

Market Outlook

May 2020

Equity Market

Weak economy but strong markets

The market that was

After registering a strong rally in April (up 15% - the highest move in a month in over ten years), May month witnessed a correction of 2.8%. Disappointed with the fiscal stimulus, the Nifty 50 corrected in the first half but recovered in the second half on improving global sentiment, as economies across the world emerged out of lockdowns. However, US-China tensions escalated with the US's threat to delist Chinese companies and China's signing of HK security legislation. Border tensions between India-China too escalated as Chinese troops moved into sensitive areas along the Himalayan frontier. India entered the list of top 10 countries hit by coronavirus as confirmed cases rose fivefold to 170k, but the death rate remained much lower than average.

Prime Minister Narendra Modi extended the lockdown for two more weeks till May end, albeit with significant relaxations in non-containment zones (Post June 1, India prepared for considerable opening up in non-hotspots with only the containment zones seeing an extension of lockdown till June 30). Activity levels continued to improve through the month, although still significantly lower than normal. Among sectoral trends, Banks (asset quality woes, moratorium extension) were the top losers in May whereas Telecom and Cement (better than expected earnings) topped the chart.

India's GDP growth moderated to a 44-quarter low of 3.1% y-o-y in Q4FY20 vs a downward revised 4.1% in Q3FY20 (4.7% previously). Real GDP growth for FY20 was an 11-year low of 4.2%, while nominal GDP growth was at a 48-year low of 7.2%. The RBI indicated (without giving precise estimates) that FY21E GDP growth is likely to be negative. Rating agencies slashed India's growth forecasts and expected the economy to contract in the range of 4.5-5% in the current fiscal.

Headline CPI inflation for April could not be released as the nationwide lockdown affected the collection of price data. However, sample data suggested that food inflation bottomed out as supply-chain disruption led to an increase in prices.

The MPC cut the repo rate further by 40bps to 4% (lowest since its introduction 20 years ago) while maintaining an accommodative stance. The RBI also extended the moratorium period by three months to 31st August factoring in the lockdown extension.

FY20 fiscal deficit came in at 4.6%, missing the revised target of 3.8% and well ahead of the budgeted target of 3.3%. The Prime Minister announced a larger than expected Rs. 20trn (~10% of GDP) economic package in response to the economic fallout from COVID-induced lockdown. Finer details, however, disappointed the street for the lack of direct stimulus measures and limited fiscal impact (~1.3% of GDP).

FII's turned net buyers in May to the tune of \$1.8bn (vs marginal net sellers in April) taking their YTD flows to -\$4.9bn whereas DII's also were net buyers of \$1.5bn (YTD +\$11.5bn).

Going Forward

India has underperformed its Asia/EM peers over the past three months, not only due to near-term earnings cuts but also rising concerns on medium-term growth prospects and worries of rising Covid-19 cases. Bloomberg consensus FY21/FY22 earnings estimates are down 18%/10% since the start of FY20. Recent earnings downgrades are steeper than those during the GFC.

With the private sector's lower propensity to spend and invest, and the financial sector's sustained risk aversion, the onus is on the government to kickstart growth. The financial package announced thus far is aimed at survival and prevention of significant dislocations.

Globally, equity markets are supported by strong liquidity and growth stimulus. Equity market valuations are supported by falling yields in India and globally.

At 55%, India's market capitalisation/GDP is almost at the same level as it was in March 2009. The long-term average is over 80%, and the peak on this ratio has been over 140%. Nifty P/E ratio at 19x is in line with the long term average. Due to uncertainty around recovery, many good companies are available at multi-year low valuations. We continue with our approach of building a portfolio of strong, quality, growth companies, with low leverage.

Yields rally amidst curve steepening on further rate cut hopes and easing

Macro Review

The imposition of a nationwide lockdown in India since Mar 25, 2020 has impacted the data collection ability of the statistics ministry. In this context, while certain gaps were observed in Mar-20 CPI data, the same got exacerbated in Apr-20, resulting in non-availability of consolidated headline CPI data. The consumer food price index increased 10.49% y/y and 2.64% m/m after three months of consecutive decline. The partial price information for Apr-20 covers approximately 52.7% of the CPI basket and makes it impossible to get a true inflation picture. Directionally, the bias seems to be mildly on the upside on account of buildup in price pressures for the index-heavy food component (45.9%) within CPI. Further, the increase in domestic fuel prices on account of increase in taxes and currency depreciation would limit the windfall from the sharp decline in international oil prices. On the core front, although it would be reasonable to argue that erosion of pricing power amidst further opening up of negative output gap could help moderate core inflation, some upside risk from wage inflation on account of ongoing dislocation in the unorganized labor market (especially for the urban casual labor) cannot be ruled out.

GDP Data

The NSO released GDP data for the 4th quarter (ended March 2020) at 3.1%, following the downward momentum from the previous quarter at 4.1% (Q3-FY 2020) and also over the year earlier which was at 5.7%. Full year GDP for FY 2020 was pegged at 4.2%. FY 2020 GDP growth was the lowest in the last 11 years. We believe both the 4th quarter and full year data could undergo downward revisions.

Govt spending pulled growth for the year, clocking 11.8% yoy in FY 2020 on the back of a 10.1% increase already seen in FY 2019. Private consumption at 5.3% was the weakest in a decade, while Investments contracted almost 3% for the full year.

Lower GDP also led to fiscal deficit rising to 4.6% (as a result of a lower denominator) from the budgeted 3.8%.

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 LAF balances for May stood at INR 5.09 trillion compared to INR 4.7 trillion in April. Liquidity was injected to the tune of 60k Cr through OMO purchase in the secondary market in the month of May. Currency leakage in the first 3 weeks of May was around INR 76,000 cr compared to INR 88,000 cr in April. The Rupee depreciated by 51 paise (-0.68%) against the USD in May. Brent Crude oil continued to trade in the range of USD 25/bbl to USD 35/ bbl in the month of May and saw some bullish bias as the economies started to re-open economic activity gradually, increasing the demand prospects for the commodity.

On 8th May, the Govt announced an expansion in its borrowing by INR 4.2 trillion for the year. This takes the aggregate borrowing for the Central Govt for FY 21 to INR 12 trillion. The government also announced a fiscal package of INR 20 trillion to support growth and offer economic relief from the pandemic. Since the stimulus only involved a cash outflow of 1%, it appears that bulk of the borrowing was to meet the revenue gap arising from lower taxes as economic activity remains sub-optimal.

The Finance Minister, as part of the fiscal package, also stated that states will be allowed to borrow more with the unconditional borrowing limits going up to 3.5% of GSDP (Gross State Domestic Product) from 3% of GSDP. There was also a provision of additional 1.5% borrowing linked to milestones. This could cause the gross SDL issuance to rise from INR 6.08 trillion to INR 8.25 trillion.

On 22nd May, the RBI in a second off-cycle move, cut key rates by 40bps. The repo rate now stands reduced to 4.0%, while the Reverse repo which has been the effective rate given surplus system liquidity, has fallen to 3.35%. The RBI also extended the moratorium given on term loan payments by 3 more months. This was announced during the last MPC policy and was scheduled to expire on May 31st. On inflation, the RBI gave guidance of inflation coming below 4% in the second half once the supply chain issue is sorted on gradual opening up of the economy. On growth, the RBI had worrisome guidance of negative growth in FY20.

The Rates market did see a knee-jerk reaction, with bonds rallying by about 12-15 bps while OIS too rallied by about 6-8 bps. However, the enthusiasm soon died in the absence of the measures that the market was looking for – OMOs and Operation Twists; and the markets closed with gains of just 7bps.

Government bonds were very volatile on the back of an announcement of additional borrowing, fiscal package and off-cycle rate cut by the RBI. Old 10Yr traded in the range of 5.88% to 6.25%. The steepening in the G-sec and corporate bond curve continued, and corporate bonds outperformed the G-sec curve as the spreads in corporate bonds were too attractive with abundant liquidity, and the credit scare being calmed down with RBI support.

Outlook

We expect the bond market to remain positive with softer CPI, lower growth and lower crude price with further monetary easing to support faltering growth. With continuing monetary stimulus and fiscal stimulus to support growth in the ongoing health pandemic we expect the steeping bias to continue. The lower end of the curve will move lower with the new lower policy rate whereas longer end will face a lot of volatility with extra borrowing due to dismal revenue and further OMO purchase announcement from RBI to support the borrowing program of the government. Given this backdrop, we find the short end of the curve (up to 5 years) attractive due to attractive term spread over the overnight rate and extremely easy liquidity conditions. The long end of the curve will be very 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 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


	April 2020	May 2020	Change (in bps)
Overnight rate (NSE MIBOR)	4.41%	4.04%	-37.00
1 yr CD	4.79%	3.99%	-80.00
10 yr GOI Yield	6.11%	6.01%	-10.00
USD/INR	75.11	75.62	51 paise
IIP (Monthly with 2 month lag)	4.60%	-16.70%	-2130.00
CPI (Monthly with 1 month lag)	5.84%	NA	
5 Yr AAA PSU spread (bps)	113	65	-48.00
5 Yr OIS	4.27%	4.18%	-9.00
US 10 Yr yield	0.65%	0.64%	-1.00
CRR	3.00%	3.00%	0.00
Reverse REPO	3.75%	3.35%	-40.00
REPO	4.40%	4.00%	-40.00

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.

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Source: RBI & Bloomberg

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