PGIM India Mutual Fund

Market Outlook

December 2021

Equity Market

Tempering expectations

Indian markets ended the last month of the calendar year with a 2.2% return. The Midcap Index rose by 2.7% and Smallcap Index by 5.9%. The positive returns on the indices mask the intra-month volatility and continued FII selling. Within the Nifty 500 Index, almost 1/3rd of companies gave negative returns for the month. The key outperforming sectors were IT (+10.1%), Metals (+8.1%), Capital Goods (+7.1%). The underperforming sectors were Energy (-1.1%), Finance (-1.1%), Telecom (-0.8%).

Despite disruptions and volatility on account of rapid spurt in Covid cases, shortage of medical supplies, imposition of lockdowns, supply chain disruption, China tech crackdown, Evergrande debt crisis, the year has ended on a strong note for equities led by accommodative monetary policies, the rapid pace of vaccination, strong corporate earnings growth and strong participation of the retail segment. During the year, NIFTY gave a healthy return of 24%, while the midcap and small-cap indices delivered 46% and 59% respectively. IT, Realty and Energy sectors were key gainers while FMCG, Pharma, and Banks were the underperformers.

In US$ terms, the World Index rallied 20.2% in 2021. The Developed Markets outperformed the Emerging Markets (-4.6%). India outperformed the EM and was in line with DM.

RBI kept the repo rate unchanged at 4%, maintaining the stance as “accommodative”. RBI expects inflation of 5-5.7% in the next 4 quarters. Their GDP growth projection stands at 9.5% for FY22. November's wholesale price inflation rose to a 23-year high of 14.23%. This was the 8th straight month of double-digit WPI inflation – for the first time in 23 years. All-time low repo rate at a time when wholesale inflation is at a 23-year high raises alarm bells and hence rates/inflation become the key variable to watch in the coming year.

The weekly average of daily virus cases more than doubled in the week ended January 2, reversing a downtrend that stretched back to May. In case it leads to a strict lockdown, it may have its bearing on the GDP projections. While the cases are rising at a rapid pace, the severity remains low. A wider vaccination program should help limit the virus curbs and the associated adverse impact on economic activity.

The current account registered a deficit of US$9.6 bn (1.3% of GDP) in 2QFY22 against a surplus of US$6.5 bn in 1QFY22 (0.9% of GDP) and a surplus of US$15.3 bn (2.4% of GDP) in 2QFY21. The central government’s fiscal deficit as of Nov end was 46.2% of the annual budget.

FIIs were net sellers to the tune of $1.7bn during the month. They sold ~$5.4bn in the last 6 weeks of the calendar year. DIIs continued the buying in Dec to the tune $4.3bn. YTD FII/DII inflows stand at +$3.8bn/$12.7bn respectively.

Going forward

Nifty is now trading at one-year forward P/E of 21.5x - which converts into an earnings yield of 4.65%, which in turn continues to be higher than a 1-yr G-sec yield of 4.37%. Hence, while equity is trading at above-average valuations, the relative valuation is still not stretched. We expect returns to come primarily from earnings growth.

After a prolonged lull (4% CAGR FY12-19), Nifty EPS is forecast (as per Bloomberg Consensus) to grow 15% annually FY19-24 (FY22-24 at 17%). The market began pricing in strong medium-term prospects for the Indian economy.

The post-Covid growth recovery is expected to continue in FY23. Even if real GDP growth for FY23 comes at 8.5%, on top of 9.5% in FY22, it translates to just a 3.4% CAGR in the three years of FY21-FY23.

Two risks remain that need monitoring. First is the change in accommodative stance by central banks, particularly in the light of a few central banks signaling a change of stance due to persistently high inflation. Second is the rise in cases of the new variant. While early evidence suggests low severity (though high transmissibility), we reckon high vaccine prevalence along with booster dose as well as a larger section of the population being brought in the vaccination ambit, this could be less of a concern.

Electorates in India's largest state of Uttar Pradesh and four other states will elect new assemblies in 1Q 2022. BJP is in power in six of these seven states and their performance in the state elections could be a pointer towards public perception on economic matters.

The approach for the year 2022 needs to be bottom-up stock selection as markets are likely to deliver lower returns compared to the broad-based rally and spectacular returns in the past 21 months. With new-age companies listing and gaining size (in terms of market cap at least), the investment paradigms are seeing a change when looked at from a traditional lens. Nonetheless, we continue to stick to our philosophy of seeking strong structural themes at a reasonable price, sticking to quality in terms of corporate governance, balance sheet and cash flow generating ability.

Debt Market

Higher Yields, inflation likely

Indian bond yields were higher by 12 to 18 bps across the curve during the month of December 2021 as RBI announced that it will start to absorb a higher amount of liquidity in variable reverse repo auctions. This means that RBI can make the Policy Repo rate operational over the course of the next two months, even as RBI was dovish and retained its accommodative stance. Concerns on the new COVID 19 Variant were largely ignored by the bond market and by the end of the month bond yields started to rise worldwide as the US Fed turned more hawkish and Bank of England surprised by hiking rates. The next big trigger for the Indian Bond markets, apart from the evolving situation with respect to the new Covid variant, will be the Union Budget. Markets are not pricing in extra borrowing given the decent revenue and surplus position of the government, our view is also that there won't be any surprise extra borrowing like last year. The key will be the fiscal deficit number and there also we do not expect major consolidation, expecting the FY23 fiscal deficit to come in the vicinity of 6.50%.

INR appreciated by 1.10% during the month though it was a very volatile month. INR went to a low of 76.23 intra month as the US Dollar strengthened. INR bounced back sharply towards the end of the month ending at 74.34 from 75.17 at the start of the month. Brent crude bounced back strongly after the sharp correction of 16% last month to end the month at 77.78 up nearly 10% from the previous month closing of 70.57. PFIs continued to pull money out of Indian markets in the last month of the year with Debt outflows at USD 1.56 Bn. For Calendar year 2021, debt outflows were at USD 3.63 Bn.

We are underweight duration as we expect yields to continue to rise, we expect Inflation to overshoot RBI expectations as the economy starts to operate at its pre-covid levels with vaccination levels increasing rapidly, though we would be closely monitoring the evolution of the new Covid19 variant.

Fixed Income Market

	November 2021	December 2021	Change (in bps)
Overnight rate (NSE MIBOR)	3.41%	3.60%	19.00
1 yr CD	4.39%	4.56%	17.00
10 yr GOI Yield	6.33%	6.46%	13.00
USD/INR	75.16	74.28	-88 paise
IIP (Monthly with 2 month lag)	3.30%	3.20%	-10.00
CPI (Monthly with 1 month lag)	4.48%	4.91%	43.00
5 Yr AAA PSU spread (bps)	20	15	-5.00
5 Yr OIS	5.29%	5.37%	8.00
US 10 Yr yield	1.46%	1.51%	5.00
CRR	4.00%	4.00%	0.00
Reverse REPO	3.35%	3.35%	0.00
REPO	4.00%	4.00%	0.00

Source: RBI Weekly Statistical Supplement & Bloomberg

Note: IIP has been revised lower for the previous reading.

Source: BSE, RBI & Bloomberg