Yields ease as MPC minutes hint at slower rate hikes

One-year bond yield logs sharpest fall in two and a half months

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Yields on government bonds fell sharply on Monday as the minutes of the Monetary Policy Committee's September 28-30 meeting were perceived as suggesting a slower pace of rate hikes by the Reserve Bank of India (RBI) going ahead. Bond prices rise when yields fall and vice-versa.

The 10-year benchmark bond yield closed 7 basis points lower at 7.40 per cent on Monday. The yield on the one-year government bond hurtled 14 basis points to close at 6.78 per cent. Short-term bond yields are highly sensitive to near-term interest rate expectations.

On Monday, the one-year bond yield registered its sharpest single-day drop since August 1 when it had declined 30 basis points. The gap between the one-year and the 10-year bond yields currently stands at 62 basis points.

That spread was at 55 basis points on Friday, reflecting a quicker rise in short-term bond yields versus long-term yields. Sovereign bond yields are the benchmarks for pricing a vast variety of credit products.

"The yield curve has steepened as short-term bond yields have plunged. The fear of an off-policy rate hike in November has eased after the minutes," Naveen Singh, head of trading at ICICI Securities Primary Dealership, told *Business Standard*.

"The yield curve flattened significantly over the past month as short-end bonds were pricing in sharp rate hikes in line with the Fed's aggressive stance. Now that has reversed," he said.

The RBI released the minutes of the MPC's latest meeting after trading hours on Friday. The minutes showed that two members of the six-member committee — Ashima Goyal and Jayant Varma — were largely in favour of pausing interest rate hikes. Goyal was the sole member of the committee who had dissented on the quantum of the rate hike. She was in favour of a 35-basis point increase as against a 50-basis point hike preferred by the rest. Varma was the only member who dissented from the stance of withdrawal of accommodation, saying that he wished for a pause rather than the focus on tightening.

In interviews with *Business Standard*, both Varma and Goyal elaborated on their views. According to Goyal, India's real interest rate should not exceed 1 per cent at the current juncture. Factoring in the MPC's inflation projections, this leaves little room for further rate hikes.

Varma said that with the MPC having tightened policy significantly over a short span of time, it was time to step back and let the effect play out.

The MPC has raised the repo rate by 190 basis points since May 4 in order to bring elevated inflation back to target. The repo rate is currently at 5.90 per cent. "The minutes have raised the prospect that the next policy meeting in December will see the two MPC members dissenting in favour of a policy pause," economists at Nomura wrote.

"Overall, the minutes indicate that the terminal policy rate is likely much lower than current market pricing; and there is a relatively limited influence of Fed funds rate and weaker currency in driving the RBI's policy reaction function," they wrote.

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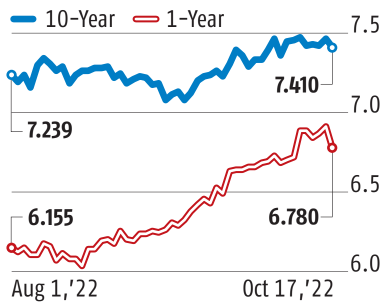
India G-sec yield (%)



Compiled by *BS* Research Bureau

Source: Bloomberg