Market outlook

Interpretation of US Federal Reserve's statement on the tapering of quantitative easing program increased volatility across all markets. Treasury yields increased across economies and Emerging markets saw portfolio outflows. First time after the Lehman crisis in 2008, almost all asset classes witnessed a synchronized fall and increased correlation. Even gold fell 11%. Emerging markets have been big beneficiaries of the excess liquidity in the global system and any reversal in central bank's stance would impact them. Financial markets have got excessively anchored to central bank's policy moves with lesser focus on economic reality. Volatility across asset classes had fallen to historic low levels and this complacency would have made US Fed more cautious. At some point excess liquidity will have to get withdrawn. Having said that, we must keep in mind that it would be contingent upon incremental economic data and they would ensure not to make it disruptive for markets and the economy. If history is any guide, then Fed tightening finally turns out to be good for the markets as it reflects strengthening of the economy. Though initially it always creates ripples across markets.

Due to foreign investor's selling, Sensex lost 1.8% over the month. In US dollar terms, it lost a meaningful 7%+, largely in-line with its emerging market peers. FIIs sold $ 1.6 billion worth of Indian equities in June. This brought down the YTD net FII inflows to $13.6 billion. Domestic Institutions turned net buyers in June with a net inflow of $1.5 billion, contracting the net YTD outflow to $7.6 billion. Portfolio outflows and uncertain global liquidity situation led to the sell-off in Rupee against dollar. Rupee depreciated a significant 5% for the second consecutive month.

Global investors have been overweight on India so outflows from emerging market bond and equity funds resulted in FII selling in our markets. We believe that in the medium term, at least within the emerging market space, India would continue to get higher allocation, given India's relatively higher growth potential, at the margin improvement in macro and interesting bottom up stock picking opportunities. We believe that given the downshift in China's growth potential, most of the other commodity producing countries would get impacted negatively. This augurs well for India. Lower commodity prices would help us in addressing trade deficit, fiscal deficit (subsidies) and inflation.

Policy environment in India remains interesting. The month witnessed cabinet reshuffle to consolidate its positioning for forthcoming election season. The move also coincided with break-up of 17-year old ally in the opposition coalition. Under pressure to perform against the onslaught on rupee, the government announced series of positive measures like - a shift in domestic gas pricing formula from fixed price to market linked, allowing Power utility companies to pass-on the increased cost of imported coal to end consumer and substantial and time-bound targets for key infrastructure sectors for FY14. The government is staying firm on its commitment through the testing period when it comes to incremental reforms on the fuel pricing.

India's core story remains intact in terms of potential opportunity from consumption, export competitiveness (furthered with recent currency depreciation), improved governance (both corporate and government) and supply side investments. While retaining our focus on bottom up stock picking, our bias has shifted towards increasing exposure to cyclicals as interest rate cycle is shifting down, growth is bottoming out and macro and policy situation are improving at the margin.

Domestic investors have been underweight on equities and should use the volatility induced by global events as an opportunity to build equity exposure as long term potential remains intact and valuations are reasonable.

Global developments guided by the prospects of tapering and unwinding of QE by the US Fed continued to guide the direction of the bond market. With the rupee coming under pressure, the bond yields retraced some of their gains in anticipation of a pause in the June policy. In the Mid-Quarter Policy Review on 17th June, RBI kept the repo rate and cash reserve ratio (CRR) unchanged at 7.25% and 4.0% respectively. The recent external sector developments which highlighted the risks surrounding capital flows in an environment of probable changes in global central bank policies weighed in on the RBI policy stance.

Subsequent to the FOMC June meeting, bond yields and the INR moved in line with the broad direction of sharp rise in global government bond yields and weaker EM currencies relative to the USD. Substantial weakness in INR owing primarily to increased uncertainty on the global front and dependence on capital flows caused the market to reassess the magnitude and timing of future rate cuts. Furthermore, substantial decline in yields over the previous few months led to profit taking on the part of various market participants. The old 10 yr benchmark bond yield moved higher by around 17 bps over the past month and closed at 7.61%. The new 10yr benchmark bond issued at a cut off yield of 7.16% ended the month at 7.44%. Subsequent to the Fed Chairman's Congress testimony in May, the new 10yr benchmark security yields have moved up by about 28 bps and the INR has depreciated about 7.17%. AAA corporate bond yields have moved up by around 35-38 bps over the last month. FII unwinding and relatively shallow volumes have resulted in spreads moving higher over the month.

Macro economic data points released over the last month continued to remain softer than market expectations. The WPI data for May 13 registered a y-o-y growth of 4.70% as compared to market estimates of 4.88%. The CPI which has been relatively sticky printed at 9.31% y-o-y for May 13 as against the estimates of 9.00% and the previous month reading of 9.39%. The inflation readings of the past several months have consistently provided a picture of declining core inflation. However, with the sharp decline in INR over the past month, we need to keep an eye on this trend going forward. Growth numbers released over the month also were muted with IIP y-o-y growth for April 13 at 2.30% compared to revised previous month growth of 3.4% y-o-y. HSBC India Manufacturing PMI for May 13 was also lower at 50.1 compared to 51 for the previous month. On the brighter side, India's 1Q2013 current account deficit improved more than expected to 3.6% of GDP from 6.5% in the previous quarter. This was driven by a lower trade deficit as exports increased and imports declined mainly led by lower non-oil non-gold imports.

The RBI policy guidance does not explicitly signal a more cautious tone from earlier guidance as the RBI is increasingly likely to factor in developments affecting the stable funding of the current account deficit for the sequencing of additional easing. The RBI has also acknowledged the positive fiscal policy developments, which if sustained could lower the risks on the twin deficits and also revive investor confidence. The domestic growth inflation outlook remains favorable for potential additional easing over the coming months. In the interim, the developments relating to the external sector and global developments may continue to impart volatility.

We expect a gradual improvement in the external sector driven by incremental slowdown in oil and gold imports and improving export competitiveness on the back of INR depreciation. Soft macro data and reduced pricing power provide leeway for additional policy rate cuts. However, the extent and sequencing of the same will depend primarily on incoming data and global market conditions. We have been managing the duration and asset allocation on a very tactical basis to take advantage of opportunities created by global events and market positioning.

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