2021 OUTLOOK

As we enter 2021, the pandemic continues to dominate the news, with the frantic rollout of vaccination across countries offering much needed light at the end of the dark COVID tunnel. After the worrisome trends in September, India has managed to get good control over the spread of the virus over past few months with the most recent weeks' data being very heartening.

A QUICK LOOK AT OUR MACRO INDICATORS AT THE START OF 2021

- India's growth outlook has undergone significant upwards revisions compared to the dismal projections earlier in the year, with the degrowth in FY21 being much lower than earlier feared, and estimates for FY22 being notched up based on healthy readings of various high frequency indicators.

- Inflation as measured by CPI remained above the 6% upper bound for most of CY20, testing the tolerance levels of the RBI MPC. However, December has seen much needed collapse in prices of food articles, especially vegetables. This is likely to sharply bring down December CPI closer to 5% level, vindicating the wait and watch policy adopted by the RBI MPC. Core inflation however, remains a worry, with various supply side issues as well as higher input prices across many industries likely to keep core CPI elevated at above 5%.

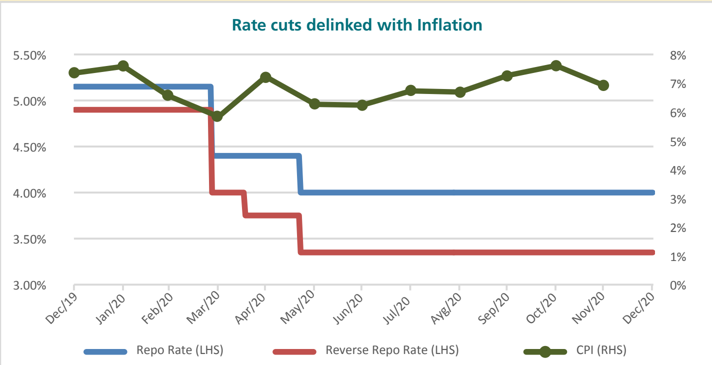
- Balance of payments situation remains very strong, with strong capital inflows (FDI and FPI) leading to a surge in FX reserves. While this offers tremendous protection for the sovereign from future uncertainties, it has also led to build-up of huge surplus liquidity in the system and if the trends in FX reserve accumulation continue, this could become a bit of a headache for policy makers.

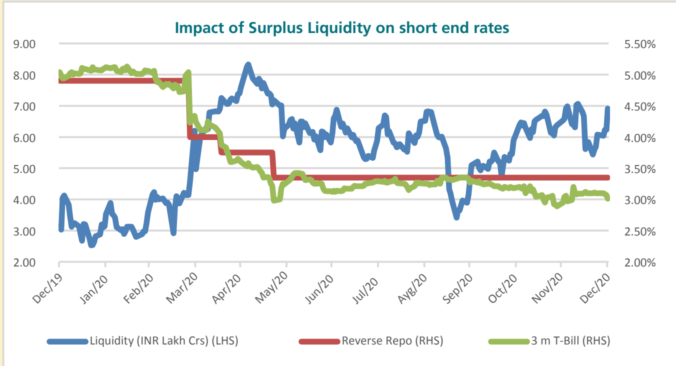
- Fiscal response to the negative growth impulse has been extremely measured and well targeted. While there was a sense that this approach could turn out to be short of what the economy needed, in hindsight- the approach has been vindicated given that the Government had to be equally mindful of the debt burden that these extraordinary measures could leave behind for the future.

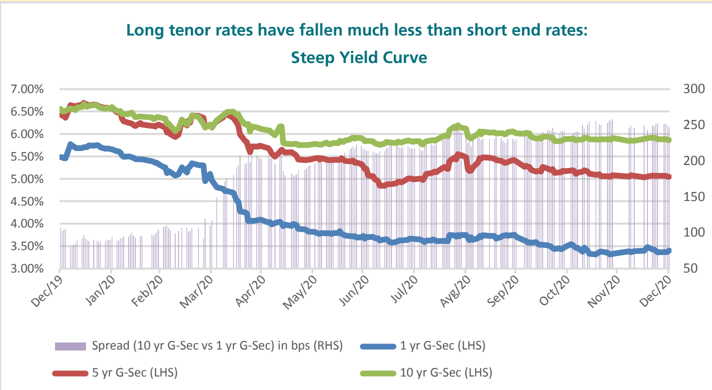
- The RBI, under the helm of Mr. Shaktikanta Das, has done as much as any EM central bank could, in terms of the plethora of measures announced, its out-of-the-box solutions, and the speed with which it has acted. The MPC, on its part, has acted in sync with other policymakers, cutting rates to the maximum extent possible, and more importantly providing forward guidance and comfort on the continuity of support to the growth recovery, despite CPI continuously being above its upper band.

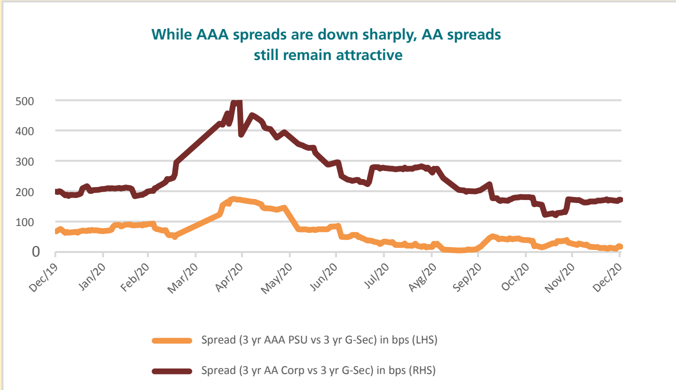
All in all, we enter 2021 – with a much more positive outlook on our growth recovery, than we could ever have imagined during the worst months of the pandemic. While equity markets have responded with indices at all time highs, bond markets haven't been too far behind – with yields at the shorter end being at all-time-lows and the longer end yields being well hinged despite the huge increase in borrowings by the centre and states. In such an environment, most Fixed income categories have seen healthy capital gains aiding returns.

LOOK BACK AT 2020









WE OUTLINE BELOW A FEW OF OUR EXPECTATIONS OF POLICY AND MARKETS OVER THE COMING YEAR

- Thanks to the presence of Mr. Das at the helm of RBI, monetary policy is likely to continue to be as growth supportive as possible. While this still may not leave any room for further rate cuts, it should at least ensure that the exit from such ultra-easy policies would be a very gradual process, spread out over the next couple of years. Risk of sharp pullbacks in interest rates is unlikely, even if the MPC has to deal with CPI (especially core CPI) continuing to remain elevated.

- Over the next few months, we expect the RBI to gradually nudge overnight rates higher, closer to the reverse repo rate of 3.35% - while ensuring that it is not interpreted as a hawkish signal, but more to preserve the sanctity and credibility of the rate setting process.

  In the second half of the year, we could see the band between reverse repo and repo – which was widened from 25 bps to 65 bps – to be reverted back to 25 bps, thereby taking the reverse repo rate to 3.75%. However, confidence in the growth recovery needs to strengthen further for this to happen. Hence, we believe such a move is unlikely to happen till Q3 or Q4 of CY21.

  For the MPC to start thinking of hiking the current repo rate of 4% towards where we were pre-COVID (i.e. 5.15%), the growth recovery needs to be well entrenched with the most severely impacted segments also showing clear signs of recovery. We believe this is probably a 2022 event, with a base case of repo reverting to 5.15% towards the end of 2022.

- While the above scenario is based on very limited visibility of the recovery process, it does help us with a base case of rate trajectory over the coming few years and juxtaposing it with the level and shape of yield curve to identify value across the curve.

- With interest rates at the short to medium end of the curve having moved sharply lower over past few months, we believe interest rates in those segments are not as attractive as they were earlier, although the carry offered is still good. **Investors should be more mindful of their investment horizons while picking funds across the shorter duration buckets. Having maturities which are spread out over the coming few years, thereby allowing for reinvestment at likely better interest rates, should start to contribute positively to returns**, unlike the period so far where adopting a bullet investment approach made more sense.

- Moving to the longer end of the yield curve, the biggest protection there is that interest rates have continued to remain elevated (i.e. fall has been relatively less), and the extreme curve steepness has ensured that the carry in the longer end of the curve offers enough cushion to absorb a gradual normalisation of policy rates. Moreover, it would remain critical to ensure that the government's borrowing program goes through without a surge in borrowing costs, and to that extent - the RBI under Mr. Das is likely to take steps as required over the coming years, to prevent a disorderly upward rise of interest rates at the longer end.

  Accordingly, **we believe that despite a bottoming out of interest rate cycle, the longer end of the G-Sec and AAA PSU curve offers sufficient carry to still be an attractive investment opportunity for investors with a 3 year + horizon.**

- **Spreads on less liquid AAA and some of the good quality AA securities still remain attractive**, and as focus of market participants shifts from the era of capital gains to one of carry and yield pickup, we expect these segments to offer good value as well.

HAPPY INVESTING AND WISH YOU ALL A WONDERFUL 2021

Source: Bloomberg, Daily Valuation Reports