EQUITY & FIXED INCOME OUTLOOK

September 2020

UTI International

Equity Markets Review

Commentary on Equity Markets

The MSCI India Index started the month at 18.29 and closed at 18.19, decreasing by 0.55% over the month. As per latest data, FIIs were net sellers in Equity markets with outflow of USD ~0.77 Bn and net buyer in Fixed Income markets with inflow of USD ~0.41 Bn. Domestic Institutions were net buyer in equities with net inflow of USD ~0.01 Bn over the month.

Commodities and Inflation

NYMEX Crude Oil prices declined by 5.6% from the previous month levels, ending at 40.22 per barrel; the prices were lower by 25.6% yoy. LMEX closed at 2967.9, lower by 1.6% over the previous month (higher by 7.0% yoy). Gold prices closed at USD 1885.21/oz ~4.1% lower than the previous month level (higher by 26.7% yoy). The USD Index rose by 1.9% vs. other currencies over the month; over the year the USD Index was lower by 5.5%.

August CPI inflation moderated marginally to 6.69% as against 6.73% (revised) in July. Food inflation remained elevated at 9.1%, even though it was lower than 9.3% in July. Meanwhile, fuel and light inflation went up by 3.1% (2.7% in July). Despite weakness in economic activity, core inflation remained unchanged at 5.3%. Core inflation was fuelled by inflation in the personal care segment and in the transport and communication segment. Inflation across education, recreation and amusement, and health came in at 1.6%, 4%, and 4.7%, respectively. Meanwhile, housing inflation moderated further to 3.1%. Rural core inflation was at 5.1%, and urban core inflation was at 5.5% Even as the slight moderation in August CPI inflation is encouraging, it remains elevated and well above the RBI's upper limit of 6%. The trajectory of food prices over the next few months would therefore be crucial for pushing headline CPI inflation back into the RBI's comfort range. At the same time, other factors like gold along with excise duty hikes may continue to weigh on the core CPI inflation trajectory.

Markets & Real Economy

IIP declined by 10.4% YoY in July 2020, while the reading for the previous month was revised to -15.8% from -16.6% earlier. The recovery in July was led by the manufacturing sector which declined by 11.1% YoY after a 16% decline in the previous month. Mining sector output registered improvement but was still down 13% YoY. Electricity production registered significant improvement and was down by only 2.5% YoY. Consumer non-durables (mainly FMCG and pharmaceuticals) continued to be the only sector in the positive territory as output grew by 6.7% YoY. Capital goods also witnessed a significant improvement from the previous month, with its output down by 22.8% YoY compared to a 37.4% decline in June 2020. Infrastructure and construction goods output was down by only 10.6% YoY.

As per the latest RBI data, Foreign exchange reserves inched up to USD 542.02 Bn over the month. The USD appreciated by ~0.20% over the month closing at 73.7637 Rs/USD vs. 73.62 Rs/USD last month.

Sector-wise Performance

The key outperforming sector during the month was Healthcare. The healthcare sector has significant long-term growth drivers in place and valuations are reasonable driving positive momentum for the sector. Indian drug consumption is expected to increase as awareness and availability of healthcare infrastructure improves. Per capital spend on Healthcare is significantly below global standards and shall rise steadily over the coming years. Several Indian companies have also established significant presence in many developed and emerging markets and shall benefit as India becomes an important player in the global supply chain. We have a positive outlook on the sector with preference for companies in chronic therapies, superior R&D capabilities and strong financials.

The key underperforming sector during the month was Metals. Stocks within the sector had performed well over the past couple of months given the rally in global commodities driven by expectations that the economic recovery will lead to increase in demand. However, decline in global commodity prices seen during the month put pressure on stock prices during the month. We continue to believe that the inherent shortcomings of the sector, like cyclicality in demand and lack of pricing power leading to poor return on capital and inconsistent cash flows, will continue and limit the potential for any sustainable long-term wealth creation. We continue to remain negative on the sector.

Key Stock Movement

Mindtree Ltd – Mindtree is a technology consulting and digital solutions company servicing over 340 clients globally. It delivers digital transformation and technology services from ideation to execution, enabling clients run businesses more efficiently or accelerate revenue growth. It offers a range of IT services to enterprises in diverse industries such as hi-tech, banking & financial services, retail, consumer, packaged goods, manufacturing, media & entertainment and travel & transportation. Digital is transforming the way business is conducted and with digital being Mindtree's forte, we envisage the company to benefit from this wave. We expect it to deliver sustained growth led by fast growing digital business contribution much higher than industry's ~30% average, top client (Microsoft) clocking superlative growth and other clients in recovery mode, and superior management quality.

Bharti Airtel Ltd – The stock has corrected due to some aggression by Reliance Jio in the post-paid segment of the market which has given rise to the concern that Average Revenue Per User (ARPU) for the industry will remain muted. However, we do not envisage this aggression spilling over to the prepaid segment which forms ~90% of the subscriber base in India. Reliance Jio is already the market leader here and incremental aggression hurts the company more than the competitors. The Indian telecom industry has gone through a phase of significant consolidation over the last couple of years driven by the rapid expansion of Reliance Jio and heightened competitive intensity due to extremely low prices. With many players having exited the market, we envisage a steady state two to three player industry. As a result, ARPUs shall start to recover leading to improvement in profitability, return on capital and significant free cash flow generation going forward. The uncertainty regarding AGR dues is behind. We remain positive on the company.

Comment on Top Holding – HDFC Ltd

Housing Development Finance Corporation Limited (HDFC Ltd.) was established in 1977 with the primary objective of meeting a social need of encouraging home ownership by providing long-term finance to households. HDFC has turned the concept of housing finance for the growing middle class in India into a world-class enterprise with excellent reputation for professionalism, integrity and impeccable service. Over the years, HDFC has emerged as a financial conglomerate with presence in the entire gamut of financial services including banking, insurance (life and non-life), asset management, real estate venture capital and more recently education loans.

HDFC Ltd is one of the best lending companies in the country having a relatively lower risk loan portfolio with secured loans forming ~75% housing loans out of which 80% are to salaried customers. The company has maintained a historical track record of best in class asset quality within the NBFC segment in India and also has the best credit profile which provides it seamless access to the market for funds leading to extremely attractive cost of funds. HDFC has been one of the key beneficiaries of the decline in funding costs, owing to its AAA rating, robust Asset-Liability Management, and large deposit base. Additionally, HDFC will benefit from market share gains in the developer finance segment as several players in this segment were stressed even before the onset of Covid-19 disruption and thus are unlikely to become active again anytime soon. HDFC Ltd has recently raised equity capital of INR 100 billion in order to fortify the balance sheet in addition to the 18 bps of contingency provisions made to absorb any fallout from Covid-19 strengthening the capital adequacy ratio to ~20% and Tier 1 capital ratio to ~19%. We remain positive on the company.

Market Outlook

After a phenomenal rally from the bottom driven by large scale monetary stimulus by central banks across the world, equity market was range bound during the month with concerns of a second wave of Covid-19 emerging from a few countries acting as a resistance to further positive moves in the market. At the same time, economic activity continues to improve on a sequential basis and there are indications that the government will consider fiscal policies to support growth to back the accommodative stance adopted by RBI. While visibility of growth in the near term remains elusive, we take comfort from the fact that a significant amount of capital has been raised to repair and strengthen Balance Sheets by the corporate sector in general and the financial sector in particular. India has, for the first time in many years, seen two back-to-back years of above normal monsoon which is a key driver for growth of the agriculture and rural economy. We remain confident of the long-term growth potential for India and will continue to invest in high quality companies that can navigate the current challenging phase and are in a position to accelerate growth, gain market share and profitability in the subsequent period as they face less competition.

Fixed Income Review

India's consumer prices inflation (CPI) eased to 6.69% YoY in August 2020 as compared to revised figure of 6.73% YoY in month of July 2020, led by a lowering in momentum in both food and core groups. Food inflation came down slightly to 9.05% YoY in August 2020 from a level of 9.27% YoY in July 2020, primarily driven by moderation in prices of vegetables, fruits, and meat and fish components. Core inflation remained steady at around 5.8% YoY for August 2020 vs. revised figure of 5.7% YoY for July 2020, due to gold price increases even as inflation in some services such as education and health eased. The wholesale price index (WPI) rose to 0.16% YoY for August 2020 (vs. disinflation of 0.58% YoY in July 2020) after declining for 4 straight months led by increase in manufactured inflation.

India's fiscal deficit reached 109% of the full-year target in the first five months of the ongoing financial year as the coronavirus pandemic continued to be a drag on the government's finance. The government's gross tax revenue dropped 24% YoY to INR 5.04 lakh crores in April-August as against INR 6.61 lakh crores collected a year ago. The GST collection in September has been INR 95,480 crores (vs INR 86,449 crore for August 2020), highest since lockdown began in March.

The Government announced an issuance calendar for G-Sec for H2FY21 and issuance calendar for SDL and T-Bill for Q3FY21. The gross borrowing of INR 12 trillion is unchanged for FY 2021. Government has already borrowed INR 7.66 trillion in H1FY21. The remaining INR 4.34 trillion will be borrowed through weekly auctions with an auction size between INR 270 billion - INR 280 billion which will start from October 2020 until the end of January 2021. SDL borrowing for Q3FY21 would be INR 2.02 trillion as against INR 1.63 trillion last year. The T-Bill gross borrowing for Q3FY21 would be INR 2.08 trillion.

Outlook

We believe local bond yields to remain range bound in the near future, especially at the longer end, as the local bond market participants continue to expect RBI to intervene through OMO (Open market operation) purchases and OTs (Operation twists) to avoid any surge in yields, brought about by fears of higher borrowing later in the year. The inflation number continues to remain above 6% which is above the comfort zone of RBI. Therefore, we expect the central bank will keep the rate on hold in the upcoming monetary policy review scheduled in October 2020. However, there is a possibility of some rate cuts going ahead once the inflation numbers drop closer to the RBI comfort zone, as the central bank aims to judiciously use the limited monetary policy space available to them.

The entire fixed income component continues to remain invested into sovereign bonds with majority exposure positioned towards the front end of the yield curve in order to generate carry by taking minimal credit as well as lower duration risk.

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