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India Insights

Foreign flows offer comfort amidst virus worries

July/August 2020

Summary

- *Data for June indicated a sharp uptick in most economic activities when compared with April and May, though much of the data remains well below pre-COVID levels and some of it has subsequently shown signs of plateauing in July*
- *With foreign flows stabilising and solid FDI inflows, India's foreign currency reserves between April and June grew by USD 31 billion, and crossed the half trillion mark*
- *Adequate and sizeable FX reserves help buffer the economy against global financial contagion, enhancing the RBI's ability to deal with episodes of sharp INR depreciation pressures and curb currency volatility in the short-term*
- *Foreign investments in India are going ahead, despite the global pandemic; between April and July, India has attracted almost USD 20 billion of foreign investments in various sectors led by digital and technology*

In the spotlight

Foreign flows offer comfort amidst continued virus worries

The COVID-19 pandemic has continued to spread in India with the country now trailing only the US and Brazil in the number of infections. The pandemic in India is now the fastest growing in the world, with new daily records being set on a regular basis. However the COVID-19 case fatality rate in the country is amongst the lowest in the world at 2.28%, according to the Union Ministry of Health. In the meantime the gradual unlocking of the economy is expected to move into its third phase, with the plan to reopen schools and metro rails still being debated.

High frequency indicators and data for the month of June show a sharp uptick in most economic activities when compared with April and May, though much of the data remains well below pre-COVID levels and some of it has subsequently shown signs of plateauing in July.

However one data point that has stood out in recent weeks is the sharp increase in India's foreign currency reserves (FX reserves) which topped the USD half trillion mark at the end of June and continued to grow in July, making it the fifth highest after China, Japan, Switzerland and Russia. India's foreign exchange reserves have been steadily increasing over the past year, adding USD 59.5 billion in fiscal year ended March 2020, as compared with a decrease of USD 3.3 billion in the previous financial year. In a little over three months, India has already added another USD 31 billion to its reserves. Here we examine why FX reserves have continued to grow and what it means for the economy and foreign investments –

(contd on page 2)

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HSBC
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Foreign flows offer comfort amidst continued virus worries (contd)

- Improved capital flows, coupled with the RBI's asymmetrical FX policy of buying FX when USD weakens to manage INR appreciation and allowing INR depreciation if the USD strengthens, have driven an upward trend in India's FX reserves since 2019
- Weekly FX reserves rose to an all-time high of USD518 billion as of 17 July. The continued increase in FX reserves has been driven by a material improvement in the current account balance as well as foreign direct investments (FDI) and external commercial borrowings (ECB)
- India witnessed record portfolio investment outflows of USD 13.7 billion in Q4FY20 amid a sharp tightening of global financial conditions in March. However, the non-reserves financial account balance still posted a health surplus of USD 17 billion as strong FDI flows (USD 12 billion) and record quarterly ECBs (USD 10.4 billion) more than made up for the portfolio capital outflows
- ECB borrowings, which to some degree reflect credit tightness in the domestic financial sector, may continue to be supported by Indian companies' demand to raise funding to shore up their balance sheet and liquidity positions
- One clear positive in recent quarters is the solid trend in FDI inflows (though new FDI inflows accounted for just 1.6% of GDP in Q4FY20 and 1.5% for FY20). FDI in India increased to an all-time high of USD 56 billion in FY20
- The recent increase in FDI inflows/pipeline, partly due to increased FDI limits, and a slowdown in India's overseas direct investments suggests relatively stable FDI outlook in the near term despite elevated risks due to the COVID-19 shock
- The recent FX reserves build-up has also been a main source of money creation at a time when monetary policy action has been taken to counter the negative growth shock and tightening of local financial conditions
- June M3 money supply growth accelerated to 12.3% yoy, the highest since November 2014. The increase has been due to FX intervention and the central bank's liquidity infusions in the banking system such as Open market Operations (OMOs). The increase in FX assets of the RBI has supported the broader monetary accommodation and reduced the need for OMOs
- Adequate and sizeable FX reserves helps buffer the Indian economy against global financial contagion, enhancing the RBI's ability to deal with episodes of sharp INR depreciation pressures and to curb currency volatility in the short-term. Any perception of lower INR risks could be supportive of foreign inflows and potentially reduce Indian corporates' FX borrowing cost

Adequate and sizeable FX reserves helps buffer the Indian economy against global financial contagion, enhancing the RBI's ability to deal with episodes of sharp INR depreciation pressures and to curb currency volatility in the short-term

Improvement in current account balance likely to remain intact in FY21 vs. FY20

- In June, India posted the first goods trade surplus since April 2002, at a record USD0.8bn, as exports continued to normalise faster than imports with domestic restrictions easing only slowly
- The monthly goods trade surplus is unlikely to be sustained, in our view, as part of the gap in export and import growth could be explained by timing – India's economic reopening and domestic activity normalisation have lagged many other countries. Despite the export normalisation, the global economic trajectory and external demand outlook remains uncertain, especially in light of the recent re-imposition of restrictions to curb virus resurgence in many countries. Lingering global supply-chain bottlenecks and geopolitical tensions are additional risks.
- On the other hand, domestic demand will likely improve in H2, pushing imports higher, although recent high-frequency activity indicators were mixed with early signs of plateauing in July from the June rebound as pent-up demand seems to be fading somewhat and localised lockdowns have led to a patchy re-opening of the Indian economy. The effects of lower oil prices on reducing the import bill likely have also peaked. Thus, we expect the goods trade balance to return to a deficit in coming months, but slow domestic activity recovery is likely to cap the deficit
- The narrowing goods trade deficit coupled with widening net invisible balances (services trade, remittances, and investment income) drove the current account balance to its first, albeit modest, quarterly surplus in 13 years. The full-year deficit for FY20 improved to just -0.9% of GDP vs. -2.1% in FY19. The expected trend in the goods trade balance suggests that the current account balance may remain in surplus in Q2FY21 and could improve further in FY21 vs. FY20, despite the risk of reductions in the invisible balances

The expected trend in the goods trade balance suggests that the current account balance may remain in surplus in Q2FY21, and we expect the balance to improve in FY21 vs. FY20

Source: Bloomberg, HSBC Global Asset Management as of July 2020

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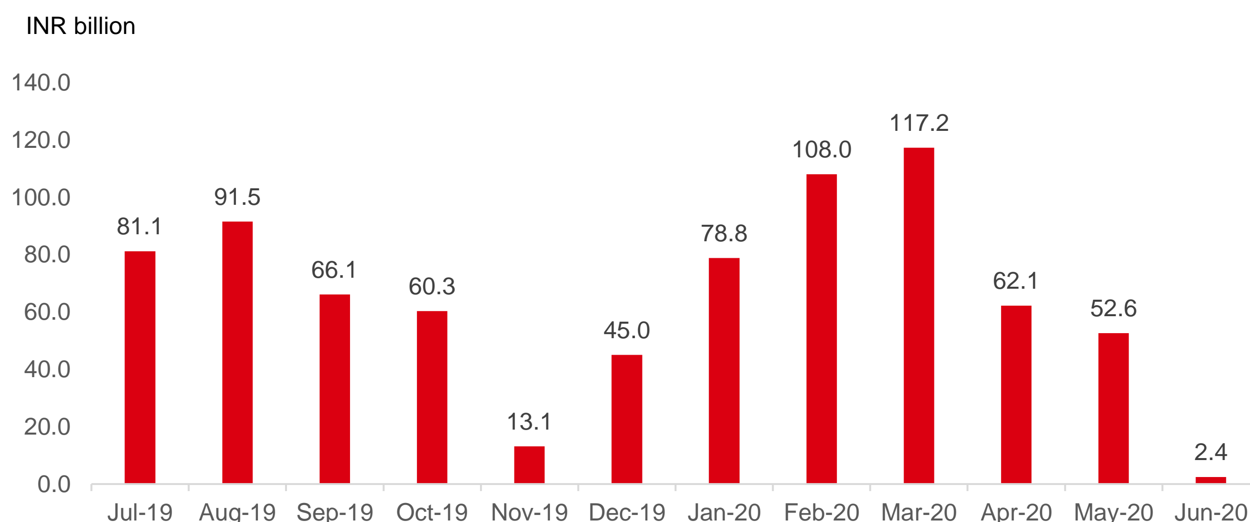
Equity market

Equity market marched up steadily on the back of optimism around the easing of national lockdown measures and positive news regarding the development of a COVID-19 vaccine

- Indian equities gradually regained their footing, with the NIFTY Index having risen close to 50% (as of 27 July 2020) from the worst point of the market sell-off on 23 March 2020 and 16% (as of 27 July 2020) since the end of May. Over the past month, the market marched up steadily on the back of optimistic sentiment toward the easing of national lockdown measures and positive news regarding the development of a COVID-19 vaccine, despite rising US-China tensions and India's own border disputes with China
- In recent weeks, the best performing sectors in MSCI India were energy, financials and consumer discretionary; whereas the only sector in negative territory was real estate. The rise in the energy sector was mainly due to an index heavyweight whose subsidiary – the digital business arm of the parent company – has attracted capital investment from a number of tech giants in the US (*details on page 4*). On the other hand, the consumer discretionary sector benefitted from a rally in auto stocks
- After a massive outflow of USD 9.1 billion in March and April combined owing to market panic, USD 4.8 billion of foreign capital returned to the India equity market in May and June, although not quite enough to replenish the outflow that took place in the previous two months. The first half of July (as of 16 July 2020) recorded a small foreign investment outflow of USD 0.7 billion due to foreign investors wanting to lock in some of their profits from the recent rally
- In June, domestic equity mutual funds also witnessed the lowest monthly inflow in four years, at INR 2.4 billion (or USD 32 million), after several months of decent inflows. Like foreign investors, domestic investors also seem to lack confidence in the recent rally, deciding to cash-in some profits and observe carefully from the sidelines
- Following the roll-out of the USD 265 billion stimulus package in May, the government continues to announce additional targeted measures to keep the economy afloat. For example, the Reserve Bank of India announced a special liquidity scheme in early July to help the NBFC sector improve its liquidity position
- According to the Indian Meteorological Department (IMD), this year's cumulative monsoon rainfall as of 16 July 2020 is 10% in excess of the long term average, which, if maintained throughout the entire season, bodes well for the agriculture sector that accounts for 15% of the country's GDP

Monthly net inflows into domestic Indian equity funds



Source: Association of Mutual Funds in India, as of July 2020

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Sector positioning

Sector	Weighting
Real Estate	Overweight
Financials	Overweight
Communication Services	Overweight
Consumer Staples	Overweight
Information Technology	Overweight
Consumer Discretionary	Underweight
Materials	Underweight
Utilities	Underweight
Energy	Underweight
Industrials	Underweight
Healthcare	Underweight

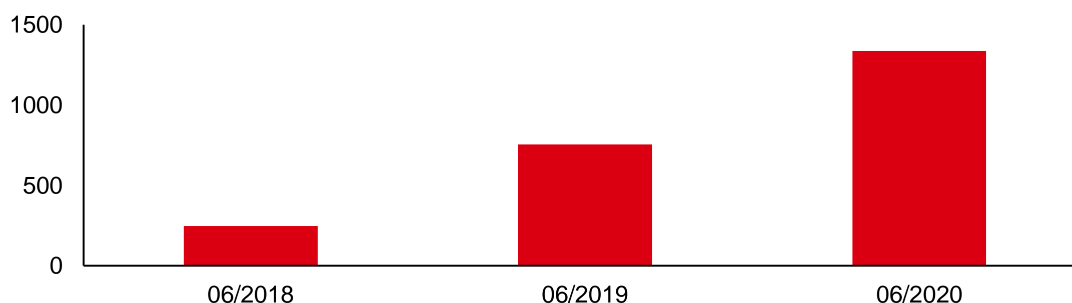
Source: HSBC Global Asset Management as of end-June 2020
Note- above information reflects the sector positioning of HSBC Global Asset Management's flagship offshore Indian equity product.

Sector focus

- A US-based multinational tech giant announced on 13 July that it would be investing USD 10 billion in India via a digitisation fund over the next 5-7 years. Investments will be focused in four areas: enabling affordable access to information, building new products and services, empowering businesses to become digital, and leveraging tech and AI in areas such as health, education and agriculture
- The USD 10 billion includes an USD 4.5 billion investment in India's largest telecoms and digital services provider. In April, one of the world's largest social networking companies also announced a USD 5.7 billion investment in the same Indian firm, which is a subsidiary of the country's most valuable company by market cap. Foreign investments in India are going ahead, despite the global pandemic. It should be noted that, between April and July, India has attracted almost USD 20 billion of foreign investments in various sectors led by digital and technology
- As evidenced by the recent investment announcements, there is enormous room for growth in India's digital economy. India has already been undergoing a digital transformation. In 2015, the government launched the programme Digital India, aimed at providing universal access to mobile connectivity, developing secure and stable digital infrastructure, and delivering government services digitally. Other initiatives such as demonetisation and GST implementation have helped advance India's formalisation and boost the country's digitisation. Digital payments have been on a constant uptrend, with a nearly 10-fold increase in per capita digital payments between 2014 and 2019. Despite the strong growth, with internet penetration remaining relatively low at 50%, there are clear signs that the country has much untapped potential
- Additionally the launch of Unified Payments Interface (UPI) in 2016 has helped drive the digital payment surge. UPI is an online payment system that is operated by the National Payments Corporation of India (RBI regulated entity) and allows instant transfer of money between two parties' bank accounts on a mobile platform. UPI enables peer-to-peer, peer-to-merchant, and business-to-business transactions. Some of the leading platforms for UPI are PhonePe by Flipkart, Paytm and Google Tez. With the coronavirus outbreak and the lockdown situation, digital payments are being utilized more than ever, and the volume of UPI transactions have soared, hitting all time high in June of 1.34 billion transactions
- Potential beneficiaries of India's digital transformation include large banks and private sector players with strong digital platforms. With UPI being an interface linking bank accounts, banks can expect to see continued deposit strength

Digital payment transactions have been increasing

UPI transaction volume (million)



Source: National Payments Corporation of India as of June 2020. For illustrative purpose only.

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Fixed income

At the end of June, the RBI announced the resumption of "Operation Twist"

While the inflation data for April to June came in higher than consensus, the RBI is not expected to change the accommodative stance in its monetary policy

- At the end of June, the RBI announced the resumption of "Operation Twist" – an unconventional policy in which it buys long term government securities while simultaneously selling the same amount in shorter maturity government securities or treasury bills. In early July, the RBI bought INR 100 billion of longer end government securities and sold an equivalent amount of treasury bills. The previous twist styled open market operations (OMO) were conducted in April and were first used by the RBI in December of last year
- Amidst monetary easing in 2020, 10-year government yields have dropped by 74bps year-to-date to 5.81% (15 July)
- The measures taken by the RBI to provide liquidity to the system have helped to lower financing costs for corporate bonds. Corporate bond spreads for highly rated names and quasi sovereigns have eased significantly over the past few weeks
- While the inflation data for April to June came in higher than consensus (see page 6 for details), the RBI is not expected to change its accommodative stance in its monetary policy given the concerns on growth on account of COVID-19. The market will be watching RBI's next move at the MPC meeting in August. We continue to expect the RBI to stay accommodative and ease pressure on bond supply by maintaining adequate liquidity and using tools such as Operation Twist and Open Market Operations, at appropriate times
- Despite the recent change in outlook of India's sovereign rating by Fitch, it is not our central view that any agency will downgrade India to below investment grade. The domestic investor base for Indian bonds (95% plus of the market) should ensure that the reaction to such an event would not be severe even if it were to occur.
- Oil prices have seen a sharp rebound from their April lows. WTI crude prices were trading at USD 41.20/barrel as of 15 July versus USD 18.80 at the end of April. Meanwhile the INR against the USD has seen little change since the end of April (see page 2 for more details). There has been increased risk appetite in Indian equities since May although year-to-date net foreign flows are still negative (outflows of INR 233 billion or USD 3 billion, year-to-date as of 15 July) given the heavy sell off during March. In debt markets, foreign outflows eased during June; net outflows year-to-date have amounted to INR 901 billion or USD 12 billion, as of 15 July.
- Our India fixed income strategy continues to be overweight INR government bonds with a predominant positioning in the 4-10 year part of the curve. While we are overweight high quality corporate bonds in the 1-3 year part of the curve, we have booked profits in certain bonds in this segment and switched into government bonds further up the curve, thereby marginally extending duration, given the sharp compression in spreads in the last month .The overall quality of the portfolio remains high, with a combination of government and quasi-sovereign bonds as well as high quality corporate bonds

Yields look attractive vis-à-vis policy rates

Source: Bloomberg, HSBC Global Asset Management, Bloomberg data as of 15 July 2020

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Data watch

Indicator	Latest data	Consensus data	Previous data	Analysis
Industrial Production (IP) (% YoY)	NA (May)	NA	NA (Apr)	IP contraction in May moderated following to large sequential drops in March and April, as lockdown measures started to ease. The improvement follows the jump in the manufacturing PMI for May and June, however overall IP remains well below pre-COVID level in terms of absolute activity, and the recovery is expected to be gradual amid the fragile backdrop.
Local passenger vehicle (PV) sales (units)	105,617 (June) (-49.59% YoY)	NA	NA (May)	Relaxation of lockdown measures has allowed for a nascent recovery in production and sales. Dealerships have been met with pent-up demand from individuals, particularly in the first-time buyer segment, who would have previously depended on public transport, however, strict social distancing requirements and realities of the coronavirus have prompted increased purchases. A bright spot in Indian autos has been tractor sales which have strongly rebounded indicating a relatively faster rural recovery.
Exports (USD) (% YoY)	-12.4 (Jun)	NA	-36.5 (May)	Drops in both exports and import moderated in May following easing lockdown restrictions across the nation. Exports fell 36.5% yoy and imports fell 51%. The steeper drops in imports saw the trade balance narrow for a fourth consecutive month to a USD3.2bn deficit. Imports remained weak due to fragile domestic demand and low oil prices. Exports, grew on a month-on-month basis, with iron ore, pharmaceutical products and spices posting positive growth. Discretionary commodity groups such as gems and jewelry, leather products and handicrafts remained at an effective standstill.
Imports (USD) (% YoY)	-47.6 (Jun)	NA	-51.0 (Mar)	
Trade Balance (USD)	0.79bn (Jun)	-4.0bn	--3.2bn (May)	
Inflation (% YoY) - CPI - WPI	6.09 (Jun) -1.81 (Jun)	5.30 -2.40	NA (May) -3.21 (Mar)	June inflation figures came in at an elevated rate of 6.1%. Many components of the index showed firmer prices suggesting an adverse and broad supply shock as a result of the pandemic and lockdowns, and outweighed effects of a slowdown in demand. Interestingly, one sector that would have expected to show higher prices, health, remained flat. As lockdowns ease and supply chains restart, we would expect deflationary forces to begin weighing on inflation.
Repo rate (%) Reverse repo rate (%) Marginal standing facility (MSF) rate (%)	4.00 3.35 4.25 (22 May)	NA NA NA	4.40 3.75 4.65 (27 Mar)	So far this year, the RBI has cut policy rates totalling 1.15% to support domestic economic activity that has been severely impacted by lockdowns. In addition to the cuts, the RBI announced fresh measures to ease financial stress including allowing the moratorium of term loans for financial companies to be extended by three months and pausing changes in asset quality classifications. The RBI has also decided to continue its accommodative stance for as long as necessary to revive growth.
GDP (% YoY) Gross value-added (GVA) (% YoY)	3.1 (Jan-Mar) 3.0 (Jan-Mar)	1.6 1.8	6.6 (Oct-Dec) 6.3 (Oct-Dec)	The sustained rise in coronavirus cases has prompted local lockdowns, prolonging an economic recovery and weighs on consumer behaviour and ultimately demand. Further monetary measures and fiscal stimulus have been announced but provides a marginal incremental impulse to growth. Overall GDP is expected to experience a sharp contraction in the 2020-2021 fiscal year.
Current Account Balance (CAB)	USD0.6bn 0.1% GDP (Jan-Mar)	-USD3bn	-USD2.6b -0.4% GDP (Jan-Mar)	Following a weakening of domestic demand and lower oil prices, imports have contracted faster than exports, resulting in a small positive current account surplus for the quarter. Portfolio flows experienced large outflows but strong capital flows because of capital raising activities, provided an offset.

Indicates improved data on month-on-month/quarter-on-quarter/year-on-year basis

Indicates worsened data on month-on-month/quarter-on-quarter/year-on-year basis

Indicates no change in data on month-on-month/quarter-on-quarter/year-on-year basis

Source: Bloomberg, HSBC Global Asset Management, as of July 2020

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