Deluge of tax-free bonds may leave less money for financial market

Less money could be chasing stocks in the coming months with Rs 40,000 crore worth of tax-free bonds set to flood the financial market. Many well-heeled investors, fishing for long term risk-free interest returns, are expected to park fresh funds in these securities. Despite the turmoil caused by developments in Greece and China, equity market displayed a degree of resilience in June and July due continuous inflow from local institutions and high net-worth investors.

But if a slice of this money goes into tax-free bonds and inflow from FIIs continue to be muted, stocks would come under pressure, said senior officials with large institutions. "While the case for structurally sustainable inflows into equity mutual funds remains intact, in second half of FY2016 equity mutual fund inflows may abate, primarily due to a robust pipeline of tax-free bonds amounting to Rs 40,000 crore," said Abhay Laijawala, MD & head of research, Deutsche Bank. "However, given the strong undercurrent in the transition of household savings from physical to financial assets, we believe that such moderation may be short-lived."

At prevailing bond yields an investor can earn as much as 7.50% by subscribing to tax-free bonds with maturities of 10 to 20 years. Since tax is not payable on the interest from such bonds, the papers appear more attractive than taxable debt instruments.

"Timing of the issuance is very important. If one year equity return during the bond issuance is lesser than yield, then some of the HNI money may move into tax-free bonds," said Nilesh Shah, managing director, Kotak Mutual Fund.

"However, if equity market picks up that time, I don't think there will be a major change in allocation." Domestic mutual funds have bought equities worth Rs 10,320 crore in June 2015, the highest monthly equity investment by them since April 2007. With persistent inflows, domestic MFs have continued to remain net buyers of Indian equities. They pumped in nearly Rs 33,600 crore so far this year.

On the other hand, investment by FIIs has slowed down in the past three months, resulting into a net outflow of about Rs 5,000 crore. Since June, the Sensex has dipped by just one percentage point against a 9% fall in the MSCI Emerging Market index - a key benchmark tracked by global fund managers.

The finance ministry has mandated seven large state-owned companies, including the National Highway Authority of India, Indian Railways Finance Corporation, Housing and Urban Development Corporation, Indian Renewable Energy Development Agency, Power Finance Corporation, Rural Electrification Corporation and NTPC to sell tax-free bonds to raiseRs 40,000 crore this financial year.

NHAI will raise Rs 24,000 crore while IRFC would tap the market for Rs 6,000 crore. Other issuers includes Housing and Urban Development Corporation (Rs 5,000 crore), Indian Renewable Energy Development Agency (Rs 2,000 crore), Power Finance Corporation, Rural Electrification Corporation and NTPC (Rs 1,000 crore each).

"There may be some impact on equities in the later part of the current fiscal as tax-free bonds with no tax liability on the interest earning are an attracting investment for HNIs and institutions," said Chokkalingam G, founder & CEO, Equinomics Research & Advisory.

"However, given the strong domestic appetite for equities, the impact could be minimal."

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