Market Outlook

The Senate (upper-house in the US parliament) passed the historic tax reform bill with a sly margin of 51-49 vote. The lower-house of the US Parliament had already passed its version of the tax reform bill in the early November.

Presently, we understand that there are some impending differences in the Senate bill and the one that the lower house passed. Thus, the government needs to merge the two bills before the final ratification of the tax reforms, which is not guaranteed to be smooth. The House and Senate versions diverge on sensitive issues including a minimum tax for corporations, the treatment of unincorporated businesses, and the arrangement of individual tax brackets.

However, both the tax bill proposes drastic cuts in US corporate tax rate from the existing 35% to 20%, in line with the election promises made by the US President. So far into this year, we had also seen the US government imposing stricter regulation on job related immigration into the US. The government has also been aiming towards higher import tariffs and border tax adjustments (BTA). BTA aims to make US' exports more competitive and imports from other countries relatively expensive. In sum, all these policies are aimed at spurring US manufacturing activities and jobs creation.

Assuming these legal glitches in the tax reform bills are sorted out, tax cuts are theoretically growth positive by the way of enhancing business profitability. However, it may not be so direct in today's scenario.

Many market participants, today, expect the eventual effective tax rates to fall only by a couple of percentage points. Further, if like the quantitative easing, these fiscal easing also ends up further driving the dividend growth and share-buybacks, the desired growth impetus may not come by so easily. Accordingly, in the interim, the US government may see a reduced revenue collection and a widening of fiscal deficit in a situation when they are already struggling with debts hugging close to the legally permissible limits.

From an international perspective, leave aside the final numeric on the effective tax rate, US' policies could actually initiate 'tax rate wars' between countries (something similar to the 'Currency war' and 'Trade war' the world have been fearing). With US targeting to make its tax-structure more (domestic) business friendly, rest of the world may be forced to follow the suit and world-wide taxation reforms could spur the business activity in respective countries. Who knows, this 'Globalization of Localization' where every country is focused on incentivizing their domestic businesses could actually be positive for aggregate growth levels of the world. This may also be supported by higher defense spending by almost all countries given the evolving geopolitical environment.

This year's story has been straightforward and hugely reassuring for the financial markets: global growth, for the most part, surprised on the upside, and inflation on the downside. Even into year-end, the global manufacturing activity is picking pace across most key economies helped primarily by the rising domestic demand and to some extent also by the external demand. The real strength, in this cycle, lies among more developed markets.

This has led bonds, equities and everything in between to rally. Barring Russia, most key equity markets moved up during the year. US equities posted YTD return of 18.3% while MSCI- EM grew by 30% up until November. Indian NIFTY, too, posted 26% returns, despite a weak earnings trajectory thus far, helped by both foreign and domestic liquidity. Indian mutual fund received US$ 31 billion (Rs. 2.1 trillion) into the equity schemes up until October while FIIs have invested US$ 8.7 billion till November. This has kept the Indian equity valuations stretched at +20 times 1 year forward PE (Sensex).

With stronger global growth, tight labor markets and rising commodity prices, global inflation is likely bottoming out. Along with the concerns about complacency in global financial markets, we had long been calling for the end of monetary easing cycle. Amongst the developed economies, the US has already delivered 75bps of rate hike over the last one-year and is expected to take rates upward even into 2018. Bank of England, too, gave its first rate high in December, first hike after a decade. Eurozone is expected to unwind its quantitative easing heading into the next year. Within the Asian economies too, most economies are on a long pause, while Korea embarked on first rate hike after 6 years. India has been one of the exceptions in Asia to deliver a rate cut this year and may remain on a prolonged pause even going ahead. We believe that extra ordinary resilience exhibited in global financial markets will be tested as monetary liquidity starts drying gradually. While political underpinnings, near term macro pressures and rich valuations are likely to keep the Indian markets under pressure in the near term; domestic flows, policy reforms and bottoming out of corporate profitability may act as support.

Higher global growth has been driving up the commodities prices. Brent price have risen nearly 8% this year and breached the 60 levels for the first time since 2015. OPEC members have abided to their decided production cut this year and the latest OPEC meeting suggests a continued co-operation (in terms of production cut) even into 2018. With an intent to normalize inventories, the resolve exhibited by Russia and Saudi-Arabia had been rather strong. Political challenges in some of the producers like Venezuela have also helped in limiting the supply. On the other hand, improving global growth has been pulling up the crude demand. While North America has been capitalizing on the higher prices and increasing the supply more aggressively, the overall effect is likely to be a sharper fall in inventories. As such, we maintain a bullish stance on crude in the near-term, until we see a sharper supply response from non-OPEC countries and the shale gas producers.

Accordingly, while the domestic growth-inflation mix warrants a continued monetary support, the rising crude and the global rates would make the central bank fidgety. A country with nearly 1.5 billion barrel of annual crude import, and petroleum related government revenues nearly at 1.5% of GDP, rising crude has the potential to disturb both external and fiscal deficit. This, in turn, may have its additional bearing on the overall macro-stability.

Five months into the GST implementation and thus far the GST revenues have been below the desired run rate. Temporary suspension of the reverse charge mechanism, e-way bill and some other aspects which enforced compliance and the recent rounds of tax rate reduction can take the collections a bit lower. That said, ~50% of assesses are yet to file the returns and hence can boost the revenue going ahead. While the state revenue is relatively cushioned at the current run rate of collection, the center seems to be walking a tight-rope for now. To add to that, the non-tax revenue (RBI dividend and telecom-related receipts) have already been a disappointment this year. Disinvestment receipts are the only feather in the hat. With Rs. 530 billion already pocketed until November end, the department of disinvestment and public asset management (DIPAM) looks set to over-achieve its target. And to that extent, it does provide some breather to the center's fiscal math. All said, the bond market participants would be closely watching every fiscal development for any untoward development in the supply calendar. Perhaps, this and global developments are the reason why G-sec yields did not budge even a tad bit, despite the rating upgrade by Moody's.

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