

18-01-2012

2012 - FIXED INCOME STRATEGY

Sensex	16451
Nifty	4955
Gold (Rs/10gm)	27,436
Crude Oil (\$/bbl)	112
10yr Bond Yield	8.25%

Introduction

The macroeconomic environment of globally and especially India has become very turbulent over the last year, driven by persistent negative news from Europe and mixed performance of the US economy. The political uncertainty in India and globally has also exacerbated the effects. This has led to increased instability and volatility in financial markets, and led to risk aversion from global investors, which has affected emerging markets particularly, leading to fall in their equity markets and depreciating currency. On the domestic front, the weak macro environment which has been characterized by low growth, high inflation, high current account deficit has had a more debilitating effect on the rupee and the equity markets.

Current domestic macro economic conditions

- GDP growth moderated to 6.9% in Q2 of 2011-12 from 7.7% in Q1 and 8.8% in the corresponding quarter a year ago.
- Industrial performance has further deteriorated as reflected in the decline of the index of industrial production (IIP) by 5.1%, y-o-y, in October 2011.
- On a y-o-y basis, headline WPI inflation moderated to 9.1% in November from 9.7% in October, falling to multi-month low of around 7.4% in December 2011.
- The fiscal deficit at 74.4% of the budgeted estimate in the first seven months of 2011-12 was significantly higher than 42.6 % in the corresponding period last year.
- The y-o-y money supply (M3) growth moderated from 17.2% at the beginning of the financial year to 16.3% on December 2, 2011.
- Merchandise exports growth decelerated sharply to an average of 13.6% y-o-y in October-November from an average of 40.6% in the first half of 2011-12. However, imports have not come off so sharply, due to stickiness in oil prices and high imports of gold. This has widened the current account deficit to 3.6% of GDP, which is a serious concern.

Market response to macro numbers

Name	1-Jan-11	1-Jan-12	Return
SENSEX	20,561	15,517	-24.5%
BSE-500	7,961	5,785	-27.3%
Nifty	6177	4640	-24.9%
Gold	20650	27170	24.0%
Crude Oil	89.8	98.8	9.1%
Debt market returns			
CRISIL 10 Year Gilt Index			5.8%
CRISIL 1 Year T-Bill Index			6.7%
CRISIL Composite Bond Index			6.9%

- In response to these weak macro numbers, the rupee has come under severe pressure since September 2011. As on December 15, 2011, the rupee had depreciated by about 17 % against the US dollar over its level on August 5, 2011. However, there has been some recovery in the recent past due to efforts of RBI and NRI inflows.
- In 2011, Equity markets were down by 25% reflecting the slower growth of the Indian economy and also the expectation of slower growth going forward. All major indices were down substantially and India was one of the worst performing markets globally.
- The RBI increased interest rates more than 13 times to combat high inflation with the benchmark repo rate at 8.5%, currently. This has impacted fixed income performance, as yields rose sharply across maturities.

The reason for this is the obvious poor macroeconomic fundamentals of the Indian economy along with the uncertain political environment and global uncertainties.

Policy response expected

We believe that the current environment of slow growth is conducive for a benign monetary policy, which is expected to aid out performance of fixed income in the short to medium term and equity over the long term once the low interest rates take effect and investment and demand environment returns. The RBI has responded by signalling an end of interest rate increases during its policy review in 2011, as the focus shifts to growth from inflation. However, this could take some time as the RBI is unlikely to be aggressive. We explain in detail the various factors that we see as the basis for our current outlook.

Inflation

Both inflation and inflation expectations are currently above the comfort level of the Reserve Bank. However, reassuringly, inflationary pressures are expected to abate in the coming months despite high crude oil prices and rupee depreciation, which has been seen by the December 2011 inflation figure of 7.7%. The growth deceleration is contributing to a decline in inflation momentum, which is also being helped by softening food inflation. We could see some effect in the food inflation which is at a negative 3%, the lowest since April 2006. Food inflation numbers have remained moderated every week since early November 2011 when it stood at double-digit.

Headline inflation, which also factors in manufactured items, besides food and fuel, has been above 9% mark since December last year. It stood at 9.11% in December and RBI has projected it to fall to 7% by March 2012. RBI has hiked interest rates 13 times since March, 2010, to tame demand and curb inflation. At its Mid Quarter Policy Review during December 2011, RBI stopped further hikes and hinted that the rate may be cut in case inflation moderates. The Finance Minister's projection of 6% inflation by year-end is well below the 7% forecast made by the Reserve Bank.

The December inflation data, although has shown a declining trend in the primary articles, but the core inflation led by manufacturing sector is still pretty high. This could prevent

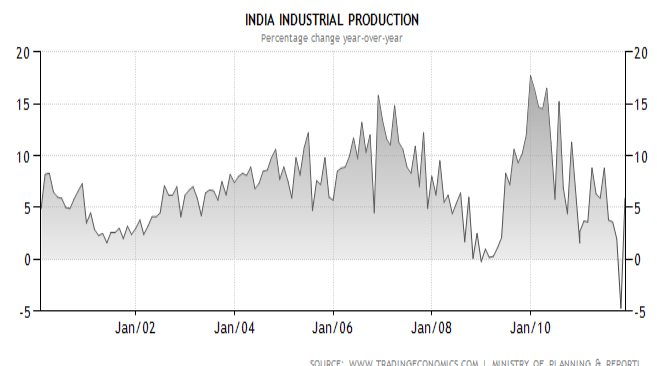
the RBI from any aggressive easing of policy rates immediately. The rate cut cycle is expected to be more gradual.



Economic growth

India GDP growth has moderated to 6.9% in Q2 FY12 from 7.7% in Q1 and 8.8% in the corresponding quarter a year ago. The deceleration in economic activity in Q2 was mainly on account of a sharp moderation in industrial growth. On the expenditure side, investment showed a significant slowdown. Overall, during the first half (April-September) of 2011-12, GDP growth slowed down to 7.3% from 8.6% last year. The high interest rate environment has affected investment to large extent

Industrial performance deterioration is reflected in the decline of the Index of Industrial Production (IIP) by 5.1 %, y-o-y, in October 2011. This was mainly due to contraction in manufacturing and mining activities. Sector-wise, agriculture registered a growth of 3.2%, industries grew at 2.8% while the services sector grew at 8.7%. Mining sector recorded negative growth of 2.9% in Q2 FY12 compared to 1.8% in Q1 FY12 and 8% in Q2 FY11. Manufacturing also recorded a steep fall to 2.7% in Q2 FY12 compared to 7.2 in Q1 FY12 and 7.8% in Q2 FY11. GDP is expected to be around 7.3% for the year 2011-12.



Liquidity/ Money Supply

The y-o-y money supply growth has been moderated from 17.2% at the beginning of the financial year to 16.3% on December 2, 2011, but still higher than the projected trajectory of 15.5% for the year. Y-o-Y non-food credit growth at 17.5 % on December 02, 2011, however, was below the indicative projection of 18 %.

Consistent with the stance of monetary policy, liquidity conditions have remained in deficit during this fiscal year. However, the deficit increased significantly beginning the second week of November 2011. The average borrowings under the daily Liquidity Adjustment Facility (LAF) increased to around Rs.89,000 crore during November-December (up to December 15, 2011) from around Rs.49,000 crore during April-October 2011. The Reserve Bank conducted open market operations (OMOs) on three occasions in November-December 2011 for an amount aggregating about Rs.24,000 crore to ease liquidity conditions.

The liquidity squeeze puts a lot of pressure on short term rates in the economy which will hurt economic expansion and growth. Although the RBI has maintained that LAF and OMO would be used to manage the liquidity pressures, the fact that borrowings from the LAF are persistently above the Reserve Bank's comfort zone, could warrant a Cash Reserve Ratio (CRR) cut, but the timing of the same remains uncertain.

Recommendation:

Equity market in the current scenario is very volatile, and hence risky, as we expect corporate earnings to be weak for the next 6-9 months. Bond market cycles typically run counter to equity market cycles. During recessions / bear markets in equities, bonds have done well historically. Bonds help diversify risk and protect against equity market shocks in the portfolio. The current high interest rate environment will allow investments to lock in on the high yields (paid through coupons annually or accrual incomes in funds) and the prospect of rate cuts will provide the capital gains as bond prices increase as rates go down.

As a result, fixed income looks a lucrative option as inflation is cooling down and RBI is expected to adopt pro-growth monetary stance, with a cut in interest rate and reserve requirements, thereby bringing down the interest rates in the economy.

However, since the government fiscal deficit is expected to be higher than forecast, the weak rupee and the persistent high core inflation could affect the pace of the rate cuts and also markets reaction to them. Hence, we are of the view that it is better to initially stay in short duration funds and shift to higher duration funds once clarity emerges on these issues.

Further, the RBI could act by easing liquidity by cutting CRR, before any rate cuts which will impact the short end of the maturity much more than long maturity bonds. Hence, we recommend investment in the short term bond for the next 3 months and switch to long ended bonds with higher duration subsequently.

Short term Strategy: Short Term Bond funds

Money market yield (3-12 month yield) will be influenced by quantum of CD refinancing by banks, gap between credit/deposit and the other factors affecting systemic liquidity. With the systemic liquidity remaining in deficit, 3 month CDs are expected to remain at 9.30-9.40% levels only. Looking at all these factors on the risk return parameters, the short term segment mainly upto 3-4 month maturity becomes very attractive investment proposition. The funds provide a high yield given the current high rates as well as some upside potential if rates go down.

The portfolio consists of Government Securities, money market instruments, securitized debt etc of varying tenors and the quantum of investments in any of the above mentioned categories is also flexible. These funds take medium term calls on interest rates and makes significant bets on the same. A significant portion of the fund's pie will be invested in higher rate corporate bonds, money market instruments and gilts. Credit call, if at all, will be taken on low duration securities. It is suitable for 3-6 months holding period.

Name	AAUM (Rs. in cr)	Duration (days)	YTM (%)	Absolute return(%) 1yr
Reliance Short Term Fund	747	649	9.06	8.1
HDFC Short Term Plan	745.65	475	NA	8.6
ICICI Prudential Short term Plan	652.59	508	10.13	8.7
Birla Sun Life Income Fund	183.7	479	9.75	9.6

Medium-Long term Strategy – High Duration Funds

As the short term uncertainty regarding government debt, fiscal deficit and inflation abates, we expect the RBI to cut interest rates sometime in March – April 2012, which is more effective on long term bonds than short term bonds since the duration of the long term bonds are more, and thus more sensitive to changes. These bonds will not only provide high accruals, but will provide capital gains as rates go down.

Their portfolio would consist of long dated bonds comprising of AAA rates corporate bonds and long dated government securities. Duration or interest rate sensitivity of these bonds will be in the range of 4-7 years. However, because of the high duration their returns could be volatile to any sudden rate changes.

Hence we recommend a staggered investment into such funds, with initial investment in short term fund and depending on the budget and RBI's action on interest rates, investment into these funds should be done periodically over a 4-6 month period. The holding period in such investments should be a minimum of around 12-15 months.

Long Term Funds

Name	AAUM (Rs. in cr)	Duration (days)	YTM (%)	Absolute return (%) 1 yr
Reliance Dynamic Bond Fund	46	2637	11.43	9.7
HDFC Income Fund	384.84	2147	NA	7.4
ICICI Prudential Income Plan	232.27	1942	9.35	7.7
Birla Sun Life Income Fund	359.31	2304	9.4	8.8

Note: Fund recommendation varies based on performance and portfolio

Risk to our view

The major risks to our views are

- Inflation does not cool off as expected due to increase in oil prices or weakening rupee.
- Government fiscal deficit goes beyond the increased forecast thereby increasing government borrowing which will depress bond prices.
- Any major global event which could increase uncertainties to asset prices.
- The result of proposed state assembly elections, which will influence the government's policy making or could lead to further political uncertainty.

All these events will influence RBI monetary stance on which this investing premise is based on.

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