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TREASURY SERVICES

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HIGHLIGHTS

Domestic Markets

Currency

Even before the ECB restriction norms came in, we had argued that the Indian rupee will gradually depreciate to Rs 42-43/US$ by year end. Now this probability looks even more certain given the current ECB restriction norms. With the sub-prime mess in the US still continuing and now spreading to Europe and Australia, there is now an even increased possibility of further global risk aversion from the emerging markets leading to increased volatility in the domestic stock markets and thus further depreciating pressure on the rupee in the days to come. Given the current scenario, we would expect our range of Rs 42-43 to a dollar to be achieved much faster than what we ourselves would have expected.

Rates

We do no expect any sharp upward movement in the 10 Yr benchmark GOI yields from the current levels. The supplies of Central Government securities from now till the end of September 2007 are only Rs 14,000 crore and there is still ample liquidity in the system, amounting to around Rs 25,000 crore to Rs 30,000 crore. Some recent softening of international crude oil prices (WTI currently at US$71/bbl as compared to US$78bn previously) and inflation remaining at sub 5% levels is also expected to lend support to the bond markets. Further, the other positive for the bond market would be the low 10-year US treasury yields that have dipped with the burden of excess flows into the economy via the "flight to safety" argument. However, even as the liquidity remains comfortable, we do not anticipate an immediate huge dip in the 10-year benchmark yields as market players are likely to continue to exercise some caution on account of the global financial market turmoil. Overall, the 10-year benchmark bond yield is likely to stay in a broad range of 7.95-8.05% in the next month.

Overseas Markets

In the last few weeks, the US markets have witnessed tremendous volatility in both the equity and the bond markets on account of the rising level of default risk in the US mortgage market and its contagion effect on other credit markets. Despite liquidity infusion by the ECB, Fed and other central banks, the global market sentiments continued to remain negative with Dow and FTSE taking a severe beating, carry trades in Japanese Yen crosses unwinding sharply and the US Treasuries rallying. As a result, in a surprising move, the U.S. Federal Reserve cut the primary discount rate by 50bps on 17th August aimed at calming jittery global markets. The Fed's recent move now heightens the probability of a Fed-Funds rate cut much earlier than December 2007 as predicted before. As far as the ECB is concerned, a rate hike in September which seemed like a definite event in early August looks like a very remote possibility now and would remain conditional on the unfolding of the sub-prime crisis in the US and its impact on the European economy. In the aftermath of the financial turmoil and the Fed's move, we expect BOJ to hold rates steady at the moment as a rate hike at this juncture would mean aggravating the strength of the Yen further and hence a loss to its exports market.

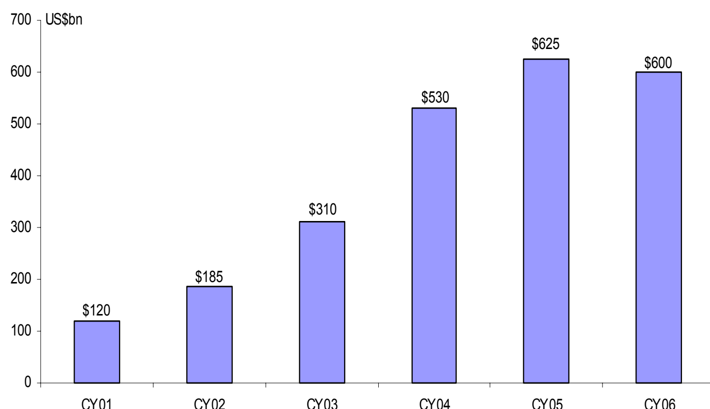
US Sub-prime woes

The genesis of the sub-prime loan market in the US

Starting in 2002, the double whammy of a technology crash and the WTC attacks forced the US Fed to slash short-term interest rates, thus making mortgages more affordable for low income buyers. Even as the low interest rates were providing a support to the housing market boom, a series of financial innovations lent further support. The advent of securitization (Mortgage Backed Securitization) and Credit Default Swaps (CDS) could create investment-grade bonds out of the subprime assets, that also became the flavour for the hedge funds to produce massive spreads. Thus securitization allowed the surplus global liquidity to gradually move into the US housing market, leading to a boom in the housing prices.

More financial engineering were to follow. "Liar loans" or "Alt-A" loans allowed borrowers to claim a given income. Some other loan types allowed borrowers to borrow more than 100% of a home's value. All the above meant that there was a huge dip in the lending standards. However the situation continued unabated as house prices were rising and there were ample refinance opportunities for the borrowers. By refinancing, the borrower not only could repay the earlier loan but could also increase their consumption with the extra cash (home equity extraction). Consequent to the attractiveness of the above instruments both for the borrower as also for the investor, subprime loans as a percentage of total mortgage loan originations have increased from 5% in 1995 to 23% by the end of 2006. The sub-prime and Alt-A loans together formed around 37% of US mortgages originated in 2006. As indicated by Exhibit 1, the pace of origination of subprimes picked up significantly with more than USD600 bn of new subprime loans originating in each of the calendar years 2005 and 2006. Some estimates put the size of the subprime loans outstanding as of date at around USD1.3 trillion.

Exhibit 1: Sub-prime originations over the years



Source: Standard & Poor's, Kotak Mahindra Bank

Crisis of the sub-prime assets

Defaults have increased significantly in the subprime segment on the back of higher loan rate resets (as US Fed increased the policy rates for 17 times on the trot) and falling housing prices. In February 2007 subprime mortgages defaulted at an annual rate of 12.6% against 1.5% for prime mortgages. About 80% of subprime mortgages today are adjustable-rate mortgages (ARMs) and the vintage 2006 ARMs are due to start resetting. Many homeowners who had expected to refinance before their payments jumped would find themselves in a problem.

HSBC's US subprime unit had taken a USD 8.8 bn loss on its portfolio. Funds of other large financial conglomerates have also reported problem. Unfortunately there is no clear estimate of the size to which the problem can escalate. The worrying part is that loses related to the US housing mortgage is no longer restricted to only the subprime segment but has already spread to other segments such as Alt-A loans, some parts of prime loans and other credit markets such as Collateralized Debt Obligation (CDO) and Collateralized Loan Obligation (CLO).

The crisis of confidence started off with Bear Stearns deciding to shut down two of its hedge funds and has now come to a boil with BNP Paribas, the largest bank in France, announcing on 8th Aug, that it was freezing withdrawals from three of its investment funds with exposure to sub-prime mortgages, as there was not enough liquidity in the system to value these investments.

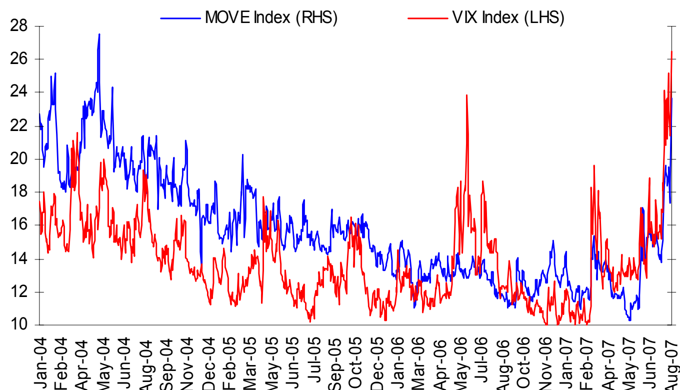
The recent financial market turmoil also proves that the problems in the US sub-prime market have now become a global phenomenon. Although it is very difficult to guess at the moment how much of deadwood still remains to be uncovered pertaining to the subprime and its derivatives products, it goes without saying that the risks have significantly heightened from a month before. If the losses keep accelerating with more hedge funds going bust, then the credit situation may worsen much more than perceived now and could have serious ramifications on the real economy growth. For the moment we expect financial markets to remain volatile in the near term till the markets have a better idea of the extent of the sub-prime damage. Recently in a Senate Banking Committee hearing, Fed Chairman Ben Bernanke has commented that: ***"the credit losses associated with subprime credit products can be as high as US $100 billion "*.**

Volatility rocks global financial markets

In the last few weeks, the US markets have witnessed tremendous volatility in both the equity and the bond markets. The Chicago Board Options Exchange (CBOE) Volatility Index – popularly known as the VIX Index, a barometer for future equity market volatility, has inched up to as high as 30.8 (as on 16th Aug'07) – triple the level it was at the beginning of 2007. Merrill Lynch's option volatility MOVE index – a measure of Treasury bond volatility has also seen a sharp move to 118.5 currently from a level of 68 in January 2007. The currency market too has not remained unscathed.

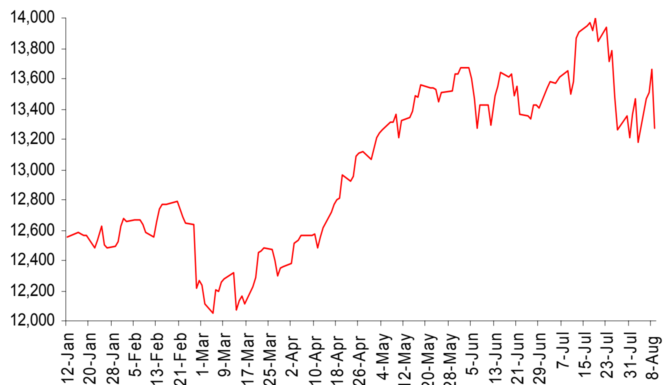
The current volatility in the global financial markets is an offshoot of the rising level of default risk in the US mortgage market and its contagion effect on other credit markets. This has led to fears of a liquidity crunch in the credit market with overnight USD Libor jumping from 5.35% to a 6-year high of 5.86%. The sudden increase in the overnight rates led to central banks worldwide to step in to supply the necessary funds and tide over the sudden cash crunch.

Exhibit 2: VIX and MOVE indices hugely volatile



Source: Bloomberg, Kotak Mahindra Bank

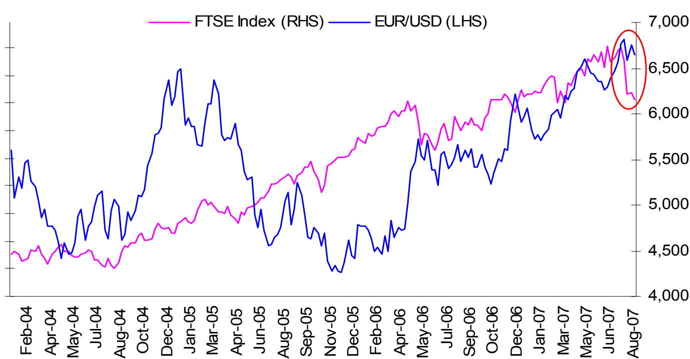
Exhibit 3: Dow Jones takes a severe beating



Source: Bloomberg, Kotak Mahindra Bank

The ECB's cash infusion provided banks with close to €95 billion at 4% on 9th August. The infusions by ECB were progressively lower on the following days at €61 billion on 10th August, €47.67 billion on 13th August, indicating that the system could be stabilizing. US Fed, Bank of Japan, Bank of Canada also had to inject liquidity to stabilize the respective markets. Despite the intervention by ECB and the Fed, the global market sentiments continued to remain negative with Dow and FTSE taking a severe beating, carry trades in Japanese Yen crosses unwinding sharply and the US Treasuries rallying.

Exhibit 4: FTSE and EUR/USD falls on subprime carnage



Source: Bloomberg, Kotak Mahindra Bank

As a result, in a surprising move, the U.S. Federal Reserve cut the primary discount rate by 50bps on 17th August aimed at calming jittery global markets. The Fed cut its primary discount rate, which governs direct loans from the central bank to commercial banks, to 5.75% from 6.25% to *"narrow the spread between the primary credit rate and the Federal Open Market Committee's target federal funds rate to 50 basis points."*

Global Macroeconomic Outlook

Fed-Funds rate cut likely to be sooner than expected

In its August FOMC meeting, the Fed kept its monetary policy stance unchanged, holding its key short-term interest rates at 5.25% while acknowledging that ***"Financial markets have been volatile in recent weeks, credit conditions have become tighter for some households and businesses, and the housing correction is ongoing."*** However the Fed continued to maintain its inflation bias (though sounding less hawkish than the previous FOMC) stating that ***"Although the downside risks to growth have increased somewhat, the Committee's predominant policy concern remains the risk that inflation will fail to moderate as expected."***

However, the global financial market turmoil that erupted shortly after the FOMC meeting led the Fed to eventually cut the discount rate by 50bps and acknowledge that growth concerns have become a bigger priority for them at the moment. The Federal Open Markets Committee said in a unanimous statement that the downside risks to growth have increased ***"appreciably"***. It also said that ***"Financial market conditions have deteriorated, and tighter credit conditions and increased uncertainty have the potential to restrain economic growth going forward".***

Although the US economy recorded a higher than expected growth of 3.4% in 2Q07 (likely to be revised downwards subsequently) after the measly 1Q07 growth of 0.7% – recent macro indicators suggest that the US economy is showing some clear signs of slowdown. The housing market slowdown is finally taking its toll on both the demand and supply side (including the labour market) of the real economy.

Exhibit 5: Almost all macro indicators showing a slowdown

Economic Indicators	Release Date	Units	Survey	Actual	Direction
Philly Fed (July)	16th Aug	index	8.6	0.0	↓
Core CPI (mom) (July)	15th Aug	%	0.2	0.2	⇔
Industrial Prodn.(July)	15th Aug	%	0.3	0.3	⇔
Core PPI (mom) (July)	14th Aug	%	0.2	0.1	↓
Retail Sales less autos (mom) (July)	13th Aug	%	0.4	0.4	⇔
Unemployment Rate (July)	3rd Aug	%	4.5	4.6	↓
ISM Non Manfctrng. Index (July)	3rd Aug	index	59.0	55.8	↓
Change in NFP (July)	3rd Aug	k	127.0	92.0	↓
Factory Orders (June)	2nd Aug	%	1.0	0.6	↓
ISM Manfctrng. Index (July)	1st Aug	index	55.0	53.8	↓
Personal Income (June)	31st July	%	0.5	0.4	↓
U. Michigan Confi. Index (July)	27th July	index	91.2	90.4	↓
New Home Sales (June)	26th July	k	890.0	834.0	↓
Durable Goods Orders (June)	26th July	%	1.9	1.4	↓
Existing Home Sales (June)	25th July	mn	5.9	5.8	↓

Source: Bloomberg, Kotak Mahindra Bank

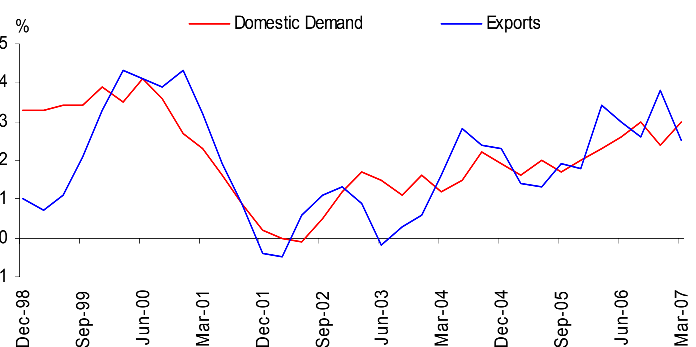
We had argued in our previous reports that the Fed will eventually go for a rate cut by the end of 2007 as the subprime mortgage problem will become uglier and feed into the real sector of the economy and the broader credit market. However, we did not anticipate the subprime contagion to be so harsh. The Fed's recent move of slashing the discount rate by 50bps therefore now heightens the probability of a Fed-Funds rate cut much earlier than December 2007.

Sept rate hike by ECB looks like a remote possibility now

Keeping in line with market expectations, the ECB kept its refinance rate unchanged at 4% in the 2nd August monetary policy meeting. The ECB gave ample hints that it is most likely to raise its benchmark interest rate once again in the 6th Sept meeting by 25bps - taking the ECB Refinance rate to 4.25%. This was indicated by Trichet's use of the code words "strong vigilance" which has in the earlier 8 times led to an interest rate hike in the next month. Moreover, this was announced over a surprise press conference held in the last minute what was originally scheduled to be nothing more than a mandatory monetary policy meeting conducted over teleconference.

Fundamentally, there could be enough reasons for ECB to tighten interest rates further. A strong domestic demand in the Eurozone (despite exports growth plateauing out), buoyant growth of monetary aggregates (June M3, at 10.9%), tightening labour market and likely rise in inflation to well over 2% later in the year, all warrant further rate hikes by the ECB. However, a rate hike in September which seemed like a definite event in early August looks like a very remote possibility now and would remain conditional on the unfolding of the sub-prime crisis in the US and its impact on the European economy.

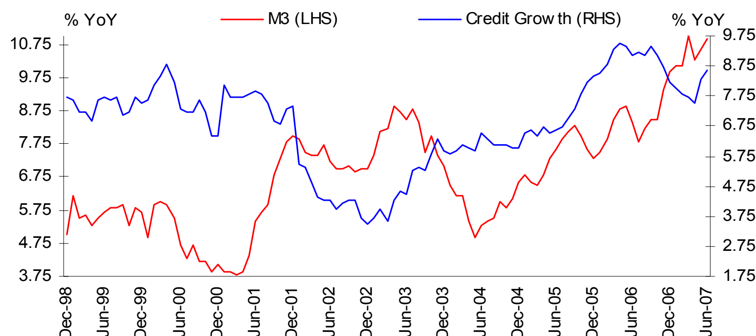
Exhibit 6: Domestic demand strong while exports plateuing



Source: Bloomberg, Kotak Mahindra Bank

If the sub-prime mess forces some more European banks or hedge funds to shut their operations leading to a credit crunch and spike in yields, then the ECB could change its mind about raising rates in September. Furthermore, the expected slowdown in the US economy could lead to further dips in the Eurozone exports, leading to its growth momentum slowing. To a large extent there could also be some comfort on the inflation numbers of the ECB consequent to the recent dip in the international crude oil prices.

Exhibit 7: M3/credit growth above ECB's comfort zone



Source: Bloomberg, Kotak Mahindra Bank

BOE unlikely to hike rates anytime soon

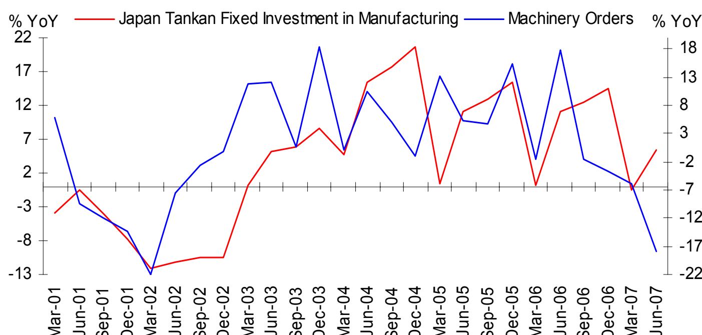
The Bank of England (BOE) kept its official interest rate unchanged at 5.75% in the 2nd Aug MPC meeting. While the decision was fully priced in by the financial markets, this was the first time that rates had been left on hold in the month of August since 2003. The BOE also published its latest outlook for the UK economy in the Quarterly Inflation Report on 8th Aug which clearly indicated that inflation will slightly surpass the 2% target in two-year's time should interest rates remain steady at the current level. The report also shows that output growth has been revised downwards to 2.5% in 2 years compared to 3%, as earlier projected in May. Although, these projections suggest that the risks of higher inflation are to the upside in the near-term, given the current financial market turmoil, it is very unlikely for the BOE to hike rates anytime soon.

BOJ may postpone the rate hike or even stall it

The Japanese Yen (JPY) was the primary beneficiary of risk aversion in the last few weeks as carry trades continued to be liquidated across the board in the wake of the subprime meltdown in US, Europe and Australia. The Yen reached an intraday high of 111.62 on August 16th led by a sharp unwinding of Yen carry trades. This trend is likely to derail any plans of the BoJ to hike rates immediately as it would mean aggravating the strength of the Yen and hence a loss to its exports market. Expectations of a BOJ rate hike this month has taken a further backseat as concerns grew about a squeeze in international credit markets, pushing Japanese share prices to five-month lows. Swap contracts on the call rate are currently pricing in around a 35% chance of a rate hike this month, down sharply from about 75% earlier.

The BOJ has kept its monetary policy on hold since raising its key policy rate to 0.50% – last in Feb'07 as inflation pressures (June CPI at -0.2%) and macroeconomic conditions still remain weak. Machinery orders for June fell by 10.4% mom, which was much weaker than market expectations of -1.1% mom. A crushing defeat for Prime Minister Shinzo Abe's coalition in the upper house election may lead the BOJ to delay the rate hike further. Taking all these factors into consideration, we expect the BOJ not to hike rates immediately.

Exhibit 8: Japan machinery orders fall sharply



Source: Bloomberg, Kotak Mahindra Bank

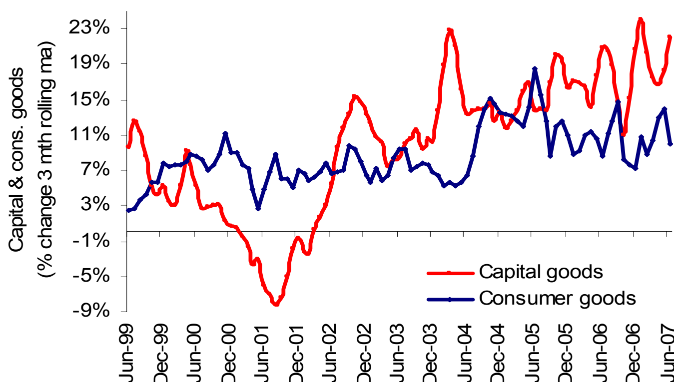
Indian Macroeconomic Outlook

Industrial production growth shows slowing trends

Industrial production grew at 9.8% in June 2007 - its slowest pace in the last eight months compared to 10.9% in the previous month. The manufacturing sector's growth was at 10.6% in June 2007 which is lower than 11.7% in the previous month and is also an eight month low. A break-up of the industrial production on the basis of a use-based classification however reveals a still strong momentum in the capital goods segment. Production of capital goods was high in June 2007 at 29% compared to 22.9% in May and averaged at 22.3% in the first quarter ended June compared to 21% in the same period last year. Capital goods production is considered crucial for understanding the future trend in the industrial performance and the continued strong performance indicates that the pace of industrial production is unlikely to crumble soon.

However, there is some stress apparent in the consumption goods segment (Exhibit 9). The stress is being specially felt by the durables goods sector that comprises of largely interest sensitive segments such as the automobiles industry. With interest rates on the rise in India, the interest rate sensitive segments have been hit first. Durable goods production growth was at 0.6% in June 2007, down from 3.5% in the previous month and 19.9% in the same month last year. In the first quarter of this fiscal, durable goods production grew at only 3.0% compared to 15.0% in the same period last year. Non-durables production also dipped to 5.4% in June 2007, thereby pulling down the overall consumer goods production to 4.2% in June 2007 compared to 9.9% a month ago.

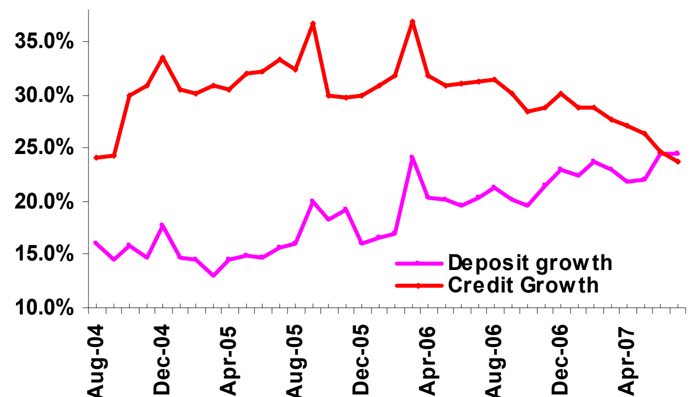
Exhibit 9: Capital goods growth strong, consumption lags



Source: Bloomberg, Kotak Mahindra Bank

The reduction in monetary policy accommodation had led to a reduction in the credit off-take significantly. However, this is yet to translate into any reasonable decline in the real sector growth. The reason for this could be that the Indian corporate was routing their fund requirements from the overseas markets via the ECB route. The increase in the risk averseness in the international financial arena has led to an increase in the credit spread. Along with this, the recent restrictions on raising ECB for rupee expenditures to only USD 20 mn per company per financial year is likely to lead to a renewed pressure on the domestic loan market. The companies that have henceforth been borrowing from abroad will thus now have to take a re-look at their financing costs and this is expected to slow the industrial sector production across the board.

Exhibit 10: Bank credit growth dips sharply



Source: Bloomberg, Kotak Mahindra Bank

No change in our outlook for headline inflation

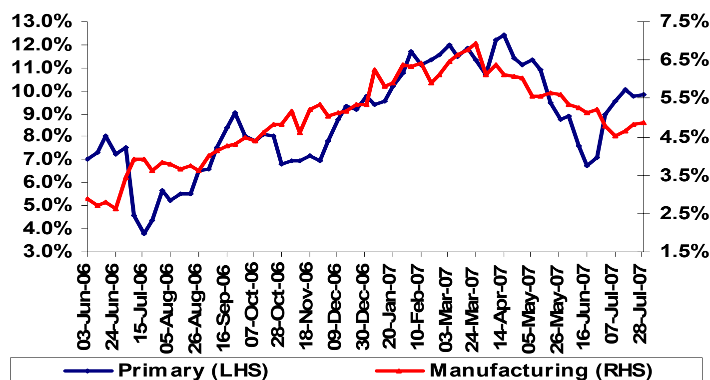
The Headline WPI inflation was more-or-less in lines with our own forecasts for July. Headline WPI inflation was quoted at its lowest at 4.03% as on 16th June but reversed trend to move higher thereafter to quote at 4.45% as of 28th July. While base effect did play its role, a part of the reduction in the Headline WPI inflation was also on account of dips in the index for the primary articles index. However in the period between mid-June and end-July, the index for the primary articles as also the manufactured goods moved higher. While this led to the primary articles inflation to move higher from 6.75% as on June 16th to 9.83% as on July 28th, the manufactured articles inflation actually came down between the above two dates from 5.13% to 4.86%.

The Q1 review of the monetary policy notes that the pass-through of monetary and fiscal measures has also been instrumental in bringing inflation lower. However, it raises adequate risks for inflation going forward with international crude oil prices continuing to rule high and states that ***"inflationary pressures remain and seem more persistent than before".***

With respect to Headline WPI inflation going forward, the progress of monsoon holds utmost importance. As on 31st

July, the cumulative seasonal rainfall since 1st June over the country as a whole was 103% of its LPA. Over the four broad geographical regions of India, the cumulative rainfall was 94% of LPA over North West India, 99% over North East India, 105% over Central India and 118% over South Peninsula. As on 31st July, cumulative seasonal rainfall was excess in 11, normal in 20 and deficient in 5 meteorological sub-divisions. The area sown under Kharif crops was higher than in the previous year as on 3rd August 2008 for most of the crops, with a key exception of Rice (that shows a drop of 1.4% till date over the previous year). Even as the risks of a poor monsoon leading to higher food-grain prices might not be incorporated analytically, one needs to be aware of the fact that global wheat prices continue to remain firm and the prices of oilseeds in the international markets remain biased to the upside in the near term.

Exhibit 11: Manufacturing and primary articles inflation inch up higher



Source: Bloomberg, Kotak Mahindra Bank

For the moment, there is no reason for us to re-look at the inflation forecast over the remaining part of the year and we stick by our estimates that were published in our previous monthly report. To restate, for our extrapolated series we have assumed a round of increase in the domestic prices of petrol and fuel (by 10% each) in the second half of the financial year. We continue with our assumption that South West monsoons are unlikely to have any adverse impact on the inflation numbers. The decision of the Government to go ahead with wheat imports for stockpiling despite the higher global prices is also likely to prevent any severe spike in food-grain prices in this year. ***Based on the above assumptions we expect Headline WPI inflation to fall to a range of 3.50-3.75% by the mid-September 2007 after which it is expected to rise to a range of 5.15-5.25% by mid-February 2008 before ending the financial year slightly softer.***

Trade deficit continues to widen in June 2007

Trade deficit continued to widen significantly in June 2007 at USD 7.33 bn. Non-oil imports in June registered a sharp rise of 52.3% in June on top of an increase by 41.6% in the previous month. The sharp appreciation of the rupee continues to take its toll on India's exports that grew by USD 11.87 bn in June 07, a rise of 14.0% of the same month of last year. For the first quarter as a whole of FY07, exports rose by 18% while total imports were higher by above 50%. Trade deficit in April-June 2007 was recorded at USD 20.6 bn, much higher than USD 11.9 bn in the corresponding period of 2006.

Exhibit 12: Trade deficit widens as non-oil imports rise

	Apr-Jun	Apr-Jun	
	2007	2006	% change
Exports	34.30	29.00	18.28%
Imports	54.90	40.88	34.30%
Of which			
Oil Imports	14.80	14.20	4.23%
Non-oil imports	40.00	26.60	50.38%
Trade Deficit	-20.60	-11.88	

Source: DGCI&S, Kotak Mahindra Bank

Hence, trade deficit can be expected to widen in 2007-08 purely on the basis of oil imports. Furthermore, the sharp appreciation of the rupee that was witnessed in the last couple of months is likely to hurt exports from India while providing a boost to imports, resulting in a further worsening of the trade deficit. On a BoP basis, we expect trade deficit to worsen to USD 76.6 bn in 2007-08 compared to USD 64.9 bn in 2006-07.

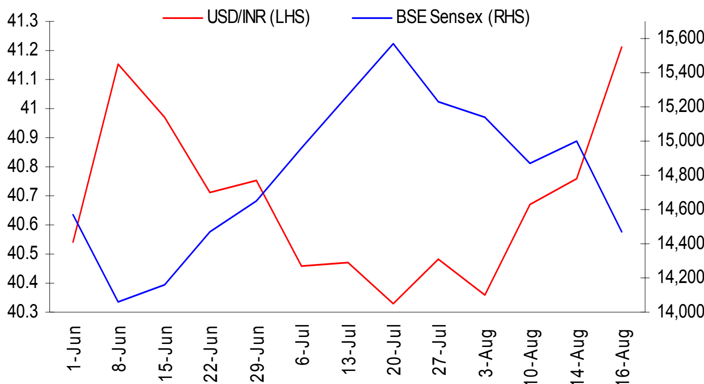
Domestic currency market outlook

Rupee weakens on global cues and ECB restriction norms

The Indian rupee hovered in the range of Rs 40.30/41.72 to US$ between the period 20th July and 17th Aug. Huge volatility in domestic stock markets caused by the recent global financial market turmoil and the new ECB restriction norms led to the depreciation pressures on the rupee.

Most emerging stock markets world over have been adversely affected due to global risk aversion led by worsening subprime conditions and a steep fall in global equity markets. This has affected the Indian stock markets as well with the BSE Sensex falling a massive 542 points on 27th July, 615 points on 1st Aug,345 points on 10th Aug and finally 643 points down on 16th Aug leading to sharp depreciation pressures on the rupee.

Exhibit 13: Stock markets correction weakens USD/INR



Source: Bloomberg, Kotak Mahindra Bank

The new ECB norms restricting raising of funds by the Indian companies to just USD 20 mn for rupee expenditures also led to a knee-jerk reaction the following day in the domestic currency market with rupee going to as high as Rs 40.81/US$ in the intra day trade before ending the day at Rs 40.53/US$.

As (Exhibit 14) shows, ECB was one of the most important sources of capital flows in FY07, accounting for nearly 36% of total capital flows. Lower global interest rates compared to India pushed Indian businesses to borrow from abroad. The sharpest jump in ECB was witnessed in 4QFY07, a quarter that also witnessed the most dramatic rise in domestic interest rates. The restriction norms on the ECB will help to restrict excess domestic liquidity in the system, thus providing further comfort to RBI in maneuvering its monetary policy.

Exhibit 14: ECB was a significant portion of capital flows in 2007

US$ bn	2006-07	2005-06
Foreign Investments	15.5	17.2
FDI	8.4	4.7
FII	7.1	12.5
External Assistance	1.8	1.7
ECB	16.1	2.7
NRI Deposits	3.9	2.8
Short Term Credits	3.3	1.7
Other Capital	4.4	-2.7
Capital Account	**44.9**	**23.4**

Source: Bloomberg, Kotak Mahindra Bank

Rupee – likely to remain depreciated around Rs 42-43/US$

Even before the ECB restriction norms came in, we had argued that the Indian rupee will gradually depreciate to Rs 42/US$ by year end. Now this probability looks even more certain given the current ECB restriction norms. The restriction on ECB will reduce inflows under capital account and with the trade deficit expected to remain wide despite some falls in the international crude oil prices, there will be a natural tendency for rupee to depreciate in the medium term.

Moreover, currently global risk aversion is extremely high – near the same levels as during 9/11 attack in the US. The ongoing domestic stock market corrections are a direct fallout of this global risk aversion which is putting depreciation pressures on the rupee. On August 17th, the intraday high of USD-INR was at 41.72. With the sub-prime mess in the US still continuing and now spreading to Europe and Australia, there is now an even increased possibility of further global risk aversion from the emerging markets leading to increased volatility in the domestic stock markets and thus further depreciating pressure on the rupee in the days to come.

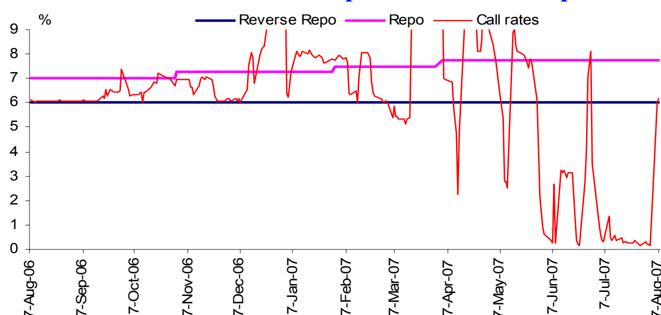
The hike in the CRR rate, removal of the Rs 3,000 cr reverse-repo cap and the increase in the MSS limit to Rs 150,000 crore from Rs 110,000 crore will also render RBI more flexibility to intervene in the forex market in order to stem further appreciation of the rupee. However, such enhancements in the MSS would probably not be needed much immediately due to the changed circumstances in the global financial markets. Given the current situations, we would expect our range of Rs 42-43 to a dollar to be achieved much faster than what we ourselves would have expected.

Domestic debt market outlook

Call rate inches up to the lower end of the LAF corridor

In a bid to control surplus liquidity in the system, the RBI hiked the CRR by 50 bps to 7.00% and removed the cap of Rs 3,000 crore on reverse repo, in its July monetary policy review. The higher CRR rate came into effect from Aug 4 which drained out approximately Rs 16,000 crore of excess liquidity from the system. The removal of the Rs 3,000 crore reverse repo cap effective from Aug 6 resulted in the call rates inching up from sub zero levels to the reverse repo rate of 6.00% (lower end of the LAF corridor). We expect the call rates to hover around 6.00/6.50% levels in the near-term as liquidity seems to be abundant in the system despite the CRR being hiked.

Exhibit 15: Call rates inch up to the Reverse-repo rate

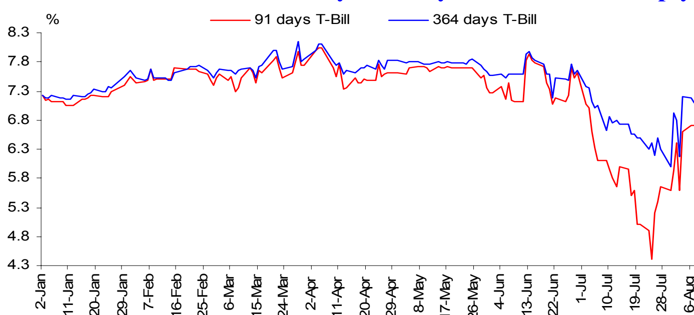


Source: Bloomberg, Kotak Mahindra Bank

Shorter end of the yield curve steepens

The liquidity tightening measures have impacted the shorter end of the yield curve, thus pushing up the yield on the 91-day Treasury bill by almost 245bps - from 3.75% before the monetary policy to 6.22% currently. Similarly, the yield on the 364 day Treasury bill has moved up recently to 7.04% from 5.95% before the monetary policy. Interest rates on the short term instruments have also gone up with one-year certificate of deposit (CD) and commercial paper (CP) fetching 8.5% currently as against 7.8% earlier.

Exhibit 16: 91 and 364 day T-bills yield has risen sharply



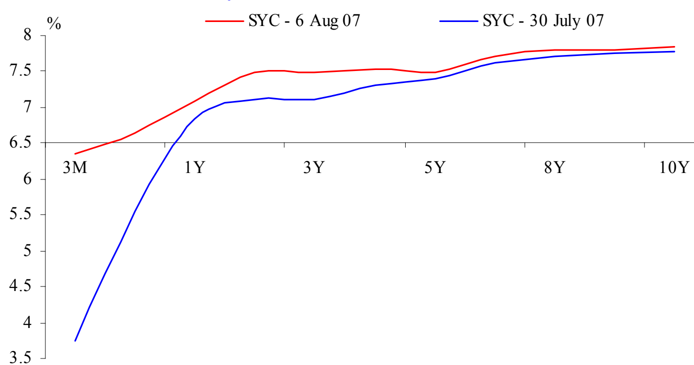
Source: Bloomberg, Kotak Mahindra Bank

Bond yields to stay range bound

Indian benchmark 10Yr bond yields moved up from 7.76% before the credit policy announcement to 7.87% post policy to end the day at 7.84%. However the RBI's liquidity tightening measures have impacted the shorter end of the yield curve more sharply than the longer end resulting in a flattening of the G-sec yield curve at the moment (Exhibit 16). We do no expect any sharp upward movement in the 10 Yr benchmark GOI yields from the current levels. The supplies of Central Government securities from now till the end of September 2007 are only Rs 14,000 crore and there is still ample liquidity in the system, amounting to around Rs 25,000 crore to Rs 30,000 crore. Some recent softening of international crude oil prices (WTI currently at US$71/bbl as compared to US$78bn previously) and inflation remaining at sub 5% levels is also expected to lend support to the bond markets. Further, the other positive for the bond market would be the low 10-year US treasury yields that have dipped with the burden of excess flows into the economy via the "flight to safety" argument.

However, even as the liquidity remains comfortable, we do not anticipate an immediate huge dip in the 10-year benchmark yields as market players are likely to continue to exercise some caution on account of the global financial market turmoil. If risk aversion of international investors persists, this could lead to further dips in the global equity markets and would put a pause to the rupee liquidity infusion into the Indian markets too (via intervention of RBI in the currency markets). Overall, the 10-year benchmark bond yield is likely to stay in a broad range of 7.95-8.05% in the next month.

Exhibit 17: G-sec yield curve flattens



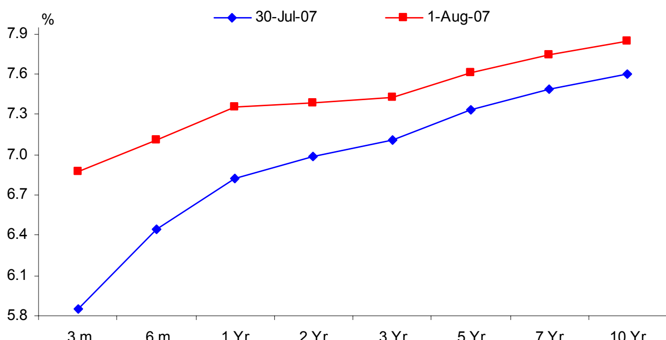
Source: Bloomberg, Kotak Mahindra Bank

Swap markets

Post credit policy, the OIS swap curve has moved up into a higher trajectory than what it was prior to the policy (Exhibit 18). The OIS swap curve has also flattened considerably post credit policy as the shorter end yields have spiked up more than the longer end keeping in line with the flattening seen in the government security yield curve (Exhibit 17). OIS traded in a volatile range post credit policy (1YOIS in the 7.05-40% and 5YOIS in the 7.40-63% band). Going forward, there is a possibility of the swap curve to steepen in the medium-term as long end of the curve may inch up due to fear of depreciating rupee, high oil prices and the wearing out of the base effect on inflation by Sept end.

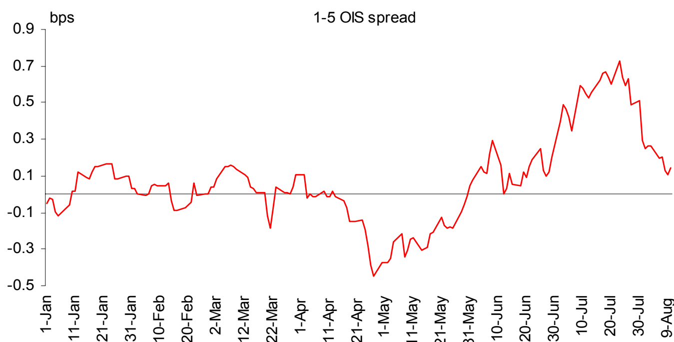
The MIFOR swap curve also moved up by 15-25 bps post credit policy led by a sharp rise in the shorter end of the curve which also resulted in a flattening of the swap curve. 1Y forward premia rose by 30-45 bps post policy announcements (1Y forwards currently at 1.94%). However, recently the Mifor swap curve has flattened further and moved a bit lower than the post policy levels. The swap curve is expected to remain flat in the coming days as the recent ECB restriction norms may reduce offshore borrowing by corporates and thus reduce the hedging pressure on the MIFOR swap curve.

Exhibit 18: OIS yield curve has moved up higher post credit policy



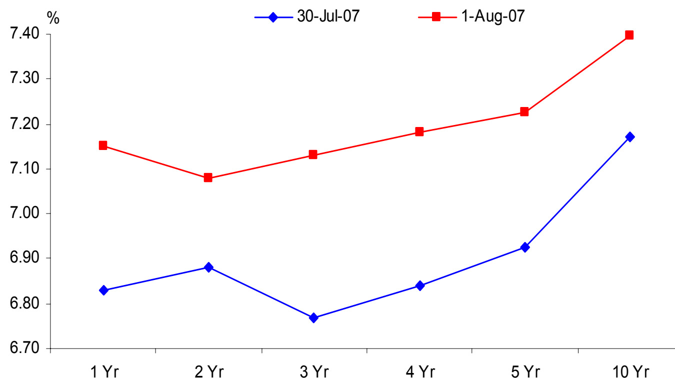
Source: Bloomberg, Kotak Mahindra Bank

Exhibit 19: Spread between the 1-5 Yr OIS shrinks



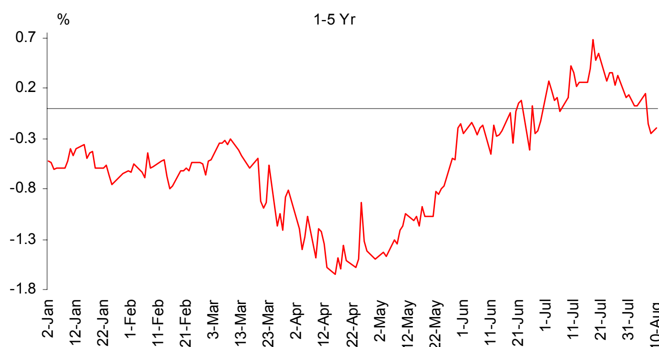
Source: Bloomberg, Kotak Mahindra Bank

Exhibit 20: Mifor yield curve has also moved up higher



Source: Bloomberg, Kotak Mahindra Bank

Exhibit 21: Spread between the 1-5 Yr Mifor has fallen significantly



Source: Bloomberg, Kotak Mahindra Bank

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