L&T Financial Services
Mutual Fund

December, 2018

Indian sovereign bond posted a drop of 25 bps to 7.37% in December vs 7.61% in November. Besides easing liquidity concerns, declining crude oil prices and appreciation in the rupee has helped the bond market. The benchmark 10-year yield continue to soften on rising hopes of interest rate cut by the Reserve Bank of India (RBI) as inflation indices continue to head downwards.

The Reserve Bank of India will purchase Rs 50,000 crore of bonds in January and has earmarked an additional Rs 10,000 crore in open market operation (OMO) for December to intensify cash injection. On year-over-year basis, the rupee depreciated by a whopping 509 paise, or 9.23%, as compared to 2017-end level of 63.87.

Oil prices ended 2018 with losses for the first time since 2015 as buyers flee the market over growing worries about a supply glut and mixed signals related to renewed US sanctions on Iran. For the year, US West Texas Intermediate crude futures slumped nearly 25%, while Brent tumbled nearly 20%.

Market Performance

The 10-year benchmark G-Sec yield closed at 7.37%, down by 25 bps from its previous close of 7.61% while that on the short-term 1-year bond ended 24 bps lower at 6.94%.

In the corporate bond segment, yields fell across the yield curve over the month. The 10-year AAA bond yield ended 15 bps lower at 8.55%, while the short-term 1-year AAA bond yield ended 30 bps down at 8.10%.

The spread between 1-year and 10-year AAA bond widened. Within the short term segment, yield on 3-month commercial paper (CP) was down 40 bps to 7.30% while 1-year CP yield was down 30 bps at 8.50%.

Macro-Economic Highlights

The Nikkei India Manufacturing Purchasing Managers' Index (PMI) strengthened from 53.1 in October to 54.0 in November led improvement in the health of the sector in almost one year.

The Nikkei/IHS Markit Services PMI rose to 53.7 last month from 52.2 in Oct lifted by a significant rise in domestic demand.

Industrial output growth shot up in October, rising to an 11-month high of 8.1% as manufacturing growth accelerated and capital goods production rose by the highest margin in the current financial year.

Consumer price inflation fell to its lowest in 17 months in November as food prices continued to decline and lower crude costs brought down fuel inflation. Retail inflation stood at 2.33% in November compared with 3.31% in October.

Wholesale inflation fell to a three-month low of 4.64% in November, driven down by decline in prices of food articles, especially vegetables, and some easing in rates of petro products.

Trade deficit narrowed to $16.7 billion, benefitting from a sharp fall in crude oil prices and 4.3% growth in imports. Exports growth falls to 0.8% in November. Fiscal deficit touches 114% of Budget estimate in first 8 months of FY19.

Crude oil, cement and fertilizer sector output growth pulled the eight core sector growth to a one-year low of 3.5% in November from 4.8% in September.

House View

Yields have continued to rally sharply through most of December, before giving up some of the gains in the last week. 10 year G-Sec yield which started the month at 7.61%, touched a low of 7.22% before finally closing the month at 7.37%. Bond markets were witness to a plethora of market moving events. The RBI MPC set the dovish tone for the markets, despite RBI surprisingly sticking to its "calibrated tightening" stance.

The state election results, a rude wake up call for the NDA government, and the consequent weakening in INR led to a bout of selling in bond yields as well. This coincided with the news of the resignation of Dr. Urjit Patel, from the post of RBI governor, adding to the nervousness. However, swift response from the government in appointing Mr. Shaktikantha Das as the new RBI Governor helped stabilize the markets more quickly than expected.

Announcement of an aggressive OMO purchase plan till March 2019, coupled with a dramatic collapse in oil prices and a sharp fall in US Treasury yields on back of global growth worries helped our bond markets stage a sharp rally, especially with a lot of market participants who were sitting short duration – scrambling to participate in the rally. However, towards the end of the month, news of farm loan waivers in more states, along with speculation around a nation-wide loan waiver scheme, led to fears of fiscal slippage taking yields up 10-15bps by month end.

As we move into 2019, with 10 year G-Sec yield in the 7.25-7.50% range, bond markets have partially priced in the positives currently at play. We, however, ***remain positive in our interest rate outlook,*** with CPI trajectory likely to continue surprising to the downside even versus the downwardly revised projections in the RBI MPC document. Food inflation continues to remain shockingly benign (surprisingly so, given the background of growing farmer agitations), oil seems anchored as of now in the $50-60 range, and growth outlook is turning out to be slightly weaker than earlier expected – both globally as well as domestically.

With the change in RBI guard, this turnaround in growth-inflation data provides enough justification to change the stance back to neutral as early as February. In fact, a rate cut is now a growing likelihood as well – either in the February or April policy. All of this does suggest scope for G-Sec yields to head closer to the 7-7.15% range. The big worry, however, is on the fiscal front. While Finmin officials have been repeatedly confirming their intent to stick to their fiscal deficit target, trends in revenue collection and expenditure data don't seem to add up.

Added to this, the increasing need for the GoI to respond meaningfully to farmer woes – has made the markets jittery around risks of fiscal slippage, atleast for FY20 even if not for FY19. One way to assuage concerns on both sides is by accessing a one-time bonanza – in form of RBI's excess capital - for which a committee under Dr. Bimal Jalan has been formed. While the technical backdrop, in terms of demand-supply might be favorable for government securities, it's quite the opposite for SDLs and for AAA corporate bonds. Corporate bond spreads have widened considerably as a result, with AAA spreads at almost 90-100bps over G-Sec.

While we continue to ***remain overweight duration across most of our strategies,*** the way forward is unlikely to be as one-sided as over the past 3 months. Accordingly, a more nimble approach to duration management will be critical. Also, while demand supply technical are clearly much more supportive of G-Sec versus corporate bonds as of now, we expect this to gradually start changing as we head into next fiscal, and with 10 year AAA corporate bond spread at 100bps – this makes a compelling case for investors with a longer investment horizon.

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The L&T Triple Ace Bond Fund is well positioned in this segment. With liquidity remaining tight, short end rates of 8-8.5% in the 6 months -3 year segment, continue to provide extremely good pickup over the policy repo rate. ***Funds such as the L&T Ultrashort Term Fund, L&T Money Market Fund and L&T Short Term Bond Fund are high credit quality funds positioned to benefit from this carry, while keeping interest rate risks relatively low.*** Finally, while credit risk funds have witnessed turbulent times, given the IL&FS as well as NBFC / HFC scare, we believe that spreads offered by such funds are actually very attractive compared to the past.

It is in times of such risk aversion, that issuers are forced to pay higher rates, which compensate adequately for their underlying credit risks. Well managed funds, with a majority of exposures in the AA segment, offer a good risk –return tradeoff. ***L&T Credit Risk Fund and the L&T Low Duration Fund offer good vehicles to take advantage of the attractive credit spreads on offer.*** To sum up – while volatility is an inseparable part of markets (and 2019 will be no different), we ***expect the coming year to be good for investors across various categories of fixed income funds,*** depending on each one's risk appetite!

This product is suitable for investors who are seeking*

L&T Ultra Short Term Fund
(An open ended ultra-short term debt scheme investing in instruments such that the Macaulay duration of the portfolio is between 3 months to 6 months.)

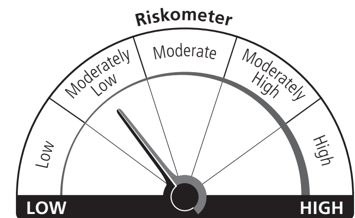
- Generation of reasonable and stable income and liquidity over short term
- Investments predominantly in highly liquid money market instruments, government securities and corporate debt

L&T Short Term Bond Fund (Formerly known as L&T Short Term Opportunities Fund)
(An open ended short term debt scheme investing in instruments such that the Macaulay duration of the portfolio is between 1 year to 3 years.)

- Generation of regular returns over short term
- Investment primarily in securities issued by Banks, Public Sector Undertakings and Public Financial Institutions in India

L&T Money Market Fund (Formerly known as L&T Floating Rate Fund)
(An open ended debt scheme investing in money market instruments.)

- Generation of regular income over short to medium term
- Investment money market instruments



Investors understand that their principal will be at moderately high risk

L&T Credit Risk Fund (Formerly known as L&T Income Opportunities Fund)
(An open ended debt scheme predominantly investing in AA and below rated corporate bonds)

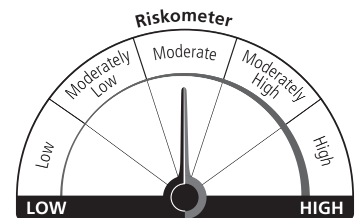
- Generation of regular returns and capital appreciation over medium to long term
- Investment in debt instruments(including securitized debt), government and money market securities

L&T Triple Ace Bond Fund
(An open ended debt scheme predominantly investing in AA+ and above rated corporate bonds)

- Generation of regular and stable income over medium to long term
- Investment predominantly in AA+ and above rated corporate bonds and money market instruments

L&T Low Duration Fund (Formerly known as L&T Short Term Income Fund)
(An open ended low duration debt scheme investing in instruments such that the Macaulay duration of the portfolio is between 6 months to 12 months)

- Generation of reasonable returns over short to medium term
- Investment in fixed income securities and money market instruments



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***Investors should consult their financial advisers if in doubt about whether the product is suitable for them.**

Source: MOSPI, Internal

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