EQUITY OUTLOOK

Harish Krishnan
Chief Investment Officer - Equity
Aditya Birla Sun Life AMC Limited

Global Markets: Geopolitical Risks and Higher Crude Interrupt India's Recovery

Global markets witnessed renewed volatility during August as geopolitical tensions in West Asia resurfaced and crude oil prices moved higher. At the same time, the AI trade stabilized following the sharp correction in July, while rising developed-market bond yields added another source of uncertainty for equities.

Indian markets consequently lost momentum after two consecutive months of gains, declining approximately 1% during August despite a strong domestic earnings season and continued improvement in fundamentals. Russia (-12%), Brazil (-2%) and France (-1%) were also among the weaker markets. In contrast, Taiwan and South Korea rebounded 9% each following their sharp July correction, while China gained 5%. Germany, Japan and the MSCI Emerging Markets Index rose approximately 3% each in USD terms.

India continues to remain among the weakest-performing major markets in CY26YTD, declining approximately 13%, second only to Russia. The continued underperformance stands in contrast to strengthening domestic fundamentals and reflects persistent global risk aversion toward India, geopolitical uncertainty and elevated energy prices

Indian Markets: SMIDs (Small Mid Cap Companies) Extend Their Outperformance

Broader markets continued to outperform large caps during August. The Mid-cap index gained approximately 2% and the Small-cap index rose 3%, leaving both segments close to their all-time highs, while the Nifty 50 declined 1%.
The continued strength in SMIDs has been supported by stronger earnings momentum, robust domestic liquidity and investor interest in emerging themes that have relatively limited representation within the large-cap universe.

Sectorally, Defence and Metals were the strongest performers during the month, gaining approximately 4% each, while Consumer and Media declined 6% and 4%, respectively.

On a CY26YTD basis, the divergence remains significant. The Nifty 50 is down approximately 8%, while Defence (+25%), Healthcare (+20%), Metals (+18%) and Capital Goods (+18%) have delivered strong gains. Technology (-18%), Consumer (-17%), Infrastructure (-5%) and Private Banks (-2%) remain the principal underperformers

India Macro: Strong GDP Growth Reinforces Domestic Resilience

India's economic growth surprised positively in the first quarter of FY27, reinforcing the resilience of the domestic economy despite elevated geopolitical uncertainty, energy prices and global trade headwinds.

Real GDP growth accelerated to 7.8% year-on-year in 1QFY27 from 6.9% in 1QFY26, comfortably exceeding the RBI's estimate of 7.0%. GVA growth also strengthened to 8.2% from 7.0% in the corresponding period last year, while nominal GDP grew 10.3%. The expansion was broad-based across manufacturing and services, with domestic demand remaining supportive. Gross fixed capital formation grew a strong 11.9%, while private consumption increased 7.1%.

India's external position has also strengthened considerably. Foreign exchange reserves reached an all-time high of approximately USD729 billion in August, rising 5% during the month. The increase was supported by strong foreign-currency inflows following the RBI's concessional FCNR(B) deposit scheme. The rebuilding of reserves provides a significantly stronger buffer against renewed crude oil shocks and global market volatility.

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Earnings Outlook: Broad-Based Growth Strengthens the FY27 Earnings Cycle

The 1QFY27 corporate earnings season concluded on a strong note, with broad-based outperformance across several sectors.

The Nifty 50 recorded PAT growth of approximately 18% year-on-year, the strongest growth in ten quarters. Earnings for the broader Nifty 500 universe increased approximately 13%. Excluding oil marketing companies, Nifty 500 earnings growth was significantly stronger at 23%.

Importantly, the improvement was broad-based, with 16 of the 22 key Nifty 500 sectors reporting double-digit earnings growth. Financials, Metals, Oil & Gas excluding OMCs and Automobiles were among the major contributors, while Chemicals, Textiles and Real Estate also reported healthy growth. OMC losses remained the principal drag on aggregate profitability.

The strength of the first-quarter results and subsequent earnings upgrades have improved confidence in the earnings cycle. We continue to expect Nifty corporate earnings to compound at approximately 15% over FY26–28E, providing an important fundamental anchor for equities

Liquidity: Domestic Flows Remain Strong as FIIs Stay Positive

Domestic institutional investors continued to provide strong support to Indian equities, investing approximately USD6.1 billion during August and extending their sequence of monthly net inflows to 37 consecutive months.

Foreign institutional investors remained net buyers for the second consecutive month, investing approximately USD2.4 billion after four months of sharp outflows earlier in the year.

On a CY26YTD basis, DII inflows have reached approximately USD60 billion, more than offsetting FII outflows of approximately USD24 billion. The structural shift toward domestic liquidity is even more evident over CY21–CY26YTD, with DIIs investing approximately USD280 billion compared with cumulative FII outflows of USD35.5 billion.

Sustained domestic flows continue to provide an important cushion against volatile global capital flows. Encouragingly, the return of foreign investors despite elevated global uncertainty suggests that the significant correction in Indian equities and improving fundamentals may gradually be restoring relative attractiveness.

Valuation: Large Caps Continue to Offer Better Risk-Reward

The prolonged price and time correction has materially improved large-cap valuations.

The Nifty 50 currently trades at approximately 18.3 times 12-month forward earnings, around 13% below its long-period average. With earnings expectations improving, this provides a more favourable risk-reward profile than was available over much of the previous two years.

In contrast, mid-cap and small-cap valuations remain elevated. The Mid-cap index trades at approximately 27 times forward earnings, around 9% above its long-period average, while the Small-cap index trades at approximately 24.1 times, representing a premium of around 31%.

While the structural outlook for several SMID businesses remains attractive, elevated valuations suggest that future returns will increasingly depend on earnings delivery rather than further multiple expansion.

Conclusion: Fundamentals Remain Supportive Despite Near-Term External Risks

India continues to underperform global peers despite strong macroeconomic and corporate fundamentals. However, the combination of robust GDP growth, a strong 1QFY27 earnings season, broad-based earnings upgrades, record foreign exchange reserves, resilient domestic institutional flows and the return of FII buying continues to strengthen the underlying market setup.

Geopolitical developments and crude oil remain the most important near-term risks. Higher energy prices can adversely affect India through inflation, the current account and corporate margins. Rising global bond yields could also delay a sustained recovery in foreign portfolio flows.

At the same time, momentum in the global AI trade appears to be moderating, while India's valuation premium relative to emerging markets has fallen to a multi-year low. A broadening of global capital allocation, combined with India's resilient domestic growth and strengthening earnings cycle, could therefore improve the relative investment case for Indian equities

Source: ABSLAMC Internal Research, MOSL

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DEBT OUTLOOK

Kaustubh Gupta
Chief Investment Officer - Fixed Income
Aditya Birla Sun Life AMC Limited

The spike in tensions in West Asia, following the recent attacks on Saudi pipelines, continued disruptions in the Strait of Hormuz and the resultant rise in crude oil prices to above US$100 per barrel, has put pressure on global rates, including those in India. India has been able to source crude oil from across the world, and sourcing should not be a problem. Moreover, the government has kept fuel prices regulated and reduced taxes on fuel early in the conflict. Consequently, the pass-through to pump prices has been moderate, and the impact on domestic inflation has been contained. However, if crude oil prices remain at triple-digit levels, we will see an impact on inflation as well.

India's real GDP (Gross Domestic Product) grew by 7.8% year-on-year in Q1 FY2026-27, above market estimates of 7.5%. However, on the nominal side, GDP grew at a more subdued rate of 10.3%, implying an economy-wide deflator of just 2.3% against quarterly average CPI (Consumer Price Index) inflation of approximately 3.9% and WPI (Wholesale Price Index) inflation of approximately 9.4%. The low deflator is the result of a change in methodology, particularly the use of double deflation in manufacturing under the new series, and a faster increase in input prices than in output prices. Notably, real manufacturing growth stood at 9.2%, compared with nominal growth of 7.8%, reflecting a faster increase in input prices than in output prices. Therefore, part of the apparent strength in real GDP reflects a changed statistical benchmark and a revised comparison base. We believe that the current nominal growth rate of 10.3%, compared with the 25-year median nominal growth rate of 11.9%, is a better indicator of the state of the economy, which is resilient and showing some positive momentum, but is not hot.

The monsoon has improved meaningfully following the severely deficient rainfall in June, but it remains in deficit by approximately 14%. The recovery in rainfall since June has helped narrow the shortfall in total kharif sowing to less than 2% compared with last year. Strengthening El Niño conditions remain an upside risk to food inflation, although foodgrain stocks, irrigation coverage and supply-management measures provide some protection.

The dollar swap scheme announced by the RBI in its June policy received a bumper response despite its early closure, bringing in US$127.2 billion, significantly above the market's and the RBI's own estimates, with flows almost doubling during the last 10 days of the scheme. Combined with other swap windows that remain open until the end of December, total inflows so far have reached US$136.4 billion. The RBI's foreign-exchange reserves have also risen to a record level of US$786 billion. The increase in the RBI's foreign-exchange reserves provides it with ample firepower to intervene in the foreign-exchange market and keep the INR stable. On the other hand, INR liquidity has surged following the strong inflows, reaching its highest level since the COVID period, with the banking-system liquidity surplus at INR 10 trillion. This has created a challenge for the RBI in the wake of inflationary pressures emanating from higher crude oil prices. Accordingly, the RBI has started withdrawing excess liquidity from the system through USD sell/buy swaps and open market operations in Government of India securities.

India's CPI inflation rose to 4.82% in August, in line with market and RBI expectations, driven by firmer food-price pressures, with food inflation increasing to 5.95%. Core inflation also strengthened to approximately 4.2%, while core inflation excluding gold and silver stood at 2.9%, indicating some gradual pass-through beyond volatile items. However, core inflation excluding precious metals remains relatively contained at 2.9% year-on-year. The RBI forecasts average inflation in FY2026-27, the fiscal year ending in March, at 5% year-on-year, and we agree with this forecast.

With the policy rate at 5.25% and inflation expected to average 5%, there is a case for a shallow rate-hike cycle to manage real rates. We expect cumulative rate hikes of 25 to 75 basis points during the cycle, depending on the evolution of crude oil prices. We believe this is more than adequately priced into the markets. Therefore, we do not expect much impact on yields from current levels unless conditions deteriorate further in terms of crude oil prices and global rates. Banks are holding INR 10 trillion of excess liquidity, which should provide a natural cap on yields.

Investors with a horizon of one month or more can consider Short Duration Debt Index Fund, while those with a three-month or longer horizon can consider Ultra Short Duration or Low Duration Fund. Investors currently concentrated in overnight or liquid categories may evaluate moving one notch higher on the duration curve. One-to-five-year corporate bonds continue to offer a favourable risk-adjusted entry point, supporting allocations to Corporate Bond Fund and Banking & PSU Debt Fund. Investors with a horizon of two years or more can consider Income Plus Arbitrage Fund of Funds, given its tax efficiency

Source: ABSLAMC Internal Research

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