Market Outlook

A second wave of virus in the Western world has become a reality. This along with failed negotiations on fresh US fiscal aid and the uncertainty around US presidential elections have acted to keep financial markets volatility high. This led to markets continuing to trade choppy for a second consecutive month, in line with our view. The news locally however was better with the reopening led improvement in economic activity continuing and more importantly Covid infections finally showing signs of moderation. Corporate results too have been better than expectations so far driven by cost control and beat from banks. Yet, given the muted domestic flows, Indian markets continue to be driven by foreign flows and should follow global trends in the near term. Globally a potential double dip in growth owing to fresh Covid-induced lockdowns and fading fiscal support is a key monitorable.

However, the most keenly awaited event in the near term stays the US Presidential election this week. The outcome assumes much greater importance in the wake of a more prominent role for fiscal policy and fragile geopolitics. We have long maintained that globally monetary policy is reaching its limits and that fiscal policy will have to play the dominant role now to reflate the global economy. While the unconventional monetary support of the past decade has certainly helped global economies, it has failed to meaningfully revive growth or inflation. Arguably, the benefits have been skewed with asset inflation being a dominant outcome even as wage inflation has failed to look up. This has led to rising inequality which in turn acts to keep aggregate demand subdued. Fiscal expansion and redistributive policies are therefore the need of the hour to revive growth and inflation. A democratic sweep appears to be the most favourable outcome in this regard.

Democrats are likely to follow a more expansionary fiscal policy with focus on redistribution. Reviving blue collared jobs through infrastructure creation appears high up on agenda. Biden’s focus on Green Infra can potentially lead to a new cycle globally. At a time when rates are low, resources are cheap, wage pressures have been absent, and there is need to replace ageing and obsolete infrastructure, with pressing environmental concerns, the timing appears just about perfect. This has the potential to create jobs, revive demand and perk up growth and inflation. To be sure, the current deflationary global environment is also a function of several structural forces such as demographics, globalization, technological advancements to name a few. And these forces are here to stay, and we must not undermine their role in keeping inflation low. However, overall a conducive demand environment will help and lead to a stronger reflationary pulse versus the deflationary environment of the last several years. For corporate America, likely increase in tax burden, regulation and labour costs may dampen margins. Yet a supportive demand environment should offset some of these pressures. Global reflation should help too as MNCs derive a chunk of their earnings from outside the USA. For EMs, global reflation and consequent weaker dollar should both be decisively positive.

Even as the base case currently is of a Democratic Sweep, other scenarios should not be completely ruled out and are likely to be less supportive for markets, especially EMs. A related near-term risk is that if the election results are close and are contested, that can lead to an interim period of policy uncertainty. This will further dampen the hopes of a near term fiscal package in the US at a time when virus surge stays unabated. Overall, we believe that there is need for sustained fiscal support in the western economies. With debt levels now reaching World War II levels, history suggests that this high debt must be paid off through growth, which in turn will require fiscal push. A restrictive or stop-start kind of fiscal policy, we believe, is a key risk to return to sustainable growth and inflation. This can very easily lead to Japanification of the world with deflationary forces continuing to dominate. This has serious implications for investors. While financial repression will mean bond investors suffer, beyond a point equities won’t work either as the experience from Japanese equities suggests- Nikkei for example is still significantly lower than the peak it hit over three decades ago. Afterall, reduction in the discount rate helps to an extent but eventually earnings growth is vital for equities to deliver.

A reflation will not only help equities as an asset class through earnings revival, but it also has implications for the complexion of equities that deliver. Just as there is inequality at an individual level, there has been increasing polarization in stock markets too with select few stocks becoming disproportionate share of overall market cap. These have either been stocks that benefit from lower discounting factor owing to their longer duration cashflow profile and stable earnings or have been on the right side of technological disruption. With growth becoming more broad-based, this polarization should reverse. Looked through other lenses, this would mean reversal in polarizations of value versus growth, small caps versus large caps, cyclicals versus defensives, and also importantly Emerging Markets versus Developed Markets.

For India, a global reflation could just be the icing on the cake. We appear to be preparing ourselves well for sustainable and inclusive growth. On one hand, we have done well on empowering masses through various social initiatives such as sanitation and cleanliness through Swachh Bharat, Ujjwala scheme for LPG connections, the JAM trinity (Jan Dhan bank accounts, Aadhar cards and Mobile connections), using technology for benefit transfers to name a few. On the other, we have undertaken a host of legislative reforms to incentivise the private sector, labour and agri reforms, tax reforms, insolvency code, and PLI schemes to incentivize manufacturing, amongst others. Incrementally, we need to stay focussed on execution - expanding our institutional capacity on judicial and administrative fronts, infrastructure creation, ensuring transparency and sanctity of contract. Having focussed on creating the engine of growth, we believe there is a strong need to kickstart that engine through a judicious fiscal boost. While fiscal capacity is constrained, given the savings glut, local as well as global, we must not underestimate our ability to fund a credible growth plan. Once set in motion, the private sector will get in by itself. The private sector on its part must respond with more innovation and strong focus on ESG to ensure sustainable growth for all stakeholders.

On the monetary policy side, the RBI has been aggressive and unconventional in the crisis. Right from ensuring abundant liquidity and providing aggressive rate cuts to unorthodox measures like TLTROs, Operation Twists, OMOs for SDLs and easing of prudential norms, the RBI has not left any stone unturned in supporting growth, while government's credit guarantees have helped provide a multiplier effect. It has been successful in bringing about an easing in credit spreads for better rated corporates as well as in reducing term premium even as the latter is still somewhat elevated. The RBI has so far also overlooked near term challenges on inflation and stayed focussed on reviving growth. Inflation so far has been supply side driven and we hope the government will ensure that it is brought under control through appropriate supply side measures so that the massive monetary effort made so far doesn't need to be reversed.

With RBI staying accommodative and with the moderation in virus spread leading to continued pick-up in economic activity, improvement in transmission should continue, which should further aid economic and corporate activity. 90% companies in our universe are witnessing earnings upgrades. Further pick-up in corporate activity is being underpinned by easing credit spreads, robust durable liquidity growth, low real rates, reduced economic policy uncertainty, steep yield curve etc. Yet it is too early to say whether the virus spread has been decisively controlled with the festive season and winters upon us. The recovery so far may have been pent-up demand led, and how consumption and savings patterns eventually shape up in the aftermath of the crisis, and whether corporates and consumers continue to stay cautious for long is yet to be seen. If anything, the nature of the recovery so far has indeed been 'K' shaped, with widely varying fortunes across sections- rural vs urban, goods vs services, formal vs informal and so on.

We therefore maintain that a fiscal boost is a must to kickstart the long overdue economic and earnings cycle in India. A decisive reflationary shift in global policy can be an added tailwind. Real estate, which has an important bearing on the economy owing to the high multiplier impact, is showing initial signs of recovery which is encouraging. Private sector balance sheets are in better health to capitalize on growth opportunities as they present themselves. We have long been below trend on both economy and earnings and the onus is on all stakeholders to strive and deliver on our potential. We are constructive on duration in fixed income portfolios, while keeping a close watch on inflation, fiscal situation, and global environment. We are anxiously excited on equities as we believe the next earnings upcycle may be near, near term risks notwithstanding.

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