



# Indian bonds: the new favourite for index providers

August 2024





# Indian bonds: the new favourite for index providers

Indian bonds have recently generated significant market buzz, primarily due to their inclusion in global bond indices. Here, we examine why Indian bonds have become the new favourite for index providers and why this asset class should be appealing for other investors, given the current market outlook and global backdrop.

## Why are index providers paying more attention to India's bond market?



### Liberalisation of the Indian bond market

India's bond market is dominated by domestic investors. Historically, foreign investors could only acquire Indian bonds through a quota system. Although this system was simplified and relaxed over time, granting greater and easier access, it nevertheless imposed a cap on foreign access.

This started to change in 2020, when Indian regulators delivered reforms that began to classify certain government bonds as 'fully accessible route' (FAR) securities. To domestic investors, these are just regular bonds, but to a foreign investor, FAR bonds are very different. Once a foreign investor has a foreign portfolio investor (FPI) licence (allowing them to invest in the domestic bond market), they can buy and sell FAR bonds unrestricted by quotas. This has significantly opened up the market to FPIs. As well as making FAR bonds easier to invest in, this reform also made them eligible for inclusion in global bond indices, as a typical prerequisite for index inclusion is for bonds to be free from capital controls.

The market grew quickly. By 2023, it had reached around US\$300 billion<sup>1</sup>. As a result, FAR bonds started to find their way into global indices. J.P. Morgan announced in October 2023 that it would include Indian FAR bonds in its GBI-EM global index suite. With inclusion starting on 28 June 2024, FAR bonds will eventually make up 10% of the index by March 2025<sup>2</sup>. Other index providers are likely to follow suit. Bloomberg has already announced the inclusion of Indian FAR bonds in its Emerging Market Local Currency Government Index and related indices, starting on 31 January 2025.

From only four FAR bonds in 2020, there are now nearly 40 FAR bonds, including India's sovereign green bonds. This amounts to well over US\$400 billion. That's around 30% of India's overall government bond market – and larger than Indonesia's entire government bond market.

---

By 2023, the market  
grew quickly and  
reached around  
**US\$300 billion**

---

---

In October 2023,  
J.P. Morgan would include  
**Indian FAR bonds**  
in its GBI-EM global  
index suite

---

---

By March 2025,  
FAR bonds will make up  
**10% of the  
index**

---

<sup>1</sup>Source: Bloomberg, JP Morgan, RBI, 1 January 2023.

<sup>2</sup>Source: Bloomberg, 5 March 2024.



## Enhancing risk-adjusted returns for global bond markets

However, these index providers aren't just responding to the liberalisation in India's government bond market. Global bond markets, and particularly those in the emerging world, have faced a challenging environment over the last decade or more. Frequent crises and episodes of quantitative easing resulted in extended periods where significant portions of the global bond market saw negative yields. According to Bloomberg data, this number peaked at close to US\$18 trillion in December 2020, or 26% of the global aggregate bond index market value. These markets have subsequently had to deal with inflation shocks and aggressive monetary tightening.

Meanwhile, Russia, Argentina, Turkey and other higher-volatility emerging markets have faced political and geopolitical crises with a negative effect on policy credibility, volatility and investor sentiment. As a result, returns for the J.P. Morgan GBI-EM local-currency index and Bloomberg global aggregate treasury indices were negative (in US dollars) over the 10 years to the end of July 2024, down 5.3% and 8.8%, respectively<sup>3</sup>. By contrast, with India's wide-ranging reforms over the last decade, many of which were supportive of the bond market, gross returns from the Indian bond market (Markit iBoxx ALBI India Index) were 63.4%<sup>4</sup>.

**As a result, index providers are seeking to improve the quality of their indices by including markets like India, with a positive impact on their risk characteristics.**

India is investment grade (BBB-)<sup>5</sup> with a belatedly improving sovereign credit rating. Its bond market is large and liquid. Its government bond market is US\$1.3 trillion and trades with tight bid-offer spreads of only 1-3 basis points (bps) – usually an indication that the market has good liquidity. In addition, the state bond market (issued by more than 30 states and union territories across India) is roughly US\$500 billion. Finally, India's corporate bond market is around US\$500 billion and includes investment-grade quasi-government issuers that are supported by very high levels of government ownership.<sup>6</sup>

At only around 5%, the market's volatility is low, helped by some of the lowest currency volatility in the world. As of August 2024, the one-month implied volatility for the Indian rupee was around 2%.<sup>7</sup>

Following India's full inclusion in the J.P. Morgan GBI-EM index, Asian government bonds will eventually account for nearly 50% of the index, highlighting the region's relative political stability, higher state capacity to push reforms and deal with crises, and stronger fundamentals. Almost half of the world's foreign-exchange (FX) reserves and sovereign wealth fund assets are also in Asia. The region will increasingly dominate global growth in the decades ahead.

<sup>3</sup>Source: Bloomberg, JP Morgan, as of end July 2024.

<sup>4</sup>Source: Bloomberg, Markit iBoxx, as of end July 2024.

<sup>5</sup>Source: S&P, May 2024.

<sup>6</sup>Source: Haver, March 2023.

<sup>7</sup>Source: Bloomberg, as of end August 2024.



# Why do Indian bonds matter more to investors now?



## Responding to increased uncertainty

The global environment remains uncertain.

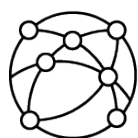
The US Federal Reserve (Fed) has played its part – arguably misjudging inflation risks, delaying policy normalisation and then having to aggressively tighten policy in 2022. Judging when the Fed will begin to ease policy has been equally challenging, making it difficult for investors to know when to position in global bond markets.

There could be more of this uncertainty in the medium term. Although the US election outcome is unclear at the time of writing, a Donald Trump victory could see a number of potential policies – fiscal stimulus, extremely aggressive tariff measures and immigration policies – that could be inflationary. This would pose a challenge for the central bank and bond market.

These challenges and uncertainties for investors demonstrate the need for diversifying trades into ones that are less influenced by global events and investor flows.







## True diversification with low correlation

In August 2024, the unwinding of yen-funded global carry trades (borrowing in a low-interest currency to buy a higher-yield asset), was partly to blame for a fall in Japan's stock market. This led to sell-offs in other markets. This episode highlighted the risk of investors over-positioning in consensus trades and correlation between markets.

Domestic Indian government bonds offer true diversification benefits because of their low correlation with several markets. This is largely attributed to the low level of foreign ownership. As of April 2024, foreign holdings of Indian government bonds were less than 3% of the overall US\$1.3 trillion domestic government bond market and less than 2% of the overall market. Even post index inclusion, foreign ownership is expected to rise to just under 4%<sup>8</sup>.

India's market is driven by banks, insurance companies and asset managers that cater to domestic investors. As a result, the correlation to a wide range of global markets and other asset classes is low. Other than the typically superior performance over a variety of time periods, it is easy to see the resilience of the market during key risk-off periods. This characteristic, while helping to improve the risk characteristics and performance of global bond indices, can also help investors to build more optimal wealth portfolios, with better drawdown characteristics and resilience.

<sup>8</sup>Source: JP Morgan, April 2024.

<sup>9</sup>Source: Bloomberg, abrdn Investments. USD unhedged, correlation of monthly returns over 10 years to 31 July 2024. Indian government bonds: Markit iBoxx Asia India Index.

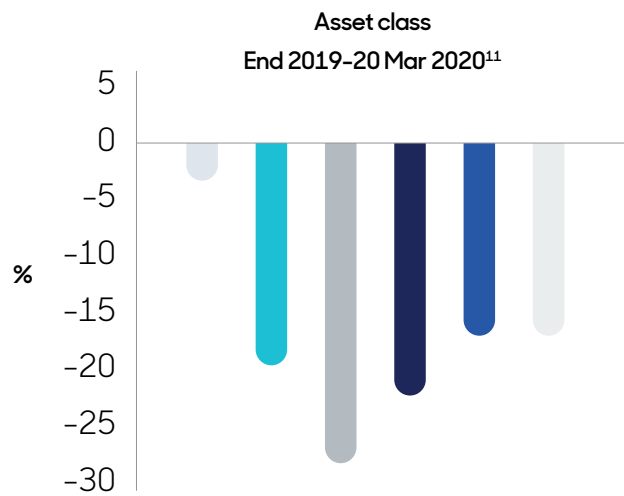
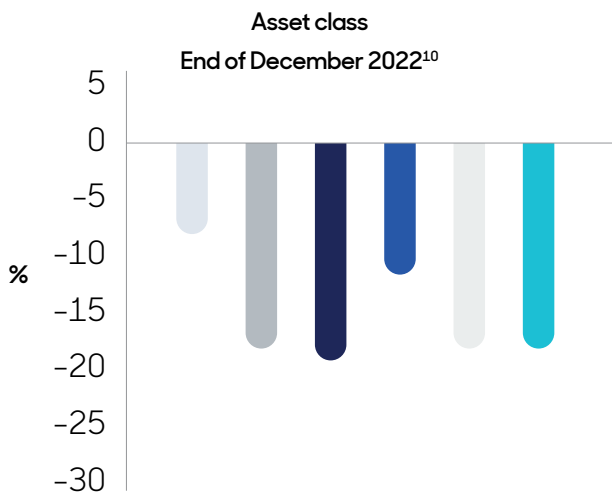
Correlation <sup>9</sup>	Indian government bonds
WTI crude oil	-0.16
Global equities	0.28
US Treasuries	0.27
Chinese equities	0.32
Global treasuries	0.35
Global high yield	0.36
Global aggregate	0.38
Global aggregate: corporates	0.42
EM USD aggregate: corporates	0.41
EM hard-currency aggregate: sovereigns	0.41
EM Asia USD credit	0.44
EM local-currency government 10% country capped	0.53



## Defensiveness in a challenging market environment

The year 2022 was one of the most challenging periods for markets in recent history. Currencies depreciated against the US dollar, credit spreads widened and equities sold off significantly. However, even in this environment, India's domestic bond market held up better than most. Reallocating to the market in these kinds of circumstances would give investors greater flexibility and opportunities, allowing them to reallocate risk and take advantage of cheaper valuations in other markets.

Similarly, from the end of 2019 to the height of the market sell-off during the Covid-19 crisis on 20 March 2020, India's domestic bond market was down by only 3%, including the impact of FX.

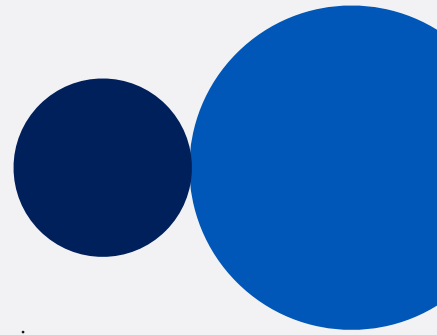


- Indian bonds
- Asian ex Japan equities
- EM USD bonds
- US equities
- EM local bonds
- Global aggregate treasury bonds

- Indian bonds
- US equities
- EM local bonds
- EM USD bonds
- Global high yield
- Asian ex Japan equities

<sup>10</sup>Source: abrIn Investments, Bloomberg, cumulative returns as of end of December 2022.

<sup>11</sup>Source: abrIn, Bloomberg, cumulative returns as of end of 2019 to 20 March 2020.



Key to this was the lower volatility of Indian bonds (typically around 5%)<sup>12</sup>. This is due to two main reasons:



### Low FX volatility

India benefits from a stable and strong currency in a global market. The rupee is one of the world's least volatile currencies. Its one-month implied volatility was 1.7% by the end of July 2024. This is a two-decade low, below the Singapore dollar's 3.7%, 3-4 times lower than the FX volatility of the G10 (the most heavily traded global currencies), and 4-6 times lower than the typical volatility in emerging markets. As well as benefiting from reforms, the rupee's stability is supported by more than US\$670 billion in FX reserves and a current-account deficit that is expected to be less than 1% in 2024 (from 5% a decade ago).<sup>13</sup> The currency is also bolstered by record foreign direct investment inflows, attracted to India's reforms and robust growth prospects.



### Low foreign ownership

Foreign ownership of Indian government bonds is expected to rise from below 2% to more than 4% of the overall government bond market by the time inclusion in the J.P. Morgan GBI-EM index concludes. Even allowing for other potential index inclusion flows, foreign ownership will remain relatively low. In addition, a large part of these flows are passive in nature, tracking index weights and not necessarily actively traded. Hence, the risk, volatility and correlation characteristics we have described should remain in place for the foreseeable future.

The rupee is one of the **world's least volatile** currencies.

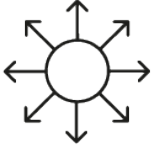
Volatility was **1.7%** by the end of July 2024.

Foreign ownership of Indian government bonds is expected to rise from **below 2% to more than 4%**.



<sup>12</sup>Source: Bloomberg, August 2024.

<sup>13</sup>Source: Bloomberg, July 2024.



## Reforms drive favourable supply and demand

Reforms such as the goods and services tax, introduced in 2017, and measures to reduce subsidies have strengthened the government's fiscal position – enabling fiscal consolidation and reducing bond supply.

## The pre-election interim budget announced in 2024 set India's fiscal deficit target at 5.1% of GDP, lower than expected. The fiscal deficit for the prior year was 5.6%, better than the budgeted 5.9%.

Strong fiscal performance continues, with resilient revenue and a larger transfer from the Reserve Bank of India (RBI) providing a fiscal buffer. The post-election budget targets a 4.9% deficit, implying reduced bond supply<sup>14</sup>. Furthermore, recently proposed RBI guidelines to tighten liquidity coverage norms for banks and finance companies could result in additional domestic bond demand from April 2025.

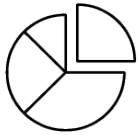
Meanwhile, proposals from India's authorities to increase liquidity buffers in the country's banks and finance companies could result in the need for them to purchase billions of dollars in additional bonds.

Digital banking and finance have been transformative in India, dramatically improving financial inclusion. However, the potential for online banking customers to quickly shift deposits creates additional risk. The government has proposed increased liquidity buffers, which extend to finance companies for unsecured lending. These would be effective from April 2025.



<sup>14</sup>Source: Government of India, Ministry of Finance. 1 February 2024.





## Why Indian bonds stand out as a compelling opportunity

### Valuations

From a valuation perspective, Indian bonds offer a compelling opportunity. As one of the very few investment-grade asset classes that offers yields around 7%<sup>15</sup>, this presents an excellent entry point for client portfolios.

### Above-inflation yields

Inflation is generally coming down. Headline consumer price index inflation for July 2024 was a lower-than-expected 3.5%<sup>16</sup>, below the RBI's 4% target. While this was partly due to base effects, inflation is expected to be getting close to the target by year-end. A good monsoon, harvest season and stabilising food inflation could bring that about even faster. Indeed, inflationary pressures have mainly been driven by supply. Core inflation has been closer to 3%<sup>16</sup> during 2024, suggesting some degree of a positive output gap and some growth pressures. As inflation stabilises, the RBI is expected to ease policy by 50-100bps over the monetary policy cycle extending through 2025. Unlike in a number of other global bond markets, this is not priced. Yields close to 7%<sup>17</sup> are above the 6.5% policy rate<sup>18</sup>, which in turn is comfortably above inflation. As yields come down in line with the policy rate, this would result in capital gains for bondholders, in addition to the attractive yields.

### Increased issuance

Another group of market participants that have taken interest in India are supranational issuers including the Asian Infrastructure Investment Bank, the European Bank for Reconstruction and Development and the Inter-American Development Bank, which have increased rupee denominated issuance. In many cases, these bonds are AAA rated, many of them are green or sustainable bonds and they are free of domestic taxes. As a result, as of the start of August 2024, as much as 17% of an Indian bond strategy can be allocated to green or sustainable bonds, with the overall strategy having a higher rating than the domestic market and lower tax impact.

### Due an upgrade?

Another positive for the asset class is that S&P has upgraded its outlook for India from "stable" to "positive"<sup>19</sup> due to robust growth and fiscal consolidation efforts. This could signal that India's credit rating of BBB- is well overdue an upgrade.

Only the beginning.  
What next for Indian bonds?

With potentially compelling valuations, above inflation yields, increased issuance and the possibility of upgrades on the horizon, there are certainly many reasons to be positive about India and its bond market.

Inclusion of Indian bonds in JP Morgan's GBI-EM index is likely to be just the beginning. Asian bond index providers are likely to increase the weight of India in Asian local-currency bond indices. And Bloomberg is assessing the potential for adding it to its global aggregate bond index. With around US\$4 trillion of global investor money tracking this index, this would be an even bigger story.

<sup>15</sup>Source: Bloomberg, August 2024.

<sup>16</sup>Source: Government of India, Ministry of Statistics and Programme Implementation. 12 August 2024.

<sup>17</sup>Source: Bloomberg, August 2024.

<sup>18</sup>Source: RBI, 8 August 2024.

<sup>19</sup>Source: S&P, May 2024.

# Important Information

**Note:** Companies selected for illustrative purposes only to demonstrate the investment management style described herein and not as an investment recommendation or indication of future performance.

**Important:** Investment involves risk. The value of investments and the income from them can go down as well as up and investors may get back less than the amount invested.

The information in this presentation is not for general circulation and should not be considered an offer, or solicitation, to deal in any funds. The information is provided on a general basis for information purposes only, and is not to be relied on as investment, legal, tax or other advice, as it does not take into account the investment objectives, financial situation or particular needs of any specific investor.

Any research or analysis used to derive, or in relation to, the information herein has been procured by abrdn for its own use, and may have been acted on for its own purpose. The information herein, including any opinions or forecasts have been obtained from or is based on sources believed by abrdn to be reliable, but abrdn does not warrant the accuracy, adequacy or completeness of the same, and expressly disclaims liability for any errors or omissions. As such, any person acting upon or in reliance of these materials does so entirely at his or her own risk. Past performance is not necessarily indicative of future performance. Any projections or other forward-looking statements regarding future events or performance of countries, markets or companies are not necessarily indicative of, and may differ from, actual events or results. No warranty whatsoever is given and no liability whatsoever is accepted by abrdn or its affiliates, for any loss, arising directly or indirectly, as a result of any action or omission made in reliance of any information, opinion or projection made in this presentation.

Any data contained herein which is attributed to a third party ("Third Party Data") is the property of (a) third party supplier(s) (the "Owner") and is licensed for use by abrdn\*\*. Third Party Data may not be copied or distributed. Third Party Data is provided "as is" and is not warranted to be accurate, complete or timely. To the extent permitted by applicable law, none of the Owner, abrdn\*\* or any other third party (including any third party involved in providing and/or compiling Third Party Data) shall have any liability for Third Party Data or for any use made of Third Party Data. Neither the Owner nor any other third party sponsors, endorses or promotes the fund or product to which Third Party Data relates.

\*\*abrdn means the relevant member of abrdn group, being abrdn plc together with its subsidiaries, subsidiary undertakings and associated companies (whether direct or indirect) from time to time.

Bloomberg data are for illustrative purposes only. No assumptions regarding future performance should be made.

The information herein shall not be disclosed, used or disseminated, in whole or part, and shall not be reproduced, copied or made available to others. abrdn reserves the right to make changes and corrections to the information, including any opinions or forecasts expressed herein at any time, without notice.

Issued by the respective abrdn group members detailed below:

**Singapore:** abrdn Asia Limited, Registration Number 199105448E

**Hong Kong:** abrdn Hong Kong Limited. This document has not been reviewed by the Securities and Futures Commission.

For more information visit [abrdn.com](http://abrdn.com)

**abrdn.com**

