

Market Outlook February 2022



Outlook 2022

Initial Commentary

Month of January 2022 saw heightened volatility with indices see-sawing based on Fed's dovish stance. Frontline stocks like TCS, HDFC Bank and host of other blue chips corrected in Jan on account of FPI offloading. FPI owned stocks saw a large correction as they continued selling in the new year too. They sold around Rs. 41300 crores in Jan 2022 on a net basis. (1.85 lac crores since April 2021)

Fed Policy

In the past we have stated that one needs to watch Fed reversing the easy money after which the equity markets will correct. Fed appears to be worried about inflation and likely to do away with bond buying by March 2022 instead of June as expected. This has led to outflow of money from all emerging markets across the world back in US Dollars.

Dollar Carry trades

With inflation rises, USD tends to gain. In US, if someone makes 2% return without country or currency risk, it is favored. Another reason is USD carry trade, where US investors borrow in USD, when interest rates are low and invest such borrowed funds in other markets or investment avenues (commodities, etc.). Such trade become risky when interest rates move up in USA and investors usually exit other assets and repay USD loans.

Quarter 3 Results

Most of us were awaiting Q3 results. Now that we are coming to the end of earnings season, we observe that results were a mixed bag this time around. Most of the FMCG, auto and manufacturing companies posted results a below estimates. Margins were affected by the steep rise in commodity prices for last one year. Third wave of Covid also affected Dec 2021 consumption rate.

Oil Prices

Oil has started moving up sharply and with Russia- Ukraine stand out, it's rising very swiftly. This is certainly not a great news for equity and debt market. This in addition to commodities' inflation is difficult news to the markets.

Inflation

Inflation has taken a toll on the world economies. Fed has taken serious note of it and will go for three rate hikes in the current calendar year. Market has discounted these rate hikes to an extent. However, increased pace in the hikes will cause the market to correct.

Addressing supply side issues and geopolitical peace is the only solution. Inflation will compel most of the central banks to raise the interest rates. If inflation and interest rates go up, then earnings will be affected.

PE Multiple

Corporate earnings multiplied by PE gives you the market price. With opening up of economy in Feb and lower than expected impacted of the third wave of the virus on the economy (evident by the highest recorded GST numbers in Jan 2022) will ensure that the earnings growth will remain intact or even better. But when margin is impacted with higher raw material prices, wages, or interest costs then multiple you get will also go down.

This PE readjustment will be seen in quarters to come as current inflation does not look transient but is here to stay

Reopening Theme

We can certainly see set back to the reopening theme as third wave was strong in terms of number of infections, and it was evident from 50% drop in air travel. Hotel occupancies too dropped in Jan 2022 post year end celebrations. Lot of B-to-B businesses get affected and cost absorption becomes difficult. This could pose as a threat to all earnings.

Budget

The Budget is out, and we felt it was like an earnings call for Government of India. Everything was done keeping economy and growth in mind.

The main theme was capital investment boost and cut down on subsidies. When private investment is not taking place then it is imperative for Govt to step in, in order to achieve GDP growth for economic, currency stability. These factors are important for any outside investor looking at India as an investment opportunity. We feel it is more realistic Budget as tax collection, Divestment targets seem to be more achievable this time around (owing to a very conservative Budget). Fiscal deficit of 6.40% was slightly off but looking at 35% hike in capital expenditure of 7.5 lac crore, we feel Govt has achieved a lot by sacrificing on fiscal prudence. In any case with the three waves of Covid, one cannot expect fiscal deficit to come under control immediately. Secondly, you cannot do it at the cost of employment, economic growth. Private capital too is limited. We feel capital spend of 7.5 lac crores will bring desired demand, employment, and consumption back in rural and urban India. Government is bound to bring down fiscal deficit to 4.5% by 2024-25 and eventually to 3.5%.

Tax structure and its main frame remains the same. We also feel revenue collection will be met with positive surprise looking at January collection of GST and I Tax collection till Dec 2021.

Q4 2021-22 earnings will be watched keenly and LIC IPO in March 2022 is expected to ease Govt finances. Budget did clip the dividend and bonus stripping options. On the other hand, capping surcharge on any long-term capital gains to 15% was a good move for the HNIs. Especially large land deals, buy backs by promoters etc. will lead to good tax savings in their hands.

What to expect from Equity Markets?

We are at 17700 level of Nifty on 2nd Feb 2022. Markets recovered sharply post Jan-end sell out by FPIs. No one knows how much of selling is still to come but our best judgment says we are definitely at the fag end based on following –

1. Fed News is out and digested by the market.
2. US bond yields already climbed to 1.85%
3. Inflation fear is real
4. Geopolitical tension running high
5. Quantum of stocks bought upwards of 17700 level of Nifty
6. Studying the Typical pattern of their selling

Thankfully, lot of monthly SIP book is intact and domestic buying helped indices to hold at current levels and lower the volatility.

Globally markets have corrected closer to 8% to 10% and we expect correction can last till the end of June 2022. This is based on the following –

1. Corporate earnings have to improve (margins need to be stronger)
2. Economy needs to open completely to reach pre covid level
3. Consumption has to resume
4. Hospitality and tourism sector needs to revive
5. Inflation to cool off will take time
6. FPI needs to start buying again

Till then we can expect Nifty to be range bound between 17000 to 18000 and to remain sideways.

Events like LIC IPO will make it volatile at times but any significant correction from current level can be ruled out

It will also remain very stock specific. As expected in our earlier outlook banking has recovered strongly. IT will gain again and sell off was more of profit booking. Looking at Budget spend on Capex we feel infrastructure sector with its enablers (like cement, steel, housing finance, banks) will gain first being direct beneficiaries.

The risk reward of investing in equities looks favorable looking at rising interest rates in debt market. We prefer multicap or flexicap strategy at this stage though large cap valuation is looking attractive too. Please note market may not favor growth only from this point on. Blend of value and growth is thus a better strategy.

Any sharp re rating of growth stock due to margin or earnings growth issue pose serious threat to growth strategy.

Avoid any sectoral bet going ahead as most of the sectors are not looking cheap post the current recovery. Thus, staggered investment till June will help as we hope markets to be in better condition in the second half of 2022-23

Also, one need to moderate return expectations from equity and keep them in line with the expected earnings growth for 2022-23

FIXED INCOME

The last Fed Meeting commentary was dovish, and concern was mostly about inflation. Fed changed stance and reduction in bond buying signaled to end by March 2022 itself. It also pointed out at least three hikes in current calendar year.

Bond yields rose sharply globally, and US 10 year touched 1.90% before settling at around 1.855. RBI too is fighting against inflation and interest rate hike in India is not far away. With fear of Covid fading slightly (impact point of view), and high inflation will make RBI to slowly stop bond buying and look at interest rate hike. RBI has already started liquidity with withdrawal of Gov securities acquisition programme (G-SAP) and tightening of short-term rates

All eyes are on the next MPC meeting on Tuesday, where RBI may hike reverse repo rate based on the huge borrowing announced in the Budget (gross borrowing of Rs. 14.1 trillion and net borrowing of Rs. 11.6 trillion where expectation was of Rs. 8 lac crores for the next financial year)

On the other hand, market took fiscal deficit number very negatively as expectation was closer to 6.2% and bond yield rose sharply post the announcement to 6.9% on 10 yr. GSec front

6.4% against 6.2% deficit was not digested by the market for want of commentary as to how they will cope with it. Borrowing calendar will help us understand it better. India will see next 12 months of rising interest rate across the curve. We expect 10 yr. to reach 7% soon and advised in the last two outlooks to stay at the lower end of the curve

We have studied the impact of missing one indexation for long term investors (holding period of 3 yrs. plus with four indexations) Our study shows it is beneficial to take additional indexation than waiting for even 50 bps rise in the yields. Thus, we feel anyone investing today with carry of about 6.50% and 50 bps expenses, may end up earning post tax 5.50% at least after 3.2 years of holding translating into 7.5 % gross returns. This is after staying in G.sec plus SDL portfolio without roll down strategy.

Roll down strategy will offer slightly better returns with a blend of some AA, AA+ or even AAA corporate papers.

Currently looking at yields carry advantage is huge and offer great cushion against volatility. It also offers good opportunity to generate better post tax returns over 3-4 years of holding by investing before March 2022. Carry against spike in yields beyond 6.91% over 3-4 yrs. has certain advantage today.

Looking at long term fiscal deficit targeting 4.5% and 3.5% by 2025, we feel comfortable investing in roll down strategy or even dynamic bond funds provided investors are comfortable seeing MTM losses for initial period of 6-8 months. Indexation advantage is huge against waiting for yields to peak out. This strategy will go wrong if yields are to shoot up to 8% from here, which does not seem likely

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