



POWER POINT

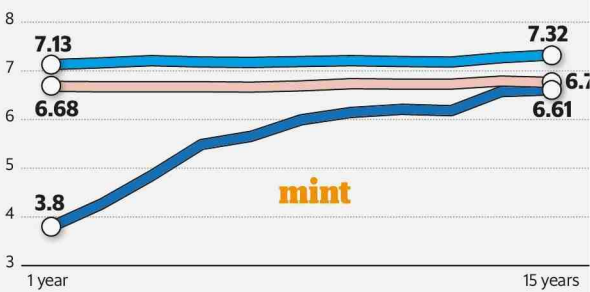
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WHAT LIES NEXT FOR OUR INVERTED YIELD CURVE

Yield curve for G-Secs

● Sep 2021 ● Sep 2023 ● Sep 2024



The yield curve is a key barometer in financial markets, illustrating how interest rates vary across bond maturities. Typically, an upward-sloping curve signals optimism about economic growth, with longer-term bonds offering higher yields. However, when the curve inverts—where short-term yields surpass long-term ones—it can raise red flags, often seen as a precursor to economic slowdowns.

In September 2021, India's yield curve reflected a healthy economy, with a 192 basis point spread between the 2-year and 10-year bonds. However, as inflation surged, the RBI responded by raising the repo rate from 4% to 6.5% between 2022 and 2023. This led to short-term yields rising more sharply than long-term ones.

By mid-2024, the spread between 2-year and 10-year bonds had narrowed dramatically to just 2 basis points, reflecting heightened caution among investors and concerns of a potential economic slowdown.

Rising demand for government bonds has driven yields lower across maturities

The inclusion of Indian government debt in JP Morgan's global bond index in 2024 attracted substantial inflows from both foreign and domestic investors. This development not only raised the global visibility of Indian bonds but also affirmed their creditworthiness, encouraging greater institutional investment.

Increased demand for government bonds has driven yields lower across maturities, as investors sought the safety of these assets amid economic volatility. However, despite inflation stabilizing, the persistently narrow yield spread—just 4 basis points between 2-year and 10-year bonds—indicates continued caution among investors.

Liquidity and banking challenges

A major factor influencing yields is banking liquidity. While improving liquidity, bolstered by increased government spending and reduced short-term borrowing, should lower short-term rates, the deposit crunch facing banks has complicated this scenario, keeping short-term rates elevated.

As banks increasingly turn to high-cost short-term certificates of deposit (CDs) and other funding instruments, short-term rates remain elevated. This has impacted the yield curve, with short-term yields failing to decline in response to improving liquidity, resulting in a flat or even inverted yield curve.

Inflation outlook and expectations

Looking ahead, fluctuations in yields are likely to be influenced by the interplay of increased government spending, festive season dynamics, and foreign investor inflows. Ultimately, the balance between supply and demand in the bond market will determine the net effect on yields.

If inflation continues to stabilize below 4%, it would pave the way for the RBI to consider reducing interest rates. This could lead to a return to a more typical upward-sloping yield curve, signalling stronger economic conditions and improving investor sentiment.

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