Restoration to Expansion: India Mid-Year Outlook

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The state of the global economy

So far in 2021, the global economy has been in a "restoration phase" of strong growth and profits delivery, rising equity markets and higher bond yields. For the second half of 2021, we are transitioning to an "expansion phase" of the business cycle. That means that although we are going to continue to make good economic progress the outlook for investment markets gets tougher. The post-covid landing zone looks different depending on where we are in the world. Some countries such as the US are moving toward "mission economy", defining a much bigger role for state activism in supporting green and inclusive growth and higher levels of investment. The principal risk in this regime is an inflation over-shoot, while higher levels of corporate taxes can erode profit margins.

The India story so far

India experienced a significant increase on covid cases starting from February that developed into a "second wave". What was disconcerting this time around were the sheer numbers of infected patients as well as the severity of the disease that led to large number of people needing hospitalization exposing shortages in critical care capacities, oxygen concentrators and lack of coherent treatment alternatives. This led to a humanitarian crisis that triggered a global response of medical supplies aid as well monetary donations.

However, all throughout this period the impact on the Indian capital markets was much muted compared to the first wave experienced in April last year. With a significantly lower patient count, and overall hospitalization for most part the equity markets corrected almost 40% in a period of two months before rebounding sharply and the toward the latter half of the year went beyond the highs achieved prior to the start of the covid first wave. By contrast in the second wave the drawdown at its worst from the highs was limited. The rebound began much sooner and in correlation to global markets quickly achieved record highs by May 2021.

The growing unease at the disparity between the humanitarian crisis, the eventual lockdowns that were taken and the slowdown in economic activity that this may entail is being noticed enough to have key commentators to opine that investors should use caution in the given situation.

The economic parameters continue to show uptick and with the supply chain relatively unaffected in the second wave, GST collections are expected to rebound much faster than in the last year and corporate earnings estimates continue to remain buoyant. Consumer confidence and demand in general has come down in recent months and this reflects the sobering effect of personal loss and suffering that many Indians have faced in recent months.

The RBI continues to support the economy by way of an easy monetary policy and the introduction of the GSAP program highlighting the intent to support the bond markets through this period. Banks in particular have taken much benefit under this regime and will ensure a much gentler glide path as they combat a surge in bad loans and higher provisioning in response to the slowdown in economic activity and lower volumes. However as in the first wave some industries will have a bigger impact than others and the divide will continue to enlarge as a fear of a "third wave" and the continuing shortages in vaccines ensure a state of uncertainty regarding the covid situation.

Is a third wave likely?

There will be permanent losses in revenue as the slowdowns drag on for more time than originally expected and this will lead to a re-evaluation of GDP estimates. Already there has been a revision downward in estimates by several leading international security houses as well as multilateral agencies and the estimates for earnings also remain much under question. The trepidation seems to be surrounding the question whether there may be a "third wave". There is a case for the third wave theory as India has experienced a combination of negative factors. For starters the availability and distribution of the vaccine has been increasingly difficult to manage. There is a pronounced

shortage of vaccine dose compared to the demand at any given time. Adjustment of the time period between doses, bulk deals from manufacturers to the central government has led to some relief but the entire supply and distribution chain still remains delicate. While private hospitals and corporations and organizations have been allowed to distribute paid vaccines, the overall availability remain thin given anecdotal evidence at this time. Combined with a large population still "under inoculated" and the opening up of lockdowns in response to the data on lower infections opens up the specter of a "third wave"

However, the numbers could yet be below the ones faced in the second wave and the management of the situation can have learnings from the earlier period and hopefully the human impact will be lower.

What does the "expansion phase" mean for global markets and for India?

For global markets the expansion phase could mean a more difficult period for markets. Where we see P/E expansions in the restoration phase anticipating future earnings, the actual delivery of the same earnings typically depresses the P/E ratio in most cases. This also may lead to higher bond yields and steeper yields curves. There may be a natural cap to where bond yields are likely to go especially in the US, but there could be difficult market conditions.

Closer home, the RBI has reiterated the importance of keeping money supply easy. While there is pressure on inflation and it has overshot the band set out by the RBI, it is likely to "see through" the print due to base effects. Market multiples may also come to more reasonable levels as the earnings get delivered and for a period of time earnings growth could outstrip market growth. While this does appear to be a more muted market environment the easy monetary policy will ensure lower interest yields leading to opportunity costs yet not souring the equity markets completely. On a comparable basis the equity asset class can continue to offer attractive returns in comparison to other asset classes, though much lower than recently delivered returns.

Will the dollar appreciate?

The expansionary phase puts us in the "belly" of the dollar smile (refer graph) and unless we slide up the curve on both edges of the smile either leading the US economy to overheat or we slide back on a weak economy or a China credit contraction raising the US dollar as a safe haven asset.

Is Inflation a big worry?

Structural changes in inflation require a shift in expectations and often follow a period of overheating and fiscal activism. However, inflation can increase in the short-term due to supply-side pressures and commodity price rises. It remains to be seen if inflation can sustain at higher levels and to most estimates will subside after an initial surge.

Conclusion

With an uncertain period ahead of us following a nascent post covid recovery a lot depends on policy action and inflation expectations. What we already know is that the easy monetary policy will continue as long it supports growth but authorities will be watchful if the fiscal activism leads to overheating where there may be implications for monetary expansion. Most asset classes do not signify mispricing at this time which means that returns as a whole across asset classes will remain muted and investors will have to look hard elsewhere for alternatives that push the envelope on returns on traditional asset classes.

In India we expect asset class returns to remain in line with averages over the past few years unlike what we have seen in the last year due to slightly hardening bond yields and rich equity market valuations. We recommend a diversified approach to asset allocation in line with investor risk appetite keeping in mind that investors will have to accept a lower return environment for some time before we move out of this period of uncertainty.

Source: HSBC Asset Management, India (HSBC AMC), RBI, Bloomberg, Data as at 21 June '21 unless otherwise given.

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