Cash Reboot! - Shifting to a new "Normal"

In a historic move, the Government cancelled high denomination notes of INR 500 and INR 1000 w.e.f. from 8th November, and replacing them with new INR 2000 and INR 500 notes. This is in line with its continued efforts to crack down on "black" money and counterfeit notes and move the economy to a new (and better) normal by reducing the cash economy and moving towards "cashless transactions" through normal financial channels.

The move has enormous implications both in the short as well long term. As old currency notes are deposited in banks, the liquidity with banks swell in the short term. The limits on withdrawal will ensure that all of the deposited monies do not flow out in coming months. Further measures are expected from the government to make cash withdrawals difficult and move the economy towards e-payments.

A sharp fall in currency in circulation (CIC) is likely to improve the chronic liquidity deficit faced by the economy every year. As the economy moves more towards the formal financial system, there is likely to be increased tax compliance with positive implications for fiscal math.

Impact on macro

GDP: The measures will have a significant negative impact on economic activity in the short-term. The impact will be concentrated in segments where cash transactions dominate. Second, the government's move may make small businesses, self-employed and professionals more risk averse in transactions using cash, even if these are completely legal and above board. Sweeping away of parallel economy wealth should have a negative impact on conspicuous consumption and would lead to spill over's into the organised economy.

Inflation: The demonetization of the higher denomination currency is expected to lead to lower inflation as demand may contract in the short term. The vast magnitude of CIC (especially that deployed for corrupt means) has been closely linked to inflation, as it leads to conspicuous consumption, and can in part explain the sharp rise in prices. Hence a drop in CIC is likely to lead to lower inflation. A meaningful correction in prices in industries such as real estate is likely to be seen, especially in the secondary market which has higher component of cash. Given the high usage of cash in the rural economy, especially with relation to agriculture, food prices are also likely to moderate. This is over and above the low inflation trend witnessed in some of the key components of the CPI basket. Overall we believe that the move is likely to moderate inflation significantly in the medium term.

Systemic liquidity: Systemic liquidity witnesses a boost as CIC is likely to see a sharp fall over coming months. In the first phase this will be a massive liquidity shock for the banking system with system liquidity turning into huge surplus as CIC falls and deposit base grows by same amount. CIC remains a key leakage from the system. Given the move to demonetize, CIC is expected to fall sharply and systemic liquidity is likely to improve significantly, which is positive for the financial system.

Fiscal deficit: Fiscal arithmetic is likely to improve in coming years. Stricter measures against black money will lead to increased tax compliance and support fiscal arithmetic in the medium term. Extinguishing of un-returned currency notes is likely to lead to a windfall for the government, which could be used to support infrastructure spending to augment economic growth. Further, complemented by the implementation of the Goods and Services Tax the move will be fiscal supportive.

Impact on Fixed Income Markets

From the bond market perspective, the liquidity impact will be a significant positive. A sharp increase in money market liquidity is going to cause the front end of the curve to drop sharply. With inflation likely to dip significantly and a sharp drop in demand, RBI is likely to upfront rate cuts in next few policy meetings.

Further, the fiscal impact will also be positive to the extent that windfall gains will help achieve deficit targets and could conceivably leave government balances on stronger footing. Over the longer term, both the move towards non-cash economy and the introduction of GST should lead to structural improvement in tax compliance and the tax-to-GDP ratio; implying re-rating of India's fiscal position by foreign investors.

Next Theme: Bull Curve flattening / Spread compression

While the short and medium tenor bonds have rallied, the longer end spread has increased. Corporate bond market rally also trailed G-Sec with spread widening a bit. The current spread for 30Y-10Y is about 40-44 bps. In a rally we have seen spread go as low as 15-20bps. Similarly AAA PSU Corporate Bond spreads are around 55 bps. In the recent past the spreads had gone down to as low as 30-35bps. Ample liquidity and expectation of rate cuts by RBI may lead to a bull flattening of the yields and contraction of credit spreads as market participants search for yield post the initial G-sec rally sobers down.

RBI's recent CRR announcement*

Over the weekend, RBI announced an increase in cash reserve ratio (CRR) on incremental increase in NDTL between September 16th and Nov 11th to 100%. Effectively, we estimate INR 3.25 tn of additional banking system liquidity will need to be parked with the RBI over the reporting fortnight that ends on Dec 9th. RBI intends the recourse to this tool to be temporary, and expects to review the new requirement on Dec 9th, if not earlier. The CRR rate remains at 4%.

RBI was so far relying on the conventional liquidity management tools in its armoury viz. the overnight and term repos and reverse repos. But the sharp influx of liquidity threatened to swamp RBI's ability to utilize the reverse repo window. Note the ability of RBI to absorb liquidity via reverse repos is constrained by the availability of eligible securities (collateral) on its balance sheet.

In terms of the monetary policy signals, we do not believe any strong inferences are to be drawn from this manoeuvre. RBI itself expects the recourse to this measure to be temporary. We retain our assumption that RBI will cut the benchmark repo rate by 25bps to 50 bps, while highlighting the downside risks to its growth projections.

** - Source - RBI*

Implications for investors

1. Ultra-Short / Short Term Category: The excess liquidity coupled with expected rate cuts will continue to put downward pressure on money market yields. With Liquid returns going down, USTF may provide superior returns to investors vis-à-vis liquid for institutional Investors.

2. Medium Term / Income Category: Liquidity is expected to remain ample in short to medium term as the cash deposited with banks will take time to flow out. Further increased scrutiny of cash withdrawal is likely to reduce the growth in currency in circulation. This is likely to increase overall systemic liquidity. With the front end of the curve falling, the 3-5-10 year should steepen further. CR MTO is primarily invested in 2-5 year segment and will benefit from the steepening. Drop in FD rates will increase attractiveness of ST/MT funds for retail investors with low to medium risk profile.

3. Dynamic / Gilt Funds: For high risk investors, Dynamic/Gilt funds can provide good opportunities as rates are expected to continue to go down on back of improving inflation dynamics and shock to growth from demonetization.

To Conclude

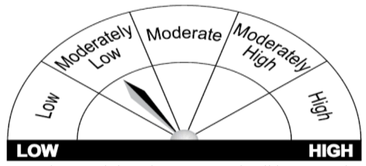
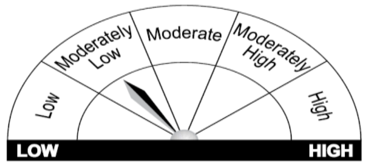
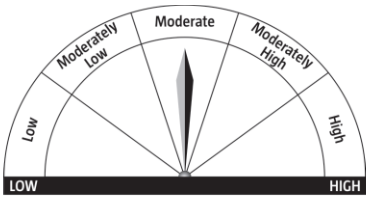
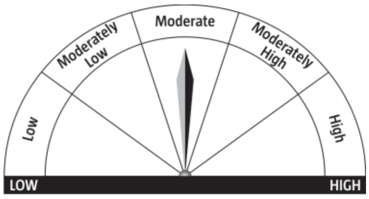
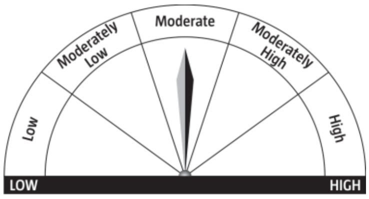
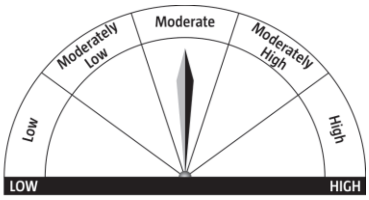
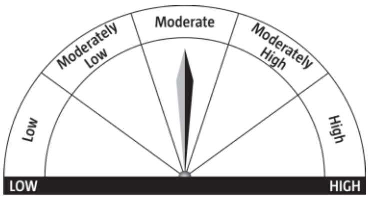
While the underlying sentiment is positive for bonds and we should see continuance of the current rally over the medium to long term, profit booking may lead to correction in yields intermittently rendering volatility in the markets. The current environment presents a magnificent opportunity to investors to capitalise on and look towards increasing their allocation towards fixed income markets. However, with interest rate trajectory still pointing downwards, there are no doubts that the bond yields are likely to soften going ahead. Hence investors should gradually expose themselves to more duration to make the most of this move. Consequently, we suggest investors to move a notch up with respect to exposure to duration. Investors in liquid funds could consider investing in Ultra Short Term funds, investors currently exposed to short term duration could look at Medium Term Funds and so on. We suggest matching risk appetite and investment horizon to fund selection. Investors looking to take systematic exposure to equities may allocate lump sum to no load debt funds and registering for Systematic Transfer Plans (STP) of periodic intervals.

Presenting our debt schemes which may benefit from the current interest rate cycle:

Fund	Description	Risk Category	Investment Horizon
Canara Robeco Savings Plus Fund	▪ Invests in the **high credit quality** papers and focuses on **accrual income**	Moderately Low	Less than 1 year
Canara Robeco Short Term Fund	▪ A fund which focuses on **generating accrual income** from Money Market Instruments and follows **an active trading strategy to generate Alpha**		
Canara Robeco Yield Advantage Fund	▪ Fund which **seeks to maximize returns through active management of the portfolio consisting of wide range of Debt and Money Market Instruments**	Moderate	1 – 3 Year
Canara Robeco Dynamic Bond Fund	▪ Fund which **dynamically manages duration risk**		
Canara Robeco Medium Term Opportunities Fund	▪ An ideal investment avenue from a **Medium Term perspective**		3 – 5 Years
Canara Robeco Income	▪ Fund which **invests with a long term view on interest rates**		3 – 5 Years
Canara Robeco GILT PGS	▪ Fund which **does not take exposure to Credit risk as it invests in G - Sec of varying maturity**		3 – 5 Years

CANARA ROBECO Mutual Fund

Riskometer:

Name of the Scheme / Plan	This product is suitable for Investors who are seeking*	Riskometer
Canara Robeco Savings Plus Fund (An Open Ended Debt Scheme)	• Income / Capital appreciation over short term • Investing in Short Term Debt Instruments and Money Market Instruments with Weighted Average Portfolio Duration of Equal to or Less Than 1 Year	 Investors understand that their principal will be at Moderate risk
Canara Robeco Short Term Fund (An Open Ended Debt Scheme)	• Income / capital appreciation over short term • Investing in short term to medium term debt and Money market securities	 Investors understand that their principal will be at Moderate risk
Canara Robeco Yield Advantage Fund (An Open Ended Debt Scheme)	• Income/ Capital appreciation over medium term to long term. • Investment in a wide range of debt securities and Money Market Instruments of various maturities and risk profile and a small portion of investment in Equity and Equity Related Instruments	 Investors understand that their principal will be at Moderate risk
Canara Robeco Dynamic Bond Fund (An Open Ended Debt Scheme)	• Income / Capital appreciation over short to medium term • Investment in Debt and Money Market securities	 Investors understand that their principal will be at Moderate risk
Canara Robeco Medium Term Opportunities Fund (An Open Ended Debt Scheme)	• Income / Capital appreciation over medium term to long term • Investment in Debt and Money Market securities with a portfolio weighted average maturity between 3 to 7 year	 Investors understand that their principal will be at Moderate risk
Canara Robeco Income (An Open Ended Debt Scheme)	• Income / Capital appreciation over medium term to long term • Investment in Debt and Money Market securities of different maturity and issuers of different risk profiles	 Investors understand that their principal will be at Moderate risk
Canara Robeco GILT PGS (An open-Ended dedicated Gilt scheme)	• Risk free return (except interest rate risk) and long term capital appreciation • Investment only in government securities	 Investors understand that their principal will be at Moderate risk

*Investors should consult their financial advisers if in doubt about whether the product is suitable for them