Debt Market Review: June 2010

As on 6th July 2010

ING ORANGE FLASH

Key Market Highlights

- India's IIP growth continued its strong performance with 17.6% for April 2010 as against 13.5% growth in March 2010 and market expectation of 14.3%.
- Inflation numbers were high compared to last month with WPI inflation coming at 10.16% for May 2010 as against 9.59% for April 2010, which was led by an uptrend in manufactured products like metals, wood, textiles and equipment. Though demand side pressure on non food manufactured products is high, we expect inflation to plateau from here and slowly move lower as higher base effect comes into play.
- Export growth deteriorated marginally from 36.2% for April 2010 to 35.1% for May 2010.
- Import growth also deteriorated from 43.3% for April 2010 to 38.5% for May 2010
- Credit growth further improved to 19.12% at the beginning of June 2010 v/s 17.64% in end of April 2010.
- Deposit growth deteriorated marginally to 14.34% at the end of May 2010 v/s 15.31% in end of April 2010.
- Q1 Current Account Deficit came at US$13bn i.e. 3.4% of GDP which is the highest since 1991. Net capital inflows rebounded to US$16.1bn in Q1 2010 from US$14.7 in Q4 2009, led by portfolio inflows. Though rising net capital inflows should easily fund this deficit, we expect higher oil prices to keep a pressure on the current account deficit.

Source: www.rbi.org.in, Bloomberg

Market Impact

- Government securities market was highly volatile during the month of June 2010. Concerns on the possible default from Euro Zone countries reduced and the interest in risk assets returned. Hence globally, interest rates inched up. Additionally, incremental growth numbers in India surprised on the positive side with IIP growth for April 2010 coming at 17.6%, which was higher than expectation. At the same time, Inflation breached the 10% mark again and posted 10.16% for month of May 2010. As a result, sentiment turned bearish and we saw yield on the 10 year G-sec hardening to 7.69% by middle of the month. There was fear of a rate hike from RBI before the scheduled credit policy on July 27, 2010.
- By the end of the month, buying interest was seen at higher levels. Also, risk aversion was seen in the global markets again due to Euro Zone concerns and as a result, global interest rates softened meaningfully and equity markets started showing signs of weakness. At the same time, RBI officials as well as Government officials made an official statement that global recovery was still weak and that India should not tighten monetary policy too much. As a result, we saw interest rates softening again and the benchmark 10 year G-sec closed at 7.55%.
- While volumes remained healthy in the 10 yr bond, the 12 yr bond i.e. 8.20% 2022 and 5 yr bond i.e. 7.17% 2015 also remained very liquid papers. The spread between the 10 yr and 12 yr bonds widened to 30-40 bps.
- The short end of the curve saw significant tightening due to strained liquidity situation. As against a regular outflow of around Rs. 25,000-30,000 crs due to quarterly advance tax payments, this time the outflow was much higher at around Rs. 130,000 crs due to additional outflow of Rs. 67,000 due to 3G auction and around Rs. 38,000 cr due to Broadband and Wireless Auction. This has created severe liquidity problem in the system. As a result the shorter end of the curve hardened significantly and three month money market papers rate hardened from 4% to around 6.50% in a very short period of time. We expect liquidity to remain strained for another month or so.
- Corporate bond yields remained range bound with volumes concentrated in the 1 yr – 3yr bond segment. Volumes in the month June were much lesser than in May. The shorter end of the corporate bond curve hardened 5-20 bps due to lower investor interest and G-sec volatility.
- INR Swap curve hardened with 5 year swap rates closing at 6.64%, as against previous month's closing of 6.53%. The 2 year OIS rate hardened from 5.47% at the end of previous month to around 5.88% at the end of June 2010.

Our assessment

INR Yields were volatile during June on account of:

1. Rise in Industrial production growth from 13.5% to 17.6% coupled with higher than expected inflation of 10.16% kept the market sentiment bearish.
2. Global macro economic developments and concerns on Eurozone kept market participants on their toes. Softening global treasuries, falling crude prices, and falling equities induced softening in interest rates.
3. Expectation of a rate hike before policy meeting kept G-secs volatile throughout the month.

Going Forward

1. We expect markets to continue keeping a close watch on global environment and track the movements closely.
2. Markets are expected to remain volatile in the near term as there is continuous supply of government securities of around Rs 11,000-15,000 crs per week, which would push the yields upwards.
3. Higher inflation and better macro economic conditions could push yields upwards.
4. On the other hand, weakness in global recovery could cause the yields to soften. In a recent report released by RBI, it was indicted that due to global linkages, global economic condition will be assessed and will be taken into consideration while shaping domestic policies.
5. The corporate bond curve is also expected to remain volatile and is expected to track movement of the base G-sec curve. The shorter end of the curve is expected to remain liquid and stable due to investor interest.

Our Portfolio Strategy

Recap - June 2010

1. In the ING Income Fund and ING Gilt Fund Provident Fund Dynamic Plan, we managed duration actively. We had a high duration in the middle of the month as we had a bullish view on the interest rates looking at global factors. However, by the end of the month, when yields had softened we reduced duration.
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 to 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 the 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 the ING Short Term Income Fund we would have around 20-25% exposure to 1-2 year bonds as there is strong buying interest in such assets. We would increase exposure to accrual assets to 50-55%, 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.

Gilt Outlook Matrix

	Outlook	Key Drivers	Key Risks
Short Term	➢ Neutral	➢ Fear of a double dip recession world over due to sovereign risk seen ➢ Expectation of weak growth due to problems seen in Euro region	➢ Quick and meaningful resolution of the Euro sovereign debt crisis ➢ Stronger than expected global / domestic growth numbers ➢ Higher than expected inflation ➢ More than expected tightening by RBI of policy rates
Long Term	➢ Neutral	➢ 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 and sustained inflation ➢ More than expected tightening by RBI of policy rates

Corporate Bond Outlook Matrix

	Outlook	Key Drivers	Key Risks
Short Term	➢ Neutral	➢ Expectation of continuing stability in the base G-sec Curve ➢ Expectation of weak growth due to problems seen in Euro region	➢ Stronger than expected global / domestic growth numbers ➢ More than expected tightening by RBI of policy rates ➢ Higher than expected tightening in system liquidity
Long Term	➢ Neutral	➢ Expectation of continuing stability in the base G-sec Curve ➢ Expectation of weak growth due to problems seen in Euro region	➢ Stronger than expected global / domestic growth numbers ➢ More than expected tightening by RBI of policy rates ➢ 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 7.55% by end of June 2010.

Credits: The yield on the 1 year CDs hardened from 6.50% in previous month to around 7%. During the month, the yield on a 10 yr AAA corporate bond remained flattish and increased from 8.65% at the end of previous month to around 8.70% at the end of June 2010.

OIS: The 2 year OIS rate hardened from 5.47% at the end of previous month to around 5.88% at the end of June 2010.

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INVESTMENTS

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Nature & Investment Objective: ING Income Fund: An open ended income scheme which seeks to generate attractive income by investing in a diversified portfolio of debt and money market instruments of varying maturities, and at the same time provide continuous liquidity along with adequate safety. **ING Gilt Fund Provident Fund Dynamic Plan:** An open ended gilt scheme which seeks to generate relatively risk free return by investing in sovereign instruments issued by the central/state government as defined under section 2 of Public Debt Act, 1944. The scheme will not make investments in any other type of security such a shares, debentures etc. **ING Short Term Income Fund:** An open ended income scheme which seeks to generate an attractive return for its investors consistent with capital preservation and liquidity by investing in portfolio of quality debt securities, money market instruments and structured obligation. **ING Treasury Advantage Fund:** An open ended income scheme which seeks to provide an investment avenue for investors preferring good liquidity and an investment horizon of 2 – 6 months. The scheme would be able to achieve its objectives by investing in a portfolio of money market and debt instruments. **ING Liquid Fund:** An open ended liquid income scheme which seeks to provide reasonable returns while providing a high level of liquidity and low risk by investing primarily in money market and debt securities. The aim is to optimize returns while providing liquidity.

Statutory Details: Sponsor: ING Group, **Trustee:** Board of Trustees of ING Mutual Fund, **Investment Manager:** ING Investment Management (India) Private Limited.