Second Wave of Covid-19, lower GDP Estimates – Dilemma for Fixed Income Investors

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The second wave of Covid-19 is far more severe as compared to the first wave. The average daily cases are touching approximately 4 lacs a day and whereas only about 2.5% of the population is vaccinated till now. Vaccine manufacturers are expected to increase production in the coming days as the USA has relaxed restrictions for export of raw materials for manufacture of vaccines.

With a complete national lockdown in March 2020, it appeared that most of India escaped the first Covid-19 wave. The national lockdown severely affected the economy as was reflected in negative growth numbers in subsequent quarters. However, this time around, the decision of the lockdown was left on the states. Of the 28 states and 8 union territories, only about 16 have declared full lockdown while the others are on partial lockdown as of May 10, 2021. We are likely to see these numbers going up in the coming days given the increasing case numbers.

Most states are allowing essential activities to continue however, the lockdown does affect businesses at varying degrees. While the non-essential establishments see business coming to a complete standstill, the establishments in the essential services also go through a lower volume of business due to various logistical issues. There is complete loss of demand for non-essential items as people start focusing on only essentials viz. food and grocery. This leads to significant output gap as idle production capacity far exceeds the demand in the economy. This in turn leads to postponement of capex cycles, which affects the capital goods markets as well. This singular survival focus of the people not only impacts the manufacturing sector but also the services sector. Construction sector is a highly labor-intensive sector and will remain a key factor from employment perspective. The second wave and consequent restrictions on non-essential domestic manufacturing could adversely affect exports.

While the GST collections until April 2021 (reflecting activity of March 2021) have been record breaking, lower numbers are expected in the coming months as the economy starts reflecting the impact of lockdowns.

Post the first Covid-19 wave, as lockdowns were being lifted partially, some revival was witnessed largely due to the pent up demand in the economy. A big contributor towards this revival was also the strong demand witnessed in the rural economy as rural India was largely able to avoid the dreaded virus. A key difference in the second wave is that, this time rural India is also witnessing large number of cases, and the impact is expected to be much larger as health facilities there are much lesser as compared to towns.

The coming months will start reflecting the impact of lockdowns in the economy and as a proactive measure, we also saw the Reserve Bank of India announcing a slew of measures to combat this expected slowdown in the last week. The true damage of Covid-19 induced lockdowns will be only realized once the pandemic starts to ebb away however; in anticipation, we have had multiple agencies lowering their growth estimates for FY22.

Whenever the economy starts to slow down, the central bank ensures easy monetary conditions along with a low interest rate regime. The RBI had brought down interest rates to record lows to combat the Covid-19 induced slowdown and had flushed the system with surplus liquidity. As the Indian economy had started showing some signs of revival, the RBI had started to withdraw some of this surplus liquidity but the impact of the second wave has made the central bank to once again reassure the markets once again that it would maintain an accommodative stance for "as long as necessary" and till it witnesses durable growth in the economy. The investors in the fixed income markets can therefore expect rates to remain low for at least a few quarters more before the rate cycle starts to reverse. The Indian Debt Capital markets have witnessed significant bouts of volatility in last couple of years, be it market driven or at times due to regulatory changes. The rates in the up to 1 year segment are too low and unattractive whereas the volatility on the longer end of the curve is something that is unpalatable for fixed income investors. In such scenarios, it would be prudent to lock investments into tax efficient roll down products which not only presents a natural hedge against a rising rate scenario but, also protect the investments from intermittent volatility.