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RATE HIKE CYCLE IS BETTER FOR PRICE DISCOVERY IN MARKETS AS RISKS GET PRICED IN

Global recovery has started losing momentum, impacted by resurgence of infections in several parts of the world, supply disruptions and the persistent inflationary pressures. Two events – Yemen Conflict and Ukraine Conflict - have somewhat unsettled the outlook in 2022. With inflation persisting at high levels, several EMEs were first off the mark in normalising and even tightening monetary policy. In AEs too, persistent price pressures have induced some of them to raise policy rates . Federal reserve (Fed) has dropped any reference to inflation as "transitory," with the Fed instead acknowledging that price increases had exceeded its 2% target "for some time." Build up to first Fed meeting has already seen sharp correction in equity prices and rise in treasury yields in the US.

Yields in India have steadily risen in narrow band. Surprisingly, the market participant as gauged from latest RBI professional forecaster survey underpriced the impact of rise in yield in response to Fed announcement. The yield is expected to continue northwards in Q4 . We believe G-sec rates could move in the range of 6.4-6.8% (pre pandemic level). We expect that even though signaling repo rate may be capped at 4% by the RBI, through much of FY23, a spread of 275 points over repo rate may be risk spread given the demand supply inequality. It is expected that crude price might stay high in near future at current levels.

However, amidst all this, there is a silver lining. The markets may have factored in that the current omicron will result in a endemic stage in the covid cycle and thus a faster normalization of economic activities. **Additionally, in any rate hike cycle, the financial markets actually does better as any material risk is factored in the prices. Interestingly, for India, with TREP and call rate currently at much higher than reverse repo rate, we believe the stage is set for a reverse repo normalization.**

In the Indian context, during the growth boom for the 3 year period ended 2008, when the signaling rate /repo rate jumped by 275 basis points, the NSE Index had jumped by 79.1%. Interestingly, for the 2 year period ended 2011 , when rates jumped by 375 basis points, NSE Index did jump by a staggering 54%. Clearly, better risk pricing always results in better price discovery in markets.

We believe that the redemption pressures of the Government is going to be significantly large and will peak in FY27 at Rs 6.25 lakh crores. The redemption of G-secs are particularly large beginning FY23. What is more significant is that average oil bond redemption at Rs 35,000 crores will be an added headache from FY24 onwards. Considering all this, the RBI and the Government in conjunction will have to do large switches in next couple of years to manage the redemption as a part of signaling.

LOGIN 2022: GROWTH, INFLATION AND GEOPOLITICS

- Global recovery has started losing momentum, impacted by resurgence of infections in several parts of the world, supply disruptions and bottlenecks and the persistent inflationary pressures that have manifested themselves in their wake.
- The slowdown in activity is occurring even in countries with relatively high vaccination rates that seemed to be emerging as global growth drivers. For many EMEs, however, vaccine access remains a binding constraint and output and employment remain below pre-pandemic levels.
- WTO now expects the volume of world merchandise trade to increase by 10.8% in 2021 and by 4.7% in 2022. The forecast for 2021 marks a strong upward revision from the previous estimate of 8.0% from last March, while the forecast for 2022 represents a more modest upgrade from 4.0% previously.
- However, pace of quarterly expansion should ease as the volume of merchandise trade approaches its pre-pandemic trend. Headwinds in the form of semiconductor shortages and shipping backlogs will probably also weigh on trade in the near term, but the biggest downside risk continues to be the COVID-19 pandemic.
- With inflation persisting at high levels, several EMEs were first off, the mark in normalising and even tightening monetary policy. In AEs too, persistent price pressures have induced some of them to raise policy rates and/or contemplate hastening normalisation. Federal reserve (Fed) dropped from the latest policy statement (that is December 15) any reference to inflation as "transitory," with the Fed instead acknowledging that price increases had exceeded its 2% target "for some time."

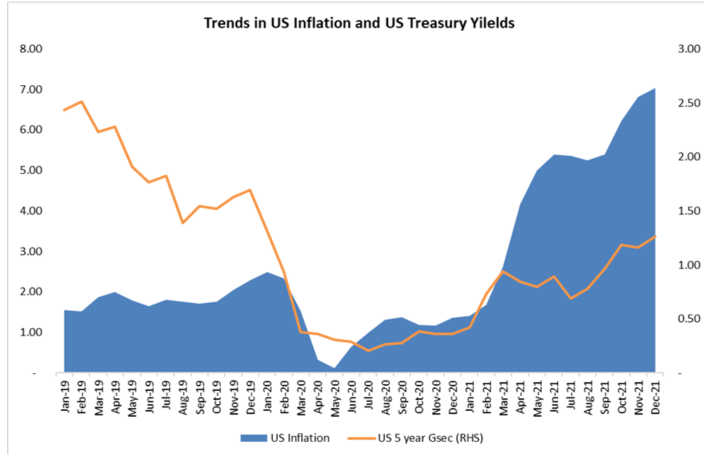
- As a result, logging into 2022, risks to the forecast are predominantly on the downside. These include long list of port congestion, rising shipping rates, and shortages of semiconductors. The combination of supply side disruptions and strong demand for goods may also be contributing to inflation, which has hit multi-year highs in certain advanced economies.
- The spill over of the Fed policy action due this week might impact the cost of financing in EMEs and sooner or latter the interest rate cycle will turn across countries.

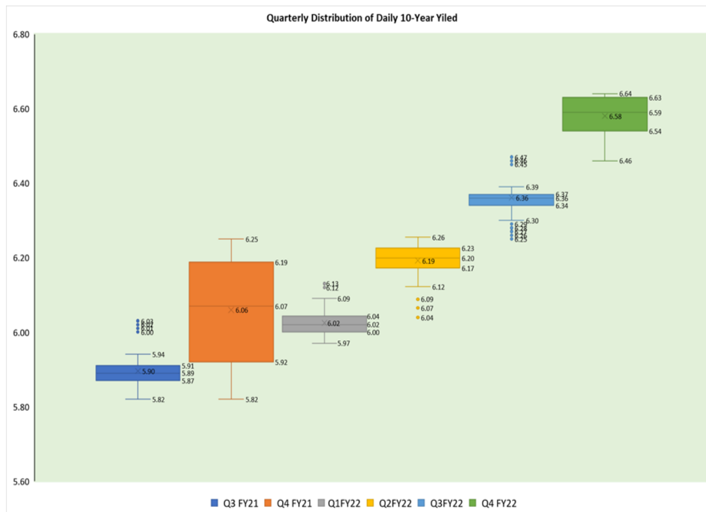
GEOPOLITICAL OUTLOOK

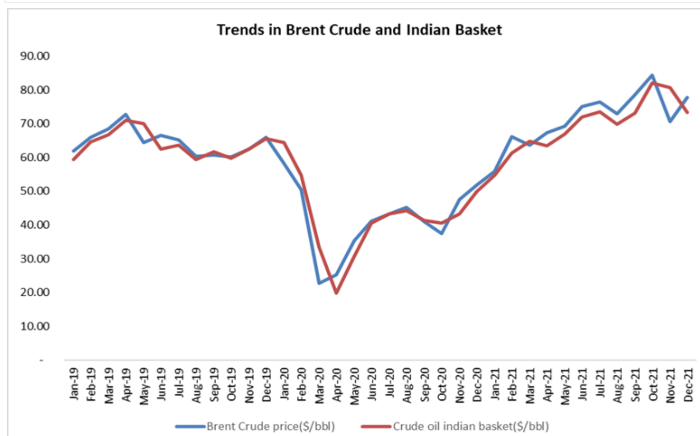
- Two events – Yemen Conflict and Ukraine Conflict - have somewhat unsettled the outlook in 2022.
- This includes the sudden escalation in hostilities between countries in Middle East region. The resurgence conflict was underestimated risk and its impact on oil price was sharp and sudden. The potential disruption of cargo traffic in strategic the Bab-el-Mandeb Strait connecting the Gulf of Aden to the Red Sea may have cascading impact on trade and commodity prices.
- The potential conflict between Ukraine and Russia would be felt across a number of markets, from wheat and energy prices. The current round will be the second round of such hostility with first such episode happening in 2014.

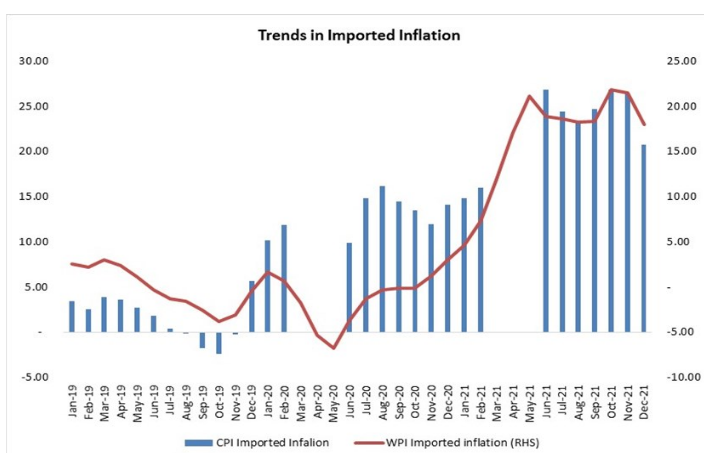
FED RATE HIKE AND ITS SPILLOVERS

- Federal Reserve said on December 15 that it would end its pandemic-era bond purchases in March and pave the way for three quarter-percentage-point interest rate hikes by the end of 2022. Dropped from the latest policy statement was any reference to inflation as "transitory," with the Fed instead acknowledging that price increases had exceeded its 2% target "for some time."
- As a result of that combination of rising prices and strong employment, officials at the median projected the Fed's benchmark overnight interest rate would need to rise from its current near-zero level to 0.90% by the end of 2022.
- That would kick off a hiking cycle that would see the policy rate climb to 1.6% in 2023 and 2.1% in 2024.
- Build up to first Fed meeting has already seen sharp correction in equity prices and rise in treasury yields in the US.









IMPACT ON INDIAN MARKETS IN Q4 AND FY23

- **10-year yield and asset prices**– Buildup of inflation and expectation of rate hike has pushed the 10-year yield beyond 6.50% in Q4. The yields have steadily rise in narrow band. Surprisingly, the market participant as gauged from latest RBI professional forecaster survey underpriced the impact of rise in yield in response to Fed announcement. The yield is expected to continue northwards in Q4.
- The increase in US treasury short rates have a higher impact of long end of rupee yield curve. A 100 bps rise in US short rates translates into 20-30 bps rise in long end. The US short end has already moved by 20 bps and is expected to harden further if rate hike materializes.
- In similar vein, the correction in equity prices is expected to continue to in Q4. As FII readjust to higher rates in US, portfolio reallocation may see lesser exposure to EME.
- **Inflation & Exchange rates** - Rate action in the US markets is expected to have some negative impact on economy through exchange rates channels and commodity prices. An appreciation in dollar will weigh on the USD/INR rate and COVID-19 supply disruption and geopolitical tension. It is expected that crude price will stay high in near future. As result depreciation of rupee will impact CPI inflation. Historically 10% deprecation translates into 40 bps upside in CPI.
- Surprisingly, the trends in imported CPI and WPI inflation have largely gone unnoticed. In 2022 these subcomponents needs to be monitored more carefully given their both direct and indirect impact on general price levels.
- We however still expect only a gradual unwinding of the liquidity overhang in the banking system by the RBI. The RBI has been conscious of the multi paced recovery and is unlikely to change its rate stance any time soon , though it might clearly move towards a liquidity neutral strategy. The FY23 Government borrowing programme needs to be managed very adroitly and orderly by putting a cap on the size of Gross Borrowing programme. Interestingly, the Government may prefer more switches this year in FY22 itself to adjust the net borrowing programme in FY23 to reduce the redemption in this regard.

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