Stars Aligned - Case for a higher debt allocation over the next 12-18 months.

December 2023

India bond markets have witnessed quite a bit of volatility in the last few months. The yields on the 10-year government bonds fell from 7.45% to 7% and have risen back to 7.25-35% due to rise in US bond yields and crude prices.

We believe that the market dynamics are changing from 3 facets :

- Fundamental - Macro picture highlighting the case for adding bonds.
- Structural - Changing market demand-supply dynamics & a case for long bonds (Duration).
- Relative – Perspective from history highlighting outperformance of bonds markets over other asset classes.

The changing market and macro dynamics have significantly improved the outlook over the next 12-18 months.

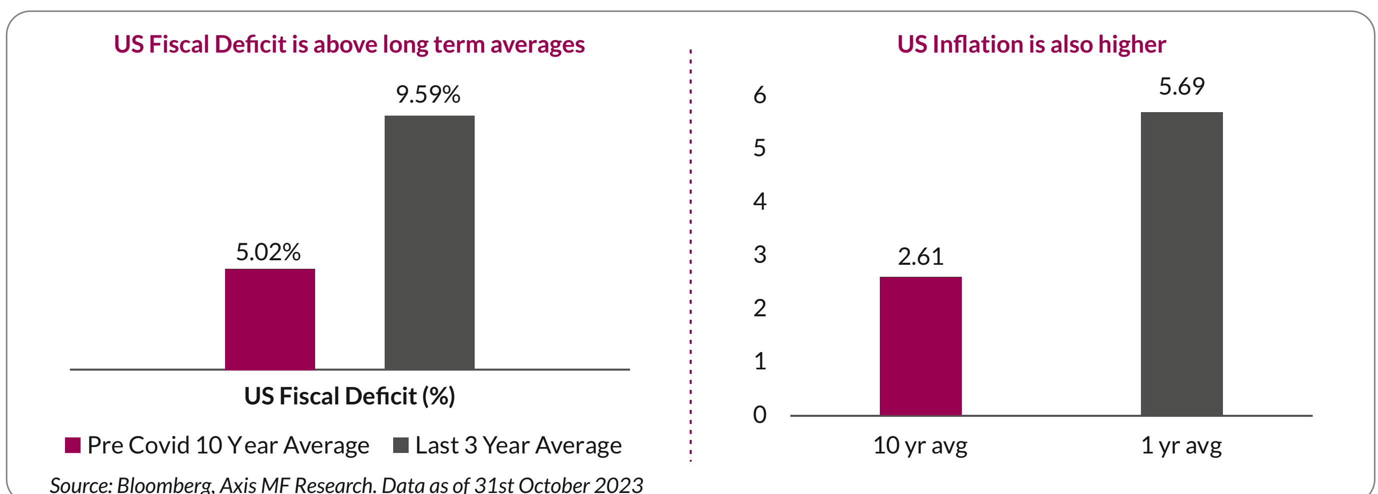
Fundamental theme

Inflation : Headline inflation is at ~5%. Decline in core inflation continues and this could be likely go below 4.5% as slowing growth in China and the weak global economy will likely keep commodity prices muted.

Growth : India's GDP growth seems to be peaking off and could remain subdued at sub 6% levels over the next two years. This is due to the fall in fiscal impetus by government & weakness in global economies.

Favourable External Position : India's external position remains comfortable considering the trinity (Forex reserves, balance of payments and current account deficit). Is China's loss India's gain? – Perhaps yes!

Narrowing US - India interest rate differential : To combat the pandemic, the US government increased spending to unprecedented levels leading to wider fiscal deficits (from sub 3% to 8-10%), a significant expansion of the US Fed balance sheet from $1-$2 trillion and an easy monetary policy stance for 2.5 years.



Source: Bloomberg, Axis MF Research. Data as of 31st October 2023

Resultant impact of easy fiscal and monetary policies over last 3-5 years has led to strong growth and inflation spiral. In the last 12 months, the US Federal Reserve hiked interest rates to the tune of 500 bps and shrank US Fed balance sheet from $3trn to $1trn.

The narrowing interest rate differential has kept RBI on tenterhooks. ***However, unless we see a large depreciation on the rupee or higher outflows,*** we do not expect RBI to raise interest rates. **RBI has already engineered a 25-bps rate increase in last two months through tight liquidity conditions.**

Therefore, bond markets are pricing in most of the negatives, macro theme augurs well for bonds, and fundamentally, the rates cycle looks positive.

Structural Theme

Question arises for bonds is high Fiscal deficits and large government bond supply, which in turn raises concerns on bond yields.

If we analyse the trend over last 7 years, we have generally witnessed structural demand supply gap of Rs 50,000 to 1.5 lakh Cr every year, where supply was higher than demand, which in turn is met by OMO purchases by RBI.

2016 to 2020 - RBI OMO Purchases	
FY 16	62,324
FY 17	1,10,494
FY19	2,99,222
FY20	1,13,664
FY21	3,13,290
Fy22	2,13,931

Source: RBI, Axis MF Research. Data as on 31st October 2023.

Nonetheless, in the last few years, there has been a growing trend of a significant increase in AUM/flows with Real money investors from INR ~55 trillion to INR ~85trillion. This has been helping to fill in the massive demand supply gap despite huge government borrowing plans over the last few years.

Growth in Capital Stock with real money investors

AUM (Rs. Cr)	Life Insurance	NPS	EPFO	Total Real Money Investors AUM	
FY20	38,90,274	4,17,479	12,70,448	**55,78,201**	3 Year Change Rs 29 lakh Cr
FY21	44,79,973	5,78,025	14,46,321	**65,04,319**	
FY22	49,52,187	7,36,594	18,17,482	**75,06,263**	
FY23	55,02,187	8,98,343	20,83,466	**84,83,996**	

Source: RBI, Axis MF Research. Data as of 31st March 2023.

In addition, we expect the fiscal deficit to normalize over the next 3 years from 6% to 4.5% and hence don't expect a significant jump in borrowing numbers Also, with India Sovereign bonds being included in JP Morgan Global indices we expect ~USD 25bn-~USD30 bn (INR~2.5 trillion) of flows in next 12-18 months, this is almost equivalent to more than 20% of next year's gross borrowings. This inclusion would be highly favourable for demand supply dynamics for bonds. Active bond traders could also pile into debt assets in the run up to the scheduled inclusion by allocating roughly $5-10 billion by March 2024.

Relative Theme

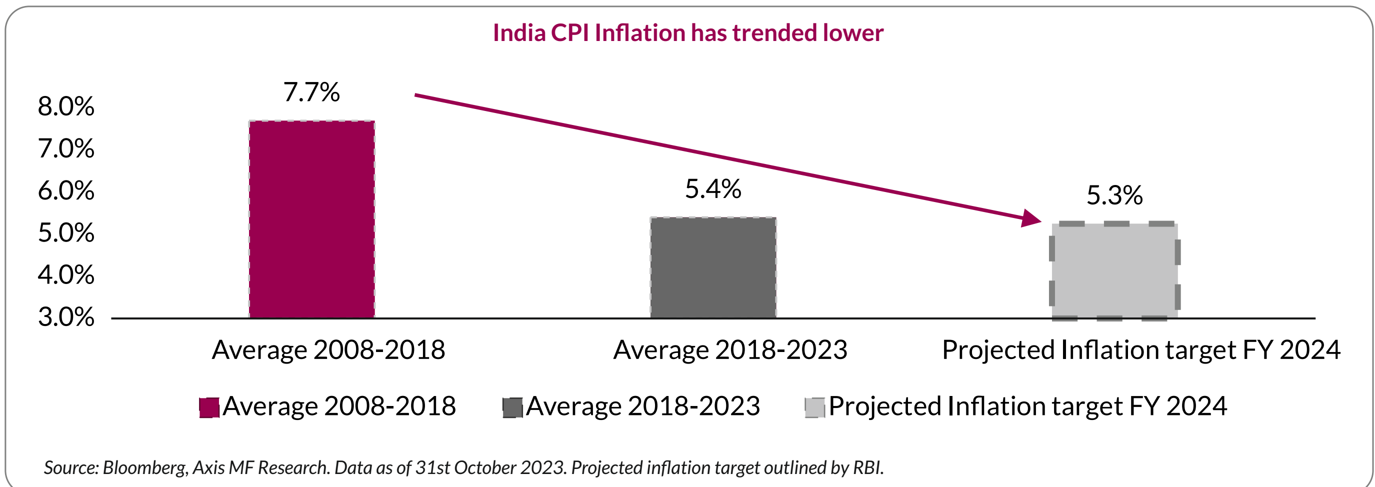
While bonds are always looked upon as an asset class that provides stability over a longer period, surprisingly and contrary to opinions, debt has outperformed other asset classes over the period's extreme/long interest rate hikes and tight financial conditions.

Start Date	End Date	Quantum of rate hike	Equity 1 year Returns (%)	Debt 1 year Returns (%)	Gold 1 year Returns (%)
29-04-2005	30-07-2008	3.0%	6.0%	19.9%	18.1%
19-03-2010	25-10-2011	3.5%	9.6%	11.6%	15.2%

Source: Bloomberg, Axis MF Research. Past performance may not be sustained in the future. CAGR returns provided. Equity returns – Nifty Index, Debt Returns - Nifty 10 years G-sec Index and Gold Returns – MCX Gold.

Why we believe that 7.25-7.35% levels for 10 year IGB's and above is a good time to add bonds to portfolio.

Historically, bond yields have traded in a band of 6-8% on an average given that inflation too has stayed in an range of 5-7% over the last decade. Inflation theme has structurally undergone changes wherein the range for CPI has changed from 5-7% historically to 4-6% range. Adding a term premium of 125-150 bps over expected inflation band we believe that Indian Government bonds offer an attractive carry and investment opportunity at current levels.



Source: Bloomberg, Axis MF Research. Data as of 31st October 2023. Projected inflation target outlined by RBI.

To conclude, analysing the fundamental, structural and relative themes, we advise a higher allocation for debt for next 12-18 months

Risks to our view

A few macro risks that stand out are **rising crude oil prices, China recovery and** a possibility of **China devaluing its own currency** to attract flows.

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