DSP CONVERSE AT A GLANCE

JULY-2024

REMAIN LONG. RISK TO YIELD RISE LIMITED.

Frankly, there is not much to say this time, apart from reiterating what we have been saying for more than a year. **The domestic demand for Indian bonds is growing faster than supply, especially with fears of new LCR regulations. The FPI inflows will only add to the demand.**

We have seen this pan out in past few months. The quirky thing about **demand is it doesn't hit till it hits**. Unlike macro indicators, where yields may fall in anticipation. Thus, yields may fall before actual fall in inflation. But that is not the case with demand/supply. One cannot advance the demand - the traders can front run, but only for so long. While markets can move in anticipation of higher demand, but soon the traders would unwind leading to a rally reversal. Only when the real demand buys the asset, would a rally be sticky.

And thus, we saw short-lived rallies between Sep 23 and June 24 - driven by traders and reversed by traders.

However, the current rally is driven by true demand and a large part of demand is still pending. We expect it to be reversed as and when RBI does OMO sell (as it needs to), but still the trend is for falling yields.

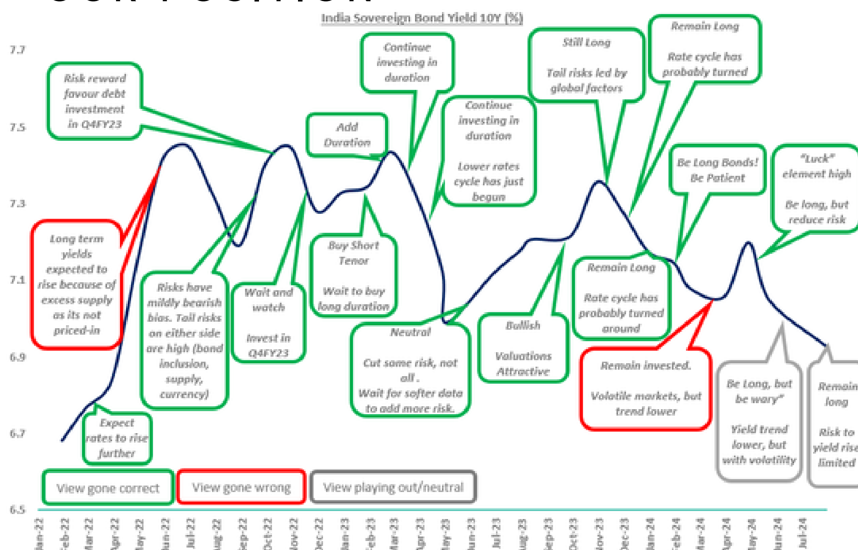
OUR POSITION

We remain long. Not because we expect rate cuts (we are agnostic), but because we see demand much higher than supply.

We prefer long bonds (30Y+). Not because we love duration - but because demand/supply mismatch is most stark in longer end.

DSP remains the fund house for those who have a view to buy bonds, but are wary of short term volatility.

Risks?
#1: US presidential impact remains a concern - on US yields and China tariffs.,
#2: Israel-Hamas war heightens



SNAPSHOT OF OUR VIEW

View complete DSP Converse presentation at dspim.com->Tools and Resources->Insights->Converse

		Q1FY25	Q2FY25	Q3FY25	Q4FY25	FY26	
RATES VIEW		Yields to move lower, though with short term volatility and uncertainty.					SLIDES IN CONVERSE

		View			Slides in Converse
MONETARY POLICY	INFLATION	Core CPI comfortable at 3.1% Headline back above 5% mark			#13, #14, #15
	GROWTH	Growth in "neutral zone"	Signs of growth sputtering in future - but no strong evidence yet.		#16
	CURRENCY	Normalized trade deficit, FX reserve nearing $670bn	Much uncertainity on global macros External sector pressures remain low/Debt FPI flows have started		NA
FISCAL POLICY	SUPPLY	Low supply in FY25 budget. RBI OMO sales to provide constant supply			#29, #31
	DEMAND	LCR guidelines may increase bank buying by 2-4 lac crores	PF/Insurance growth will outstrip Gsec supply growth.	Sugar Rush of bond inclusion fades	#27, #31
	FPI FLOWS	FPIs bought ~36k crores in June and July (since inclusion)			#31
GLOBAL DRIVERS	COMMODITIES	Risks are evenly balanced			NA
	GEO-POLITICS	Risk of China/US trade barriers & Israel-Hamas conflict			NA
	GLOBAL YIELD	Global data has softened. Fed has gained greater confidence	Difficult to project macros too much in future		#7, #33
OTHERS	RBI REGIME	Liquidity has improved. RBI to manage overnight rates with VRR/VRRR RBI may track US FED,			#35

Mutual Fund investments are subject to market risks, read all scheme related documents carefully

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- What is the preferred maturity for an investor?
- Are corporate bonds better or Gsecs?
- Is the term premia of 50bp for 10-Year bond too low? (repeat)
- Are we afraid of RBI OMO?
- Note: The relation of long-term yields & bank deposits – and inevitability of inverted yield curve
- **DSP CONVERSE** - in whole

What is the impact of the LCR regulation changes?

One liner: The sugar rush of bond flows will continue, if the recently released RBI draft guidelines on LCR for banks is implemented on 01st Apr 2025.

We have heard economists mention an impact of more than Rs. 3 lac cr (upto 6 lac cr) of buying in bonds due to these regulations. How big is this number? For reference, total Gsec net borrowing for FY25 is 11.6 lac cr., and total banks purchase of SLR was Rs. 7 lac cr for FY24. In this context, the expected additional banks purchase is mammoth. Such additional demand from banks could potentially lead to an undesirable sharp fall in yields. RBI will be wary of this.

Thus, there may be some dilution: (i) staggered implementation of LCR rules, (ii) Public sector banks reducing their LCR over coverage, (ii) dispensation on HQLA haircuts for non-Gsecs, or (iii) dip into CRR for HQLA, etc. These may reduce the impact on the yield curve. But we have no idea which of these actions may fructify.

Nonetheless from demand perspective the news is as big, if not more, than JP Morgan index inclusion. LCR regulations, even in diluted form, would mean a sustained downward pressure on yields .

A large part of this flow will come this year (as new regulations will come in Apr 2025).

So, our view is Investors need to invest in duration, remain invested. The risk of yields rising is limited.

Counterpoint: This is a draft guideline. In past RBI has pushed the can of draft guidelines to next year. If yields fall cataclysmically, or banks have genuine concerns then the guidelines may not come to force in Apr 25.

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What is the preferred maturity for an investor?

One liner: Depends on investor profile. We prefer long end.

DSP advised (and invested) in 30- and 40-Year paper in Feb 2023, right after last years budget. The demand vs supply was too skewed for long bonds. While markets avoided those bonds at that time, they have gradually warmed up.

These bonds are still the best bonds for absolute profit investors, but their outperformance will not be one-way street anymore. Why?

Firstly, lets discuss the demand – **demand is strong across the curve.** New LCR regulations will lead to more demand in shorter end (banks usually prefer shorter duration, especially since nor higher SLR will increase PV01 risk). The new FAR regulations will be marginally beneficial to shorter duration bonds. However, the long duration bonds have too much working for them. The domestic demand is overshadowing the supply. The demand from Insurance/PF/NPS/EPFO will continue to outstrip supply, partly due to beneficial taxation.

Secondly, the supply – **govt cannot increase long bond supply too much**. The share of supply of the long bonds is nearly 40% of total supply. RBI cannot increase it further. To lock most of the borrowing in 30Y+ at 7% yield runs structural risk if India's nominal growth falls, like China (mirror image of risk of short-term borrowing). RBI just reduced the short bonds supply in H1FY25. Thus, it is unlikely that RBI can reduce the supply of short bonds further or increase for long-end bonds. In fact, if there is a further rally in short bonds due to LCR, then it is very likely that RBI will increase short bond of supply.

At times long bonds will rally, other times short bonds will rally. RBI may tinker with the supply to ensure that one does not overshadow other. **However, all segments of yields will fall.**

For **absolute gain investor it makes sense to be in long bonds** as gain in every bp fall of long bonds (~40y) is ~4 times the fall of short bonds (~4y). Thus, even if curve steepens, long bonds is more meaningful.

If you are more bothered about reward/risk like a bank trader, then prefer short bonds. However, the universe that tracks Sharpe ratio is small for MF investors – and thus **we would continue to invest in long bonds in our no duration limit funds.**

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Are corporate bonds better or Gsecs?

One liner: Difficult one. There are too many moving parts to make a clear decision. While the demand from LCR and FPI will be in Gsecs, but as yields gravitate lower the search for extra carry will make corporates attractive.

In DSP Converse two months back, we preferred Gsecs to corporate bonds. Since then corporate spreads have slightly increased while yields have fallen, we are in a neutral zone.

We believe that in this juncture both curves are attractive. However, to generate alpha it is important to play tactical calls. Right now, we are at the start (i) of bond inclusion flow, and (ii) LCR demand fears. Since these flows will be concentrated in Gsecs, we prefer slightly additional Gsec holding – despite the corporate spread having widened.

Is the term premia of 50bp for 10-Year bond too low? (repeat)

The term premia of 50bp may seem too low, especially compared to the recent times. But for a decade upto COVID, the 50bp premia was par for the course. Especially, when RBI's next rate action was a cut.

Over and above, this year the bond demand is much larger than supply. This puts natural pressure on premia to be lower. In fact, in current times, most of the global markets have inverted yield curve. Not so in India.

For comparison, US 10Y is trading ~100bp **lower** than overnight rate. Thus, the positive term premia of ~50bp in India is quite attractive.

Especially when US faces fiscal worries, whereas India faces fiscal prudence.

Conclusion: Term premia can fall much lower.

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Are we afraid of RBI OMO?

RBI OMOs are going to happen, and happen in size. But that is nothing to be afraid about. Why?

Let's imagine if RBI wasn't going to sell bonds this year. The demand /supply mismatch **(slide 31)** will be so vast, that Indian yields could fall below 6%. There are just not enough Gsecs to whet the appetite of PF/Insurance & FPI & now Banks (LCR).

RBI won't allow for such drastic fall in yields. A decade back when FPI used to sell bonds and giving additional supply of bonds to domestic market (and tight liquidity), RBI would buy bonds (and infuse liquidity). Today RBI will have to do reverse.

Thus, RBI will certainly sell sizeable bonds. But that selling will be sufficient to reduce volatility – not stop the movement of lower yields.

The RBI sell is a reaction to speeding bond-demand train and will create speed bumps, but not put a halt.

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The relation of long-term yields & bank deposits – and inevitability of inverted yield curve

Last year Govt came up with higher taxation for debt mutual funds. It was hoped that the decision will help banks gather deposits. A year later, and banks are still scrambling for deposits.

The bigger players in debt (and competition to debt financial savings) are PF, PPF, EPFO, Insurance, NPS. These investors benefit from better taxation. Thus, bank deposits face stiff competition for debt savings.

And where do these products invest in. They invest in long term bonds. The long-term bond yields are quite attractive in India – thanks to govt increasing the longer-term supply. The recent limitation on long term FAR securities only add to this pressure.

Thus, these investors have two benefits compared to bank deposits (i) better taxation, and (ii) attempt by govt to keep long bond yields high.

Till the time the net returns post taxes are significantly higher in long term investment products, they will continue to garner higher allocation of debt financial savings. This will keep impacting banks' deposit growth.

There are only two ways to stem the flow: (i) remove any tax benefit from Insurance/NPS/PF etc and bring them in par with deposits/MF, or (ii) let the long-term bond yields be driven by market to such low levels such that long term investments give similar returns to deposits.

The Indian bond curve will have to invert. Any other curve is just not sustainable!

Higher long-term yield makes long term investment products much more competitive. This makes them garner more AUM (from deposits). This makes the pressure on long term yields stronger.

Thus, the long-term yields will need to be lower than belly of the curve (inverted curve) to dissuade investors from investing in those instruments. Until then, even if Govt tries to keep the long bond yields higher, the excess investments in attractive long-term bonds will ensure that the long bond yields cannot remain high.

Conclusion: G-sec curve will become inverted with long term yields falling. We don't know when – but it will have to happen. At that time the bank deposit should also improve.

July 2024

DSP

#INVESTFORGOOD

Remain long.
Risk to yield rise limited

DSP CONVERSE

Our Framework

Monetary Policy

Inflation
- June CPI back above 5%, led by vegetable prices
- Core CPI comfortable at 3.1%
- Telecom tariff hikes impact CPI by ~20bps

Growth
- Domestic activity is resilient so far
- No green-shoots in Q1 commentary (as far as rural economy is concerned)
- Overall credit growth slowed down to ~14% YoY

Currency/CAD/BOP
- External sector pressures remain low
- INR risks have abated – Debt FPI flows started
- Trade deficit eased vs May. However, still elevated at $21bn

Fiscal Policy

Supply
- H1FY25 borrowing (%) lower than last 5 years
- H1FY25 SDL calendar high, but actuals 36% lower
- RBI OMO sales to provide constant supply

Demand
- FPI demand to continue
- Proposed LCR guidelines may increase bank's buying by 2-4 lac cr (~20% of net Gsec borrowing).

FPI
- FPIs bought ~36k crores in June and July (since inclusion)

Global Drivers

Global Yields
- US economy/ labor/ inflation softened
- FF Futures pricing 3 rate cuts in CY24
- Fed has gained greater confidence in Q2 data

Geopolitics
- Risk of China/US trade barriers
- Ukraine Russia conflict is in backburner
- Israel-Hamas war heightens

Commodities
- Price risks are evenly balanced

Others

RBI Regime
- Cautious but nimble
- Liquidity improved & overnight rate below repo
- RBI needs a "descent of inflation to 4% target"
- Fine tuning o/n rate through VRR and VRRR

Misc.
- US political risks

Positive
Neutral
Negative

Takeaway:
Domestic environment steady. Fed has gained greater confidence (to cut) in Q2 data

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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; FPI: Foreign Portfolio Investment; NSSF: National Small Savings Fund; VRR: Variable Repo Rate; VRRR: Variable Reverse Repo Rate; o/n: Overnight

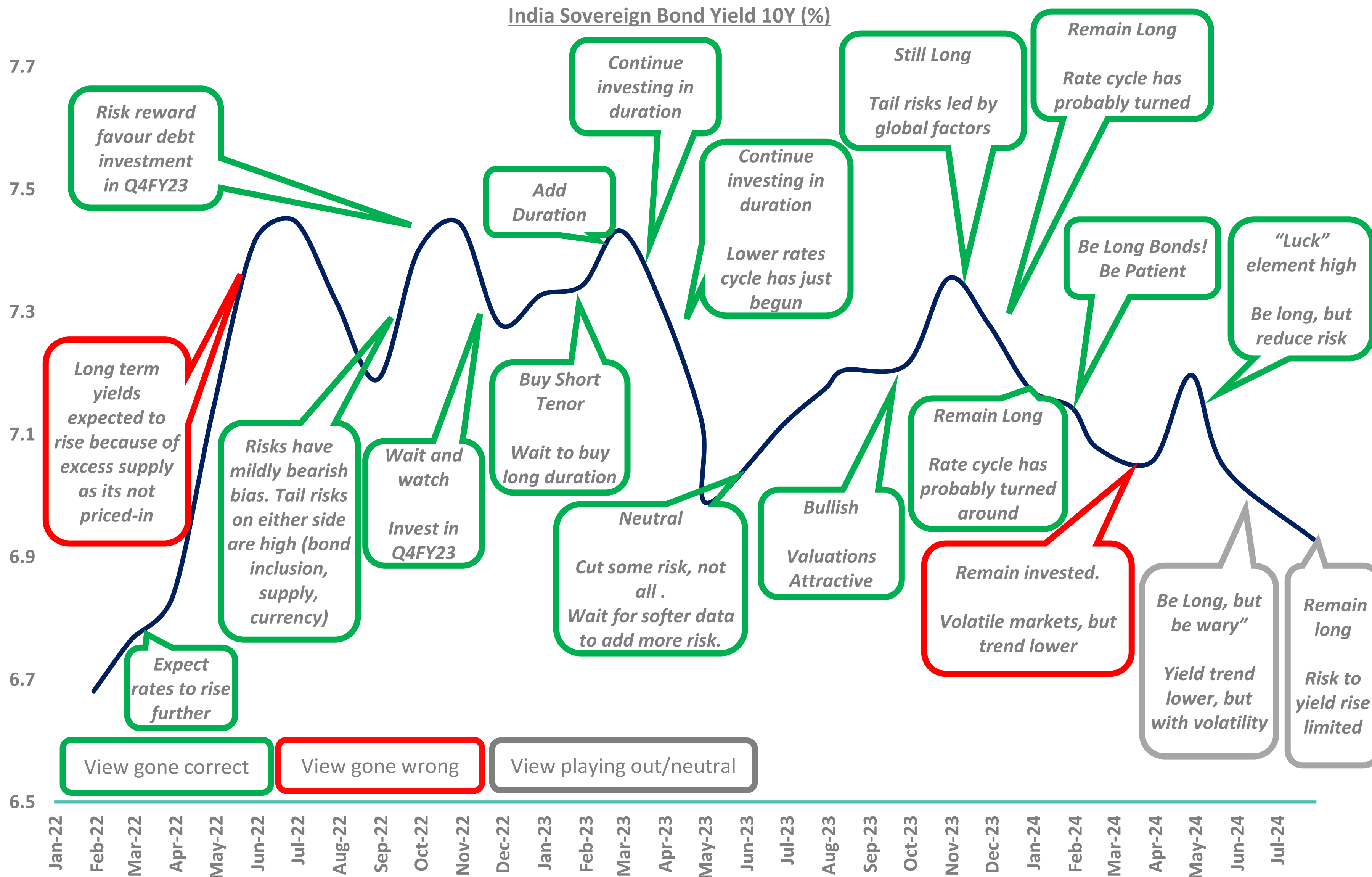
Be Long! Why?

Domestic macros supportive of lower yields

Favorable demand/supply metrics

US data is softening

Let’s revisit our rates call trajectory



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Source – Bloomberg, Internal

To start with,

Recap of events since last DSP CONVERSE release

WHAT HAS CHANGED

US Data is Softening & Fed has gained greater confidence

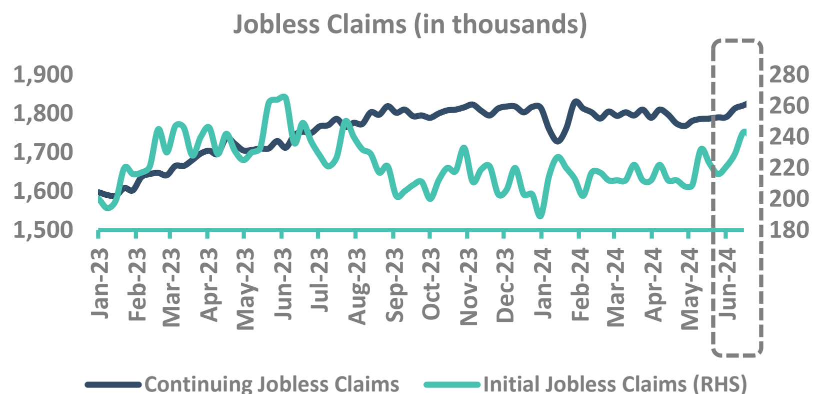
Domestic macros comfortable

Proposed LCR guidelines to increase bank's demand

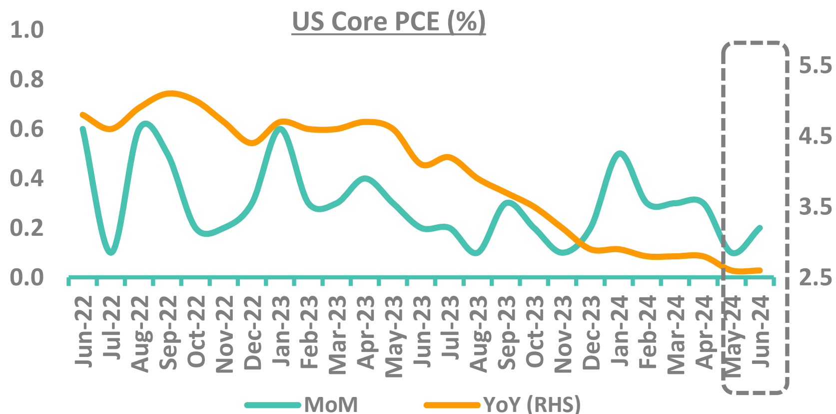
US Political risks emerging

US data has softened

➢ The US jobs market showing weakening signs



➢ But inflation still remains sticky



➢ US Fed remains on "data dependent" mode

- Commentary balanced overall
- Inflation has eased notably over the past year
- Labor market remains tight, but supply/demand conditions continue to come into better balance
- It has gained greater confidence in Q2 data

Fed Fund Projected Rates				
Fed Policy	As of last converse		As of 31st Jul	
	Implied Rate	No. of cuts/hike	Implied Rate	No. of cuts/hike
Sep'24	5.191	-0.545	5.038	-1.144
Nov'24	5.131	-0.788	4.857	-1.868
Dec'24	4.986	-1.365	4.598	-2.902
Jan'25	4.915	-1.650	4.403	-3.685

Takeaway:
Fed not to rush into cutting rates

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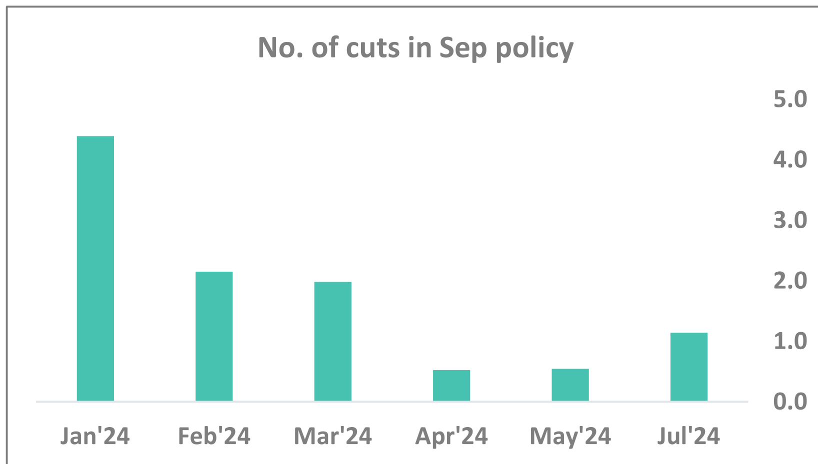
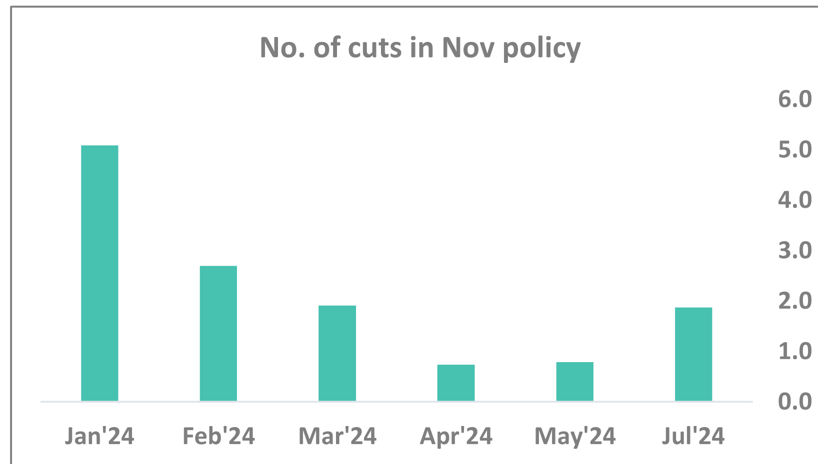
Source – Bloomberg, Federal Reserve

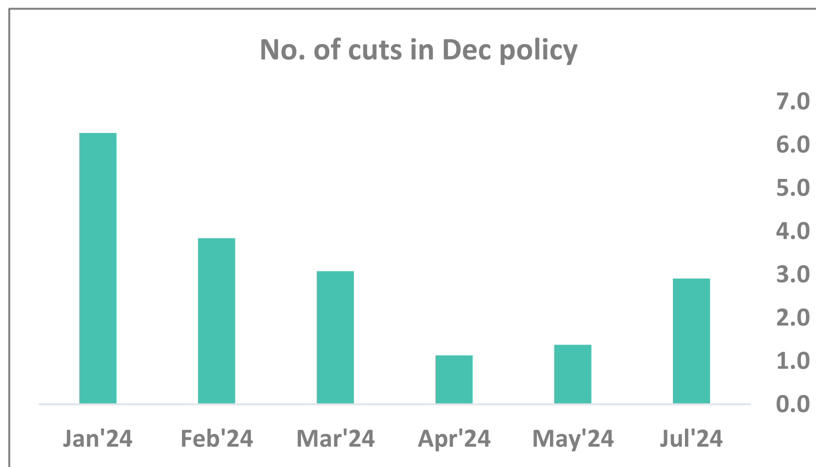
PCE: Personal Consumption Expenditure; FOMC: Federal Open Market Committee

Rate cuts again getting priced-in for CY24

From pricing in just 1 rate cut during Apr-May to now 3 rate cuts







WHAT HAS CHANGED

Proposed LCR guidelines to increase Bank demand

	HQLA (bn)	Outflow (bn)	Reported LCR (%)	Pro-forma Outflow* (bn)	SLR Buying (Same LCR) (bn)	SLR Buying (120% LCR) (bn)
Axis	2,585	2,152	120.1	2,352	298	295
Bandhan	291	224	129.9	248	38	13
DCB	114	94	120.7	105	15	15
HDFC	5,601	4,863	115.2	5,349	686	949
ICICI	3,992	3,307	120.7	3,588	427	401
IDBI	803	670	119.8	715	71	72
IDFC First	476	419	113.6	460	57	87
IndusInd	948	803	118.0	858	85	102
RBL	314	225	139.7	238	26	-22
Yes	645	555	116.1	592	57	81
BoB	2,749	2,192	125.4	2,428	358	225
BOI	1,556	1,016	153.1	1,172	275	-121
BOMH	596	476	125.2	524	73	46
Canara	3,054	2,367	129.0	2,574	336	98
CBOI	980	478	205.1	580	233	-270
Indian	1,627	1,205	135.0	1,325	199	-4
IOB	617	444	138.9	510	106	8
PNB	3,123	2,205	141.6	2,476	456	-90
PSB	273	218	125.4	242	36	23
SBI	13,131	10,178	129.0	11,157	1,558	531
UCO	600	396	151.7	446	90	-54
Union	2,752	2,087	131.9	2,293	334	56
Total					**5,814**	**2,439**

* 5% additional run-off on deposits. Assuming 70% internet/mobile banking for Pvt Banks and 60% for PSU Banks

Source – Individual Banks. Nos. as of Mar'24, Internal Estimates

Now our framework

And

What we track

Our Framework

Monetary Policy

Inflation
- June CPI back above 5%, led by vegetable prices
- Core CPI comfortable at 3.1%
- Telecom tariff hikes impact CPI by ~20bps

Growth
- Domestic activity is resilient so far
- No green-shoots in Q1 commentary (as far as rural economy is concerned)
- Overall credit growth slowed down to ~14% YoY

Currency/CAD/BOP
- External sector pressures remain low
- INR risks have abated – Debt FPI flows started
- Trade deficit eased vs May. However, still elevated at $21bn

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RBI Regime
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Positive

Neutral

Negative

Takeaway:
Domestic environment steady. Fed has gained greater confidence (to cut) in Q2 data

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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; FPI: Foreign Portfolio Investment; NSSF: National Small Savings Fund; VRR: Variable Repo Rate; VRRR: Variable Reverse Repo Rate; o/n: Overnight

Resilient domestic economic activity

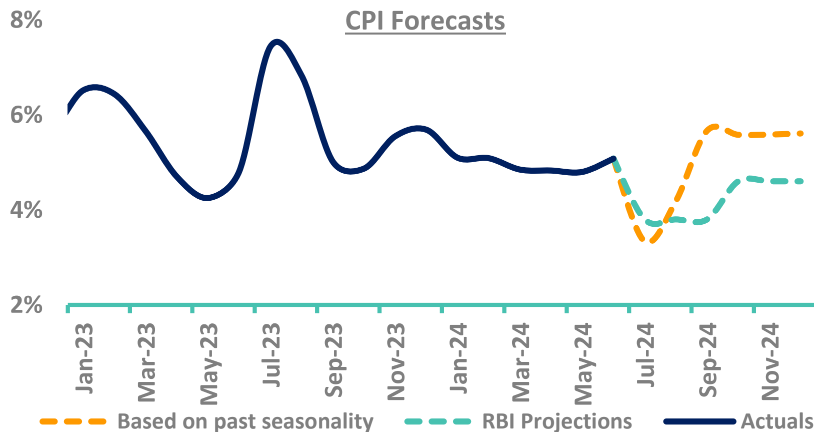
Expansion in urban demand while rural still not completely out of woods

Inflationary risks seem contained

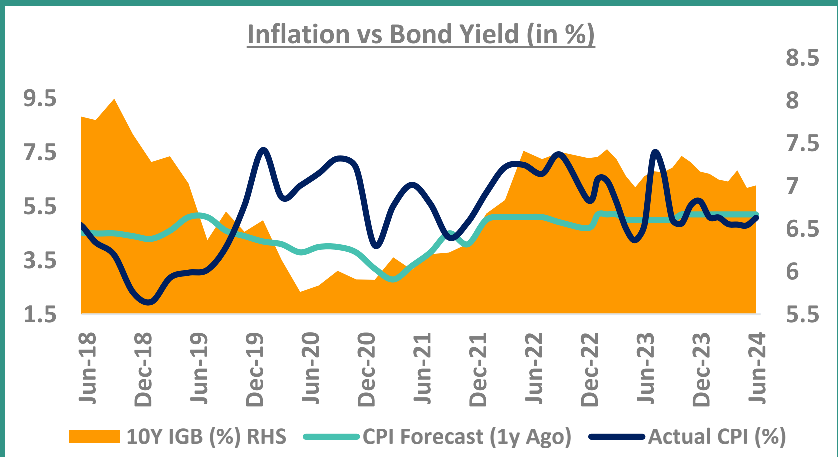
RBI to be nimble in liquidity management

Core CPI remains comfortable. Risks seem contained

- **Jun CPI increases to 5.08% vs 4.80% in May**
  - Back above 5% mark after three months
  - Led by sharp increase in vegetable price inflation, up 2.7% MoM
  - Telecom tariff hike to impact inflation by 20 bps
- **Core inflation at 3.1% mark (3% in May)**



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



Takeaway:
Domestic inflation risks seem contained. Volatility in CPI has not impacted yields (especially in 2023)

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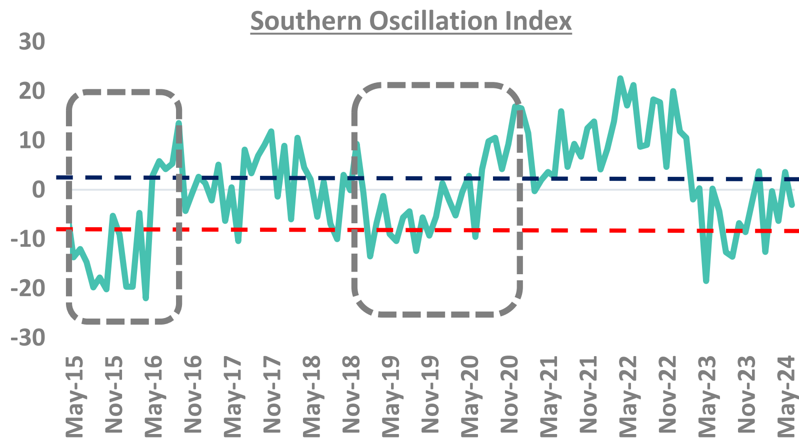
CPI: Consumer Price Inflation; RBI: Reserve Bank of India; IGB: India Government Bond

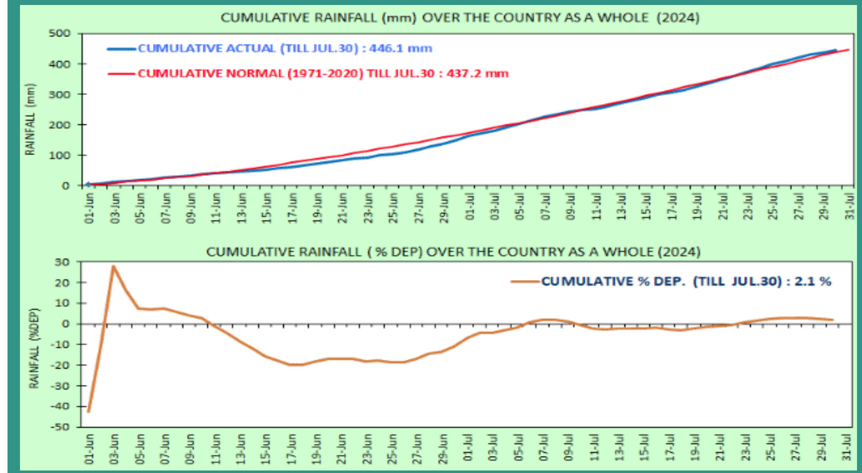
Source – Bloomberg, RBI, Internal

Good monsoon bodes well for food inflation

- **Southern Oscillation Index value within normal range**
- **Reservoir levels inching up (25th Jul)**
  - ✓ Reservoir live storage at 69.27 BCM (at 82% of the live storage of corresponding period last year and 96% of storage of average of last ten years)



- **India monsoon catching up**
  - From a cumulative deficit of 17.1% as of 27th Jun to now at marginal surplus of 2.1%
  - Significant deficit in the eastern part still remains a concern



Takeaway:
Surplus cumulative rainfall bodes well for reservoir levels thus food inflation

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Source – FCI, Australian Govt BoM, NFSM

MSP hike insignificant and comfortable stock levels

MONETARY POLICY

- **Rice (including paddy) stock at record levels**
  - Exporters now urging Govt to lift ban for exports
- **Wheat stocks are on the lower side**

In (lac tonne) (Jun)	Wheat	Rice	Unmilled Paddy	Rice + Unmilled Paddy
2019	458.31	284.21	105.10	389.31
2020	549.91	271.71	182.99	454.70
2021	603.56	296.89	289.87	586.76
2022	285.10	317.07	231.51	548.58
2023	301.45	253.49	232.99	486.48
2024	282.61	326.14	237.09	563.23

- **MSP announced for Kharif crops for marketing season 2024-25**
  - Although the hikes were lower than in 2023-24

MSP			
Crops	MS 2024-25	Increase (23-24)	Increase (24-25)
Moong	8,682	10%	1%
Sesamum	9,267	10%	7%
Cotton (Long Staple)	7,521	10%	7%
Groundnut	6,783	9%	6%
Cotton (Medium Staple)	7,121	9%	8%
Jowar-Maldandi	3,421	8%	6%
Ragi	4,290	7%	12%
Jowar- Hybrid	3,371	7%	6%
Pady-Common	2,300	7%	5%
Soybean (Yellow)	4,892	7%	6%
Paddy-Grade A	2,320	7%	5%
Maize	2,225	7%	6%
Bajra	2,625	6%	5%
Nigerseed	8,717	6%	13%
Tur/Ahar	7,550	6%	8%
Sunflower Seed	7,280	6%	8%
Urad	7,400	5%	6%

Takeaway:
Comfortable food stock to act as buffer against any supply shock

Source – FCI, Australian Govt BoM, NFSM

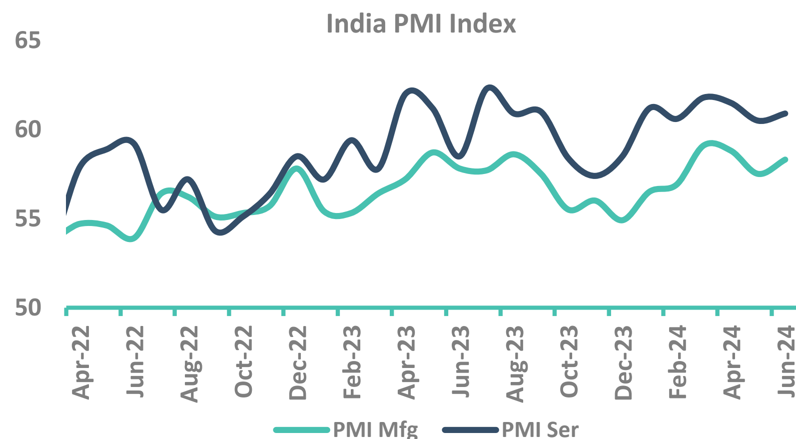
Domestic growth resilient so far: But watch out for trends

➢ Watch out for domestic growth

- PMI continue to be in expansionary mode
- GST collection for Jun at 1.74 lac crores, up 8% YoY (lower than 10-11% seen in past)
- Lack of any green-shoots in Q1 commentary

➢ Overall credit growth moderated slightly to 14%

- Unsecured PL and loan to NBFCs have moderated
- Housing loan and services growth remain strong
- Credit to industry has remained stable

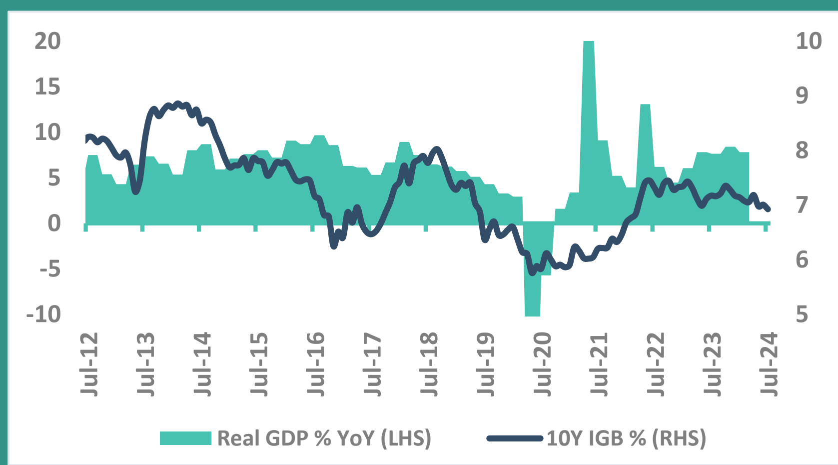


➢ How closely do yields track growth?

- Yields have usually tracked GDP growth, with correlation stronger when growth slows, barring
  - ✓ 2013, rupee depreciation and debt outflows
  - ✓ 2017, during demonetization

➢ FY24, growth may not be big driver for yields

- FY23 GDP growth at 7.2% -in line with RBI projections.
- Q3FY24 GDP Growth came in at 8.4%.



Takeaway:
Domestic growth seems to be resilient so far but watch out for emerging trends

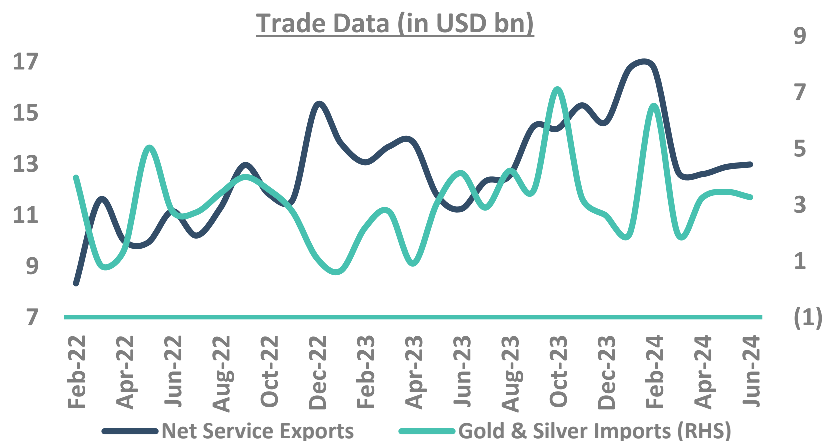
DSP

Source – Bloomberg, PIB, Internal

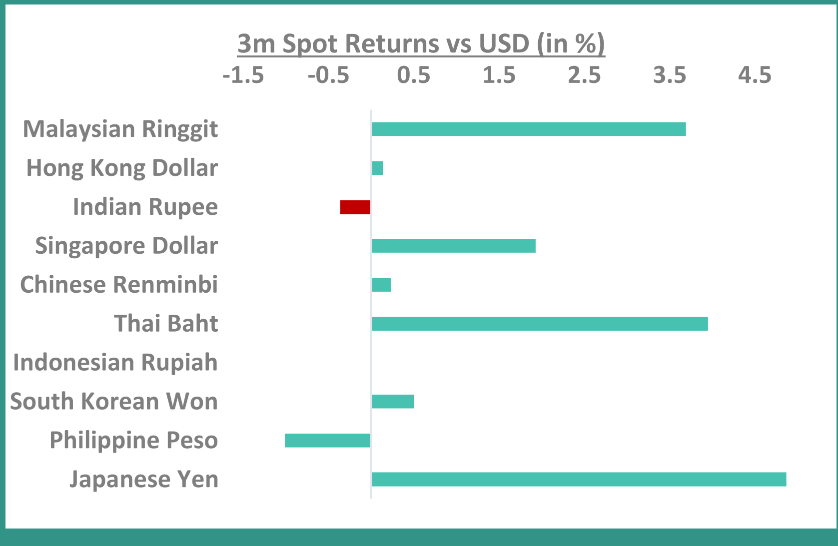
GDP: Gross Domestic Product; PMI: Purchasing Managers' Index; GST: Goods and Service Tax; IGB: India Government Bond

External sector metrics remain comfortable

- **FX reserves at record high level**
- **Trade deficit remains elevated at $21bn**
  - However, lower vs 23.8bn in May, led by lower oil deficit
  - Services trade surplus continues to hold steady



- **Rupee is Stable as compared to its Asian counterparts**
- **Active FPI Inflows already there and passive flows have also started**



Takeaway:
External Sector metrics remain comfortable

DSP

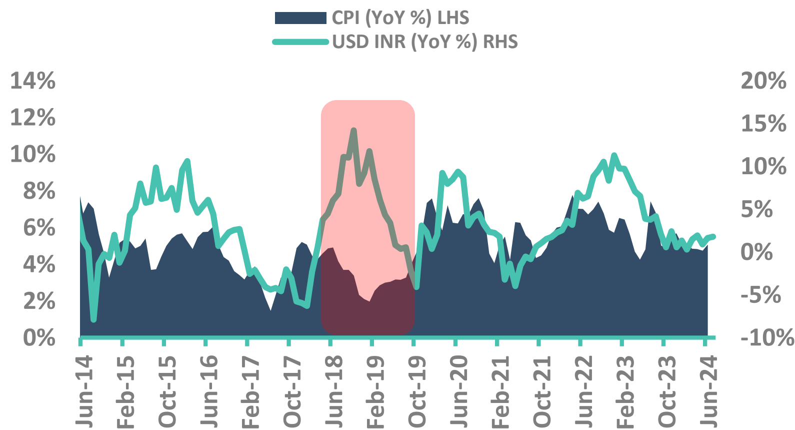
Source – Bloomberg

BoP: Balance of Payment; MTM: Mark to Market; EM: Emerging Markets; UST: US Treasury

Rupee depreciation risks seem contained

Rupee and Inflation have a strong correlation

- There is a strong co-relation between rupee movement and CPI (barring 2018-2019)
- Reaffirms that India bears risk of imported inflation
- RBI intervention visibly reduced as USD/INR touched lows of 83

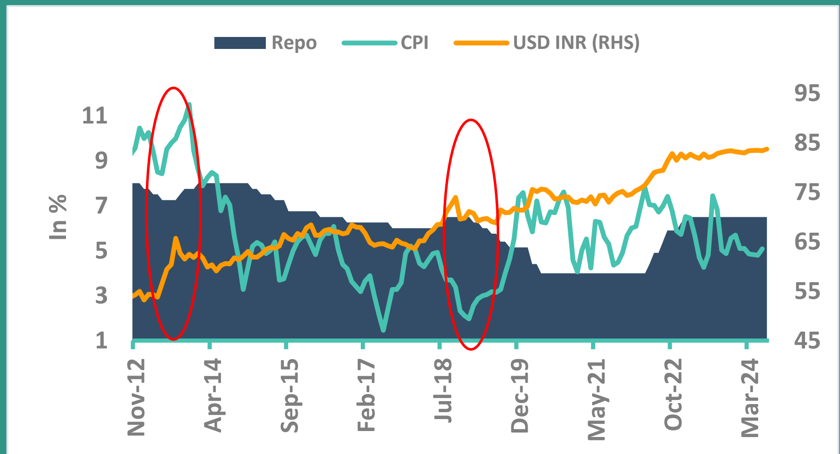


RBI has in past acted swifter to protect currency than inflation

- In 2013 and 2018 RBI increased rates when rupee depreciated
- In 2018, in inflation was within RBI's target levels

We don't see rupee depreciation risk

- Bond Inclusion flows have started
- Equity FPI flows (India being the sweet spot)
- Easing US yields to result into flows in emerging markets



Takeaway:

With record high forex reserve and passive flows, rupee depreciation risks seem contained

DSP

MPC – Monetary Policy Committee; CPI: Consumer Price Inflation; USD – US Dollar; Source: Bloomberg

What makes RBI Cut Rates?

In our view, the likely scenario

Rate cuts: Waiting for evidence from Fed cuts

➢ **Checklist for cut:**
- ✓ Fed Pause/Cut
- ✓ Stable Rupee
- ✓ CPI less than 6% (except in 2013 when RBI didn't have 6% target)

➢ **How is the Checklist now:**
- ✓ Awaiting cuts from FED, it has gained further confidence
- ✓ Given the FPI flows, forex reserves at $600bn+ and normalization of trade deficit, rupee to remain stable
- ✓ Inflation risks seem contained

CPI

Rupee

8
7.5
7
6.5
6
5.5
5
4.5
4
3.5
3

Apr-13 Oct-13 Apr-14 Oct-14 Apr-15 Oct-15 Apr-16 Oct-16 Apr-17 Oct-17 Apr-18 Oct-18 Apr-19 Oct-19 Apr-20 Oct-20 Apr-21 Oct-21 Apr-22 Oct-22 Apr-23 Oct-23 Apr-24

■ Series1

Source – Bloomberg

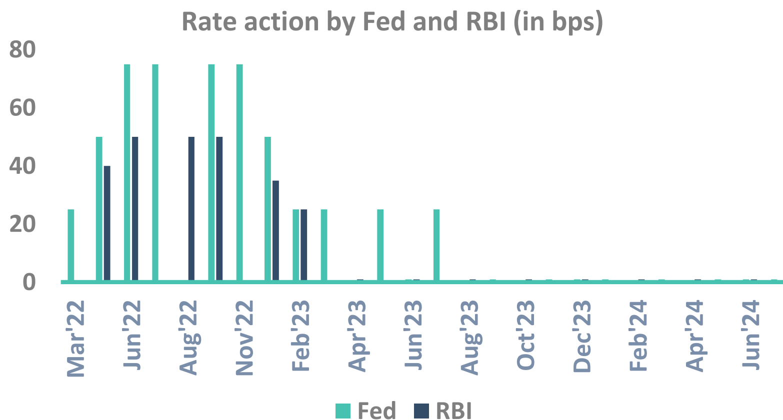
DSP

FPI: Foreign Portfolio Investment; CPI: Consumer Price Inflation; Fed: Federal Reserve; RBI: Reserve Bank of India

RBI actions followed FOMC – expect the same going ahead

Fed paused in the June'23 policy

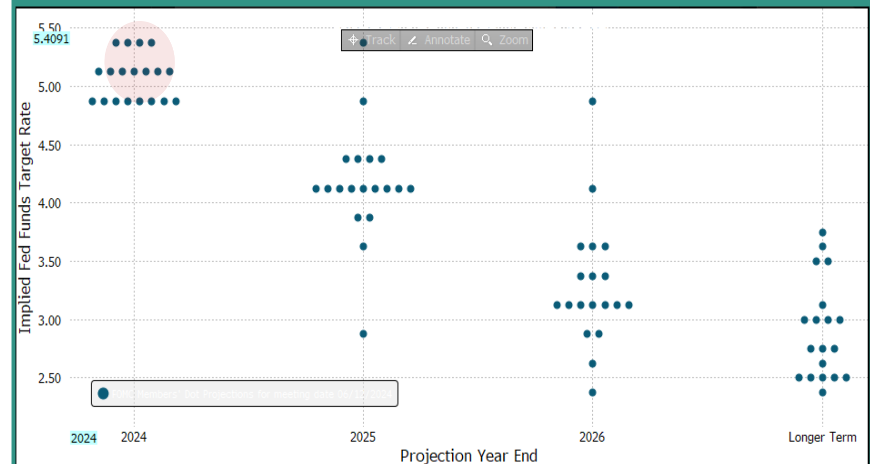
- RBI has echoed FOMC decisions, albeit more moderately
- RBI started hiking after Fed
- RBI rate hikes 25bp lower than Fed – in every policy



Fed reduces 2024 rate cut expectations

- Dot plot now indicates just 1 rate cut vs 3 in March
- However, FF Futures pricing 3 rate cut in CY24

But longer term projections remain intact



Takeaway:
RBI MPC has shades from FED FOMC. RBI rate cut to follow Fed

DSP

Source – Bloomberg, Federal Reserve

RBI: Reserve Bank of India; US FED: US Federal Reserve; FOMC: Federal Open Market Committee; MPC: Monetary Policy Committee

What makes RBI hike Rates?

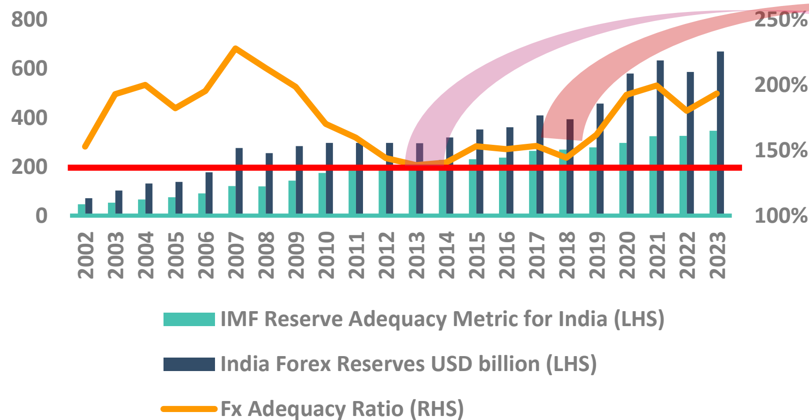
Highly unlikely

MONETARY POLICY

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

- **RBI FX reserves at record high of $657.16 bn**

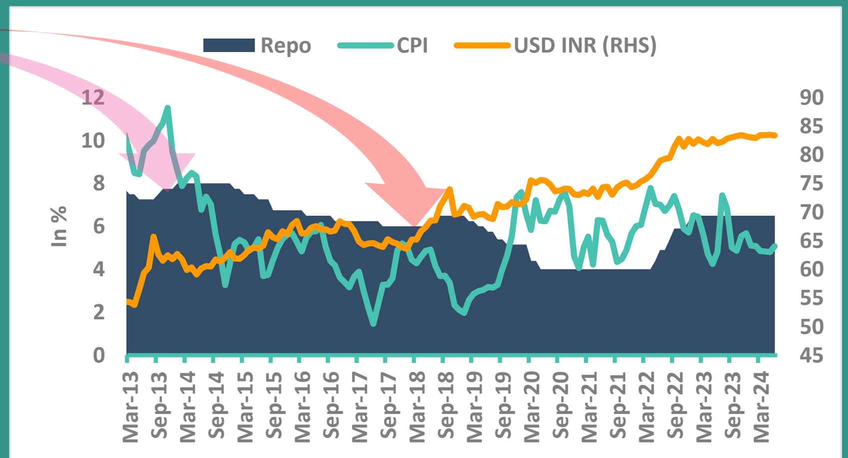
- **IMF FX adequacy ratio at historically high levels**
  - Buffer of ~USD 151 bn to reach 2013 and 2018 levels (~150% ratio)



- **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 at record high levels

DSP

Source – Bloomberg

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

Core CPI remains comfortable

Growth remains resilient

FPI flows to support INR

Let’s turn to Fiscal policy

Generally, it drives the long bond yields

It is reflected in demand/supply equation

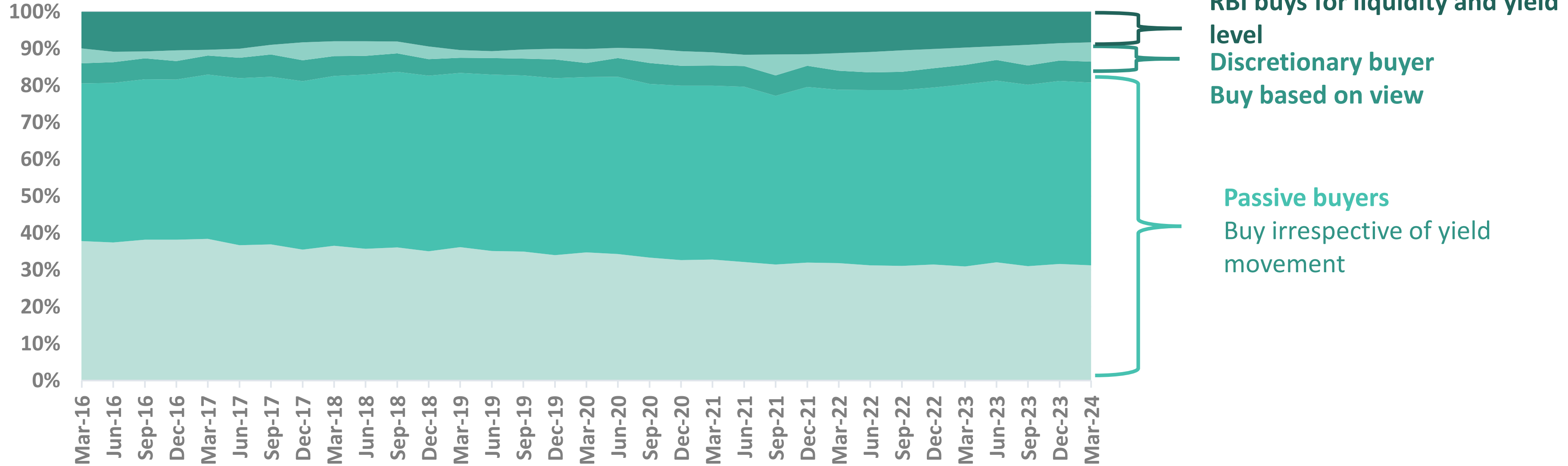
Fiscal policy is favouring bonds right now

Only a small part of bond buyers are discretionary buyers

They drive yields

Supply fluctuation is borne by these buyers

Gsec market is still driven by lumpy institution purchases



Takeaway:
Increase in supply impacts the discretionary buying. Banks excess holding, passive buyers have been absorbing the supply

DSP

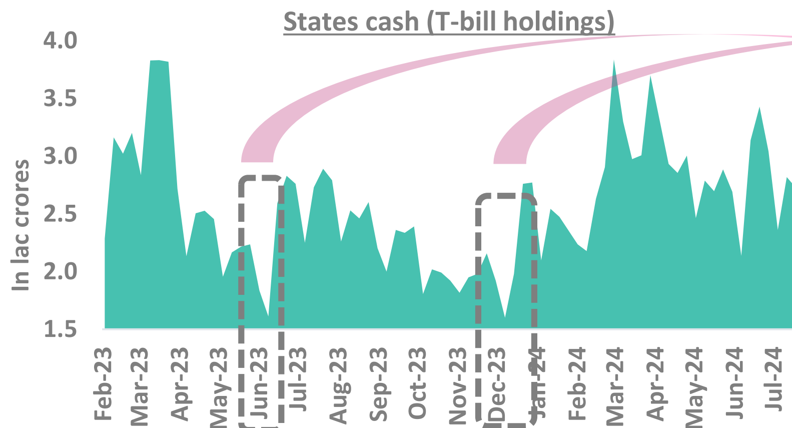
Source – DBIE

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

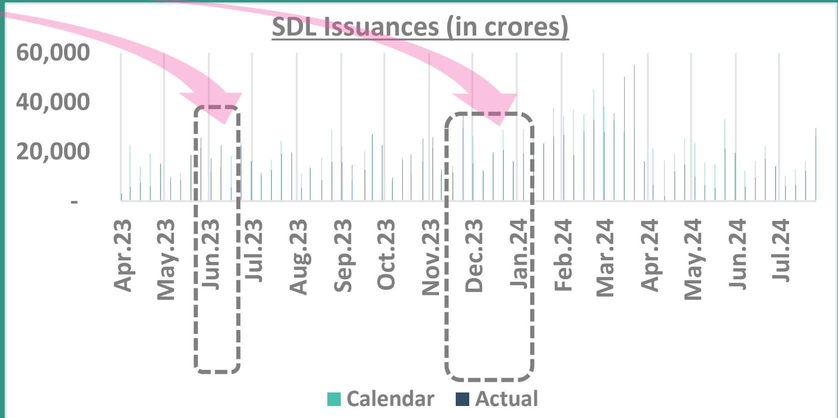
Comfortable demand/supply dynamics for FY25

SDL supply only increases when states cash dip

- **States cash balance remains above 2 lac crores**
- **Center has front-loaded devolution of tax**
- **Issuance is expected to be lower than calendar**



- **Actual SDL borrowing in line with expectations**
  - Borrowing higher than the calendar only when state cash balances dipped below 2 lac crores
  - YTDFY25 issuance 36% lower than calendarized
- **With high states cash balances SDL issuance impact is expected to be limited**



Takeaway:
SDL demand-supply to remain well-matched in FY25

DSP

Source – DBIE, RBI

T-bill: Treasury Bill; SDL: State Development Loans

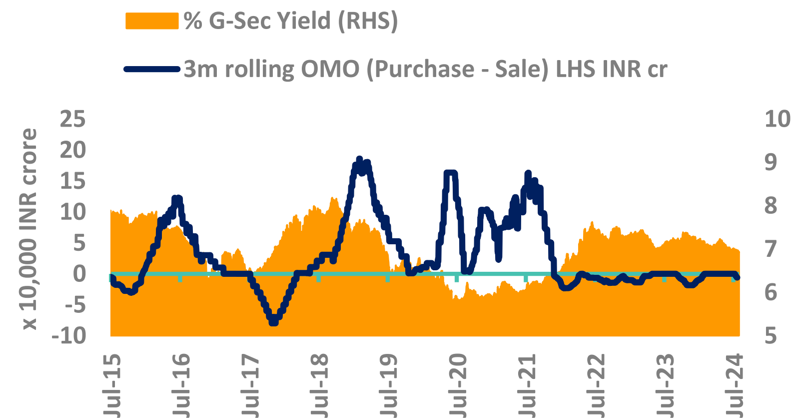
Banks SLR holdings has increased again

- **Banks SLR holdings has again increased to 29.83%**

- **The current pace of purchases is expected to continue**
  - As natural NDTL growth will still lead to demand
  - Proposed LCR guidelines will prompt further buying of SLR securities

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

- **RBI softened its liquidity management stance**
  - Liquidity conditions have improved now
  - Overnight rates below REPO despite VRRRs



Takeaway:
Proposed LCR guidelines may prompt banks to buy more SLR securities

DSP

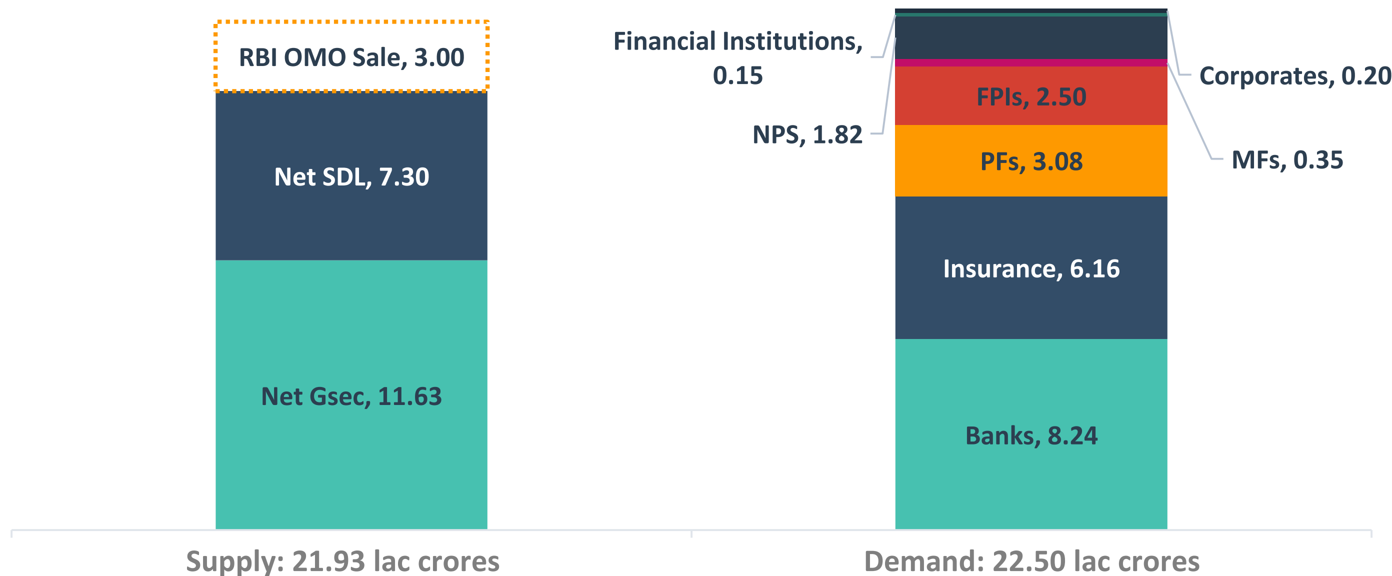
Source – Bloomberg, DBIE, Internal

OMO – Open Market Operations, SLR – Statutory Liquidity Ratio; G-Sec – Government Securities; RBI: Reserve Bank of India; SCB: Scheduled Commercial Bank; CIC: Currency in Circulation

FPI buying to drive excess demand in FY25

- **Demand to outpace supply in FY25**
  - ✓ G-sec *plus* SDL supply is higher only by 4% over FY24
  - ✓ Global Index inclusion to support passive/active FPI buying
  - ✓ Natural demand to come from other passive buyers like Insurance, PF, NPS, etc.

- **Increase in RBI OMO Sales & bank's demand (INR 2 lac crores) contingent on proposed LCR framework.**
  - ✓ Highly unlikely RBI will sell Rs. 3 lac cr.. Yield drop will most probably dissuade discretionary buying, thus limiting RBI sell.



Takeaway:
Demand-Supply highly skewed in FY25.

FISCAL POLICY

DSP

Source – Internal, CGA

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; NSSF: National Small Savings Fund

Indian yields tracking Global yields

But with lopsided beta

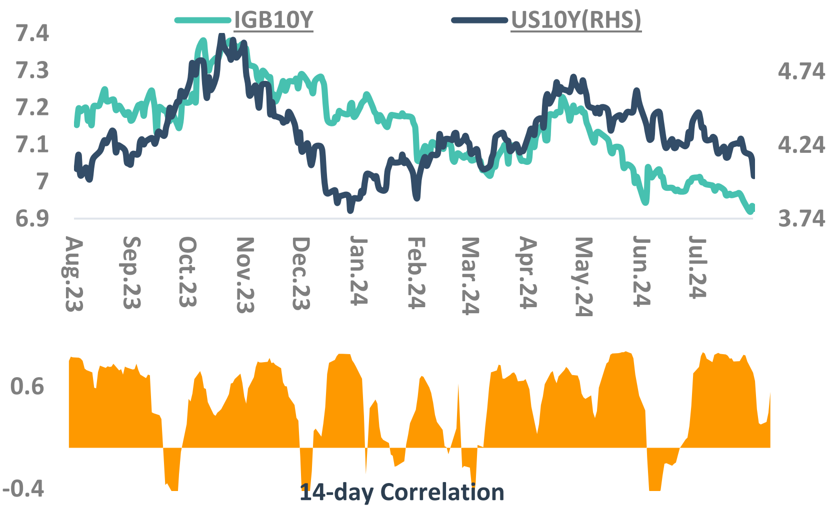
Impact of US yields on Indian yields

➢ So far Indian 10Y yields tracked US 10Y

- Except for times when UST has risen sharply

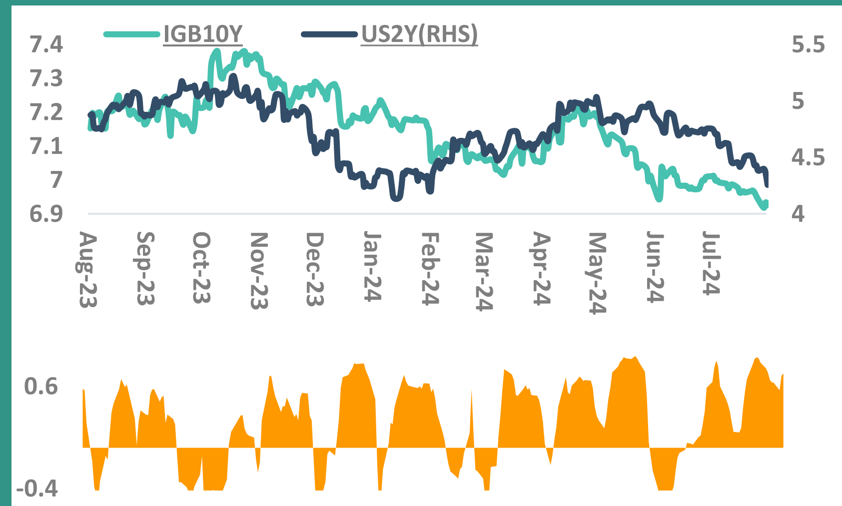
➢ When correlation broke, RBI has acted

- Higher yields -> OMO announcement (Oct'23)
- Lower yields -> Liquidity infusion - VRR (Dec'23)



➢ IGB vs UST correlation would be co-incidental rather than causal

- UST may impact IGB in short term noise
- But IGB yields will trend lower, irrespective of UST



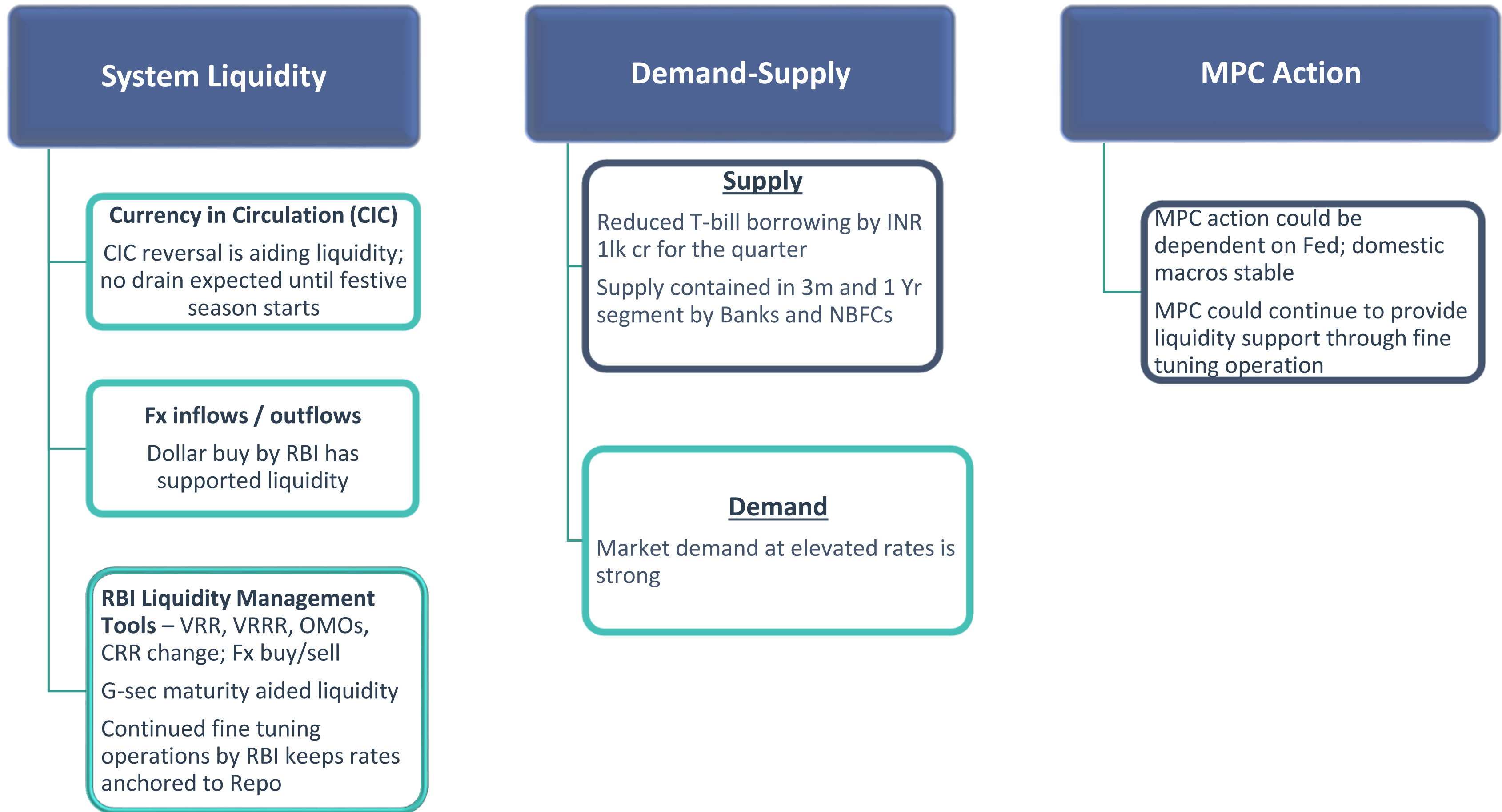
Takeaway:
Expect correlation to reduce further

Source – Bloomberg, Internal

DSP

Fed: Federal Reserve; CPI: Consumer Price Inflation; RBI: Reserve Bank of India; IGB: India Government Bond; FOMC: Federal Open Market Committee; UST: US Treasury

Money Market Assessment Framework



Takeaway:
With lower T-bill borrowing and well matched demand supply dynamics, money market yield drivers currently are favourable. We remain long across our money market funds.

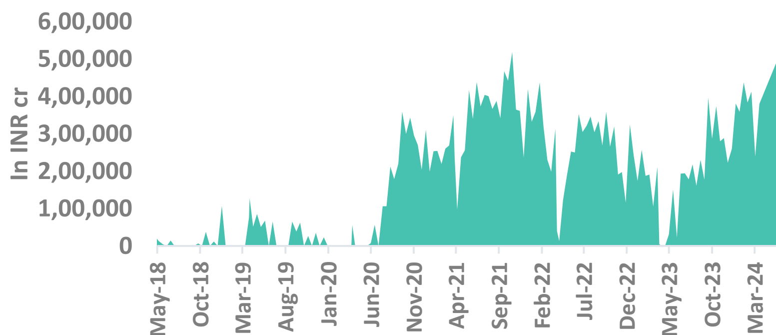
CIC: Currency in Circulation; CD: Certificate of Deposits; OMO: Open Market Operations; VRR: Variable Rate Repo; VRRR: Variable Rate Reverse Repo; RBI: Reserve Bank of India: GOI: Govt of India

Liquidity to remain positive in the near term

➢ Systemic liquidity remains above INR 4*lakh cr

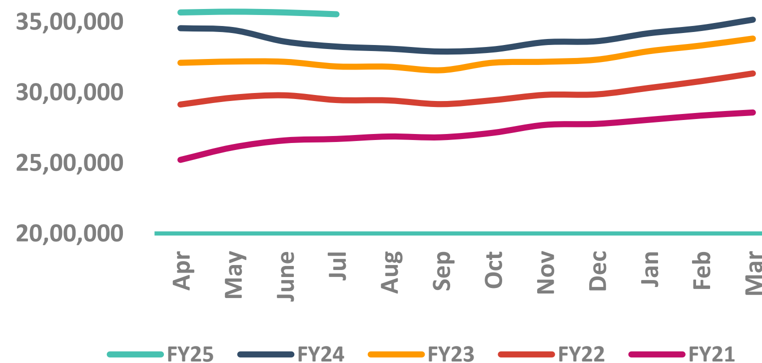
- Multiple drives impacted liquidity positively
  - G-sec maturities of ~INR1.5lk cr in July aided liquidity
  - Fx intervention by RBI of ~USD4.5bn over the last one month

➢ Expect liquidity to remain in surplus with no near-term liquidity draining events



➢ We are in the phase of seasonal CIC reversal

- Jan-May saw a CIC build up of ~INR 2lakh cr, which contributed negatively to the liquidity
- However, we are in the CIC reversal season which has aided liquidity and will continue over the next 2 months
- CIC pressure to only commence in festive months starting October



Takeaway:
Liquidity drivers in the near term remain positive, low risk to upward movement in money market rates

DSP

G-Sec – Government Securities; CIC: Currency in Circulation

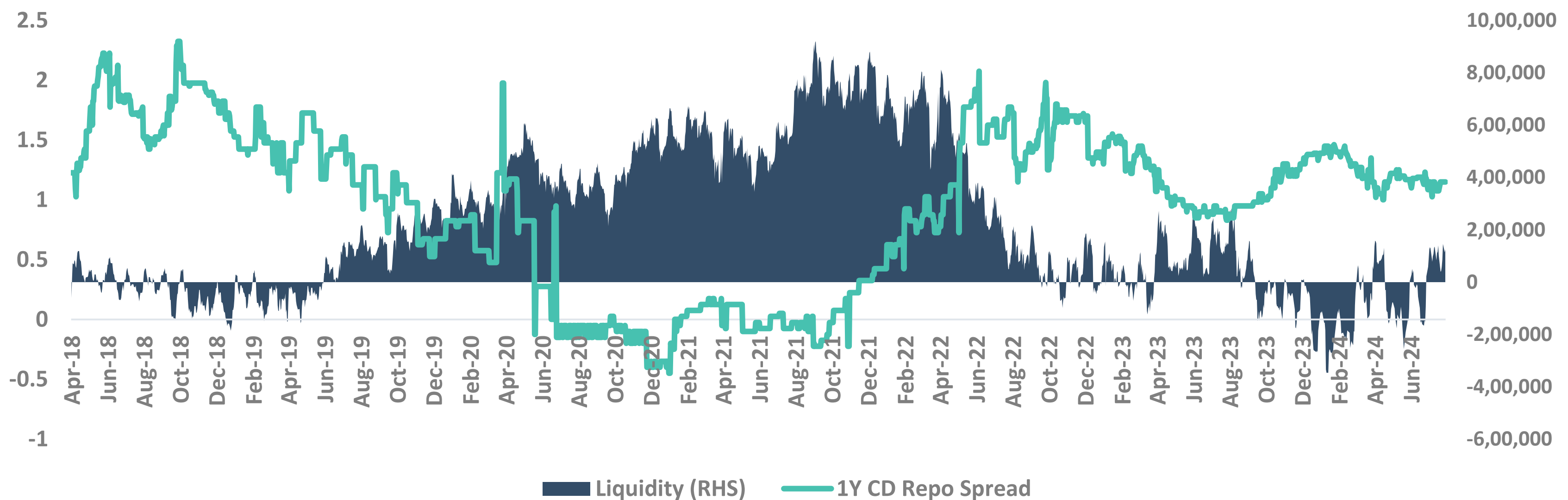
Source – Bloomberg, RBI, DBIE, *Internal Estimates

Well matched demand-supply dynamics

- **Reduced T-bill borrowing by INR 1lk crore announced in the budget**

- **1Y CD spread over policy rate still attractive at ~115bps**
  - Despite 1YCD-Repo spreads shrinking from highs of 140bps as of March 2024 to ~115bps now

- **CD supply from banks continue at current pace**
  - Outstanding CDs remain high at INR 4.2 lakh cr
  - However, demand has matched supply keeping rates anchored



Takeaway:
With well matched demand-supply combined with lower T-bill supply to keep money market rates anchored

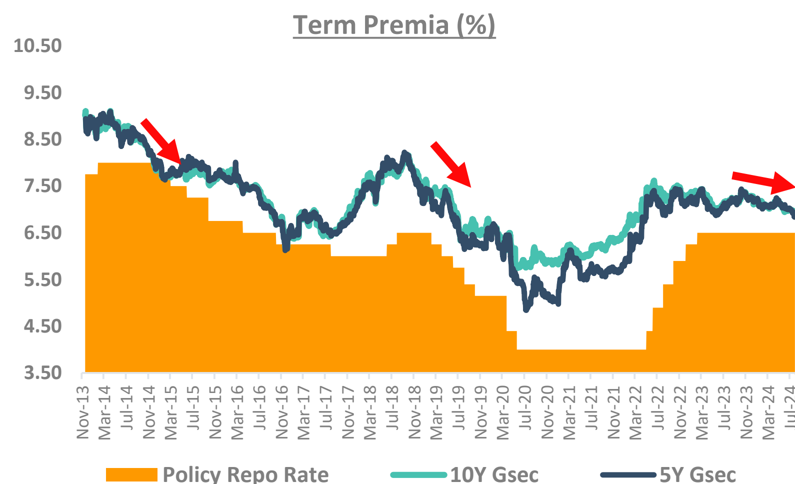
DSP

CD: Certificate of Deposits

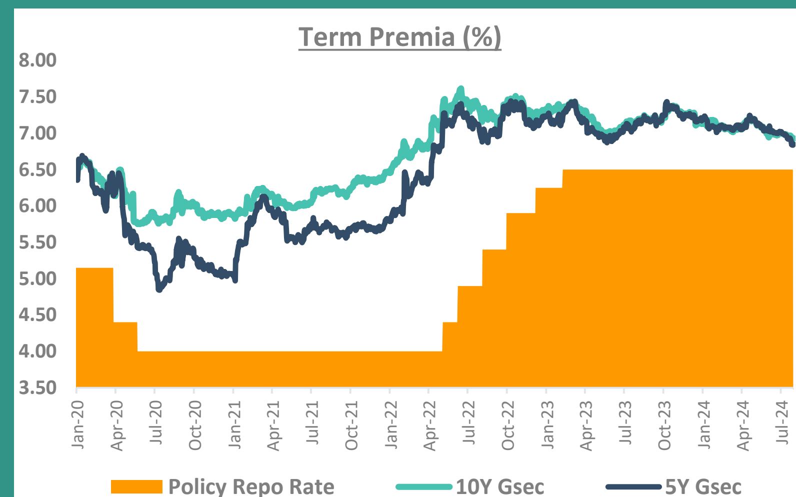
*Internal Estimates

Term premia is *still* not low

- **Term premium falls sharply before rate cuts**
  - This time, the slope of the fall is much less
  - If rate cuts get priced, the spread of 70bp will be high
- **Why do we prefer slope, not absolute levels?**
  - The slope removes the underlying demand/supply dynamics and thus can be compared across time
- **Even absolute levels are attractive**
  - Even absolute levels are attractive from prior regimes preceding rate cuts



- **Term premia: function of demand/supply and rate expectation**
  - During covid term premia high
    - Supply high: Govt increased fiscal deficit
    - Repo rates were expected to rise
  - Post covid term premia fall is natural
    - Supply low: Reduced FY25 supply, FPI flows
    - Rates are expected to fall
- **The trend of high demand, low supply strong**
  - Unlikely that govt will leave fiscal consolidation



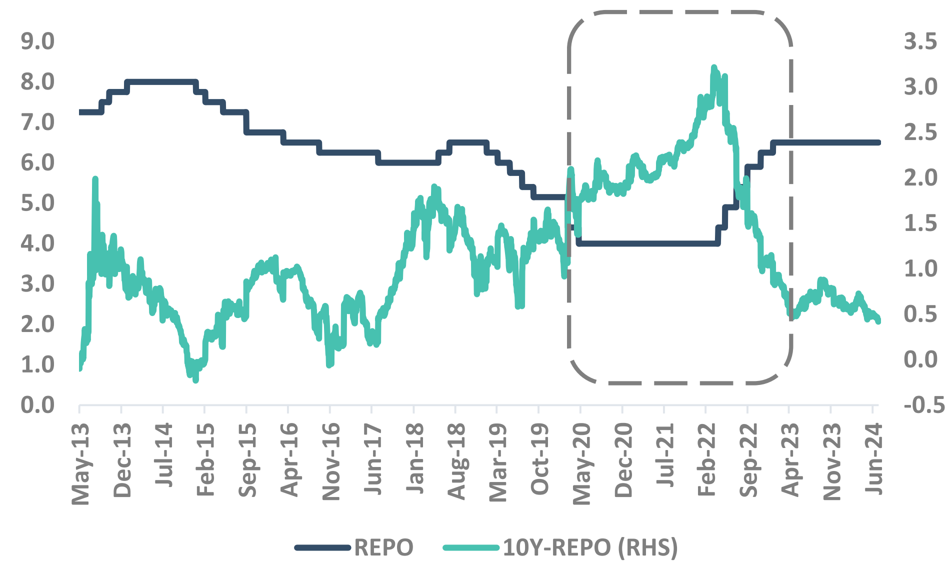
Takeaway:
Term premia is still attractive given favorable demand supply dynamics

DSP

Source – Bloomberg

Recency bias: Is 10Y-Repo Spread low?

- **The 10Y yield and repo spreads are not low**
- **Incorrect to compare with covid era spreads: Recency bias**
- **Covid was exceptional times, and barring covid, the spreads are not low**
- **With the govt. borrowing reduced and bond inclusion flows, the spread is not bad.**



Takeaway:
While recently spreads have reduced, past data suggests that current yield levels are not extremely low

DSP

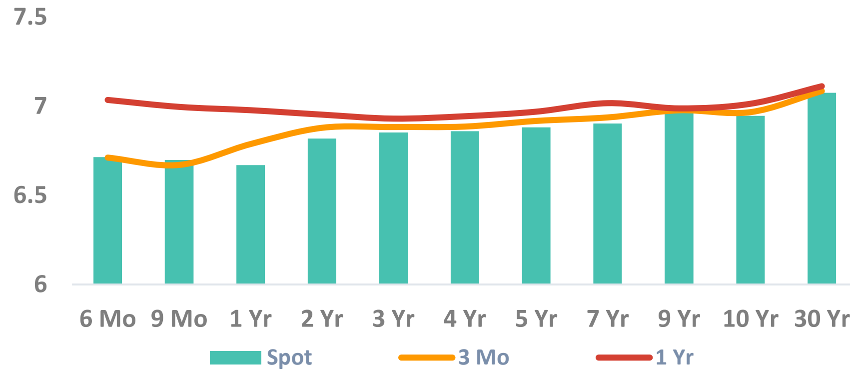
Source – Internal, Bloomberg

CHECKLIST

DSP FI Framework checklist

Drivers	1Y	5Y	10Y	>10Y	Remarks
Monetary Policy	**Neutral**	**Neutral**	**Neutral**	**Neutral**	
Inflation	Neutral	Neutral	Neutral	Neutral	Headline CPI back above 5% mark. Core CPI comfortable at 3.1%.
Growth	Neutral	Neutral	Neutral	Neutral	Resilient growth so far; lack of green-shoots in rural recovery
CAD/BOP/ Currency	Neutral	Neutral	Neutral	Neutral	External sector pressures low
Fiscal Policy	**Neutral**	**Positive**	**Positive**	**Very Positive**	
Supply	Neutral	Positive	Positive	Positive	Favourable FY25 demand supply dynamics
Demand	Neutral	Neutral	Neutral	Positive	Banks SLR holding increase. LCR guidelines to further increase bank's demand
FPI Flows	Neutral	Neutral	Positive	Neutral	FPI have bought ~36k crores since inclusion
Global	**Neutral**	**Neutral**	**Neutral**	**Neutral**	
Global yields	Positive	Positive	Positive	Positive	Fed has gained greater confidence in Q2 data
Geopolitics	Negative	Negative	Negative	Negative	Geopolitical risks on the horizon
Commodities	Neutral	Neutral	Neutral	Neutral	Risks balanced
Others	**Positive**	**Positive**	**Neutral**	**Neutral**	
RBI Regime	Neutral	Neutral	Neutral	Neutral	RBI will be influenced by Fed action
Miscellaneous	Positive	Positive	Neutral	Neutral	RBI remains cautious but nimble
Total	**Positive**	**Positive**	**Positive**	**Positive**	

DSP Duration decision:



The chart shows how much expected yield fall/rise is already priced in the current curve.

Large gap between the spot yield and forward yield shows that yield change is priced in – and thus yield change will not give capital gain/loss.

Similarly small gap means that the market is not pricing change in yields.

- **Short-term yields (2Y-5Y) may rally more than long term (7Y+)**
  - *The forward curve is inverted, we think that it is unlikely to realize*
- **Yet, long term yields may end up making more money**
  - *The duration of 30Y is 4x the duration of 4Y bond*
  - *i.e. for every 40bp fall of 4Y, the 30Y bond needs to fall only 10bp*
    - *Even if curve bull steepens by 30bp, long bonds give similar value*

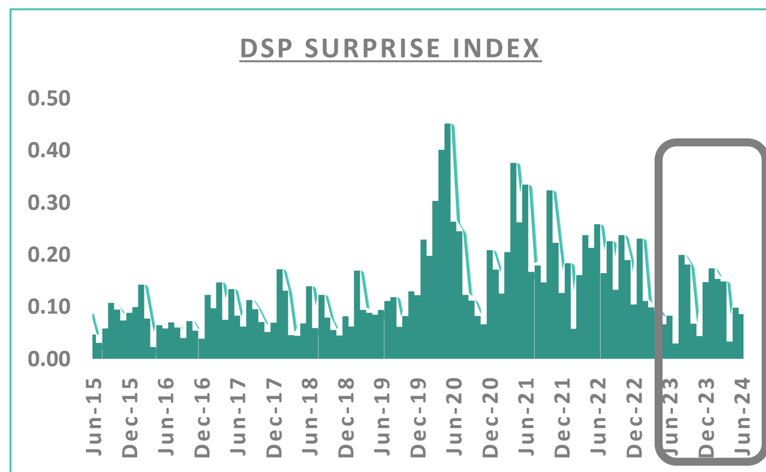
Maturity	1Y	5Y	10Y	>10Y
What's expected (Total)	Positive	Positive	Positive	Positive
Is expectation (above row) priced in ?	No	No	No	No

Source – Bloomberg; as on 27/May/24

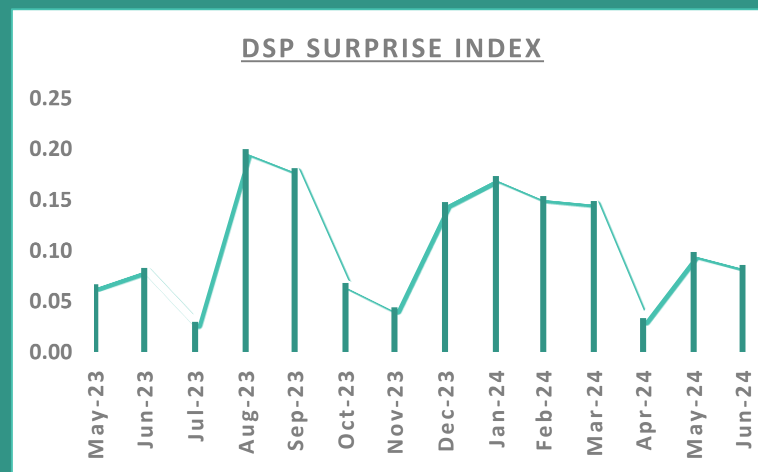
Introducing DSP "SURPRISE" Index

DSP Surprise Index: An alert to manage the risks!

- **DSP Surprise Index to identify high risk times**
  - During these times, "random" and unpredictable risks are higher than usual.
- **DSP Surprise Index identifies when the markets are surprised by data (US)**
  - Chose 8 indicators from inflation, growth and labor.
  - Post covid, we are still in high uncertainty area



- **In last 1-Year**
  - The index spiked in Aug'23, Dec'23 and May'24
  - During these times, the markets were most volatile
  - We found our funds had reasonable underperformance
- **Interpretation**
  - During high DSP Surprise Index times, we would prefer to rationalize our risks.
  - During low DSP Surprise Index times, we would prefer to run conviction trades



Takeaway:
As US data softens, the Surprise Index has come down

WHAT'S NEW

DSP

We have discussed duration and yield movement.

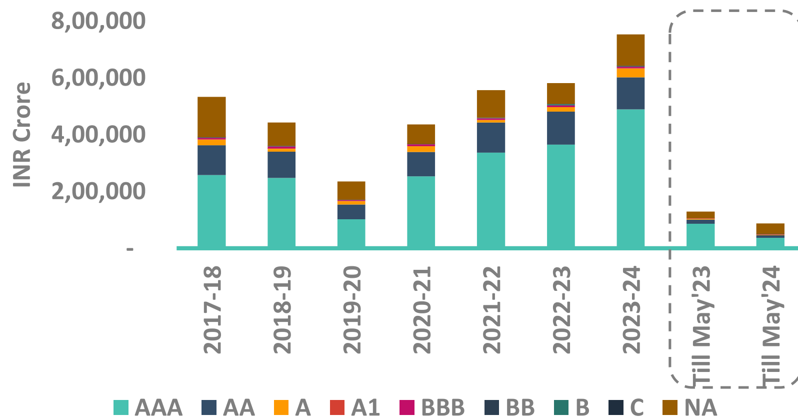
How do we choose corporates and credit?

ASSET ALLOCATION

DSP Asset Allocation:

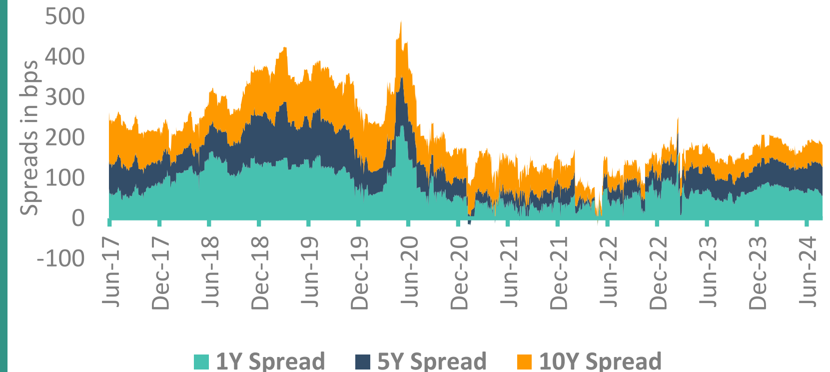
➢ Supply has remained manageable so far

- Infrastructure Bond issuances has picked up in 10Y and above segment: well participated by long term buyers like EPFO, NPS, Insurance
- NBFC issuances were not participated much
- Expect supply to pick up in Infrastructure long bonds, PSU segment mainly in 3-10Y and NBFC in 1-3Y segment.



➢ Corporate bond spreads moved up

- 3Y Corporate bond spreads has widened by 5bps AAA PSU Spread has touched 65bps and NBFC at around 110-115bps.
- PSU Issuances has picked up in 3Y and 10Y(mainly Infra Bonds) and will increase in coming quarter. NBFC issuances remained in 1-3Y segment.



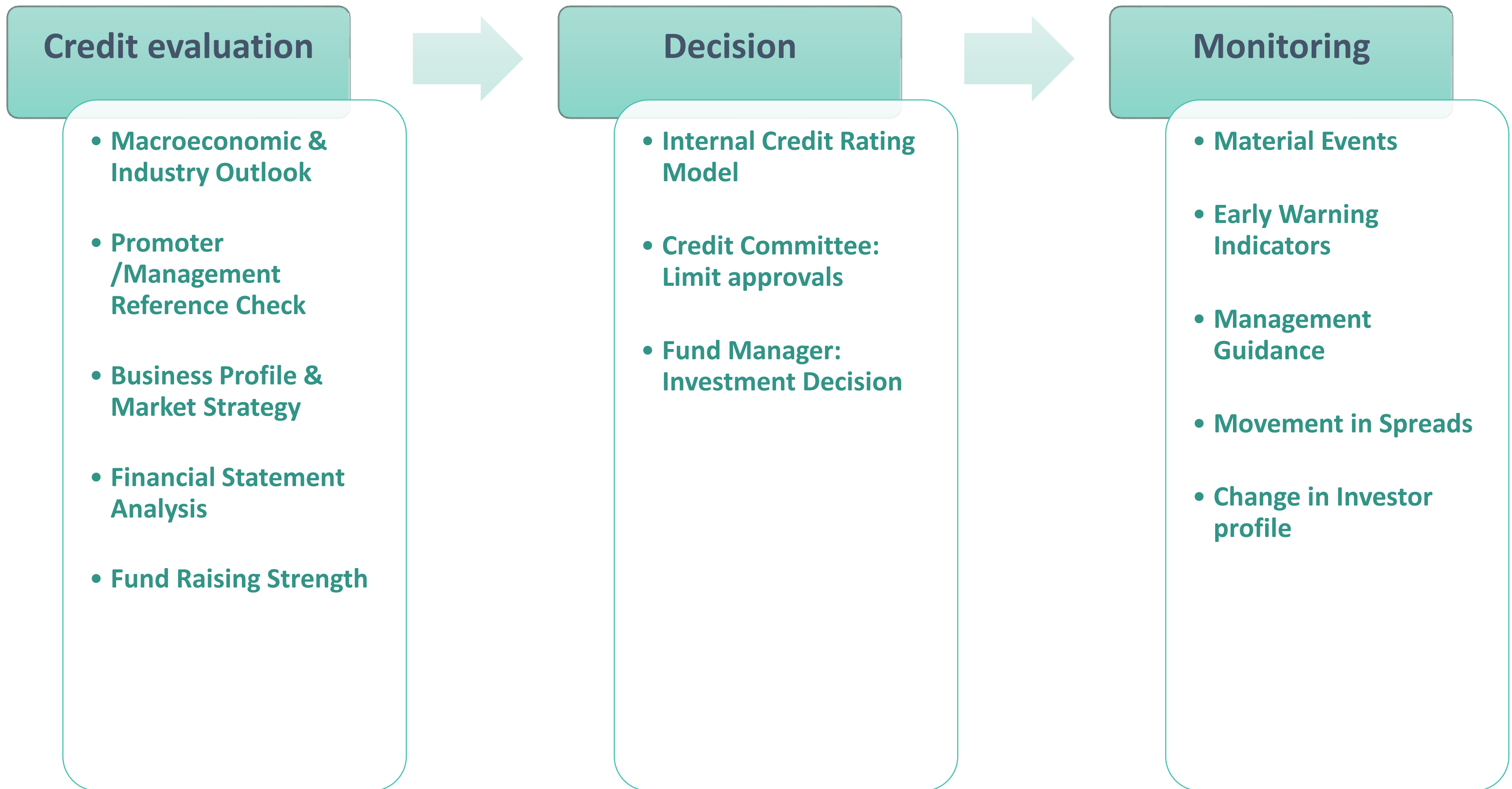
Takeaway:
Corporate bond spreads has widened as expected and closed at 65bps.

DSP

PSU: Public Sector Undertaking, NBFC: Non-Bank Financial Companies

Source – Bloomberg, CCIL, Internal

DSP Credit Investment Process – Focus on Governance



Information sources: Financial results, Management Discussion, Rating Agency Feedback, Sell Side Research, Equity analyst feedback, Lender's feedback, etc.

DSP Credit view on sectors

Sector	Cash Flow Strength	Balance Sheet Strength	Outlook	Remarks
Automobile and Auto Components	🟢	🟢	🟠	Growth depends on the segments e.g. SUV (doing better) vs small cars. Lately, rural demand has pushed up 2W sales
Capital Goods	🟢	🟠	🟠	Infrastructure spending by the Government has supported companies.
Chemicals	🔴	🔴	🔴	For export-oriented businesses, inventory destocking as supply chains normalize and global slowdown are impacting profitability. Chinese oversupply is also to be watched. However, the longer-term story is intact- steady demand and India as a manufacturing base.
Construction, Metals	🟢	🟠	🟠	Commodity cycle has by and large been stable. Spread and volume trends are evolving, but are within acceptable credit parameters.
Consumer Durables	🟢	🟢	🟠	Commercial demand has been strong given the pickup in infra segment. Retail remains largely stable with churning in the market share
Consumer Services	🟠	🟠	🟠	Initial commentary on festive demand has been weaker than expected – inventories need watching.
FMCG	🟢	🟢	🟠	Volume growth has been weak only overall. But balance sheet and cashflows are strong
Financial Services	🟢	🟠	🔴	Asset quality has weakened in the unsecured segment led by heat-wave, elections and over-leveraging in some pockets.
Media, Entertainment & Publication	🔴	🟠	🟠	Exposure only towards are large private conglomerate and comfort out of its parentage as well as leadership position
Oil, Gas & Consumable Fuels	🟢	🟢	🟠	As end fuel prices are fixed, profitability of OMCs depend on price of oil which has been volatile, but on the lower side. Companies have built in strong cushions in the past year, and refining margins have been high. Capex for PSUs well as Government action on fuel prices need monitoring.
Power	🟢	🟠	🟠	Power demand supply remains favorable, especially in peak load demand, resulting in a favorable cycle for power companies and equipment suppliers (e.g. transmission grid). Key risk remains political as States still do not appear to be charging proper prices for electricity - a fundamental flaw in India. However, with Central Government initiatives, receivables for power companies have declined.
Realty	🟢	🟠	🟠	Strong real estate cycle has positively impacted residential companies. Floor-wise denotification and return to office trends is likely to be favorable for commercial real estate.
Telecommunication	🟢	🟢	🟠	Virtually a two company story in India, we expect credit profiles of those two to remain solid.

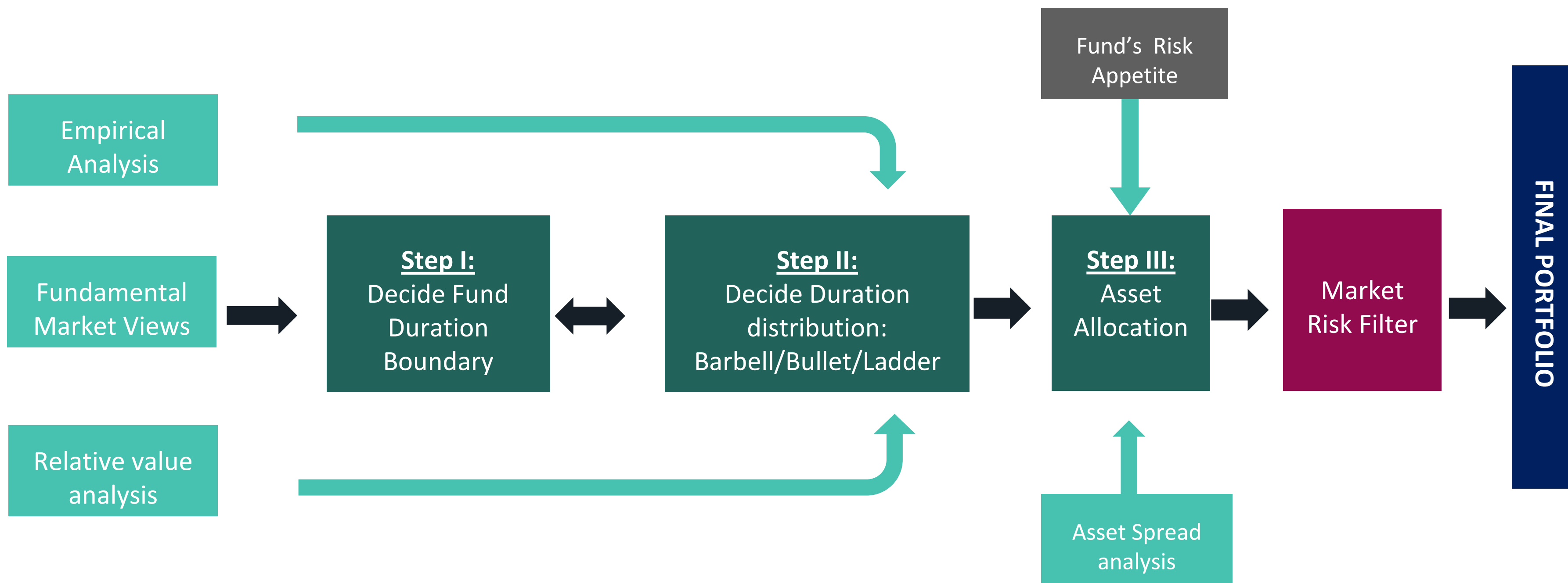
Done with our market view framework?

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.

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

Key Risks associated with investing in Fixed Income Schemes

Interest Rate Risk - When interest rates rise, bond prices fall, meaning the bonds you hold lose value. Interest rate movements are the major cause of price volatility in bond markets.

Credit risk - If you invest in corporate bonds, you take on credit risk in addition to interest rate risk. Credit risk is the possibility that an issuer could default on its debt obligation. If this happens, the investor may not receive the full value of their principal investment.

Market Liquidity risk - Liquidity risk is the chance that an investor might want to sell a fixed income asset, but they're unable to find a buyer.

Re-investment Risk: If the bonds are callable, the bond issuer reserves the right to "call" the bond before maturity and pay off the debt. That can lead to reinvestment risk especially in a falling interest rate scenario.

Rating Migration Risk - If the credit rating agencies lower their ratings on a bond, the price of those bonds will fall.

Other Risks

Risk associated with

- floating rate securities
- derivatives
- transaction in units through stock exchange Mechanism
- investments in Securitized Assets
- Overseas Investments
- Real Estate Investment Trust (REIT) and Infrastructure Investment Trust (InvIT)
- investments in repo of corporate debt securities
- Imperfect Hedging using Interest Rate Futures
- investments in Perpetual Debt Instrument (PDI)

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