DHFL Pramerica MUTUAL FUND

Fixed Income Outlook - November 2016

View in the wake of currency demonetization

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The Decision

In a landmark move the Government on November 8th decided to demonetize old high value currency (OHVC) comprising the INR 500 and INR 1000 notes, in a bid to weed out black money. The move was e ective from the mid night of November 8th.

The move was triggered among others by the unusually high usage of HVC with their outstanding at 86% of the aggregate Currency in Circulation (CIC) as at the end of March 2016. In absolute terms, the INR 500 and INR 1000 notes accounted for INR 7.85 trn and INR 6.32 trn, respectively. To put this in perspective, HVC in circulation aggregated almost 10% of India's GDP.

Impact on Fixed income markets

Glut of liquidity

As an immediate impact of demonetization, the first few days following the move has seen large amounts of CIC re-enter the banking system. Data shows that in the first 6 working days alone, collection into Savings and Current Accounts with banks has crossed INR 4 trillion. While this is less than a third of the total currency being de-monetized, we expect a steady stream of inflows into the banking system to continue over the next few weeks.

Even as the old high value currency is exchanged for new notes, there are various estimates of the demonetized currency that is unlikely to be o ered for exchange. Broadly this is expected to range between INR 2.5-4 lakh crores,being equivalent to 1.8-2.8% of the GDP.

While the exact treatment of this untendered / non-replenished currency is yet to be clarified by the RBI / Govt (either as a one-time write back through dividend or through a balance sheet adjustment by cancellation of outstanding G secs in the balance sheet of RBI), it is clear however that this quantum is substantial and will significantly improve the overall fiscal profile and health, going forward.

So even as substantial cash (net of the portion that is not likely to be surrendered) is tendered back to the banks, fresh withdrawal limits over the next 4-8 weeks will substantially moderate CIC. Going forward, we expect the demonetization move to act as a deterrent in holding cash for citizens. Besides, demonetization is likely to accelerate the move to a 'less cash' economy through faster adoption of alternative payment routes such as credit / debit cards, e-wallets, UPI payments etc. As a result, the new normal for CIC could be lower than in the past.

On an adjusted basis i.e net of cash returned vs fresh withdrawals, deposit growth with banks could be in the range of INR 2-3 lakh crores, which is almost 2% of the GDP and close to 3% of their existing aggregate deposit base.

Inflation – further good news

Latest CPI reading issued yesterday stood at 4.20% as against 4.3% in the previous month. CPI declined on the back of softer food inflation as both vegetables and pulses recorded a fall in prices. The impact of a good monsoon and better output hitting the markets has led to a general softening in food prices.

Going forward the combination of softer food inflation and base e ect is expected to help CPI push lower in the coming months. The recent demonetization is expected to lead to short term demand disruptions as a result of the fall in CIC. As a result, CPI in the coming months is expected to soften even faster.

Softer inflation for the remainder of the financial year is expected to cause average CPI for FY 17 to print lower than 5%. Note that in the last few months starting April, readings have remained consistently close to 6% on an average. Over the next few months headline CPI is expected to print at close to 4% with a slight downward bias.

Outlook

The demonetization move is extremely positive for rates as the combination of a glut in liquidity and prospects of further monetary easing on the back of some cut in GDP (expected 0.3-0.4%) and softer CPI in the months ahead could cause the curve to shift lower.

Surplus liquidity is likely to cause overnight rate fixing at closer to the reverse repo rate if the excess liquidity is not sucked out by the Central Bank. Given the steady stream of cash inflows that is expected into the banking system

over the next few weeks, a complete neutralization of surplus liquidity may not be entirely possible. **As a result, we are likely to see the front end yields rally strongly.**

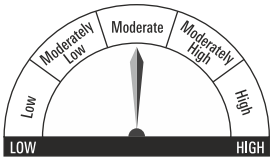
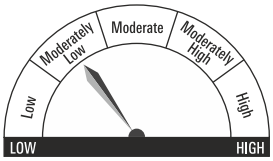
Global rates have witnessed an upmove following the US election as Trump was voted to power. Prospects of a Fed rate hike in December have also brightened given the shift in inflation expectation as Trump has articulated plans to boost spending in infra even as tax rates are cut.

INR has weakened post the US election outcome. However, INR weakening is in line with other EM currencies weakening and is more as a result of the dollar strength. The boost in domestic liquidity would more than cover for any short fall in liquidity that was envisaged as a result of the FCNR. As a result, we do not expect any more OMOs from RBI until March'2017. It is likely however that RBI may resort to reverse repo's / OMO sale to suck out some excess liquidity in the system.

Post the demonetization we expect rate easing of 75-100 bps over the next 9-12 months. While the long end is likely to react a little more to the external yield environment, the short end will be influenced largely by domestic liquidity conditions. Even as the curve shifts lower the short and mid end upto 3 years) will react more to a combination of improving liquidity and likely rate actions.

Given the significantly changed yield environment, we advise investors with a longer term horizon and higher appetite for rate volatility to actively consider allocation to relatively longer duration products (with average maturity ranging from 3-7 years. Product choices could include gilt funds, medium term bond funds and dynamic bond funds.

Even as the rate view is unequivocally positive, the downward shift in yields as always could be accompanied with volatility. We advise investors who have a preference for lesser volatility and regular income needs to stay predominantly at the front / mid segment of the curve through the selection of products with average maturities between 2-5 years. This could include funds such as the Short Maturity fund, the Banking & PSU fund and the Premier Bond fund.

This product is suitable for investors who are seeking*	
DHFL Pramerica Short Maturity Fund (An Open Ended Income Scheme) • Income over the medium term • Investment in short term debt and money market instruments • Degree of risk – MODERATE	 Investors understand that their principal will be at moderate risk
DHFL Pramerica Banking and PSU Debt Fund (An Open Ended Income Scheme) • Income over the short term • Investment in debt instruments and money market instruments issued by Banks and Public Sector companies • Degree of risk – MODERATELY LOW	 Investors understand that their principal will be at moderately low risk
DHFL Pramerica Premier Bond Fund (An Open Ended Income Scheme) • Regular income over the medium term • Investment in debt securities and money market instruments • Degree of risk – MODERATELY LOW	
* Investors should consult their financial advisers if in doubt about whether the product is suitable for them.	

Source: Bloomberg

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