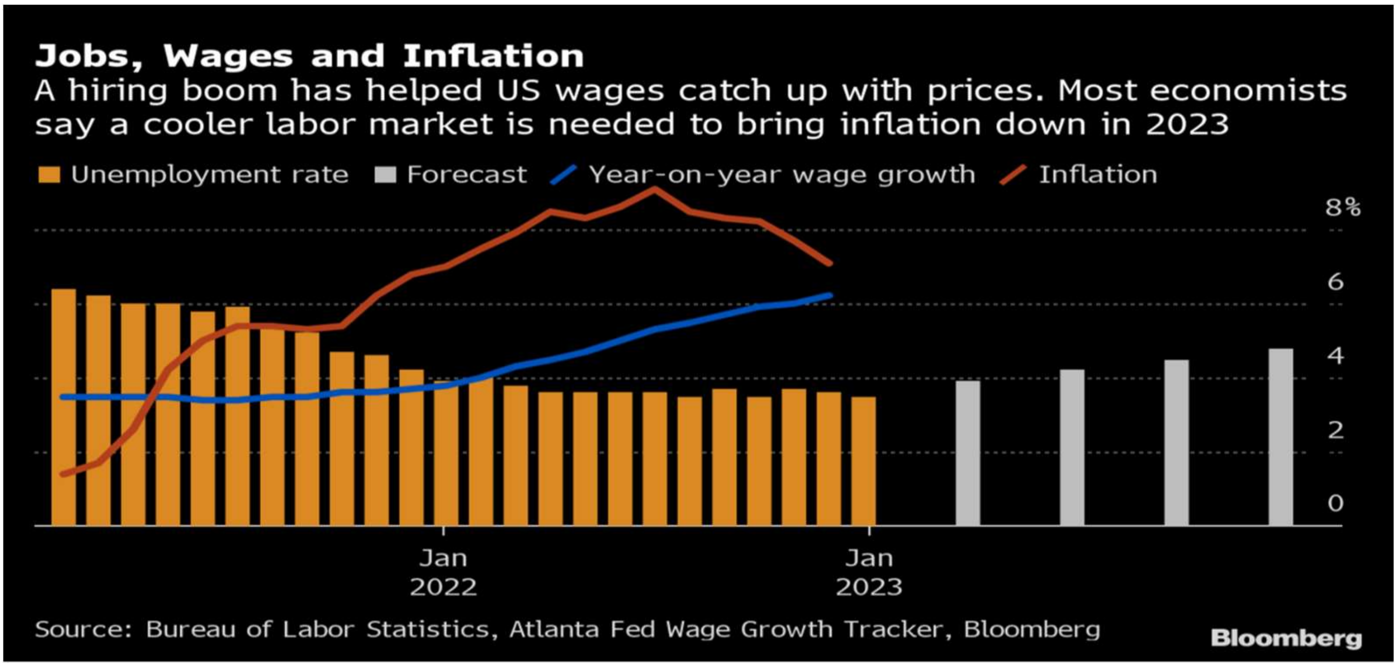
2023, Up over a Crow's Nest

18th Jan 2023

2023 is finally here, the much talked about mythical 'cure all', the year market participants had been awaiting with bated breath expecting a 'pause' and even a 'pivot' from the sharp increase in interest rates and hawkish monetary policies in 2022. However, will the year pan out the way market participants had anticipated?

If last months data on US employment, jobs additions and wage growth are to be taken as a barometer, then US Labor markets are still resilient, with only wage growth tapering down slightly (hourly earnings increasing by 4.6% which is below market expectations of 5%), even as unemployment is at a historical low of 3.5% and Non-Farm Payrolls point towards 2,28,000 new jobs being added in December (against market predictions of an increase of 2,00,000). Even headline US CPI inflation print for Dec'22, which eased to 6.5% yoy growth as compared to 7.1% in Nov'22, still highlights a resilient core (up 5.7% yoy and 0.3% MoM), led by a continued surge in shelter costs.

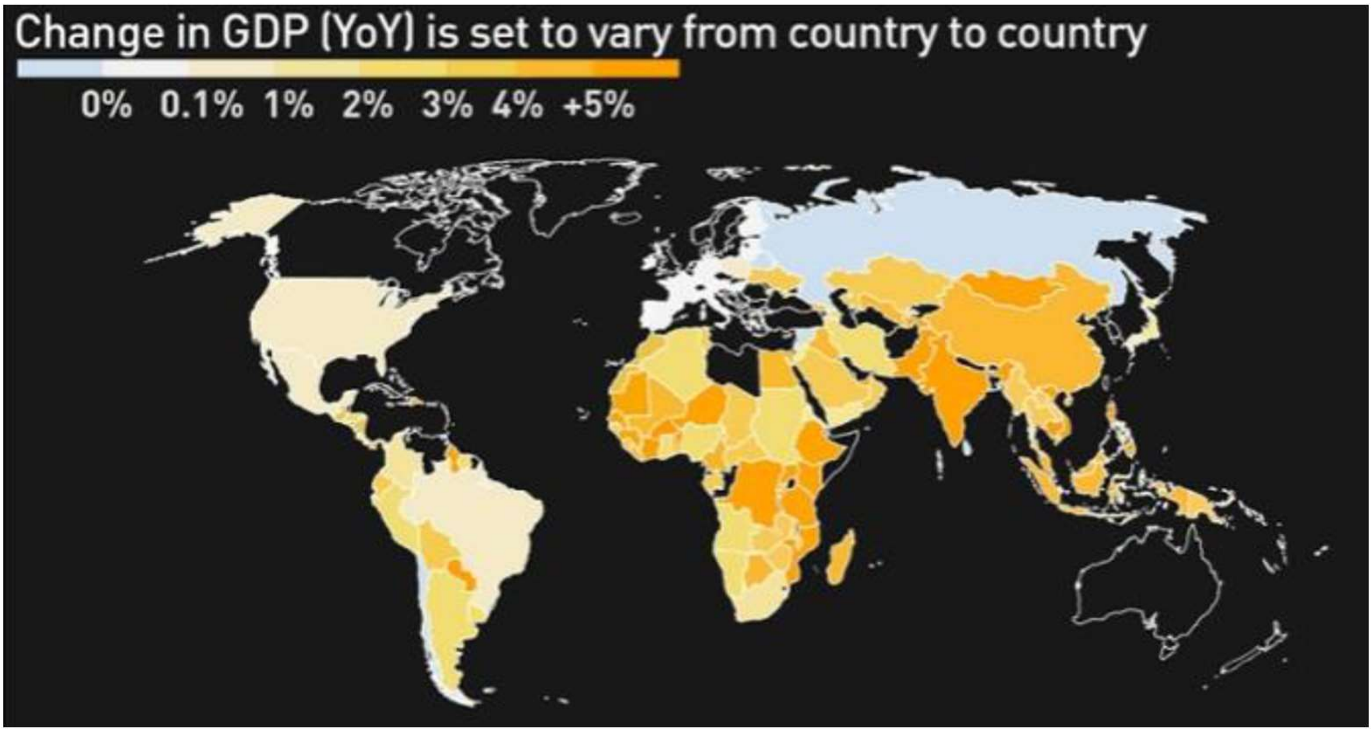
We believe the US bond and equity markets have priced in higher amount of exuberance on US Fed's monetary policy 'pivot' than is warranted considering the current economic indicators. While we believe US Fed will pause their rate hikes at some point of time in CY'23, a further hike of 100 bps in benchmark rates looks very much on the horizon, followed by an elongated pause stretching into Q1 CY'24. We do not foresee a cut in interest rates by the US Fed in CY'23. We would be keenly watching the outcome of the first FOMC discussion for this year on the 1st of Feb'23 and expect a hike in interest rate by 50 bps and maintenance of a hawkish stance on interest rates, with resilient core inflation being highlighted as a reason for the hawkish stance.



Market Impact: US 2 Year and US 10 Year yields are down sharply in the first 2 weeks of Jan'23, with US 2-year yields lower by nearly 30 bps and US 10-year yields down 38 bps. US equities have ushered in the new year sharply higher too with both Dow Jones and S&P 500 up by 2.3% and 4% respectively while the much beaten down technology stocks represented by NASDAQ, also witnessed sharp uptick, up 6% for the same period.

Global Growth projected to be slow in 2023 :

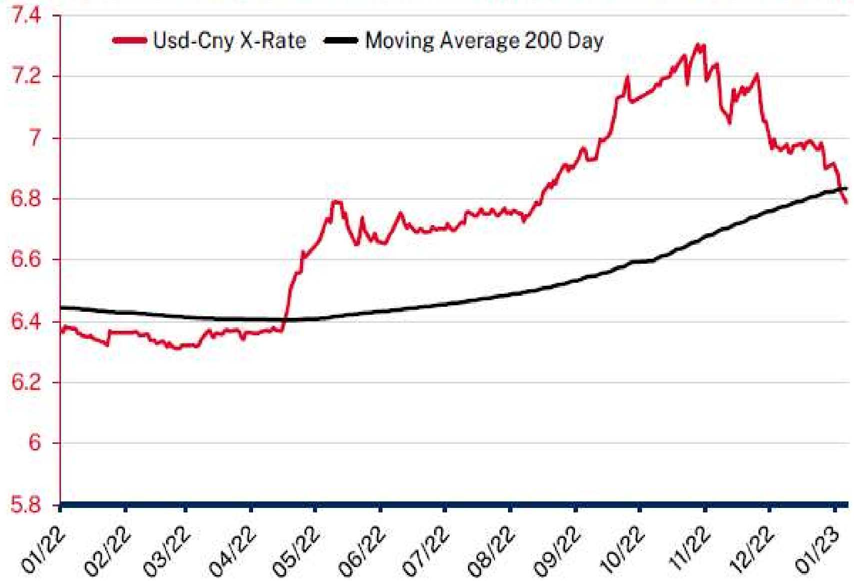
As per latest reports from World Bank, global GDP growth for CY'23 is projected to grow by 1.7%, sharply lower than 3% which was forecasted in Jun'22, although it's projected to recover to 2.7% in CY'24. While US is expected to grow by 0.5% (down from forecasted 2.4% growth as on Jun'22) , EU is expected to foresee nil economic growth (revised downward from 1.9%) and emerging markets (ex China) is forecasted to achieve GDP growth of 2.7% (down from 3.8%). Indian economy is expected to grow at 6.9%, the fastest pace among large economies in CY'23 while China is expected to grow by 4.7%, a decline by 0.9% from previous forecast.



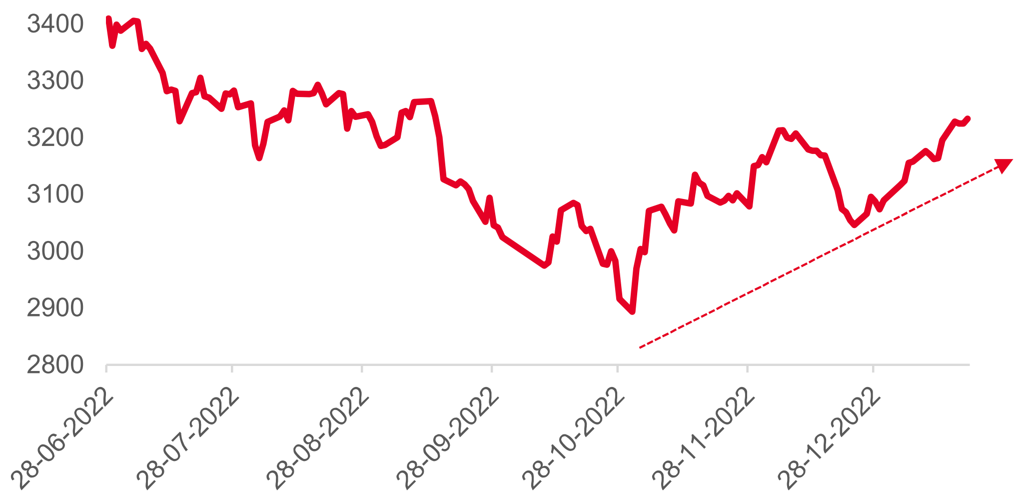
All eyes on China :

China continues to hold everyone's attention. As the economy reopens from strict Covid enforced lockdowns, it is unfortunately witnessing sharp spike in infection rates, completely overwhelming their healthcare infrastructure. While we await more information on whether the new Covid-19 Omicron strains which has spread rapidly in China namely BA. 5.2 and BF.7 is as virulent globally; Chinese authorities seem to have taken the current situation in their stride and are proceeding with ease in restrictions.

USDCNY exchange rate breeched 200-day moving average for the first time since April 2022.



While Chinese equities registers recovery from October lows



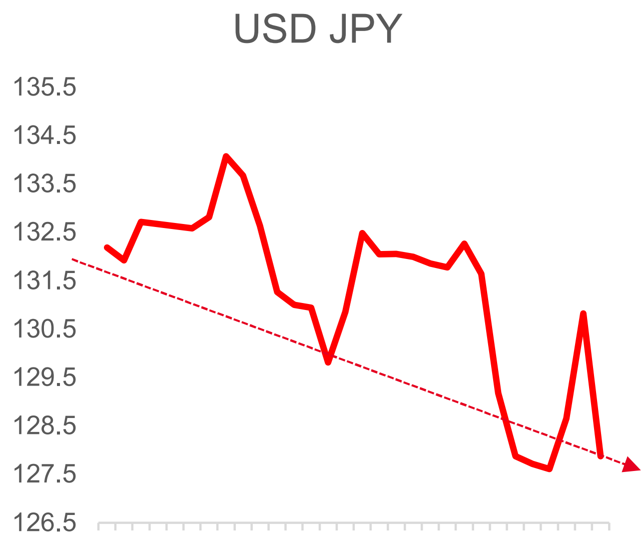
Resultant impact of Chinese economy getting back to normalcy :

While Chinese economy reopening is good news for risk assets, as it provides much needed support in consumption and industrial activity in an otherwise slowing economy, global central banks would also be wary about its resultant impact on crude and commodity prices, which could extend the current inflationary run up in consumer prices. Additionally, we would need to keep an eye on 'near shoring' / 'friend shoring' activities undertake by the US, EU and other major economies activities with regards to securing essential imports which may limit the benefits from supply chain restoration as had been projected previously post Chinese economy opening.

Bank of Japan takes its first step towards Quantitative tightening :

Bank of Japan took its first step to limit their aggressive quantitative easing measures as they widened their tolerance band for Japanese Government Bonds (JGB) 10-year yields from 25bps to 50 bps. BoJ had followed a twin measure of easy monetary policy, maintaining base interest rates at -0.1% and vowing to be the buyer of last resort whenever 10 Yr JGB yields breached 0.25%. However, owing to enormous pressure from market participants, BoJ acknowledged the need to expand the targeted band as inflation also showed signs of normalizing consistently printing above the 3% threshold set by the central bank.

USD JPY appreciated sharply post the BoJ policy action on 20th Dec'22 and breached the 130 handle to trade at its highest level against USD since 27th May'22. Risk assets reacted negatively as expected with rise in risk free rates with Nikkei down nearly 10% before recovering to pre policy levels in the second week of Jan'23.



Resultant impact of policy normalcy from BoJ :

While BoJ didn't expand the Yield Curve Control (YCC) band in their 19th Jan policy beyond +/- 50 bps, its widely anticipated to continue tweaking the curve upwards, or relinquishing the measure altogether in 2023 as inflation continues to increase in the economy. This would increase the cost of carry trades with JPY primarily used as a funding currency considering its near zero rate of interest and is expected to further dampen risk sentiments for global equities.

Indian Equity Update :

The year 2022 was a year of consolidation for the Indian Equities market with a low single digit return in CY'22. Nifty 50 Index ended the year 4.32% higher at 18,105.30 (vs 17,354.05 as on 31st December 2021). **The Indian market performance has shown resilience and outperformed major global markets on the back of strong economic growth expectations, inflation prints not getting out of hand & continuous inflows by Domestic Institutional Investors (DII).** During the year, foreign institutional investors (FIIs) turned out marginal sellers with net sales of INR 2,78,429.48 crs, while DII remained marginal buyers with net purchases of INR 2,75,725.71 crs (Source – Money control).

Sectoral indices like Nifty IT, Realty & Healthcare took most of the beating, falling 26.04%, 10.81% & 10.79% respectively during the year while Nifty Banks & Autos balancing their falls, surging 21.15% & 15.31% respectively during the year.

Outlook for 2023

India has seen a substantial increase in its index weight within the EM index and is now the second largest weight in the MSCI. However, in the near term, India may under-perform other EMs majorly because :

- Valuations are expensive: it trades at over 100% premium to EM index on a PE basis & it is trading at 12 month trailing PE of ~22 times (Source – Bloomberg), above the long-term averages
- India was a major outperformer last year
- With Chinese Economy reopening, foreign flows may be diverted towards China

India's relative performance would also be largely driven and get necessary cushioning through overall earnings trajectory. Any material impairment or derating in earnings amidst recessionary rhetoric's can add negatively to overall sentiments.

In the Year 2023, Portfolio defensiveness can continue to be build through hygiene centricity and large cap allocations while having a continued assessment of small cap space. Small caps have underperformed considerably in 2022 falling -14% vs a 4.3% gain for the large caps and they are trading at more reasonable valuations being at a 29.2% PE discount to the large caps in valuations.

India Fixed Income Update :

India's Dec'22 CPI inflation data release came in at 5.7% which was the second consecutive month of the data being within RBI's upper band of tolerance of 6%. This has led to expectations among market participants on Indian interest rates nearing its peak with probability of another 25bps rate hike in RBI's MPC meeting in the first week of Feb'23 being the last in the current rate hike regime.

Indian 10-year Bond yields have been trading firmly in the band of 7.22% – 7.35% for the past month and a half. While decline in headline CPI numbers across the US and India along with lower Crude prices have aided sentiments, a stubborn core inflation and continued hawkish commentary from both the US Fed as well as RBI has kept aggressive bond volumes in check. We expect market positioning to be light as we look ahead towards an event heavy month with Union Budget announcement on 1st Feb'23 followed closely by outcome of the US FOMC meeting and then RBI's MPC meeting decision on the 8th Feb'23.

Market participants will be keenly eyeing the fiscal deficit target announcement from our Finance Ministers Budget speech. Any widening from last years target of 6.4% will be taken as a negative with current expectations in the range of 6 – 6.2% range. ***The spread between 5 yr. and 10 yr. sovereign bond yields continue to hover in the narrow band of 14-16 bps, making long duration trades relatively unattractive currently.***

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 –

- We expect 2023 to usher in increased volatility primarily owing to divergent central bank policy actions primarily led by BoJ, PBoC and US Fed during global economic slowdown. We feel exposure to volatility hedges through market neutral strategies should be a part of all asset allocations this year as we expect long short fund managers to benefit from dispersion in returns across sectors.
- 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 6.5% (repo rate currently stands at 6.25%) 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, we had recommended a strategy in our July publication titled “Revalidate”, to deploy the first 1/3rd of the money in July on account of more reasonable valuations and improved macroeconomic condition in India. 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.
- 2023 so far has turned out to be a good year for Indian Rupee, falling sharply from 82.75 levels as on 31st Dec’22 to 81.25 levels as on 19th Jan’23. With USD Index tracking newer lows and crude hovering around USD 80-85 per barrel, expect USDINR levels to be supported at current levels, even though trade deficits continue to widen and FPIs continue to exit their India exposure. In the near term, expect INR to hover in the 81 – 82 band with RBI keeping any further INR appreciation in check.
- 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.
- Gold has overtaken Dollar Index as one of the best asset classes in the past 2-3 months, delivering 17.5% absolute return in USD terms even as USD Index is down 9.5% for the same period. Allocation to gold which is a part of inflation hedge quadrant should be maintained in one’s portfolio and is expected to act as a stabilizer in an otherwise volatile year from portfolio return perspective.

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