

Key Market Highlights

- India's August IIP yoy growth continued its robust performance with 10.4% v/s a rise of 7.20% in July (revised from 6.80%).
- WPI inflation continued to inch upwards and was at 1.51% for week ended 24 October, 2009.
- Export growth improved to -13.80% for September 2009 as against -19.40% for August 2009.
- Import growth was negative at -31.30% for September v/s -32.40% for August
- Credit growth fell further to 10.75% in mid October (lowest in last decade) as against 13.24% in mid September
- Deposit growth further slowed down to 19.98% in mid October as against 20.20% in Mid September
- M3 growth was flat at 18.9% at end of October v/s 19.0% at end of September

Source: www.rbi.org.in

RBI Quarterly Policy Highlights

- RBI keeps Repo Rate and Reverse Repo Rate unchanged at 4.75% and 3.25% respectively.
- RBI increased Statutory Liquidity Ratio (SLR) by 100 bps from 24% to 25% of net demand and time liabilities.
- Bank rate unchanged at 6% and CRR remains unchanged at 5%.
- Special refinance facility for scheduled commercial banks and special term repo facility for providing funding to MFs, NBFCs and HFs has been withdrawn.

Source: www.rbi.org.in

Market impact

- Government securities market was volatile during October as initially there were fears of exit from accommodative monetary stance, which pushed the yields higher. Also, since there was no announcement on increase in cap of HTM (non mark-to-market portfolio of banks' investments) for more than a month, the sentiment became more bearish. Benchmark 10 yr G-sec saw a high of 7.47% before the quarterly monetary policy statement. However, the RBI in its policy increased the Statutory Liquidity Ratio (SLR) by 1% from 24% to 25% for banks, which means that the banks would have to invest a minimum of 25% of their net demand and time liabilities in government securities. The RBI did not increase any of the key interest rates and it did not withdraw / reduce any excess liquidity from the system. These measures impacted the G-sec market very positively and the 10 yr benchmark bond rallied to 7.25% at its low and was a little higher at 7.30% at the end of the month.
- Going forward we expect markets to remain volatile within a 20-30 bps range with a possibility of rates moving higher in the next 6-8 weeks as inflation is expected to rise sharply and industrial production numbers are expected to post strong performance. However, if there are concerns about growth due to weak private consumption and weak investment demand, we could see expectations of RBI continuing its accommodative monetary stance for a longer period getting built in, which could improve the sentiment and rates could soften from the current levels.
- Yield on the 10 year benchmark G-sec increased from 7.21% at the end of September 2009 to 7.30% at the end of October 2009. Yield on 5 yr benchmark security hardened, however to a lower extent than 10 year benchmark, from 7.07% at the end of September 2009 to 7.11% at the end of October 2009.
- Corporate yields were flattish at around 6.75% for 2 year bonds and around 7.75% for 3 yr bond. 5 yr bond has been steady at around 5.40-5.50% range and 10 yr corporate bond was at 8.80-8.85% level.
- INR Swap curve has hardened with 5 year swap moving up from 6.60% to 6.77%. 2 year OIS rate also hardened a bit from 5.50% at end of September 2009 to 5.58% at the end of October 2009. 5 year G Sec – Swap spread reduced from 50 bps to 30 bps during the month as Swap moved up and 5 yr G-sec yields were flat.

Source: www.bloomberg.com

Our assessment

INR Yields were volatile during October on account of:

1. Announcement of a front loaded schedule of the H2 borrowing programme announced by the RBI, with heavier supply in the first 3-4 months of second half FY10.
2. Better economic numbers and increasing inflation pushed up the yields as expectations of a reversal of accommodative monetary policy started building in. There was wide expectation in the market that the RBI could start its exit from accommodative stance in the quarterly policy during October, by increasing CRR by 25/50 bps.
3. However, the RBI, in its quarterly monetary policy increased Statutory Liquidity Ratio (SLR), left all the key rates unchanged and did not increase the CRR, as any signal of an early exit from accommodative stance could hamper growth, which according to RBI is still not on firm ground.
4. Fear of downside risk to growth has returned in the developed economies, with statements coming from major central banks of the world stating that global economic growth is still fragile and that interest rates may have to be kept at low levels for extended period.

Going Forward

1. Markets are expected to remain volatile as on the one hand, the fear of reversal of accommodative stance of the monetary policy has reduced, but on the other hand, inflation numbers will continue their journey upwards in the short term due to the base effect. Over medium to longer period of time, the direction of inflation is uncertain as it would get impacted by the strength of global recovery and the resultant effect on commodity prices as well as on the domestic food price situation.
2. The corporate bond curve could flatten, with the short end of the corporate curve expected to underperform the longer end as any negative surprise on inflation would impact the shorter end much more than the longer end of the curve.

Our portfolio strategy

Recap - October 2009

1. We managed duration actively as we were expecting volatility in rates. We increased duration of the Long term Bond and Gilt funds when yields were higher and exited after booking profits at lower yields.
2. In short term fund we have maintained mark to market component at around 30% and increased accrual assets to around 35% of the fund, which would help in getting better carry with minimal impact of any increase in interest rates.
3. In Liquid fund, we have been maintaining a judicious mix of cash and very short term instruments. We expect rates of 1-3 months CDs and CPs to remain stable and hence would like to remain invested in upto 3 months CD's and good quality corporate CP's.

Strategy going forward

1. In the long bond funds and the Gilt fund, we would look to actively manage duration to take advantage of any mispricing or spread widening / contraction. As the market is expected to remain range bound, we would look to increase duration when rates are attractive and reduce duration at lower rates after booking some profits.
2. In the Short Term fund we would continue have mix of accrual assets and mark to market assets to get a decent accrual income with minimum impact of any increase in interest rates.
3. In Liquid fund, we have been maintaining a judicious mix of cash and very short term instruments. We expect rates of 1-3 months CDs and CPs to remain stable and hence would like to remain invested in upto 3 months CD's and good quality corporate CP's.

Gilt Outlook Matrix

	Outlook	Key Drivers	Key Risks
Short Term	<ul style="list-style-type: none"> • Neutral 	<ul style="list-style-type: none"> • Continuation of accommodative monetary policy stance by RBI • Tepid global recovery • Easy liquidity 	<ul style="list-style-type: none"> ➤ Possible reversal in accommodative monetary stance ➤ Increasing inflation due to higher food prices ➤ Stronger rebound in the global economic growth ➤ Better domestic economic numbers
Long Term	<ul style="list-style-type: none"> • Negative 	<ul style="list-style-type: none"> • Rise in central bank policy rates 	<ul style="list-style-type: none"> • A possible "U" shaped recovery scenario for the world economy

Corporate Bond Outlook Matrix

	Outlook	Key Drivers	Key Risks
Short Term	<ul style="list-style-type: none"> • Neutral 	<ul style="list-style-type: none"> • Stability in the underlying G-sec base curve • Easy liquidity • Good carry in 3-5 year bonds 	<ul style="list-style-type: none"> • High supply in terms of refinancing and reissuances by banks and corporates
Long Term	<ul style="list-style-type: none"> • Negative 	<ul style="list-style-type: none"> • Rise in central bank policy rates • Large investors in fixed income mutual funds can exit in one day notice 	<ul style="list-style-type: none"> • Lower pick up in credit growth • A possible "U" shaped recovery scenario for the world economy

Month end levels

Sovereign: The yield on the ten year benchmark sovereign bond closed at 7.30%, 9 bps higher than the previous month closing levels of 7.21%

Credits: The yield on the 1 year CDs increased from 5.52% in previous month to around 5.60% during this month, the yield on a 10 yr AAA corporate bond was flat at 8.83% at the end of October v/s 8.86% at the end of September 2009.

OIS: 2 year OIS rate hardened a bit from 5.50% at end of September 2009 to 5.58% at the end of October 2009



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INVESTMENTS

www.ingim.co.in



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