

## Time For Duration Funds

A lot has changed in the Indian and the global economies over the past few months. The anxieties in the Indian markets, initiated by the US Federal Reserve's (Fed) statement of its intention to gradually taper its US\$ 85 bn per month bond buying program in the month of May last year, seems to be finally settling down as the country's key macro-economic indicators have begun to show initial signs of improvement. With the outlook for Indian economy set to improve (as explicated herewith), we believe that it is the right time for the investors to get into the long - duration funds.

### US Tapering and its impact on the Indian Economy

Jittery had spread in the emerging economies following the announcement by the Fed of its intention to gradually taper its bond buying program. The Fed announcement was followed by a panic sell-off by the Foreign Institutional Investors (FIIs) from the Indian debt market, which resulted in exodus of almost US\$ 13.31 bn between Jun '13 - Nov '13. Resultantly, the outstanding FII investment (Chart 1) in the Indian debt market declined from a high of US\$ 37.36 bn in May '13 to US\$ 24.04 bn in Nov '13.

This huge outflow of FII money severely impacted the domestic currency, which began to depreciate sharply against major international currencies, including the US dollar beginning May '13. The rupee continued to depreciate sharply against the dollar until the beginning of Sep '13 and touched record lows of ₹ 68.36 per US\$ in Aug '13 (Chart 2).

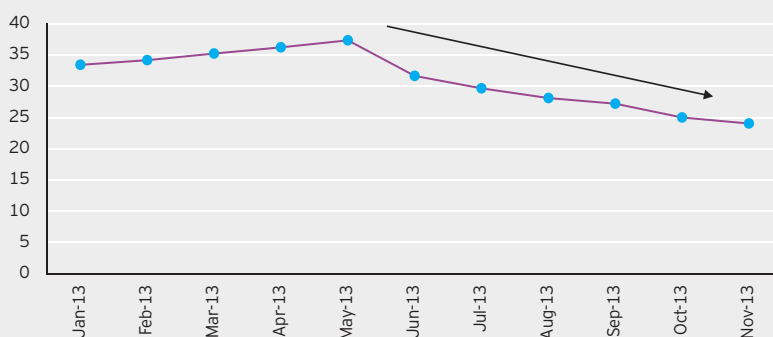
The steep decline in the value of rupee vis-à-vis the dollar, in such a short period of time, led to fears of rise in the country's already high retail inflation due to mounting import bills and also of further deterioration in the country's current account deficit (CAD) along with fears of sovereign rating downgrade (Chart 3).

Rupee depreciation, rising inflation and a deteriorating CAD led to drying up of foreign inflows in the Indian market even as FIIs continued to pull money out of the country (Chart 4).

### RBI Intervention & Tightening of Monetary Policy

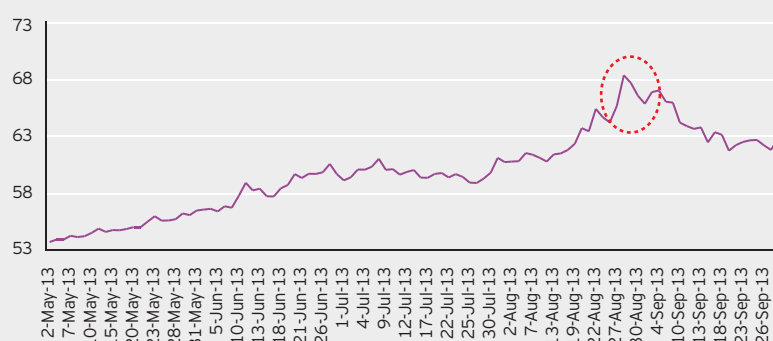
The Reserve Bank of India stepped in to check the Rupee's fall by restricting the flow of money from being used for currency speculation, if any. RBI thus resorted to various measures, such as hike in short term interest rates, to drain liquidity from the system and tighten the monetary policy. While the temporary hike in the short term Marginal Standing Facility (MSF) rates were unwound to a great extent by Oct'13, the repo rate was hiked multiple times by RBI. (Repo Rate is the rate at

**Chart 1: Outstanding FII Investment in the Indian Debt Market (US\$ bn)**



Source: SEBI

**Chart 2: Exchange Rate INR / USD (₹)**



Source: RBI

**Chart 3: Current Account Deficit (US\$ bn)**



Source: RBI

which the Central Bank lends money to the Commercial Banks). RBI hiked the Repo rate for the third time since May last year to 8% in its latest monetary policy review in the month of Jan '14 (Chart 5). The RBI's move to hike interest rates at frequent intervals, in its bid to attain price stability, has begun to show the desired effects by targeting one of the key macro-economic concerns, Inflation.

## A) Inflation

Retail Inflation has been one of the RBI's key targets and the Central Bank has been pressing on the immediate need to control inflation to put economy back on track.

Following a series of interest rate hikes over the past few months, the retail inflation has finally begun to show signs of cooling. The retail inflation (Consumer Price Index) was pegged at 8.79% in the month of Jan '14, which was the lowest in past two years (Chart 6). That the country's CPI has begun to show signs of cooling can be attributed to softening of two key components of retail inflation, namely, Food and Fuel.

### - Food Inflation

One of the key reasons for retail (CPI) inflation to have risen sharply over past few years is high cost of food (Chart 7). The food inflation has been high in the country mainly due to significant hike in the minimum support prices (MSP) over the past few years (Chart 8). MSP is a price for the agricultural produce fixed by the Government and is the minimum price that one must pay to the farmers to purchase various kinds of agriculture produce - both food-grains and non-food-grains. Thus, with every hike in the minimum support price, the prices of agricultural produce for the end consumer increases, leading to a higher outflow of money for the same commodity over a period of time. For example, the minimum support price for Rice has increased from ₹ 645 per quintal or ₹ 6.45 per kg in 2007-08 to ₹ 1,310 per quintal or ₹ 13.1 per kg in 2013-14, which is an increase of more than 100% (in absolute terms) during this period.

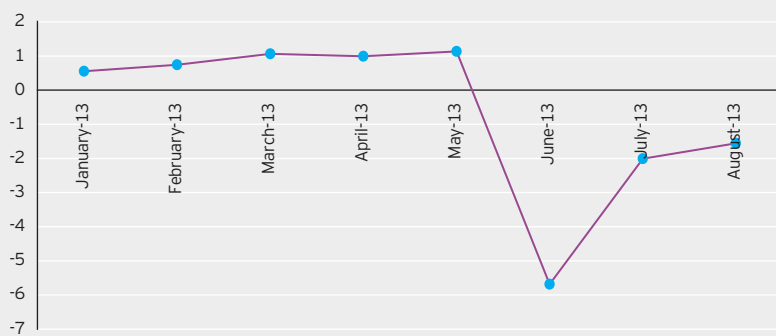
*While the Government is expected to continue raising MSP in order to protect the interest of the farmers, we are of the view that going forward, the pace of rise will be much slower due to the current high base, which will keep retail inflation in check.*

### - Fuel Inflation

Another key reason for high retail inflation in India has been the fuel cost. With India heavily dependent on fuel imports to meet its domestic consumption demand, any rise in the international fuel prices or depreciation in the value of rupee against the dollar, inflates India's fuel bill that impacts not just its retail inflation but also runs the risk of deepening its current account deficit and eating into its foreign exchange reserves.

However, following recent developments resulting in gradual rise in the availability of shale gas in the USA, the global crude oil prices have begun to hold steady thereby reducing the concerns of a spike in the international fuel prices in the near to medium term.

Chart 4: FII Flows in Indian Debt Market (US\$ bn)



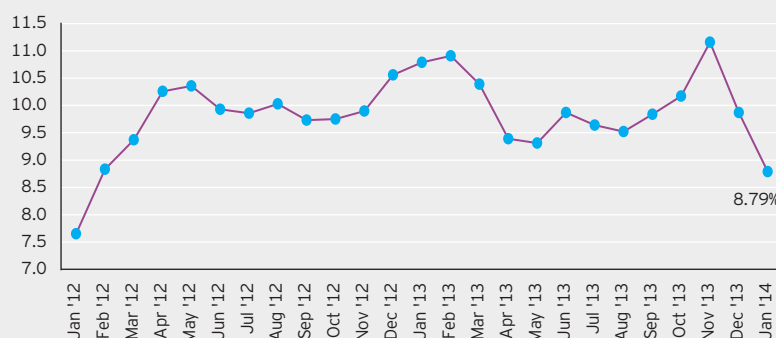
Source: SEBI

Chart 5: Repo Rate (%)



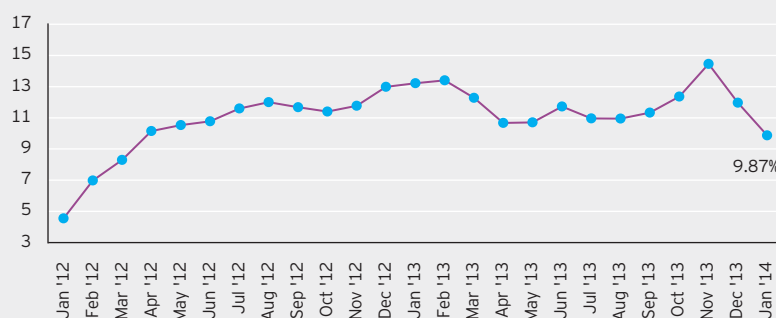
Source: RBI

Chart 6: CPI (All India) - Overall Index (%)



Source: RBI

Chart 7: CPI - Food, Beverages & Tobacco (%)



Source: RBI

This, along with stability in the domestic currency against the dollar and gradual reduction in the diesel subsidies in India has helped put a check on retail inflation on account of fuel (Chart 9).

*Over the years as US becomes self sufficient on energy, external shocks should reduce for India.*

## B) Current Account Deficit (CAD)

The pressure on India's current account deficit has begun to ease following the imposition of custom duty by the Government on the import of precious metals such as gold and silver. Also, a gradual pick-up in the export activities in the recent months has helped in narrowing the CAD significantly from US\$ 31.77 bn in Dec'12 quarter to US\$ 5.17 bn in Sep '13 quarter (Chart 10). The CAD for FY '14 is expected to be under US\$ 45 bn compared to US\$ 88 bn in FY '13.

*With import curbs on gold and silver likely to stay put, as indicated by the Government, and export earnings expected to strengthen going forward as US economy recovers, we do not expect the current account deficit to deteriorate in the near term.*

## C) Foreign Exchange Reserves (Forex)

With import curbs on precious metals well in place; import bills for fuel costs under check and given the gradual recovery in the export earnings, the country's foreign exchange reserves have begun to improve and are gradually inching close to record highs (Chart 11).

## D) Exchange Rate Fluctuation

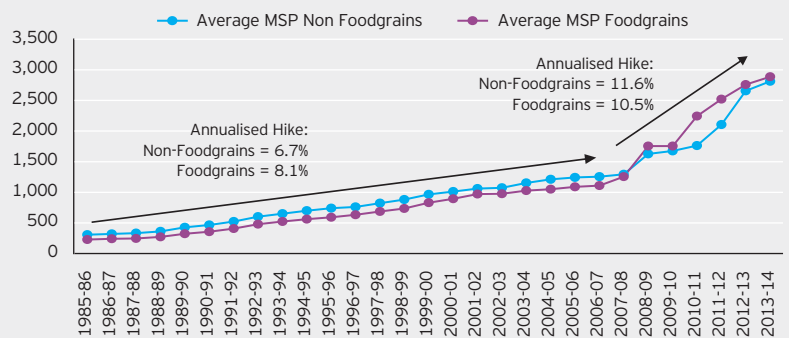
RBI's measures to tighten the monetary policy and drain liquidity out of the system to restrict the flow of surplus money for currency speculation has had the desired effect in supporting the rupee from further depreciation vis-à-vis other major international currencies, especially the dollar.

Also, the strengthening of the current account deficit (CAD) and the gradual increase in the foreign exchange reserves (Forex) are lending the much needed support to the domestic currency - the rupee, whose exchange rate volatility vis-à-vis the dollar has reduced considerably over the past few months (Chart 12).

## Going Forward

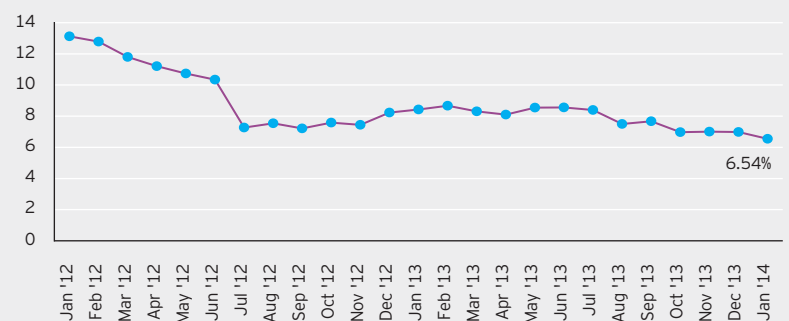
- While the monetary policy will target the headline CPI inflation over the quarters (Urjit Patel committee recommendations), a gradual decline in the MSP hikes and stable crude oil prices is also expected.
- The retail CPI inflation is expected to remain low over the next few quarters.
- RBI is likely to pursue a status quo stance on interest rates after the recent Jan '14 hike.
- Fed tapering is not expected to have any dent on the stability of the currency in light of the improved CAD, decline in non essential imports and improved forex reserves.

Chart 8: Average Minimum Support Price (₹)



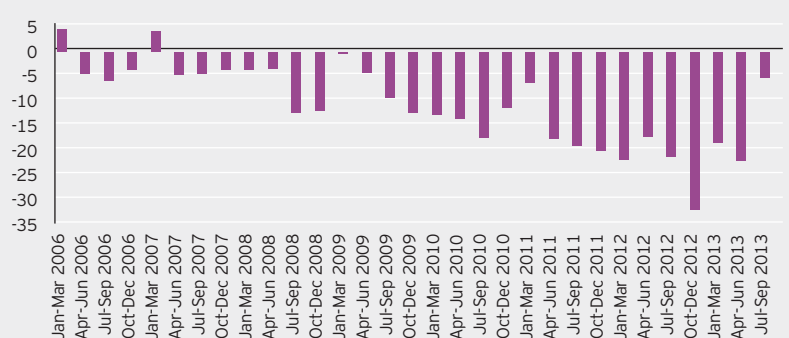
Source: RBI

Chart 9: CPI - Fuel & Light (%)



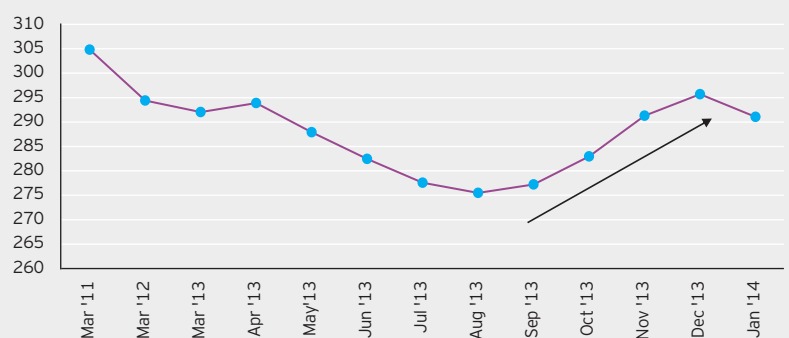
Source: RBI

Chart 10: Current Account Deficit (US\$ bn)



Source: RBI

Chart 11: India's Foreign Exchange Reserves (US\$ bn)



Source: RBI

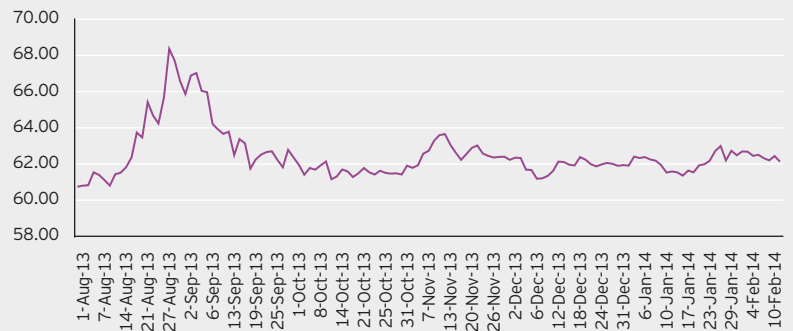
We are thus of the view that the recent hike in the repo rate by the RBI was probably its last at this juncture and there may not be any further interest rate hikes going forward, in the near to medium term.

While benign rates are desirable to support economic growth, RBI might wait on the sidelines and see the unfurling of the headline inflation. The liquidity within the system is expected to be maintained at adequate levels through various term repo auctions. While RBI might be vocal about the inflation target, it will continue to fight against inflation expectation. Market yields are expected to move in line with RBI's guidance and inflation trajectory. While the yields are pricing in the present market risks and probable one more rate hike, the yields should start softening with some decline in inflation and a status quo stance of RBI on rates. In the event of inflation coming off in the near term, the bond yield, which is currently trading reasonably above the long term averages, is expected to come off from their current highs.

Currently, the 10Y benchmark sovereign yield is trading at 140 bps higher than its 10Y long term average while the 10Y AAA corporate bond yield is trading at 118 basis points above its 10Y long term average (Charts 13 & 14).

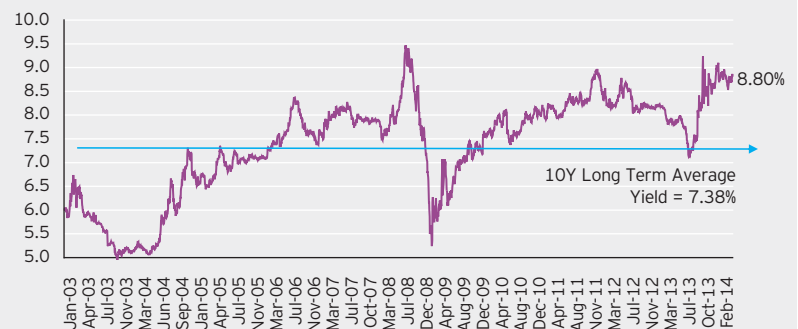
*Investors are encouraged to consider the option of investing in long duration funds in light of cheap valuations and the possible decline in yields amidst a stable to softening inflation.*

**Chart 12: Exchange Rate INR / USD (₹)**



Source: RBI

**Chart 13: 10Y G-Sec yield (%)**



Source: Bloomberg

**Chart 14: 10Y 'AAA' Bond yield (%)**



Source: Bloomberg

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