Debt Market Review

L&T Financial Services
Mutual Fund

December, 2019

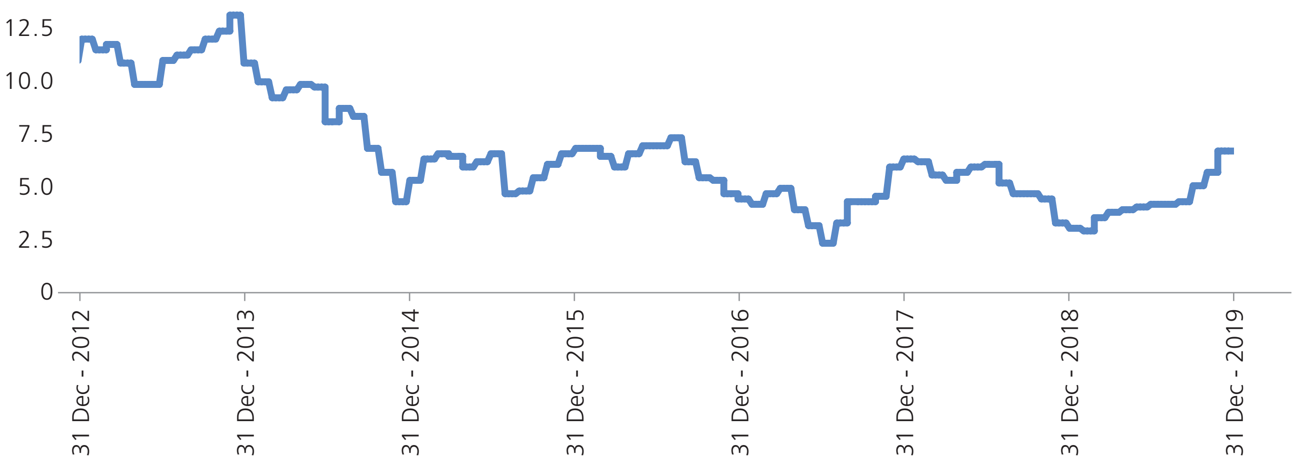
Indian sovereign bond ended at 6.55% vs 6.46%, up by 9 bps from its previous close. The Reserve Bank of India bought Rs 10,000 crore of 10-year bonds from the secondary market, while selling Rs. 8,501 crore of short-term bonds, in the special open market operations, held for the second time in 2019.

Macro-economic Developments

Retail inflation spiked to over a 3-year high of 5.54% in November due to costlier food products like vegetables, pulses and protein-rich items. Wholesale prices based inflation rose to 0.58% in November.

Industrial activity contracted for the third consecutive month in October by 3.8%, driven by a fall in activity across sectors.

CPI Combined



Market Performance

The 10-year benchmark G-Sec yield closed at 6.55%, up by 9 bps from its previous close of 6.46% while that on the short-term 1-year bond ended 16 bps higher at 5.30%.

In the corporate bond segment, yields rose across the yield curve over the month. The 10-year AAA bond yield ended 7 bps higher at 7.52%, while the short-term 1-year AAA bond yield ended 10 bps up at 6.10%.

The spread between 1-year and 10-year AAA bond narrowed. Within the short term segment, yield on 3-month commercial paper (CP) was down 5 bps to 5.15% while 1-year CP yield was up 5 bps at 6.05%.

Outlook

The first half of December was dominated by market disappointment around MPC's surprise status quo on rates, surging oil prices, fiscal worries and of course CPI data which had reached 5.5% for November. The sell-off was the worst in the longer end of the G-Sec curve, with 10-year G-Sec reaching a high of 6.80% (vs 6.45% pre-policy).

During the post MPC briefing, despite being non-committal about the steepness of the curve and dodging queries around likelihood of an 'operation twist", the RBI ended up surprising the markets by doing just that. Through the second half of December, the RBI conducted two Rs 10,000 cr twist operations, by buying the 10-year G-Sec benchmark and selling 2020 maturing G-Sec. Shorter end of the curve has since moved up by 25-30 bps, while the longer end has rallied sharply, recovering most of the post MPC sell-off.

The term spread has corrected sharply, with 5-10 year spread coming off to 10 bps versus 30 bps earlier. On the corporate bond side too, the shorter end of the curve 1-3 years has moved higher by about 20-30 bps, while the longer end has remained flat, with AAA spread over G-Sec continuing its gradual compression.

We expect the RBI MPC to remain on hold in the upcoming February MPC meeting, and continue to believe that the rate cutting cycle is almost done, with possibly a final 25 bps cut sometime through the middle of the year. With liquidity continuing to remain in surplus mode and fund flows into short and medium duration funds likely to remain strong, we expect the yields to now stabilize at the short to medium end. ***The*** **recent sell-off has improved the carry in this part of the curve, with funds such as L&T Ultra Short Term Fund, L&T Money Market Fund and L&T Short Term Bond Fund YTMs back to attractive levels.**

Activity in the longer end of AAA curve has picked up, with markets increasingly focusing on the attractive carry that that segment offers. As we have been expecting for some time now, the longer end of the AAA curve has started outperforming with 3-10 year AAA spread coming down to 95-100 bps, from a peak of almost 125 bps in end November, and a long term average of 14 bps. ***We expect this move to sustain and expect the term spread of the AAA corporate bond to compress further.***

Investment Strategy

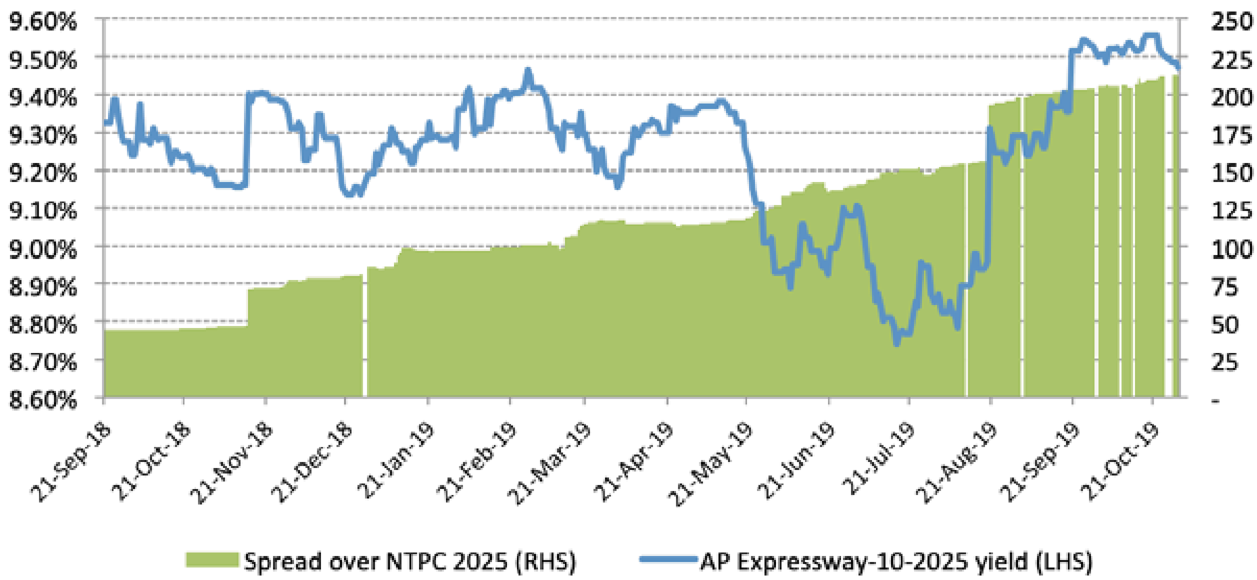
As highlighted in our various pitches on the ***<u>L&T Triple Ace Bond Fund</u>*, we believe the longer end of the curve has finally started outperforming, with a reversal in the curve steepening that we had been witnessing over July-November.**

We continue to believe that for investors able to take MTM volatility, the 10-year AAA bond strategy is likely to perform well over a 2-3 year period, given the attractive carry. Breakeven analysis suggests that over an investment horizon of 3 years, even if yields move up by more than 100 bps for a 9-10 year AAA bond, the extra carry provided by that segment would still result in a total return which can beat the returns from a 2-3 year AAA bond.

Similarly, ***we also believe that - going forward -markets will start focusing on the less liquid AAA and AA rated papers of good quality issuers, which offer attractive credit spread over the liquid AAA papers.*** As shown in the accompanying chart, spreads on these bonds are now in excess of 200 bps, compared to 40-60 bps a year back, which indicates the extent of extreme risk aversion prevalent in the bond market.

For investors looking at products which benefit from the extreme credit risk aversion prevalent currently and the attractive spreads available on the less liquid bonds, the ***<u>L&T Resurgent India Bond Fund</u> is well positioned with attractive yield and spread pick-up while still having 70% of the assets in the AAA segment, and 30% in the AA segment.***

Spread movement of NHAI Annuity AAA over plain vanila AAA



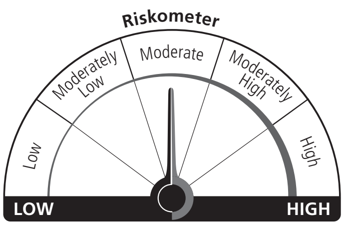
With a large part of the liquidity driven rally in the 2-5 year liquid AAA space now behind us, we believe that the carry offered by the less liquid, moderate risk AAA/AA bonds stands out in terms of attractiveness and the yields in some of these issues have already started moving lower over the past few weeks.

This product is suitable for investors who are seeking*

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

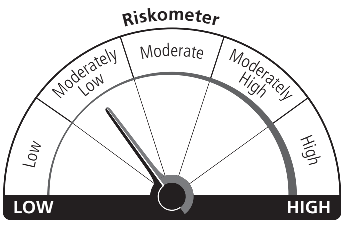
L&T Short Term Bond Fund
(An open ended short term debt scheme investing in instruments such that the Macaulay duration of the portfolio is between 1 year to 3 years)
- Generation of regular returns over short term
- Investment in fixed income securities of shorter term maturity.



Investors understand that their principal will be at 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

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

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