Debt Market Review

L&T Financial Services
Mutual Fund

November, 2019

Indian sovereign bond ended flat at 6.46%, (as on Nov 29) almost flat from previous close. Market participant hopes for further easing of repo rate on December 5 to boost consumer sentiment amid macro-economic challenges.

Market Performance

The 10-year benchmark G-Sec yield closed at 6.46%, nearly flat from its previous close while that on the short-term 1-year bond ended 17 bps lower at 5.14%.

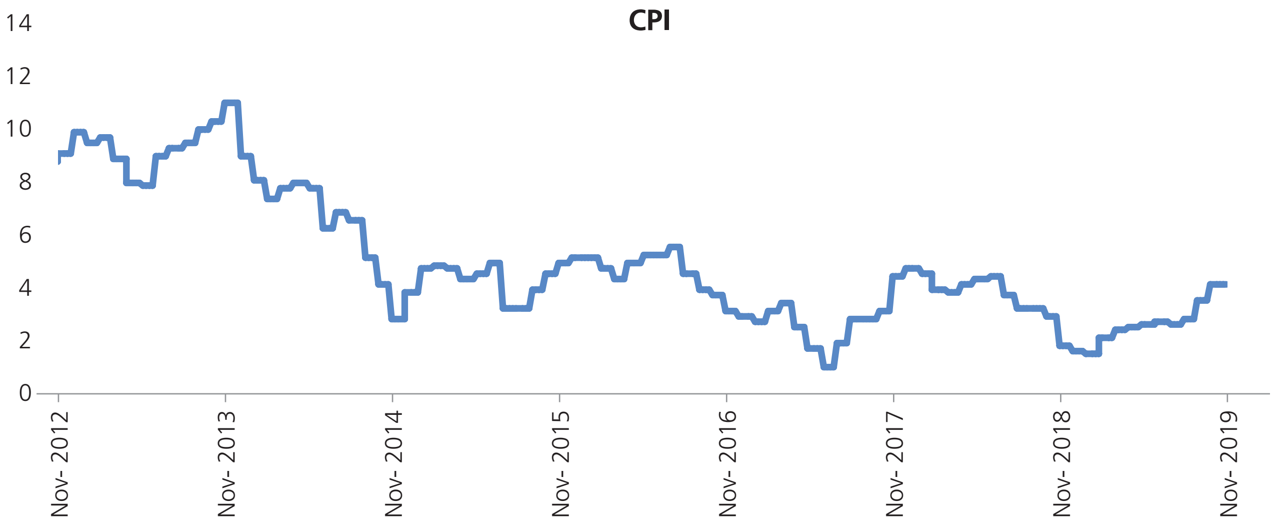
In the corporate bond segment, yields fell across the yield curve over the month. The 10-year AAA bond yield ended 11 bps lower at 7.45%, while the short-term 1-year AAA bond yield ended 20 bps down at 6.00%.

The spread between 1-year and 10-year AAA bond widened. Within the short term segment, yield on 3-month commercial paper was down 20 bps to 5.20% while 1-year CP yield was down 30 bps at 6.00%.

Macro-economic Developments

Inflation: Wholesale inflation eased to 0.16% in October, its lowest in more than three years, on the back of a fall in prices of fuel and manufactured goods. Retail inflation touched 4.62% in Oct vs 3.99% in Sept due to higher food prices.

Industrial production: Factory output contracted by 4.3% in September to 7-year low due to negative growth in all the three sectors of manufacturing, mining and electricity.



Outlook

Headline CPI for October came in at a high 4.6%, clearly breaching the 4% midpoint of the flexible inflation targeting range. However, this has been primarily driven by food inflation spikes, while core CPI continues to remain on a downward trajectory.

Q2 GDP growth also came in at a mere 4.5%, reflecting the sharp slowdown across segments. More importantly, nominal GDP came in at 6.1%, suggesting a tough situation for tax revenue collections and government's ability to stay within its stated fiscal deficit target of 3.3% of GDP.

The Monetary Policy Committee (MPC) is due to meet on December 5, 2019 and with this growth-inflation mix, it is likely to be an interesting discussion and possibly non-consensual action at the end of their meeting. While lack of any kind of demand side inflationary pressure and the anemic growth outlook would suggest ample room for MPC to cut rates significantly from the current level of 5.15%.

We believe the MPC may give more weightage to the very limited incremental benefit from such potential rate cuts on kickstarting growth. Accordingly, while it is a tricky call, we believe the MPC may see room for only about 25 bps of rate cuts, before hitting the pause button and instead focus more on other areas such as monetary transmission related issues and rely on GoI measures to address various sectoral issues plaguing the economy. The RBI's dovish stance will likely be reinforced by its forward looking commentary, suggesting continuation of its accommodative stance till "growth revives", supplemented by maintaining positive liquidity in the system.

While G-Sec yields moved up in the early part of November driven by fiscal worries, the latter half has seen retracement with yields remaining almost unchanged over the month. Sharp rally has been witnessed in the short to medium tenor (upto 5 years) AAA bonds, with spreads compressing to 35-50 bps over G-Sec compared to almost 80 bps few months ago.

The longer end of the yield curve underperformed with 10-year Gilt trading in a band of 6.45% to 6.55%. ***Activity in the longer end of AAA curve is gradually picking up, with markets increasingly focusing on the very attractive carry that that segment offers.*** We have been highlighting this for the past few months, and ***we expect the longer end of the curve to continue to do well with spreads still at an attractive 75-90 bps over equivalent G-Sec, and with 3-10 year AAA spread at 125 bps versus long term average of 14 bps.***

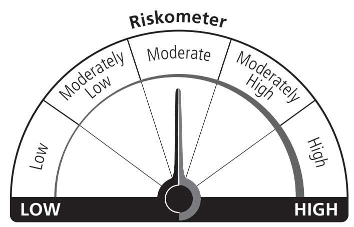
Investment Strategy & Fund Recommendations

Last month we had written in detail about the merits of the 10 year AAA space, with a focus on the ***L&T Triple Ace Bond fund.*** ***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 125 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.*** Spreads on these bonds are at an attractive level as compared to a year back, which indicates the extent of extreme risk aversion prevalent in the bond market.

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



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

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