PGIM India Mutual Fund

Market Outlook

June 2020

Equity Market

Hopes of recovery but uncertainty remains

The market that was

Equity markets were strong in June, with the benchmark Nifty Index moving up by 7.5%. The broader market outperformed with Nifty Midcap100 Index rallying 10.8% and Nifty SmallCap100 Index rallying 15.3% (the best month for small caps in 6 years). All sectors were up vs May with Realty, Financials and Auto being the outperformers. The reopening of economic activity combined with pent-up demand and an earlier-than-expected normalization in certain consumption sectors are key positives. However, escalating tensions between India and China, fears of a second wave of Covid-19 infections, a pessimistic outlook by the US Fed on recovery timelines, no immediate relief by the Supreme Court on AGR dues, a weak set of 4QFY20 results kept the gains in check.

With this, the quarter ended on a positive note, with quarterly returns being the best in several years – Nifty (+19.8%, best in 11 years), Nifty Midcap (+25.6%, best in 6 years) and Nifty Small Cap (+28.4%, best in 6 years).

On the global front, US markets were again jittery as daily new cases hit an all-time high. At the same time, China passed the controversial National Security Law for Hong Kong even as the US prepared to pare back Hong Kong's special status. On the domestic front, apart from Covid-19, geopolitics was also in focus as the India-China border standoff took a deadly turn with clashes leading to casualties on both sides.

The Covid-19 situation remains a challenge. With 586k+ cases and 17k+ deaths, India continues to see rising Covid-19 cases. Around 396k new cases were seen in June vs 155k new cases in May. Deaths per day have increased to 400+ vs ~150 in May. Due to a steady uptick in cases, most Indian states announced a further extension of lockdowns.

India's sovereign rating was reviewed, and all three major rating agencies still rated India as investment grade with stable (S&P and Moody's) or negative (Fitch) outlook.

In its revised forecast, IMF projected a deeper 4.5% contraction for India in FY21, citing a longer lockdown period and slower than anticipated recovery. FY22 growth was forecast at +6% vs +7.4% earlier. April IIP fell by 55.5% yoy as compared to a contraction of 18.3% in March amidst the nationwide lockdown. Headline CPI inflation data was not released for May as well due to lockdown restrictions. Sample data suggested a partial normalization of supply chains. May merchandise trade deficit narrowed to a decade low $3.2bn on weak crude and a faster recovery in exports vs imports. Current account in 4QFY20 registered a surplus of US$0.6 bn (0.1% of GDP) as against a deficit of US$2.6 bn in 3QFY20 (0.4% of GDP). RBI's FX reserves hit a record $500bn on portfolio inflows and lower trade deficit.

PM Modi announced an extension of free food ration scheme till end-November, a period coinciding with many Indian festivals. In the govt's estimate, this move will likely cost the exchequer ~Rs900bn more, taking the total to ~Rs1.5trn.

FIIs were net buyers to the tune of +$2.5bn (vs +$1.8bn in May) reducing YTD outflows to -$2.2bn. DIIs, on the other hand, were marginal net buyer of +$0.3bn (vs +$1.5bn in May) taking their YTD inflows to +$11.8bn.

Q4FY20 results were below estimates with broad-based weakness. Sales declined by 5% and EBIT by 23%. Nifty FY20 EPS was at 400, down 9% YoY to the same level as FY18. Apart from Pharma and Telecom (least impacted by the lockdown), every sector saw downward revisions.

Going Forward

The battle between the world and the Coronavirus has been the biggest driver of market and economic events in the past several months. In a recent paper published by PGIM Global, it compares the probability of death from COVID-19 against deaths from automobile accidents, concluding that the risks for most young people going to work in the USA - and potentially getting the disease - are far lesser than the risk of driving to work. There is a similar realization with the Indian government and it is advising state governments against complete lockdowns. Though the number of confirmed and active COVID-19 cases continues to rise steadily, there is steady in recovery rates to almost 60%.

Expectations for further normalization of economic activity continue to be supported by positive news on the treatment and vaccine front with several pharma and biotech companies around the world announcing encouraging results.

The Monsoon has been encouraging so far, with total rainfall in June being above normal and strong Kharif sowing. Amidst balancing lives and livelihoods, rural India is recovering faster than urban India. FY21 is likely to see a decline in economic growth and corporate profits, with growth expected to come from the second half.

Consensus growth estimates for the Nifty EPS remain elevated and likely to see downgrades in the coming weeks. We are focussing on sectors/companies that can recover faster and gain market share while keeping a healthy balance sheet.

Debt Market

Yield curve flattening as market awaits fresh cues

Macro Review

Data gathering was hampered by the ongoing lockdown, which led to the CPI combined General Index not being published for May-20. However, some major indices have been published with limited information. Consumer food price inflation eased from 10.5% to 9.3% mainly on the basis of vegetable price inflation cooling off to single digits at 5.3% YoY after a long time. Other than vegetables, most other items are showing an uptick. Protein-based items such as Meat and Fish rose significantly (by 16% YoY). Housing index showed a decline with activity muted in the month of May, with inflation at 3.7% YoY as compared to 3.94% YoY in Apr-20. Fuel and Light index too showed a decline with inflation at 1.43% YoY as compared to 2.93% YoY in the previous month, as activity remained muted throughout the month. The only sub-component published in the miscellaneous group was Health, which showed an uptick in inflation, at 4.3% as compared to 2.8% in Apr-20. Going forward, as the restrictions on transport loosen up further, the prices of essentials should also stabilize. Moreover, with a normal monsoon, expectations of food inflation stabilizing should provide some relief to the consumer.

Liquidity and Rates

Liquidity conditions continued to remain in surplus mode in line with RBI's accommodative stance and the pledge to improve transmission of past rate cuts. Average daily LAF balances for June stood at INR 3.78 trillion compared to INR 5.09 trillion in May. Average LAF Balance declined as WMA borrowing fell to zero compared to 1lac -1.5 lac cr in May, which infused temporary additional liquidity. Currency leakage in the first 3 weeks of June was around INR 44,000 cr compared to INR 81,000 cr in May. The Rupee appreciated by 10 paise (0.13%) against the USD in June. Brent Crude oil continued to trade in the range of USD 35/bbl to USD 45/bbl in the month of May and continued the bullish bias as the economies reopened economic activity thereby increasing the demand for the commodity.

Government bonds traded in a narrow rage of 10bps for the whole month. Markets ignored most of the negatives from S&P outlook change, spike in oil prices and rise in Covid cases. Although 10yr+ segment was largely flat and nonvolatile for the month, one saw nice move down in belly of the curve (4yr to 8yr) where yields closed 15-20bps lower for the month. Towards the end of the month, RBI announced OMO Twist for INR 100bn which further helped bonds. Like in May, we saw primary auctions getting very good demand from local banks, with the RBI continuously exercising green shoe options in each of the auctions despite being large-sized auctions.

Corporate bonds once again outperformed government bonds but the spread compression was not so stark as the last month. The key reason for corporate bond outperformance was the substantial inflows in MFs Scheme which invest predominantly in corporate bonds. The lack of supply in corporate bonds, also led to a downtick in yields with a major fall in yields witnessed in high yield AAA corporate bonds like PFC/REC/HDFC etc.

Outlook

We expect the bond market to remain positive on the back of softer food inflation, abundant liquidity, lower growth, stable crude oil price and possibility of further OMO twist announcements. Front end of the curve could move lower given excess liquidity and rate cut hopes, whereas the longer end will face volatility from weak tax revenues and further OMO purchase announcements.

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.

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

	May 2020	June 2020	Change (in bps)
Overnight rate (NSE MIBOR)	4.04%	3.89%	-15.00
1 yr CD	3.99%	4.05%	6.00
10 yr GOI Yield	6.01%	5.99%	-2.00
USD/INR	75.62	75.5	-10 paise
IIP (Monthly with 2 month lag)	-18.30%	-55.50%	-3720.00
CPI (Monthly with 1 month lag)	NA	NA	
5 Yr AAA PSU spread (bps)	65	52	-13.00
5 Yr OIS	4.18%	4.15%	-3.00
US 10 Yr yield	0.64%	0.65%	1.00
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