PGIM India Mutual Fund

Market Outlook

September 2020

Equity Market

Unlocking the Economy

The market that was

After 3 straight months of gains, Indian markets faced bouts of volatility in September, with Nifty declining by 1.2%. Broader markets fared better, with Nifty Midcap Index gaining 1.8% and Nifty Small Cap Index gaining 4.2%. IT and Healthcare were the top performing sectors, while Financials and Telecom dragged the markets down.

Even as the high-frequency activity indicators improved, some cities like Pune, Bengaluru and Mumbai saw a “second wave” of infections. However, on the whole, daily new cases in India fell steadily from a high of +93k, suggesting that the country has crossed the peak phase of infection spread. Meanwhile, media reports suggested that the government was weeks away from announcing another fiscal stimulus package ahead of the festive season, which may include an urban jobs scheme and a massive infra thrust.

SEBI’s new circular for multi-cap schemes led to short-lived optimism for small and mid-caps, as further clarification revealed options to merge, convert or switch with other schemes and avoid shifting weight to small or mid-caps. September also saw Nifty rebalance, whereby Divi’s Labs and SBI Life replaced Zee and Bharti Infratel in the Nifty 50.

After 4 months of consecutive net buying, FIIs turned net sellers in September to the tune of ~$0.8bn, lowering their YTD inflows to +$4bn. DIIs were marginal buyers (+$12mn), taking their YTD inflows to ~$9bn. Domestic MFs were net sellers of ~$0.6bn (YTD +$2.4bn), likely driven by redemptions, while Insurance companies were buyers of ~$0.6bn (YTD +$6.6bn).

After a Q1 GDP print of -23.9%, the IMF said that there is need for another stimulus, especially in health, food and income support. India’s industrial output contracted for the fifth consecutive month in July, led by a fall in the production of consumer durables and capital goods. The Index of Industrial Production (IIP) is lower by 10.4% compared to a last year; the index had fallen by 15.7% in June. CPI inflation was unchanged at 6.7% y-o-y in August, falling below expectations of 6.9%, with the July reading revised to be lower. Food & beverage price inflation abated slightly with the ex-vegetable basket gradually correcting in August. Core inflation rose to 5.7% y-o-y in August, increasing from 5.5% in July, which mainly reflects supply-side factors such as the higher retail prices of gold, silver and petroleum products.

The April-August fiscal deficit hit 109% of the full-year budget target. Contrary to expectations of an upward revision, the government’s 2H borrowing calendar remains unchanged, casting a shadow on further stimulus. The government’s delay in nominating 3 new external members to the MPC led to the RBI rescheduling the October MPC meet.

The Rajya Sabha (Upper House of Parliament) passed two farm bills aimed at liberating farmers from the control of middle men and improving farmers’ income. This move, however, irked opposition MPs and led to protests by farmers who were suspicious of the government’s claim of continuing Minimum Support Prices (MSPs) along with the new mechanism. As protests continued, the government announced MSP hikes for 6 rabi crops, a month ahead of schedule. However, this is the lowest increase in the last 10 years.

The Lok Sabha (Lower House of Parliament) passed three labour bills that allowed businesses flexibility in hiring and retrenchment, and made industrial strikes difficult. The bills also facilitate ease of doing business and expanding the social security net. These bills too were met with criticism as they overlooked smaller firms, potentially leaving their workers vulnerable.

The government was reportedly planning incentives worth ~$23bn to attract companies to set up manufacturing units in the country. After mobile phones and pharma, the PLI (production linked incentives) scheme could be extended to autos, solar panels and consumer appliances in a bid to entice supply chains moving away from China.

Going Forward

The economy has been steadily moving towards recovery. With initial signs that point to a reduction in active Covid cases, a faster return to normalcy and growth is quite possible. The Ministry of Home Affairs has issued the new unlock guidelines, wherein they allowed cinemas and multiplexes to open at 50% capacity, removed limits on outdoor gatherings and considered the re-opening of schools from October 15. Pent up demand in the system, along with the forthcoming festive season, are promising for economic growth.

Hoping for normalization in FY21, Indian equities continue to rally because of the push led by the global liquidity surplus. As the Indian economy undergoes unlocking/neo-normalisation, economic activity will continue to increase, but a fair chunk of this is being discounted in the equity markets. Despite the rally, India’s Market Cap to GDP ratio stands at a significant low compared to the long-term average. India became the second country to cross 6 million Covid cases, but recovery rates have picked up pace. With the longer term growth story intact for India, we will stick to quality franchises with strong moats, cash flows, balance sheets and higher earnings visibility in terms of our investment exposure.

Debt Market

High inflation remains a concern

Macro Review

The Consumer Price Index (CPI) for August remained at 6.69%, almost unchanged over the previous month, which itself saw a downward revision in print to 6.73%. But inflation staying over 6% in each of the months this fiscal remains a cause for worry for the Reserve Bank of India (RBI). Average CPI for the period April to August (5 months) stood at 6.64%.

The key items driving CPI comprised protein-based food items such as meat & fish, pulses – both of which rose in double digits. Vegetables up by 11.41% and transport & communication by 11.05%, were the other item heads registering high-paced increase.

Core CPI (ex food and fuel) for August, came in at 5.4%, marginally higher (+10 bps) from 5.3% in July. Core inflation in the first 5 months of this fiscal has also averaged 4.9%, reflecting supply side issues and firming prices in key items such as gold.

Liquidity and Rates

Liquidity conditions continued to remain in surplus mode in line with RBI's accommodative stance. Average daily Liquidity Adjustment Facility (LAF) balances for September stood at INR 3.31 trillion as against INR 3.68 trillion in August and INR 3.59 trillion in July.

Increase in Currency in Circulation (CIC) has been showing a steady decline consistent with the gradual unlocking. The rise was the highest in the 3 months of March to May, also the peak lock-down months that also witnessed a mass exodus of migrants from cities / urban centres to their hometowns. Rise in CIC by an average of almost INR 900 bio per month in this period has since tapered to INR 439 bio in June and a mere INR 25 bio in September.

In the first 9 months of this calendar year, the absolute increase in CIC stood at INR 4.12 trillion, as against INR 1.6 trillion over the corresponding period of the previous year. We expect CIC to moderate as the economy unlocks further, even though we may witness some pick-up again in the festive season.

MPC deferred

The term of the existing MPC members came to an end in September and was to be filled with new appointments. The delay in finalising the MPC members has also led to a deferment in the MPC meeting which was originally scheduled for October 1st.

While we were not expecting any policy action at the meeting, the delay in the MPC appointments is a market negative since the process of policy decisioning and rate setting was getting institutionalised in the last few years and the delay has somewhat interrupted the schedule.

H2 - FY2021 borrowing calendar

There were no surprises as far as the borrowing calendar was concerned. There is no change proposed in the borrowing quantum (INR 4.34 trillion) for the second half. The borrowing calendar in H2 compares with an issuance volume of INR 2.62 trillion in H2-FY 2020.

The front end (upto 5 years) with volumes of 20% and the belly (5-14) with volumes of 44%, will benefit from moderate issuance volumes. The longer end comprises over 30% of the volumes. Floating rate bonds (FRBs) – short – comprise 6% of the issuance volumes.

The choice of segments for issuance is weighted in favour of the long end – beyond 14 year tenor, which is likely to exert some pressure on the long end of the curve.

The issuance calendar will be done by end January, which offers the Govt some time for extra issuances, if needed.

State govt borrowings (through SDLs – State Development Loans) are pegged at INR 2 trillion for the Oct- Dec quarter. There is some likelihood of a spill-over in Q3 even as Q4 is expected to be well higher than INR 2 trillion (INR 1.63 trillion in the previous year).

SDLs are likely to remain under pressure given the relatively weak fiscal position of the State govts and the need to issue an additional INR 0.97 trillion just to plug the GST shortfall. We expect the longer end and SDLs to hence experience pressure on yields and volatility in the second half of the financial year.

Outlook

Inflation readings on the macro remain a key monitorable for the markets. Combined with the volume split in the issuance calendar, we remain positive on the front and mid segment of the curve. 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. We expect yields to remain largely range bound at the shorter end.

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 slightly higher appetite for volatility.

Fixed Income Market

	August 2020	September 2020	Change (in bps)
Overnight rate (NSE MIBOR)	3.78%	3.79%	1
1 yr CD	3.84%	3.94%	10
10 yr GOI Yield	6.12%	6.02%	-10
USD/INR	73.6	73.76	16 paise
IIP (Monthly with 2 month lag)	-15.80%	-10.40%	540
CPI (Monthly with 1 month lag)	6.73%	6.69%	-4
5 Yr AAA PSU spread (bps)	30	38	8
5 Yr OIS	4.56%	4.52%	-4
US 10 Yr yield	0.71%	0.69%	-2
CRR	3.00%	3.00%	0
Reverse REPO	3.35%	3.35%	0
REPO	4.00%	4.00%	0

Source: RBI Weekly Statistical Supplement & Bloomberg

Note: IIP has been revised higher for the previous reading. CPI has been revised lower for the previous reading. New 10year GSEC Yield is taken instead of Old 10 Year.

Source: BSE, RBI & Bloomberg