Market Outlook

A fact not widely appreciated is that India is transforming from a “data poor” to a “data rich” society. A variety of forces including the Aadhar biometric card, cheaper data connectivity, significant push from the government and rapid adoption by a young population can lead to a paradigm shift.

Government is aiming at digitizing and integrating the services of all government bodies starting with digitization of land records, integrating tax collection under one ‘big data’ platform and deploying Aadhaar for last mile delivery of government services. These measures help bringing down corruption, enable system-wide efficiencies, and could free up huge economic value, through improved cost and operational performance. This transformation from a ‘data poor’ to ‘data rich’ nation is happening at an exponential pace. The policy level thrust towards adoption of technology could unleash significant productivity gains and growth in India. There is surely a big move towards “digitalization of finance” with banking and financial services witnessing rapid adoption of technology.

Government has rolled out a program, under the name of ‘VISAKA’ to train households on internet literacy. Internet literacy can be a significant platform to bridge the divide between rural and urban India. Whole host of services and innovations that can ride the digital platform and citizens can draw immense benefits from healthcare to education, citizen services to transport and the like. With Internet penetration hovering at around 20% and increasing very fast, there is a lot of scope for this ambitious program to succeed.

Indian equity market started the year with two fears- impact of Demonetization on growth and Trump’s policy in US. Reassuringly, corporate India’s Q3 FY17 performance and the release of Q3 GDP numbers have downsized the fears on the former. The corporate results reflect some discolorations in rural demand due to demonetization, impacting the profitability of consumer companies with rural focus, but urban demand remained largely intact. There is another visible trend that formal sector seems to be benefiting at the cost of informal sector and implementation of GST may further accentuate that trend.

Coming to the latter, while there are still a number of unknowns as to how Donald Trump’s policy measures would pan out, we know that there are clearly ‘nationalist’ tendencies in his policy. These policies are aimed at spurring US manufacturing activities and jobs creation. The government is trying to achieve this via following a restrictive immigration policy, higher import tariffs and border tax adjustments (BTA). BTA aims to make US’ exports more competitive and imports from other countries relatively expensive.

Our analysis suggests that India is certainly less vulnerable to US’ tax and trade policies when compared to other countries. Further, the intensity with which US’ reforms measures impact India will also depend on the extent to which prices and currency adjust. The silver lining amidst uncertainties surrounding US policies is that cyclical recovery in global growth can continue to act as a tailwind for Indian exports, which makes nearly one-fifth of India’s growth now.

From a longer-term perspective, like the ‘Currency war’ and ‘Trade war’, US’ policies could actually initiate ‘tax wars’ between countries. With US targeting to make its tax-structure more (domestic) business friendly, rest of the world may be forced to follow the suit and world-wide taxation reforms could spur the business activity in respective countries. Who knows, this ‘Globalization of Localization’ where every country is focused on incentivizing their domestic businesses could actually be positive for aggregate growth levels of the world.

With regards to Indian equity market, the ever improving liquidity and fading away of demonetization fears drove the market returns in February. FIIs turned out to be net buyers in February; pumping US$ 1.42 (year-to-date) and domestic mutual fund continue to remain buyers for nearly three years now.

On growth, the impact of reform measures, remonetization, monetary transmission and pick-up in global trade can stimulate cyclical demand in India. Nevertheless, we see the twin balance-sheet stress (corporate and banking sector) as one of the key pestering issues, which need to be ironed out to drive a sustainable growth in the country. With Sensex trading at around 18 times 1-year forward earnings, equity valuations are at the upper-end of the historical range and near-term upside may be capped. Liquidity is also chasing growth opportunities down the cap curve and some of the mid and small caps have risen sharply. That said, we remain positive from medium to longer term perspective owing to inherent structural strengths of the economy, bottoming of corporate profitability and prospects of domestic flows.

With regards to the bond market, double whammy of no rate cut and a relatively hawkish outlook in the last monetary policy meeting (on February 8th) took the market by surprise. The immediate impact was negative and yields have inched up by about 50-70bps post the rate decision.

The significant consideration underpinning the shift in monetary stance is the persistence of core inflation, which could provide further downward inflexibility in movement of headline inflation. Without stating it explicitly, the RBI has also seemingly shifted its focus towards core inflation rather than headline inflation. The central bank has candidly opined on transitory features of current soft inflation. By not responding to food led CPI decline, RBI has bought itself sufficient reasons to remain unmoved at the time of transitory upside risks in future. With GST likely to be rolled out this year, states adopting the 7th Pay commission and global developments rendering multiple channels of uncertainty, such instances (of upside pressures) will be many.

We expect the central bank to closely monitor the Inflation and commodity price movements. At the same time, monetary policy actions are unlikely to be independent of any material financial stability concerns arising from global developments, given that any such events could have feedback loop into domestic macros though the currency channel.

Since December, we have been running lower duration and our conservatism has been reinforced in the last two monetary policy meets. While, we believe that policy rate moves would be data-dependent but the adoption of neutral stance is likely to lend bearishness to the bond market in the near term. Supply-demand dynamics of the government bonds, liquidity situation of the banks once the demonetization effects completely dissipates, bank credit outlook and, global outlook will take prominence in guiding the bonk markets trajectory. We remain constructive, but with a slightly longer term approach as average CPI settle lower and government's measures to widen the tax base leads to structural improvement in the fiscal balance. Accordingly, we may increase the duration at the opportune time.

Navneet Munot, CIO – SBI Funds management Private Limited
March 3, 2017

(Mutual funds' investments are subject to market risks, read all scheme related documents carefully.)