India Equity & Fixed Income Markets

Market Commentary: January 2023

Global Economy

The US GDP grew at an annualized rate of 2.9% in Q4CY22, slowing down from a 3.2% growth in Q3CY22. The US Fed, in its February policy meet slowed its pace of rate hikes, increasing the fed funds rates by 25 bps, taking its benchmark lending rate range to 4.50% - 4.75%. The US Fed also indicated that the disinflationary process has started, although it would need to see substantial evidence of inflation been on a sustained downward path before any pause to take place.

The Eurozone economy expanded by 1.9% y-o-y in Q4CY22, compared to a 2.3% growth in the previous quarter. The European Central Bank raised its main refinancing operations rate by 50 bps to 2.50% and also indicated a further hike of the same amount in March.

The UK's economy contracted by a revised 0.3% from the earlier estimate of 0.2% on a sequential basis in Q3CY22. The Bank of England in its February meeting raised interest rates by a further 50 basis points to 4.0%, indicating that inflation risks remain significantly skewed towards the upside.

China's GDP growth slowed down from a 3.9% y-o-y expansion in Q3CY22 to 2.9% in Q4CY22. The People's Bank of China (PBoC) kept its interest rates unchanged for the fifth consecutive time in its January 2023 meet as the central bank looks to support the economic re-opening.

Japan's economy staged a recovery in Q4CY22, expanding by 2.3% on an annualized basis compared to a 0.8% contraction in the previous quarter. The Bank of Japan defied market expectations of a policy tightening, maintaining its key short-term interest rate at -0.1% in its January meet. It also maintained its yield curve cap on 10-year government bonds near to 0% levels. (Source: CRISIL Research)

Indian Economy

High frequency indicators in January continue to suggest that economic momentum remains robust. Air traffic, rail freight, electricity demand, bank credit, tractors sales – all show sequential improvement, whereas air cargo and container traffic (Dec) is slowing. In sequential terms, domestic demand strength seems to be offsetting external demand weakness. Demand side indicators like bank credit growth, tractor sales, consumer sentiment and rural wage growth are improving.

PMIs indicate sturdy sequential momentum in both manufacturing and services though there is a slight dip versus previous month. Manufacturing Purchasing Managers' Index (PMI) fell from December's recent high of 57.8 to 55.4 in January 2023, as the PMI data pointed to a 19th consecutive month of expansion. Services firms indicate robust growth in new business, which is resulting in capacity issue, but this is not yet transforming into inflation concerns with prices charged rising at a slower pace. The services PMI dipped slightly to 57.2 in January from 58.5 in December. (Source: CRISIL Research)

Equity Market Performance and Key Updates

Indian equity markets corrected sharply in the last few days of the month declining 3% in USD terms (MSCI India), thus underperforming the MSCI EM index which was up 7.9% in USD terms. The correction in the markets was particularly due to concerns around a US based research report on one of the big conglomerate in India (Adani Group of companies).

All sectors barring IT and Consumer Discretionary ended the month in the red. Midcaps declined 3.3% while smallcaps declined -0.5%. (Source: Morningstar Direct, Currency: USD)

Foreign portfolio investors (FPIs) remained net sellers of Indian equities in the month to the tune of USD 3.1bn while domestic institutional investors bought USD 2.4bn of equities. (Source: NSDL, BSE)

The Union budget for FY24 tabled in the Parliament on 1st February managed to strike a good balance between fiscal priorities, capital expenditure push (up 33% y-o-y) and resisted from any big populist measures. Key highlights of the budget were the substantial increase capex (INR 10tn from INR 7.5tn last year) focused on railways and roads, affordable housing program and urban infra development in Tier 2 and Tier 3 cities. The Budget also provided tax relief to the middle class and introduced various measures focused on sustainable energy, digitalization and inclusive development for all sections of society. There was also no tinkering with capital gains tax which is a positive. While doing all this, Government managed to remain committed to the fiscal glide path.

Bond Markets

Bond yields continued to rise on account of tighter liquidity conditions and strong credit growth. The benchmark 10-year G-Sec closed at 7.36% on January 31, 2023, up 3bps in the month. But the shorter end of the curve moved up higher; 1-year G-Sec yield climbed to 6.92%, up 20 bps. (Source: CCIL; RBI)

Similarly, the 91-day T-bill yield rose to 6.47%, up 10 bps in a month; 182-day T-bill yield rose 17 bps to 6.87%. Overnight yields had fallen during the month but rebounded to previous highs as surplus liquidity dried up. Liquidity surplus on a m-o-m basis moderated from INR 602bn to INR 25bn. The RBI's target call money rate closed at 6.45% on January 31, 2023, down 1bp over previous month's end. (Source: CCIL; RBI)

Corporate bond yields saw a similar flattening of the yield curve. The 5-year AAA corporate bond yield rose 7 bps to 7.75% whereas the 1-year AAA bond rose 15 bps to 7.77%. Credit spreads over G-Secs compressed in the shorter end of the duration and widened in the longer end of duration. (Source: NSE)

FPIs turned net buyers in Indian debt markets after 3 months with net flows of USD 435mn. (Source: CDSL, Morgan Stanley research)

Monetary Policy

The Reserve Bank of India (RBI) has raised its benchmark repo rate by a smaller 25bps to 6.5% in its latest policy meet on 8th February, as core inflation remained high despite signs retail inflation has peaked. The central bank said that its policy stance remains focused on the withdrawal of accommodation. The decision was voted by the committee with a 4:2 majority, as compared to a 5:1 majority in last meeting. In aggregate, the repo rate has increased by 250bps in the current financial year, from 4% to 6.5%. (Source: RBI)

Currency

INR appreciated 1.0% closing at INR 81.92 per USD in January. In the past 12 months, the INR has depreciated 8.9%. (Source: Bloomberg, JP Morgan research)

Inflation

Retail inflation rose to a three-month high of 6.52% in January, led by rising food prices. The annual inflation number has exceeded the Reserve Bank of India's tolerance limit for the first time in three months. Core inflation has remained steady at 6.09% from 6.10% last month. (Source: MOSPI, CRISIL)

Bank Credit/ Deposit Growth

Bank deposits grew 10.6% & non-food credit grew 15.5% y-o-y in January vs 10.4% and 15.8% in December. (Source: RBI)

Liquidity

Liquidity in the month has decreased, with the average daily absorption under the liquidity adjustment facility now at INR 25bn as of 31st January as compared to INR 602bn as of 31st December. (Source: RBI)

GST Collections

Gross Goods and Services Tax (GST) collections in January 2023 touched nearly INR 1.56tn, marking the second-highest monthly collections recorded since the launch of the indirect tax regime in July 2017. (Source: Ministry of Finance)

Government Deficits

Federal fiscal deficit for the first nine months of the financial year (Apr-Dec) rose to USD 121bn billion (59.8% of annual budget), as compared to a 50.4% deficit in same period last year.

Trade deficit in December widened to USD 23.8bn, as exports slowed down by 12% from a year before to USD 34.5bn, while imports dropped by a slower pace to USD 58.2bn in the month. (Source: MOSPI, RBI)

Equity Outlook

Indian market performance has remained subdued over the past few months as compared to other Asian markets on account of elevated valuations and also local bank deposit rates going up notably which may have prompted discretionary retail outflows from markets. Over the last month, in USD terms, MSCI India (-3%) has underperformed the MSCI EM index (+7.9%), thereby narrowing the valuation gap with EM index. Indian equities valuations are now closer to its own long term average levels. We believe there still lies some scope for valuations to normalize as compared to its emerging market peers and its own long term levels, which may keep markets volatile in the short term.

However, 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. As major developed & emerging economies grapple with multiple problems like rising inflation/interest rates and slow growth, India is doing relatively better and remains a favored destination to play the China +1 theme.

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 financials, auto, retail and some new age companies. In terms of market capitalization, on a valuation basis, large caps are better placed than mid cap and midcaps are better placed than small-caps.

Going forward, any pause in rate hikes by global central banks in their further meetings and their balance sheet normalization, trajectory of crude oil prices, any signs of resolution of conflict in Europe, inflation trajectory in India and finally retail investor sentiments may provide cues for market performance.

Fixed Income Outlook

The 10 year Gsec yield rallied by 8bps post the Union budget on 1st February due to lower than expected gross borrowing number and Government's commitment to fiscal consolidation path.

While growth has normalized, we believe the pace of fiscal consolidation remains slow. Strong tax buoyancy due to higher nominal growth (inflation included) made this year's fiscal deficit target comfortable. However, next year's conditions due to higher inflation base may make the fiscal deficit target difficult to achieve.

We expect economic growth to remain robust as the quality of spending remains good in the budget.

The higher inflation print as witnessed in January 2023 (6.52%) is uncertain for the inflation trajectory, with the RBI forecasting a 5.7% headline for Q4FY23. Higher than expected headline prints with a sticky core inflation, could imply a higher probability of central bank action in the April 2023 monetary policy meeting.

Changes in tax structure in select insurance products would be a dampener for the demand of long-dated bonds.

The yield curve is flat, making the term-premium unattractive. Hence, we continue with our stance of remaining cautious on the longer-end of the yield curve. We prefer to be invested on the shorter end of the curve and continue with our recommendation that accrual strategy will be the key driver of returns for fixed income investors going forward.

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