PGIM India Mutual Fund

Market Outlook

August 2024

Equity Market

Credible signs of performance shift from low growth/quality names to high growth and high-quality firms

Indian markets fell sharply at the beginning of the month after a weaker-than-expected US employment data, a sell-off in Japan led by reversal of Bank of Japan's monetary policy stance and geopolitical tensions in the Middle East. It however ended up with a 1% gain by the end of the month. Sectoral indices ended on a mixed note. Healthcare (+7%), consumer durables (+4%) and IT (+4%) were the major gainers whereas PSU (-4%), realty (-4%) and capital goods (-3%) were the major losers. Mid Cap and Small Cap index also recorded gains of 0.9% and 1.2%, respectively. In CY24YTD, Mid Caps and Small Caps have outperformed Large Caps and have risen 28.4/27.5% each vs. a 16.1% rise for the Nifty.

On the economy front, CPI inflation in July fell to 3.5% from 5.1% in June, supported by a favourable base despite a continued increase in vegetable prices. WPI inflation in July fell to 2% from 3.4% in June. IIP growth in June was 4.2% compared to 6.2% in May. Real GDP growth fell to a five-quarter low of 6.7%YoY in 1QFY25 vs. 7.8% in the previous quarter.

Goods trade deficit in July remained elevated at US$23.5 bn, higher than US$21 bn in June. There was a surprising strength in real GVA growth which rose to 6.8%YoY. GST revenue for the month of August 2024 stood at ₹1.74tn, higher 10% YoY. August Manufacturing PMI came at 57.5 vs 58.1 in July. July-24 sectoral deployment data shows a tad slowdown in loan growth (13.6% yoy vs. 13.8% yoy in June-24) mainly due to MoM degrowth in MSME, NBFCs and Services segments.

Deposits growth was muted at 10.6% YoY and LDR is range-bound at 79%. Despite a tepid start, monsoon has progressed well. Cumulative rainfall is above normal by 4.0%. Reservoir levels have also improved sharply and is now higher than last year and the 10-year average level. Moody's Ratings raised India's Gross Domestic Product (GDP) growth projection for this calendar year to 7.2% from 6.8% previously. Ratings agency Fitch has also affirmed India's sovereign credit rating (BBB-). The central government announced Unified Pension Scheme (UPS) for 23 lakh government employees with higher employer contribution and guaranteed returns. Capital expenditure by the Central Public Sector Enterprises, including departmental agencies (CPSEs) fell by 16% in aggregate in April-July, due to impact of general elections on project implementations.

In Q1FY25, Sales/EBITDA/PBT/PAT growth for Nifty constituents came in at +7%/+5%/+4%/+4% YoY in 1QFY25. The aggregate performance was hit by a drag from Oil Marketing Companies (OMCs). Excluding OMCs, the Nifty posted 9% earnings growth a tad soft but expected in an election quarter.

FPIs bought US$1.2 bn of Indian equities in the secondary market, whereas DIIs bought US$5.7 bn. FIIs net bought $6.5bn in CYTD24. On the other hand, DIIs have continued to remain net buyers to the tune of $37bn in CYTD. Within DIIs, mutual funds have been the key buyers contributing to $30.2bn buying.

Going forward

India continues to deliver one of the highest economic growth among the larger countries. Macro variables like fiscal deficit, current account deficit and currency are in a goldilocks scenario. Despite a coalition setup, Government has continued with its thrust on public capex. Rising private capex should further accelerate the capex cycle. Liquidity remains strong as domestic inflows have far exceeded FII flows, providing cushion to capital markets.

We are seeing early but credible signs of performance shift from low growth/quality names to high growth and high-quality names from the start of this fiscal, accentuated post June'24. After having underperformed in FY24, there is a favorable potential risk reward in high growth and high-quality basket of stocks. We are also seeing valuations being frothy in certain segments of market wherein lies the dual risk of earnings as well as multiple correction. There could be further headwinds for stocks in the micro bubble segment of the market due to likely volatility related to events like upcoming US elections, rate-cut anticipation, heightened geopolitical tensions and state level elections in India.

We are primarily adhering to our time-tested philosophy of high growth and high quality investing and are confident that this philosophy would yield healthy results in times to come.

Debt Market

RBI may maintain status quo on policy rates till the end of CY25

The positive undertone of the Indian bond markets continued as yields drifted lower, in August 2024, and were down 6-7 bps across the curve. The MPC meeting outcome was on expected lines, as the divergence of views between the MPC members from the RBI and the external MPC members continuing with members of RBI striking a cautious tone whereas two of the three external members voting for a rate cut. Further, the RBI governor sought to address the debate on whether to target 'core inflation' only, by strongly pushing back on suggestions of relooking at the monetary policy framework in context of the limited influence of monetary policy on food inflation which is mostly supply-driven. The Governor's statement mentioned that the MPC's target is the headline inflation, where the weight of food inflation is 46% and with such a high weight, food inflation cannot be ignored. Further the Governor's statement highlighted that "public at large understands inflation more in terms of food inflation than the other components of headline inflation". And further stated that "high food inflation adversely affects household inflation expectations, which have a significant impact on future trajectory of inflation. Household inflation expectations, after witnessing a moderating trend between May 2022 and September 2023, have edged up on the back of high food inflation since November 2023. Persistently high food inflation and unanchored inflation expectations – if they materialise – could lead to spillovers to core inflation through pick-up in wages on cost-of-living considerations. This, in turn, could be passed on by firms in the form of higher prices for services as well as goods, especially in a scenario of strong aggregate demand. Third, these behavioural changes can then result in overall inflation becoming sticky, even after food inflation recedes. The MPC may look through high food inflation if it is transitory; but in an environment of persisting high food inflation, as we are experiencing now, the MPC cannot afford to do so. It has to remain vigilant to prevent spillovers or second round effects from persistent food inflation and preserve the gains made so far in monetary policy credibility". RBI's inflation forecast for FY25 was upped marginally to 4.57% from 4.50% earlier while retaining its growth forecast for FY25 at 7.20%, assuming normal monsoons.

CPI Inflation came in at 3.54%. This inflation print was aided by base effect which offset the higher momentum in food prices and higher telecom tariff. The increase in telecom tariff led to an increase in 'core inflation' to 3.35%, from 3.15% a month ago, though prices remained stable across other categories underscoring stable underlying inflation. Given this number, in all likelihood, CPI inflation is likely to undershoot RBI's forecast for inflation in Q3-FY25. RBI had forecasted CPI inflation to average at 4.4% for Q3-FY25 but the actual average inflation for Q3-FY25 is now likely to be around 4%. Overall, for FY25, against RBI projection of 4.5%, the actual inflation is likely to come in lower by 10 to 20 bps.

Ahead of the state elections, the central government announced the new Unified Pension Scheme (UPS) which can have a potential negative impact on both the central and the states' fiscal deficit. The UPS is expected to benefit around 2.3 mn central government employees, and if the states adopt it then the beneficiaries can go up to 9 mn. There are different estimates of the impact on the fiscal with the government estimating the impact to be around INR 62.50 bn while some other estimates are talking about an impact of around INR 400-450 bn which can result in a fiscal impact of 15 bps (Macquarie report). The fear is that the states' fiscal deficit can also be adversely impacted which is already running above the threshold levels of 3%. Poll-bound Maharashtra has become the first state to adopt UPS. The GDP data for Q1-FY25 was released on the last working day of the month and it came in line with expectations at 6.70% (exp. 6.80%) but the GVA numbers surprised on the upside and came in at 6.8% which was higher than expectations of 6.4%. Overall, the growth numbers look good, though going forward, there is a possibility of both the inflation and growth numbers getting revised downwards.

Monsoons progressed well and as of August-end nation-wide rainfall was 8% above the long period average (LPA), though the regional distribution remained skewed. In fact, India witnessed the wettest July-August period in 30 years. Reservoir levels were also good at 80% of their capacity (vs. the 2015-2023 average of 68.2%). The IMD forecast of excess rainfall in September is a risk as it can adversely impact crop harvesting.

Banking sector liquidity eased on back of government spending though short-term money market yields remained elevated due to skewed distribution of liquidity, with 3-month maturity bank CD's trading at 7.2%.

FPI inflows into debt remained stable with USD 2.14 bn coming in the month of August. Cumulatively, the CYTD24 FPI inflows into debt have crossed USD 13.08 bn. The OIS curve steepened with the 1 yr OIS ending the month at 6.49%, down 18 bps during August, while the 5 yr OIS was lower by 14 bps, and ended the month at 6.08%. The INR depreciated by 10 paise and closed at 83.87 per USD. Commodities were down during August, and brent ended the month below INR 80, at INR 78.80 per barrel.

Global bond yields also cooled off with the benchmark US 10 yr bond yield down by 13 bps on back of dovish outlook given by the US Fed Chairman which cemented the start of the US rate cutting cycle from September onwards, and the US bond markets pricing in more than 100 bps of rate cuts in US over the next 6 months. The Reserve Bank of New Zealand also cut rates in a surprise move and more rate cuts are expected from ECB and BOE.

Going forward, we believe that the RBI is likely to maintain status quo on policy rates till the end of CY25. The rate cutting cycle in the developed markets has started in the right earnest, though in the domestic context given the current growth-inflation dynamics and the continuing endeavour of RBI to narrow the wedge between the deposit and the credit growth rates, we believe that rate cuts in India are likely to start from Q1-CY25. Markets tend to react before the start of a rate cutting cycle and any retracement in yields from current levels offers a good opportunity to investors to increase their allocation to fixed income as real and nominal yields remain attractive with favourable demand-supply dynamics playing out in the G-Sec market. We expect the 10 yr benchmark bond yield to keep drifting lower gradually and converge with the policy repo rate before the start of the rate cutting cycle.

Fixed Income Market

	July 2024	August 2024	Change (in bps)
Overnight rate (NSE MIBOR)	6.55%	6.80%	25
1 yr CD	7.57%	7.65%	8
10 yr GOI Yield	6.93%	6.87%	-6
INR/USD	83.73	83.87	14 paise
IIP (Monthly, with 2 month lag)	6.20%	4.20%	-200
CPI (Monthly, with 1 month lag)	5.08%	3.54%	-154
5 yr AAA PSU spread (bps)	50	53	3
5 yr OIS	6.22%	6.08%	-14
US 10 yr yield	4.03%	3.90%	-13
CRR	4.50%	4.50%	0
REPO	6.50%	6.50%	0
SDF (Standing Deposit Facility)	6.25%	6.25%	0

Source: RBI Weekly Statistical Supplement & Bloomberg

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

Source: BSE, RBI & Bloomberg