Fixed Income Outlook

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Contents

Fault Lines in Euro Zone

The Greek Tragedy

– Made in Athens. Endured by the world

– 17th June election is a *critical* Milestone

– Germany continues to hold its view on austerity

– Too many cooks spoil the...

- **Syriza** – hard left coalition
  - – Pro EU Membership but Anti Austerity
- **New Democracy**
  - – Pro EU Membership
- **Pasok**
  - – Pro Bailout

– Prolonged political instability increases the probability of Grexit.

Euro Zone Borrowing Costs and Credit Spreads

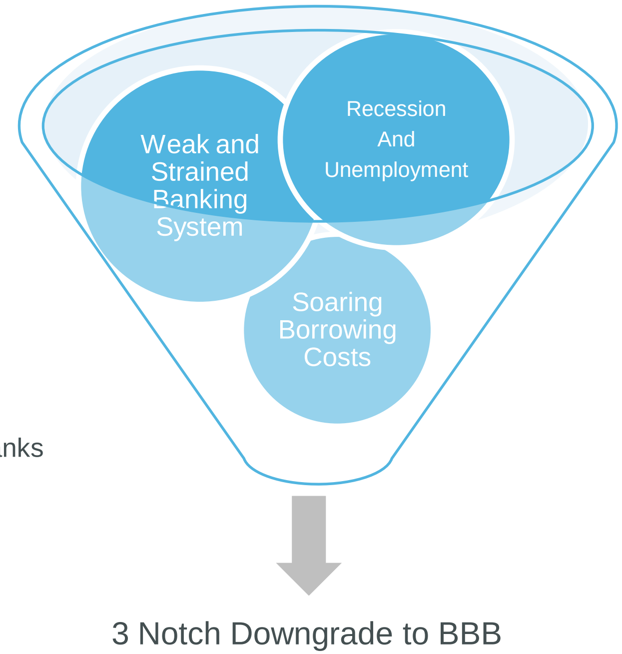
Country	Yld	Spd	Chg	Spread	#SD / Day	Low	Range (Avg / Now)
1) Germany	1.296	--	--			--	
2) Finland	1.613	31.7	+0.7		0.1	26.1	
3) Netherlands	1.768	47.2	+2.0		0.3	34.1	
4) Austria	2.163	86.7	+3.5		0.3	72.5	
5) France	2.493	119.7	+1.9		0.1	93.1	
6) EFSF	2.570	127.4	+3.4		0.3	98.0	
7) Belgium	2.928	163.2	+1.7		0.1	119.4	
8) Slovakia	3.518	222.2	+5.4		0.4	183.1	
9) Italy	5.744	444.8	+13.8		0.3	276.1	
10) Spain	6.125	482.9	+16.6		0.3	310.4	
11) Ireland	7.023	572.7	+3.1		0.1	461.1	
12) Portugal	10.694	939.7	-4.2		-0.1	826.7	
13) Greece	27.413	2611.7	+4.4		0.0	1534.2	

Source: Bloomberg

Fault Lines in Euro Zone

The Pain in Spain is not so Plain

- It is more of a Banking System Crisis that has not yet become a broad based Sovereign Crisis
- Domestic leverage and property bubble (facilitated by banks) has lead Spain's total debt at 90% of GDP
- Brussels and Berlin need to give some breathing room to Spain
  - Think more about bank cleanup – less about austerity
- **Is there a solution?**
  - European Funds (ESM, EFSF, IMF, EU Commission) should collectively put money in the Spanish banks
  - This ends the vicious spiral between weakening banks and faltering public finances
- **It only sounds simple…**
  - High and mighty political hurdles
    - Requires approvals from national parliaments
    - Germany holds a 'philosophical' argument against bank strengthening



Global Outlook

In Summary..

- Spain's problems are relatively contained within its banking system
- Spain will likely not seek an international bailout like those of Greece, Ireland and Portugal
- Safe Haven bonds (Germany, Switzerland, Holland. US) will continue to rally until volatility subsides
- Greece exit is likely but will not happen immediately and that will keep the volatility alive
- China is visibly slowing down – evident from fresh round of stimulus and bias towards easy credit
- Slowing aggregate global demand is likely to keep Oil prices tamed
- Coordinated central bank Quantitative Easing is around the corner
- Volatility is here to stay

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Domestic Outlook

I. Inflation is sticky and stubborn

II. Fiscal Deficit is troublesome

III. Current account deficit is all time high at north of 4% of GDP

IV. Currency has depreciated

V. Growth is faltering

VI. Government inaction on reforms

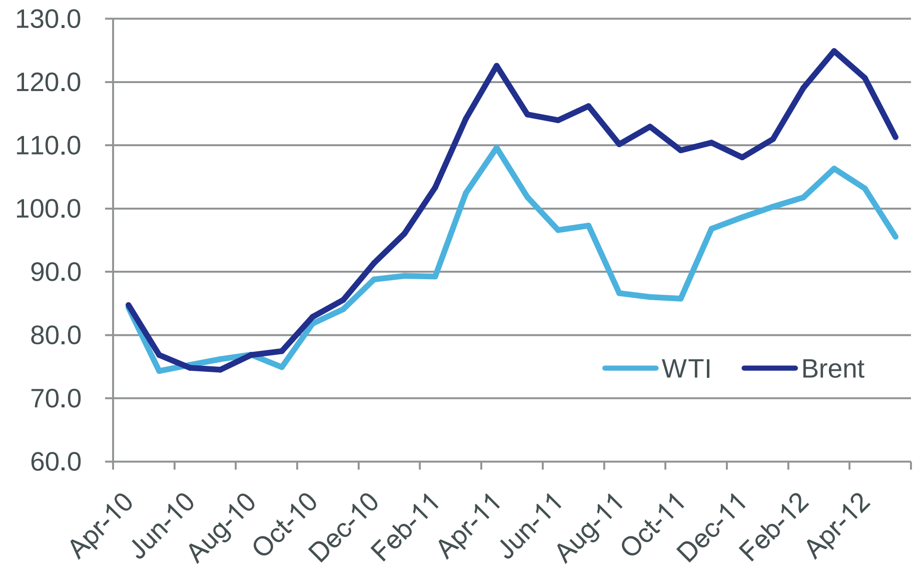
Are things really that murky from an investor's point of view?

We don't think so.

Domestic Outlook

I. Inflation is sticky and stubborn

- I. Against the backdrop of slowdown in growth, inflation can not become a serious threat
- I. Oil prices are receding
- II. Monsoon unlikely to disappoint
- III. Global food prices are trending down



II. Liquidity conditions are tight

- I. OMOs have kept liquidity closer to RBI's comfort zone
- II. RBI intervention in currency market is diminishing

III. Twin deficits are troublesome

- I. FII flows have been resilient so far ($12.8 Billion YTD) – adequately funding CAD
- II. Much awaited diesel price hike anticipated by end of June – helps largest component of subsidies (Every 10$ barrel helps 0.3% of GDP in subsidy)
- III. Again, declining oil prices (around $99/barrel Brent) could come to rescue for both, Current Account Deficit and Fiscal Deficit
- IV. India's non-oil import (70% of total imports) is expected to decelerate to single digits in FY13 from 24% y-o-y last year

Source: Bloomberg, Internal

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Domestic Outlook

IV. Currency has depreciated

I. INR has weakened almost 20% against the USD and 15% in nominal effective exchange rate (NEER) in nearly 1Y

II. World can rely on Fed to talk USD down as QE3 morphs into reality

III. In absence of a major risk aversion scenario, INR exhibits a strengthening bias in medium term

V. Growth is faltering

I. Manufacturing growth holding steady, while services have picked up pace

II. Domestic consumption driven economy is somewhat insulated from weak global demand

VI. Government inaction on reforms

I. The government is now more likely to kick start its fiscal reform process

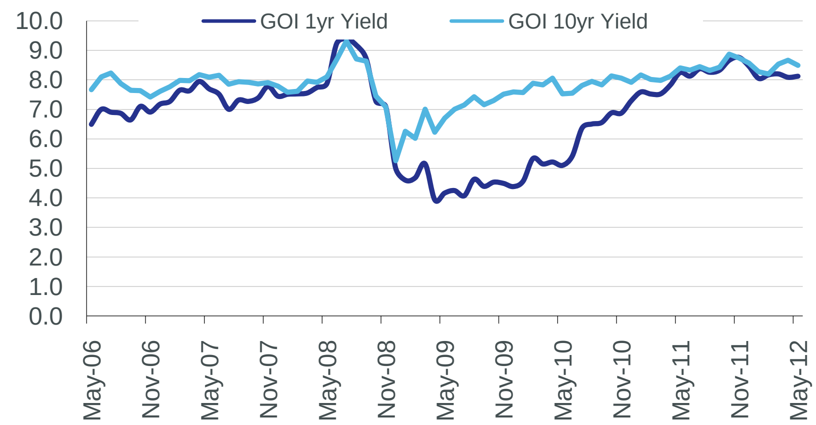
II. This should provide a much needed impetus to financial markets

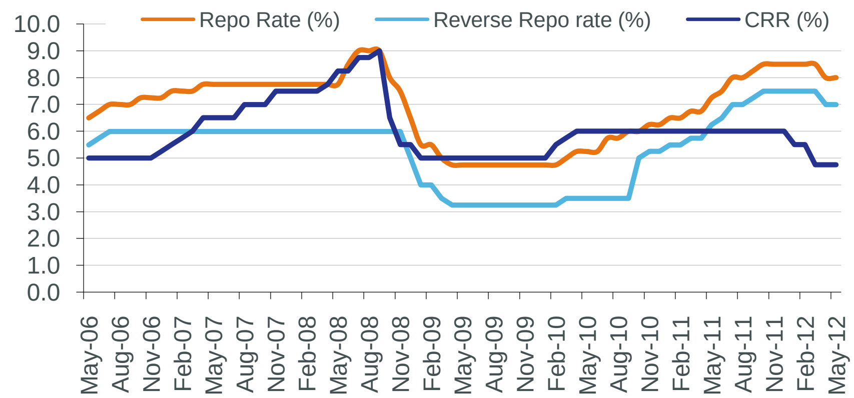
The resurgence of the euro area crisis and severe *risk off* scenario poses downside risk to our view.

Domestic Outlook

So where does it leave domestic markets?

- Market participants are less pessimistic across the board
- RBI is likely to step on the gas with rates easing
- We expect additional 50-75 bps rate cuts this year
- Now is the time to add duration in a gradual manner without sacrificing liquidity
- Credit spreads could widen from current levels though
- Road is likely to be bumpy along the way.





Source: Bloomberg, RBI, Internal

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