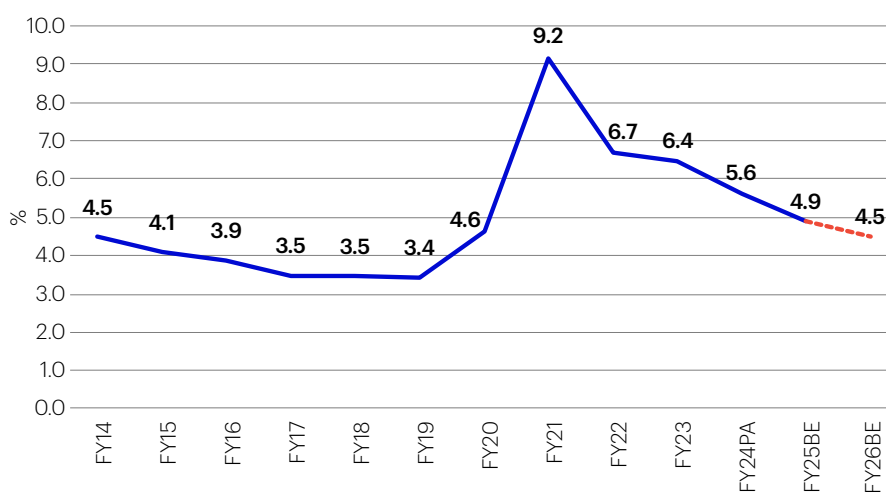


## Union Budget: Positive for Fixed Income market across the yield curve

The Union Budget presented on July 23, 2024, exemplifies the government's commitment to fiscal prudence over the past decade. Initially, markets were cautious as the coalition government was presenting its first budget, fearing a shift from prudent fiscal management to populism. However, the finance minister and the government alleviated these concerns by maintaining continuity, even in a year with a substantial surplus transfer from the RBI.

Remarkably, the finance minister (FM) announced a fiscal deficit target of 4.9% for FY25, down from 5.1% in the interim budget. The government also intended to reduce debt to Gross Domestic Product (GDP) which in turn will reduce the fiscal deficit post FY26 as well. The chart below illustrates the fiscal discipline the government has achieved in recent years:

### Fiscal Deficit (as a % of GDP)



PA – Provisional Actuals, BE- Budget Estimates

Source: Budget document 2024-25

### Credible Budget Numbers

The government has projected nominal GDP growth at 10.5%, with the Reserve Bank of India (RBI) estimating real GDP growth at 7.2%, resulting in a deflator of 3.3%. This makes the 10.5% nominal growth projection reasonable. The finance minister has assumed an ~11% growth in gross tax receipts, which appears credible. GST is expected to grow by ~10-11% over last year, a conservative estimate. Net tax revenue is pegged at 7.9% of GDP, up from 7.88% last year, indicating a conservative assumption in tax buoyancy. These numbers seem achievable.

In terms of non-tax revenue, the government has already received a higher surplus transfer from the RBI. Public Sector Undertakings (PSUs) are also expected to deliver higher dividends due to improved profitability. The government anticipates a significant increase in telecom revenues, justified by recent tariff hikes.

If we compare the numbers with that of Interim budget presented in February'24, Total receipts are increased by Rs. 1.27 lakh crore which is equivalent to additional surplus received from the RBI. The finance minister kept the capital expenditure unchanged while used this excess cash received to reduce fiscal deficit by Rs. 72,100 crore (compared to FY25 interim budget estimates). This re-confirms FM's intent to remain fiscally prudent.

Rs. lakh crore	FY24 Provisional Actual	FY25 Interim BE	FY25 BE	YoY Growth %	Change over Interim BE
<b>Nominal GDP</b>	295.36	327.72	326.37	10.50%	-1.35
GDP Growth %		10.96%	10.50%		
<b>Revenue Receipts</b>	27.28	30.01	31.29	14.7%	1.28
Net Tax Revenue	23.27	26.02	25.83	11.0%	-0.19
Non Tax Revenue	4.02	4	5.46	35.8%	1.46
<b>Capital Receipts</b>	17.14	17.64	16.91	-1.3%	-0.73
Borrowings	16.54	16.85	16.13	-2.5%	-0.72
<b>Total Receipts ex Borrowings</b>	27.88	30.8	32.07	15.0%	1.27
<b>Total Expenditure</b>	44.43	47.66	48.21	8.5%	0.55
Revenue Expenditure	34.94	36.55	37.09	6.2%	0.54
Capital Expenditure	9.49	11.11	11.11	17.1%	0
<b>Fiscal Deficit</b>	16.54	16.85	16.13	-2.5%	-0.72
% of GDP	5.60%	5.10%	4.90%		

BE – Budget Estimates. Source- Budget Document 2024-25

### Bihar and Andhra Pradesh get their presence felt in budget without Revenue Expenditure

The finance minister strategically allocated a portion of the Rs. 11.11 lakh crore capital expenditure (Capex) to Bihar and Andhra Pradesh, focusing on infrastructure development rather than granting special statuses. Bihar received Rs. 58,900 crore, earmarked for roads, bridges, power plants, and irrigation projects. Andhra Pradesh was allocated Rs. 15,000 crore, sourced via multilateral entities. This allocation includes grants for backward regions—Rayalaseema, Prakasam, and North Coastal Andhra—as stipulated by the Andhra Pradesh Reorganization Act. The Rs. 15,000 crore represents the first tranche, with additional funds expected in subsequent years.

### Prudent funding of Fiscal Deficit creating enough cushions

The government has reduced the absolute fiscal deficit by Rs. 72,100 crore compared to its projection in the interim budget. Notably, the government's strategy for funding this fiscal deficit stood out.

The fiscal year began with a favorable demand-supply dynamic, driven by reduced net supply and the gradual inclusion of Indian Government Bonds (IGBs) into JP Morgan's Emerging Market Debt Index. Throughout the year, the bond markets received positive surprises, including an improving global macroeconomic backdrop and a significant surplus transfer from RBI. On the day of this surplus transfer, the 10-year government securities (G-sec) yield touched a low of 6.94% (as on June 04, 2024). This record surplus transfer raised market expectations for a reduction in dated supply by Rs. 30,000 crore to Rs. 50,000 crore.

The sovereign yield curve has remained flat, with strong demand for longer-dated securities, while short-term rates have been elevated due to strained banking liquidity. In May 2024, the government attempted to address this by buying back short-maturity G-Secs and reducing the T-Bill issuance calendar. Despite these efforts, short-term rates remained high.

To further address this issue, the finance minister reduced the T-Bill supply by Rs. 1 lakh crore compared to the interim budget, resulting in a net supply of negative Rs. 50,000 crore. Additionally, the government decided to draw down Rs. 1.4 lakh crore from its cash reserves. This move is expected to improve liquidity in the banking system and marginally enhance banks' credit-to-deposit ratios.

Moreover, the government has reduced its reliance on small savings to fund the fiscal deficit. These financing sources might positively surprise the markets, potentially reducing further pressure on dated borrowing, which has been marginally reduced by Rs. 12,000 crore, including a Rs. 6,000 crore reduction from not issuing Sovereign Green Bonds in the May 31, 2024 auction.

#### Funding of Fiscal Deficit (Rs. lakh crore)

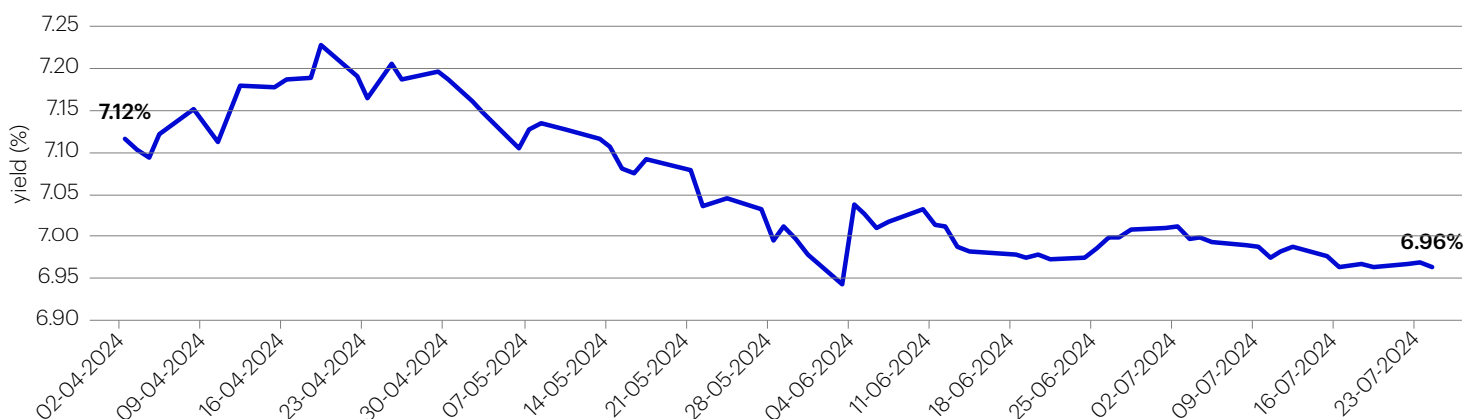
	FY24 Provisional Actual	FY25 Interim BE	FY25 BE	Change over interim
T-Bills	0.53	0.5	-0.5	-1
Small Savings	4.51	4.66	4.2	-0.46
State Provident Fund	0.05	0.05	0.05	0
Others	0.83	-0.31	-0.81	-0.50
External Debt	0.55	0.16	0.16	0
Cash Drawdown	-1.72	0.04	1.4	1.36
Net Market Borrowing	11.78	11.75	11.63	-0.12
Redemption	3.62	2.38	2.38	0
Gross Market Borrowing	15.4	14.13	14.01	-0.12

Source: Budget document 2024-25

#### Market activity in fiscal year so far

Despite global macro volatility in April'2024, the Indian 10-year G-sec has shown remarkable stability falling from the highs of 7.23% in April'2024 to 6.94% in June'2024 and trading within a narrow 10 basis point range thereafter. The 10-year yield has fluctuated between 6.94% and 7.05% (from April 01, 2024 till July 23, 2024), with significant trading activity at both ends of the spectrum. With fiscal metrics at their most favourable levels, attention will now shift to monetary policy, heavily influenced by food inflation trends. The monsoon season, which began weak in June'2024, has recovered robustly in July'2024, with sowing hectareage surpassing last year's figures. Meteorological agencies predict an above-normal monsoon with even spatial distribution, which may bolster RBI's confidence in implementing monetary policy measures. However, we do not anticipate a significant rise in yields, as there is ample market demand to secure higher yields.

## 10-year G-sec yield



Source: Bloomberg

## Foreign Portfolio Investors (FPIs) and Foreign Banks' Activity since Inclusion

Since the announcement of Indian Government Bonds' (IGBs') inclusion in JP Morgan's (JPM) emerging market bond index, there has been a significant surge in demand from FPIs. Starting in October 2023, FPIs have purchased over Rs. 1 lakh crore in Fully Accessible Route (FAR) bonds. While most of these purchases occurred in FY2024, the trend has continued, with June'2024 recording inflows of Rs. 17,239 crore as the actual inclusion began.

JP Morgan noted in its post-inclusion call that many FPIs unable to open accounts in India are using the SSA (Supranational, Sovereigns and Agencies) and TRS (Total Return Swap) routes. Secondary market activity by foreign banks in FYTD confirms a strong demand for TRS. However, these routes may face challenges as the IGBs' weight in the indices increases to 3-4%, potentially leading to tracking errors.

With a fiscally prudent budget and a favorable domestic macroeconomic backdrop, we believe that both active and passive FPI investors will continue investing in FAR bonds. This sustained demand from FPIs, along with robust demand from rapidly growing domestic investors, is likely to keep the demand for dated government securities higher than the supply.

FPI Buying of FAR securities	Rs. Crore
Sep 23 till Apr 24	77,164
Apr-24	-9,857
May-24	5,208
Jun-24	17,239
July MTD (as on 22 Jul'24)	11,351
<b>FYTD</b>	<b>23,941</b>
<b>Total since JPM Announcement</b>	<b>1,01,106</b>

Source: CCIL

Participant Data (Rs. Crore)	Q1FY25	FYTD (till July 23, 2024)
<b>Foreign Bank</b>	33,218	59,039
<b>PSU Bank</b>	443	-11,401
<b>Private Bank</b>	2,546	-11,723
<b>Mutual Fund</b>	10,588	19,894
<b>Others</b>	63,604	70,973
<b>Primary Dealers</b>	-1,10,380	-1,26,768
<b>Constituent</b>	1,28,970	1,53,819

## State Development Loan (SDL) supply tracking lower than calendar

State governments have consistently shown significant deviations between their indicative borrowing calendars and actual borrowings. This variability can be attributed to the dependence of State revenues on the Central Government, which often leads to uncertainty in both the timing and quantum of funds received.

Below is a table that highlights the trends in indicative calendar vs. actual borrowings by State Governments over recent years:

## SDL overview year wise (Rs. lakh crore)

	Q1		Q2		Q3		Q4		FY	
FY	Calendar	Borrowed	Calendar	Borrowed	Calendar	Borrowed	Calendar	Borrowed	Calendar	Borrowed
FY19	1.16	0.77	1.37	0.81	1.23	1.30	2.19	1.91	5.95	4.78
FY20	1.10	0.88	1.39	1.44	1.71	1.62	2.09	2.46	6.29	6.40
FY21	1.27	1.67	1.78	1.86	2.02	2.02	3.16	2.43	8.24	7.99
FY22	1.78	1.45	1.92	1.64	2.02	1.57	3.24	2.35	8.96	7.02
FY23	1.90	1.10	2.12	1.66	2.53	1.81	3.41	3.01	9.96	7.58
FY24	2.00	1.68	2.37	1.90	2.37	2.46	4.13	4.03	10.88	10.07
FY25	2.54	1.46	2.64						5.18	1.46

Source: RBI

In the current fiscal year, States have consistently borrowed less than their scheduled amounts, with only 60% of the calendar amount being borrowed in auctions as of July 23, 2024. This trend positively impacts the demand-supply dynamics of the bond market. The final budget has increased the share of States in gross tax revenue and grants for capital expenditure compared to the interim budget. This adjustment provides states with additional financial buffers, allowing them to reduce borrowing further. The following table illustrates the month-wise borrowing pattern by the States:

SDL Borrowing (Rs. crore)	Calendar	Borrowing	% of Calendar
<b>Apr-24</b>	98,140	51,200	52%
<b>May-24</b>	86,650	42,800	49%
<b>Jun-24</b>	69,250	51,821	75%
<b>Jul-24</b>	53,390	38,883	73%
<b>Total</b>	3,07,430	1,84,704	60%

Source: RBI

## Reduction in T-Bill might increase purchase of short dated Government Securities

In the Union Budget, the finance minister decided to maintain the net T-bill supply at negative Rs. 50,000 crore. This decision warrants an analysis of the participant-wise holdings of T-bills. The following table shows the participant-wise holdings of T-bills as of March 2024:

Category Holdings (Mar-24)	% share	Rs. Crore
Commercial Banks	58.53	5,10,184
Mutual Funds	11.89	1,03,641
Financial Institution	7.16	62,411
State Governments	5.88	51,254
Others	16.54	1,44,173
Total	100.00	8,71,662

Source: RBI

The above categories i.e. Commercial Banks, Mutual Funds, Financial Institutions and State Government hold ~83.46% of the T-bills outstanding. Banks and financial institutions purchase T-bills to meet liquidity ratios, State Governments buy T-bills to park their cash balances, and mutual funds are also required by regulations to invest in T-bills.

Hence, if the outstanding T-Bills fall by Rs. 50,000 crore, these buyers may increase purchase of either G-Sec or Short Dated SDLs, boosting further demand in the dated securities.

## **Fiscal Deficit for FY26: An achievable target with another year of favorable demand -supply**

### **Supply for FY26**

Based on the budget numbers for the current fiscal year, we believe that the finance minister will achieve a fiscal deficit of 4.5% or lower in FY26. If the economy continues to grow at the projected rate, the fiscal deficit in absolute terms is expected to be lower given that the government intends to progressively reduce the fiscal deficit over the coming years.

Further in recent years, the finance minister has funded 70% of the fiscal deficit through dated securities. If we expect this trend to continue, the net dated supply for the next year will be lower than the Rs. 11.63 lakh crore projected for the current fiscal year.

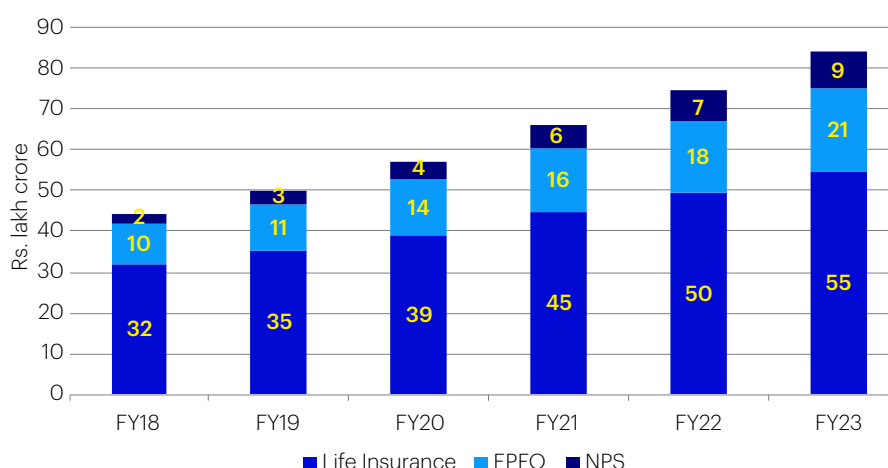
Thus, we are of the view that the Indian bond markets are poised for a structural downtrend in yields.

### **Demand for FY26**

AUM growth in Insurance, Employee Provident Fund Organisation (EPFO) and National Pension System (NPS):

As previously discussed, the Assets Under Management (AUM) of long-only investors such as Insurance Companies, EPFO, and NPS have been expanding at a compound annual growth rate (CAGR) of ~14% over the last 5 years. If this growth trend continues, these entities are likely to absorb a significant portion of the long tenor dated supply in the upcoming fiscal year. This reinforces our expectation of a structurally softer yield environment.

### **AUMs (Rs. lakh crore)**



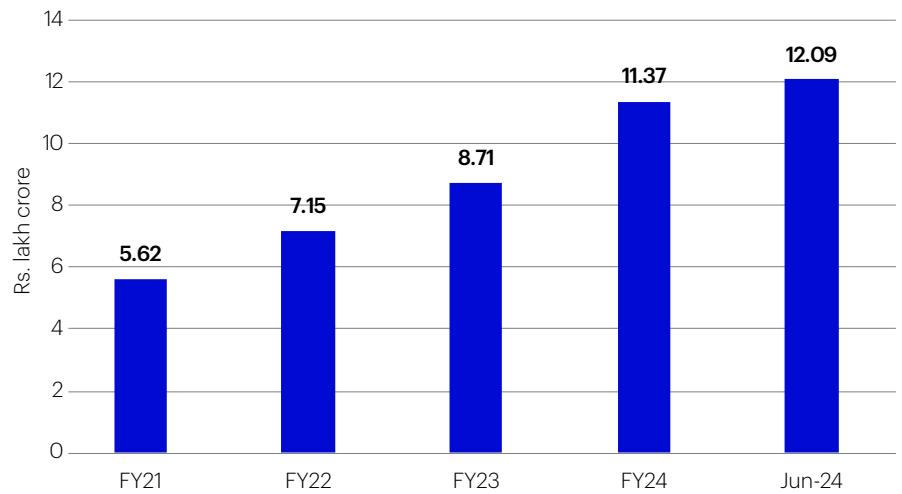
## **NPS and EPFO: Booster for already fast-growing AUMs**

The chart below highlights the rapid growth in AUM for the NPS. The industry, which saw an AUM increase of Rs. 2.66 lakh crore in FY24, has already added Rs. 0.72 lakh crore in Q1 FY25, despite this quarter typically being less favorable for fund inflows.

Additionally, the finance minister has raised the contribution limit to NPS from 10% to 14% of the basic salary for individuals opting for the new tax regime. This change is expected to drive even higher inflows into these funds in the forthcoming fiscal year.

Along with the boost for NPS, the government has announced skilling and employment generation schemes where the government will be targeting to create over 41 million jobs over next 5 years. This will not only increase the subscriber base for EPFO but also enhance the growth in its AUM.

#### NPS AUM (Rs. lakh crore)



Source: NPS

#### Conclusion

The current fiscal year's budget and associated economic indicators signal a favorable outlook for the Indian bond market and fiscal management. The finance minister's commitment to a fiscal deficit target of 4.5% or lower in FY26, alongside prudent fiscal policies, sets a solid foundation for fiscal stability.

The strategic allocation of capital expenditure to key states like Bihar and Andhra Pradesh highlights a focus on productive investment. With States consistently borrowing below their calendar amounts and the finance minister's decision to keep net T-bill supply at negative Rs. 50,000 crore, the net supply for the FY25 remains low.

Budget has proved to be quite positive for both the short end as well as the long end of yield curve. Good for short end of the yield curve as the Budget has estimated a net negative supply of T-bill of Rs. 50,000 crore, thereby reducing the supply at shorter end. Additionally, Government has budgeted to draw down Rs 1.37 lakh crore from its cash balance which is largely on account of the fiscal saving achieved in FY24. This will help in releasing banking liquidity and will drive down the short end yields. Budget is also positive for long end of the yield curve as Finance Minister has clearly laid out a fiscal consolidation path over next few years. While the Government had much more room to reduce the dated G-sec borrowing in FY25, they have prudently opted for a lower reduction given the huge G-sec FPI demand from JP Morgan Debt index inclusion this year. Demand supply was already favorable in FY25 on the back of JP Morgan debt index inclusion and domestic demand. Longer end demand gets further boost now with higher expected mobilization in NPS / EPFO which normally invests at the longer end. With this budget, even FY26 seems comfortably placed on demand – supply dynamics.

Overall, the combination of disciplined fiscal management, strategic state allocations and robust growth in institutional AUMs suggests a favorable environment for bond markets. This backdrop is likely to lead to a structural downtrend in yields, presenting a positive outlook for investors in the Indian bond market.

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