DSP

#INVESTFORGOOD

"In point of fact, all sorts of considerations enter into the market valuation which are in no way relevant to the prospective yield.

- John Maynard Keynes

While I was making this months' *Converse*, I could not help but think that the news for bonds is all negative. US CPI is slowing gradually, the labor data is robust, Indian CPI is eye-popping high, and growth is strong, RBI has shown its intent to keep overnight rates higher using a CRR hike. Why on earth would we buy?

Well, we are still buying, despite the negative narrative! Why?

It is because of **valuations**. It is not the negative data that moves the market – but whether that negative data has surprised the market. The markets tend to price in good and bad data, and it gets reflected in the valuations. Is current negativity priced in?

At 10Y IGB around 7.20%, the negative news is priced in according to us. Yes, a further rise in US yields could lead to yield rise in India. But unlike US, where yield curve is 100bp is ***lower*** than the overnight rate, in India it is a rich 75bp spread ***above*** repo rate. 75bp!!! And it's the US which is facing a fiscal glut!

What does this difference in spread mean? It means that across the globe, the rate cuts are getting priced in, but in India rate hikes are priced. This **asymmetry leads to asymmetrical odds** – in favor of long bonds.

Importantly, this spread is not because of fiscal risks. There are **no demand supply risks this year**. The NSSF is far beating the expected trend set in budget (and even last year's numbers). Govt. fiscal position remains strong. Tax collections remain buoyant. Some were expecting (not us) demand from insurance and PFs to be tepid, but it remains strong. And corporate bond supply remains modest. This is a good year.

Historically, when (i) there are no rate hikes anticipated, and (ii) demand supply is not a worry, then the spread over repo is much less. Indian bonds are a buy.

When lacking in domestic drivers, Indian and US yields become corelated (currently a beta of ~1/3). This correlation should continue, but there may be one-sided skewness due to divergent rate expectations. If global yields fall our yields will have large beta (still less than 1) – if they rise our yields will have low beta.

This means that if global yields rise then *India vs US spread* will narrow, else it will widen. But more importantly the **Indian bonds will gain more if US yields fall and lose less if US yields rise**. Convexity of sorts.

This brings us to question many pose – that the spread between US vs Indian yields is very low and this is negative for Indian bonds. Such analysis of simple comparison with empirical spreads is fraught with dangers. The EM-US spread has narrowed considerably across the globe – India still is attractive relatively. Instead of just yields. one may want to compare (i) real rates, or (ii) term premium, or (iii) future derived policy rates – or any other fundamental or market parameters. I believe most will show **India is attractive**.

As always, we discuss **risks to our view** now.

Currency depreciation remains something on our radar. We are not worried – just alert. There is no large exodus of foreign capital, RBI has robust reserves and somewhere capital flows in India are getting decoupled from China (driver of EM weakness). Rupee depreciation (vis-à-vis USD) is par-for-the-course (necessary & healthy) based on interest rate parity. Rupee is fine based on REER, and we aren't worried.

US yields remain a bigger concern. Are we having a Volcker era Deja-vu where US yields can move a few hundred bp higher? We have toyed with this thought for weeks. While this thought has its own attractions, there just isn't data to support it. Maybe a few more rate hikes, but to look back to exceptions of Volcker era is being biased, in our view.

Oh, and that high CPI print? If you read our *Converse* you already know why – it appears to be driving looking at the rear view mirror only!

SCROLL TO READ **DSP CONVERSE**

Aug 2023

DSP

#INVESTFORGOOD

Bullish on bonds

Wary of data, but attracted to valuations!

DSP CONVERSE

Our Framework

Monetary Policy

Inflation
- July print was stormed by surge in vegetable prices
- …but fall may be sharp
- Weather related risks remain but have reduced
- Core inflation < 5% after 3 yrs

Growth
- Domestic activity is resilient
- High services PMI
- High GST collections

Currency/CAD/BOP
- External sector pressures remain low, but…
- EM reaction makes rupee vulnerable
- Not worried but concerned

Fiscal Policy

Supply
- Low supply of G-Secs
- SDL supply is expected to remain muted
- Healthy NSSF deposit

Demand
- Banks SLR holding remains high, may reduce
- OMO possibility is low

FPI
- FPIs are unlikely to sell: holdings are already low
- FPIs are unlikely to buy in current yield spread

Global Drivers

Global Yields
- US data continues to weaken, but less than expected
- Despite narratives being on the either side

Geopolitics
- China/US trade war can cause supply disruption
- Ukraine Russia conflict is not over yet

Commodities
- Price risks are evenly balanced

Others

RBI Regime
- Data dependent
- Focused on durable moderation in inflation
- Tail risks could emerge from large FOMC action

Misc.
- Sufficiently large liquidity is providing support
- Although temporary tightening on account of I-CRR implementation

Takeaway:
No major driver for yields. We are bullish on account of attractive valuations.

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CAD – Current Account Deficit; BoP – Balance of Payment; SLR – Statutory Liquidity Ratio; SDL – State Development Loans; RBI: Reserve Bank of India; G-Sec: Government Securities; OMO: Open Market Operation; FPI: Foreign Portfolio Investment; FOMC: Federal Open Market Committee; I-CRR: Incremental Cash Reserve Ratio; PMI: Purchasing Managers' Index; GST: Goods and Services Tax; NSSF: National Small Savings Fund

SUMMARY

We are bullish

Why? Because of Valuations!

Markets are pricing in a lot of negativity

Yet, inconclusive evidence to justify fall in yields. Or rise in yields.

Any positive news may cause a sharper rally, than a sell-off due to negative news

View Summary: Bullish

Our Strategy: We turn long in our active funds

10Y Indian G-sec yields *have risen to ~7.20: upper end of our expected range, tracking US yields (and may continue in future).*

Even though the US labor, CPI and services data have weakened, its lower than the expectations. Unless US economic data softens significantly, rate cuts won't be expected. Until then yields won't fall.

On the other hand, risks of FED being hawkish are real – yet tail risks. Data is softening, previous rate hikes are still percolating in the economy – and higher rates for longer can lead to black swan events – which no one can predict.

While Indian CPI has come at ~7.4%, it will not lead to a trend. As we always mention, in India the volatility of supply driven CPI can only create noise – not trend. In few months as tomatoes and vegetable prices fall naturally – so will CPI. Markets (and RBI) should look right through it – though there will be noise.

For money markets investment: *We will keep adding duration as and when the spreads look attractive. The surplus liquidity and matched demand-supply will keep a cap on rates, despite CRR hike.*

➢ Reasons for our view

1. **Data isn't a one-way street – so why are markets?:** US data is softening, but not fast enough. Indian CPI has risen but its transient. Why should central banks take strong rate actions? In such times, recent yield spike makes *valuations* attractive.
2. **India term premium** is still high, especially considering the fiscal strength. With benign rate outlook, current yields are attractive.

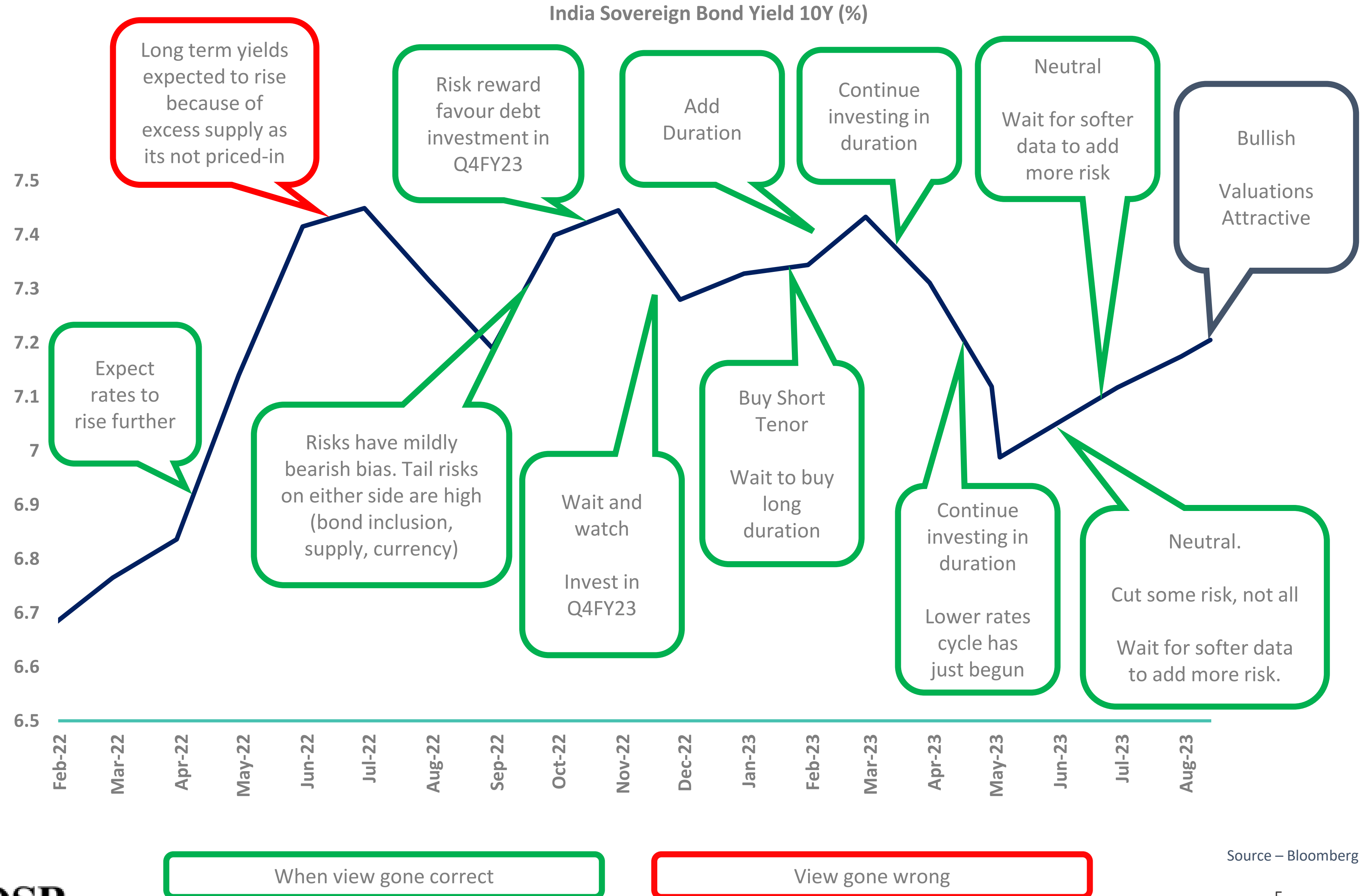
➢ Risks to our view

1. **Are we running a hope trade and biases?** Are we "*hoping*" for data to weaken – when we ourselves mention that data is not looking weak. We have ensured that we are not having a confirmation bias – we look at data from both sides of the spectrum.
2. **Tight stop loss:** We are aware that we are digressing from our framework. Frameworks are to be followed– but digression is needed at times. Digression means more responsibility: (i) one needs to be aware of why and when we digress, and (ii) one needs to be disciplined to exit such trades if they do not work - not wait it out. We have followed first part – and wont hesitate to follow the second part.

G-Sec: Government Securities; CPI: Consumer Price Inflation; FED: Federal Reserve; RBI: Reserve Bank of India; CRR: Cash Reserve Ratio

TRAJECTORY

Let’s revisit our rates call trajectory



Source – Bloomberg

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To start with,

Recap of events since last release.

RBI continued with a PAUSE

With caution around inflation

India CPI at 15m high (led by veggies)

FED raised rates by 25bps

US CPI and labor market show signs of cooling off – but not enough

RBI continued with a PAUSE

Rate Action

Unanimously voted to keep key policy rates unchanged at 6.5%

Stance

5 of 6 members voted for remaining focused on withdrawal of accommodation

Inflation

Revised higher by 30bps to 5.4% for FY24

- ✗ Revised up sharply for Q2 from 5.2% to 6.2%
- – Spike in vegetable prices to exert sizeable upside pressures on near-term headline inflation trajectory (although likely to correct with fresh market arrivals)
- ✗ Impact of uneven rainfall distribution warrants careful monitoring
- ✗ Crude oil prices have firmed up amidst production cuts

Growth

GDP forecast retained at 6.5% for FY24

- ✓ Recovery in kharif sowing and rural incomes, buoyancy in services and consumer optimism to support consumption
- ✗ Weak external demand and geo-political tensions remain a concern

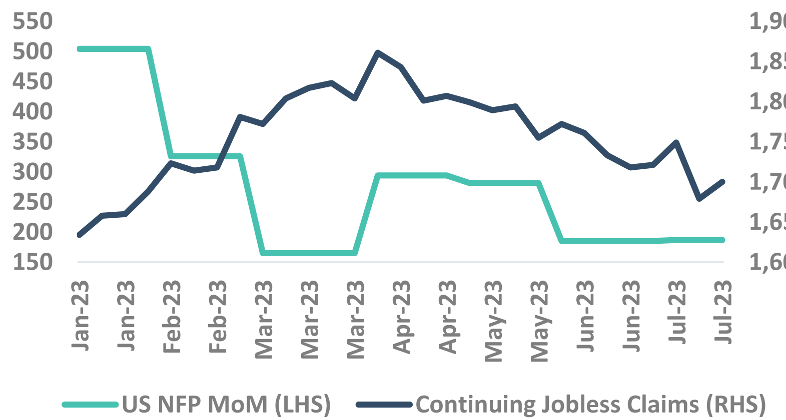
RBI: Reserve Bank of India; GDP: Gross Domestic Product

US Data continues to soften: but markets want more

US DATA

➢ Labor market is showing cooling-off signs

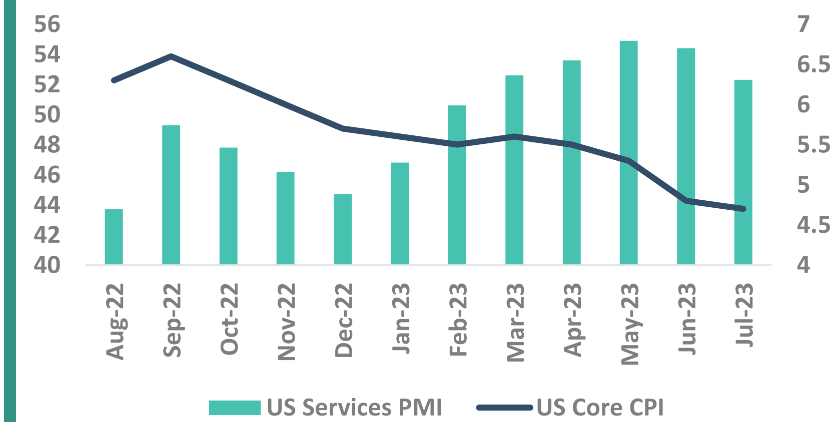
- Continuing jobless claims seem to have bottomed out
- Jul NFP expanded at 187k vs 200k expected
  - ✓ May and Jun also revised lower by 25k and 24k
- Average hourly earnings growth is down to 4.4% from an 18m peak of 5.6% (although remains sticky)



➢ Services PMI softened for 2nd consecutive month

➢ Core CPI (sticky) also showing signs of moderation

- Momentum is softening sequentially as well



Takeaway:
Services sector being the major contributor to employment and inflation, any further softening to provide a tailwind

DSP

Source – Bloomberg

NFP: Non Farm Payroll, PMI: Purchasing Managers' Index; CPI: Consumer Price Inflation

Now our framework

And

What we track

Our Framework

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- Domestic activity is resilient
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- External sector pressures remain low, but…
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- Focused on durable moderation in inflation
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Misc.
- Sufficiently large liquidity is providing support
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Takeaway:
No major driver for yields. We are bullish on account of attractive valuations.

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CAD – Current Account Deficit; BoP – Balance of Payment; SLR – Statutory Liquidity Ratio; SDL – State Development Loans; RBI: Reserve Bank of India; G-Sec: Government Securities; OMO: Open Market Operation; FPI: Foreign Portfolio Investment; FOMC: Federal Open Market Committee; I-CRR: Incremental Cash Reserve Ratio; PMI: Purchasing Managers' Index; GST: Goods and Services Tax; NSSF: National Small Savings Fund

RBI commentary:

“Stable Domestic Macros”

“Vegetable price led inflation surge”

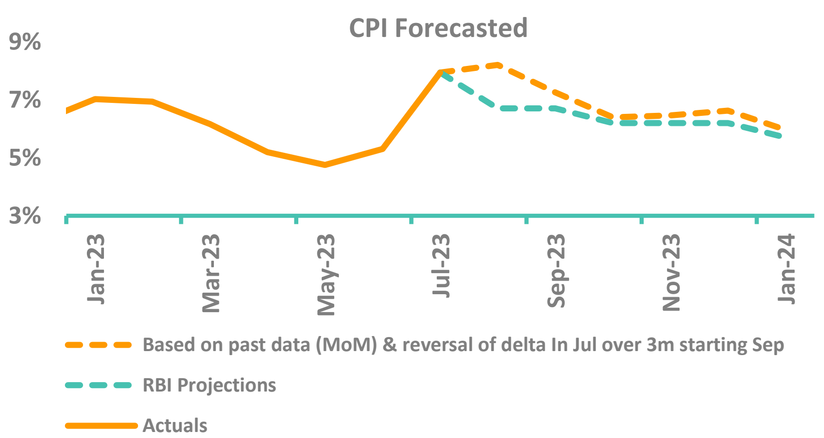
“Core print of sub 5% provides comfort”

“MPC can look through high inflation print

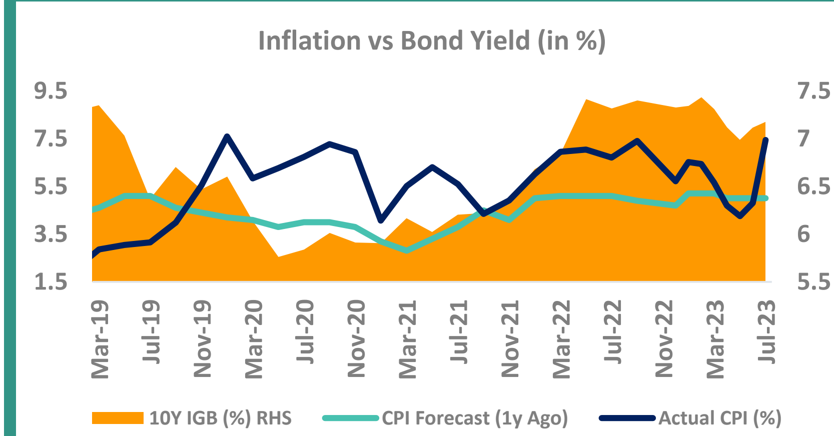
...caused by such shocks”

Headline inflation at 15m high, Core CPI falls – don't fret!

- **July'23 CPI at 15m high of 7.44% - temporary?**
  - Vegetable prices contributed to ~32% of the CPI (mainly tomatoes)
  - Tomato prices have already eased since then
  - Uncertainty remains from adverse weather events, but have reduced significantly
- **Core CPI below 5% after 3 years (at 4.9%)**
- **We, and probably markets, will look through this CPI spike.**



- **Do yields track inflation projection? No.**
  - Orange area (chart) is 10Y yields, Blue line is CPI
- **Can forecasters predict Indian CPI? No.**
  - Green line is forecasters CPI 1-Yr ahead prediction
  - Blue line is where inflation actually came
  - Guess the error of margin!
- **CPI forecast corelated (not causality) to yields**
  - Low predictive power, high current corelation



Takeaway:
Caution around inflation. Rules out any rate cuts for now.

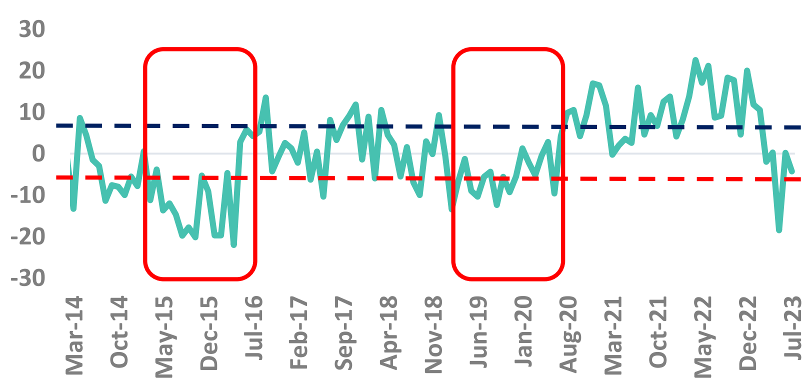
Source – Bloomberg, RBI, Internal

CPI: Consumer Price Inflation; RBI: Reserve Bank of India; IGB: India Government Bond

El Nino a very high possibility albeit may not be a major risk to inflation

El Nino is a possibility, but impact dubious

- Southern Oscillation Index value lower than −7 often indicate El Nino episodes.
- India monsoon rain now in deficit vs surplus (since last DSP converse)
  - ✓ The temporal & spatial distribution of monsoon has been uneven



El Nino impact on cereal prices was inconclusive as in past occurrences (refer to table below)

- Rice (including paddy) stock at adequate levels
- Wheat stocks are on the lower side
  - Might get exacerbated with Russia/Ukraine embargo

Table 1 (lac tonne)	FY15	FY16	FY20	FY21	FY22	FY23	FY24
Wheat							
Production Growth (YoY)	-10%	7%	4%	2%	-3%	6%	
Opening Stock (Aug)	381	368	436	513	565	266	280
Rice							
Production Growth (YoY)	-1%	-1%	2%	5%	5%	4%	
(Rice + Unmilled Paddy)							
Opening Stock (Aug)	274	203	355	399	520	474	439

Overall Kharif sowing already higher vs last year

Weekly Area Coverage under Kharif Crops (11th Aug'23)			
Crops	Area Sown (lakh Ha)		Inc/Dec
	2023	2022	
Rice	328.22	312.80	4.93%
Pulses	113.07	122.77	-7.90%
Coarse Cereals	171.36	167.73	2.16%
Oil Seeds	183.33	184.61	-0.69%
Sugarcane	56.06	55.20	1.56%
Total	979.88	972.59	0.75%

Takeaway:
El Nino risks remain, however, not a major risk to inflation

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Source – FCI, Australian Govt BoM, NFSM

India’s

growth remains resilient

across high and low frequency data.

MONETARY POLICY

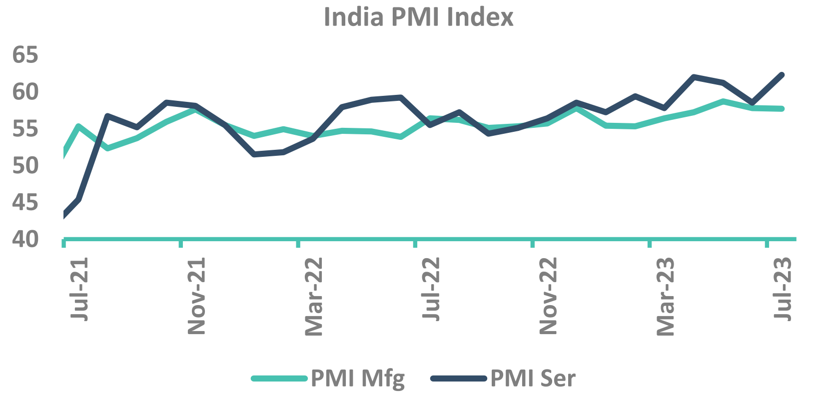
Will global slowdown test domestic growth?

➢ Domestic growth data is still robust

- PMI continues to be in expansionary mode
- July Services PMI at 13y high of 62.3
- GST collections at ₹ 1.65 tn; YoY growth at 11%

➢ Strong credit growth

- Led by retail, MSME and services
- Credit to large industry is also picking up (specially in infra related sectors)

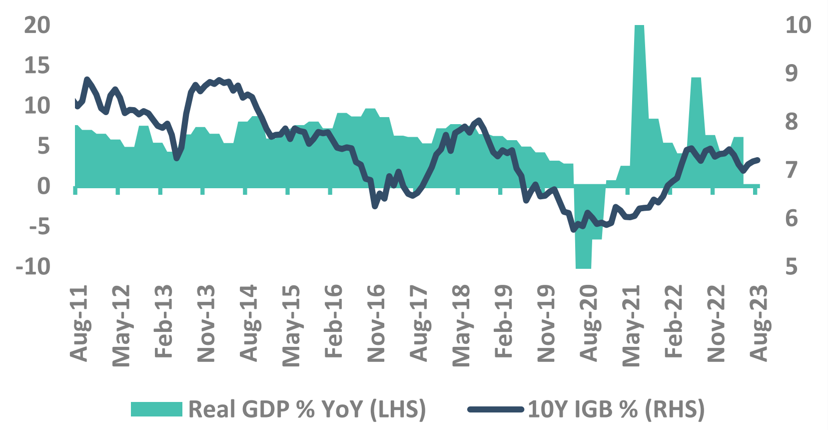


➢ How closely do yields track growth?

- Yields have usually tracked GDP growth, with correlation being stronger when growth slows, barring
  - ✓ 2013, rupee depreciation and debt outflows
  - ✓ 2017, during demonetization

➢ FY24, growth may not be big driver for yields

- FY23 GDP came in at 16.1%, in line with RBI projections



Takeaway:
Domestic growth seems to be resilient so far despite global slowdown fears

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Source – Bloomberg

GDP: Gross Domestic Product; PMI: Purchasing Managers' Index; GST: Goods and Service Tax; IGB: India Government Bond; Mfg: Manufacturing; MSME – Micro, Small & Medium Enterprises; RBI: Reserve Bank of India

What made RBI Pause?

What drives pauses: Series of hygiene factors - Neutral

MONETARY POLICY

The checklist for pause:

A. When the US Fed starts pausing

- Reduces risk of capital outflows

B. When inflation is within comfort

- Reduces risk of inflationary policy
- Barring 2014, when RBI did not have 6% CPI target
  - ✓ But CPI was falling in 2014

C. When BoP (and currency) is stable

- Reduces inflationary / external risks

How is the checklist now?

↔ A: US markets indicating no more hikes

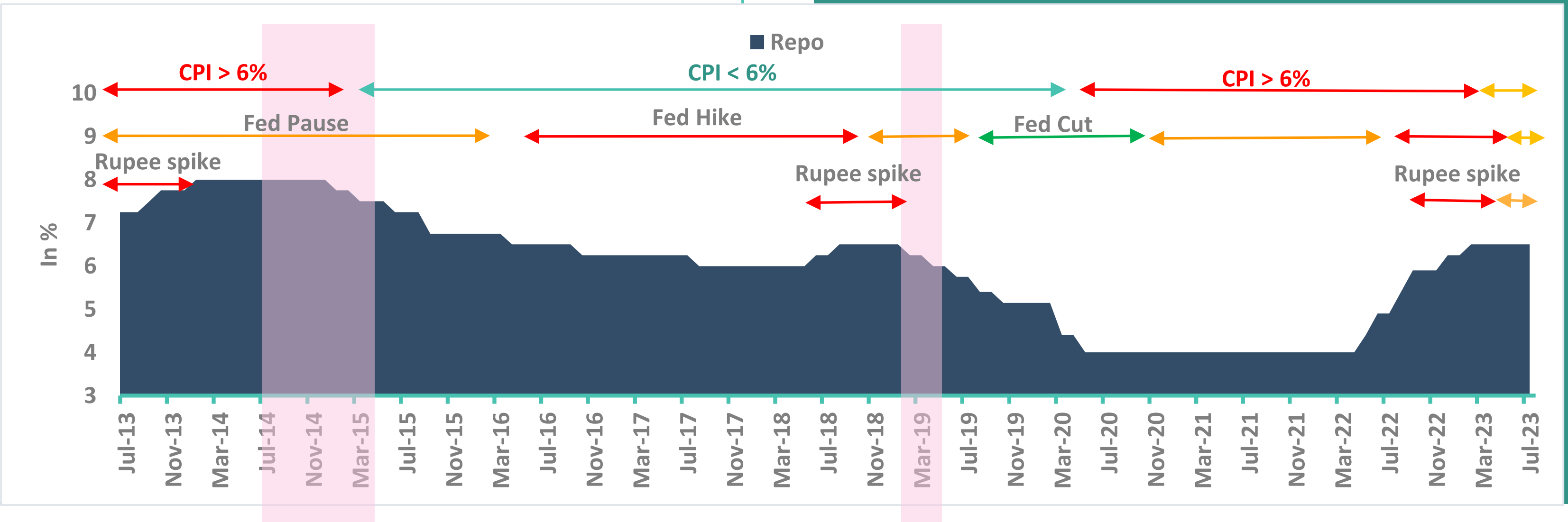
- Even though FED remains data dependent
- FED itself says we are closer to rate hike cycle

↔ B: Inflation is high, but not a major worry

- Transient high inflation + core CPI is easing

↔ C: BoP is stable, but rupee has fallen

- Bop in surplus in Q4FY23
- But EM currencies are weakening, and so has rupee



Takeaway:
So far, there is no conclusive reasons for any rate action by RBI.

DSP

Source – Bloomberg

RBI: Reserve Bank of India; US FED: US Federal Reserve; BoP – Balance of Payment; CPI: Consumer Price Inflation; EM: Emerging Markets

What makes RBI Hike?

FX and FED (primarily), and CPI (hardly).

Although hike unlikely, as the FX reserves have increased significantly

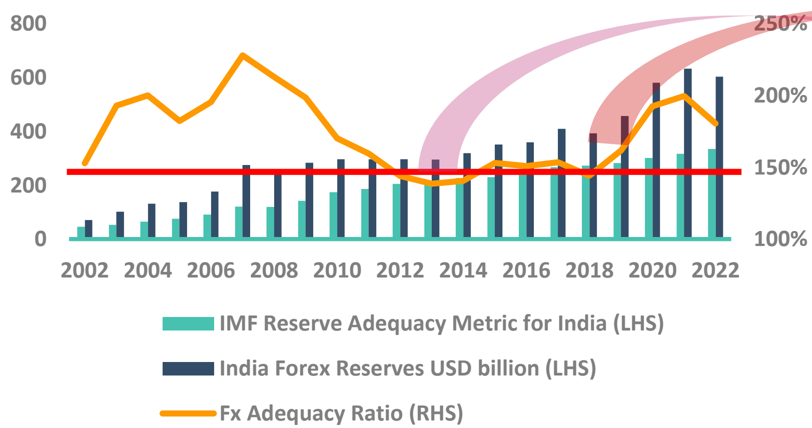
Did you know – when our Fx reserves dip, RBI hikes

RBI FX reserves have increased significantly

- Forex reserves increased significantly to ~$601bn

RBI FX Reserve / IMF FX adequacy ratio declined sharply

- Buffer of more than $100 bn to reach 2013 and 2018 levels (~150% ratio)



RBI only hiked rates twice in past 10 years, barring now

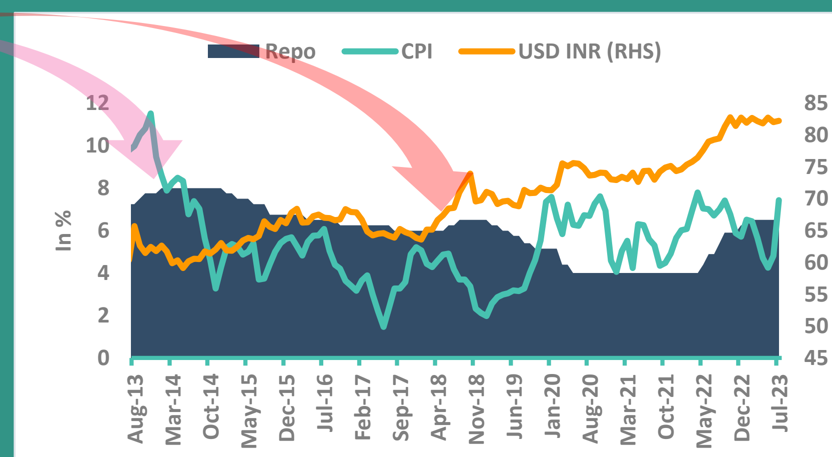
- Increased rates to control rupee, not inflation

RBI has tolerance for inflation, not rupee fall

- In 2018, inflation was within RBI's target levels
- In 2013, inflation was high for long yet RBI cut

When RBI FX reserve fall

- RBI avoids using reserves and does rate hikes to control rupee.



Takeaway:
FX Reserves have increased significantly, and there is enough ammunition to protect rupee

DSP

Source – Bloomberg

RBI: Reserve Bank of India; IMF: International Monetary Fund; US FED: US Federal Reserve; FX: Forex; CPI: Consumer Price Inflation

Data has worsened since last DSP Converse

Rupee is higher, CPI is higher, US data weakened (although less than expected)

We reiterate what we said last time:

"*tail risks remain from any large FOMC action*"

Let's turn to Fiscal policy

Generally, it drives the long bond yields

It is reflected in demand/supply mismatch.

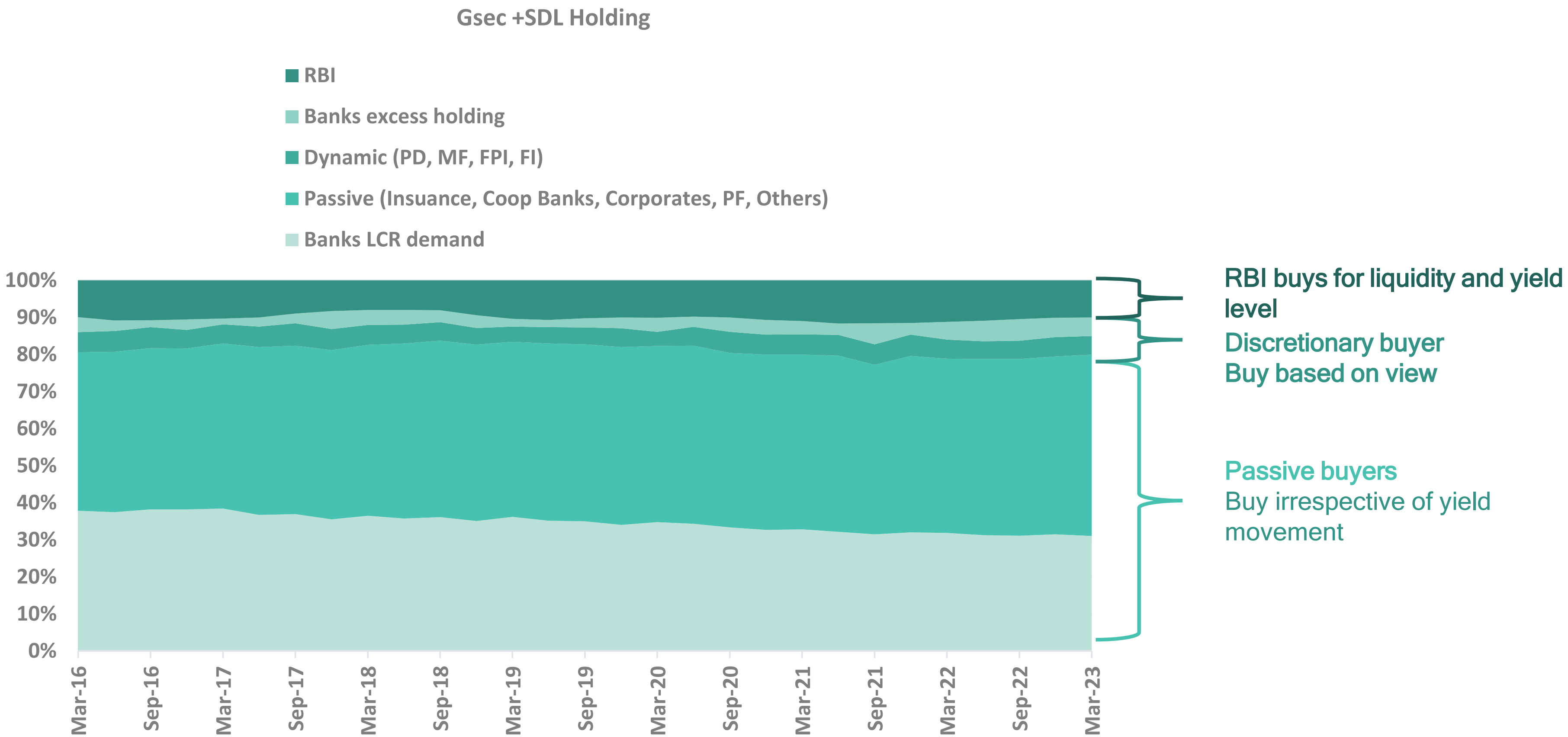
Fiscal policy is less of a driver right now – though election risks will precipitate in next few months

Only a small part of bond buyers are discretionary buyers

They drive yields

Supply fluctuation is borne by these buyers

Gsec market is still driven by lumpy institutions



Takeaway:
Increase in supply impacts the discretionary buying. Banks excess holding, passive buyers have been absorbing the supply

Source – DBIE

LCR – Liquidity Coverage Ratio; SDL – State Development Loans; PF – Provident Funds; PD – Primary Dealerships; MF – Mutual Funds; FPI – Foreign Portfolio Investors; FI – Financial Institutions; RBI: Reserve Bank of India; G-Sec: Government Securities

Comfortable supply/demand dynamics for FY24

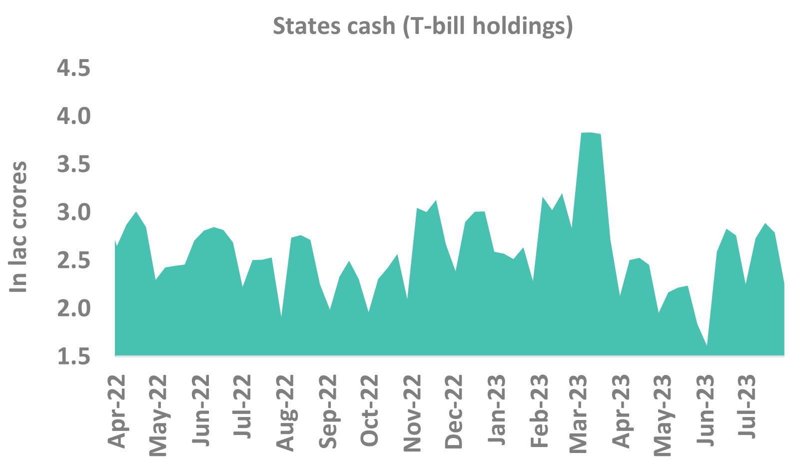
But it will be bumpy ride

Last 4 months demand/supply has been rosy (latent purchases, low SDL issuances)

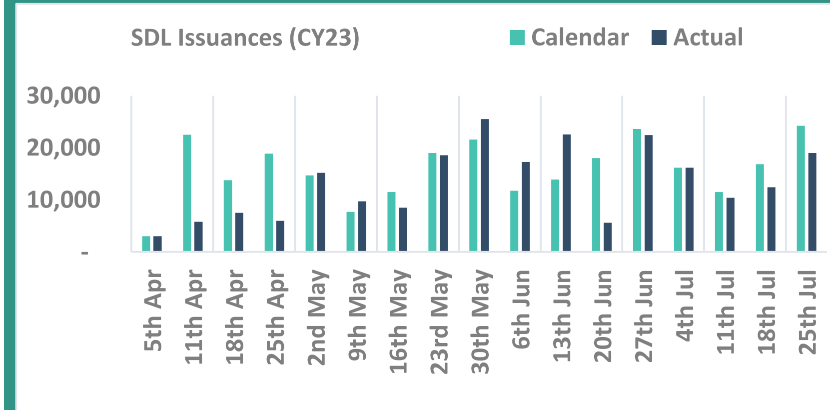
FISCAL POLICY

Comfortable SDL demand-supply metrics

- **State cash balance is above ₹ 2 trillion**
- **Center has front-loaded devolution of tax**
- **Issuance is expected to be in line with the calendar /marginally lower at best**



- **SDL borrowing has now normalized**
  - Apr’23: 60% lower than calendar
  - May’23: higher than calendar (Rs 3k cr)
  - Jun’23: largely in line with calendar
  - Jul’23: 16% lower than calendar
- **SDL issuance impact is expected to be limited**



Takeaway:
SDL supply may remain muted in FY24

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Source – DBIE, RBI

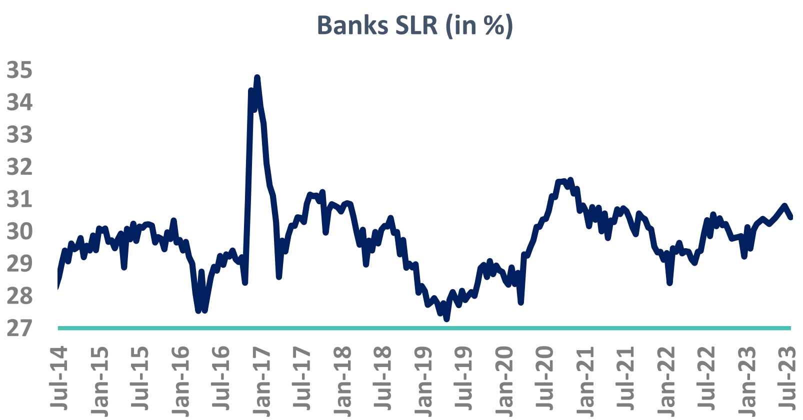
T-bill: Treasury Bill; SDL: State Development Loans

Banks have already bought significantly!

➢ **Banks SLR holdings has risen sharply**
- Part of SLR holding (~1%) is hedges of FRA & TRS, and not naked holdings
- Yet, SLR holding remains high

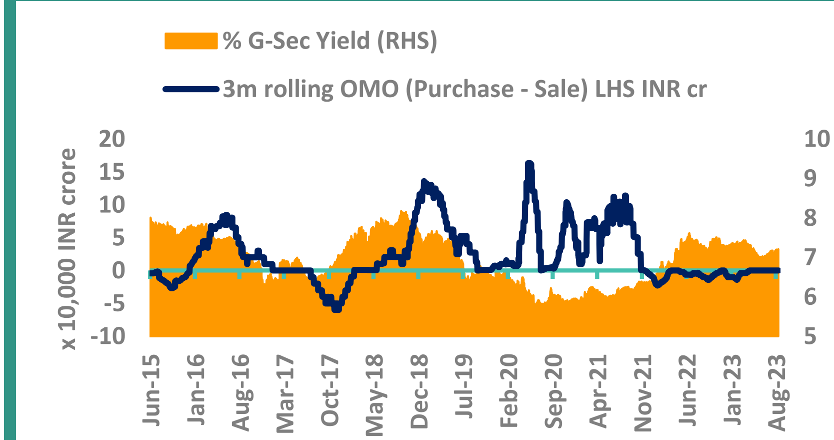
➢ **SLR ratio may reduce, still absolute demand will absorb supply for FY24**
- Natural NDTL growth will still lead to demand

➢ **But banks have bought nearly ₹ 3.5 tn in 4mFy24**
- Rest of the year demand will be muted



➢ **Yields track RBI OMO purchases**
- Yields have strong correlation with RBI OMO
- Demand/Supply mismatch is filled in by RBI

➢ **RBI OMO is pushed to latter half of FY24**



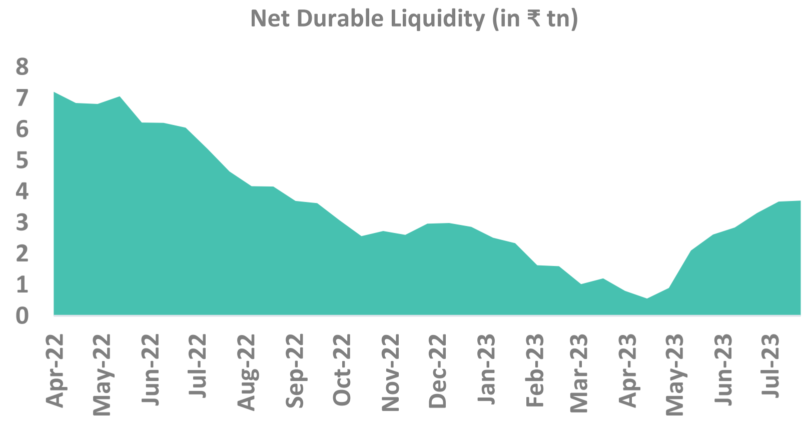
Takeaway:
Banks' probably lesser demand in future to be negative.

Source – Bloomberg, DBIE, Internal

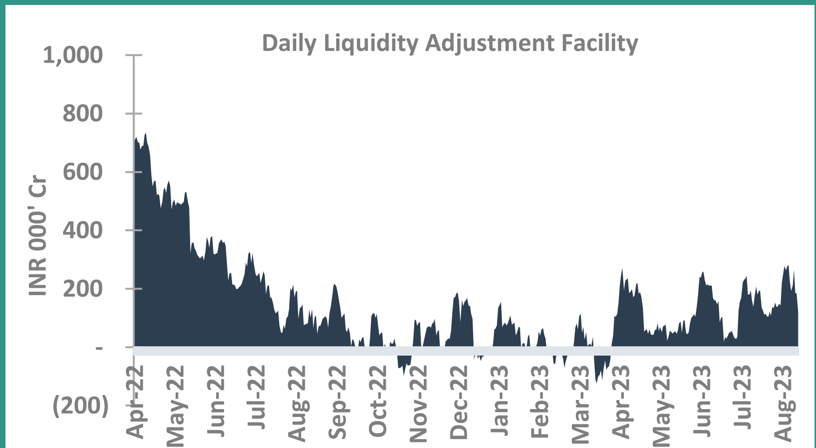
OMO – Open Market Operations, SLR – Statutory Liquidity Ratio; G-Sec – Government Securities; RBI: Reserve Bank of India; FRA: Forward Rate Agreement; TRS: Total Return Swap

Large liquidity overhang continues

- **RBI announced withdrawal of ₹ 2000 notes (Demonetization 2.0)**
  - 88% of ₹ 2000 notes (3.14 tn) in circulation was already returned as of Jul'31
  - Of this, ₹ 2.76 tn was in the form of deposits
- **Core liquidity is comfortable at more than ₹ 3.5 lac crores**



- **RBI announced dividend of ₹ 87K cr**
  - Surpassing budget estimates of ₹ 48K cr
- **Liquidity is expected to remain in surplus for few months**
  - Due to seasonality of liquidity
  - Seasonal infusion of ₹ 45-60K cr as we enter a period of reversal in CIC until Q3FY24



Takeaway:
Liquidity expected to remain adequate

Source – Bloomberg, RBI

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RBI: Reserve Bank of India; CIC: Currency in Circulation

FISCAL POLICY

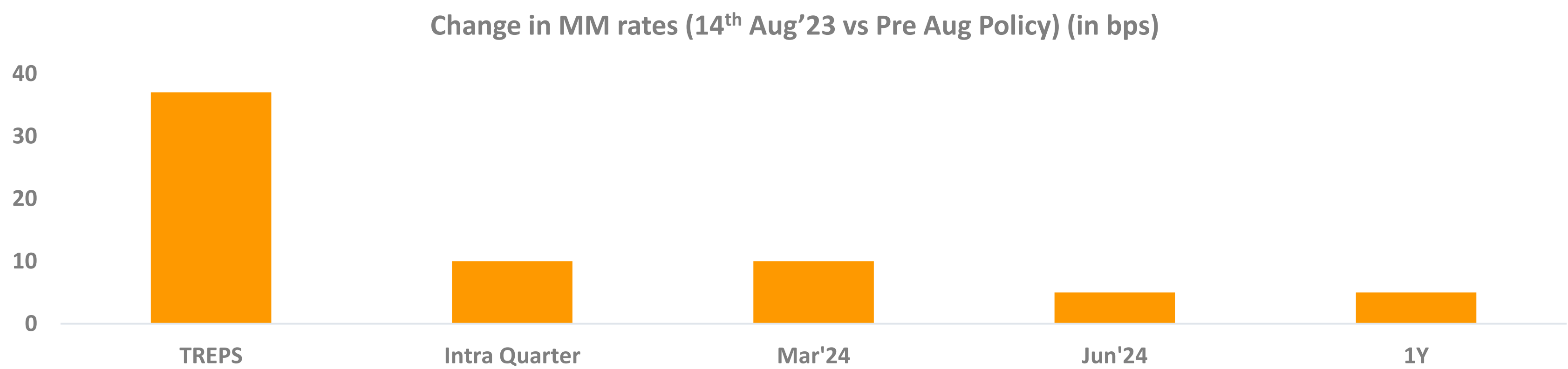
RBI's intent to anchor overnight rates at REPO

RBI introduced incremental CRR (I-CRR) of 10%

- This applies to incremental NDTL between 19th May to 28th Jul
- Expected to suck-out liquidity of around 1.1tn
- To be reviewed on 8th Sep or earlier
- Expected to have a temporary impact on liquidity
  - ✓ However, overnight rates to trade closer to REPO

Background

- Excessive liquidity poses risk to price and financial stability
- Banks were not tendering enough in VRRR auctions which the RBI was using to moderate liquidity
- Overnight rates were hovering at SDF levels



Takeaway:
RBI to keep overnight rates anchored at or around REPO levels

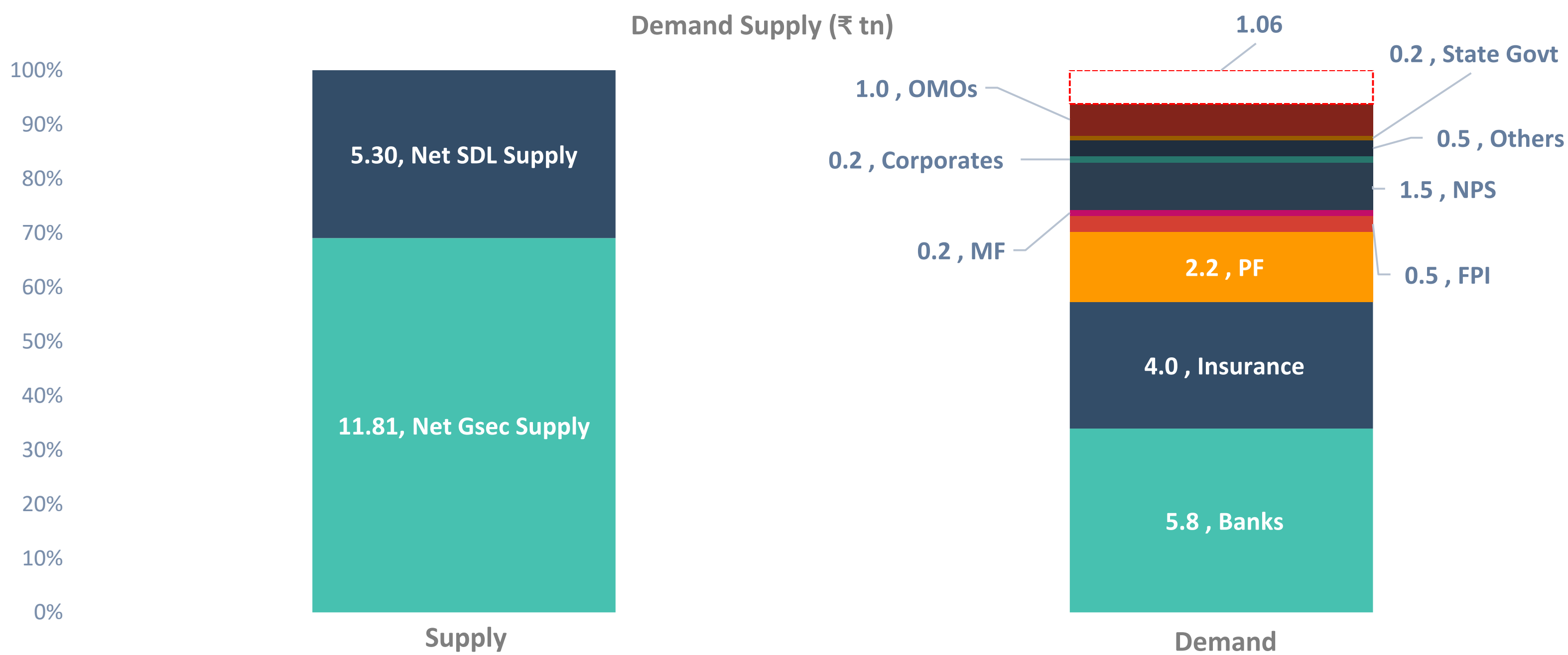
Source – RBI, Internal

I-CRR: Incremental Cash Reserve Ratio; MM: Money Market; NDTL: Net Demand and Time Liabilities; SDF: Standing Deposit Facility; VRRR: Variable Reverse Repo Rate; RBI: Reserve Bank of India

How much is the excess supply

➢ Excess supply can be matched

- ✓ G-sec supply is higher only by 7% over FY23, however demand is expected to rise much more
- ✓ Continuing strong demand from long end investors like EPFO, Insurance and PFs
- ✓ NSSF deposits at ₹ 1.94tn (till June) vs ₹ 1.34tn (till Jun'22)



Takeaway:
Estimated excess supply of ₹ 1.06 tn is not very significant. NPS may grow at 20% (we have taken 13%), Banks may sustain current SLR ratio of 30.5% (we have taken 30%)

Source – Internal, CGA

G-Sec: Government Securities; OMO: Open Market Operation; RBI: Reserve Bank of India; FPI: Foreign Portfolio Investment; NPS: National Pension System; MF: Mutual Fund; SDL: State Development Loans; SLR: Statutory Liquidity Ratio; PF: Provident Fund; EPFO: Employees' Provident Fund Organisation; NSSF: National Small Savings Fund

In last DSP Converse we said that US yields may not drive Indian

No more

With domestic data being neutral and directionless…

We will dance to the tune of US yields.

With less beta, but still correlated

GLOBAL DRIVERS

Indian yields – Dancing to the tune of US Yields

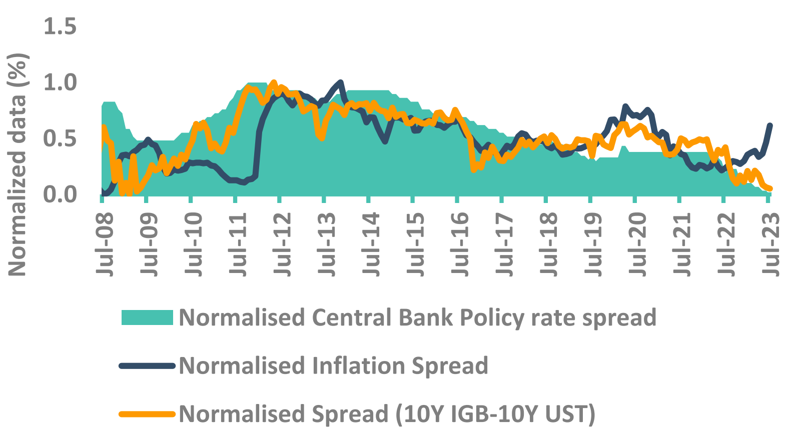
➢ FOMC rate at 5.50% - more hikes at play?

- Labor data has softened, but no conclusive evidence yet
- Tails risks of services inflation remaining sticky

➢ Are spreads of US Treasury and Indian Govt. Bonds low?

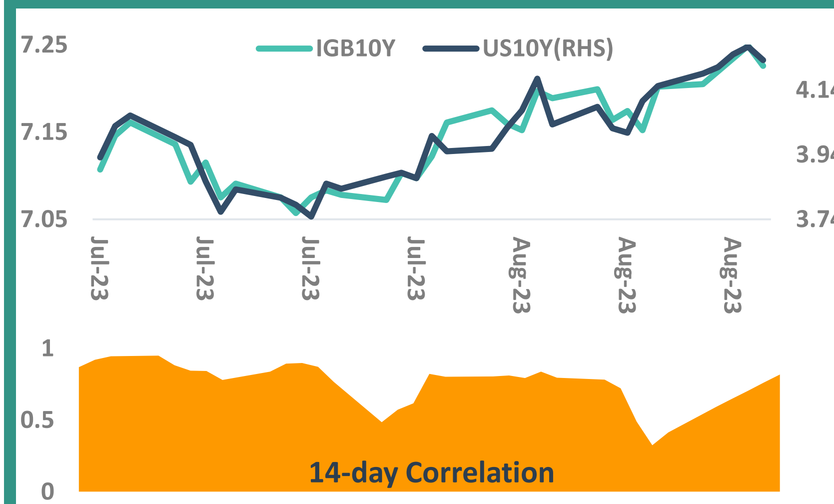
- No, Bond yields difference mimics the inflation and policy rate differential.
  - ✓ 10Y yields seem to have priced in the inflation spread

✓ Even if US yields don't fall, Indian yields may.



➢ Are Indian yields tracking US Rates? Yes

- Domestic data on the neutral side
- Tail risks remain from any large FOMC action
- India yields tracking US yields



Takeaway:
With domestic data being on the neutral side, India yields tracking US yields

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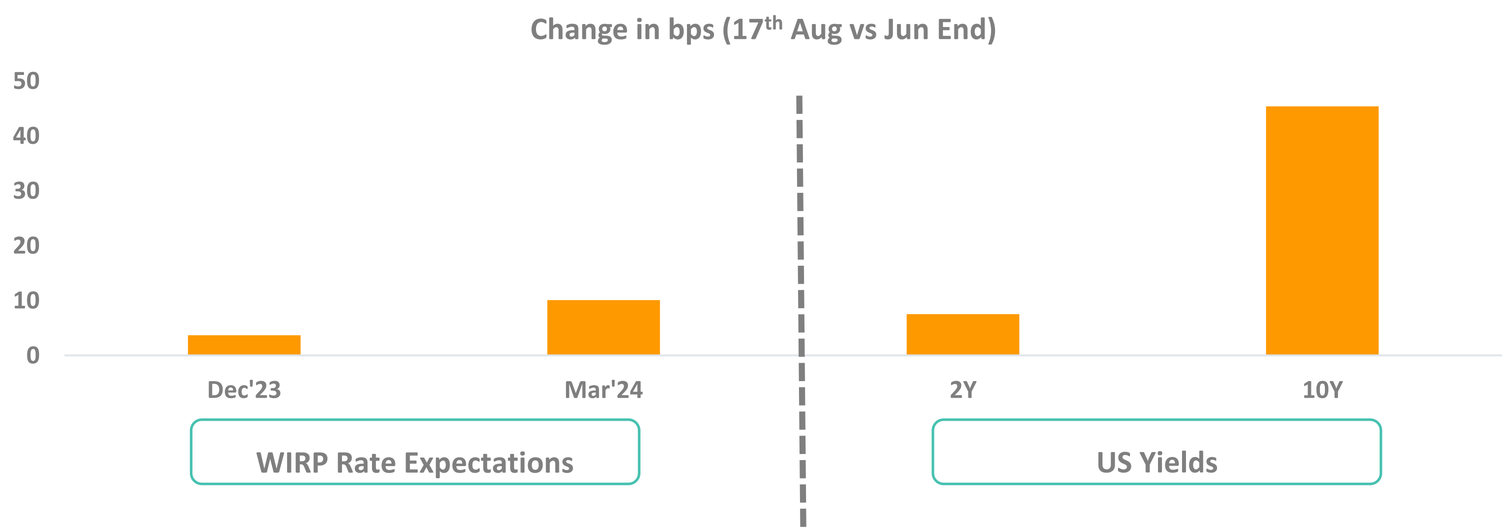
Source – Bloomberg, Internal

Fed: Federal Reserve; CPI: Consumer Price Inflation; RBI: Reserve Bank of India; IGB: India Government Bond; FOMC: Federal Open Market Committee; UST: US Treasury

US Yield Curve and WIRP

➢ US yield curve has bear steepened

- No major change in expectation of rate action by the FED
- However, longer end of the yield curve has moved up
  - Reflects a "higher for longer" view
  - That inflation will only gradually decline, but may be higher than the "2%" in past
  - Excess US fiscal supply, and demand constrained as Quantitative Tightening on



Takeaway:
US yield curve impacted by higher for longer and demand-supply issues

Source – Bloomberg

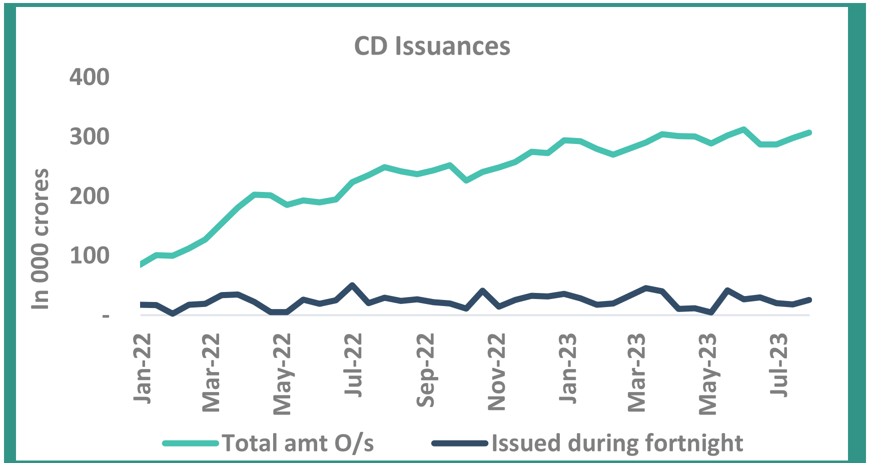
What else

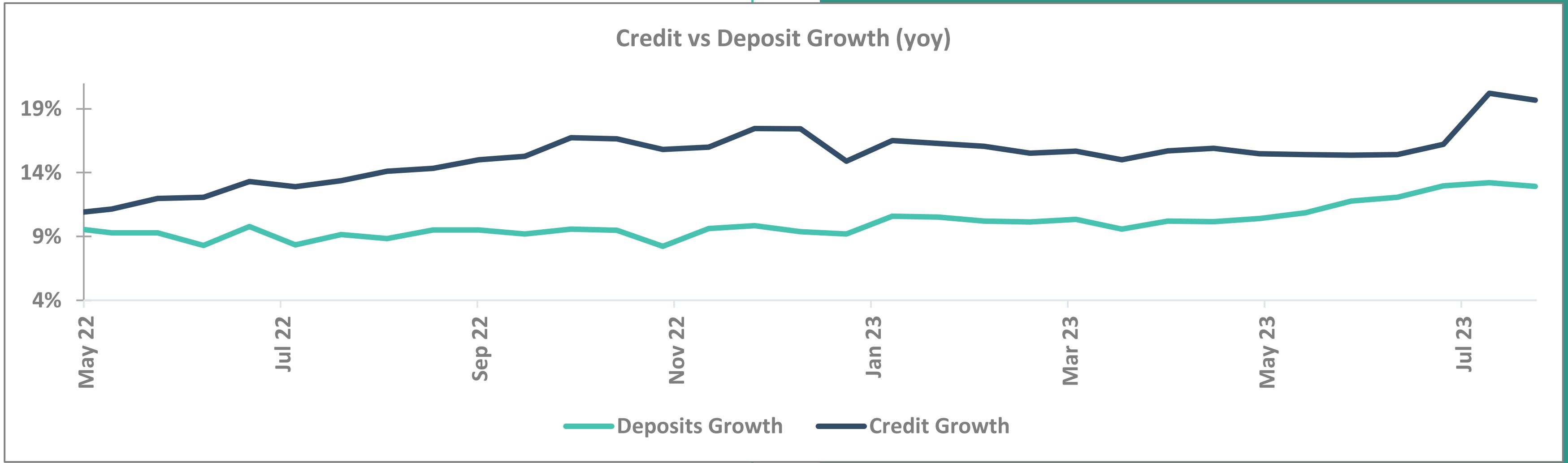
that

can’t be bunched up

Supply-demand and liquidity: Key driver for short end yields

- Divergence between credit and deposit growth continues
- Demand supply seems to be well-matched
- I-CRR (RBI's intent of anchoring overnight rates to REPO) may cause liquidity disruptions
- Expect a volatility of 10-15bps



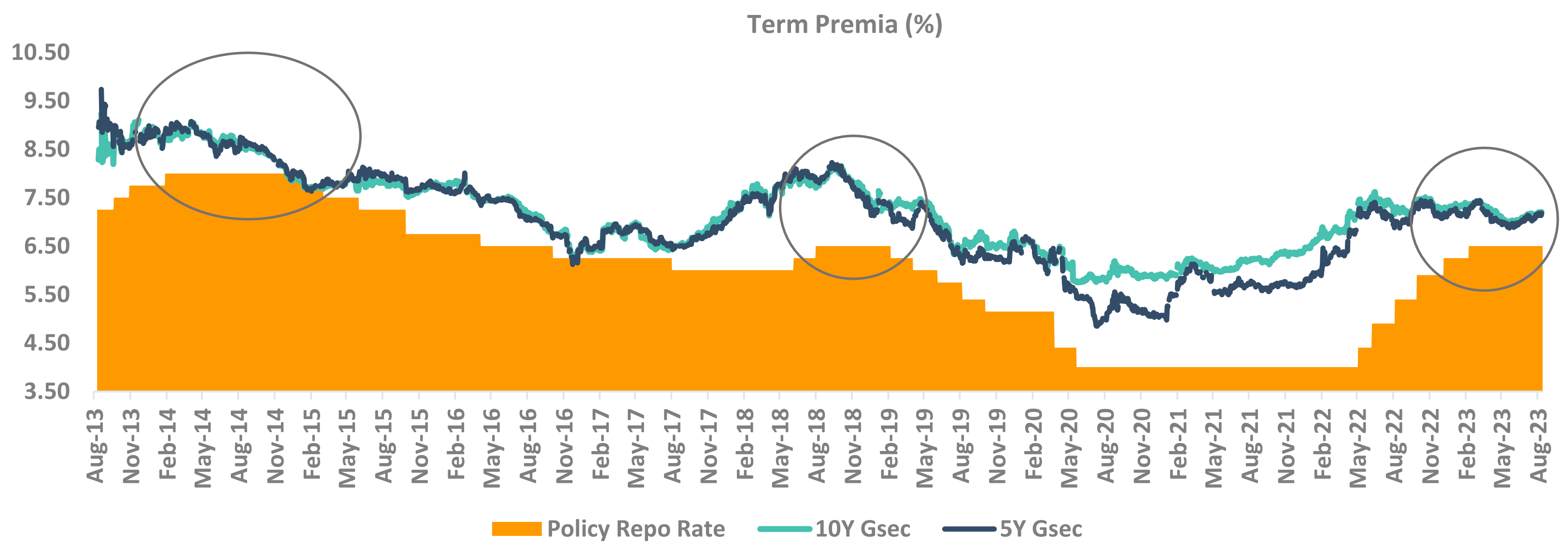


Source – Bloomberg, Internal

CD: Certificate of Deposits; RBI: Reserve Bank of India; T-bill: Treasury Bill, I-CRR: Incremental Cash Reserve Ratio

Term premia: It's a BUY!

- **This slide is the reason why we have long bias – Valuations**
  - So far, every point in our presentation was neutral or hawkish…
- **…But that bad news has been priced in**
- **Even if RBI hikes (unlikely and even then probably last hike)…**
  - The spread with 5-Year bond is 50bp!
  - Take away covid (hikes were expected) and reverse demonetization: currently the spread is neutral…
  - …then price in future rate cuts in FY25 (as in 2014-2017 and 2019) – suddenly bonds are a good buy
- **Since last DSP converse, data has worsened – so have yields. The odds are in favor.**



Takeaway:
India term premium is still high.

Source – Bloomberg

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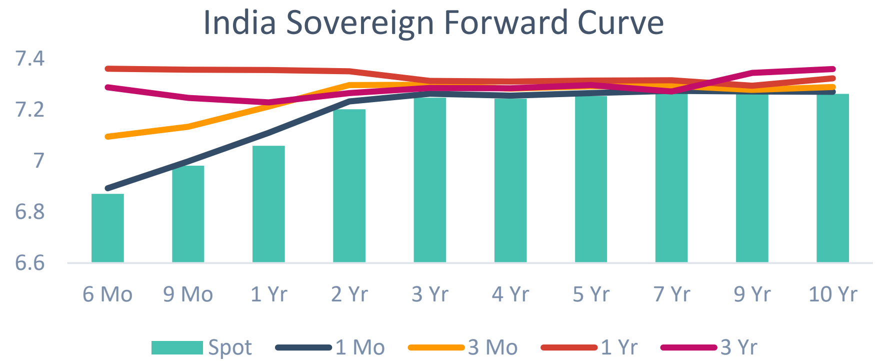
RBI: Reserve Bank of India

DSP FI Framework checklist

Drivers	1Y	5Y	10Y	>10Y	Remarks
Monetary Policy	**Neutral**	**Neutral**	**Neutral**	**Neutral**	
Inflation	Neutral	Neutral	Neutral	Neutral	Latest print stormed by veggies, but fall may be sharp
Growth	Neutral	Neutral	Neutral	Neutral	Growth continues to be robust; global slowdown can pose a risk
CAD/BOP/ Currency	Neutral	Neutral	Neutral	Neutral	External sector pressures low, however, EM reaction makes rupee vulnerable
Fiscal Policy	**Neutral**	**Neutral**	**Neutral**	**Neutral**	
Supply	Positive	Positive	Positive	Positive	H1FY24 has higher issuances in longer tenor; SDL issuances to have limited impact
Demand	Negative	Negative	Negative	Negative	Banks demand should lessen, yet sufficient to absorb supply
FPI Flows	Neutral	Neutral	Neutral	Neutral	No meaningful flows expected
Global	**Negative**	**Negative**	**Negative**	**Negative**	
Global yields	Negative	Negative	Negative	Negative	US data has softened, but less than expected
Geopolitics	Negative	Negative	Negative	Negative	US-China trade war could disrupt supply-chain, Russia Ukraine war not over yet
Commodities	Neutral	Neutral	Neutral	Neutral	Risks balanced
Others	**Mildly Negative**	**Neutral**	**Neutral**	**Neutral**	
RBI Regime	Neutral	Neutral	Neutral	Neutral	RBI will be influenced by Fed action
Miscellaneous	Mildly Negative	Neutral	Neutral	Neutral	CRR hike may be temporary but its impact more lasting as the overnight rates may end up being higher as banks use VRR more.
Total	**Mildly negative**	**Mildly negative**	**Mildly negative**	**Mildly negative**	

DSP Duration decision: Negative data priced in. Valuation attractive



The chart shows how much expected yield fall/rise is already priced in the current curve.

Large gap between the current yield and forward yield shows that yield change is priced in – and thus yield change will not give capital gain/loss.

Similarly small gap means that the market is not pricing change in yields.

DURATION DECISION

➢ Market expects yield curve to remain flat

- The future rate curve is close to current yield curve, expecting yields to remain range bound

Maturity	1Y	5Y	10Y	>10Y	Remarks
What's expected (Total)	**Mildly Negative**	**Mildly Negative**	**Mildly Negative**	**Mildly Negative**	**From previous slide**
Is expectation (above row) priced in ?	Yes	Yes	Yes	Yes	At current yields levels (after recent rise) the higher rates have been priced in.

Source – Bloomberg; as on 17/Aug/23

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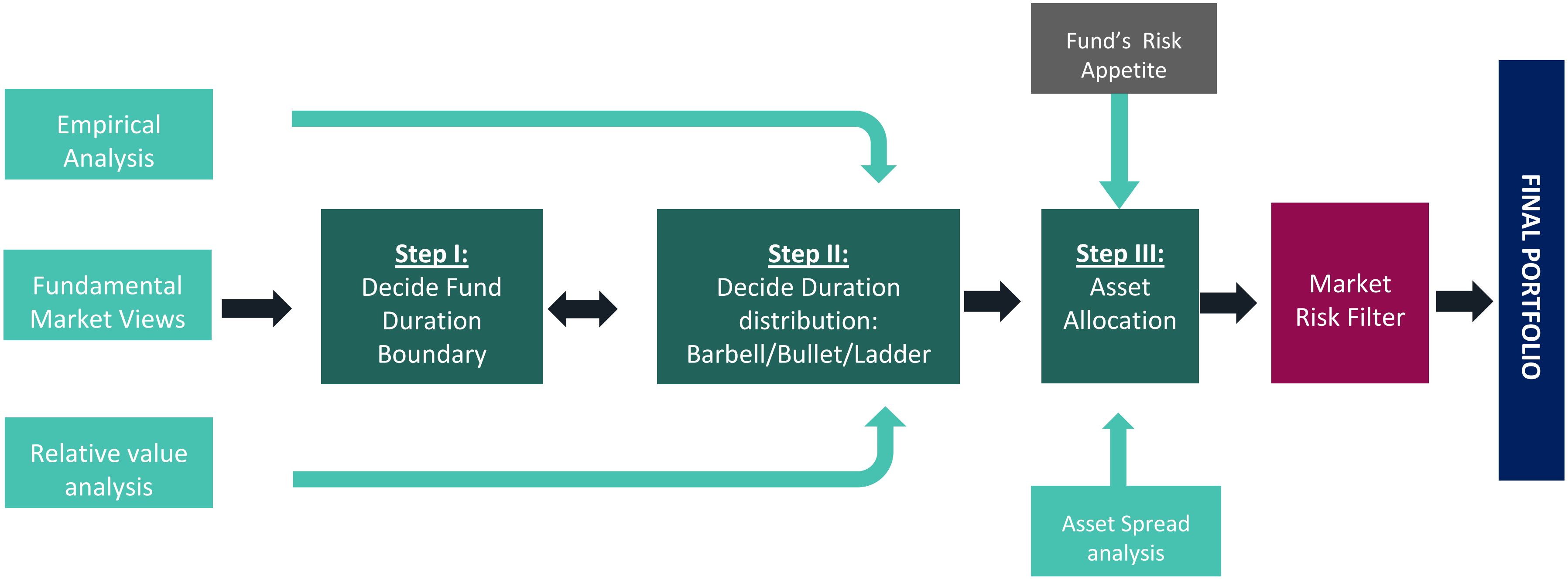
Done with our market view framework?

Now

Our Portfolio creation framework

DSP Portfolio Creation: Multi-step process

DSP Fixed Income Funds follow a defined methodology for fund portfolio construction



- We apply market risk filter which can help the Fund Managers not to take extreme risks. Thus, Value at Risk is limited by ensuring the positions are balanced.

DSP Credit Investment Process – Better Safe, than Sorry!

CREDIT PROCESS

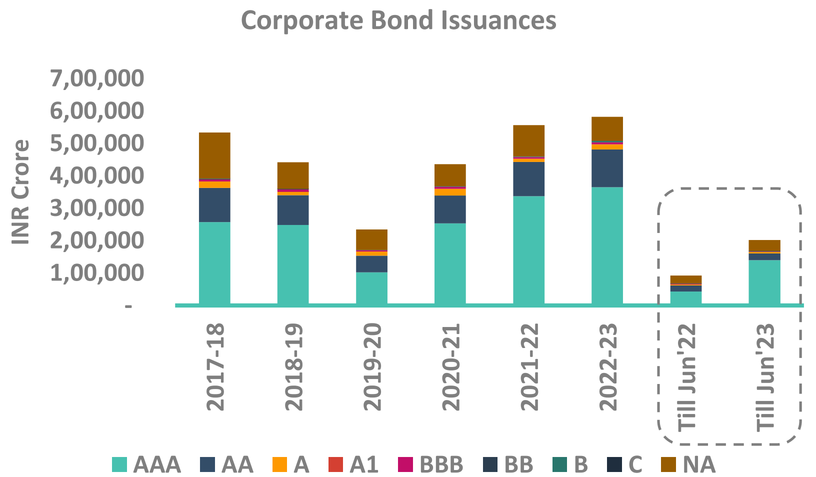
Credit evaluation	Information sources	Decision	Monitoring
Macroeconomic factors and Industry Outlook	Financial results & presentations	Limit Setting by Credit Committee	Material Events and its Impact
Promoter reputation and Management depth	Promoter and Management Discussion		Early Warning Indicators
Business Profile & Market position	Rating agency feedback		Questioning Management Guidance
Financial due diligence & Cash flow analysis	Sell Side Research & Equity analyst feedback	Investment Decision by Fund Manager	Movement in Spreads
Ability to refinance / Ability to exit	Lender's feedback		Who has exited?

DSP Asset Allocation: Corporate bonds vs. Sovereign Bonds

Higher supply of corporate bonds so far

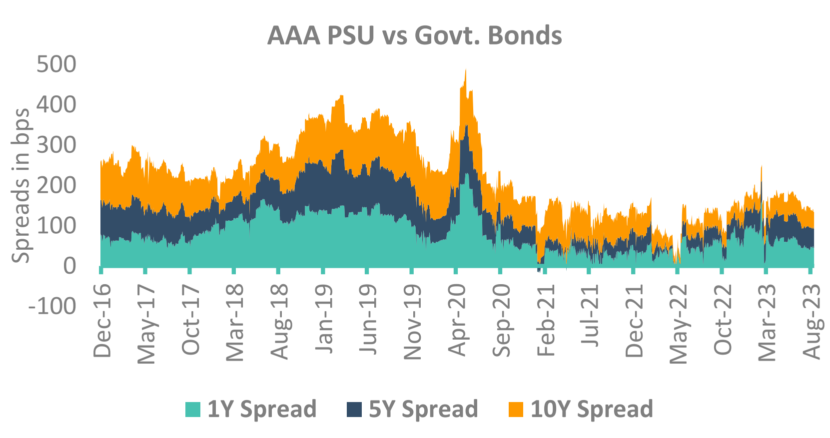
- Q1FY24 issuance at ~2x of Q1FY23 led by AAA rated segment
- AAA supply decreased from ₹ 77k crores in June to ₹ 49k crores in July
- PSU & NBFC supply slowed down this month as issuers await further clarity on rates & liquidity

Issuances expected to pick up again in Sep



The corporate bond spread remains elevated

- 2-3Y NBFCs providing steady accrual
- AAA PSU Spreads remain to be in the narrow band of 45-55bps
- Demand-supply well-matched & expected to remain the same



Takeaway:
Corporate bond spreads near their long term average, spread curve flat.

Source – Bloomberg, CCIL, Internal

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PSU: Public Sector Undertaking, NBFC: Non-Bank Financial Companies

Key Risks associated with investing in Fixed Income Schemes

Interest Rate Risk - When interest rates rise, bond prices fall, meaning the bonds you hold lose value. Interest rate movements are the major cause of price volatility in bond markets.

Credit risk - If you invest in corporate bonds, you take on credit risk in addition to interest rate risk. Credit risk is the possibility that an issuer could default on its debt obligation. If this happens, the investor may not receive the full value of their principal investment.

Market Liquidity risk - Liquidity risk is the chance that an investor might want to sell a fixed income asset, but they're unable to find a buyer.

Re-investment Risk: If the bonds are callable, the bond issuer reserves the right to "call" the bond before maturity and pay off the debt. That can lead to reinvestment risk especially in a falling interest rate scenario.

Rating Migration Risk - If the credit rating agencies lower their ratings on a bond, the price of those bonds will fall.

Other Risks

Risk associated with

- floating rate securities
- derivatives
- transaction in units through stock exchange Mechanism
- investments in Securitized Assets
- Overseas Investments
- Real Estate Investment Trust (REIT) and Infrastructure Investment Trust (InvIT)
- investments in repo of corporate debt securities
- Imperfect Hedging using Interest Rate Futures
- investments in Perpetual Debt Instrument (PDI)

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