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DEBT FUNDS OUTLOOK FOR 2024

Invest in longer-duration funds to gain from anticipated rate cuts

Avoid going overboard with exposure to these funds as unforeseen events could prevent inflation from softening

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Debt funds underperformed both equity funds and gold in 2023. In 2024, however, many longer-duration categories of debt funds could yield low double-digit returns if the anticipated rate cuts materialise.

Positive drivers

Possible rate cuts: Experts foresee the strong possibility of a rate cut this year. "Core inflation has already moved close to 4 per cent. If we get a decent monsoon, consumer price index (CPI)-based inflation could also move towards that mark. That could lead to at least two rate cuts from the Reserve Bank of India (RBI)," says Murthy Nagarajan, head of fixed income, Tata Mutual Fund.

The RBI's actions will partially be influenced by the actions of global central banks. Globally, the rate hike cycle is coming to an end, with a strong possibility of rate cuts, especially in the US, Europe and other parts of the Western world where rates have been hiked much above neutral levels.

The US Federal Reserve has indicated 75 basis points of rate cut.

In India, a few Monetary Policy Committee (MPC) members are already talking of rate cuts.

"If inflation continues to soften, there is a reasonable chance of a rate cut by the middle of 2024," says Pankaj Pathak, fund manager-fixed income, Quantum Asset Management Company. The RBI's current policy stance remains withdrawal of accommodation.

"Before the RBI can cut rates, it will have to change the stance from withdrawal of accommodation to neutral. Depending on the inflation trajectory, it could do so in the first half of the calendar year or by June and then perhaps start cutting the repo rate in the second half of 2024, say, between July and September," says Joydeep Sen, corporate trainer (debt markets) and author. Rate cuts will boost bond prices and translate into better returns from debt funds.

CREDIT RISK: BEST-PERFORMING CATEGORY OVER PAST YEAR

Category	(Returns in %)	1-year	3-year	5-year
Credit Risk Fund		8.7	10.3	5.7
Gilt Fund with 10-year Constant Duration		7.7	3.6	7.2
Long Duration Fund		7.5	3.5	7.2
Low Duration Fund		7.4	5.4	5.9
Gilt Fund		7.4	4.5	7.4
Money Market Fund		7.4	5.3	6.1
Medium Duration Fund		7.4	6.2	6.3
Short Duration Fund		7.3	5.5	6.7
Dynamic Bond Fund		7.2	5.1	6.8

Returns are of direct plans. Only top nine categories (by past year performance) included Source: NGEN Markets

Inclusion in global index: The inclusion of Indian government securities in global bond indexes will lead to inflows of foreign funds into the Indian market, boosting bond prices.

Negative factors

One negative could be commodity prices going up. "Whenever interest rates are cut, commodities tend to rally. If the price of oil rises, that would prevent CPI inflation from coming down," says Nagarajan. A poor monsoon or a coalition government coming to power are other potential headwinds. The global environment is another cause for concern. "Conflicts keep flaring up at intervals," says Pathak. Sen, too, cautions that unanticipated geopolitical issues could impact supply chains and cause an unexpected spike in inflation.

Enter long-duration funds

Experts say this is a good time to enter longer-duration debt funds.

"If rate cuts happen, bond yields will come down and investors will make mark-to-market capital gains on them," says Sen.

Portfolio construction tips

Some part of the portfolio, say, an amount equivalent to around 6-12

months of your salary, should be kept in a liquid fund for emergency purposes. To avoid taking too much risk in your debt fund portfolio, invest the bulk of your money in shorter-duration funds with a duration of up to one year.

Select individual categories by matching your investment horizon with the category or individual fund's duration.

Take some exposure to longer-duration debt funds to benefit from the anticipated rate cuts.

"However, avoid going overboard," says Sen. If you take exposure to these funds for trading gains, have a set timeframe in mind.

Whether the gains materialise or they don't within that timeframe, exit. If you wish to play it safer, take exposure to longer-duration funds as part of your asset allocation. In that case, match your investment horizon with the duration of the fund you are investing in. A longer horizon will take care of intermittent volatility and smooth out returns.

An alternative to investing in long-duration funds is to go for dynamic bond funds.

"In case rate cuts don't materialise, the fund manager will change the portfolio based on the outlook," says Pathak.

