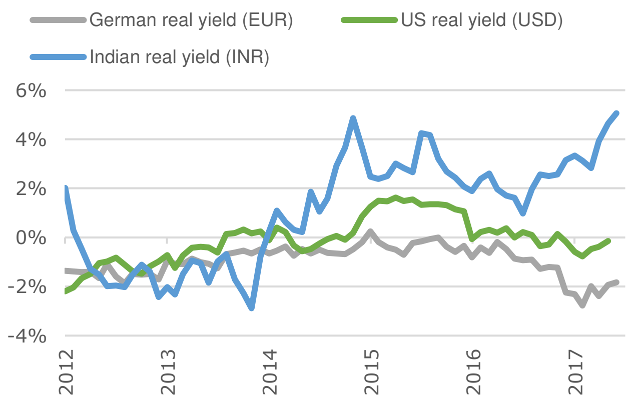
Indian Local Bonds offer attractive Yields

Investment Insight | Series III

In a series of articles we discuss and present investment opportunities we actively use in our building blocks to form our absolute return portfolios. So far we discussed "structured credit" as well as "private debt". In Series III we introduce you to one of our most appealing higher beta themes: Indian local bonds. They bear currently not only an attractive **nominal yield of 7%, but also a real yield that exceeds 3% - much above the levels in the developed world.**

Chart I: Indian real bond yield gaps up vs USD/EUR

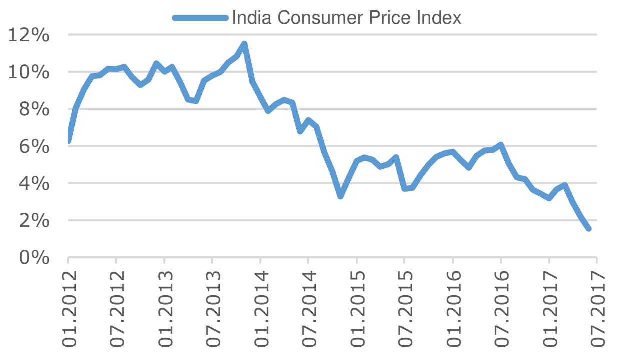


Source: Bloomberg / Alpinum Investment Management

Most recently, the real yields (nominal 5 year government bond yield adjusted for inflation) in Indian bonds have exceeded the threshold of 5%. While we believe this elevated level will be only temporary, we still expect continued positive real rates in the Indian Rupee as it was the case since 2014, when inflation started to fade. India's attractive real rates are a significant yield advantage as it is well exemplified in chart I. In a world of low nominal yields in general and real yields of only 0% in the U.S. or being even negative in Europe, investments in high quality bonds in economies such as India remain an attractive investment opportunity.

Historically, the Indian Rupee ("INR") has been a weak currency and the yield advantage of an investor was typically eaten away by a depreciating currency. With India's **paradigm shift in its monetary policy in August 2016 towards an "inflation-forecast targeting" model, the dynamics for the currency have changed meaningfully to the positive.** India implemented an inflation target of 4% for at least the next 5 years (until March 31st 2021). This shall help increasing the macroeconomic stability of the country and keep the inflation in check. The inflation rate shall range within an upper tolerance level of 6% and a lower limit of 2%. The Reserve Bank of India ("RBI") steers via its Monetary Policy Committee ("MPC") the implementation. This policy was set up in consultation with Raghuram Rajan, the former Governor of the RBI.

Chart II: Inflation in structural down trend

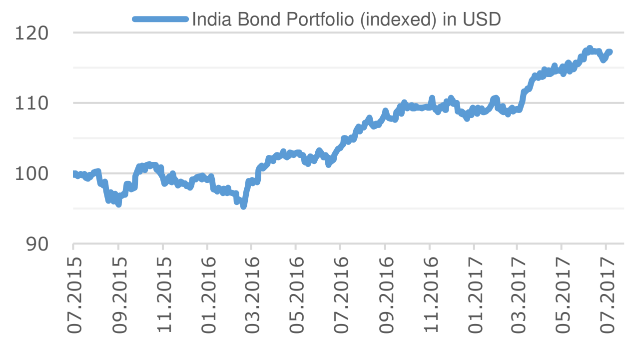


Source: Bloomberg / Alpinum Investment Management

Chart II above does well demonstrate the early success of the newly implemented monetary policy.

Since India's Prime Minister Narendra Modi took over the lead in 2014 his reform agenda was supported by strong economic fundamentals and this has resulted in strong returns for investors. This was especially true for Indian equities. However, with the newly employed monetary policy and the resulting lower inflation outlook, high quality bonds enjoyed also strong performance.

Chart III: Performance of our Indian bond exposure



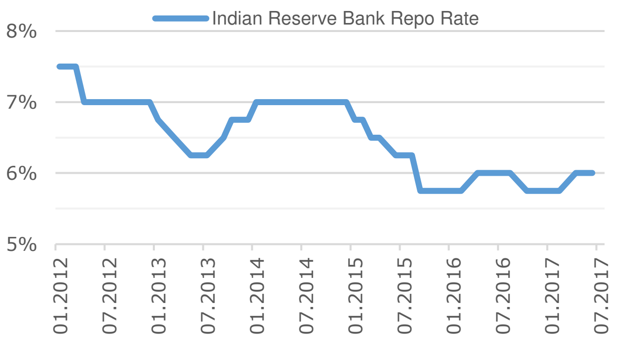
Source: Bloomberg / Alpinum Investment Management

We initiated our first Indian bond investment in March 2016. Chart III shows the performance of our **Indian bond portfolio, which is primarily made of government bonds and earns at the moment a yield of 7% p.a. with a duration of 5 years**.

On July 1st, India implemented with the **Goods and Services Tax ("GST") probably its most significant economic reform since decades**. The GST will transform the country's 29 states into one single market. This is a landmark achievement for India, which accounts for almost a fifth of the world's population (1.3 bn people). Both equity and fixed income markets are beneficiaries of the longer term effects of this new tax regime as this will lead to less bureaucracy and higher productivity. However, in the short term, we also expect some economic disruptions with the implementation of the GST as the transformation process needs time to be successfully put through. A slightly softer economic growth outlook (but still above 6%) leads to disinflationary forces, which could result into lower interest rates and give inherent support to bond prices.

While the above described economic implications may weigh negatively on the short term prospects for some equity investments, they bear at the same time positive effects for Indian (government) bond investors. Both the implementation of the GST as well as the expected slightly lower economic activity should help keeping inflation in check. Hence, there is scope for stable or even decreasing interest rates, what would lift bonds higher.

Chart IV: Indian Reserve Bank Repo Rates headed lower

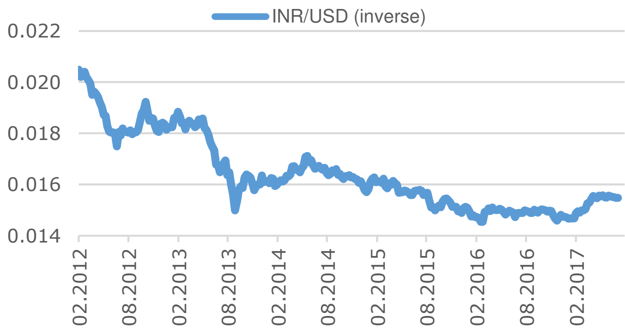


Source: Bloomberg / Alpinum Investment Management

At its last meeting in June, the MPC left its policy unchanged and maintained a neutral stance. However, it has cut its CPI inflation forecast for FY18 to an average of 3.5%. While the recent inflation downturn may be only temporary, the real rate is still extraordinary high with more than 3%. Should inflation prove to be in a structural decline, this could lead to further rate cuts over the next 12 months. The Reserve Bank Repo Rate has not yet fully discounted such an outcome (pls see chart IV for illustration).

The slowing inflation pressure combined with the high real rates have stopped the devaluation path of the INR. On the contrary, the currency has even started to level off versus the USD. The chart below shows well the **stabilization of the INR vs. the USD** since 2016.

Chart V: INR shows signs of stabilization



Source: Bloomberg / Alpinum Investment Management

As stated before, the Indian economy is growing with more than 6% p.a. and the implementation of the GST may cause some sort of short term economic softness. However, we believe that this will be only a temporary effect. On the opposite, a high level of bad debt in the corporate sector remains one of the major headwinds for the Modi government, which has otherwise managed the economy well. This weighs also negatively on the profitability and solidity of Indian banks (non-performing assets reached on average a level of 6%). In this respect, the implementation of India's new insolvency and bankruptcy bill that became live in 2016 (it shall resolve bankruptcies within 6-9 months) is a move into the right direction. However, this needs several years to have a meaningful positive impact.

For our investments in the Indian bond market, the above described negative environment for the Indian banking sector is of little concern as we primarily invest in Indian government bonds. These are very safe investments with respect to default risk as the Indian state is very solidly financed and it runs low public debt. For illustration purposes, the public debt ratio (debt/GDP) in India is 22%, what compares for example favorably versus the U.S. with a ratio of 74% or France with 96%. Hence, the largest risk for our exposure in Indian bonds is not default, but rather currency risk.

With 7% nominal and attractive real yields, Indian bonds remain one of the most appealing investment themes in our global fixed income portfolios. With the current moderate inflation outlook, the RBI could even cut its benchmark repo rate in one of its next meetings (what would lead to higher bond prices) and the Indian Rupee is currently backed by short term disinflationary forces and strong medium term economic growth prospects.

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