Fed rate hike won't wreak havoc in Indian markets, says Kumaresh Ramakrishnan

By Sakshi Denis, ECONOMICTIMES.COM | Aug 31, 2016, 03.39 PM IST

If the US Federal Reserve hikes rate at its September meeting, the domestic equity market will see only limited impact, said Kumaresh Ramakrishnan, Head of Fixed Income, at DHFL Pramerica Asset Managers. In an email interview with Sakshi Denis of ETMarkets.com, Ramakrishnan said chances are there will be one rate hike by the Fed this year, which may or may not happen in September. Excerpts:

The next rate-setting meeting of the US Fed is due on September 20-21. Should the Fed decide to hike interest rate, how will it impact financial markets, especially in India?

RBI has reiterated in the past under Dr Raghuram Rajan that the domestic rate-setting process is largely influenced by local factors driven mainly by inflation and its expectations, besides other macros. The Fed hiked rates for the first time in its current upward cycle towards the end of calendar 2015. The markets largely remained stable after the rate hike in 2015.

Market expectations at the start of the year were for at least three rate hikes by the Fed in calendar 2016. So far, there has been no rate hike and the probability of a rate hike, if at all, has narrowed down to one for the remainder of the year.

The current benchmark yield differential between the US and the Indian government's 10-year bond yields stands at over 550 bps, which is attractive and well above the historic average. As such, we see limited impact on the Indian market if the Fed does hike rate.

What are your expectations from the forthcoming FCNR redemptions and how will it influence the bond market and the rupee?

The Reserve Bank of India (RBI) has reaffirmed in the past and as recently as in the latest monetary policy review meeting that the FCNR redemptions would be managed without market disruptions. It has also said that it is open to conducting its ongoing domestic liquidity operations and foreign exchange interventions in this regard. Given this, we expect both the money and bond markets to remain largely stable through this period of FCNR-B payouts.

The bond market's reaction to Urjit Patel's appointment as RBI Governor was a bit muted. Do you think the bond market is appreciating Patel as Rajan's successor?

The bond market has been consolidating recently after a steady runup in the past few months, which saw the benchmark bond yields rally almost 80 basis points (bps) from the high of 7.90 per cent in February. The market is also drawing cues from both the monsoon progress and other external developments such as the recent Fed hawkishness. This has got reflected in the slight reversal in yields. This has also coincided with the change of guard at RBI. In our view, the slight reversal seen is temporary and is a part of the overall yield consolidation process.

Inflation has risen to a two-year high. Do you think it can be a big trigger for the bond market going ahead?

After falling through the end of last calendar year and early part of calendar 2016, inflation has started reversing from

April 2016. Food inflation has been driven higher by three items - fruits & vegetables, pulses and sugar.

Seasonally, inflation picks up in the summer months driven by higher food inflation as prices of fresh fruits and vegetables tend to spike. The summer of 2016 marked the second successive year of drought. Reservoir levels and soil moisture content fell to very low levels which pushed up food prices. Over the last year, one of the main culprits within food inflation has been the runaway prices of pulses. The trailing 12-month pulses inflation has been close to 25 per cent.

However, a relatively better monsoon this year is likely to cause inflation to reverse its course over the next few months. Pulses' output in the coming months is expected to be substantially higher (+40 per cent) fuelled by relatively higher sowing acreages this season (owing to higher incentives offered to farmers on pulses) and good rains in the pulses growing regions.

In fact, we have already witnessed some cooling off in pulses inflation in August. Overall, the headline inflation is expected to recede to 5 per cent level by March, as food prices subside. As such, we view the recent upsurge in inflation as temporary.

You manage various funds including dynamic bond funds, income funds and inflation-indexed bond funds. Given the prevailing market condition, which one among the bond category could offer best returns in the long term?

Even in the absence of a rate cut, we expect yields to enjoy a downward bias, particularly at the front end (2-5 years), as liquidity conditions remain balanced and credit demand remains subdued. This will continue to assist curve steepening as already witnessed in the last few months.
We advise investors with a preference for lesser volatility and regular income to consider the frontend of the curve through shorter-tenure products (2-4 years), including both accrual products and short maturity funds (a combination of duration and accrual).

Investors with a longer horizon and higher appetite for rate volatility can consider some allocation to pure longer duration products (with average maturity ranging from 3-7 years).

What is your advice to debt fund investors? Which category of debt funds will give investors better returns over the next one year or so?
We always ask investors to choose products based on their risk appetite and asset allocation needs. Short and intermediate bond funds appear to be well-placed as the liquidity improvement theme plays out.

This segment is reasonably hedged from any sharp short-term yield reversals sparked by unforeseen or external developments. Given the reasonable 'good carry' still prevailing within this category of funds post the recent rally, we advise that these funds should form an integral part of the bond allocation for investors.