FIXED-INCOME OUTLOOK

Conducive environment for fixed-income markets

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In 2015, the Reserve Bank of India (RBI) cut the repo rate by a total of 125 basis points (bps), leading to softening of bond yields. However, the continued expectation of a rate increase by the US Federal Reserve and, subsequently, its raising these by 25 bps reversed a significant amount of these gains toward the end of the year.

Still, full transmission of RBI's rate cuts is yet to happen, which could augur well in 2016. Meanwhile, there were credit concerns on individual companies. However, an improving credit ratio seems to indicate that we broadly appear to be in a credit upgrade cycle. Further transmission of policy rate cuts would help to bring down cost of capital for companies, which could bode well for an improvement in the credit environment.

Inflation, after a downward trend through most of 2015, picked up towards the year-end due to a sharp jump in food prices on account of weak summer crop output and incoming weak data on winter crop sowing. However, the drivers of inflation — fiscal deficit, rural/urban wages and international commodity prices -- continue to remain benign and, hence, supportive of a decelerating trajectory in the medium term. Going ahead, any action on interest rates by RBI would be a function of this trajectory and the status of fiscal consolidation.

The rupee has depreciated a little over five per cent versus the dollar but was among the best performing in emerging market currencies during 2015. While the impact of the Fed rate rise has already been factored in, other external factors such as a slowdown in China and weakness in Asian markets might lead to the rupee's further weakening. Still, factors such as contained twin deficits, lower commodity prices and improving domestic macro economic indicators might provide some support.

The upcoming foreign portfolio investors' (FPIs') debt limit auction in January could provide cues for inflow and the subsequent impact on the foreign exchange and bond markets.

Any further rate increase by Fed and demand-supply mismatch in government securities could lead to volatility in the bond markets. The anticipated transmission of rate cuts, expectation of continued softness in crude oil prices and elevated spreads between the repo rate and yield curve could benefit duration strategies. Hence, we recommend investors (who can withstand volatility) to consider duration bond/gilt funds for a medium to long-term horizon.

Also, with growth picking up (albeit at a slower pace) and the economy recovering (though in early stages), we believe the credit environment will continue to improve. Hence, we remain positive on corporate bonds and accrual strategies.

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