Rise in Bond Yield - Causes and Impact

What is the issue?

- Yields are rising on government securities or bonds in the United States and India.
- This has triggered concern over the negative impact on other asset classes, especially stock markets, and even gold.

What are bonds?

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

How are bond prices, bond yields and interest rates related?

- **Price** - Face value is the money amount the bond will be worth at its maturity.
- It is also the reference amount the bond issuer uses when calculating interest payments.
- The issuance price of a bond is typically set at par, usually $100 or $1,000 face value per individual bond.
- But a bond's price changes on a daily basis, just like that of any other publicly-traded security.
- The actual market price of a bond depends on various factors including:

i. the credit quality of the issuer
ii. the length of time until expiration
iii. the coupon rate compared to the general interest rate environment at the time

- **Interest rates** - The price of a bond primarily changes in response to changes in interest rates in the economy.
- 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.
    - This would make the corporate bond much more attractive.
    - 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.
- **Yield** - In simple terms, yield is the amount of return that an investor will realize on a bond.
- If the investor holds the bond to maturity, s/he will be guaranteed to get the principal amount back plus the interest.
- However, a bond does not necessarily have to be held to maturity by the investors.
- Instead, investors may sell them for a higher or lower price to other investors.
- The bond prices and yields generally move in opposite directions.
- This is because, as a bond's price increases, its yield to maturity falls.
- E.g. for a bond purchased with a par (face) value of $100, and a 10% annual coupon rate, its yield would be 10% (10/100 = 0.10)
- If the bond price fall to $90, the yield would become 11% (10/90 = 0.11).

How have bond yields moved in the recent past?

- During the first half of 2020-21, bond yields were mostly below 6% due to effective yield management by the RBI.
- However, this changed after the Budget, when the government upped its borrowing programme for the current fiscal.
    - It has announced an aggressive borrowing plan for FY22.
- The yield on 10-year bonds in India moved up from the recent low of 5.76% to 6.20%.
- This was also in line with the rise in US yields.
    - Bond yield in the US, which was at 0.31% in March 2020, touched 1.40% recently.
- The development has led to concerns in the stock market.
- Notably, benchmark Sensex fell 2,300 points in the past week.

What is the significance?

- There are over Rs 70.55 lakh crore of outstanding government securities (G-Secs).
- The government is also planning to borrow more from the market through G-Secs.
- So, the movement of yields in the coming months becomes significant.

What caused the recent rise in bond yields?

- The major factors affecting the yield are -
    1. the monetary policy of the RBI, especially the course of interest rates
    2. the fiscal position of the government
    3. government's borrowing programme
    4. global markets, economy, and inflation
- With the pandemic's impact, Finance Minister has pegged the fiscal deficit for 2021-22 at 6.8% of GDP.
    - The original target was 3.5%.
- The government aims to bring it back to below 4.5% by 2025-26.
- A fall in interest rates makes bond prices rise and bond yields fall and vice versa.
- In short, a rise in bond yields means interest rates in the monetary system have fallen.
- In other words, the returns for investors (those who invested in bonds and government securities) have declined.

How has the rise in yield affected stock markets?

- The sudden rise in domestic and global bond yields recently moderated the enthusiasm of equity market participants around the world.
- Traditionally, when bond yields go up, investors start reallocating investments.
- They shift away from equities into bonds, as they are much safer.
- As bond yields rise, the opportunity cost of investing in equities goes up.
- Equities become less attractive.
- Also, a rise in bond yields raises the cost of capital for companies.
- This, in turn, compresses the valuations of their stocks.

How will the borrowing programme and economy be impacted?

- When bond yields rise, the RBI has to offer higher cut-off price/yield to investors during auctions.
- This means borrowing costs will increase.
    - And this happens at a time when the government plans to raise Rs 12 lakh crore from the market.
- However, RBI is expected to stabilise yields through open market operations and operation twists.
- Also, government borrowing costs are used as the benchmark for pricing loans to businesses and consumers.
- So, any increase in yields will be transmitted to the real economy.

Will high yields impact the flow of FPI funds?

- Traditionally, when bond yields rise in the US, FPIs (foreign portfolio investment) move out of Indian equities.
- Also, it has been seen that when the bond yield in India goes up, it results in capital outflows from equities and into debt.
- A higher return on treasury bonds in the US leads investors to move their asset allocation from more risky emerging market equities or debt to the US Treasury.
- So, a continued rise in yields in developed markets may put more pressure on Indian equity markets.
- India will likely witness an outflow of funds.
- Even a rise in domestic bond yields would see allocation moving from equity to debt.

How does the future look?

- Yields have already risen across the world, and they are almost certain to rise further in the US.
- This will happen especially if the Biden administration gets its $1.9 trillion package over the line.
- A slow but steady rise will allow other asset classes to adjust.
- However, a rapid increase in the US yields will likely have deeper implications.

What should investors do?

- Bond yields move on account of various factors.
- So, investors will have to keep an eye on both domestic and global developments while investing in them.
- With the RBI now allowing retail participation in G-Secs, investors need to be watchful of developments before taking a decision.

Source: The Indian Express