

Recalibration

17th Jul'23

Inflation levels globally continue to display signs of being well entrenched, especially in the US. The factors contributing to the same seem undeterred even after a spate of interest rate hikes. This has led to a renewed upsurge in the hawkish policy stance of most major central banks. The Central banks of a few large economies have already hiked the benchmark rates in Jun'23 with the expectation of further hikes in July. As the interest rate 'glide path' consistently rises at each policy meeting, it becomes increasingly difficult to predict the eventual terminal rates. Against this backdrop, market participants are eagerly anticipating the upcoming decision by the US Federal Open Market Committee (FOMC) regarding their monetary policy stance on 26th Jul'23.

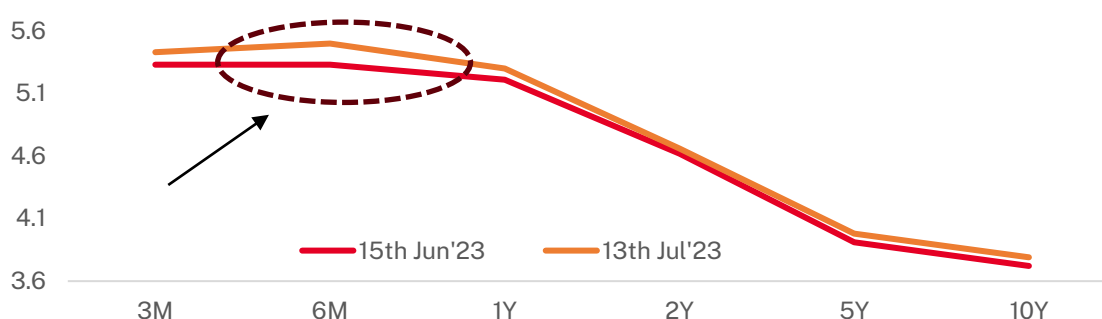
Data released for Jun'23 in the US highlighted a steady yet moderating job market. While the Non-Farm sector added 209,000 jobs for the month (exp. 225,000), hourly wages grew 0.4% MoM and 4.4% YoY, both beating market estimates. The unemployment rate inched lower to 3.6% from 3.7% in the previous month.

The US Consumer Price Index (CPI) data for the month of Jun'23 came in sharply lower than the previous month, registering a YoY and MoM growth of 3% (exp. 3.1%) and 0.2% (exp 0.3%), down from 4% and 0.3% respectively in May. The Core CPI also inched lower from 5.3% YoY and 0.3% MoM in May'23 to 4.8% YoY and 0.2% MoM in Jun'23 (exp 5% and 0.3% respectively). Housing prices continued to inch higher (0.4% MoM and 7.8% YoY) and emerged as the highest contributor to headline as well as the Core CPI levels.

We expect the US Federal Reserve to proceed with a hike of 25 bps in their 26th Jul monetary policy decision. Following the underwhelming jobs and inflation data, there is strong anticipation for guidance from the Federal Reserve regarding the future interest rate trajectory and the eventual terminal rate.

Market Impact: Yields across tenors in the US have edged higher more notably in the shorter end (1 year and below), as is evident from the illustration below. The US equities endured a volatile month with losses in the earlier half and then recovering in the last few days. The Nasdaq gained 3.76%, the S&P 500 gained 3.14% while the Dow Jones remained unchanged during the observation period (15th Jun-13th Jul'23). The USD lost significant ground and retraced below the 100 handle post the US CPI data release, a sharp drop from the 104 handle in the previous observation date (15th Jun-13th Jul'23).

Yield Comparison



Global central banks interest rate outlook:

As highlighted earlier, there has been an upward trend in global interest rates due to several major central banks adopting a hawkish stance, driven by persistent levels of inflation. This may result in terminal rates that are higher than initially anticipated and prolong global liquidity tightness.

Global Central Bank Policy Snapshot

Central Bank	Current Rate	Last Change	Next Meeting	Expectations
Bank of Canada	5.00%	12th Jul'23 , 25 bps Hike	6th Sep'23	Hike by 25 bps
Bank of England	5.00%	22nd Jun'23, 50 bps Hike	2nd Aug'23	Hike by 25 bps
Bank of Japan	-0.10%	29th Jan'16, 20 bps Cut	28th Jul'23	Status Quo
European Central Bank	3.50%	15th Jun'23, 25 bps Hike	27th Jul'23	Hike by 25 bps
US Federal Reserve	5.25%	3rd May'23, 25 bps Hike	26th Jul'23	Hike by 25 bps
People's Bank of China	3.65%	22nd Aug'22, 5 bps Cut		
Reserve Bank of Australia	4.10%	6th Jun'23, 25 bps Hike	1st Aug'23	Hike by 25 bps
Reserve Bank of India	6.50%	8th Feb'23, 25 bps Hike	10th Aug'23	Status Quo
Swiss National Bank	1.75%	22nd Jun'23, 25 bps Hike	22nd Sep'23	Status Quo

Gold and Silver prices renew uptrend:

Gold prices fell sharply to USD 1907/oz and breached the USD 1900 handle intraday on 29th Jun'23. Since then, the precious metal has witnessed a continuous uptrend towards USD 1955/oz (as of 13th Jul'23). Interestingly, this upward movement coincided with a fall in the USD Index, highlighting a negative correlation between the two asset classes.

Silver prices posted sharp gains in the past two trading sessions after enduring a relatively lackluster month and are currently trading at USD 24.69/oz, up 3.7% (15th Jun-13th Jul'23).

Crude prices inches higher

Over the last month, crude prices have experienced a moderate increase. This can be attributed to the firm control over supplies exercised by the Organization of the Petroleum Exporting Countries (OPEC) members, particularly led by Saudi Arabia. Despite the uncertain global demand growth outlook, OPEC has maintained a strong hold on oil production levels. Meanwhile, the US Strategic Petroleum Reserve (SPR) continues to decline and is currently at a 40-year low. Brent crude prices were up by 3.5% during our observation period (15th Jun-11th Jul'23).

INR trades steady amidst a resilient USD:

The Rupee witnessed a steady selloff over the past couple of weeks but regained strength as the USD weakened post the CPI data release. The USD-INR exchange rate touched a high of 82.77 on 6th Jul (from 81.91 as of 15th Jun'23) and is currently trading around 82.11 (13th Jul'23). The RBI continued to add to its FX reserves (up to USD 596B as of 30th Jun'23), an increase of ~USD 18B since Mar'23.

Indian Equity Update :

The Nifty continued to move up in Jun'23, and the index closed the month higher by 3.5% at 19,189. The upward trend in the current month has persisted, with the index reaching its highest level at 19497, representing an all-time high. Although there has been a slight decline from the peak, it is currently trading at 19413 (as of 13th Jul'23), resulting in a month-to-date (MTD) gain of 1.2%.

Foreign Portfolio Investors (FPIs) continued their focus on Indian equities, with May'23 and Jun'23 registering inflows of USD 12.7B (the highest since Dec'20). On the other hand, Domestic institutional investors (DII) net bought ~USD 0.14Bn (INR 1100cr) in May'23 and Jun'23 combined. The month of July started on a positive note with net inflows of USD 2.8B (till 13th Jul'23), although DII turned net sellers with outflows of ~USD 0.9B.

All sectoral indices except Nifty Oil & Gas and Nifty IT ended Jun'23 on a positive note, with the biggest gains seen in Nifty Realty (up 10.8%), followed closely by Nifty Healthcare (Up 10%). Nifty Oil & Gas, and IT were down 0.8% and 0.3% respectively. For the month of July (till the 11th), Nifty Oil & Gas led the pack (up 5%), followed closely by Nifty Auto (up 3%). Nifty IT was down 0.8% while Nifty Banking remained unchanged.

India Fixed Income Update :

Indian sovereign yields ticked higher in June post a relatively benign move in May, as the 10-year, 4-year, and 6-year benchmarks increased by 13 bps each. Shorter tenor yields stayed rangebound as the liquidity scenario eased relatively, aided primarily by the incremental deposits owing to the discontinuation of the INR 2000 currency note. The trend reversed in the second week of July, post the US CPI data with the 10-year, 4-year, and 6-year yields lowering by 5-6 bps, even as the India CPI data came higher (4.81% in Jun'23 against 4.25% in May). The term premia continue to be negligible among the maturity buckets.

We have prepared a brief questionnaire to summarize the current Indian fixed-income outlook.

➤ *What are the expectations from the RBI on near-term interest rate trajectory?*

We do not foresee another hike from the RBI in the current scenario. However, we believe that they will hold the interest rate at the current level with minimal probability of a rate cut in CY'23.

➤ *What are the expected levels of the Indian 10-year benchmark yields?*

The 10-year yields have inched higher of late and briefly traded above the 7.15 handle. It has since declined below 7.10 (7.09% as of 11th Jul'23). However, the current spread over benchmark rate is ~60 bps which is close to the last 12-year average. We do not anticipate any sharp yield downtick from here and the 10-year yields are to be range bound between 7.0% -7.20% till rate cuts come into consideration.

➤ *Are there any potential downside risks to the Indian economy due to any change in the RBI Policy stance?*

Any disruption in monsoons owing to the 'El Nino' effect, therefore impacting the agri output, combined with an unprecedented hike in rates by the US Fed could disrupt the RBI's current stance. Another outlier could be a resurgence in crude prices.

➤ ***Which part of the yield curve looks attractive to build portfolio duration at current levels?***

Considering the current situation where there is a lack of significant term premiums, the 3-to-6-year maturity curve appears to be the most appropriate for building duration. This is because longer-term instruments do not offer enough risk premiums to justify exposure in those tenors.

➤ ***What are the expectations on Credit and Tenor Spreads going forward?***

Credit spreads have been at historic lows primarily due to cleaner corporate balance sheets and robust bank lending. We anticipate the spreads to tighten going forward as the liquidity tightens. Even tenor premia is expected to increase, though it may happen at a slower pace.

INVESTMENT OUTLOOK :

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. By integrating our in-house Asset Allocation framework, which consists of four quadrants - Asset Growth, Return Stability, Inflation Hedge, and Volatility Hedge - with our current market stance (as discussed earlier), we formulate the following investment outlook:

- Global VIX levels have been unusually compressed and are now below the Pre Covid levels, with Indian VIX following a similar pattern. The central banks, globally, seem to have renewed their stance on controlling inflation, at the cost of sacrificing growth, as the geopolitical standoff continues between Russia and Ukraine. Against this backdrop, we firmly believe allocations to Volatility Hedge strategies should continue.
- Within the return stability quadrant, our preference remains for allocating funds to maturities in the 2–5-year range. This is due to the attractiveness of current yields, particularly for investors with an investment horizon of 2 years or more. Investors could also look to invest in well-managed credit funds to lock in a relatively attractive coupon rate (on the AIF platform), with a focus on capital preservation and periodic cashflows.
- India's equities have displayed remarkable resilience as an asset class in Q1'FY'23 and the rally has been broad-based across Large, Mid, and Small Cap entities. We believe that Indian equities will continue to be a robust driver of wealth creation for the medium to long-term duration. However, the current macroeconomic environment combined with richer valuations warrants some caution. We, therefore, recommend tranching out allocations over the next 3-6 months to take advantage of any intermittent volatility.
- In the near term, we continue to be bullish on themes that benefit from the Government spending on capex, as well as initiatives towards export promotions and import substitutions (e.g., the PLI scheme). This is expected to spur private capex, benefitting Cement and Engineering goods, while a healthy corporate and bank balance sheet is expected to aid Banks and Financial Services. We continue to maintain caution towards themes that are dependent on consumption that continue to display weakness, although 'premiumization' has been emerging as a vibrant growth category within the consumption theme and we are keeping a close watch on this evolving segment.
- Our view on maintaining a steady allocation to Gold has reaped steady returns for investment portfolios over the past year, and we continue to be bullish on the commodity as a vital asset allocation tool.

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