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COVER STORY

SIDE POCKETING

murugappa

CONTENT

Editorial

Markets were looking muted at the beginning of the year, since the global cues were also not so encouraging. FII's were again net sellers and domestic investors were buyers, but the volume of participation was slightly down.

Again NBFC companies were in the news for wrong reasons, and this created panic among investors in certain type of schemes which saw huge redemptions.

In this issue, we have covered about important highlights about the interim budget and monetary policy update and its impact on debt markets.

We are introducing new section called "Learn a Term" from this issue, which will talk about the some new concepts or investment terms or ideas which should help our clients in making sense of their investments.

Happy Investing!!

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DEBT MARKET OUTLOOK

G-sec bonds edged higher to 7.48% vs. 7.37% in December-2018. Bond market remained under pressure during the month due to expanding fiscal policy, higher borrowing etc. The headline inflation was edging lower towards RBI target ban. Market also took comfort from the outcome of Fed meeting that signalled a pause in rate hikes.

Monetary Policy Committee (MPC) decision to reduce the repo rate by 25bps surprised the market. The consensus and expectation were a change in the policy stance from calibrated tightening to neutral. It also revised the inflation projection downward. The revised estimates are at 2.6% & 2.8% from 2.7% & 3.2% for 3Q and 4Q FY19. For 1HFY20 the revised estimates are 3.2% to 3.4% from 3.8% to 4.2%. GDP growth projection was maintained 7.4% at FY20 with evenly balanced risk. The yield curve rallied positively with reduction in rates revised downward inflation. This also signalled that they would continue to maintain the stance and a possibility of further rate cut in future.

To facilitate the credit flow to rated NBFC's, RBI indicated that banks exposure would be risk weighted as per ratings assigned by the accredited rating agencies. Core investment companies will continue to be risk weighted at 100%. These guidelines are expected to be in effect by end Feb-2019.

RBI expected the headline inflation to stay below it target of 4% for entire of 2019 and further rate will done basis incoming data. As a result of this, the implication is that the yield curve to steepen as the market is called upon to take higher supply at the duration part of the curve.

Looking at the other macro data's, Index of Industrial Production (IIP) for November fell to 0.5% after a robust 8.4% in Oct-18. The substantial decline was a surprise, although it was broad based, and was mainly because of contraction in sub sectors of manufacturing. Consumer Price Index (CPI) for Dec'18 fell further to 2.2% from 2.3%, because of subdued food prices, while core inflation was high at 5.7%. The reason for increase in core inflation was attributed miscellaneous inflation led by health and education.

The interim budget postponed the fiscal consolidation targets again. The fiscal deficit for FY19 slips marginally to 3.4 %(BE-3.3%). This slippage is expected to widen, since government has taken aggressive direct tax assumptions in revised estimates of 20% growth. FY19 20% growth on budget capex, but the actual numbers might be lower to manage revenue shortfall. GST assumptions are also ambitious to target rate of Rs.1.14trn Vis-a -Vis average collection of Rs.957bn in FY19RE.

We expect the CAD and capital account are likely to balance themselves going forward if oil stays @ $60. Bond yields are expected to be lower bound and more balance between consumption and capex.

The market was in panic mode after the default of IL&FS subsidiaries, allegations on DHFL and Zee group companies.

During the month of Jan, Jharkhand Road projects, subsidiary of IL&FS defaulted on their payment. Similarly another subsidiary of IL&FS, Hazaribagh Ranch Expressway which was due for payment in April-2019, was downgraded. The SPV of these companies have asked their trustees to refund the debt payments made to their bond holders after Oct-15, 2018 and expressing intention to stop further payments. Since this SPV is self sustaining, if it is being stopped form making payments towards their debtors, it will destabilise their ratings and the effectiveness of ring fenced structure payment is in doubt. The issue is raised in the court of NCLT and waiting response.

As far as the ZEE group is concerned, the issue erupted when it was probed by SFIO (Serious Fraud Investigation Office) of Rs.3000 crore during the period of demonetisation. As a result of this news, the company shares saw a free fall, till the meeting between promoters and stake holders reached a consensus to hold on till the sale of group companies take place. This decision also helped the share value a quick comeback.

Finally DHFL was in the storm, due to allegation from Cobra Post journal. This time the management was quick to respond to refuse the allegations, it did not go well with investors. There was panic among investors and started to redeem their deposits and prices in bond market sharply fell. Government has announced that they will look in to the allegations and set up a panel to do necessary investigations. Mutual funds had different levels of exposure to these companies, and as per SEBI guidelines they have taken haircut accordingly in their NAVs.

In our view, we suggest investors to be watchful in choosing their debt funds, since YTM alone does not matter, the underlying Portfolio of papers is more important. Particularly Credit risk funds will have exposure to papers other than AAA and as the name suggests, the fund will carry credit risk papers and during this kind of situation in the market, the fund NAV will undergo bumpy rides.

Otherwise in our view, we feel short term funds will continue to perform better, while client with less than one year horizon can look at low duration or ultra short term funds depending on time horizon of investment.

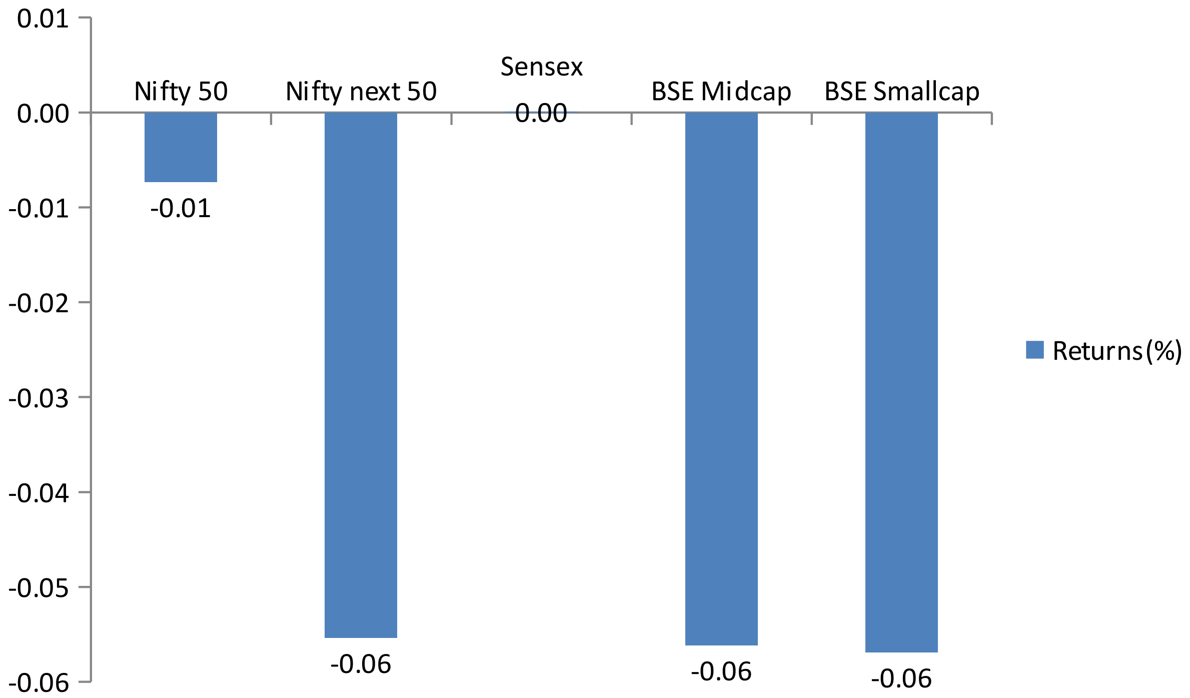
EQUITY MARKET OUTLOOK

January month was a tough month for equity indices as majority of the sectors traded with negative bias. The major index Sensex and Nifty were almost flat, while among indices, auto, capital goods, FMCG, health care, realty and telecom ended negative, while energy, IT and Bankex closed marginally positive.

Sentiments were positive following global cues in the form of dovish tone from US. Market was also encouraged by a slew of measures announced in the interim budget and short covering on expiry of Jan sales F&O contracts.

The central Statistics Office revised upwards the country's economic growth rate to 7.2%. India's core sector growth slowed down to 2.6% in Dec 2018 from 3.8% a month earlier.

The government empowered public sector banks to request lookout circulars against wilful defaulters and fraudsters. Government also confirmed to not extend deadline of Feb-1 for implementing the revised guidelines for e-commerce companies having FDI.



FII's turned net sellers after two months with outflows of $460 Mn. Domestic investors continued to be buyers of higher quantum to previous month inflows of $300 Mn. Domestic funds buying was strong with net inflows of $1.2 Bn, while insurance companies were sellers to the quantum of $880 Mn.

Beginning through this year, the index started on weak note after volatile CY18. Macros are getting better with oil prices staying low and currency stabilized. Q3FY19 earnings season has started to show signs of recovery with 70% of Nifty Company's aggregate profit of 9% and is driven by revenue growth and expect margins should start recovering with recent downtrend in input costs. The pre election budget offered lot of goodies to the farmer and middle income population, and the underlying fiscal data looks optimistic. Policy support to the property sector is a good move and should help in revival of the sector. We also expect the economy to recover as GST related disruption seems to be behind us and consumption revives on back of MSP hikes, rural wage growth and implementation of pay commission. We also expect stable currency and resolution to NPA's in banking system.

We expect the markets will be facing several events this year starting from elections, global growth concerns, and crude oil price movements, US China trade spat etc to name a few.

An important point to note is that individuals who have been investing in SIP's in the last one year or so, have made negative returns YTD, but one should not be worried about the situation, since this is the time where you should continue your SIP, in fact you should try and increase the allocation to SIP. This phase of volatile market is best suited for SIP investment and we recommend continuing your investment.

Also the recent market corrections provide an opportunity to entry to equity and we maintain our view to invest in equity in STP basis till the outcome of elections and clients with moderate risk appetite can look at hybrid category funds.

BUDGET UPDATE

Interim Budget for the year 2019 was presented on 1-Feb-2019, was aimed at providing stimulus to the slowing economy with consumption boost and was also a populist in terms for farmers and middle class income, with an eye on upcoming elections.

We have listed the key highlights in the budget for an easy understanding for our clients.

- GDP was expected to witness a revival in FY19 through FY20 and real GDP as of Q2 FY19 stands at 7.1% and average consumer inflation at 4.6%.
- Total estimated expenditure in RE 2018-19 is Rs.24, 57,235 crore amounting to increase of Rs.15, 022 crore from BE 2018019. For 2019-20 is pegged at Rs.27, 84,200 crore which is an increase of 13.3% over 2018-19. The increase is in account of support to agricultural sector.
- Capital expenditure is expected to increase to Rs.3, 36, 293 crore in BE 2019-20 from Rs. 3, 16, 623 crore in RE 2018-19.
- Fiscal deficit stands at 3.4% as of FY19RE and budgeted to be 3.4% of GDP in FY20. Going forward it is expected to adhere to FRBM Act targeted to 3.0% in 2020-21. For the benefit of readers, FRBM stands for Fiscal Responsibility and Budget Management, which is an act enacted in 2003 which sets targets for government to reduce fiscal deficits.
- In the agriculture front, under Pradhan Mantri Kisan Samman Nidhi, farmer having cultivable land up to 2 hectares will be provide income support of Rs.6000/- per year in the form of direct benefit transfer. This scheme will be effective from Dec-20 18 and will be paid from Mar-2019 in three equal instalments of Rs.2000/- each.
- Earlier interest subvention of 2% for farmers affected by natural calamities was provided for first year of the rescheduled loan. Now all farmers affected by natural calamities where assistance is provided by Natural Disaster Relief fund will be provided with interest subvention of 2% and prompt repayment incentive of 3% for the entire period of the loan tenure.
- To facilitate the interest subvention, interest subsidy for short term credit to farmers has been increased from Rs.14,987 crore in FY2019 to Rs.18,000 crore in FY2020.
- Budget allocation for crop insurance has been increased from Rs.12.976 crore in FY19 to Rs.14,000 crore in FY20.
- Under connectivity of rural villages Pradhan Mantri Gram Sadak Yojana, Rs.19,000 crore has been allocated in BE 2019-20 against Rs.15,500 crore in RE 2018-19.
- Under housing for all scheme – Pradhan Mantri Awas Yojna, the allocation has been marginally reduced Rs.25,853 crore in FY2020 from Rs.26,405 crore in FY 2019.
- Overall Railways expenditure stands at Rs.1,58,658 crore and the capital support for the budget for railways is proposed at Rs.64,587 crore in 2019-20 BE compared to Rs. 55,088 crore in 2018-19 BE.
- In the social welfare front, Pradhan Mantri Shram Yogi Maandhan, the unrecognised sector workers

with monthly income up to Rs.15,000/- will be provided with monthly pension of Rs.3,000/- from the age of 60. This will be done with a small affordable contribution during their working age and Government will contribute equal matching share in the pension account. A sum of Rs.500 crore has been allotted for the scheme.

- In direct taxed, in BE 2019-20, Gross Tax Revenue is budgeted Rs.25,52,131 crore which is 12.1% of GDP. GTR is expected to grow at 11.9% and 13.4% in 2020-21 and 2021-22 respectively.
- Direct taxes are estimated to grow at 14.9% and 15.3% in 2020-21 and 2021-22 respectively.
- Individual tax payers with annual taxable income up to Rs.5 lakhs will get full tax benefit and will not be required to pay any tax.

- Earlier under sec 87A, tax rebate was up to Rs.2500/- up to income of Rs.3,50,000. Under the new amendment, the income limit is increased to Rs.5 lakhs and rebate up to Rs.12,500.
- Please note this tax rebate is applicable only for individuals with taxable income up to 5 lakhs, for the rest it will be regular structure as earlier will be applicable.
- Currently, an individual with income up to Rs.2.5 lakhs (up to 60 yrs) is exempt from tax, for senior citizens from age 60 yrs but below 80 tax exemption limit is up to Rs.3 lakhs and for super senior citizens aged above 80 yrs, will have tax exemption up to Rs.5 lakhs.
- The tax rate for Rs.2,50,001 and Rs.5 lakhs will be 5%, between 5,00,001 and Rs.10 lakhs tax rate will be 20% and above Rs.10 lakhs will be 30%
- TDS threshold earned on bank and post office deposits is increased from Rs.10,000 to Rs.40,000.
- TDS threshold for deduction of tax on rent is proposed to be increased from Rs.1,80,000 to Rs. 2,40,000.
- Levy of income tax exempted on notional rent on second self occupied house
- The rollover benefit of capital gains under section 54 will be increased from investment in one residential house to two residential houses for capital gains up to Rs.2 crore.
- Under section 80-IBA of income tax act for affordable housing schemes, the benefit has been extended for one more year up to 31-March-2020.

LEARN A TERM – "SIDE-POCKETING"

Investors, who have been investing in debt funds, would have come across this term called Side-Pocketing. With the recent default in companies, this concept is getting much more searched article in sites. So we have made an attempted to explain this concept in simple terms.

After the IL&FS crisis, SEBI has allowed this way called Side-Pocket. Say for example, we have invested in a corporate debt fund, which has a portfolio of five bonds. Out of which, for some reason one the bond has defaulted in terms of their debt re-payment, then as per SEBI guidelines, MF Company can write off the value of the bond to the extent in its portfolio, so that the rest of the portfolio does not take a hit. That is the reason; you will see a sudden drop in the NAV of the fund.

Once the default is settled and MF is able to recover the loss, then it brought back to the fund and valued accordingly.

Now what we need to note is that, as investors during this time of panic, what we do is we rush to redeem the units. As the redemption pressure goes up, the fund manager ends up selling the next immediate liquidable bonds in the portfolio. So the investors who had stayed in the fund, once the defaulted bond recovers and pays back, the proceeds are shared among those investors who have stayed invested in the fund and the new investors who invested after this will not be eligible for this share.

Side pocketing is a process whereby segregating a bad bond in a side pocket, the fund house can avert the risk of mass exit of investors of the affected fund and help the existing investors to recoup the losses if the defaulted company recovers.

While talking of the advantages, there is also a disadvantage if the fund manager creates too many side pockets by taking increased risks and it becomes quite difficult to the track them for regulators and investors.

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