MARKET OUTLOOK

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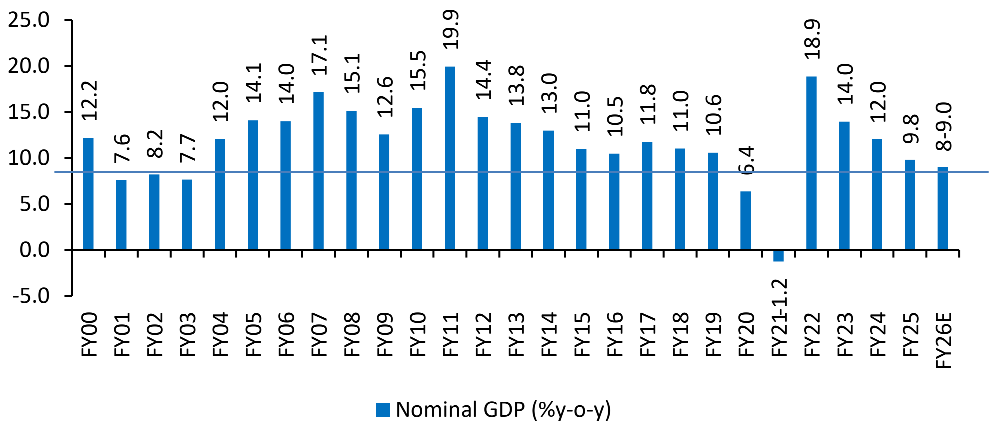
While real GDP growth print was strong at 7.8% for the first quarter of FY26, nominal GDP growth slowed to 8.8%. The weak nominal growth has been reflecting across indicators including corporate earnings. The adverse US tariffs on Indian goods will likely weaken exports momentum going ahead and a slowdown in government expenditure could further weigh on growth. Amidst these slowdown concerns, we believe the government may be keen to undertake transformational reforms to push growth higher. The GST overhaul is a signficant step in that direction and should aide domestic economy by revitalizing consumption. On the trade front, fast-tracking trade deals, improving India-China relations, lowering import tariffs on inputs, and easing FDI norms are already in progress. Deregulation (across centre and state governments) could also come in focus.



Source: Bloomberg, SBIFM Research

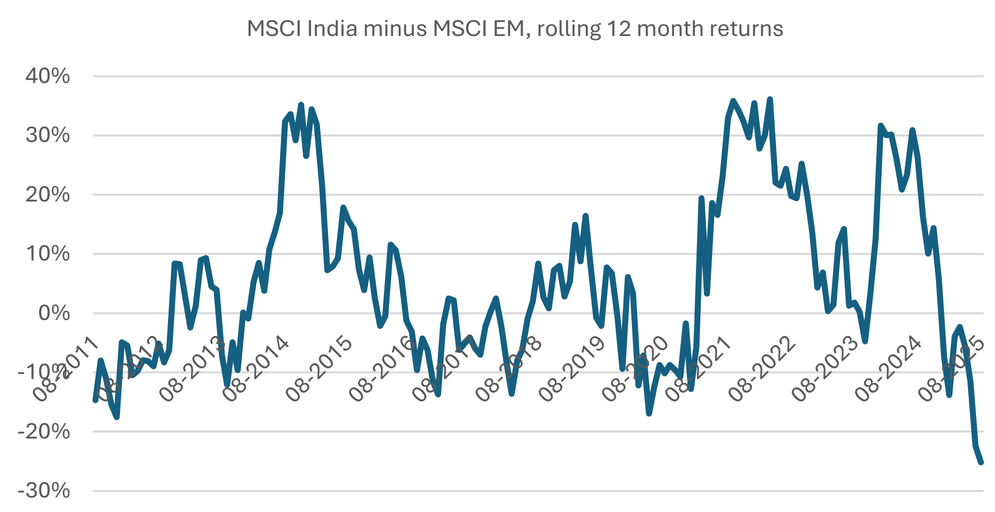
EQUITY

August was an eventful month for Indian financial markets. The US imposed a 50% tariff on Indian goods, alluding to trade barriers and India's defence and energy ties with Russia. At 50% headline and closer to 35% effective tariff (adjusting for thus far exempt sectors such as pharmaceuticals, electronics, fuels etc and sectors under Section 232 with differential tariffs such as Auto, Steel, Aluminium etc), India is amongst the worst hit nations and at a significant disadvantage to many Asian peers. India may however look to soften the blow with continued negotiations with the US, opening the economy to other countries including potentially China and focussing on the domestic economy beginning with a significant reform of the current GST (Good and Services Tax) regime.

The Nifty and the Sensex lost 1.2% and 1.6% respectively for the month, the performance down the market capitalization curve was even weaker with losses of 2.8% and 3.6% for the Nifty Midcap 150 and the Nifty Smallcap 250 indexes respectively. Adjusting for the 0.7% INR depreciation for the month, the dollar returns were weaker and compare with 1.5% USD gains for MSCI Emerging Market Index and 2.6% gains for MSCI World Index. On a 12-month basis, India's underperformance is starker at 27% with MSCI India index shedding nearly 10% versus close to 18% gain for MSCI EM Index (both dollar returns) thus reversing part of the outperformance of the past few years.

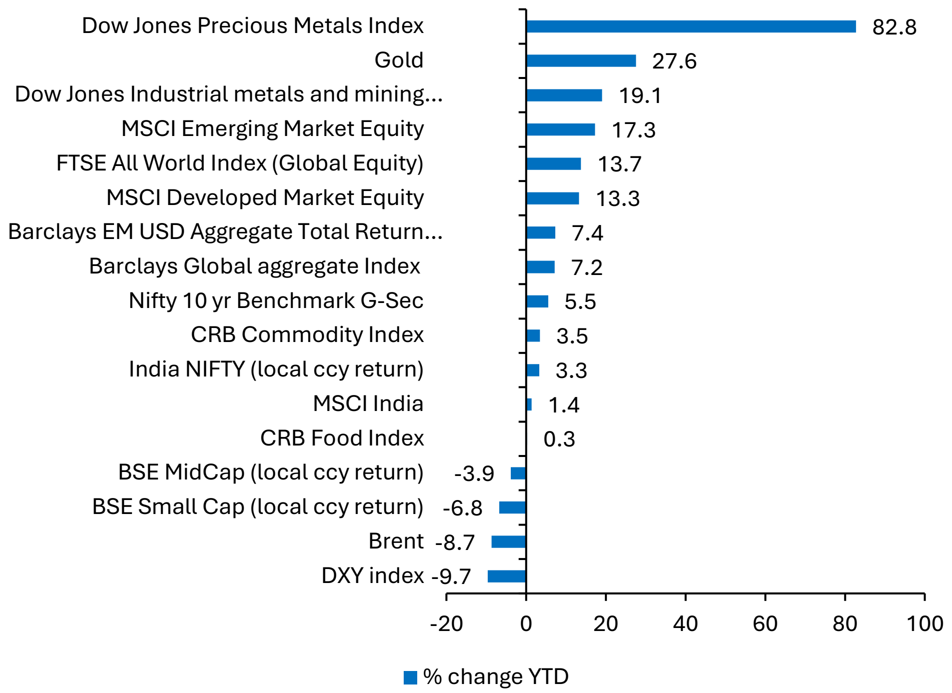
This has come against the backdrop of continued dollar weakness which has otherwise energized Emerging Market Equities and Commodities and related plays (led by, but not limited to, precious metals) after several years of underperformance. Yet on a longer timeline, EM assets as well as commodities may have a lot more to catch up in the context of several years of relative underperformance. From a fund flow perspective, incremental flows may indeed look for alternative destinations as the US exceptionalism fades away. The Fed Chair's Jackson Hole speech has significantly raised market's expectations of a rate cut in the US and may further aide dollar weakness and EM and commodity performance.

India has significantly underperformed Emerging Market equities over the past year...



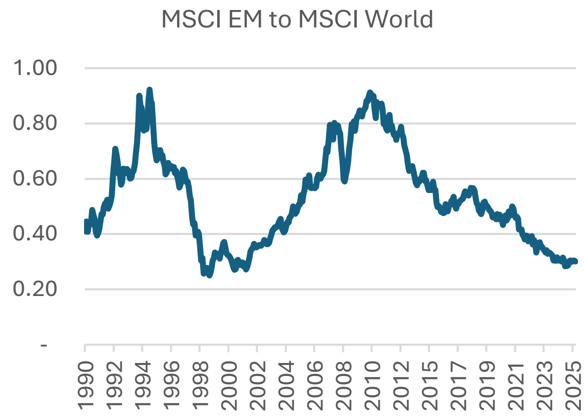
Source: Bloomberg, SBIFM Research

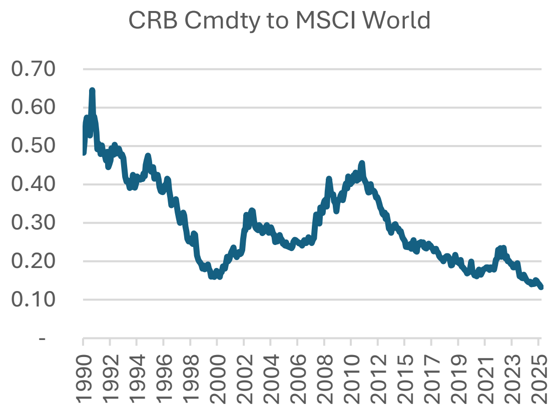
...even as dollar weakness has helped energize EM equities and commodity plays this year



Source: Bloomberg, SBIFM Research

After years of relative underperformance, EM equities and Commodities have a lot of catch up to do versus DM equities

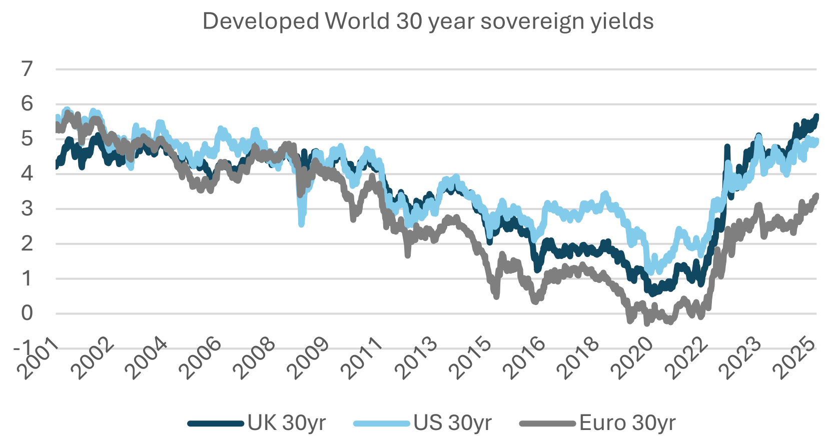




Source: Bloomberg, SBIFM Research, EM stands for Emerging Markets, DM stands for Developed Markets. MSCI World represents developed world equities. CRM Cmdty is Commodity Research Bureau BLS/US Spot All Commodities Index.

Yet, long end sovereign bond yields in the developed world have continued to surge as investors fear expansionary policy, and potential undermining of central bank independence, will challenge central banks' ability to manage inflation going ahead and potentially lead to higher inflation outcomes. Even as EM economies try and chart out their own paths, a surge in developed world yields will be a negative in the near term and remains a key global risk to watch out for.

Surge in long end developed world yields remains a key global risk



Source: Bloomberg, SBIFM Research

In response to the adverse external developments, especially around US tariffs, Indian government has sought to soothe the economic impact by revitalizing consumption, amongst other measures. In his Independence Day speech, Prime Minister Modi made a commitment to rationalise India's GST structure. The GST council has followed through and delivered on that promise with a simplified GST structure with just three slabs: 5% for essentials, 18% for standard goods and services, and 40% for sin and luxury items. This move is expected to reduce complexity, improve compliance, and lower costs for businesses-especially MSMEs. Importantly, consumers benefit from rate reductions on a large number of daily-use items, small cars, two wheelers, health insurance, farm equipment and cement amongst many other categories.

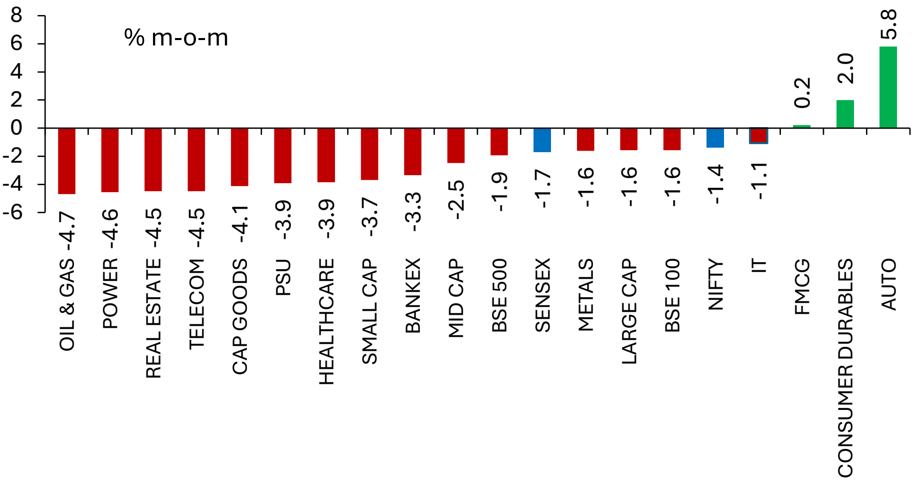
This should be a big, direct boost to consumption and several other pockets of the economy consequently. This initiative follows earlier steps to stimulate demand, including personal income tax cuts and easing retail lending norms. Enthused by policy support, consumer facing sectors are already the best performers in the month gone by.

GST revenue distribution by GST slabs

Rate Slab	%
5%	6-8%
12%	5-6%
18%	70-75%
28%	13-15%
Other	1%

Source: Source: Finance Ministry, RBI, IMF, XV Finance Commission, GST RNR Committee, SBIFM Research

Consumption related sectors did well in August boosted by policy support



Source: Bloomberg, SBIFM Research

While the government is likely to continue engaging in trade negotiations with the US, it may also pay to increase diversification to other countries given US' share in global trade is likely to continue declining as it addresses its large trade deficit. Amongst others, the recent normalization in India-China relations point to a potential beginning of stronger economic linkages between the two. As it is, India runs a trade deficit in excess of US$ 100bn with China. China rechannelling some of this surplus back into India through the FDI (foreign direct investment) route may be mutually beneficial. India could use capital and technical know-how to grow its manufacturing sector and create jobs, and on the other hand China gets access to the world's fastest growing economy. This, however, entails striking a fine balance as safeguarding local industry against dumping in certain sectors as also protecting national security interests is vital. Regulatory and institutional capacity must evolve to ensure the same.

All in all, the current adversity provides us with opportunity for transformational reform, and the process appears to have begun. Our equity view stays neutral supported by neutral valuations (as measured on equity earnings yield to bond yield spread) and neutral sentiment (as measured on our proprietary equity sentiment index).

FIXED INCOME

Ever since the RBI policy actions in June, that sought to ensure transmission of policy rate cuts into the wider economy, market yields have continued to inch up, thereby diluting the large transmission that has happened so far through the markets channel. Even as the impending CRR cut would infuse additional liquidity, the overall trend of softening rates has clearly stalled. In the context of emerging external threats to growth, the emerging trend clearly remains a headwind.

GSec	05-Jun-25	30-Jul-25	30-Aug-25	Mthly Change	Change since June Policy
3-year G Sec	5.70%	5.90%	6.09%	0.19%	0.39%
5-year G Sec	5.88%	6.04%	6.28%	0.24%	0.40%
10-year G Sec	6.19%	6.36%	6.57%	0.21%	0.38%
15-year G Sec	6.42%	6.68%	6.97%	0.29%	0.55%
30-year G Sec	6.82%	7.03%	7.30%	0.27%	0.48%
slope 10x15y	0.23%	0.32%	0.40%	0.08%	
slope 10x30y	0.63%	0.67%	0.73%	0.06%	
SDL					
10-12Y	6.60%	6.88%	7.25%	0.37%	0.65%
SDL Spread	0.41%	0.52%	0.68%	0.16%	
AAA- PFC/REC					
1Y AAA	6.54%	6.46%	6.57%	0.11%	0.03%
2Y AAA	6.51%	6.56%	6.71%	0.15%	0.20%
3Y AAA	6.50%	6.70%	6.87%	0.17%	0.37%
5Y AAA	6.62%	6.82%	6.96%	0.14%	0.34%
10Y AAA	6.85%	7.05%	7.23%	0.18%	0.38%
Slope 1x10y	0.31%	0.59%	0.66%		
Spreads Vs GSec					
3Y AAA	0.72%	0.71%	0.69%	-0.03%	
5Y AAA	0.65%	0.69%	0.58%	-0.07%	
10Y AAA	0.56%	0.59%	0.55%	-0.01%	

Source: SBIFM Research

Over the course of the previous month, the abiding theme has been shallow liquidity and volatility driven by incremental news flows. The rating upgrade by S&P that led to a 10bps downward movement in yields was immediately followed by a retracement, the next working day on announcement of GST rate cuts. Higher duration supply in SDL and wider spreads on auction cut offs also impacted sentiments negatively. Even as the wider consensus on RBI policy stance remains a hold over the coming reviews, there remains both near term and structural demand side challenges that are visible in the context of government borrowings. Mitigating both remains essential to ensure stable funding dynamics in the bond market over the longer term. Potential RBI actions such as Twists operations, rebalancing duration supply across the curve in primary auctions and open market operations/ targeted market interventions may provide a near term turn in sentiments. At the same time, the medium-term demand side issues remain equally essential to be addressed.

Demand – Supply gaps

A well-matched demand supply balance has been the supportive factor for sovereign bonds over the last few years. Even as the government has followed the fiscal consolidation trajectory and has incrementally been focusing on reducing Public Debt/GDP, new sources of demand from FPIs have emerged following the index inclusion. The overall government revenue trajectory also has been positive with revised estimates of tax revenues being higher than the budgeted numbers. It is essential to appreciate that at the margin, some of these tailwinds have clearly receded.

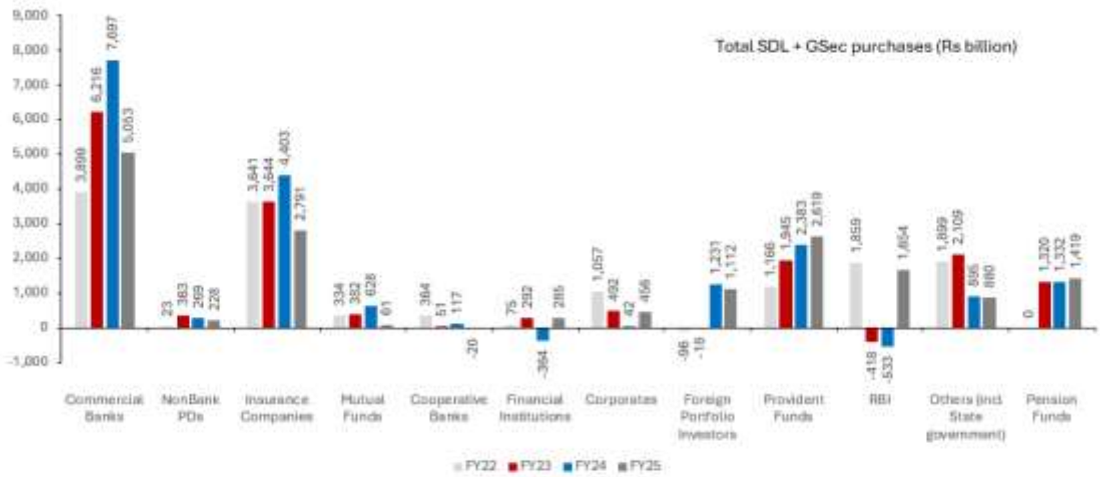
1. Tax revenue Growth

Incremental figures on tax revenue growth have been below estimates. In the context of the impending GST rate rationalization, the overall Tax revenue numbers for the year are unlikely to provide any additional buffers. Gross direct tax collection over the first 4 months of the fiscal year show a degrowth of 1.87%, with the Personal Income tax segment showing a material slowdown over the previous year. The buffer from RBI dividend as well as the compensation cess kitty could provide some buffer for the GST rate reductions. Accordingly, an expansion of market supply is unlikely at this point for the ongoing fiscal year. Revitalizing economic growth alongside continued increase in Tax compliance remains essential to safeguard the gains on the fiscal side on a durable basis, even as the recent tailwinds abate. Tax buoyancy has shifted from being a tailwind to at best a neutral factor with respect to markets currently.

2. Impact of regulations

Regulatory mandates governing investment allocation for longer term investors have traditionally preferred fixed income and, within those, relatively higher sovereign exposures such as SDL and Long-term Government securities. This alongside SLR demand from the banking system has enabled a steady/ predictable demand for sovereign securities. Over the last year or so, at the margin some of these enablers have moderated as the investment patterns and flows have largely been incrementally towards equity.

- The NPS investment guidelines impacting the government sector corpus was amended this year to allow equity exposure till 25% of the corpus as against 15% till last FY.
- Scheduled commercial banks incremental investments in SLR securities have tapered off this year as new investment norms seem to have reduced risk appetite in trading books. At the same time, the amended LCR norms provide sufficient buffer within the existing SLR as the runoff factors in certain categories of deposits have been brought down.



Source: SBIFM Research, RBI

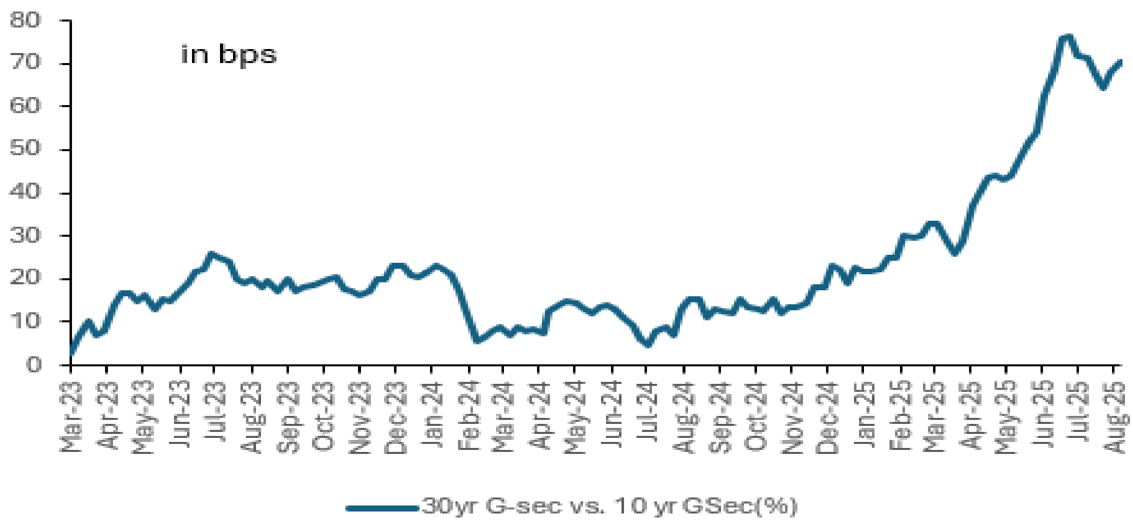
3. Impact of taxation changes

Taxation amendments pertaining to Fixed income Mutual funds as well as Insurance premiums have had the impact of affecting pattern of fund flows in both these segments. While the MF taxation has clearly impacted flows into medium- long term debt funds and a visible skew into money market products, insurance taxation changes has more impact on the long end of the sovereign curve.

The Finance Act, 2023, amended section 10 (10D), of the Income Tax Act, 1961 to remove the exemption available to the sum received from a life insurance policy in case the aggregate premium for non-linked policies issued on or after the 1 April 2023 exceeds Rs 5 lakh. This has impacted the near-term flows into guaranteed return products which were anchoring the demand for long-term sovereign securities.

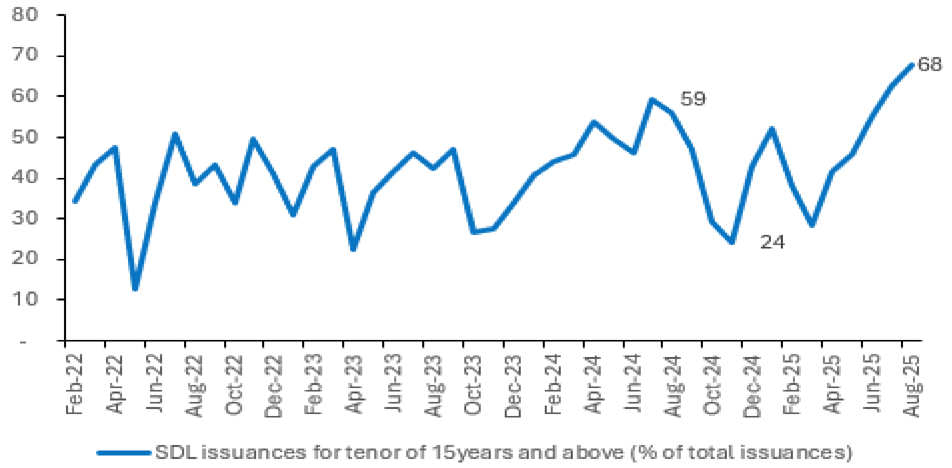
The pattern of flows into insurance also seem to validate lower than anticipated flows in the non-par segment and higher flows in market linked products such as ULIPs. Fy25 net sovereign purchased from the insurance segment was below estimates at Rs 2.79 trillion as against Rs 4.4 in FY24.

Some of these short term as well as structural changes had minimal impact last fiscal as the demand side was largely supported by RBI OMO purchases and healthy FPI flows on account of index related flows. Both these demand side flows are unlikely to be a factor for markets in the near term. Sufficient excess liquidity and the global context provide little headroom for demand from RBI and FPI's to materialize. The shifting pattern of long-term flows clearly is reflected in the slope of the sovereign curve as given below.



SDL duration supply

The issuance pattern of SDL's has shifted over the years towards more duration supply. Healthy demand from long-term investors has enabled these issues to be finely priced. Even as signs of demand weakness emerge, the heavy supply of SDL across tenors has the potential to broadly push up the cost of borrowings across all other market segments.



Terminal rate expectations- state of rate cycle:

Tariff related uncertainty and soft patch in domestic credit demand are likely to eventually reset growth projections lower. Weakness in currency that should be a logical outcome of tariffs and readjustments in crude prices if cheaper options are curtailed are possible upside risk factors to the inflation outcomes on a forward basis. Reduction in indirect taxes, at the same time, should lead to a downward bias in forward inflation numbers. Recent comments from the Governor have emphasized the importance of forward projections with respect to policy actions going forward.

With the change in stance and the guidance of limited space, market expectations have broadly converged to the possibility of an elongated pause. While the bar remains higher for additional policy cuts, considering recent events, one could argue that at the margin the bar has possibly shifted a bit lower vis a vis the expectations a few months ago.

A reasonably large liquidity surplus alongside visibility on a stable policy rate in the near term should provide sufficient monetary support to growth impulses in the economy. However, guarding against a breakdown in the monetary transmission mechanism through the markets is equally essential when the economy faces multiple challenges in maintaining the growth momentum.

Portfolio strategy:

Even as market yields have broadly stabilised in recent days, on a forward-looking basis, it is expected to remain volatile. Arguments from a “state of the economy perspective” on a forward-looking basis, clearly warrants positioning for some market intervention with a possible short-term respite in market yields. Incrementally, we would continue to be more tactical in running duration profiles. Support from a rates positive domestic outlook (lower than target inflation and weaker than projected growth outlook on a forward basis) and liquidity surplus need to be balanced against negative headwinds from tariffs, rupee volatility, global rates environment and domestic demand-supply dynamics.

Overall, on a risk – reward basis, spreads on high grade bonds as well as selective credits at the shorter end remain attractive. Given the anticipated external volatility and its likely resetting of market expectations, strategies on duration would require to be more nimbler.

Short tenor high grade bond funds continue to provide higher accrual, wider spreads as well as an optimum risk/ reward that provide opportunities over the coming months as well as into the coming year.

**Mutual Fund investments are subject to market risks,
read all scheme related documents carefully.**