

## Press Release

### Stagflation risks spills over to the bond markets

#### 10 Yr. Gsec yield at a 3 month high, rate cut window virtually closed in near term

26 August, 2020

The inflationary concerns and the risks of stagflation have started to seep into the domestic bond markets. The 10 year Gsec yields have climbed up rapidly by 35 bps over the last 3 weeks and may make borrowing costs higher for not only the government but also the corporates despite the ongoing accommodative monetary policy. While RBI has announced OMO to manage the bond yields, such a task may be increasingly difficult going forward given the current monetary environment and the twin concerns on inflation and fiscal deficit.

**Says Suman Chowdhury, Chief Analytical Officer, Acuite Ratings** "We believe that the rate cut window is virtually closed in the short term and there is a significant likelihood of a change in RBI's accommodative policy over the next 3-6 months particularly if the CPI print doesn't settle down within the central bank's comfort band of 2%-6%."

The initial trigger for the spurt in the bond yields, clearly has been the decision of MPC in early August to hold the rates, highlighting the inflationary concerns in the short term. While the CPI trajectory has been on an uptrend since Q3 of FY20 primarily riding on food inflation, the healthy agricultural growth in FY20/21 couldn't alleviate such pressures due to the supply constraints emerging from the protracted Covid lockdown. On the other hand, the continued prevalence of high food inflation has started to impact the core CPI basket due to cost push pressures, a weak economic environment nonetheless. Core inflation has actually moved up by 50 bps in July 2020, surprising the market participants who had been expecting that the base effect factor will start to moderate the inflation print in the short term. Such a scenario has enhanced the risks of stagflation, which implies a painful phase of high inflation but low or negative growth, aggravating the challenges currently faced by the Indian policy makers.

Clearly, the other significant headwind for the bond yields has been the increasing fiscal deficit and consequently, higher government borrowings. Although the initial budget estimates had projected a gross borrowing of Rs. 7.9 Lakh Cr, it has been subsequently revised upwards significantly by almost 50% to Rs. 12.0 Lakh Cr given the additional fiscal measures required and the expected shortfall in revenue receipts in a Covid environment. As on the second week of August, the Central Government has already raised 49% of the revised borrowing estimates; at Rs. 5.5 Lakh Cr, the gross debt mobilised rose 70% as compared to same time last year; similar trends can be seen among state issuances as well. The quicker pace in debt mobilisation may also enhance the concerns among market participants regarding the possibility of further fiscal measures and even higher fiscal deficit. While Acuite had estimated the fiscal deficit for the year at 5.9%, this figure can be larger as the slow economic revival may translate into a sizeable GDP contraction and therefore, sharply lower tax revenues. **Adds Mr. Chowdhury** "The additional borrowings of the central government along with that of the state governments are likely to maintain an oversupply of sovereign papers in the domestic market, thereby putting pressure on bond yields and also crowding out corporate bond issuances to an extent. Since most of the banks already have excess SLR holdings, the continued participation of the FII's will be a key factor in stabilising the government bond yields."

We observe that the yield differential between 2 year and 10 year Government securities has again expanded since the start of the monetary stimulus programmes; as on August 24th, the yield differential between the instruments in question was recorded at over 180 bps, back to the levels seen on April 24th. Moreover, the effective annualized forward rates for a 2 year and 10 year zero coupon instrument are substantially higher by 66 bps and 32 bps respectively, highlighting the market participants' concerns on the longer term impact of inflation. In our opinion, these are early signs of the yield curve adjusting itself to a higher level. Acuite nonetheless, expects RBI to respond to such concerns through an array of monetary tools. Recently, RBI has decided to conduct 'Operation Twist', a kind of open market operation to control the widening differential between the short and the long term bond yields.

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Acuite Ratings & Research Limited is a full-service Credit Rating Agency registered with the Securities and Exchange Board of India (SEBI). The company received RBI Accreditation as an External Credit Assessment Institution (ECAI), for Bank Loan Ratings under BASEL-II norms in the year 2012. Since then, it has assigned more than 8,000 credit ratings to various securities, debt instruments and bank facilities of entities spread across the country and across a wide cross section of industries. It has its Registered and Head Office in BKC, Mumbai.

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