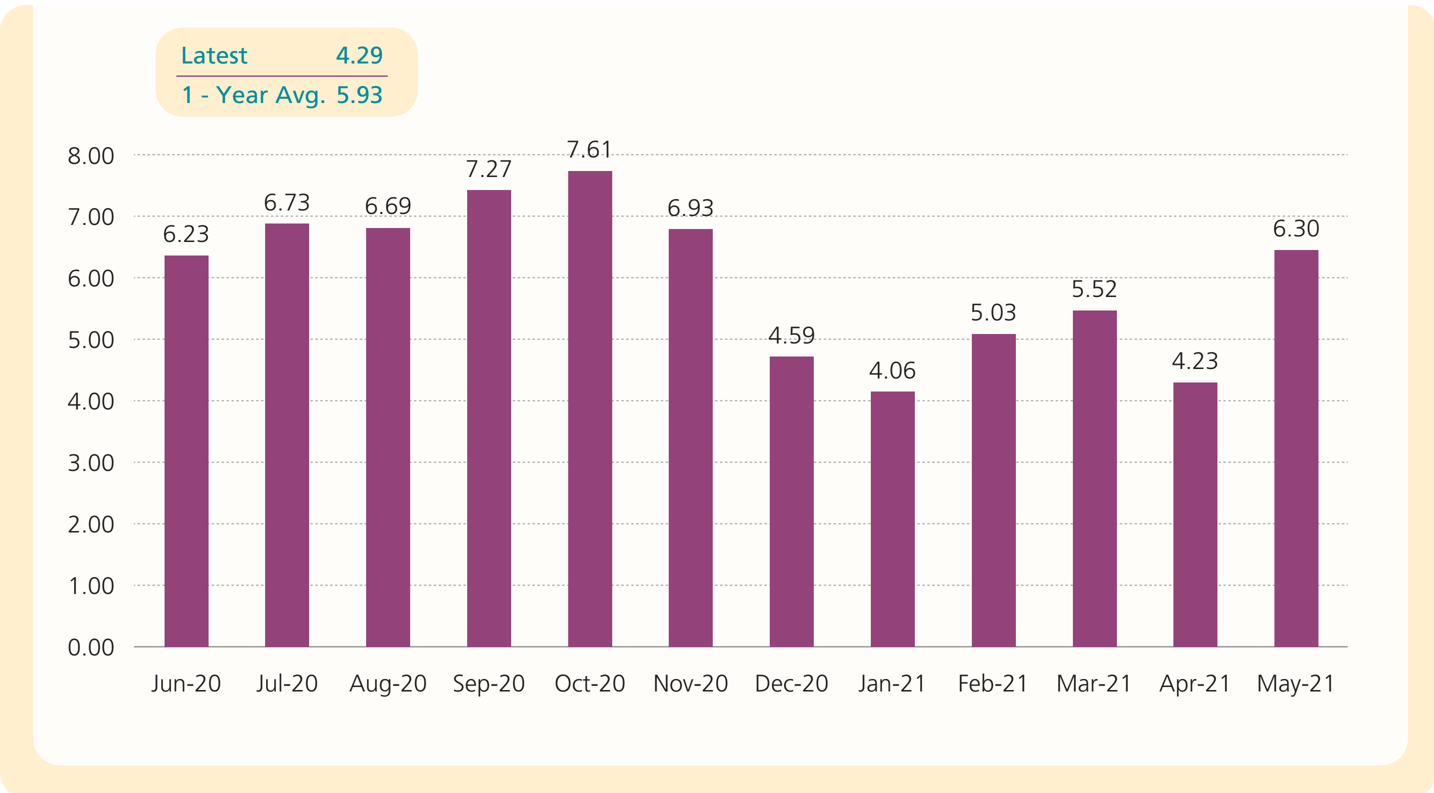
The Federal Open Market Committee (FOMC) in its June meeting maintained status quo on policy rates and also maintained their Quantitative Easing (QE) purchase program unchanged at $120 bn per month. However, the forward guidance sounded more hawkish than what markets had expected. The most significant change was in the 'dot plot' which showed that median expectation of officials was of a 50 bps hike by end 2023 and 7 out of the 18 members expected at least one rate hike as early as in 2022. The FOMC acknowledged that a strong vaccination program had helped in reducing infection rates and growth outlook looked more constructive (although risks to growth outlook remain). Hence, the GDP growth forecast for 2021 was revised higher. US CPI inflation for May came in at 5% (highest level since 2008) and Core inflation came in at 3.8% (highest level since 1992). The FOMC also revised the inflation expectations higher.

Although, the current assessment is that inflationary pressures are transient due to base effect and supply chain disruptions, however, with economic activity picking up, there is a higher likelihood that inflationary pressures eventually turn out to be persistent. Although, the expectations on unemployment rate have been left unchanged, recent data on labour market have not been very encouraging. Incoming data will be key for any signalling pertaining to tapering of asset purchase program in the next policy. 10-year US Treasury yields moved from 1.60% to 1.47% over the month.

On the domestic front, multiple factors remain key to determining rates going forward. Crude prices have firmed over the last few months and have remained on a steady trajectory, trading currently at ~ $76/bbl and having remained over $70/bbl last month. This will continue to exert pressure on inflation, which saw a slightly unanticipated high print of 6.30% in May 2021, and is expected to show a high reading this month as well. Core inflation also spiked up to 6.55%, after having softened in previous month. WPI inflation too jumped to a multi-year high of 12.94%. IIP expanded at 134.4% for April 2021 (vs -57.3% last year) due to favourable base effect.

CPI Combined (YoY)



There has been some chatter around cut of excise duty on fuel to abate pressures on inflation, however if that happens, it will add further to fiscal woes. Markets are expecting an extra borrowing of around INR 1.5 Lakh Crs to fund the shortfall in GST; however, the timing and maturity bucket of this additional supply is still uncertain. The counterbalancing factors remain the high liquidity and the G-SAP 2.0 program of INR 1.2 Lakh Crs for Q2 FY2022, which the RBI announced in the previous MPC meeting. However, any action from RBI in terms of pulling out liquidity or normalisation of rates earlier than expected will remain a key monitorable.

RBI continued to show discomfort over higher auction cut-offs on benchmark securities. All four G-Sec auctions in June 2021 saw one or more securities being devolved on PDs. Out of the INR 34,575 Crs of G-Sec bought by RBI in the third tranche of G-SAP 1.0, INR 26,779 Crs was in the 10-year benchmark security. In the last auction of the month, RBI did not accept any bids in the 10-year paper, thereby reducing the float of this security in the market resulting in extremely low trading volumes. Post CPI, yields moved higher across the curve, with the impact felt most in the 2-7 years bucket and the longer end of the curve. Comparing pre-CPI levels with June-end levels, yields in the 2-7 years bucket moved up by 20-30 bps and corporate bond yields moved higher by 15-35 bps across the curve. The OIS curve saw strong paying for hedging and squaring of positions resulting in yields going up by 20-30 bps.

The T-Bill and SDL auction calendar were announced for Q2 FY2022. T-Bill borrowing number for Q2 saw a significant reduction from INR 4.68 Lakh Crs for Q1 FY2022 to INR 2.21 Lakh Crs for Q2 FY2022. SDL borrowing number announced for Q2 FY2022 was INR 1.7 Lakh Crs. In order to incentivise PDs and investors to bid aggressively in G-Sec auctions, RBI announced that all benchmark securities will be auctioned under uniform price method (unlike multiple price method earlier) and only the extreme long end securities will continue to be borrowed through multiple price method.

RBI finds itself at a difficult juncture currently, where growth is still not back on track and forecasts are being cut, crude prices are on an upswing, inflationary pressures are starting to show, demand for G-Sec is dwindling and markets are staring at a further higher borrowing number for the year, with RBI expected to continue to do the heavy-lifting for the impending supply. Will the above factors push the RBI to prepone normalisation of rates, reduce surplus liquidity from the system, let go of the yield curve control at some point of time or ignore the current inflation prints, continue to maintain ample liquidity and further shoulder the responsibility of the extra supply, will have to be seen?

MARKET PERFORMANCE

The 10-year benchmark G-Sec yield closed at 6.05%, up by 03 bps from its previous close of 6.02% while that on the short-term 1-year bond ended 15 bps higher at 4.00%.

In the corporate bond segment, yields rose across the yield curve over the month.

The 10-year AAA bond yield ended 10 bps higher at 6.88%, while the short-term 1-year AAA bond yield ended 13 bps up at 4.30%.

The spread between 1-year and 10-year AAA bond narrowed. Within the short-term segment, the yield on 3-month commercial paper (CP) was down 05 bps to 3.55% while 1-year CP yield was up 05 bps at 4.25%.

10-Year G-Sec

Past performance may or may not be sustained in the future.

INVESTMENT STRATEGY

With Repo Rate at 4.00% and so much surplus liquidity conditions, the reverse repo (3.35%) has been the operational rate for the last 1 year. However, the current inflation print (@ 6.30% ~ 100 bps over market expectations) and the gradual reopening of the economy, the RBI will normalise the extra accommodation which was done over the last 1 year. We would expect RBI to gradually lift the reverse repo to 3.75% and bring the difference between Repo and Reverse Repo back to 25 bps (pre pandemic level) in this financial year. The surplus liquidity will also be reduced over this period as part of the normalisation process. At the same time, the MPC will also have to be mindful of supporting growth, closing the output gap and seeing employment back to pre-covid levels and in the process the MPC might be willing to look through some of the higher inflation prints even though they would be out of the 4+/- 2% band.

Post the CPI print, the shorter end of the yield curve has sold out, whereas the longer end of the yield curve has been anchored. Yields on 2 to 4 year G-Sec's have moved up by ~40bp while 10-year Gsec has been trading in 6-6.10% range. The 15 year G-Sec has moved up by only 10 bps along with the 30-year and 40-year G-Sec. The yields on corporate bonds similarly in the 2 to 10 year space have moved up by 20-40 bps.

Under this backdrop, we have reduced durations across our funds while we wait for clarity both on global and domestic data and events. ***Funds such as Ultra Short, Money Market and Low Duration Funds are positioned for investors who seek clarity in terms of how the RBI actions unfold through the year. In our view the Funds in the category of Short Term and Banking and PSU Debt Fund are suited for investors who would want to ride this current upwards rate cycle with lower volatility over the next 2-3 years with highest quality portfolios.***

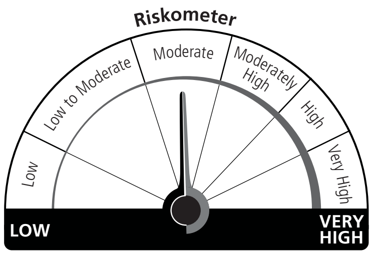
The L&T Triple Ace Bond Fund, which invests in the 2028-29 maturity segment, with investments in the highest credit quality AAA corporate bonds is positioned for long term investments, especially versus tax free bonds but comes with lot of potential volatility through the year. The yields on this part of the curve (7 years average maturity) are the most favourable from a risk-reward perspective.

L&T Resurgent India Bond Fund is positioned with attractive yield while still having more than 70% of the assets in the AAA segment. The interest rate volatility is low as the average maturity of the fund is below 3 years, making it an ideal investment opportunity for investors seeking higher returns over plain vanilla AAA funds over a 3-year period.

This product is suitable for investors who are seeking*

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 Resurgent India Bond Fund
(An open ended medium term debt scheme investing in instruments such that the Macaulay duration of the portfolio is between 3 years to 4 years (please refer to page no. 18 under the section "Asset Allocation Pattern" in the SID for details on Macaulay's Duration)#
- Generation of income over medium term
- Investment primarily in debt and money market securities



Investors understand that their principal will be at moderate risk

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

Source: MOSPI, Internal, Bloomberg