Publication:	Wealth Forum e-zine	**Title:**	Large part of the guilt rally has already played out
Date:	25th Jan, 2016	Edition:	Online

Large part of the guilt rally has already played out

Bekxy Kuriakose, Head- Fixed Income**, Principal Mutual Fund**

Principal has renamed its Long Term Fund as Dynamic Bond Fund, to better reflect its active management style. Bekxy has reduced the portfolio duration and gilt exposure in this fund in the last 2 months, as she believes a large part of the gilt rally has already played out.

10 yr G-Secs should range between 7.25% - 8% she feels. A key variable to watch out for is a regime change at RBI when Dr.Rajan's term ends, and the new regime's outlook on inflation targets.

Given the current macro economic environment, Bekxy believes the 175-200 bps spreads between AAA and lower rated papers, are justified. It would need a lot of prudence to cherry pick in lower rated papers in this environment.

WF: What is the impact on our fixed income market from the current round of global and domestic currency and equity market volatility?

Bekxy: If we look at movement of yields since the year end, short term gilt yields have fallen (prices rallied), medium term gilt yields including the benchmark have been stable, long end gilt yields are slightly higher. Money market rates have shown divergent trend. While CD rates are broadly stable, CP rates (three month and higher) have gone up and hence CD-CP spreads have gone up.

Overall I would say fixed income market has been far more stable compared with the volatility in other markets.

WF: Why have the 125 bps rate cuts of 2015 not resulted in a meaningful reduction in market yields?

Bekxy: Firstly, Rate action and yields do not move in parallel synchronized fashion always. This is because market has a tendency to discount in advance actions of the Central Bank.

Secondly, there has been a substantial reduction in market rates since second half of 2014 in anticipation of RBI cutting rates. The ten yr benchmark gilt has fallen by about 60-70 bps between October 2014 levels and when RBI started cutting rates in Jan 2015. During 2015, the ten yr benchmark gilt fell to a low of 7.50% before it started rising again due to other factors. Similar rate movement has happened across corporate bonds as well from October 2014 onwards. So long end yields did react by 100 bps or more in anticipation and during the rate cut cycle. Money market rates more or less have fully discounted the rate cuts. The 2 mo CD rate prior to the rate cut cycle was trading around 8.30% levels and are now trading around 7.25% levels, so they too have come down by more than 100 bps.

WF: Some experts believe that the Government may be pushed to widen its fiscal deficit in this Budget, to stimulate the economy. What impact can this have on Government borrowing and on market yields?

Bekxy: This would lead to an increase in borrowing through dated government securities from the fixed income market. Market may take this news negatively and this could push yields up if it happens.

WF: What is your outlook on the 10 yr G Sec over the next 14 months upto March 2017? What will be the key drivers and what are the key risks to your assessment?

Bekxy: Broadly the ten yr gilt could trade in a range of 7.25% - 8.00% over next 14 months. Key drivers would be macro data of which the most important would be CPI inflation and its trajectory. Government's fiscal deficit targets for FY 17 and borrowing programme would also be important. Global bond yields and further hikes (if any) by the US FOMC can also be a trigger for volatility in bond yields. There is much speculation in the market that a new RBI governor may take charge when Raghuram Rajan's term ends. A new regime and relaxation of inflation targets could also be key risks and trigger for the market.

Any sharp sustained rebound in commodity prices can also lead to inflationary pressures and end of RBI's accommodative stance.

WF: Corporate bond spreads at 200 bps appear attractive, but an uncertain economic environment suggests prudence in credit selection on the other hand. Are you more in the prudence camp or do you believe in cherry picking among relatively lower grade papers?

Bekxy: Currently AAA PSU spreads are tight at around 60 bps (on an annualized basis comparison). Spreads at AA-and lower rating lvls are around 175-200 bps or higher. Given current macro environment these spread levels are justified. Cherry picking among relatively lower grade papers assumes a high level of prudence so I don't think both approaches are mutually exclusive.

WF: What is the current portfolio stance of your Dynamic Bond Fund? How has it changed over the last 12 months?

Bekxy: We have renamed our Principal Long Term Fund to Dynamic Bond Fund recently in January to better reflect the active duration management style. We have reduced the portfolio duration and gilt exposure over last two months considering that a large part of the rally has played out as far as long term gilt and bond yields are concerned.

WF: Where do you see the best opportunities in the fixed income space now?

Bekxy: Dynamic Bond Funds, Ultra Short Term Funds and Short Term Funds would to me appear to be the best opportunities.