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Indian Bonds Loosing Sheen

Why in news?

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Foreign investors have sold a net $1.12 billion in Indian debt market (primarily bonds) this month, the highest since December 2016.

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What are bonds?

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- A bond is a debt investment.
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- Corporates or governments issue bonds directly to investors, instead of obtaining loans from a bank.
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- This is to raise money and finance a variety of projects and activities.
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- The investor buys the bonds and loans money to the entity and in turn receives fixed interest.
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- This is for a defined period of time (till maturity date) and a variable or fixed interest rate (coupon rate).
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How are bond prices, bond yields and interest rates related?

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- **Price** - Face value is the money amount the bond will be worth at its maturity.
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- It is also the reference amount the bond issuer uses when calculating interest payments.
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- The issuance price of a bond is typically set at par, usually $100 or $1,000

face value per individual bond.
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- But a **bond's price changes** on a daily basis, just like that of any other publicly-traded security.
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- The actual market price of a bond depends on various factors including:
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i. the credit quality of the issuer
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ii. the length of time until expiration
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iii. the coupon rate compared to the general interest rate environment at the time
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- **Interest rates** - The **price of a bond primarily changes in response to changes in interest rates** in the economy.
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- For instance, say the investors get a better return in corporate bond either due to rise in their rate or due to fall in rate of government's bond.
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- This would make the corporate bond much more attractive.
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- Investors in the market will bid up the price of the bond until it trades at a premium that equalizes the prevailing interest rate environment.
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- **Yield** - In simple terms, yield is the amount of return that an investor will realize on a bond.
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- If the investor holds the bond to maturity, s/he will be guaranteed to get the principal amount back plus the interest.
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- However, a bond does not necessarily have to be held to maturity by the investors.
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- Instead, investors may sell them for a higher or lower price to other investors.
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- The **bond prices and yields generally move in opposite directions.**
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- This is because, as a bond's price increases, its yield to maturity falls.
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- E.g. for a bond purchased with a par (face) value of $100, and a 10 percent annual coupon rate, its yield would be 10% (10/100 = 0.10)
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- If the bond price fall to $90, the yield would become 11% (10/90 = 0.11).
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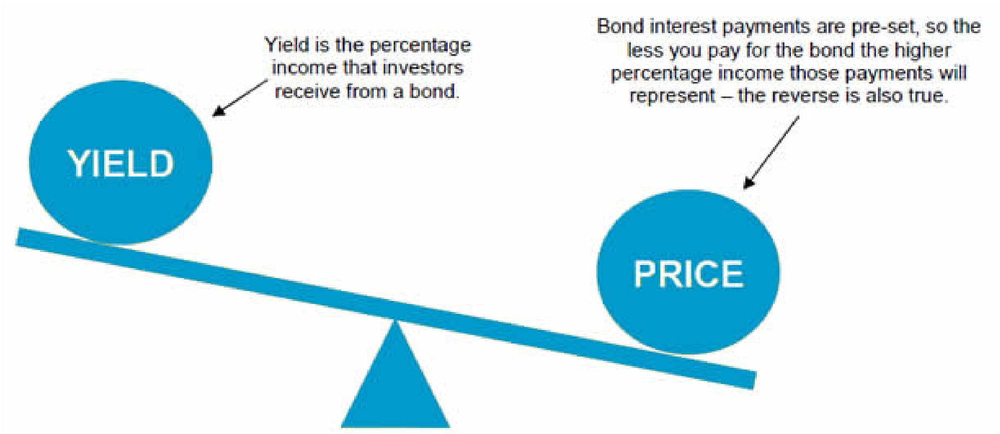

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What is happening to Indian bonds?

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- Indian bonds were once regarded as hot emerging market play.
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- The country received about $26 billion in inflows last year through this.
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- Notably, higher bond yields and stable currency have been driving factors for its attractiveness.
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- But Indian bonds are now losing their allure with foreign investors.
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- The 10-year bond yield dropped to as much around 7.3% from 7.62%, its lowest since January end.
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What are the driving factors?

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- **Rupee** - R**upee weakness** is one of the major reason for the change in

investor sentiment.
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- The partially convertible currency has lost nearly 2% against the US dollar this year.
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- A fall in local currency ultimately erodes returns for foreign investors.
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- **US Fed Rate** - The interest rates hikes in the US could lead to outflow of foreign portfolio investor funds from emerging markets.
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- This is a concern for India, as funds would move out of the country to be parked in US Treasury bonds.
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- **Economic concerns** - Inflation has stayed above the RBI's 4% target for 5 consecutive months.
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- Adding to this is the fear of the central bank raising the interest rates further.
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- Moreover, rising energy prices are widening India's trade and current account deficits.
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- The government has also loosened its fiscal deficit targets to finance increased spending ahead of general elections due by 2019.
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- **Banks** - The public sector banks, typically the biggest lenders to the government, have turned wary of lending.
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- State-run banks are unable to buy government bonds amid widening treasury losses.
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- This inability also reduced confidence in the country's debt.
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- State-run lenders are estimated to be been selling Rs 5.30 billion of government debt on average every day this year.
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What is the way forward?

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- Domestic investors are already concerned with widening fiscal deficit.
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- Banks hold about 30% of the government bonds while foreigners own about 7.5%.
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- Thus foreign selling is also now adding pressure on the market.
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- A new investor class is needed to absorb upcoming bond supply.
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- It is thus essential that the RBI re-examine the rule limiting the role of foreign investors in the bond market.
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Source: The Hindu, Economic Times

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