DEBT MARKET REVIEW

SEPTEMBER, 2020

L&T Financial Services
Mutual Fund

Indian sovereign bond closed at closed at 6.02% vs 6.10% from its previous close. The Reserve Bank of India will announce monetary policy on October 9.

Brent oil price declined 7.7% in September to end the month at US$41.0/bbl following a 3.7% gain in August. YTD, oil prices are still 38% down. Rupee depreciated by 0.2% and ended the month at 73.77/$ in September.

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 0.68%.

MARKET PERFORMANCE

The 10-year benchmark G-Sec yield closed at 6.02%, down by 08 bps from its previous close of 6.10% while that on the short-term 1-year bond ended 10 bps higher at 3.67%.

In the corporate bond segment, yields rose across the yield curve over the month.

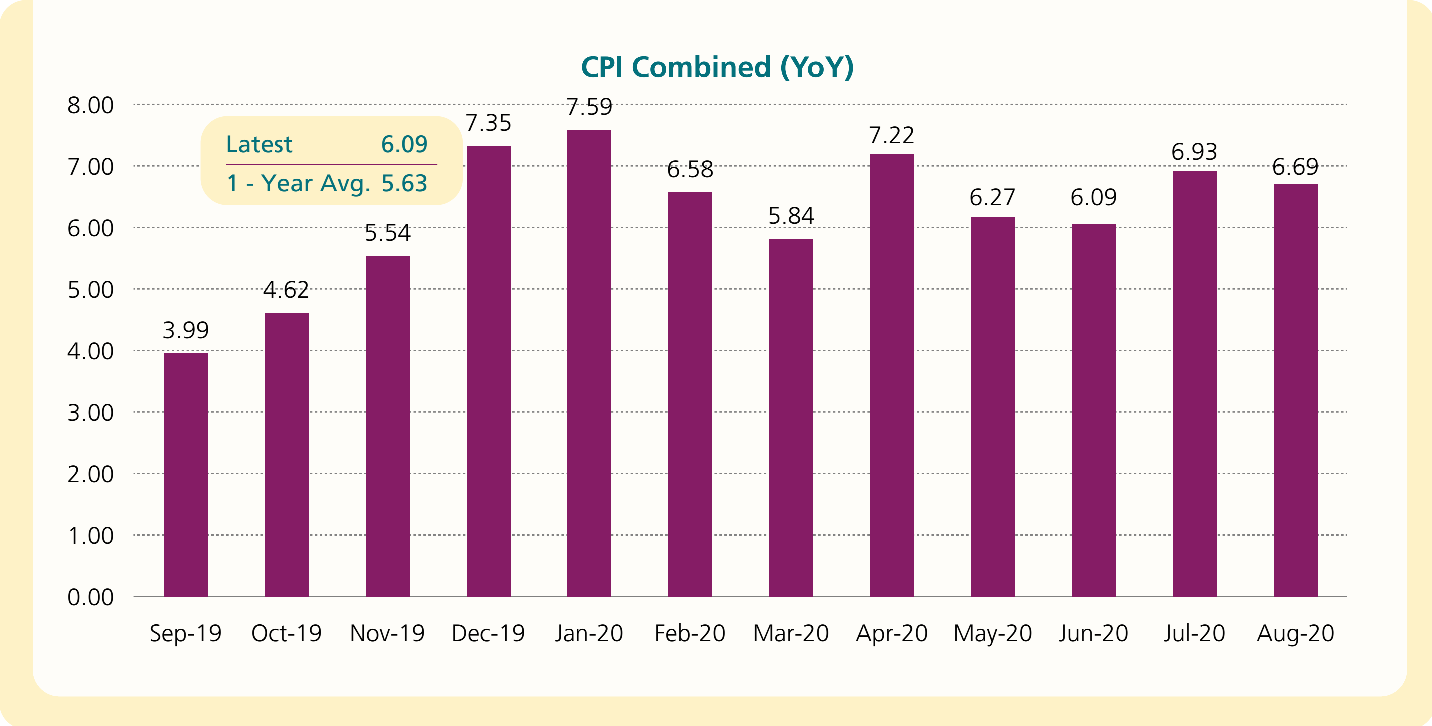
The 10-year AAA bond yield ended 12 bps higher at 6.77%, while the short-term 1-year AAA bond yield ended 5 bps up at 4.30%.

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 up 5 bps to 3.55% while 1-year CP yield was up 5 bps at 4.15%.

MACRO-ECONOMIC DEVELOPMENTS

IIP & Inflation: The index of industrial production fell by 10.4% in the month of July, after contracting by 33.9% in June and 57.6% in April 2020. The wholesale price index inflation stood at 0.16% in August against a contraction of 0.58% in July. Retail inflation growth across the country eased to 6.69% in the month of August.

PMI & Trade Deficit: IHS Markit India Manufacturing Purchasing Managers' Index (PMI) increased from 52.0 in August to 56.8 in September - highest since January 2012. Exports rose 5.27% on year to $27.4 billion in September while imports declined 19.6%, leaving a trade deficit of $2.91 billion.



OUTLOOK

The tacit understanding between bond markets and the RBI, that the latter would step in whenever needed, was in full play during the May to July period, ensuring that interest rates moved lower, stayed low and the large GoI borrowing got absorbed by the bond markets without much indigestion. However, once that understanding got disrupted in August, the nervousness of the bond markets became apparent as market players kept pushing yields higher – both in the secondary market as well as the primary market, forcing the RBI to step in and communicate its intent (of ensuring lower interest rates) much more clearly to the markets. While end of August saw a slew of RBI measures being announced, including 20,000 cr of special Open Market Operations (OMOs) and HTM limit increase for incremental G-Sec purchase by banks from 19.5% to 22%, these turned out to be inadequate in the face of high CPI (August reading at 6.69%) and markets fearing the worst in terms of the likely H2 supply of G-Sec, SDL and T-Bills.

To-and-fro communication between the RBI and bond market players continued through September, via signaling through G-Sec (and SDL) auctions and OMOs. Despite some confusing signals from the RBI, ***the markets gradually gained back the confidence that the RBI backstop was still in play,*** and that it would step in if yields moved

OUTLOOK Cont...

significantly higher. Yields gradually settled into a range with the 10-year hugging the 6% level. The shorter end of the curve (up to 5 years) however continued to underperform, with yields retracing back to their highs.

The MPC meeting which was due to be held from September 29 to October 1 was postponed at the last moment, as the three external MPC members could not be finalized and inducted on time! Albeit with a delay, the GoI appointed economists Shashant Bhide, Ashima Goyal and Jayanth Varma as the independent members of the MPC. Their first MPC meeting, which will be eagerly watched by the markets to gauge their 'growth vs inflation' tilt, is scheduled to be held from Oct 7-9. We expect the MPC to maintain status-quo on rates (with an accommodative bias), given the still elevated CPI readings. At the same time, we believe ***the MPC minutes are subsequently likely to reveal the new MPC members' growth supportive bias, which should help in alleviating some of the bond market worries.***

The other big overhang for the markets was around the second half borrowing calendar. The GoI positively surprised the markets, by sticking to its full-year gross borrowing figure of Rs. 12 lakh cr, thereby resulting in H2 G-Sec supply of only Rs. 4.34 lakh cr. The maturity profile of the IGB issuance is more skewed towards the longer end, compared to the first half – which should aid the belly of the curve. SDL and T-Bill supply for Q3 also underwhelmed market expectations. While these announcements have led to a small relief rally, especially in the 3-7 year part of the G-Sec curve, markets are still not fully convinced about the ability of the GoI to stay within the announced borrowing targets, given the large revenue slippages. Also, the markets would keep a keen eye on the CPI trajectory over the coming months as any further upside surprises leading to a delay in CPI coming in below 6%, could test our fledgling "flexible inflation targeting" regime. ***We expect the strong base effect over the coming months and subsiding food prices to help nudge CPI into the 5-5.5% zone by December, which should then make life somewhat easier for the new look MPC.***

FUND STRATEGY

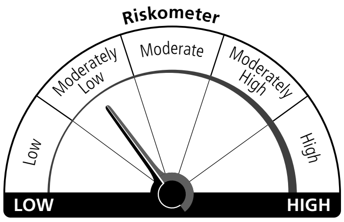
On a risk-adjusted basis, the yield curve continues to remain steep, with carry remaining attractive as we move longer on the yield curve. Accordingly, in our view, ***the AAA curve remains fairly attractive both on the 3-year space (where our L&T Short Term Bond Fund and L&T Banking & PSU Debt Fund 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.***

The other alternative for the 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 250-300 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

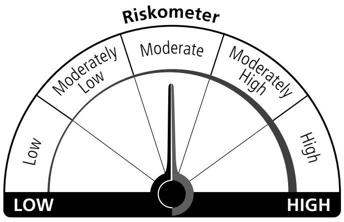
L&T Banking and PSU Debt Fund
(An open ended debt scheme primarily investing in debt instruments of banks, public sector undertakings, public financial institutions and municipal bonds)
• Generation of reasonable returns and liquidity over short term
• Investment predominantly in securities issued by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



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

Source: MOSPI, Internal, Bloomberg