Flash note
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India - Bonds, equities and Fx continue receiving love from investors. We maintain confidence in equities and Fx

Economics & Covid

India also took a big economic hit from the pandemic, with GDP growth contracting by -23.9% YoY in 2Q20, a record fall after a +3.1% YoY in 1Q20. Growth is picking up from its 2Q nadir, though only slowly, and high frequency indicators suggests an (uneven) recovery. With the exception of high-contact activities like domestic travel, several high-frequency indicators (passenger car sales, etc.) had pointed to a strong rebound after lockdown was lifted. But these have stalled, raising questions about how long pent-up demand can continue to drive the economy. Certainly, the spike in unemployment rates has now corrected, but this is probably due to the return of migrant workers to their villages, which pushed down urban joblessness while the government's rural job-guarantee program kicked into overdrive. Looking at 3Q and FY GDP growth, business activity dipped again in July after local lockdowns were reimposed. The surging number of Covid cases means further localized restrictions cannot be ruled out, and with Many migrant workers being in no hurry to return to the cities, this will cause a prolonged contraction in the urban workforce, which in turn could cut potential growth. As long as we see it, with growth in the July-Sept quarter set to remain deep in negative territory, India is heading towards a full-year GDP contraction of -7%, -10%. In any case, it is necessary to ask whether the GDP data in India is comparable with the rest of the countries, knowing that the fiscal stimuli promoted by the Delhi government have been infinitely lower than those fiscal programs observed in the rest of countries, as Delhi pursues the objective of not deteriorating public finances. The pandemic continues to soar in India in absolute terms, though it remains below the US and Brazil on a per-capita-basis, with the worst-affected states—Maharashtra, Andhra Pradesh, Tamil Nadu and Karnataka—being among the most important economically. Delhi began relaxing its lockdown in June, and the government is clear that it will not reimpose nationwide restrictions, but the high number of Covid-19 cases has forced many states to impose local lockdowns, which is creating economic uncertainty.

External sector as a silver lining

India's external position has strengthened dramatically, largely thanks to much weaker demand for imports. India recorded its first quarterly current-account surplus for 13 years in 1Q20 and is on track to post another surplus in 2Q. Together with surprisingly strong capital inflows into equities, this has enabled the RBI to boost India's forex reserves to a record level.

Banking system.

India's banks are preparing to absorb yet another round of bad debts. The RBI forecasts that the NPL ratio will rise by 4pp to 12.5% by the end of March 2021. Around half of all outstanding bank loans were under the repayment moratorium that ended on Aug 31. What happens next is uncertain, as the Supreme Court has ruled that new defaulters will be reprieved until further notice. This will probably lead to risk-averse banks to further tighten lending standards.

The central bank is helping, but its firepower is limited

The RBI cut rates by 115bp early in lockdown. But with inflation now running above its upper target of 6%, the central bank has had to pause its easing cycle.

Bond market tantrum. Why?

The government knows that a bigger fiscal stimulus is needed, and Delhi seems to be preparing now a more aggressive fiscal response, though it has indicated it that it may delay this until after a vaccine is available, fearing that the multiplier effect will be lackluster while economic uncertainty remains so high. This fiscal conservatism is at the root of the bond market's tantrum. Greater certainty about public spending plans could flatten the yield curve and reduce borrowing costs. Having said this, bonds are now expensive.

Indian Equities continue receiving love from investors. What next?

Indian equities have followed the global trend, bouncing back since their March trough, but they seem to be now overpriced (see the chart 1). Yet this self-evident truth has never stopped investors from bidding up markets to new highs. What next? Prices can keep rising while money remains cheap and easy, and with global money set to remain abundant, share prices could continue to rise even as the real economy suffers from a deep and prolonged recession.