India Equity & Fixed Income Markets

Market Commentary: February 2023

Global Economy

The US GDP grew at an annualized rate of 2.7% in Q4CY22, slowing down from a 3.2% growth in Q3CY22. The US Fed, in its February policy meet hiked 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 another 50 bps to 3% and also indicated a further hike of the same amount in March.

The UK's economy expanded by 0.4% on a y-o-y basis in Q4CY22, compared with 1.9% growth 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.

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 at 0.5% levels. (Source: CRISIL Research)

Indian Economy

Real GDP growth for the quarter ending December 2022 slowed down to 4.4% y-o-y, lower than consensus expectations. The slowdown can be mainly attributed to loss in momentum of private consumption, which grew by 2.1% y-o-y as compared to 8.8% y-o-y growth previous quarter. On the positive side, fixed capital formation and exports have continued to hold up, driven by Government's infrastructure spending and services exports respectively. (Source: CRISIL Research)

Equity Market Performance and Key Updates

Indian equity markets corrected for a third month in a row, with the MSCI India index declining 4.6% in USD terms. Market sentiments were affected by the hawkish policy stance by global central banks post resurgence in inflationary pressures, escalation of geopolitical tensions in Europe and the continuing spillover effects of the correction in Adani Group stocks post the cancellation of its Follow on Public Offer worth INR 200bn. Indian markets outperformed the broader EM index though, as MSCI EM corrected by 6.5% in the month.

All sectors barring Staples and Capital Goods ended the month in the red with Utilities, Metals and Energy correcting the most. Midcaps and Smallcaps relatively outperformed the broader MSCI India index, correcting by 2.7% and 2.9% respectively. (Source: Morningstar Direct, Currency: USD)

Foreign portfolio investors (FPIs) sold USD 647mn worth of Indian equities while domestic institutional investors bought USD 2.3bn during the month. (Source: NSDL, BSE)

Bond Markets

Bond yields continued to rise on account of concerns around negative global cues in the form of non-farm payroll data in US which could lead to further rate hikes by the Fed. Also, inflationary pressures resurged in January led by food inflation which has led to renewed expectations of another rate by the Reserve Bank of India in its April meet. The benchmark 10-year G-Sec closed at 7.43% on February 28, 2023, up 9bps in the month. But the shorter end of the curve moved up by much more; 1-year G-Sec yield climbed to 7.23%, up 31 bps. (Source: CCIL; RBI)

Similarly, the 91-day T-bill yield rose to 6.89%, up 42 bps in a month; 182-day T-bill yield rose 38bps to 7.22%. Overnight yields too have risen by 31bps to 7.04% as surplus liquidity has dried up. The RBI's target call money rate closed at 6.65% on February 28, 2023, up 20bp over previous month's end. (Source: CCIL; RBI)

FPIs continued their net purchase of Indian debt in the month with net inflows of USD 302mn, following USD 435mn net inflows in January. (Source: CDSL, Morgan Stanley research)

Monetary Policy

The Reserve Bank of India (RBI) raised its benchmark repo rate by 25bps to 6.5% in its latest policy meet on 8th February, as core inflation remained high. The Central Bank said that its policy stance remains focused on the withdrawal of accommodation. (Source: RBI)

Currency

INR depreciated over the month (down -0.9% MoM) and ended the month at 82.67 per USD in February as compared to INR 81.92 per USD in January. In the past 12 months, the INR (-8.9% YoY) has underperformed the JP Morgan EM FX index (-5.7%). (Source: Bloomberg, JP Morgan research)

Inflation

India's retail inflation edged down slightly to 6.44% in February from January's three-month high of 6.52%. However, the inflation print stayed above the Reserve Bank of India's (RBI) upper tolerance level of 6% for second straight month. (Source: MOSPI, CRISIL)

Bank Credit/ Deposit Growth

Bank deposits grew 10.1% and non-food credit growth by 15.9% on-year in February vs 10.6% and 15.5% in January. (Source: RBI)

Liquidity

Liquidity in the month remained adequate, with the average daily absorption under the liquidity adjustment facility now at INR 182bn as of 28th February as compared to INR 25bn as of 31st January. (Source: RBI)

GST Collections

GST collections for February 2023 came in at INR 1.50tn, up 12% from the corresponding period a year ago. (Source: Ministry of Finance)

Government Deficits

Fiscal deficit for the first ten months of the financial year (Apr-Jan) rose to USD 206bn (67.8% of annual budget), as compared to a 58.9% deficit in same period last year.

Trade deficit narrowed to a twelve-month low in January 2023 as a continuing decline in exports was accompanied by a decline in imports. The trade deficit narrowed to USD 17.75 billion in January, compared with USD 23.76 billion in December 2022. (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. On a YTD basis, in USD terms, MSCI India (-7.4%) has underperformed the MSCI EM index (+0.9%), thereby resulting in moderation of its valuation premium to EM peers. While Indian equities valuations are now closer to its own long term average levels, we believe there still lies some scope for valuations to normalize 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, market share gainers and sustainable business models. We are positive on sectors which are closely linked to the economic recovery like banks, auto, E-commerce and retail. 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, equity markets seem to be on a firm footing for this year as inflation and interest rates are likely to peak soon, which is supportive of equity market returns. Foreign investor positioning too has reduced over the past year which could support markets once flows reverse. We expect Indian markets to deliver high single digit returns in CY2023. Going forward market could take cues from global central policies, trajectory of crude oil prices, any signs of resolution of conflict in Europe, inflation trajectory in India and sentiment of retail investor flows.

Fixed Income Outlook

High inflation and anticipated hawkishness from the US Fed due to strong growth numbers in the US may force the RBI to continue hiking rates. We believe the appeal of Indian fixed income as an asset class has increased significantly. This is because of the higher yields provided by the environment's high inflation and rising interest rates. The yield curve shape has also flattened, bringing down term premiums and the extra carry from long-dated securities. A suitable investment approach would be to invest in shorter one- to three-year portion of the curve.

With the economic cycle advancing from slowdown to growth, and no sight of rate cuts in the near term, we expect credit spreads to expand further. In such a phase, we expect accruals to become a dominant source of returns Overall, fixed income yields are above the inflation rate, delivering a positive real rate of return, making it a good year for investment.

INR has depreciated less compared to the broader basket of currencies, providing some scope for further depreciation to make it competitive.

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