

Key Market Highlights

- India's July IIP yoy growth continued its strong performance with 6.80% v/s a rise of 8.20% in June (which was revised upwards from 7.80%), indicating that downside risk to growth has reduced.
- WPI inflation broke into positive territory and was at 0.83% for week ended September 19, 2009.
- Export growth improved to -19.40% for August 2009 v/s -28.40% in July.
- Import growth was negative at -32.40% in August v/s -37.10% in July
- Credit growth continued to be slow at 13.38% in mid September as against 14.96% in mid August
- Deposit growth further slowed down to 20.20% in Mid September v/s 21.83% in mid August
- M3 growth was flat at 19.7% at end of September v/s 19.4% at end of August

Source: www.rbi.org.in

Market impact

- Government securities market saw softening of rates as the H1 borrowing calendar came to an end and the second half borrowing calendar was expected to be lighter. At the same time, statements from Reserve Bank officials stating that they were examining the limit on HTM portfolio of the banks came as a positive surprise. Further, RBI along with many other central banks of the world stated that it was too early to exit from stimulus as rebound in growth was still in its initial stages, which added to the positive sentiment and as a result 10 yr benchmark index saw a low of 7.05% during the month. However, rates hardened a bit by the end of the month as the borrowing calendar for second half of FY10 was worse than expectation since the borrowing is front loaded with entire borrowing being completed by first week of February 2010. At the same time, there was no announcement on relaxing of the HTM limit till end of the month. As a result, the 10 yr G-sec rate ended at 7.20% at the end of September 2009 after seeing a low of 7.05% during the month.
- Going forward we expect markets to remain volatile within a 15-20 bps range with a possibility of rates moving higher in the next 4-6 weeks as inflation is expected to rise sharply by then with base effect kicking in. Also, the industrial production numbers are expected to post good performance during the next 2-3 months. However, if there is any substantial (higher than expected) relaxation in the limit for HTM portfolio of banks, we could see a positive impact on the rates.
- Yield on the 10 year benchmark G-sec softened up from 7.44% at the end of August 2009 to 7.20% at the end of September 2009. Yield on the 5 yr benchmark security fell, however to a lower extent than 10 year benchmark, from 7.17% at the end of August 2009 to 7.07% at the end of September 2009.
- Corporate yields softened marginally along with fall in rate of the G-Sec market. 10yr corporate bond yield fell from 8.86% to 8.80%, while 5 year bond yield reduced from 8.50% to 8.44%.
- Short end of the corporate bond curve i.e. 18-24 months papers softened the most, with 2 year bond yields falling from 7.05% to 6.70% and 18 months yield falling from 6.70% to 6.15% during the month of September. This was due to reduced fear of RBI taking any steps to unwind stimulus by either reducing liquidity in the system of increasing interest rates. However, going forward, as inflation is expected to increase rapidly, this segment is expected to underperform as the fears of RBI taking any unwinding steps would return, in short to medium term.
- INR Swap curve has hardened with 5 year swap moving up from 6.38% to 6.60%. 2 year swap rates moved up on inflation concerns from 5.26% at end of August 2009 to 5.49% at the end of September 2009. 5 year G Sec - Swap spread reduced from 79 bps to 50 bps during the month as Swap moved up and G-sec yields softened.

Source: www.bloomberg.com

Our assessment

INR Yields softened in September largely on account of:

1. Completion of the borrowing calendar for the first half of the fiscal year and the lower supply of G-sec in the second half as compared to the first half.
2. Announcements by the central bank officials saying that they would examine the limit on HTM portfolios of the banks, which gave rise to expectation that the limit could be increased by around 2-3 percentage points.
3. Reserve Bank of India allaying fears of the market of an early exit from the accommodative monetary policy stance. RBI along with many other central banks of the world made it clear that they would not exit the stimulus at this stage as growth rebound was still at an early stage and any withdrawal of stimulus could have a negative impact.

Going Forward

1. Markets are expected to remain volatile as on 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 due to the base effect.
2. The corporate bond curve is expected to flatten, with the short end of the corporate curve expected to underperform the longer end as any negative numbers on inflation are expected to impact the shorter end much more than the longer end of the curve.

Our portfolio strategy

Recap - August 2009

1. We increased the duration of the Long term Bond and Gilt funds as we expected a pull back in the rates due to completion of the borrowing calendar for the first half of the fiscal year and the lower supply of G-sec in the second half.
2. In short term fund we have maintained mark to market component at around 30% and increased accrual assets to around 30% 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 to have a 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"> • Possibility of hike in HTM limit of Banks by RBI • Easy liquidity 	<ul style="list-style-type: none"> • Possible reversal in accommodative monetary stance • Increasing inflation due to higher food prices • Better 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 	<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 7.20%, 24 bps lower than the previous month closing levels of 7.44%

Credits: The yield on the 1 year CDs fell sharply from 5.80% in previous month to 5.52% during this month, the yield on a 10 yr AAA corporate bond was flat at 8.86% at the end of September v/s 8.80% at the end of August 2009.

OIS: 2 year OIS rate moved up on inflation concerns from 5.26% at end of August 2009 to 5.49% at the end of September 2009



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INVESTMENTS

www.ingim.co.in



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