Market outlook

Greece continued to dominate the headlines with events taking a dramatic turn every few hours. Its citizens voted against the creditor's proposal and gave an upper hand to the Syriza party's government for negotiating a better deal. Post referendum results, market opinion has swung towards a much greater possibility of a debt default and eventual exit of Greece from the Eurozone. Our base case is still that authorities in Europe would try hard to ensure Greece stays within the Euro zone. This is based on our assessment of geopolitical compulsions and less on pure economic rationale. Markets have witnessed some volatility, though; there have not been any signs of a major contagion effect as of now. There could be some complacency; however, we believe it is market's faith in the central banks capacity particularly of European Central Bank (ECB) that is likely to use its monetary firepower in case of any unforeseen event.

Chinese policy makers seem to be taking desperate measures to combat the crash in Shanghai equities since June. The meteoric rise in market was fuelled by leveraged trading and retail speculation and the government seems to be worried about potential fallout on the economy of a crash in equities. This signals the underlying vulnerabilities of the Chinese economy. Looking at the world, we remain confident that broadly commodity prices are likely to remain soft. This is positive for India.

On ground, most of the economic indicators continue to show improvements. The outlook on inflation remains optimistic with softer global commodity prices and proactive supply side policy response. While the industrial output is yet to revive, there are signals of bottoming out. The rain gods are smiling towards a better agri-throughput. RBI announced a 25 bps rate cut and managed partial transmission of the same. There are signs of pick up in Government spending.

Prime minister's vision for "Next India" has four critical props – economic diplomacy, efficient governance, ease-to-do-business and a distinct civilizational identity. There has been steady progress so far on each of these count, be it Jan-Dhan-Yojana, Digital India, Direct Benefit Transfer of subsidies, fair and transparent resource allocation framework, Housing-for-All, Make-In-India, Clean-India, Yoga, Women empowerment and initiatives against Money-Laundering. Some of these initiatives will go a long way in creating building blocks for a "Next India" that thrives on transparency, efficiency and inclusive growth.

We believe this phase of transformation would gradually envelope parallel economy into mainstream economy with core asset creation. We further feel that financialization of assets would accelerate more from hereon. These make for a structural story for Indian equities from a pure demand perspective. The domestic investments are positive for a year now and accelerating – providing a counterbalance to the foreign outflows witnessed in the phase of global uncertainties.

There exist some near term pain points in terms of sluggish rural growth, stressed loans in banking system, fractured balance sheet of large corporates and sluggish capital investments. Some of these cannot be cured overnight and need the system to take some poison pills. RBI has begun well with its landmark guidelines on banks' takeover of borrowers' companies in case of defaults. The metamorphosis of a caterpillar to a butterfly is a process of patience – slow and painful, but mandatory. Our ground interactions with corporates and their value chains echo this pain. India needs to go through this phase to evolve as a vibrant economy. The physical and digital infrastructure is being rebuilt. The old models of growth and entrepreneurship are under serious threat. We feel the winners of 'Next India' would be different. They would benefit from the megatrends of aspirational consumption, digitization, urbanization, manufacturing exports and proactive and transparent governance.

Going forward, the market would be closely watching developments on monsoon session of parliament where key reforms would be debated, corporate earnings, progress of monsoon and global events. India stands out in a growth starved world due to positive predictability on policy and macro environment and fair valuation. We also feel the long term returns from mid-cap segment of the markets would be higher. We have augmented our investment approach for an early log-in to these future winners of the "Next India".

A cautious Monetary Policy stance and uncertainties regarding the evolution of the South West monsoon resulted in bond yields moving up by more than 20 bps over the month. This was further compounded by an uncertain external environment surrounding the crisis in Greece and its possible ramifications globally. At the current juncture, the markets remain uncertain about near term trajectory, as evidenced by the lack of incremental appetite for bonds. This has manifested itself in the weekly primary auction for government securities, wherein the RBI had to devolve stock to primary dealers twice and the government choosing not to accept bids in another.

The progress of the South-West Monsoon in the month of June has been better than initially anticipated. The government has also announced only a modest increase in minimum support prices (MSP) for crops as expected, with policy focus likely to shift more towards structural agriculture sector reforms. These developments should provide comfort to the central bank which had flagged off concerns surrounding upside risks to CPI inflation.

Notwithstanding near term uncertainties, the requirements for a more structural downtrend in inflation are being gradually met, with the rollout of the above mentioned initiatives. A successful execution of these could go a long way towards weather proofing agricultural output and thereby mitigating food price shock scenarios on a more durable basis. The presence of excess capacity across sectors, increasing adopting of technology and also e-commerce platforms provides a cap on the pricing power. Looking at the global situation with subdued growth prospects and the demand-supply dynamics, commodity prices are likely to remain soft. With near term demand side price pressures remaining subdued, there remains little possibility of even a short lived food price spike if it materialises, leading to any generalised price pressures.

Our portfolio construct remains biased towards a higher duration given that medium term prospects for bond yields remains positive. Looking at the global bond yields, India is likely to remain relatively attractive and increased flows can be expected as policy makers relax market access norms for foreign investors. We expect further policy rate cuts in the near term, but more importantly, the overall policy framework has created initial conditions for a durable long term softening in nominal yields over a period of time. Supportive fiscal policy actions and supply side measures, would supplement the gains made in improvement of the macro economy in recent years. Any volatility induced by global factors would present a good entry opportunity for domestic investors.

Navneet Munot

CIO – SBI Funds management Private Limited

July 7, 2015