Global Economic Outlook

- After reaching a three-year high of 2.4% in June, headline inflation in the UK eased marginally in July. The slowdown was partly due to the high base of last year, when lockdown restrictions were first eased. Consumer items led the downward trend, while fuel and industrial raw materials stayed expensive due to supply chain issues.

- Labour shortage and the resultant wage growth in UK, has been a major contributor to upward price pressures. A policy action from the BoE seems far, until the economy gains durable strength. The Bank of England predicts price growth of 3% in August and more than 4% in the final two months of the year.

- The Eurozone's retail inflation rose 3% y-o-y in August, the most in 10 years, from 2.2% in July. The decade-high inflation was driven by a rebound, higher energy costs, bottlenecks in global supply chains and reversal of tax cuts in Germany, the largest economy in the region. While the price rise is still being seen as temporary for the most part, the recent jump nudged the European Central Bank (ECB) last week to moderately scale back its bond purchase programme.

- Saudi Arabia's economy posted a 1.8% annual growth in the second quarter, according to official gross domestic product (GDP) estimates, but the non-oil sector of the world's largest oil exporter lost steam.

Domestic Outlook

- Consumer Price Index-based Inflation (CPI) for August 2021 came in at 5.30 percent, compared with 5.59 percent in July, as food prices cooled further, especially in the case of vegetable inflation. Consumer Food Price Inflation (CFPI) for August stood at 3.11 percent compared to 3.96 percent in July. However, concerns remain with high edible oil prices, which registered an increase of 33 percent year-on-year (YoY).

- IIP rose by 11.5 per cent on a year-on-year basis in July 2021. The growth came after a 10.5 per cent fall suffered in July 2020. Output of mined products grew by 19.5 per cent, while electricity generation increased by 11.1 per cent. The manufacturing sector reported a 10.5 per cent growth in production in July 2021, over an 11.4 per cent fall in the year-ago month. The improvement in the performance of the manufacturing sector was broad-based, with 20 of the 23 sub-groups reporting a rise in production.

- Supply-side bottlenecks and a reopening-led
disequilibrium with demand have led to a rise in retail prices in the US. A pickup in inflation, including higher costs for fuel and household energy, has also dimmed prospects for more robust spending and economic growth. The big fear is that if inflation gets out of control, it could prompt the US Federal Reserve to raise interest rates abruptly and possibly derail the economic recovery. But Federal Reserve Chairman Jerome Powell has repeatedly said that he and his fellow policymakers believe the current wave of higher prices is a temporary consequence of supply bottlenecks and that inflation will eventually moderate.
India’s consumer market could grow by USD 1.8 trillion over the next decade while Asian consumers are expected to account for half of global consumption growth in the next decade, equivalent to a USD 10 trillion opportunity, according to a report by McKinsey. Factors that will influence this growth include the increasing number of high-income households, shrinking household size, the doubling of the consumer class, seniors going online and the rise of e-commerce in the country. India will have the third-largest number of high-income households globally after the United States and China by 2030, the report said.

India’s total merchandise exports are projected to grow by 33 per cent to USD 98.5 billion during July-September 2021 from USD 74 billion recorded during the corresponding period in the previous fiscal, according to Export-Import Bank of India (Exim). The rise in the country’s exports could be attributed largely to the low base effect, pick-up in growth in advanced economies and the resultant increase in global import demand. Increase in commodity prices has also contributed to the increase in India’s exports.

India’s foreign exchange reserves rose by USD 8.9 billion to USD 642.5 billion during the week ended 3 September 2021. Foreign currency assets, the largest component of India’s foreign exchange reserves, increased by USD 8.2 billion to USD 579.8 billion. Both, gold reserves and special drawing rights (SDRs) rose by USD 642 million and USD 29 million, respectively. India’s reserves position in International Monetary Fund (IMF) improved by USD 11 million to USD 5.1 billion during the week ended 3 September 2021.

Indian rupee averaged Rs.74.2 per US dollar in August 2021, marking a mild improvement from its 11-year low of Rs.74.5 per USD dollar in July 2021. The Indian currency unit hovered around the Rs.74.3 per USD mark till August 26, 2021. Following the allocation of 12.6 billion special drawing rights (SDRs) to the Reserve Bank of India (RBI) by the International Monetary Fund (IMF), which pushed up the country’s foreign exchange reserves to a new high of USD 633.6 billion on August 27, the Indian currency unit appreciated to Rs.74.1 per US dollar. On the following day, it appreciated further to Rs.73.5 per US dollar.

The India Meteorological Department (IMD) projected above normal rainfall during September at 110 per cent or above of the long period average (LPA). As a result, IMD expects southwest monsoon to end with rainfall at the lower end of the normal. Normal rainfall falls between 96 per cent and 104 per cent of the LPA. This could aid the progress of sowing but not crop yield. Deficient rainfall during the first fortnight of July and almost the entire August is likely to hit crop yield.

**Interest Rate Outlook**

- The Reserve Bank of India will conduct a Variable Rate Reverse Repo auction on September 14, 2021 of ₹1,00,000 crore. In an indication that the current surplus liquidity is beyond comfort levels, the RBI conducted an additional 7-day variable rate reverse repo operation (VRRR) worth ₹50,000 crore on September 07, 2021, ahead of a scheduled 14-day ₹3,50,000 crore on Variable Rate Reverse Repo auction on September 09, 2021.

- India could be included in the global bond index in early 2022, a move that may attract $170-250 billion in bond inflows for the country in the next decade according to a recent Morgan Stanley note.

### Weekly Benchmark Bond Yield Movement (%)

<table>
<thead>
<tr>
<th>Date</th>
<th>03/9</th>
<th>06/9</th>
<th>07/9</th>
<th>08/8</th>
<th>9/8</th>
</tr>
</thead>
<tbody>
<tr>
<td>India 10 year</td>
<td>6.16</td>
<td>6.17</td>
<td>6.19</td>
<td>6.19</td>
<td>6.18</td>
</tr>
<tr>
<td>India 5 year</td>
<td>5.57</td>
<td>5.60</td>
<td>5.63</td>
<td>5.61</td>
<td>5.61</td>
</tr>
<tr>
<td>USA 10 year</td>
<td>1.32</td>
<td>1.32</td>
<td>1.37</td>
<td>1.33</td>
<td>1.29</td>
</tr>
</tbody>
</table>

Source: CMIE, worldgovernmentbonds.com

- In the wake of our reading of the global and domestic situation, we expect that 6.25 per cent level will act as a support in the near term and the benchmark 10-year bond yield is unlikely to shoot beyond this mark unless there is any unanticipated shock in terms of inflation or external factors.
What is Bond?

- Bond is a fixed income instrument that pays interest periodically to the investors (bondholder), known as Coupon Amount. At maturity, the principal is paid back to the investor.
- A bond’s Coupon Rate is the rate of interest that the bond pays annually. Whereas Bond Yield, is the return an investor realizes on bond. Mathematically it is calculated by formula.

\[
Yield = \frac{\text{Coupon Amount}}{\text{Bond Price}} \times 100
\]

- Coupon Rate is fixed whereas Bond Yield is variable and depend on the current price of the bond in the market.
- Zero Coupon Bond- does not carry regular interest and instead derive their value from the difference between the purchase price and the face value paid at the maturity.

Yield Curve

- Yield curve plots yields of bonds having equal credit quality but differing maturity dates. There are several hypotheses regarding information content of the yield curve.

**Hypothesis 1- The yield curve reflects the Stance of the Monetary Policy-** When Monetary policy is tightened (eased), long term rate rise (fall) less than the short-term rates resulting in a flatter (steeper) yield curve.

**Hypothesis 2- The yield curve reflects the direction of Future Inflation Changes-** When long-term expectations of inflation rise, investors demand higher long-term interest rates resulting in a steepening of the yield curve.

**Hypothesis 3- The yield curve contains information on Credit Market Condition and Growth-** In recession, investors turn risk averse leading to decline in prices of long-term bonds and consequent increase in their yields. Under recessionary trends, yields on long-term bonds tend to be high while short term yields remaining low resulting in an upward sloping yield curve. In recession, the steeper the yield curve, the stronger is the economic recovery expected.

Understanding the relationship between Bond yield, Price and Interest Rate.

- Consider a zero-coupon bond issued at Rs 950 and has a face value of Rs 1000. Now the yield at present is \((1000-950)/950 \times 100\% = 5.26\%\), thus an individual will get a return of 5.26% on his investment.
- If current interest rate rose, where newly issued bonds were offering a yield of 10% then the old zero-coupon bond yielding 5.26% would be less attractive.

- To attract demand, the price of the old zero-coupon bond has to fall enough to be consistent with the yield of the new zero-coupon bond, there will be drop in price of old zero coupon bond from Rs 950(yield 5.26%) to approximately Rs 909.9 which gives yield \(((1000-909.9)/909.9) \times 100 = 10\%\) (approximately)

The Term Structure of Interest Rates

- Differences in the default risk of bonds lead to differences in the yields. However, even bonds with identical default risks can have different yields. The economists have put forward the following theories to explain the shape of yield curve.

**Expectation Hypothesis-** Under the assumption that investors view a series of short-term bonds as perfect substitutes for long term bonds, it asserts that long term interest rates are an average of the shorter-term interest rates expected to prevail during the life of the longer – term asset.

**Segmented Market Hypothesis-** Under the assumption that bonds with different maturities are not perfect substitutes to each other, it states that their yields are determined independently of one another. The hypothesis views the market for bonds with varying maturities as separate and yields are determined by the intersection of the demand and supply of each type of bond.

**Preferred- Habitat Hypothesis-** The hypothesis combines key features of both Expectation and Segmented-Market hypotheses. It states that while investors prefer loanable funds of a given term, they are willing to substitute away from their preferred terms if they are compensated for doing so. The compensation required to induce investors to purchase an asset with a different term to maturity than their preferred terms is known as the term premium.

Factors affecting Bond Yields

- Bonds are relatively secured, but it is not that they are totally isolated from the shocks and trembles of economy and secondary market. It adjusts itself according to market forces prevailing at that time. The following factors (listed in Table), directly or indirectly influences in the bond yield.
### Factors Influencing Bond Yield

<table>
<thead>
<tr>
<th></th>
<th>Increasing Bond Yield</th>
<th>Decreasing Bond Yield</th>
</tr>
</thead>
<tbody>
<tr>
<td>Defaults by Government/Companie</td>
<td>High Level of Private Savings</td>
<td>Bond Price↑, demand for bond (bonds are secured investments)-price↑ yields will ↓</td>
</tr>
<tr>
<td>s- If Market fears default-Likely to demand higher yield to compensate for the risk.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Good prospects for Economic Growth-Prospects of other forms of investment↑ bond attractiveness↓ price ↓ and yield ↑</td>
<td>Recession- In times of uncertainty-attractiveness of secure investments ↑ (i.e., bonds) Bond Price ↑ Bond yields therefore ↓</td>
<td></td>
</tr>
<tr>
<td>Increase in policy rate (Repo rate) - Bond has fixed Interest-If repo rate increases Bond attractiveness ↓ Bond price↓ thus yield increases.</td>
<td>Falling Equity Market Correction in Stock market-investors may get attracted to the safety of bonds-demand ↑ - yield ↓</td>
<td></td>
</tr>
<tr>
<td>Increase in Govt Borrowing- ↑ in supply of bonds- Demand Supply mismatch-Yield ↑</td>
<td>Decreasing Crude Oil Prices- Inflation eases ↑ in real value of bond-demand of bond ↑ yield ↓</td>
<td></td>
</tr>
<tr>
<td>Fed Interest rate hike -Foreign Portfolio Investors may start pulling out from emerging economies to invest in US due to relatively higher risk-adjusted returns- leading to ↓ in bond price and an ↑ in bond yield in emerging economies.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>As Bond approaches maturity date, bond price moves towards face value</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Taper Tantrum

- Surplus liquidity in the system softens the interest rates and lead to higher demand for credit. When economy enters recession, this may help in reviving the economic activity. This may be achieved through quantitative easing (purchasing bonds in the market thus pumping money into the market) with an intention to promote economic growth. This policy can stimulate growth in short-term but this growth may not be sustainable as it can be accompanied with high inflation rate.
- Fed currently buys $120 billion of bond each month, helping to keep prices of those bonds high and yields low, with the aim of keeping cost of borrowing less and ensuring households and companies get access to easy credit.
- Tapering is reversal of quantitative easing (QE) policies and involve the slowing of asset purchases by the central bank. The phrase came into limelight back in 2013 when U.S. Treasury yields surged following the Federal Reserve (Fed) announcement of its intention of tapering its policy of quantitative easing, started in reaction to the 2008 financial crisis and ensuing recession.
- Federal Reserve Chair Jerome Powell, in his latest speech to Jackson Hole agreed on reducing the pace of asset purchase by end of this year if economy evolves as anticipated.

### RBI and Bond Yield

- CoVID-19 pandemic hit the nation with first case being reported in Kerela on 2nd February 2020. Later the near total lockdown over two months hit the economy hard, forcing government to remain on spending side with fiscal deficit taking backseat.
- In 2021-22 budget, fiscal deficit for the FY 2020-21 was revised upward from 3.5% (BE 2020-21) to 9.5%. The fiscal deficit for 2021-22 is estimated at 6.8% (BE) of GDP.
- Higher than expected fiscal deficit and announcement of additional market borrowing of Rs 80,000 crore to meet higher fiscal deficit for 2020-21, have led to rise in benchmark 10-year bond yield.
- The rate of interest at which commercial banks borrow money from RBI against government securities is called the repo rate. Currently, Repo rate is 4% and any further rate cut was not possible as economy was in the phase of recovery from recession and there was fear of inflation getting intensified. RBI has assured that it would consider revision in policy rates only when revival of economic activity shows signs of durability and signs of sustainability.
- In such a scenario, the central bank has to deal with inflation worries along with keeping in check the market borrowing cost of both state and central governments. It was important for RBI to actively participate in the bond market to ensure that the bond yields are in check.
- With this aim, RBI, announced Open Market Purchase of Government of India Securities under G-Sec Acquisition Programme (G-SAP 1.0) of Rs 1 Lakh crore in Q1 2021-22 and Rs 1.2 lakh crore under the G-SAP 2.0 in Q2:2021-22. We expect continuation of this programme in the current FY.

### Negative Bond Yields

- The bond is said to have negative yield when an investor receives less money at the time of bond’s maturity than the original purchase price of the bond. It is an unusual situation where issuer of the bond is paid to borrow. These bonds attract investments in period of uncertainty and stress as investors look to protect their capital from significant erosion. Recently, China sold negative-yield bond for the first time, and it was in high demand from investors across Europe.