

Event Update

Fed rate hike and outlook

US Federal Reserve's decision to increase policy rates by 25 bps (first time since 2018), has come in-line with market expectations, hence there is no surprise element. Prior to the announcement yesterday, the only question was whether Fed would opt to wait out this policy, considering the ongoing geopolitical crisis and reassess the impact on growth. However, that was not to be the case, with policy makers focusing more on the inflation concerns and has gone ahead with the anticipated commencement of the rate hike cycle. The real GDP growth for 2022 was scaled down sharply to 2.8% from 4% earlier while inflation expectations have been revised upward (by 170 bps to 4.3% for end 2022). Going to the finer details, the market was plotting a series of 7 hikes of 25 bps each in 2022 (i.e. cumulative 175 bps) and now that has been confirmed in Fed's further hawkish shift during this meeting. The Fed officials are now penciling this estimate in the dot plot with a high degree of consensus established on this front (lowest dot plot suggest about 5 hikes). So there is a convergence of view between market and Fed, about the quantum of hikes expected this year. Further, median dot plot is indicating another 100 bps hike in 2023 too. Closer home, the RBI has remained dovish so far with an accommodative stance to support economic recovery. However, with domestic inflation remaining sticky, RBI may be forced to revise their inflation estimates higher and is likely to commence a rate hike cycle sometime over the next 3-6 months.

Impact on equity markets: There is no immediate impact on equity markets as the Fed's rate hike cycle has largely been on expected lines. In the US, the Dow Jones index rose 1.6% while tech-heavy NASDAQ index gained 3.8% on 16 Mar 2022. Back home, Nifty index is up 1.8% on 17 Mar 2022. Sentiments were also helped by reports of peace talk between Russia and Ukraine and resultant moderation in global crude oil prices. The focus now shifts to the Fed's balance sheet reduction decision (i.e. Fed taper). While there FOMC didn't release much details after yesterday's policy meeting, the finer details are expected in the FOMC minutes to be released in early April. There are indications that the Fed's balance sheet tightening process could begin as early as mid-May (as opposed to earlier expectation of mid-June) and could be done at a faster pace than the last cycle. This reaffirms the view on an important transition underway in the global markets viz shifting away from the era of zero interest rates and gradually moving from liquidity surplus era to a gradual tightening phase. So a liquidity withdrawal process coupled with rate hike cycle, could mean some headwinds for equity markets to contend with for the remainder of 2022. That is because, the risk free assets will turn slightly more attractive (given higher interest rates), while higher yields could moderate the valuation multiples for equities. Another risk is in the form of moderation in global growth (as indicated in the sharp revision of US GDP growth by Federal Reserve). Having said that, history indicates that equity markets have done not so badly in the rate hike cycle. In fact, as per a Bloomberg report, in the previous eight hiking cycles, the US equity markets (S&P 500 index) was higher a year after the first increase, every single time. The market valuations have come-off from the peak post the recent correction and that should help the short term performance. Given the twin variables of rising rates and withdrawal of liquidity, the equity returns are likely to moderate from the levels we have seen in the COVID recovery phase. As a result, over the next 1-2 years, equity returns shall largely come from earnings growth rather than valuation multiple expansion, in our view.

Investment & portfolio view: There are no immediate changes envisaged in the portfolio stance as a result of yesterday's US Fed's action. However, we shall continue to monitor incoming data, especially with respect to inflation and global growth, which are likely to influence the earnings trajectory of our investee companies. We remain focused on the fundamentals of our investee companies and especially the earnings growth trajectory. But we will reassess the scenario on a regular basis, especially in light of the earnings impact on rising input costs (sustained higher inflation) and any structural changes in our thesis w.r.t investee or potential investee companies in light of the monetary policy actions, globally and locally.

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