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The inflation demon is attacking economies around the world. Interest rates are likely to soar over the next few quarters. Stock markets have already reacted and trended down. Amidst all that chaos, investors are looking for an oasis-an area of calm and strength.

In 2022 so far, the NSE Nifty is down 2.6%. The Nifty Bank index is down 1%. However, the Nifty PSU Bank index is up 8%. The sharp outperformance also holds for one year. There is something about public sector banks like Canara Bank, Bank of Baroda, and State Bank of India attracting investors. The Nifty Bank index is dragged by HDFC Bank, the most valuable private sector bank, down nearly 11% in 2022. However, there is a structural reason for the investor fancy for public sector banks that have traded for long at a discount to their book value. (share price to book value is a measure to track banking sector stock performance)

There is a significant improvement in the underlying performance of public sector banks. According to

"Banks overcoming the Asset Quality Review hump in provisioning and hence exhibiting higher profitability," the agency observed, indicating better days of profits ahead. The improvement in the ratings of banks and non-banks is one thing. There is a significant surge in the credit ratio put together by Care Ratings at 2.64 times in the second half of 2021-22. It is the number of overall upgrades to downgrades in credit ratings.

Credit rating agencies track loans provided by banks and non-banks to corporates and assign them ratings regularly. If the borrowing company shows signs of weakness, rating agencies cut the credit outlook for such a company. If the company delivers more robust financial performance and can service the loan efficiently, the rating agency upgrades those ratings. Currently, the number of rating upgrades is well above the rating downgrades.

All of that is great news for banks. Most public sector banks have suffered a setback due to the non-performing loans between 2010 to 2018. They could not provide loans needed to businesses as they had to make higher provisions for potential losses due to non-performing loans. Such provisioning is likely to trend down. That would mean banks would have more profits accumulating. At the same time, they would have enough resources to expand the loan portfolio and generate more interest income. That is good news for shareholders across the board. Public sector banks could be the biggest beneficiaries in improving the finances of companies in the infrastructure and manufacturing sectors.

However, just like any other story, there are twists and turns. The latest Global Financial Stability Report published last week by the International Monetary Fund highlights a surge in the ownership of government bonds by public sector banks. The report observes that the bank holding of sovereign debt has increased in most emerging markets. India has doubled to 20% of total banking assets from 10% a decade ago. Such high ownership indicates that banks have fewer opportunities to lend to the private sector. Banks tend to own more government debt when interest rates are high.

That is no good news. With surging global inflation, interest rates are set to rise across countries. India will be no exception. Credit growth is likely to remain slow. In that context, the monetary policy committee of the Reserve Bank of India has kept the monetary policy stance 'accommodative' to support growth but withdraws it if inflation persists. The wholesale price inflation in India has been in double digits for a whole year now. As interest rates rise, the committee is expected to raise borrowing rates.

While structural issues related to the quality of loans banks hold are resolved steadily, the market cycle is moving to a higher interest rate regime. That should keep your expectations in check from the rally in PSU stocks.

(The author is editor-in-chief at www.moneyminute.in)

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