Yield Spread

Why there is a spread between Bond Yields?

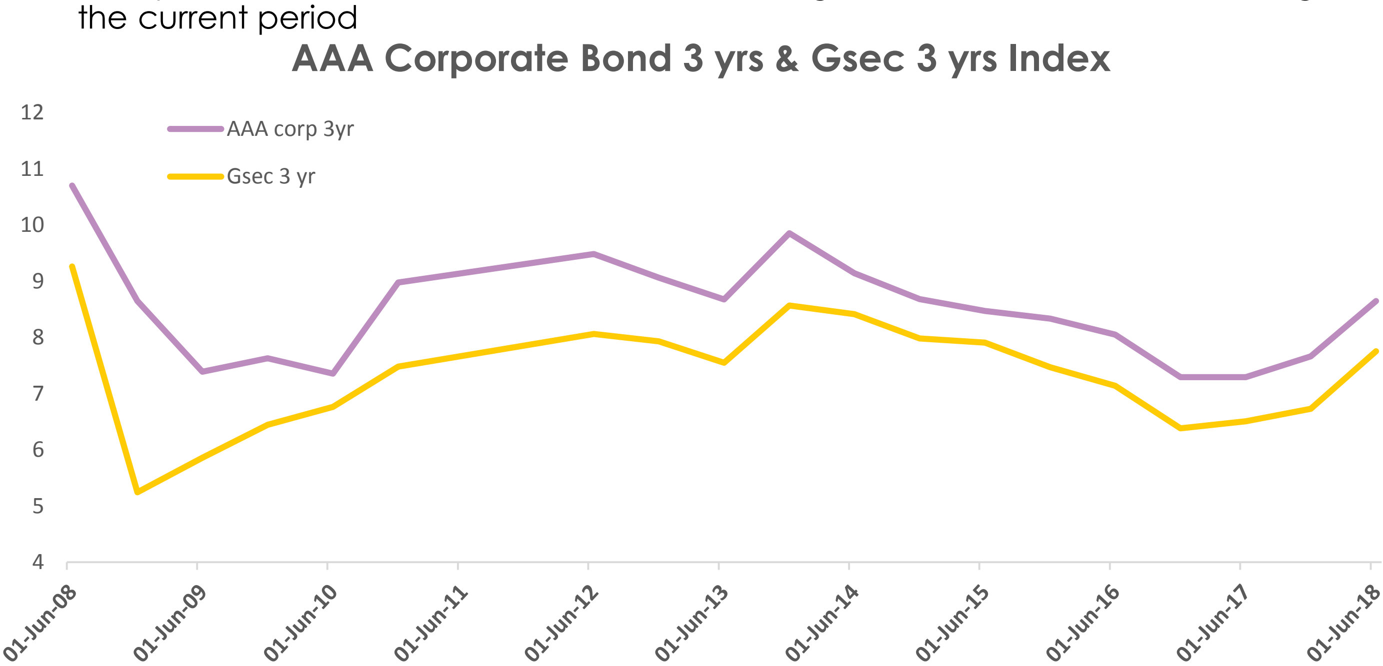
- Government bonds are free from credit risk i.e. risk arising from the issuer of the bond to default in making the payment of the principal amount and interest.
- Government bonds being default free, Gsec yields are taken as a benchmark against which other bond yields are compared.
- This enables the investors to get an idea of the credit risk associated in investing in bonds other than government bonds.
- Investors to be compensated for investing in less safer bonds than the government bonds demand higher yield than Gsec resulting in the differences in the bond yields.
- Yield spread is the difference in the yield between two bonds of the same maturity.
- Commonly, yield spread is the difference in the yield of any bond (PSU, corporate or banks) and Government bonds having the same maturity.
- Suppose AAA 10 year corporate bond yield is 8.6% and 10 year Gsec yield is 7.46% then, the yield spread is 114 bps (1.14%).
- Spread is generally expressed in basis point (bps) where 1 percent is equal to 100bps.

Risk

- Yield spread reflects the extra compensation investors receive for bearing credit risk.
- Higher the credit risk, higher is the yield spread as investors need to be paid in order to take the additional risk.

What causes changes in Yield Spread

- Yield spread can increase i.e. widen or decrease i.e. narrows.
- Widening yield spread means yield difference between other type of bonds and government bonds is increasing.
- Narrowing yield spread means yield difference between other type of bonds and government bonds is decreasing.
- Changes in the yield spread is due to changes in the interest rates, supply and demand of bonds, risk associated with the bond and economic conditions.
- Any change in interest rates causes yield on government bonds to change. Since other types of bonds are benchmarked against Gsec yield, any change in Gsec yield may cause other bond yields to change.
- When there is economic slowdown, company performances are impacted which increase their credit risk. This causes yields on corporate bonds (or PSU, bank bonds) to increase to compensate investors for the additional risk involved, thereby widening yield spread.
- Also during deteriorating economic environment with credit risk of companies increasing, investors chooses to invest in safer bonds i.e. government bonds rather than riskier corporate bonds. This leads to fall in Gsec yields as demand increases causing bond price to rise and yields to fall.
- As yields on corporate bonds are rising and Gsec yields are falling, resulting yield spread to widen.
- Conversely, when economy is booming, company profitability increases improving their performance lowering their credit risk. This causes investors to view investments in corporate bonds favorable causing yields to fall, thereby narrowing yield spread.
- Also during booming economy with lower credit risk, investors invest in corporate bonds rather than government bonds. Since demand for government bond falls, causing their yields to rise.
- Given below is the chart for AAA Corporate Bond yields & Gsec 3 yrs Benchmark. The spread had widened between them during Dec 2008, while it is narrowing for the current period



Source: Bloomberg. Yield spreads against Gsec 3Yrs index. Jun’11 & Dec ‘11 data point is excluded as data points not available.

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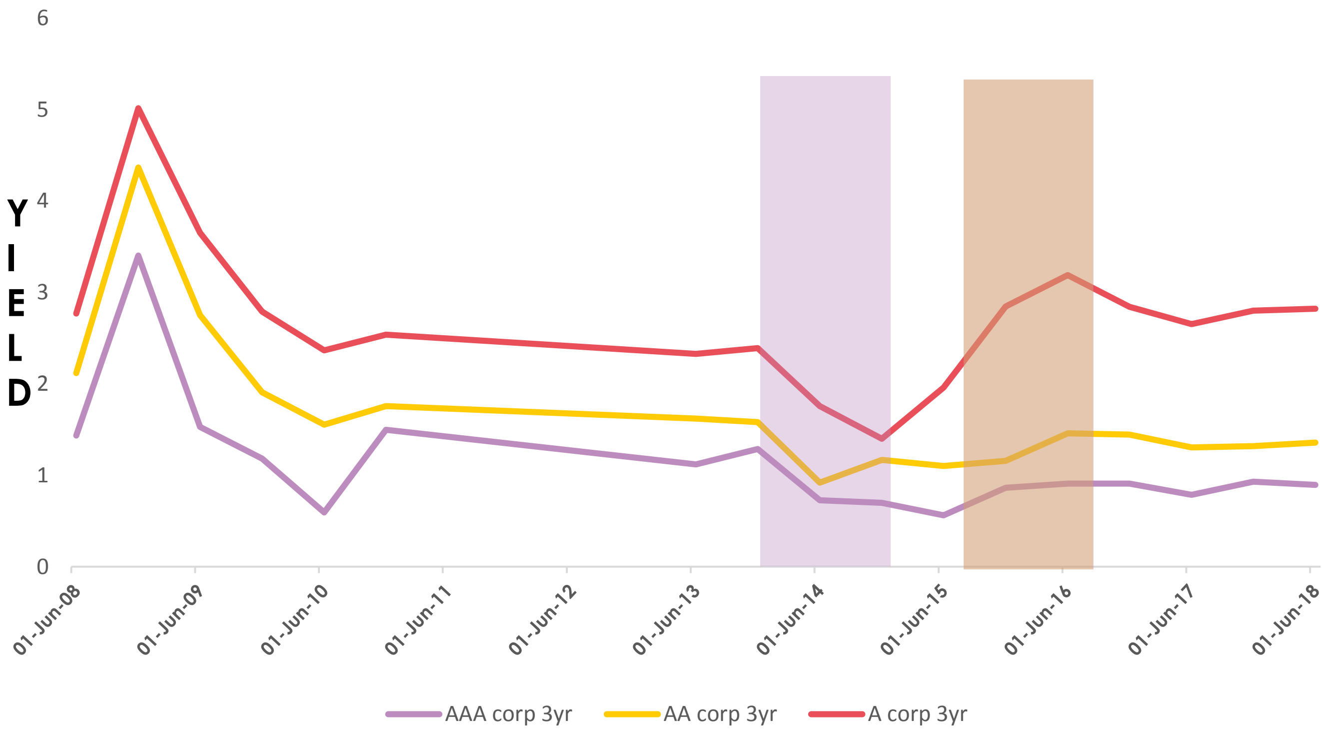
Yield Spreads



Source: Bloomberg. Yield spreads against Gsec 3Yrs index. Jun'11 & Dec '11 data point is excluded as data points not available.

- The above chart shows the yield spreads over the last 10years. We can observe higher the credit risk higher is the bond yield.

- Corporate AAA bond having highest credit rating has lowest spread. As we can observe from the above chart. The spreads between the AAA corporate bond and AA corporate bond had narrowed during Jun 2014.

- Corporate AA bond having lower credit rating which means higher credit risk has higher spread. As seen in the chart the spreads betweenWhile spreads between AAA corporate bond A corporate bond narrowed during Dec 2014.

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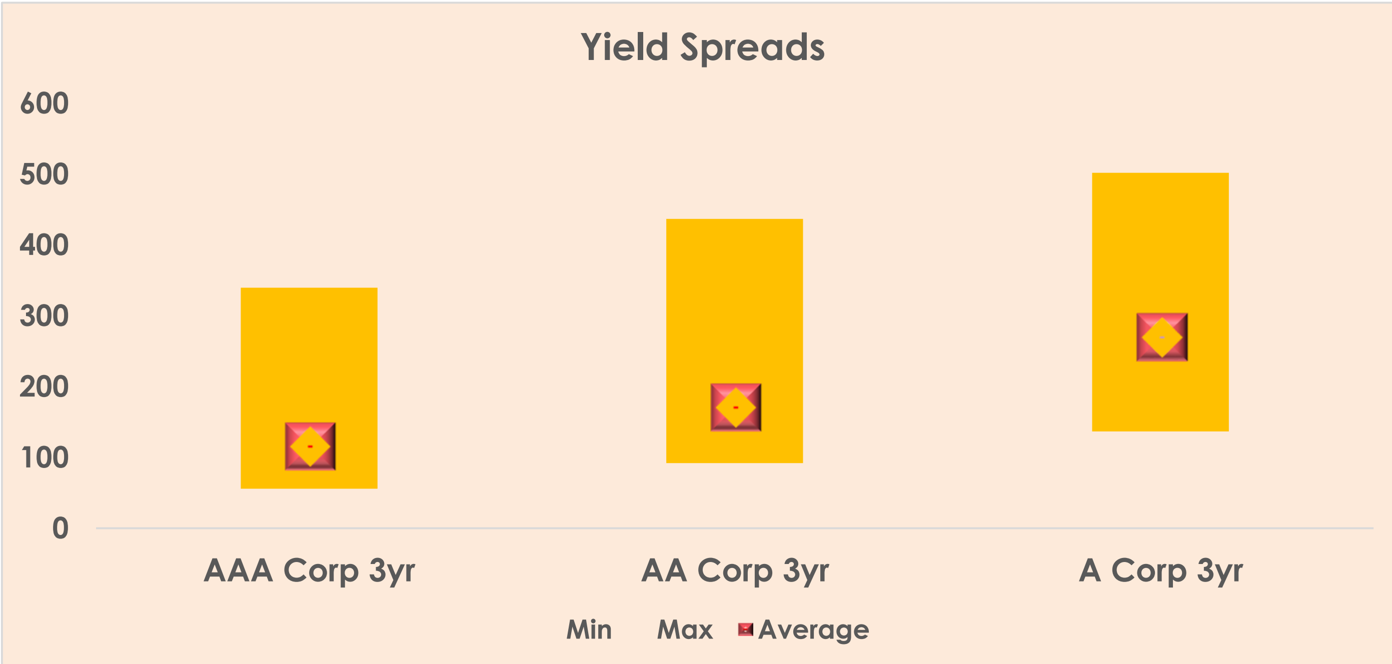
- Corporate A corporate bond has the lowest rating and highest risk among the three bonds. The spread between the AAA corporate bond & A corporate bond were high in Jun 2016.



Source: Bloomberg, yield spreads against Gsec 3Yrs index in basis points.

- Given above is the chart of yield spreads for various corporate bonds over the last 10 years, as compared to Gsec 3yrs in basis point. The minimum spreads during 2008-2018 was between AAA corporate bond & Gsec 3years index, of 56bps. While, the maximum spreads for A Corporate bonds were 502bps.

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