

Recent Debt Market Volatility

Key Takeaways

- Current Spike in yields is temporary.
- The spike has been primarily caused by redemption pressure and risk of trades.
- This should settle down as the volatility in the global and domestic markets subside.
- Investors can continue to remain invested in good quality portfolios.

Volatility in Domestic Debt Markets

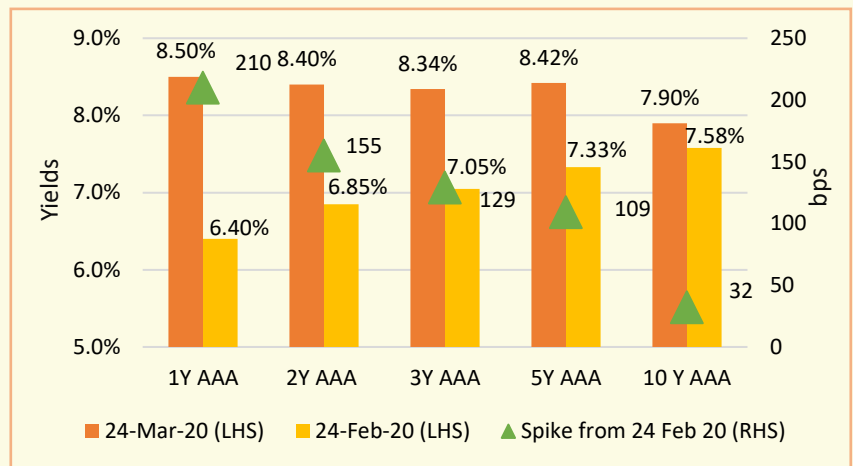
Along with equity markets, Coronavirus has impacted the debt markets too. The prevailing market conditions have exaggerated the market volatility in debt funds despite a surplus banking liquidity environment.

Debt yields in the last one month have spiked across different categories and across maturity profiles. In the period since, 24th Feb this year, the yields on non PSU AAA has gone up approx. 100 bps on an average with 1 year yields rising by almost 200 bps. The yields have risen more sharply in the short term space as compared to the medium and long duration space.

This spike in yields has led to marked to market losses for all funds investing in corporate debt securities regardless of the duration.

As can be seen in the table, the yields of 3-mth, 6-mth and 1-year instruments (CDs and CPs) also rose in the range of ~200-300 bps in one month's time frame. A sharp rise in yields of corporate instruments in March 2020, especially at the shorter end of the curve, saw spreads widen considerably.

AAA Corporate Bonds Non PSU (HFC) spiked up in past month



Source: IDFC AMC

Yields	Certificate of Deposit (CD)			Commercial Paper (CP)		
	Current	1 Mth Ago	Change in Bps	Current	1 Mth Ago	Change in Bps
3 Mts	8.50%	5.35%	315	8.00%	5.65%	235
6 Mts	8.25%	5.60%	265	8.10%	6.00%	210
1 Yr	7.90%	5.80%	210	8.00%	6.35%	165

Data as on 24th March 2020; Source: IDFC AMC

Reasons for Volatility in Yields

- Year-end liquidity requirements due to advance tax requirements.
- In addition, domestic investors have withdrawn additional funds do to cash requirements and flight to safety.
- Overseas investors (FPIs/FIIs) have sold \$7.1 billion (54,000 Cr) in the Indian debt market in March both long term and short term debt papers.
- The situation surrounding the 'Yes Bank moratorium' too induced bear sentiment.
- The liquid funds have also shown negative volatility as they are also now required to mark to market papers which are above 30 days' maturity.

Impact of Volatility

The impact of the spike in the yields has led to mark to market losses across various categories of funds including liquid funds.

In 1-mth, the returns of Medium duration have fallen the most (-4.3%) followed by Credit risk funds (-4%) and Banking & PSU (-3%).

While under Liquid category, Low duration has been the under performer which posted negative 2.4% followed by Ultra short term falling by (-0.5%) under 1-mths time frame.

Categories	Absolute (%)		
	1 Week	2 Weeks	1 Month
Short Duration	-1.06	-2.21	-2.13
Banking & PSU	-1.35	-2.93	-2.75
Medium Duration	-1.22	-2.70	-4.27
Corporate Bond	-1.28	-2.77	-2.47
Credit Risk	-0.94	-1.74	-3.97
Dynamic	-0.88	-2.30	-1.56
Gilt	-0.61	-2.20	-0.53
Liquid	-0.12	-0.04	0.18
Low Duration	-0.81	-1.25	-2.35
Money Market	-0.80	-0.88	-0.62
Overnight	0.08	0.17	0.36
Ultra-Short Term	-0.63	-0.75	-0.54
Category average as on 24th March 2020; Source: ICRA MFI			

Central Bank Actions

The RBI has taken a slew of measures to increase liquidity to the bond market & to ensure availability of credit to borrowers. Some of the measures that have been announced:

- Earlier, RBI has announced Dollar-Rupee swap measures in excess of US\$ 4 bn to support the forex market.
- Other than that, RBI has already done an OMO of Rs 10,000 cr. Over that, additional OMO of Rs 30,000 cr has been announced.
- Today, RBI governor announced a massive 75 bps cut in repo rates to 4.4% as a measure to counter the economic slowdown caused by the COVID-19 pandemic. The reverse repo rate has been cut by 90 bps to 4%. While, the CRR has been reduced from 4% to 3%; releasing Rs 1.37 lakh crore liquidity in the banking system.
- RBI will conduct Targeted Long Term Repo Operations (TLTROs) for up to 3 years amounting to a total of Rs 1 lakh crores. The rate will be floating and linked to the policy rate.
- Also, MSF limit raised from 2% of SLR to 3% of SLR effective immediately till end June. This will potentially provide access to another Rs 1.37 lakh crores under the RBI window.
- With a total Rs 3.74 lakh crore pumped into the system, the RBI actions will significantly help liquidity easing in the system and bring down the elevated yields.

Opportunity in Current Elevated Yields

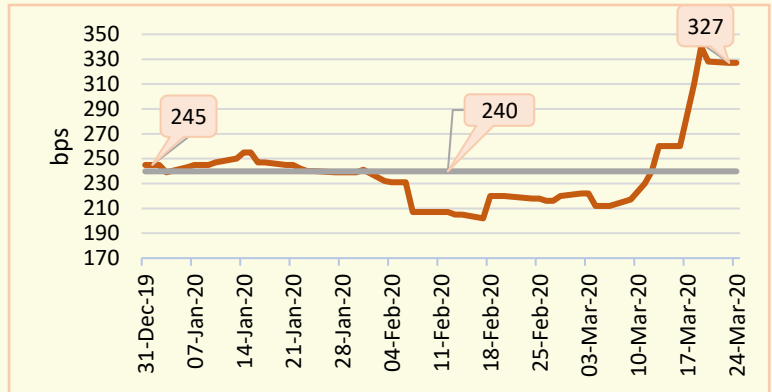
The market has reacted to the current spate of bad news and the risk off trade has led to large redemptions from emerging market debt. This has created opportunity for existing as well as potential investors in fixed income space.



Spreads between 5 Year AAA Non PSU Corporate (HFC) and Repo

Besides; the spreads between the repo rate and 5 Year AAA Non PSU Corporate Bond - Housing Finance Company (HFC) have spiked to as high as 340 bps i.e. 100 bps above the YTD average of 240 bps, giving an opportunity to the investors to invest at elevated yields where the risk reward is highly favourable.

Current high yields coupled with massive rate cut announced by RBI provide an attractive entry opportunity for investors in the debt funds.



Source: IDFC AMC

What should Investors do?

Existing investors in debt funds should continue to hold the portfolio including liquid funds. Policy action in the past in similar situations has resulted in sharp reversal trends of debt fund returns benefitting the investors. With RBI injecting sufficient liquidity and cutting rates the elevated yields should normalise.

Moreover, in the current environment, the investors should also look at reallocation funds with questionable paper quality to better quality selected funds to navigate the current volatility and economic slowdown.

Fresh investment can be considered in the debt categories with higher AAA paper exposures at this point in time. Accordingly, investors can consider the following categories:

- Short Duration
- Corporate Bond Funds
- Banking & PSU Funds

Category	AAA / P1+ (%)	AA+ / P1 (%)	Below AA+ (%)	Cash / Call / Others (%)
Banking & PSU Debt Fund	84.56	5.41	2.78	7.25
Corporate Bond Fund	86.86	2.11	3.34	7.69
Short Duration Fund	75.55	3.62	10.10	10.72

Category Average as on Feb 2020 Source: ICRA MFI

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