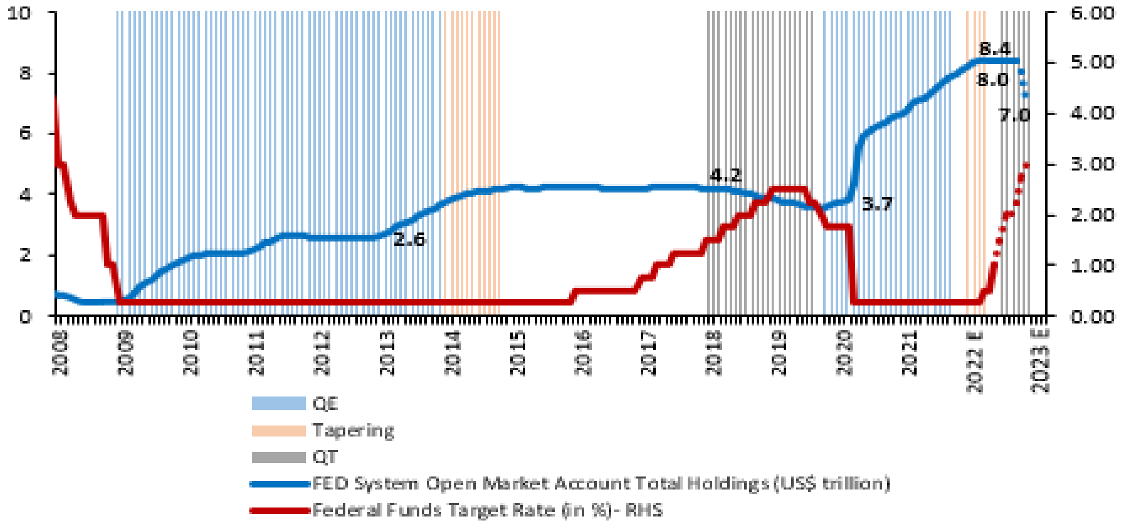
Market Insights- June 2022

As the war in Europe drags on, financial markets continue to take cues from high frequency data that may point to signs of weakening growth and peak inflation. 10 Year US treasury yields have swung between 3.13% to 2.74% over the last month on growth negative data and settled flat over the month. Implicit in this move seems to be the hope that central banks would step in at the first sign of market stress or weaker growth data by dialling down/going slow on Monetary tightening. With global inflation running at decadal highs, the monetary policy response to a Stagflationary environment is unknown. The US FED is scheduled to start its Quantitative Tightening from June with a monthly run off of USD 47.5Bn from its balance sheet. How this process plays out alongside policy rate hikes could have a material bearing on financial market outcomes over time. Currently the market expects FED funds rate of close to 3% by February 23.

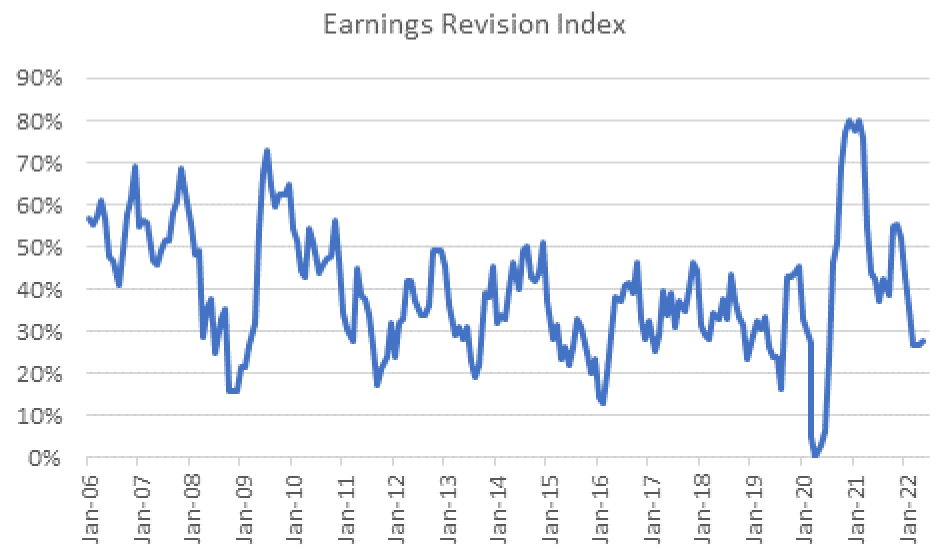



## Equity:

May was another rough month for Indian equities. The Nifty and the Sensex recovered quite a bit from their respective intra month lows but still finished lower by 3% and 2.6% respectively. Broader market performance was significantly weaker with the Nifty Midcap 150 and the Nifty Small cap 250 indices losing 5.2% and 8.6% respectively for the month. The 10-year G-sec yield increased by another 28 bps for the month to end at 7.42%, proving to be a major headwind for equity valuations. Indian consumer price inflation surging to 7.79% and the RBI's out of turn policy announcement to hike policy rates by 40bps acted to exert upward pressure on yields. The government announced a slew of measures to provide relief on inflation including excise cuts on fuel, export duties on steel and reducing import duties on coal. However, elevated global crude oil prices continue to be a worry. Locally, monsoon will be a monitorable for its impact on crop and inflation.

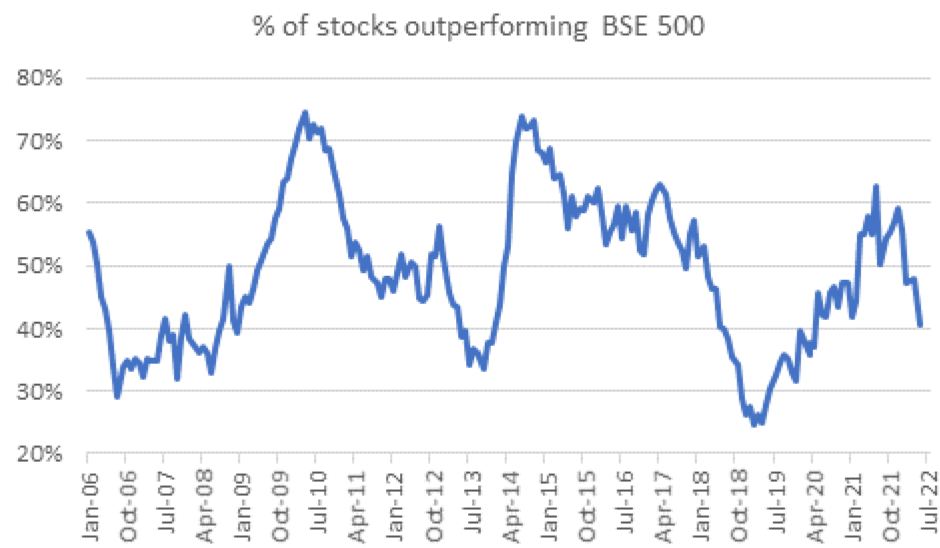
Overall, rising prices and the challenge it poses for policy makers continue to be major headwinds for risk assets globally. Higher rates impact equity valuations adversely. Persistent higher inflation and rates may also adversely impact demand, margins, and hence corporate earnings. This is already reflecting in earnings downgrades outweighing upgrades in India with nearly 3 in 4 stocks seeing earnings being revised downwards. This is consistent with the continuing deterioration in market breadth.

**Earnings revisions in India continue to be negative with nearly in 3 in 4 stocks seeing downgrades…**




*Source: FactSet, SBIFM Research*

**…which has also resulted in deteriorating breadth of stock performance**




*Source: FactSet, SBIFM Research. Note: % of BSE500 stocks outperforming the index over the past 12 months.*

Inflation therefore stays the biggest monitorable for risk assets in the near term. On that front, we continue to keep an eye out on global money supply growth which has already decelerated to 3% odd from nearly 20% towards the end of CY20. A sharp decline in money supply should have a favourable impact on global inflation in time. However, it is likely to be accompanied by a decline in economic activity as well.

**Sharp deceleration in globally money supply growth may be a precursor to slowing inflation and growth**


*Source: Bloomberg, SBIFM Research. Note: Approximated by adding up US, Eurozone and China money supply measures.*

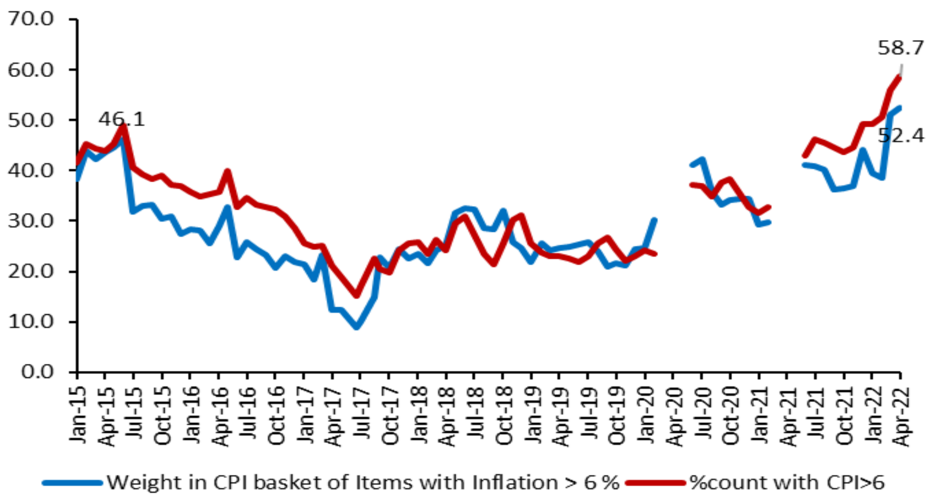
The near term therefore stays challenging. We however continue to see the interim turbulence as an opportunity to add on to pro-economy assets to benefit from a long-term manufacturing/capex led upcycle on the other side of the current inflation challenge.

**Fixed Income:**

The off-cycle Policy actions by the RBI in the first week of May 22, set the tone for market trends over the last month. At the same time, the Central Government announced various measures including export ban on wheat and export duty on steel apart from tax cuts on oil products. The excise duty reductions on petrol and diesel are expected to lead to a modest reduction in headline inflation by about 30 bps over time. The government measures have at the same time held up hopes of potentially lesser RBI monetary actions. While fiscal measures are a necessary enabler in the current context, it may not be sufficient as the Monetary conditions continue to be accommodative even now.

Higher nominal GDP growth, better compliance and tax buoyancy helped by conservative budgeting may enable the central government to avoid additional market borrowing at least in the first half of this fiscal year. The additional expenditure to be incurred on fertiliser and food subsidy alongside the excise duty reduction and lesser dividend from the RBI may to some extent be made up through higher gross tax revenues. We do not anticipate fiscal dynamics to move bond yields at least for the first half, notwithstanding the heavy supply schedule and lack of RBI OMO support, unlike the previous years. The Monetary policy cycle and expectations on sequencing as well as the terminal rate may be the key variable of interest in the near term.

The RBI faces the challenging task of normalising monetary policy settings alongside a tightening of financial conditions globally that could over time lead to emerging concerns around growth. In the near term, market has been broadly conditioned to expect the Policy Repo rate to move to 5.15%, with debates largely surrounding the sequencing of the same. However, both persistence of elevated inflation as well as increasing dispersion of items in the CPI basket with higher than 6% inflation would warrant closer vigil and timely action. About 59% items captured in CPI basket by count & 52% by weight report inflation above 6% vs. ~40% few months ago. Wider dispersion of higher inflation in the retail price basket is clearly evidence of probable second order effects. This would necessitate additional policy actions alongside normalisation of liquidity. We expect FY23 CPI to average around 6.7% and the RBI is widely expected to review the FY23 CPI projections upwards from the current level of 5.7%. Real policy rates based on expected CPI of 6.7% stays negative even if policy rates move to 6% over the year.




Source: SBIMF research

Beyond policy rate actions in the near term, the more challenging aspect would be to anchor inflation expectations, which probably has been conditioned at 6% over the last year or so. More than moving policy rates in the near term to pre pandemic levels, the biggest challenge would be to gradually condition expectations towards the midpoint of the inflation target i.e 4%. The role of liquidity conditions in the transmission of policy rate has probably been reinforced with the CRR hike announced in May. Guiding the tolerance band for surplus liquidity around a specific range on NDTL seems a long overdue measure, more so as the monetary cycle has shifted. Sufficient analytical basis is available around this, more so with the RBI Currency & Finance report 2022 identifying surplus liquidity beyond 1.52% of NDTL as inflationary based on long period data from 2000-2020.

With the RBI having shifted its tone and initiated the process of normalisation, implied policy rates as indicated by the swaps market seem to be pricing in policy rate at around 7% within a year. The impact of the off-cycle rate action has also led to market yields moving up across the curve, with the benchmark 10y moving up by around 26bps over the month. Given that we are quite early in the policy normalisation process, its likely that as rates and liquidity normalise, market yields as well as spreads could continue to reset directionally higher, though the magnitude may be debated. A front-loaded policy rate adjustment seems more likely rather than a long drawn-out rate adjustment process considering the domestic and external backdrop. We expect the policy rate adjustment process to be completed over the fiscal year.

A lower duration stance in the near term, though with adequate flexibility in duration mandate would enable debt investors to navigate the changing dynamics. In this context, rather than target a specific level on the benchmark, investors with duration appetite may choose to incrementally take exposure on a staggered basis over the coming months as the RBI continues to normalise monetary policy settings. Investors with moderate duration tolerance could benefit from the higher carry offered by the reset of money market and short-term rates.