L&T Financial Services
Mutual Fund

RECAP OF THE YEAR GONE BY...

As the world moved into the second year of the pandemic, Governments and Central Banks globally faced the challenge of reviving the dwindling growth on one hand, while keeping inflation in check. Growth took center stage while inflation took a back seat. While Governments provided the quintessential impetus to growth through fiscal stimulus, Central Banks complemented through accommodative policies by providing surplus liquidity and absorbing bond supply through monetary policy tools. Easing of restrictions, progress on vaccination and pick up in spending resulted in a rebound in growth.

However, as the year progressed and economic activity picked up, inflationary pressures which earlier seemed transitory in nature turned out to be more entrenched. Supply side bottlenecks and soaring commodity prices added to concerns. Although resurgence in infections across the world has emerged as a threat to global recovery, various Central Banks are now pushed to act to stem the spiraling inflation. The eventual impact of recent outbreaks might be seen over the next few months

The past year has been fairly volatile across asset classes, both globally and from a domestic perspective. Equity markets scaled new highs across various economies, however, threats around newer variants of the virus denting economic growth resulted in periods of correction. Commodity prices have seen a surge this year. Recovery in manufacturing activity and rising supply bottlenecks pushed metal prices higher before seeing some softening. Crude prices have remained elevated on improving demand conditions and have in turn fed into inflation for major oil-importing nations. Bond yields which had remained benign in the earlier part of the year, edged up higher as inflation pressures prompted various Central Banks to commence exiting from ultra-easy monetary policy stance.

On the domestic front, with a pick-up in external demand, exports have remained buoyant. Imports also rebounded sharply on the back of the revival of domestic demand and higher Crude prices. Recent PMI prints have also been encouraging. Fiscal deficit for Apr-Oct 2021 is at 36.3% of Budget estimates (FY2022) on the back of robust tax collections. However, Government spending is expected to pick up. The recent supplementary demand for grants might put some pressure on the budgeted fiscal deficit. On the other hand, timely progress and completion of bond index inclusion will provide a positive sentiment in an otherwise cautious market environment. The Centre reduced the excise duty on petrol and diesel in November. Although this is marginally negative from a fiscal perspective, buoyant tax collections would most likely render the impact redundant. Excise cut augurs well from an inflation perspective, though an increase in telecom tariffs could possibly offset the positive impact.

RBI has used G-Sec Acquisition Programme ("G-SAP") as an effective tool to absorb part of the large supply of Government bonds and to anchor yield expectations. Liquidity has remained surplus to facilitate a conducive financial environment for economic recovery. Over the last few months, RBI has deployed Variable Rate Reverse Repo ("VRRR") auctions as the primary tool for liquidity management. Multiple tenor VRRR auctions have been conducted to push short-term rates higher. This will most likely be followed by a hike in the Reverse Repo rate, followed by a shift of accommodative stance to neutral and eventual hike in the Repo rate. However, RBI has been careful in guiding markets that the overall lift-off process will be gradual and non-disruptive.

EXPECTATIONS FROM 2022

As we head into 2022, the world is dominated by the rapid spread of the Omicron variant. While the numbers are mindboggling, the relatively muted impact of the virus on health gives enough reason for the hope that this too shall pass. If this trend holds up over the coming few months, central banks globally may remain focused on their path of gradual policy normalisation, liquidity absorption and rate hikes, which should keep yields inching higher.

- As markets become comfortable that growth will hold up despite these moves, we expect the longer end of DM yield curves to move up more rapidly than they have done so far.

Closer home - with RBI clearly indicating that they are in no hurry to take away monetary support prematurely, the decision to shift stance from accommodative to neutral may be delayed by a few months.

- The first priority remains to narrow the LAF corridor to 25bps, which should happen by April, instead of February as expected earlier. If by that time, we are past the Omicron hump (hopefully with no other new variants to deal with), the RBI is expected to shift to a more balanced approach between supporting growth and controlling inflation.
- We expect inflation, especially core, to remain in uncomfortable territory, which should push the MPC to shift stance to neutral by the middle of the year and hike repo rates by atleast 50bps in CY22, a scenario already priced in by the short to medium end of the yield curve.
- With a rising current account deficit and volatile global flows environment, maintaining policy credibility with regard to flexible inflation targeting becomes that much more crucial and may force RBI to focus on policy normalisation somewhat faster than currently telegraphed.

The trickier question is about the longer end of the curve, which so far has been controlled closely by RBI actions.

- With liquidity already in huge surplus, the central bank's ability to do outright OMO purchases would be limited and the demand-supply mismatch would lead to markets pushing yields higher to check the RBI's resolve on this issue. Timely announcement of India's inclusion in the global bond index can help prevent some of the damage.
- We expect the 10-year G-Sec benchmark to gravitate towards the 6.75-7% zone through the course of the year.
- Credit spreads remain very low, as supply has underwhelmed the liquidity-driven demand for bonds. Expect this to change, as issuance gradually picks up and spreads widen towards historical ranges.

Accordingly, we would continue to be somewhat cautious in the positioning of our funds and advise investors to do the same. ***Carry is indeed attractive for going longer on the yield curve – however, it needs to be clearly synchronised with the investment horizon of investors.***

...Cont. Expectations from 2022

While Covid worries are likely to wax and wane over the coming months and quarters, leading to high levels of uncertainty around future projections of growth and inflation, the RBI has clearly communicated that future policy normalisation would be gradual, well-calibrated and telegraphed, which ***should provide debt investors with much needed comfort against any abrupt sharp movements of interest rates, in our view.***

HAPPY INVESTING

AND

WISH YOU ALL

A WONDERFUL 2022

Source: Bloomberg, Daily Valuation Reports