One-on-one interview
Indian Fixed Income: A sweet spot in the EM debt universe

Gordon Rodrigues
Director, Head of Asian Rates & FX

Stepping into the second half of 2017, the Indian Fixed Income market continues to enjoy the spotlight within the EM debt universe, thanks to a stable-to-lower interest rate environment, an improving fiscal balance sheet and encouraging FDI / FPI inflows into the Indian market. Marking the fifth anniversary of our Indian fixed income strategy, Gordon Rodrigues, Director, Head of Asian Rates and FX, explains how the country’s policy reforms and improving fundamentals can benefit its fixed income assets, and how he plans to continue delivering superior risk-adjusted returns for investors.

What have been the key drivers for the Indian market over the past few years?

India stands out in a relatively low yield global environment, fraught with possibly rising rates and political and monetary policy uncertainty. There are a number of favourable factors that make the case for investing in Indian fixed income markets, including: bond yields on an average of around 7%, political stability, slowly recovering growth with no demand side inflationary pressures, fiscal prudence at the centre, continued economic reform, an independent Monetary Policy Committee (MPC), a stable to lower interest rate environment, a well regulated, wide and liquid government bond market, a growing corporate bond market, low foreign ownership at around 4%, low correlation to global bonds and a relatively resilient currency. It is therefore no surprise to see flows not only into equity but more significantly into its bond market as investors seek better risk adjusted returns.

With 10y bond yields at around 6.60%, valuations are fair and since the market is range-bound with a possible dovish bias, we think investors could benefit from the carry in the portfolio with some upside potential. At the start of the year, we saw the India story as being one of carry in a stable interest rate environment. We now see the scope for some capital gains as well.

How do you see the recent policy reforms in India impact on its fixed income sector?

The spate of reforms that we have seen from the Modi government since 2014 are targeted at putting India back on track to achieve its medium term growth potential. These have included making the use of Aadhaar (India’s biometric identification system) to enable more broad-based financial inclusion, introduction of the Goods and Services Tax (GST) & the Bankruptcy Code, improvement in supply-side food management, encouraging foreign direct investment (FDI) inflows and the demonetisation exercise.

From a fixed income standpoint, these measures have helped improve India’s fiscal balance sheet by widening the tax base, bringing the informal economy into the formal fold, rationalising the tax structure, improving effectiveness of subsidy delivery as well as lowering structural inflation by improving productivity, reducing costs of production and mitigating the impact of monsoons on food inflation. Going forward, reducing state fiscal deficits through better management of finances is key to seeing reduced state development loans and bringing down credit costs for the corporate sector. While there are a few supply side factors such as the 7th Pay Commission house rent allowance that could have one-off impact on headline inflation, given the historic low CPI print in June and the likelihood of low headline inflation numbers in the coming months, we believe a 25bps repo rate cut is on the cards at the upcoming August 2 meeting. Any further rate cuts would be dependent on the ability to meet the medium term inflation target on a sustainable basis.

Is the Indian fixed income strategy a good addition to a global portfolio under current market conditions?

Our Indian Fixed Income strategy aims to provide investors with exposure to both the onshore market via our Foreign Portfolio Investment (FPI) license comprising government bonds and corporate bonds, as well as offshore USD Indian credit with an non-deliverable forward (NDF) overlay for the INR currency exposure.

Fig 1: India’s core inflation on a downward trend

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Source: CEIC, HSBC, 30 June 2017

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We asset-allocate between onshore and offshore depending on where we see the best alpha opportunities. In addition, when we go onshore, we prefer to invest more strategically, since onshore bonds are subject to taxes, and place a strong emphasis on more efficient duration and sector rotation management. We tend to be more tactical offshore, in terms of relative value trading, credit opportunities across sectors and tenor spreads, given the absence of taxes. We also have the flexibility to invest in Masala bonds, i.e. bonds issued by Indian companies offshore, denominated in INR but settled in USD.

At present, we are overweight duration through both onshore government bonds and highly liquid credit bonds. The liquid corporate bonds also provide a reasonable carry in a stable to lower interest rate environment. We tend to choose bonds we believe represent the best value on the yield curve, for example our current preference is for the 13-16Y part of the government bonds curve.

In summary, I think India has come of age and recommend allocating to India on a strategic rather than a thematic basis to improve risk adjusted returns as well as achieve the relatively low correlation diversification benefit in a global portfolio.

Fig 3: Adding Indian fixed income to global portfolios can enhance risk adjusted return

Despite a possible marginal widening of the CAD, as imports pick up, market consensus still expects the basic balance i.e. CAD plus FDI to be positive this year which together with portfolio flows should keep the INR relatively resilient.

The INR has continued to trade strongly amidst increased inflows from foreign investors. In the first 6 months ending 30 June 17, net FPI debt inflows have been INR 942 billion vs. an outflow of INR 115 billion for the same period in 2016. As of 30 June 17, the INR has appreciated by 5.18% year-to-date against the USD and has added to foreign investors’ gains.

Given improving economic fundamentals, narrowing inflation differentials and strong FX reserves, we expect the INR to move in line with Asian currencies and to remain range-bound going forward.

Fig 4: INR continues to be one of the better performing Asian currencies

How would you characterise your experience of managing the offshore Indian Fixed Income portfolio for the past five years?

As someone who cut his teeth in the Indian fixed income market since 1993, the experience of re-entering the asset class as a global investor and looking in from the outside, while the market opened up, has been both fascinating and rewarding.

It has been fascinating in terms of the various limits / regulations that have been tweaked over the years, as the RBI and the government have improved access for offshore investors on their own terms, all the while taking in feedback from global institutional investors in order to achieve sustainability and stability in the country’s economy.

It has also been rewarding as the Indian market has offered investors a low correlation to global interest rates, while delivering good risk adjusted returns. Through this period, India has gone from being part of the “Fragile Five” in 2013 to becoming a far more robust emerging market economy today.

The success of our strategy is in no small measure due to the support I get from our talented India team, who are my eyes and ears on the ground.

As we complete our fifth year, our Indian Fixed Income strategy has gained critical mass and continues to provide investors with exposure to a market which can still be termed an “access” market by all accounts but should be a strategic part of any global portfolio.
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