

## Short term bond funds- A safer bet during volatile times



In its recent policy review on 24th January, even as it cut Cash Reserve Requirement (CRR) for banks as a liquidity easing measure, the Reserve Bank of India (RBI) expressed its concerns over various factors affecting Wholesale Price Index (WPI) inflation. The reduction in CRR by 50 bps (from 6% to 5.5%) for the first time in last two years led to a release of around Rs. 32,000 crore into India's cash - strapped banking system, however it also generated uncertainties over Open Market Operations (OMOs) conducted by the central bank thereby triggering sell-off in government securities.

To arrive at an outlook on [debt funds](#) in this scenario, one needs to consider several factors including system liquidity, demand - supply dynamics and inflation expectations arising out of various factors. Post the CRR cut (effective 28 January), the cash deficit in the system will come down to around Rs. 1 trillion, but it could spike again in coming months especially in March when advance corporate tax outflow add to the liquidity constraints. Normally, the government increases its spending in March and in this manner releases money into the system, but this time around, we may not see too much of government spending because it has drawn down around Rs. 14,980 crore as of 13th January 2012 from the Ways and Means Advances (WMA) window of the RBI. Global factors like the euro zone crisis are also adversely influencing economic growth; however we believe that the steps being taken towards improving the global economic scenario would trigger a rally in commodity prices thereby resulting in another phase of higher inflation on the domestic front.

Over and above that, we need to consider the Budget numbers before taking a call on rates as the magnitude of the gross government borrowing for the next financial year will decide the direction of longer term yields. In our view, the 10-year bond yields should be trading in the range of 8.00 - 8.50% for this quarter. As such, even if inflation starts cooling off and we witness rate cuts, large government borrowings coupled with low deposit growth will put an adverse pressure on the G-Sec prices. Therefore investors focusing on gilt funds should wait for the budget to get a clearer picture.

Summing up, the Reserve bank will now wait for data points on the current year fiscal slippage and level consumption spending in FY 13 to gauge government borrowing requirement in FY 13 and thereby draft its more clear view on the liquidity and inflation management front. In terms of rate cuts, it may not consider the same unless strong signs of fiscal consolidation emerge. The coming months will witness liquidity pressure and the central bank is expected to continue with Open Market Operations (OMOs) to infuse more liquidity into the system. However the current liquidity situation can worsen because of any spike in credit growth arising out of pickup in economic activity or increase in the OMC's borrowing because of surging crude oil prices. In such a scenario, banks will need to raise more deposits. In a tight liquidity situation bank's chase for money will put upward pressure on money market rates especially short-term CD rates higher thereby making [short-term debt funds](#) an attractive investment proposition. Hence investors can consider parking their money in short term debt funds (with portfolio duration of 1.2 to 1.5 years) for securing higher yields due to distressed liquidity with a view of 3 to 6 months.

**- Yadnesh Chavan**

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