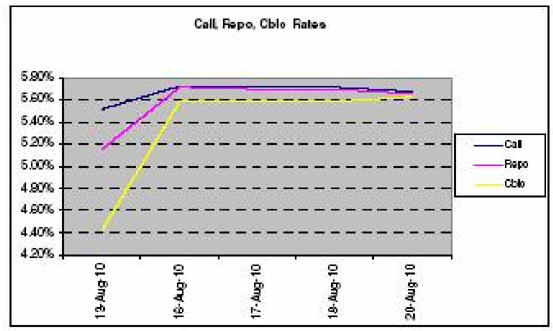
Weekly Money Markets – Week Ended 20th August 2010

Market caught in a bear trap

Domestic bond yields bucked global trends with the benchmark ten year bond yield moving up week on week to close at four month highs. The market chose to ignore falling bond yields globally, falling oil prices and a weaker than expected inflation number for the month of July 2010 and instead focused on a tightening liquidity scenario and on the never ending supply of bonds to take up bond yields. The market is caught in a trap where participants are unwilling to hold on to positions even on the back of positive cues and nervous unwinding of positions is forcing the market to focus on negatives in justification for higher bond yields. The market is also getting caught in a dilemma of the current ten year benchmark bond, the 7.80% 2020 bond going off the run as there are only around three more issuances left for the bond. The market is choosing to trade the new twelve year bond, the 8.13% 2022 bond as the alternative for the ten year benchmark and in the process has narrowed the spreads between the two bonds to 4bps from a high of 23bps seen three weeks ago. The narrowing of the spread does not help the wider market as there are far more holders of the 7.80% 2020 bond which has an outstanding of Rs 45,000 crores than the 8.13% 2022 bond which has an outstanding of less than Rs 15,000 crores. The market is now sitting with losses on the 7.80% 2020 bond and unless there is a significant positive shift in sentiments the market will tend to be a seller at every rally keeping a tight lid on bond yields. The supply factor is restraining buying in the secondary market with the government issuing Rs 12,000 crores of bonds every week.

Bond yields fell across the globe on the back of growth worries with benchmark bonds in the US,



Source: CCIL

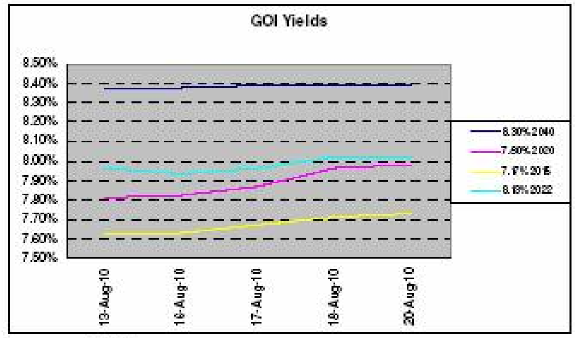
UK, Germany and Japan touching multiyear lows last week. Oil prices fell on demand worries with nymex crude oil prices falling by USD 7/bbl week on week. Domestic inflation numbers came in weaker than expected with inflation as measured by the WPI (Wholesale Price Index) coming in at 9.97% for the month of July 2010 against market expectations of 10.40%. The global growth fears coupled with headline inflation numbers coming off may see the RBI tempering rate hikes. Bond yields are factoring in higher than expected rate hikes rather than tempering of rate hikes and the mid policy review in September 2010 may throw more light on RBI's policy moves.

Liquidity, as measured by bids for reverse repo/ repo in the LAF (Liquidity Adjustment Facility) auction of the RBI tightened on fresh demand for funds from the banking system. Bids for repo at 5.75% averaged Rs 15000 crores last week against an average of Rs 10,000 crores in the week before last. Liquidity is expected tighten further on demand for funds by the system in the face of further expected tightening of liquidity in September 2010. Overnight rates will hover around repo rates of 5.75% for an extended period of time.

Government Bonds

Government bonds saw yields move up week on week with the 8.13% 2022 bond yield moving higher by 6bps to close at 8.02% levels. The benchmark ten year bond, the 7.80% 2020 bond, saw yields rise by 16bps to close at 7.98% levels. The spread between the 8.13% 2022 bond and the 7.80% 2020 bond narrowed by 11bps week on week to close at 4bps levels. The 7.17% 2015 bond saw yields close up 11bps at 7.73% levels. The long bond the 8.30% 2040 bond yield closed almost flat at 8.39% levels. Government bonds yields are likely to be choppy on the back of nervous market sentiments.

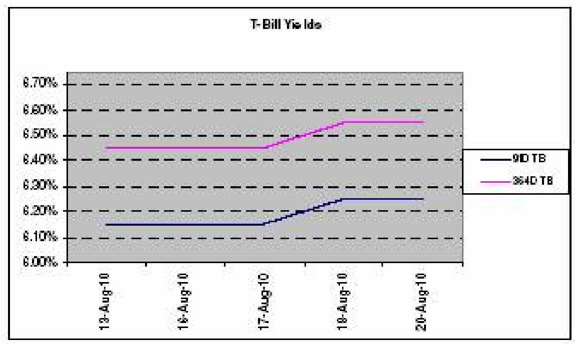
The government auctioned Rs 12000 crores of bonds last week. The bonds auctioned were the 7.46% 2017 bond for Rs 4000 crores, the 8.13% 2022 bond for Rs 5000 crores and the 8.30% 2040 bond for Rs 3000 crores. The cut offs came in at 8%, 7.99% and 8.40% respectively.



Source: CCIL

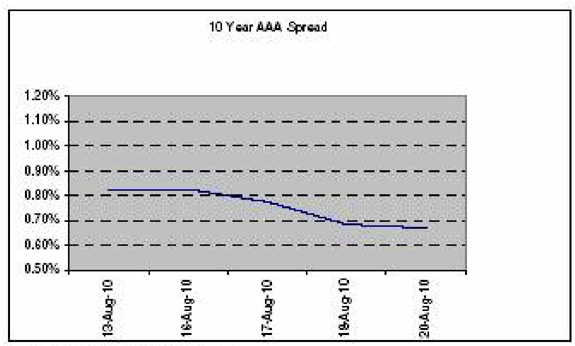
Treasury Bills, Corporate Bonds and Overnight Index Swaps

Treasury bills (T-bills) yields were higher in the 91 day T-bill auction held last week with the cut off on the 91 day T-bill auction held on the 18th of August 2010 coming in at 6.27% against a cut off of 6.15% seen in the previous auction. The 182 day T-bill auction saw the cut off coming in at 6.46% against a cut off of 6.35% seen in the previous auction. The RBI is auctioning Rs 7000 crores of 91 day T-bills and Rs 1000 crores of 364 day T-bills this week.



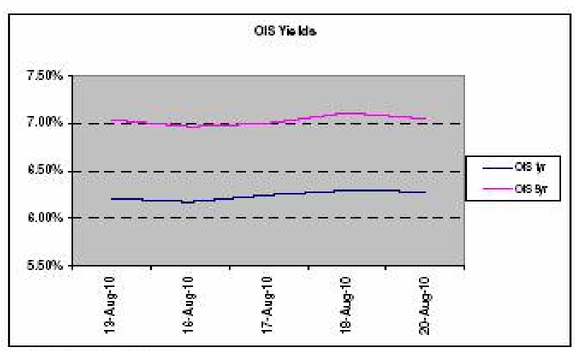
source CCIL

Corporate bonds yields closed flat week on week on thin trading interest. Five year AAA bond yields closed last week at 8.50% levels while ten year AAA bond yields closed at 8.80% levels. Credit spreads moved down as corporate bond yields remained flat while government bond yields rose. Five year and ten year spreads came off by 6bps and 15bps to close at 66bps and 67bps respectively. Corporate bond yields are likely to remain sticky at current levels and spread levels will depend on movement in government bond yields.



source: Market Quotes

Overnight Index Swaps (OIS) saw the curve move up week on week on the back of nervous sentiments in the government bond market. The five year OIS yield closed up by 2 bps at 7.06% levels while the one year OIS yield closed up by 7bps at 6.28% levels. The one over five spread closed down by 5bps at 78bps levels. The swap curve is likely to remain pressured on weak sentiments in the government bond market.



source: bloomberg

Disclaimer : The author is Senior Fund Manager – Fixed Income IDFC Mutual Fund and views are personal.