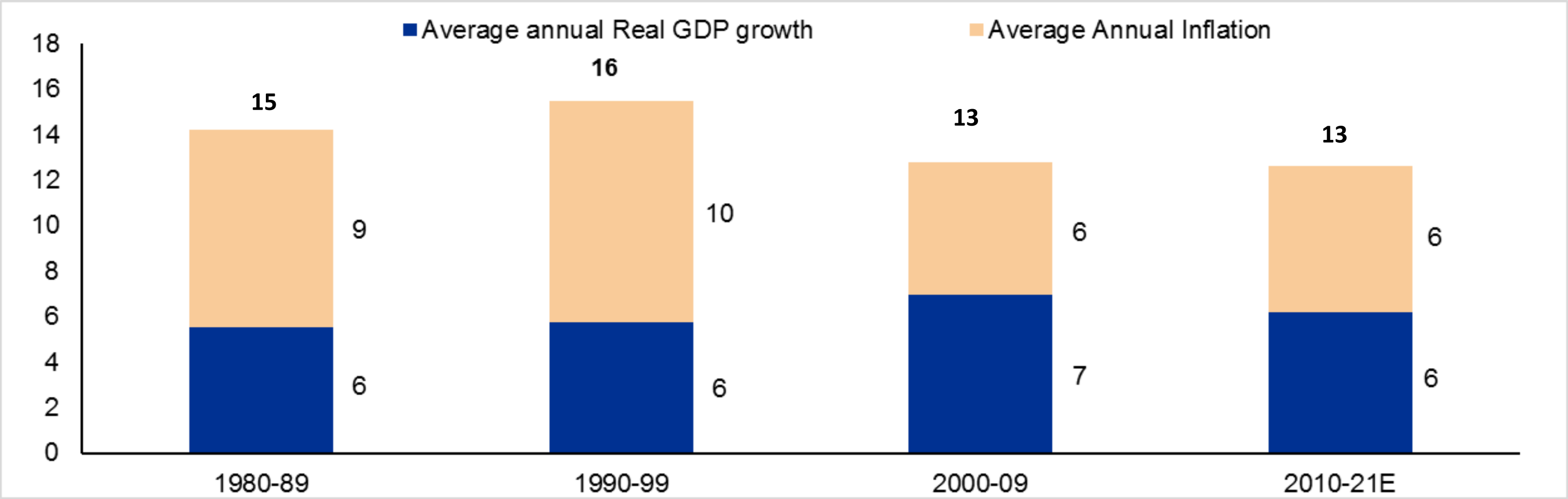
Economy & Equity Market Outlook

Apr 2022

Indian economy has grown steadily despite several challenges



1980-89
Operation Blue Star
Rajiv Gandhi Government
Birth of IT Industry
Rise of BJP in Indian Politics
Advent of TV, Maruti Car

1990-99
Global Oil Crisis - Gulf War
BoP Crisis, Reforms commence
Asian Crisis, Era of coalitions
1st BJP govt., Kargil Conflict
Growth of IT, Satellite TV, Mobiles

2000-09
Violence in Gujarat post Godhra
9/11 , Dotcom Bubble bust
Growth of Indian Generics Cos.
10 year Congress rule
Lehmann Crisis, QE

2010-21E
Coal, NIMO etc. scandals
QE Tapering, PIGS, Greece
High FD & CAD, high inflation
BJP Government elected twice
Demonetisation, GST, Make in India
Covid-19
Russia-Ukraine war

Source : IMF Data, Estimates are IMF estimates; For 2010-2021E data taken till 2021E to normalize the impact of 2020 which was an abnormal year

India Economy : Long Term Growth drivers

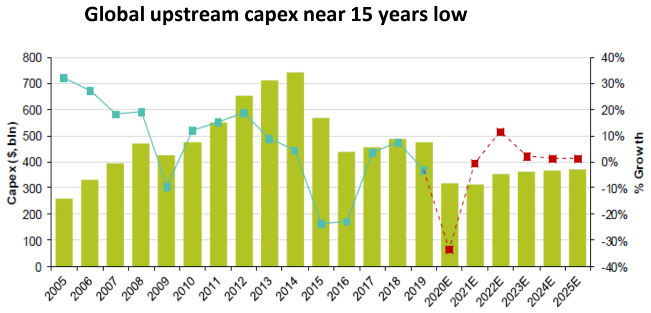
- Excellent demographics and large availability of skilled, young, English speaking and competitive manpower (~65% of Indian population is in 15-59 years age bracket)
- Abundant natural resources except oil
- Global leadership in services
- Manufacturing opportunity – Reducing competitiveness of China & desire of MNCs to reduce dependence on China is opening up manufacturing opportunity for India, for a second time^.
- Low penetration of consumer goods, improving affordability over long term and large unmet needs of infrastructure
- Rapid adoption of digital and a vibrant startup ecosystem
- Favourable regulatory environment and improving ease of doing business ranking (from 134 in 2014 to 63 in 2020)
- Better coordination between Government and business; Government's role as an enabler of business increasing and presence in businesses to reduce over medium to long term

While events like 9/11, Global Financial crisis, Covid-19 etc. get disproportionate attention, it is these silent forces that drive growth

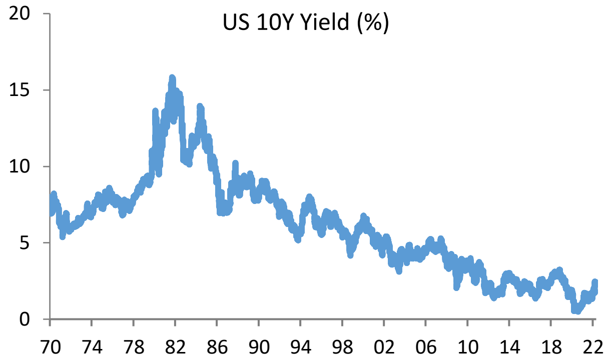
^ first time was during early 2000, when China gained significant market share in global merchandise trade

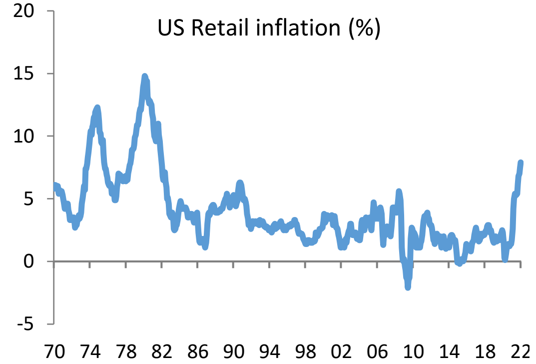
Medium term issues

- Driven by increasing climate awareness and 'Net Zero target' objectives, investments in oil were significantly scaled back in the past decade
  - Notably, despite higher oil drawn in 2021, capex has remained flat
  - Higher oil prices in medium term ?

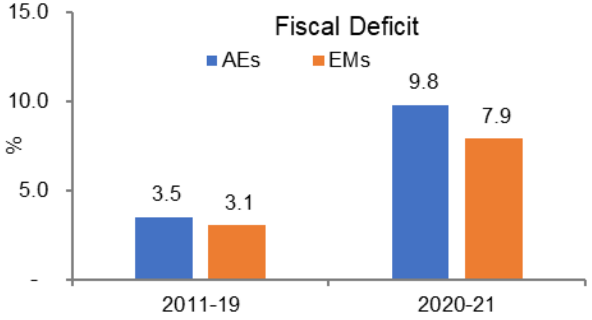


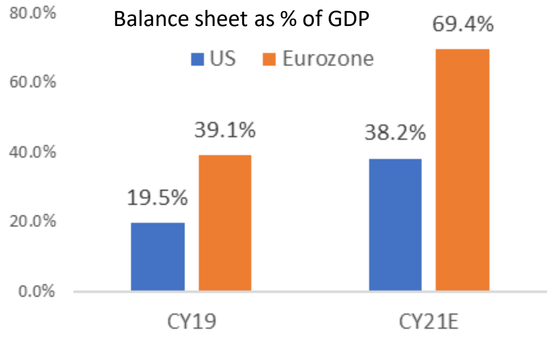
- US inflation and interest rates





- Why inflation and interest rates can surprise on the upside
  - Deflationary impact of China's manufacturing is fading
  - Under investments in fossil fuels supply can result in higher energy prices
  - Large fiscal and monetary stimulus in response to pandemic to support demand





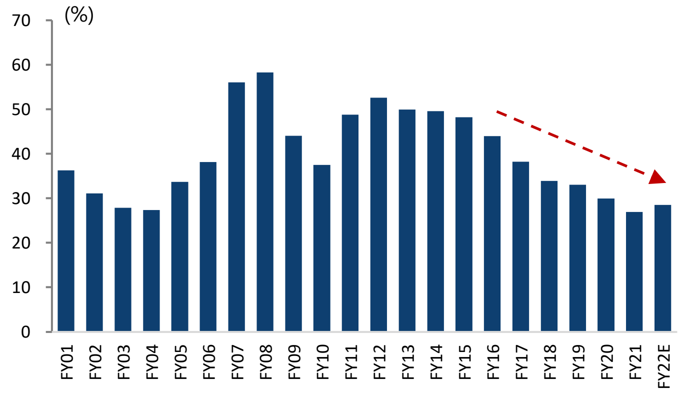
Source : IMF Data, Kotak Institutional Equities, Bloomberg

India – Relatively better placed

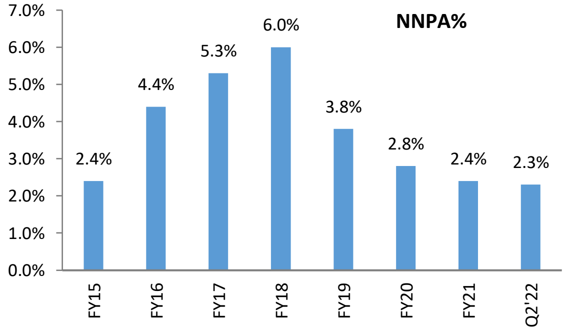
- Difference between India and US yields remains reasonable and thus, eases pressure on capital flows into India

- Housing affordability is near all time high

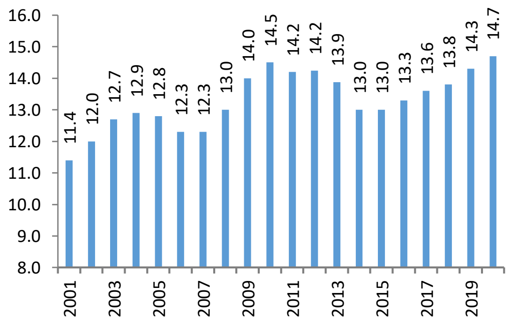
Affordability ratio (Home loan payment / Income ratio)



- Banking system in good health with adequate capitalization and end of corporate NPA cycle.



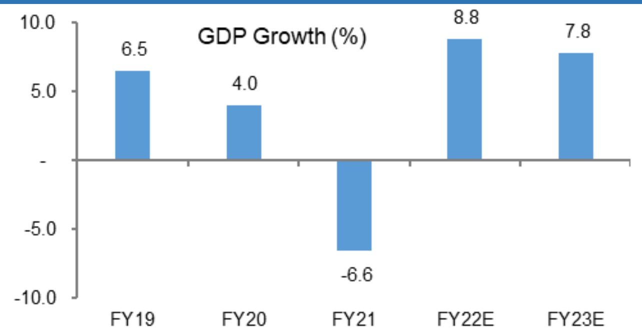
Capital adequacy near 2 decades highs (%)



Source : Jefferies, Investec

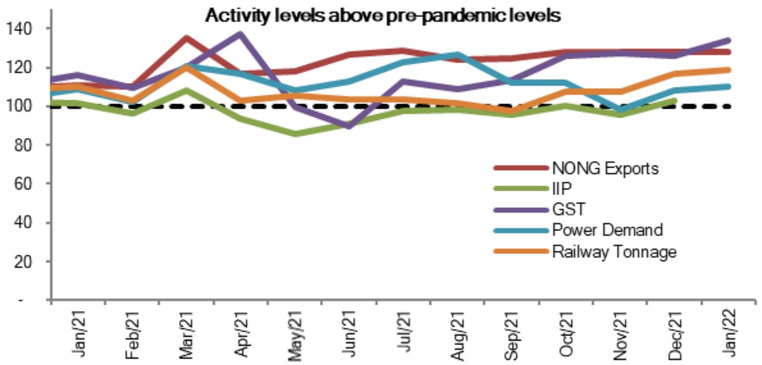
Indian economy : Positive outlook

- Indian economy is set to witness a V-shaped recovery in FY22 after a sharp fall in FY21 driven by base effect, pent up demand, favourable external environment, fast pace normalisation and supportive fiscal and monetary policies



Source: CMIE, RBI

- Leading indicators like Power demand, railway goods movement, GST collections, NONG exports, etc. are signaling a strengthening and broadening of economic recovery
    - Manufacturing and Investments have rebounded at faster pace, services continues to lag



Source: CMIE,POSOCO

- India's medium term growth outlook is promising

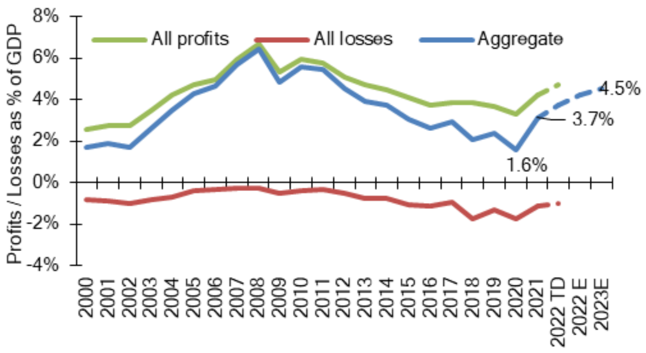
Future growth drivers		
Steady growth in Consumption	Rising employment and wages	Robust Exports
Acceleration in Infrastructure Investments	Robust FDI inflows	Increasing competitiveness vs China and PLI schemes
Divestments and Fiscal deficit under control	Favorable Regulatory reforms across industries	Ample liquidity and benign interest rates

PLI - Production Linked Incentives, NONG – Non Oil Non Gold, GST – Goods & Services Tax

*At India Ideas Summit which was hosted by US-India Business Council (USIBC) in 2020

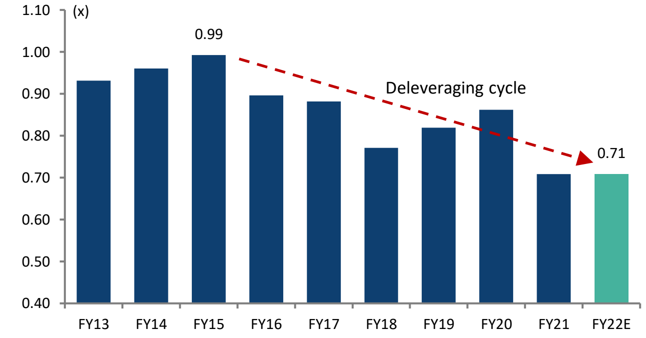
Private capex and Credit growth

- Broad based improvement in profitability across major manufacturing sectors like metals, cement, sugar, textile, chemicals, paper, etc.



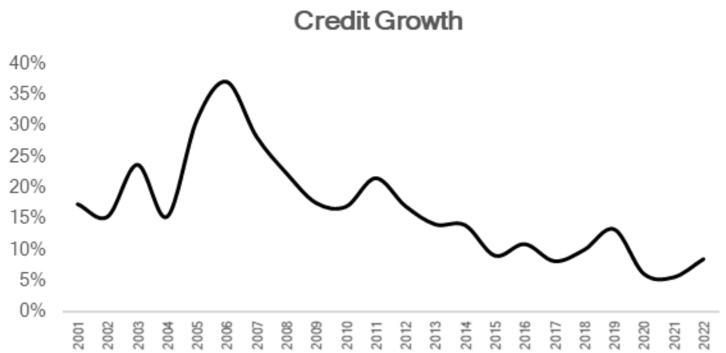
Sources: ICICI Securities

- Conducive environment for private capex
  - Corporate leverage is near 10 year low
  - Improved competitiveness vis –a – vis China
  - Rising interest of global MNCs to set up manufacturing driven by China plus one policy
  - Supportive government policies and thrust on “Aatmnirbhar Bharat”
  - Ample liquidity and benign interest rates



Sources: Jefferies

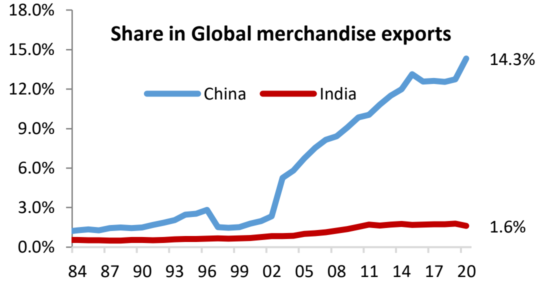
- Credit growth is weak due to good corporate profitability and deleveraging. Higher inflation, low debt / equity ratio of corporates and broad based revival in corporate profitability should lead to improved credit growth going forward.



Sources: Investec

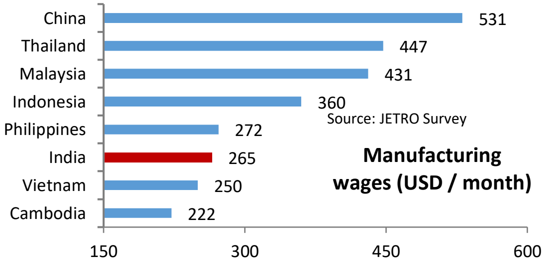
Manufacturing beckons

- India lost to China in scaling up manufacturing in last two decades
  - India's manufacturing sector share in Gross Value added (GVA) reduced despite its consumption spending rising, implying India's dependence on imports increased over the period



Source: World Bank

- Disruption due to Covid-19 has triggered an urgency to diversify global supply chain and many global MNCs are implementing China+1 strategy; further, wages and compliance costs in China have also risen
- This trend has come at an opportune time as India's competitiveness has improved due to lower wages, PLI schemes, tax incentives, etc. along with other favourable government policies



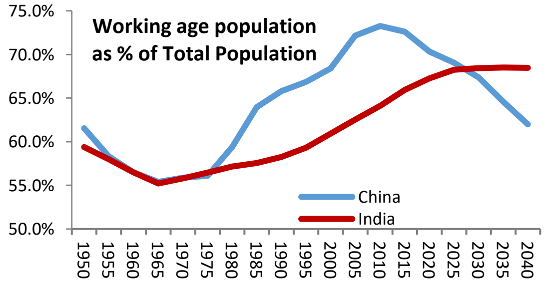
Is India Ready ?

- India is a likely beneficiary of this shift in manufacturing due to the following reasons
  - a large domestic market & improving ease of doing business
  - skilled human resources at competitive costs
  - Tariff and non-tariff measures to aggressively support manufacturing in India
  - Production linked incentive scheme (PLI) improves competitiveness
  - Focus on self reliance in defence, chemicals, pharmaceuticals, etc.

Steps taken to boost domestic manufacturing
PLI Schemes for select industries to promote import substitutions and increase exports
Raising duties under Phased Manufacturing Programme
Rationalization of Labour Laws and land reforms
Reducing tax rates for manufacturing units set up before Mar-23
Opening up defence sector and banning imports of select items
Revision of MSME definition to incentivise scaling of operations

Source: Morgan Stanley; Publicly available information

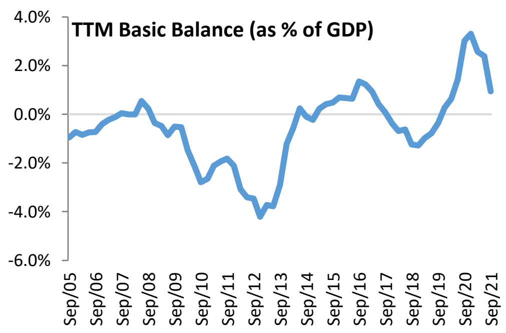
- **Structural advantage**
  - India's share of working age population will overtake China by 2030

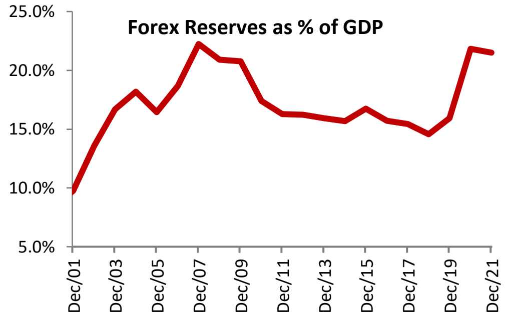


Source: UN Population database

Comfortable External sector

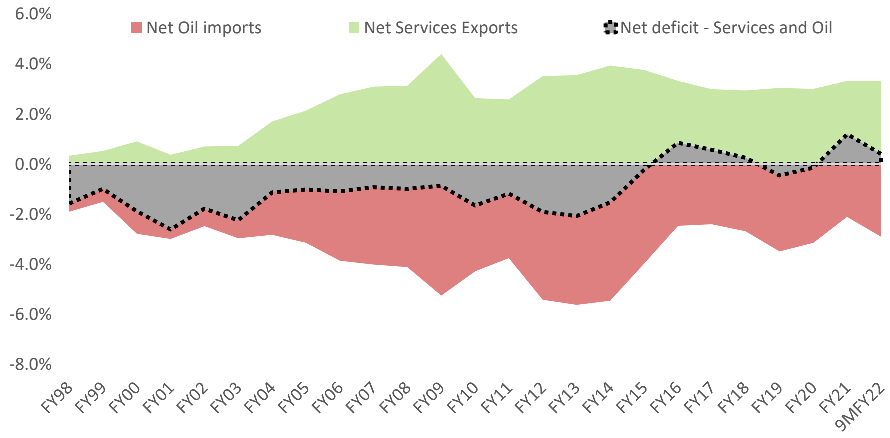
- Outlook on External sector remains comfortable with basic balance (CAD+FDI) well above the long term average





Source: CMIE, Basic Balance = CAD+FDI, TTM – Trailing 12 months

- India's services exports have surpassed its oil imports

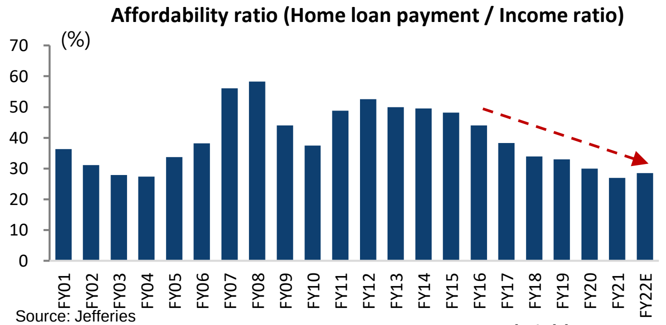


Source: CMIE, RBI, Kotak Institutional Equities, BoP – Balance of Payment, Basic Balance = CAD+FDI

Source: CMIE

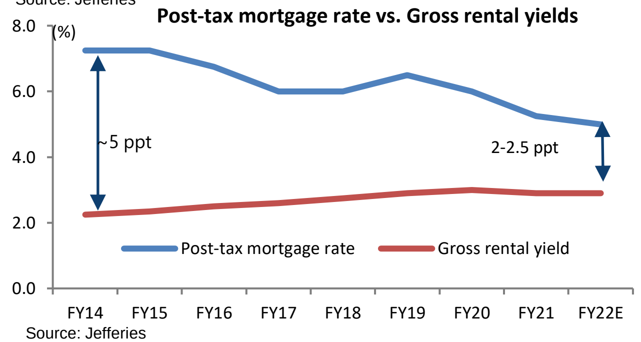
Housing – Better prospects

- Over the past two decades, house affordability has improved and is close to decadal best
  - With India Inc. moving towards a hybrid work model (Office + WFH), demand for home improvement sector is likely to get a boost
  - Improving affordability, rising employment, and rise in wealth due to the rise in stock markets, etc. is positive for real estate demand



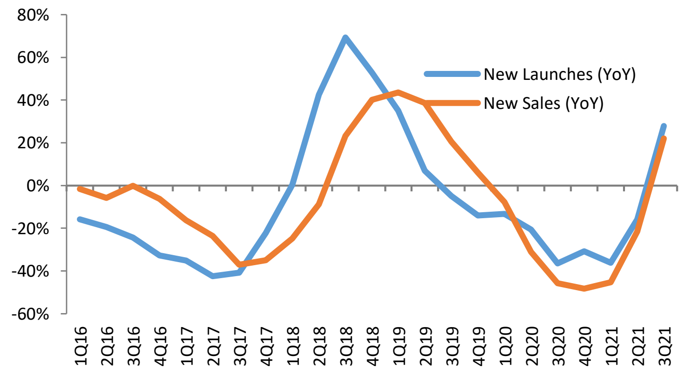
Source: Jefferies

- Attractive trade off between rental yields and Mortgage rates



Source: Jefferies

- Real estate volumes have picked up and the trend is likely to sustain in the near term

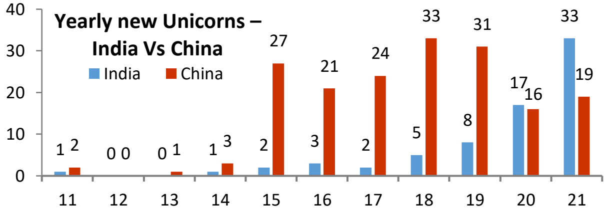


Source: Morgan Stanley

Housing is an important part of Gross capital formation and its revival should support faster growth

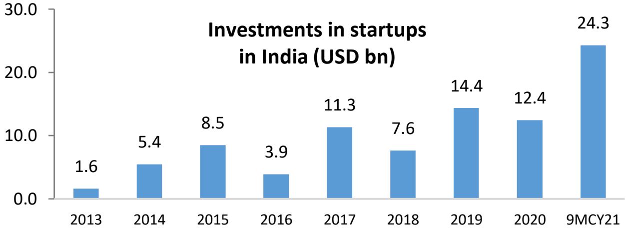
Startup India - Primed for sustained growth

- Indian startup ecosystem has seen significant progress over the past few years and has become a critical growth driver for India
  - India has overtaken China in number of new unicorns* in 2021
  - Crackdown on China tech sector has possibly impacted start-up funding in China



Source: Article by Hindu business line published on 20 Oct 2021

- Investments in startups have been increasing despite pandemic on back of rising digital penetration and availability of risk capital



Source: DAM Capital

- Journey of becoming a Unicorn has become shorter

Name of Startups	Period to become Unicorn
Naukri, Makemytrip	20 years
Zomato, Flipkart and Policy bazaar	8 to 10 years
Nykaa and Oyo	5-6 years
Udaan and Ola Electric	3 years

Source: An article published in Feb 2021 on Yahoo.com

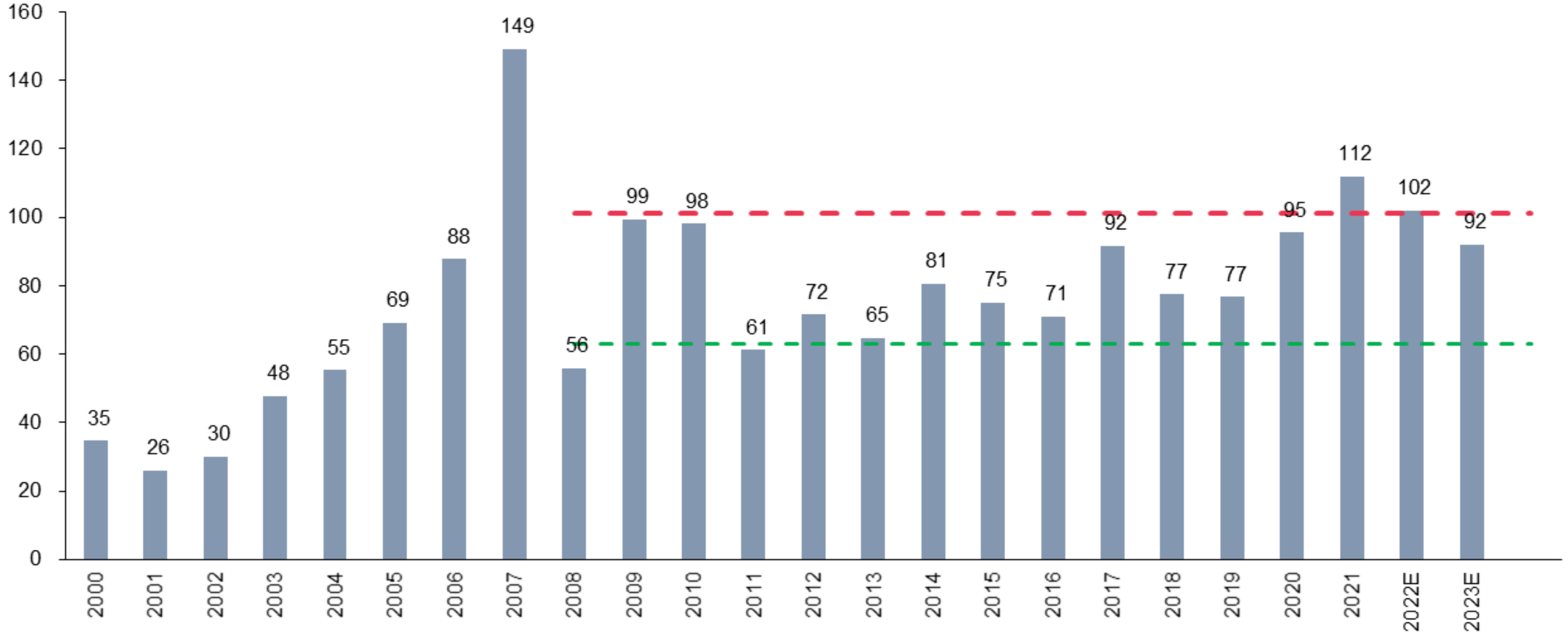
- Estimates suggest that number of Indian startups is set to nearly double to 1 lakh over next 4 years and start ups could employ over 3.25 million people

Source: 3one4 Capital report

Availability of big talent pool, large market and risk capital bode well for startup ecosystem

*Unicorns are referred to private firms valued at USD 1 billion or more

Equity Market Outlook



- NIFTY 50 TRI returns over the past 10 years and 15 years are 14.1% and 12.0% CAGR^ respectively, largely in line with nominal GDP growth. Market cap / GDP is also in line with the past range. Markets are thus fairly valued and the long term returns should be in line with the nominal GDP growth

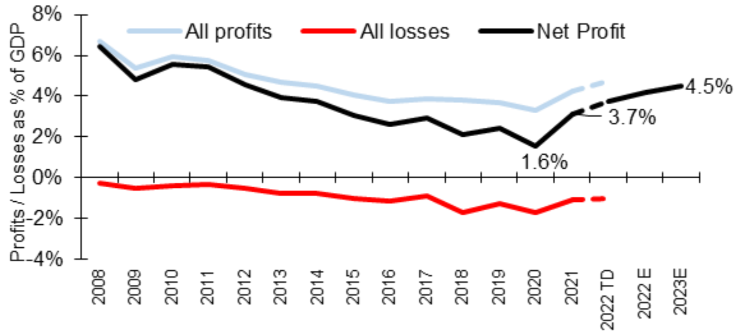
- FPI flows, US yields, oil prices and primary supply of stocks are key variables in the near term

Source : Kotak Institutional Equities, Bloomberg

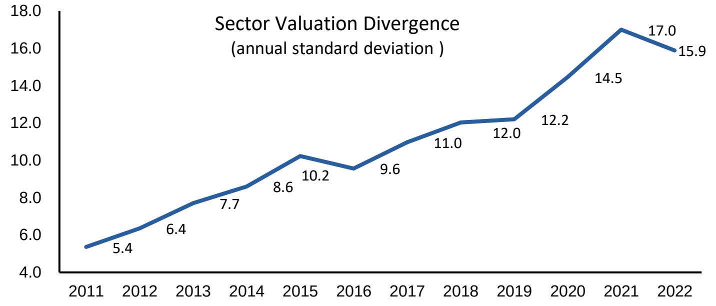
Profit Growth and sectoral valuations

- Smart recovery in profit growth after a long period. Expectations of a broad based profit growth due to low corporate NPAs, capex revival and higher commodity prices

NIFTY50	FY21	FY22E	FY23E	FY24E
EPS	536	720	839	938
% growth	18%	34%	17%	12%
P/E			20.8	18.6



- High divergence in valuations across sectors



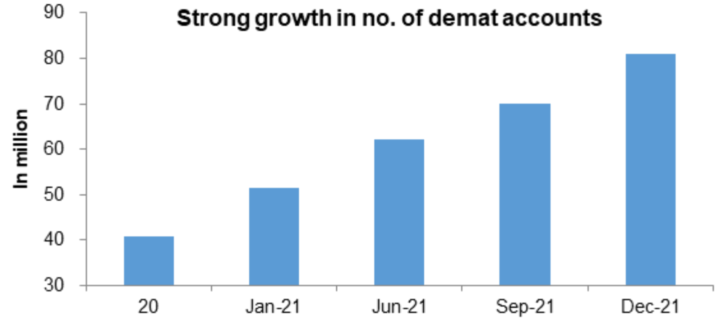
- Valuations
  - CD, IT, Auto and FMCG are trading at premium to LTA.
  - Tobacco is trading at a discount.
  - Metals - Discount is misleading as it is a cyclical sector
  - Utilities – Though in line with the LTA, cheap in absolute terms

	12 months forward Price To Earnings		
Sector	**Current#**	**10 Year LTA**	**Discount / Premium^**
CD	67.3	47.9	40.5
IT services	26.5	19	39.2
Auto	22.9	17.8	28.7
FMCG	49.2	43.2	13.9
Oil and gas	12.4	11.6	7.4
Cement	26	24.3	7.0
Electric utilities	10.3	10.4	-0.5
Pharma	23	23.1	-0.6
PSU Banks	1	1	-1.1
Private Banks	2.4	2.5	-3.9
Metals	7.3	10	-26.4
Tobacco	15.5	23.3	-33.5

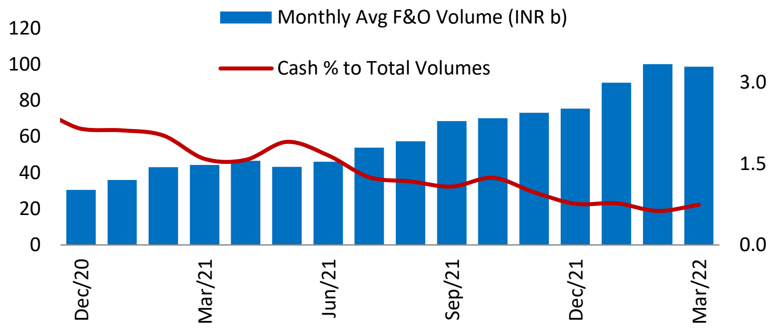
Source: Kotak Institutional Equities, ICICI Securities

High FPIs selling – Resilient Markets

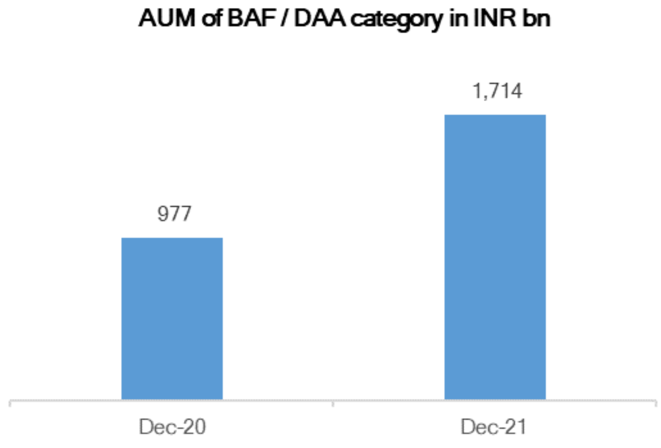
- Trailing 12-month FPI selling in Indian equities is turning out to be the highest since the global financial crisis (GFC) of CY08 with TTM FPI cumulative selling of USD 36 bn vs USD 28 bn during the GFC. However, as a % of Market Cap, it was 2.4% during GFC vs 0.7% now.



- Domestic Institutional and retail investors have been large buyers on other hand. Cash's share of volumes has decreased from 2.1% to 0.7%, suggesting higher leverage with retail.



- Sharp increase in the AUM of Balanced advantage / Dynamic Asset Allocation funds that tend to increase the equity allocation when market corrects and vice versa.



Steady DII flows, strong retail flows, rising F&O volumes and growth in dynamic asset allocation funds are reasons why markets have held up well

Sources: CDSL, NSDL, Motilal Oswal, Morgan Stanley, MFI Explorer

Summary

- India's growth outlook appears stable driven by
  - Healthy outlook for Infra / private capex
  - Stable consumption
  - Favourable regulatory environment
  - Comfortable external situation
  - Healthy balance sheets of corporates and banks

- Currently, Indian market capitalization is ~87%^ of GDP (based on CY 2023 GDP) & NIFTY 50 is trading at 18.6x^ FY24E which is reasonable. Hence, market returns should be in line with the nominal GDP growth over the long term.

- Healthy inflows in Mutual funds and rapid increase in retail participation in equities have improved market's resilience to FPI outflows.

- FPI flows, US yields, oil prices and primary supply of stocks are key variables in the near term

^Source: Kotak Institutional Equities

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