India Equity & Fixed Income Markets

Market Commentary: June 2022

Global Economy

The US Federal Reserve increased the federal funds rate by 75 bps, the sharpest hike since 1994 in order to tame inflationary pressures. The federal funds rate now lies in the range of 1.5%-1.75%, with the Fed hinting at further 50bps rate hikes in subsequent meetings with a more aggressive 75bps rate hike ruled out.

The European Central Bank (ECB) maintained status quo on interest rates. Although it confirmed that it will end a long-running bond buying scheme on 1st July and signaled the beginning of the rate hike cycle, starting with a 25bps hike in its 21st July meeting.

The Bank of England hiked its main interest rate for a fifth consecutive meeting, to its highest level since the global financial crisis in 2009 to 1.25% as it forecasted inflation levels in Britain to surge further this year to above 11%.

Japan's GDP contracted to a lesser extent, a revised estimate of -0.5% y-o-y in Q1 2022, as private consumption remained resilient. The Bank of Japan maintained ultra-low interest rates in its latest meeting and vowed to defend its cap on long term bond yields at 0% with unlimited buying, bucking a global wave of monetary tightening in a show of resolve to focus on supporting a tepid economic recovery.

China’s central bank abstained from cutting a key policy interest rate, avoiding further policy divergence from the US that could add pressure on the yuan. Earlier, the People's Bank of China (PBoC) had reduced its 5-year prime loan rate by 15bps to 4.45% from 4.6% previously in order to support economic growth in the light of the recent Covid lockdowns. (Source: CRISIL Research)

Indian Economy

The World Bank cut India's economic growth forecast for the current fiscal to 7.5% while Fitch Ratings revised it to 7.5% from 8% earlier as rising inflation, supply chain disruptions and geopolitical tensions taper recovery. Fitch ratings also upgraded India's outlook to Stable from Negative citing fading downside risks to medium growth on the back of rapid economic recovery and easing of weaknesses in the financial sector.

High frequency indicators continued to remain robust as indicated by the services PMI, external trade, air traffic, two wheeler and passenger vehicle sales and bank credit growth. Cumulative rains have improved over the last week with the deficit shrinking to 2% below normal (as of 5th July). More importantly, crop sowing as of 1st July has also improved drastically with the deficit now 5.3% below last year. Improvement in rains bodes well for domestic supply of soft commodities and fresh foods which are important for macro stability parameters. (Source: CRISIL, MOSPI)

Equity Market Performance and Key Updates

The Indian equity markets continued to decline on the back of a major sell-off in global equities, rise in crude oil prices and further tightening measures by global central banks. Benchmarks S&P BSE Sensex and Nifty 50 each declined by nearly 5% each in the month in LCY terms. In the quarter ended June 2022, both indices corrected sharply by ~10% each, the sharpest fall since March 2020.

Mid and small-cap indices underperformed. Largecaps in the month – the Nifty Midcap 100 index fell 6.5% and the Nifty Smallcap 100 Index fell 8.3% in LCY terms. Among sectors, Auto sector continued to deliver positive returns as domestic two wheelers and passenger vehicles volumes continue to witness steady improvement, with the S&P BSE Auto index rising by 1.2% in the month. Metals sector underperformed broader markets in June as well, declining by 14.1%. (Source: NSE, BSE, Bloomberg).

Foreign Institutional Investors (FII) remained net sellers of Indian equities for June, marking the 9th consecutive month of outflows (-USD 6.3bn, following –USD 4.9bn in May). Domestic Institutional Investors maintained their buying trend from the previous month, recording their 16th consecutive months of positive net flows (+USD 5.7bn in June 2022). (Source: Bloomberg, JP Morgan research)

MSCI India too declined by 6.8% (in USD terms), along with the broader EM markets in May (-6.7%). (Source: Morningstar; Currency: USD).

Government introduced a windfall tax on domestic crude oil producers, imposed export duties of INR 6/ltr on petrol and aviation turbine fuel (ATF), INR13/ltr on high speed diesel, and hiked the import duty on gold to 15% from 10.75% in efforts to reduce pressure on the rupee, rein in the current account deficit (CAD), and increase the domestic supply of petroleum products.

The Indian Meteorological Department (IMD) had said the monsoon rainfall over northwest India is likely to be 'normal' this year, which is 92-108% of the long term average.

Bond Markets

G-Sec yields surged as the Reserve Bank of India (RBI) hiked repo rate by 50 bps (to 4.9%) in the June MPC meet. The benchmark 10-year G-Sec yield crossed 7.60% on June 16, 2022, ~20 bps higher compared to 7.4% on May 30, 2022.

Yields, however, cooled down to 7.44% by the month end, buoyed by a lower May 2022 inflation print. The shorter-end of the G-Sec curve remained elevated, rising 10 to 20 bps over the previous month's end. State Development Loans (SDL) moved in a similar trend.

Corporate bond yields lowered slightly as the 10-year AAA-rated bond closed at 7.78% on June 30, 2022, down ~6 bps in a month. The 10-year AA-rated bond yield closed at 8.50%, down 9 bps in a month.

Excess banking liquidity continued to gradually lower in part due to RBI's action. We expect this trend to continue as the RBI has withdrawn its accommodative stance. On the auction front, the RBI mopped ~INR 1.3tn via sale of G-Secs; another INR 1.7tn via sale of T-bills. (Source: CCIL, NSE, BSE)

Monetary Policy

The Reserve Bank of India (RBI) in its third meeting for FY2022-23 on 8th June, raised the repo rate by 50bps to 4.9%, maintaining its focus on tackling inflation. The vote was unanimous, with all six members of the MPC also voting to" remain focused on the withdrawal of accommodation to ensure inflation remains within the target going forward, while supporting growth". Furthermore, the RBI increased its full-year FY23 inflation forecast by a full 100bps from 5.7% to 6.7%, reiterating its commitment to keep inflation expectations anchored. (Source: RBI)

Currency

INR depreciated sharply over the month (down 1.7% MoM) and ended the month at INR 78.97 per USD in June. The JPM EM FX Index was down 2.9% MoM in June. In the last 12 months, INR (-5.9%) though weaker, has performed better than the broader EM FX (-10.5%). RBI via its circular dated 06 July 2022, announced various measures to enhance forex inflows while ensuring overall macroeconomic and financial stability. (Source: Bloomberg)

Inflation

Retail inflation continues to moderate to 7.01% in June from 7.04% in the previous month due to moderation in food inflation. Core inflation — the non-food, non-fuel component of inflation — was at 5.95%, declining to less than 6% after a gap of three months. (Source: MOSPI, CRISIL Research)

Bank Credit/ Deposit Growth

Bank deposits grew 9.3% and credit growth by 12.0% y-o-y (a 35-month high) in June versus 9.7% and 10.8% in May. Overall, the credit growth improved due to growth in credit card outstanding, consumer durables, housing finance companies and Micro and Small Industries. (Source: RBI, CRISIL Research)

Liquidity

Net liquidity in the banking system reduced further to from INR 3.3tn as of May 31, 2022, to INR 2.9tn as of June 30, 2022. (Source: RBI)

GST Collections

GST revenue collection for June was at INR 1.44tn; up 56% y-oy and its second highest monthly collections since the launch of GST in 2017 (Source: Ministry of Finance)

Government Deficits

India’s fiscal deficit was 12.3% of the FY23 Budget Estimate (BE) on higher expenditure vs 8.2% of FY22 BE during the corresponding period last year (April-May).

India's current account deficit (CAD) for the quarter ended March 22 was sequentially narrowed to USD 13.4bn (1.5% of GDP) as remittances from overseas citizens as well as software exports surged and the outflow from dividend and interest payouts moderated. For the entire FY22, the current account deficit has come in at 1.2% of GDP, as against a surplus of 0.9% in FY21 as the trade deficit widened to USD 189.5bn from USD 102.2bn a year ago.

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Equity Outlook

Globally central banks are now on a policy tightening course with recessionary fears increasing amidst an environment of persistently high inflation. The war in Europe too continues to elongate with supply chain bottlenecks persisting globally. Going ahead, equity markets are likely to remain volatile as the extraordinary monetary and fiscal stimulus conditions recede around the world which might lead to a risk-off sentiments from EM equities. Foreign Portfolio investors have pulled out ~USD 29bn from Indian equities since the beginning of the year, which is one of the highest in comparison to its Asian peers.

Broad market valuation levels have moderated from their expensive levels back in October 2021 and are now at around their long term average levels. However, the recent market corrections haven’t been as disruptive yet as markets have been supported by resilient corporate earnings and increased participation of retail and domestic institutional investors. On YTD basis, domestic institutional investors have been strong buyers of Indian equities with cumulative net flows of more than USD 30bn, thereby offsetting foreign outflows. (Source: Bloomberg).

We would continue to accumulate companies with strong balance sheets, agile managements, low leverage and sustainable business models. We are positive on sectors which are closely linked to the economic recovery like real estate, banks, auto and telecom and also healthcare where valuations are reasonable.

Over the long term, we remain constructive on Indian equities owing to a conducive domestic environment, supportive Government policies focused on capex led economic growth, favorable external indicators - high forex reserves, increased share of Foreign Direct Investment (FDI) flows and increasing participation of domestic investors in equity markets which is a more structural trend.

Going forward, the pace of US Fed rate hikes in their further meetings and its normalization of balance sheets, trajectory of crude oil prices, geopolitical developments in Europe, RBI’s own pace of rate hikes and finally retail investor sentiments may provide cues for market performance. Market performance ahead could also be determined by earnings growth in coming quarters as the current high inflationary environment could lead to downgrades in the earnings estimates for some sectors.

Fixed Income Outlook

- We expect bond yields to remain elevated as the markets build rate-hike expectations from the RBI MPC meet in August. We expect higher fluctuations in the shorter-end of the curve than the longer-end as the term spreads at the longer end of the yield curve inch closer to their historical average levels.

- Going forward, active management will play a key part in navigating fixed-income markets due to fast-evolving macros involving global central bank tightening monetary policy and rising inflation levels.

- We are invested in floating rate bonds as the spread over 6-month T-bill is attractive and would get further adjusted to rising yields.

- Going ahead, we expect the RBI to prioritize containing inflation over supporting growth with a series of rate hikes in the upcoming meetings. Active management will be a key part in navigating fixed income markets going ahead. We also continue to maintain position in floating-rate bonds as a defensive stance due to rising rates.

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