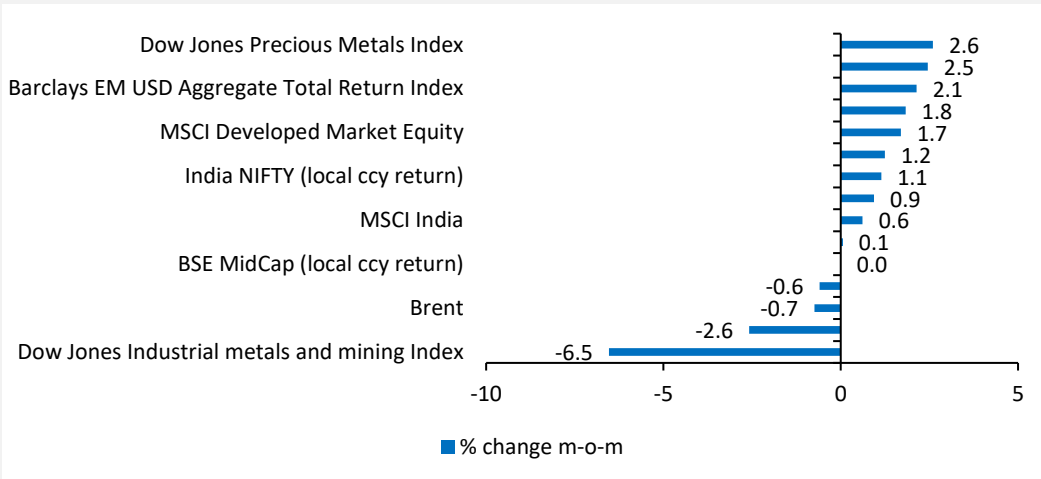




A softer than expected payroll data in the 1st week of August set the stage for significant asset market correction and pull back in sovereign yields globally. Market positioning also started to price in possibility of a 50-bps rate cut in September by the FOMC. The correction in asset prices was accentuated by potential unwinding of Yen carry trades. Over the course of the month, incremental data on a broader level in the US painted a relatively more sober assessment with data that validates a scenario of a softer landing. The FOMC chair during the much-anticipated Jackson Hole seminar also seemed to validate a reduction in policy rates in the September FOMC meeting. Asset markets broadly remained positive over the month with pullbacks post the correction in the early half.

Chart 1: Indian assets remain unaffected



Source: Bloomberg, SBIFM Research

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EQUITY

Indian equities continued their up move in August to close the month at fresh highs. The month had started with a violent sell off in global markets due to a confluence of macro factors. On one hand, economic data from the US has started to weaken reigniting recession fears. While this comes at a time when the Fed Chair has already hinted at rate cuts, monetary easing will help the economy only with a lag. There has been a considerable drop in the US 10-year bond yields consequently, to nearly 3.8% now versus levels of 4.7% earlier this year. On the other hand, and in sharp contrast, Bank of Japan raised interest rates to 0.25% taking markets by surprise and marking an end to an era of zero interest rates. BoJ tightening at a time when Fed is nearing cuts led to a significant appreciation in the Yen against the Dollar towards 145 now versus 160+ levels from a couple of months ago. This spooked markets on a potential reversal of the Yen carry trade. While the calm of the past couple of weeks has allowed equities to claw back their losses, dust has not settled yet as JPY continues to hold on to recent gains while US 10-year yields hold on to recent declines.

Indian markets recovered too with the Nifty and the Sensex rising 1.1% and 0.8% respectively, while Nifty Midcap 150 and Nifty Small cap 250 indices rose 0.3% and 1.2% respectively during the month. While at the headline index level, equities continue to do well, there appears to be a change in the underlying market complexion. For one, breadth has started to decline, as evinced in a declining proportion of BSE500 stocks outperforming the index. As a style, Quality has started to do well with the top quintiles on quality outperforming the bottom quintiles in August. Sectorally too, Defensive sectors such as Consumer, Tech and Healthcare have started to outperform cyclical sectors such as Capital Goods, Real Estate and PSUs.

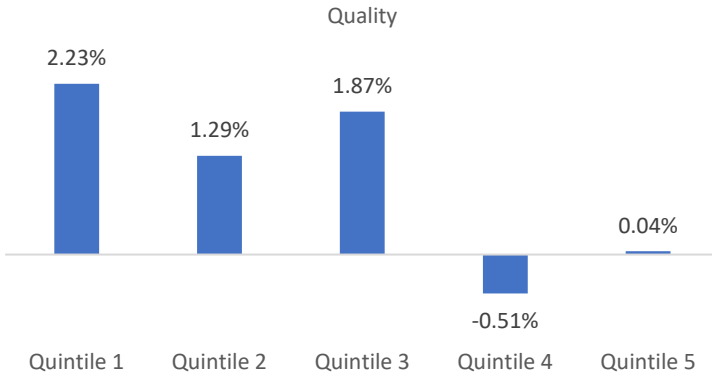
There, therefore, appears to be a defensive shift underway in the equity markets. This has been our base view for some time now. The global macro uncertainties appear to be coming at a time when Indian equity valuations have been expensive. Also, our proprietary equity sentiment measure stays elevated suggesting heightened complacency. Finally, while we stay constructive on earnings in the medium term, the near-term trajectory has been decelerating as commodity price tailwinds abate and revenue growth stays anemic. This mix we believe is ideal for a reduction in the thus-far-unabated speculative action in equity markets. We remain of the view that increasingly the market will become more discerning and move back towards companies which have strong business models, long-term earnings growth visibility and sustainable cashflows.

Chart 2: Market breadth has been narrowing in the recent upmove



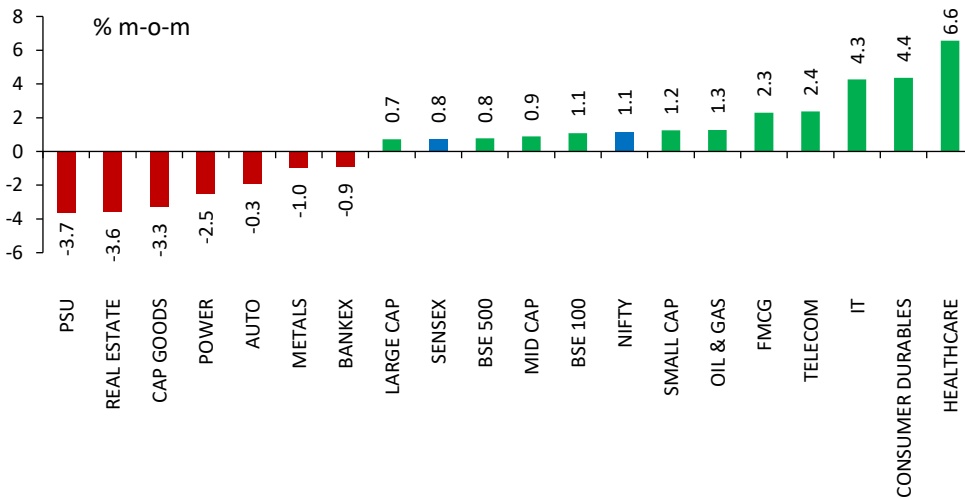
Source: FactSet, SBIFM Research

Chart 3: Quality has started to come back



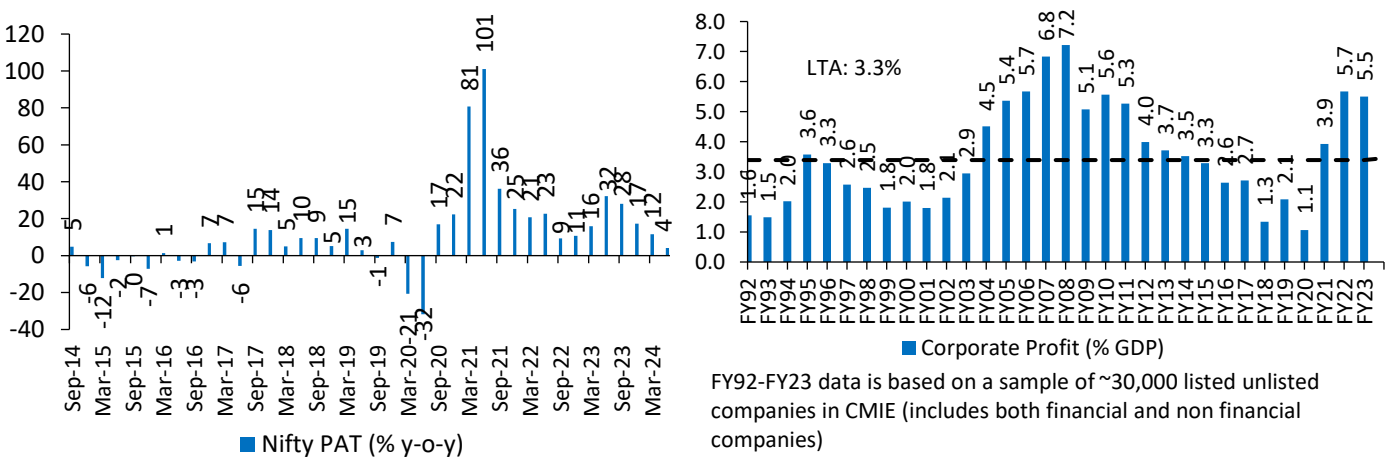
Source: FactSet, SBIFM Research. Performance is for the month of August. The classification into quintiles is based on SBIFM's definition of the Quality style/factor. Q1 is top20% on Quality, Q2 is the next 20% and so on.

Chart 4: Defensive sectors outperforming cyclicals now



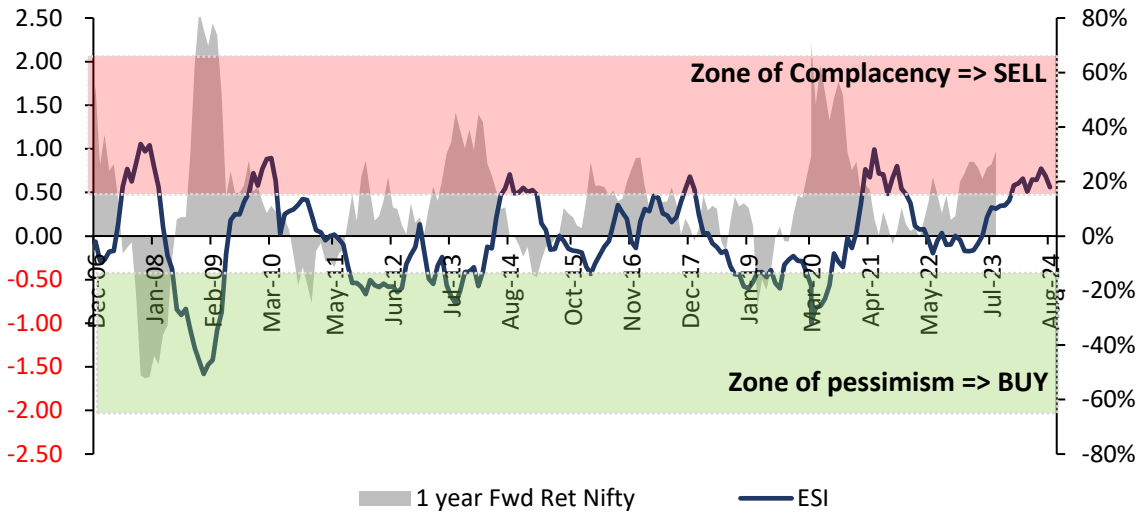
Source: Bloomberg, SBIFM Research

Chart 5: Earnings in slow lane near term, medium term outlook intact



Source: CMIE Economic Outlook, MOSL, Bloomberg, SBIFM Research

Chart 6: Complacency stays high as Equity Sentiment stays stretched



Source: Bloomberg, FactSet, SBIFM Research; Note: ESI stands for Equity Sentiment Index

Chart 7: Time for Quality?



Source: FactSet, SBIFM Research. Returns are the difference in rolling 3-year CAGR returns of the average of top 2 quintiles on the two styles. The classification into quintiles is based on SBIFM's definition of the respective style/factor.

Fixed Income

Over the last month the impact of easing global yields, supported by steady FPI demand led to a parallel move in the sovereign curve. Swaps continued to track global factors, with a steepening trend with the curve shifting lower about 14-18 bps. A softer CPI print in line with estimates, a still cautious RBI minutes and a pickup in corporate bond issuances were the other notable points. Banking system credit- deposit growth mismatch continues to put a floor on money market rates and the short end of the bond curve.

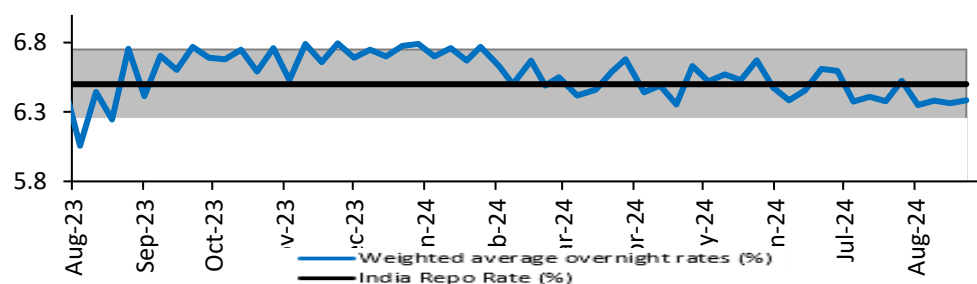
Gsec	31-Jul-24	31-Aug-24	Change
3-year G Sec	6.83%	6.75%	-0.08%
5-year G Sec	6.83%	6.77%	-0.06%
10-year G Sec	6.93%	6.86%	-0.07%
15-year G Sec	7.00%	6.91%	-0.09%
30-year G Sec	7.06%	7.00%	-0.06%
Swaps			
1Y	6.67%	6.49%	-0.18%
3Y	6.27%	6.11%	-0.16%
5Y	6.22%	6.08%	-0.14%
AAA- PSU			
1Y AAA	7.64%	7.70%	0.06%
3Y AAA	7.53%	7.48%	-0.05%
5Y AAA	7.43%	7.41%	-0.02%
10Y AAA	7.46%	7.40%	-0.06%

Liquidity & Short end rates

Improved government spending helped by reserve accretion have clearly led to improvement in banking liquidity and core liquidity respectively. This has effectively led to an implicit easing with the overnight rate settings being better aligned with respect to the Repo rate for a while. While RBI has conducted small lot OMO sales on the NDS, this hasn't clearly been signalling any discomfort with respect to improved liquidity conditions.

Chart 8:

Improvement in liquidity leads to overnight rates staying aligned to Repo or lower

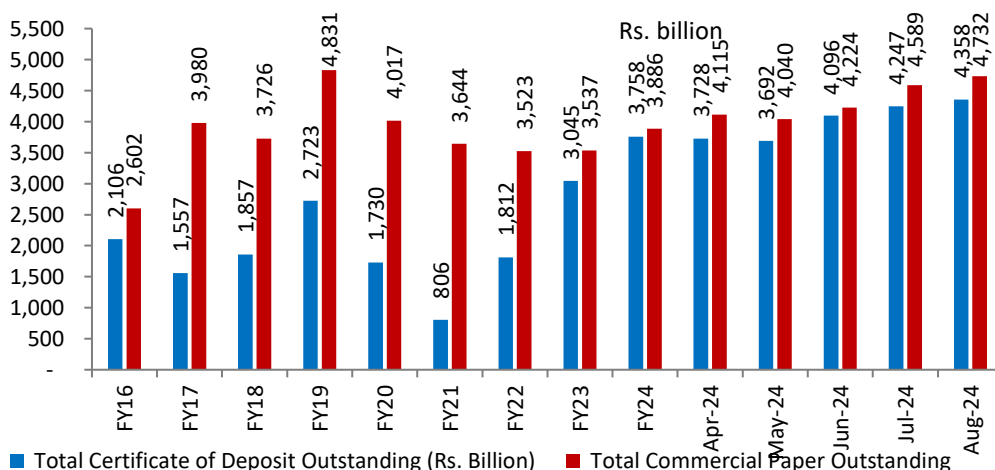
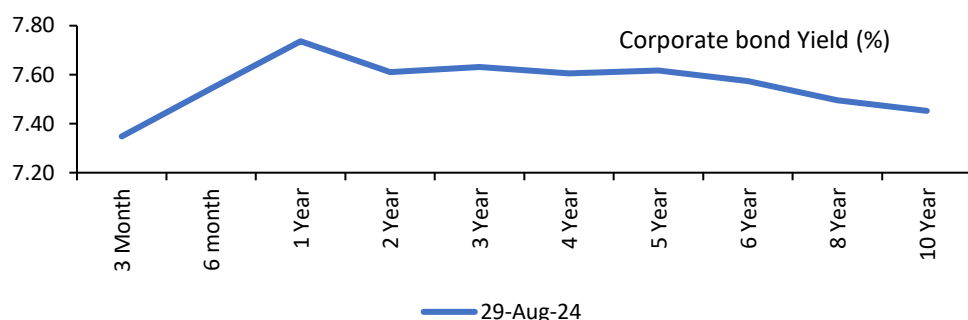


Note: The shaded area represents the policy corridor- where upper end represents MSF and lower end represent

Source: Bloomberg, SBIFM Research

Notwithstanding better liquidity dynamics, the system continues to deal with higher funding rate for corporate issuers and less than adequate transmission, more so at the shorter end. The dynamics of the banking system and peculiarities in demand account for the skewness.

Chart 9:
Inverted Yield curve



Source: Bloomberg, SBIFM Research

The demand outlook for long term bonds, especially AAA PSU/PFI remains strong with limited supply that potentially falls short of incremental demand from long term investors. At the same time, recent trends indicate increased issuances of Infra bonds by banks that could potentially cater to the demand. However, the trend remains of strong demand leading to tighter spreads in this tenor. With respect to the shorter end, the reduction in MF flows led by taxation amendments clearly is a long-term negative for demand, better market pricing as well as secondary market liquidity. Potential FPI demand, if it materialises could potentially lead to some reset. The challenges of the banking system clearly has kept a floor on short term rates. With higher CD issuances and bulk deposits being offered at higher rates, the full transmission of easier liquidity and potentially of any rate actions in the future also would remain constrained.

The prevalence of larger government cash balances on an average sitting outside the banking system has clearly led to shortfalls in banking liquidity and float. While this has helped in better savings for the government, the lack of deposit growth could be partly attributed to the same. In the absence of any changes to the process, the RBI could potentially need to ensure a larger than normal core liquidity surplus with tolerance of overnight rates staying below the repo rate on an average.

Outlook

With the gap between credit and deposit growth persisting, the extent of excess SLR at a system wide level would be a key factor influencing market yields over the coming months. Pick up in issuances of long tenor SDL could also determine the shape of the sovereign curve going forward. On balance of risks, a steeper curve than what we have seen over the recent past seems more likely in the near term.

Not much is expected to change with respect to the monetary stance in the near term as the RBI has clearly delinked the stance from system liquidity dynamics and aligned it with progress towards the inflation target. With global central banks likely to move into easing mode, expectations could get built in with respect to RBI's policy easing. However, monetary policy divergence is clearly likely as domestic macro factors vary and could shape the timing and outlook of policy actions. Even as government spending moved lower over Q1FY25, the GDP data points to reasonable resilience and confidence that FY25 growth could print closer to 7%. Inflation trend so far seems to suggest a gradual easing with likely outcome close to 4.5%.

A forward outlook where growth remains stronger and macro financial stability is not under threat, provides the central bank sufficient leeway to sequence policy actions to sustainably meet the inflation mandate. This would be independent of policy actions undertaken by other central banks. Even as the RBI tolerance towards liquidity surplus increases to ensure alignment of operating target to the policy rate, a stance change could potentially be the likely outcome over H2FY25. The evolution of market rates could vary basis demand- supply dynamics as well as flows. This can clearly lead to lower yields over the coming months, even as policy rates are unlikely to change in India in the near term. We remain alert to capture these trends.

With visibility emerging on the liquidity dynamics, the elevated levels at the front end of the curve should settle lower over the coming months. This should enable better risk- reward equation for incremental investments at the shorter segment (up to 5y) of the curve. Geo political developments also are an unknown risk element and would be keenly watched.

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