PGIM India Mutual Fund

Market Outlook

August 2023

Equity Market

Macro takes front seat

August 2023 saw deceleration in progress of monsoon, higher than expected inflation print and unexpected increase in CRR requirement for banks by the Reserve Bank of India (RBI) resulting in the Nifty50 index correcting by 2.5%. The rally in small and midcap indices continued due to strong buying by domestic institutional investors. The NSE Midcap100 index and the NSE Smallcap100 index were up 3.7% and 4.6% respectively for the month. Indices for Energy, Banks, FMCG and Infrastructure underperformed the broader market, while the indices for Information Technology and Pharmaceutical outperformed. Q1FY24 earnings season was mixed with Financials and Auto seeing earnings upgrades and Materials and Information Technology sectors seeing earnings downgrades.

Amongst the key domestic macroeconomic datapoints, the CPI inflation surged higher than expectation in July to 7.4% vs. 4.9% in the previous month due spike in food inflation, India's Q1FY24 GDP reading came near expectation, at 7.8% and June IIP growth came in at 3.7% vs 5.3% in May. Trade deficit expanded as imports remained stable M-o-M while exports dipped by 6%. GST collections for July (collected in August) were 10.8% Y-o-Y higher at Rs1.59 tn. In the monetary policy review, RBI kept the repo rate unchanged at 6.5%, and held on to its "withdrawal of accommodation" stance. In an expected move RBI imposed an incremental CRR of 10% on the change in deposits between May 19, 2023 and July 28, 2023. FPIs were net buyers, in the month of August, to the tune of US$ 1.5 bn, while DIIs were net buyers of US$ 3bn.

Going forward

We remain cautiously optimistic on the market from a medium-term perspective. Our caution is because markets are trading at a premium to its current fair value. However, the fair value is likely to grow at a strong pace in the medium term, hence we remain optimistic. Globally, many developed and developing economies are seeing growth slowdown in an inflationary, high interest rate and an uncertain geopolitical scenario. While India too is not totally immune to global growth tantrums and is likely to see some slowdown, however it is still likely to be one of the fastest-growing economies due to its structural growth drivers. Weak monsoon, spike in inflation, rising crude prices and slowdown in FPI flows are key near-term risks to the equities. As we inch closer to 2024, we would see increased volatility due to the general elections scheduled in May 2024. We are positive on sectors which are linked to domestic consumption and manufacturing compared to sectors which are dependent on global growth. Accordingly, we are more positive on Financials, Healthcare and Consumer Discretionary sectors.

Debt Market

Monsoon and food inflation cast a shadow

Despite high volatility witnessed in August 2023, bond yields closed almost flat month over month. Yields were higher across curves, as rising food inflation and hardening global bond yields spoiled sentiments. The 10yr bond yield touched a high of 7.25% before retreating to end the month at 7.18%, flat from last month. The curve flattened further with the longer end outperforming the shorter end. The AAA corporate curve outperformed the sovereign curve on favorable demand supply dynamics.

The MPC policy was largely on expected lines, but the announcement of Incremental CRR (I-CRR) surprised markets and led to hardening in the shorter end of the money market curve. The Overnight Index Swaps (OIS) curve also moved up. CPI Inflation came in higher than expected at 7.44%, though core inflation moderated. The rise in CPI Inflation was largely driven by food inflation, especially vegetables. Over the last month, vegetable prices have cooled down but concerns over the monsoon linger on as August was not only the driest August in India since 1901 but also the hottest. The government has been managing inflation proactively through fiscal steps and has taken a series of steps to bring down food inflation. Nonetheless, given the monsoon deficit and the irregular pattern of rains because of the El Nino effect, food inflation needs to be watched over the next couple of quarters. In the MPC minutes, RBI Deputy

Governor Michael Patra commented that the liquidity overhang can pose a challenge from an inflation perspective. This comment assumes significance, as in all the last three monetary tightening cycle in India, we have seen interbank liquidity getting into the negative zone, and with food inflation remaining a concern, we believe that the next quarter could see liquidity tightness persisting in the banking system.

Indian GDP growth for Q1FY24 came in line with expectations at 7.80%, with the services sector doing better, along with investments. Rural growth continues to lag urban growth, and GDP growth is likely to slow down sequentially. The government is confident about achieving 6.50% GDP growth in FY24 though the consensus among analysts is around 6%. Total tax collections in this financial year so far continue to be lower than last year. Productivity of capital as denoted by the Incremental Capital Output Ratio (ICOR) seems to be improving though the productivity of other factors of production also need to improve; particularly labor productivity, for India to increase its long-term potential rate of growth. Monsoons and global growth will be key variables to watch out for going ahead with respect to both growth and inflation trends in the short run.

Globally, yields hardened led by US treasuries as fiscal concerns topped optimism that the Fed may not hike further. Fiscal concerns in the US led to a steepening in the curve and the dollar Index (DXY) went above 104 even as the economic data came in mixed.

The policy rate differential between US and India has narrowed close to a historically low level. India's strong and stable macroeconomic variables and narrowing of Inflation differentials with US have been the underlying reasons for the narrowing of spread and for the spreads to sustain at lower levels we need to make sure that we remain on a solid macroeconomic footing.

Brent crude continued its upward momentum, rising by 2% over the month, and closing at USD 87 a barrel. The US crude stocks, including Strategic Petroleum Reserves (SPR) are at multi-year lows and along with the production cuts announced earlier by OPEC+ being carried forward, Brent is seen to continue its upward trajectory. The INR depreciated marginally over the month ending at 82.78 from 82.25 at the start of the month but breached the long-standing resistance level of 83 as it touched a low of 83.15 before retracing back below 83 on probable RBI intervention. Portfolio flows continued to be strong both in debt and equity. Equity flows at USD 1.48bn and debt flows at USD 935mn.

Indian and global growth looks to be faring much better than anticipated at the start of the year. Given the current growth inflation dynamics we think we are in the last leg of the global monetary tightening cycle which began last year, and Central banks are likely to be on a long pause from next quarter onwards.

We believe that the RBI will be on a long pause and the rate cutting cycle in India will start only when the developed market Central banks have addressed the challenge of inflation effectively, which in our view will happen from 2024 onwards.

We expect the 10yr Benchmark bond to trade in a range of 7.10% to 7.30% over the next one month.

Fixed Income Market

	July 2023	August 2023	Change (in bps)
Overnight rate (NSE MIBOR)	6.60%	6.69%	9
1 yr CD	7.40%	7.44%	4
10 yr GOI Yield	7.17%	7.18%	1
USD/INR	82.25	82.78	53 paise
IIP (Monthly with 2-month lag)	5.30%	3.70%	-160
CPI (Monthly with 1 month lag)	4.81%	7.44%	263
5 Yr AAA PSU spread (bps)	30	30	0
5 Yr OIS	6.51%	6.56%	5
US 10 Yr yield	3.96%	4.11%	15
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.