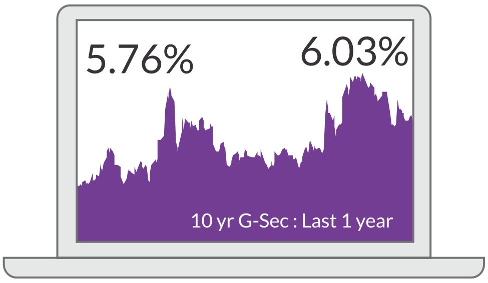
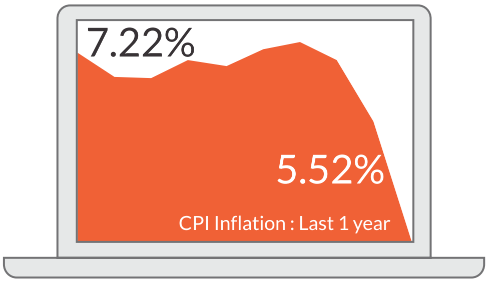
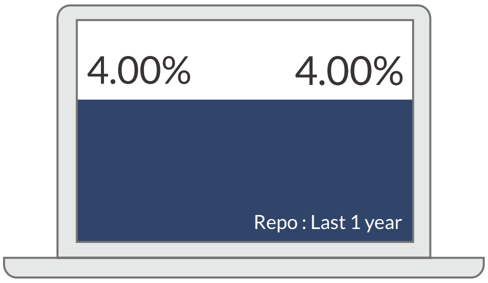
AXIS MUTUAL FUND

FIXED INCOME OUTLOOK

MAY 2021







QUICK TAKE

- Major risks over the last 6 months have been played through active portfolio management.
- We anticipate a gradual rise in yields and calibrated phasing out of the accommodative monetary stance. The reinvestment theme is an ideal play in rising rate environments.
- Credits continue to remain attractive from a risk reward perspective give the improving macro fundamentals.

Key Market Events

- **RBI Action– Pre-emptive Steps:** The RBI governor made an unscheduled statement highlighting the RBI's commitment to efficiently manage liquidity and financial conditions and support growth. The RBI announced a slew of measures aimed at ensuring credit availability to the critical healthcare sector and the MSME's. The RBI Governor also announced the second tranche of G-SAP within the previously announced Rs 1 lakh cr for the first quarter. The impact on markets of these announcements was limited.
- **Covid-19 second wave:** The COVID-19 caseload in India continues to surpass previous local and global peaks, as it moves from western and central India, to eastern and southern India. The fatality rate remains low but the sheer size of mortalities is high, and rising. Unfortunately, the pace of vaccination has halved from the pact a month ago. For India to vaccinate a critical mass of its population by end-2021, it will need to double the vaccination rate to over 5m a day in H2 2021. A second wave of Covid has been a key risk for us this year.

10 YEAR G-SEC YIELD

6.03%

- **Lockdown & The Possible Economic Impact:** States seeing a surge in cases have imposed some restrictions with Maharashtra, Karnataka & Rajasthan amongst others announcing lockdowns. For Maharashtra (highest state GDP), the partial lockdown is likely to lower national GVA growth by around 20-25 bps. A similar cumulative impact for the 7-10 larger states would be around 100-150 bps. With manufacturing and construction being allowed (with usual restrictions), the impact will be restricted to parts of services and frictions in supply chains. This has resulted in the market reassessing the expectations around RBI's withdrawal of liquidity and interest rate normalization. As a result, we saw a fall in yields across the board. Taking a forward looking view, it is likely that this second wave will wane in the coming months and growth will resume. Therefore, while RBI may have delayed its monetary policy normalization, it certainly will not have abandoned the process. We should still expect rates to head higher in the coming 12-18 months.
- **Inflation – Stable but elevated:** CPI inflation moved closer to the upper limit of RBI's target band amid elevated core inflation. March CPI inflation rose to 5.52% led by food and transport. As Western economies complete vaccination goals, there is the expectation of a global recovery. This is leading to higher inflation expectations. With the US Fed having stated its preference for an average inflation target, there is the expectation that for some period of time, inflation may remain above the 2% level. This is causing commodity prices to rally. This rise in commodities is quite broad based – spread across energy, metals and food. If it becomes entrenched, it could pose a new challenge for RBI.
- Global rates Rising – Economic Rebound Likely: A strong global recovery has put the focus back on rates. US 10 Year rates rose past the key 1.6% levels before correcting. Higher yields in developed markets like the US also have a significant bearing on international markets (Including India) as investors will likely demand higher risk permia on their emerging market investments.

Market View

Over the last 6 months we have been highlighting three key risks to the markets and the economy – Budget 2021, Covid 2nd Wave & Global inflation & Rates. With the budget, there was a significant increase in gross borrowings which led to yields rising (Feb to mid-March). Conversely the second wave of covid has led to an expectation of a delay in RBI action and yields have dropped (late-March to mid-April). The strong rebound in the global economy and rising global rates is something markets will have to contend with over the next few quarters.

All three risk events were factored into our portfolios. Accordingly, our debt portfolios pivoted to factor in the probable implications in the debt market and that has resulted in material outperformance over the last few quarters.

Today our stance favors caution as RBI is likely to resume rate normalization in the next few months. Additionally inflation risk is now the new key risk to the investment thesis. The commodity cycle and global demand have had a bearing on inflation and are likely to impact the monetary policy timelines. We continue to anticipate a gradual rise in yields and a calibrated phasing out of the accommodative monetary stance. Our portfolios endeavor to play our cautious stance through carry and leverage barbell strategies across the yield curve where opportunities present themselves.

In our short and medium duration strategies we are following barbell strategies – a strategy where we mix long duration assets (8-10 year) with ultra-short assets including credits (Up to 2 years) to build a desired portfolio maturity. The ultra-short assets will help us play the reinvestment trade whilst limiting the impact of MTM as yields rise. Long bonds will likely add value in capturing higher accruals with relatively lower credit risk and lower MTM movement in the current context.

Credits remain an attractive play for investors with a 3-5-year investment horizon as an improving economic cycle and liquidity support assuage credit risk concerns especially in higher quality names. While we remain selective in our selection and rigorous in our due diligence, we believe the current environment is conducive to credit exposure.