IDFC
IDFC MUTUAL FUND

MARKET OUTLOOK

DEBT MARKET

January 2019

WHAT WENT BY

Introduction

Just by looking at year opening and closing bond yields, one may be forgiven in thinking that not much has gone by this year. Thus the 10-year government bond yield between the start and end of the year has barely moved. As we know, however, this masks a greater than 100 bps range intra year and was accompanied by nothing less than full drama with respect to Indian and global macro. The theme of this year end piece is 'gravity'. Apart from being the title of a favorite song, this word also marks a lot of goings on this year both in macro as well as in markets.

Shifting Sands

To us the biggest theme of the year was the changing narrative on global growth. It is useful to put this in context by recalling some recent history. Post the Chinese devaluation and the associated force of gravity on commodities, the world entered a period of growth scare. However, we were pulled back from this through implicit policy coordination amongst the world's large economies. Thus, China launched a mini stimulus to backstop growth deterioration whereas the US 'talked down' the dollar somewhat which resulted in some easing of global financial conditions. From there, the world entered into a phase of largely synchronized recovery which lasted till the better part of 2017 and which was possibly aided by the change in US presidency towards a more regulation light and pro fiscal policy. The one economy that bucked this trend of synchronized recovery and buckled to the force of gravity, however, was India. We actually slowed during this period and materially so. Most of this is probably attributable to India specific factors like demonetization and the potential uncertainties around GST. However, the momentum had somewhat begun to slow over 2016 itself. Nevertheless, as these factors started stabilizing India showed a strong recovery over first half of 2018.

Starting 2018, however, the world narrative on synchronized recovery started to shift. Thus the US was accelerating largely on a late cycle fiscal stimulus implemented by the Trump government. But many parts of the rest of the world, notably China, had started to feel some gravitational pull. This shift in theme had two major implications for emerging markets including India. One, export cycles started slowing with a decided skew getting created in world demand. Two, since growth was being led by the US, the dollar started to rise materially. Also, quite unhelpfully for India oil prices spiked during the year even has metals and soft commodities were largely subdued. This combination of rising dollar and higher crude was a potent mix for many emerging markets and particularly for large oil importers like India. There was rapid tightening in our financial conditions specifically over the 3rd quarter of the calendar year which, alongside a slowing global export cycle, had obvious implications for growth.

Over the last couple of months of the year, there seems to be another shift to the global narrative. Gravity is after all a universal force. The phase of synchronized recovery that had given way to unsynchronized recovery for most of 2018 seemed to be moving into some sort of synchronized slowdown. Thus parts of the US including housing and auto as well as business investments more generally seem to be losing momentum. Growth forecasts for next year are closer to the perceived longer term trend rate of growth versus the fiscal induced much-above-trend growth this year. Helping the narrative along are minor inversions in the US yield curve seen lately. At close of year, the markets have almost fully priced out any rate hikes from the Fed next year. The dollar versus emerging markets has come off as well thus helping financial conditions everywhere. Oil has experienced a brutal force of gravity, falling more than 1/3rd in a couple of months. Given these, a lot of pressure on India has subsided. Helping the turn has been our food CPI experiencing an exceptional gravitational pull as well and collapsing into deflation, thereby keeping us on course for a second successive year of sub 4% CPI.

The RBI's Reaction Function

A lot of critique is opportunistically piled on to RBI's door for consistently overestimating CPI, and sometimes remarkably so. However, in most cases this has been true for private forecasts as well. These errors tell more about the nature of the forecast variable itself rather than the process of forecasting. Nevertheless, there are enough lessons from CPI targeting thus far to start to appreciate that it is a difficult variable to forecast and even more difficult to target. So far most of our history with CPI targeting

has been sanguine and has coincided with large downward changes in minimum support price (MSP) growth and rural wages. There have potentially been efficiency gains as well with better management of cereal inventory and possible fall in transportation costs. Many of these, it is to be noted, have little to do with monetary policy. The point here is that the efficacy of monetary policy to target a variable that is heavy on food and fuel and may also be responding to changes in cost of financing in the informal economy, may be limited. Thus the recent sanguine phase shouldn't be wasted and the RBI/MPC should potentially start targeting some band on a consistent definition of real rates and link it to the assessed phase of the business cycle. Thus it can target a higher real rate band in a closed output gap scenario and so on. But we digress, and further exploration of this theme is best left to a future note.

In some ways, MPC's rate setting has been the best in as much as it has tended to not react to extremes. Thus when talk was of 'deflationary forces' affecting the economy around mid of last year, it avoided reacted excessively, choosing to reluctantly offer one rate cut only. Then in the run up to this October's policy when the consensus wanted substantial rate hikes to defend the rupee, it chose to focus on underlying CPI and merely contended itself with changing stance. This slower moving reaction function seems more apt when changing policy rates, which themselves only impact the real economy with a 2 – 3 quarter lag. If one has to fault at all, one could potentially have asked for more patience last year when RBI absorbed INR 90,000 crores of permanent system liquidity via open market operations (OMOs) when currency in circulation (CIC) trends were still stabilizing and when its own analysis had deemed this excess liquidity as being largely non-inflationary. Similarly, one could have argued that pace of OMO purchases could have been stepped up earlier in the current year itself responding to the evolving balance of payment (BoP) situation and with the CIC calculations already pointing towards sizeable deficits later in the year. Nevertheless, the important thing is that the approach on liquidity is now solidly proactive with the central bank working on anticipated drain and not hesitating in providing forward guidance on liquidity creation.

There is a role for gravity here as well. Lately the narrative with respect to the RBI versus government has turned somewhat too simplistic. The primary hypothesis has been that the government wants RBI to do its bidding in a variety of ways and that the recent change in Governor will help facilitate these demands. These are matters of utmost gravity and one has to exercise due prudence in making such interpretations. First, there is enough evidence already of full continuity in monetary policy under the new governor. The preference of tool for liquidity creation remains OMOs rather than CRR, whereas the potential for monetary easing if CPI moves as envisaged had already been flagged by previous governor Patel in his last monetary policy. So to say that potential for monetary easing has now opened up is untrue. Amongst non-monetary policy considerations, a big item of debate has been the view that RBI is overly capitalized and that some part of its reserves should thus be transferred to the government. A committee, composed 50% of current and ex RBI officials, has been formed that will study the matter and opine in due course. Again it is hard to envisage how this could have been much different had there been no change in governor at RBI. The point is to caution against excessively simplistic causations that give no benefit of doubt to what is the most important policy maker and an important custodian of the country's macro-stability, the government.

The Goings On In Credit

The latter part of 2018 witnessed an important domestic development for our money markets: a wobble in the housing and non-bank finance (HFC / NBFC) market. Apparently triggered by default by a large NBFC, the financing market for all but the bluest of chip HFC / NBFCs seemed to dry up for a period of time over September – November. Thankfully, the financing issues have now been largely arrested without any major systemic accident, chiefly courtesy proactive liquidity provided by state run banks. As gravity presumably strikes to future balance sheet growth and as more generally credit flow to certain sub-sectors slows in an environment slowing growth momentum, it remains to be seen what happens to general asset qualities in some segments going forward.

An important development was in the credit markets in India. As risk aversion led by the HFC / NBFC episode took hold, one would have reasonably assumed the lowest rated assets to do the worst. Instead, we saw the spread between AA and A rated papers on an average dropping by a full 100 bps during this period! Exploring this unexpected imposition of gravity further, we found the underlying reason to be quite mundane but nevertheless concerning. A bulk of A rated and below category papers don't trade and hence there is no actual price discovery in such papers. Whereas, AA had better price discovery from the market and hence felt the impact of the environment. This led to the massively counter-intuitive narrowing of spreads between the two. It provides obvious food for thought to investors who anyway should be looking to move towards quality fixed income given the underlying macro backdrop of slowing growth and a more constrained fund raising environment for parts of the system.

The Way Forward

Given the massive shifts in macro and themes over the past year itself, any year ahead prognosis has to come with significant caveats. Thus ideally forecasts should be made for the real long term (when either

one dies or averages catch up) or not at all. Nevertheless, fortified with year-end cheer and protected with assumptions generously made, we shall go ahead with at least a thesis for the next year. Thus the start point for the year is a possible phase of synchronized global slowdown developing. This largely means that the US is finally responding to the gravitational pull already in play for most of the rest of the world. If this sustains, it is obviously bullish for bonds including in India. Thus, our view for some time already has been that peak growth in India is past us and that owing to recent tightening of financial conditions and slowing global trade cycles, incremental momentum is set to slow. This saw early evidence in July – September growth data itself. Combined with the global backdrop of demand concerns and easing commodity prices, as well as local CPI also meaningfully surprisingly lower, this means that it is reasonable to look for easier monetary policy ahead. Indeed, our swap curve, which was pricing in more than 3 successive rate hikes a few months back, is already pricing in monetary easing over the next year. While the fall in bond yields has also been dramatic from the top, there is still more than enough value in quality bonds for the asset allocator, if this is indeed the turn of a global economic cycle. The current dramatic pace of OMOs will of course subside come April. This will probably narrow some of the very large spreads on AAA and state government bonds versus central government bonds. But if the global theme remains that of slowing growth and inflation and potential changes to reaction functions of large global central banks, then OMOs should not be the only dominant variable in thinking about the market. Neither is value on a risk – reward basis only limited to one area of duration. The one risk to be continually monitored in India will be the evolution of fiscal stance both in the run up to as well as post the general elections scheduled in the year.

The global theme itself may take one of many directions. The first, and probable best case, is that the gradual de-acceleration sustains which leads the Fed to back off completely and heralds a period of contained dollar strength and commodity prices. This will be good for emerging market bonds including India and will provide policy space to ease for local reasons if required. The second is that this slowdown accelerates accompanied with higher financial market volatilities. In such a case dollar may get safe haven bids and may strengthen alongside falling bond yields. However, this kind of dollar strength may not deter emerging markets like India from easing policy given that commodity prices will be weak in such a scenario and local growth impact could be substantial. The third could be that the current scare fades, trade tensions resolve, the recent resolve from China for measured accommodation yields results and the current deflationary fears fade completely. In such a case, there may be no case left for long duration bonds.

All told and taking into account recent events, it is prudent, for now to stay with the theme of slower growth and higher market volatilities. In such a scenario, some significant adjustments need to be made to fixed income allocations away from credit and into quality fixed income. Most asset allocation has leaned heavily towards credit over the past few years. This has been consistent with one phase of a cycle and needs to change if the cycle turns. Thus slowing growth and rising volatility is almost always associated with rising credit spreads. This is already happening elsewhere in the world but has barely started in India. Also, as in the case of A and below mentioned above, in some cases spreads have unjustifiably compressed in India only reflecting lack of liquidity. Thus there is significant price distortion in the lower rated part of the market which first needs to correct to earlier equilibrium and then rise further to reflect the new realities in credit markets.

While signing off one can do little better when summarizing risk versus reward in fixed income in context of the evolving macro backdrop, than quote from the same favorite song that has been the inspiration for this note (minor liberties taken with the lyrics):

"Twice as much

Isn't twice as good

And can't sustain

Like one half could".

Wishing you a very happy new year!!!

IDFC MUTUAL FUND

Our Product Offerings

Data as on 31st December 2018

- **IDFC Banking & PSU Debt Fund :** An open ended debt scheme predominantly investing in debt instruments of banks, Public Sector Undertakings, Public Financial Institutions and Municipal Bonds.

  Modified Duration: 3.19 years | **Average Maturity:** 3.99 years | **Yield to Maturity:** 8.36%

- **IDFC Credit Risk Fund (CRF)** (previously known as IDFC Credit Opportunities Fund) **:** An open ended debt scheme predominantly investing in AA and below rated corporate bonds.

  Modified Duration: 1.86 years | **Average Maturity:** 2.39 years | **Yield to Maturity:** 9.17%

- **IDFC Corporate Bond Fund (CBF) :** An open ended debt scheme predominantly investing in AA+ and above rated corporate bonds.

  Modified Duration: 1.16 years | **Average Maturity:** 1.33 years | **Yield to Maturity:** 8.47%

- **IDFC Dynamic Bond Fund (DBF) :** An open ended dynamic debt scheme investing across duration

  Modified Duration: 6.27 years | **Average Maturity:** 9.33 years | **Yield to Maturity:** 7.95%

- **IDFC Bond Fund – Income Plan** (previously known as IDFC Super Saver Income Fund – Investment Plan) **:** An open ended debt scheme investing in instruments such that the Macaulay duration of the portfolio is greater than 7 years.

  Modified Duration: 6.15 years | **Average Maturity:** 9.14 years | **Yield to Maturity:** 7.96%

- **IDFC Bond Fund - Medium Term Plan** (previously known as IDFC Super Saver Income Fund – Medium Term) **:** An open ended medium term debt scheme investing in instruments such that the Macaulay duration of the portfolio is between 3 years and 4 years.

  Modified Duration: 2.69 years | **Average Maturity:** 3.72 years | **Yield to Maturity:** 8.35%

RISKOMETER

LOW, MODERATELY LOW, MODERATE, MODERATELY HIGH, HIGH

Investors understand that their principal will be at moderate risk

IDFC Dynamic Bond Fund

This product is suitable for investors who are seeking*:
- To generate long term optimal returns by active management.
- Investments in money market & debt instruments including G-Sec across duration.

IDFC Bond Fund – Long Term Plan

This product is suitable for investors who are seeking*:
- To generate optimal returns over long term.
- Investments in Debt & Money Market securities such that the Macaulay duration of the portfolio is more than 7 years.

RISKOMETER

LOW, MODERATELY LOW, MODERATE, MODERATELY HIGH, HIGH

Investors understand that their principal will be at moderate risk

IDFC Corporate Bond Fund

This product is suitable for investors who are seeking*:
- To generate medium to long term optimal returns.
- Investments predominantly in high quality corporate bonds.

IDFC Credit Risk Fund

This product is suitable for investors who are seeking*:
- To generate optimal returns over medium to long term.
- To predominantly invest in a portfolio of corporate debt securities across the credit spectrum.

RISKOMETER

LOW, MODERATELY LOW, MODERATE, MODERATELY HIGH, HIGH

Investors understand that their principal will be at moderate risk

IDFC Bond Fund – Medium Term Plan

This product is suitable for investors who are seeking*:
- To generate optimal returns over medium term.
- Investments in Debt & Money Market securities such that the Macaulay duration of the portfolio is between 3 years and 4 years.

IDFC Banking & PSU Debt Fund

This product is suitable for investors who are seeking*:
- To generate optimal returns over short to medium term.
- Investments predominantly in debt & money market instruments issued by PSU, Banks & PFI.

*Investors should consult their financial advisors if in doubt about whether the product is suitable for them.

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