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Earnings revival, deleveraging, wider ownership to cushion equities: ICICI Bank's B Prasanna

"As far as equity markets are concerned, there has been a divergence in terms of how growth and value stocks have been looked at by investors, not only in India but globally. But on an aggregate basis, given the revival in corporate earnings, deleveraging and widening ownership through more domestic savings getting channelized into the markets, there is limited downside to the markets," Prasanna said in an interview to ETMarkets.com.

Over the last couple of weeks, Indian equity markets have witnessed a bout of severe volatility, with many questioning whether a much talked-about correction in rich valuations was finally materializing. The benchmark indices -- the Nifty and the Sensex have tumbled as much as 8 per cent from the highs and the latest strain of Covid -19 dubbed 'Omicron' has done nothing to improve sentiment. In these uncertain times, ICICI Bank Group Head-Global Markets-Sales, Trading & research Prasanna Balachander believes that while there are fault lines in equity markets, the potential for a further steep decline is limited.

The market veteran said that the Reserve Bank of India has already started the process of adjusting ultra-loose monetary policy through its actions on the liquidity front. Accordingly, Prasanna predicts the policy rate corridor, currently at 65 bps, will narrow to 25 bps over the next two meetings of the Indian rate-setting committee.

With an unexpected surge in US retail inflation in October prompting talk of a faster pace of bond tapering and potentially of monetary policy tightening, the dollar has largely been on a strengthening spree. How do you see this playing out as far the rupee is concerned? Where do you see it by the end of December?

With the US economic activity normalizing at a brisk pace post vaccination, Fed policy focus has rightly shifted towards rising inflationary risks. In that context, the process of gradual normalization with QE taper has begun. However, given that higher inflation is turning out to be more than transitory, the probability of accelerated path of normalization, both in terms of QE taper and policy rate is well founded. On the other hand, given the rising risk of renewed pandemic scare in Europe, the European Central Bank continues to be relatively dovish. Such growth and monetary policy divergence has created a dollar supportive environment and is likely to persist. However, strength in Dollar/ Asia ex-japan is relatively muted given that growth differential is still favoring this part of the aisle and capital flows remain supported. The rupee has also benefited in that overall context, but given the rising pressure on the external trade front, we expect weakness in rupees towards 75.50 against the dollar by December end.

The RBI has reiterated that it will adopt a well-telegraphed and gradual approach when it comes to normalizing policy. Opinion is divided as to whether there will be a reverse repo hike in December. What are your expectations from the policy? Do you think the apex bank is in sync with other central banks when it comes to normalizing ultra-loose policy?
The RBI normalization has to be seen in the overall context of the growth-inflation trade off. With most of the core economic indicators normalizing to pre-Covid levels, RBI has begun adjustment to its ultra-loose policy prescription - with liquidity normalization through variable reverse repo (VRRR) auctions across tenors and discontinuation of the GSAP program. The rate cut-offs at VRRR auctions have already pushed the overnight liquidity cost of the banking system closer to the repo rate. Hence, a formalization of such adjustment is very likely through a hike in reverse repo rate. We expect the policy rate corridor to narrow down to 25bps over the next two policy meetings.

What is the road ahead for the government bond market? The fact that the RBI has opted not to conduct any more OMOs since the discontinuation of the GSAP programme signals the central bank's aversion to pumping in more durable liquidity. How will the combination of tighter liquidity and potentially higher rates play out for the market? Which segment of the yield curve would you recommend at the current juncture?

In an environment of global monetary policy normalization, upward pressure on the yield curve is expected to remain as market participants figure out the extent of policy normalization in the wake of persistently high inflation. Moreover, the less benign fiscal glide path suggests that demand supply balance will remain challenged and more so in an environment of lesser outright RBI support through OMOs. However, there is a silver lining, as IGBs are poised to get included in global bond indices which could attract substantial real money foreign flows in the sovereign bond market. Moreover, given the already significant risk premium being priced in a steep sovereign yield curve, the belly (10-14y) is likely to outperform the front end. In the near term, we think a bear flattening of the curve is the most likely outcome.

The latest data on domestic inflation showed only a marginal rise in October but several analysts are warning of CPI rising to 6 per cent around February and March 2022, especially as food prices remain elevated. Given this, what is your timeline for a hike in the repo rate?
Headline CPI has moderated in recent months but core inflation remains sticky. Moreover, the elevated wedge between WPI and CPI suggests that the pass through of higher producer prices is still underway and to that extent there is an upward bias to consumer prices. Overall,

the CPI trajectory looks heading towards the higher end of the MPC's target band of 2%-6%. As far as a repo rate hike is concerned, we are looking at a change in policy stance to neutral in the February policy meet followed by the first repo rate hike in Q1FY23.

From a growth perspective, we seem to have seen quite a bounce-back since the second wave even though the 20.5% growth of Apr-Jun underwhelmed markets. Do you agree with the RBI's assessment of 9.5% for FY22? What are the headwinds and tailwinds in your opinion?

We are quite optimistic about the overall growth scenario and expect FY22 growth to exceed 9.5%. The faster and wider coverage of inoculation has reduced the tail risk from pandemic which has led to much sharper recovery in domestic mobility and economic indicators. Moreover, the export performance during the current fiscal has been a hallmark which is an additional tailwind to the entire growth narrative. Going forward, even the investment cycle is likely to kick start given the sharp improvement in both corporate and bank balance sheets. However, there is a risk that higher inflation could turn out to be more persistent, leading to a faster pace of policy normalization across markets. Moreover, risks from higher commodity prices and resurgence in infections need to be watched carefully.

Do we have a problem of too much froth in the system leading to mispricing in both debt and equity markets? Could our low real interest rates dissuade foreign portfolio investors as the world embarks on policy tightening?

If you go by the market pricing of policy rates derived from interest rate swaps or bond yields, there has been a lot of adjustment in the forward rates trajectory. However, there is still some scope for a higher adjustment in credit spreads which remain benign in the wake of corporate deleveraging and muted capex demand. As far as equity markets are concerned, there has been a divergence in terms of how growth and value stocks have been looked at by investors, not only in India but globally. But on an aggregate basis, given the revival in corporate earnings, deleveraging and widening ownership through more domestic savings getting channelized into the markets, there is limited downside to the markets. As far as fixed income is concerned, India still offers a better real rate return to global investors. Moreover, given the inflation targeting regime of MPC which provides stability around the exchange rate, there is definitely a case for higher foreign portfolio inflows in the bond market.

How confident are you of the government meeting its fiscal deficit target for the current financial year? Are government revenues in a good enough shape to completely rule out the possibility of any additional market borrowing?

The government revenue on the tax front is likely to exceed by Rs 3 trillion over budgeted one. A shortfall in the aggressive disinvestment target is most likely. However, on the non-tax front, the RBI has already provided a higher-than-budgeted dividend. The revenue buoyancy has prompted the center to absorb the entire GST compensation shortfall to states which is another indicator of healthy government finances despite a hit on account of excise duty reduction on petroleum products and extension of the PM-GKAY till Mar'22. Overall, we are not expecting any additional market borrowing from the central government since shortfall in financing, if any, could be met through higher-than-budget cash drawdown and borrowings from the NSSF.

The most recent developments have been the resurgence of the virus with a new mutation described as “Omicron”. What is the impact third will have on all of what you have described above?

This is a stop press kind of development and we need to take stock. It is still very uncertain but things might get a little bit clearer soon. For the moment, the new mutation “Omicron” is a real reminder that the pandemic is far from over. However, given that the entire ecosystem has now learnt to deal with this pandemic, I would put this risk in the category of “known-unknown”. It may take the better part of the next couple of weeks for the medical fraternity to get a handle on what the new mutation means and the efficacy of the current vaccination regime. In the interim, the risk sentiment may take a back seat as market participants and policy makers assess its severity. However, I am optimistic that initial knee-jerk market reaction will give way back to a medium term outlook which looks constructive for most of the asset class. As far as monetary policy is concerned, it reduces the possibility of a speeding up of the taper timeline that the market had started speculating. I don’t see this development changing the RBI action on start of the Reverse repo normalization in the ensuing policy though views on REPO hikes could undergo a change.