PGIM
India Mutual Fund

Market Outlook

August 2020

Equity Market

Strong market despite mixed numbers

The market that was

Indian Equities rose for the third straight month in August (Nifty +2.8%), with the US markets also touching new highs during the month. Broader markets outperformed, with the BSE Mid-cap gaining 6.6% and BSE Small-cap gaining 10.1%. Among sector indices, the BSE Metals index gained 13%, followed by Realty (+11.6%) and Banks (+9.6%). Dollar weakness, gradual re-opening of the economy and hopes of a vaccine supported sentiments.

While the growth rate of virus spread in India moderated over August, absolute daily cases touched new highs. Geopolitical tensions flared up once again along the India-China border spooking the markets. The government banned the import of 101 defense items. The FDI limit in the defense sector under the automatic route has been raised to 74% from 49%. Market Regulator SEBI disallowed extension of new higher-margin norms taking effect from 1st Sep, potentially reducing the retail activity from now on.

1Q FY21 Real GDP growth contracted by 23.9% yoy, weaker than the consensus estimates of -18% yoy. Led by a strict lockdown and labor migration, construction was the worst hit, followed by trade, hotels, transport and communication. July's CPI inflation print of 6.9% (vs 6.2% in June) drastically reduced chances of a rate cut soon. India's trade balance turned to a deficit of ~$4.8bn in July, from a rare surplus of ~$0.8bn in June, as gold and other imports started to pick up. India's fiscal deficit stood at Rs8.2trn at the end of July, at ~103% of the budgeted target for the current fiscal year. A sharp fall in tax receipts coupled with resilient government expenditure led to the high deficit in the period. The central government has announced a plan to allow restructuring of loans impacted by the pandemic just as the moratorium period was coming to an end in August. The auto industry was disappointed after the GST Council didn't cut rates on 2W.

After an erratic July, August witnessed excess rainfall of 26%, highest print since 1901 (when the weather office started recording). India's manufacturing PMI for August came in at 52 vs 46 in July – the first recording above 50 after months. The Govt of Maharashtra reduced stamp duty rates to kick-start economic activity.

The June-quarter (1QFY21) corporate earnings were better than muted expectations. Sales were impacted by the COVID-led lockdowns; however, Corporate India undertook stringent cost control measures to protect their bottom lines and arrested the decline in operating profit. Healthcare, Utilities, Private Banks and Technology sectors reported YoY profit growth, while Autos, Retail, Metals and Telecom posted losses. Overall, management commentaries indicated MoM improvement in demand during the quarter after easing of the lockdown restrictions. Nifty sales declined 29% YoY while EBITDA declined 6% and Net profit declined 26% YoY.

FII buying accelerated in Aug with net inflows being ~$6bn (primarily driven by participation in capital raises) taking the YTD inflows up to ~$4.7bn. DIIs, on the other hand, continued to be net sellers of ~$1.5bn reducing their YTD inflows to ~$9bn. Both Domestic MFs and Insurance Cos were net sellers during Aug and net buyers YTD of $2.9bn and $6.1bn respectively.

Going Forward

The government announced further relaxations under Unlock 4.0 including the lifting of restrictions on inter / intra-state movement of people and goods. On the virus front, the medical fraternity seems to have developed suitable protocols to treat COVID positive patients. Also, the presence of antibodies in about 20% of people tested is a significant relief.

Markets have done exceptionally well (Nifty rallied over 50% since March lows), but concerns remain on economy and virus. Markets are lead indicators, and economic data is likely to see a good improvement compared to the past 4-5 months. However, there is reasonable uncertainty on the extent of recovery and sustainable growth rates as demand destruction and job losses are real. While earnings are likely to post decent growth in FY22, there is room for downgrades in FY21 and FY22 consensus numbers.

Liquidity is playing a vital role in the current rally across the world, including India. But this is not a good situation to be in as markets can turn choppy when FIIs start selling.

Despite the rally, India's Market Cap to GDP stands at a significant discount to long term average. With the longer-term growth story intact for India, we stick to quality franchises with strong moats, cash flows, balance sheets and higher earnings visibility in terms of our investment exposure.

Debt Market

Inflation high even as growth slows

Macro Review

The July Consumer Price Index (CPI) inflation rate came in at 6.9%, higher than consensus expectation of 6.3%. Inflation has averaged 6.5% over the March to July and has remained over RBI's 6% upper end of the target for over seven months and over 4% for 10 consecutive months.

Core inflation also inched up to 5.87% compared to 5.33% in June'20, despite weak demand conditions. The July inflation surprise came from all the key quarters. As expected, food inflation ticked higher, led by both a seasonal rise in vegetable prices as well as supply disruption in the transport of food items. Pump petrol and diesel prices rose too, given elevated taxes. Sustained rise in gold prices added another 50bp. Even after shaving off all of this, our measure of core inflation excluding gold, rose 0.4 % over the last month, driven by price pressures in most of the underlying items - education, personal and household items. Inflation is likely to face upward pressure in the near term but likely to ease eventually on lack of demand and favourable base effect in the latter part of the year.

Liquidity and Rates

Liquidity conditions continued to remain in surplus mode in line with the RBI's accommodative stance and the pledge to improve transmission of past rate cuts. Average daily, Liquidity Adjustment Facility (LAF) balances for August stood at INR 3.68 trillion compared to INR 3.59 trillion in July. Currency leakage in the first 3 weeks of August was at approx. INR 16,000 crore compared to INR 12,000 crore for the month of July in line with seasonal trend and also on account of reducing risk aversion and cash hoarding as the economy has unlocked. The Rupee appreciated by 122 paise (1.63%) against the USD in June. Brent Crude oil continued to trade in the narrow range of USD 40/bbl to USD 45/ bbl in the month of August.

The RBI kept the policy repo rate on hold at 4% on 6th Aug, after having cut it by a cumulative 115bps over the last two meetings. Consensus was evenly divided (52% expecting a cut, 48% expecting rates on hold, as per Bloomberg). All the six Monetary Policy Committee (MPC) members voted for a continuation in the accommodative stance as well as the pause on rates. The status quo reflects the near term uncertainty, while accommodative stance reflects the need to support a weak growth impulse once headline inflation stabilizes. There was assurance from the RBI that it has further space for policy rate cut and will use it judiciously as and when the situation warrants.

On inflation, the RBI outlined a slew of uncertainties, ranging from a delayed fall in vegetable prices, the supply-demand mismatch in protein-based food items, the higher tax on oil resulting in elevated pump prices, and volatility in asset prices.

On growth, while the RBI was positive on the rural economy, it highlighted that "extreme uncertainty" characterized the overall outlook. It mentioned that growth was likely to be negative in FY21, without attaching a number to it. However, in the recently released Financial Stability Report, it has pegged baseline growth at -4.4% y-o-y.

GDP for Q1-FY 2021

The Central Statistical Organisation (CSO) yesterday released India's Q1 GDP data for the fiscal FY 2021. GDP numbers were on expected lines contracting by 23.9%, quarter on quarter (annualised). For comparison, the Q4 GDP in FY 20 grew by +3.1%. This contraction was the worst in seven decades but not unexpected given the pain and intensity of the lockdown. Gross Value Added (GVA) contracted by 22.8% for Q1. The plunge was led by severe decline in Construction (-50%), Trade, Hotels, Transport & Communications (-47%).

Manufacturing overall fell by 38.1%, as against agriculture which grew by 3.4%. Services contracted by 20.6%.

Given that the second quarter has continued to witness sporadic and localized lock-downs, the economy is yet to recover to full capacity. While operational activity and economic momentum has certainly picked up in Q2, it is likely that the quarter will witness a contraction, though a lesser one compared to Q1. Besides, with the virus infections yet to peak (daily numbers are still rising), it appears that the flattening and decline will only happen by Q3.

Data collection and accuracy are an issue given the inability to get granular and timely data in the last five months. The silver lining for the year is likely to come from agriculture which should do well for the remainder of the fiscal. Sowing is markedly higher this year (the highest in the last 3 years) and rainfall for the country at the end of August stood at 109% of the long period average. Reservoir levels are also higher than the last 10-year average which should help the Rabi crop.

Given that the slowdown should start tapering off, contraction for the full year (in Q1 the decline has been 6% absolute) should range in the 7-9%.

Recent RBI actions

In a quasi-policy of sorts, RBI released a slew of measures on August 31, in a bid to try and cool the nervous bond markets, after long end yields rose almost 30-35 bps through the month. Key measures included the following.

a) Special Open Market Operations (Also called Operation Twist) aggregating INR 200 billion for September. This was over and above the INR 200 billion that was already announced for August.

b) Term repos of INR 1 trillion were announced for banks. This should mainly address the cash needs mid-month as September is an advance tax payout month.

c) Limit for Held to Maturity (HTM) securities was raised to 22% from 19.5% at present, for all fresh purchases through primary auctions of G-secs starting September 1. This in our view is very meaningful and structural as this can potentially generate additional investment demand of INR 3.5 trillion (@ 2.5 % of Net Demand and Time Liabilities of INR 140 lakh crore) from banks. This move should help banks (and more specifically PSU banks) add more duration without fearing market losses, since the HTM is not marked to market.

d) Option to reprice the existing Long Term Refinancing Operations (LTROs) at prevailing repo rates - This is a welcome step for banks to lower their cost as few of the LTROs were availed pre-March 27, when the first rate cut was announced. With this move, banks would be able to enhance the margin on the money already lent out on the LTROs by moving to the existing rate of 4%.

e) To remain ready to conduct market operations as required through a variety of instruments to ensure orderly market functioning.

Outlook

Recent measures reassures markets that the RBI remains comfortable on the inflation trajectory six months out. Further, it is also a reaffirmation that the RBI remains sensitive to any reversal in yields and would act with urgency if needed. This should help the bond markets since there is now comfort on the near-term cap on long yields.

Our long end calls remain tactical and will leverage some of these short-term rallies in the market. On a structural basis though, the funds remain overweight on medium tenor bonds.

As regards the short end, liquidity remains satisfactory and as such should help support yields. However, lack of an immediate rate action will also prevent any significant fall in yields along the money market curve. We expect yields to remain largely rangebound at the shorter end.

Recommended Products

We recommend short and mid-duration products in the average maturity range up to five years, given the evolving macro backdrop. We recommend the PGIM India Banking & PSU Debt Fund and PGIM India Premier Bond Fund within this category as suitable investment options for investors seeking moderate duration exposure and a preference for high quality (AAA) portfolio. PGIM India Dynamic Bond Fund is recommended for Investors with a slightly higher appetite for volatility.

Fixed Income Market

	July 2020	August 2020	Change (in bps)
Overnight rate (NSE MIBOR)	3.86%	3.78%	-8.00
1 yr CD	3.75%	3.84%	9.00
10 yr GOI Yield	5.96%	6.24%	28.00
USD/INR	74.82	73.60	-122 paise
IIP (Monthly with 2 month lag)	-33.90%	-16.60%	1730.00
CPI (Monthly with 1 month lag)	6.23%	6.93%	70.00
5 Yr AAA PSU spread (bps)	33	30	-3.00
5 Yr OIS	4.16%	4.56%	40.00
US 10 Yr yield	0.53%	0.71%	18.00
CRR	3.00%	3.00%	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 higher for the previous reading. CPI has been revised higher for the previous reading.

Source: BSE, RBI & Bloomberg