11th May 2020

Vol: 04/2020-21

PNB GILTS LTD (Subsidiary of Punjab National Bank)

ECONOMY & GILT WATCH

Government on a Record Borrowing Spree

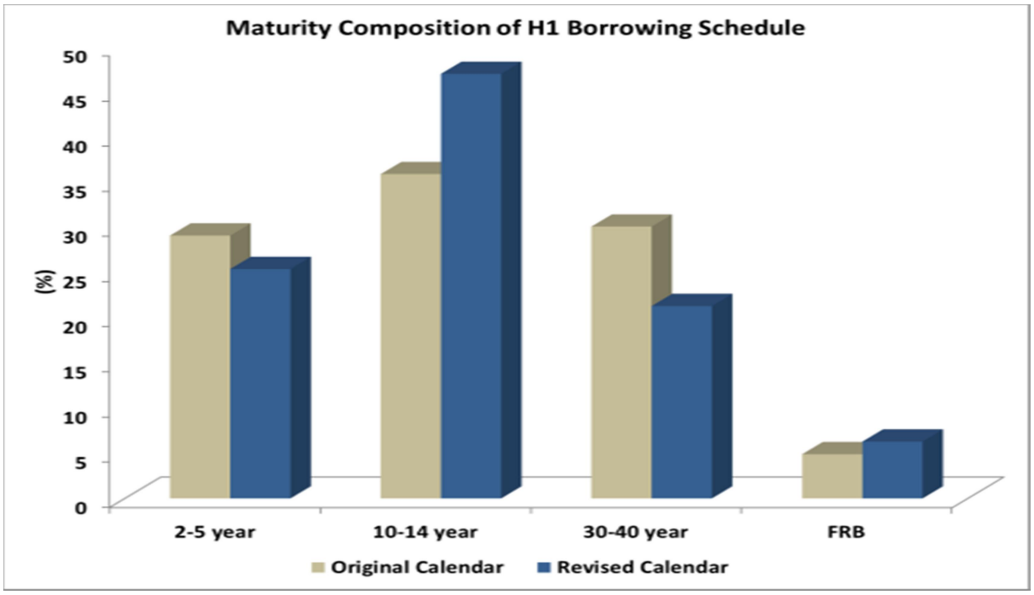
Government, after market hours on last Friday, announced a sharp hike in its market borrowing program for the first half of FY21, putting an end to continued speculation over the extent to which the borrowings would be shored up in order to tide over the economic fiasco that the Covid crises has caused. The government is set to borrow ₹ 6.98 lakh crore in H1 as against ₹ 4.88 lakh crore announced in the budget, while the gross borrowing for the full FY21 has been estimated at a whopping ₹ 12 lakh crore as against ₹ 7.8 lakh crore as per the original budget estimate. While the government was much expected to increase its borrowing given that the revenues have come under severe strain and that the expenditure has to be inevitably increased to give life support to the economy, the announcement came at a time when the bond markets were pricing in lesser damage to the fiscal position. In the auction conducted on Friday, the new 10-yr bond was lapped up by investors at a yield of 5.79%, which is the lowest yield on a 10-yr paper since 2009.

INSIDE THE ISSUE

Dissecting the new borrowing numbers

The revised borrowing numbers certainly look intimidating at ₹ 12 lakh crore, which is almost a 54% increase over the budgeted estimate of ₹ 7.8 lakh crore. The net market borrowings stand revised at ₹ 9.6 lakh crore vis-à-vis ₹ 5.4 lakh crore, while weekly supplies for H1 are at a daunting ₹ 30,000 crore. The government has also changed the maturity composition of the borrowing program from the original calendar with almost 47% borrowing concentrated in the 10-14 year segment (36% as per original calendar). On the other hand, government has reduced its dependence on short and long dated segment. Nonetheless, the borrowing numbers will shock the bond markets and yields will witness a spike in absence of any credible plan to help the market absorb the

humongous supply. Hitherto, RBI had been conducting special OMOs to manage the yield curve by buying medium dated papers and selling short dated papers, which has helped in flattening of the term structure. However, with the issue now being of creating sustained appetite for bonds while keeping interest rates low would be a mean task for the central bank and it would have to be seen what instruments RBI shall deploy to manage the same. Occasional OMOs shall not serve the purpose and only a planned buyback program supplementing the borrowing program will help create space for the record supplies. Also, it would be interesting to see if RBI initiates some measures to direct the excess liquidity in the system towards buying of bonds by further de-incentivizing parking of funds at the reverse repo window.



Monthly Borrowing Details (Revised) (₹ Cr)			
Month	Monthly Borrowing	Redemptions	Net Borrowing
April'20	60000	35608	24392
May'20	128000	49962	78038
June'20	120000	52868	67132
July'20	150000	0	150000
August'20	120000	0	120000
September'20	120000	0	120000
	698000	138438	559562

Fiscal math gets a rejig

While the government has provided only the additional borrowing numbers for FY21, the entire fiscal, revenue and expenditure calculations have been upended by the Covid crisis. The new budget workings will have to factor in significant changes in all the variables affecting the fiscal deficit number. Not only the revenue and expenditure numbers will have to undergo significant revision, the projected nominal GDP growth of 10% for FY21 will also need to be adjusted to arrive at a more realistic and believable fiscal deficit projection. Nevertheless, the situation is likely to remain dynamic and it will be difficult to anticipate the actual likely fiscal slippage and the increase in borrowing may not be limited to this one instance. For perspective, revenue slippage is expected to be of the order of around ₹ 4 lakh crore which eats up the entire additional borrowing that government has come up with. And with the economy in a dire need of an economic package, the actual funding requirement of the government may be even higher. Lately the government has desperately been trying to increase its revenues and the latest hike in the fuel taxes is expected to bring some respite to the fiscal position with likely revenues of around ₹ 1.5 lakh crore.

Will rating agencies swing the axe?

The upward revision in borrowings comes close on the heels of a rating downgrade warning by Moody's in case the fiscal parameters deteriorate further. The global rating agency had revised down its outlook for India from Baa2 stable to Baa2 negative in November 2019 and its rating is a notch higher than that assigned by the two other rating agencies, Fitch and S&P. The risks of a rating downgrade by Moody's has flared up substantially as the country's debt to GDP ratio is set to shoot up (with increase in borrowings and growth expected to stay flat or even contract marginally in FY21). However, the fiscal slippage was a foregone conclusion as erosion of revenues was imminent. Moreover, the current situation warrants a fiscal response as the consumption and investment expenditure will remain fragile for a prolonged period of time while exports are also not expected to bounce back any time soon given the bleak global economic outlook.

Rating Agency	Current Rating	Last Downgrade/upgrade
Moody's	Baa2 (negative)	Nov'19 ↓ (from Baa2 stable)
S&P	BBB- (stable)	Sep'14 ↑ (from BBB- negative)
Fitch	BBB- (stable)	June'13 ↑ (from BBB- negative)

Fixed Income Outlook

Fundamental View

After witnessing a spectacular rally at the closing of the fortnight, bond markets are up for difficult times yet again with sharp upward revision in the government borrowing estimate for FY21. Markets had closed on a positive note not expecting significant damage to the fiscal position, however with the expectations being clearly belied; the term structure shall witness an upward shift. The 10-yr segment shall be pressurized given the fact that government plans to borrow most from this segment, while the long end of the curve is also likely to move up owing to deteriorating fiscal outlook. Bond market is expected to remain jittery and a strong RBI intervention will be needed to create space for the humongous weekly supplies.

Technical View

Analyst1: 6.45% G-Sec 2029 yield settled at 5.97% on Friday's session. However, post borrowing announcement it opened with sharp gains at 6.20% on Monday, indicating a pause to current down trend in yields. Last fortnight, benchmark yield headed lower and touched low of 5.96%. Momentum indicator RSI is showing slight divergence on EOD charts (as shown in chart), indicating yields may resist to fall below support levels of 6.06%/5.98%. On higher side immediate resistance level is placed at 6.25% zone. From here on, we believe markets may trade range bound between 6.06% to 6.25% zone and either side sustainability will confirm the further path of action for 10 yr yield.

Chart source: Investing.com

Analyst 2: Since the beginning of this financial year, 6.45% GOI 2029 had a strong downtrend from 6.50% to 5.96%. Owing to the recent upward revision in gross borrowing, the downtrend is expected to stop and face a trend correction in yields.

Broadly , 6.45 GOI 2029 has opened around 6.23% on May 11 , 2020 and during the day the paper has down trended towards 6.16% levels. However , the view is the ignore the yield band between 6.23% to 6.06% as 38.2% retracement level of 6.50% to 5.96% band ie., 6.17% has been broken at the opening tick. Hence, the market is expected to hit its 61.8% retracement level at 6.30%. Hence, on the upside if the yield reverses after touching 6.30% we may look to enter. On the downside, if the drop in yields continue, then entry may be made below 6.06%.

Investors' Digest

What are "Bad Banks"?

A Bad bank, as the name suggests, is a corporate structure which segregates the non-performing assets of a bank, taking them into its balance sheet, which helps in cleaning up the bank's balance sheet and hence improve its lending capacity. After taking the bad loans, such banks try to recover the amount by using the various recovery methods and the original bank or the institution may clear the balance sheet after transferring those assets. With revival in lending capacity, the bank will earn enough interest from new, good loans to cover the losses from the bad loans.

Why is the idea of a Bad Bank being mooted in India?

Lately, Indian banks have been pitching for structuring of a Bad Bank in order to deal with the overhang of stressed assets in the banking system. Moreover, the current bout of Covid crisis and lockdown induced restrictions has taken a huge toll on economic activity both at business and household level. The NPA situation is only likely to worsen from here, putting further pressure on the strained banking system.

The idea of a bad bank is not new and has been brought to the fore previously as well. In 2017, the Economic Survey suggested Public Sector Asset Rehabilitation Agency or PARA, to buy out the largest NPAs from Indian banks. Recently, in proposing Project Sashakt, a plan to revive Indian banks, the Sunil Mehta panel suggested that a new Asset Management Company (AMC) be set up to tackle bad loans of over ₹500 crore. The AMC will in turn set up alternative investment funds (AIF) that will buy up stressed assets in different sectors, from asset reconstruction companies (ARC), then try to auction them off to raise cash.

Challenges in the way

Though well intended, the main challenge that comes in way of structuring a bad bank is the capitalization issue. Moreover setting up a bad bank is a complex process and it cannot act as a panacea for all the problems afflicting the Indian banking sector.

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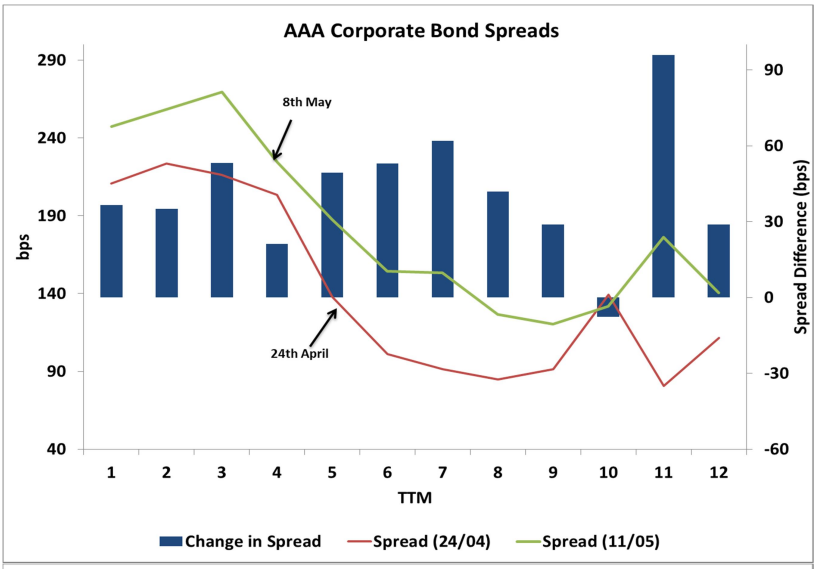
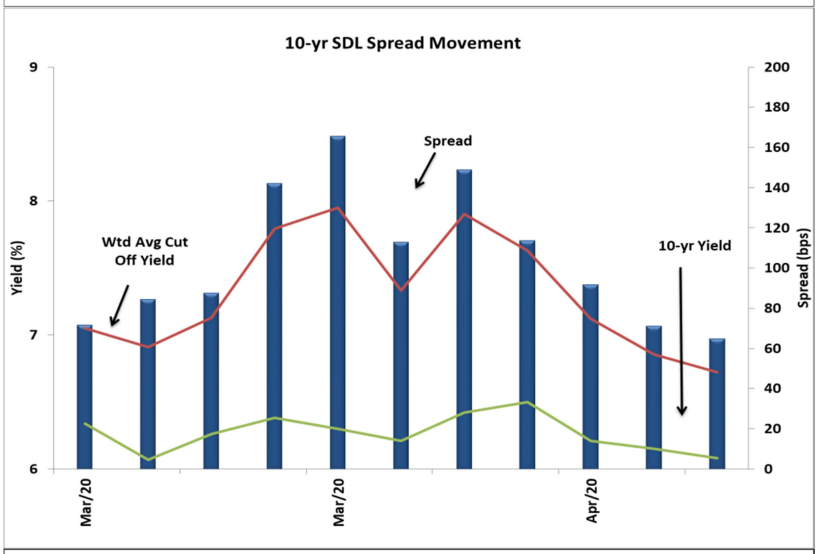
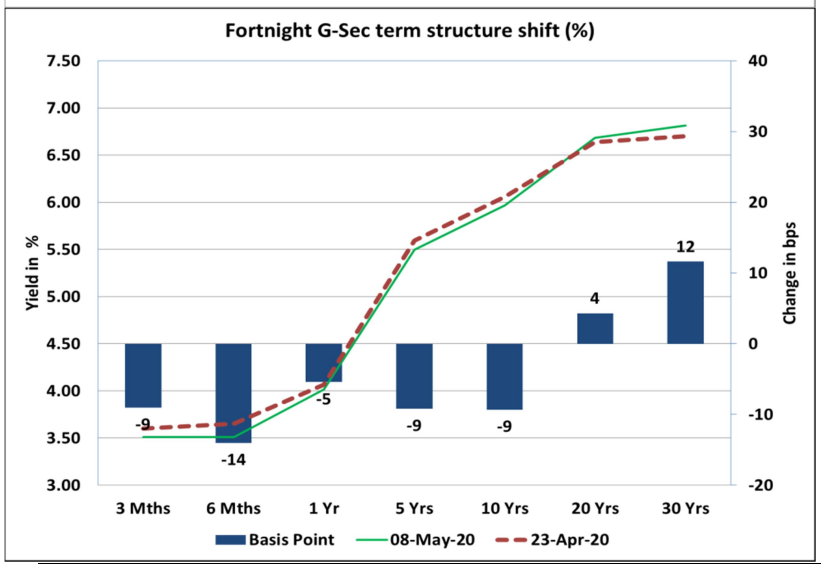
SPREAD MONITOR



Corporate bond spreads widened during the fortnight and are expected to stay at elevated levels.



With increasing funding requirement of states, the spreads on SDLs are expected to widen in the medium term.



Yield curve is expected to steepen owing to heavy supplies in the mid and long end of the curve. Short term yields will continue to stay low on account of excess liquidity and lesser supply burden.

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