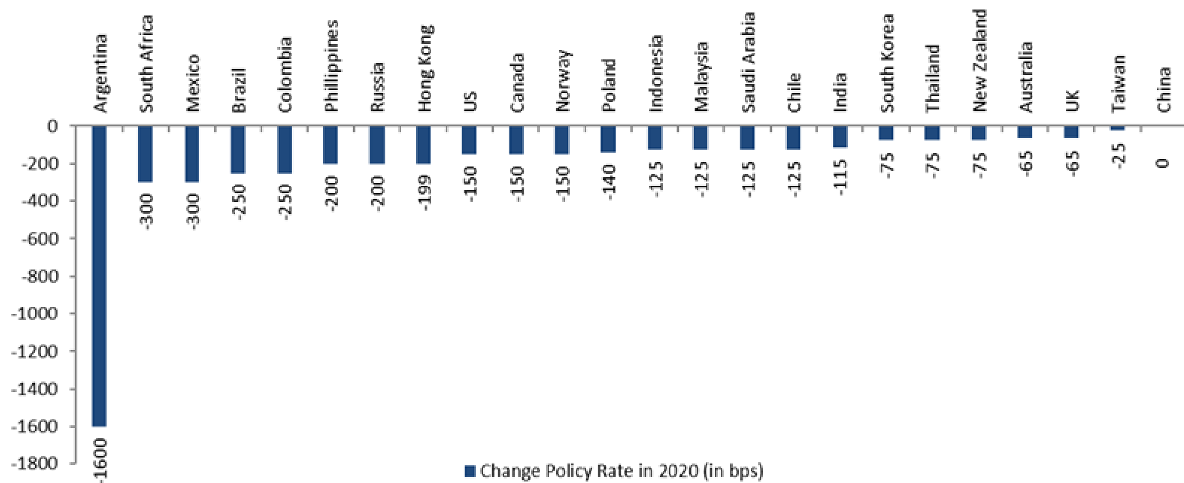
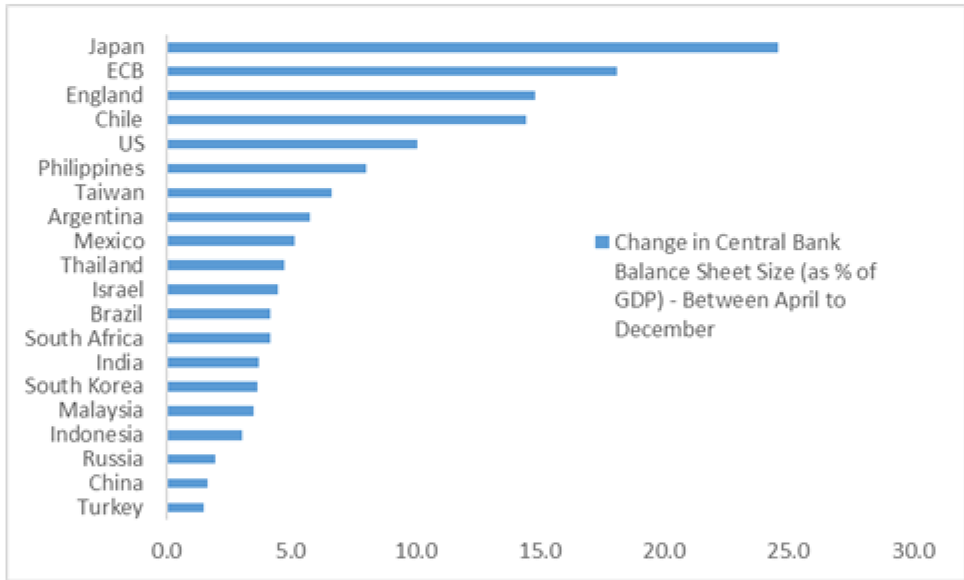
Market Outlook

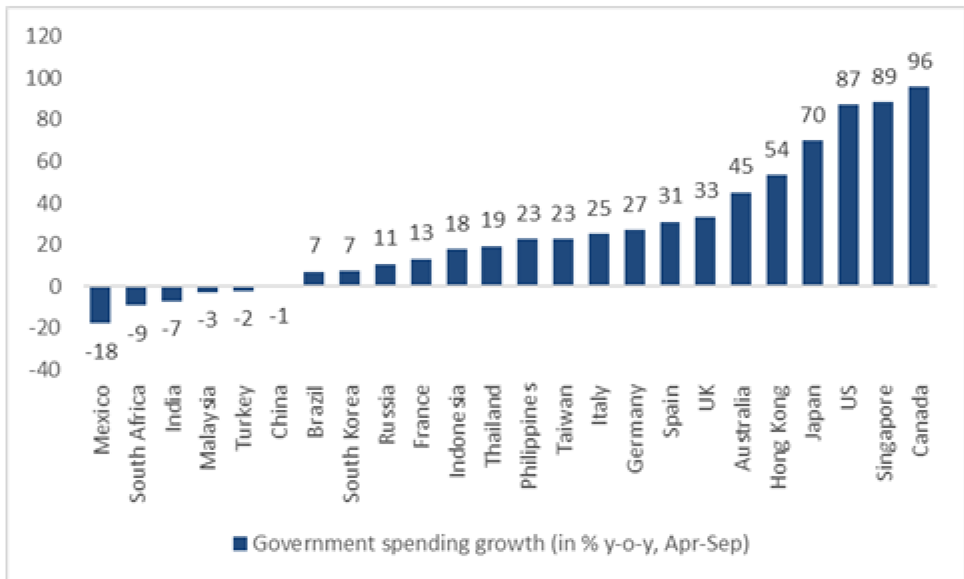
Central bank interventions backstopping financial markets have been the abiding theme in global markets for a while, which got accentuated last year. As financial markets went into a tailspin with the Pandemic induced effects during Feb- March 20, Central Banks turned on the liquidity spigots led by the FED. This was accompanied by large fiscal policy interventions in the developed world. Fiscal policy support till the end of June 20 amounted to about 19.8% of GDP in Advanced economies and about 5.1 % in EM's (Source RBI). This has led to markets bouncing back over the rest of the year. While the economic recovery from the shutdown and rollout of vaccines provide a positive tailwind for markets, the effects of low discounting rates on asset price valuations should not be undermined. The 'low for ever 'discourse on risk free rates remains preponderant as well as the 'Central Bank Put '. Large fiscal stimulus measures have been backstopped with central bank bond purchases, with even direct monetization been resorted to, by EM central banks like Bank Indonesia. Mainstreaming of 'Modern Monetary Theory' with central bank printing presses backstopping fiscal measures is not probably far away.

The other notable actions have been the US Fed changing the monetary policy framework to an average inflation targeting approach and the Euro Zone 750 Bn Euro Recovery Fund, potentially opening the door to an eventual debt mutualization or at least a closer fiscal framework. In the near-term, fiscal policy actions would take centre stage to provide the much-needed support for growth recovery, with all eyes on the incoming new US administration and its policy actions. This sets the stage for capital flows into India and other EM's to be a constant variable to track as we head into CY21.



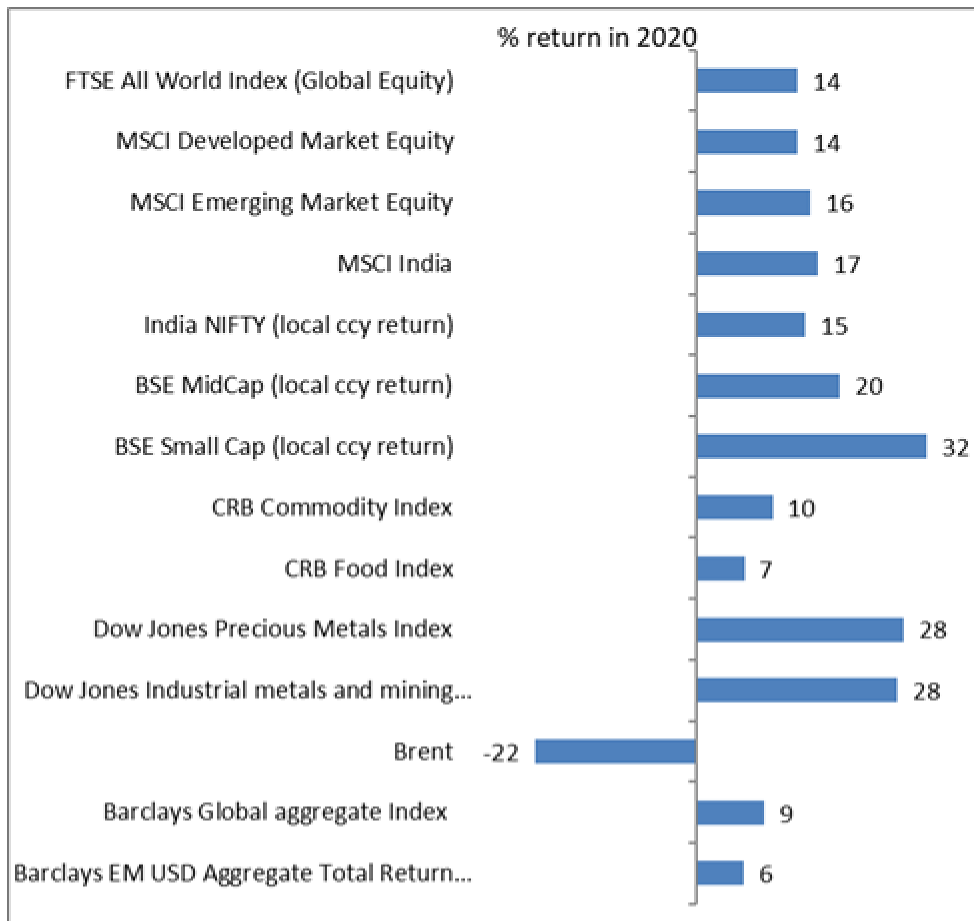
source- Bloomberg, SBIMF Research





source- Bloomberg, SBIMF Research

From the financial markets viewpoint, the narrative has quickly changed from deflation to reflation as a result. An important consequence of this massive policy support has been a surge in government debt burdens to levels last seen only during World War II. Liquidation of this debt may necessitate keeping nominal rates 'lower for longer' and real rates negative for several years to come. On the other hand, the policy action has led to an unprecedented surge in broad money growth, again to the extent not seen over the last several decades. While negative real yields themselves have portfolio implications and force investors to diversify into other assets, the belief that rates will stay low even as growth picks up and/or inflation flares up has helped a surge in risk assets across the board.



source- Bloomberg

Equity

Equities are now expensive on conventional valuation metrics and continue to be driven by the narrative on equity risk premium, which compares the currently low earnings yield to even lower bond yields. We believe while these narratives can help frontload equity returns, continued sustained up move requires a substantial uptick in corporate earnings. Indeed, starting at multi-year lows on the corporate profits to GDP ratio in India currently, there is room for catch-up in earnings. Last few years have seen a clean-up in Indian banks' balance sheets, corporate balance sheets are much healthier, cost structures are leaner and there have been significant reforms around corporate taxes, PLIs, labour laws, agriculture and so on. Additionally, if the current efforts by global policy makers for a successful reflation do fructify, that may just do the trick for India's corporate profit cycle to revive.

As we move into 2021, it is evident that sentiment has swung firmly, from extreme despair in March to optimism now and valuations have rerated alongside. Sticking to investment discipline and asset allocation stay as important as they have always been. A successful global reflation is still not a given. Loose fiscal policy from governments could bring too much inflation too soon while being too restrictive on the other hand may lead to failure to beat deflationary forces. Treading a prudent middle path is critical. Market internals suggest that polarizations still stay high. Market capitalization stays polarized towards large caps versus mid-small caps. Similarly, relative underperformance of value versus quality is at multi-decade highs. Emerging market equities have been massive underperformers versus developed world peers, especially the US, over the past decade. These polarizations should reverse if a successful reflation does materialize. Given the still elevated uncertainties and in the

context of high market polarization, being bottom-up should be more rewarding versus staying focussed on aggregates.

Debt

CY 20 has been an eventful year for the domestic debt markets. India has been an outlier as the larger growth shock has been accompanied by CPI inflation above 6% all through the year. This has complicated RBI policy choices along with the liquidity deluge arising out of unsterilized capital flows. The large negative economic shock on account of the pandemic led the RBI to cut policy rates by 115 bps to 4% and institute multiple liquidity infusion windows such as TLTRO's and LTRO's and a CRR reduction. Large capital flows subsequently led to additional liquidity infusion as the RBI has pushed back against currency appreciation. This has pushed the effective operating rate to even below the reverse repo of 3.35%, thereby providing a larger effective policy easing than implied by the Repo rate cuts as well as significant tightening of corporate credit spreads. FPI debt flows have stayed negative through the year.

The RBI also stands apart from its peers in having allowed a large amount of the additional market borrowings to be absorbed by the market. Active interventions through outright OMO's in dated securities have been limited so far with liquidity neutral Twist Operations being conducted. While the government borrowings through dated securities have been ramped up by additional Rs 5.10 trillion, the same has been largely to cover the revenue shortfalls including the GST compensation. Effectively the burden of stimulus measures has been borne by monetary and liquidity policy as fiscal constraints have handicapped government spending. This is evident from the year to date government expenditure data with total government spending for the year likely to be even lower than the Budget estimate of Rs 30.4 Trillion.

At the same time, reforms measures on various supply side issues as well as incentivizing manufacturing through PLI schemes have been announced. Government relief measures have been targeted at welfare measures such as food support scheme under PMGKY and credit guarantee schemes. These measures have rightly focused on providing support to the needy while recognizing the resource constraints on the fiscal.

CY21 starts with the positive news flow surrounding the impending rollout of India's first Covid vaccine approval. This should lead to a more accelerated normalization of economic activity. Government budget for FY22 would be framed in the context of a gradually recovering, though fragile economic context. While tax revenue would be expected to pick up from FY21 actuals, the requirement of larger market borrowings may remain, especially as government spending is likely to be scaled up to support a recovery. This can be mitigated through better realization under the asset sale/ divestment program. Improvement in India's fiscal dynamics would be a multi-year process , given that the fiscal problems have been simmering for a while, largely masked by prospects of higher nominal growth, accounting adjustments as well as the support from a funding source that is predominantly domestic and in local currency. Return to rapid growth and widening the tax base are the only medium-term solutions towards a sustainable and moderate Public Debt/ GDP ratio. In this context, measures would be anticipated to increase the direct tax / GDP ratio through better compliance. Recent measures to plug revenue leakages in the indirect tax regime are rightly designed and would over time lead to better tax realisations both on the indirect and direct taxation fronts.

For the coming year as recovery normalizes, government borrowings may continue to require RBI support in the absence of additional demand sources. From a debt market perspective, RBI actions in CY 20 has rightly prioritized growth with the central bank looking through above target inflation. The

prospects for CY21 would be dependent on the evolution of the sequential growth momentum. The monetary and liquidity setting required for preventing/ limiting economic damage during a pandemic induced shock could be different from that required to nurse a recovery, especially in a context where CPI readings remain elevated. While we remain confident that the peak in CPI is behind us, it is important to recognize that the RBI MPC resolution in Dec has provided an expected range for CPI between 4.6%-5.2% for H1 of FY22.

The prospects for the debt markets accordingly should be based on the anticipation that the extra ordinary monetary support would be incrementally unwound as recovery in growth materializes. The near-term prospects on capital flows, the existing overhang of liquidity and the requirement of market intervention (both government securities and Fx) may necessitate activation of sterilization tools to absorb liquidity at the margin. A transition from excessively surplus to moderate surplus liquidity stance is likely with a gradual alignment of money market rates at least to the reverse repo rate and over time closer to the policy rates. Policy repo rate may remain on hold for a reasonable time in the absence of further inflation shocks. The RBI current stance of a passive yield curve control with targeted / tactical OMO/Twist Operations may remain the preferred market intervention strategy for a while. This should anchor long end rates in a range, with a gradual flattening of the curve. While segments of the sovereign rates curve continue to provide relative value, investors in debt products would need to potentially moderate return expectations given the existing lower absolute yields and the likely normalization in monetary conditions over time.

Wishing all a very Happy New year.

Mutual Fund investments are subject to market risks, read all scheme related documents carefully.