India Outlook 2023

'Beginning of a New Era'

Recap of outlook 2022

What we said last year

Deflation to Reflation

Countries especially US & UK witnessed decadal high inflation

Elevated Equity Valuations

Indian equities were richly valued throughout 2022

Macros challenging for Fixed Income

Recommended active duration management & a nimble approach

Short-end of yield curve expensive

Major brunt of RBI normalization borne by short end

Interest rate rise cycle

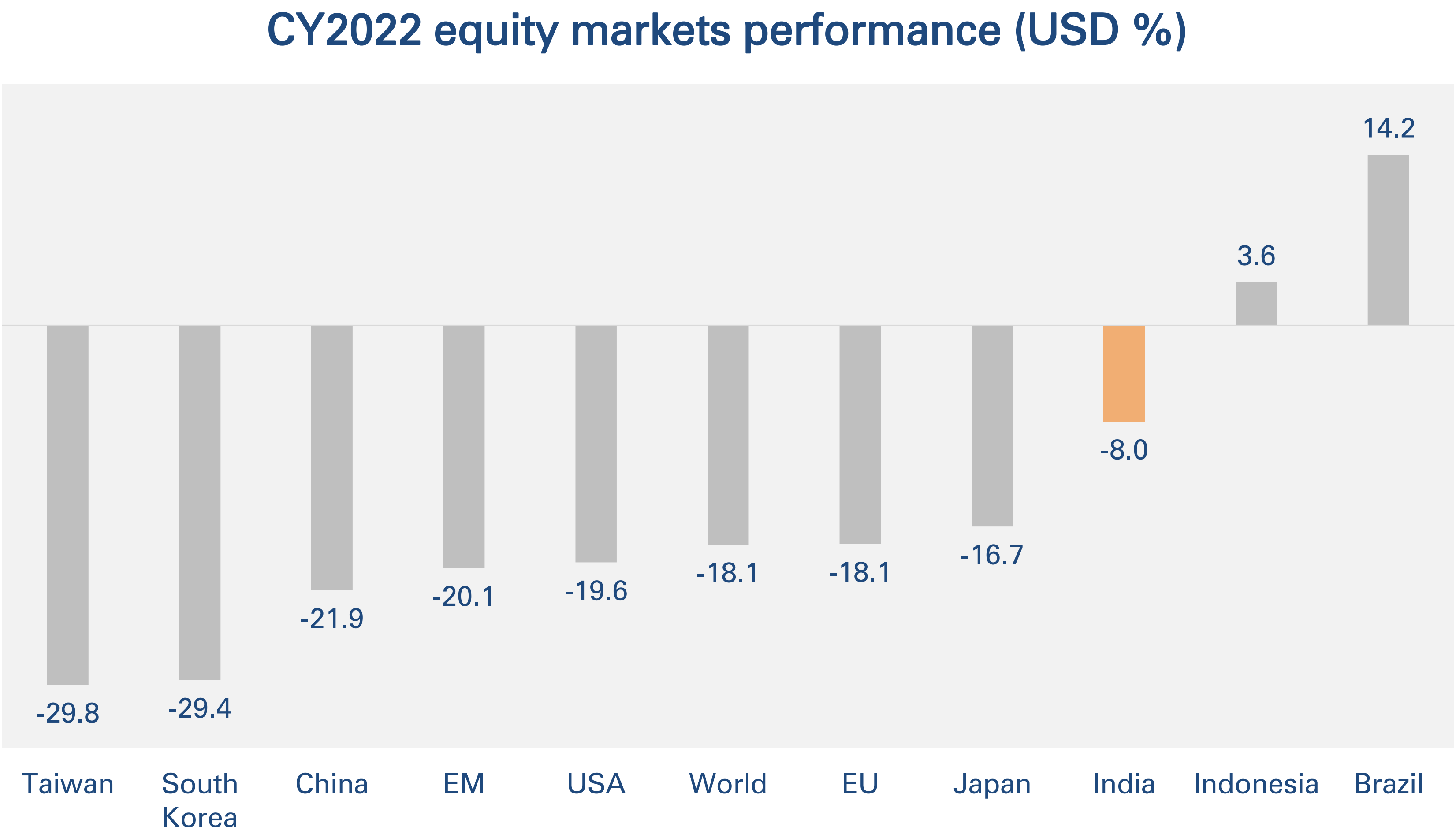
Policy normalization was in action. Recommended Floating Rate Bonds & Spread Assets

RBI – Reserve Bank of India

Our calls last year

- Strong buy call on floating rate instruments due to interest rate-rise cycle
- Remained cautious on equities due to high valuations
- Maintaining lower duration in most of our fixed income strategies

India a relative outperformer in CY2022



Barring few commodity exporting nations, Indian markets have noticeably outperformed other markets

Source: Morningstar Direct; Currency: USD; Data as of December 30, 2022

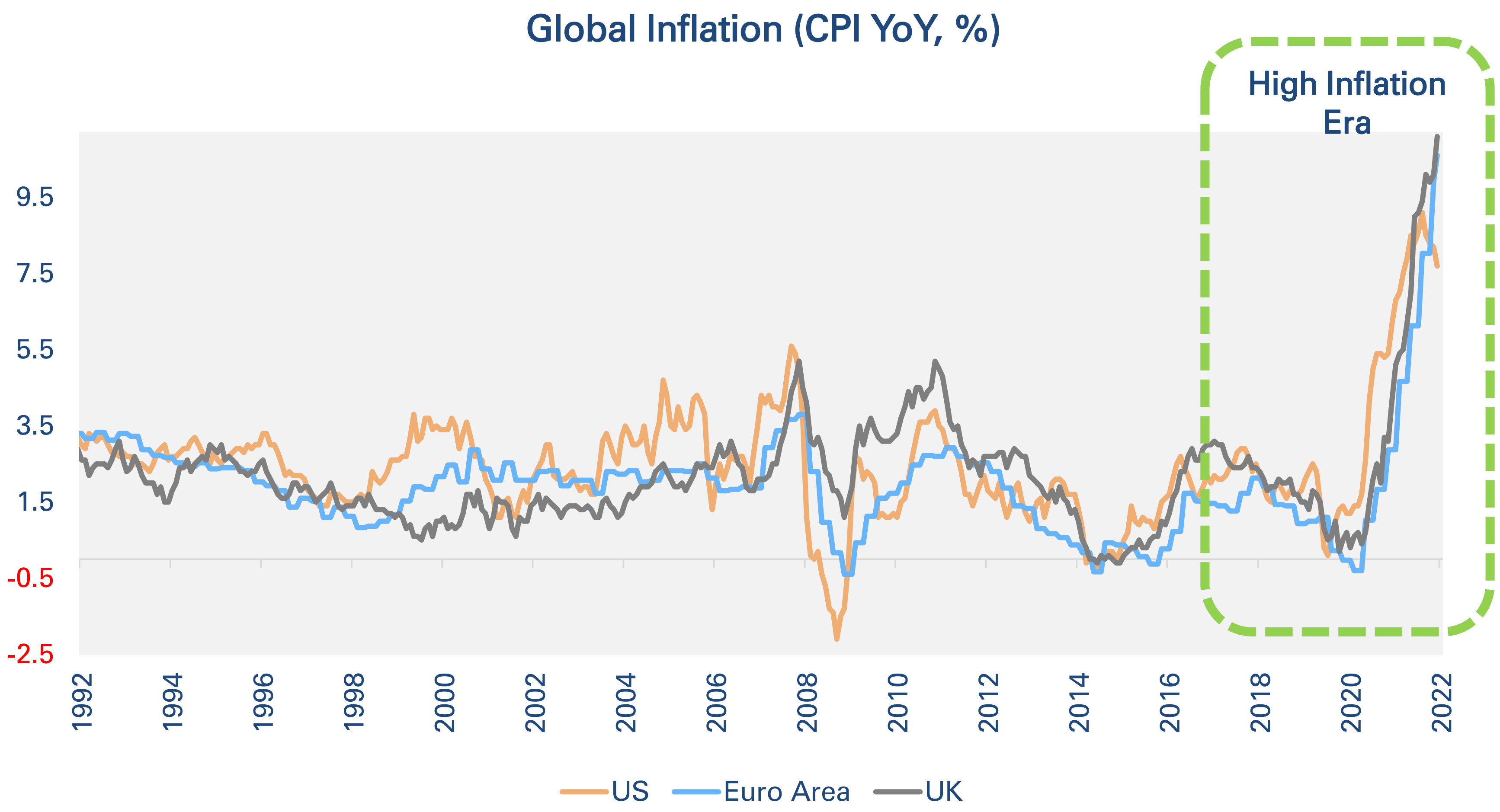
Outlook 2023 – 'Beginning of a New Era'

- In our previous Annual Outlook documents (2021 & 2022), we distinctly highlighted the complex and dynamic macro-economic changes that were shaping financial markets. Our **Annual Outlook for 2021** was based on the theme **'TURNING POINTS'** which focused on pointing early signs of macro changes in terms of Global Central Banks' monetary stance, liquidity conditions, sectoral/theme leadership, etc.

- These shifts called for further caution in our **Annual Outlook for 2022**which was based on the theme **'The year of active management'** as macros were expected to evolve further and dynamism was at its peak. The unusual macro trends were hinting at transition to a new era / new financial world order

- As we enter 2023, our annual outlook is based on the theme **'BEGINNING OF A NEW ERA'** as we believe that transition of decadal macro trends from **low inflation to high inflation, low interest rates to high interest rates, abundant liquidity to limited liquidity, de-escalation to escalation, monetization to tightening and low to high volatility** is now complete. The new era warrants for a change in investment style with a need to prudently handpick asset classes which may perform at different points in time

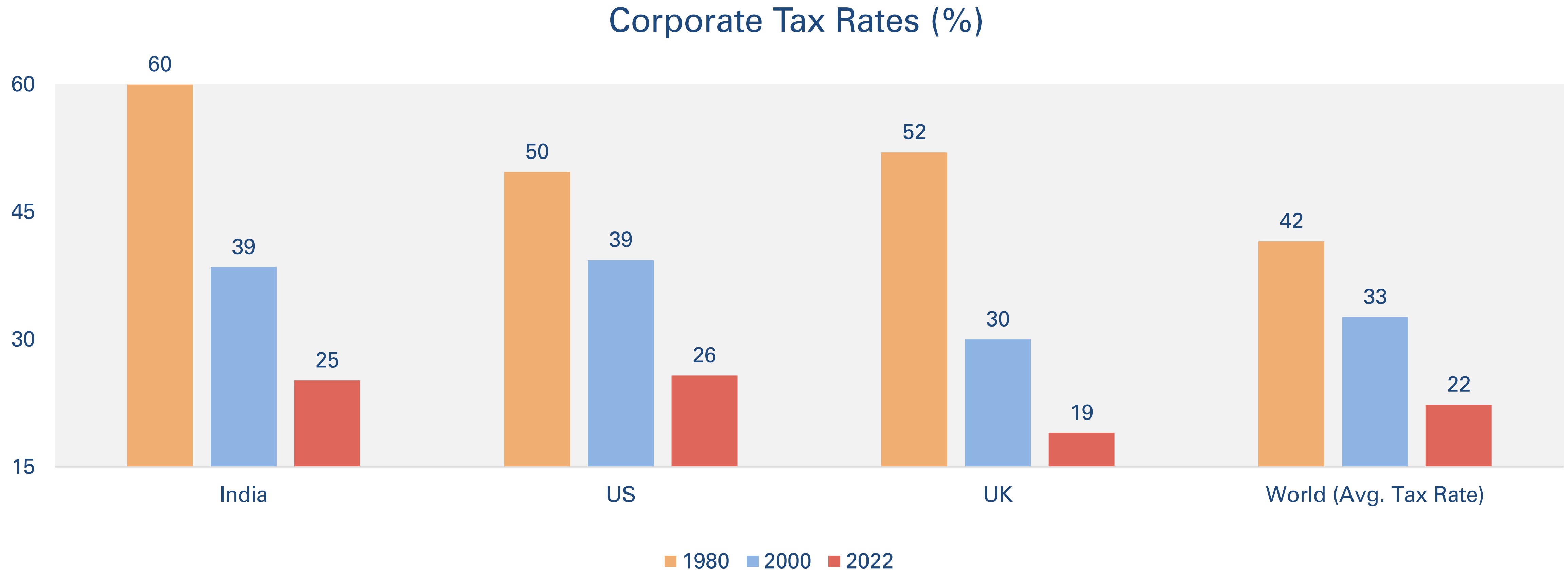
Beginning of a New Era – Disinflation to Inflation



Developed economies historically witnessed inflation in the range of 0%-2%, are now facing decadal high inflation

Source: Nuvama Institutional Equities. Data as of November 30, 2022. US – United States, UK – United Kingdom, CPI – Consumer Price Index.

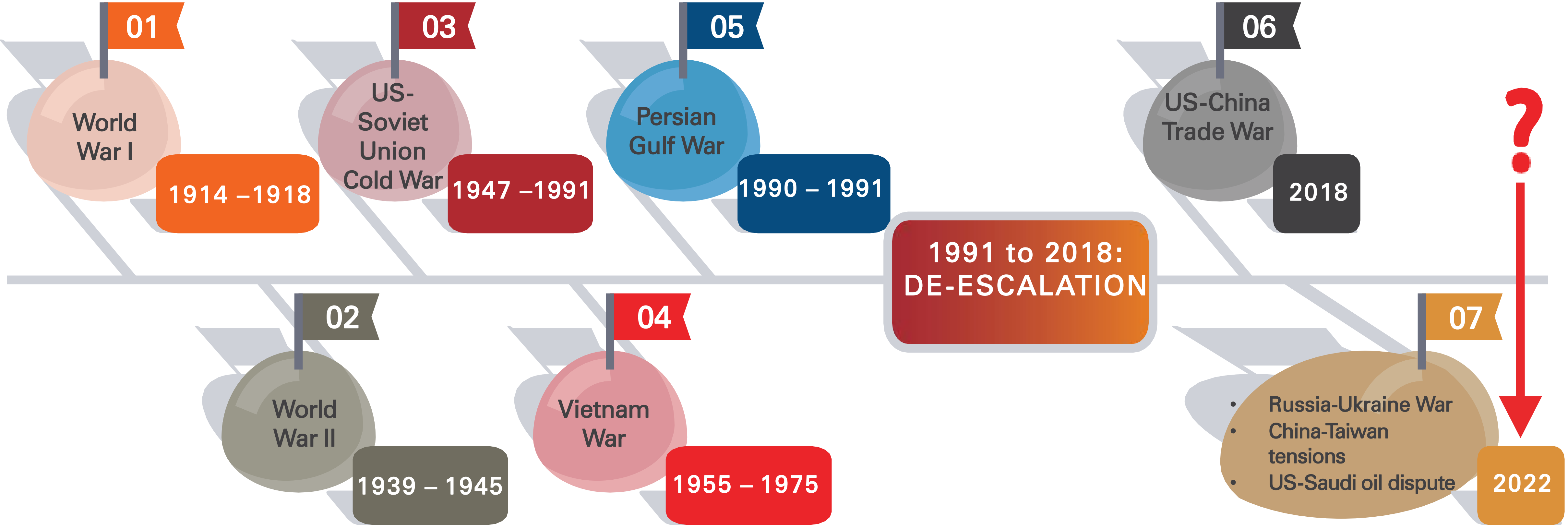
Beginning of a New Era – De-regulation to Regulation



Low tax rates, one of the key measures of easing of regulations, have declined in last 40 years.
This trend seems to be reversing again with US & UK set to hike corporate tax rates to 28% & 25%

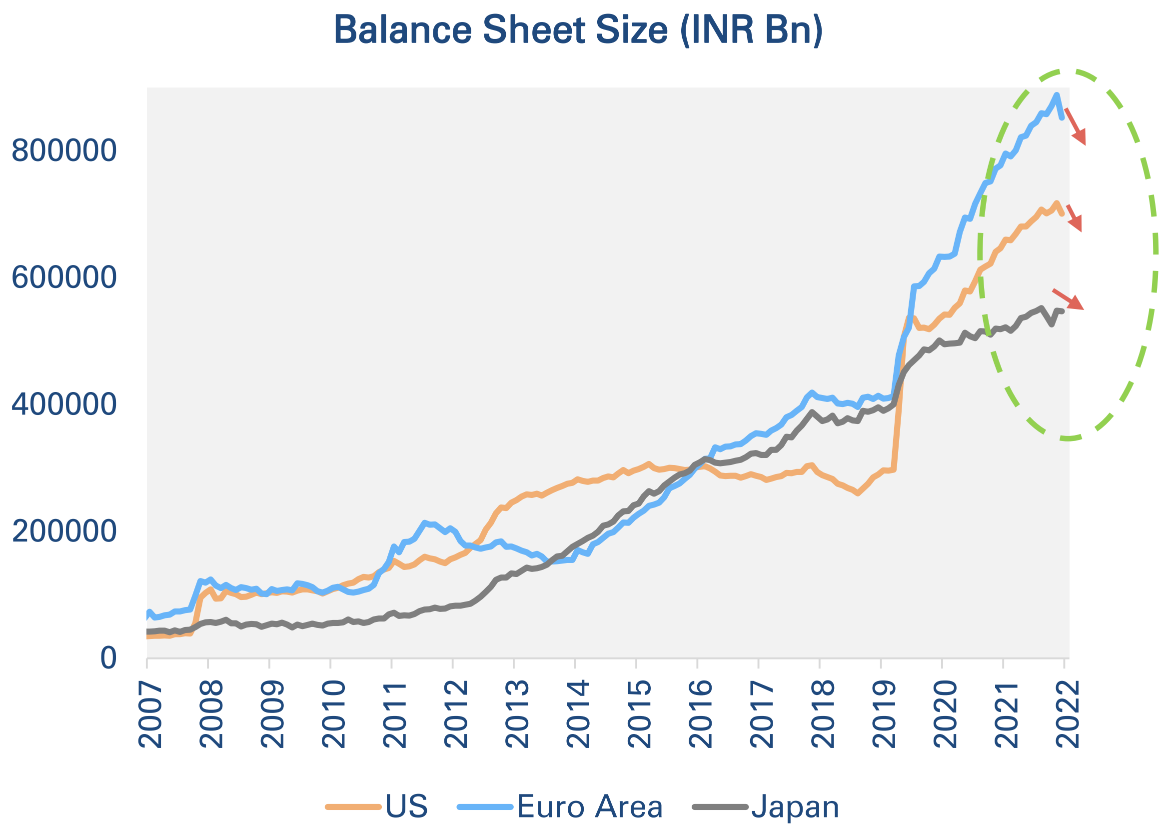
Source: DAM Capital research; Data as of December 30, 2022.

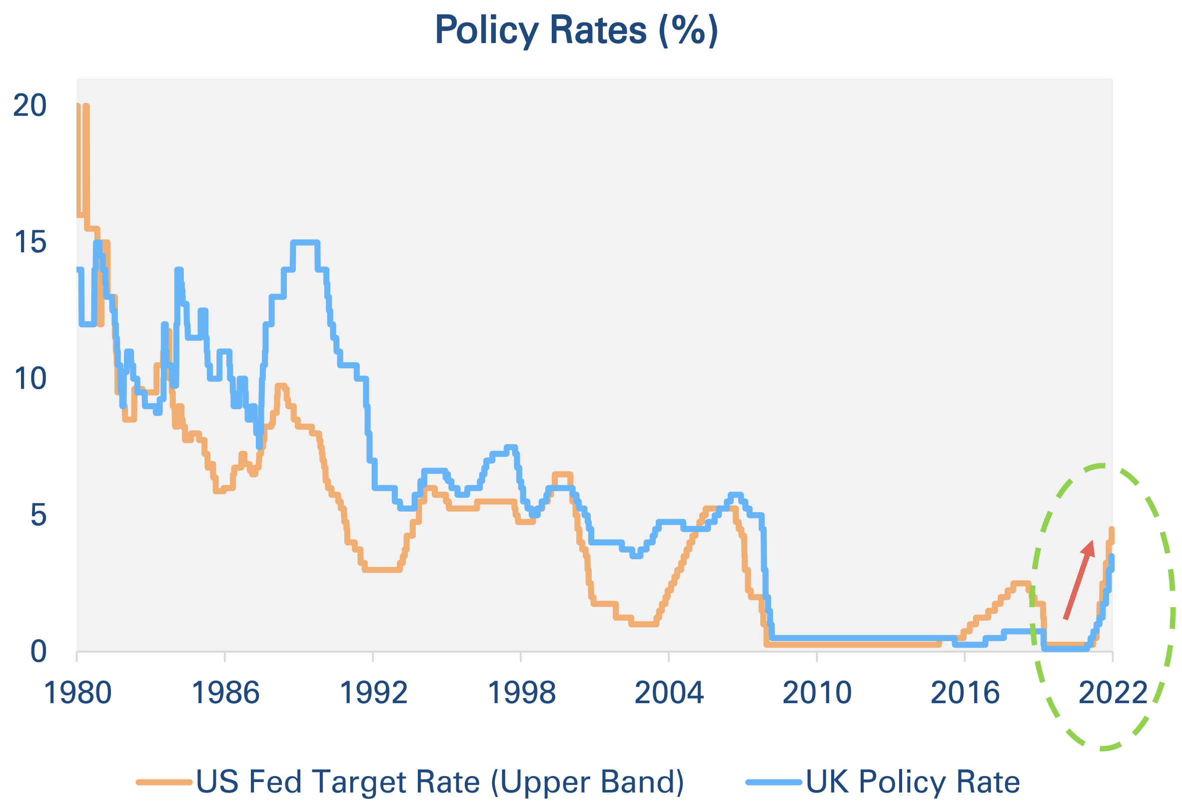
Beginning of a New Era – De-escalation to Escalation



20th century was marked by numerous geo-political issues.
21st century seemed different until 2018, post which multiple geo-political issues have come to the fore

Beginning of a New Era – End of Monetization

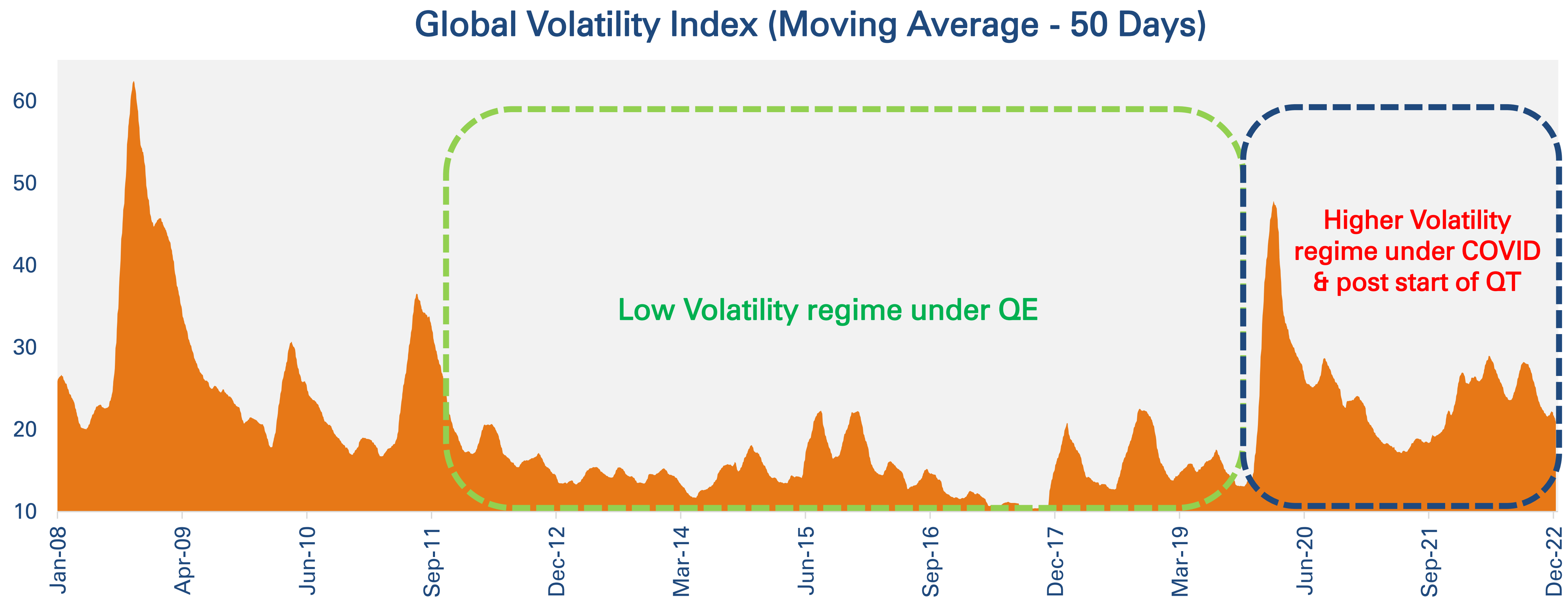




Last four decades were marked by low interest rates, quantitative easing and ample liquidity.
The scenario is changing as we move towards a high interest rate era

Source: Morgan Stanley, US Federal Reserve, Bank of England, US – United States, UK – United Kingdom.

Beginning of a New Era – End of low volatile period



Global volatility was on the lower side last decade as Central Banks especially US Fed opted for QE.
Currently volatility is on the rise as Central Banks are opting for tight monetary policies

Source: Wall Street Journal, QE – Quantitative Easing, QT – Quantitative Tightening, GFC – Global Financial Crisis, COVID – Coronavirus Disease.

Indian equities

Among the best long term structural stories

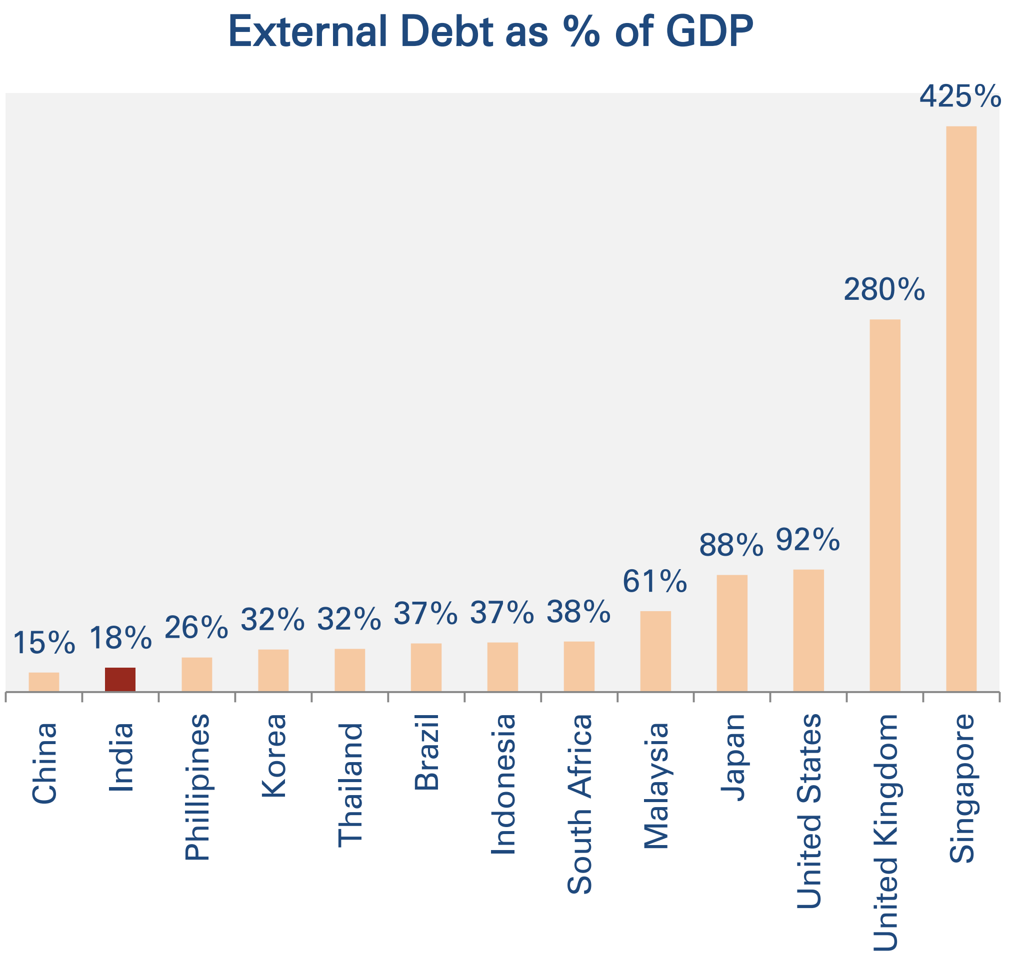
Macro fundamentals in much better shape

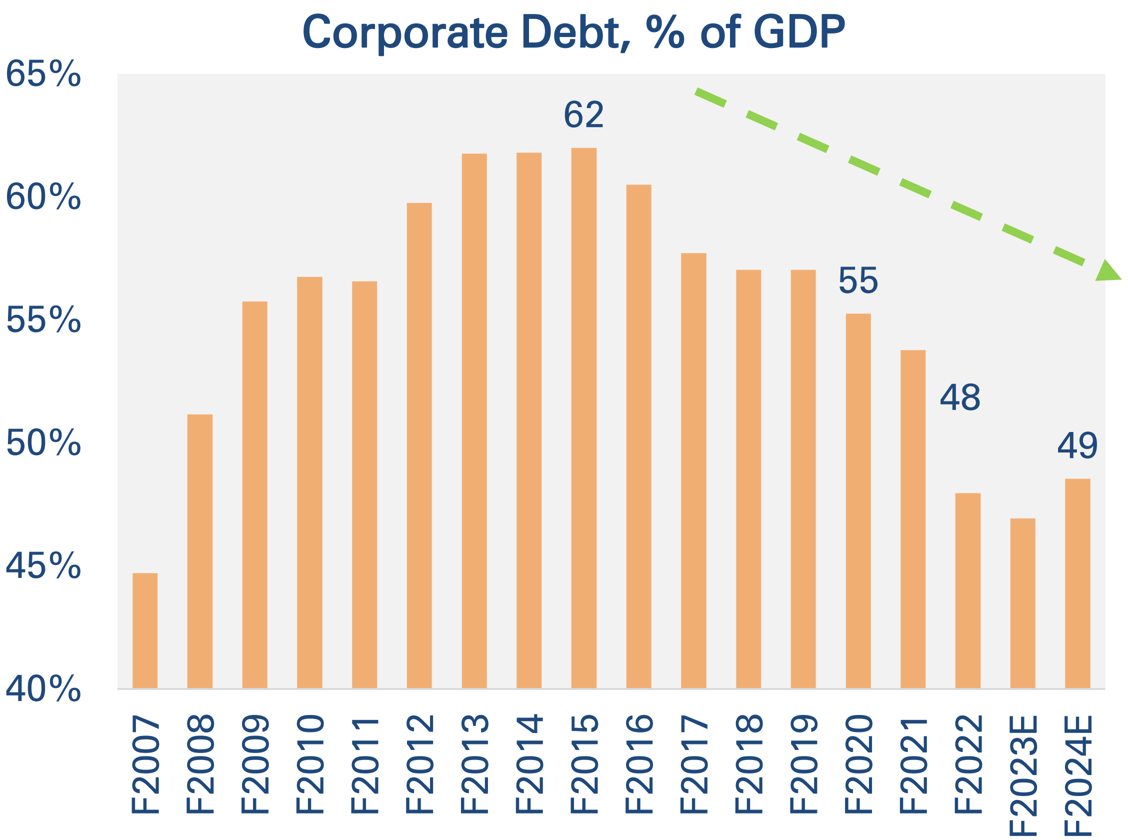
Parameters	Global Financial Crisis (2008-09)	Fed Taper Tantrum (2013-14)	Global Slowdown (FYTD 2022)
CPI Inflation (%)	7.9	9.4	5.8
Currency (INR against USD, %)	-21.3	-9.4	-8.5%
Exports (USD Bn)	167	312	500
Net FDI Flows (USD Bn)	22.7	16.1	58.8 (FY 2022)
Corporate Debt to GDP %	64.0%	67.5%	50.9%
Forex Reserves with RBI (USD Bn)	309.2	303.7	564.1

India has come a long way when it comes to economic resilience and is no more referred to as the 'Fragile Five'

Source: RBI, Press Information Bureau, JM Financial, Morgan Stanley. Financial Year data is sourced for 2008-9, 2013-14, 2020-21 & 2022-2023. FYTD: Financial Year Till Date. Past performance may or may not sustain in future. CPI – Consumer Price Index, FDI – Foreign Direct Investment, GDP – Gross Domestic Product. CPI data is considered for the month of March of respective Financial Years and For FYTD, Data as on November 30, 2022I. RBI: Reserve Bank of India

Debt levels are healthy and sustainable



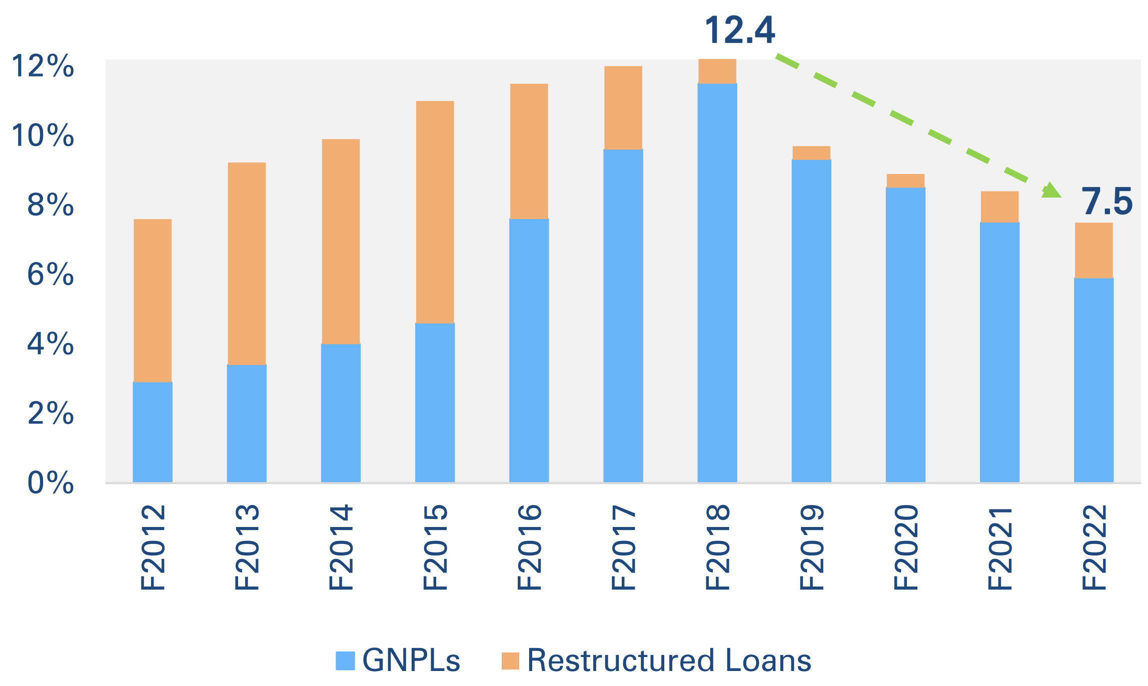


A lower Debt to GDP (Govt. + Corporate) can help India attain better financial stability

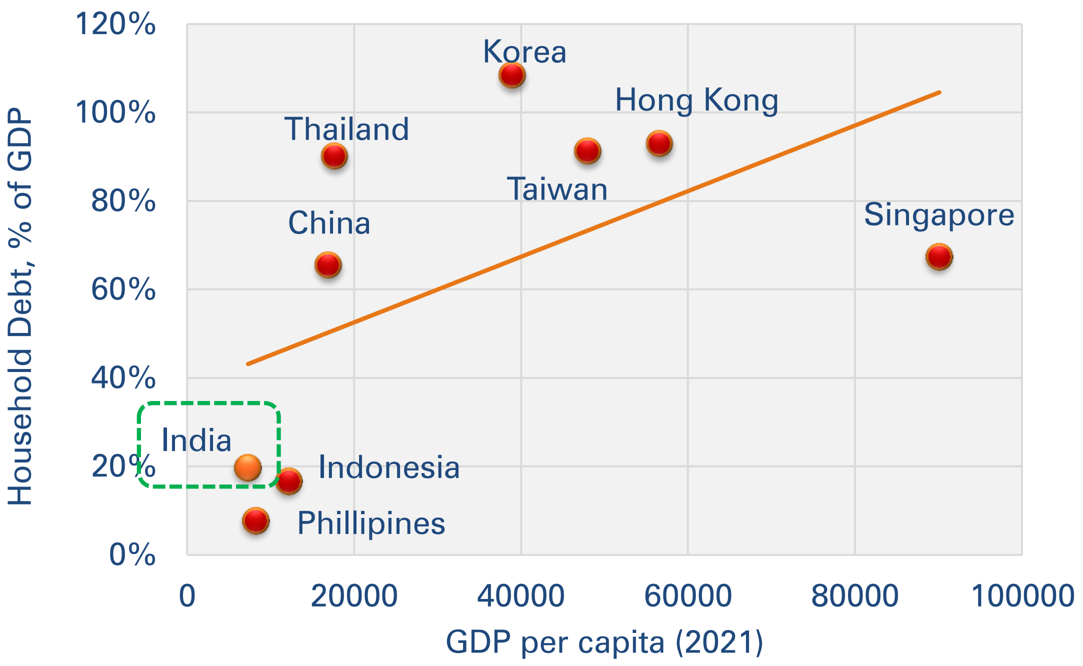
Source: Morgan Stanley and Nirmal Bang Institution. Past performance may or may not sustain in future. GDP – Gross Domestic Product, Govt. – Government, E – Estimates

Debt levels are healthy and sustainable

Banks have repaired their Balance Sheets in last few years



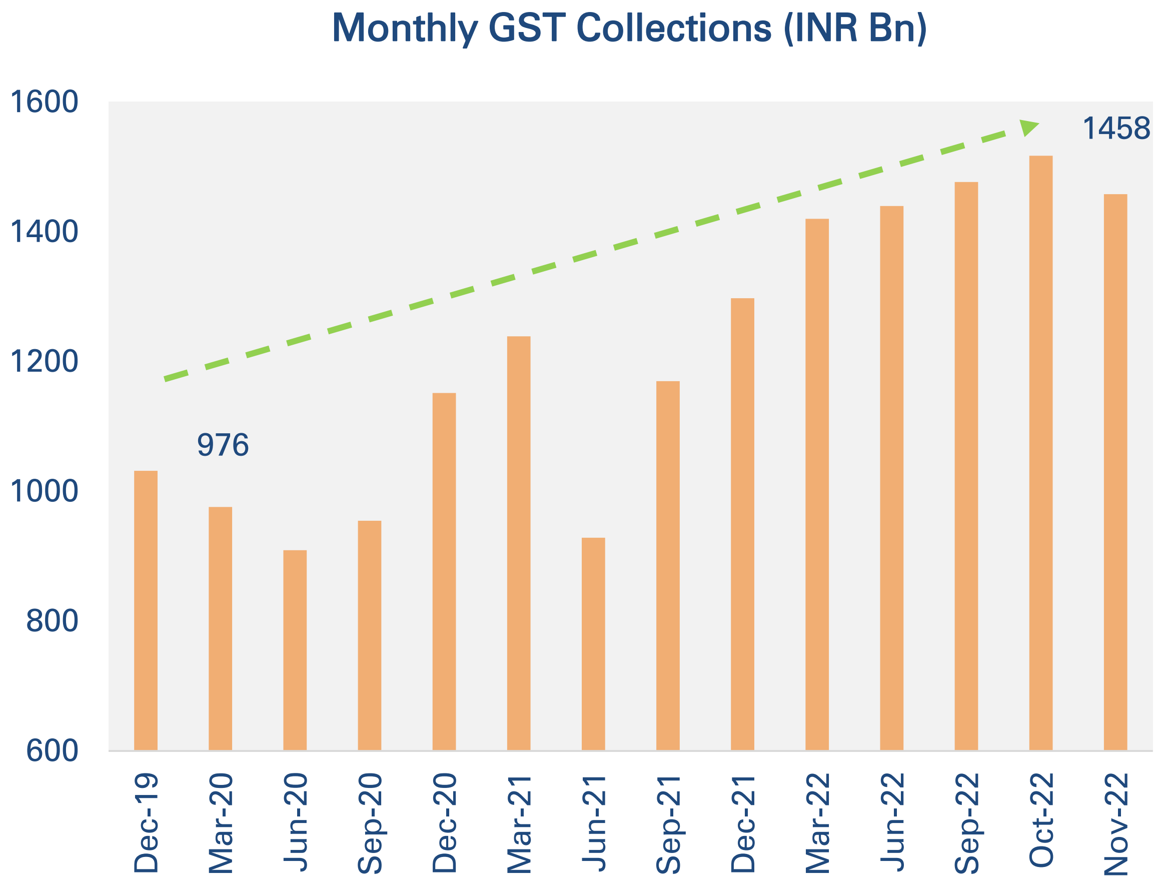
Household balance sheet is not leveraged compared to other countries

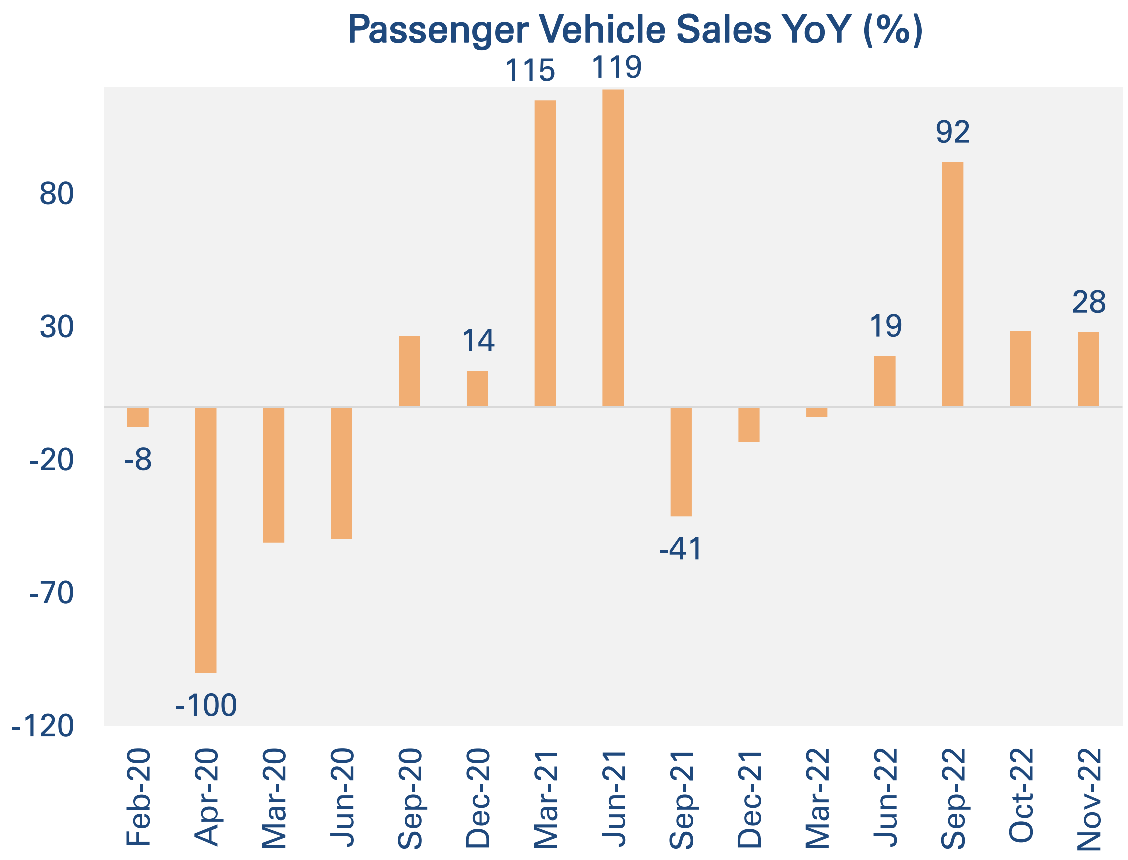


Lower stressed assets helps in freeing up Banks capital & lower household debt creates a conducive environment for consumer demand

Source: Morgan Stanley. GNPL: Gross Non Performing Loans. GDP: Gross Domestic Product

Economic recovery gaining strength





India not only swiftly recovered from the pandemic but is also experiencing persistent rise in economic activities

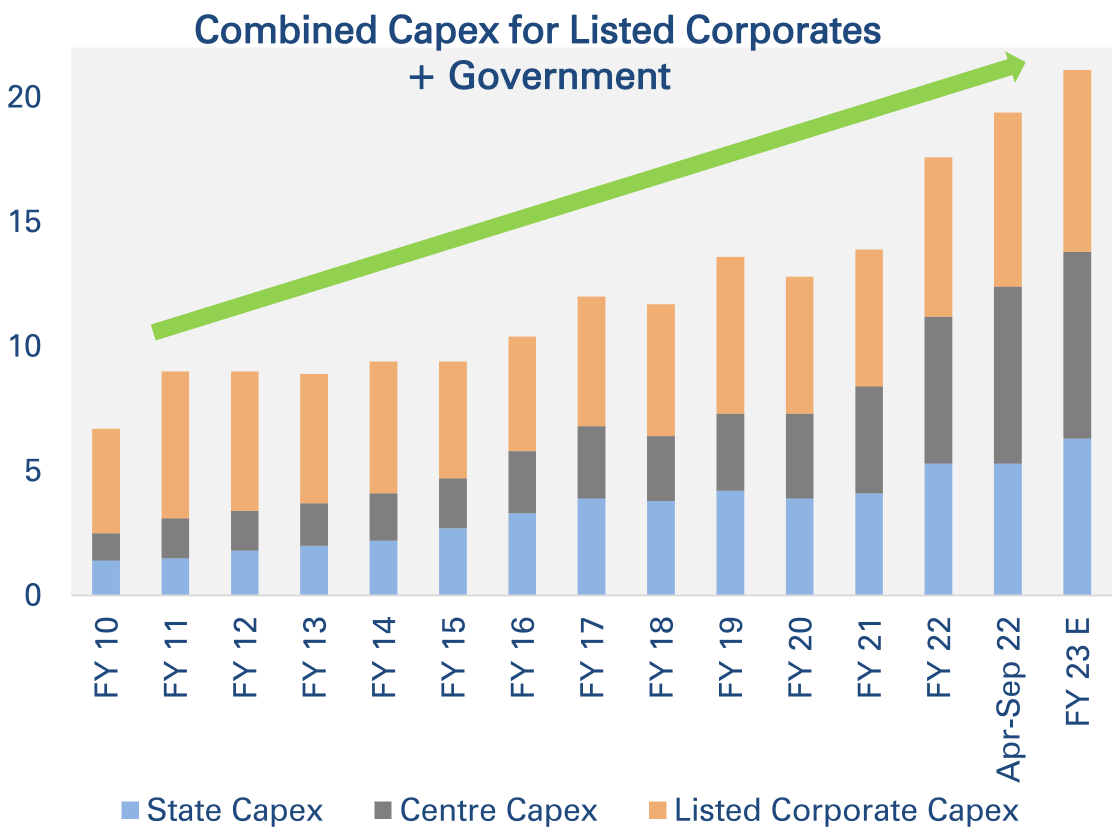
Data Source: Nirmal Bang Institution, Union Ministry of Finance and Elara Capital. GST: Goods and Service Tax, YoY: Year on Year

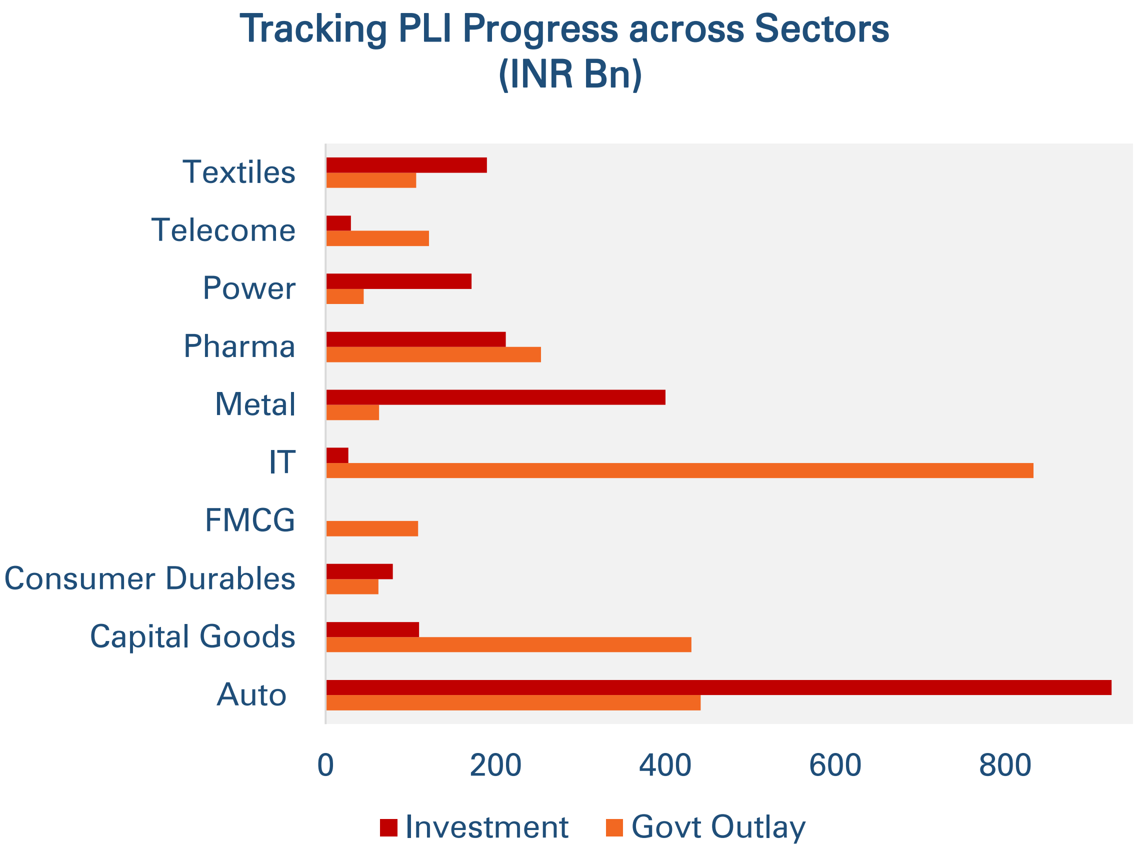
Reforms are now showing results

Formation of Monetary Policy Committee (2014)	Liberalization of FDI Limits (2014)	Inflation targeting (2016)	Real Estate Regulation Act (2016)
Insolvency and Bankruptcy Code (2016)	Demonetization (2016)	Financial Inclusion (2017)	Goods and Services Tax (2017)
Privatization of SOE's (2018)	Corporate Tax Cuts (2019)	Production Linked Incentive Scheme (2020)	Labour Codes (2020)

Figures in brackets show the year of passage of reform; SOE's refers to State Owned Enterprises

Capex is picking up

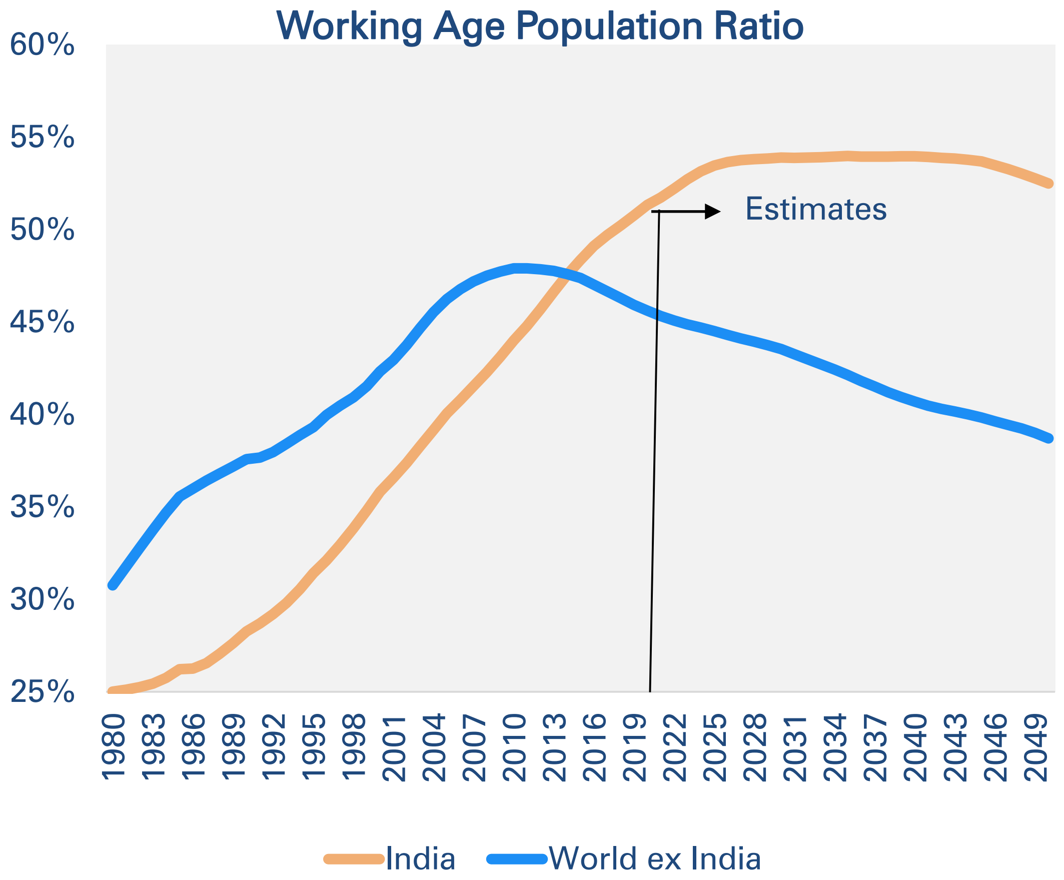




Govt. incentive programs like PLI is rejuvenating the Private Capex cycle

Source: Morgan Stanley research. Capex – Capital Expenditure, E - Estimate, PLI – Production Linked Incentives, IT – Information Technology

Consumption growth to follow



India has larger scope to penetrate in white goods consumption with Rising income levels

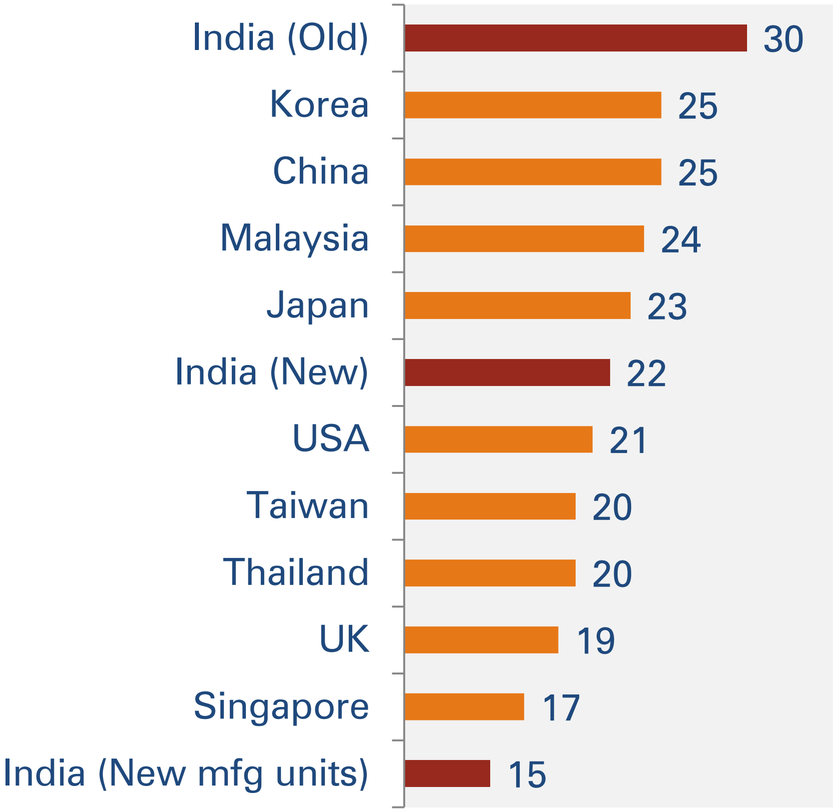
Products/ Services	India	China	USA
Auto	4%	15%	81%
Outbound Trips	6%	9%	42%
Air Conditioners	8%	60%	90%
Refrigerators	18%	94%	100%
Smartphone Users	37%	54%	83%
Internet Users	58%	60%	95%

'Capex + Rising Working Age Population' coupled with wider scope for penetration can accelerate India's Consumption Engine

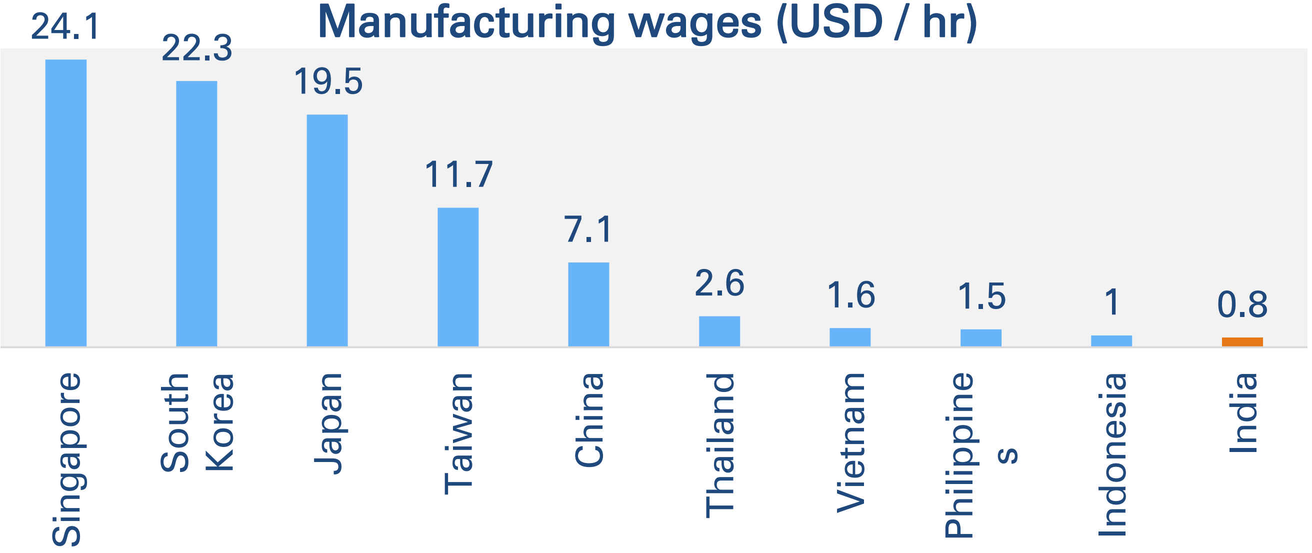
Source: OECD and Morgan Stanley research, FDI: Foreign Direct Investment, GDP: Gross Domestic Product

India - an attractive destination for manufacturing

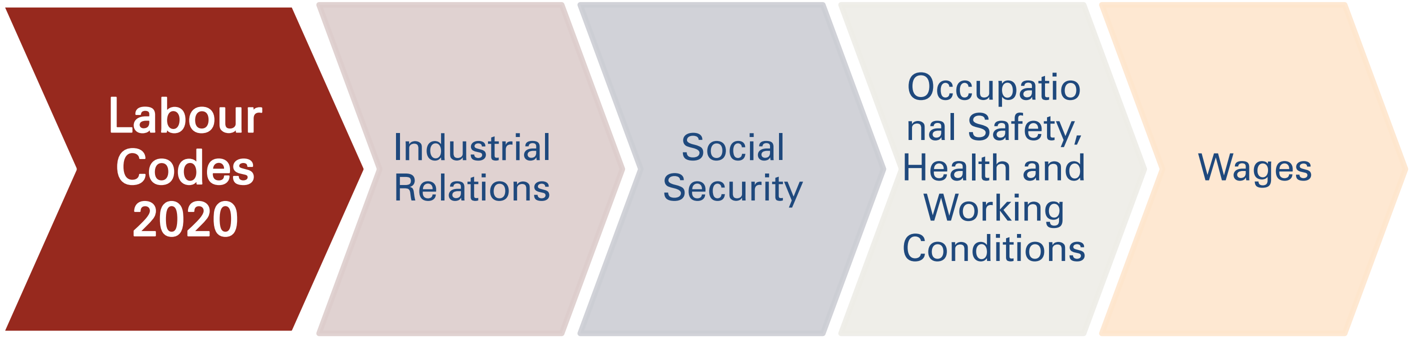
Corporate Tax Rates (Base Rate %)



Manufacturing wages (USD / hr)



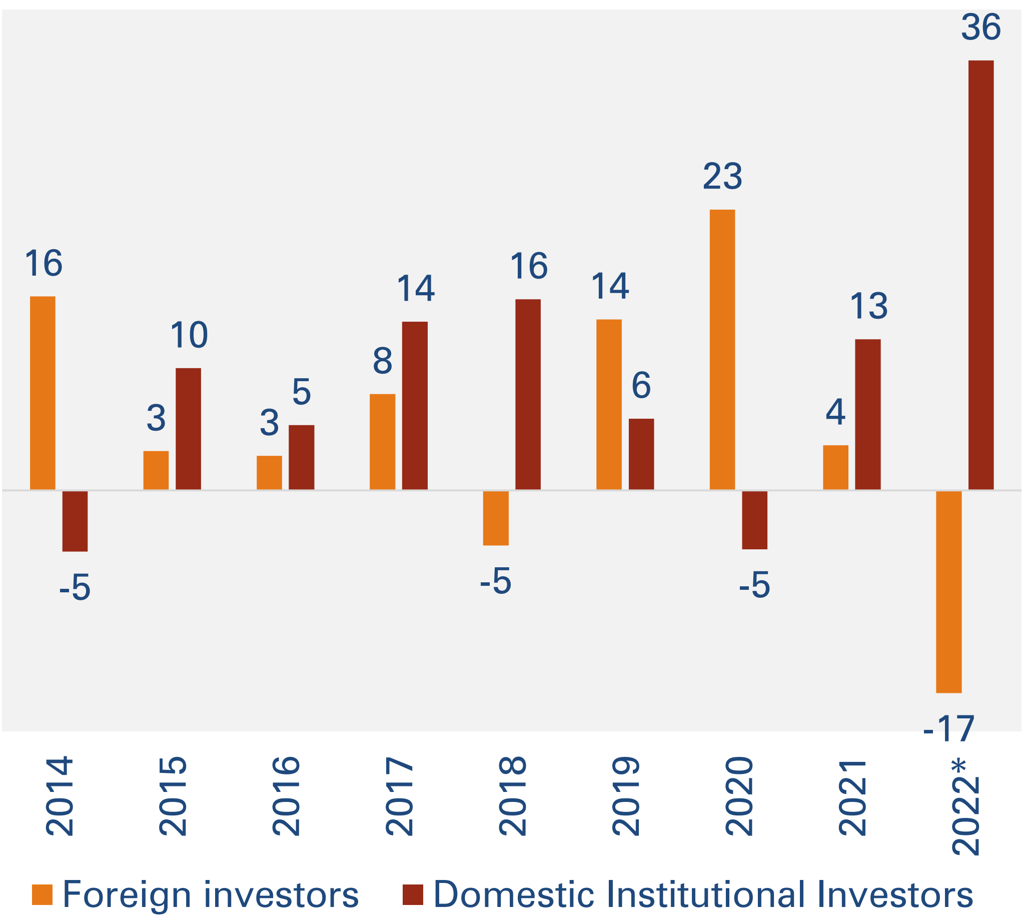
Simplified labour code



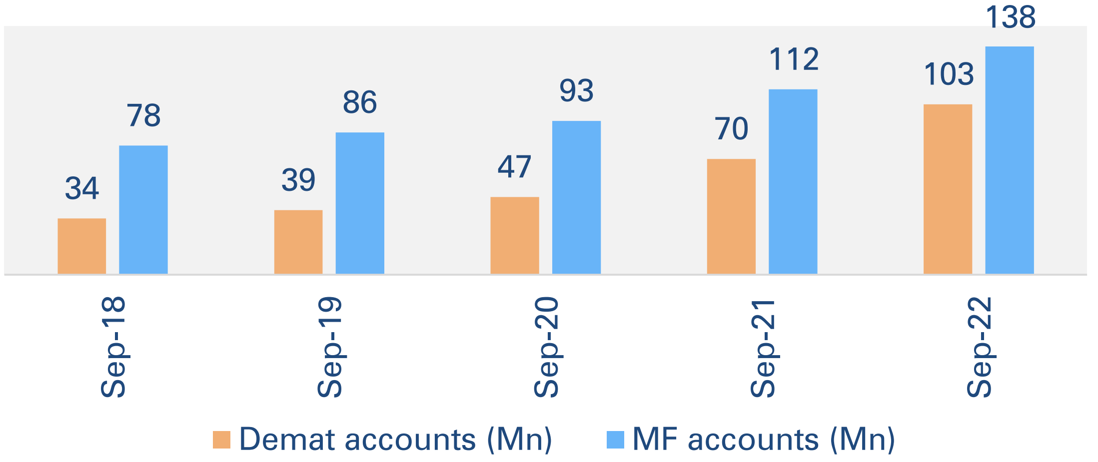
Source : Morgan Stanley research, Government of India; Manufacturing wage data is as of 2021

Domestic participation in equity markets remain strong

Net Flows (USD bn)

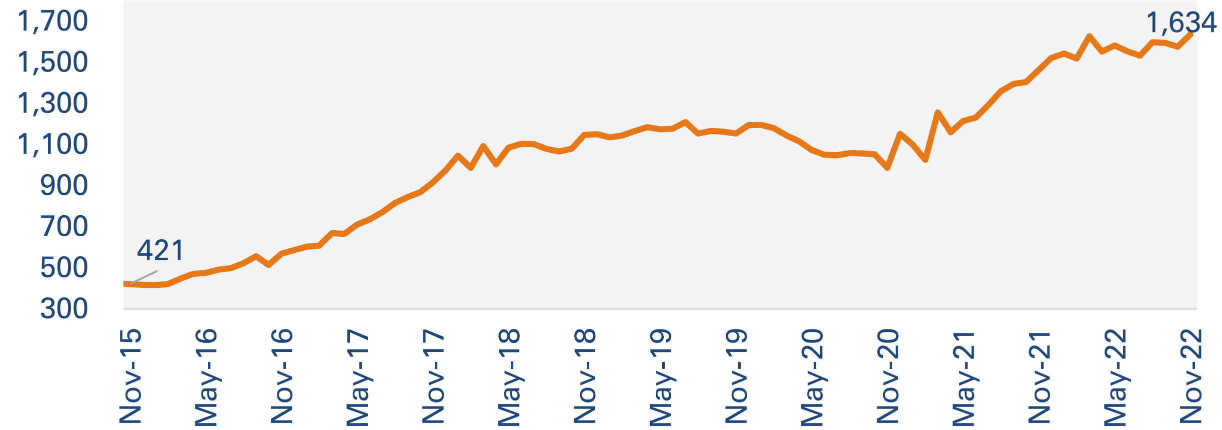


Sharp uptick in new trading and mutual fund accounts (Mn.)



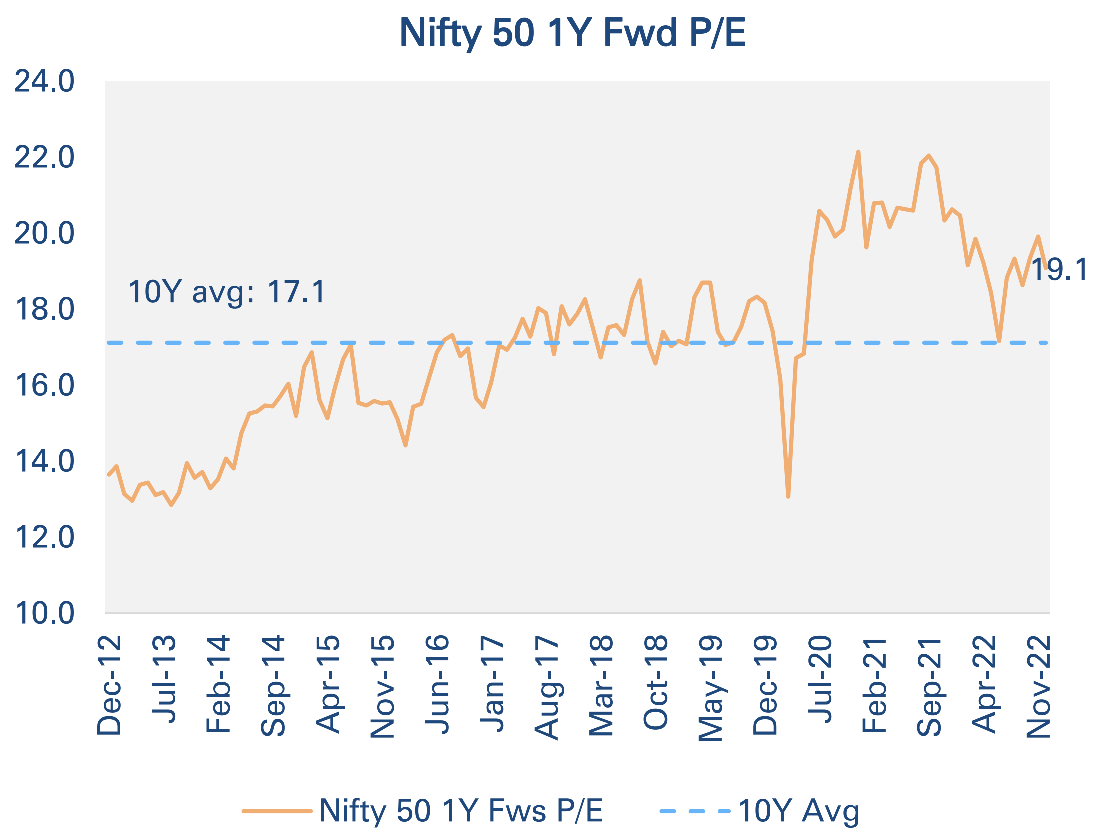
USD mn.

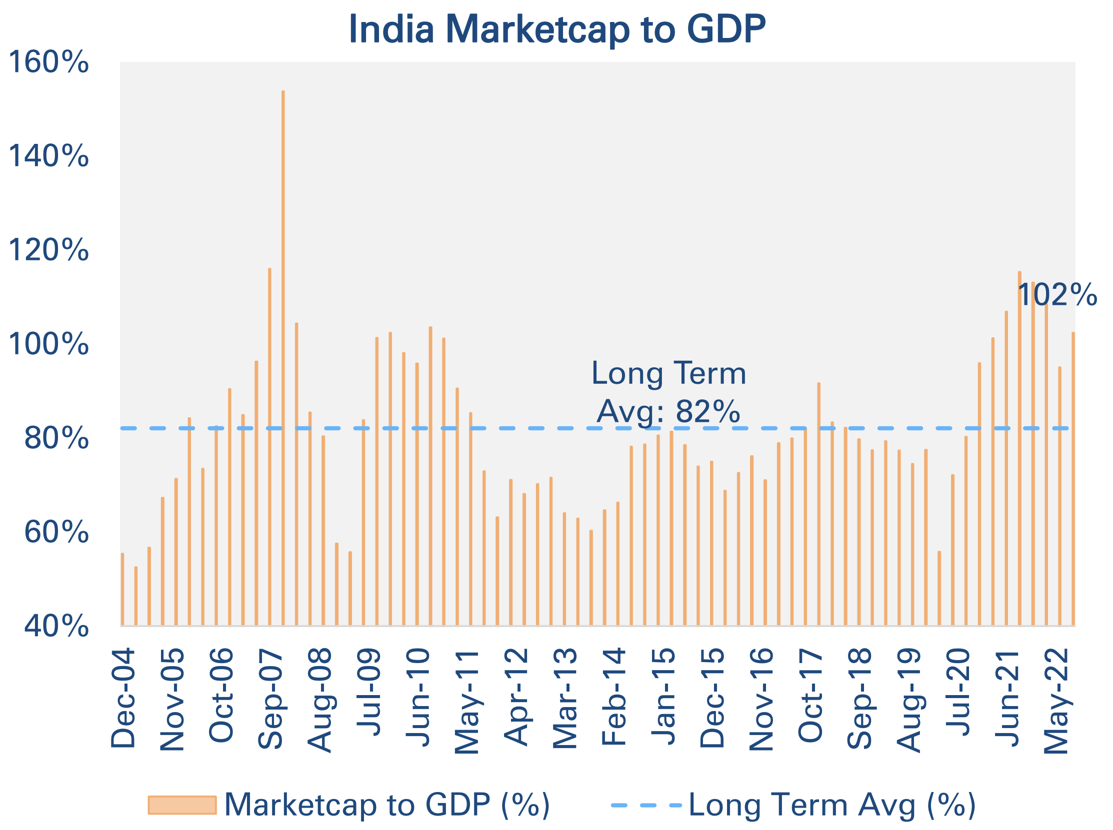
Monthly SIP flows ~4x since 2015



Source: CEIC, Haver, Morgan Stanley research, UBS research; *CY2022 flows as of December 29, 2022

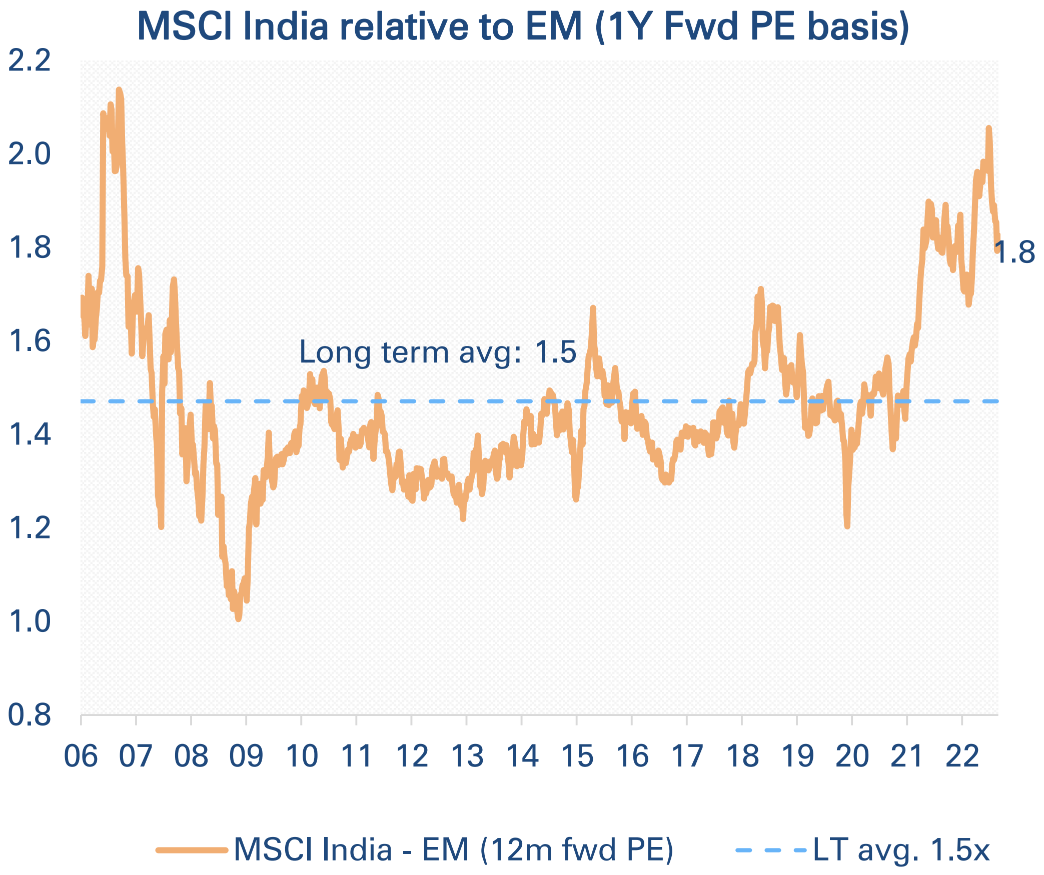
Valuations are not cheap

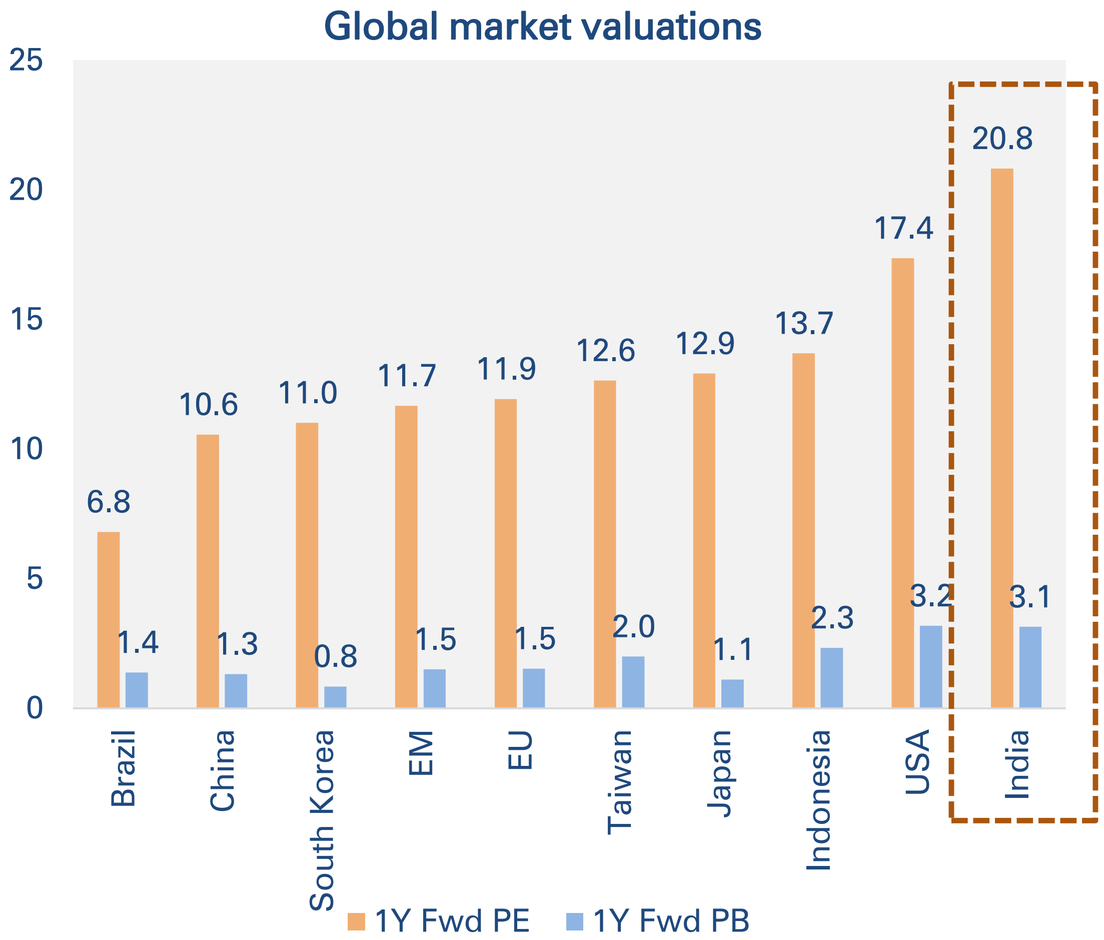




Source: Bloomberg, Valuation data as of December 30, 2022; Market cap to GDP data as of September 30, 2022

India’s premium to EM is above long term averages

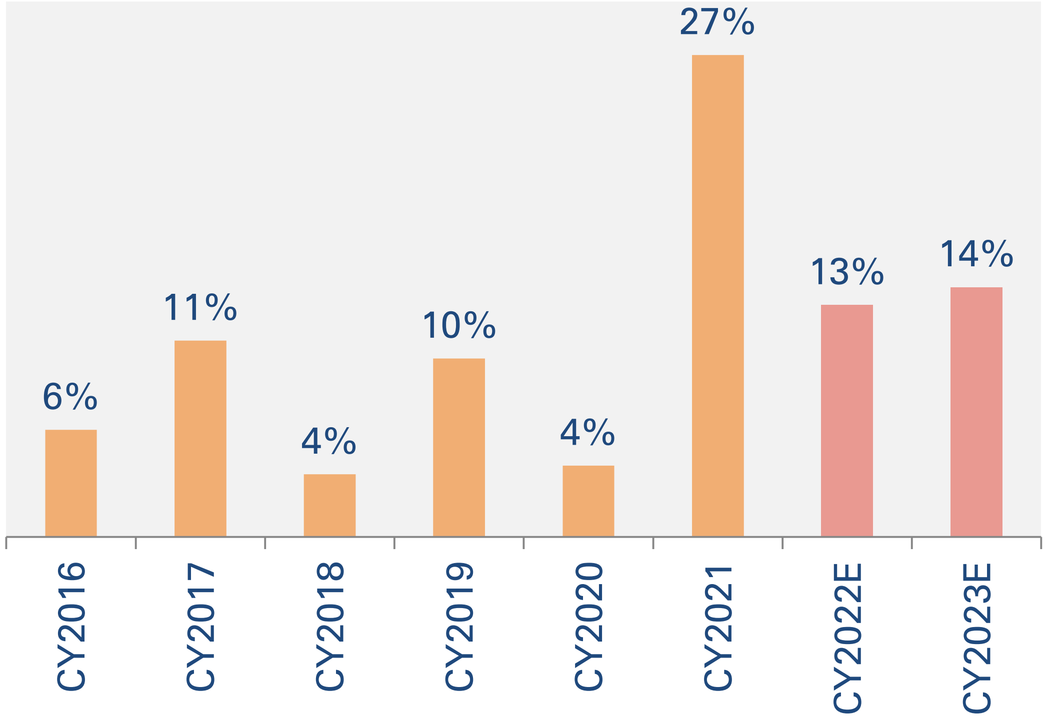




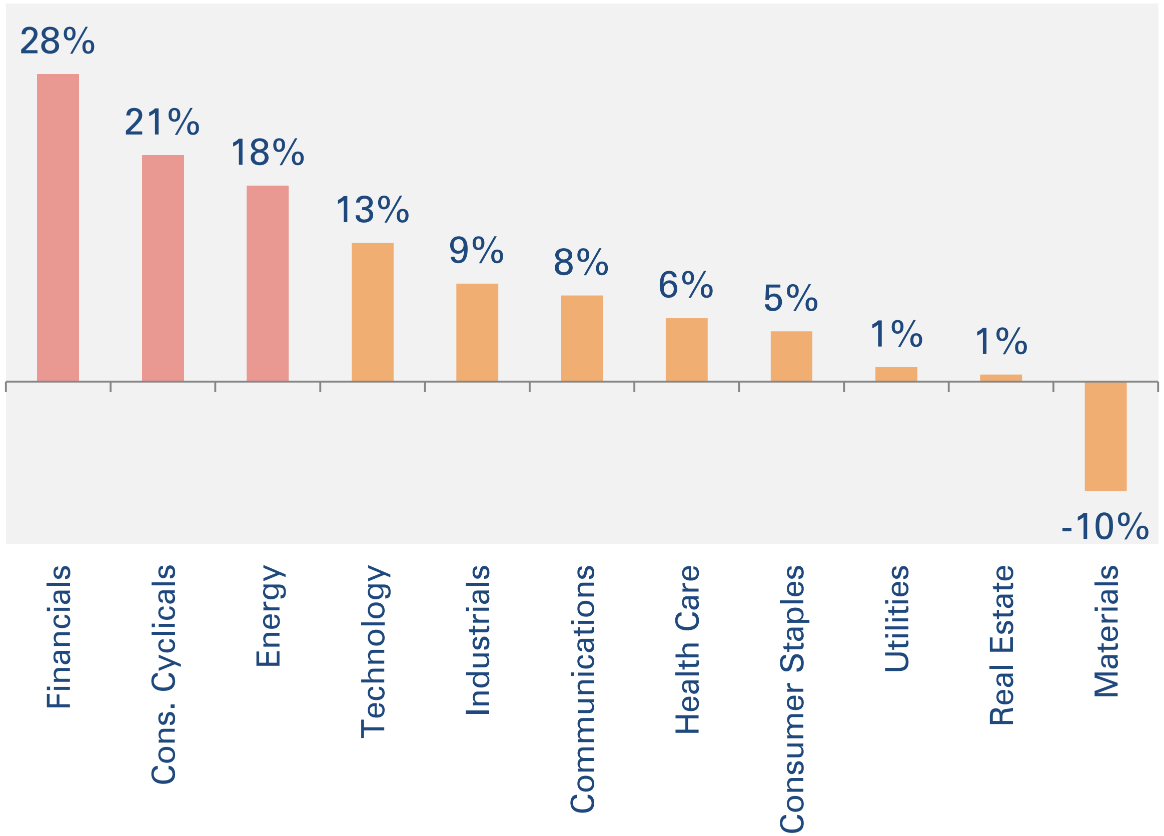
Sources: UBS research, Morgan Stanley research; Data as on December 30, 2022; Indices used: India – Nifty 50, Brazil – Ibovespa , Singapore – Strait Times, China, SSE Composite, Taiwan – Taiwan Capitalization Weighted, US – S&P 500, Germany – DAX Index, Japan – Nikkei 225.

Decent earnings growth prospects

Earnings growth for MSCI India Index (YoY)



MSCI India CY2022-23E EPS growth contribution by Sector (%)



Financials, Energy and Discretionary to drive earnings growth

Source: Bloomberg, Goldman Sachs Research;

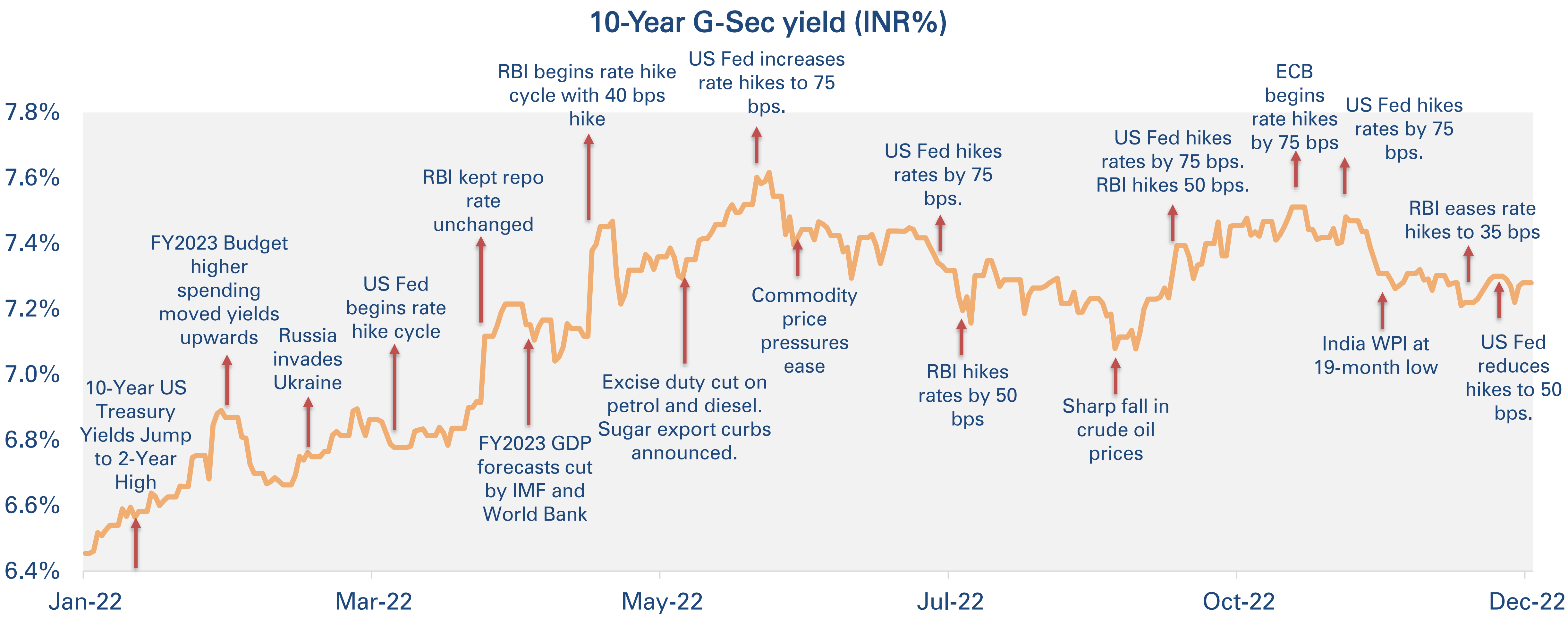
Annual market outlook

- India among the best performing equity market in 2022
- India is the most promising investment opportunity for long term investors – structural, fundamental, healthy external position, reform oriented and likely tailwinds from global 'China +1' diversification strategy
- For short term investors, valuations are elevated hence the upside could be capped; however, downside also limited due to strong domestic participation
- For long term investors, volatility and corrections should be used as an opportunity to accumulate Indian equities for superior risk adjusted returns
- Prefer large caps over mid and small caps; positive on domestic oriented sectors like **Financials, Retail, Auto, Infrastructure, pharma and select consumer oriented sectors**
- Continue to invest in companies with **strong balance sheet, agile management, low leverage and sustainable business models**

Indian fixed income

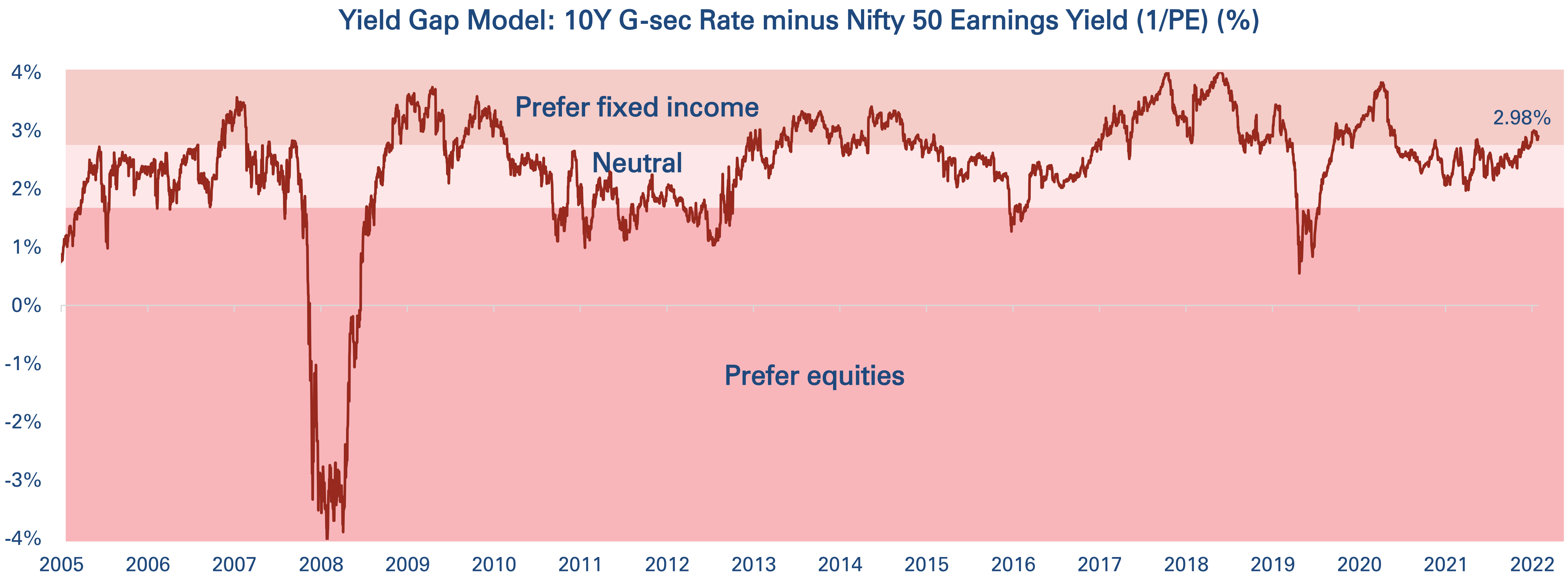
An attractive opportunity for 2023

Recap of 2022 in fixed income markets



Data as on Dec 19, 2022. Source – RBI, www.federalreserve.gov, MOSPI. RBI – Reserve Bank of India, CRR – Cash Reserve Ratio, OMO – Open Market Operations, GDP – Gross Domestic Product, G-SAP – G-Sec Acquisition Programme, VAT – Value Added Tax, VRRR – Variable Rate Reverse Repo. Past performance may or may not sustain in future

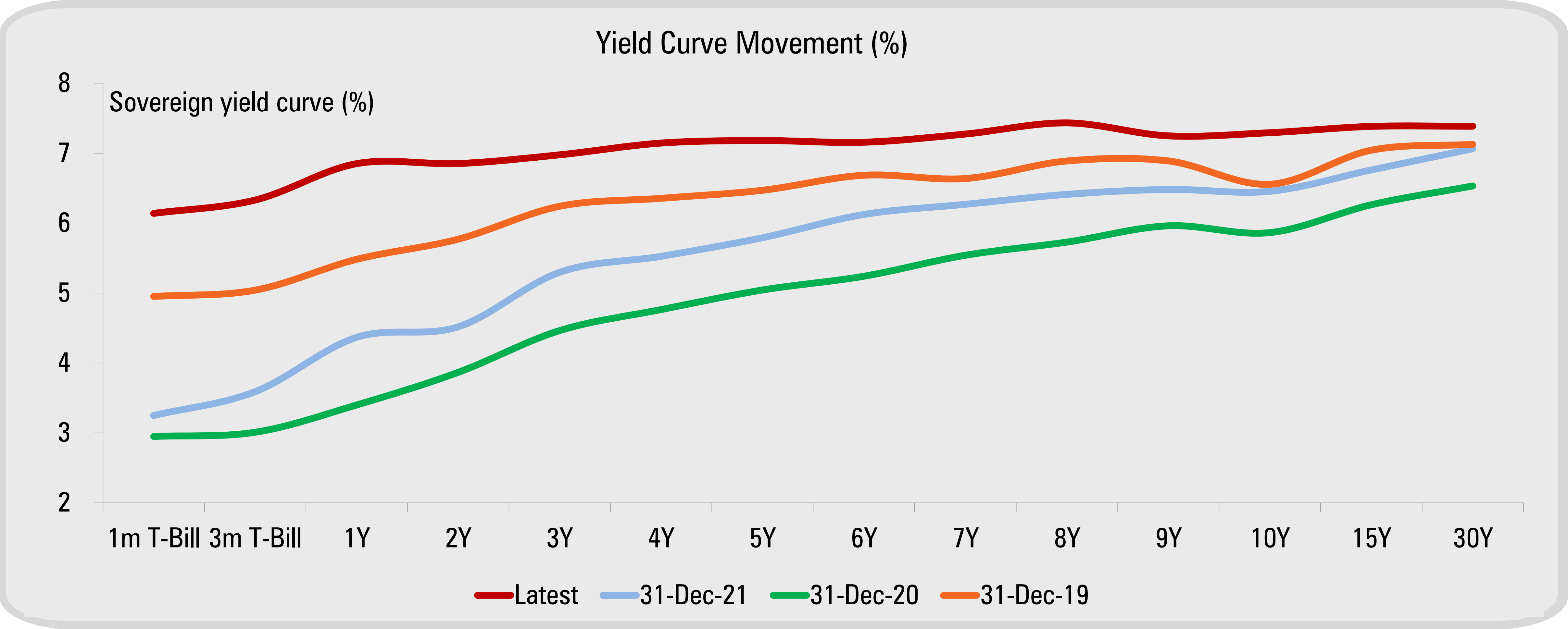
2023 – a year of fixed income



Equity Market Valuations and Debt instruments yields moving higher, the relative attractiveness of fixed income investment has increased

Data as on December 27, 2022. Source – Kotak Research, P/E – Price to Earnings Ratio. The Yield to Maturity (YTM) mentioned is based on scheme portfolio dated Dec 23, 2022. YTM is the rate of return on a bond if held until maturity. This should not be considered as an indication of the returns that maybe generated by the scheme. The securities bought by the scheme may or may not be held till their respective maturities.

2023 – a year of Fixed Income - Yield curve movement



With RBI hiking rates aggressively, the whole yield curve has shifted upwards, making the yield on the fixed income space attractive

Data as on December 14, 2022. Source : IIFL Research

2023 – a year of Fixed Income - Yields much better now

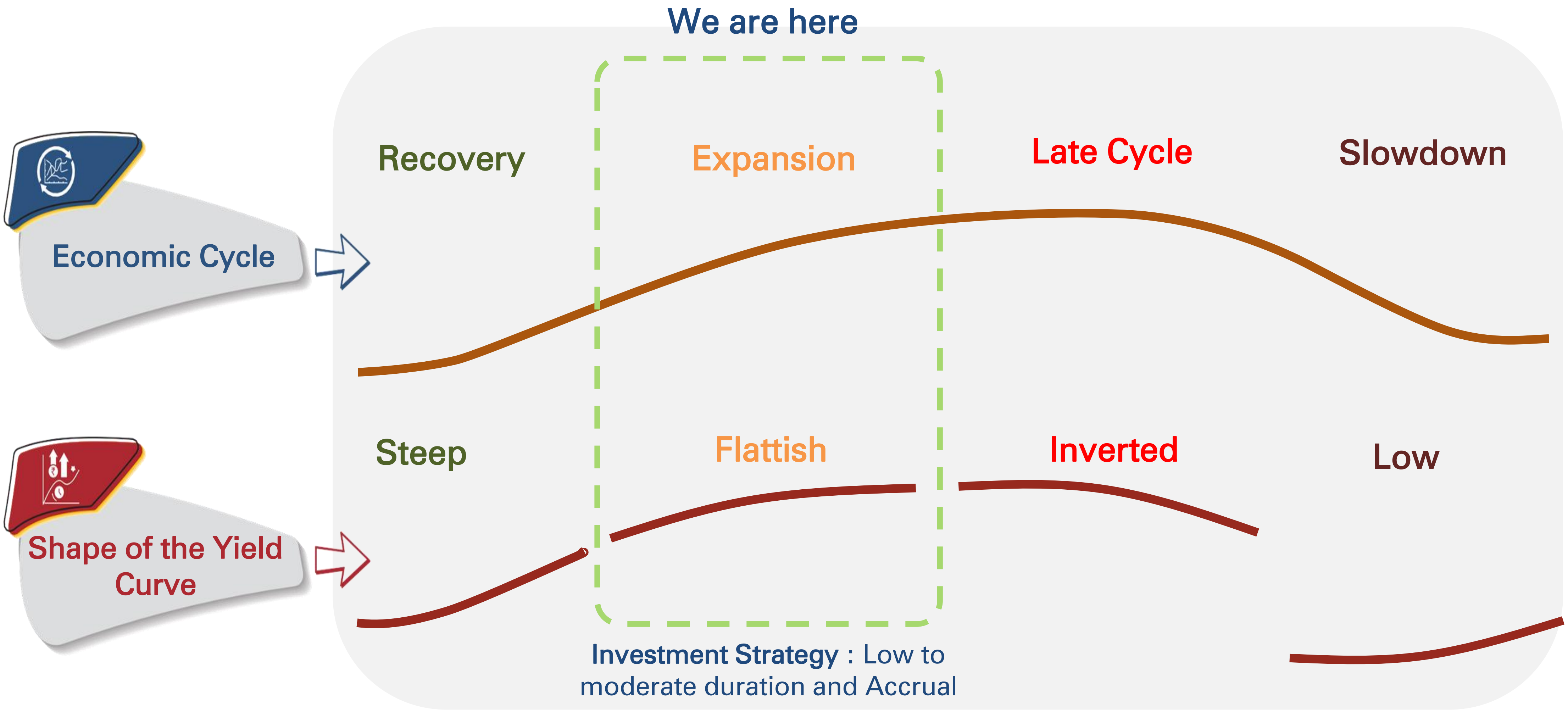
Instruments/ Investment Avenues	Rate as on Sept 30, 2021 (%)	Rate as on Dec 23, 2022 (%)	
Repo Rate	4.00	6.25	2.25%
Traditional Instrument	5.40	6.75	1.35%
6 Months CP	4.05	7.65	3.60%
1 Year AAA	4.20	7.55	3.35%
2 Year AAA	4.80	7.57	2.77%
3 Year AAA	5.30	7.58	2.28%

Capital Market

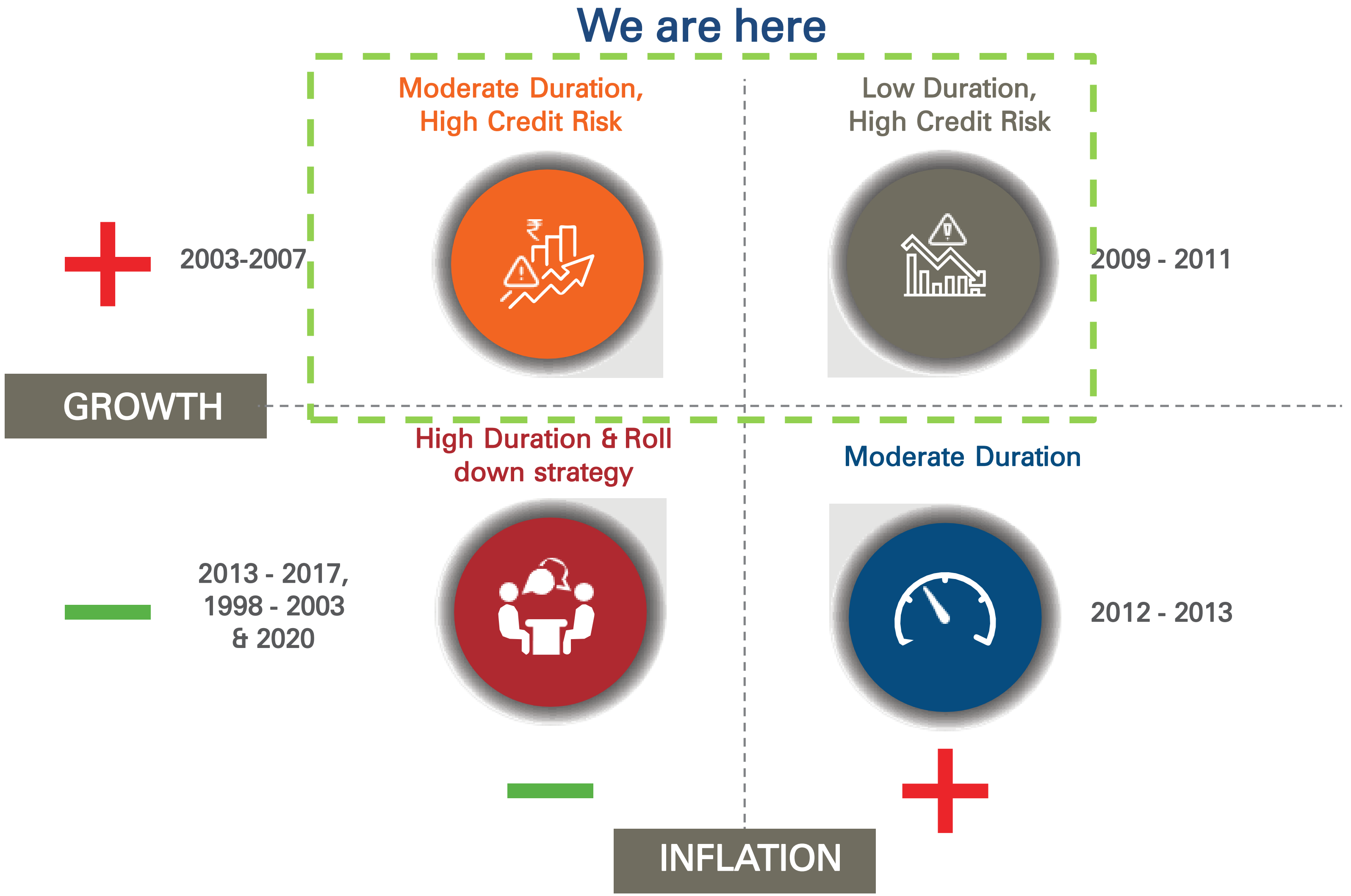
The transmission of rates has happened efficiently when it comes to capital markets compared to traditional investment avenues

Traditional Instrument has the highest safety for Principal invested. There is no assurance or guarantee of future performance of mutual fund schemes. The rates/yields of traditional investments are dependent on various factors and market conditions, such factors can be updated from time to time.
The Yield to Maturity (YTM) mentioned is based on scheme portfolio dated Dec 23, 2022. YTM is the rate of return anticipated on a bond if held until maturity. This should not be considered as an indication of the returns that maybe generated by the scheme. The securities bought by the scheme may or may not be held till their respective maturities. For traditional instrument, regular term deposit for 3 years is considered. CP – Commercial Paper. Past performance may or may not sustain in future

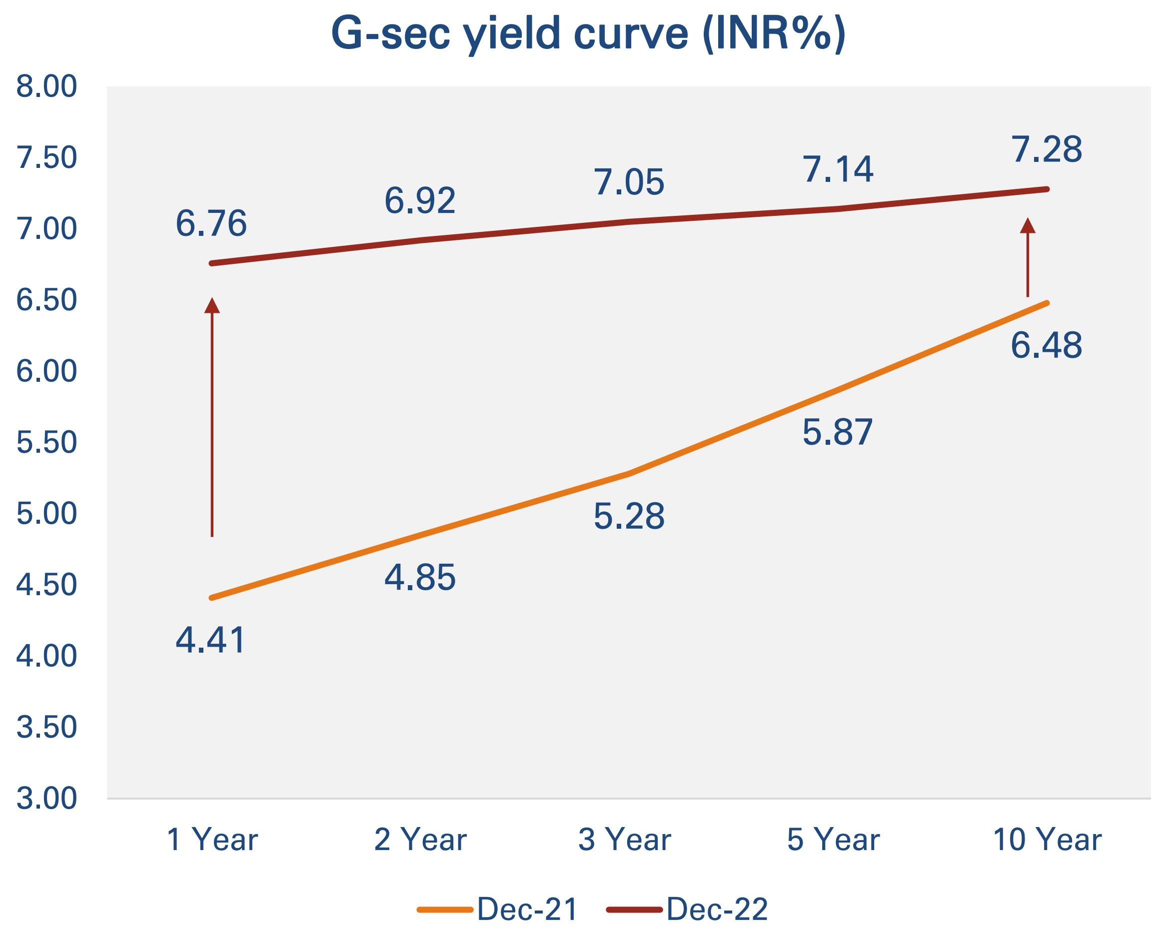
Economic cycles and yield curves

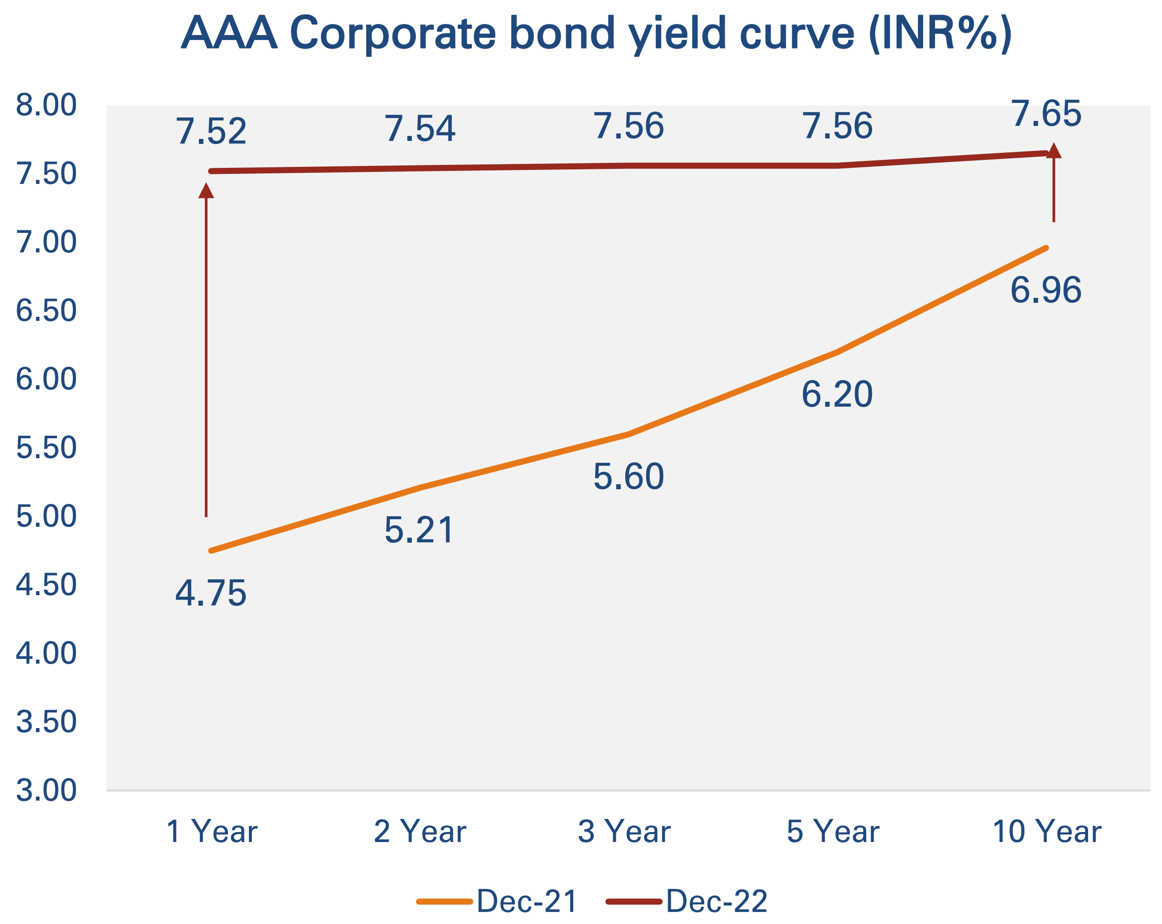


Product Strategy in different cycles



Yield curve is flat making shorter end attractive

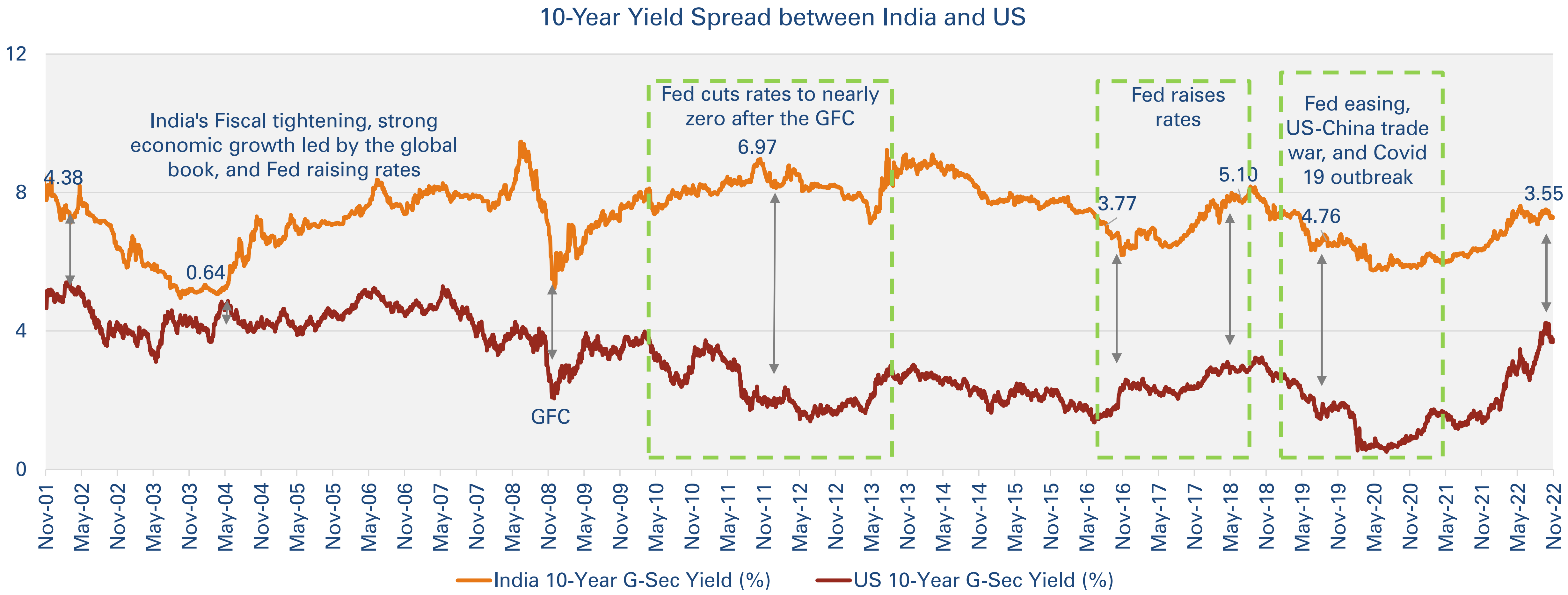




Short-end of the yield curve has turned attractive post rate hikes, this has resulted in term premium collapsing and making the long-end unattractive

Data as on November 30, 2022; CRISIL Research

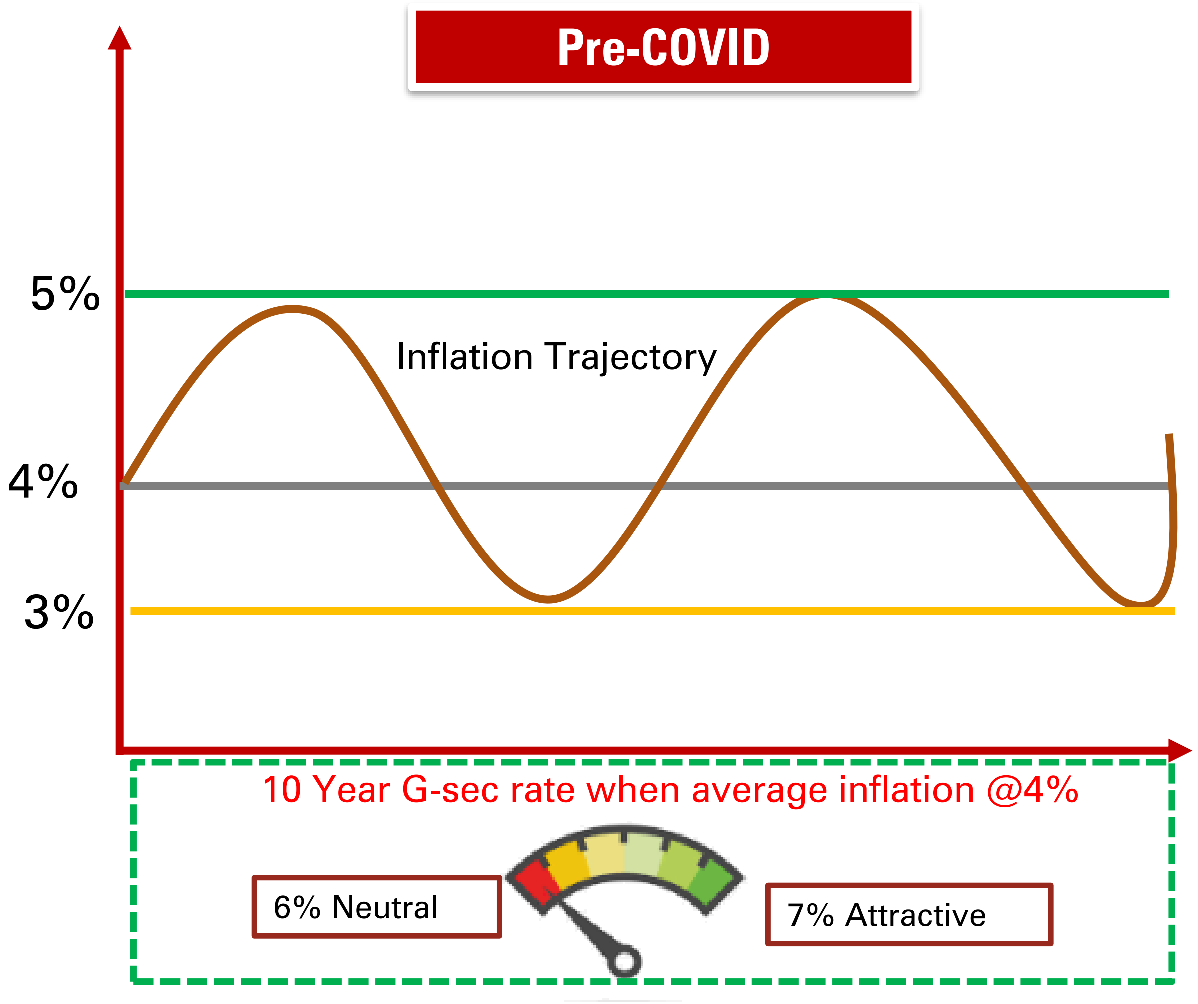
India 10-year Gsec yield vs US 10-year Treasury

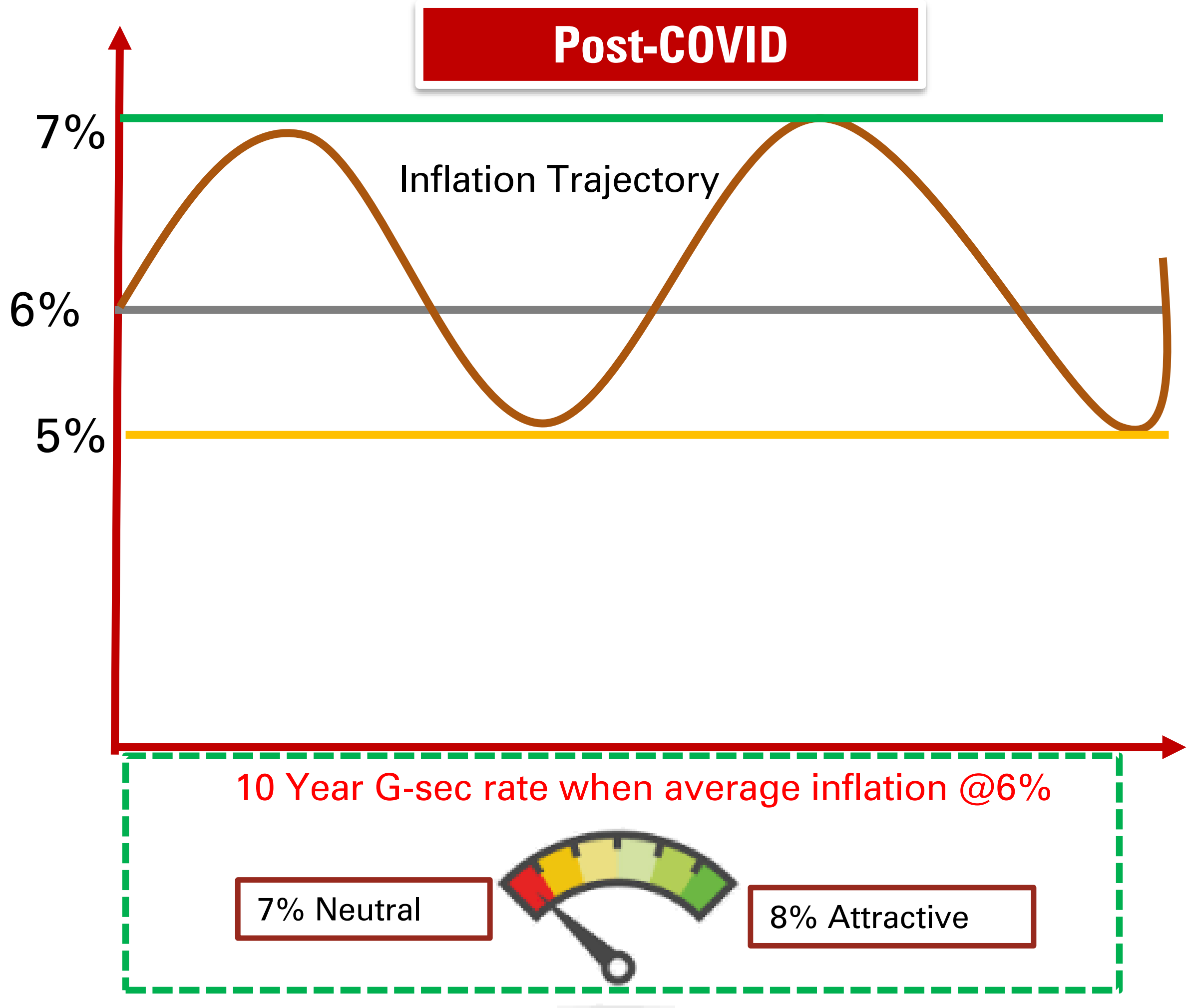


Yield differential between US and Indian G-secs are at their least since June 2009, may result in volatility in the longer-end of the yield curve

Source: CRISIL Research, Data as on November 30, 2022;

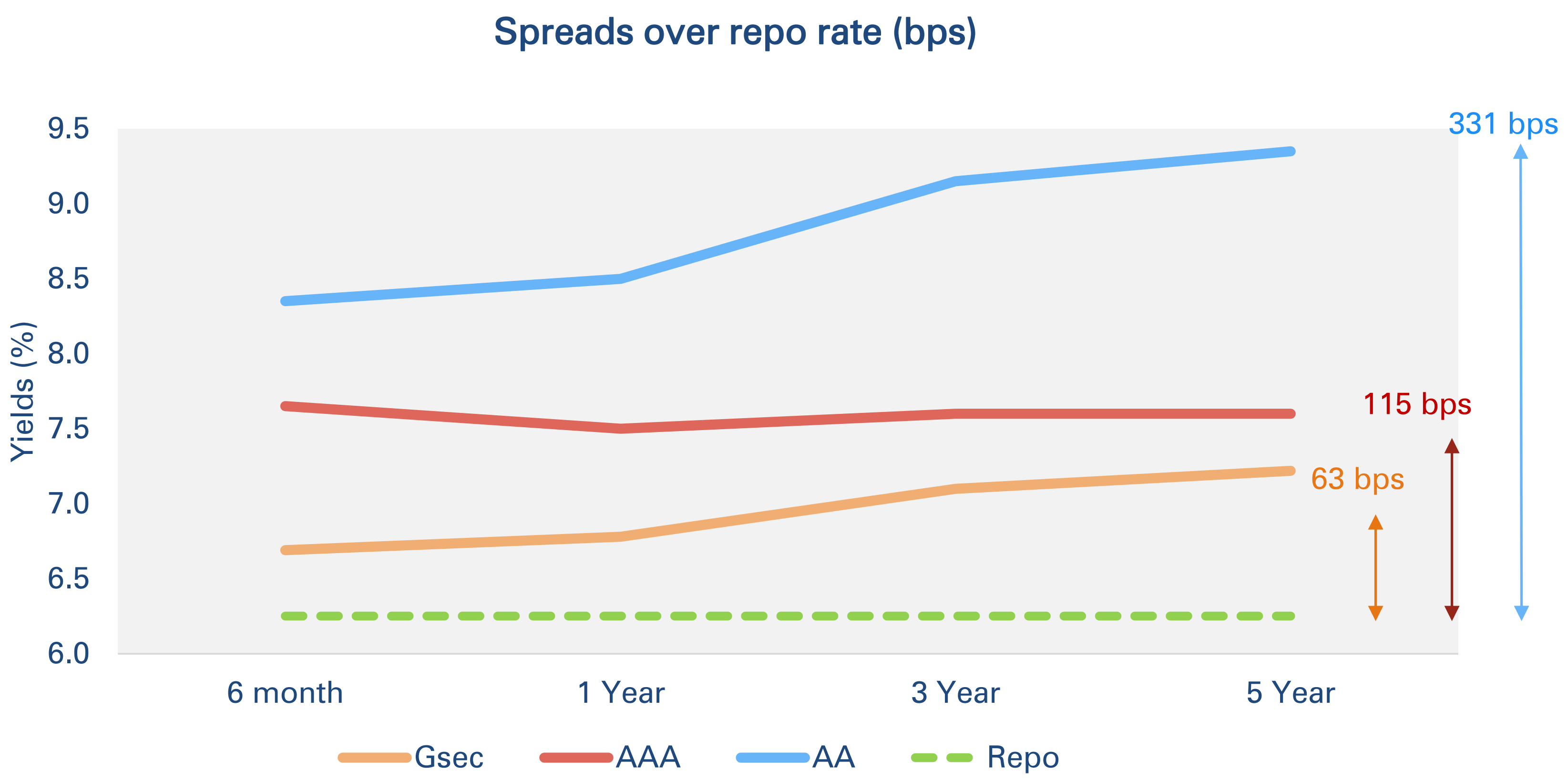
Case for low to moderate duration – change in inflation goal post





Last few years, RBI focus was to keep inflation closer to 4%, but now RBI is comfortable with 6% inflation.
This would lead to the yields on 10 Year G-secs moving higher

Accrual strategy to drive returns



The yield curve is currently flat with low probability of rate cuts
Prefer higher spread assets with higher accrual in such a scenario

Data as on December 27, 2022; Source: CRISIL Research

Fixed income outlook

- In CY22, fixed income markets remained volatile due to geopolitical issues
- In Dec-22, domestic bond yields have eased due to a sharp decline in crude oil prices, softer than expected inflation prints and signs of slowing rate hikes by Global Central Banks
- RBI has hiked rates by 225bps in the interest rate cycle that commenced in May 2022 ; we expect another 25bps rate hike in the Feb 2023 policy after which RBI could pause
- RBI is now more focused on growth and comfortable with inflation hovering~ 6%
- From a valuation perspective, Indian fixed income is more attractive compared to Indian equities as bond – equity earnings yield gap is at decadal highs
- The yield curve currently is flat, hence prefer being positioned in the short end of the curve. Carry in the 1-3 year segments are attractive favoring an accrual strategy going ahead
- INR has depreciated less compared to the broader basket of currencies, providing some scope for further depreciation to make it competitive

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