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Macro-economic developments

- US labour market continued to improve, with 1.8 million jobs added in the month of July (higher than expected) vs 4.8 million jobs added in the previous month. Unemployment rate fell to 10.2% in July vs 11.1% in June, and a record high of 14.7% in April.
- The US Fed announced new approach to target inflation, which could keep interest rates lower than longer. The Fed will be adopting "flexible form of average inflation targeting", which implies it will allow inflation run moderately above its 2% target for some time, before hiking interest rates.
- Economic activity improved globally, and Global Manufacturing PMI rose to a 21-month high of 51.8 in August from 50.3 in July. PMI data below 50 means contraction in activity.
- Domestically in India, Q1 FY21 GDP contracted more than consensus estimate--by a record 23.9%YoY, as a result of the stringent lockdown for most of the quarter. During the April-June 2020 quarter, India was one of the bottom performing major economies globally. GDP was dragged down by heavy-weight private consumption expenditure--which fell 26.7%YoY, while Gross Fixed Capital Formation (or Investments) fell sharply by 47.1%YoY during the quarter. However, government expenditure was the only savior and grew by a healthy 16.4%YoY during the quarter.
- GVA growth for India also contracted by a record 22.8%YoY during Q1 FY21. Industry and services sectors contracted by 33.8%YoY and 24.3%YoY respectively during the quarter. However, the agriculture sector grew 3.4%YoY during the quarter.
- India Manufacturing PMI rose to 52.0 in August (in expansion territory after 5 months) from 46.0 in July. India Services PMI rose sharply to 41.8 in August, vs 34.2 in July. PMI lower than 50 indicates contraction in activity.
- Consumer price inflation (CPI) data for the month of July 2020 came in higher than expected at 6.9%YoY, compared to 6.2%YoY in the previous month. Food inflation (which has 39% weight in the CPI index) moderated to 6.9%YoY in July versus 8.7%YoY in the previous month. However, core inflation (ex food and fuel) continued to rise to 5.7%YoY in July from 5.4%YoY in the previous month.
- Crude prices continued to rise on the back of recovery in global economic activity, and OPEC production cuts. Brent crude rose ~5% in August, to close the month at $45.3/bbl.
- The rupee rose 1.6% against the USD to close the month at INR 73.62/USD, helped by foreign equity inflows and with global risk appetite persisting.

Equity market developments and Outlook

- Indian equity markets delivered moderate returns during the month of August and saw a correction at the end of the month due to rising concerns of geo-political tensions between India and China.
- The benchmark Nifty 50 index returned +2.8% during the month. The broader markets outperformed significantly, with the Nifty Midcap 50 index and the Nifty Smallcap 100 index returning +9.1% and +11.5% respectively in August.
- The sectors that outperformed during the month of August were cyclical sectors like metals, realty, banks, power and capital goods. The sectors that underperformed during the month were defensive sectors like IT, FMCG, pharma and also the oil & gas sector.
- Global markets continued to recover, with economic activity picking-up and liquidity being strong. Developed markets outperformed Emerging & Asian markets during the month of August. The MSCI World index returned +6.6% in August, while the MSCI Emerging Markets index and MSCI Asia ex-Japan index returned +2.1% and +3.4% respectively.
- The US markets outperformed in August, with the benchmark S&P 500 index returning +7.0% during the month. Major European markets like Germany and France also outperformed. Within Asia—Japan, South Korea and India outperformed in August, while Malaysia, Taiwan and Thailand underperformed.
- Foreign portfolio investors (FPIs) registered a record net equity inflow of ₹ 45,637 crore in the month of August (helped by some large QIPs), compared to a net inflow of ₹ 8,590 crore in the previous month.
- Domestic Institutional Investors (DIIs) registered a large net outflow of around ₹ 11,000 crore in the month of August, compared to a net outflow of ₹ 10,000 crore in the previous month.
- The market seems to be ignoring a possible recession in FY21 and is factoring in a quicker recovery. We have seen a recovery in high-frequency economic indicators since the economy started opening-up, although it remains to be seen if the momentum continues going forward. Also, aggregate supply indicators have shown better recovery than aggregate demand indicators, and the rural sector has been faring better due to less Covid disruptions.
- While earnings expectations for Q1 FY21 were muted due to the stringent lockdown for most of the quarter, the commentary from the corporate sector has been encouraging and better than expectations, helped by cost cutting initiatives undertaken by companies and their ability to quickly adopt work-from-home method, where possible. Most companies have also been focusing on conserving capital and have raised liquidity. The market is factoring in a strong recovery in earnings for FY22 at this juncture.
- Markets valuations are presently above the long-term average. There is a possibility that near-term equity returns could be muted if there are any risks to the anticipated strong earnings recovery in FY22 due to prolonged weakness in the economy. However, long term investors can continue to systematically invest in equities. Investors can also use any large market corrections/dips to make lumpsum investment in equities. Historical data has shown that investments made in well diversified portfolio in challenging times can be quite rewarding for investors over the medium to long term.

Fixed Income market developments and Outlook

- Bond yields rose sharply during the month, with the 10-year G-sec yield closing the month up 24 bps at 6.08%. The rise in bond yields was on the back of RBI's slightly hawkish comments on rising inflation—thereby dwindling hopes of a rate cut in the near term. Higher fiscal deficit, government borrowing and cut-off yields in recent auction, and FPI outflows also put pressure on bond yields.
- However, with the sharp rise in bond yields and with the 10 year G-Sec yield breaching the 6.2% mark intra-month, the RBI stepped in at the end of August, and announced a number of measures to calm and support the bond markets. Bond yields fell at the end of the month post these measures and continued to fall in beginning of September as well. Some of the key announcements were as follows:
  - RBI announced "Operation Twist"/OMOs of an aggregate ₹ 200 billion to be conducted on 10th and 17th September. This follows an earlier operation twist/OMO of an aggregate ₹ 200 billion announced in the earlier week.
  - A term repo of ₹ 1 trillion to be conducted in September to provide durable liquidity and assuage any pressures that may arise from advance tax payments at the end of the quarter. Banks will be allowed to repay earlier LTROs borrowed at the higher repo rate of 5.15% and borrow at the current repo rate of 4%.
  - An HTM limit increase, allowing banks to hold up to 22% of NDTL in SLR securities (up from 19.5% earlier) for a 6-month period ended March 2021. This will reduce the hit to profitability of banks on account of any rise in yields and encourage investment by banks in G-secs.
- In its early-August monetary policy review, the RBI kept policy rates unchanged (as expected), citing rising inflation. RBI expects inflation to remain elevated in Q2 FY21, but to moderate in H2 FY21. RBI also allowed re-structuring of corporate/retail loans, further liquidity support to NHB and NABARD, increased LTV ratio for gold loans from 75% to 90%--thereby allowing less collateral for gold loans.
- India's fiscal deficit for first four months of the fiscal year (April 2020 to July 2020) has already breached the full fiscal year target and stood at 103% of the budgeted estimate, compared to 78% of the annual target in the corresponding period in the previous fiscal year. The high fiscal deficit has been due to sharp drop in revenue & tax collection—with total revenue receipts (upto July) at only 11% of the budgeted estimate so far. However, government spending (upto July) was at 35% of the budgeted estimate—thereby causing a large shortfall/deficit.
- Finance Ministry data showed that GST collections in August fell marginally to ₹ 86,449 crore from ₹ 87,422 crore in July.
- Foreign Portfolio Investors (FPIs) registered a net outflow of ₹ 4,156 crore in the month of August, compared to a net outflow of ₹ 1,833 crore in the previous month.
- RBI has indicated that there is space for more monetary action if inflation subsides as per the projected trajectory. However, we may see a continued pause in the upcoming October monetary policy review, if inflation remains elevated in the short term. From an investment perspective on the fixed income side, we presently prefer the shorter to medium-term part of the yield curve.