Outlook for 2012: Fixed income

"Flexible approach to fixed income investing crucial for maximising returns in 2012"

Shriram Ramanathan, Fund Manager – Fixed Income, Fidelity Worldwide Investment, India

2011 has been a tough year for India, partly due to global macro worries but also importantly due to idiosyncratic domestic issues and uncertainties. Economic growth has been losing momentum since the middle of 2011 and this has become apparent across a host of indicators such as falling industrial production and weakening corporate investments. A loose fiscal policy has resulted in the government being unable to stick to its fiscal deficit target, and consequently has led to substantial increase in the government's borrowing programme versus its budget target. Unfortunately, this policy undermined the Reserve Bank of India's (RBI) ability to get inflation quickly under control despite its tight monetary policy through most of last year. A significant weakening of the Indian rupee over the last quarter of 2011, given its deteriorating balance of payments situation, added to the weak macro backdrop for India, with the 'India shining' story at risk of losing some of its sheen.

The outlook for 2012 remains uncertain, especially on the political front. However, growth slowdown and falling inflation, in the backdrop of limited fiscal manoeuvrability are likely to compel the central bank to take on the mantle for supporting growth. The markets have started expecting the central bank to deliver aggressive rate cuts through 2012 and ease the tight liquidity situation. We expect the RBI to deliver on these expectations, with the caveat that an unexpected global recovery or a rise in geo-political tensions in the Middle East, could lead to a spike in oil prices and in turn slow down the pace of rate cuts relative to expectations. At the same time, a global market meltdown due to a euro zone breakdown could hasten the speed of monetary policy easing. Hence, a flexible approach to fixed income investing would be crucial in maximising returns in 2012.

We expect the domestic fixed income market to perform well this year, and would advise investors to take advantage of the attractive yields and potential for capital gains, by having diversified exposure across various fixed income products depending on their risk appetite and cash flow requirements. For investors with a medium to long term horizon and a high risk appetite, we believe bond funds with a flexible investment approach offer an attractive opportunity. For investors with a shorter investment horizon or lower risk appetite, we would recommend a combination of short term income funds and fixed maturity plans as ideal risk-adjusted investment opportunities.

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