Debt Market Review: July 2010

As on 4th August 2010

ING ORANGE FLASH

Key Market Highlights

- RBI hiked Repo Rate and the Reverse Repo Rate by 25 bps each on July 02, 2010 to 5.50% and 4.00% respectively
- RBI announced its Quarterly Policy on July 27, 2010.
  - RBI hiked Repo Rate by 25 bps to 5.75%, while it hiked the Reverse Repo Rate by 50 bps to 4.50%, thus narrowing the Liquidity Adjustment Facility (LAF) corridor by 25 bps to 125 bps.
  - In its policy statement, RBI stated that the policy stance had shifted decisively towards containing inflation. RBI raised serious concern towards inflation stating that inflation was now very much a generalized phenomenon.
  - The projection for real GDP growth for 2010-11 was revised to 8.5%, up from the previous projection of 8.0%
  - The projection for WPI inflation for March 2011 has been raised to 6.0% from the previous projection of 5.5%
- RBI officials also said that looking at higher inflation, it was advisable that the operative rate would continue to be Repo Rate.
- India's IIP growth continued its strong performance with 11.5% for May 2010 albeit lower than market expectation of 16.2% and previous month growth of 16.5%
- Inflation numbers continued to be in double digit with the headline WPI inflation coming at 10.6% for June 2010 as against 10.2% for May 2010, which was led by primary articles by 16.3%, fuel index by 14.3% and manufactured products by 6.7%. Though with expectation of normal monsoon, there may be moderation in prices of food articles, it could be partially offset by higher fuel prices due to de-regulation. We expect inflation to remain in mid to high single digit for the next few months.
- Export growth deteriorated marginally from 35.1% for May 2010 to 30.4% for June 2010
- Import growth also deteriorated from 38.5% for May 2010 to 23.0% for June 2010
- Credit growth improved to 19.82% in mid July 2010 v/s 18.42% in mid June 2010.
- Deposit growth was flattish at 13.91% for mid July 2010 as against 13.92% in mid June 2010.

Source: www.rbi.org.in, Bloomberg

Market Impact

- Government securities market was bearish during the month of July 2010. The month started with RBI hiking the policy rates i.e. Repo Rate and the Reverse Repo Rate by 25 bps each to 5.50% and 4.00% respectively in an unscheduled policy move. Market was range bound for some time after that. However, with strong IIP data and high inflation at 10.6%, the market sentiment turned marginally bearish.
- In its quarterly monetary policy, RBI raised Repo by 25 bps to 5.75%, however, it raised Reverse Repo Rate by a higher 50 bps to 4.50%, which was not factored in by the market. Along with it, RBI stated that its policy stance had shifted decisively towards containing inflation. RBI also revised its year end WPI inflation projection to 6.0% from 5.5% earlier.
- RBI officials also made hawkish statements regarding expectations of continuing strong growth and of high inflation. RBI officials also stated that for policy to be effective in controlling inflation, it was advisable that the system liquidity continue to remain negative and the operative rate remains Repo Rate. There were also some unverified statements from RBI officials, saying that RBI needed to hike rates at far more aggressive pace to control inflation. Market sentiment turned very bearish and yield on the 10 year benchmark bond rose sharply to 7.80% by end of the month, as against 7.52% at the beginning of the month. There is widespread expectation that RBI would hike rates by another 25-50 bps in its mid-quarter policy on September 12, 2010.
- The yield on new 5 year benchmark bond also spiked up from 7.25% at the beginning of the month to 7.63% by the end of the month. This bond underperformed all other bonds on the curve.
- The short end of the curve has seen higher increase in rates due to strained liquidity and expectation of system liquidity continuing to be negative for some more time to come. 1 yr CD rates moved up from around 7.00% to 7.50%. Similarly corporate bond yields in 2-3 year bonds segment increased sharply with yield on 2 year bonds rising from 7.10-15% to around 7.75-80% during the month.
- INR Swap curve hardened with 5 year swap rates closing at 7.35%, substantially higher than previous month's closing of 6.71%. The 1 year OIS rate also rose sharply from 5.47% at the end of previous month to around 6.37% at the end of July 2010.

Our assessment

INR Yields were volatile during July on account of:

1. Inflation numbers continuing to be in double digit with the headline WPI inflation coming at 10.6% for June 2010 as against 10.2% for May 2010.
2. RBI hiking policy rates twice during the month. In its quarterly policy review, RBI hiked Reverse Repo Rate by 50 bps which was higher than market expectation.
3. Hawkish statements made by RBI officials regarding inflation and expectation of strained liquidity scenario continuing for some more time to come.
4. Unverified statements coming from RBI stating that the policy rates need to be hiked at a faster pace to fight against inflation.

Going Forward

1. G-sec market is expected to remain volatile in the near term as there is continuous supply of government securities of around ₹11,000-15,000 crs per week, which could push the yields upwards.
2. Higher inflation and better macro economic conditions would continue to keep yields at higher level.
3. There is widespread expectation that RBI would hike policy rates by another 25-50 bps in its mid quarter policy review on September 12, 2010. This would continue to keep yields at higher level.
4. However, with the first half of the Financial year FY10-11 close to an end, there could be softening of yields during the next month on expectation of lower government borrowing in the second half due to higher than expected collection from 3G and BWA auction.

Our Portfolio Strategy

Recap - July 2010

1. In ING Income Fund and ING Gilt Fund Provident Fund Dynamic Plan, we managed duration actively. We had moderate to low duration in the middle of the month as we believed that yields could harden with expectation of rate action in RBI policy. However, by the end of the month, when yields started to rise up rapidly, we reduced duration significantly.
2. In ING Short Term Income Fund we increased exposure to 3-6 months money market papers as the yields were attractive in that segment due o strained liquidity.
3. In ING Liquid Fund and ING Treasury Advantage Fund, we maintained judicious mix of cash and very short term instruments.

Strategy going forward

1. In ING Income Fund and ING Gilt Fund Provident Fund Dynamic Plan, we would look to actively manage duration to take advantage of any mispricing. We would continue to keep lower duration as markets are expected to remain bearish from here. However, if the market over reacts and yields are at a very attractive level, we would look to increase duration.
2. In ING Short Term Income Fund we would continue to have around 20-25% exposure to 1-2 year bonds as there is good carry in these assets. We would continue to have 50-55% exposure to accrual assets, which are being traded at higher rates currently due to tight liquidity situation currently.
3. In ING Liquid Fund and ING Treasury Advantage Fund, we would continue to maintain a judicious mix of cash and very short term instruments. However, we would continue to give higher importance to Asset Liability Management (ALM) for these funds.

Gilt Outlook Matrix

	Outlook	Key Drivers	Key Risks
Short Term	➢ Neutral	➢ Expectation of high inflation sustaining ➢ Expectation of further rate hikes in mid quarter review could keep yields high ➢ Fear of a double dip recession world over may induce softening bias ➢ Expectation of reduction in Govt borrowing in the second half of FY11 may lead to softer rates	➢ Quick and meaningful resolution of the Euro sovereign debt crisis ➢ Stronger than expected global / domestic growth numbers ➢ Higher than expected fall in inflation ➢ Higher than expected borrowing by govt for second half of FY11
Long Term	➢ Neutral	➢ Moderation in inflation due to higher base effect and a good monsoon ➢ Expectation of weak growth due to problems seen in Euro region. ➢ Reduction in Fiscal deficit due to good response to 3G auction and possibility of good mobilization due to disinvestment	➢ Quick and meaningful resolution of the Euro sovereign debt crisis ➢ Stronger than expected global / domestic growth numbers ➢ Higher than expected fall in inflation ➢ Higher than expected borrowing by govt for second half of FY11

Corporate Bond Outlook Matrix

	Outlook	Key Drivers	Key Risks
Short Term	➢ Neutral	➢ Expectation of range bound movement in the base G-sec Curve ➢ Expectation of weak growth due to problems seen in Euro region ➢ Reduction in Fiscal deficit due to good response to 3G auction and possibility of good mobilization due to disinvestment	➢ Stronger than expected global / domestic growth numbers ➢ Higher than expected fall in inflation ➢ Higher than expected borrowing by govt for second half of FY11
Long Term	➢ Neutral	➢ Expectation of range bound movement in the base G-sec Curve ➢ Expectation of weak growth due to problems seen in Euro region ➢ Reduction in Fiscal deficit due to good response to 3G auction and possibility of good mobilization due to disinvestment	➢ Stronger than expected global / domestic growth numbers ➢ Higher than expected borrowing by govt for second half of FY11 ➢ More than expected tightening by RBI ➢ Higher supply of bonds due to higher issuance by PSU /Pvt sector issuers

Month end levels

Sovereign: The new 10 year benchmark bond i.e 7.80% Govt bond maturing in 2020 closed at 7.80% by end of July 2010 as against 7.52% at the beginning of the month.

Credits: The yield on the 1 year CDs hardened from 7.00% in previous month to around 7.50%. During the month, the yield on a 10 yr AAA corporate bond increased from 8.70% at the end of previous month to around 8.80% at the end of July 2010.

OIS: The 5 year swap rates closed at 7.35%, as against previous month's closing of 6.71% whereas 1 year OIS rate hardened from 5.47% at the end of previous month to around 6.37% at the end of July 2010.

Mr. Ramanathan K
Chief Investment Officer – Single Manager Division, ING Investment Management (India) Pvt. Ltd.

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