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PNB GILTS LTD (Subsidiary of Punjab National Bank)

ECONOMY & GILT WATCH

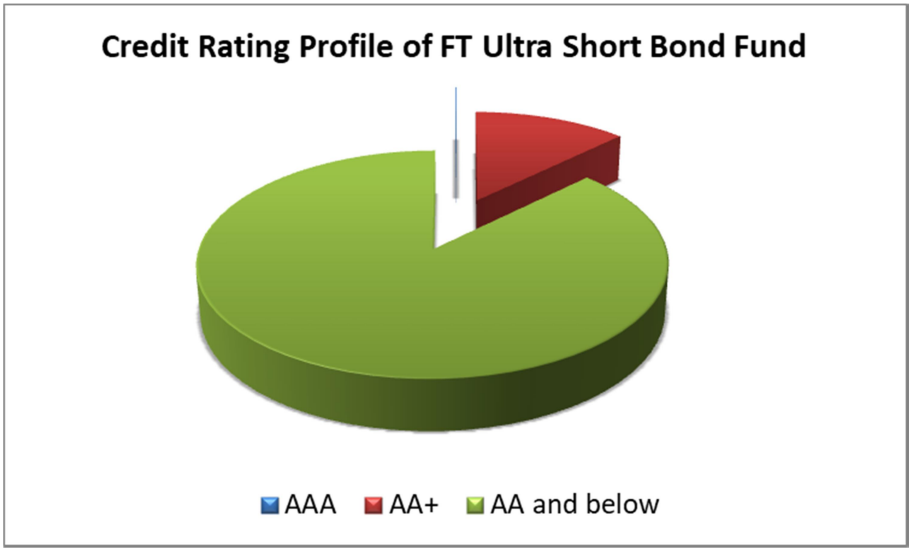
The Franklin Debacle

A development that has created flutter in the mutual fund space was unwinding of six of debt mutual fund schemes with immediate effect by Franklin Fund Mutual Fund. The six schemes are credit risk strategy funds having significant exposure to low rated high yielding debt securities with almost Rs. 30,000 crore of funds (25% of AUM of FT India) being managed under them. Franklin has cited liquidity issues and redemption pressure on its fund as reasons behind the decision which has caught the investors off guard. AMFI was quick to respond to this development stressing that this was a one off event and that other debt funds had appropriate maturity, liquidity profile and credit quality.

What went wrong?

The six funds Franklin Templeton (FT) has closed were all short-maturity, high-risk-high-return credit funds. While credit risk funds are characterized by yield chasing strategies with significant allocation to low credit quality papers, FT's ultra-short, short and low duration funds which account for more than 65% of the funds invested under the six schemes, also had significant exposure to low rated illiquid papers, despite the fact that such low duration funds are favoured by investors seeking regular income. For instance, only less than 1% of the portfolio holding in Franklin India Ultra Short Bond Fund is in AAA rated papers, which raises a pertinent question whether investors' money should have been locked up in illiquid papers for a 3 to 6 month horizon. And in the post Covid scenario, corporate balance sheets under duress amid rising liquidity crunch and a thin domestic corporate bond market, further aggravated the problem, forcing the closure of the FT schemes while also triggering fears of a cascading effect on other debt mutual fund schemes.

INSIDE THE ISSUE



With significant exposure in low credit quality corporate debt and lack of exit opportunities, liquidation process of the FT schemes may be a long haul

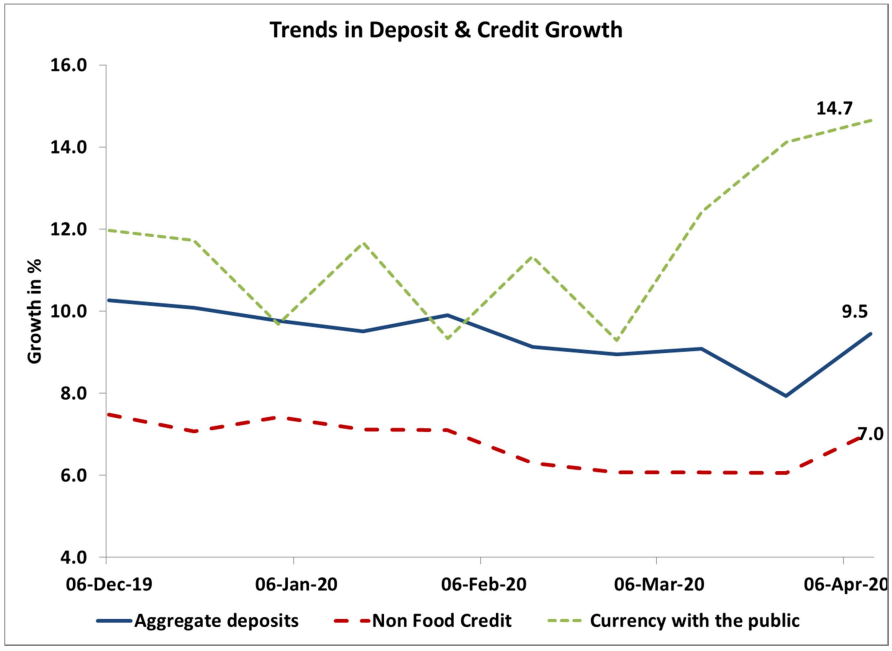
Will Franklin fiasco cause a domino effect?

On the face of it, the Franklin fiasco underscores a liquidity issue as redemption pressures pile up on the funds, however, in a heightened risk aversion scenario, the problem is intricately associated with the credit quality issues which become adverse during times of distress in the credit cycle. And in unforeseen times like these when general risk aversion and uncertainties are ruling high, the risks of the Franklin fallout resulting in contagion in other segments of the mutual fund industry and financial markets in general cannot be downplayed. The corporate bond markets reacted and spreads on AA rated corporate bond widened substantially post announcement by FT. However, one needs to note that the corporate sector has been facing stress for a long period of time and that the FT episode is a symptom of the larger issues plaguing the corporate sector. For perspective, there have been a large number of rating downgrades in FY 2019-20 compared to the FY19 with almost 1600 corporates being downgraded in the last financial year. And with current slump in demand seen across the length and breadth of the economy amidst the Covid lockdown, the pain is only likely to increase for the Indian corporates. RBI as largely expected has added yet another tool to prevent the issue from flaring up into a larger systemic problem. RBI has extended a Special Liquidity Facility for MFs aggregating Rs. 50,000 crore under which banks can tap funds through the Repo window and pass it on to the Mutual Funds by directly lending to them or by purchasing their holdings. However with banks displaying shrinking

risk appetite, there may not be takers for the liquidity line opened up for MF as was seen in the poor response to the first tranche of TLTRO 2 for NBFCs.

Trends in deposit & credit growth

In the fortnight ended 10th April, non-food credit grew by 7% y-o-y as against 6.1% in the previous fortnight, meanwhile, deposit growth in the banking system rose to 9.5%, up 150 bps from 7.9% in the previous fortnight. Another important change in trend was a sharp spike in currency in circulation which seems to be due to people hoarding up cash to meet expenses amidst the ongoing lockdown which has restricted movement. This also explains the sharp decline in demand deposits by Rs. 1.35 lakh crore during the fortnight. On the other hand, time deposits saw an influx of Rs. 2.83 lakh crore which could be a result of the increasing risk aversion amongst investors forcing them to seek safer investment options. As a result, despite the sharp decline in demand deposits, banks have been sitting on excess cash which they are parking with the RBI on the Reverse repo window. During the last fortnight, despite the 75 bps cut announced in the reverse repo rate, banks parked an average of Rs. 7.06 lakh crore with the RBI.



There has been a sharp spike in currency in circulation as people hoard up cash to meet expenses amidst the Covid lockdown.

Fixed Income Outlook

Fundamental View

Last fortnight saw the 10-yr yield yet again testing the 6% levels, buoyed by the general risk aversion in global markets and announcement of special OMO auction by RBI swapping G-sec for T-bills and CMBs for an aggregate amount of Rs. 10,000 crore. However, the unwinding of six schemes of Franklin Fund resulted in bonds paring the gains at the end of the fortnight.

Going forward, market is expected to play in a range bound manner with 6% for 10-yr being a strong resistance, unless a large OMO auction calendar is announced which the market participants have been longing for to support the government borrowing program for the new financial year. Meanwhile, yields are also not expected to fly off significantly as RBI has shown clear intent in capping rise in yields. Hence the overall bias remains positive for bonds with short end of the curve expected to remain the highlight amidst excessive liquidity in the system and increasing demand for safe haven assets.

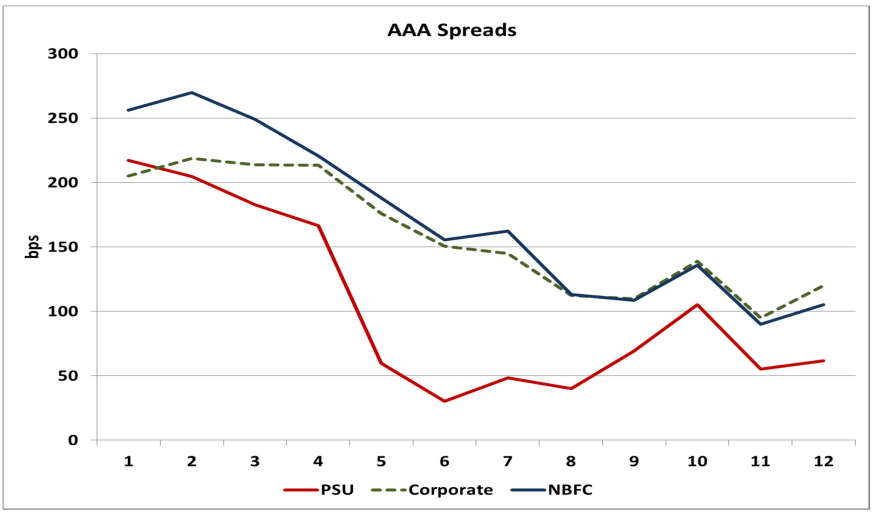
Technical View

6.45% G-Sec 2029 Yield settled at 6.17% in previous session. Last fortnight, benchmark Yield headed lower as it sustained below crucial support zone of 6.42% and touched low of 6.01%.

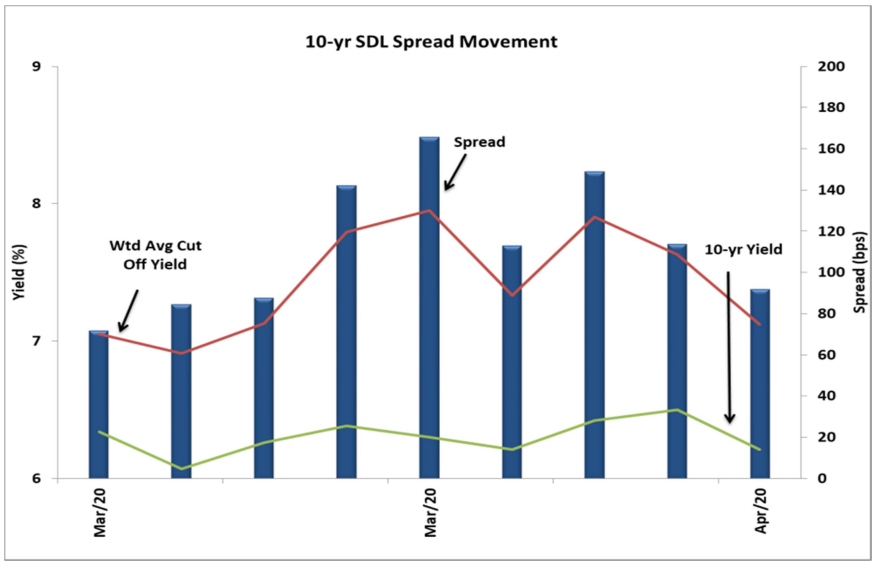
Momentum indicator RSI is resisting settling above 60 zone (as shown in chart), indicating yield to resist at higher level. On EOD chart, post Thursday's bearish engulfing candle, 10 Yr witnessed an inside candle on Friday, indicating pull back to extend further if it sustains above 6.18%. Having said that, our view still remains range bound to weak in 10 year yield, with major resistance at 6.29% (Middle Bollinger band) and 30 EMA zone. On lower side 6.08% and 6%(as indicated in chart) will act as a crucial support zone, as thrice in two month markets have respected this level and have witnessed a bounce back.

Chart source: Investing.com

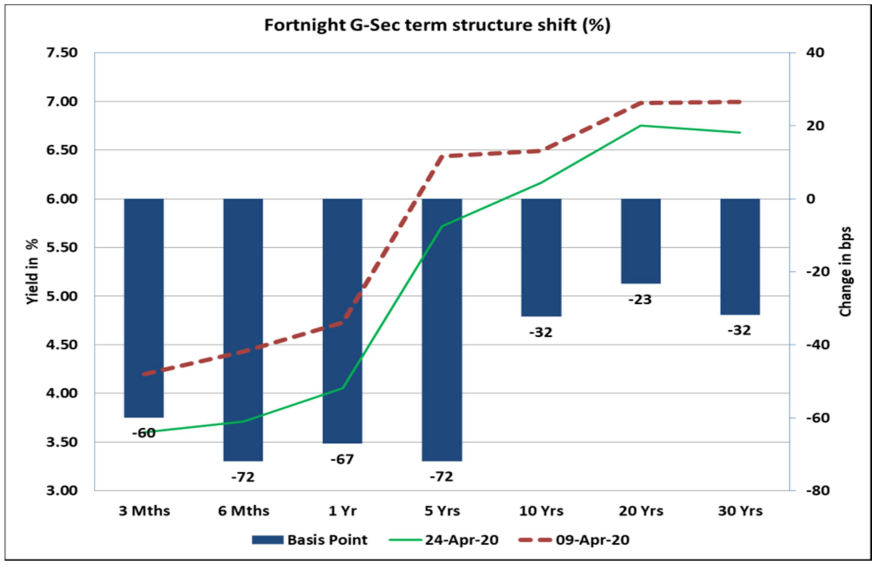
SPREAD MONITOR



Corporate & NBFC spreads remain elevated as investors prefer PSU and other safer options for investment in times of heightened risk aversion



SDL spreads have come off after concerns of state finances coming under severe stress were assuaged as RBI increased WMA limits for states by 60% till 30th Sep'20



Announcement of OMO auction and expectations that RBI will continue to intervene in the bond markets to keep interest rates low has driven down yields across the curve.

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