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Fixed Income

India Fixed Income Monthly

Volatile Times Ahead
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Highlights of This Issue

Outlook For November: Things Could Get Worse Before Getting Better

We expect gilts to rule weak in November too despite the sharp rise in yields in October. Factors triggering the weakness are supply amid tight liquidity conditions coupled with subdued demand from nationalized banks. Adding to this will be the uncertain outlook and the bearish sentiment.

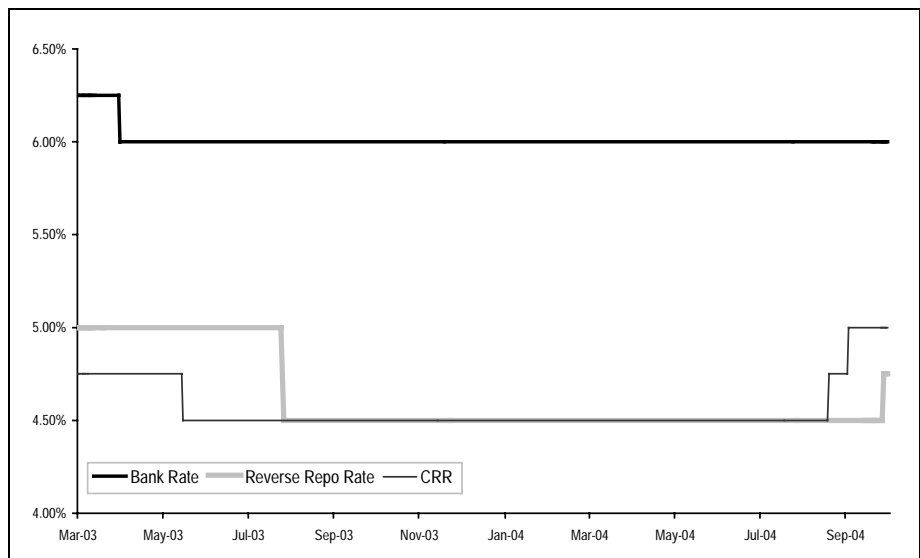
Recommendation: Increase Cash, Look For Opportunities In Auctions

We recommend increasing cash levels while focusing holdings in the short segments. We acknowledge the risk to our recommended 4-7yr segment from auction supply and recommend reducing positions and raising cash only to reinstate them in the weakness following the auction announcement.

Special Topic: A Symbolic Rate Hike

In this section we look at the key takeaways from the policy announcements. We feel that RBI is keen to ensure that inflationary expectations do not move up significantly. Inflationary trends will dictate the future moves in key rates.

Chart 1: RBI Continues Their Measured Hikes



Source: RBI, ML Research

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Executive Summary

Outlook for gilts remains bleak despite the sharp correction in October. The repo rate hike and hawkish tone in the policy should keep the market pricing in a higher probability of more rate hikes should conditions deteriorate. Adding to the market's woes is the tightening of liquidity. The focus is now shifting to more local issues and easing crude prices and rallying USTs will likely have a marginal impact in the short term. We feel that an improvement in liquidity and buying by banks is the most important factor to watch.

More Weakness Is In Store

■ It's Not Over Yet

We expect gilts to rule weak in November too despite the sharp rise in yields in October. Factors triggering the weakness are supply amid tight liquidity conditions coupled with subdued demand from banks. Adding to this will be the uncertain interest rate environment and inflation worries. Global factors might not have as significant an impact in the short run. There could be positives in the form of unwinding of MSS liquidity to support the borrowing program and other flexibilities depending on market conditions. Liquidity is expected to ease later in November after ruling firm in the first half. Nationalized banks hold the wildcard, look for increased demand from them before getting comfortable or signs from the RBI that the current round of weakness is overdone and needs to stabilize.

■ Silver Linings

Current levels do discount more rate hikes but tight liquidity and muted buying by banks remain a concern. RBI has indicated that rate rises on supply shocks will be transient and that they will ensure appropriate liquidity. Signs from RBI must be closely monitored to gauge the end of the bearish move.

Strategy

We recommend reducing duration by increasing cash levels. Supplies will likely present opportunities to build positions in short segments. *We recommend staying focused on short segments and increasing exposure to auction paper in the short segment as that segment will have likely corrected sharply in the run up to the auction.*

Mid-year Review of Annual Policy

As expected, RBI lowered their growth forecasts, upped their inflation forecasts and highlighted the risks to interest rates if the present unfavorable trends continue. RBI also hiked the repo rate by 25bp keeping other key rates steady. RBI had ahead of the policy given indications of this measured response. Key takeaway was the inflation worry and the need to stabilize inflationary expectations.

A Repo Rate Hike And Tight Liquidity

Gilts weakened in two stages in October. The first stage of weakening peaked with the auction results. Factors worrying the market during this time were higher crude prices, UST yields, low demand from banks and also comments from the FM and RBI Governor that were indicative of a rate hike. WPI inflation largely eased during the month but the final numbers were revised upwards significantly. Gilts got a leg up subsequently buoyed by the overall demand, drop in commodity prices, UST yields, deferment of fuel price hikes and the auction cancellation. This move however fizzled out ahead of the policy announcements as last minute jitters triggered unwinding. The repo rate hike triggered a sell-off. Comments by RBI officials that the hike was short-term etc failed to support. Finally the state loan announcement triggered losses despite the easing crude and the China rate hike.

■ Rupee Derivative Segments

OIS moved higher with the weakness in gilts but outperformed gilts. The repo rate hike triggered more weakness in the short end and the OIS curve flattened. Some paying pressure was likely visible as gilts and T-bills yields ruled above OIS levels. MIFOR rates moved higher with the forward premium. MIFOR swap rates were 25-30bp higher across the curve and the curve flattened marginally.

■ Credit Segments

Bonds weakened in October, the weakness sharpest around the auction of 7.38% 2015. Subsequently, bonds recovered when 5/10 gilt spreads started to widen. However, bonds weakened to close around the highest levels after the 25bp repo rate hike. Long bonds weakened in line with gilts and spreads were steady but short segments relatively underperformed as spreads widened sharply. Issuance activity was light with short maturities and floating rate papers being the most popular.

■ Expectations On INR Strength Accelerated

The INR/USD exchange rate appreciated over 1%. The triggers came from dollar weakness, rate hikes and easing crude prices. Players started positioning for a stronger rupee early in the month as the dollar witnessed weakness against other major currencies. Visible flows were supportive as equity inflows continued strong. Rate hikes in India and China also had a positive impact as Asian currencies strengthened against the US Dollar. Forward premium ended higher, failing to move lower with the strong INR.

Trading Ideas & Strategy

In this section we discuss trading and strategy and give an update on previously recommended trade ideas.

■ Short-term Outlook Remains Grim

The outlook on gilts remains worrisome. Liquidity is expected to remain tight early in the month. The state tap sale and scheduled auction have the potential to trigger more weakness. Demand from nationalized banks is not visible and primary supply to the full extent can have a significant adverse impact in a weak market. Risk appetite continues to fall as players see little chances of making trading gains. Positives can come from the cancellation or postponement of the auction, a low probability event, given the recent cancellation.

■ Increase Cash Further

Given the near term uncertainty, we recommend increasing cash levels while focusing holdings in the short segments. We acknowledge the risk to our recommended 4-7yr segment from the auction supply and hence recommend reducing positions and raising cash only to reinstate them in the weakness following the auction announcement.

■ Avoid Long Maturities And Auction Segments

Primary supply is expected to spark off weakness in those segments on expectations of poor demand. This would prompt defensive bidding and as a result the auction could clear at much higher yield levels than that prevailing in the secondary market. Auctions are scheduled in the 5-14yr and 20yr and above segments, meaning that barring a cancellation or change in form, most part of the curve is at risk. RBI has said that they could be flexible and conduct the borrowing program with care. Those moves could be supportive but we feel it is better to react after the event than take a contrarian call and position ahead of their moves as the risk-return payoff is unfavorable.

■ Rupee Derivatives Market

The OIS curve is expected to remain under paying pressure on tight liquidity and the initiation of trades to take advantage of the positive spread and expected convergence of the OIS curve and T-bills and short maturity gilts. We expect UST yields to remain soft and forward premium to ease. We recommend received positions in short maturities on the MIFOR curve and 2/5yr steepening trades.

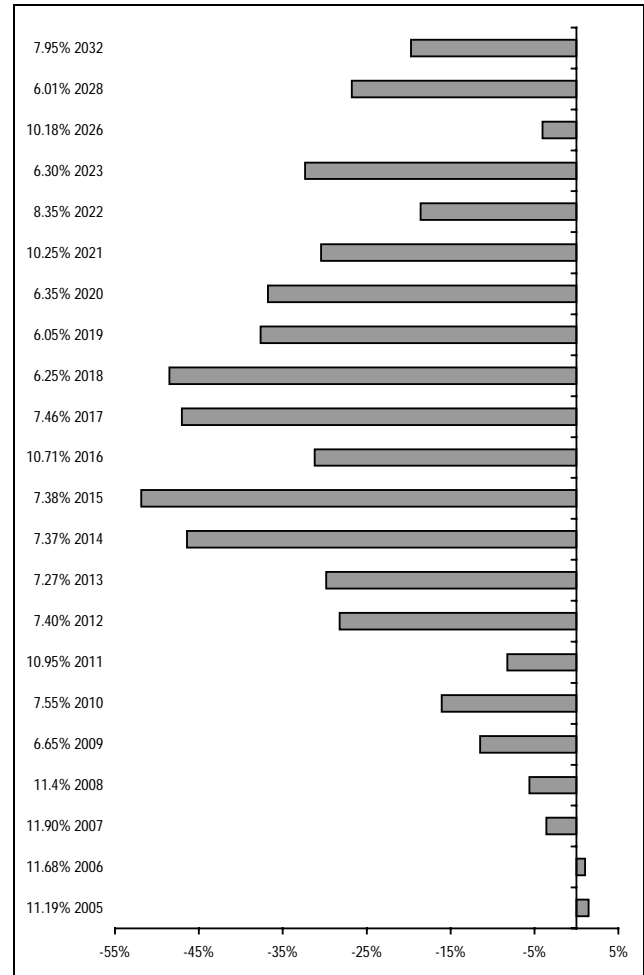
■ Underweight Long Bonds

An uncertain interest rate environment and strong credit demand will likely keep buying interest low in bonds. On a relative basis, spreads over gilts continue to be tight and we expect spreads to widen. Short segments could gain with the improvement in liquidity later in November and as more market participants buy into this segment of the credit curve on higher accrual and positioning motives.

■ Review Of Recommendations

Higher cash and lower duration outperformed as the long segments underperformed significantly. The OIS curve remained under paying pressure but the 2/5yr MIFOR swap spreads compressed against expectations. Credit segments weakened, but the short segments also lost as liquidity tightened much more than anticipated.

Chart 2: Annualized Total Returns In October



Source: Merrill Lynch Research

Chart 3: Expect 10/20Yr Spreads To Widen On Supply



Source: Merrill Lynch Research

Mid-Term Review Of Annual Policy

■ Main Policy Measures

- Repo rate increased 25bps to 4.75% effective Oct 27.
- Bank Rate and CRR unchanged.
- Reverse Repo and Repo rate band reduced 25bps to 125bps, as Reverse repo rate is unchanged.
- 7-day and 14-day under LAF scheme to be discontinued.

■ Main Revisions From Annual Policy

- GDP growth expectations scaled down to 6-6.5%
- Inflation expectations hiked to 6.5% (from 5%)
- Credit growth expected to be higher at 19%

■ Stance Of Monetary Policy For 2H FY05 ...

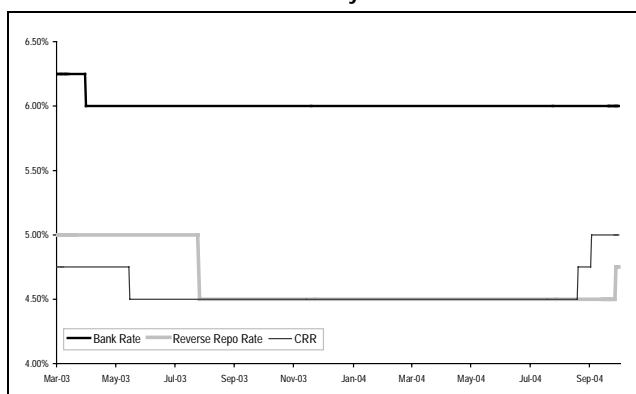
- Provision of appropriate liquidity to meet credit growth and support investment and export demand in the economy while placing equal emphasis on price stability.
- To pursue an interest rate environment that is conducive to macroeconomic and price stability, and maintaining the momentum of growth.
- To consider measures in a calibrated manner, in response to evolving circumstances with a view to stabilising inflationary expectations.

We have, in this comment, focused only on the policy's specific impact on the fixed income markets though the policy continued to address various areas of the economy, banking, forex and markets.

■ Rate Hikes ...

RBI continued the sequence of measured steps, following their comments and action on CRR with a 25bp hike in the Repo Rate. The hike was largely effected with a view to curbing inflationary expectations. Other key rates were left unchanged.

Chart 4: Measured Increases In Key Rates



Source: RBI, ML Research

■ ... With A 'Bearish' Undertone

Though RBI expects growth to be marginally lower at 6.0%-6.5% in FY05, RBI is more worried on the inflation front. RBI upped their inflation expectations, on a point-to-point basis, to be around 6.5% in FY05. Despite assessing the rise in inflation as emanating from supply shocks, they acknowledge that the current levels are lower than potential, as higher international prices have not been reflected locally. This alignment as well as the pass-through effect should add 2.2% to the WPI. Uncertainties regarding commodity prices are a worry.

More worries that are highlighted are from the conduction of the borrowing program at a time when credit demand is strong. The unwinding of MSS liquidity could be considered to ensure appropriate liquidity. RBI has also highlighted that the overhang of liquidity is substantial.

RBI has also said that it is necessary to recognize the risk of stronger adjustments that may be needed if less than adequate adjustments are made at the appropriate time.

Reading between the lines of the policy coupled with our in-house research view on commodities, we see risks of another hike in the repo rate in the medium term. We expect the market to reflect this uncertainty and discount a bearish outlook on gilt yields, especially in the short term.

■ The Market Was Prepared And The Reaction Was Expected

RBI's annual review, comments and actions coupled with local and external developments had already triggered bearish undertones. The market was discounting a hike in the repo rate (likely upto 50bp) but the recent increase in positions and risks of further hikes triggered a sell-off post-policy announcements.

■ We Remain Conservative

We believe the following are serious concerns, at least in the short run.

1. Poor demand for gilts from the banking system, given strong credit demand and an uncertain outlook on rates. Risk appetite of traders is low and flow of funds to mutual funds not supportive.
2. Risks of more 'measured' steps from the RBI if inflationary pressures persist and/or liquidity surplus start to build again.
3. Higher global commodity prices coupled with the pickup in local investment cycle could translate into sustained inflationary pressures.
4. External uncertainty on the rates front continues though consensus now expects the tightening cycles to be put on hold soon.

We remain bearish in the short term and see a possibility of higher yields, especially in the longer segments, where supply pressures influence yields. We expect to see an improvement in sentiment around 4Q FY05 and defer any increase in long duration assets till clear signs emerge.

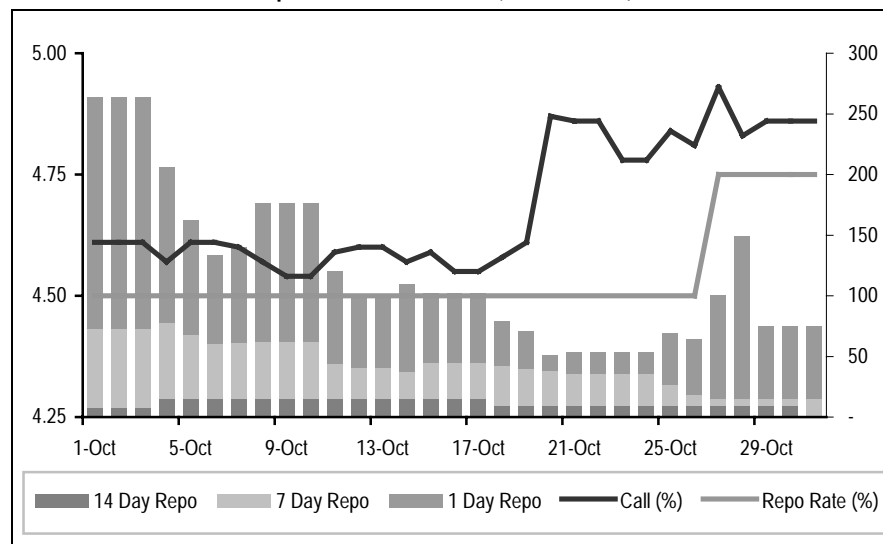
(Reprinted From India Fixed Income Strategy, Oct 27)

Money Markets

■ Liquidity Conditions Expected To Deteriorate Further

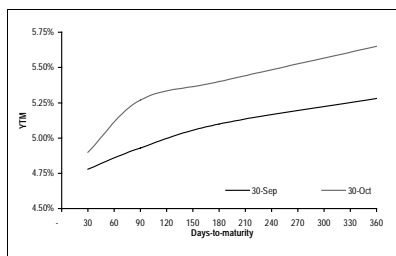
We expect liquidity to tighten in early November before easing late in the month. The current surplus as at end-Oct is Rs75bn and known flows (coupon and redemption less auctions) indicate a deficit of Rs44bn (see Table 9). Festival outflows, likely resulting in an increase in cash in circulation will likely add to the tightness and likely create spikes in overnight rates. Flows neutralizing this tightness will likely come from increased government spending and if RBI has to intervene in the FX markets, this time purchasing dollars to slow rupee strength.

Chart 5: Call Rates And Repo Amounts With RBI (RHS in Rsbn)



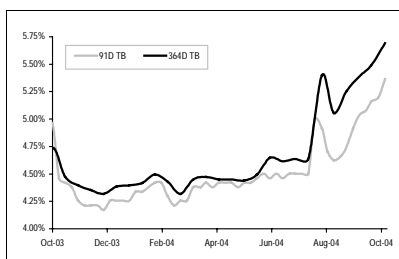
Source: RBI, NSE

Chart 6: T-Bill Yield Curve



Source: Merrill Lynch Research, Market Information

Chart 7: Auction Yields On T-Bills



Source: RBI, Merrill Lynch Research

■ A Lower Surplus And Repo Rate Hike Pushes Call Up in October

Call rates moved higher in October as the surplus in the system fell sharply and nationalized banks were also borrowing. The surplus liquidity started to fall after the second stage of the CRR hike came into effect and likely on increased credit demand. The auction cancellation covered the deficit on flows from gilts. The surplus with the GoI was largely steady, ending the month with around Rs180bn. The repo rate hike cemented the higher level though call rates were already in the 4.80% levels. RBI announced the discontinuation of the 7 & 14 day repo auctions, changed the repo/reverse repo terminology in line with international practice and has reduced non-bank lending in the call markets to 30% from 45% from Jan 8.

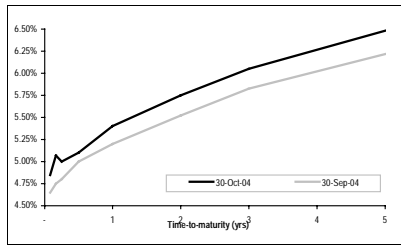
■ T-bill Yields Likely To Remain Under Pressure In November...

Tighter liquidity conditions could exert some residual pressure on T-bill yields. However, the correction in yields has been very sharp and is likely exaggerated. We expect T-bill yields to start to ease late in the month as liquidity conditions improve or RBI is forced to reduce the notified amount to let the MSS unwind to add to the liquidity in the system.

■ ... After Continuing To Rise In October

Tight liquidity, the repo rate hike and continued interest rate uncertainty pushed T-bill yields higher. The T-bill segment appears to be discounting more hikes in the near future though some of the weakness appears exaggerated on account of liquidity conditions. Outflows from short duration mutual funds also likely added to the weak demand.

Chart 8: OIS Curves



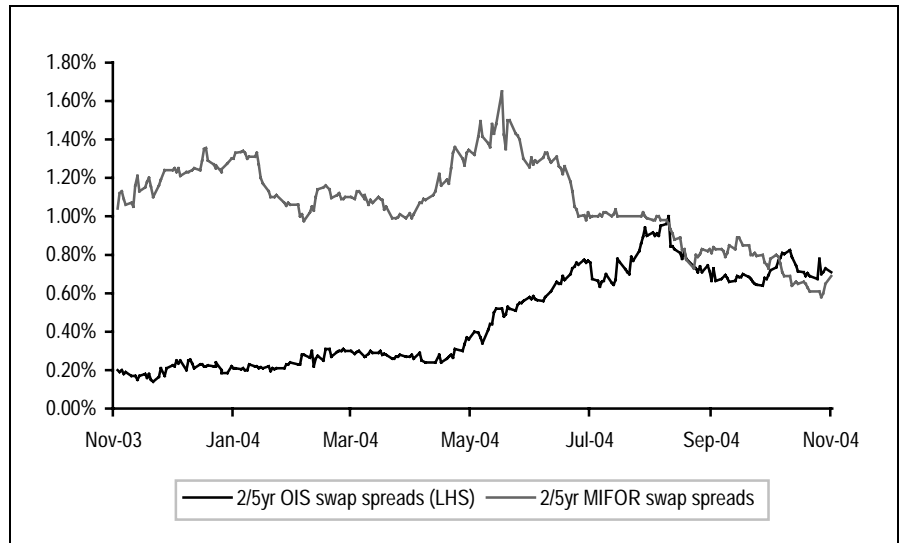
Source: Reuters

Interest Rate Swaps

Overnight Indexed Swaps (OIS)

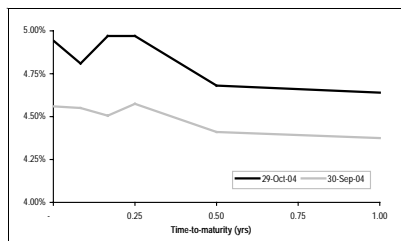
OIS moved higher with the weakness in gilts but outperformed gilts. The repo rate hike triggered more weakness in the short end and the OIS curve flattened. Some paying pressure was likely visible as gilts and T-bills yields ruled above OIS levels. Players will likely continue to initiate trades expecting this to converge. We recommend initiating received positions if the short segments converge with the T-bill curve as improved liquidity later will lead to a fall in yields at the short end.

Chart 9: 2/5yr OIS Spreads And 2/5yr MIFOR Swap Spreads



Source: Reuters; Merrill Lynch Research

Chart 10: MIFOR Curves

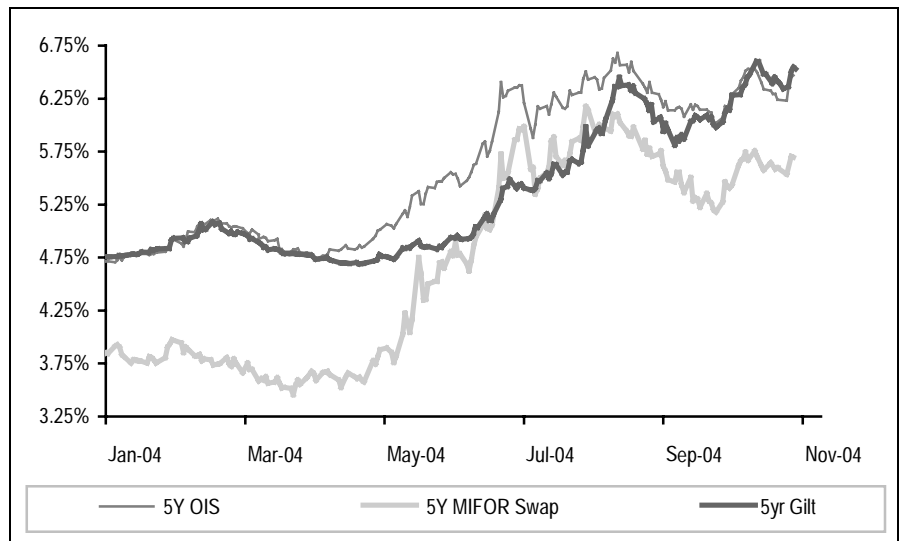


Source: Reuters

MIFOR Swaps

MIFOR rates moved higher with the forward premium. UST yields were largely range bound and the outlook on the rupee improved. We expect UST yields to remain soft as the rate hike cycle comes to a halt and forward premium to ease as players see the INR strength sustaining. This should support received positions in short maturities on the MIFOR curve and 2/5yr steepening trades.

Chart 11: Trends In Rates



Source: Reuters; Merrill Lynch Research

Government Securities Market

■ It's Not Over Yet ...

We expect gilts to rule weak in November too despite the sharp rise in yields in October. Factors triggering the weakness are supply amid tight liquidity conditions coupled with subdued demand from banks. Adding to this will be the uncertain interest rate environment and inflation worries. Global factors might not have as significant an impact in the short run. There could be positives in the form of unwinding of MSS liquidity to support the borrowing program and other flexibilities depending on market conditions. Liquidity is expected to ease later in November after ruling firm in the first half. Nationalized banks hold the wildcard, look for increased demand from them before getting comfortable or signs from the RBI that the current round of weakness is overdone and needs to stabilize.

What Is The RBI Saying?

RBI continued with its measured response to rising inflation, hiked the repo rate and emphasized on the need to stabilize inflationary expectations. They highlighted the fact that the current level of inflation is understated on fuel prices. Despite the sharp drop in the surplus liquidity, RBI said that the overhang of liquidity continues to be substantial. They have also said that the market must be prepared for uncertainty. In subsequent comments RBI highlighted that the repo rate hike was not part of a series of staggered hikes and was short-term to tackle supply shocks and the Bank Rate was the signaling rate, something they left unchanged. However, the door is open on more rate hikes should inflation show signs of demand pull inflation or there are more supply shocks.

Appropriate Liquidity, Primary Supply And Weak Demand

Liquidity is expected to tighten in the 1H November as festival outflows and increase in cash in circulation coupled with auctions puts pressure on overnight rates. RBI will have to infuse liquidity by way of repos and unwinding of MSS. The state tap sale and scheduled auctions will likely put pressure on yields as bank participation is subdued. Credit demand continues to be strong and the recent push towards credit will likely keep the momentum strong. One disturbing trend seen is the increase in short term loans at very aggressive rates, in some cases below yields on illiquid gilts. Another worry in the short run comes from the fact that bank participation is also going to be lower as rising rates also prompts them to stay away and wait for some stability in yields.

Inflation Concerns

Provisional WPI numbers indicated that inflation was easing but the revisions to the final numbers are worrying. Inflation as of Aug 21 peaked at 8.46%, the highest since Feb 01. Fuel prices will eventually be raised though the GoI appears to be postponing the hike. Crude prices will have to fall sharply and sustain there for a while if we were not to witness any hikes. The CPI (IW) for September has climbed to 4.81% from 4.61% in August. Inflation is likely going to remain a concern in the coming months though the base effect is favorable to the extent of 55bps.

Silver Linings

Current levels do discount more rate hikes but tight liquidity and muted buying by banks remain a concern. RBI has indicated that rate rises on supply shocks will be transient and that they will ensure appropriate liquidity. Signs from RBI must be closely monitored to gauge the end of the bearish move.

Strategy

We recommend reducing duration by increasing cash levels. Supplies will likely present opportunities to build positions in short segments. ***We recommend staying focused on the short segments and increasing exposure to the auction paper in the short segment as that segment will have likely corrected sharply in the run up to the auction.***

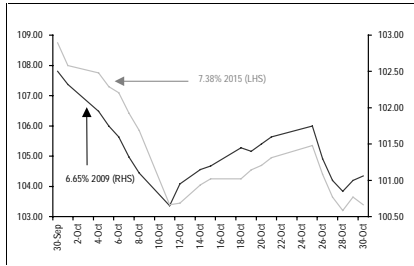
More weakness is in store for the markets if supply is as per schedule. Tighter liquidity conditions will likely exaggerate the weakness in the short run.

■ Things Went From Bad To Worse In October

Gilts weakened in two stages in October. The first stage of weakening peaked with the auction results. Factors worrying the market during this time were higher crude prices, UST yields, low demand from banks and also comments from the FM and RBI Governor that were indicative of a rate hike. WPI inflation largely eased during the month but the final numbers were revised upwards significantly. Gilts got a leg up subsequently buoyed by the overall demand, drop in commodity prices, UST yields, deferment of fuel price hikes and the auction cancellation. This move however fizzled out ahead of the policy announcements as last minute jitters triggered unwinding. The repo rate hike triggered a sell-off. Comments by RBI officials that the hike was short-term etc failed to support. Finally the state loan announcement triggered losses despite the easing crude and the China rate hike.

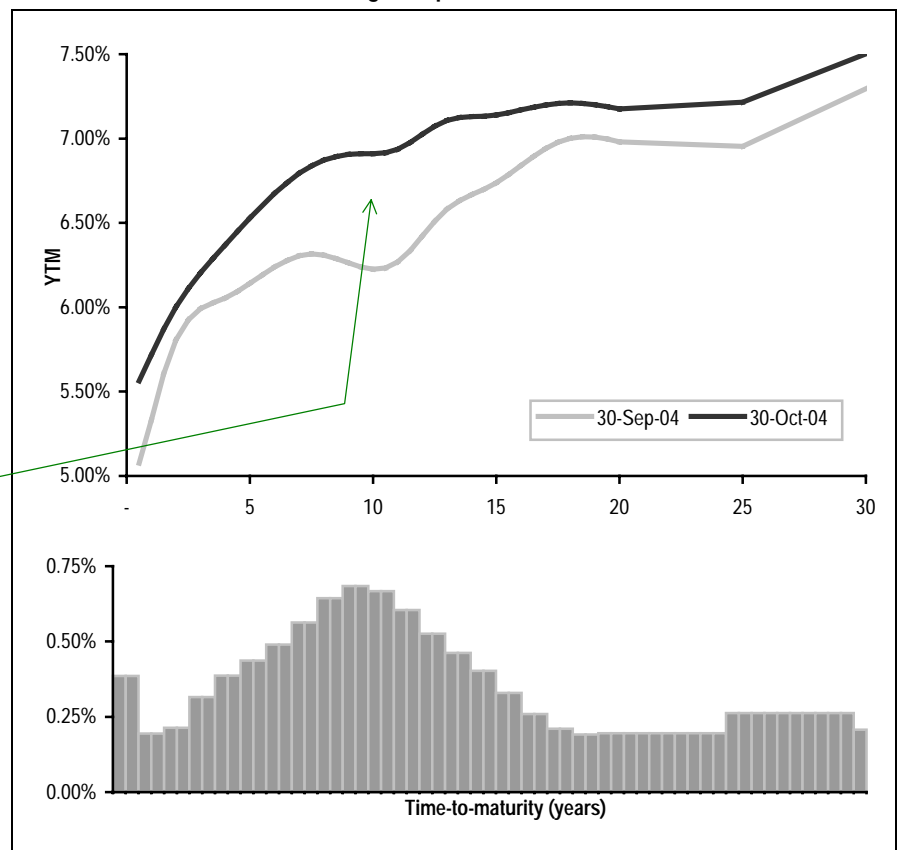
Gilts were weakening on rising crude and UST yields but recovered marginally when the FM urged central banks to be careful in raising rates. More comments by the FM ‘he expects RBI to take measured steps to curb inflation’ and RBI Governor, ‘that inflationary expectations must be tackled’, caused a sell off as players interpreted it as indicative of a rate hike. More losses were triggered by the auction as players expected a cancellation or floater. The auction cleared much below market expectations. Later, the auction cancellation on relevant factors (likely tight liquidity, GoI surplus and close to the policy) triggered an improvement in sentiment. Players were willing to hold higher positions, also likely indirectly indicating moderating rate hike expectations and reacted very positively to the fall in inflation. The repo rate hike in the policy triggered unwinding, taking prices down sharply despite supportive comments by the RBI Governor and DG that the Bank rate was the medium term signaling rate and the repo rate hike was to take care of supply shocks and a short term measure. The tap SDL sale announcement triggered more losses on a weak demand outlook. Gilts reacted favorably to the China rate hike, but could not hold levels.

Chart 12: Price Movement (Rs)



Source: Merrill Lynch Research

Chart 13: Gilt Yield Curve And Change In Spreads



Source: Merrill Lynch Research

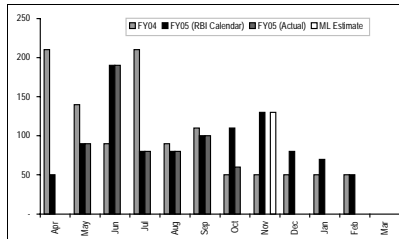
Yields ended higher across the curve with the 10/11 segments witnessing the maximum losses.

7.38% 2015 lost Rs5.35 during October and slipped from 6.67% to 6.95% just after the policy announcements.

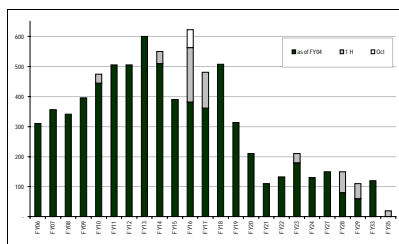
The curve flattened, 1/30 yr spreads compressed to 179bp from 196bp but 2/10 spreads widened from 46bp to 94bp.

Tight liquidity, the absence of banks, low volumes, lower provisional WPI but higher final numbers and the rate hike characterized the month.

Secondary volumes were around Rs518bn in gilts with volumes in 7.38% 2015 aggregating around 59% of total volumes and 6.65% 2009 with 17% of the volumes.

Chart 14: Monthly Issuance Calendar (Rsbn)


Source: Merrill Lynch Research, RBI

Chart 15: Maturity Profile of Dated Securities (Rsbn)


Source: RBI, Merrill Lynch Research

Government of India's Borrowing Program

Primary supply continues to weigh on market sentiment given the poor response at the previous auctions. Rs130bn of scheduled dated security supply and the announced Rs62bn of state loans would worry the market in November. Liquidity conditions have deteriorated and with liquidity expected to remain tight in the first half, players would look at auction announcements with apprehension. We expect the Rs62bn 7.36% SDL 2014 tap sale to witness under subscription as yields on some illiquid gilt are around those levels. Credit demand amid tight liquidity would also dampen sentiment. The market could possibly start discounting a delay in the central loan auction, though government officials have hinted that the auction will be as per schedule, as liquidity conditions might force the RBI to postpone the auction to later in November. The government still has a surplus (Rs180bn as per media reports) and this could support such a move. RBI in its mid-year review of annual policy has hinted that the borrowing program will be calibrated carefully and RBI will also consider the unwinding of MSS liquidity to keep liquidity from tightening sharply. Overall, RBI will likely have to act dilute the expected negative effect of supplies in November.

The current borrowing calendar envisages sizeable collections in the form of state loans that would be used for the state debt swap. While small savings collections will likely remain strong, market demand for state government paper could be adversely impacted on account of the prevailing bearishness and low liquidity. This lower collection could have to be compensated by higher than scheduled dated security issuance.

Table 1: Status Of Government of India Borrowing Program (FY05E)

| | Budget Estimates (Rsbn) | | Actual (Rsbn) | |
|-----------------------------------|-------------------------|--------|---------------|---------------|
| | Gross | Net | Gross | Net |
| Dated securities | 1246.81 | 903.65 | 600.00 | 256.84 |
| 364D TBs | 260.00 | 0.00 | 160.00 | 0.00 |
| As a % of Budget Estimates | | | 50.44 | 28.42 |
| Balance Borrowing in FY05 | | | 746.81 | 646.81 |
| State Govt. Securities | 420.71 | 369.48 | 234.44 | 228.31 |

Note: State government issuance assumes retaining over subscription, MSS issuance is Rs550.87bn

Source: Merrill Lynch Research, data as on month-end

■ Market Unwilling To Absorb Supply, GoI Cancels Auction

Strong credit demand and an uncertain interest rate environment translated into poor demand for the only auction last month. Contrary to expectations of a floater or twin auction of smaller sizes, the RBI announced the auction of Rs60bn 7.38% 2015. The auction announcement triggered weakness as demand was expected to be low. This was also reflected in the underwriting commission, Re0.21, the highest in recent years, and only Rs10bn was underwritten. The auction cleared much below levels in the secondary market and much lower than expectations as conservative bidding prompted players to position for the tail. The only positive was that the auction witnessed bidding interest of over Rs110bn for the paper.

The GoI cancelled the second scheduled auction (Rs50bn 5-9yr security) citing relevant factors. We feel tight liquidity conditions ahead of the policy and with the Rs180bn surplus with the GoI prompted the move. The GoI announced the tap sale of Rs62bn 7.36% 2014 from Nov 2.

Table 2: Borrowing Calendar – November

| Date | Amt (Rsbn) | Term |
|--------------|------------|-------------------|
| Nov 1-8 | 60 | 5-9 year |
| | 20 | 20-year and above |
| Nov 16-24 | 50 | 10-14 year |
| Total | 130 | |

Source: RBI

Table 3: Auction Statistics (Amounts In Rsbn)

| Descriptor | Issue | Maturity | Notified Amount | Devolvement | | Bids | | Cut-off | | |
|------------|-----------|----------|-----------------|-------------|------|----------|----------|---------|-----------|----------|
| | Date | Date | | RBI | PDs | Received | Accepted | Price | Yield (%) | Weighted |
| 7.38% 2015 | 12-Oct-04 | 3-Sep-15 | 60.00 | 0.00 | 0.00 | 111.25 | 60.00 | 102.95 | 6.99 | 103.23 |

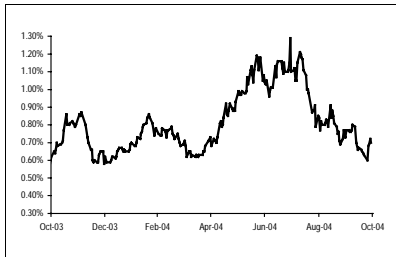
Source: Merrill Lynch Research, RBI

Corporate Debt Market

■ Long Bonds Could Underperform In November

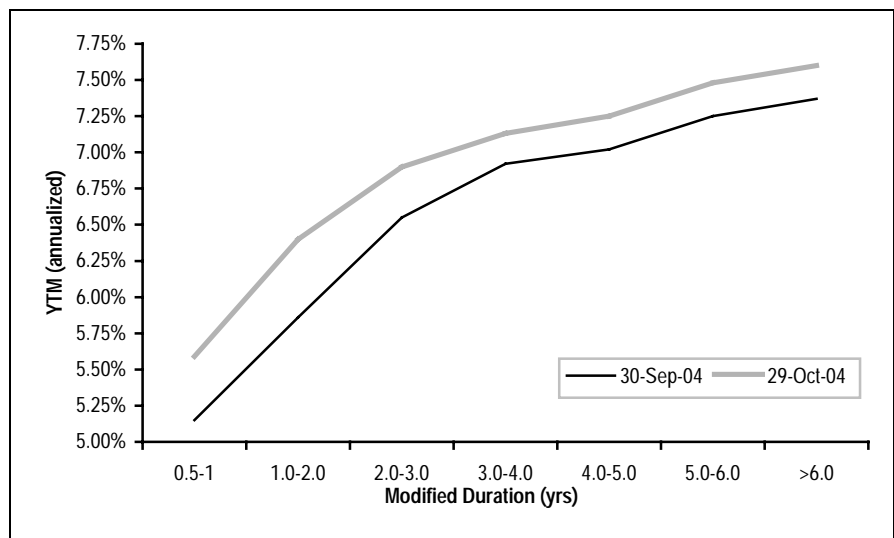
An uncertain interest rate environment and strong credit demand will likely keep buying interest low in bonds. Demand from traders, banks and mutual funds is likely to be low. Banks are witnessing strong credit demand and mutual funds continue to be relatively overweight bonds in their income funds. The prevailing uncertainty and low liquidity in this segment will also keep traders from increasing positions. One positive for this segment is the fact that the issuance pipeline is also light. On a relative basis, spreads over gilts continue to be tight and we expect spreads to widen. Short segments could gain with the improvement in liquidity later in November and as more market participants buy into this segment of the credit curve on higher accrual and positioning motives.

Chart 16: 5-yr AAA Spread Over Gilts



Source: Crisil

Chart 17: AAA Yield Curve



Source: Crisil

■ Bonds Weaken In Line With Gilts

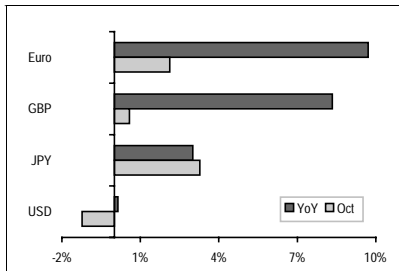
Bonds weakened in October, the weakness sharpest around the auction of 7.38% 2015. Subsequently, bonds recovered when 5/10 gilt spreads started to widen. However, bonds weakened to close around the highest levels after the 25bp repo rate hike. Long bonds weakened in line with gilts and spreads were steady but short segments relatively underperformed as spreads widened sharply. This was likely on account of unwinding by mutual funds following large redemptions from short duration funds. Banks were seen redeeming funds from mutual funds after liquidity tightened significantly in the second half of the month. Issuance activity was light with short maturities and floating rate papers being the most popular. The low appetite for bonds in the capital market prompted corporates to resort to borrowing from banks.

Table 4: Debt Issuance In The Month Of October 2004

| Issuer | Type | Rating | Amount (Rsbn) | Coupon (%) | Maturity (years) |
|---------------------|------------|--------|---------------|---|-------------------|
| Dewan Housing Fin | Debentures | AA | 0.35 | 1st yr INBMK+80, 2nd yr INBMK+105, 3rd yr INBMK+130 | 3yr put every yr |
| Power Finance Corpn | Debentures | AAA | 2.00+os | 6.80 | 7yr with 5yr p/c |
| Exim Bank | Debentures | AAA | 1.35 | 7.00 | 10yr with 7yr p/c |
| UTI Bank | CD | | 2.30 | 1yr INBMK + 20bp | 2yr |
| Kotak Mahindra Bank | Tier II | AA+ | 0.50+0.25 | 5.90 | 6mth |
| | | | | 7.50/1yrINBMK+90bp | 102mth |

Source: Market Information

Note: sa – semi-annual; pa – per-annum; os – Over-subscription; bb – Book Building; p – put option; c – call option; INBMK – Reuters benchmark

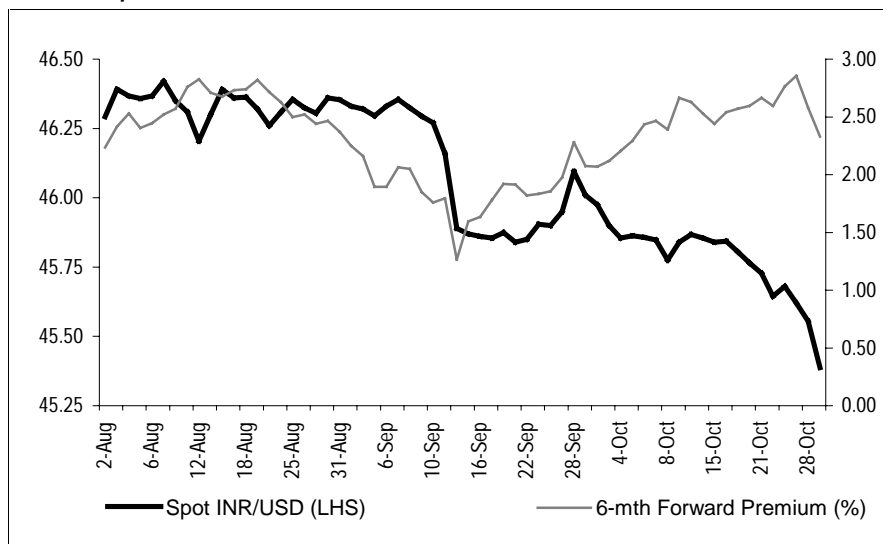
**Chart 18: Relative Performance
(Primary Currencies Vs INR)**


Source: Bloomberg

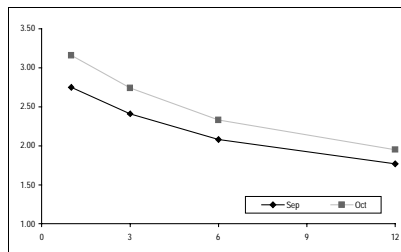
Foreign Exchange Market

■ Expect INR/USD To Appreciate Further Before Consolidating...

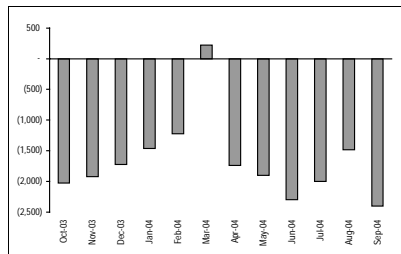
We expect the current momentum to take the rupee stronger against the US Dollar in November. Increasing expectations of a stronger rupee and improved sentiment will likely trigger the strengthening. A weakening US Dollar, strong regional currencies and supportive flows should support this view. Dollar weakness is getting more pronounced and expectations favor a weaker dollar. The rate hike in China should also serve as a trigger for appreciation in regional currencies. RBI has been intervening, selling dollars at higher levels and market positioning would have normalized since Mar-Apr. The stress on inflation control will also support expectations, as RBI would be expected to be comfortable with a relatively overvalued rupee in the short-to-medium term. Crude prices continue to be a wildcard and the market impact of lower prices will likely be stronger than the negative impact of higher prices (at least in the short run). Rupee volatility is likely to remain high as fears of intervention by RBI (dollar support) trigger an unwinding of trading positions. Forward premium will likely move lower.

Chart 19: Spot INR/USD And 6-month Forward Premium


Source: Reuters

Chart 20: Forward Premium Curve (%)


Source: Reuters

Chart 21: Trade Balance (US\$m)


Source: Ministry of Commerce

■ Expectations Gained Ground In October

The INR/USD exchange rate witnessed another round of strength and appreciated over 1%. The triggers came from dollar weakness, rate hikes and easing crude prices. Players started positioning for a stronger rupee early in the month as the dollar witnessed weakness against other major currencies. Visible flows were supportive as equity inflows continued strong. Higher invisibles and strong exports helped balance the pressures from higher imports. Rising crude prices (WTI at US\$55) likely kept the pace from picking up further. Rate hikes in India and China also had a positive impact as Asian currencies strengthened against the US Dollar. Forward premium ended higher, failing to move lower with the strong INR. RBI increased the ceiling on NRE deposits to Libor/swap rates plus 50bp in its mid-year review of annual policy.

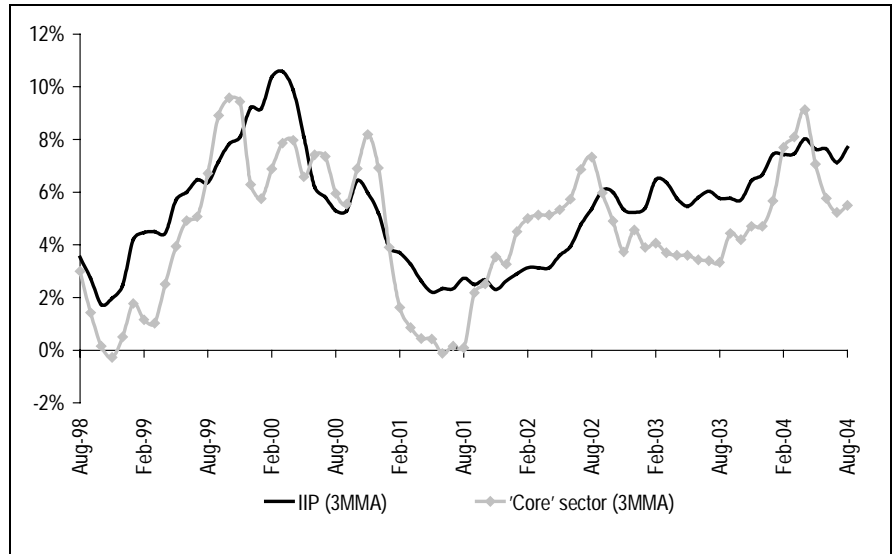
■ Trade Numbers – September 2004

Exports rose 17% YoY in September to US\$6.2bn and imports rose 41% to US\$8.6bn, boosted by higher oil imports. The trade deficit widened to US\$2.4bn. Exports in the six months through September rose 24% to US\$33.8bn. Oil imports rose 58% to US\$14.5bn and non-oil imports advanced 26% to US\$31.9bn.

Economic Data And Government Finances

Economic data releases continue to reflect the strength in the economy. RBI has also voiced that growth (ex agriculture) is strong and not temporary. Core 'six' industries growth was up 5.9% YoY. IIP growth for Aug'04 was at 7.9%. For Apr-Aug, IIP has grown by 7.9% YoY vs 5.9% last year.

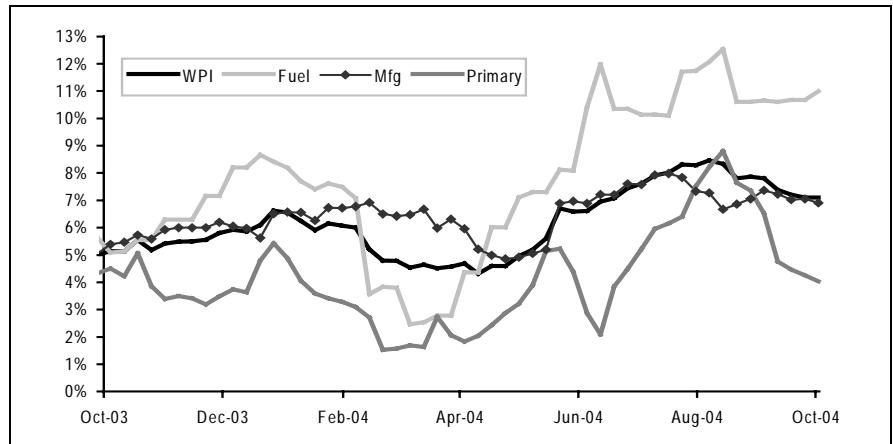
Chart 22: IIP & 'Core' Industries Growth Trend



Source: CSO, RBI

WPI data released in October showed YoY numbers falling from 7.87% to 7.10% as lower primary article inflation pulled the index lower. In October, GoI refrained from hiking fuel prices. The base effect for data to be released in Nov is -55bp. CPI (IW) continues to inch up, now at 4.81% in Sep.

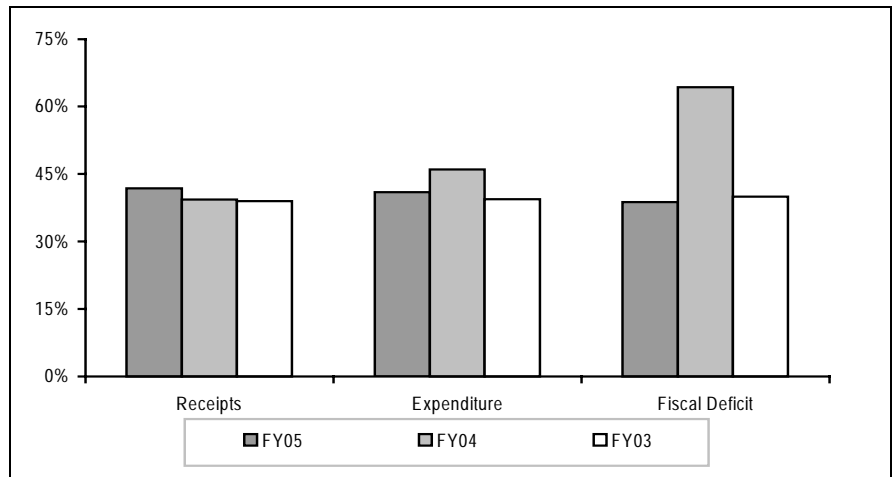
Chart 23: WPI And Components (YoY Growth)



Source: Ministry of Commerce, ML Research

Higher tax collections have helped government finances. The GoI continues to run a Rs180bn surplus with the RBI. Concerns come from the pace of collections of indirect taxes and expectations of a shortfall in state debt swap proceeds on low demand.

Chart 24: Government Finances as a % of Actual / Budgeted (Apr - Sep '04)



Source: Ministry of Commerce, ML Research

Table 5: India Economic Forecasts

| | FY02 A | FY03A | FY04 | FY05 MLE | FY06 MLE |
|-----------------------------------|--------|-------|-------|----------|----------|
| GDP(% real change) | 5.8 | 4.0 | 8.2 | 6.2 | 7.3 |
| Components of GDP (% real change) | | | | | |
| Agriculture | 6.5 | -5.2 | 9.1 | -0.5 | 2.5 |
| Industry | 3.2 | 5.7 | 6.8 | 7.4 | 8.4 |
| Services | 6.5 | 7.1 | 8.5 | 8.4 | 8.6 |
| Wholesale Price Index (Year end) | 1.4 | 6.2 | 4.5 | 5.6 | 5.0 |
| Money supply (% YoY) | 14.2 | 15.5 | 16.3 | 15.0 | 14.0 |
| Deposit growth (% YOY) | 13.6 | 12.2 | 16.9 | 15.0 | 15.0 |
| Credit Growth (% YOY) | 12.4 | 17.8 | 14.8 | 19.0 | 18.0 |
| Exports (fob ;US\$ bn) | 44.9 | 52.5 | 63.0 | 76.1 | 89.2 |
| Exports (% YoY) | 0.0 | 16.90 | 19.9 | 20.8 | 17.3 |
| Imports (f.o.b.;US\$ bn) | 57.6 | 65.4 | 79.7 | 98.1 | 115.7 |
| Imports (% YoY) | -2.8 | 13.5 | 21.8 | 23.2 | 17.9 |
| - Oil imports (% YoY) | -10.2 | 25.9 | 15.0 | 15.6 | 8.0 |
| - Non-oil imports (%YoY) | -0.1 | 9.6 | 24.3 | 25.8 | 21.0 |
| Trade Balance | -12.7 | -12.9 | -16.7 | -22.1 | -26.5 |
| Current account(% GDP) | 0.2 | 0.8 | 1.5 | 0.3 | -0.3 |
| Current Account (\$ bn) | 0.8 | 4.1 | 8.7 | 2.4 | -2.0 |
| Fiscal deficit (% GDP) | 6.2 | 5.9 | 4.5 | 4.8 | 4.5 |
| Exchange rate (Re/ US\$) year end | 48.8 | 47.4 | 43.6 | 45.0 | 44.5 |
| PLR | 11.0 | 10.5 | 10.0 | 10.0 | 10.5 |

Source: Gol, Merrill Lynch Estimates

Table 6: Key Indicators

| Amounts in Rsbn | Data Frequency | Latest Outstanding | Variation Over | | |
|---|----------------|--------------------|----------------|-----------|---------|
| | | | Previous | FY so far | Year |
| Ways and Means Advances (22/10/04) | Week | 0 | 0 | - | 0 |
| Foreign Exchange Reserves (US\$mn) (22/10/04) | Week | 120616 | 980 | 7657 | 27515 |
| Aggregate Deposits (15/10/2004) | Fortnight | 1605233 | 42.18 | 6.70% | 15.90% |
| Banks' Investments in govt. Securities (15/10/04) | Fortnight | 6814.18 | 28.83 | 266.60 | 704.53 |
| Bank Credit (15/10/2004) | Fortnight | 9710.18 | 351.13 | 15.50% | 28.80% |
| Non-food Credit (15/10/04) | Fortnight | 9350.58 | 377.92 | 1302.35 | 2153.79 |
| M3 (15/10/04) | Fortnight | 21235.14 | 127.54 | 6.00% | 14.50% |

Note: All amounts in Rsbn unless specified; Source: RBI

Table 7: Treasury Bill Auction Statistics (Amounts In Rsbn)

| Issue Date | Type | Size Rsbn | Cut-off | | Competitive Bids | | Devolvement RBI |
|------------|---------|-----------|---------|-------|------------------|----------|-----------------|
| | | | Price | Yield | Received | Accepted | |
| 01-Oct-04 | 91D TB | 20.00 | 98.76 | 5.04% | 23.91 | 20.00 | 0.00 |
| 08-Oct-04 | 91D TB | 20.00 | 98.75 | 5.08% | 40.67 | 20.00 | 0.00 |
| 14-Oct-04 | 91D TB | 20.00 | 98.73 | 5.16% | 36.53 | 20.00 | 0.00 |
| 22-Oct-04 | 91D TB | 20.00 | 98.72 | 5.20% | 44.04 | 20.00 | 0.00 |
| 29-Oct-04 | 91D TB | 20.00 | 98.68 | 5.37% | 37.09 | 20.00 | 0.00 |
| 01-Oct-04 | 364D TB | 20.00 | 94.90 | 5.39% | 64.66 | 20.00 | 0.00 |
| 14-Oct-04 | 364D TB | 20.00 | 94.81 | 5.49% | 51.75 | 20.00 | 0.00 |
| 29-Oct-04 | 364D TB | 20.00 | 94.63 | 5.69% | 64.45 | 20.00 | 0.00 |

Source: RBI, Merrill Lynch Research

Table 8: Key Rates

| | Latest | Last Move | Last Move Date |
|------------------------|-------------|-----------|------------------|
| Repo Rate (%) | 4.50 | +25bp | October 27, 2004 |
| Bank Rate (%) | 6.00 | -25bp | April 30, 2003 |
| Deposit Rate (%) | 5.00-5.50 | | January 2004 |
| PLR (%) | 10.25-11.00 | | January 2004 |
| Cash reserve ratio (%) | 5.00 | +25bp | October 2, 2004 |

Source: RBI, Market Information

Note: Month end rates, deposit rates relate to term deposits of over one year maturity

Table 9: Forward Calendar – Inflows/Outflows in November 2004

| Date | Descriptor | Type | Amount (Rsbn) | Daily Total (Rsbn) |
|--------------|---------------------------------|---------|----------------|--------------------|
| 02-Nov-04 | 12.00% 2008 | coupon | 7.20 | 7.20 |
| 03-Nov-04 | 7.40% 2012 | coupon | 5.92 | 5.92 |
| 05-Nov-04 | 13.75% 2005 | coupon | 0.69 | 0.69 |
| 06-Nov-04 | 9.10% Karnataka SDL 2011 | coupon | 0.14 | 0.14 |
| 07-Nov-04 | FRB 2016 | coupon | 1.35 | 1.35 |
| 08-Nov-04 | 11.50% SDL 2008 | coupon | 2.06 | |
| 08-Nov-04 | 10.35% SDL 2011 | coupon | 2.79 | 4.85 |
| 10-Nov-04 | FRB 2012 | coupon | 1.16 | 1.16 |
| 12-Nov-04 | 6.40% SDL 2013 | coupon | 2.53 | |
| 12-Nov-04 | 91D & 364D TB | net | (12.50) | |
| 12-Nov-04 | 7.50% 2010 | coupon | 0.55 | |
| 12-Nov-04 | 11.50% 2006 | coupon | 3.02 | |
| 12-Nov-04 | 11.83% 2014 | coupon | 6.80 | 0.40 |
| 14-Nov-04 | 7.55% 2010 | coupon | 2.64 | |
| 14-Nov-04 | 8.35% 2022 | coupon | 6.68 | 9.32 |
| 15-Nov-04 | 13.85% SDL 2006 | coupon | 1.66 | |
| 15-Nov-04 | 6.75% 2006 | coupon | 0.27 | |
| 15-Nov-04 | 11.50% 2009 | coupon | 2.59 | 4.51 |
| 19-Nov-04 | 10.79% 2015 | coupon | 1.45 | 1.45 |
| 20-Nov-04 | Ker / Mah / MP/ Punjab SDL 2012 | coupon | 0.27 | |
| 20-Nov-04 | FRB 2014 | coupon | 1.15 | 1.42 |
| 21-Nov-04 | 10.50% 2005 | coupon | 0.25 | |
| 21-Nov-04 | 11.50% 2015 | coupon | 2.05 | 2.29 |
| 22-Nov-04 | 14.00% SDL 2005 | coupon | 4.41 | |
| 22-Nov-04 | 6.75% 2007 | coupon | 0.21 | |
| 22-Nov-04 | FRB 2006 | coupon | 0.44 | 5.06 |
| 23-Nov-04 | 11.50% 2008 | coupon | 4.01 | |
| 23-Nov-04 | 12.60% 2018 | coupon | 7.96 | 11.97 |
| 24-Nov-04 | 9.00% 2013 | coupon | 0.79 | |
| 24-Nov-04 | 11.50% 2011 | coupon | 6.33 | 7.11 |
| 25-Nov-04 | 7.00% 2009 | coupon | 0.42 | 0.42 |
| 26-Nov-04 | 364D TB | auction | (10.00) | (10.00) |
| 28-Nov-04 | 5.70% SDL 2014 | coupon | 2.41 | |
| 28-Nov-04 | 11.90% 2007 | coupon | 8.03 | 10.45 |
| 30-Nov-04 | 10.00% 2014 | coupon | 1.17 | |
| 30-Nov-04 | 10.95% 2011 | coupon | 6.57 | |
| 30-Nov-04 | 9.81% 2013 | coupon | 5.40 | |
| 30-Nov-04 | 10.25% 2021 | coupon | 6.77 | 19.90 |
| 1-8 Nov | 5-9yr Gol paper | auction | (60.00) | (60.00) |
| 1-8 Nov | 20yr and above Gol paper | auction | (20.00) | (20.00) |
| 16-24 Nov | 10-14yr Gol paper | auction | (50.00) | (50.00) |
| Total | | | (44.39) | (44.39) |

Source: Merrill Lynch Research, RBI Auction Calendar

Note: Does not include non-competitive bidder flows and 'nil' flows in T-bills, Net – Auction less repayment

Table 10: Yield Table

| | Oct-03 | Jan-03 | Mar-04 | Jul-04 | Sep-04 | Oct-04 |
|--|-----------|-----------|-----------|-----------|-----------|-----------|
| Call Rates (average %) | 4.66 | 5.66 | 4.46 | 4.48 | 4.53 | 4.69 |
| Range (%) | 4.50-6.50 | 5.44-6.11 | 4.36-4.48 | 4.43-4.50 | 4.45-4.82 | 4.54-4.93 |
| Treasury Bills (primary) | | | | | | |
| 91 days (%) | 4.42-4.95 | 5.41-5.65 | 4.22-4.30 | 4.46-4.50 | 4.63-5.04 | 5.08-5.37 |
| 364 days (%) | 4.37-4.74 | 5.42-5.50 | 4.32-4.43 | 4.62-4.64 | 5.06-5.39 | 5.49-5.69 |
| Treasury Bills (Month-end secondary market) | | | | | | |
| 3 month | 4.53 | 5.70 | 4.24 | 4.49 | 4.93 | 5.30 |
| 1 year | 4.53 | 5.70 | 4.30 | 4.59 | 5.28 | 5.64 |
| Rupee Derivative Rates | | | | | | |
| 1yr OIS (%) | 4.42 | 4.43 | 4.44 | 5.09 | 5.20 | 5.40 |
| 5yr OIS (%) | 4.65 | 4.71 | 4.79 | 6.43 | 6.22 | 6.47 |
| 6mth MIFOR (%) | 1.94 | 1.19 | 2.12 | 4.73 | 4.41 | 4.68 |
| 5yr MIFOR Swap (%) | 4.05 | 3.84 | 3.68 | 6.15 | 5.41 | 5.71 |
| Government Securities (Month-end semi-annual) | | | | | | |
| 1 year (%) | 4.63 | 5.71 | 4.37 | 4.75 | 5.33 | 5.72 |
| 3 year (%) | 4.79 | 5.92 | 4.57 | 5.54 | 5.99 | 6.21 |
| 5 years (%) | 4.80 | 6.06 | 4.77 | 5.84 | 6.14 | 6.53 |
| 7 years (%) | 5.01 | 6.18 | 5.01 | 6.13 | 6.30 | 6.79 |
| 10 years (%) | 5.11 | 6.29 | 5.15 | 6.16 | 6.23 | 6.91 |
| 15 years (%) | 5.58 | 6.44 | 5.56 | 6.51 | 6.74 | 7.14 |
| 20 years (%) | 5.90 | 6.69 | 5.94 | 6.74 | 6.98 | 7.18 |
| 25 years (%) | 5.95 | 6.77 | 6.03 | 6.59 | 6.95 | 7.22 |
| 30 years (%) | 5.94 | 6.77 | 5.99 | 6.72 | 7.29 | 7.50 |
| 3 month Commercial Paper (P1 +) (%) | 4.75-4.95 | 5.65-5.80 | 4.70-4.95 | 4.60-4.90 | 4.80-5.10 | 4.90-5.25 |
| Inter Corporate Deposits (AAA) | | | | | | |
| 15 days to 30 days (%) | 4.80-5.00 | 5.50-5.75 | 4.75-5.00 | 4.95-5.15 | 5.00-5.35 | 5.10-5.35 |
| 90 days (%) | 5.25-5.40 | 5.90-6.05 | 5.00-5.25 | 5.10-5.35 | 5.30-5.60 | 5.50-5.75 |
| Bank Bonds – Taxable (AAA) | | | | | | |
| 3 year (%) | 5.20-6.05 | 5.85-6.00 | 5.75-6.00 | 5.75-6.00 | 6.10-6.30 | 6.40-6.50 |
| 5 years (%) | 5.15-5.50 | 6.00-6.30 | 5.90-6.40 | 6.15-6.40 | 6.70-6.90 | 6.85-7.00 |
| 7 years (%) | 5.45-6.00 | 6.30-6.50 | 6.00-6.50 | 6.30-6.50 | 7.00-7.25 | 7.10-7.30 |
| FI Bonds – Taxable (AAA and AA+) | | | | | | |
| 1 year (%) | 5.40-6.00 | 6.00-7.75 | 5.15-6.00 | 5.30-5.50 | 5.35-5.45 | 5.75-5.95 |
| 3 years (%) | 5.15-6.10 | 5.95-8.50 | 5.50-5.75 | 5.90-6.30 | 6.70-6.80 | 6.90-7.00 |
| 5 years (%) | 5.25-6.55 | 6.05-7.00 | 5.55-6.50 | 6.75-7.20 | 7.00-7.10 | 7.15-7.25 |
| Private Corp– Taxable (AAA) | | | | | | |
| 1 year (%) | 5.10-5.25 | 5.80-6.00 | 5.30-5.70 | 5.00-5.10 | 5.00-5.35 | 5.50-5.85 |
| 3 years (%) | 5.20-5.60 | 6.00-6.15 | 5.30-6.10 | 6.25-6.50 | 6.40-6.60 | 6.65-6.80 |
| 5 years (%) | 5.35-6.35 | 6.05-6.75 | 5.65-6.25 | 6.45-6.90 | 6.65-6.90 | 6.80-6.95 |
| 7 years (%) | 5.50-6.00 | 6.15-6.75 | 6.00-6.15 | 6.60-7.10 | 6.70-7.10 | 7.00-7.25 |
| PSU Bonds – Taxable (AAA) | | | | | | |
| 1 year (%) | 5.20-5.50 | 5.85-6.00 | 5.10-5.35 | 5.00-5.05 | 5.00-5.30 | 5.50-5.80 |
| 3 years (%) | 5.15-5.75 | 5.85-6.10 | 5.40-5.80 | 5.80-6.10 | 6.35-6.50 | 6.50-6.70 |
| 5 years (%) | 5.15-6.10 | 6.25-6.90 | 5.55-6.00 | 6.30-6.80 | 6.60-6.85 | 6.70-6.90 |
| 7 years (%) | 5.50-6.10 | 6.20-7.00 | 5.75-6.25 | 6.40-6.90 | 6.70-6.90 | 6.90-7.05 |
| 10 years (%) | 5.60-6.50 | 6.35-7.00 | 5.95-6.25 | 6.50-7.00 | 6.90-7.10 | 7.10-7.25 |
| PSU Bonds - Tax-Free | | | | | | |
| 1 - 3 years (%) | 3.95-4.20 | 5.20-5.35 | - | - | - | - |
| 3 - 5 years (%) | 4.25-4.75 | 5.60-6.20 | - | - | - | - |

Note: The yields mentioned above takes into account the fluctuations during the entire month. In many cases the yields may be indicative as deals in exact maturities may not have happened; Source: Merrill Lynch, Market information, NSE – Call rates

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