December, 2018

Equity Market Review

Equity market rebounded in November with the benchmark indices (Sensex and Nifty) surging by 5% each. Improvement in some of the underlying factors like FPIs turning buyers by infusing Rs 12, 260 crore into the Indian capital markets, falling crude oil prices, appreciation of rupee against the US dollar and improvement in liquidity situation aided the rally.

BSE Midcap and Smallcap indices underperformed the larger peers by gaining between 2-3%. Global markets were volatile led by softening crude oil prices, trade war and Fed commentary. On the sectoral front, BSE Realty, Capital Goods, Bankex and Auto indices gained between 5-7%. Domestic investors continued to be net buyers with net inflows of $125 million taking their YTD tally to $15.8 billion. Mutual Fund continued to be net buyer for 28th straight month with net buying of $348 million in November.

House View

After September and October, markets staged a smart comeback in November as key concerns impacting Indian markets – Oil, currency, G-Sec, FII selling, have seen sharp reversals led by fall in oil prices, which has eased the macro backdrop for India considerably. Key near-term risks for the Indian markets hinge on the outcome of state elections.

We can expect the impact of elections to last for a while before focus returns to fundamentals, which have improved recently. On the micro front, we see stability in earnings as moderation in crude oil prices and stronger currency does provide margin respite. Expect markets to be volatile as we head into the election year. Our focus will be to remain invested in companies with strong earnings visibility.

On global front trade war is a risk. We expect the economy to recover as GST related disruption smoothens and consumption revives on back of improving farm income and implementation of pay commission. ***With YTD underperformance, Mid-caps indices now trade at a discount to their 5 year average which does provide a good entry point.***

All key markets continue to trade at a discount to India. However, India's RoE remains superior to most EMs, an important differentiator for valuation premium. Liquidity concerns have improved over month as money market rates have been coming of its recent highs. ***We continue to remain invested in strong and able management with earnings visibility.***

Debt Market Wrap

Indian sovereign bond posted a drop of22 bps to 7.61% in November vs 7.83% in October. A recent drop in crude oil prices also eased fiscal slippage and higher inflation also added positive sentiments among the investors. Reserve Bank of India announced additional Rs 40,000 crore worth of open market operation (OMO) purchases in December.

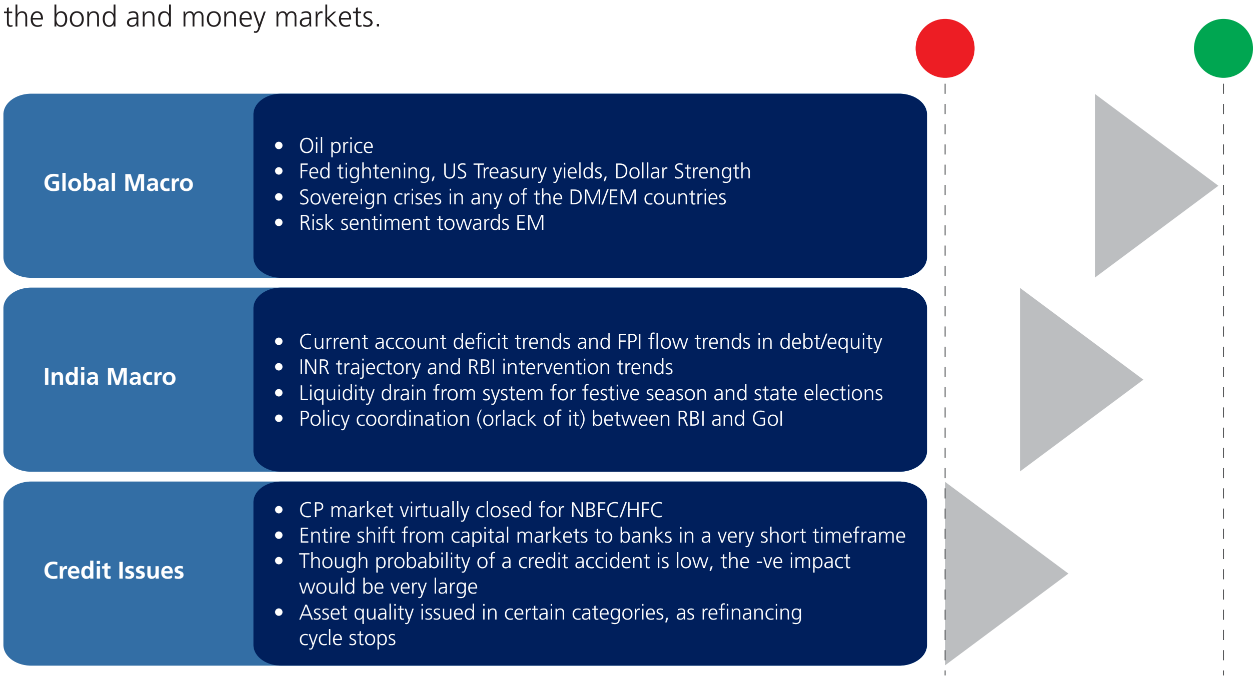
Indian rupee gained 5.5% in November on drop in crude prices, speculative positioning. Oil prices dropped by 22% in November the biggest monthly percentage loss in a decade as traders fretted over a possible glut in global supplies. The 10-year US Treasury note tumbled 14.1 basis points to 3.015%, its largest such move since August last year.

The 10-year benchmark G-sec yield closed at 7.61%, down by 22 bps from its previous close of 7.83% while that on the short-term 1-year bond ended 22 bps lower at 7.23%. 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 8.60%, while the short-term 1-year AAA bond yield ended 25 bps down at 8.40%.

House View

In our last month's outlook (for October), we had highlighted the turnaround that the bond market had started to witness. All three factors which were earlier flashing red had started improving sharply. November saw these factors move rapidly towards the green end, with Brent prices collapsing to below $60/barrel, INR to below 70/USD and 10 year US Treasuries to below 3%. Credit related worries also abated with most NBFCs/HFCs meeting their CP maturity obligations, albeit with a nudge and a push from policy makers.

The chart below sums up our take on the markets now. The improvements in all three indicators (viz. global macro, India macro and onshore credit issues) underscore our relatively more optimistic take on the bond and money markets.



The positive fundamental backdrop was further aided by very favorable technicals in the government bond market, with RBI proactively supplying liquidity to the market with a monthly pre-announced calendar of OMOs. With GDP growth data surprising on the lower side at 7.1% (vs 7.5% expected) and the CPI print for November likely to be significantly below 3%, the backdrop for the RBI's MPC meeting on Dec 5th is clearly very interesting.

Takeaways from the RBI MPC policy:

The RBI kept policy rates unchanged at its MPC meeting, while retaining its "calibrated tightening stance". Our key takeaways:

- On the growth front, despite worries about a likely sharp slowdown reported in the public media by analysts and GoI representatives, the RBI has taken a rather sanguine view of this. With several indicators such as improving capacity utilization, elevated levels of PMIs, and importantly high levels of non-food credit offtake – all suggesting that growth is holding up as per their expectation and the output gap remains virtually closed, the RBI has stuck to its growth forecast of 7.4% for FY19.
- On the CPI front, however, the RBI lowered its inflation forecasts sharply, down to 2.7-3.2% in H2 FY19 (vs 3.9-4.5% earlier) and for Q1/H1 FY 20 from 4.8% to 3.8-4.2% in H1 FY20. While core inflation continues to be high, food disinflation has clearly dominated the decline in headline CPI.

- While such a sharp revision would seem to have warranted a change in stance to neutral, the MPC noted that the unexpected softening of food inflation and the collapse in oil in a relatively short period of time (and with much higher implied volatility) necessitates further monitoring over the next few months, to confirm if both of these are indeed durable and sustainable or are overdone due to transitory factors.
- On the liquidity front, the RBI clearly spelt out their preference for continued use of OMO purchases to infuse the required amount of durable liquidity, with the RBI DG Viral Acharya mentioning that they would continue with their pace of OMO purchases into Q4 FY19 as well, all the way till March as required by liquidity considerations. Also, use of CRR as a tool for liquidity injection was totally rejected in their post policy interactions.
- Finally, the RBI announced a staggered cut in the SLR by 25 bps over next six quarters, taking it down from the current 19.5% to 18% of NDTL, thereby, aligning SLR with Liquidity coverage ratio (LCR).

Market impact and outlook post RBI MPC:

While status quo on rates and stance was broadly expected by the market, couple of statements in the post policy interactions is extremely positive for the bond market.

- If markets and data over the next few months (oil, food inflation, CPI etc) all remain near current ranges, then RBI seems to be signaling that a change in stance to neutral in its next policy meeting in February is increasingly likely, thereby ruling out the risks of further rate hikes.

- The statement on OMO purchases being augmented further all the way till March 2019, suggests that demand supply equation for government bonds is extremely favorable.

- Finally, this MPC has given an assurance to the market that liquidity requirements of the market over the next few months would be adequately provided for by RBI through durable means.

Markets, which had already done very well through the month of November, have continued to rally sharply post policy, with the 10 year G-Sec at 7.44%, down almost 40 bps since 1st week of November (13 bps on the day). Various other segments have also done well, with yields down 5-10 bps across the money market and corporate bond curve.

We expect the current positivism to sustain, as there is a fair amount of carry that is still available in various segments of the curve and several market participants are still quite under bought. As pointed out in our October outlook, we had moved from a cautious, short duration stance across our various funds, to an overweight duration approach (in 1st week of November), as suitable within each fund category. We continue to remain overweight duration given the positive takeaways from this MPC.

While longer end G-Sec are attractive and yields there are likely to move lower, for the more conservative investors we believe ultrashort and short term bond funds are likely to deliver attractive returns as well. ***The L&T MF approach of keeping high quality funds such as L&T Ultra Short Term, L&T Short Term Bond Fund, L&T Banking and PSU Fund invested only in the top quality AAA papers ensures that credit risks in these funds are kept at a minimum, and we would advise investors to start looking at these segments gradually, given the attractive levels they offer.***

From a 3-5 year perspective, we believe investors who can absorb near term volatility, could gradually allocate a portion of their long term savings to debt products which invest in the longer end of the AAA corporate bond curve such as the L&T Triple Ace Bond Fund. We believe such a strategy should do quite well, especially compared to investing in tax free bonds or long term FDs where current yields are quite unattractive.

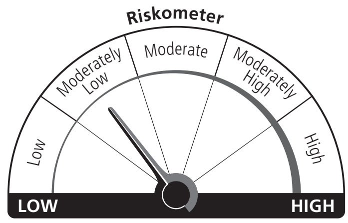
This product is suitable for investors who are seeking*

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



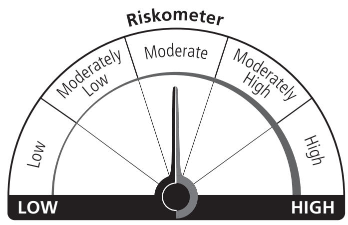
Investors understand that their principal will be at moderately high risk

L&T Banking and PSU Debt Fund
(An open ended debt scheme pre dominantly investing in debt instruments of banks, public sector undertakings, public financial institutions and municipal bonds)

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

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



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

Mutual Fund investments are subject to market risks, read all scheme related documents carefully.

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