DSP

#INVESTFORGOOD

March 2023

Penny wise, Pound foolish? Why wait?

DSP CONVERSE

SUMMARY

We asked to invest in duration last month.

Continue investing in duration..

At this time, risks to yields rising are limited

Our View – Summary

➢ Risks to yields moving higher greatly diminished

We believe we are close to peak yields; thus risk/reward gravitates towards a long duration position:

1. **Favorable Demand-Supply:** Announced govt borrowing for FY24 is just 8% more than FY23. Demand expected to grow at faster pace. No more G-sec auction/supply for the rest of the month.

2. **RBI OMOs:** In FY24, RBI will finally purchase govt bonds, after a gap of more than 1-year.

3. **Lag effect of rate hikes:** The rate hikes have few quarter lag. The impact in economy will start showing now. Not just lower inflation, but economy slowdown and unknown event risks are heightened across the globe.

➢ Risks to our view, however at current yields these risks seem to be priced in

We had mentioned three reasons for yields to be under pressure in this quarter.

1. **Rupee depreciation:** We are confident that the BoP risks are still not behind us, despite rupee stability in recent weeks. However, these risks seem to be overshadowed by the positive drivers.

2. **Global inflationary pressures could recur:** Inflation is a difficult beast to predict. While we expect inflation to come down globally – but who knows!

3. **Liquidity:** Liquidity continues to tighten which has been pushing the short end yields up. But there is a risk that RBI might delay its liquidity infusion actions – especially if there is concern on currency.

➢ Risk/Reward to buy duration

For long duration investment: With low chances of yields spiking up, we advise to add duration. The event risks also favor long bonds.

For money markets investment: We like the 1-year segment because of its high term premium. The high carry is lucrative. Central banks stance change will lead to fall in yields in this segment.

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Fed: Federal Reserve; RBI: Reserve Bank of India; G-Sec: Government Securities; OMO: Open Market Operation

To start with,

What has **changed** since last Converse edition?

Firstly, in India

Inflation surprised on the upside.

Driven by cereal prices statistical anomaly.

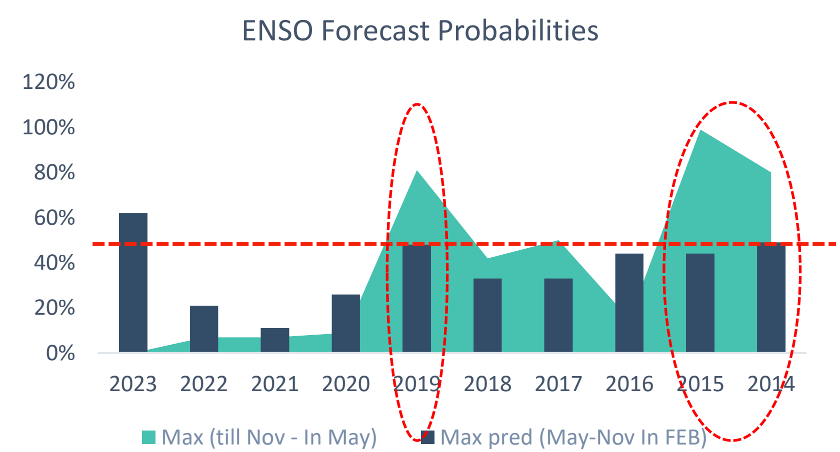
El Nino a real possibility, though not a major risk.

EL-NINO

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

- **CPI in Jan & Feb surprised on the upside, led by higher cereal prices**

- **EL Nino risks, could impact monsoon**
  - EL Nino probability rises to 60% in May-Nov 23
  - For comparison, EL Nino probability in previous occurrences was less than 50% (2014, 2015 and 2019)



El Nino impact on cereal prices was inconclusive as per past data

- However, heat conditions could impact the wheat production
- With wheat reserves at very low levels (of 154 lakh tonnes), the supply could be tight
- Yet rice/paddy reserves are robust to absorb shocks

	FY15	FY16	FY20	FY21	FY22	FY23
Wheat						
Production Growth (YoY)	-10%	7%	4%	2%	-3%	5%
Opening Stock (Feb) (lac ton)	251	203	304	318	283	154
Rice						
Production Growth (YoY)	-1%	-1%	2%	5%	5%	0%
Rice + Un-milled Paddy Stock						
Opening Stock (Feb) (lac ton)	305	352	533	632	756	622

Takeaway:
El Nino looks like a likely possibility at this time. However, past data does not conclusively show any impact on cereal inflation

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El Niño, La Niña, and the Southern Oscillation, or ENSO; Source: Columbia Climate School, Internal

CPI: Consumer Price Index

Secondly, Global Central banks remain **Hawkish**

- Labour markets remain tight in US
- Inflation remains high and sticky
- Stance may be diluted, due to banks contagion risk

But we don't expect pause yet.

But most importantly,

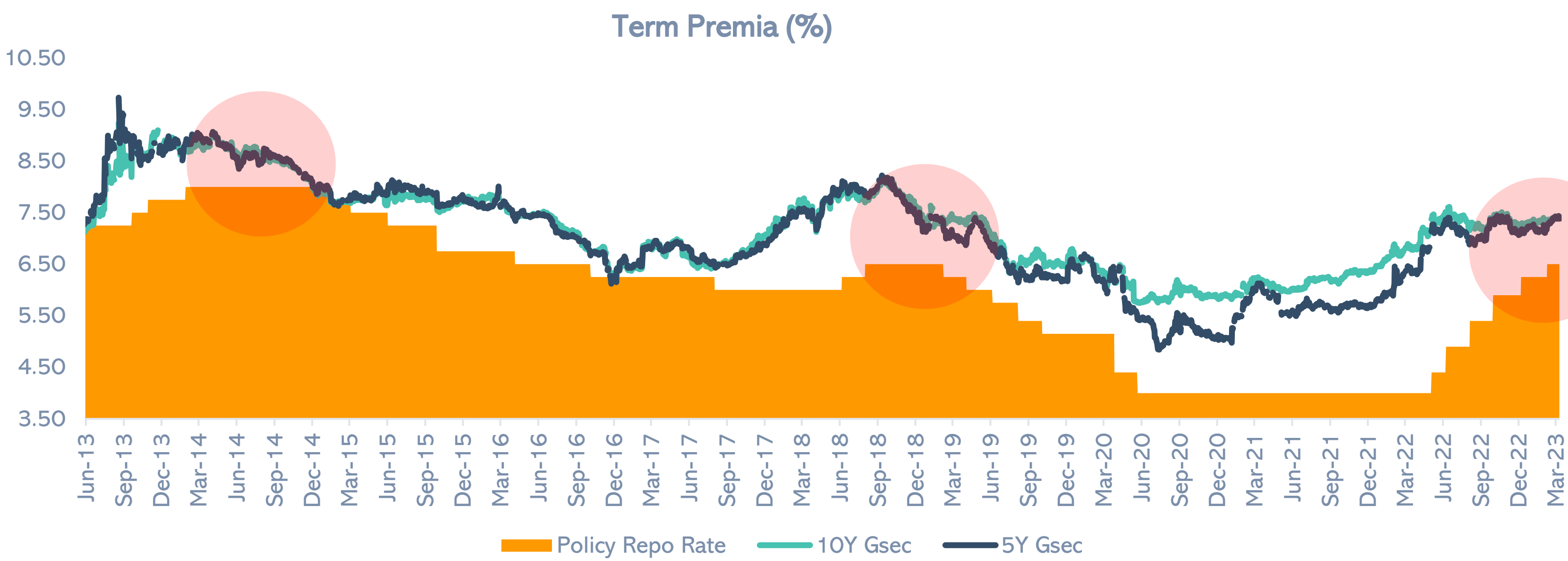
Closer to a Pause in the rate cycle.

But we do expect another hike by the MPC.

Why add duration when we expect policy rate hike?

- **Closer to peak rates the term premia reduces considerably**
  - In 2014, the term premia reduced – with long term yields below repo before rate cuts
  - In 2018, term premia crashed at peak rates
  - Both these instances led to rally in duration yields

- **Thus further rate hike(s) may not lead to much increase in duration yields**



Takeaway:
Term Premia has been low historically in years of high policy rates.

Source – Bloomberg; Data as on 10/3/2023

OIS – Overnight Indexed Swap

Now our framework

And

What we track

Our Framework

Monetary Policy

Inflation
- CPI surprised on the upside
- Core inflation continues to remain sticky

Growth
- Domestic activity resilient
- Exports remain weak due to slowing global demand

Currency/CAD/BOP
- Current Account Deficit still high, but falling
- BoP inflows probably increased

Fiscal Policy

Supply
- Low supply of G-Secs
- SDL supply unclear

Demand
- Banks SLR holding has been increasing
- RBI OMO expected in FY24

FPI
- FPI unlikely to sell: holdings already at low
- FPI unlikely to buy: low yield differential

Global Drivers

Global Yields
- Why is the gap between US and India bond yield so low?
- US labor market remains strong
- Hawkish central banks

Geopolitics
- Ukraine war extension

Commodities
- Price risks evenly balanced

Others

RBI Regime
- Divergence between MPC members?
- Focused on curtailing inflation

Misc.
- Liquidity to tighten further, albeit at a lower pace
- Yet, further tightening may lead to CRR cut, followed by OMO

Takeaway:
Parameters point to lower yields. The risk/reward indicates a long position in bonds.

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Source – Internal

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; CPI: Consumer Price Index; MSP: Minimum Support Price; OMO: Open Market Operation; FPI: Foreign Portfolio Investment; MPC: Monetary Policy Committee

Let’s take a look at

Monetary policy

Likely to be less hawkish than in past…

Will keep short-term rates capped

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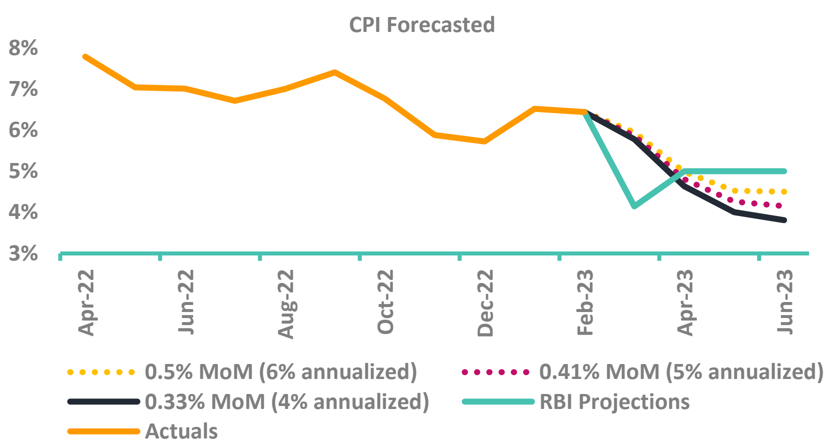
How persistent is core inflation?

Remains Above 6%

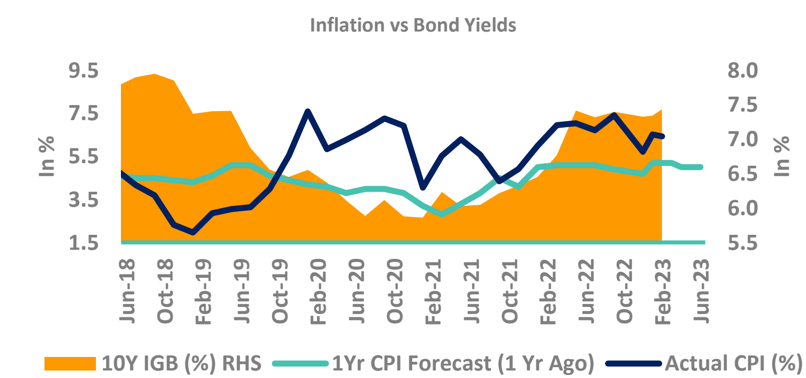
Another 25bps hike on the cards

Inflation concerns continue; El Nino not a major risk

- **CPI higher than expectation for both Jan & Feb 23**
  - Driven by high food prices and higher core inflation
    - Cereal prices led to statistically higher inflation
  - Followed two months of low CPI in Dec 22 & Nov 22
  - Core continues to remain sticky & elevated
- **RBI's revised Q4 target of 5.7% looks difficult now**



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



Takeaway:
Sticky core should lead to RBI rate hike of 25bps in April unless Fed action surprises in the next policy.

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Source – RBI, CSO, Bloomberg

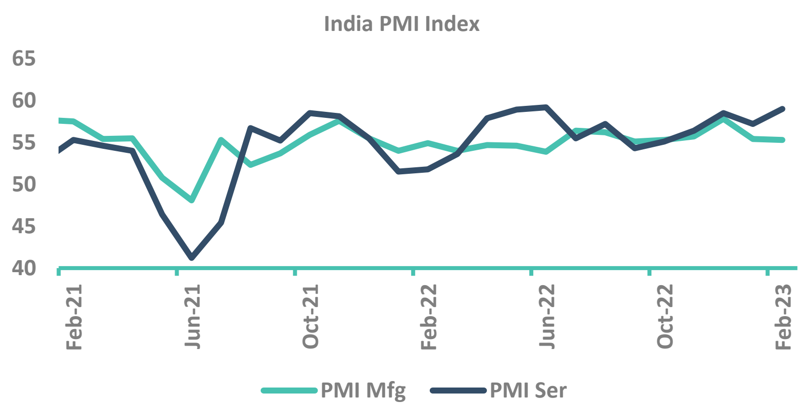
CPI: Consumer Price Inflation; RBI: Reserve Bank of India; IGB: India Government Bond

Growth not a big driver right now

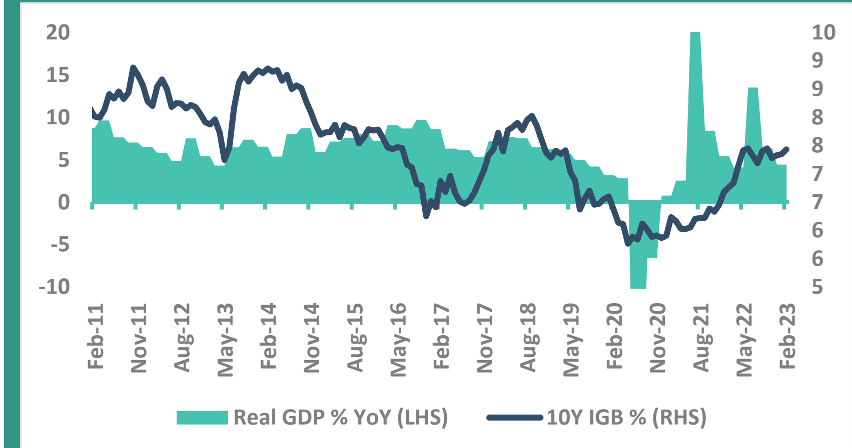
skip the next slide if in hurry

Will global slowdown test domestic resilience?

- **Domestic growth resilient as PMI continues to be in expansionary mode**
  - Feb '23 Mfg. PMI at 55.3 vs 55.4 in Jan 23
  - Services PMI up to 59 (vs 57.5 previous month)
  - GST collections picked up
    - ✓ Feb 23 collections stood at INR 1.5tn (up 12% y-o-y)
    - ✓ Above ₹ 1.4 tn for last 12 months
- **Risks of global slowdown are playing out**
  - Trade deficit narrowed to USD 17.7bn in Jan 23
  - Exports continue to decline, due to decline in global demand



- **How closely do yields track growth?**
  - Yields have usually tracked GDP growth, with correlation being stronger when growth slows, barring
    - ✓ 2013, when rupee depreciation and debt outflow
    - ✓ 2017, during demonetization
- **FY24, growth may not be big driver for yields**
  - Q3FY23 GDP came in at 4.4%, in line with RBI projections



Takeaway:

Domestic growth seems resilient despite global slowdown fears

Source – Bloomberg

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GDP: Gross Domestic Product; PMI: Purchasing Managers' Index; GST: Goods and Service Tax; IGB: India Government Bond; Mfg: Manufacturing

So far we have been mentioning

" When rupee depreciates

RBI hikes"

No matter what the inflation!

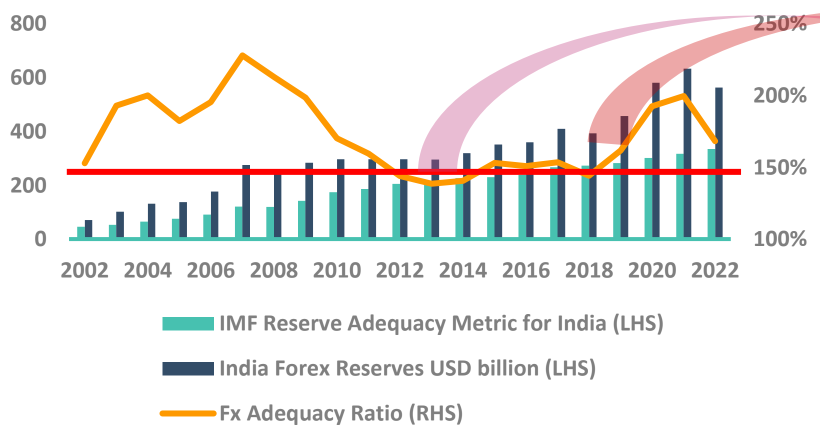
Did you know – when our Fx reserves dip, RBI hikes

RBI FX reserves on a downtrend

- Forex reserves down from USD574 bn (in Jan 23) to USD562 bn (Mar 23)
- Majority of the change in reserves caused by valuation

RBI FX Reserve / IMF FX adequacy ratio declined sharply

- Buffer of ~USD 70 bn to reach 2013 and 2018 levels (~150% ratio)



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

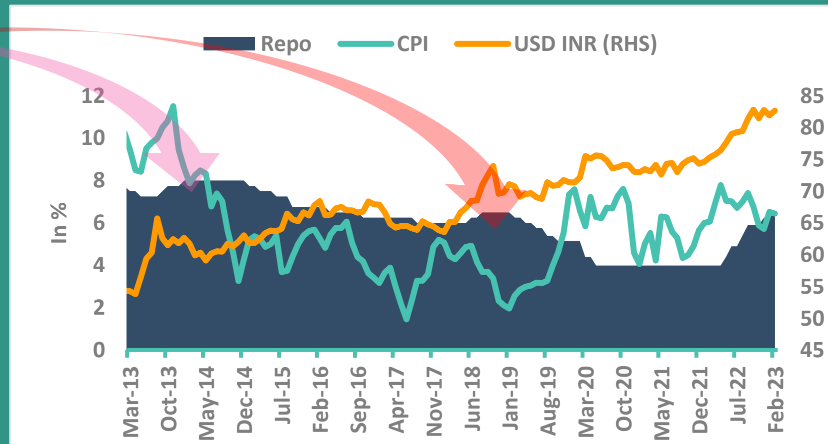
- Increased rates to control rupee, not inflation

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:
Foreign exchange reserves continue to remain low

Source – Bloomberg

DSP

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

But question now is not hikes,

But what will make RBI

Pause the rates!

What drives pauses: Series of hygiene factors

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 FED has indicated lower *ongoing* hikes**

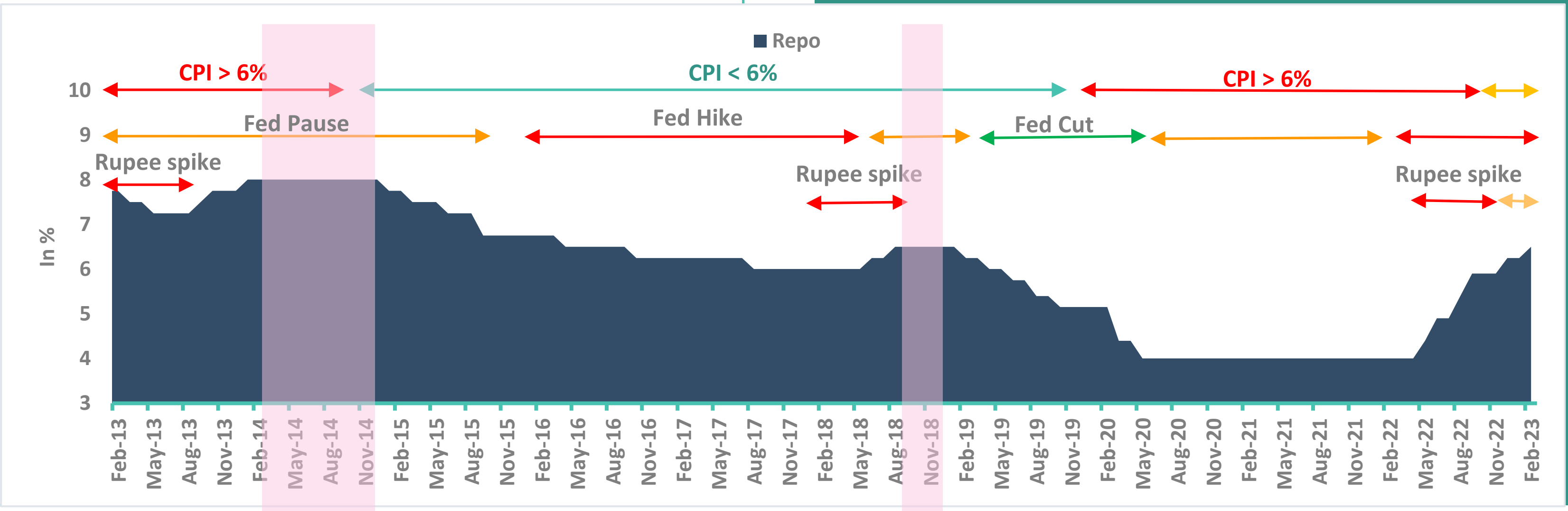
- US yields much lower, expecting rate cuts in CY23
- RBI talking in Fed's voice

✓ **B: Inflation moderating to comfort zone**

- While CPI >6%, but base effect will bring it lower

X **C: BoP (rupee) still remains a concern**

- Most economist expect muted BoP of around USD 10bn
- However valuation gains have increased FX reserves



Takeaway:
We expect another rate hike, yet closer to pause

Source – RBI, Bloomberg

RBI: Reserve Bank of India; IMF: International Monetary Fund; US FED: US Federal Reserve; BoP – Balance of Payment

We expect RBI to tone down its stance

Either 25bp hike, with chances of future pause.

Or,

a pause, with chance of future hike

Let’s turn to **Fiscal policy**

Generally, it drives the long bond yields

It is reflected in demand/supply mismatch

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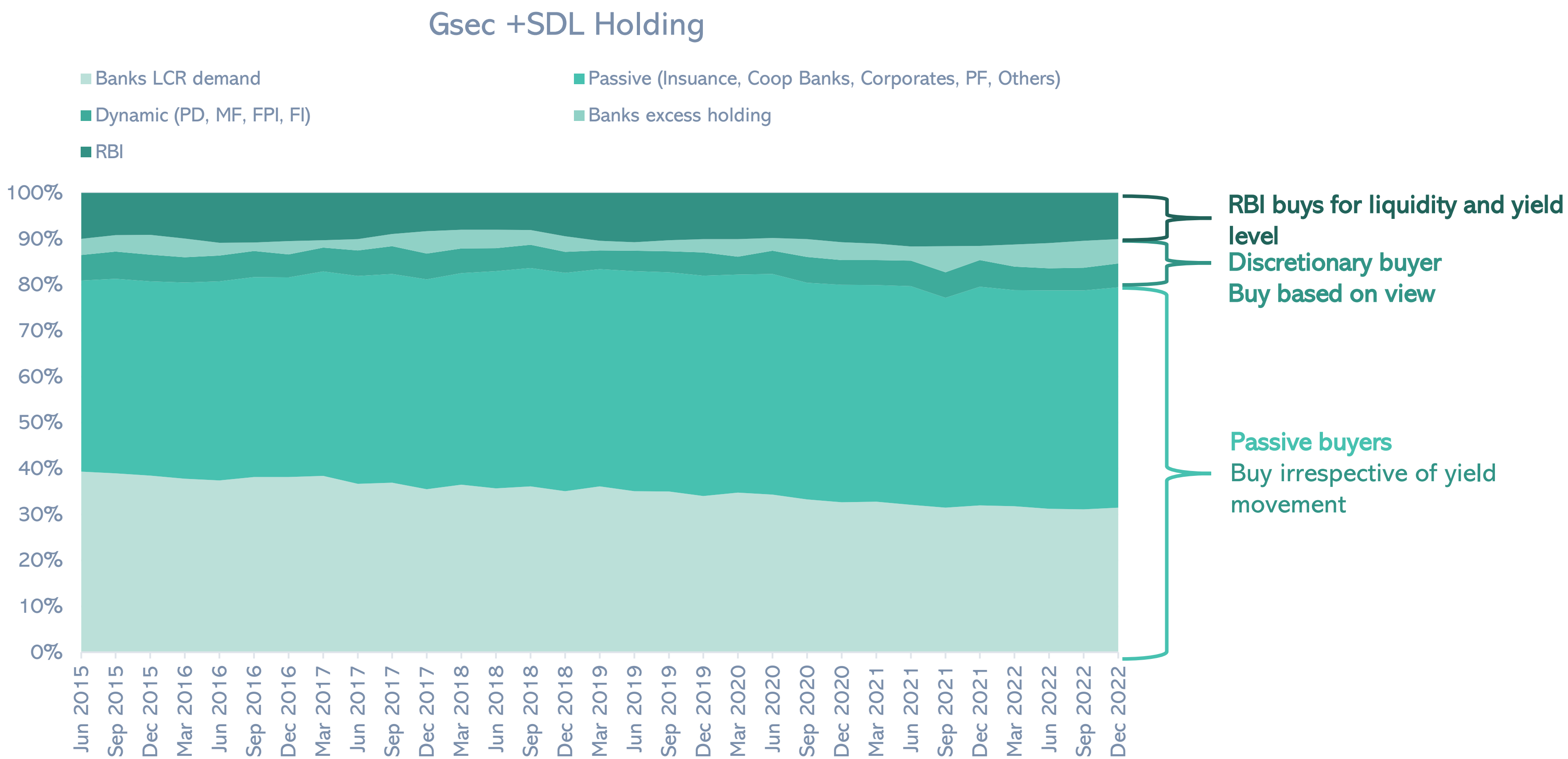
Only small part of bond buyers are discretionary buyers.

They drive yields.

Supply fluctuations is borne by these buyers.

FISCAL POLICY

Gsec market still driven by lumpy institutions



Takeaway:
Increase in supply impacts the discretionary buying. Banks excess holding and Passive buyers have absorbed the supply so far.

DSP

Source – DBIE

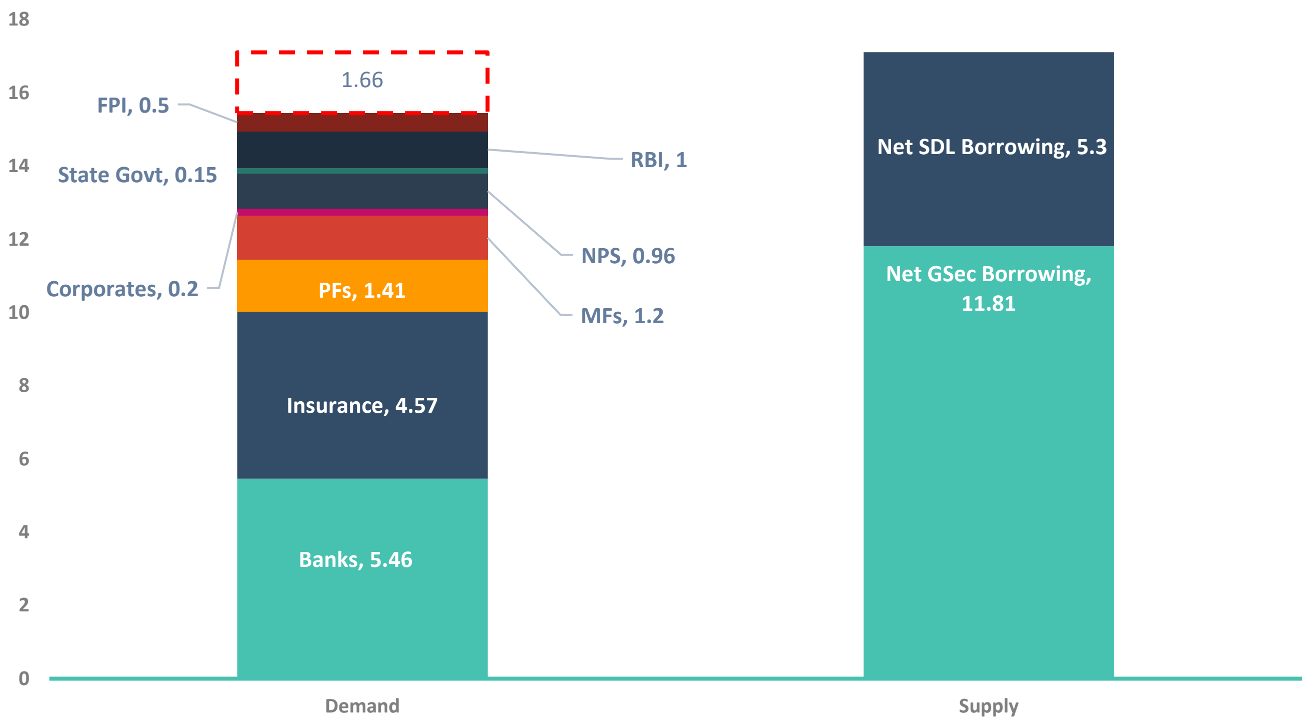
LCR – Liquidity Coverage Ratio; SDL – State Development Loans; PF – Provident Funds; PD – Primary Dealerships; MF – Mutual Funds; FPI – Foreign Portfolio Investors; FI – Financial Institutions; RBI: Reserve Bank of India; G-Sec: Government Securities; SDL: State Development Loans

Comfortable supply/demand dynamics for FY24

Supply is just about ₹ 1.7 lac cr. more than natural demand

How much is the excess supply

- **Excess supply can be matched by**
  - ✓ G-sec supply higher only by 7% over FY23, however demand is expected to rise much more
  - ✓ Continuing strong demand from Banks and long end investors like EPFO, Insurance and PFs
  - ✓ Limited room for OMO purchases by RBI as minimal G-sec maturities this year



Takeaway:

Estimated excess supply of INR 1.67 tn not very significant, considering any increase in SLR holdings by banks can substantially reduce the gap

DSP

Source – Internal

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

Demand – In neutral zone for FY24

Banks SLR holdings has risen sharply

- Part of SLR holding (~1%) is hedges of FRA & TRS, and not naked holdings
- Yet, considering tight liquidity, SLR holding remains high

While the holding ratio may reduce, on absolute levels demand will absorb supply

- SLR holding ratio will trim in FY24, but not substantially
- Natural NDTL growth will still lead to demand

Banks SLR (in %)

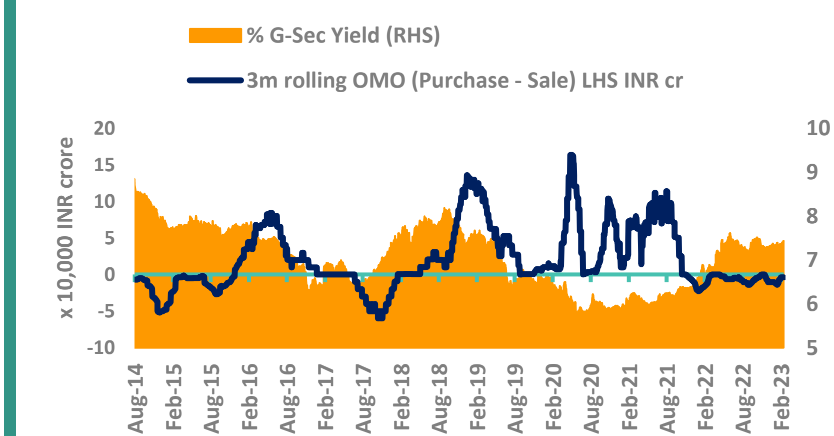
Yields track RBI OMO purchases

- Yields have strong correlation with RBI OMO actions
- Demand/Supply mismatch is usually filled in by RBI

RBI OMO expected in FY24 as

- RBI balance sheet rise muted due to less USD inflow
- Gap to be filled by OMO purchase & CRR
- Liquidity on path to neutrality due to CIC outflow

RBI OMO may be delayed, and not front ended



Takeaway:
Demand – Supply is broadly balanced, but new buyers can provide fillip

Source – Bloomberg, DBIE, Internal

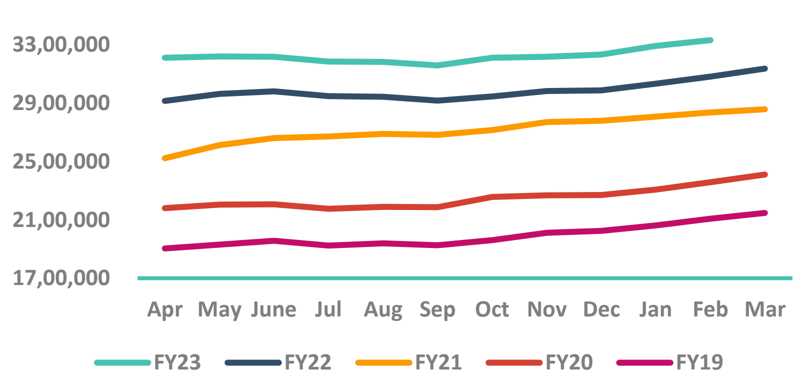
DSP

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

RBI OMO: Delayed but coming in FY24

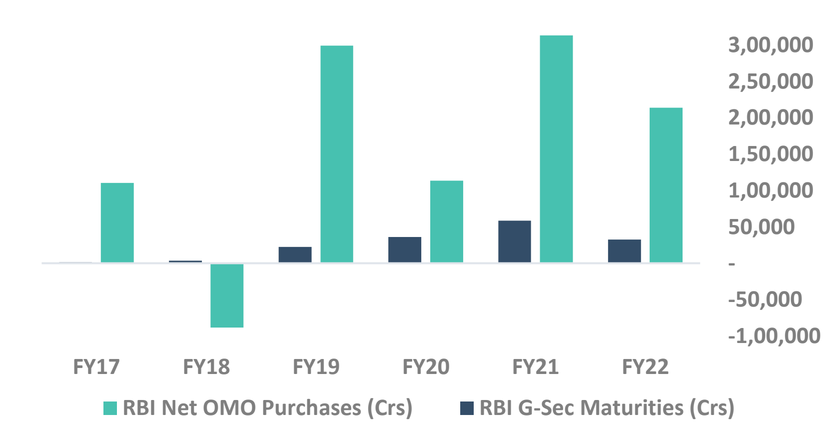
Liquidity will continue to tighten. Why?

- **Firstly, Currency in circulation is cyclical**
  - Jan-May is when CIC increases
  - Expect liquidity to tighten more by May
- **Secondly, unlikely that the BoP will be large**
  - Thus, reduces possibility of FX driven liquidity infusion
- **RBI OMO in FY24 likely when liquidity tightens further**



Reasons why OMO may get delayed, but will occur:

- **RBI will possibly reverse FY23 CRR hike as first step**
- **Bond maturities may not reduce RBI balance sheet**
  - RBI has switched short tenor bonds with Govt
  - Natural reduction of balance sheet (& liquidity) is lesser
  - Similar to FY17 (post demonetization)
    - RBI exhausted its short-term G-sec through OMO sale.



Takeaway:
RBI to conduct OMO Purchases when liquidity tightens. Expected to be in FY24

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Source – Bloomberg

RBI: Reserve Bank of India; CIC: Currency in Circulation; OMO: Open Market Operation; CRR: Cash Reserve Ratio; G-Sec: Government Securities; BoP: Balance of Payment

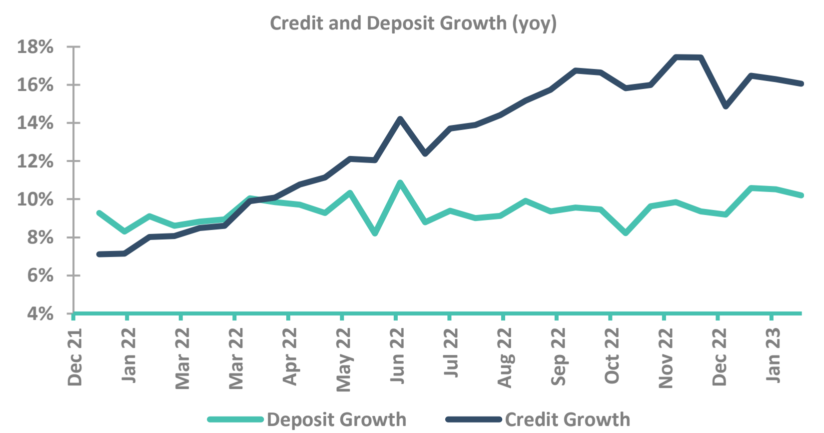
Attractive Spreads in

short tenor (~1 year)

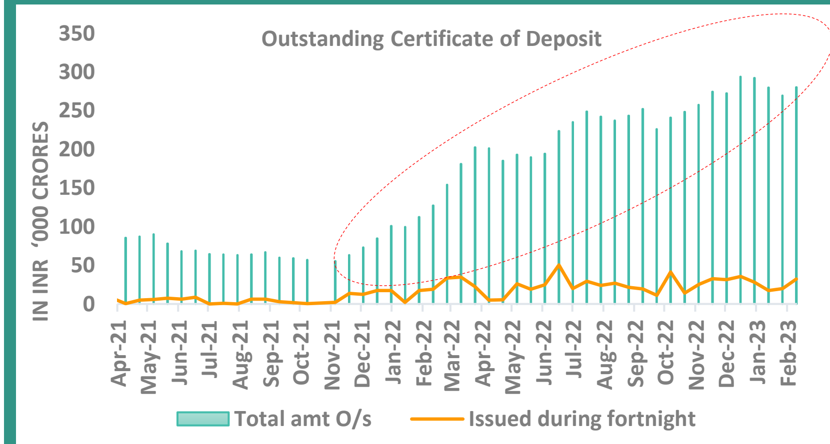
may not last long into next FY

Where are the shorter end rates headed?

- **Pace of credit growth likely to taper**
  - It is already reduced from earlier highs
  - Likely reduction in working capital requirements
    - Easing commodity prices
    - Lower supply chain bottlenecks
  - Capex may get moderated with faltering global growth



- **Growth of banks' CDs may taper**
- **Signaling of future pauses will lead to yield rationalization**
- **However, tighter liquidity will limit the fall in short term rates**



Takeaway:
Short term yields currently high due to supply pressures, any significant uptick from here unlikely

Source – Bloomberg

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Is it possible to be completely decoupled from global actions?

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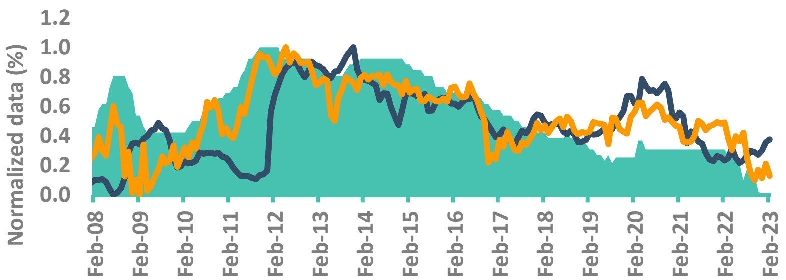
Should we be looking closely at **US yields** movement?

It will create noise,

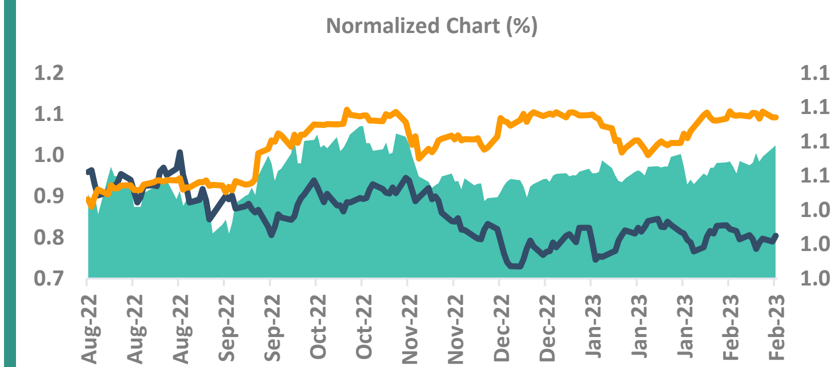
not trend.

Is India de-coupled from global markets?

- **Fed hiked the rate by 25bps, with terminal rate now closer to 5% (market expectations)**
  - However, rates may go higher than market expectations
  - US headline and core inflation came in strong
  - Fed speakers indicated higher rates than anticipated
- **Are spreads of US Treasury and Indian Govt. Bonds low?**
  - But, Bond yield spread mimics the inflation and policy rate differential.
    - ✓ RBI policy rate is low & has not tracked inflation spread
    - ✓ 10Y yields seem to have priced in the inflation spread



- **Are rupee risks impacting Indian yields?**
- **Rupee has weakened substantially, but**
  - Currency tail risks looking less likely.
    - ✓ Trade deficit has reduced substantially (from USD 30b+ to lower than USD 20b)
    - ✓ Capital out flows have reduced
    - ✓ However, risks of US FED taper remain
- **Bond yields uncorrelated with INR movement lately**
    - ✓ Shows currency fears abated



Takeaway:
India bond yields more driven by domestic factors than tracking global yields

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What else

that

can’t be bunched up

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RBI REGIME

Currently MPC had Hawkish Tilt

with

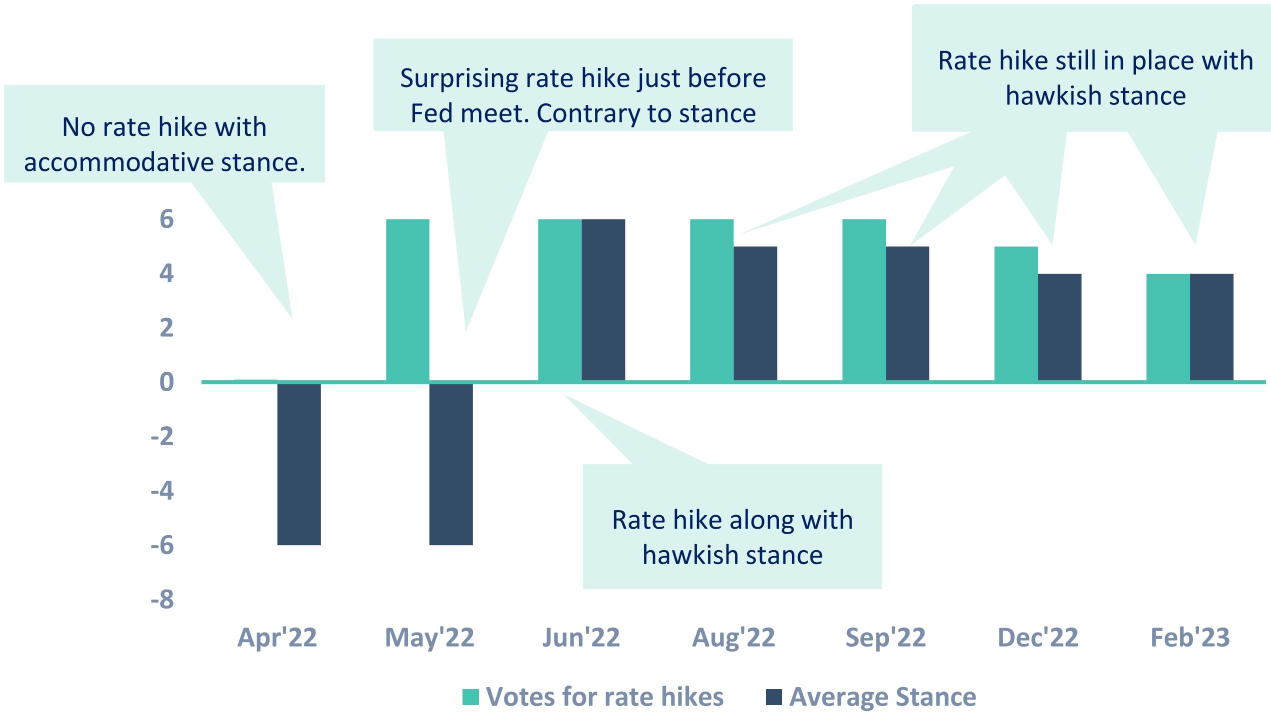
Similar underlying Data

RBI regime – Still hawkish, with some divergence

RBI REGIME

Key highlights of the Feb 23 MPC Minutes -

- "The continuously high core inflation points to the persistence in 'steady inflation', which warrants caution. Thus, it will be premature to pause when there are no definitive signs of slowdown in inflation, particularly core inflation." *- Dr Ranjan*
- "Although it seems to have peaked, inflation remains high and, in my view, it is the biggest threat to the macroeconomic outlook." *- Dr Patra*
- Dr Goyal and Prof Varma showed concerns around overtightening



Takeaway:
The voting pattern for rate hikes moved from 6-0 to 4-2. However, persistence of sticky core inflation a worry for the MPC

Source – RBI

RBI: Reserve Bank of India, MPC: Monetary Policy Committee; CPI: Consumer Price Inflation

Our View – Summary

➢ Risks to yields moving higher greatly diminished

We believe we are close to peak yields; thus risk/reward gravitates towards a long duration position:

1. **Favorable Demand-Supply:** Announced govt borrowing for FY24 is just 8% more than FY23. Demand expected to grow at faster pace. No more G-sec auction/supply for the rest of the month.

2. **RBI OMOs:** In FY24, RBI will finally purchase govt bonds, after a gap of more than 1-year.

3. **Lag effect of rate hikes:** The rate hikes have few quarter lag. The impact in economy will start showing now. Not just lower inflation, but economy slowdown and unknown event risks are heightened across the globe.

➢ Risks to our view, however at current yields these risks seem to be priced in

We had mentioned three reasons for yields to be under pressure in this quarter.

1. **Rupee depreciation:** We are confident that the BoP risks are still not behind us, despite rupee stability in recent weeks. However, these risks seem to be overshadowed by the positive drivers.

2. **Global inflationary pressures could recur:** Inflation is a difficult beast to predict. While we expect inflation to come down globally – but who knows!

3. **Liquidity:** Liquidity continues to tighten which has been pushing the short end yields up. But there is a risk that RBI might delay its liquidity infusion actions – especially if there is concern on currency.

➢ Risk/Reward to buy duration

For long duration investment: With low chances of yields spiking up, we advise to add duration. The event risks also favor long bonds.

For money markets investment: We like the 1-year segment because of its high term premium. The high carry is lucrative. Central banks stance change will lead to fall in yields in this segment.

Fed: Federal Reserve; RBI: Reserve Bank of India; G-Sec: Government Securities; OMO: Open Market Operation

CHECKLIST

DSP FI Framework checklist : What is our view on yields movement?

Drivers	1Y	5Y	10Y	>10Y	Remarks
Monetary Policy	**Neutral**	**Neutral**	**Neutral**	**Neutral**	
Inflation	Neutral	Neutral	Neutral	Neutral	Inflation is out of RBI's range, but should fall
Growth	Positive	Neutral	Neutral	Neutral	Lower growth means closer to peak rates , but risk of higher fiscal deficit
CAD/BOP/ Currency	Neutral	Neutral	Neutral	Neutral	CAD was at 2.8% in Q1FY23. but trade deficit is crashing significantly
Fiscal Policy	**Neutral**	**Positive**	**Positive**	**Neutral**	
Supply	Neutral	Positive	Positive	Neutral	H1FY24 borrowing may have more issuances in longer tenor
Demand	Neutral	Neutral	Neutral	Unknown	RBI may conduct OMO in FY24. Banks demand should lessen, yet sufficient to absorb supply. Impact of Insurance tax changes on long bonds unclear.
FPI Flows	Neutral	Neutral	Neutral	Neutral	No meaningful flows expected unless bond index inclusion
Global	**Mildly Positive**	**Mildly Positive**	**Mildly Positive**	**Mildly Positive**	
Global yields	Mildly positive	Mildly positive	Mildly positive	Mildly positive	Policy rates closer to peak
Geopolitics	Neutral	Neutral	Neutral	Neutral	Risks balanced
Commodities	Neutral	Neutral	Neutral	Neutral	Risks balanced
Others	**Mildly Negative**	**Neutral**	**Neutral**	**Neutral**	
RBI Regime	Negative	Neutral	Neutral	Neutral	RBI wary of sticky core inflation. Even global banks focussed on meeting inflation target
Miscellaneous	Neutral	Neutral	Neutral	Neutral	Risks balanced
Total	**Mildly Positive**	**Positive**	**Positive**	**Mildly Positive**	

Takeaway:
Markets should consolidate – risk of event led rallies – currency risks not over.

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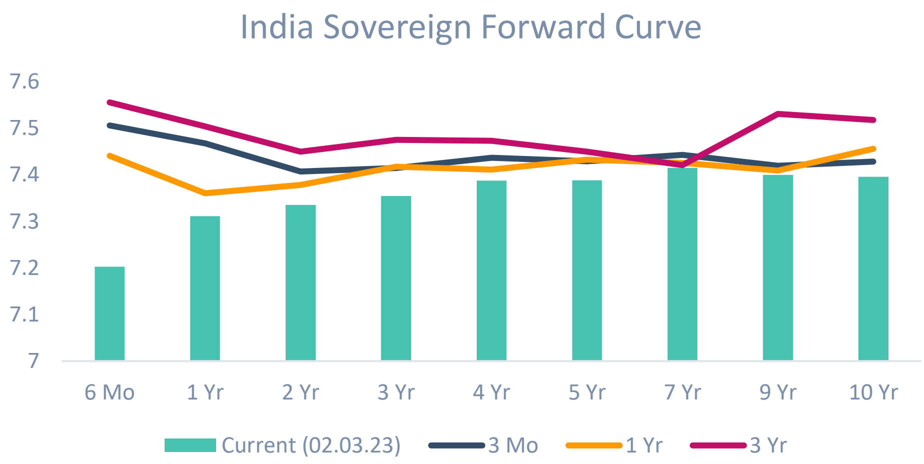
DURATION DECISION

DSP Duration decision: How much of yield movement is priced in?



- **In short tenor the bearishness is priced in**
  - Upside risks are largely priced in –seen in the sharp uptick in short tenor in forward curve
  - The roll-down benefit negates the impact of yield uptick
- **In long tenor, the bearishness is partially priced in**
  - The longer tenor forward curve is pricing just 5bp-10bp up-move.
- **Where to invest?**
  - Short tenor yields have moved higher, and have already priced in further rate hikes.
  - To find the best maturity to invest, one needs to take into account higher price risk in longer duration.

The chart shows how much yield rise is already priced in the current curve. Large gap between the current yield and forward yield shows that yield rise spike is priced in – and yield uptick may not lead to losses. Similarly small gap means that the market is not pricing yields to rise significantly.

Maturity	1Y	5Y	10Y	>10Y	Remarks
What's expected (Total)	**Mildly Positive**	**Positive**	**Positive**	**Mildly Positive**	**From previous slide**
Is expectation (above row) priced in ?	No	No	No	Yes	Short tenor has priced in liquidity tightening, but duration is still pricing in worst-case scenario.

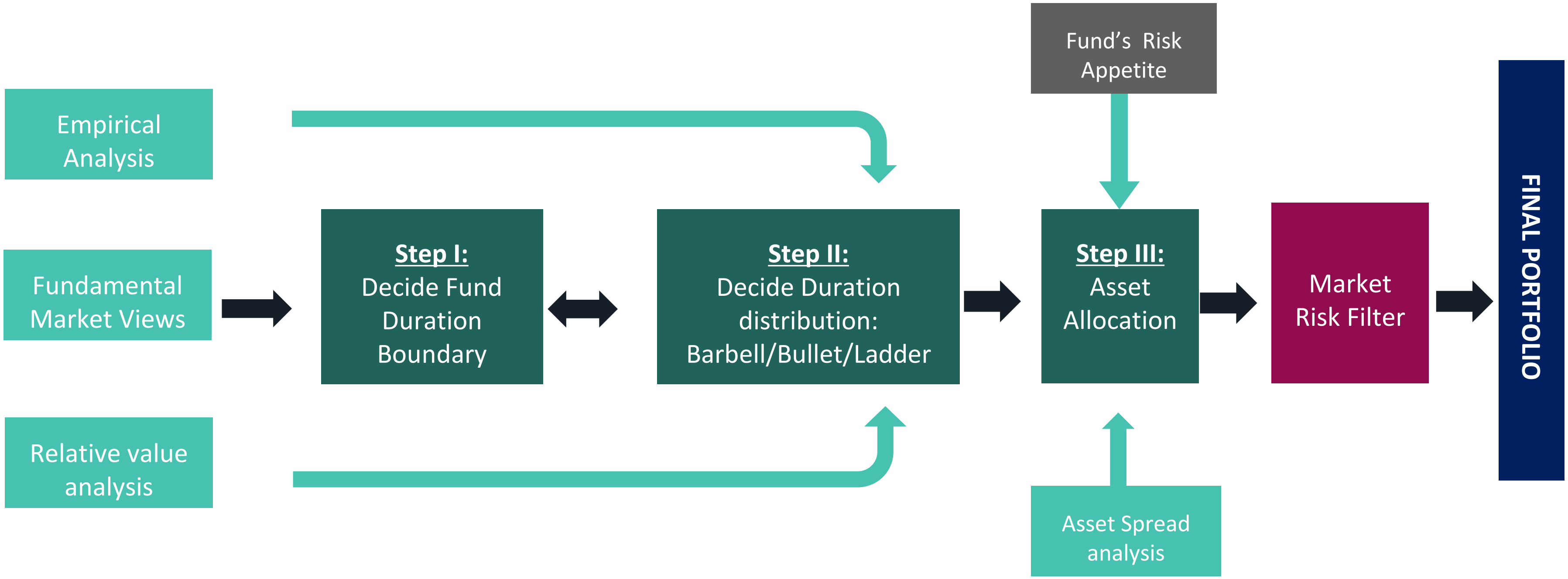
Done with our market view framework?

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.

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Investment approach / framework/ strategy mentioned herein is currently followed & same may change in future depending on market conditions & other factors.

DSP Credit Investment Process – Better Safe, than Sorry!

Credit evaluation

- Macroeconomic factors and Industry Outlook
- Promoter reputation and Management depth
- Business Profile & Market position
- Financial due diligence & Cash flow analysis
- Ability to refinance / Ability to exit

Information sources

- Financial results & presentations
- Promoter and Management Discussion
- Rating agency feedback
- Sell Side Research & Equity analyst feedback
- Lender's feedback

Decision

- Limit Setting by Credit Committee
- Investment Decision by Fund Manager

Monitoring

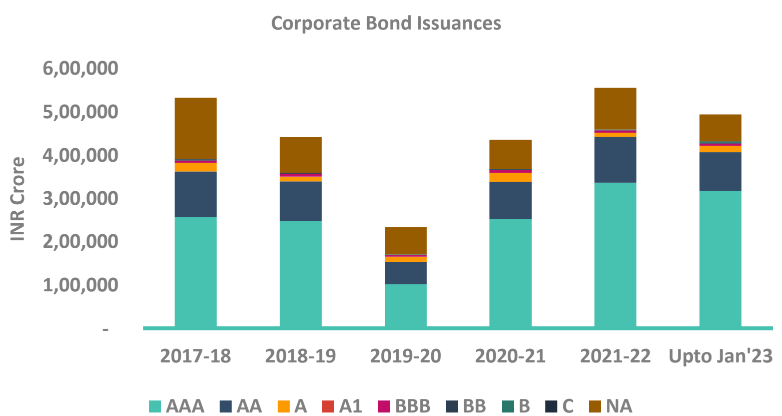
- Material Events and its Impact
- Early Warning Indicators
- Questioning Management Guidance
- Movement in Spreads
- Who has exited?

ASSET ALLOCATION

DSP Asset Allocation: Corporate bonds vs. Sovereign Bonds

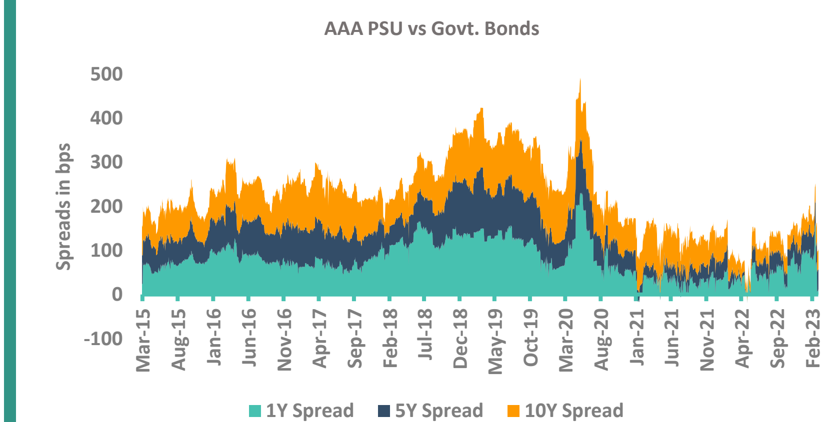
➢ **Demand for corporate bond in the long end has been exceeding the supply keeping the spreads low**

- Corporate bond issuances have picked up
  - The issuances till Jan in FY23 have increased to ₹ 4.94 tn vs ₹ 3.85 tn till Jan 22
  - But with govt. on path to reduce off-balance sheet borrowing, issuances may not increase meaningfully
- The non-discretionary / stable demand from the long-end investors viz. EPFOs, Insurance, NPS have matched the supply of bonds in the longer end keeping the spreads narrow.



➢ **The corporate bond spreads have increased, demand from long end investors has flattened the yield curve**

- The short end spreads (1-3Y) are at their median levels, the long end spreads remain narrow as the demand is strong from long end investors
- Steadily increasing allocation to short tenure corporate bonds as spreads have widened.
- Tighter liquidity, and high credit offtake could mean that CD supply from banks will remain elevated.



Takeaway:

Corporate bond spreads have slightly widened, we are steadily adding corporate bond allocation in our funds

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Source – Bloomberg, CCIL

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DSP MUTUAL FUND

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