As FPIs bond with Indian paper, cost of money falls

Flow into bonds double that of equity; yields drop 15-18 bps

The surge in foreign flows into the Indian bond markets, poised to overtake flows into equities for the second consecutive year, is already driving down the cost of money. Yields on gilts have already dropped by 15-18 basis points across tenures since the Reserve Bank of India (RBI) lowered the key repo rate by 50 basis points on September 29. On Friday, Rural Electrification Corporation (REC) priced its 10-year public issue of tax-free bonds at a coupon of sub-7%. Shashikant Rathi, executive vice-president, investments, at Axis Bank, said this was a clear indication yields were headed down. “This is the first time in probably three years that the coupon on corporate paper in the form of a public issue is being priced at a coupon of sub-7%,” Rathi said.

Despite the cap on investments into debt, foreign flows into rupee bonds so far in 2015 are already twice as large as into equities. Bloomberg data show foreign portfolio investors (FPI) have invested $8.6 billion in the debt market as on October 20, with $2 billion pumped in so far this month after the RBI allowed additional investments into G-Secs and state development loans (SDLs).

According to Bank of America Merrill Lynch, Indian bonds still offer a relatively high real rate within the region and the rupee has been the best-performing currency this year adjusted for volatility. While yields on the benchmark bond were 7.61% on September 29, it dropped to 7.51% by October 5 and remains around those levels. The periodic incremental FPI flows are expected to sustain the demand for bonds with the benchmark yield tipped to move closer to levels of 7.3-7.4% by March next year.

In contrast, equity inflows have been relatively subdued at $4.42 billion as a combination of local and external influences has prompted institutions to book profits. In 2014, FPIs invested $26.25 billion in rupee bonds compared with $16.16 billion in stocks, Bloomberg data show.

The first tranche of the auction for G-Sec limits in October, after the RBI’s policy announcement, attracted unprecedented response. The bid-to-cover ratio was almost 1:3, wherein investment limits worth R5,600 crore saw bids worth R17,200 crore. The cut-off premium was set at 66 basis points with the highest bid at 85 basis points, indicating a willingness to pay 85 paise for every R100 worth of bonds. At the previous auction in September the cut-off was 53.01 basis points while the top bid was 70 basis points.

Additionally, investors bought Rs 1,000 crore of bonds issued by state governments, using up nearly 27.6% of the upper limit of Rs 3,500 crore on the first day itself, suggesting comfort with state government paper. Subsequently, over the next few days, the entire quota was subscribed to.

Bankers believe FPI appetite for Indian paper will remain robust and that any unutilised G-Sec limits will be fully used up as and when available. At its September 29 credit policy meeting, the central bank had announced an increase in the FPI limit in G-Secs to 5% of the outstanding stock by March 2018, thereby opening up an additional R1.2 lakh crore ($18 billion) investment limit over the next two and a half years, over and above the existing limit of R153,500 crore.

These investments would occur in tranches over the stipulated time frame. Each tranche would entail an increase in limits by R13,000 crore for central government securities, of which R7,500 crore will be for long-term investors and R5,500 crore for others, according to RBI's September credit policy statement.

Moreover, a limit of R3,500 crore in SDLs will also be opened up for all FPI investors. FPIs have also been permitted to invest in SDLs, which will be increased in phases to a figure of 2% of the outstanding stock by March 2018. This would amount to an additional limit of about Rs 50,000 crore.

The increase for the current financial year is taking place in two tranches in October and January 2016, amounting to Rs16,500 crore (nearly $2.5 billion). Over a period of the next two and a half years, FPI investment limits into G-Secs and SDLs will be close to double the current figure of $30 billion allowed in G-Secs. As of October 21, the quota for corporate bonds of Rs 2.44 lakh crore has been used up to the extent of 76.62% as on October 21.

Meanwhile, German investment banking firm Deutsche Bank advised equity investors to stay defensive till emerging market currencies stabilise. "We believe that global macro factors will predominate investor sentiment. Even the RBI's action in the next credit policy will be determined by global macro factors, particularly the environment for capital flows in EMs and further actions from the PBOC and the Fed. Investors should be looking out for stabilisation of emerging market currencies and bond spreads, before drawing any comfort on buying beta. Markets will stay unsettled until there is clarity on what the Fed is likely to do," Abhay Laijawala, MD and head of research, Deutsche Equities (India), said.

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