

India Fixed Income Investing for Foreign Investors

April 2018

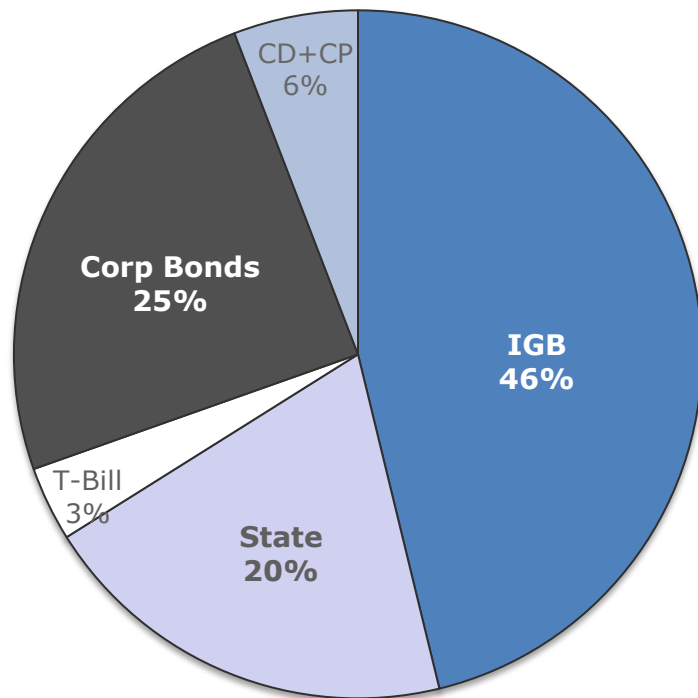


INR Debt Product Landscape

Outstanding Rupee Debt [Onshore]



Total Onshore Rupee Market Debt – USD 1.70 tn



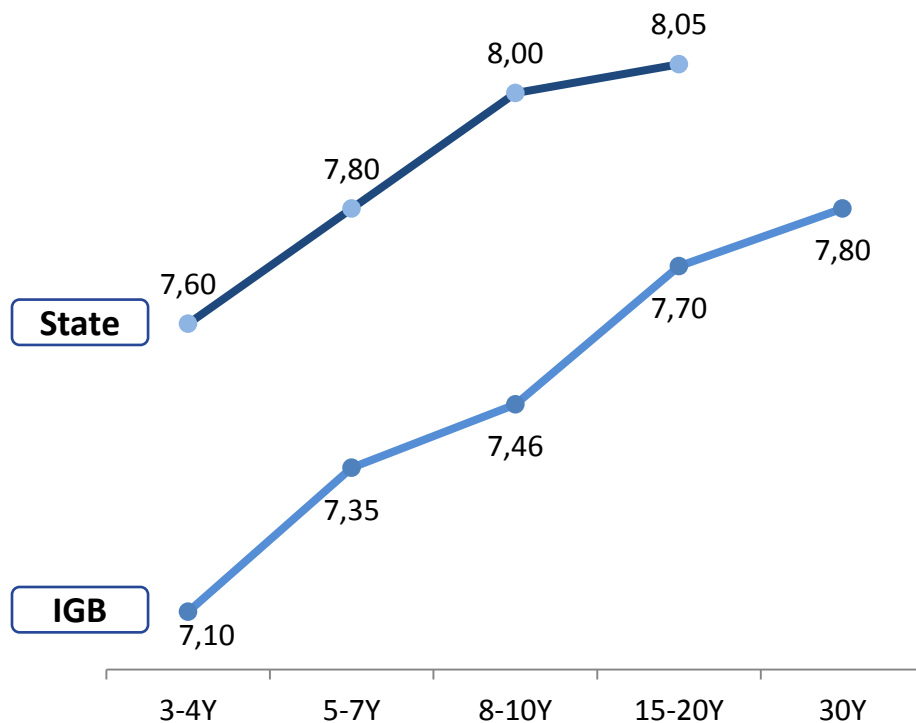
Current Outstanding (USD bn)		Sovereign
Govt Bond (IGB)	790	
State	340	
T-Bill	60	
Corp Bonds	420	
CD	30	
CP	70	
Total	1700	

Corporate Bonds growing much faster than IGBs
Share in 2014: IGB – 51%, Corp Bond – 21%

Yield Curve

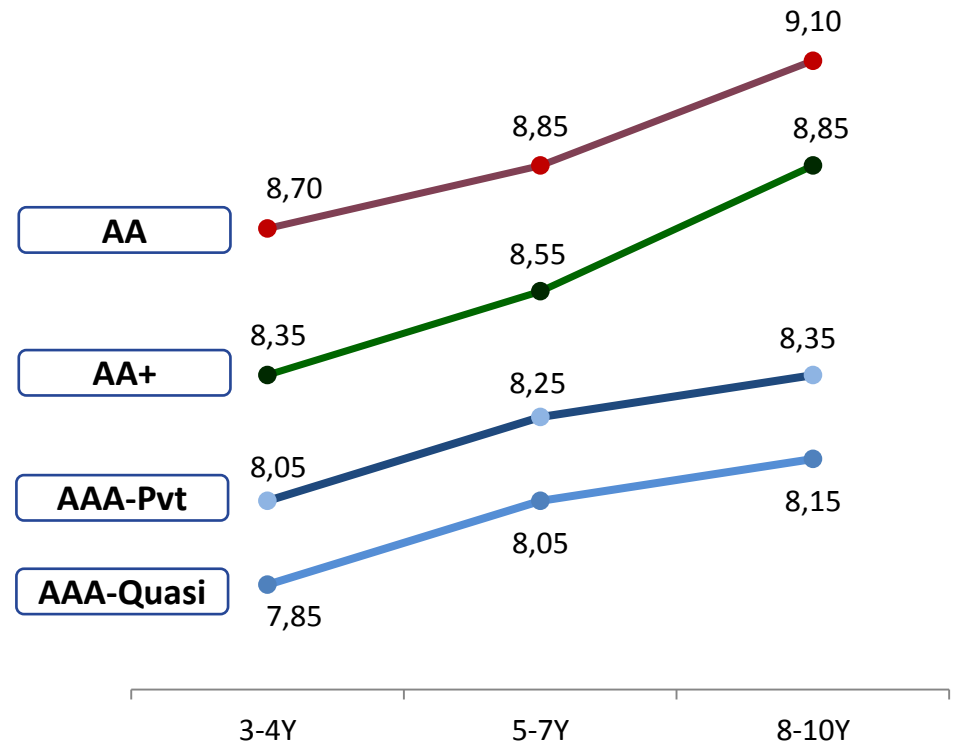


Sovereign Bonds



- Off-the-run IGBs offer yield pickup of 15-20 bps
- FPIs prefer off-the-run, non-benchmark IGBs

Corporate Bonds [Domestic Rating]



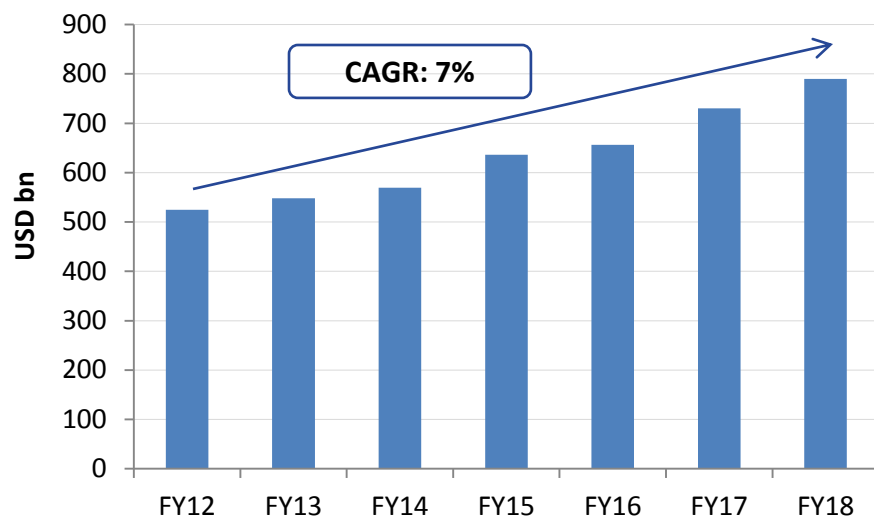
- Yields vary significantly beyond AA for same rating
- Higher yields in structured, collateralized deals

Market Trends – Size



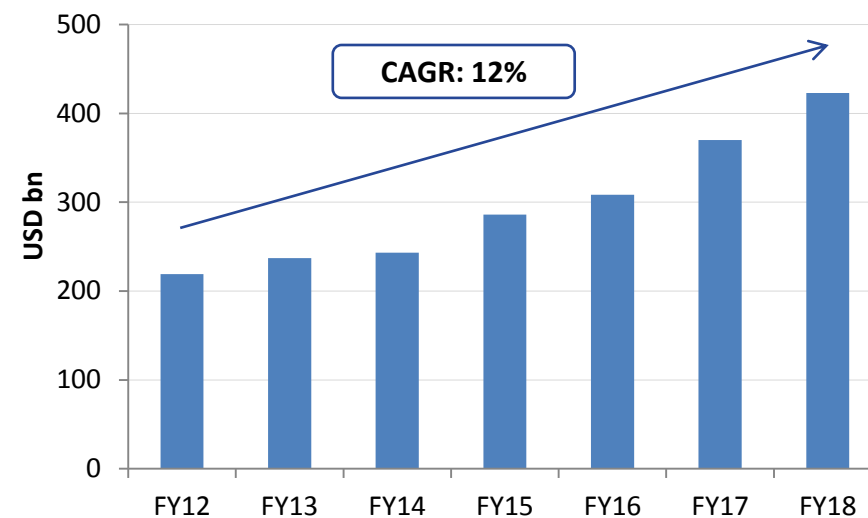
Government Securities – Outstanding

Source: RBI



Corporate Debt – Outstanding

Source: SEBI

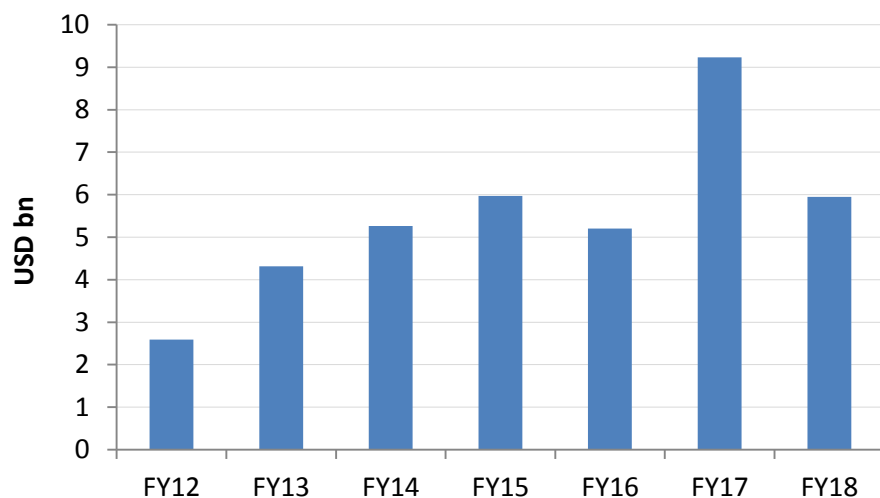


Market Trends – Liquidity



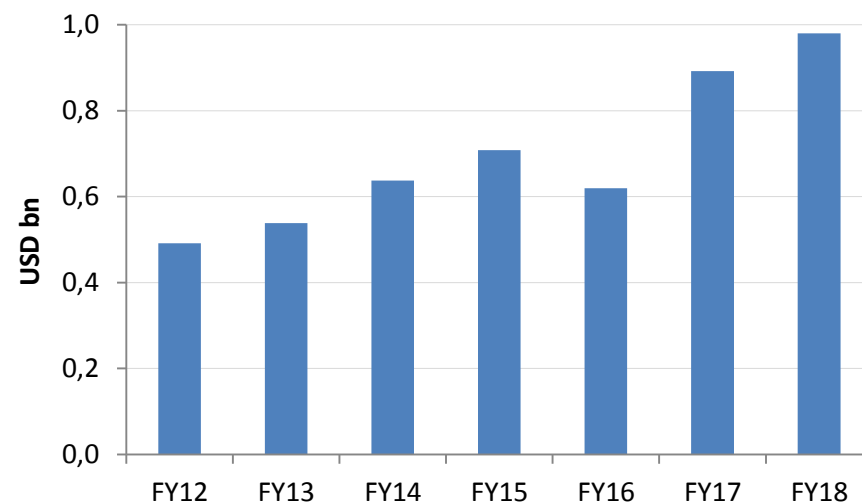
Government Bonds – Secondary Market Transactions

Average daily traded volume in G-Secs, Source: RBI

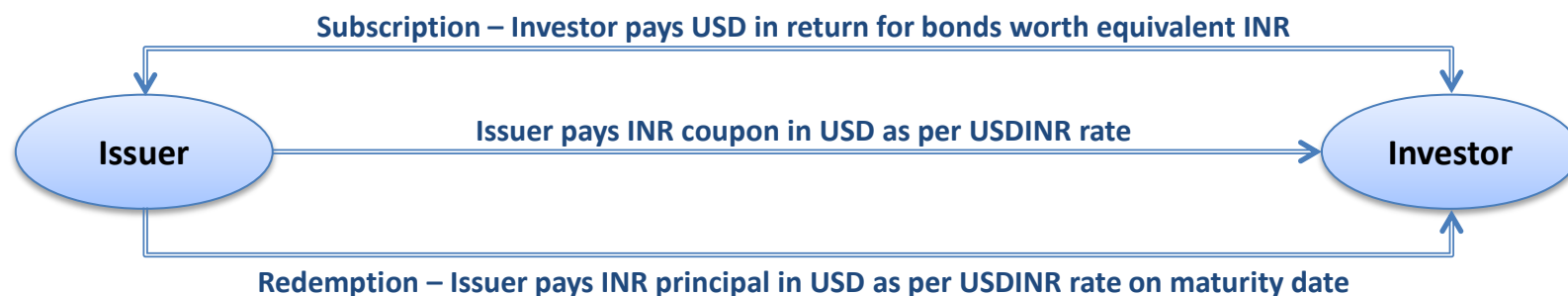


Corporate Bonds – Secondary Market Transactions

Average daily traded volume in Corp Debt, reported on NSE & BSE



Offshore Rupee Bonds [*Masala Bonds*]



Parameter	Criteria
Denomination	INR denominated – offers local currency exposure for investors
Settlement Currency	Subscription, coupon payments & redemption may be foreign currency settled
Instrument	Plain vanilla bonds
Borrowers	All Indian corporates (public & private sector) permitted to issue such bonds
Investors	Any investor from a FATF compliant jurisdiction
Maturity	Minimum 3 years for issue size of USD 50 mn per year, 5 years for issue size > USD 50 mn
All-in-Cost Ceiling	300 bps over IGB yield of corresponding maturity
End Use Restriction	Real estate other than affordable housing; Investing in capital markets; Activities prohibited under FDI; On-lending for these objectives; Purchase of land
Withholding Tax	5% – On par with onshore bonds and other ECB borrowing

Masala Bonds – Key Issuances



- Relatively slow progress on issuance despite strong and willing private sector pipeline

Issuer	Size	Tenor
HDFC – Tranche I	INR 30 bn	3Y 1m
NTPC – Tranche I	INR 20 bn	5Y
Adani Transmission	INR 5 bn	5Y
HDFC – Tranche II	INR 20 bn	4Y
Indiabulls Housing Finance	INR 13.3 bn	3Y 1m
Fullerton India	INR 5 bn	3Y 1m
ECL Finance	INR 5 bn	3Y 2m
Shriram Transport Finance	INR 11.5 bn	3Y 1m
HDFC – Tranche III	INR 33 bn	3Y 1m
NTPC – Tranche II	INR 20 bn	5Y
NHAI	INR 30 bn	5Y
IREDA	INR 19.5 bn	5Y
HDFC Bank	INR 23 bn	7Y

Cash Settled Interest Rate Futures [Bond Futures]



Parameter	Specification
Contract	Futures contracts based on <ul style="list-style-type: none">• IGB 6.79, 2027• IGB 7.17, 2028• Other tenors (2022, 2023, 2026, 2029, 2030, 2031) are very illiquid
Trading Hours	Monday to Friday 9:00 A.M. to 05:00 P.M. IST
Expiry Day	Last Thursday of the month
Contract Cycle	Monthly - 3 serial months, Current, Mid & Far months Quarterly – 3 serial quarters
Contract Size	Face Value per contract = INR 200,000 equivalent to 2000 bonds with face value of INR 100 each
Price Quotation	Similar to the quoted price of underlying GOI security
Contract Value	Quoted price * 2000

Salient Features

- Cash settled, exchange traded
- Single traded liquid bond is the benchmark as against a notional basket in the earlier avatar
- Underlying is the most liquid instrument – hence no pricing uncertainty
- Low margin requirement (< 4%)

Strategies

- View based
- Arbitrage
- Portfolio Hedging

Trading Statistics

- Average Daily Trading Volume: INR 15 bn
- Current Open Interest: INR 45 bn

Dedicated INR 50 bn limit available for FPIs



Regulations, Limits & Trends in FPI Debt Investments

FPI Investment Overview



Who can invest?

- Any investor registered with SEBI as **Foreign Portfolio Investor (FPI)** can invest in the Indian Fixed Income space

Eligible Instruments

- Government Securities (dated securities with residual maturity > 3 years)
- Non Convertible Debentures / Bonds issued by Indian Companies (residual maturity > 3 years)
- Units of Debt-oriented mutual funds – except Money Market MFs

Taxation

- Interest and Capital Gains are subject to taxation
- Base tax rates are as follows:
 - Coupon: **5% withholding tax**, for interest accruing between Jun 2013 and Jun 2020 (eligible only if coupon less than SBI base rate + 500 bps)
 - Short term capital gains (< 1Y): 30%
 - Long term capital gains: 10%
- Favorable tax rates will override the above rate in case of applicable tax treaty with the country of domicile

Investment Limits for FPIs – Sovereign Bonds (as of 12th Apr)



	IGB	
	All FPIs	Long-term FPIs
Current Limit (USD bn)	32	12
Current Investment (USD bn)	29	8
% Free Limit	9%	34%

- **Residual maturity to be 3 years or higher at the time of investment in all categories**
- No lock-in or holding period restriction
- **Limits will be increased to 5.5% of outstanding IGB stock by Mar-2019 & 6% of outstanding by Mar-2020**
- Settlement Cycle: T+1 or T+2
- **Generic FPIs: Limits available on-tap till 90% of limit is utilized; Auction mechanism to be followed post 90% util**
- Dedicated limit available on tap for “Long Term FPIs” – SWFs, Multilateral Agencies, Endowment Funds, Insurance Funds, Pension Funds & Foreign Central Banks

Investment Limits for FPIs – Corporate Bonds (as of 12th Apr)



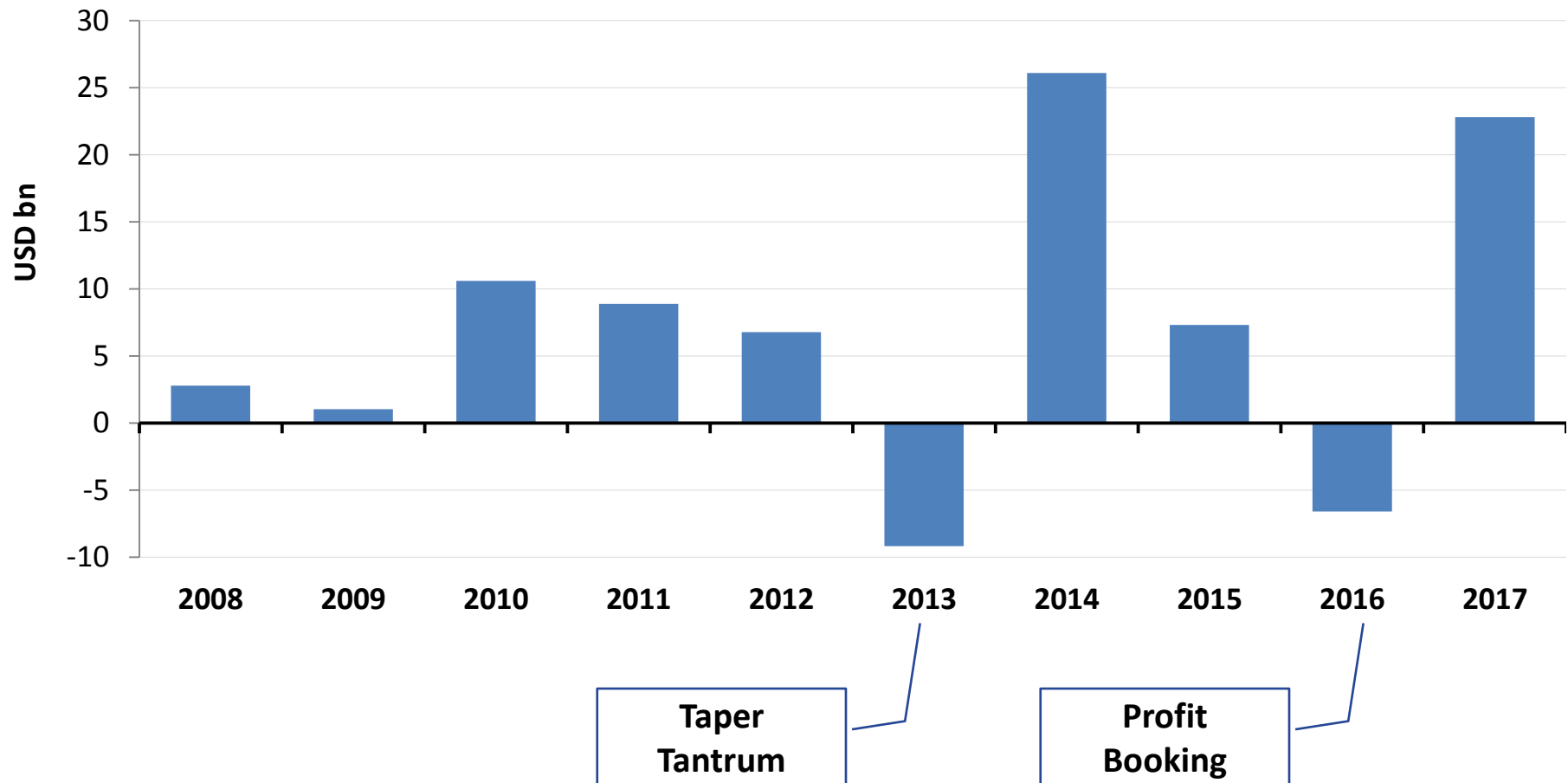
	Corporate Bonds [Quasi-Sovereign & Private Sector]
	All FPIs
Current Limit (USD bn)	41
Current Investment (USD bn)	33
% Free Limit	19%

- **Residual maturity to be 3 years or higher at the time of investment in all categories**
- No lock-in or holding period restriction
- **Limits to be announced / fixed in rupee terms at 9% of outstanding stock of corporate bonds**
- Settlement Cycle: T+0, T+1 or T+2
- **Generic FPIs: Limits available on-tap till 95% of limit is utilized; Auction mechanism to be followed post 95% util**

Foreign Investor Inflows into INR Bonds



Net Debt Flows into India (Source: SEBI)



FPI Checklist



FPI registration with SEBI (Securities and Exchange Board of India)



Appointment of custodian (for trade settlement)



**Investor registration with clearing houses of exchanges (for Corp Bonds) & CSGL
(for IGBs)**



Appointment of intermediary for trade execution



KYC formalities with counterparties





Macro-economic / Interest Rate Outlook

Key Projections for FY19	
GDP Growth	7.20-7.30%
CPI Inflation	4.5-4.7%
Currency	65-67
CAD (% of GDP)	2.0-2.1%
Fiscal Deficit (% of GDP)	3.30%
Repo Rate	6.00%
10Y Benchmark	7.10-7.50%

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- Distressed Credit

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- Asset Management
- Capital Markets

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- Life Insurance
- General Insurance



Bank-like business model

Multiple vectors of growth

Consistent growth and profitability

Reduction in volatility

Growth aligned with market tailwinds

Career opportunities and retention of management

Comprehensive Research Support



Periodic Updates

- * Daily report, briefly covering day's activity along with key data points
- * Monetary Policy Preview and Review

Analytic Update

- * Weekly Statistical Supplement (WSS) to understand changing deposit, lending and investment pattern of the banking system

Special Reports

- * Liquidity Jigsaw - Analysis of the systemic liquidity deficit drivers
- * State Development Loans – A trend analysis
- * Tax-free Bonds – Landscape & Outlook
- * US Fed Rate Hike – Timing, Implications, Hangover
- * FII Debt Flow Monitor
- * G-Sec Auctions: Key Influencers

Macroeconomic Research

- * Macro data analysis - Inflation, IIP, GDP, Budget

BOND VECTOR

Fixed Income Daily

India Fixed Income Research

Short covering, value buying help stem the free-fall of Gilts; LAF plunges

- Markets did not lose further ground at the open as yields were more or less at yesterday's level, in the absence of any major news and ahead of an extended trading break, short-covering led to trimming of positions and yields headed south.
- In addition, there were instances of value buying as yields are at attractive levels after the recent fall and as the markets begin to factor in rate cuts at RBI's upcoming policy meet.
- The 10-Y benchmark rallied 5 bps from yesterday's level to end the session at 8.69%.
- Overall G-sec volumes also picked up after a series of below par activity sessions.
- The OIS market which was relatively insulated amidst yesterday's panic had a strong session today as swap rates came off by more than 5 bps across tenors. This is a likely fallout of the easing liquidity trajectory and anticipation of RBI rate action. The 1Y OIS closed at 7.88-8.00% vs 8.02-8.08% and the 5Y swap traded at 7.54-7.60% as against 7.60-7.68%.

Non-SLR Market

ABFI placed April 04m maturity CP worth INR 500mn @ 9.50%. Shriram Equipment Finance Limited placed June maturity CP worth INR 250mn @ 10.40%. Sundaram Finance placed 1 month CP worth INR 500mn @ 9.80%.

Money Market

The liquidity situation has finally shown signs of moderating with the LAF borrowing coming off to INR 838bn (across 2 windows combined) – this is largely on expected lines with year-on-strike easing away. The call rates also softened in tandem, with the 5-day borrowing WARR settling at 9.24% vs 9.35%.

India Yield Curve – G-Sec & OIS



Liquidity Situation – LAF borrowing rose to INR 838bn



Source: Edelweiss Research, Reserve Bank of India

MONETARY POLICY PREVIEW

Hawkishness might translate into another repo rate hike

India Fixed Income Research

The latest round of inflation data points leaves little doubt as to the tone of the RBI at the upcoming policy review. The uptick in both wholesale and retail prices is likely to form the cornerstone of the review and might even translate into a 25bps repo rate hike. The RBI has been clear in its guidance that anchoring inflation and inflationary expectations is top priority and there is no reason to waver from this stance. As with the last review, the actions are likely to be dual natured with the rate hike being accompanied by further easing of the liquidity measures. One of the most probable actions on this front is a 25bps reduction in MSF borrowing rate to 8.75%, thereby normalizing the spread between LAF and MSF rates to 100bps. The recovery in the repo in September and stability therein has enabled the RBI to reverse part of the extraordinary measures and it is expected to continue with the recent over the next couple of months in the absence of any shocks. Relaxation of the LAF borrowing limit of 0.5% of NGDP, one of these steps but it has a lower probability of being undertaken at this review.

The RBI did not have to resort to incremental interest rate defense to tackle the currency volatility as the initial set of measures combined with import curbs have proved successful. However, the monetary easing trajectory that was set rolling in the first half of 2023 has been abruptly halted and we are facing a possibly extended tightening engine. Elevated retail inflation despite a good monsoon will be the primary concern and hence the RBI might be prompted to tackle the issue with a second successive rate cut. Even if the rate is kept on hold at this review, we expect rate hikes totaling 25-50 bps through the rest of this fiscal and resumption of monetary easing might have to wait till the beginning of the next fiscal, at the earliest.

No respite from rising food prices; Trade deficit trend comforting

Although growth has been in an extended downward mode, the policy recognized the need for action earlier in the year, persistently high inflation will continue to garner most of the policy focus in the near term. On the other hand, the positive trend to have emerged of late is the sharp dip in imports (particularly gold) which will result in a highly improved current account deficit as compared to earlier years. The currency might also be supported around current levels due to this as well as the possibility of US Fed tapering being delayed to March next year. Hence the RBI might make use of this interest to tackle inflationary pressures via its monetary policy guidance.

Money market tightness eases significantly; Mid to long term yields in narrow range

The yield curve has flattened in tune with the RBI actions as the short end of the curve saw a sharp correction in response to the liquidity measures. The overnight rates have responded to the MSF borrowing rate reduction while overall liquidity tightness has been assuaged by OMO backflow and the offering of 71.4-day term repo. Conversely, the repo rate hike and appreciation of further hike have kept the mid to long end of the curve under pressure. However trading has been largely range bound as a stable repurchase, lifting of the US budget impasse and delayed tapering helped improve some of the inflation related weak sentiment. The market is expecting a hawkish guidance by the RBI and if a repo rate hike is announced, it can impact further bondmarket, banking yields by 10-15 bps.



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Short covering, value buying help stem the free-fall of Gilts; LAF plunges

Yield Curve	0.1Y	1Y	5Y	10Y	30Y
G-Sec	8.69%	8.75%	8.75%	8.75%	8.75%
OIS	7.88%	8.02%	8.08%	8.15%	8.25%

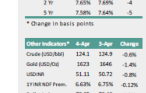
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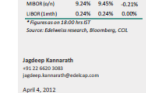
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India Yield Curve – G-Sec & OIS



Liquidity Situation – LAF borrowing rose to INR 838bn



Source: Edelweiss Research, Reserve Bank of India

INFLATION

Manufacturing & core inflation below 6%; Food inflation higher as base effect recedes

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STATE DEVELOPMENT LOANS

A Trend Analysis

India Fixed Income Research | December 2013



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India Fixed Income Research



Source: Edelweiss Research, Reserve Bank of India

INFLATION

Manufacturing & core inflation below 6%; Food inflation higher as base effect recedes

India Fixed Income Research

WM inflation for the month of February was 6.95% YoY, slightly ahead of the consensus estimate of 6.75% and higher than previous month's 6.55%. However, the breakdown of the data makes for pleasant reading as core and manufacturing inflation softened further to below 6%, now almost 1.5% below RBI's comfort level of 7%. This would provide the required buffer in case inflation is expected to bounce as a result of the important component from higher credit price as well as any near-term fuel price hike.

Given that the growth indicators are displaying fluctuating trends of late, stable inflation will be the key guide for the RBI in timing monetary policy action. Brent crude has stayed over USD 120/bbl since mid-Feb (average level of USD 125 in March), and if the March inflation number also steps up to spite of elevated crude, RBI might get the conviction to begin rate cuts in the April review.

Headline inflation shows first uptick in 5 months

Inflation which had steadily declined from 10% in Sep to 6.55% in Jan is now inched up in February primarily on account of receding base effect in food inflation, as expected. Primary articles and food inflation have moved back above 6% (6.3% and 6% respectively) and should now stabilize in the 6-7% range. Fuel inflation has come down from 14.2% last month to 12.5%. The headline number is expected to stay around the 7% mark in the near term with upward pressure likely to come in from the rising import bill and if the government decides to hike fuel prices.

Core & manufacturing inflation dip to more comfortable levels

The lagged effect of monetary tightening and the narrow appreciation in Jan & Feb have helped in controlling the closely watched components of CPI inflation. Core inflation (non-food manufacturing) has come off to 5.7% YoY vs 6.7% in Dec and manufacturing inflation is at 5.75% vs 6.5%. Higher crude prices and any hike in domestic fuel prices can push up these numbers, however, the fact that the current reading is quite in control means that only a significant shock can fuel the near term inflation trajectory. The central bank should gain assurance from the February data and a reading on similar lines for March can provide the trigger to begin rate action as early as the April policy review.

Policy implications and near term yield impact

The bond markets have been in a cautious to nervous mood of late and reacted quite negatively to the recent positive surprise in the data. Rising rate cuts might be delayed. The inflation release on the other hand has been cheered by the market and yields have almost spontaneously rallied by ~10bps. We believe this is a one-off reaction as attention should soon shift back to the RBI's commentary in the policy review tomorrow (no rate action is expected) and a realistic fiscal consolidation effort in the Union Budget on Friday. If these are not off current market expectations, gilt should fare favorably and pave the losses of last couple of weeks, backed by the underlying inflation trend and the investment downturn.

Source: Edelweiss Research, Reserve Bank of India

Contact Details



For any further details you may contact us at:

Ajay Manglunia – Head, Fixed Income Advisory

Contact - +91-22-6623 3343

Email – ajay.manglunia@edelweissfin.com

Jagdeep Kannarath – Fixed Income Research & FII Sales

Contact - +91-22-6620 3083

Email – jagdeep.kannarath@edelweissfin.com

Achala Jethmalani – Economist

Contact - +91-22-6141 2719

Email – achala.jethmalani@edelweissfin.com

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