

Market view

Equity markets

Easing commodity prices particularly crude oil, hopes on resolution of Greek crisis and government announcement of increase in retail fuel prices along with duty rationalization on petro products led to a recovery in the market. The BSE Sensex recouped the losses towards the month-end and closed 1.85% higher. FIIs poured over a billion dollar in last 5 trading sessions and that has made them a net buyer of Indian equities for year till date.

Greek vote of affirmation on austerity measures amidst massive public protest has come as a sigh of relief for global markets. But given the structural issues and lack of growth drivers, the crisis has been avoided for the time being and not completely resolved. Problems in peripheral Europe will continue to hound markets for quite some time, in our view.

Our view has been that moderation in global economic growth, monetary tightening in emerging economies, end of quantitative easing by US Federal Reserve and unwinding of speculative positions would lead to softening in commodity prices. Nymex crude oil price has fallen by 17% over the last 2 months. Industrial metals and several other commodities have witnessed price declines. This augurs well for Indian economy and corporate profitability. Pressure on margins on account of increase in input prices, wages and interest rates was evident in quarterly earnings. Though the WPI back data is steadily being revised upwards and is likely to witness further uptick next month on the back of increase in fuel prices, fall in global commodity prices will help in soothing nerves about inflationary expectations.

The Indian Meteorological Department (IMD) announced that rainfall during the current South-West monsoon would to be 'below normal' marking a downgrade from its earlier 'normal' forecast. Globally, agri-commodity prices have softened recently and with record food grain stocks with the government, food price inflation on a high base of last 2 years is expected to remain under control. However, markets would be closely watching progress of Monsoon as any shock on food prices could aggravate the inflation and fiscal situation.

Global uncertainties, lag effect of monetary tightening, policy gridlock and slowdown in fixed capital formation would take a toll on growth expectations, in our view. The eight core infrastructure industries registered a disappointing growth of 5.3% in May 2011 compared to 7.4% in May 2010. In cumulative terms, core infrastructure industries registered a slow growth of 4.9% in April-May 2011-12 as against 7.9% during the corresponding period of the previous year 2010-11. Slowdown is also evident in discretionary spending as growth in auto sales has moderated sharply.

Though RBI is likely to increase policy rate by 25 bps in next policy setting meeting, we are getting closer to the end of tightening cycle as growth momentum seems to be tapering off. Our bigger worry is on the fiscal side where mounting subsidy bill and shortfall on revenue side and disinvestment targets could lead to slippages to the extent of 0.5% of GDP. As government borrows more money in the second half of financial year, it could crowd out private investment.

As a result of unearthing of a series of scams, the country has been facing policy impasse for almost a year. The governments' attention has got diverted to managing the political situation and public uproar and there is a sense of inertia within the bureaucratic system. Judiciary and media have been more active while executive working has been in a state of gridlock. This has resulted in severe loss of confidence among

business community and getting reflected in slowdown in capital formation. FDI inflows have fallen sharply while Indian corporate houses are looking overseas for further growth as doing business locally is becoming tough. Roll out of GST and Direct taxes code seem to be getting deferred. On top of all these, global uncertainties, high inflation and tight monetary conditions have made matters worse for the corporate India. In this environment, stock market would surely reward companies with stronger balance sheets, high capital productivity and free cash flow generation and having visibility of growth with pricing power. The premium that investors are paying for these attributes has never been so high in recent history. Is this trend likely to change? Our answer would be yes but the key is getting the timing right. Given the current environment and macro headwinds, it may be little early to turn contrarian but the pay-off as and when the trend turns could be quite handsome.

While markets may remain volatile for some more time for the reasons discussed above, we recommend investors to use this as an opportunity to increase exposure to equities in a gradual manner. The long term fundamentals of Indian economy and structural drivers of growth remain intact while valuations are reasonable and in line with historical average.

Fixed income

RBI continued with its anti inflationary monetary policy stance and raised repo and reverse repo by 25 bps points to 7.50% and 6.50% respectively in its policy setting meeting on June 16. This was the 10th rate hike since last year. Wholesale Price Index (WPI) for May at 9.06% came in higher than market expectations and more worrisome was core inflation that was at 7.30%. RBI mentioned that inflation continued to remain its primary concern while there was no evidence of a broad-based deceleration in economic growth. RBI believes that underlying inflationary pressures are not fully captured in the headline number. In fact, the pass-through of higher global energy prices is yet to be factored in. RBI acknowledged that the monetary tightening so far has been effective in checking aggregate demand, but rightly appears ready to sacrifice some near-term growth for stronger sustainable medium-term growth in a lower inflation setting.

The month of June continued to witness the usual tightness on account of advance tax outflows of around Rs.30,000 crores and due to the quarter end demand for funds. Despite the tightness, short term money market rates fell as mutual funds having enough maturities during the month bought aggressively. As far as liquidity situation is concerned, the worst seems to be behind us as structural mismatch in credit-deposit ratio is getting corrected.

The 10 year government bond touched a low of 8.19% before closing at 8.33% during the month. Post RBI policy announcement, government bonds reacted negatively, but rallied thereafter with global environment supporting risk free assets in the wake of Greek crisis. US treasuries touched a low of 2.87% before closing the month at 3.16%.

Bond yields are unlikely to soften much from current levels in the immediate term in view of hawkish stance of RBI and continued supply pressure from government. However, we believe that RBI is near the end of tightening cycle in terms of policy rates and global environment is turning positive for bonds. While the near term pressures are evident, inflation could moderate in medium term given that global commodity prices are showing signs of cooling off. With the past rate hikes taking effect, we could witness some slowdown in growth targets forcing the RBI to soften its stance. But we are more concerned about the fiscal side where mounting subsidy bill and shortfall on revenue side and disinvestment targets could lead to slippages to the extent of 0.5% of GDP. The additional borrowing by the government in second half will keep the downside in yields checked.

Though market may remain in a trading zone for some more time, we believe that investors with risk appetite and longer horizon should consider investing in Dynamic bond fund. There would be trading opportunities both in G-sec and credit markets while core portfolio of short term assets would offer decent accrual income. Investors should take advantage of high short term yields by investing in accrual products like short term funds and Fixed Maturity plans.

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(Mutual funds investments are subject to market risks, please read the scheme Information document carefully before investing.)