It’s time for investors to lock in attractive bond yields

With rate cycles nearing peak, experts believe that the debt market has become an attractive investment option for retail investors.

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The collapse of Silicon Valley Bank and Signature Bank in the US; and the crisis in Credit Suisse have not only spooked the equity markets but have also dented the yields in the debt market.
Despite the recent fall in yields due to global developments, experts are betting on the debt market.

Analysts believe that as we are close to the end of the rate hike cycle and due to a significant rise in the yields over the past months, the debt market has become an attractive investment option for retail investors.

Rate cycle close to its peak

With easing of inflation, decline in crude oil prices and weaker growth, analysts are not expecting much increase in interest rates in coming months. Experts agree that the interest rate cycle will peak out in the next few months.

“Debt mutual funds have become more attractive with the rise in yields as investors can gain from higher coupons and lesser mark-to-market impacts on portfolios as interest rates may be reasonably close to peaking out. For investors who are in higher tax brackets, debt funds continue to be very attractive due to indexation benefits if they are held for more than 3 years,” Vishal Dhawan, Vice Chairman, Association of Registered Investment Advisors told TNIE.

The Reserve Bank of India (RBI) in the current rate hike cycle has raised repo rates by 250 bps since May 2022 till February 2023 from 4% to 6.5%. In India, rate hike cycle is near end with expectations of one last rate hike of 25bps in April 2023. Since higher return in the debt market is made when investments are done near the peak of the rate cycle, the year 2023 could mark the comeback year of debt markets in India as well as globally,” said Sachin Jain, Research Analyst, ICICI Direct.

“Given the increase in the yields in the past months, this is the best time to invest in debt funds. Going forward, I am very positive on debt funds in India. All the negative news like- inflation is high, central banks will keep raising rates- have already been priced in,” Sandeep Yadav, Head - Fixed Income, DSP Mutual Fund told this newspaper.

“Inflation is easing, rupee is comparatively stable. Now the incentive for the RBI to hike rates is much less. One rate hike is already priced in by the market and that hike is not going to make yield fall significantly,” he said.

Yields have risen

The yields across the curve and across the credit spectrum have moved up significantly in the last two years. Yield on the 3-year AAA-rated corporate bond has moved up from the October 2020 lows of 4.7% to 7.9% currently in March 2023. Similarly, yield on 5-year AAA rated corporate bonds has moved up from 5.6% to 7.8% during the same period. The benchmark 10-year G-Sec yield is trading around 7.35% levels up from below 6% levels at the start of the current rate hike cycle.

“Indian debt market has become attractive after the continuous rise in yields in the last few years. The yields across debt mutual funds have risen and offer excellent investment opportunities,” said Jain.
Analysts believe that the current higher level of yields closer to 8% is around peak levels and likely trend lower over a period of time.

“The YTMs (Yield to Maturity) of a representative short term debt fund or corporate bond fund is currently around 7.7%-8% and offers excellent investment opportunities. The risk of capital loss due to further rise in yields is minimal at current levels and therefore the return going forward is likely equal or higher than current YTMs of the fund,” added Jain.

Time to lock-in higher yields

Investors should avoid trying to time the market on debt funds and invest through a combination of hold to maturity debt funds and short-term debt funds to lock in yields. “Investors should consider laddering their investment maturities over different time frames to reduce reinvestment risk,” Dhawan said.

Existing investors should be mindful of taxes when they shuffle their debt portfolios and also focus on the credit quality of the underlying assets,” he added. “New investors should ideally invest in high credit quality short to medium term funds, with a portion in hold to maturity instruments,” he added.

Experts say that the volatility in the global bond market due to movement in interest rates will not impact investors who have exposure to debt funds holding bonds having maturity of less than three years. “When it comes to the impact of interest rates on debt funds, investors should look at the duration of bonds. Investors need to check if their fund is holding bonds greater than five years.

If it is so, then the rate movement could impact them materially. For bonds less than four years, the interest rate movement will not have a major impact on the performance of debt funds,” Feroze Azeez, Deputy CEO of Anand Rathi Wealth, told TNIE. “From debt market standpoint, Indian retail investors do not have to worry about what’s happening around the world,” he added.

Attractive yields

7.9% Yield on 3-year AAA-rated corporate bond in March 2023

4.7% Yield on 3-year AAA-rated corporate bond in Oct 2020

7.8% Yield on 5-year AAA rated corporate bond in March 2023

5.6% Yield on 5-year AAA rated corporate bond in Oct 2020

7.35% Yield on benchmark 10-year government bonds