Indian sovereign bond (old* 10-year benchmark G-Sec) closed at 6.17%, in anticipation of more monetary steps by the Reserve Bank of India, as the lockdown imposed to curb the COVID-19 pandemic has taken a huge toll on an already faltering economy.

In May, the RBI’s Monetary Policy Committee (MPC) lowered the repo rate by 40 basis points, to a record low of 4.00%, taking the total tally of rate cuts since March to a whopping 115 bps. With RBI Governor recently warning of a contraction in India’s GDP in 2020-21 (Apr-Mar), the central bank is likely to continue loosening its monetary policy to nurse the economy back to shape.

**MARKET PERFORMANCE**

The old* 10-year benchmark G-Sec yield closed at 6.17%, up by 06 bps from its previous close of 6.11% while the new 10-year benchmark closed at 5.78%. The levels on the short-term 1-year bond ended 30 bps higher at 3.5%.

In the corporate bond segment, yields fell across the yield curve over the month. The 10-year AAA bond yield ended 35 bps lower at 6.8%, while the short-term 1-year AAA bond yield ended 140 bps down at 4.6%.

The spread between 1-year and 10-year AAA bond widened. Within the short term segment, yield on 3-month Commercial Paper (CP) was down 150 bps to 4%, while 1-year CP yield was down 150 bps at 4.5%.
MACRO-ECONOMIC DEVELOPMENTS

**GDP:** India’s Gross Domestic Product (GDP) grew 3.1% in January-March vs 4.1% in the previous quarter, reflecting the partial impact of the COVID-19 lockdown on the manufacturing and services sectors. India’s fiscal deficit widened to 4.59% of Gross Domestic Product (GDP) for the previous fiscal, overshooting the government’s revised target of 3.8%.

**IIP & Inflation:** Annual WPI Food Index eased to 3.60% in April while the retail inflation stood at 5.84% in March, lowest in 4 months. Index of Industrial Production (IIP) steeply contracted by 16.7% in March, amid complete shutdown of industries due to coronavirus lockdown.

OUTLOOK

The MPC meeting scheduled in June was preponed by 15 days and the repo rate was cut by 40 bps from 4.40% to 4%. Consequently the reverse repo rate was also lowered by 40 bps from 3.75% to 3.35%. The stance of the policy continued to be accommodative, as long as necessary, to revive growth and mitigate the impact of COVID-19 on the economy, while ensuring that inflation remains within the target.

The Government announced increase in the dated securities borrowings by Rs. 4 lakh crore. Weekly auctions thereafter increased from Rs. 19,000 crore to Rs. 30,000 crore. The details of the Rs. 20 lakh crore package, announced by the Finance Minister, seems to suggest that the actual spend by the Government will be around Rs. 1-3 lakh crore, which was comforting from a fixed income market perspective.

Yields on the 10-year G-Sec remained range-bound, with the old 10-year trading in the range of 5.90 to 6.25%. The new 10-year benchmark security was issued at 5.79% and has been trading in the range of 5.70% to 5.90%. The sovereign yield curve is very steep with the spread between the 10-year and the repo rate at 175 bps to 200 bps.
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RELATIVE VALUE AND FUND POSITIONING

Short end rates (up to 1 year) have realigned, for most part, to the current reverse repo and repo rates. However, with liquidity remaining in abundant surplus in the system – we expect this part of the curve to sustain around the current levels.

The 2-3 year AAA bonds, despite having rallied sharply over the past month, continue to offer attractive carry, with spread of ~2% vs reverse repo rate and almost 1% vs 1-year CDs. We expect limited upside risks to yields, with possibility of yields moving lower, given the positive demand-supply backdrop in this segment. Funds such as L&T Short Term Bond Fund and L&T Banking and PSU Debt Fund offer relatively high credit quality, less volatile avenues for deployment, for investors with a 3-year investment horizon.

The segment, with the space to rally the most (and also more volatile) is the longer end of the curve. With 10-year G-Sec still trading at 250 bps over the reverse repo rate and 10-year AAA corporate bonds trading at 90 bps over the G-Sec benchmark, the longer end of the curve offers reasonably attractive pickup. We expect the RBI to announce its OMO strategy soon and that could lead to a rally in yields, at the longer end. L&T Triple Ace Bond Fund is well positioned in this space, with almost 100% AAA portfolio – especially compared to tax-free bonds and other such long-term investments.
The current bond market environment is a tricky one, where rates are likely to stay low or rally over the coming year, with potential for normalization (upward movement) of rates in 2021/2022, as and when the economic situation in the post COVID-19 era improves. **Active management of duration to capture the ongoing rally while limiting losses in later years through well timed duration reduction – can offer the most optimal strategy.**

L&T Flexi Bond Fund and L&T Gilt Fund, both have a demonstrated track record of active duration management in past such cycles and are well suited in the current market conditions.

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This product is suitable for investors who are seeking*

**L&T Banking and PSU Debt Fund**
(An open ended debt scheme primarily investing in debt instruments of banks, public sector undertakings, public financial institutions and municipal bonds)
- Generation of reasonable returns and liquidity over short term
- Investment predominantly in securities issued by Banks, Public Sector Undertakings and Public Financial Institutions and municipal corporations in India

**L&T Triple Ace Bond Fund**
(An open ended debt scheme predominantly investing in AA+ and above rated corporate bonds)
- Generation of regular and stable income over medium to long term
- Investment predominantly in AA+ and above rated corporate bonds and money market instruments

**L&T Flexi Bond Fund**
(An open ended dynamic debt scheme investing across duration)
- Generation of reasonable returns over medium to long term
- Investment in fixed income securities

**L&T Gilt Fund**
(An open ended debt scheme investing in government securities across maturity)
- Generation of returns over medium to long term
- Investment in Government Securities

**L&T Short Term Bond Fund**
(An open ended short term debt scheme investing in instruments such that the Macaulay duration of the portfolio is between 1 year to 3 years)
- Generation of regular returns over short term
- Investment in fixed income securities of shorter term maturity.

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

**Source:** MOSPI, Internal, Bloomberg

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