Bond yield falls on RBI's plan to buy additional G-Secs

Why in news?

The RBI's decision to step up purchase of government securities under the government securities acquisition programme (G-SAP) led to the yield on the benchmark 10-year bond falling below 6%.

What is the recent bond yield event?

- In April 2021, the RBI launched G-SAP under which it said it would buy Rs 1 lakh crore worth of bonds in the April-June quarter.
- It has so far bought Rs 25,000 crore worth of government securities (G-secs).
- The 10-year bond has declined 15 basis points from 6.15% in the last one month (April).

What impact will this have?

- Movements in yields, which depend on trends in interest rates, can result in capital gains or losses for investors.
- If an individual holds a bond carrying a yield of 6%, a rise in bond yields in the market will bring the price of the bond down.
- On the other hand, a drop in bond yield below 6% would benefit the investor.
- This is because the price of the bond will rise, generating capital gains. [Click here to know more on the relation between bond price and bond yield.]
- G-SAP has engendered a softening bias in G-sec yields which has continued since then.

Why are bond yields softening?

- The fall in bond yields in India could also be due to a sharp decline in US Treasury yields or the economic uncertainty caused by Covid-19.
- But the most important driver of the bond market was RBI interventions.
- The announcement of a bond-buying programme, the G-SAP, at the start of the month played a crucial role in turning the market sentiment.
- The RBI continued to send strong yield signals by cancelling and devolving government debt auctions.
- In the last month alone (April 2021), the RBI cancelled more than Rs 30,000 worth of debt auctions.

- A part of this amount was offset by availing the green-shoe option (option to accept bids for more than the notified amount of debt auction) in other securities.
- However, the decision to buy Rs 35,000 crore worth of bonds in May 2021 would help the market absorb a portion of the Rs 1.16 lakh crore market borrowings by the government during the month.

What is the impact on markets and investors?

- The structured purchase programme has calmed investors' anxieties.
- It has reduced the spread between the repo rate and the 10-year government bond yield.
- A decline in yield is also better for the equity markets because money starts flowing out of debt investments to equity investments.
- This means that as bond yields go down, the equity markets tend to outperform by a bigger margin and vice versa.
- Also, when bond yields go up, the cost of capital goes up.
- So, when bond yields go up, it is a signal that corporates will have to pay a higher interest cost on debt.
- As debt servicing costs go higher, the risk of bankruptcy and default also increases.
- This typically makes mid-cap and highly leveraged companies vulnerable.

Why is the RBI keen on keeping yields in check?

- The RBI has been aiming to keep yields lower because this reduces borrowing costs for the government.
- Meanwhile, it prevents any upward movement in lending rates in the market.
- On the other hand, a rise in bond yields will put pressure on interest rates in the banking system.
- This, in turn, will lead to a hike in lending rates.
- The RBI wants to keep interest rates steady to kick-start investments.
- If yields come down, the RBI will be able to bring down the cost of government borrowing for 2021-22, which is set at Rs 12.05 lakh crore.

How does the future look?

- Potential changes in the US monetary policy direction and Fed bond yields are the biggest risk factors for the Indian bond market in 2021.
- Notwithstanding this risk, bond yields may remain in a tight range in near future supported by RBI's bond purchases.
- Over the medium term, inflation and potential monetary policy normalisation will play a more important role in shaping the interest rate trajectory.

- It is expected that the market interest rates would move higher gradually over the next 1-2 years.
- The rest also depends on other global factors.

Source: The Indian Express

