To 'Hike' Or Not to 'Hike'

16th Mar 2023

To be or not to be, pondered Prince Hamlet in William Shakespeare's masterpiece 'Hamlet'. Though written by Shakespeare nearly five centuries ago, various versions of Hamlet's musings seem to find relevance across different aspects of life with Central bank policymaking being no exception. Post an unrelenting pace of rate hikes over the past year, market participants are building expectations of the US Federal Reserve reflecting on the path ahead as well as rein in terminal rate expectations as it meets on the 21st March. What changed then? And why this sudden expectation buildup on US Fed changing its iron clad grip on interest rates?

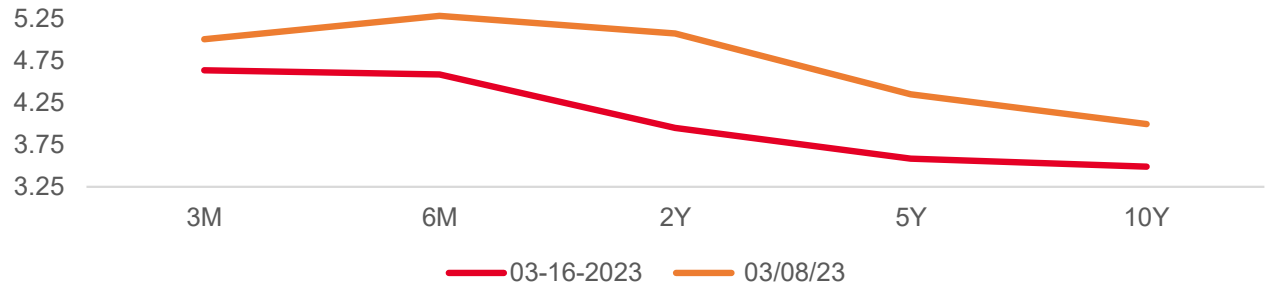
It seems that the recent incidence of US based Silicon Valley Bank (SVB) going under, among other things, led to a sharp spike in marked to market losses even in shorter tenor sovereign holdings, and has aided market chatter on US Fed holding onto the current rates.

The jobs data for Feb'23 was a mixed bag. Non-Farm Payrolls job additions came in higher than market expectations at 311k (exp 205k), unemployment inched higher to 3.6% (prev 3.4%) even as labor force participation increased marginally to 62.5 (prev. 62.4%) while hourly wage growth went up marginally to 4.6% (prev 4.4%) but below forecasted growth of 4.8% .

US CPI data release for Feb'23 registered a growth of 6% YoY and 0.4% MoM, down from 6.4% and 0.5% increases in Jan'23 respectively. While the headline inflation growth for both time period is in line with market expectations, core CPI continues to be resilient, registering MoM growth of 0.5% which is higher than consensus estimates and will be keenly watched by the US FOMC when they meet on the 21st of March to decide on the future path of interest rates.

Market Impact : US 2 year and US 10 year yields crashed post the SVB saga, falling by ~100 and 40 bps (down ~20% and ~10%) respectively from the peaks as on 8th March when 2-year treasuries topped 5% yields and inversion between the 2 and the 10-year spreads breached 1% , the highest since Sep'81 and currently hover around ~60 bps. US equities witnessed sharp corrections, with Dow Jones and S&P 500 correcting nearly 2%, as risk off sentiments gained ground. USD Index has remained steady around ~105 highlighting continued strength in USD.

Change in weekly spreads between 3m to 10y US sovereign Curve



Source : Bloomberg , Lighthouse Canton

BoJ hints at continuing with QE, while BoE and ECB uphold hawkish projections :

Outgoing Bank of Japan Chair Haruhiko Kuroda vowed to continue his stance on easy monetary policy as he kept interest rates unchanged at -0.1% while reiterating BoJ's objective to keep 10-year sovereign yields at near zero levels. BoJ reiterated the continuation of their current stance till CPI (not considering fresh food) meaningfully breaches the 2% mark and stays there for an extended period (Japan's Jan CPI was at 4.1%) Kazuo Ueda was also officially appointed as the new BoJ Chair in their policy meeting held on the 10th Mar'23. A proponent of accommodative monetary policy, he is expected to carry forward Kuroda's legacy to continue the path of enhancing Japan's economic activity to increasingly robust levels.

At the other end of the spectrum lies the European Central Bank (ECB) which hinted at a 50-bps hike in benchmark rates in their Mar'23 meeting scheduled for 16th March, with another 100-bps rate hike expected in the near future, thereby taking benchmark rates from 2.5% currently to roughly 4%. ECB's chief economist also hinted at broader level CPI projections for the calendar year in the band of 4.1% to 8.1%, thereby highlighting significant unpredictability in the Euro area inflation trajectory with volatile energy prices being the key culprit. Euro Zone CPI for Feb'23 stood at 5.6%.

Bank of England (BoE) which is set to announce its decision on interest rates on the 23rd Mar'23 is anticipated to hike benchmark rates by 25 bps, thereby taking their base rate to 4.25%, which we believe could be the terminal rate for the time being as also hinted by the BoE Governor Andrew Bailey. The current base rate of 4% is at a fifteen-year high. However, unlike the Euro Zone, inflation in England is expected to drop steadily primarily owing to the high 'base' effect owing to a sharp spike in energy prices since April'22.

Market Impact :

Japan – Japanese Yen, which had appreciated considerably towards the end of 2022 and early 2023, post touching a 35-year low of ~150 to around 128 levels against the USD, restarted its downfall on the back of BoJ's reaffirmation of its accommodative stance and currently trades in the 133 handle. 10-year Japanese Government Bond yields currently trading at 0.28%, much below the targeted 0.50% bps, managed yield barometer primarily owing to risk-off sentiments while Nikkei gave up on most of its gains over the past week, though it's up ~5% YTD.

Euro Zone – EUR-USD currency pair has stabilized at around ~1.07 handle after briefly breaching parity in and around Sep and Oct'22 when it lagged US Fed in policy actions. However, rumors of instability around a major European financial institution led to further weakening of the currency pair which went down to the 1.06 handle. Euro Stoxx 50 gave up a major part of its gains over the past few days but is still up 4.6% for the year.

England – GBP-USD has stabilized around the 1.21-22 handle and 10-year yields have crashed by 65 bps from a high of 3.9% at the start of the month of March. It currently trades around 3.25%, primarily due to dovish statements from the BoE Governor recently. FTSE though, had a quiet start to the month of March, down ~5% for the month and up 0.03% YTD.

US Banks in Focus, even as a large European Institution aids trepidation:

US Mid-sized banks garnered all the global investor attention over the past few days. Regulators announced the closure of Silicon Valley Bank on the 10th of March, which was closely followed by similar action on Signature Bank on March 12th.

Both banks had familiar business models, a narrow depositor base contributing the majority of deposits as well as a specific borrower profile, leading to significant ALM and liquidity concerns in the event of large withdrawals, which played out over the past couple of days.

The authorities though addressed the situation with unprecedented agility and ensured all the depositors were eligible for complete withdrawals of their balances even over and above the FDIC guaranteed sum of US$250k, which anchored market sentiments after a surge in risk-off sentiments post the closure announcements.

Meanwhile, rumours of a key investor backing out of a major European Financial Institution created a surge in volatility, especially in bank stocks in Europe further aiding risk-off sentiments.

What's Next?

While concentrated exposures (exposure to Real Estate and Crypto Currency deposits by Signature Bank and longer-dated Mortgage Backed Securities and ALM gaps by Silicon Valley Bank) are pointed out as the current state of misery faced by these banks, we believe it would be prudent to acknowledge the role of sharp devaluation in instruments (especially in the shorter maturity curve which had to bear the brunt of a steep hike in benchmark rates) having a role to play in the current scenario.

Understandably, this has led to a rise in expectations of the US Fed reassessing its current path of interest rate tightening. Whether the Fed reconsiders this scenario will be known by the 22nd of this month. We believe a 25bps rate hike is still a highly probable outcome as current US macroeconomic data continues to be robust and inflation continues to display rigidity.

Gold regains its luster amid Risk off surge while Silver maintains parity :

Gold prices recovered from their slumber and registered a 5% jump over the past week primarily driven by risk-off sentiments. Silver spot prices traded marginally higher, although on a considerably weaker note as compared to Gold, which underlined the current market sentiments.

USDINR pair gives up on gains:

USDINR pair had gained sharply , with INR appreciating 1.5% between 24th Feb till 5th Mar'23. However, the currency pair shrugged off all its gains primarily owing to surge in risk off sentiments and is expected to trade in the 82.50- 83.50 handle in the near future till bearish sentiments ease out.

Indian Equity Update :

Nifty ended February with a loss of 2.03% - its 3rd consecutive month of decline whereas Sensex closed the month down 0.99% as weakness continued to persist on global as well as domestic stock markets.

Till 15th Mar'23, Nifty was down 1.92% falling below the key 17,000 level. Interestingly, the index has never been down for 4 months consecutively in the last 20 years - Not even in 2008 or 2020, so how this month plays out will have to be seen.

In Feb'23, foreign institutional investors (FIIs) registered net sales of INR 11,090.64 crs. This brings the total net selling by FIIs to INR 52,555.37 crs in CY'23. On the other hand, Domestic institutional investors (DIIs) remained net buyers with net purchases of INR 19,239.28 crs in Feb'23 (Source – Money control).

All sectoral indices closed on a negative note in the month of Feb'23 except FMCG. The biggest fall was seen in the Nifty Metals index which fell 18.54% followed by the Nifty PSU Bank index which fell 8.69%.

With the recent down move, Nifty 50 12-month trailing PE has come down to ~20.78 times (Source – Bloomberg) but is still above the long-term averages. Thus, we would continue to recommend a staggered or tactical deployment approach.

India Fixed Income Update :

Indian short tenor yields witnessed a sharp spike over the past month with 364 Day T Bill yields spiking to 7.48%, which traded higher than the 10-year sovereign yields (7.44%) for a brief period with the sovereign yield curve displaying mild inversion.

This however normalized over the past week as expectations of a more benign US Fed rate action amidst the current global volatility, especially in financial markets gained traction. The yield curve trajectory though remained flat, with minimal spreads between the 1-year, 5-year and 10-year benchmark yields. We expect the shorter end to display continued volatility as the current interest rate cycle plays out. Markets would await the borrowing calendar announcement in the early part of April as well as RBI's and FOMC's guidance on future interest rates trajectory.

INVESTMENT OUTLOOK :

Taking the cue from our previous publications, we would like to reiterate that investors are encouraged to adhere to 'Asset Allocation' and calibrate investment decisions by carefully monitoring the ever-evolving economic and geopolitical data points. Marrying our in-house Asset Allocation framework (comprising 4 quadrants – Asset Growth, Return Stability, Inflation Hedge, and Volatility Hedge) with our current stance on markets (as explained above), we build an investment outlook as follows –

- Volatility surged over the past week underlying our theme for the year. In this current backdrop, we continue to be bullish on the volatility hedge allocations played through long short and market-neutral strategies
- On return stability quadrants, we continue to prefer allocations to short and medium-term bond funds and/or roll-down funds (match funds duration with the investment time horizon). As mentioned above, we believe the RBI may continue to hike rates towards 6.75% (repo rate currently stands at 6.5%) followed by a long pause extending into Q4 CY'23 or Q1 CY'24. Short to medium-term bond funds continue to be attractive at current levels, especially for Investors with an investment horizon of 3 years. Investors could also look to invest in well-managed credit funds (on the AIF platform) where the focus is on capital preservation and current income.
- We continue to avoid lumpsum deployments in equities – part of the asset growth quadrant and we prefer a staggered approach. For long-term investors who prefer to invest more tactically, 1/3rd of the money can be deployed before the end of the current financial year given the recent market corrections & moderate earnings growth. We would invest the second tranche at the end of the Fed rate hike cycle, which is expected sometime in H1-2023 (in the past, markets have generally been positive 6-12 months out from the last rate hike). The third tranche can be deployed prior to a possible Fed pivot, however, that is not expected to materialize in CY2023.
- Funds that benefit from domestic growth led by government spending and policies, and selective consumption and export opportunities could be considered as an investment opportunity. Allocation to the asset growth quadrant should be consistent with the risk profile of an investor.
- While Gold prices have taken a breather recently as highlighted earlier, we continue to believe in continued allocation to this asset class and expect CY'23 to be a rewarding year for investors in this precious metal.

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