Indian sovereign bond closed at 6.10% vs 5.84% from its previous close. The Reserve Bank of India (RBI) hinted of a prolonged pause in the interest rate cut due to high retail inflation.

The RBI announced new measures to maintain stability in the financial system during the coronavirus pandemic, including two more tranches of special OMOs in its 'Operation Twist' and some easing of held-to-maturity (HTM) limits for bond holdings by banks.

Indian rupee appreciated by 1.6% and ended the month at 73.62/$. Brent oil price gained 3.7% (MoM) to end the month at US$44.4/bbl following a 4.7% (MoM) gain in July.

Global yields have eased meaningfully as central banks globally have cut policy rates aggressively and have announced large QE programs, to counter the negative impact on global growth from the COVID-19 outbreak. US 10Y yields are at 0.71% (-79 bps over the last 1 year).

MARKET PERFORMANCE

The 10-year benchmark G-Sec yield closed at 6.10%, up by 26 bps from its previous close of 5.84% while that on the short-term 1-year bond ended 10 bps higher at 3.57%.

In the corporate bond segment, yields rose across the yield curve over the month. The 10-year AAA bond yield ended 20 bps higher at 6.65%, while the short-term 1-year AAA bond yield ended 20 bps up at 4.25%.

The spread between 1-year and 10-year AAA bond widened. Within the short term segment, the yield on 3-month commercial paper (CP) was flat at 3.5% while the 1-year CP yield was up 5 bps at 4.10%.

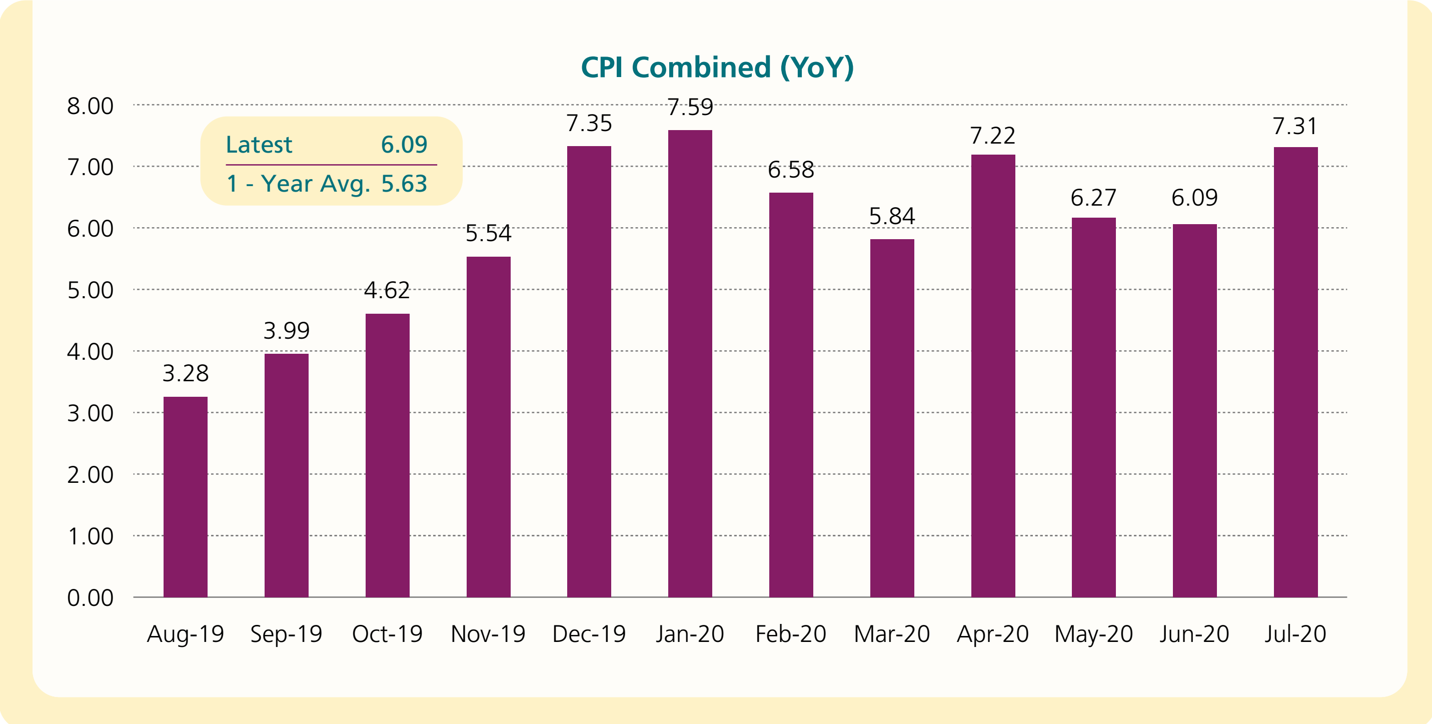
10-Year G-Sec

MACRO-ECONOMIC DEVELOPMENTS

GDP: India's Gross Domestic Product growth rate had contracted by 23.9% for the April to June quarter.

Inflation & IIP: The WPI declined 0.58% in July, even as food items turned costlier while the CPI spiked to 6.93% mainly on account of higher food prices. IIP contraction slows to 16.6% in June amid industrial activity relaxation.

PMI & Trade Deficit: India's Purchasing Managers' Index (PMI) for manufacturing slipped in July (46.0) after a rebound in June (47.2) and the Services PMI stood at 34.2 in July, against 37.7 in June. India recorded a trade deficit of $4.83 billion in July. While imports to India plunged 28.4% on-year to $28.47 billion in the month, exports fell 10.21% to $23.64 billion.



OUTLOOK

The month of August saw a spike up in volatility in the Indian bond market. To begin with, the Monetary Policy Committee (MPC) decided to hold the repo rate unchanged, through a 6-0 unanimous vote citing inflation concerns. However, the stance of the policy remains "accommodative" on concerns of lower growth.

The bigger setback for the markets was when the CPI for the month of July spiked up to 6.93% (YoY), raising concerns of stagflation. CPI inflation has been outside the MPC band of 4+/- 2 % in 7 out of the last 8 months. The MPC minutes which were released later were much more hawkish than the market had expected. The negative sentiment resulted in market pricing in higher yield expectations for clearing Government auctions, with the 10-year G-Sec yield rising from 5.85% to 6.20%. This forced the RBI to signal its discomfort with the higher yields, by devolving the entire 10-year issuance of Rs 18,000 cr on the Primary Dealers. RBI also announced the much-awaited OT (Operation Twist) for Rs 20,000 cr. This was followed by a series of measures to ensure the orderly functioning of financial markets.

- Additional Rs 20,000 cr of special Open Market Operation (OMO) taking the total to Rs 40,000 cr of Operation Twist in August and September

OUTLOOK Cont...

- Increasing HTM limits for incremental G-Sec purchase by banks from 19.5% to 22%
- Term repos of 1 lac crore to be conducted in the month of September to assuage pressures on the market on account of advance tax outflows.

Other comforting takeaways from the release were as follow:

- In RBI's view, food and fuel prices are stabilizing and cost-push factors are moderating. In addition, the recent appreciation of the rupee is working towards containing imported inflationary pressures
- The RBI has assured that the borrowing program of the Centre and States for the year 2020-21 will be completed in a non-disruptive manner
- In support of the accommodative stance of monetary policy, the RBI has committed to ensuring comfortable liquidity and financing conditions in the economy. The RBI stands ready to conduct market operations as required so as to ensure orderly market functioning.

In addition to these the RBI has been signaling lower interest rates, through the aggressive purchase of 10-year Gilts under the special OMO. All these measures have ensured that yields on 10-year G-Sec have moved back below 6% at a rapid pace from a high of 6.20% reached during the month. Towards the end of the month, India's Q1 GDP printed a record low of – 23.9% (YoY), significantly worse than market expectations.

The yield curve still remains very steep as overnight rates are around 3% while the 10-year G-Sec trades at 6%. With inflation at above tolerance levels of MPC, RBI MPC is unlikely to be able to cut policy rates for the rest of the year. Any significant downward move in yields would require prudent policies by Central and State Governments to limit market borrowings, while at the same time use the resources judiciously to get the economy out of recession in a year hit by the pandemic. While the Centre is having its own challenges around revenue shortfall and the increasing need to announce additional fiscal stimulus, the States are also in dire need of funds as they are faced with not just their own revenue shortfall, but also GST compensation shortfall from the Centre.

Hence, in order to ensure that interest rates remain on a downward trajectory, the RBI would need to continue to step in with tools like Operation Twist, OMO purchases, long term repos and other tools as and when the yields move above its comfort zone. Accordingly, ***we expect the volatility to remain high, with the 10-year G-Sec yield trading in a wide range of 5.75-6.25%, thereby providing tactical trading opportunities for actively managed funds.***

INVESTMENT STRATEGY & FUND RECOMMENDATIONS

On a risk-adjusted basis, the yield curve continues to remain steep, with carry remaining relatively attractive as we move longer on the yield curve. Accordingly, in our view, ***the AAA curve remains lucrative both on the 3-year space (where our L&T Short Term Bond Fund and L&T Banking & PSU Debt Fund are invested), and also at the longer end (where L&T Triple Ace Bond Fund is positioned).***

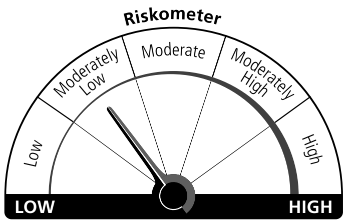
For investors looking to make additional alpha, a good alternative is to play duration actively. Active management of duration, to capture any rally, while limiting losses in later years through well-timed duration reduction – can offer the most optimal strategy. ***L&T Flexi Bond Fund and L&T Gilt Fund, both have a demonstrated track record of active duration management in past such cycles, and are well suited in the current market conditions.***

OUTLOOK Cont...

The other alternative for alpha generation that is slowly catching investor attention is good quality, but less liquid securities in the AAA/AA+/AA rating buckets, which have been disproportionately punished in terms of market pricing following the credit-related fiasco over the past few months. While the credit environment surely remains extremely challenging and warrants abundant caution, we do believe that funds which can offer access to good quality issuers in these higher rating buckets could be considered by investors willing to move up a notch in the risk-reward chain. ***L&T Resurgent India Bond Fund is well-positioned in this space, with a pickup of almost 300 bps over 3-year AAA PSU yields.***

This product is suitable for investors who are seeking*

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 moderately low risk

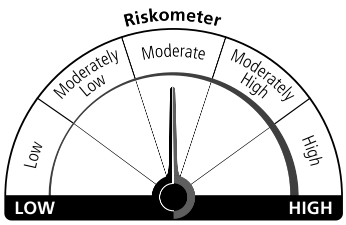
L&T Banking and PSU Debt Fund
(An open ended debt scheme primarily investing in debt instruments of banks, public sector undertakings, public financial institutions and municipal bonds)
- Generation of reasonable returns and liquidity over short term
- Investment predominantly in securities issued by Banks, Public Sector Undertakings and Public Financial Institutions and municipal corporations in India

L&T 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 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 Gilt Fund
(An open ended debt scheme investing in government securities across maturity)
- Generation of returns over medium to long term
- Investment in Government Securities

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

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

Source: MOSPI, Internal, Bloomberg