EQUITY OUTLOOK

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Global Markets: AI Leadership Continues While Macro Risks Re-Emerge

Global equity markets delivered another month of divergent performance in May, with AI-led markets continuing to outperform despite rising macroeconomic uncertainties. South Korea, Taiwan, and Japan remained the standout performers, supported by strong earnings momentum across semiconductor and technology companies, while broader global indices also generated positive returns.

However, beneath the surface, market conditions have become increasingly complex. Escalating tensions in West Asia, elevated crude oil prices, rising global bond yields, and growing fiscal concerns in the US have introduced new risks to the global growth and inflation outlook. The sharp rise in long-duration bond yields, particularly the US 30-year Treasury yield moving above 5%, reflects a reassessment of inflation expectations and reinforces the possibility of a prolonged higher-for-longer interest rate environment.

While global growth remains resilient, investors are increasingly balancing enthusiasm around AI-driven productivity gains against the potential drag from higher energy costs, tighter financial conditions, and geopolitical uncertainty.

India Macro: Resilient Fundamentals Confront External Pressures

Indian equities faced renewed volatility during May after recovering sharply in April. The market corrected modestly during the month as investors grappled with persistently elevated crude oil prices, continued foreign institutional selling, and ongoing currency weakness.

The macro environment remains challenging. Crude oil prices continue to trade well above pre-conflict levels, creating pressure on inflation, external balances, and corporate profitability. At the same time, sustained FII outflows and capital rotation toward AI-driven global markets have contributed to pressure on the rupee, which briefly touched record lows before stabilizing following RBI intervention.

Despite these headwinds, domestic fundamentals remain relatively resilient. Economic activity continues to be supported by healthy consumption trends, stable credit growth, and ongoing government-led investment. Domestic liquidity remains a key stabilizing force, helping offset external volatility and supporting market resilience.

Earnings: Broad-Based Beat, But Forward Expectations Moderate

The Q4FY26 earnings season concluded on a stronger-than-expected note, with broad-based outperformance across sectors. Financials, metals, technology, automobiles, telecom, and oil marketing companies were among the key contributors to earnings growth, while weakness remained concentrated in select energy-related segments.

Nifty delivered modest earnings growth during FY26, marking a second consecutive year of single-digit earnings expansion. While reported earnings exceeded expectations, management commentary across sectors reflected increasing caution regarding the impact of higher energy costs, currency weakness, and global demand uncertainties.

Consequently, earnings expectations for FY27 have witnessed modest downward revisions. Although earnings growth remains positive, the risk of further downgrades will depend largely on the trajectory of crude oil prices and geopolitical developments over the coming quarters.

Market Structure: Domestic Liquidity Remains the Key Anchor

A notable feature of the current market environment continues to be the divergence between domestic and foreign flows.

Domestic institutional investors maintained their strong buying momentum during May, extending a multi-year trend of sustained inflows supported by retail participation and SIP contributions. In contrast, foreign investors remained net sellers amid global risk aversion, geopolitical concerns, and the relative attractiveness of AI-led opportunities in other markets.

The persistence of strong domestic flows has helped cushion market declines and prevented a more severe correction despite record levels of foreign selling. However, market leadership is becoming increasingly selective, with stock-specific earnings delivery playing a greater role than liquidity-driven expansion.

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Valuation: More Reasonable at the Index Level

Following the correction witnessed over the past several months, Nifty valuations have moved significantly closer to historical averages. The index now trades at a discount to its long-term average valuation, improving the overall risk-reward profile for long-term investors.

However, valuation dispersion remains elevated. While large-cap valuations appear more balanced, mid-cap and small-cap segments continue to command premiums relative to historical averages. This suggests that future returns are likely to be driven increasingly by earnings execution rather than multiple expansion.

Sector Outlook: Selectivity Becomes Increasingly Important

The market is transitioning toward a phase where earnings visibility and balance sheet strength are becoming more important than broad-based sector rotation.

Industrials, Manufacturing and Capital Goods: Structural capex themes remain intact, supported by government spending, defence investments, manufacturing localization, and infrastructure development. While valuations remain elevated in parts of the sector, long-term earnings visibility remains favourable.

Automobiles and Consumer Discretionary: Demand remains resilient despite macro uncertainty. Premiumization trends, improving product cycles, and healthy balance sheets continue to support earnings growth.

Financials: Asset quality remains stable and credit growth continues to be healthy. Margin concerns have largely stabilized, supporting a constructive medium-term outlook despite near-term sensitivity to liquidity flows.

Technology: The sector continues to navigate uncertainty around AI-driven disruption and global demand moderation. However, recent corrections have improved valuations, and selective opportunities are emerging among companies positioned to benefit from AI adoption.

Metals and Commodities: Earnings remain supported by favourable commodity pricing, though performance remains highly dependent on global growth and energy costs.

Key Risks

The most significant risk to the Indian market remains the persistence of elevated crude oil prices.

Sustained oil prices near current levels would increase pressure on inflation, widen the current account deficit, weaken the rupee, and compress corporate margins. Additionally, rising global bond yields could tighten financial conditions further and reduce the flexibility of central banks globally.

The trajectory of the West Asia conflict and the stability of energy flows through the Strait of Hormuz therefore remain critical variables for both global and Indian markets.

Conclusion: Near-Term Volatility, Medium-Term Opportunity

Markets continue to operate in an environment characterized by competing forces. On one hand, strong domestic liquidity, resilient economic activity, and healthy medium-term earnings prospects provide support. On the other, geopolitical uncertainty, elevated energy prices, rising bond yields, and persistent foreign outflows continue to create volatility.

While near-term market direction will remain heavily influenced by macro developments, the broader investment environment is gradually becoming more attractive following the valuation correction of the past year. We believe the market is increasingly transitioning from a liquidity-driven cycle to an earnings-driven cycle, where stock selection, earnings visibility, and business quality will become the primary drivers of returns.

The medium-term earnings outlook for corporate India remains constructive, but the path is likely to be accompanied by elevated volatility until greater clarity emerges on crude oil prices, global monetary policy, and geopolitical developments

Source: ABSLAMC Internal Research

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DEBT OUTLOOK

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The Iran crisis and particularly the Hormuz blockage has been the most important monitorable for Indian markets and economy, and the latest Iran-US breakthrough materially reduces the tail risks, with both sides announcing a preliminary framework to halt hostilities and reopen the Strait of Hormuz. The framework reportedly includes cessation of military operations, removal of the US naval blockade on Iranian ports, and restoration of shipping through Hormuz, though the detailed text is still not public and implementation remains conditional but markets, particularly commodity markets have reacted positively to the announcement with Brent crude declining to below 85.

For India, the impact is clearly positive with sharp decline in not only the crude oil price but also the likely decline in price of fertilizers imports as well as palm oil. Note that India's annual Balance of Payment changes by US$1.75bn for every dollar change in crude price and hence the opening will substantially aid in Balance of Payment, besides impacting fiscal and inflation. That said, full normalization has not happened till now and negotiations over nuclear programme, sanctions relief, inspections and enforcement will continue for 60 days and shipping recovery itself may take weeks because of mine clearance, security checks and vessel backlogs.

The RBI's June MPC unanimously kept the policy repo rate unchanged at 5.25% while also retaining the neutral stance choosing to look through the supply chain shock amidst concern on growth slowdown and remain data dependent. The wide uncertainty surrounding outcome of West Asia crisis would have also resulted in RBI choosing a wait and watch approach. While there was no rate action, RBI announced strong measures to attract capital flows and support the rupee. RBI announced concessional Swap windows for FCNR (Foreign Currency Non-Resident) and ECB (External Commercial Borrowing) borrowing. A 3-5Y FCNR(B) scheme was announced with RBI bearing the full hedging cost which will be exempt from CRR/SLR requirements. Concessional swap facility was also announced to incentivize ECBs by PSU entities. RBI also removed short-term, security-wise and concentration limits for foreign investment in G-Secs under the General Route, merged the earlier general and long-term buckets, and expanded FAR (Fully Accessible Route) to all new 15-, 30- and 40-year Government securities. Simultaneously, Union Government exempted eligible foreign investors from tax on interest income and capital gains on Government securities, effectively removing the earlier 20% withholding tax on G-Sec interest. This should provide near-term support to reserves, liquidity, INR sentiments, banks deposit base and corporate borrowing costs.

India's Q4 FY26 GDP print came in stronger than expected at 7.8% YoY, taking full-year FY26 growth to 7.7%, above the earlier advance estimate and ahead of most street expectations. The print suggests that domestic activity entered FY27 with solid underlying momentum despite global trade uncertainty, elevated crude prices and geopolitical stress. Growth composition was encouraging, with real GVA (Gross Value Added) also at 7.9% and services remaining the key driver, while construction and manufacturing contributed positively. On the demand side, there was resilient private consumption and a notable pick-up in investment, suggesting domestic demand held up well into the year-end. That said, we note the role of very low deflator, at lowest value since 1976 as well as the weak nominal GDP at 9.1% . The key driver of high real GDP is near double digit growth in services which does not have double deflation in estimating real GDP. Net-net, the GDP release is reassuring for the macro backdrop, but sustaining this pace will depend on how effectively domestic demand offsets a more adverse global environment.
India's May CPI inflation edged up to 3.93% from 3.48% in April, remaining just below the RBI's 4% target and slightly market expectation of little above 4%. The pick-up was driven by 17-month high food inflation, fuel price hikes (up 3%) and precious metals (up 78%). Core inflation inched up to a six-month high of 3.7% but core ex-precious metal is hovering close to ~2% y-y suggesting the inflationary pressures are concentrated and mainly from supply side and there too the impact of West Asian crisis has so far been muted. Nearly three quarter of inflation basket is below 4%. Going forward, evolution of Hormuz conflict and monsoon remains the key factors driving inflation.

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The June RBI policy shows that MPC remained firmly anchored to its core mandate of price stability and any pressure on external account will not be tackled with rate action. We have been highlighting that pressure on INR is largely a capital account phenomenon and is best addressed through targeted measures to boost capital inflows rather than monetary policy trade-offs. Thus, further rate action will be contingent on monsoon and spill-over of development on West Asia on inflation. We note that despite recent rally in Indian bonds, both term and credit spreads remain elevated. The expected healthy capital inflow due to FCNR(b) and external borrowing by PSUS should be positive particularly for upto 5 year corporate bonds. Measure to boost FPI inflows including easier onboarding, change in FPI taxation, and FAR-related measures have increased chance of addition to Bloomberg Aggregate Index, which is supportive for Sovereign Curve.
We recommend investors with 1 month+ horizon to invest in our 3-6M Financial Services Index fund, 3 months+ to invest in our ultra short or low duration fund. Investors having a 2Y+ horizon should look at our Income Plus Arbitrage FOF given tax efficiency. Investors in overnight/liquid categories should evaluate going one notch higher on the duration curve. The key risk that we are tracking development in West Asia and progress of South West Monsoon.

Source: ABSLAMC Internal Research.

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