# 2022 Fixed Income Outlook

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“Year 2022 to see a high volatility in debt market as the World adjusts to lesser fiscal & monetary support. managing the expectations on returns vs volatility to be the biggest challenge.

## 2021 yet another year dominated by Covid-19 led disruption

2021 proved to be yet another year dominated by Covid-19 led disruption across the world. While the countries having a fast-paced vaccination program fared relatively better, many other countries found themselves helpless against the Virus.

Led by synchronised actions by most of the Govts & Central Banks since the Pandemic, World economy witnessed a sharp improvement, as reflected in IMF’s projection of world Growth rate of 6% in 2021 as against the contraction of 3.6% in 2020. However, the recovery has been far from broad-based as many other constraints like energy shock, supply side disruptions, China slowdown, vaccination availability, new virus variants, etc have surfaced. Inflation proved to be more permanent, which was earlier thought to be transitory. Global Interest rates remained volatile during the year with an upward bias as the market participants struggled to gauge the inflation trajectory.

Year 2021 will also be defined as a point of inflection for many Key Central banks like US FED, Bank of England, Bank of New Zealand, to name a few & also including few other EM Central banks, which have made a transition from a non-conventional ultra-lose monetary policies adopted in response to the Covid-19 led disruption to a more conventional - inflation targeting monetary policy.

India also witnessed a high level of volatility during 2021. Few major themes that are worth highlighting –

- Despite a slow start, India emerged as one of the successful countries on vaccination program.
- Handsome recovery in economic growth but still un-even. Rural India expected to be below the pre-pandemic level.
- Projecting inflation has been tricky – surprised both on negative as well as the positive side; core inflation remains stubbornly high.
- RBI maintained growth supportive accommodative stance, while keeping a close watch on inflation. Policy normalization started with a gradual & well anchored liquidity re-calibration.
- Domestic financial stability showed resilience with no major credit defaults / worsening of asset quality.
- External financial stability improved further with increase in Fx reserves & surplus BoP on the back of record high FDI inflow.
- INR proved to be one of the most resilient Emerging Market currency against the global tantrums.

- G-Sec yield curve got elevated upwards by 60 – 80 bps with a marginal flattening bias.
- Credit market improved considerably, though remained fragmented : Good became better (read as : widely accepted Issuers saw credit spread compression, while others not)

## Year 2022 expected to remain volatile too

Year 2022 is expected to remain volatile for financial assets as the world adjusts to lesser availability of fiscal, monetary and most crucially - the liquidity support for economic recovery, as the normalcy gathers pace & controlling of inflation becomes a key task for Central Banks. While the emergence of new Covid-19 can disturb the economic recovery, high vaccination rates & accumulated learning to live with the Virus are expected to soften the incremental economic impact. Having said that, different countries are at different point of normalcy curve and may require the various policy actions which best suits them, instead of moving in a synchronised way with other Central banks, unlike the approach taken during the pandemic. For instance, many countries have started tightening the monetary policies in different ways, at the same, China has loosened it up recently to mitigate the slowdown risk.

Specifically for India – we expect the following broad themes in 2022 –

- Economy is expected to continue with recovery momentum and become broad-based. As the Govt spend provides the enabling lever & high vaccination rates, higher consumption will drive the overall recovery. Private Capex is expected to pick up in 2nd half while the exports may witness a slowdown. Overall, we expect FY23 to clock in a healthy GDP growth rate – making it one of the fastest growing countries.
- Inflation may surprise on the upside and remain outside of the RBI's projections as of now. CY22 avg. inflation may reverse the declining trend and inch higher to 5.40% - 5.60% on the back of elevated core inflation and as the manufacturers pass on the higher input cost with demand recovery.
- INR to remain better placed relative to other Emerging Market currencies. Nonetheless, INR is expected to depreciate, though marginally, with general USD strength & incrementally higher trade deficit.
- Central Govt is expected to continue with the fiscal gliding path unless any significant disruption is caused by the pandemic.

- RBI to continue with the policy normalisation with further liquidity re-calibration and restoring the policy rate corridor back to 25 bps by hiking Reverse Repo rate by 40 bps in Feb & April 2022 policy. However, we expect a gradual repo rate hike cycle to start only in 2HCY22 with 2 rate hikes in repo rate in CY22. RBI's policy rate actions will become data dependent on growth-inflation dynamics. Operative rate may move from Reverse Repo rate to Repo rate by 2022 end as the liquidity is re-calibrated back to Neutral.
- Indian Rates to get elevated further with a flattening bias.
- One big event – inclusion of Sovereign bonds in global bond indices can be an inflection point for Indian debt in terms of lowering the cost of capital. It can result in a 20 – 30 bps rally in the longer end of the rate curve.

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### Tale of two halves

For India, 2022 is expected to be a tale of two halves. In first half, we expect MPC to continue to focus on the growth impetus till the time economic recovery becomes well entrenched and broad based. Recent emergence of new Covid-19 variant will also warrant the continuation of monetary policy support. While the headline inflation may test the 6% mark during this period, RBI is expected to take comfort from the moderation in inflation trajectory, going forward. Nonetheless, RBI may continue with its policy normalisation in this period. In the 2nd half, RBI may make a smooth transition to inflation control towards the medium-term target of 4%, without losing an oversight on continuation of growth recovery. During this time, we expect RBI to begin with a gradual repo rate hike cycle, while remaining prepared to take proactive actions to support growth recovery, if needed. Overall, we expect "RBI to maintain Lower Repo Rate for Longer" in order to provide necessary support to revive & sustain growth on durable basis, while keeping a close watch on the inflation trajectory.

RBI has shown its intent towards an accommodative liquidity stance, in line with the accommodative policy rate stance while gradually re-calibrating the liquidity in a timely and a non-disruptive way which is supportive of economic recovery. While the net durable liquidity continues to remain in a surplus of ~Rs 11 lakh cr, RBI has started absorbing large part of this liquidity through the VRRRs of 14 days / 28 days and also the shorter tenor VRRRs. This has helped the RBI in anchoring the reverse repo rate expectations as the weighted average cost of liquidity absorption has already risen to ~3.8%, which in a way is almost equivalent to the normalised policy rate corridor of 25 bps.

## Improving Credit Environment; though risk-reward not that attractive as of now

Credit Environment has improved considerably over the last one year on the back of RBI's concerted efforts and gradual economic recovery. Same is also reflected in a greater number of credit rating upgrades than the downgrades since Nov-20, as compiled by the domestic rating agencies. However, investor's risk appetite, especially in the Mutual Fund segment continues to be very limited, and only the select AA rated issuers have got the benefit of improvement in credit market. Such select credits have seen larger acceptance amongst the investors, which coupled with very limited issuances of high yielding papers, has led to their spread compression of 40-50 bps over the AAA Corporate bonds. On other hand, not so well accepted AA rated issuers continue to struggle for secondary market liquidity and their spreads continue to remain very high. While we expect further improvement in credit environment going forward, we believe the risk-reward metrics is not very favourable for investors as of now considering very narrow credit spreads on acceptable credits. Accordingly, we advise investors to remain contained with high quality AAA issuers along with few select AA rated issuers and wait for better entry points once the economic recovery has become much more sustained & at better credit spreads as the issuances pick up. We continue to remain watchful of the contact intensive service sectors like hospitality, travel, retail, etc., which are still reeling under the pressure of Covid-19 led precautionary measures and are expected to be operating below the pre-pandemic levels. We also continue to remain wary of the un-organised & rural segment which we believe is significantly impacted especially during the 2nd wave of Covid-19. Accordingly, we remain cautious of the banks / NBFCs / HFCs having high exposure to such segments like SMEs / MSMSEs, small ticket personal loans, micro loans and real estate loans etc.

**Disclaimer:** The sectors referred above should not be construed as recommendations from Invesco Asset Management (India) Private Limited and/or Invesco Mutual Fund.

## Biggest Challenges in 2022

Against this backdrop, one of the biggest challenges in 2022 will be to manage the return vs the volatility expectations. A conventional approach of lower the duration, lesser the volatility may not work as the extreme short end of the rate curve will react to the expected reverse repo rate hike & liquidity re-calibration over next few months. Extreme steepness of the yield curve may provide merit to go up the curve; however, longer end may remain volatile as the global backdrop changes to relatively tighter money policies for tackling inflation.

While we expect a general hardening of interest rates across the curve in 2022, we believe that the curve will undergo a bear flattening with extreme short end getting more impacted as compared to the longer end of the curve.

## Investment opportunity

We feel that upto 6 months segment of the yield curve provides an opportunity to risk-averse investors amidst expectations of liquidity re-calibration & Reverse repo rate hike over next few months. Invesco Debt Fund categories like Ultrashort term, Money Market and Low Duration Funds with a defensive positioning towards the expected reverse repo rate hike are suited for such investors.

For Investors looking at the core allocation, the 2 to 5 year segment of the yield curve remains attractively placed from carry perspective, given the current steepness of the yield curve. To us, it is a sweet spot on the yield curve – neither too short which gets impacted by low gross yields, nor too long that can get impacted by the rate volatility. Invesco Debt Fund categories like Short term Bond Fund, Corporate Bond Fund and Medium Duration Fund having a large proportion deployed in this segment can be looked at by such investors.

Investors with long term investment horizon & ability to absorb short term volatility can find merit in having a 10% - 15% allocation in long end of the curve – 10 yrs or higher on the back of conviction that the rate curve is already very steep and that the sovereign bonds will get included in global bond indices at some point in time in 2022. Invesco Debt Fund categories like Gilt Fund and Banking & PSU Debt Fund can provide participation to the longer end of the curve.



## Key Risk to Our Views

As of now, our view is that the Economical recovery will further get entrenched across the sectors which will give the confidence to RBI to start unwinding the loose monetary policy in a gradual way for bringing inflation towards the medium- term target of 4%.

Below are key risks to our view

- Any subsequent waves led by Covid-19 new variants, including Omicron in India or in other major countries, which can disrupt the nascent economic recovery and force the Central banks to stay put with loose monetary policies for longer. This can cause a rally of interest rates across the curve with a steepening bias as the short end may price in more benign liquidity.
- Any significant negative surprise on domestic inflation led by global factors like commodity flareup & supply side disruption which can force the RBI to front end the policy tools to control inflation.
- Political risk in 2022 with many key states going for State Elections. Any upward revision in fiscal gliding path by Central Govt to accommodate populist measures can put pressure on rates, especially at the longer end.
- Trigger of global risk-off sentiments with faster than expected tapering of liquidity & rate hikes, sharper slowdown of China led by credit issues, etc. can have spill over effects on all Emerging Market countries, including India, which can influence the monetary policy actions.