PGIM
India Mutual Fund

Market Outlook

February 2024

Equity Market

Valuation excesses are especially stark in the Mid and Small Cap buckets

Market remained rangebound in February with the Nifty50 index generating 1.2% return and the Nifty Mid Cap 100 index and Nifty Small Cap 100 index correcting by 0.5% and 0.3% respectively for the month.

Indices for Auto, Information Technology, Pharma, Energy, and Infrastructure outperformed the broader market, while indices for Banking and FMCG sector underperformed. At the end of earnings season of 3Q FY24, overall earnings growth for BSE500 companies was strong at 28% Y-o-Y led primarily by margin expansion due to commodity price deflation while revenue growth remained weak at 3% YoY (ex-BFSI).

In the Interim Union Budget for FY25, the Government reiterated its focus on fiscal consolidation as FY25 fiscal deficit was budgeted at 5.1%, and the plan to bring it down further to 4.5% in FY26 was reiterated. Other key developments during the month were US FOMC and the Reserve Bank of India maintaining policy rates at 5.25-5.5% and 6.5% respectively, and the Indian mutual fund industry body, AMFI, advising fund houses to implement investor protection measures for Mid Cap and Small Cap investments due to concerns about potential market bubbles.

On the domestic macroeconomic front, CPI inflation in January 2024 came in at 5.1% compared to 5.7% in December 2023, while the December IIP growth increased by 3.8% from 2.4% in November, led by manufacturing activity, and the 3Q FY24 GDP growth came at 8.4%, versus 8.1% in 2Q FY24. During February, FIIs were net buyers to the tune of $483 mn, and DIIs remained net buyers to the tune of $3.06 bn.

Going forward

Macro indicators accompanied by strong corporate earnings growth and a stable policy environment have buoyed the markets that are currently sitting at their all-time highs. We remain optimistic on Indian equity markets on a medium- to long-term basis. However, valuations make us cautious on the near-term return potential. Valuation excesses are especially stark in the Mid and Small Cap buckets, and visible more so in the weak (low growth + low quality) companies' bucket. We find better relative value in the large cap category and the strong (high growth + high quality) companies' buckets, and believe that they still present an attractive opportunity for long-term investors. Limited triggers to boost valuations further necessitates focus squarely on the capability of companies to grow cash flows and earnings, and reinvest the same. The select group of companies that can deliver on that front may continue to benefit from the broader macro and demographic tailwinds.

Debt Market

RBI is likely to be on a long pause

Indian bond markets were largely stable during the month. The yield curve bull flattened after the presentation of the Union Budget on 1st February 2024 as the fiscal deficit numbers and the fiscal consolidation path enthused the markets. The narrative of macroeconomic stability gained further strength as 'core' inflation came in at 3.60%, lowest since November 2019, and close to the all-time low of 3.44%.

The GDP growth for Q3 (Oct-Dec 2023) came in higher than expected at 8.40%. The street estimate was 6.60%. Gross Value Added (GVA) numbers were more in line with the consensus estimates at 6.50%. This makes it a third consecutive quarter of 8%-plus growth after revisions to growth in the first half of the fiscal year (Apr-Sep 2023). The GDP numbers for FY22 and FY23 were also revised, the FY22 growth was revised higher to 9.7% (prior 9.10%) and for FY23 growth was revised a tad lower to 7% (prior 7.20%). The GDP estimate for FY24 has been revised upwards to 7.60%, from 7.30% earlier.

There are some concerns that the GDP growth for Q3 is exaggerated but there can be no denying that the underlying growth momentum remains pretty strong. Apart from the growth numbers, government also released the household consumption expenditure survey which indicated a faster pace of consumer expenditure growth for rural households.

Share of food in total spending, continued to decline across rural and urban households. In real terms, the average monthly per capita consumption expenditure grew at a CAGR of 3.1% for rural households and 2.70% for urban households. The data will play a key role in reviewing economic indicators like GDP, CPI, and poverty levels. The government is conducting two back-to-back surveys. While the current survey was carried out between August 2022 and July 2023, the next survey is likely to be completed by the second half of 2024.

Brent crude rose by 2% during the month, and INR appreciated marginally during the month. PFI inflows into debt continued to be strong with USD 2.7bn of flows coming in February 2024 after USD 2.3bn inflow in the first month of 2024.

The OIS curve was higher during the month tracking higher global bond yields, with the 1yr OIS rising by 14 bps at 6.74% while the 5yr OIS was up by 16 bps, ending the month at 6.35%. The OIS curve underperformed the sovereign curve last month. The benchmark 10yr bond yield was down by 6 bps though the yield curve flattened with yields at the shorter end of the curve (2-5yr) rising by 1-2 bps. Yields at the longer end of the curve outperformed the entire curve as the 40yr bond yield fell by 15 bps. The money market yields (up to 1yr maturity) were lower by 10-15 bps as interbank liquidity eased on back of higher government spending.

Global bond yields were higher during the month on the back of robust economic data coming out of US while inflation remained sticky. The continued strength of the US economy and sticky inflation has led the bond markets in US to scale back their expectations of rate cuts this year. The bond markets, which were pricing in almost 150 bps of rate cuts in 2024 at the start of the year, are now pricing in around 75 bps of rate cuts. The benchmark US 10yr yield was higher by 34 bps during February, ending at 4.25%.

Going ahead, we believe that RBI is likely to be on a long pause, and is likely to start cutting rates only after the global rate cutting cycle has started, which in our view, is likely to happen from Q2/Q3 of CY2024 onwards. Markets tend to react before the start of a rate cutting cycle and the current yields offer a good opportunity for investors to increase their allocation to fixed income as real and nominal yields remain attractive with favourable demand supply dynamics playing out in the sovereign bond market.

Bond yields tend to move in advance of rate action and investors can look to increase allocation to Fixed Income as we expect long bond yields to keep drifting lower and expect the benchmark 10yr bond yield to go lower towards 6.50% by Q2/Q3 of CY2024.

Fixed Income Market

	January 2024	February 2024	Change (in bps)
Overnight rate (NSE MIBOR)	6.85%	6.80%	-5
1 yr CD	7.90%	7.80%	-10
10 yr GOI Yield	7.14%	7.08%	-6
USD/INR	83.04	82.91	13 paise
IIP (Monthly with 2 month lag)	2.40%	3.80%	140
CPI (Monthly with 1 month lag)	5.69%	5.10%	-59
5 Yr AAA PSU spread (bps)	45	45	0
5 Yr OIS	6.19%	6.35%	16
US 10 Yr yield	3.91%	4.25%	34
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.

Source: BSE, RBI & Bloomberg