India Outlook 2022

Focus on growth but keep an eye on volatility

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As we close the year it appears that the easy transition gains of pandemic driven economies into the restoration and the expansion phase are more or less behind us. Asset classes have displayed handsome returns across the globe be it equities, commodities or crypto currencies. Emerging market debt, gold, US treasury bonds were asset classes that delivered negative returns for the year. From a style perspective "quality" outperformed both "value" as well as "growth". While most developed market equities delivered handsome returns some emerging market economies such as India delivered very good returns.

The global economy seems to have recovered from the Covid shock aided by policy support across countries almost in a concerted manner. Whether one takes US personal income, the OECD unemployment rate or China industrial production, all parameters are unequivocally positive for the year so far. Record economic activity figures are complemented by sharp drops in unemployment numbers and rising personal incomes. The direct impact is felt in demand led inflation and price of essential and industrial commodities have seen a steady rise. A number of economists debated that this inflation was led by a start-stop nature of a global economy coming back after a shock, and that it may transitory, a number of factors have now emerged that make this debate a little contentious. A number of market experts and commentators have opined that inflation this time can remain "sticky" and that the world is unprepared for a longer period of inflation. However, our base case remains that inflation is transitory.

A few key themes emerge as a result:

- The strength in markets over the past 18 months has compressed yields and risk premia, reducing future returns. Stocks should continue to outperform
- Many of the temporary factors that are boosting inflation now should peak in Q1 2022. Inflation will decline thereafter as supply chains repair and consumption rebalances from goods to services
- The warp-speed recovery has created uncertainties in the global macro system. Investors need to be prepared for this
- China's economy has slowed under the headwinds of a property sector downturn, power shortages, and past policy tightening. Flexible policymaking limits further downside
- The easy gains from re-opening are now mostly exhausted. In the expansion phase, we are past the peak of GDP and profits, while policy is normalising

The India story

While the global situation looks to slow down, India appears to be in a sweet spot. Multiple tail winds starting from being a little behind on the restoration curve to policy response already moderating indicating it being slightly ahead of the curve offer some sustainable market environments. However, valuations continue to remain elevated compared to various parameters either over longer term historical averages or on an absolute basis. From an economic growth perspective India should continue to see secular and sustained growth in the coming couple of financial years

Corporate earnings are expected to rise for FY23 at a brisk pace after delivering above average earnings growth for FY22. This performance is on the back of the "re-opening" trade and the buoyancy seen in corporate revenues driven by sustained demand. Cyclical companies and consumer discretionary is seeing order growth at unprecedented levels. Oil prices are finding themselves in domestic inflation and erratic rainfall has seen a steady rise in food prices.

The upcoming election in the crucial state of UP also sets up a stage for uncertainty for the markets. Markets crave constancy and the latest about face by the central government on agricultural laws has put a question mark on continuing reform momentum. While this could be a minor setback the upcoming elections now become a barometer of the popularity of the central government and resultant volatility if there is a surprise.

Inflation and interest rates continue to remain under pressure however a dramatic rise in either is not the base case. It is expected that government revenues on the back of robust GDP growth will not lead to additional borrowing and while there may be a gradual hardening of interest rates a certain portion of the same appears to be priced in.

We continue to reaffirm that equities will perform much better than other asset classes in the coming year based on robust earnings expectation and benign interest rate regime. Interest rates will remain low and active fixed income investors could exploit the steepness of the curve at the forward end as it gradually flattens. Commodity markets are expected to be volatile given the uneven recovery expected to happen globally and with rising interest rate expectations emerging in the US, developing markets may see weaker currencies.

We continue to emphasize that climate change and sustainable themes will continue to attract responsible capital. An exposure to these themes can provide a much needed inflation buffer that traditional fixed income instruments may be unlikely to offer in world markets. We recommend a judicious asset mix in the coming year that is most likely to remain challenging from a returns perspective. Individual investors are encouraged to look at their risk thresholds before investing in risk assets and understand the long term nature of asset returns.

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Source: HSBC Asset Management India, Data as on 6 Dec '21 unless otherwise given

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