Why 10-year G-Sec could trade between 8.10%-8.40% by Dec 2022?

In the MPC statement, RBI's average inflation projection of 6.7% in 2022-23 assumes average crude oil price (Indian basket) of US$ 105 per barrel. Brent crude oil Aug 2022 (2 month) futures was trading above $123 on the policy day. Projection of 6.7% average inflation itself witnessed an upward revision of 100 bps from April policy forecast. A $5 a barrel change in crude oil prices could impact CPI inflation by 25-30 bps. So, today's prices itself would take CPI forecast above 7.0%.

Why 6.7% CPI looks optimistic?

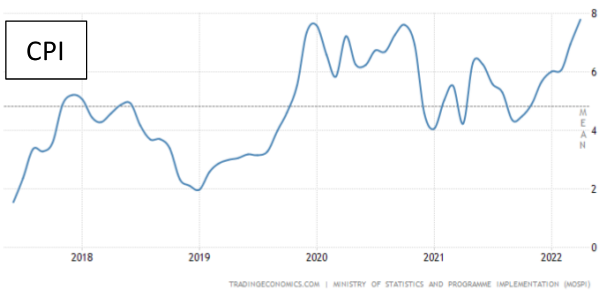
There are reports which states that India has increased its share of import of Russian oil from 1% in the full year 2021 to 5% in the month of April itself. While price assessment agencies have reported a discount of $35 per barrel to Brent, combination of shipping and insurance costs, which have sharply risen due to war, and increased traders' margins have resulted in an effective concession of $10 a barrel to Indian buyers.

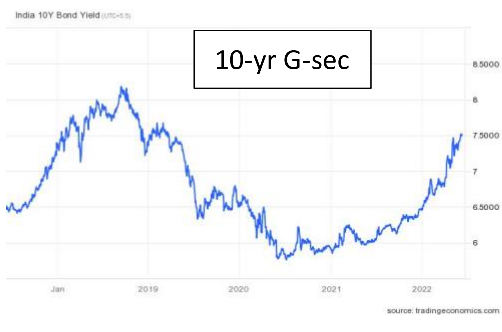
At present, there is clear change in market dynamics of Crude oil market as Russian oil has fewer buyers after European Union's partial ban. This change could be structural and could continue even if Russia ends the war against Ukraine due to sanctions from US and EU. Clearly, this is negative news for importing countries like India as upward pressure to crude oil prices could be witnessed in the near future unless something dramatically changes. China's ongoing economic recovery could only add fuel to fire going forward, as it is the largest consumer of crude oil.

Due to these factors crude oil staying above $105 is anybody's guess. So one may expect upward revision in CPI trajectory in subsequent policies.

Why 10-year G-Sec could trade between 8.10%-8.40% by Dec 2022?

According to the economist, terminal Repo rate in this cycle could range between 6.00% – 6.50%. Given the recent revision in terminal rates one could argue that 10-year G-sec could trade at 7.75%-8.00%. But another major factor that could put upward pressure on yields would be heavy G-Sec supply. Given the fact that Indian bond market participant are witnessing third consecutive year of high supply, with the ongoing rising interest rate cycle, participants would certainly demand a higher trading range to comfort one's portfolio positioning. As India's current account deficit (CAD) could near 3.0% mark this year the external situation looks challenging. This could also get aggravated by the ongoing FPI selling in equity markets thereby pressurizing the INR, as FPIs still hold around $50 billion in Indian equities.





Post pandemic, average 10-year G-sec yield for the period Apr 2020-Mar 2022 was 6.15% while the repo rate was mostly unchanged at 4.00%. Spread between 10-yr G-sec and repo rate stood as high as 215 bps given the uncertain environment post pandemic. CPI (see chart above) for the same period averaged at 5.97%. During this period there was extreme pessimism on growth, but due to high G-sec and SDL borrowing calendar long end yields were at an elevated spreads vs repo rate.

Taking into account all the above factors, 8.10%-8.40% range for 10-yr G-sec looks possible. Simple working: With terminal repo rate projected at 6.50%, adding around 200 bps spread 10 year might trade around 8.50%.

However, downward revision of GDP forecast by RBI for FY23 and FY24 could help capping the yields below this range.

Happy investing!

Gajendra M

Fund Manager

Composite PMS