DHFL Pramerica MUTUAL FUND

From the CEO's desk – July 2018

Flattening of the US yield curve is not a sign of US recession but...

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The month of June saw many major events like:

- US fed raising rate by 25 bps to target rate 1.75-2.00. A seventh hike in the current cycle.
- ECB declaring end of bond buying program from Dec18, but indicating possibly no rate hikes till middle of next year.
- OPEC meeting that ended with countries unofficially agreeing to raise output by one million barrels per day (bpd).
- Fresh tariffs and counter tariffs being put by trading partner countries .

However what acted as a catalyst to spread jitters in the global markets was the phenomenon of 'Flattening of the yield curve in US'. The yield curve is a graph of bond yield corresponding to the maturity of the bond. Under normal economic conditions, the shape of the curve is what is called as rising with longer maturity bonds at higher yield than those with shorter maturity. When the recession is about to set in the curve becomes inverted i.e. the short term rates become higher than the long term rates. With 0.34% difference between 2 year and 10 year treasury yields, the US treasury curve is almost in the territory of being flat a stage prior to inversion. In fact, fed fund futures are pricing in between two and three additional increases this year, which is above the central bank's forecast of two more in 2018. Rate hikes adds to the probability of us seeing an inverted curve. This has sparked speculation around likelihood of recession in US economy as the formation of inverted curve eventually was followed by an economic slowdown in the US in nine out of ten occasion since 1955.

Given the strong US macro fundamentals coupled with economic growth maintaining momentum in many geographies across the globe, chances of a recession in the US looks remote. Having said that what holds the key is the Trump trade policy - clarity is not yet there if Trump is following a "good cop/bad cop" approach focused upon the short term November poll or is it a more long-term policy of backing the trade warriors in terms of targeting China's "Made in China 2025" policy which means total confrontation. If the former is true then the hypothesis of a likelihood of inversion in the yield curve and onset of recession in US is a very remote possibility. This will get established in the near future.

Given the unique situation of improving micros and worsening macros in India, for the equity investors a diversified portfolio and select quality midcaps portfolio is recommended - most suited is a systematic investment plan which will offer a best risk reward proposition. Our portfolios built across mutual funds continue to be aligned with the philosophy of buying quality businesses with growth prospects having high ROE/ROCE, low debt and good corporate governance which becomes utmost crucial in these uncertain times.

For fixed income as we see short term liquidity and medium term inflation to remain under pressure, we would like to reiterate that funds with duration of 1-3 years offer best proposition to lock in the higher yields.

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