

# Market Outlook

January 2020

## Equity Market

### Earnings are seeing buoyancy led by lower tax rates and low base of FY 2019

#### The market that was

Led by global cues (Iran tensions and Coronavirus scare), Indian markets were weak in January 2020. Sector wise, metals, energy and banks were laggards while realty and cement sectors were outperformers. While large caps saw a muted month (Nifty down 1.7%), the focus was clearly on midcaps and small caps and the respective indices were up 5.3% and 6.7% in the first month of 2020.

Nov IIP (+1.8%) rose after 3 months of contraction, while Dec manufacturing PMI print came in at its highest level since May 2019. Spike in vegetable inflation (+60% YoY) pushed the December headline CPI print to 7.35% and was at a 65-month high. Furthermore, fuel and telecom inflation too came higher than expected and core inflation came in at 3.7%. The trade Deficit narrowed further to \$11.3bn in Dec 2019 as fall in imports at 8.8% was much higher than the fall in exports at 1.8%.

GDP growth is likely to come in at 5% in FY2020 from 6.8% in FY2019, according to first advance estimate released by Government of India, making it the lowest growth rate in recent years. For FY2021, growth has been projected at 6.3%.

FIIIs were net buyers to the tune of \$1.4bn (partly due to fund raise in Telecom sector) in January whereas DIIs were net buyers of \$0.3bn. Domestic Mutual Funds were net buyers of \$0.2bn whereas Domestic Insurance companies bought \$0.1bn during January.

#### Going Forward

The Union Budget was presented on 1st February and while there were no stark negatives, a lack of stimulus and policy measures disappointed in the backdrop of heightened expectations. There was no significant growth in allocation for core sectors which could have been used to accelerate investments in a sluggish economy. The Union Budget is a routine exercise of balancing revenue and expenditures of the government and it is not the only policy and stimulus event for the country. Steps have been taken outside of the Budget as well (e.g. corporate tax rate cuts in September 2019).

We reckon the economy is on the path of a gradual recovery. Earnings are seeing buoyancy led by lower tax rates and a low base of FY2019. At the time of writing this report, 30 out of 50 Nifty companies have reported Q3FY2020 results (with 84% weightage in Nifty) and adjusted profits are up ~17% YoY (though aggregate profits are significantly higher led by a low base of last year). Consequently, Nifty P/E (trailing) which was ~26x about a month ago has moderated to 23x (with five year average being 22.4x). With earnings catching up and valuations coming off from peaks, risk reward continues to be favourable and as when economy gains traction, the dichotomy of market performance and economy's performance should contract towards alignment.

## Debt Market

### Bond Markets rally on fiscal consolidation and liquidity

#### Macro Review

CPI for December 2019 printed at 7.35%, higher than both RBI's 4% target and market expectation of 6.7%. Core inflation inched only marginally higher from 3.50% to 3.70% due to partial impact of mobile tariff rise. In general we continued to witness weak pricing power amongst producers, which is reflected in the subdued core CPI. Headline CPI however moved up strongly due to a rapid increase in food prices, which rose 2.37% on a m/m basis. On an annual basis, the increase was 14.12% led by volatile perishables (milk, eggs, meat, veggies) and protein (pulses) rich items. The recent price rise is widely foreseen to be transitory on the back of adverse base effect, erratic weather conditions and supply disruptions.

#### Liquidity and Rates

Liquidity conditions continued to improve despite the government lowering spending in a bid to contain the fiscal deficit. Government borrowed almost INR 1.3 trillion through WMA (overdraft with RBI) at the month beginning, thus pushing the system liquidity to INR 400 bio. Average daily system balances for January stood at INR 3.16 trillion compared to INR 2.56 trillion in December. INR was mostly stable, appreciating by 2 paise (0.03%) against the USD in January.

Crude witnessed increased volatility rising to USD 70 per bbl due to a spike in tensions in the middle east but later settled to under USD 66 per bbl. Crude fell to USD 57 per bbl in the latter part of the month in response to concerns over falling demand due to the fear of spread of coronavirus.

Government bonds remained volatile on the back of crude oil prices which were elevated. RBI continued with its operation twist and conducted 2 operations aggregating INR 20,000 cr. RBI also switched INR 40,000 cr directly with the Govt, enabling a maturity elongation. Despite the ongoing operation twist, the long end of the curve underperformed as market turned cautious ahead of the budget.

India Government presented the Union Budget on February 1st, 2020. In line with market expectation, the government invoked the escape clause to revise FY20 fiscal deficit higher to 3.8% of GDP vs the initial target of 3.3% and fiscal deficit is budgeted at 3.5% for FY21. The budget however relies heavily on non tax revenues to bridge the revenue shortfall next year with a bulk of revenues expected from disinvestment (INR 2.1 lakh cr), telecom receipts (INR 1.33 lakh cr) and RBI/PSU dividends (INR 1.55 lakh cr).

The bond markets were surprised as the budget did not propose any extra borrowing for FY20 against market expectation of INR 30,000 Cr. The nominal GDP growth for FY 21 was budgeted to rise by 10% which appears reasonable, though still 2.5% above the level for FY 20. For FY21, the net g-sec borrowing is budgeted to increase to INR 5.45 trillion from INR 4.74 trillion. The gross borrowing for FY21 is pegged at INR 7.8 trillion which came in line with market expectation. Bonds reacted positively post budget by 10bps in 10yr as the borrowing numbers came in line with market expectation and market positioning was light before the budget.

## Outlook

We expect the bond market to remain positive in the near term as demand and supply dynamics is favorable due to fiscal year end investment demand from Insurance and Provident funds. Continuance of operation twist could further help push yields lower. There are also positive sentiments due to the likelihood of India being included in global bond indices and a proposed increase in FPI limits for corporate bonds to 15%.

Despite opting for prudence over a big bang stimulus and realistic forecasts, downside risks exist. Delayed recovery to a 10% nominal rate is the biggest risk given the continuing local headwinds to growth. For the first time in 10 years, there was no capital allocation to banks in the budget, which together with sub par credit conditions could impede credit and GDP growth.

Also, capital markets locally need to stay adequately buoyant to help see through the rather ambitious disinvestment drive. In FY 20 for instance, the disinvestment target has been scaled down from INR 1.05 trillion to INR 0.65 trillion, while the realised figure stands at INR 0.18 trillion.

Besides the world is preparing to face fresh risks arising from the effects of the health epidemic in China which could seriously slow down its GDP and pull down global growth in the near term.

Given this backdrop, we find the short end of the curve (upto 5 years) attractive due to attractive term spread over the overnight rate and easy liquidity conditions. The long end of the curve will stay elevated in medium term because of ample supply starting Apr 2020 and higher reliance on funding the fiscal deficit through small saving scheme (INR 2.4 trillion).

## Recommended Products

We recommend short duration products in the average maturity range up to 5 years, given the evolving macro backdrop.

We recommend the PGIM India Banking & PSU Debt Fund along 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 higher appetite for volatility.

## Fixed Income Market

	December 2019	January 2020	Change (in bps)
Overnight rate (NSE MIBOR)	5.26%	4.90%	-36
1 yr CD	6.02%	5.95%	-7
10 yr GOI Yield	6.56%	6.60%	4
USD/INR	71.38	71.36	-2 paise
IIP (Monthly with 2 month lag)	-4.00%	1.80%	580
CPI (Monthly with 1 month lag)	5.54%	7.35%	181
5 Yr AAA PSU spread (bps)	48	35	-13
5 Yr OIS	5.54%	5.41%	-13
US 10 Yr yield	1.92%	1.56%	-36
CRR	4.00%	4.00%	0
Reverse REPO	4.90%	4.90%	0
REPO	5.15%	5.15%	0

Source: RBI Weekly Statistical Supplement & Bloomberg

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

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Source: RBI & Bloomberg

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