Credit Spreads Watch

December 2017

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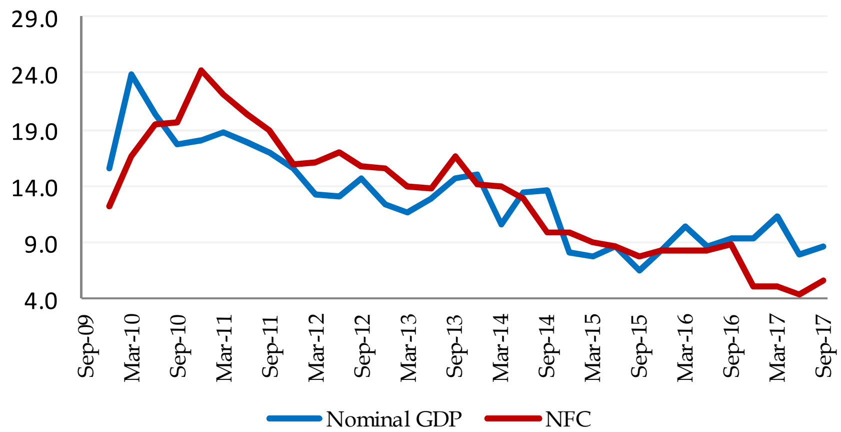
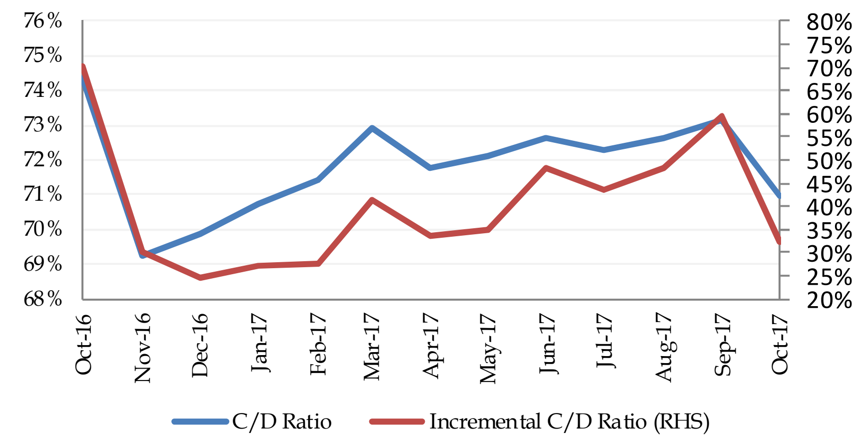
Bank Credit Picture

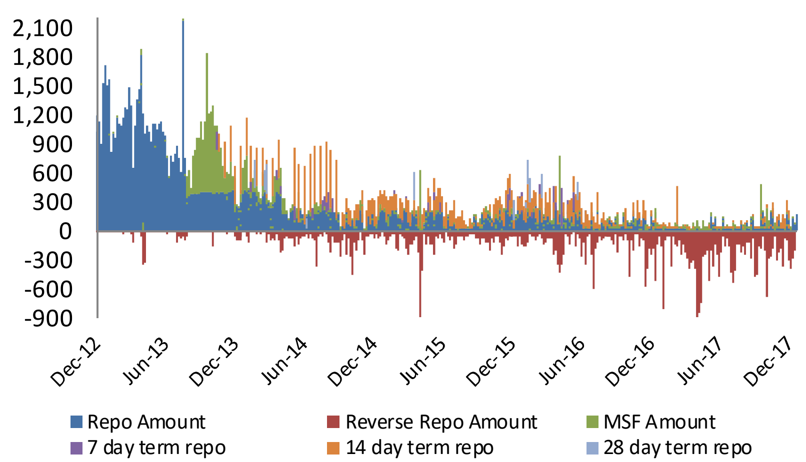
Non-food Credit Growth (%)



Credit Deposit Ratio (%)



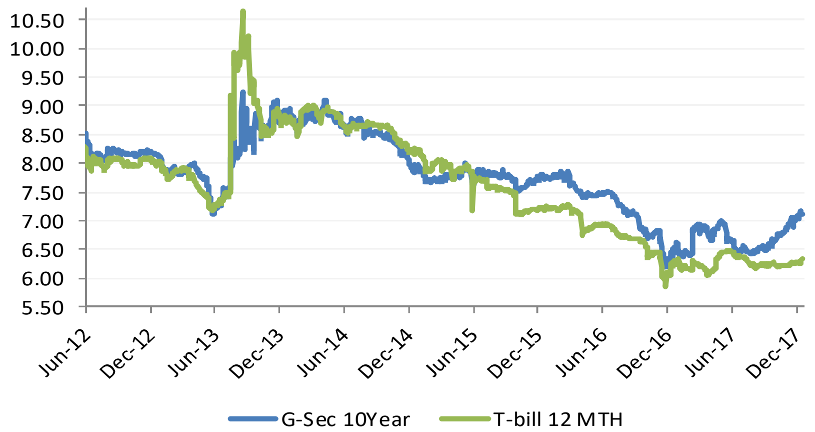
Liquidity Adjustment Facility (Rs B)



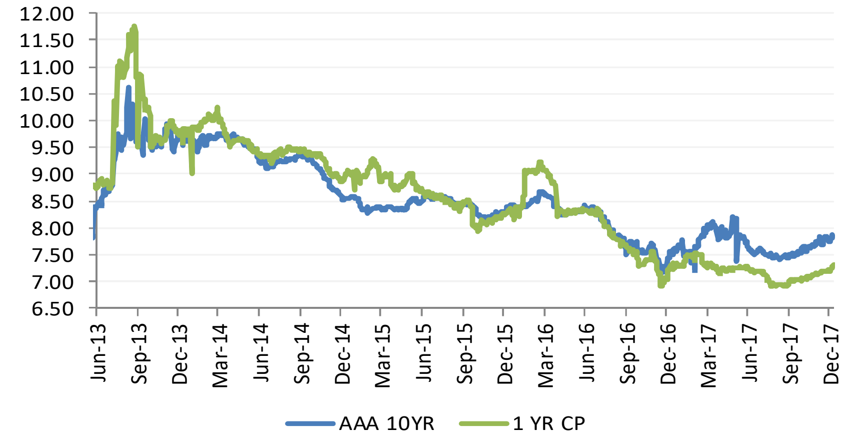
- Liquidity picture remains comfortable especially after the RBI's decision to bring the liquidity deficit to a neutral level.
- The surge of deposits post demonetisation has also led to surplus liquidity in the banking system
- Non-food credit growth was 6.6% YoY in October 2017 and deposit growth was 8.7% YoY, leading to incremental C/D ratio of 32.3%.
- Although nominal credit growth has remained subdued, there is adequate credit availability to most sectors once the numbers are adjusted for inflation and increased borrowing from the commercial paper market and other non-bank funding sources.

Credit Spreads

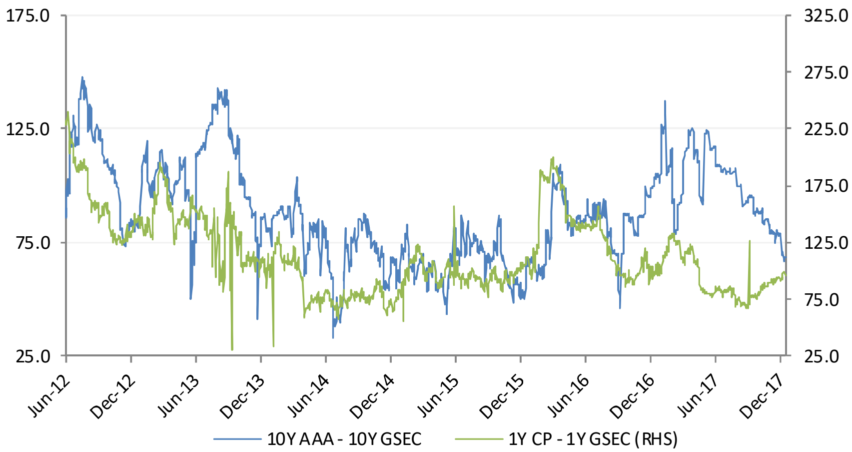
G-sec Yield (%)



Corp AAA Yield (%)



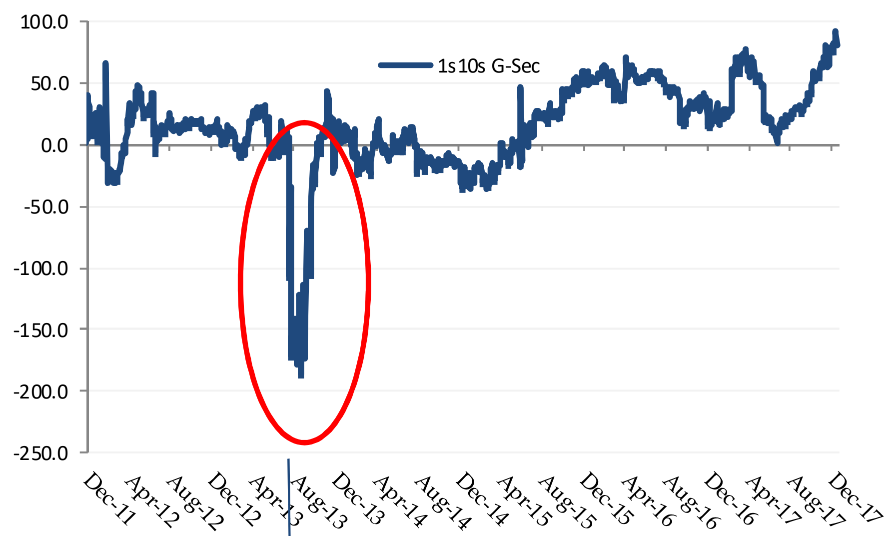
10 Year and 1 Year Corp AAA Spreads (bps)



- Given the benign liquidity conditions and lower headline CPI, both long term G-Sec and AAA yields have come down until June, however as CPI inflation started picking up and worries about fiscal deficit set in, yields have moved higher
- The corporate yield curve has mainly mirrored the move in the Gsec curve however the corporate yields did not move as sharply as Gsec yields as inflation started moving up. Consequently 10 year corporate spreads have moved down from in 108bps in June to 70bps in December.
- One Year spreads have remained stable as liquidity conditions continue to be supportive

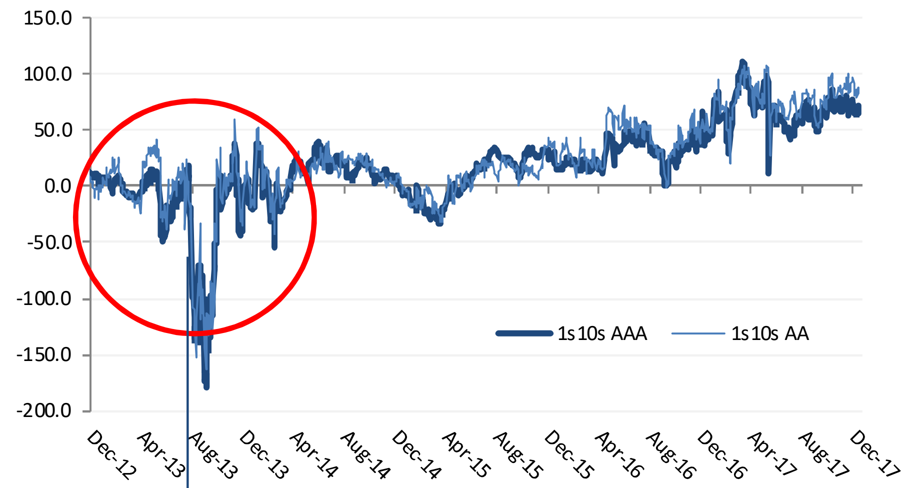
Bond Term Structure

Govt. Securities 1s10s (bps)



Negative terms structure is due to the RBI liquidity tightening measures in 2013

Corporate Bonds 1s10s (bps)

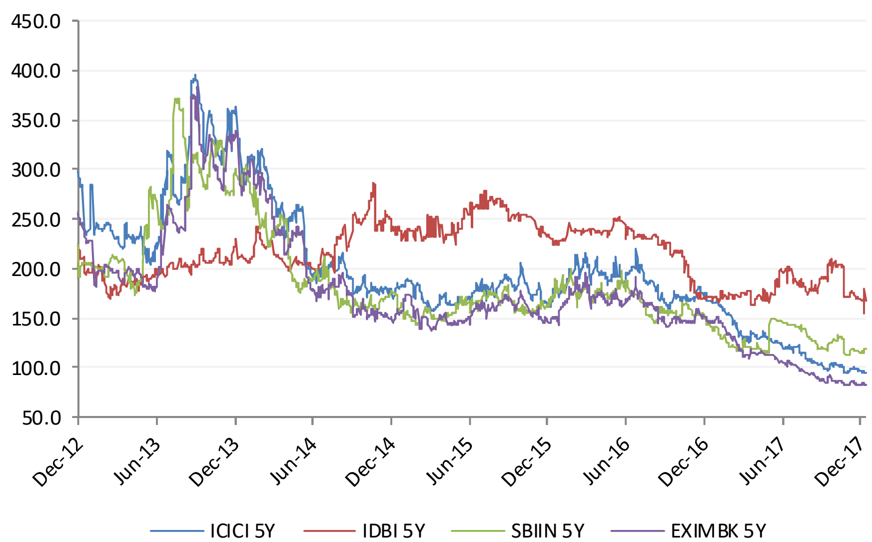


Negative terms structure is usually due to seasonal reasons which improves as liquidity improves`

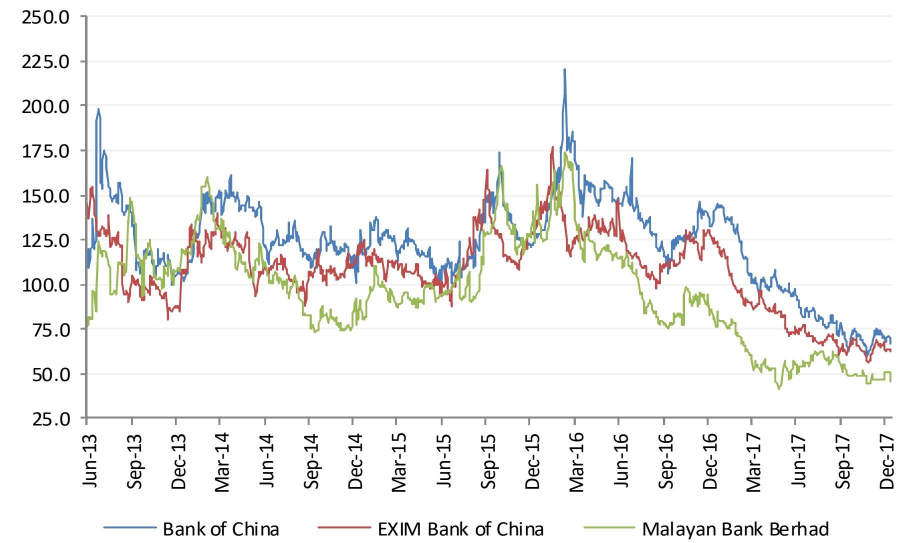
Source: Bloomberg, FIMMDA, Trust Research

Bond Term Structure

Govt. Securities 1s10s (bps)



Corporate Bonds 1s10s (bps)



- CDS prices across emerging markets have been volatile over the last several years reflecting both macroeconomic and geopolitical developments.
- In May-2013, CDS prices rose across EM as global bond markets started to take into account the scaling back of the QE program by the Federal Reserve.
- Since May-2014, India specific CDS prices declined to historic lows as market friendly BJP's victory in the 2014 General elections spurred India specific bond and equity $ flows.
- In June and July- 2015, India CDS spreads rose though remained below multi-year highs. However, other EM CDS spreads rose to Aug-13 highs as concerns over the global and EM economies grew. Currently Indian CDS spreads remain relatively stable reflecting improving macro economic fundamentals and growing confidence that the government will sustain reform agenda.

Source: Bloomberg, FIMMDA, Trust Research

Conclusion

- The premium required by corporate bonds over Gsecs which represents both credit and non-credit risk has been volatile over the last few years. The credit spread has moved from 100bps point at the end of March 2012 up to to 120bps by March 2017 and is now back down to 70bps as of December 2017. These moves have at times reflected changes in credit quality but at other times have stemmed from other factors such as risk aversion and liquidity.
- Typically tightening of credit spreads indicate a pickup in economic activity. The idea is that companies are less likely default in a growing economy and therefore the credit risk on their bonds will fall. Changes in credit spreads are affected by changes in expected recovery rates, which affect payoffs to bondholders. Because the expected recovery rate is a function of the overall business climate a rising economy should drive credit spreads down.
- In fact the latest period of widening spreads has coincided with the post demonetisation period where market participants expected a slowdown due to the adverse effects of the resulting cash crunch. Thereafter the tightening credit spreads have partly reflected the recovery in growth post the transient demonetisation slump. It has also been driven by the recent rapid pick up in Gsec yields as inflation has accelerated quickly over the last few months.
- In addition there has been a number of regulatory developments which have contributed to tightening of credit spreads. Some of these measures include inter alia allowing domestic lenders to issue masala bonds, accepting corporate bonds under the liquidity adjustment facility, increasing the ceiling for credit enhancement for corporate bonds and providing FPI’s direct access to bond trading platforms.
- We believe these measures have improved the liquidity in Indian corporate bonds and bring down the liquidity premium that exists in the market. This combined with constructive liquidity management by the RBI have shifted spreads down. Some concerns remain on spate of corporate defaults given the high leverage in the system, though we expect such risks to remain idiosyncratic in nature.
- With liquidity conditions still relatively benign, and macroeconomic fundamentals strong, conditions are right for spreads to remain at current historically tight levels. Hence, we expect the 10 Year credit spreads will remain 70- 100 bps over the short to medium term.

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Thank You

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