Debt Market Review

L&T Financial Services
Mutual Fund

July, 2019

Indian sovereign bond ended 33 bps lower to 6.37% in July on the expectation of a probable rate cut amid a subdued inflation outlook and sluggish growth. The government surprised markets by trimming the budget deficit target for this fiscal year from its estimate in February, and shifting a part of its market borrowing overseas.

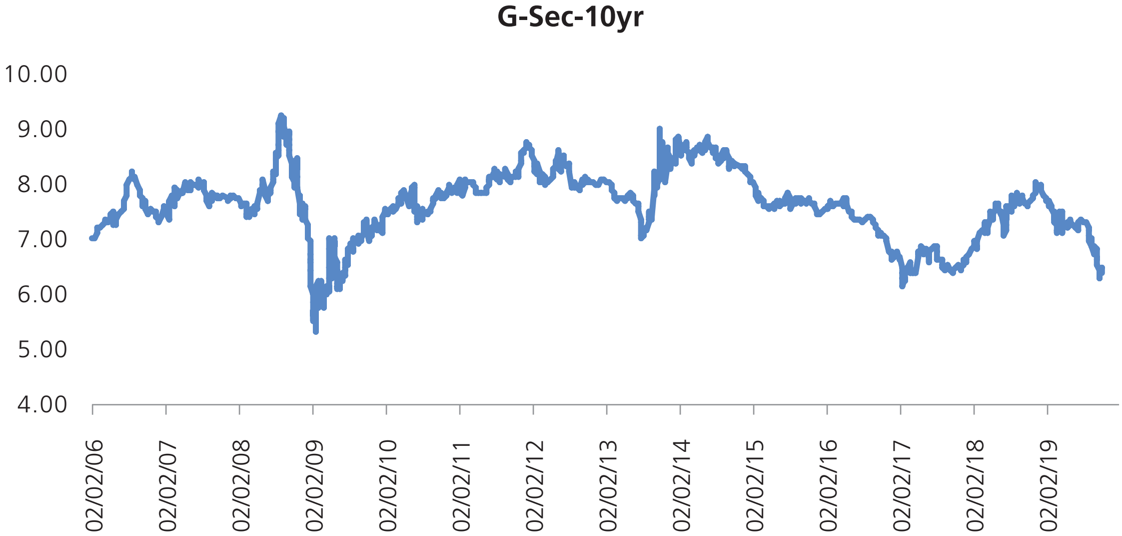
The Monetary Policy Committee (MPC) reduced repo rate by 35 bps from 5.75% to 5.40%. The stance of the policy remained unchanged at 'accommodative'. Four members of the MPC voted to cut rates by 35bps, whereas two members voted to cut rates by 25 bps.

Globally, the US Federal Reserve decided to cut the rate by 25 bps and signalled its readiness to provide more support as growth slows in the world's largest economy.

Market Performance

The 10-year benchmark G-sec yield closed at 6.37%, down by 33 bps from its previous close of 6.70% while that on the short-term 1-year bond ended 19 bps lower at 5.94%. In the corporate bond segment, yields fell across the yield curve over the month.

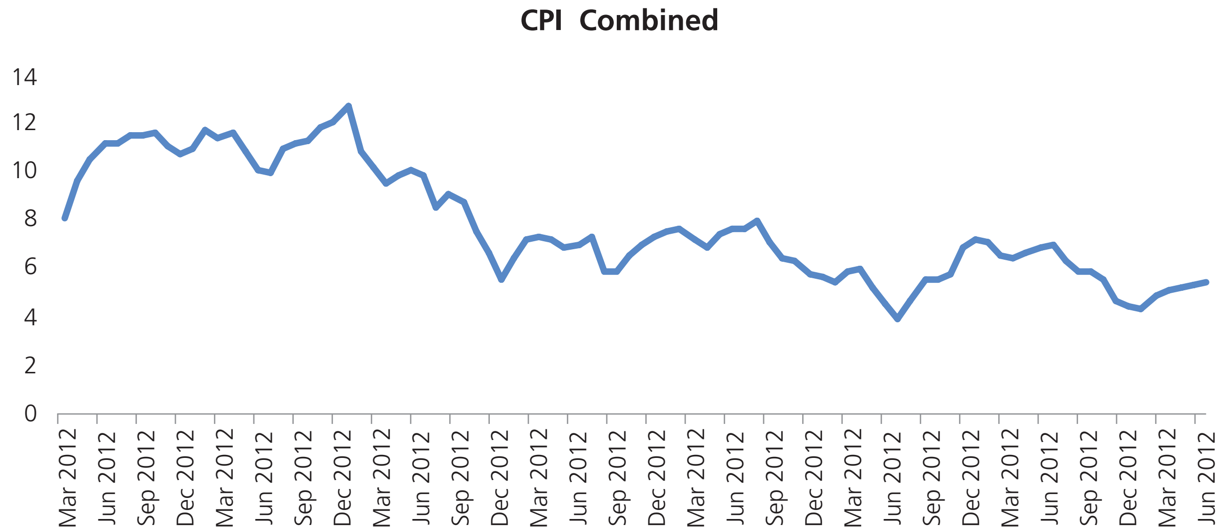
The 10-year AAA bond yield ended 20 bps higher at 7.45%, while the short-term 1-year AAA bond yield ended 15 bps down at 7.05%. The spread between 1-year and 10-year AAA bond narrowed. Within the short-term segment, yield on the 3-month commercial paper (CP) was down 50 bps to 6.10% while 1-year CP yield was down 50 bps at 7.00%.



Macro-Economic Overview

India's factory production lost momentum in June as the Manufacturing PMI fell to 52.1 in June vs 52.7 in May. Markit India Services Business Activity Index fell to 49.6 in June, down from 50.2 in May. The combined Index of Eight Core Industries stood at 138.7 in May.

Industrial production grew at 3.1% in May, mainly on account of improvement in power generation. Wholesale price-based inflation declined for the second consecutive month to its 23-month low of 2.02% in June, helped by decline in prices of vegetables as well as fuel and power items. Retail inflation has risen to 3.18% in June from 3.05% in May, hitting an eight-month high.



Market Impact And Outlook Post RBI MPC

Pre Policy, the 10-year benchmark was trading at around 6.32-6.34%. Market was already pricing in a 25 bps rate cut and a dovish tone which is what the MPC delivered. ***Post policy, the curve steepened with the 5-year Gilt closing at 6.15%, down 7 bps, whereas 10-year Gilt closed at 6.37%, up 3 bps.*** The spread between the 5-year and the 10-year Gilt is now 22 bps. ***The spread between the 10-year and 15-year Gilt has also widened considerably and stands at 35 bps.***

We believe we are nearing the end of the rate-cutting cycle, with the terminal rate likely to be in the range 5-5.25%. While there is a risk that a further dramatic collapse in the global backdrop could lead RBI to take further extraordinary measures, in the current context – globally and domestically – we believe RBI has already done its bit in terms of the series of rate cuts since early this year and most importantly, the surplus liquidity provided to the system. The rest of the growth revival measures need to come from the side of Government of India.

Investment Strategy & Fund Recommendations

From a longer end G-Sec perspective, ***we believe we are nearing the lower end of the band with 10 year G-Sec yields likely to bottom in the 6.00-6.25% zone.*** G-Sec supply is still an issue, especially, given the need for fiscal support for the economy, increasing likelihood of shortfall in revenues, and importantly lack of OMO support from the RBI on the backdrop of positive flush liquidity in the system. There remains confusion over whether the USD sovereign bond will go through this year, and if not – that will bring back that much more supply to our local bond market.

However, ***where we remain very positive is with regard to the AAA corporate bond curve and spread over G-Sec.*** With liquidity likely to remain positive over the coming year at least, and bank deposit rates likely to move sharply lower, **we expect the short to medium part of the curve to move lower significantly from current levels.**

We would continue to encourage investors to look at products such as the ***L&T Banking & PSU Fund (a passive 3.5-year roll down strategy) and the L&T Short Term Bond Fund which invests predominantly in the 2-5 year part of the AAA corporate bond curve.*** These funds have a yield pickup over G-Sec of upwards of 100-120 bps, which we believe can fall towards the 50-60 bps range or potentially even lower, given the chase for the limited supply of high-quality AAA assets in this space.

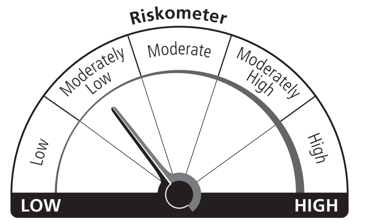
The L&T Triple Ace Bond Fund, which invests in the 2028-29 maturity segment, with investments in the highest credit quality AAA corporate bonds is also a good carry product, especially in comparison to tax free bonds. While the underlying government bond yields are somewhat lower than the longer term fair value, ***we are still positive in our outlook for the spread of AAA corporate bonds over G-Sec,*** which currently continues to be in excess of ~100 bps, versus the long term average of 50 - 55bps. We expect that this spread will compress over the coming quarters, thereby allowing corporate bonds to outperform underlying G-Secs.

For investors looking at products which benefit from some of the credit risk aversion prevalent currently and the attractive spreads available on the less liquid bonds, the ***L&T Resurgent India Bond Fund is ideally positioned with attractive yield and spread pick-up while still having more than 70% of the assets in the AAA segment.***

This product is suitable for investors who are seeking*

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 in fixed income securities of shorter term maturity.



Investors understand that their principal will be at moderately low risk

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

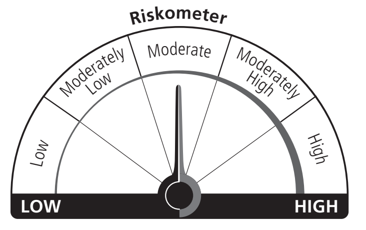
- Generation of regular and stable income over medium to long term
- Investment predominantly in AA+ and above rated corporate bonds and money market instruments

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

- Generation of reasonable returns and liquidity over short term
- Investment predominantly in securities issued by Banks, Public Sector Undertakings and Public Financial Institutions and municipal corporations in India

L&T Resurgent India Bond Fund (Formerly known as L&T Resurgent India Corporate Bond Fund)
(An open ended medium term debt scheme investing in instruments such that the Macaulay duration of the portfolio is between 3 years to 4 years)

- Generation of income over medium term
- Investment primarily in debt and money market securities



Investors understand that their principal will be at moderate risk

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

Source: MOSPI, Internal, Bloomberg