India Equity & Fixed Income Markets

Market Commentary: May 2022

Global Economy

The US GDP shrank at an annualized pace of 1.5% in Q1 2022, a downward shift from 6.9% annualized growth in Q4 2021. The US Federal Reserve on 4th May raised its benchmark interest rate by half a percentage point, the most aggressive step yet to contain the 40-year high inflation print in March 2022. The federal funds rate now lies in the range of 0.75%-1%, with the Fed hinting at further 50bps rate hikes in subsequent meetings with a more aggressive 75bps rate hike ruled out. Also, The Fed has started on its quantitative tightening journey with a balance sheet roll of worth USD 30bn in Treasuries and USD 17.5bn in mortgage-backed securities (MBS) to commence from 1st June 2022. After three months, the roll off for Treasuries will increase to USD 60bn and USD 35bn for MBS per month.

Euro area GDP expanded by a revised 5.1% y-o-y in the Q1 2022, higher than an upward revised estimates of 4.7% in Q4 2021 while the European Central Bank (ECB) maintained status quo on interest rates, although hinting at a faster than expected normalization of policy this year.

The Bank of England hiked its main interest rate for a fourth consecutive meeting, to its highest level in 13 years at 1% as UK's inflation rose to its highest level of in 30 years (7% in March 2022).

Japan's GDP contracted by 1% y-o-y in Q1 2022, from a revised 3.8% growth in Q4 2021. The Bank of Japan left its key short-term interest rate unchanged at -0.1% and that for 10-year bond yields around 0% during its January March meeting, and has also maintained its easy monetary policy stance.

China's GDP grew by 4.8% y-o-y in Q1 2022, quicker than the 4% increase in the previous quarter. Earlier, the Chinese government had cut its GDP growth target in CY2022 to 5.5% in order to focus on sustainable growth and stabilise its economic fundamentals. The People's Bank of China (PBoC) has 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

India's economic growth decelerated to 4.1% y-o-y in Q4FY22 (quarter ended March 2022), modestly lower than consensus expectations. The deceleration in private consumption to 1.8% y-o-y (vs 7.4% in Q3FY22) and a contraction of 2.9% q-o-q, weighed on growth momentum. However, a 30% q-o-q jump (and a 4.8% y-o-y rise) in Government spending arrested further downside and also aided in surpassing India's GDP above the pre-pandemic levels.

For the entire fiscal year, growth for FY22 came in at 8.7%, after a contraction of 6.6% in FY21. Growth was majorly driven by investments, largely Government spending, but also private investments in some pockets and by the Performance Linked Incentive schemes for the manufacturing sector to an extent. (Source: MOSPI, CRISIL)

Equity Market Performance and Key Updates

Indian equity indices continued to decline in May with benchmarks S&P BSE Sensex and Nifty 50 declining 3% each in the month in local currency terms, after the Reserve Bank of India (RBI) surprised the market with a rate hike to cull inflationary pressures and due to increasing concerns over an impending global recession. Concerns over persistently high inflation and expectations of further rate hikes and policy tightening by the central bank further dampened sentiments during the month. Both Midcaps (-5.3 %) and Smallcaps (-10.2%) underperformed Largecaps noticeably during the month. (Source: NSE; Currency: INR).

Among sector indices, Auto and FMCG sectors delivered positive performance in the month, rising 4.9% and 0.6% respectively while the Metals sector corrected by 16.4%. Auto shares gained after the Government cut excise duty on petrol and diesel by INR 8 and INR 6 per ltr respectively, which will result in a 7-8% reduction in pump prices. Metal stocks declined after the Government hiked export duties on iron and steel intermediaries and owing to fears of a global economic slowdown.

Government announced series of fiscal measures to help buffer the external commodity shock; 1) A cut in the gasoline and diesel excise duty by INR 8 and INR 6 per ltr respectively, which should result in a 7-8% reduction in pump prices, 2) Provision of INR 200 per cylinder (~20%) subsidy for 12 LPG cylinders annually for beneficiaries of the government subsidy scheme, 3) doubling of the fertilizer subsidy outlay in the Union Budget from INR 1.05 trillion to INR 2.15 trillion and 4) A cut in import duties on coal from 2.5% to 0% and the imposition of export duty on various items in the ferrous value chain (ores, pellets and steel products) to help cut domestic steel prices by ~7-8%.

Foreign portfolio investors (FPI) remained net sellers of Indian equities in May with net selling of USD 4.7bn, following net USD 3.8bn outflows in March. This marked the 8th consecutive month of net equity outflows for FPIs, with YTD outflows of USD 22.1bn. FPIs continued their selling in the debt markets too, with USD 752mn of outflows, following USD 518mn of outflows in April. Domestic institutional investors recorded inflows of USD 6.6bn in May, maintaining their buying streak since March 2021. (Source: Bloomberg, JP Morgan research)

MSCI India too declined by 6.0% in the month, underperforming the MSCI EM Index which gained 0.1% in USD terms during the month (Source: Morningstar; Currency: USD).

On the COVID front, cases in the country have started rising again in the past few weeks, with the new daily cases now at ~4,000 per day as compared to nearly 1000 per day for the past few months. The surge in cases have been led by the states of Maharashtra and Kerala, with both the states now bringing back the mandatory masking requirements. However, vaccination coverage levels remain healthy with a total dose being administered at ~1.95bn up to date, with ~88% of the adult population now fully vaccinated.

Bond Markets

G-Sec yields surged after the Reserve Bank of India (RBI) surprised the markets with a repo rate hike of 40 bps (to 4.4%) and an increase in CRR to 4.5% (from 4%), both announced at an off-cycle MPC meet on May 4, 2022. The benchmark 10-year G-Sec yield rose to 7.42% on May 31, 2022, up 28 bps in a month. The shorter-end of the curve felt the most impact of rate hikes, with the 1-year G-Sec yield jumping to 6.01% on May 31, 2022, up 90 bps in a month. Corporate bond yields rose steeply as well.

The 10-year AAA-rated bond ended May at 7.84%, up 53 bps in a month. The 10-year AA-rated bond yield closed at 8.59%, up 54 bps in a month. (Source: CCIL, NSE, BSE)

T-bill yields, too, saw a steep rise of 80-100 bps during the weekly auctions. Overnight yields remained above 4% for most of the month. Interbank call money rates hovered below the RBI's repo rate of 4.4% in May owing to surplus liquidity in the system.

Monetary Policy

In a continuation of the off-cycle meet last month, the Reserve Bank of India (RBI) on 8th June raised the repo rate by 50bps to 4.9%, maintaining its focus on tackling inflation. The vote was unanimous, while 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". RBI also revised its inflation outlook for FY23 meaningfully upwards from 5.7% earlier to 6.7%, justifying the front loading of rate hikes while it maintained its growth forecast for FY23 at 7.2%. (Source: RBI)

Currency

The INR depreciated sharply over the month (down 1.6% m-o-m) and ended the month at INR 77.64 per USD in May (Source: CRISIL Research)

Inflation

The CPI inflation for May 2022 was softer than expected at 7.04% compared to 7.79% in April. The core CPI reported was lower at 6.1% in May, also lower than expectation from 7.2% in April'22. The fall in inflation was primarily a function of base effects over last month and the recent measures by Government to keep inflation in check. (Source: MOSPI, CRISIL Research)

Bank Credit/ Deposit Growth

Bank deposits grew 9.7% and credit grew 10.8% y-o-y in May compared with 10.0% and 10.1% growth in April, respectively. (Source: RBI, CRISIL Research)

Liquidity

Net liquidity in the banking system reduced further to its pre-Covid levels of INR 3.3tn as of May 31, 2022, from INR 5.4tn as of April. (Source: RBI)

GST Collections

Goods and Service Tax (GST) collections in May 2022 increased 44% on year to INR 1.41tn, but dropped 16% m-o-m. The decline in May can be attributed to the fact that historically collections for May (which pertains to activity in April) is always lesser than collections in April (which pertains to activity in March), the financial year end. (Source: Ministry of Finance)

Fiscal Deficit

Fiscal deficit for FY23 has been budgeted at 6.4% of GDP by the Government. (Source: Union Budget FY23 documents)

Equity Outlook

Globally central banks are now on a policy tightening course with RBI too finally beginning its rate hike cycle. The war in Europe too continues to elongate with supply chain bottlenecks persisting amidst COVID related lockdowns in China. 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 22bn 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, however, the recent market corrections haven't been as disruptive yet as markets have been supported by resilient corporate earnings in the past few quarters and expanding high frequency macro indicators.

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. On YTD basis, domestic institutional investors have been strong buyers of Indian equities with cumulative net flows of more than USD 24bn, thereby providing support to equity markets. (Source: Bloomberg).

Going forward, the pace of US Fed rate hikes in their further meetings and its normalization of balance sheets, crude oil prices and the geopolitical developments in Europe and RBI's own pace of rate hikes 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

- The outcome of the monetary policy meet on 8th June was on expected lines as inflation concerns continue to gain prominence over growth. However, we expect inflation levels to be comparatively higher despite the upwards revision by the RBI.

- The hike in the policy is expected to push the overall yields up and expect longer-end to more protected compared to shorter-end due to the high term premium.

- Going ahead, we expect the RBI to prioritize containing inflation over supporting growth with a series of rate hikes in the upcoming meetings.

- We expect yield curve to flatten and shorter-end to elevate in a bear flattening scenario. We continue to be positioned in floating-rate bonds as a defensive stance due to rising-rate environment and expect them to outperform all other fixed-income instruments in the current rising interest rate scenario.

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