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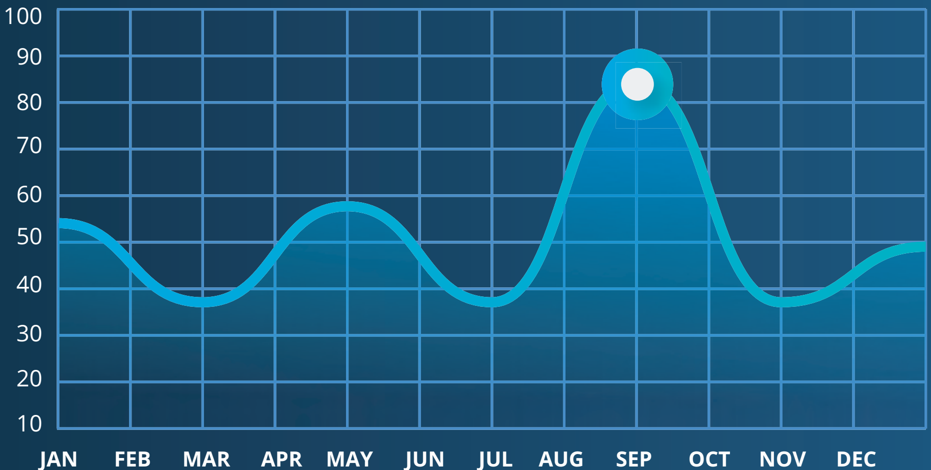

BOND YIELDS

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30th Year of Publication

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Theme No: 352: **BOND YIELDS**

"When learning is purposeful, creativity blossoms. When creativity blossoms, thinking emanates. When thinking emanates, knowledge is fully lit. When knowledge is lit, economy flourishes."

- Dr. A.P.J. Abdul Kalam

The "SIB Students' Economic forum" is designed to kindle interest on Finance and Economy in the minds of younger generation. We highlight one theme in every monthly publication. Topic of discussion for this month is "**Bond Yields**".

Across the world, governments sell bonds to raise money to meet their expenditure. Government bond yields, which serve as benchmarks for pricing debt securities, have been rising lately. Yield on India's 10-year benchmark paper rose to a near six-month high, German Bund to an eight-month peak, and US Treasury to a near one-year top.

What is Bond Yield?

Bond yield is the return an investor realizes on a bond. The bond yield can be defined in different ways. The simplest version of yield is calculated by the following formula:

$$\text{Yield} = \frac{\text{Coupon Amount}}{\text{Price}}$$

When the price changes, so does the yield.

Here's an example: Let's say you buy a bond at its Rs.1, 000 par value with a 10% coupon. The issuer pays you Rs.100 a year for 10 years, and then pays you back the Rs. 1,000 on the scheduled date. The yield is therefore 10% (Rs.100/Rs.1000).

Bond Yield vs. Price

However, if you decide to sell the same on the market, it will not fetch you Rs.1, 000, because bond prices change on a daily basis as per prevailing interest rates. If the price of the bond in the market is Rs.800, it means that it is quoting at a discount. If the price of the bond in the market is Rs.1, 200, it means that it is quoting at a premium. Regardless of the market price of a bond, the coupon remains the same. In our example, the bond holder continues to receive Rs.100 a year.

What are the changes in the bond yield? If you sell it for Rs.800, the yield will be 12.5% (Rs.100/Rs.800). If you sell it for Rs.1, 200, the yield will be 8.33% (Rs.100/Rs.1, 200). When the price goes up, yield goes down and vice versa. Technically you'd say the bond's price and its yield are inversely related.

So which is more favourable, a high yield or a high price? The answer depends on your status. If you are a bond buyer, you would want high yields. A buyer wants to pay Rs.800 for the Rs.1, 000 bond, which gives the bond a high yield of 12.5%. On the other hand, if you already own a bond, you've locked in your interest rate, so you hope the price of the bond goes up. This way you can gain by selling your bond in the future.

Factors that influence the Bond Yields

Default: If markets fear the possibility of government debt default, it is likely they will demand higher bond yields to compensate for the risk. If they think that a country will not default but is safe, then bond yields will be relatively lower. It is worth mentioning debt default is

relatively rare in developed economies (except issues in Eurozone)

Private sector saving: If the private sector has high levels of savings, there will tend to be a higher demand for bonds because they are a good way to make use of savings, and yields will be relatively lower. Savings tend to rise during periods of uncertainty and low growth.

Prospects for economic growth: Bonds are an alternative to other forms of investment like shares and private capital. If there is strong economic growth, then the prospect for shares and private investment improves, therefore bonds become relatively less attractive and yields go up.

Recession: Similarly, a recession tends to cause a fall in bond yields. This is because, in times of uncertainty and negative growth, people would rather have the security of government bonds – than more risky company shares.

Interest rates: When prevailing interest rates go above the bond's coupon rate, the bond becomes less attractive. In this situation, the bond price drops to compensate for the less attractive yield. Conversely, if the prevailing interest rate drops below the bond's coupon rate, the price of the bond goes up as it becomes more attractive. For example, if a bond has a 4% coupon and the prevailing interest rate rises to 5%, the bond becomes less attractive and so its price will fall. On the other hand, if a bond has a 4% coupon and the prevailing interest rate falls to 3%, that bond becomes more attractive which pushes up its price on the secondary market.

Inflation: Inflation has the capacity to reduce the real value of the bond.

If you borrow Rs.1, 000 now but experience inflation of 20% for the next 10 years, the Rs.1, 000 bond will rapidly decrease in value. Therefore, higher inflation will reduce demand for bonds and lead to higher bond yields.

Market conditions: Broader market conditions can have an impact on bonds. For example, if the stock market rises, investors typically move out of bonds to equities. By contrast, when the stock market goes through a correction, investors may seek the perceived safety of bonds.

Ratings: Bonds are assigned credit ratings by ratings agencies, such as Moody's and Standard & Poor's. The ratings signal to investors the agency's view of the issuer's ability to pay the interest and principal when due. If a bond's credit rating is downgraded, the bond becomes less attractive to investors and its price is likely to fall.

The age of a bond: The age of a bond relative to its maturity date can affect pricing. This is because the bondholder is paid the full face value of the bond when the bond reaches maturity. As the maturity date gets closer, the bond's price will move towards par.

Bond Yields and Monetary Policy

Bond yields are significantly affected by Monetary Policy. Monetary policy is shaped and set by a Government administration, and executed through its Central Bank. Central banks are aware of their ability to influence asset prices through Monetary Policy. They often use this power to moderate swings in the economy. During recession, they look to hold off deflationary forces by lowering interest rates, leading to increase in asset prices.

Increasing asset prices have a mildly stimulating effect on the economy. When bond yields fall, it results in lower borrowing costs for corporations and the government, leading to increased spending. Mortgage rates may also decline with the demand for housing likely to increase as well.

Monetary policy at its core is about determining interest rates. In turn, interest rates define the risk-free rate of return. The risk-free rate of return has a large impact on the demand for all types of financial securities, including bonds.

Rising Bond Yields

Interest rates came down to low levels and liquidity became aplenty due to the accommodative monetary policy by various Central Banks, and the expansionary fiscal policies pursued by the governments. This was a direct response to the economic distress

caused by the global pandemic and the resultant fall in employment, output, and demand. The resurgence in growth, the re-emergence of inflation, the fears of an imminent return to liquidity and policy normalization all contributed to the current spike in bond yields. In addition to all this, the inflationary expectations in some of the major economies have been rising. The potential for higher inflation was shown high in the US, and the Fed had on one occasion brought about a change in the inflation target converting it from a 2 percent target to an average of 2 percent, with an implicit connotation that the Fed would be tolerant of a higher than 2 percent price level. In a general assessment, the US economy still stands the chance of encountering a higher price level. This is further occasioned by the additional fiscal stimulus and the expected spending revival in the coming months.

In India, post the Union Budget on February 1, 2021, a higher fiscal deficit was expected. But, as a surprise, it rose to 9.5 per cent as a percentage of GDP for FY21 and is projected to touch a low of 6.8 per cent in FY22. Equity markets gave a thumbs-up to the Budget, but a higher fiscal deficit was a daunting news for the bond market, leading to a surge in bond yields. Market borrowing of the Central Government is projected at Rs 12 lakh crore in FY22. To facilitate the government market borrowing programme, RBI has also allowed retail investors to open gilt account with RBI. Increased supply of government bonds in the market could lead to demand-supply mismatches, putting pressure on yields. India 10-year benchmark bond touched 6.25%. India bonds have moved from 5.76% to 6.20% in line with the rise in US yields. In USA, bond yields was 0.31% in March 2020 which touched 1.50% recently.

What are the implications of rising bond yields in India?

Higher bond yields will create a problem for bank bond portfolios

Indian banks, especially PSU banks are among the largest holders of the government of India bonds. SLR predominantly consists of government bonds and the RBI also uses this to meet the Government's borrowing program. Bond losses are a major problem for banks as a rise in yields leads to a fall in bond prices and therefore these losses have to be booked by the banks.

Rising bond yields is not great news for NAVs of debt funds

Just like banks lose out on their bond holdings, debt funds holding on to these government bonds also see erosion in their NAV. This problem is more acute in case of mutual funds that hold long-dated government bonds as these bonds are most vulnerable to a rise in bond yields. The bottom line is that fall in NAV reduces the wealth of investors, both retail and institutional.

Indian corporates may be forced to borrow at higher rates of interest

As bond yields rise, the banks will have to raise the rates paid out on deposits to keep them attractive. But to compensate for that they are also forced to raise the lending rates to maintain their spread. It may be recollected that demonetization resulted in a glut of liquidity in the banking system bringing down yields sharply.

Government borrowing programs will be impacted negatively

Higher bond yields will mean that the government will have to borrow at much higher rates, something it will not be prepared to do as it will sharply increase its borrowing cost. This is not great news considering that the government needs to borrow heavily to meet its budget expenditure. Higher yields could be a major dampener to the government borrowing program.

It could also have a negative impact on equity valuations

Equity valuations are done based on the discounted cash flow (DCF) method. Here the future cash flows are discounted to the current year by using the cost of capital as the denominator. The cost of capital is a weighted average of the cost of equity and the cost of debt. If the bond yields go up then it means the cost of capital goes up and therefore

current valuations are more depressed.

Impact on Foreign Portfolio Investors (FPI)

Bonds yields play an important role in FPI flow. When bond yields rise, FPI's move out of the equity markets.

RBI's battle to tame bond yields

In the last bimonthly monetary policy meeting (MPC), the RBI Governor reiterated the evolution of an orderly yield curve as a public good. As the economy is gradually recovering from the recessionary phase, the fear of rising inflation is getting stronger. In such a scenario, there won't be any further rate cuts in the near term. The RBI Governor has assured that its accommodative stance will be maintained as long as necessary to bring the economy back to the growth trajectory. Yet, the restoration of cash reserve ratio (CRR) in two phases beginning March 2021 could be seen as the first step towards normalization of monetary policy. This could even put more pressure on bond yields. In the current scenario, RBI would be having a tough time in keeping the yields in check. The central bank has to deal with inflation worries along with the increased market borrowing from both the central and state governments. RBI needs to actively participate in the bond market and communicate to market participants to ensure that the bond yields are in check. In this background, RBI has been buying bonds via OMOs to keep yields below 6%. It has also been conducting special OMOs (also known as Operation Twist) to prevent a steepening of the yield curve. The aim is to lower long-term yields to help the Centre and firms borrow cheaply from the market.

It needs to be noted that India is not the only country where bond yields have hardened in February. The yield curve has become steeper in most countries due to the optimism fuelled by the Covid-19 vaccine rollout. As growth improves, Indian G-Sec yields are going to rise further. And that is not such a bad thing, as it is good for savers. Also, empirical data shows that economic growth has been strong in periods of rising yields and vice versa. The RBI can, therefore, restrict itself to infusing confidence in the market about its ability to manage the government borrowing in the least disruptive manner.

Extra Read - Regular Bonds vs. Zero Coupon Bonds

The difference between a regular bond and a zero-coupon bond is the payment of interest, otherwise known as coupon. A regular bond pays interest to bondholders, while a zero-coupon bond does not issue such interest payments. Instead, zero-coupon bondholders merely receive the face value of the bond when it reaches maturity. Regular bonds, which are also called coupon bonds, pay interest over the life of the bond and also repay the principal at maturity. Zero-coupon bonds are typically purchased at deep discounts to the bond's face value. This discount frequently leads to higher returns in the long run. Zero-coupon bonds are more volatile than coupon bonds, so speculators can use them to profit more from anticipated short-term price movements.

References: Investopedia, Hindu, Businessline, Financial Express, Motilal Oswal, Moneycontrol, Livemint, Business Standard, Taxguru

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