

Higher for Long

19th May'23

In April's note titled 'Stasis' or One Last Bitter Pill', we shared our outlook on the US Fed delivering on a 25-bps rate hike in their recently concluded meeting. We believe this could well be the last rate hike in their current rate hiking cycle. As such, the focus now shifts to how soon, or if at all, whether we would witness a much-awaited Fed Pivot in CY'23.

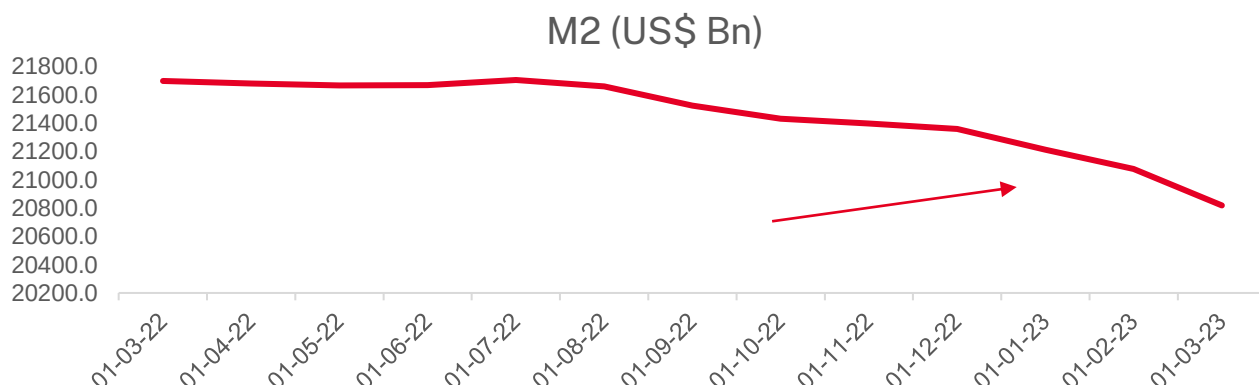
The data released for April'23 highlights continued resilience in the US economy and painted a robust picture yet again. While Non-Farm Payrolls added 253,000 jobs for the month, unemployment rate fell to 3.4%, lowest since 1969, and hourly wages grew 0.5% MoM and 4.4% YoY, all of them beating market consensus. However, one thing to take note of is the sharp cutdowns in Feb and Mar'23 payroll numbers. These were cut by 71,000 and 78,000 jobs respectively from the last released provisional numbers and currently look less robust than previously estimated. US retail sales meanwhile posted a 0.4% MoM gain in April'23 and reversed the negative trend witnessed in the first three month of CY'23.

The Apr'23' US CPI release continued its downward trajectory, registering a YoY and MoM growth of 4.9% (est. 5%) and 0.4% (est. 0.4%). Core inflation grew 5.5% YoY and 0.4% MoM, again in line with market expectations. Growth in shelter prices declined marginally however energy and used car prices moved higher as 'super core' inflation (ex. Food, energy and shelter) came in at 3.7%, hinting that inflation continues to be stubborn.

Overall, the data releases for Apr'23 continue to hint at a resilient economic environment in the US and makes us believe that the US Fed will continue to hold on to interest rate at current levels in CY'23.

Market Impact : US 2-year and US 10-year yields came down marginally when compared to our report last month (17th Apr'23), declining by 10 bps and 6 bps respectively. While shorter end yields went higher with 6 month and 1 year treasury yields increasing by 20 bps and 6 bps highlighting tighter liquidity conditions. US equity indices painted a mixed picture, with the NASDAQ gaining 1.5% over previous month's observations whereas S&P 500 and Dow Jones were down 1% and 3% respectively. The USD Index shrugged off intermittent weakness and ended up marginally higher to currently trade around 102.88 as compared to the previous month's observations at 102 levels.

Exhibit 1: Money supply in the US indicates tighter systemic liquidity impacting shorter end yields



What other Central Banks are up to:

The moves by Central Banks to hike global interest rates looks most likely to be in its last leg. Barring the European Central Bank and the Bank of England, most major central banks have either paused their hiking cycle or like the US Fed , may have hiked for one last time (Exhibit 2). Even the Bank of England and the European Central Bank are expected to revisit their current interest regimes. This comes post the recent hike in benchmark rates with forecasts of one additional 25 bps rate hike in the next monetary policy meeting, and it being the last in the current rate hike cycle.

Exhibit 2: Global Central Bank Policy Snapshot

Central Bank	Current Rate	Last Change	Next Meeting	Expectations
Bank of Canada	4.50%	25th Jan'23 , 25 bps Hike	7th June '23	Status Quo
Bank of England	4.50%	11th May'23, 25 bps Hike	22nd June'23	Hike by 25 bps
Bank of Japan	-0.10%	29th Jan'16, 20 bps Cut	16th June'23	Status Quo
European Central Bank	3.75%	4th May'23, 25 bps Hike	15th June'23	Hike by 25 bps
US Federal Reserve	5.25%	3rd May'23, 25 bps Hike	14th June'23	Status Quo
People's Bank of China	3.65%	22nd Aug'22, 5 bps Cut		
Reserve Bank of Australia	3.85%	2nd May'23, 25 bps Hike	6th June'23	Status Quo
Reserve Bank of India	6.50%	8th Feb'23, 25 bps Hike	8th June'23	Status Quo
Swiss National Bank	1.50%	23rd Mar'23, 25 bps Hike	22nd June'23	Status Quo

Source : Investing.com, Lighthouse Canton

Precious Metal Losing its Luster :

Gold prices capped a volatile month and edged down 1% after scaling a near 14-month peak of US\$2050/oz around 4th May'23, breaching the US\$2000 handle on its way down to trade around US\$1981/oz. as on 18th May'23.

Silver followed a similar trajectory to Gold, witnessing intermittent volatility for the month, although the decline was much sharper, down more than 5% over last month and currently trades at US\$23.73/oz.

Crude continues its downtrend :

Global Crude prices continue to decline sharply as weaker global economic environment weighs on the commodity. Brent Crude is down ~10% over our last month's observation, although the International Energy Association's latest report is hinting at a demand growth of 2million per barrel/day, which may act as an anchor to current levels. However, much of the growth in demand (roughly 90%) is estimated as demand from China, which could be prone to disruption as the economy finds its way back to normalcy.

USD continues to gain against INR as USD Index regains strength:

The USD gained marginally against the INR over last month, capping off a volatile month as the INR surrendered the gains post the Fed's policy decision, briefly reaching 81.71 levels and then retracing to 82.42 levels as on 18th May'23. We don't expect sharp depreciation in the INR however, primarily owing to benign crude prices as well as robust services exports and remittances keeping USD inflows handy. The downside risk to the INR could stem from weakening exports as global economic headwinds continue to impact merchandise exports.

Indian Equity Update :

The Nifty continued its upward trajectory in Apr'23 and the index closed the month higher by 4.06% at 18,065. Even for the month of May'23 (till 19th May'23), the Nifty posted marginal gains over last month as Foreign Portfolio Investors (FPIs) returned to Indian equities, with investments of INR ~40,000 Crs in the months of Apr and May'23 (till date). On the other hand, Domestic institutional investors (DII)s extended their buying momentum with net purchases of INR ~2,200 Crs in April although they turned net sellers in May'23 till date, with outflows amounting to INR ~5700 Crs.

All sectoral indices except the Nifty IT, ended the month on a positive note in the month of Apr'23. The largest gain was seen in the Nifty Realty index, which was up 14.91% followed by the Nifty PSU Bank index, which was up 12.15%. The earnings season also hinted at more hits than misses as 22 out of 40 Nifty 50 entities who had declared Q4 financial results till 19th Mar'23, either exceeded or met analyst estimates.

While the earnings calendar has been robust and the overall equity investor sentiment remain exuberant, there is a need for caution. Tighter liquidity conditions, stretched consumer appetite amid a 'higher for longer' interest rate trajectory and any potential disruption in rainfall patterns may act as potential headwinds in the near term, even as the medium to longer term equity outlook continues to be in good shape.

India Fixed Income Update :

Indian sovereign yields have continued their downward trajectory since the RBI announced a pause in rate hikes. However, the entire gain has been witnessed mostly in the greater than one-year segment, while the shorter end yields continue to inch higher. The Indian sovereign yield curve has flattened even further with negligible term premia across tenors with mild inversion in the shorter end of the curve.

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

➤ *What is expected from the RBI on the near-term interest rate trajectory?*

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

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

10-year yields have come down sharply to trade around 7% handle and the current spread over benchmark rates is ~50 bps which is lower than the last 12-year average. We do not anticipate any sharp yield downticks from here and we expect 10-year yields to be range bound between 6.90% -7.10% till rate cuts come into consideration.

➤ *Are there any potential downside risks to the Indian economy and what will be the resultant impact on the RBI Policy stance?*

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

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

The 3-to-6-year maturity curve looks most suited to build duration as negligible term premia at current juncture doesn't offer sufficient risk premia to build exposures in longer tenor instruments.

➤ ***What expectations do we have on Credit and Tenor Spreads going forward?***

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

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 inhouse 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 –

- In this current macro economic environment, 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 funds running maturities in the 3 – 5 year bucket as the current yields continue to be to be attractive 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 periodic cashflows.
- We continue to avoid lumpsum deployments in equities – part of the asset growth quadrant and we prefer a staggered approach with deployments over the next 3 – 6 months.
- Funds which 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.
- 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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