Dear Talks

03 October 2022

Bond Yield inversion: Who Pays? Who Gains?

Neha Gupta and Dr. K J S Satyasai

Shape of a yield curve is one of the indicators of how markets read into the current state of economy and help predict a downturn. An inverted yield curve i.e., long-term interest rates drop below short-term rates, indicates that investors are becoming more pessimistic about the economic prospects for the near future. If market believes that a recession is imminent, then the demand for long term bonds will soar leaving behind the short-term bonds as a result. Such an inverted yield curve had preceded 10 most recent economic recessions in the world as per Forbes.

Now in USA 10-year/2-year treasury spread has been negative for 60 trading days. The two-year U.S. Treasury yield, which manifests interest rate expectations, is close to its highest level in 15 years. This comes on the heels of Federal Reserve hiking interest rate by 75 basis points for third consecutive time. Jerome Powell, Federal Reserve Chairperson, was hawkish at the recent Jackson Hole retreat of US Federal Reserve in August 2022 when he invoked former Fed chairman Paul Volcker, who drove the economy into a deep hole in the early 1980s with punishing rate increases to break the back of double-digit price gains. He basically pointed bluntly at accepting recession as the price of controlling inflation. The Federal Reserve has also increased its projection of the terminal rate for federal fund rate (interest rate) to be 4.6% in 2023 (Summary of Economic Projections, Federal Reserve), up from 3.8% at their last such release, thereby anchoring of expectation of interest rate increase soon.

Spike in short term bond yield in US has also been exacerbated by the fears of recession as multi-lateral agencies revising growth forecast downwards such as OECD revised its forecast of USA in the wake of rate hikes from 1.5% growth this year to only 0.5% next year, down from June forecasts for 2.5% in 2022 and 1.2% in 2023.

As US caught cold, we cannot be much behind from sneezing. The spread between the yield on the 10-year and two-year Government of India bonds declined to a 38-month low of 36 basis points on 27th September 2022 compared to 83 basis points at the close of August 2022 and 200 basis points at the end of December last year. This is mainly on the back of liquidity crunch in the system with it falling below ₹60000 crore for the first time in three years and inflation stubbornly remaining above the comfort band of

RBI for eighth consecutive month. RBI increased its policy rate (repo rate) by 50 basis points on 30th September 2022 taking the total hike this year to 190 basis points since its first unscheduled mid-meeting hike in May 2022. There is a market expectation that terminal rate for this year is 6.50% (repo rate) pointing towards a 60-basis point hike in coming months. This has anchored expectation among the Indian investors for interest rate in the short-term leading to spike in short term yield. Of course, global cues must be playing their part.

Indian flattening yield curve is signaling an impending slowdown in Indian economy as a fallout of global recession especially in US and Eurozone even as our economy is showing resilience. Although inflation in India is just off the RBI target unlike US and Eurozone facing runaway inflation. US central bank's rate hike programme is and will continue to put pressure on RBI to remain in tandem with US's rate hike to check the spread between US and Indian interest rate from increasing to cushion Dollar-Rupee rate. Any such increase in the spread will put pressure on USD/INR rate just as it has impacted Euro-Dollar parity and Yen-Dollar rate adversely. Any hike in repo rate as we discussed earlier is bound to pressurize short term yield of bonds. Against this background of global recession fears, increasing interest rate in US and even Eurozone now and RBI's rate hike expectation, a question that needs answers are how this scenario affects different players in the Indian bond market.

We expect short term yields to remain elevated as RBI will not allow liquidity to build up as we witnessed in past two years with global developments and rate hike of RBI to guide the bond yields. However, we expect RBI to keenly watch liquidity situation as Non-Food Credit growth rate reached 16% in August 2022 as compared to 6.1% in August 2021 while the deposit growth remained below 10% during the same time. This has led to liquidity crunch in the system. RBI will support the liquidity like it recently by undertaking Variable Rate Repo (VRR) of ₹50000 crore but as we predicted it will not let the liquidity to build up. Indian yields will remain elevated (at current levels) but will not touch decades' level high as in US because the strong revenue situation of Indian government has led to no increase in the borrowing plan of Government of India (RBI) and GST collection touching ₹1.4 lakh crore for seventh month in a row. Despite all these things, yield will increase (albeit moderately) as rate hike cycle is on.

Coming to our question of who gains from the yield inversion, we expect the long term bond yields, which increased from 6.46% at the start of this year to 7.35% in August 2022, to not increase further. This is good news for banks especially Public Sector Banks who had endured mark-to-market losses in Q1 2022 (like SBI reported loss of ₹6,549 crore on its investments), as long term bonds are not expected to increase further thereby reducing the losses to already invested entities. However, the spike in short term yield is not a good news for borrowers like NBFCs, corporates even NABARD which borrows money through commercial paper (short term instrument) as their cost of borrowing is set to remain elevated in near future. Asset liability management of many NBFCs and other entities may go for a toss with higher cost of borrowing in short term and lower asset income in long term.

Happy Reading!!!