

New virus strain: Putting a “strain” on risk sentiment

As the world was getting a grip on COVID-19, and moving from despondency to some degree of buoyancy, the news of the novel strain has led to some marring in sentiment. While there is fair bit of uncertainty regarding the details of the new strain, the high infection rate, (reported around 70% more infectious), could lead to some reversal in trends both in markets and the real economy. Whether this will derail the considerable recovery we have seen so far remains unknown, and may be unlikely, but the immediate impact will be in the form of heightened uncertainty and proactive measures from all Governments, including ours, to curb any untoward manifestations on health, and prevent a spread.

We could see the impact of the new strain panning out through the following channels:

- **Real economy:** News of the more virulent strain led to sharp international reaction of strict travel bans to and from the UK. Given that there is a high likelihood that the new strain has been present since September, it is possible that it has already spread to other countries. This could lead to imposition of more stringent local lockdowns as well as further travel and trade bans, bringing about headwinds to global growth. The impact on the Indian economy would be dependent on the persistence of the new strain, with the first channel of impact being felt through trade. Exports that were already on a weak footing, could see further downside. In the possible circumstance that the strain has already entered the country, and in the event of a sharp surge in infections, localized lockdowns cannot be ruled out (though this is not our base case for the moment), leading to some downside risks to growth.
- **Impact on financial markets:** While the impact on the real economy will be contingent on several factors, the exuberance seen in financial markets could be put on hold. The timing of the new strain could not have been worse, with current sentiment being driven by positive news on vaccine deployment, continued support from the Fed and the US stimulus package. To add to it are the thin trading volumes around the holiday season.
 - **Equity markets** in India have been largely buoyed by foreign flows with FYTD (April – present) ~USD 28 bn with nearly USD 18 bn inflows being seen since October 2020 – present. These trends could see some reversal in the short-term with the advent of the increasing risk averse environment. The news of the novel strain, along with the fact that market trends have been diverging from economic fundamentals could accentuate the volatility in the markets.
 - **The fixed income markets** could see some divergence in trends. Fears of increased lockdowns and ensuing additional fiscal support measures with expectations of higher allocation towards vaccine deployment (need to disseminate the vaccine at a faster pace than initially planned could also emerge) and health infrastructure could add upside pressures in the long-end. This would be accentuated on the back of expectations of a high supply of Government paper from both Centre and States for the next fiscal as well, with our early estimates indicating Gross General Government borrowing of higher than 8.5% of GDP for FY22. While this news does not change our call on a long pause on rates and a possible shift to a neutral stance in the June 2021 policy, we will be mindful of the developments and revise our call accordingly. Persistence and rise in the new strain and possible spread to India could lead the central bank to remain on an accommodative stance for much longer than our current base view. Moreover, given that global central banks could continue with easy policy on the front foot (with any expectations of unwinding of ultra-easy monetary policies taking a backseat for the moment), could also make the RBI continue to maintain surplus liquidity in the system. Overall the curve could see continued steepening bias with our expectations of the 10-year ranging between 6.0-6.50% in FY22.
 - **USD/INR:** The Rupee is presently seeing weakness in a situation of increased risk aversion, given the concerns surrounding the new strain, and the subsequent flight to havens like the Dollar. The destruction in risk sentiment will have an impact on all Emerging Market currencies, including the Rupee. In conjunction with this, some paring of portfolio inflows is also weighing on the sentiment for the Rupee at the moment. The USD/INR is likely to move toward the 74 handle and could possibly move beyond that as risk aversion worsens. The RBI may probably allow some weakening in the domestic currency, while checking for undue volatility. The trading range in the USD/INR will likely shift upward for a while, and, as holidays keep trading volumes thin, volatile moves are possible with knee-jerk reactions as more news emerges on the new strain and its implications.

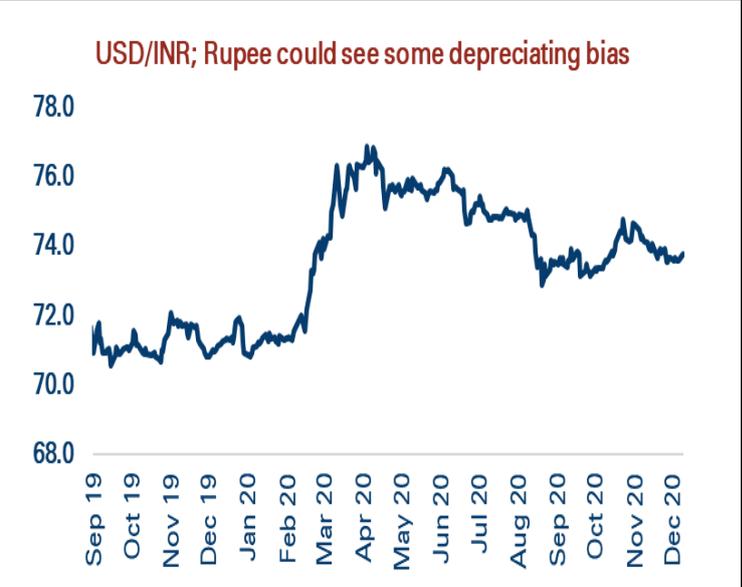
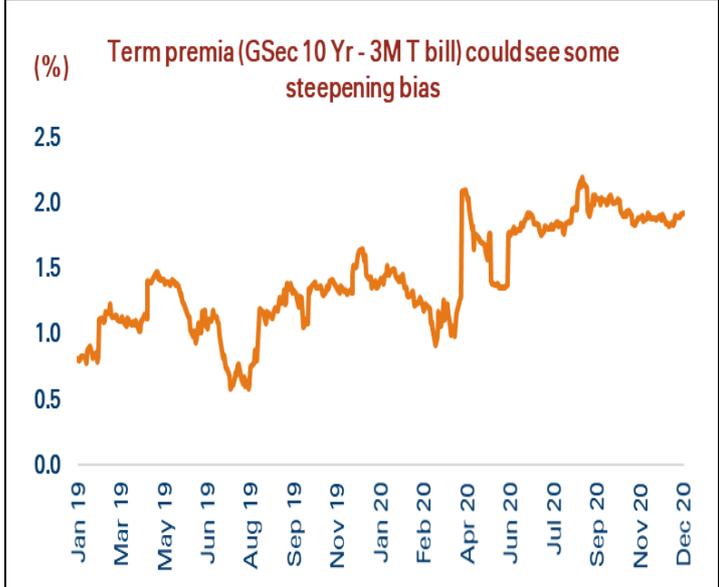
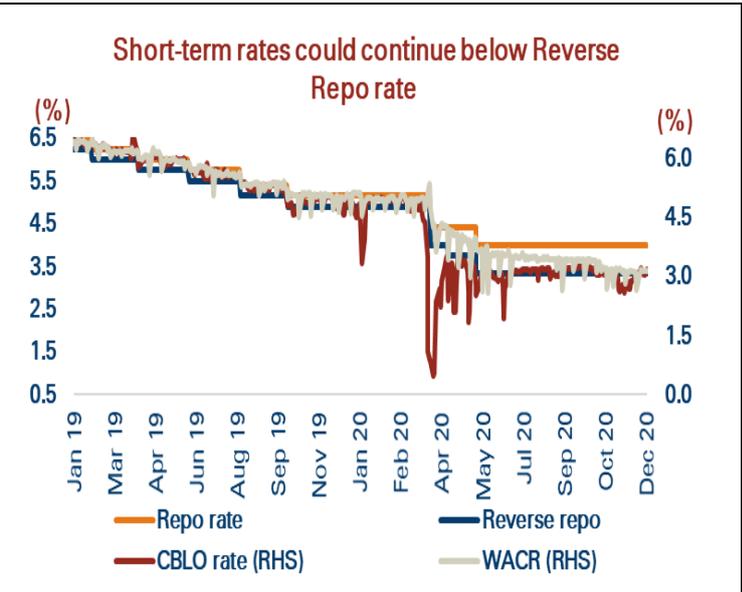
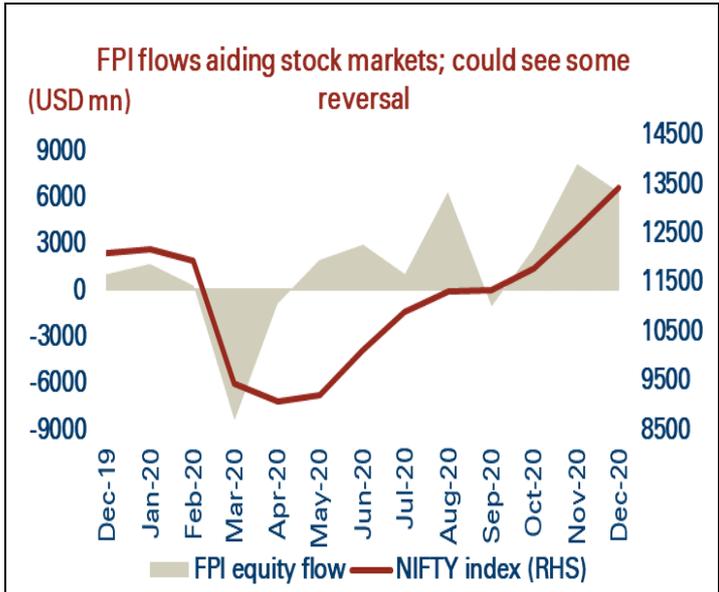
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