOR A RAINY DAY

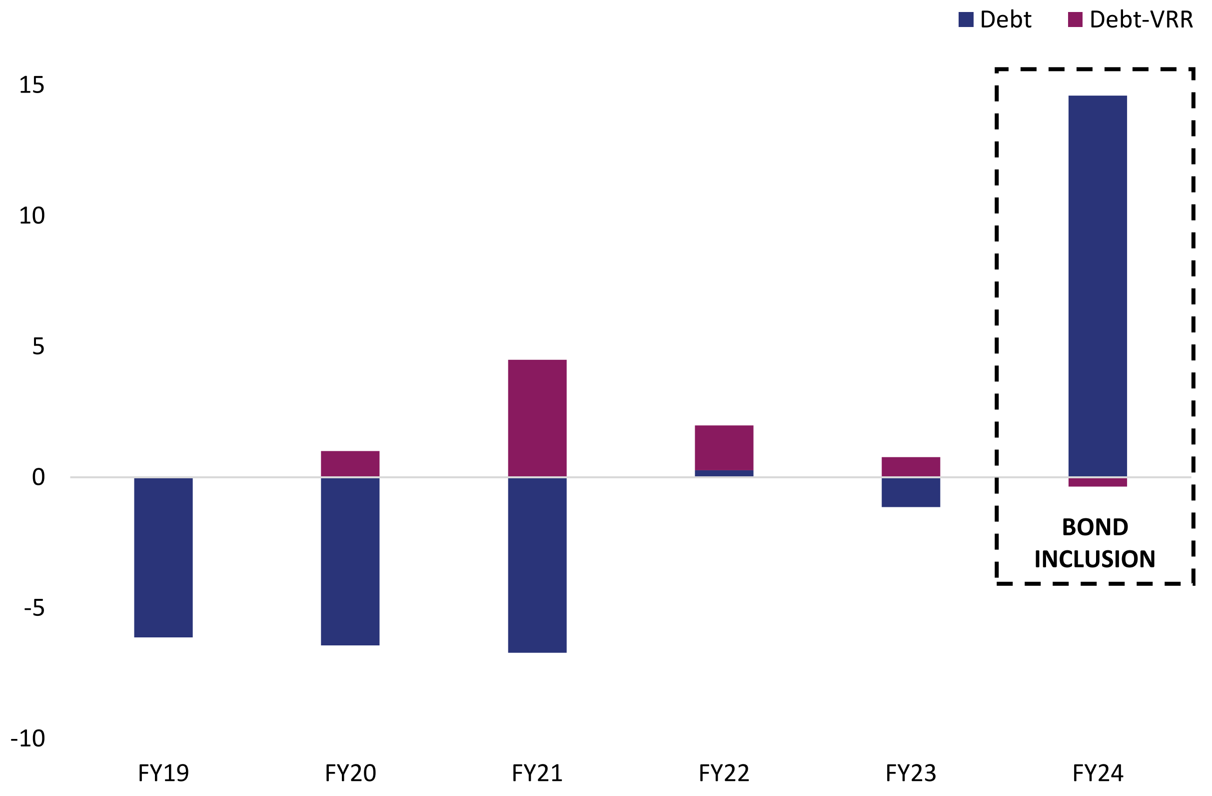




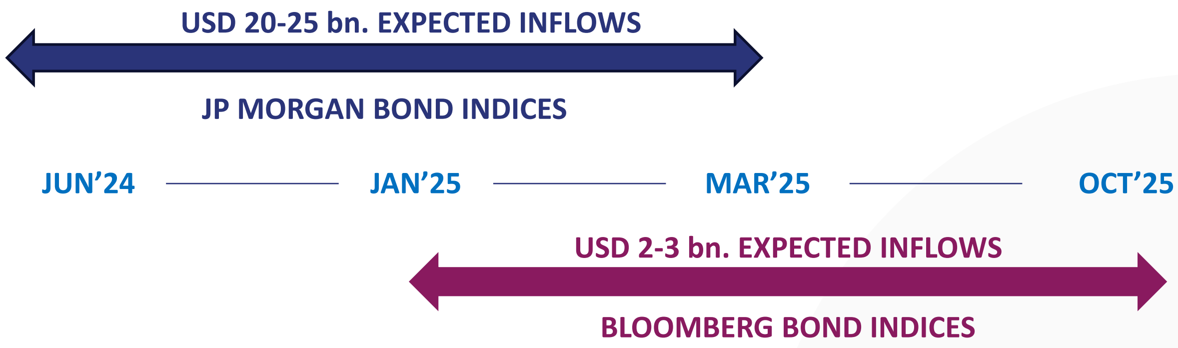
Source: RBI, SBICAPS

BOND INDEX INCLUSION TO FURTHER BUTTRESS CAPITAL FLOWS IN FY25

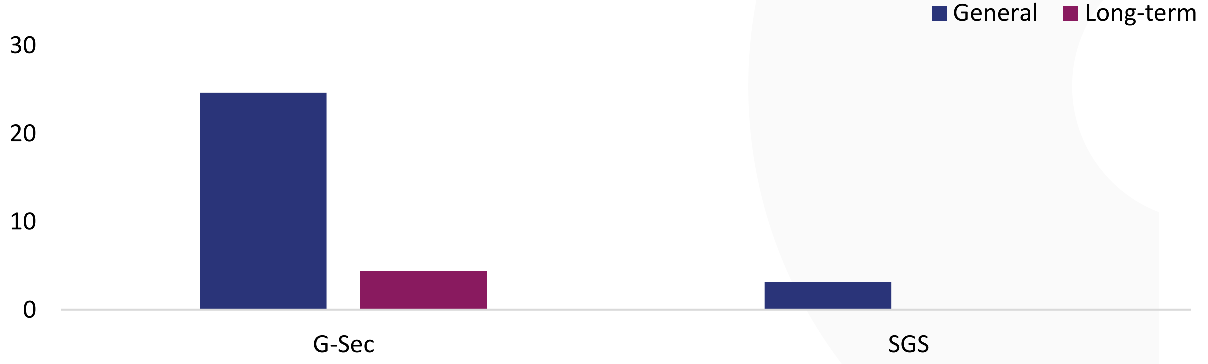
NET FPI DEBT INFLOWS (USD bn.)



INFLOWS EXPECTED DUE TO INDEX INCLUSION



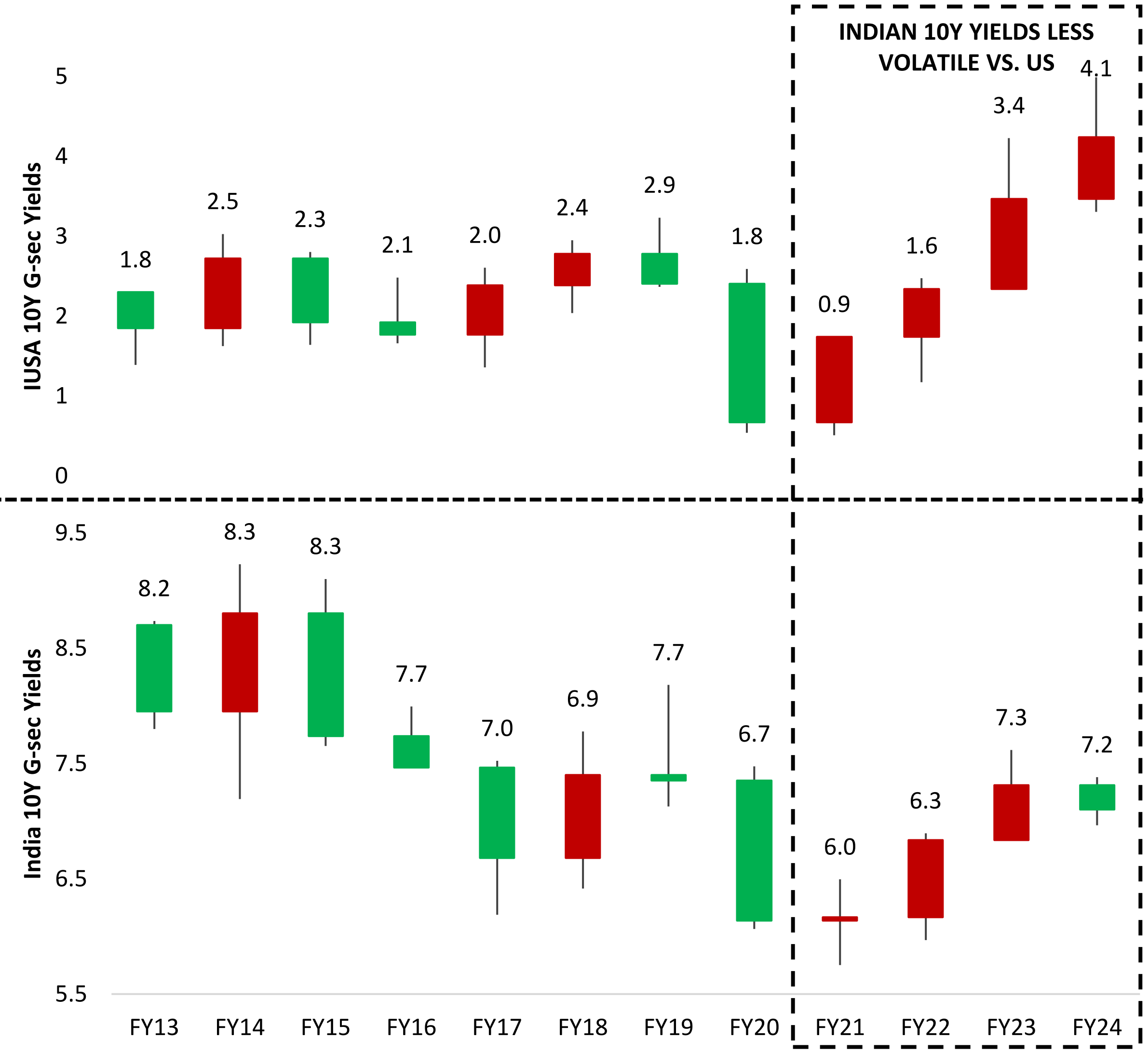
LIMITS' UTILISATION BY FPI (%) AS ON MAY'24



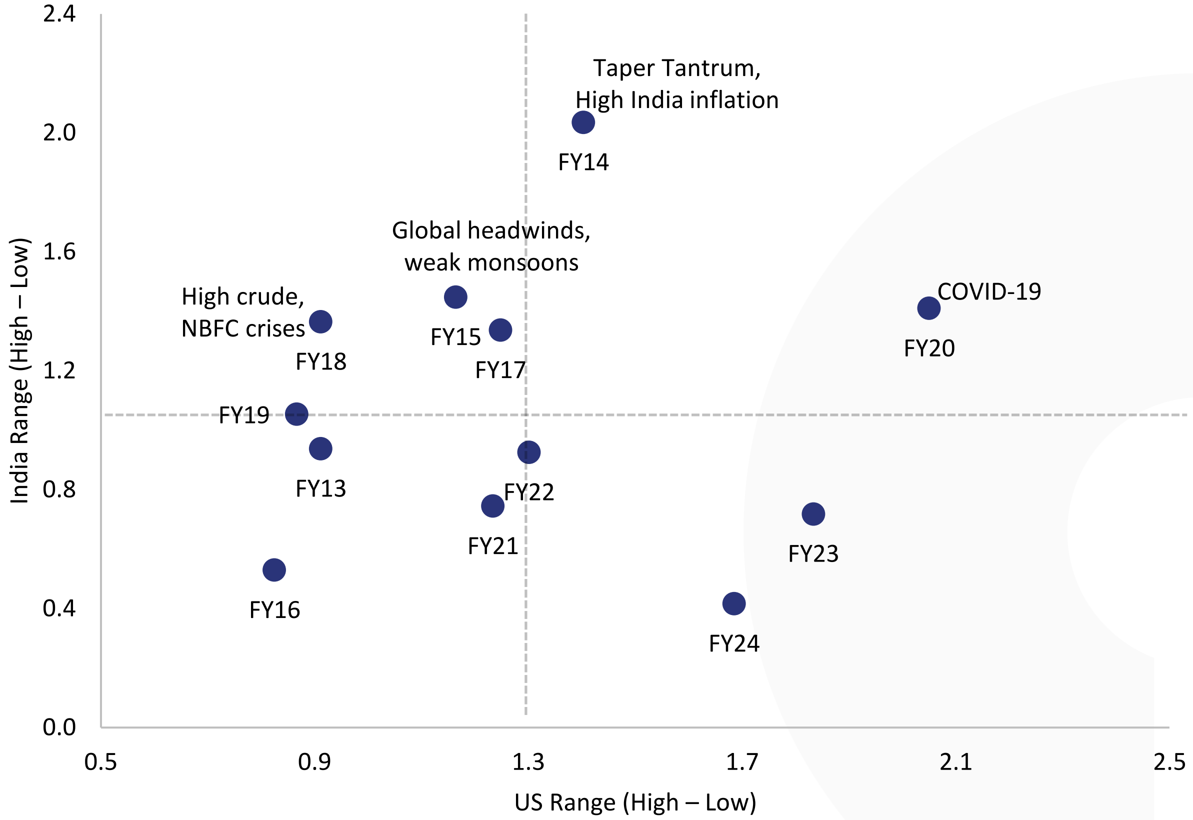
- Gsec inclusion in Global Emerging Market indices of JP Morgan and Bloomberg is expected to lead to FII inflows over the current financial year
- Share of FIIs might rise from 1.6% currently to 3-5% over the next couple of years
- Limited liquidity in old Gsec papers and RBI's management of liquidity would be key monitorables

INDIAN G-SEC YIELDS SHOW LOW VOLATILITY VS. US

US VS INDIA 10Y YIELDS (%)



US VS INDIA YIELDS RANGE (%)



- Fiscal stimulus provided by US over CY20-21 was 12% of nominal GDP vs. 6% for India
- Fast and pronounced policy rate hikes in US, while India increased rates gradually. US vs India policy rate spread ay multi-decade low
- Over the past 2 years, Fed's policyspeak have varied widely, vs. stable in India

Note: Figures in the chart indicate average yields for the year. FY means Apr-Mar period. *Source: RBI, IMF, Bloomberg, News Sources, SBICAPS*

VIEW ON POLICY: A SLOW DESCENT TO THE DESTINATION

TIMELINE FOR RATE CUTS IN CURRENT CYCLE LIKELY PUSHED BACK

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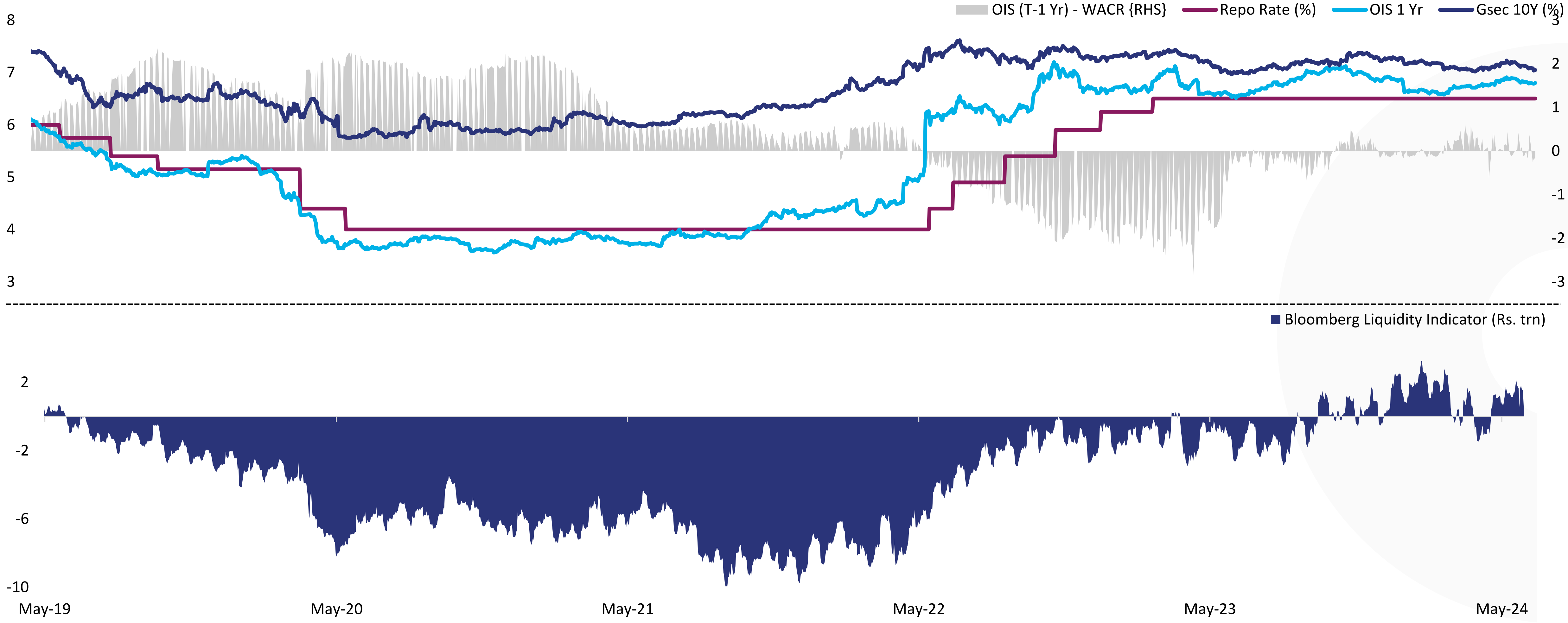
1 YR OIS TRADES 25 BPS HIGHER THAN REPO, SUGGESTING A PUSH BACK TO CUTS



However, OIS seems to under/over-predict cycle shifts as it is also dependent on liquidity

LIQUIDITY MANAGEMENT: AN IMPORTANT POLICY TOOL WITH RBI

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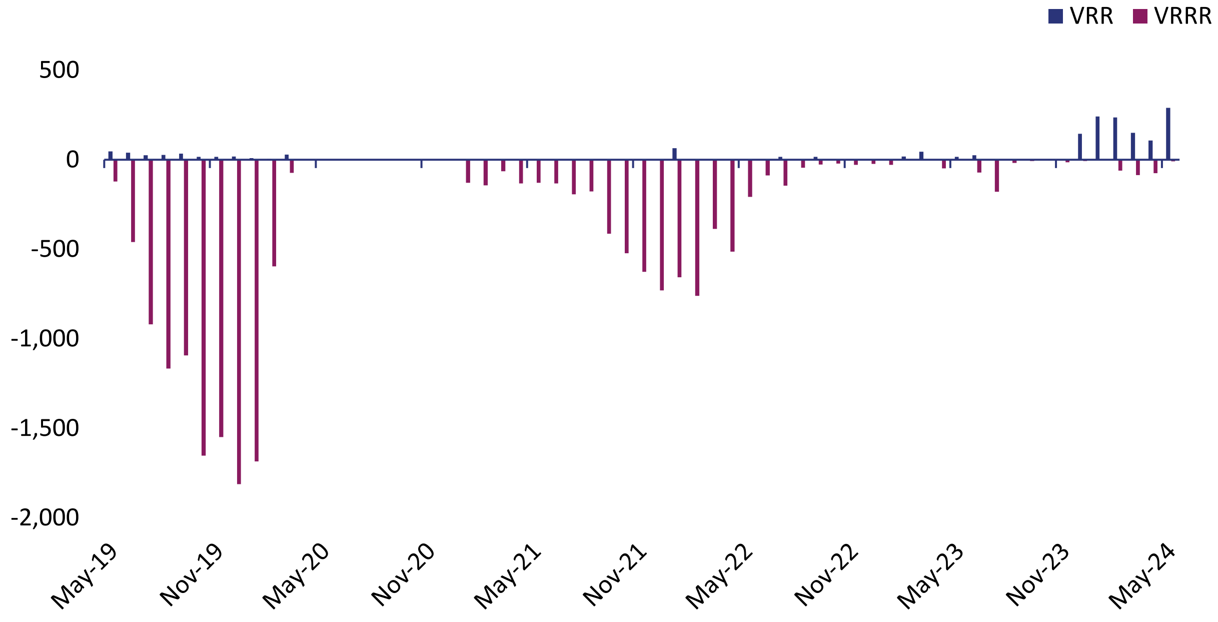
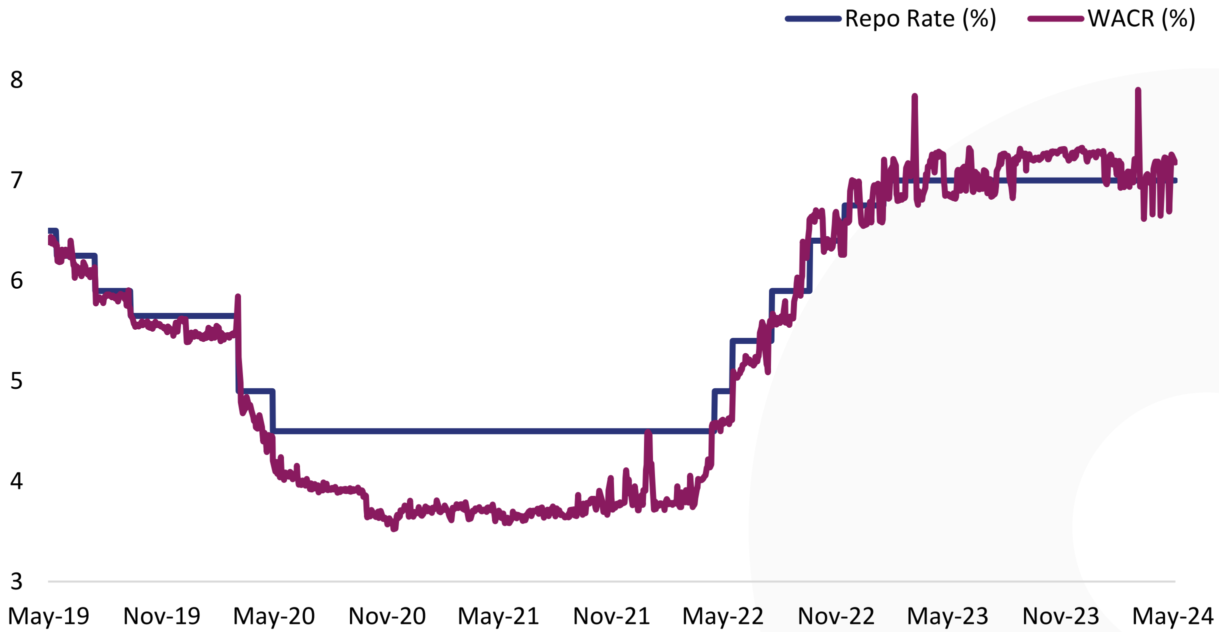
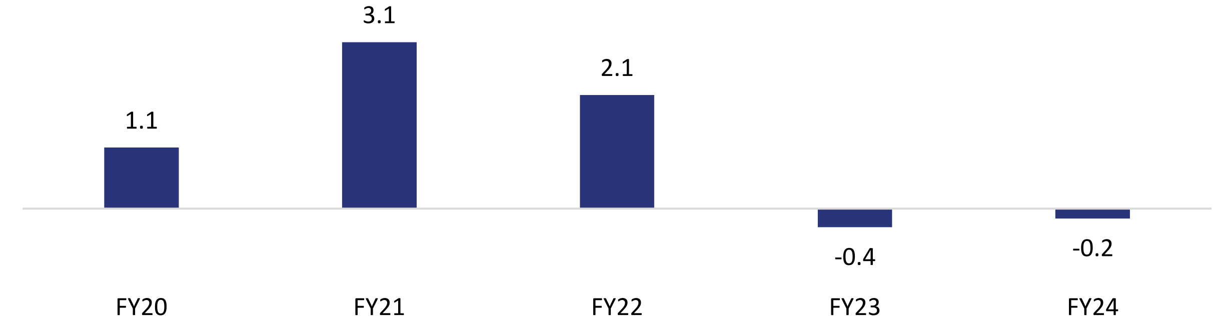
KEY LAF OPERATIONS (Rs. bn.)



WACR VS REPO RATE (%)



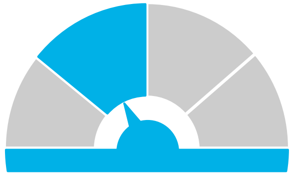
RBI NET OMO PURCHASES (Rs. trn.)



- RBI has been managing liquidity actively over the recent past, using multiple monetary tools in its arsenal
- Currently, liquidity remains in slight deficit echoed by kickback demand in VRR auctions and WACR trading higher than repo, due to lower government spending during elections

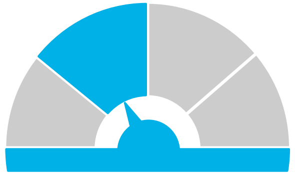
A SUMMARY OF FACTORS IMPACTING IMPENDING RATE CUT CYCLE

Inflation



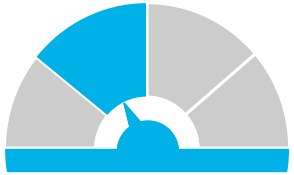
Despite inflation cooling from FY24 prints, consumer inflation might remain higher than RBI target of 4.0%, **averaging 4.7% y/y in FY25 due to food inflation**

Growth



Domestic factors remain robust, led by government capex and manufacturing pick-up. Strong monsoons could help rural consumption catch up. We expect real growth **to print around 7.0% y/y in FY25,** with risks in external sector

Global Factors

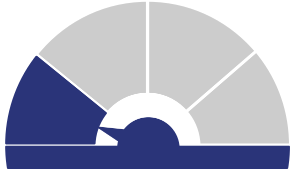


Fuller transmission of higher absolute rates (despite 1-2 cuts) amid high debt & deficit, might lead to de-growth in US, resulting in **aggressive cuts in CY25 for US.** China and Europe appear better placed than before

External Sector/ Currency

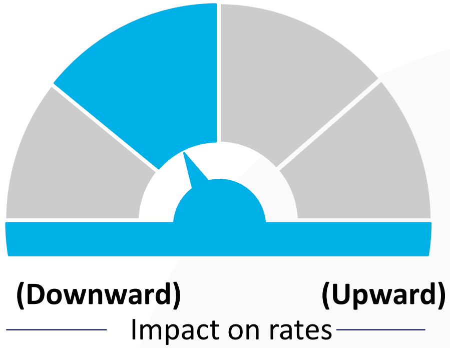
'Higher for longer' interest rate scenario, dim global trade, and geopolitics, pose risks. Strong buffers will help shield Indian currency from sudden deterioration

Bond inclusion



With expected inflows of USD 25-30 bn, some of the risks in external sector might be mitigated. This shall also fortify already strong RBI forex buffers for a rainy day. On the flipside this could magnify the volatility due to FPI flows

VIEW ON RBI POLICY



Adjoining factors indicate the need for cuts. However, the timing remains shrouded in mystery

Rate cuts are required to bring real rates close optimum. These cuts will likely start in Q3FY25

Prudential liquidity management, and usage of other monetary tools may precede rate actions to guide the market yields

FROM POLICY TO YIELDS: SUPPLY DIP AMIDST SURGING DEMAND

TAX BUOYANCY HAS BEEN INCREASING

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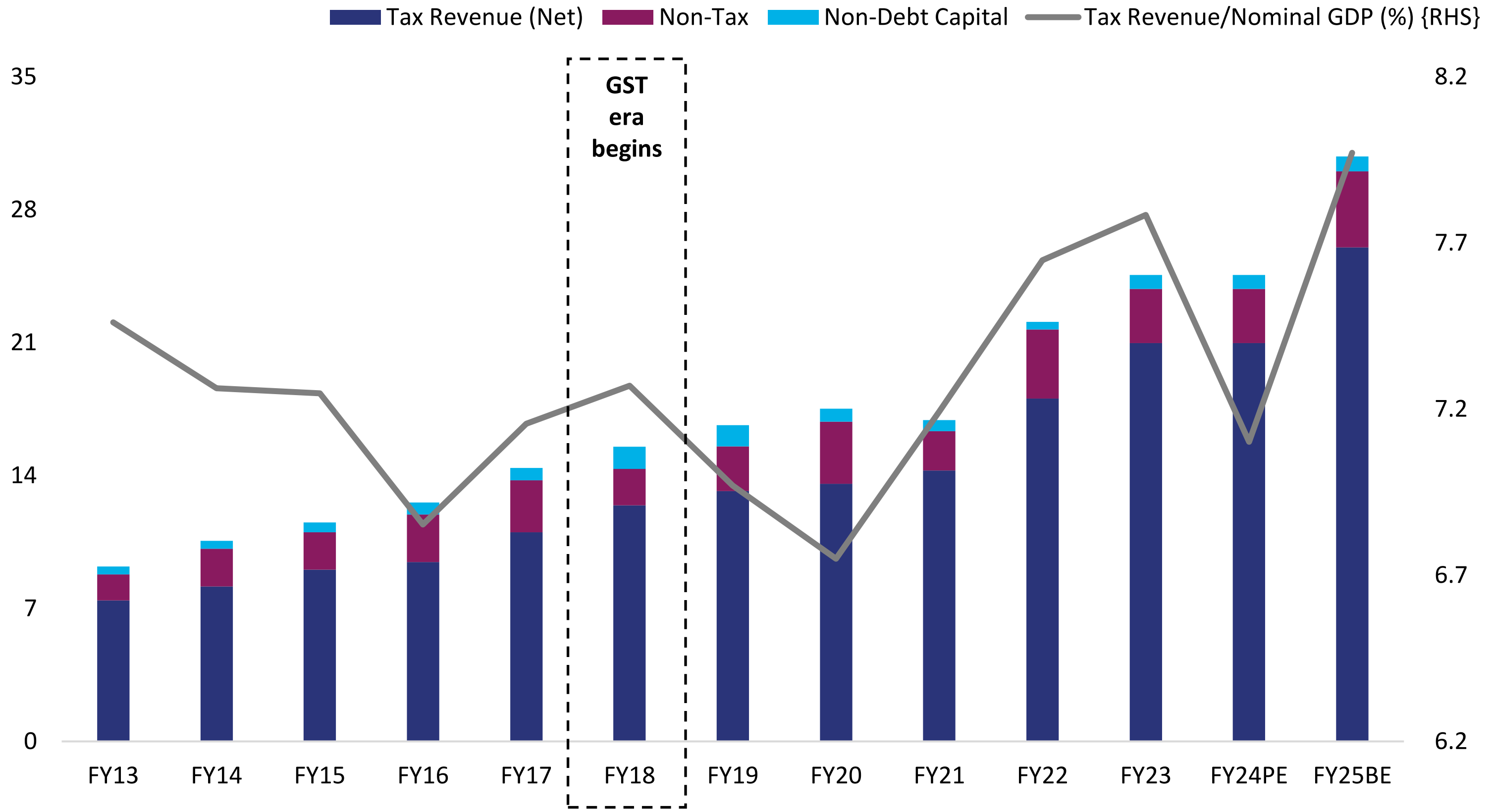
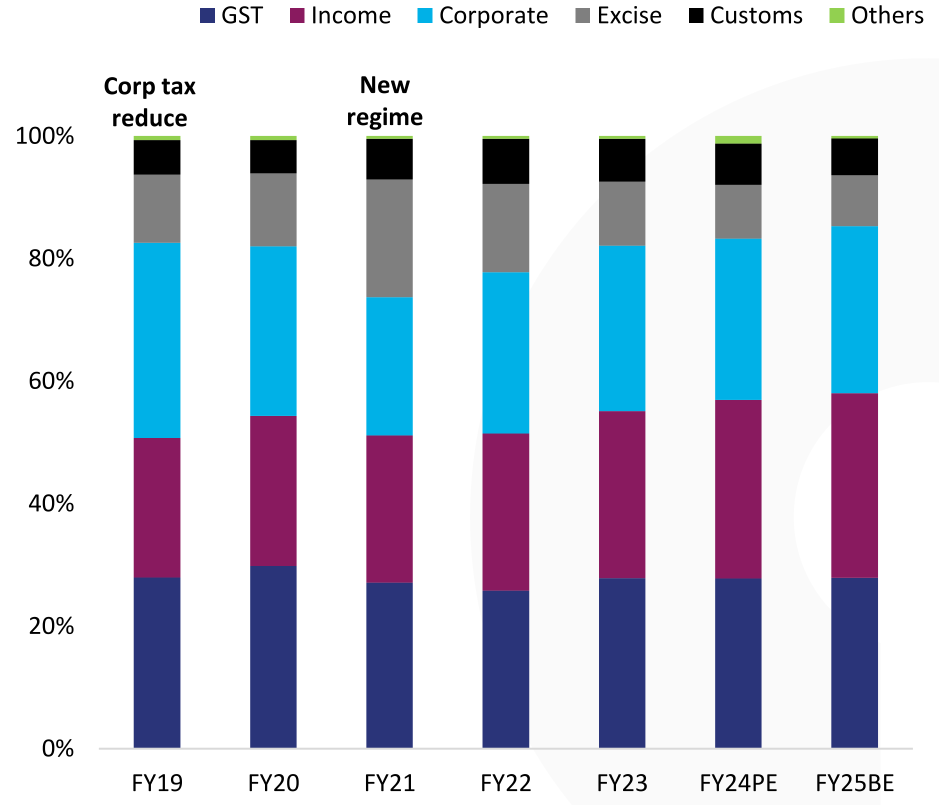
SOURCES OF RECEIPTS FOR UNION (RS. trn.)



SOURCES OF TAX REVENUE POST GST



- Tax revenues have been exceptionally strong in the last few quarters – this is not only due to improved collection of personal taxes, but also structurally improved taxation due to the implementation of GST

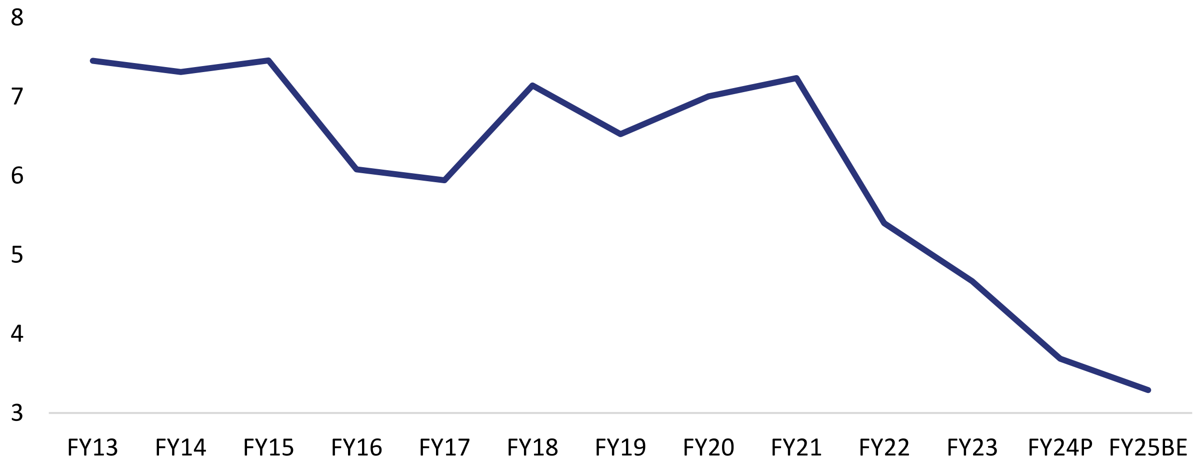
Source: Union Budget Documents, CGA, SBICAPS

QUALITY OF SPENDS HAS SIGNIFICANTLY IMPROVED OVER THE PAST DECADE

%Y/Y CHANGE IN SPENDS OF KEY MINISTRIES

	Finance	Defence	Consumer Affairs	Home Affairs	Rural Dev	Road	Agriculture	Chemichals & Fertilizers	Railways	Health	Education	Housing & Urban	Communica-tions
FY13	10%	8%	17%	5%	-20%	-14%	6%	-7%	5%	3%	10%	-2%	9%
FY14													
FY15													
FY16													
FY17													
FY18													
FY19													
FY20													
FY21													
FY22													
FY23RE													
FY24BE													
FY25BE	9%	5%	4%	3%	13%	3%	2%	-6%	6%	2%	7%	1%	11%

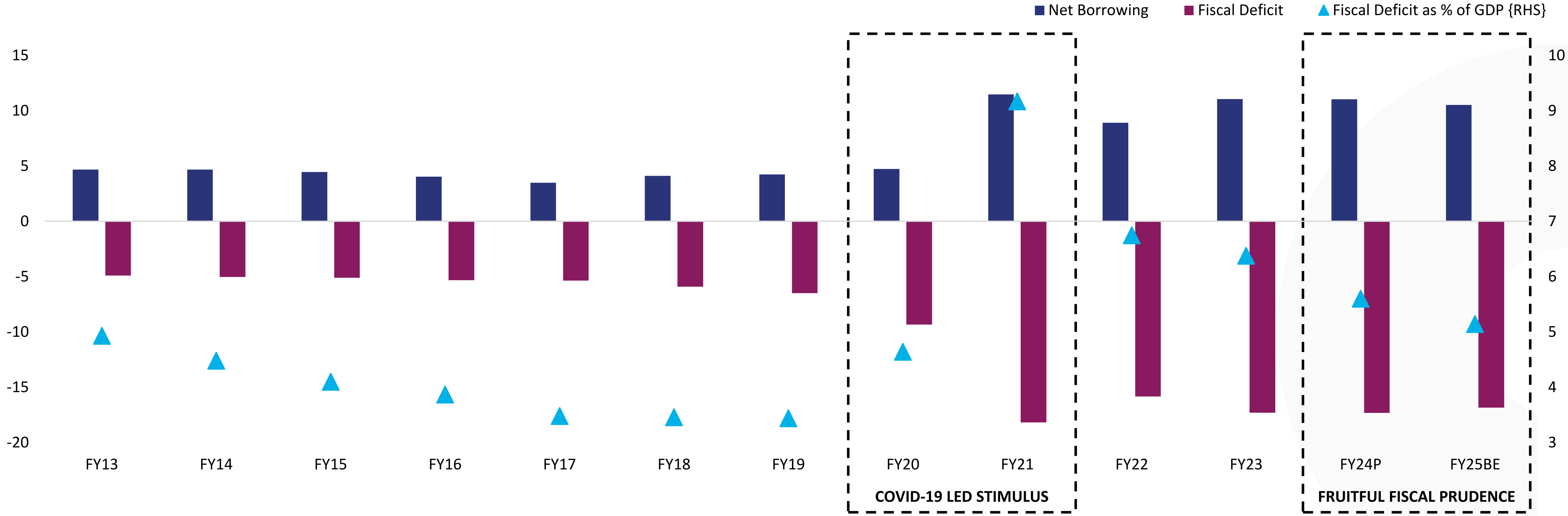
REVEX/CAPEX RATIO (TIMES)



- The Union has emerged from the shackles of the pandemic, significantly cutting down on revenue expenditure, which has kept fiscal deficit in check
- At the same time, the released quantum has been reallocated to capex in key infra segments such as Roads and Railways, which has boosted quality of expenditure

UNION G-SEC ISSUANCE GROWTH MODERATING ALONG WITH FISCAL DEFICIT

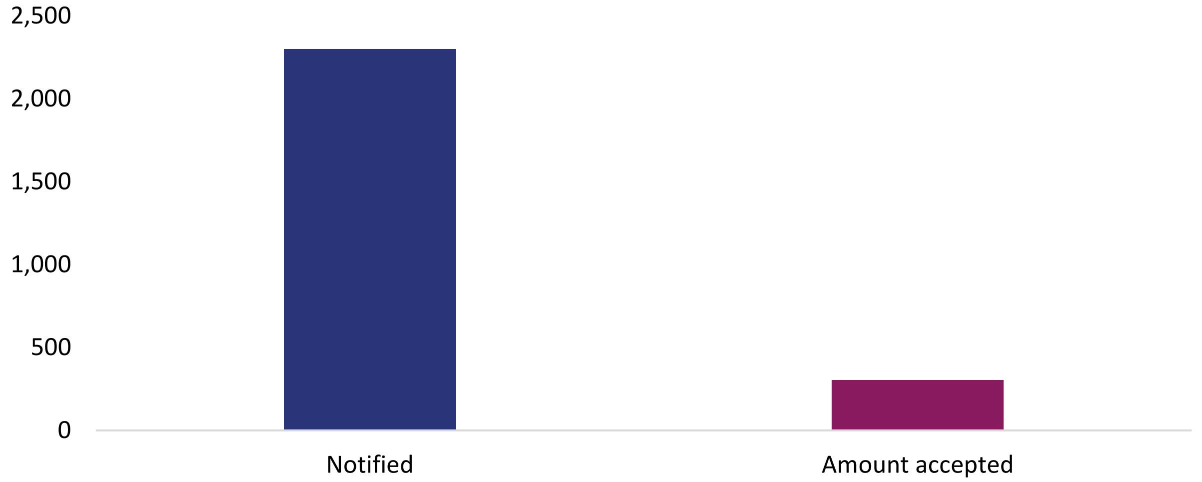
NET BORROWING AND FISCAL DEFICIT (RS. trn.)



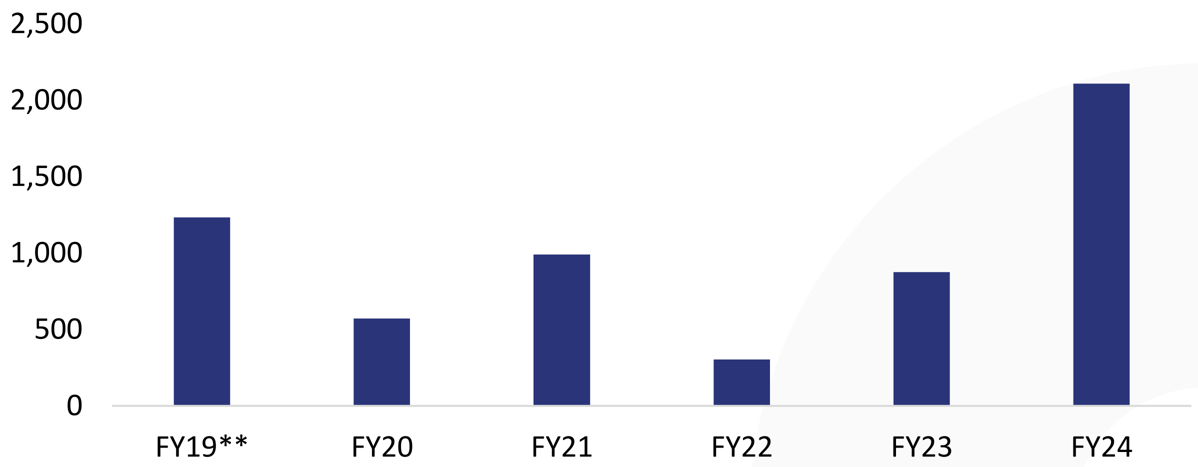
- Fiscal deficit peaked in FY21, on account of COVID led fiscal stimulus, and has moderated since then. Capex led growth seem to achieve the multiplier effect targeted with private participation stimulated, which will lead to lower Union's net borrowing expected in FY25BE at Rs. 10.5 trn.
- Slashed fiscal deficit of FY24P to 5.6% surpassed all market expectations and a target of 5.1% in FY25BE and 4.5% in FY26 is a commendable feat. Also, Union may do even better than these targets. This is a positive signal to bond markets and rating agencies, who are already noticing by revising sovereign rating outlook

SUPPORTED BY BUYBACKS, DIVIDENDS AND UPWARD DRIFT IN SOVEREIGN RATING

GSEC BUYBACKS IN FY25TD (RS. bn.)



RBI DIVIDEND (RS. bn.)



SOVEREIGN RATING OUTLOOK UPGRADED

S&P changed the sovereign outlook to "Positive" from "Stable" while maintaining the rating at BBB-. Growth forecasts were also revised upwards

Credit metrics improved by cautious monetary policy, robust growth, improvement in quality of fiscal spending, and commitment to consolidation

Rating may be upgraded if cautious fiscal policy is adopted to reduce general govt. debt below 7% of GDP (vs. 8.6% for FY24 and 6.8% until FY28) on a structural basis

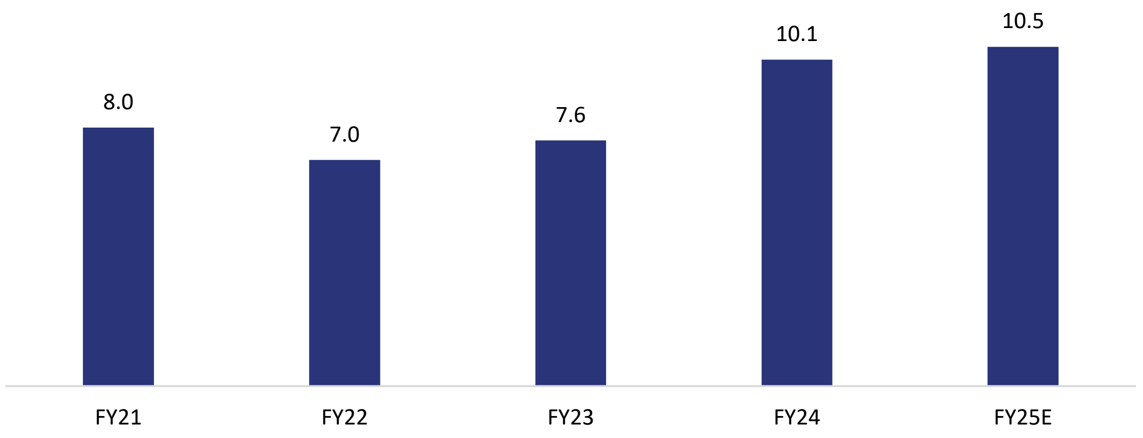
Sustained and substantial improvement in monetary policy effectiveness, such that inflation is durable lowered over time, also merits rating upgrade

- Higher than expected RBI dividend to Union in FY25 expected to not only ease liquidity conditions, but also positively impact fiscal deficit
- G-Sec buyback auctions have been receiving a tepid response, but regular auctions (esp. of shorter-term securities) bode well for instilling liquidity in the system
- Rating upgrade, alongwith higher foreign participation in debt capital markets, to drive benchmark yields lower

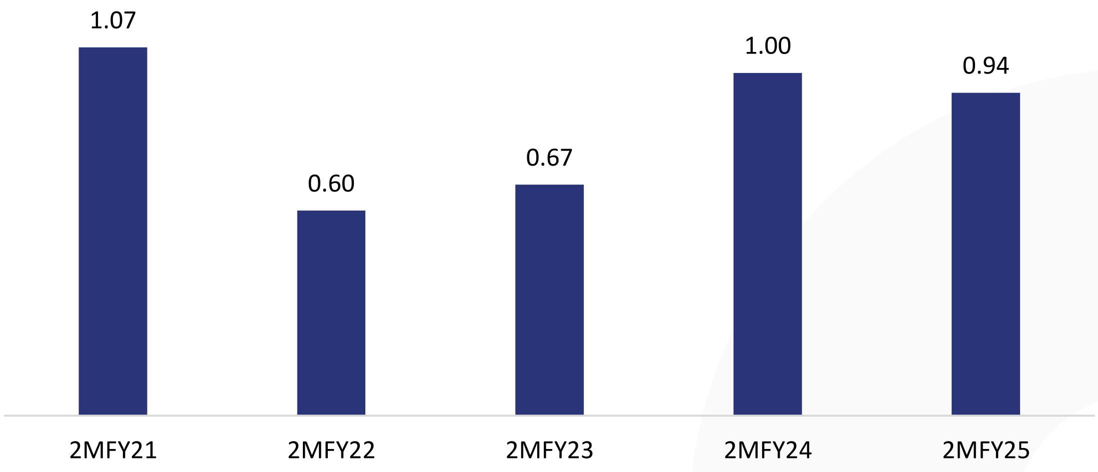
**Includes special dividend *Source: RBI, S&P, SBICAPS*

INCREASE IN SGS CONTRASTS UNION G-SEC DECLINE

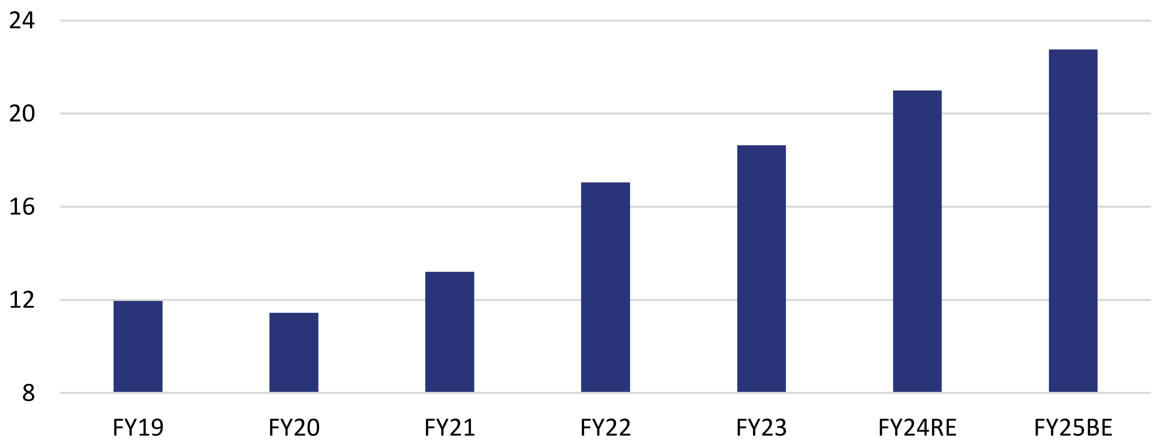
GROSS SGS ISSUANCE (Rs. trn.)



SGS BIDS ACCEPTED YTD (Rs. trn)



TOTAL TRANSFER TO STATES AND UTs (Rs. trn)



- *State Budget derived trends suggest that gross SGS borrowing of states collectively could rise by ~4% to ~Rs. 10.5 trn in FY25, contrasting declining Union G-sec trend*

EVOLVING MATURITY PROFILE REFLECTS CHANGING INVESTOR BASE

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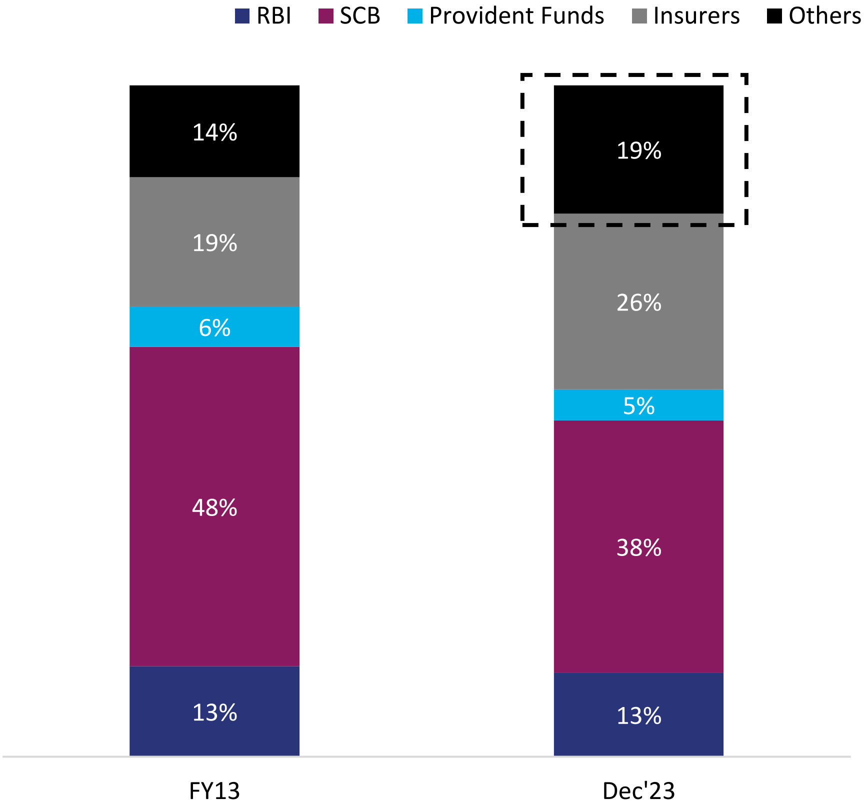
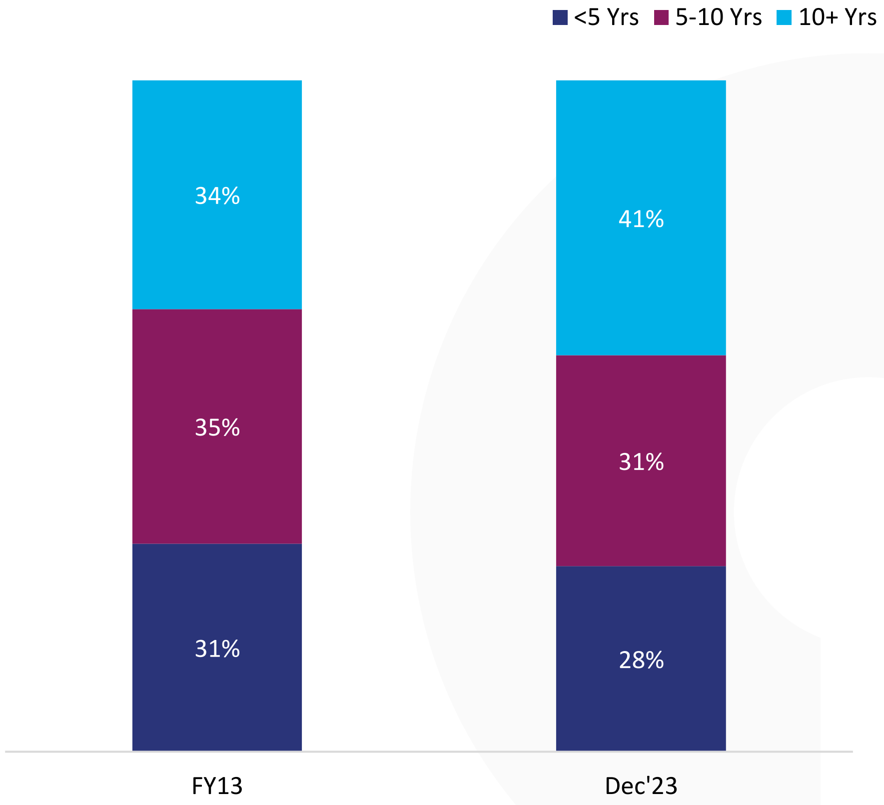
OWNERSHIP PATTERN OF GSEC (%)



SHARE OF OTHERS (DEC'23)

MATURITY PROFILE (%)



- RBI's efforts to diversify GSec ownership pool has been bore fruit with banks' share witnessing a secular decline, replaced by Pension Funds, Insurers, Financial Institutions, which seek relatively longer-term papers
- As AUMs of Non-Banks increase, they drive demand of longer-term GSecs.

Note: Pension funds reclassification impacts ownership pattern of GSecs. *Source: D-EA, SBICAPS*

BANKS SET TO REMAIN LARGEST INVESTORS DRIVEN BY REGULATORY NEEDS

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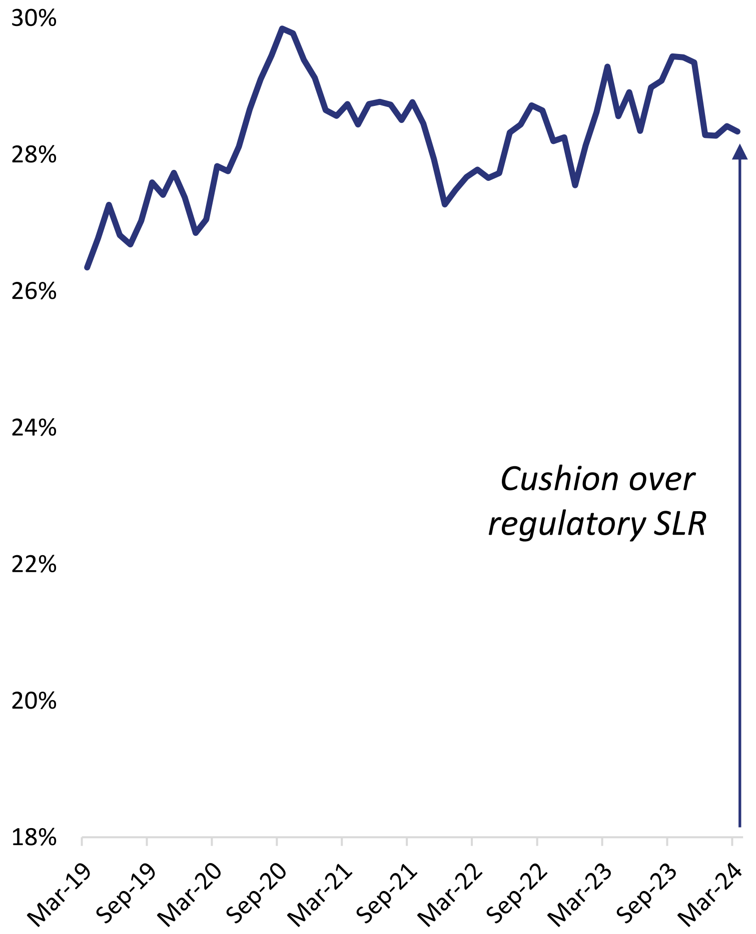
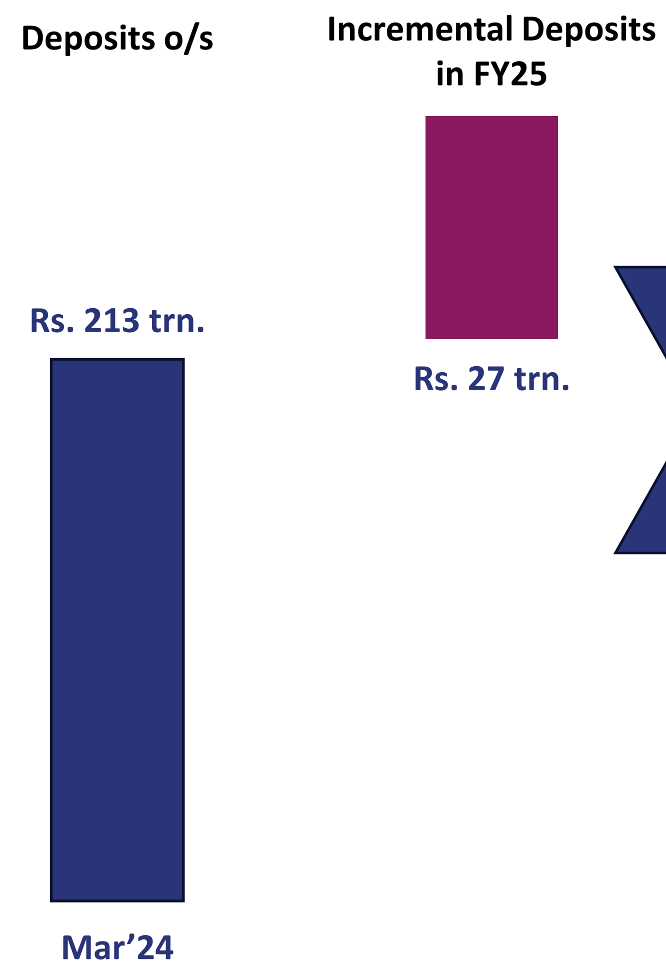
INVESTMENT IN SLR (% OF NDTL)



DEPOSIT GROWTH



INCREMENTAL SLR FOR FY25

- *Even if SLR related buying from banks is at regulatory levels, their share in gross G-sec buying is not expected to dip materially*
- *SLR maintenance itself would create a demand of Rs. 5 trn*
- *If current SLR level of 28% is maintained, then share will increase significantly*

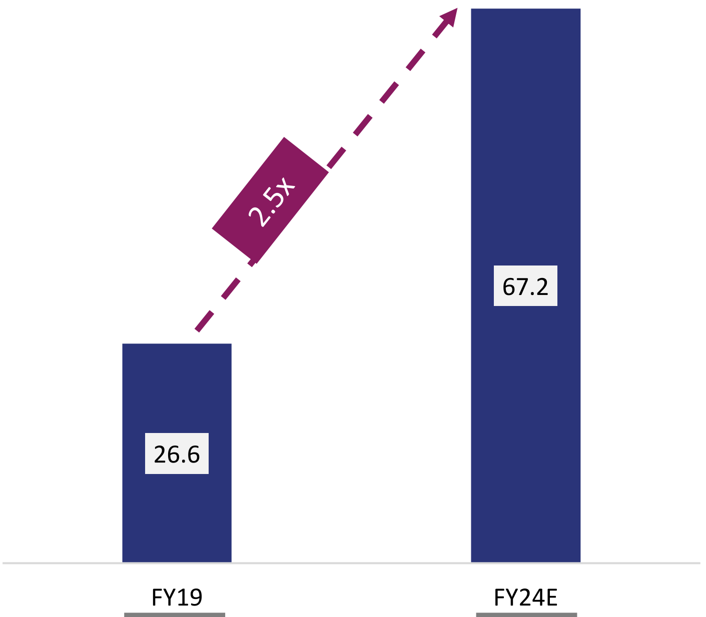
Source: RBI, SBICAPS

NON-BANK DRIVERS PROVIDE HEFT TO THE DEMAND SIDE

While GSec outstanding has grown by 1.9x since FY19, AUM growth of non-banks have outpaced significantly

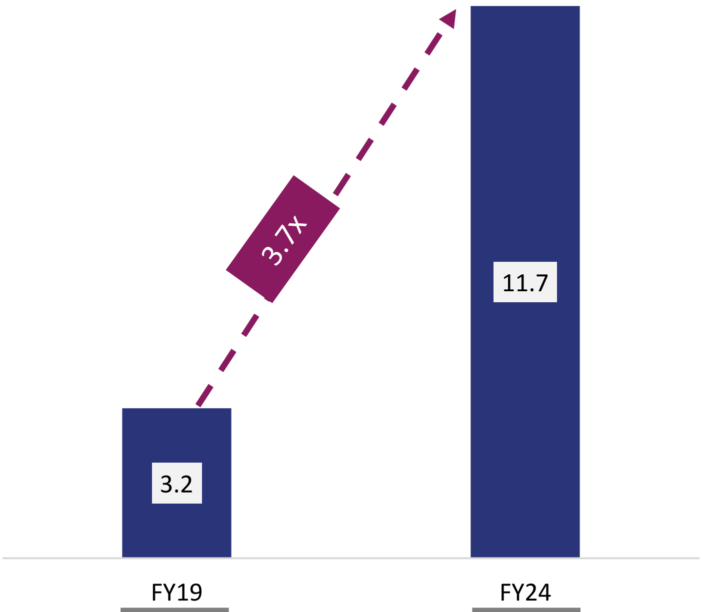
Ownership share (%) in Gsec Outstanding (as on Dec’23)

INSURERS AUM (RS. trn.)



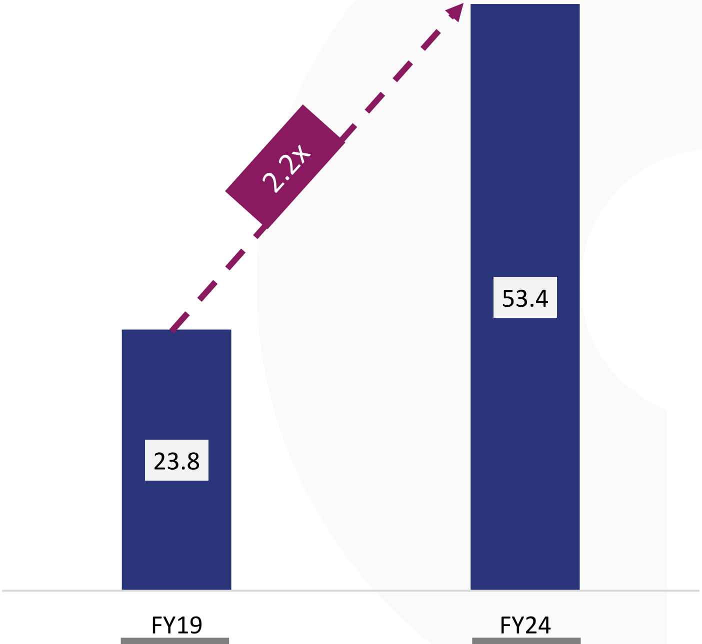
FY19	FY24E
24%	26%

PENSION FUNDS AUM (RS. trn.)



FY19	FY24
-	4.4%

MUTUAL FUNDS AUM (RS. trn.)



FY19	FY24
0.4%	3.0%

BFSI is still massively under-penetrated compared to global peers. As the economy formalizes, more savings are expected to be channelized into non-banks. Thus, assets of these institutions are expected to increase alongwith their participation in capital markets

Source: PFRDA, AMFI, IRDAI, RBI, SBICAPS

VIEW ON YIELDS: LOWER FOR LONGER?

REAL RATES REMAIN ELEVATED FROM LONG TERM AVERAGES

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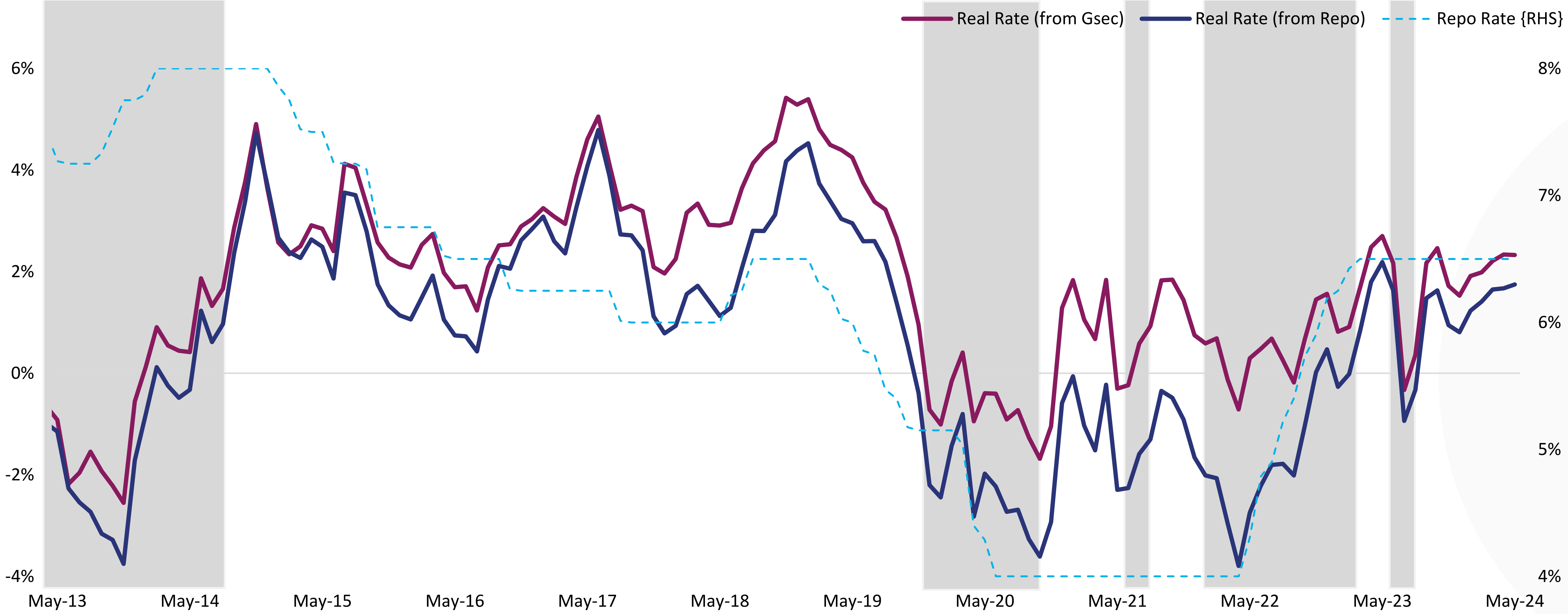
SPREADS BETWEEN AVERAGE GSEC 10Y YIELDS AND CPI VS REPO (%)



	May'24	LTA
Real Rate (from Repo)	2.3	1.7
Real Rate (from Gsec)	1.8	0.6

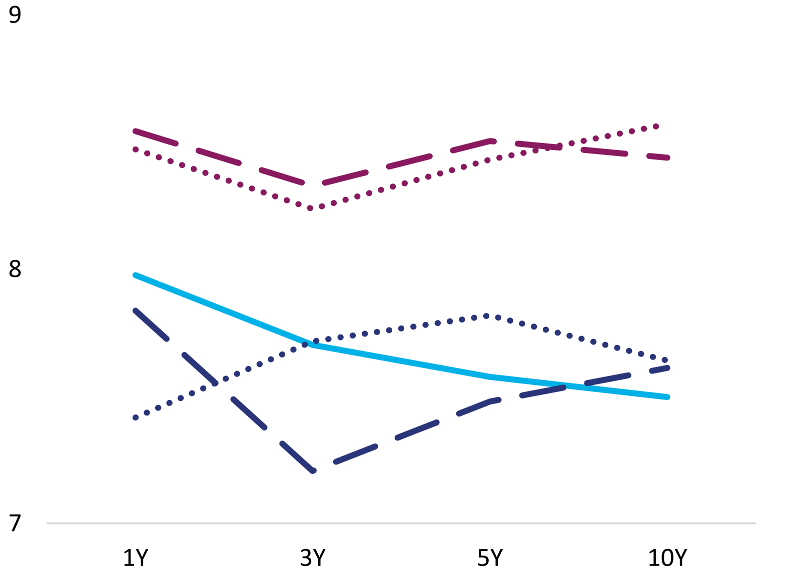
- With cooling inflation, real rates are elevated from their long-term averages, however they are yet to peak considering the current cycle of a hold. We believe that real rates (from repo) might reach their local maxima in Q2FY25, and then reduce in the following quarters of FY25. Further, it is observed that a spike in real rates generally precede a cut.
- Due to a limited difference between policy rates and yields, the transmission of pronounced policy actions might be thinner on the 10-year yields. However, other supply-demand factors might lead a regime change supporting yields

Note: Highlighted area indicates CPI above 6%. *Source: Bloomberg, RBI, SBICAPS*

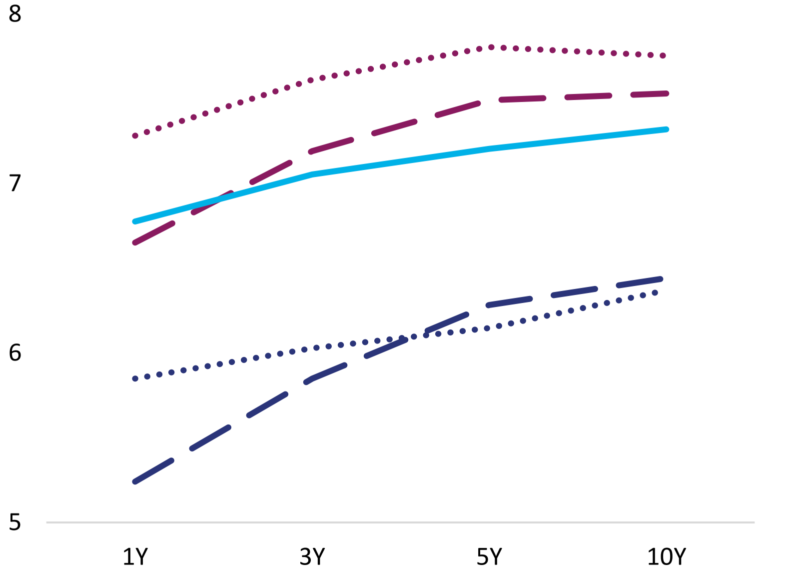
FLAT YIELD CURVE – A NORM?

1 year before | 6 months before | First cut/ current | 6 months hence | 1 year hence

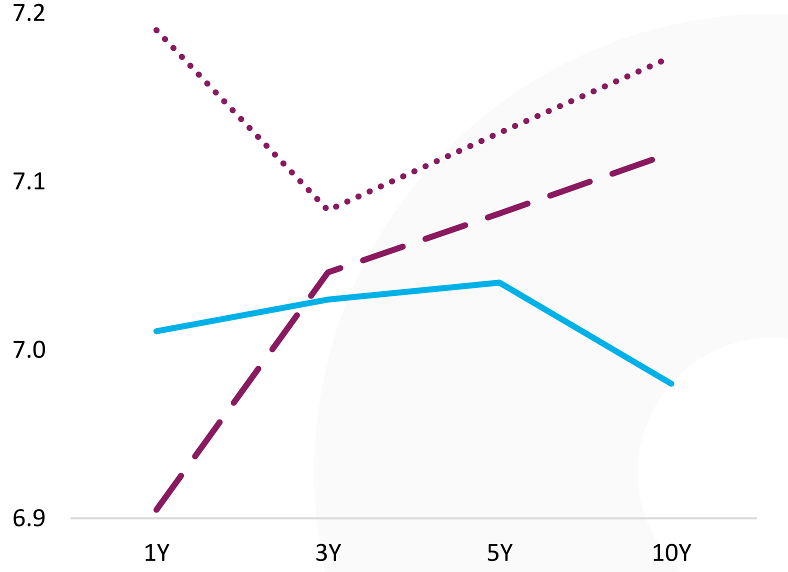
RATE CUTS STARTING JAN'15



RATE CUTS STARTING FEB'19



CURRENT CYCLE



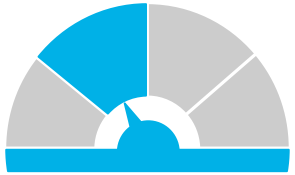
DECODING THE CURRENT FLAT CURVE OF INDIA

- Not an indicator of economic stress
- Long-term country risk premium expected to reduce
- Economic growth reaching optimum level
- General long-term inflation levels exhibit downward pressures
- Long-term participants share increasing
- Bond inclusion in medium to longer-term securities

Note: 1Y on graph refers to 12M T-bill cut off yield in primary markets. *Source: Bloomberg, RBI, News Sources, SBICAPS*

YIELDS TO CONTINUE THEIR DESCEND THROUGHOUT FY25

RBI Policy

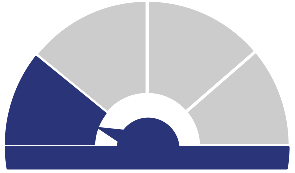


We foresee Repo rate cuts, starting later in CY24. Prudential liquidity management and usage of other monetary tools to precede them

Liquidity & other indicators

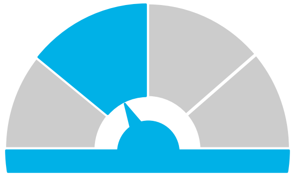
RBI would continue its nimble liquidity management. Pick up in government spending, higher FII flows due to bond inclusion remains key triggers.

Fiscal Consolidation and Union Borrowing Plan



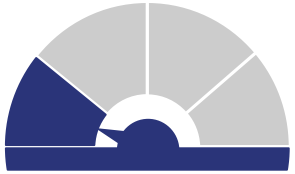
Managed deficit and lower borrowing plan evidences fiscal consolidation. Higher tax receipts & prudent expenditure management continue to surprise positively

Demand Drivers – Banks

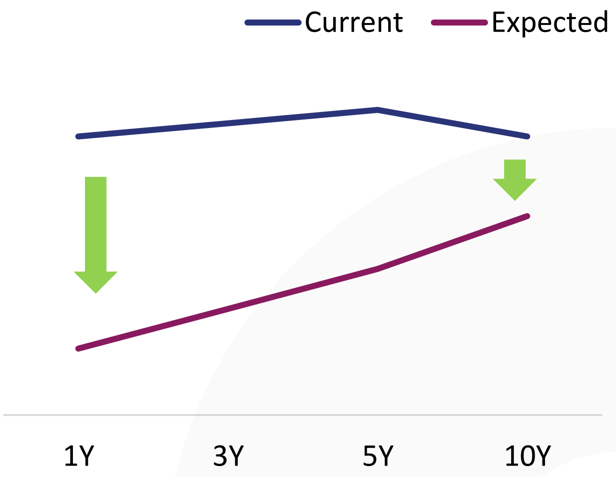


Banks' share in Union G-sec issuances might not reduce materially led by copious deposit growth and lower net borrowing by Union in FY25

Demand Drivers – Insurers, PFs, MFs, etc



Other demand drivers are expected to significantly contribute to G-Sec demand, as their AUM grow significantly, led by financialization of savings



Downward pressures transcend beyond policy, led by prominence of supply-demand factors

While the entire curve welcomes cuts, impact on shorter-end tends be more pronounced & faster

10-year yields have already descended below 7%, and are expected to continue the descent

Additionally, we expect the 10-year yields to fall by 25-30 bps from current levels with the curve witnessing a bull steepener

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