## Fixed Income Markets :

# Current Environment and Outlook

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**October 2009**

# Macro Events

- Industrial output grew the most in 22 months to 10.4% in August, indicating a steady turnaround in the economy. In aggregate terms, industrial growth stood at 5.8% against 4.3% in April-August a year ago

- Manufacturing, which accounts for about 80% of industrial output, continued the strong growth trend of July, growing 10.2% in August against 1.7% in the same month last year

- India's Inflation rate based on the WPI rose to 1.5% in the week ended Oct 17 from 0.70% a month ago. Food prices have risen substantially in recent weeks, though they are showing signs of some correction

- International economic data was mixed. US GDP posted a strong performance in Q3 with growth in output coming in at 3.5% (y/y). GDP growth in the U.K came in at a negative 5.2% (y/y) against expectations of positive growth, showing that the U.K is still in a recession. In Europe - France, Germany and Japan all saw growth return in the second quarter

- All major Central Banks – Federal Reserve, Bank of England and the European Central Bank kept policy rates unchanged except for Reserve Bank of Australia, which has hiked policy rates by 50 basis points

# RBI – Credit Policy Highlights (Oct 09)

- RBI holds CRR at 5.0%, repo rate at 4.75% and reverse repo at 3.25%.
- The Statutory Liquidity Ratio (SLR) for scheduled commercial banks raised by 1% to 25% from Nov 7, 09.
- Real GDP growth forecast retained at 6% with an upside bias; modest decline in agriculture seen
- Money supply growth projection for 2009-10 revised downwards to 17% from18% announced in the annual policy document
- Non-Food credit growth target revised downwards to 18% from 20%
- Special repo facility withdrawn

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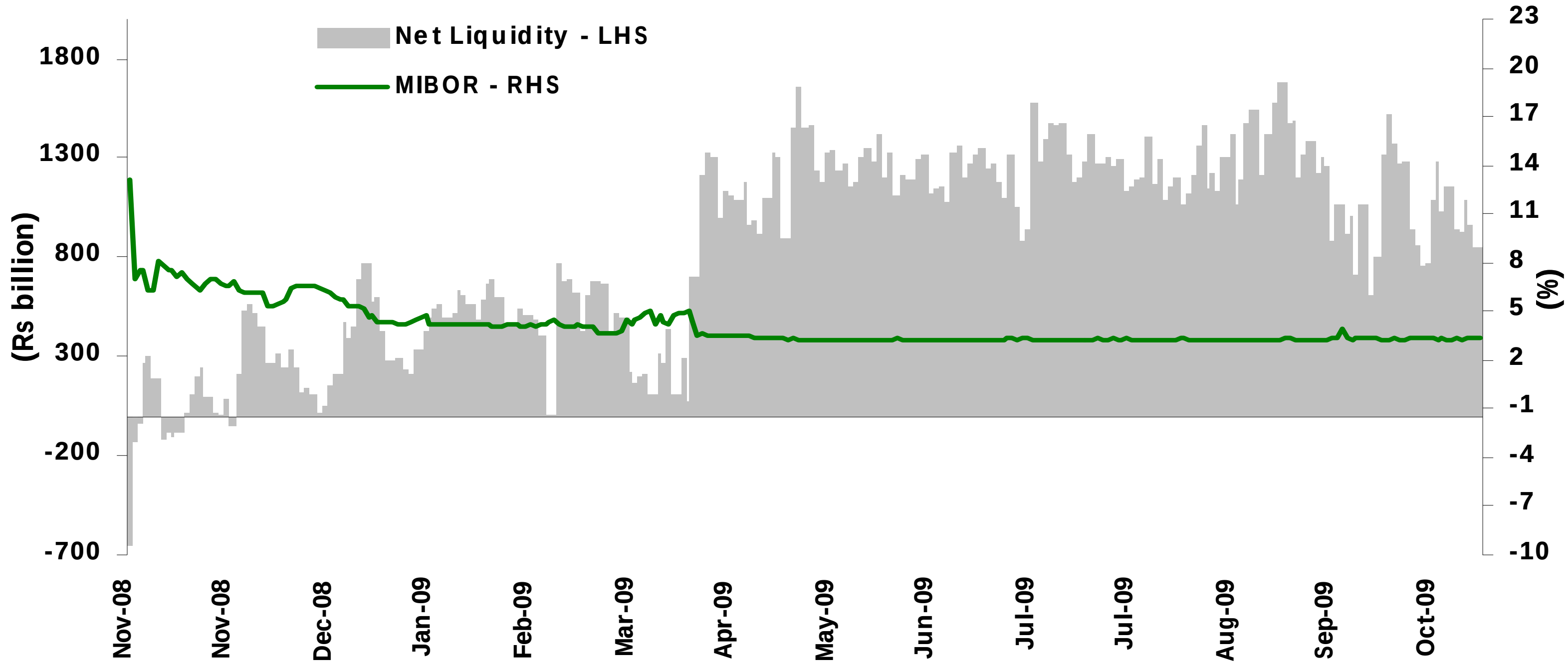
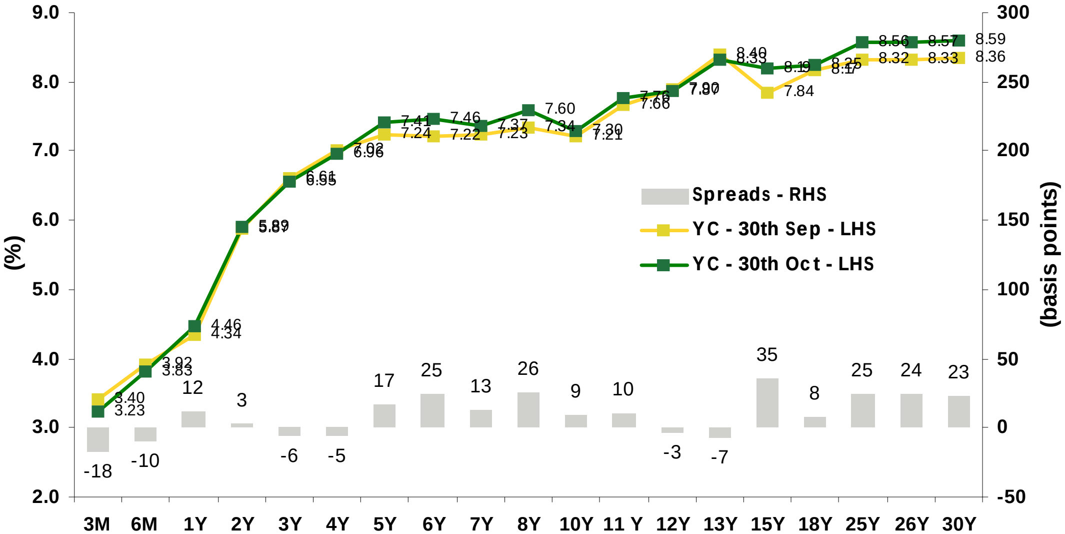
# Liquidity – remains abundant

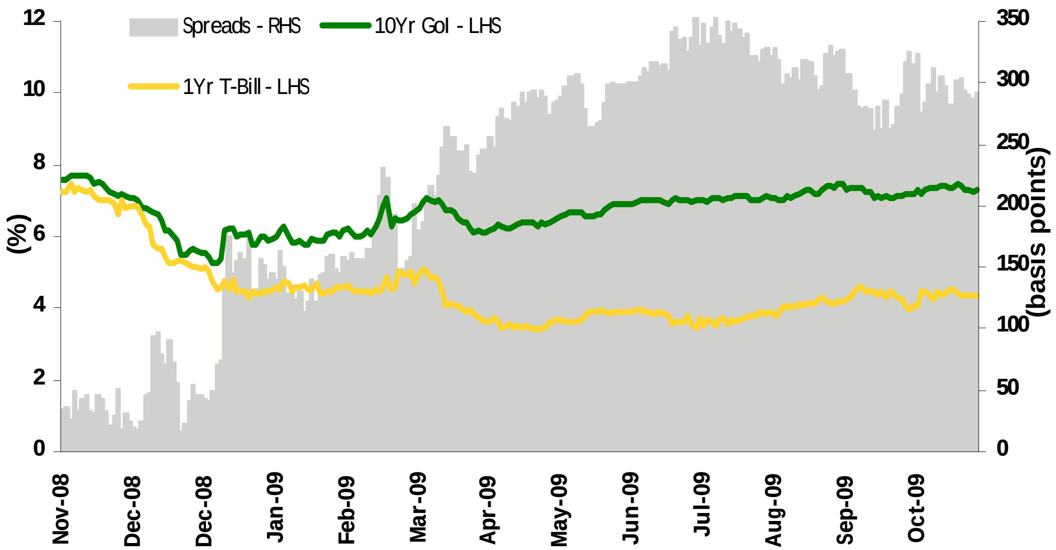



Source: Bloomberg

- The system remained flushed with liquidity in October with the daily RBI LAF reverse repo averaging over INR 1,00,000 crore during the month
- MIBOR rates remained comfortably low averaging just 3.2% during the month

# G-Sec Yield Curve – Steeper during the month

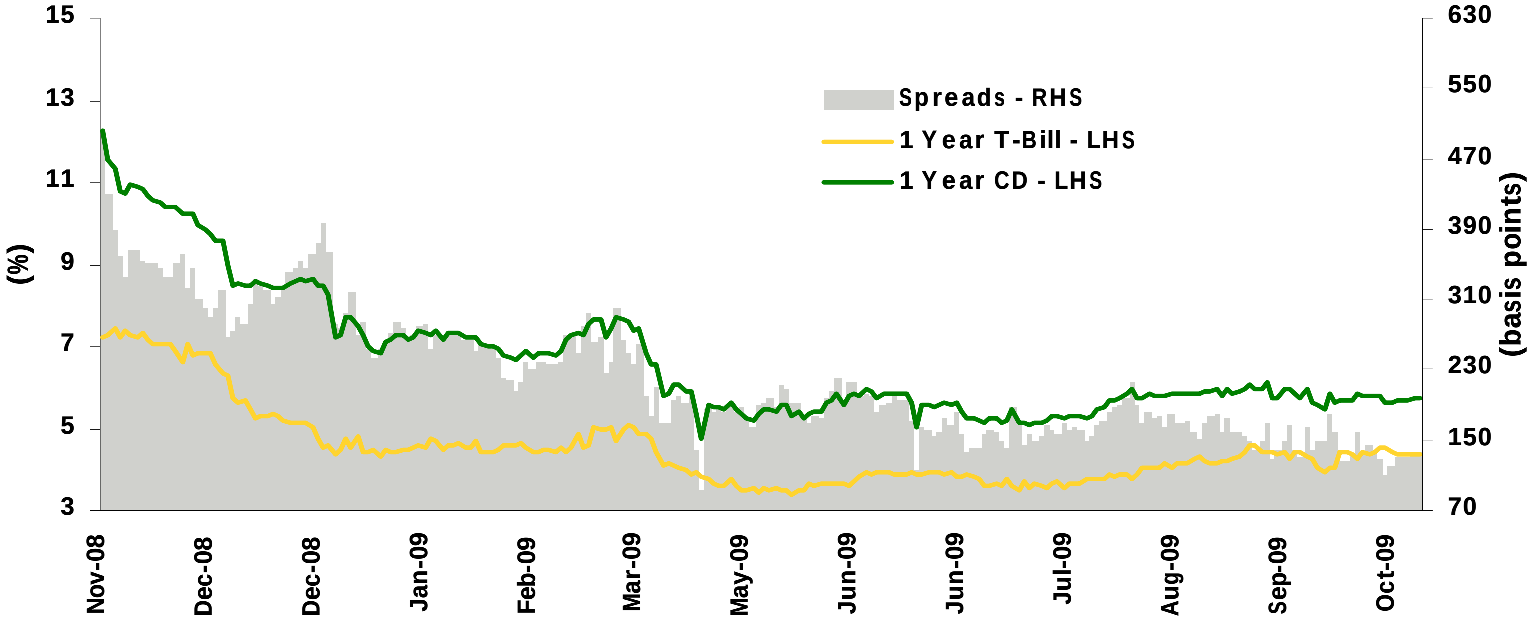



- G-Sec yield curve steepened from the previous month as rates above the 4 year segment moved higher. Short end rates, below 1-Year, went lower
- The 10yr benchmark yield rose to 7.30% from 7.21% at the start of the month
- In the T-Bill Auction results on Nov 04, 91-day T-bill issued at 3.28% and the 364-day paper yielded 4.53%
- Current 1yr vs.10yr GOI spread was at 280 basis points as against the mean spread of 180 basis point over the last 1 year. We expect the current spread to compress and revert to the mean. Mean reversion is being witnessed since the last few months

Source: Bloomberg

# Money Market – low rates amidst easy liquidity




Source: Bloomberg

- Money market rates traded at extremely low levels due to ample liquidity in the system
- Spreads between 1 Year CD's and T-Bill's compressed 25 bps during the previous month, and spreads between CP's and CD's too compressed by 60 bps. Overall, 1 Year CP spreads over 1 Year T-Bills compressed substantially by 85 bps over the month
- Spread compression indicates reduced risk aversion and demand for short-term assets

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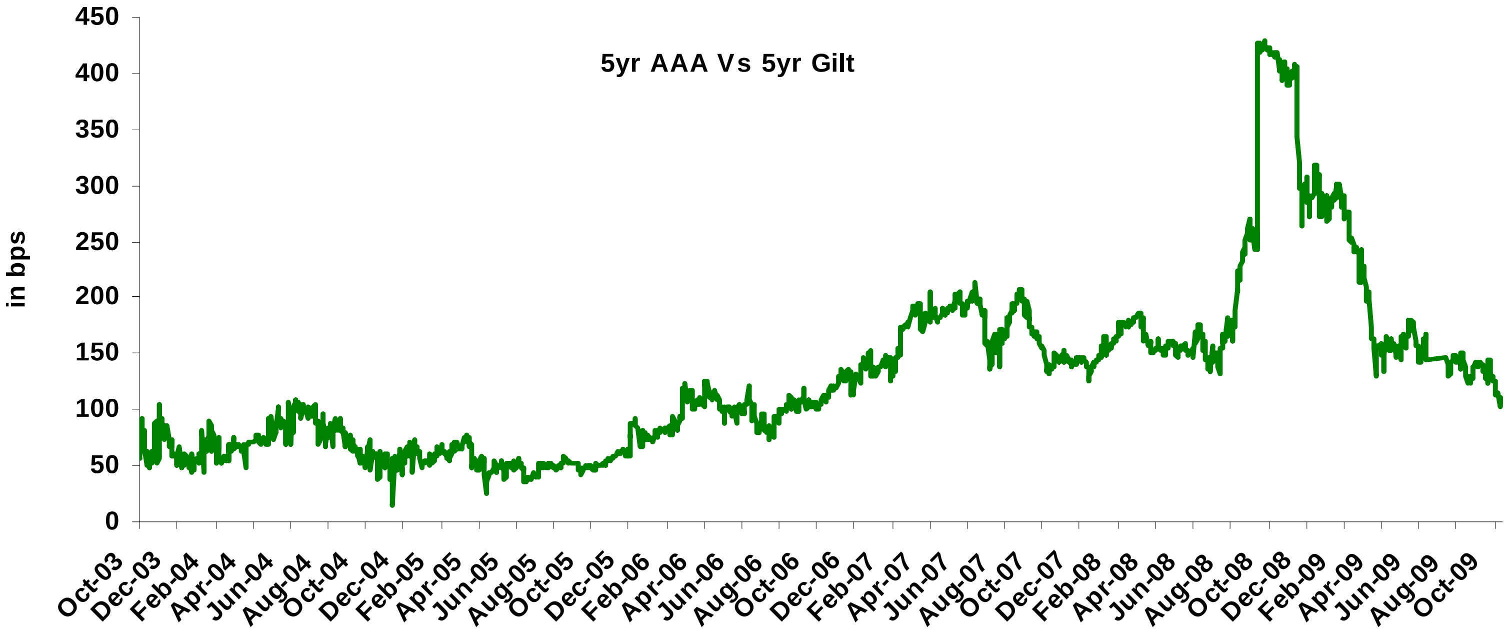
# Corporate Bonds spread – witness compression




Source: Bloomberg

- Spreads of 5-Year AAA corporate bonds over their corresponding benchmark sovereigns, compressed by 30 bps during the month to under 110 bps, with higher yields on benchmark sovereigns contributing wholly to this compression

- The 5 year corporate paper yield remained unchanged at around 8.5% during the month

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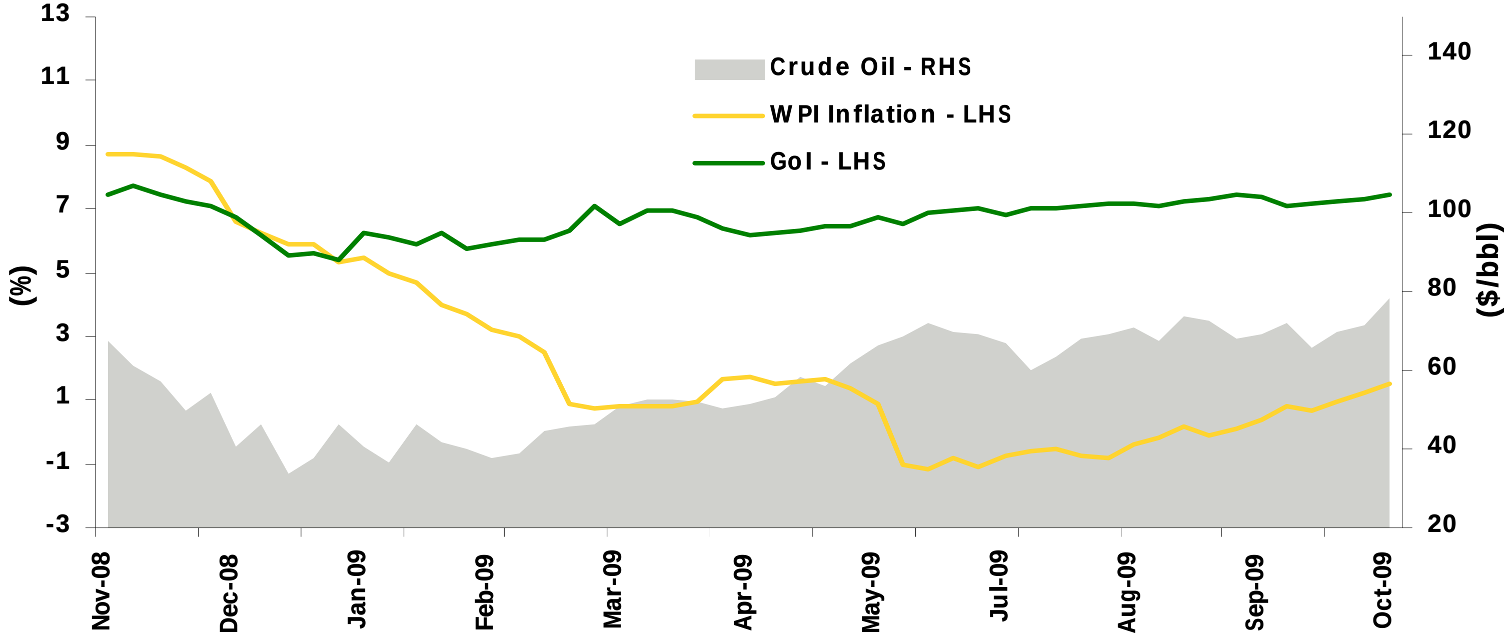
# Crude and Inflation Dynamics




Source: Bloomberg

- Crude Oil prices restarted their upward climb with the NYMEX Crude Oil Barrel going above $80 during October
- The WPI Inflation Index rose to 1.5% for the week ended Oct 17, 09 from just 0.7% on Sep 26, 09
- In the Credit Policy, RBI revised upwards its WPI projection to 6.5% with an upside bias by end-Mar 10, though we believe that the rate could be even higher

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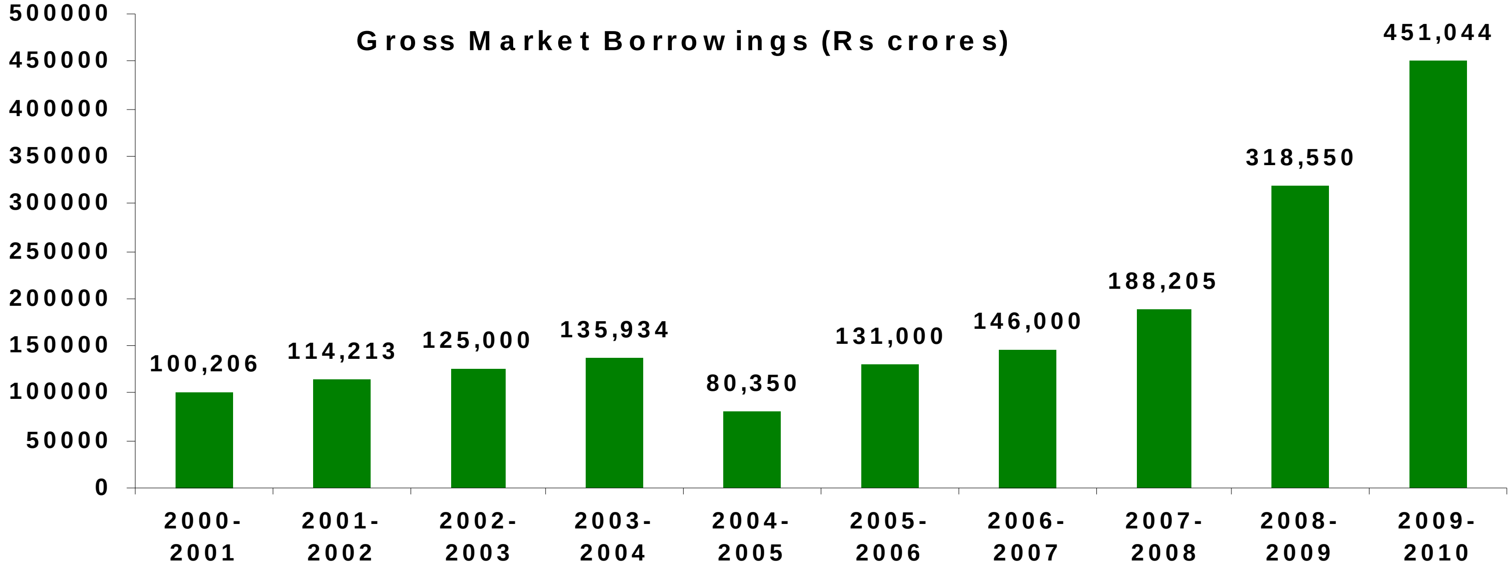
# Government's borrowing program




**Source: indiabudget.nic.in**

- The market will continue to witness volatility though the RBI is to ensure "non-disruptive" borrowing program
- OMO to be used only in case there is substantial hindrance in the auction process

# Religare MF: Fixed Income Outlook and Opportunities

# Fixed Income Market Outlook

- Global economic data continues to surprise positively
- Risk trades continue to be in favor leading to increase in global stocks and commodities
- Inflationary pressures likely to build in the coming months taking into account – a) pressure from global commodity price rise b) agflation and c) reversal of positive base effect of the past year
- Liquidity conditions are likely to remain comfortable on a) RBI maintaining a status quo on policy rates in calendar 09 b) weak credit pick up as Corporates going slow on CAPEX plans and c) RBI dollar intervention on FII/FDI inflows
- RBI, in its credit policy review, has taken the first steps towards normalization of its excessively accommodative stance as global economic conditions still remain fluid
- In the medium term, macro conditions are likely to lead RBI to hike interest rates. We believe RBI may deliver a rate hike in the first quarter of calendar 2010

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# Ideas for investors

- Risk-averse investors should continue to look at the short end of the yield curve- Ultra short term funds, defensive short term funds and double indexation Fixed Maturity Plans

- With RBI maintaining a status quo on policy rates, the long end would be influenced mainly by a) global cues and b) monthly inflation data. We believe that the 10 year benchmark gilt yield in likely to trade in a broad range of 7.0%-7.5%. Investors should time their entry and exit in long duration funds accordingly

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