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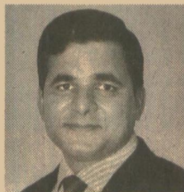
Go for a prudent mix of accrual and dynamic bond funds



MARKET MIND

AMIT TRIPATHI

The bond markets have had a secular bull run since 2014. A combination of prudent fiscal policies, an inflation-centric monetary policy, benign global interest rate and liquidity conditions and last but not the least, improved domestic liquidity conditions have been the key drivers of this superior performance.

This year started on a different note. Buoyed by slightly better growth prospects and higher commodity price induced inflation prints, global central banks, led by the US Fed, are starting to withdraw from an extremely loose monetary stance. The Reserve Bank of India (RBI), too, in its February policy changed its stance from 'accommodative' to 'neutral', thereby signalling a pause in the rate cut cycle. While near-term inflation prints have been on the lower side, RBI is clearly focussed on achieving its medium-term inflation target of four per cent on a sustainable basis.

In this environment, two factors will continue to support the Indian bond markets in the medium term.

First, global trend growth rates have come down sharply since the global economic crisis, and large parts of global economies are still struggling. Even in India we are some time away from achieving full potential in terms of higher growth rates. This has implications from an inflation standpoint (subdued aggregate demand), which will mostly remain low and range-bound going forward, thus allowing RBI to maintain a conducive environment for growth.

Second, the Indian debt markets continue to be cushioned by abundant domestic liquidity conditions, which being more structural in nature are likely to sustain for a reasonable period of time. Good liquidity conditions always help sustain softer interest rates.

The yield curve has also steepened, owing to good liquidity conditions, thus benefitting investors from a risk return perspective. A steep yield curve also creates potential for capital gains which add to total returns, thereby reducing the need for higher absolute yields to incentivise debt investments and savings.

The current period of policy adjustments and evolving macro entails a higher degree of near term uncertainties and potential volatility. Investors will need to overweight their allocations near term to portfolios operating in the two-five year segment (shorter end of the yield curve). Accrual portfolios continue to remain favourably placed in that regard.

From a medium to long-term perspective though, it's advisable to maintain a reasonable allocation in dynamic bond funds as well given potential opportunities in terms of rate moves, spread plays and favourable demand supply dynamics in government securities. Indian debt markets are very attractive for all long-term investors; given the RBI focus on inflation and positive real rates.

It is also pertinent to note in the medium to long term, all debt funds generate a predominant part of their returns through carry, interim volatility notwithstanding. In an environment where most investors have investment horizons of two-three years and above, a prudent mix of accrual and dynamic bond funds, which would suit an investor's individual risk appetite is advisable.

Happy investing.

The author is CIO – fixed income investments, Reliance Mutual Fund