ICICI Asset Management

India Equity & Fixed Income Markets

Market Commentary: August 2022

Global Economy

The US Gross Domestic Product (GDP) shrank at a 0.6% annualized rate last quarter, contracting at a more moderate pace than initially thought in the second quarter as consumer spending blunted some of the drag from a sharp slowdown in inventory accumulation. US Fed Chair maintained his hawkish stance post the recently concluded Jackson Hole conference, hinting at further interest rates hikes and committing to keep interest rates elevated until inflation is decisively under control, even if it comes at the cost of a slowdown in the economy.

The Eurozone GDP rose 0.6% q-o-q in Q2 2022 for a 3.9% y-o-y rise, slightly downwards revision from the earlier estimated 4% y-o-y growth. The European Central Bank has raised interest rates for the first time since 2011, by 50bps to 0% and plans to further hike rates later in the year as inflation in the Eurozone came in at 9.1% in August.

The UK's economy expanded 2.9% y-o-y in Q2 2022, compared to 8.7% growth in Q1 2022. The Bank of England raised its main interest rate by 50 bps to 1.75%, its steepest hike since 1995, to counter surging inflation.

Japan's economy grew an annualized 2.2% in Q2 2022, as robust private consumption provided a boost to the country's long-delayed recovery from the COVID-19 pandemic. The Yen on plunged to its lowest level against the US dollar since August 1998 as hedge funds in Europe and the US resumed bets that the Bank of Japan's ultra-loose monetary policy would continue.

China's government have implicitly dropped their official 5.5% GDP growth target for the year and shall strive to 'achieve the best possible results for the economy', without mentioning a hard growth target. China's GDP growth in the H1CY22 has meanwhile slowed to 2.5% y-o-y. The People's Bank of China cut its five-year loan prime rate to 4.3% from 4.45% previously and the one-year loan prime rate to 3.65% from 3.7%. (Source: CRISIL Research)

Indian Economy

Q1FY23 real GDP growth came in at 13.5% y-o-y, below consensus expectations of 15.2%, aided by private consumption growth of 25.9% y-o-y and investment growth of 20.1% y-o-y. Nominal GDP was quite strong, expanding 26.7%YoY. While the growth in the June quarter was largely supported by a rebound in contact-intensive services consumption on economic reopening, Government's capex push and improving capacity utilisation levels, a drag came from lower net exports.

India's manufacturing sector activity in August witnessed the second-strongest improvement in operating conditions in nine months, boosted by strengthening demand conditions and softening inflation concerns, with the Manufacturing PMI index remaining steady at 56.2, as compared to 56.4 in July. The Index of Industrial Production's (IIP) winning streak continued with 1.3% m-o-m increase in June on the back of healthy growth in May (0.4%) and April (2.9%). This means that, on a year-on-year basis, IP was higher than expectations printing at 12.3%. (Source: CRISIL Research)

Equity Market Performance and Key Updates

Indian equities gained +4.1% in USD terms (MSCI India), continuing its upward momentum in August on the back of softening inflation prints and expectations of smaller rate hikes by the Reserve Bank of India going ahead, while outperforming the MSCI Asia Pac ex-Japan and EM indices (+0.4%/-0.01%). Performance of both Midcaps +4.3%) and Smallcaps (+5.2%) was better than Largecaps (+4.1%). All sectors barring Healthcare and Information Technology ended the month in the green. (Source: Morningstar Direct; Currency: USD)

On a YTD basis, India has been a significant outperformer (-3.5%) as compared to the broader MSCI EM (-17.5%), MSCI World (-17.8%) and MSCI EU (-26.9%) markets. (Source: Morningstar Direct; Currency: USD)

FPIs were buyers of Indian equities in August after reversing the previous trend of selling in July (+USD 6.3bn, following +USD 0.8bn in July). So far, India has seen YTD FPI outflows of USD 21.5bn. FPIs also turned net buyers in the debt market after 6 months (+USD 539mn, following –USD 291mn selling in July). DIIs saw selling to the quantum of USD0.9bn in August, reversing the buying trend observed since March 2021. Mutual funds and Insurance funds were both net sellers in August with USD 0.2bn outflows and USD 0.7bn outflows respectively. (Source: Bloomberg, JP Morgan Research)

Bond Markets

Benchmark 10-year treasury yields averaged at 7.25% in August (14bps lower vs. July average). On month end values, the 10Y yield moderated by 13bps to end the month at 7.19%. A pullback in domestic and US inflation numbers and expectations of slower pace of rate hikes from the RBI going forward buoyed the sentiments in the bond markets.

On the shorter end, overnight yields moved up ~30 bps to 5.3% in a month. The 91-day T-bill yield rose ~7 bps to 5.63%; 182-day T-bill yield rose 17 bps to 6.06%. (Source: CCIL; RBI)

Similar trend was visible in corporate bonds as yields on the 10-year AAA-rated and AA-rated bonds fell ~7 bps in a month to 7.61% and 8.34%, respectively. Meanwhile, the 1-year AAA bond yield rose 33 bps to 6.78% and AA bond yield rose 27 bps to 7.48%. (Source: NSE, BSE)

Monetary Policy

The Reserve Bank of India (RBI) in its fourth meeting for FY2022-23 on 5th August, raised the repo rate by 50bps to 5.4%, maintaining its focus on tackling inflation. The rate hike seemed to be front loaded on account of elevated higher core inflation and current account deficit. The vote for 50bps hike was unanimous, with all but one 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 maintained its FY23 inflation projection at 6.7%, reiterating its commitment to keep inflation expectations anchored. (Source: RBI)

Currency

INR depreciated by 0.2% over the month and ended the month at 79.46/USD in August. In the last 12 months, INR (-8.1%) though weaker, has performed better than the broader EM FX (-11.8%). (Source: Bloomberg, JP Morgan research)

Inflation

CPI inflation eased to a 5-month low 6.71% in the month of July down from 7.01% in June. While the Wholesale inflation eased to 13.93% in July which had spiked to 15.18% during the month of June. (Source: MOSPI, CRISIL)

Bank Credit/ Deposit Growth

Loan growth continues to improve, up 15.3% y-o-y as of August 12, vs. 14.5% y-o-y in the previous fortnight (July 29, 2022), while the deposit growth moderated to 8.8% y-o-y vs. 9.2% last fortnight (July 29, 2022).

Loan-deposit (LD) ratio inches up to 73.3% vs. 72.9% last fortnight, with the Incremental L-D ratio is running high at 120% vs. 110% in the previous fortnight. (Source: RBI, CRISIL)

Liquidity

Banking system liquidity surplus remained nearly flat in the month at INR 1.14tn, as compared to INR 1.05tn in the beginning of the month. (Source: RBI)

GST Collections

Goods and services tax (GST) collections in August came in at INR 1.44tn in August this year, 28% higher than the same month in last year. Growth in GST revenues in the fiscal year period up to August 2022 (April-August) over the same period last year is 33%, continuing to display very high buoyancy. (Source: Ministry of Finance)

Government Deficits

India's fiscal deficit was 20.5% of the FY23 Budget Estimate (BE) in the fiscal period up to July 2022 (April – July) vs 21.3% of FY22 BE during the corresponding period last year.

Trade deficit narrowed USD 28.7bn, from an all-time high of USD 31bn in July, as imports rose at a slower pace while exports contracted. (Source: MOSPI, RBI)

Equity Outlook

Markets have continued their upward momentum in the month due to anticipation of smaller rate hikes by the Reserve Bank of India going ahead on the back of softening inflation prints in India. Globally though, 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.

Broad market valuation is still above their long term average levels and are not cheap. 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 Banks, Auto 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. As major developed & emerging economies grapple with multiple problems like rising inflation and rising rates, slowing growth and contracting economic activity, India is relatively doing better on these parameters and remains of the favored destination to play the China +1 theme.

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, inflation trajectory in India 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 the RBI to continue to prioritize taming inflation over supporting growth, despite moderating inflation.
- Expect rate hikes in the upcoming policies as Inflation is likely to remain above the RBI's target range of 4% +/- 2% on account of imported inflation due to dollar strengthening and elevated energy prices.
- Economic indicators suggest that we are currently in the growth phase of the economic cycle. In this phase, normally credits spreads tend to widen, making spread assets more attractive. Going forward, we expect accruals to become a dominant source of returns, compared to capital appreciation.
- Going forward, active duration management will play a key part in navigating fixed-income markets due to fast-evolving macros involving global central bank tightening, rising inflation levels and recessionary pressures.
- We continue to be positioned in floating-rate bonds as a defensive stance as the spread over 6-month T-bill is attractive and would get further adjusted with rising yields. We expect them to outperform all

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