

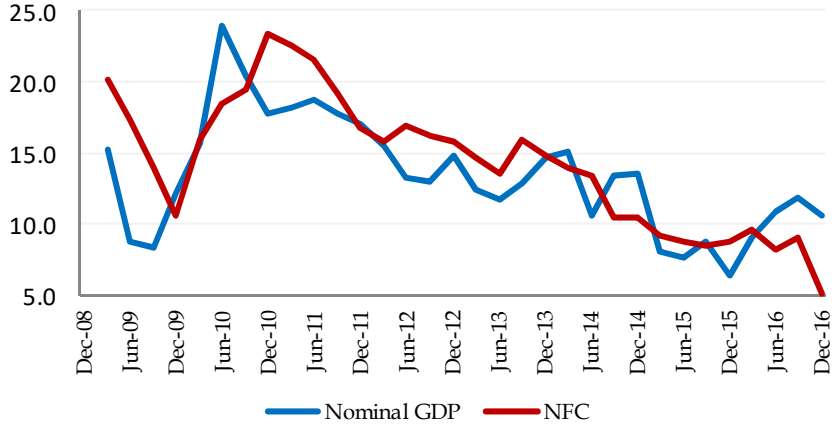
Credit Spreads Watch

March 2017

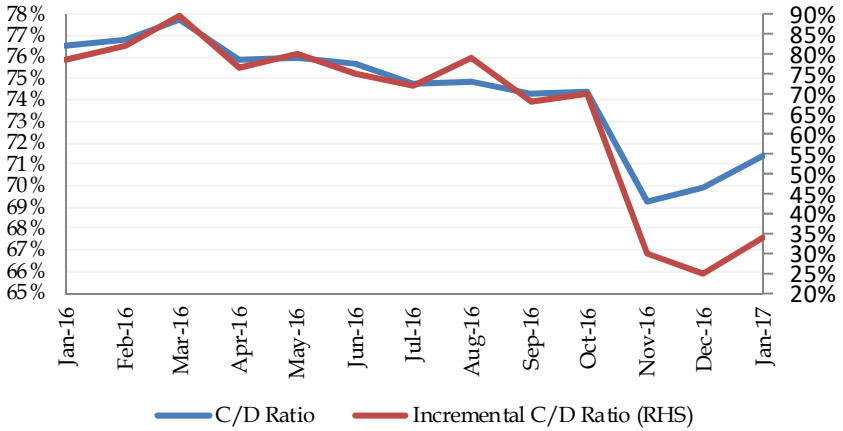
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Credit Picture

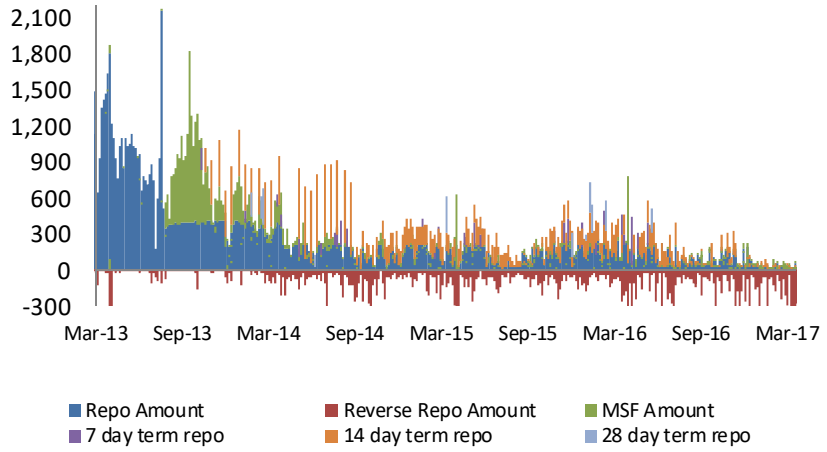
Non-food Credit Growth (%)



Credit Deposit Ratio (%)



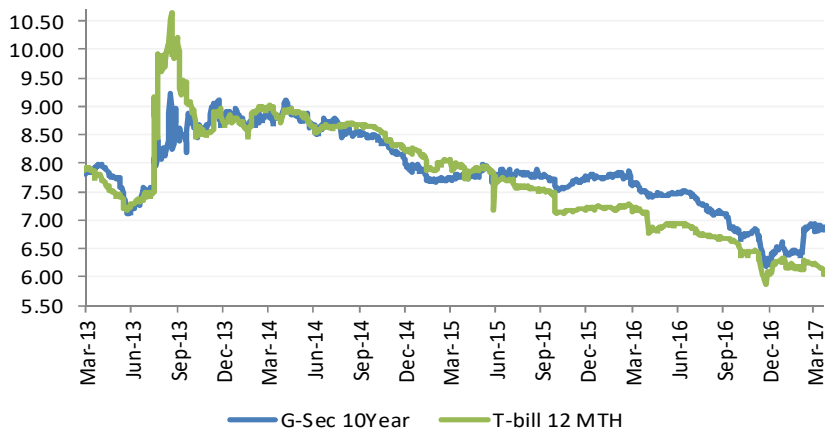
Liquidity Adjustment Facility (Rs B)



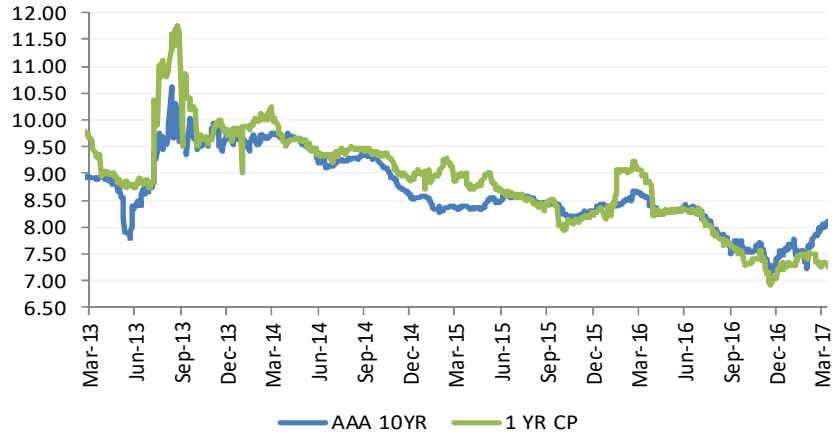
- Liquidity picture remains comfortable especially after the RBI's decision to bring the liquidity deficit to a neutral level.
- The surge of deposits post demonetisation has also led to surplus liquidity in the banking system
- Non-food credit growth was 3.5% YoY in January 2017 and deposit growth was 13.8% YoY, leading to incremental C/D ratio of 33.9%.
- Although nominal credit growth has remained subdued, there is adequate credit availability to most sectors once the numbers are adjusted for inflation and increased borrowing from the commercial paper market and other non-bank funding sources.

Credit Spreads

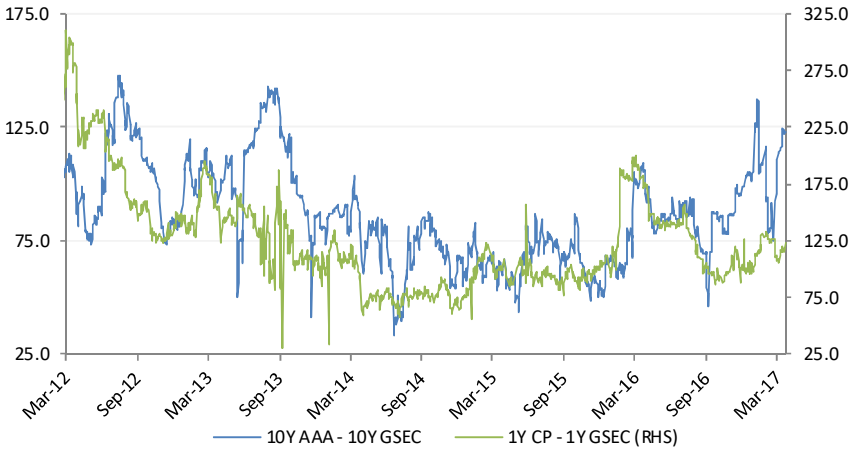
G-sec Yield (%)



Corp AAA Yield (%)



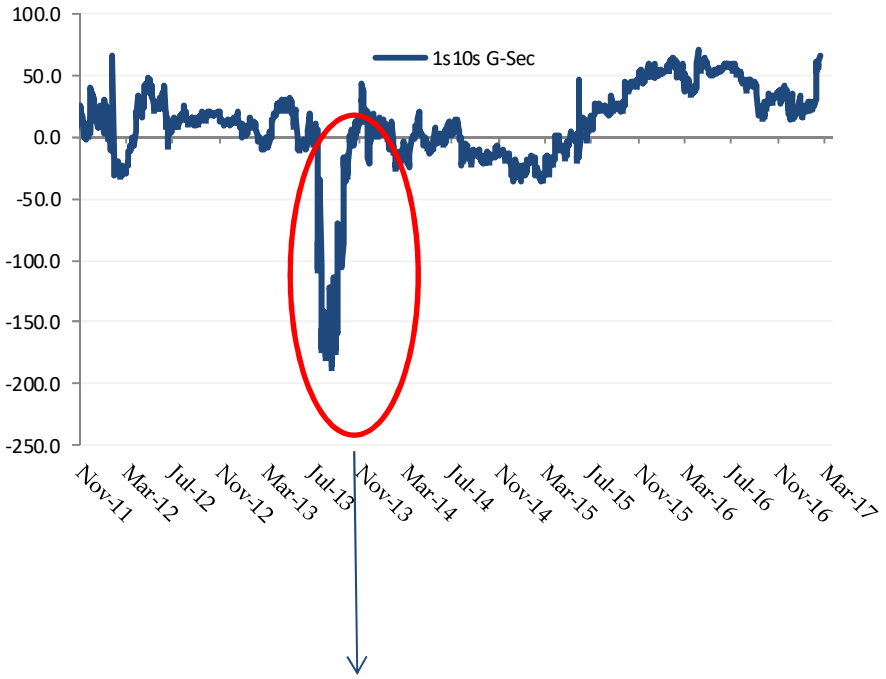
10 Year and 1 Year Corp AAA Spreads (bps)



- Given the benign liquidity conditions and lower headline CPI, both long term G-Sec and AAA yields have declined in over time notwithstanding the rise in yields when RBI changed its monetary policy stance.
- However the fall in Gsec yields has been much faster than corporate spreads as Indian corporates continue to struggle with a debt overhand and thereby 10 Year spreads have increased to 120bps in March from 60bs at the end of August
- One Year spreads have come down as liquidity conditions have improved over the last few months

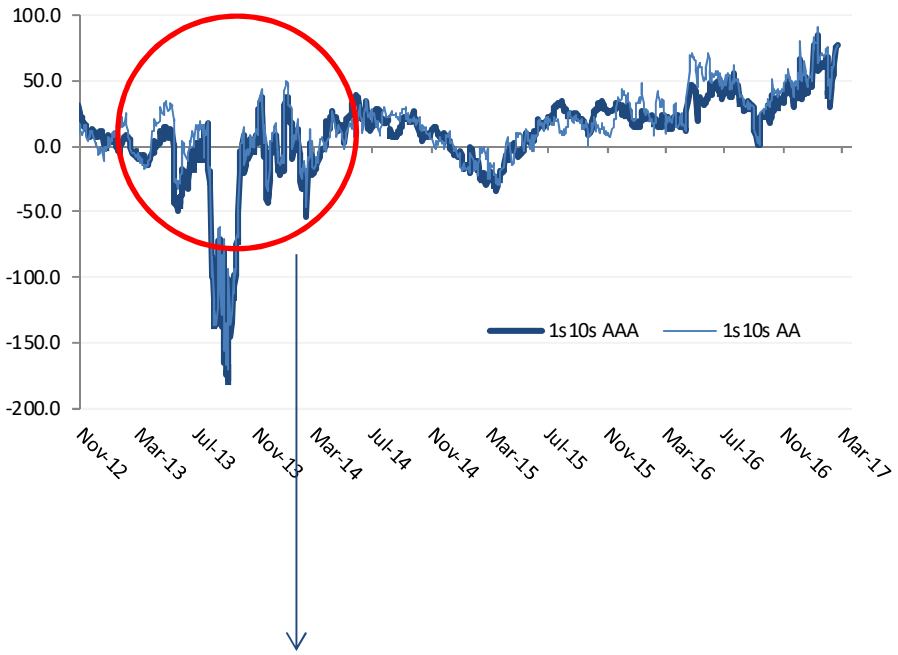
Bond Term Structure

Govt. Securities 1s10s (bps)



Negative terms structure is due to the 15th July RBI liquidity tightening measures

Corporate Bonds 1s10s (bps)

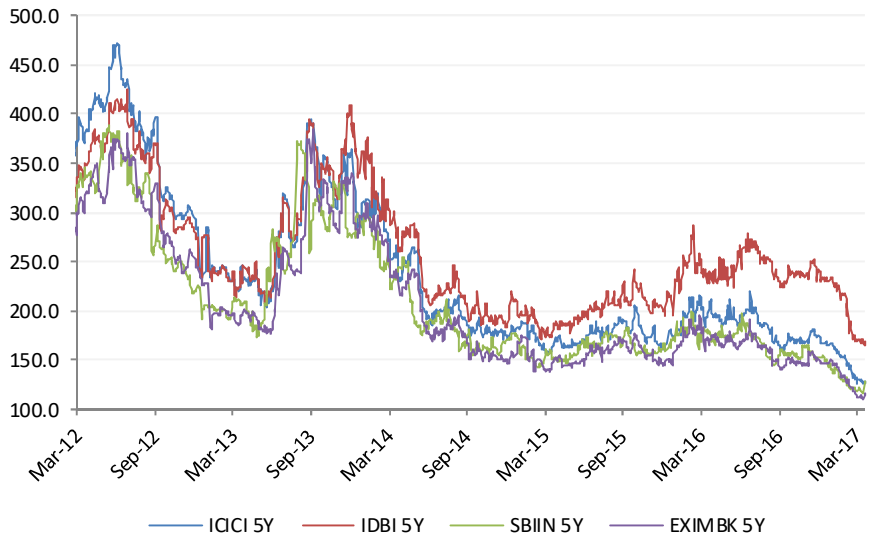


Negative terms structure is usually due to seasonal reasons which improves as liquidity improves`

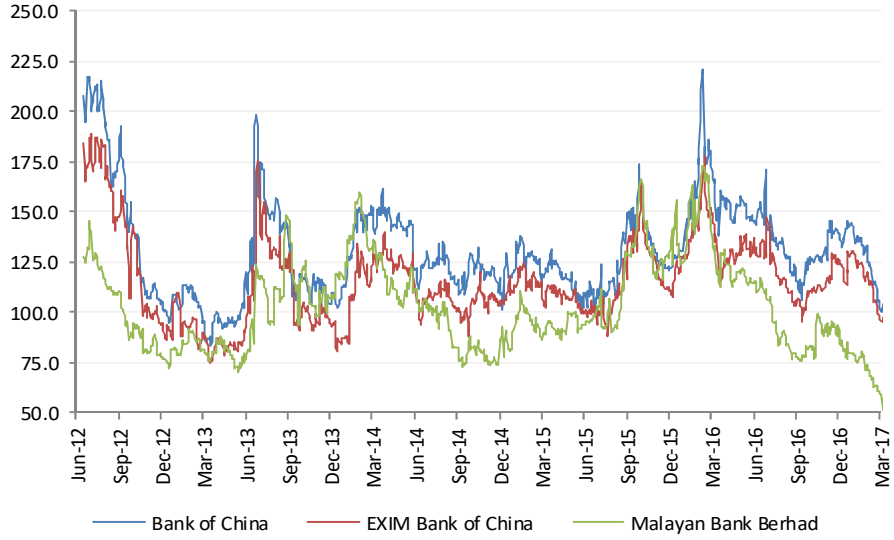
Source: Bloomberg, FIMMDA, Trust Research

Bond Term Structure

Govt. Securities 1s10s (bps)



Corporate Bonds 1s10s (bps)



- In May-2013, CDS prices rose across EM as global bond markets started to take into account the scaling back of the QE program by the Federal Reserve.
- Since May-2014, India specific CDS prices declined to historic lows as market friendly BJP's victory in the 2014 General elections spurred India specific bond and equity $ flows.
- In June and July- 2015, India CDS spreads rose though remained below multi-year highs. However, other EM CDS spreads rose to Aug-13 highs as concerns over the global and EM economies grew. Currently Indian CDS spreads remain relatively stable reflecting improving macro economic fundamentals and growing confidence that the government will speed up reform agenda.

Source: Bloomberg, FIMMDA, Trust Research

Conclusion

- The premium required by corporate bonds over Gsecs which represents both credit and non-credit risk has been volatile over the last few years. The credit spread has moved from 100bps point at the end of March 2012 down to 70bps by March 2014 and is now back up to 120bps as of March 2017. These moves have at times reflected changes in credit quality but at other times have stemmed from other factors such as risk aversion and liquidity.
- Typically widening of credit spreads indicate a slowdown in economic activity however we do not expect the current widening is indicative of a sustained slowdown. The idea is that companies are more likely default in a slowing economy and therefore the credit risk on their bonds will rise. Changes in credit spreads are affected by changes in expected recovery rates, which affect payoffs to bondholders. Because the expected recovery rate is a function of the overall business climate a slowing economy should drive credit spreads up. In fact the latest period of widening spreads has coincided with the post demonetisation period where market participants expected a slowdown due to the adverse effects of the resulting cash crunch.
- **However, given that the impacts of demonetisation are expected to be transient and that growth is expected to recover we should expect to see a tightening of credit spreads.**
- In addition there has been **a number of regulatory developments which we expect will lead to tightening of credit spreads.** Some of these measures include inter alia allowing domestic lenders to issue masala bonds, accepting corporate bonds under the liquidity adjustment facility, increasing the ceiling for credit enhancement for corporate bonds and providing FPI's direct access to bond trading platforms.
- We believe these measures will improve the liquidity in Indian corporate bonds and bring down the liquidity premium that exists in the market. This combined with constructive liquidity management by the RBI will shift the spreads down. Some concerns remain on spate of corporate defaults given the high leverage in the system, though we expect such risks to remain idiosyncratic in nature.
- **With liquidity conditions benign, and expected quick economic recovery post demonetisation, conditions are right for tightening spreads. Hence, we expect the 10 Year credit spreads will come down to be 80- 100 bps over the short to medium term.**

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Thank You

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