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WHY INDIA’S BOND MARKET STICKS OUT LIKE A SORE THUMB

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What happened to the bond market in 2020?

The covid-19 pandemic wreaked havoc on markets in the initial months, but after central banks globally pumped in liquidity, investors began to look for the best options to park this money. A recessionary year meant bonds would do well and low-risk government paper sold like hot cakes. In search of returns, the dollars rushed into bonds issued by Asian countries. But this logic turned on its head in India. While Asia’s fixed income market got a record $152 billion in 2020, India saw $13.7 billion move out, as per Barclays Bank. Thailand and Indonesia saw outflows too, but relatively smaller in quantum.

Where did the US dollars flow into?

China towered over others with record inflows in its bonds. By the end of 2020, foreign investors held $475 billion worth of Chinese paper, a large chunk in sovereign paper. By its sheer size and active offshore bond market, China managed to garner a big chunk of dollars. But others such as Korea and Malaysia too got their share. Korean bond holdings of foreign investors went up to $138 billion while Malaysian paper holdings added up to $55 billion. Holdings in India dropped sharply to $41 billion. Foreign investors held just 2% of outstanding government paper in India, against over 40% in Malaysia and nearly 9.7% in China.

Why are foreign investors avoiding Indian bonds?

A host of factors are responsible, but the most important is the worry over supply. Market borrowings from the states and central government have over doubled in FY21, with the Centre set to borrow 12 trillion. India’s domestic bond market bears the entire burden of financing the deficit, which has led to a view that bond yields have bottomed out.

How will such investors warm up to India?

While some experts believe that greater access and inclusion in global bond indices are key, it all comes down to how much returns investors can get. India’s bond market has been under the heavy influence of the central bank with operation twists and open market operations dictating yields. That means punting on the yield curve is severely restricted. RBI in the past has indicated that it is loath to see the benchmark 10-year bond yield rise above 6%, while the incessant supply has meant yields don’t trend much lower.

Will they be returning to India anytime soon?

This will depend on how long interest rates remain benign and liquidity remains surplus. These factors help keep government bond yields from rising. But RBI's recent move to signal the first step towards withdrawing pandemic-related measures doesn't bode well for liquidity. Moreover, with the Union Budget due next month, foreign investors would wait to see the headline deficit figures for FY21 and FY22 as well as the fine print on financing those. Global liquidity, for now, may continue to prefer equities over Indian bonds.

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