Axis Banking & PSU Debt Fund

Strategy Change – 4 Year High Grade Corporate Bond Strategy

Fund Manager: Aditya Pagaria

Axis Banking & PSU Debt Fund – Recap

- In 2018, as the NBFC crisis broke out, the interest rate scenario turned opportunistic
- We introduced a 3.5-year corporate bond strategy in our Axis Banking & PSU Debt Fund.
- The strategy offered a high quality portfolio and defined 'carry' potential in times of extreme uncertainty.
- Was ideally suited for investors looking to navigate the prevailing interest rate volatility.

Fund Repositioning

- **Repositioning to a 4-year High Grade Corporate bond strategy predominantly investing in bonds issued by banking companies and public sector undertakings (PSU's).**
- Global headwinds and inflation have driven market yields materially higher. Markets extremely volatile.
- As markets settle, we are looking forward to attractive redeployment opportunities in the 3-4-year High Grade Corporate Bond segment over the next few months.

Current Interest Rate Environment - Aggressive rate hikes priced in

The last 3 months have seen monetary policy responding to aggressive inflation pressures. As global central banks attempt to combat runaway inflation, global debt markets have priced in sharp rate hikes. Off cycle monetary meets and surprise rate hikes have kept markets volatile.

Global Central Banks	Implied Hikes	Implied Policy Rate
US Fed (June 2023)	+67	3.00%
ECB (June 2023)	+110	1.01%
BOE (June 2023)	+153	2.72%

Source: Bloomberg, Respective central bank statements, Axis MF Research. Data as of 29th July 2022

Domestic markets echo similar sentiments as bond markets in India have priced in terminal policy rates closer to 6.25%-6.50% from the current repo rate of 4.9%. Swap markets are pricing even higher aggressive rate hikes with implied policy rate expectations of 6.25% over next 12-18 months.

	Implied Hikes	Implied Policy Rate
RBI	+100-125	6.25%-6.35%*

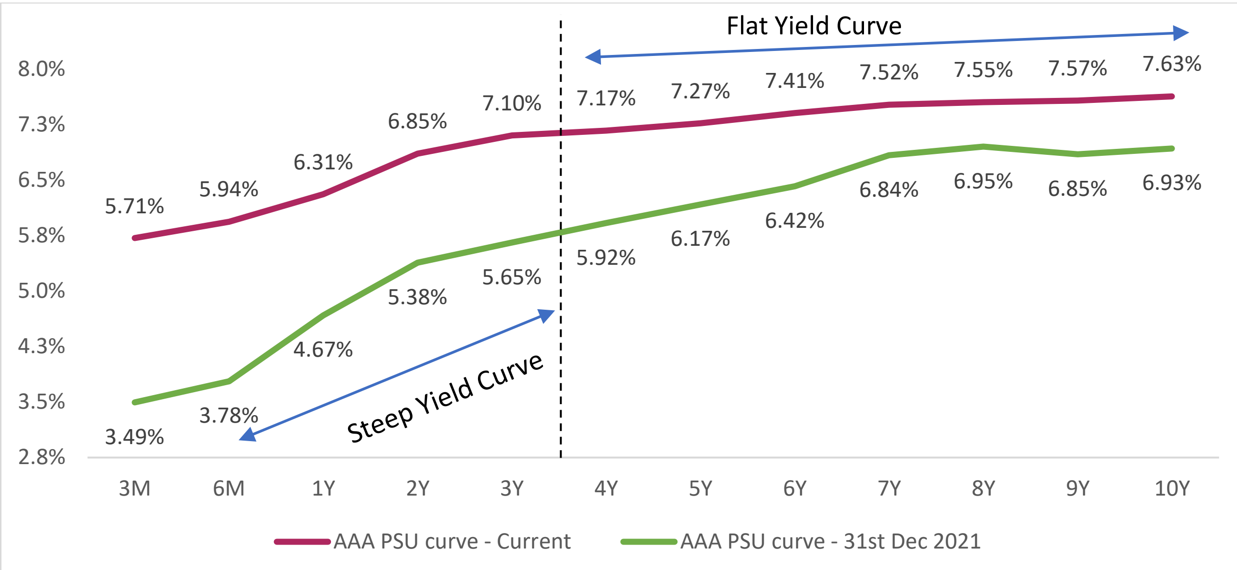
Source: Bloomberg, Axis MF Research. Data as of 29th July 2022

A key positive for central bankers has been the sharp fall in commodities. Commodities have corrected by 30-40% driven by weaker global demand outlook and fears of an inflation induced recession. Weaker commodities bode well for inflation, especially in a country which has a commodity heavy import bill. This offers conviction that we may be near anticipated peak interest rate levels.

Curve flattening theme has played out

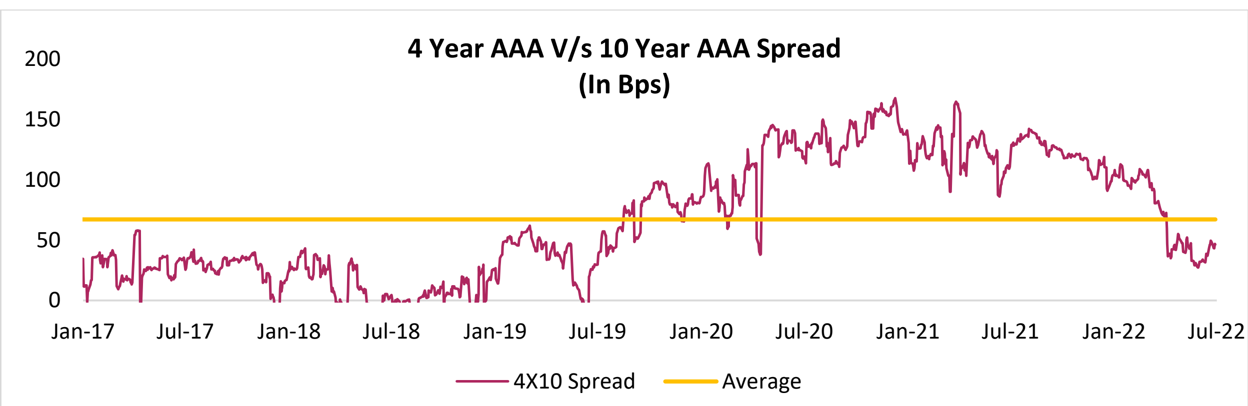
Since December 2021, RBI has been systematically withdrawing excess liquidity from the banking system as it looks to control runaway inflation. The 5 to 10-year part of the yield curve had already priced in the need for large simultaneous rate hikes resulting in a near flat yield curve.

The RBI was initially slow to react to changing economic pressures leading to steepness in 3m to 5yr part of the yield curve. This artificial steepness has begun correcting since March 2022. Typically, liquidity withdrawal affects the short end of the curve more than the long end. The resulting market movements have driven a surge in short bond yields. (Refer chart below).



Source: Bloomberg, Axis MF Research. Data as of 29th July 2022

This resulted in Spread Compression between 4X10 segment. The result offers attractive 'carry' opportunities for investors with 4-5-year investment horizon.

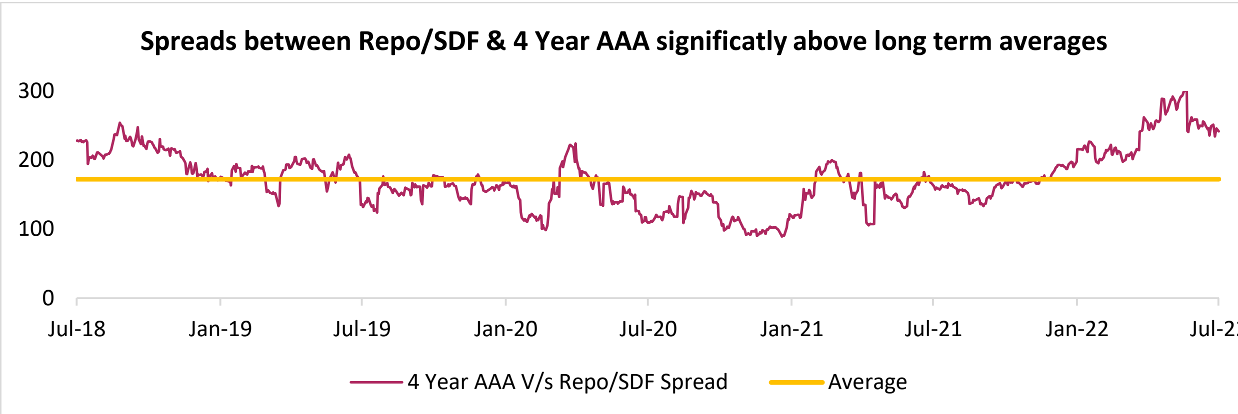


Source: Bloomberg, Axis MF Research. AAA – PSU curve used. Data as of 29th July 2022

Given the steepness at the short end the 4-year segment offers a unique mix of 'Margin of safety' as well as competitive carry opportunities. With markets pricing in much of the rate hikes forecasted by the RBI, we anticipate limited market yield rises incrementally i.e. limited MTM impacts on such a strategy.

Attractive spreads V/s Repo Rate/SDF:

Spreads of AAA PSU's V/s Repo Rate/SDF (India's benchmark for the overnight rate) have widened in the recent times and are above long term averages. Further, from a demand-supply perspective, the Demand looks balanced in Corporate Bonds with large anticipated incremental demand (Regulatory Buying) coming from Real money investors.



Source: Bloomberg, Axis MF Research. AAA – PSU curve used. Data as on 29th July 2022

4-year Strategy – Tax efficient solution for existing investors

For existing investors, continuing with the fund, offers twin benefits – medium term high quality strategy with an attractive 'carry' play and tax efficiency. For investors investing in debt mutual funds, Incidence of taxation takes place at the point of sale. By virtue of staying invested in an open ended scheme, investors defer the point of taxation to the point where they actually need liquidity rather than exiting by compulsion in traditional FMP's and index funds. Let's illustrate

	Traditional Open ended MF with continuous roll down strategies
Leg 1: Initial Investment (31st July 2018)	**₹ 1,00,000**
Return Earned	8%
Value of Investment (31st July 2022)	₹ 1,36,077
Indexed Cost of Acquisition*	NA
Taxable Income	NA
Tax Paid	NA
Leg 2: Reinvestment in a 4 Year Strategy	**₹ 1,36,077**
Return Assumption	7%
Value of Investment (31st July 2026)	₹ 1,78,401
Indexed Cost of Acquisition**	₹ 1,49,243
Taxable Income	₹ 29,158
Tax Paid	₹ 5,832

Total Tax Paid (Leg1 + Leg 2)	**₹ 5,832**
Total Return Earned	**₹ 78,401**
Net Tax adjusted Return (%)	**7.06%**

* Based on CII issued by the income tax department.

** Assumed inflation rate of 6%

Data is not a return calculation and should be used only for illustrative purposes. Tax rate for resident investors assumed is 20% excluding surcharge and cesses. For complete tax related information on mutual funds please consult your tax advisor. Projections used should not be considered as returns.

Scenario Analysis

	Black Swan Event (Bear Case)	Normal Expectations (Base case)	Dovish Stance (Bull Case)
	• Oil @ US$150 • USD/INR – 85/$	• Oil @ US$100 • USD/INR – 80/$	• Oil @ US$70 • USD/INR – 75/$
Rate Impact/ Target Horizon	**+ 100 Bps**	**No Change**	**-50 bps**
1 Year	4.30%	7.15%	8.58%
2 Years	5.73%	7.15%	7.86%
3 Years	6.20%	7.15%	7.62%
4 Years	7.15%	7.15%	7.15%

Note: The above scenario analysis is based on the prevailing market rates on the AAA – PSU curve as of 29th July 2022. The analysis is conducted using a modified duration of a bond at 2.85 years. The illustration is not an indication of returns. The analysis is to be used only for illustrative purposes only. The strategy assumes instruments are held to maturity over the 4-year investment horizon.

Way forward & Conclusion

To summarize, the bond markets face the following headwinds over the next few months

- **Volatility in Yields** – Driven by global interest rates and monetary policy action
- **Inflation** – Impact of commodities, monsoons & domestic price factors
- **Fiscal concerns** and potential additional government borrowing
- **Corporate Bond Supply** – Case for normalization of rising spreads between corporate AAA curve & G-Sec curve

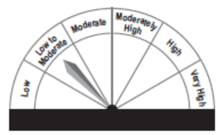
The above factors, in our opinion, are key triggers for domestic interest rates to remain Volatile in the near term. For the Axis Banking & PSU Debt fund, the current elevated rates offer attractive reinvestment opportunities as the fund looks to re-deploy into duration assets over the next few months.

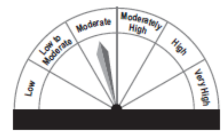
Product Labelling

<table>
<tr><th>Fund Name & Benchmark</th><th>Product Labelling</th><th>Product Riskometer</th><th>Benchmark Riskometer</th><th>Potential Risk Matrix (PRC)</th></tr>
<tr>
<td>Axis Banking & PSU Debt Fund

(An open ended debt scheme predominantly investing in debt instruments of Banks, Public Sector Undertakings & Public Financial Institutions. A relatively high interest rate risk and moderate credit risk.)

Benchmark: NIFTY Banking & PSU Debt Index</td>
<td>This product is suitable for investors who are seeking*
• Regular income over short to medium term
• Investment in debt and money market instruments issued by Banks, PFIs & PSUs.

*Investors should consult their financial advisers if in doubt about whether the product is suitable for them.</td>
<td>

Investors understand that their principal will be at Low to Moderate Risk</td>
<td>
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<tr><th colspan="4">Potential Risk Class</th></tr>
<tr><td>Credit Risk →
Interest Rate Risk ↓</td><td>Relatively Low (Class A)</td><td>Moderate (Class B)</td><td>Relatively High (Class C)</td></tr>
<tr><td>Relatively Low (Class I)</td><td></td><td></td><td></td></tr>
<tr><td>Moderate (Class II)</td><td></td><td></td><td></td></tr>
<tr><td>Relatively High (Class III)</td><td></td><td>B-III</td><td></td></tr>
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Disclaimer

Source of Data: Bloomberg, Axis MF Research. Data as of 29th July 2022.

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