PGIM India Mutual Fund

Market Outlook

July 2020

Equity Market

Positive news cheers markets

The market that was

July was another strong month for Indian equity markets (in line with EM peers) with the Nifty 50 Index rallying 7.5% during the month. The key positives are; better than expected Q1FY21 corporate results (on low expectations base), progress in numerous Covid-19 vaccine trials & treatment, and signs of earlier-than-expected normalization in economic activity. The broader markets were also strong with the Nifty Midcap 100 Index rising 5.2% and the Nifty Small Cap 100 index rising 8.6%. IT (22.5%) and Pharma (11.7%) were top gaining sectors during the month, while Media (-4.3%) and Realty (-0.8%) were laggards.

India has recorded 1.81 Mn cases of Covid-19 so far (doubled in 20 days) with 38.2k deaths (doubled in 28 days). The cases are on the rise with 35.8k new cases per day in July vs 13.2k in June (+171%). While recovery is improving, incremental active cases were also rising at 11.1k per day in July vs 4.1k in June. India also recorded an average of 617 COVID-19 deaths per day in July vs 400 in June (+54%)

India's current account posted a rare surplus last quarter, as measures to contain the coronavirus pandemic crimped imports. The surplus was $600 million in January-March, or 0.1% of GDP vs a deficit of $4.6 billion, or 0.7% of GDP, in the year-ago period. India recorded a trade surplus in June for the first time in 18 years as exports rebounded from pandemic-driven disruptions quicker than imports. The trade surplus for June stood at $0.79 billion as compared to a deficit of $3.15 billion in May 2020.

The Q1FY21 fiscal deficit was at 83.2% of FY2021BE, much higher than the last five-year average of 60% in Q1. Gross tax collections for Q1FY21 fell by 33% with direct taxes and indirect taxes witnessing a contraction of 30% and 34%, respectively. India's manufacturing PMI for July came in at 46.0 – 4th straight month of sub-50 number and lower than 47.2 reading in June.

Retail inflation in India remained elevated in June despite a sharp plunge in economic activity, as the cost of some food articles and transportation remained high. Consumer Price Index inflation stood at 6.09% in June 2020 vs estimates of 5.3%. The Wholesale Price Index declined 1.81% in June compared with a decline of 3.21% in May.

According to RBI, the gross nonperforming assets (GNPA) ratios of all banks may increase from 8.5% in FY20 to 12.5% in FY21 and if the macroeconomic environment worsens further, this may increase to 14.7%.

During the month, FPIs bought US$1.1 bn worth of equities while DIIs sold US$1.4 bn. Interestingly, retail participation remains very high. Mobile trading turnover in the cash markets jumped almost 9 percentage points to 23% since February 2020. Most broking houses have also reported significant growth in new and active clients.

Going Forward

Though the number of new cases continues to rise as COVID-19 spreads across the country, there is more confidence in our ability to manage the virus as demonstrated by high recovery rate and lower mortality rates in Delhi and Mumbai. However, fear of virus remains elevated, and efforts are on to address this. Looking ahead, relaxations under unlock 3.0 should lead to an increase in activity levels, especially in urban India. However, the pace of recovery is likely to be gradual, more due to demand side issues than supply-side constraints. There are challenges on government finances as fiscal deficit continues to inch up. The financial services sector, especially NBFCs, are in a fragile mode. Overall, corporate India is likely to report a double-digit decline in revenues for the first time. Though the government is trying its best to stimulate demand through lower interest rates, incentives and grants, etc., it is too early to assume that normalcy is back.

Amidst the decline in growth rates in economic indicators as well as corporate profits, global liquidity was high. With higher liquidity and hopes of recovery from the pandemic global equity markets continue to be buoyant (Nifty rallied ~46% since March lows). There could be challenges in the near term as more corporates have lined-up to raise capital, if the virus spreads faster and economic data remains weak. Markets are likely to stay volatile. Despite the rally, India's market cap to GDP stands at 67% - a significant discount to long-term average. With the longer-term growth story intact for India, we stick to quality names, strong balance sheets, healthy cash flows and higher earnings visibility in terms of our investment exposure.

Debt Market

Supply side issues may keep CPI inflation high

Macro Review

CPI data was released for the first time in three months, as data collection on prices was impacted due to the nation-wide lockdown. CPI inflation for April, May and June, came in at 7.22%, 6.27% and 6.09% respectively. Although declining after the April shock, CPI remains higher than consensus estimates of under 6% for this period.

Acceleration in CPI was driven by higher food inflation (excluding vegetables) combined with a sharp rise in the core CPI – as transportation costs rose from petrol/diesel tax hikes, higher personal care and gold prices. Core Inflation has spiked since March, led by rising personal care, health, gold and education costs, which together have more than offset a fall in recreation, household goods and services inflation.

The next couple of CPI prints are also likely to stay elevated due to supply side issues, especially in food items, and might take a few more months to normalize. Furthermore, as the forward and backward linkages of economic activity are gradually repaired, the supply shock will likely fade while the demand shock will remain, pushing core inflation gradually lower.

Liquidity and Rates

Liquidity conditions remained in surplus mode on the back of RBI's accommodative stance and the pledge to improve transmission. Average daily LAF balances for July stood at INR 3.59 trillion compared to INR 3.78 trillion in June. Currency leakage in the first 3 weeks of July was very low at approx. INR 5,000 cr compared to INR 49,000 cr in June, aided by a resumption in economic activity, business and a partial return of labor to work. The Rupee appreciated by 68 paise (0.90%) against the USD in June. Brent continued to trade in the narrow range of USD 40/bbl to USD 45/ bbl in the month of July.

Government bonds traded in a narrow range of 15bps in July. Yields on short government bonds (3-5yr) saw some uptick post CPI data while the longer end of the curve remained protected, given strong investor demand and OMO hopes, leading to curve flattening. A new 10-Year benchmark was auctioned, which witnessed a cutoff of 5.77%. Liquidity premium over the existing 10-year was only 6 bps, explained by a shortening in life spans for benchmarks, given the large supply in auctions. Corporate bonds continued to outperform the government bonds on the lack of supply and higher demand from MFs.

Outlook

We expect the bond market to retain a positive bias on the back of softer food inflation, abundant liquidity, lower growth, stable crude oil price and possibility of further OMO / Operation Twist announcements. Lower end of the curve moving lower in the event of a rate cut whereas longer end retaining some volatility on account of weak revenue and absorption pressures is likely.

In this backdrop, we continue to like the shorter end (up to 5 years) and find it attractive due to attractive term spread over the overnight rate and extremely easy liquidity conditions. The long end of the curve will be volatile with negative push from worsening fiscal leading to extra borrowing and positive push from OMO purchase.

Recommended Products

We recommend short and mid 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

	June 2020	July 2020	Change (in bps)
Overnight rate (NSE MIBOR)	3.89%	3.86%	-3.00
1 yr CD	4.05%	3.75%	-30.00
10 yr GOI Yield	5.99%	5.96%	-3.00
USD/INR	75.5	74.82	-68 paise
IIP (Monthly with 2 month lag)	-57.60%	-34.70%	2290.00
CPI (Monthly with 1 month lag)	6.27%	6.09%	-18.00
5 Yr AAA PSU spread (bps)	52	33	-19.00
5 Yr OIS	4.15%	4.16%	1.00
US 10 Yr yield	0.65%	0.53%	-12.00
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 upwards for the previous reading. CPI has been revised lower for the previous reading and latest CPI for the month of April is not available.

Source: RBI & Bloomberg