Managed Portfolios - Insights

RBI Policy: *Steering India through the 'Storm'*

Morningstar Investment Adviser India

September 30, 2022

As widely expected, the RBI's MPC, by a majority of 5 out of 6 members, voted to increase the policy rate by 50 bps to 5.90% and to remain focused on the withdrawal of accommodation to ensure that inflation remains within the target going forward, while supporting growth. Consequently, the standing deposit facility (SDF) rate stands adjusted to 5.65%, and the marginal standing facility (MSF) rate and the Bank Rate to 6.15%.

Investors have been roiled by the high volatility that markets have faced in 2022 given the uncertainty over global growth contributed by a multitude of factors such as monetary tightening by central banks to tame inflation, the Russia-Ukraine war and tepid demand from China owing to the zero COVID policy. Central banks, particularly, in the advanced economies are now aggressively fighting off multi-decadal high inflation, even at the cost of growth. Commodity prices have witnessed some correction since June, but they are still higher than pre-COVID times. Back home, the inflation situation has not been as alarming as in the west, but inflation has persisted above RBI's upper tolerance band for the eighth month as of August 2022 which coupled with concerns around the rupee's sharp fall has supported RBI's rate action today.

Our Views

The RBI has raised policy rates by a cumulative 190 bps points so far in 2022. We expect the current rate tightening cycle to peak around 6.25-6.75% by the end of the current fiscal year with upside risks depending on evolving domestic inflation situation, rupee-dollar dynamics and the pace of monetary tightening by advanced economies. With inflation expected to taper off from Q3:FY23 amid a decline in crude oil and other commodities, further rate hikes from current levels are expected to be gradual and data dependent.

In recent times, the debt market has been buoyed by expectations of India's inclusion in sovereign bond indices, which was expected to bring in about USD 30-40 bn of passive inflows into the bond market. However, yields were subsequently pressured by anticipation of aggressive tightening by the U.S. Fed which later apart from delivering a 75 bps hike also showed unwavering resolve in taming inflation. The RBI Governor termed the aggressive tightening and aggressive forward guidance from advanced economies' central banks as a 'third major shock'. Persistence in domestic inflation and a sharp depreciation of the rupee too has firmed yields further amid expectations of a sizeable rate hike by the RBI. The 10-year G-sec benchmark has risen to 7.43% (as of Sep 30, 2022) having dipped to a low of 7.11% since the last RBI policy in August. The yield on the 10-year benchmark G-sec was trading around 7.43% post the policy announcement.

©2022 Morningstar. All Rights Reserved. The Morningstar name and logo are registered trademarks of Morningstar, Inc. This document includes proprietary materials of Morningstar. Reproduction, transcription, or other use, by any means, in whole or in part, without the prior written consent of Morningstar is prohibited.

Rates at the shorter end have moved up sharply (~250 bps) in 2022 following rate hikes by the RBI, and a sharp decline in banking system liquidity amid improved credit offtake, forex intervention and liquidity absorption measures by the RBI. The overnight rate has now (post today's policy) moved just above the repo rate of 5.9%. Systemic liquidity has declined to a deficit of INR 18,728 crore from a surplus of over INR 8 lakh crore at the start of the year. Improving credit offtake and higher demand for cash given festive season demand is expected to create further demand for liquidity. The Governor assured that fine-tuning operations either to inject or withdraw liquidity would continue as needed from time to time. Also, a pick-up in government spending in H2:FY2023 along with drawdowns of excess CRR and SLR holdings of banks is expected to ease liquidity pressure. The sharper up move at the shorter end has resulted in the yield curve flattening by a considerable extent, lowering the relative attractiveness of the medium-long term segment relative to the short-term segment and cash. The term spread (10-year – 3-month T-bill) is now ~1.3% vs 3% in March end, and is now lower than its long-term average of ~1.5%. Considering the latest inflation print of 7% (August 2022), real rates at the shorter end are in slightly negative territory but compare favourably with much deeper negative rates in the U.S.

India's current account deficit (CAD) printed at 2.8% in Q1:FY2023 (0.9% surplus a year ago) driven by a widening merchandise trade deficit (8.0% of GDP). India's CAD is expected to be ~3.5% of GDP for FY2023 owing to sagging external demand and strong domestic demand. The widening deficit along with strength in the U.S. dollar has weighed on the rupee which has depreciated ~9% in the YTD period (as of Sep 29, 2022), but it has appreciated against most other currencies (including the Pound Sterling, Euro, Yen) supported by RBI's intervention in the forex markets to prevent a sharp depreciation of the rupee. Consequently, this has resulted in the forex reserves declining to USD 537.5 bn (Sep 23, 2022) from a peak of ~USD 640 bn a year ago. The decline in forex reserves is also aided by a devaluation of foreign currency assets (FCA) which are held in different currencies against the USD. FPIs have sold aggressively since the Fed announcement (~USD 2 bn) having witnessed strong inflows earlier during the quarter. RBI re-iterated its position on currency management stating that it aims to curb volatility and isn't targeting a specific level for the currency. With the rupee declining to nearly 82 levels, it would be interesting to see RBI's response to shore up the currency – by conventional or unconventional means.

Retail headline inflation inched up to 7.0% in August from 6.71% in July due to higher food prices. The consumer price index-based inflation is above the upper level of the Reserve Bank's comfort range of 2% to 6% for the eighth month in a row. Food inflation stood at 7.62% in August, up from 6.69% in July and 3.11% in the year-ago month. Core inflation stood at ~6% in August, broadly unchanged from that in July and has been sticky around the 6% mark for a major part of the last year. RBI is now factoring in the price of the Indian crude oil basket at USD 100 per barrel (USD 104 earlier). Though crude oil and other commodities prices have declined, upside pressures to inflation exist in the form of higher food prices and higher pass-through of input costs amid improving domestic demand. RBI has therefore retained its inflation estimate for FY2023 at 6.7%. CPI inflation is expected to print within RBI's tolerance band by the end of the current fiscal, with inflation estimates at 6.5% in Q3, 5.8% in Q4 of FY2023.and then to 5.0% in Q1:FY2024.

India's GDP has surpassed the pre-pandemic level by 3.8% in Q1:FY2023 led by growth in private consumption and investments. Leading indicators show month-on-month improvement in activity

©2022 Morningstar. All Rights Reserved. The Morningstar name and logo are registered trademarks of Morningstar, Inc. This document includes proprietary materials of Morningstar. Reproduction, transcription, or other use, by any means, in whole or in part, without the prior written consent of Morningstar is prohibited.

pointing to India's resilience. Manufacturing activity continued to expand robustly (August PMI at 56.2 vs 56.4 in July) boosted by new orders and output. Services activity has particularly picked pace recently (August PMI at 57.2 vs 55.5 in July), led by the contact intensive services amid improving demand and business confidence. Capacity utilization (seasonally-adjusted) has picked up to 74.3% (a three-year high) from 73.0% in Q4, and may kick-start the much-awaited Capex cycle. Robust tax collection (direct, indirect, GST) and widening trade deficit indicate demand is improving. Credit offtake in the non-food credit segment has improved considerably printing at 15.1% (as of July 29, 2022) compared to ~5.1% a year ago driven by the personal loans segment (housing loans) and services segment (NBFCs, trade credit). For agriculture, the current reservoir levels at 87% of capacity (as of Sep 29, 2022) should bode well for the upcoming Rabi crop which in turn should support rural demand.

India's GDP growth would likely face pressure owing to aggressive global monetary tightening, geo-political tensions, supply-chain disruptions and declining exports amid slowing global demand. Considering these risks, RBI has trimmed its growth forecast for the current fiscal to 7.0% from the 7.2% estimated earlier. In the face of the lingering uncertainty that we find ourselves in today, the RBI has reiterated its commitment to ensuring price and financial stability, while being supportive of growth.

How are Morningstar Managed Portfolios positioned?

Based on our valuation-driven asset allocation (VDAA) approach, we are currently underweight equities across our portfolios in the range of ~1 to 3% and overweight fixed-income. Within equities, we are underweight domestic and U.S. equities which rank low in our opportunity set and overweight Europe and E.M equities which rank favourably from a forward-looking perspective. Though Chinese equities are the top-ranked asset class from a forward-looking perspective, we are cognizant of the fundamental risks at play in the region and have capped our exposure to below 2%. Within the domestic equity space, we favour the large-cap segment relative to the mid and small-cap segments wherein valuations appear stretched relative to the large-cap segment. Within fixed-income, we favour the medium-to-long-end segment from a risk-reward perspective, though the relative attractiveness has lowered recently following the sharp up-move at the shorter end of the yield curve.

We believe our valuation-driven approach to investing and the mix of the underlying funds in the portfolio are well suited to benefit investors over the long term. We endeavor to outperform the benchmark on a risk-adjusted basis over the long term and provide a less volatile investment experience for our investors. We continue to actively monitor our asset class views & positions relative to markets to identify attractive opportunities as they arise. K

©2022 Morningstar. All Rights Reserved. The Morningstar name and logo are registered trademarks of Morningstar, Inc. This document includes proprietary materials of Morningstar. Reproduction, transcription, or other use, by any means, in whole or in part, without the prior written consent of Morningstar is prohibited.

THIS DOCUMENT IS FOR PROFESSIONAL CLIENTS ONLY AND SHOULD NOT BE DISTRIBUTED TO OR RELIED UPON BY RETAIL INVESTORS.

About Morningstar, Inc.

Morningstar, Inc. is a leading provider of independent investment research in North America, Europe, Australia, and Asia. The company offers an extensive line of products and services for individual investors, financial advisors, asset managers, retirement plan providers and sponsors, and institutional investors in the private capital markets. Morningstar provides data and research insights on a wide range of investment offerings, including managed investment products, publicly listed companies, private capital markets, and real-time global market data. The company has operations in 29 countries.

About the Morningstar Investment Management Group

Morningstar's Investment Management Group, through its investment advisory units, creates investment solutions that combine award-winning research and global resources with proprietary Morningstar data. With more than USD $253 bn in assets under advisement and management as of June 30 2022, Morningstar's Investment Management Group provides comprehensive retirement, investment advisory, and portfolio management services for financial institutions, plan sponsors, and advisers around the world. Morningstar's Investment Management group comprises Morningstar Inc.'s registered entities worldwide including: Morningstar Investment Management LLC; Morningstar Investment Management Europe Limited; Morningstar Investment Management South Africa (Pty) Ltd; Morningstar Investment Consulting France; Ibbotson Associates Japan, Inc; Morningstar Investment Adviser India Private Limited; Morningstar Investment Management Asia Ltd; Morningstar Investment Services LLC; and Morningstar Investment Management Australia Ltd.

Important Information

The opinions, information, data, and analyses presented herein do not constitute investment advice; are provided as of the date written and are subject to change without notice. Every effort has been made to ensure the accuracy of the information provided, but Morningstar makes no warranty, express, or implied regarding such information. The information presented herein will be deemed to be superseded by any subsequent versions of this document. Except as otherwise required by law, Morningstar, Inc or its subsidiaries shall not be responsible for any trading decisions, damages, or losses resulting from, or related to, the information, data, analyses, or opinions or their use. Past performance is not a guide to future returns. The value of investments may go down as well as up, and an investor may not get back the amount invested. Reference to any specific security is not a recommendation to buy or sell that security.

©2022 Morningstar. All Rights Reserved. The Morningstar name and logo are registered trademarks of Morningstar, Inc. This document includes proprietary materials of Morningstar. Reproduction, transcription, or other use, by any means, in whole or in part, without the prior written consent of Morningstar is prohibited.

MORNINGSTAR®

There is no guarantee that a diversified portfolio will enhance overall returns or will outperform a non-diversified portfolio. Neither diversification nor asset allocation ensures a profit or guarantees against a loss. It is important to note that investments in securities involve risk, including as a result of market and general economic conditions, and will not always be profitable. Indexes are unmanaged and not available for direct investment.

This commentary may contain certain forward-looking statements. We use words such as “expects,” “anticipates,” “believes,” “estimates,” and “forecasts,” and similar expressions to identify forward-looking statements. Such forward-looking statements involve known and unknown risks, uncertainties, and other factors which may cause the actual results to differ materially and/or substantially from any future results, performance, or achievements expressed or implied by those projected in the forward-looking statements for any reason. The Report and its contents are not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country, or other jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or which would subject Morningstar or its subsidiaries or affiliates to any registration or licensing requirements in such jurisdiction.

For Recipients in India: This Report is issued by Morningstar Investment Adviser India Private Limited. Morningstar Investment Adviser India Private Limited is registered with the Securities and Exchange Board of India as a Portfolio Manager (Registration number INP000006156), and as an Investment Adviser (Registration number INA000001357), providing investment advice and research. Morningstar Investment Adviser India Private Limited has not been the subject of any disciplinary action by SEBI or any other legal/regulatory body. Morningstar Investment Adviser India Private Limited is a wholly-owned subsidiary of Morningstar Investment Management LLC, and is part of Morningstar’s Investment Management Group, which comprises Morningstar’s regulated entities worldwide In India, Morningstar Investment Adviser India Private Limited has one associate, Morningstar India Private Limited, which provides data-related services, financial data analysis, and software development.

©2022 Morningstar. All Rights Reserved. The Morningstar name and logo are registered trademarks of Morningstar, Inc. This document includes proprietary materials of Morningstar. Reproduction, transcription, or other use, by any means, in whole or in part, without the prior written consent of Morningstar is prohibited.

MORNINGSTAR®