October, 2019

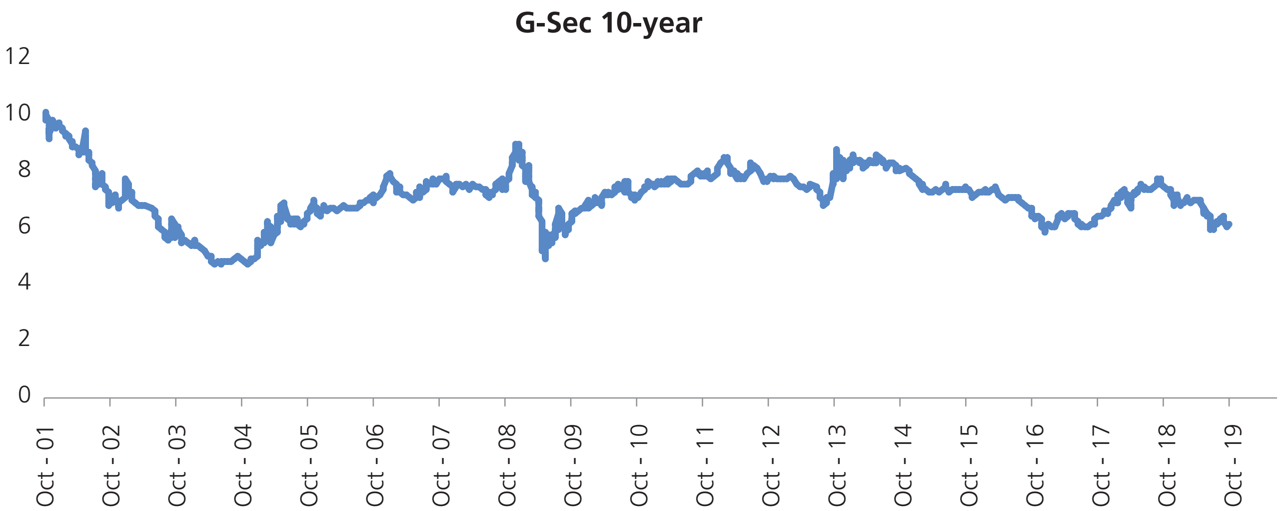
Indian sovereign bond ended almost flat at 6.46% in October on the expectation of the Reserve Bank of India lowering interest rates early next month amid a subdued inflation outlook and sluggish growth. Crude oil (+0.2%) was essentially unchanged for October. Globally, the Federal Open Market Committee lowered its benchmark funds rate by 25 basis points to a range of 1.5% to 1.75%.

Market Performance

The 10-year benchmark G-Sec yield closed at 6.46%, up by 1 bps from its issuance yield of 6.45% (issue date: 07th October 2019) while that on the short-term 1-year bond ended 31 bps lower at 5.31%.

In the corporate bond segment, yields fell across the yield curve over the month. The 10-year AAA bond yield ended 4 bps lower at 7.56%, while the short-term 1-year AAA bond yield ended 50 bps down at 6.20%.

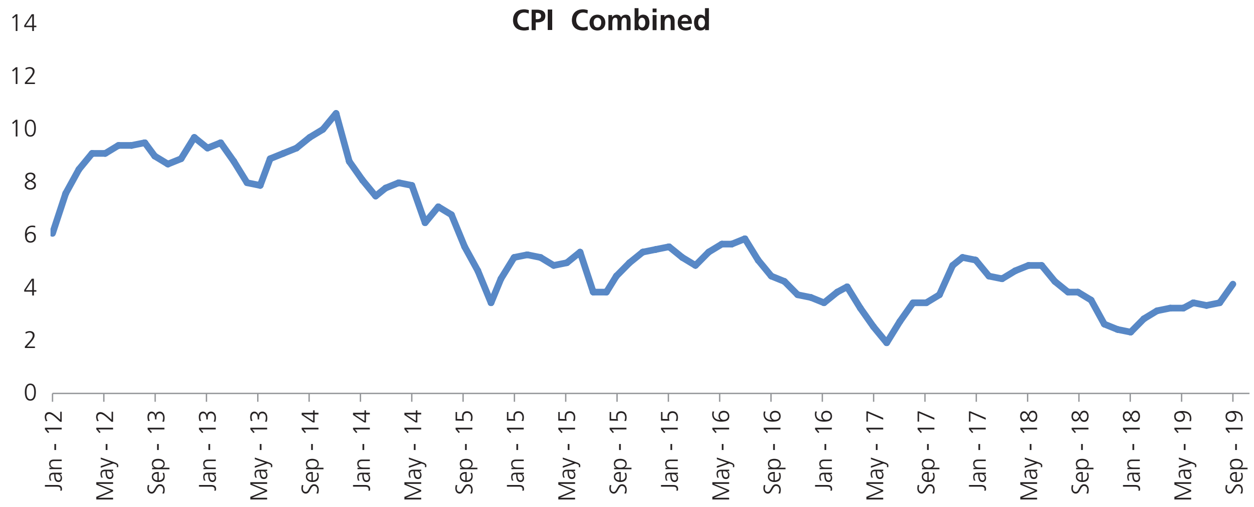
The spread between 1-year and 10-year AAA bond widened. Within the short term segment, yield on 3-month commercial paper (CP) was down 10 bps to 5.40% while 1-year CP yield was down10 bps at 6.30%.



Macro-economic Developments

CPI rose to 4% in Sep vs. 3.2% last month. Core inflation slowed down to 4% and converged with headline numbers. WPI inflation for Sep at 0.3% was the lowest print in the last 39 months.

Composite PMI for Sep shrunk to 19 months low and fell into contraction phase at 49.8. Aug IIP declined 1.1% YoY and printed a 7 year low. India's monthly trade deficit at $10.9 bn narrowed sharply in September (-6.6% YoY) while Imports were down 13.8% YoY in September.



Outlook

The Monetary Policy Committee (MPC) reduced the repo rate by 25 bps to 5.15% in the October policy while maintaining an accommodative stance. In a more forward looking guidance as far as stance of the policy is concerned, the MPC decided to continue with an accommodative stance as long as it is necessary to revive growth ensuring that inflation remains within the target.

The month of October saw a sharp rally in the front end (1-4 year) of the corporate bond curve. The AAA spreads vs corresponding G-Sec in the 2-4 year segment compressed by 20 bps from 60-80 bps to 40-60 bps. The spread compression and rally was fueled by surplus liquidity in the system for the month. Average surplus liquidity in the system was at around 2 lac crore vs 1.12 lac crore in the month of September.

The longer end of the yield curve underperformed with 10-year Gilt trading in a band of 6.45% to 6.55% whereas 10-year AAA bonds traded in a range of 7.50% to 7.70% (spread of 85-100 bps). The yield curve steepness is predominantly due to fears of excess supply in the G-Sec market as the Government struggles to meet its fiscal deficit target of 3.3% for FY 20. The muted tax collections due to reduction in corporate tax rate with below par GST collections has resulted in lower collections while expenditures continue to track broadly as per budgeted numbers. There are talks of aggressive divestment targets to bridge the deficit.

Going forward market will be looking for the incoming inflation prints where food inflation has jumped up due to higher vegetable prices, whereas core inflation is coming down due to tepid demand of goods and services. The MPC will decide on the rates post the second quarter GDP growth to be released in November end.

The MPC may find it difficult to cut rates aggressively in this policy with inflation prints shooting up while growth numbers for Q2 come lower. However, MPC has already cut rates by 135 bps in this cycle and accommodative stance along with surplus liquidity will keep longer end of bond markets rates in a range, till there is more clarity on the extent of government’s fiscal slippage and consequent excess borrowing for FY20.

Investment Strategy & Fund Recommendations

With repo rate at 5.15%, surplus liquidity conditions and a relatively steep yield curve at the shorter end, the carry remains attractive for investors in 4-12 months products such as L&T Ultra Short Term Fund and L&T Money Market Fund.

With shorter end yields in the 1-5 year segment moving down sharply over the past month, we believe incrementally there is more value at the longer end of the curve – both for government securities as well as for AAA corporate bonds, for investors willing to take some risk to earn alpha. While worries about demand-supply of government bonds in H2 will continue to weigh on that segment till more clarity on the fiscal side emerges, ***we believe bond yields are pricing in majority of these worries adequately.***

While AAA corporate bond spreads in the 3-5 year segment have collapsed by 25-30 bps over past few months, ***spreads in the 7-10 year AAA segment continue to remain attractive at 85-100 bps. Corporate bonds at the longer end, yielding 7.60-7.70% offer attractive carry*** and breakeven analysis versus the shorter end suggests that there is adequate cushion to absorb some more incremental negative news, while still being able to outperform the shorter end over a 2-3 year investment period.

Funds such as the L&T Triple Ace Bond Fund and L&T Flexi Bond Fund are well positioned to benefit from this curve steepness and spread play.

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 well positioned with attractive yield (8.82% as of October 30) and spread pick-up while still having 70% of the assets in the AAA segment and 30% in the AA segment.

Spreads on the less liquid AAA bonds and AA+/AA bonds over the liquid AAAs are now in excess of 200 bps, compared to 40-60 bps a year back, which indicates the extent of risk aversion prevalent in the bond market. ***For investors looking for alpha in their portfolios, we believe a fund like L&T Resurgent India Bond Fund offers a good vehicle to exploit this opportunity.***

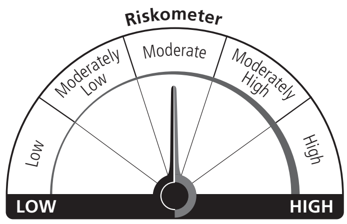
L&T Financial Services
Mutual Fund

This product is suitable for investors who are seeking*

L&T Flexi Bond Fund
(An open ended dynamic debt scheme investing across duration)
- Generation of reasonable returns over medium to long term
- Investment in fixed income 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

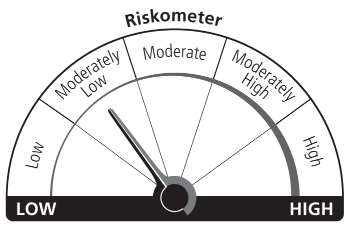
L&T Resurgent India Bond Fund
(An open ended medium term debt scheme investing in instruments such that the Macaulay duration of the portfolio is between 3 years to 4 years)
- Generation of income over medium term
- Investment primarily in debt and money market securities



Investors understand that their principal will be at moderate risk

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 Money Market Fund
(An open ended debt scheme investing in money market instruments)
- Generation of regular income over short to medium term
- Investment in money market instruments



Investors understand that their principal will be at moderately low risk

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

Source: MOSPI, Internal, Bloomberg