Economic Update

The Indian market continued to outperform the MSCI Emerging Markets Index during the last quarter, reaching a new high and a market cap of USD 5 trillion. Mid and Small Cap indices outperformed the large-cap indices. Despite various initiatives taken by the Chinese government, India continued to outperform China. China's factory activity contracted for a second straight month in June, signaling weakness in an area that Beijing is betting on to drive the economy. The trade war rhetoric between China and the USA gets louder, which will continue to impact China's exports.

Annual inflation in the USA stands at 3.3% as of May 2024, compared to 3.4% in April. That inflation rate is well down from peak levels in the summer of 2022. However, the Federal Reserve Open Market Committee (FOMC) is wary that its inflation target is 2% and wants to be sure that inflation is on a path to that level before cutting interest rates. Hence, the FOMC is expected to cut interest rates at least once during its four remaining meetings of 2024, with the majority expecting up to two cuts this year. The median rate this year is at 5.1% vs. 4.6% in March and 4.1% next year vs. 3.9% prior. The median member now expects four rate cuts in 2025 and another four cuts in 2026. The RBI's Monetary Policy Committee (MPC), at its meeting in June, decided to keep the policy repo rate under the liquidity adjustment facility (LAF) unchanged at 6.5%. The MPC also decided to remain focused on withdrawing accommodation to ensure that inflation progressively aligns with the target while supporting growth. These decisions are in consonance with the objective of achieving the medium-term target for consumer price index (CPI) inflation of 4% within a band of +/- 2%, while supporting growth. Over the quarter, foreign institutional investors recorded strong net outflows of USD 1.1 billion, while domestic institutions recorded net inflows of USD 14.6 billion. The G-sec yield was volatile during the quarter but settled at 7.0%. The price of crude oil remained volatile too but steadied around USD 87 per barrel at quarter end. The INR remained steady through the quarter and closed at 83.39 against the USD. India has been included in the GBI-EM Global index suite starting June 28, 2024, which will result in USD 30-40 billion inflows in bond markets over the next few months. This shall also support a stronger INR.

For the quarter ending March 2024, India's GDP growth came in at 7.6% YoY from 8.16% in the quarter ending December 2023. This was meaningfully above consensus estimates (7%), mainly led by a sharp increase in net indirect taxes (GVA + Net Indirect Taxes = GDP, Net indirect taxes = Indirect tax Less Subsidy). The increase in net indirect taxes (as per the government's monthly accounts data) was driven by continued growth in tax collections and a decline in subsidy expenditure on a YoY basis. Headline CPI softened a tad, to a 13-month low of 4.7% YoY. Core CPI (excluding food and fuel) moderated to 3.1% YoY in May from 3.2% in April. The current account recorded a surplus of 0.6% of GDP (USD 5.7 billion) in QE Mar-24, vs. a deficit of 1% of GDP (USD 8.7 billion) in QE Dec-23, driven by a narrowing trend in the trade deficit. On a four-quarter annualized basis, the current account deficit narrowed to 0.7% of GDP in QE Mar-24, its lowest since Dec-22. The overall BoP surplus accelerated to USD 30.8 billion (3.3% of GDP) in QE Mar-24, from USD 6 billion (0.7% of GDP) in the previous quarter, buoyed by surpluses in both the current and capital accounts.

General Election 2024

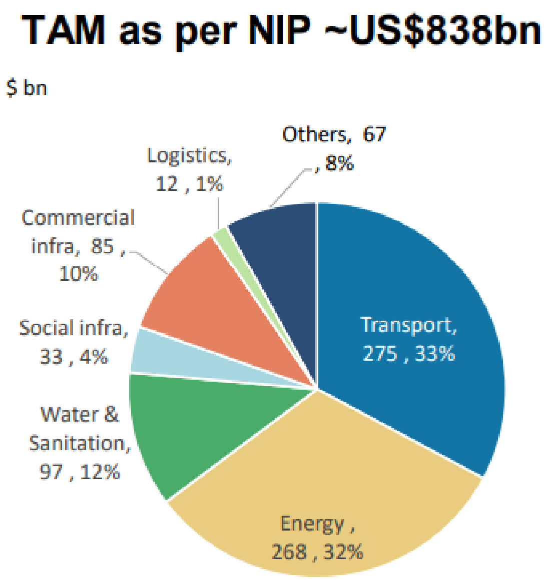
India's national elections concluded with the BJP-led NDA forming the government for the third consecutive time. However, BJP failed to cross the halfway mark, resulting in MSCI India falling by ~6% on vote counting day on June 4. Post-election, equities recovered strongly by ~10% since then. MSCI India ended the volatile month at around record highs of 1313. BJP retained most of the high-profile departments with their ministers (such as home, defense, finance, external affairs, road transport and highways, among others). During the past decade, the BJP has carefully created an image of a clean government, minimizing wasteful spending and corruption, making the Budget more transparent by reducing off-budget expenditure/borrowings, leading to higher center's capex allocation, resisting calls for large rural support, and maintaining fiscal prudence. We strongly believe (and hope) that there will not be substantial changes in its mindset/philosophy, creating policy continuity. However, there could be more challenges to pass legislation on the more ambitious parts of the government reform agenda in areas like agriculture, land, labor, and judicial, which are usually out of Budgets, as they would require more negotiations and debates.

Infrastructure Story: A Long Way to Go

India's infrastructure has materially improved in recent years, and we see significant scope for further improvements through recent government initiatives like PM Gati Shakti (PMGS). The PMGS includes all the existing and future plans of all the ministries and departments under one portal, making tracking and implementing them easier. It helps in synchronizing the activities of each department. India has not been able to realize its full potential of economic growth for multiple decades. There is a wide gap between macro planning and micro implementation, resulting in subpar infrastructure development. Several reasons for the underperformance are:

- Lack of coordination between various ministries as they worked in silos.
- Lack of standardization
- Slow approval process and speed of execution

The current National Infrastructure Pipeline (NIP) is estimated to be around USD 838 billion, providing a huge opportunity for EPC players.



Source: Morgan Stanley

Efficient infrastructure can lower logistical costs and improve India's manufacturing competitiveness. India's global ranking on logistics has improved 16 places since 2014, now being 38th. To reduce logistics costs, the government has initiated a Comprehensive logistics action plan (CLAP) under which there will be a key focus on Integrated Digital logistics systems and benchmarking of service standards, etc. Eventually, they want to reduce India's logistics cost from 14% of GDP currently to 8% by 2030 and improve India's ranking from the current 38th to 25th by 2030.

Overall, the benefits of PMGS can be as follows:

- Forecasted investments will increase from USD 1,203 billion in FY24 to USD 2,099 billion by FY29e, rising from 33.7% in FY24 to a peak of 36.2% of GDP by FY29e. Infra investments should have a 2.5-3x multiplier effect on the economy.
- Expect a 3x rise in manufacturing by FY34e: PMGS helps reduce logistical costs of the Indian economy, thus improving India's share of manufacturing in GDP from 14.2% in FY24 to a peak of 21% by FY31 and remain steady thereafter, implying a manufacturing base size of USD 1,657 billion by FY34.
- Expect a 2x rise in exports.
- The government's various supply-side reforms should dampen India's inflation impulses.

China is way ahead on infrastructure than India, providing a big opportunity to further invest in that sector.

India's Infrastructure: India vs. China (C23)

	C07 China	C23 India	C23 China	C07-23 CAGR China
Macro				
GDP ($ bn)	3,556	3,669	19,041	11%
Population (bn)	1.32	1.42	1.43	
Land area (mn sq.km)	9.60	3.29	9.60	
Infrastructure				
National Highways (Km)	137,100	146,145	379,500	7%
Electrified rail track (Km)*	25,457	64,124	114,321	10%
Electrified rail track (% of total)*	32.7%	95.0%	73.8%	
Number of Airports (nos)**	148	148	254	3%
Total Generation capacity (GW)	713	442	2,811	9%
% Renewables	*0.6%*	*32.5%*	*33.4%*	
% non fossil (RE+N+H)	*22.2%*	*45.0%*	*50.5%*	
Utilization of assets				
Rail Traffic goods (MMT)	3,131	1,591	5,007	3%
Ports Cargo (MMT)	3,882	1,539	10,835	7%
Domestic Air passengers (mn pax)***	169	140	548	8%
Intl Air passengers (mn pax)***	17	26	64	9%
Total Electricity consumption (BU)	3,256	1,616	9,264	7%
% Renewables	*0.2%*	*13.0%*	*16.1%*	
% non fossil (RE+N+H)	*17.1%*	*23.5%*	*36.2%*	

Nifty Q4 FY24 Earnings Review

The Q4 FY24 corporate earnings ended on a strong note, with widespread outperformance across aggregates. Domestic cyclicals, such as Autos and Financials, along with Healthcare, Capital Goods, and Cement drove the beat. Sales/EBITDA/PBT growth for Nifty constituents was in line with consensus estimates at +7%/+11%/+12% YoY in Q4 FY24. However, PAT was above consensus estimates and grew 12% YoY (vs. an estimate of +5%).

Auto volumes (excluding tractors) grew 20% YoY in Q4 FY24, led by a healthy recovery in 2Ws and steady growth in the SUV segment. The banking sector reported a healthy performance in Q4 FY24, driven by robust business growth and controlled provisions. NIM performance was mixed, with many banks reporting margin improvements. Fresh slippages were under control, with most large private banks reporting a decline in the slippage ratio, while recoveries and upgrades were healthy. Advances growth was strong, with most large private banks growing at 14-18% YoY.

NBFCs reported strong AUM growth of around 20% on average, but NIMs were under pressure due to rising funding costs. Microfinance companies saw asset quality deterioration, while other NBFCs maintained strong asset quality. Life Insurance companies exhibited stable 12-15% APE growth, while VNB margins were muted. Hospitals delivered yet another strong quarter with 20% earnings growth on average, and Pharma companies delivered strong US sales along with lower raw material costs driving earnings. As expected, capital goods order inflows moderated, largely due to the election cycle. Healthy traction was seen in key sectors such as power T&D, renewable energy, data centers, real estate, defense, etc. Infrastructure execution was weak due to delays in land acquisition, and NHAI awarding continued to be weak. Real Estate bookings traction sustained in Q4 FY24, with realizations also going up due to premiumization. Cement volume growth was strong at double digits, while realization went down. Retail demand continues to remain weak with the expectation of a recovery in the second half of FY25. Results for Tier-1 companies have remained weak so far due to lower-than-expected growth, weak demand, the re-scope of contracts, and project cancellations.

Portfolio Review

The overall exposure of the portfolio hasn't changed much, with Mid & Small caps maintaining similar exposure. Portfolio adjustments included adding exposure to Information Technology, Industrials, Consumer Staples, Communication Services & Real Estate while reducing exposure in Consumer Discretionary & Healthcare. We sold off a substantial exposure of Bajaj Finserv and allocated that to SBI, HDFC Bank, Axis & ICICI Bank. Bajaj has certain concerns related to CEO change and regulations on large NBFCs, which is keeping it subdued despite strong results. All the other large private banks have underperformed over the last 12 months and are available at extremely competitive valuations compared to the market. We exited SBI in February this year but re-entered due to consistently strong results and asset quality. We added a new IT company, Coforge, and more exposure to existing names like Infosys as the worst in growth should be behind them in one to two quarters. Reliance has been an underperformer for the last few quarters and hence provided a good opportunity for more exposure in the portfolio. It's going to be a big beneficiary of the telecom tariff hike announced at the month's end. We fully exited Tata Motors as the best in terms of balance sheet is already priced in, and earnings growth for the next two years doesn't seem exciting. We replaced that with Mahindra & Mahindra, which has a strong product introduction cycle in the SUV EV space in India. Also, expectations of a good monsoon can result in an upside in its tractor business. We booked partial profit in JB Chemicals and Medanta due to the valuations reaching our target levels. We added more exposure to Dabur due to the expectation of government policies favoring rural India. We also added a new technology platform, IRCTC, which is the main online ticket website for Indian Railways. It's a government-owned entity with almost a monopoly in its business.

We invested in IRCTC, which operates one of the most transacted websites, www.irctc.co.in, in the Asia-Pacific region. We believe IRCTC is a unique asset-light consumer-facing play on the transformation of Indian Railways. With the government's increased investment in capacity expansion and modernization of passenger trains, we anticipate a resurgence in rail passenger growth and a higher share of the passenger wallet for the railways (thanks to premium services). IRCTC is strategically positioned to benefit from this trend, as it operates across the entire rail passenger value chain, including internet ticketing, rail catering, packaged drinking water, and travel & tourism. Moreover, it enjoys a regulatory monopoly in three out of its four business segments, making it an unparalleled business with no comparable peers. Today, Indian Railways has 51 operational Vande Bharat (VB) trains. Overall, the GoI is aiming to add 475 VB trains by March 2025. While train addition timelines might get stretched, we see significant earnings optionality for IRCTC from VB train additions. Our calculations suggest one VB train can generate an annual EBIT of about INR 30mn for IRCTC (2/3 from catering and 1/3 from e-ticketing). With the Government of India aiming for 475 VB trains, the total EBIT potential can be INR 10-12bn, which is 1.1x IRCTC's FY23 EBIT – supporting higher earnings growth in the medium term. Also, a catering menu tariff revision is likely over the next 12 months as the previous tariff revision came in November 2019. We expect IRCTC's earnings to grow at a 20% CAGR over FY24-26F.

We invested in CG Power, an engineering conglomerate with an impressive and diverse portfolio of products, solutions, and services for Power and Industrial equipment and solutions. A rebound in the capex cycle, strong leadership, and focused strategies of the new leadership team (Murugappa Group) have enabled CG Power to bounce back swiftly in the last couple of years. The growth in its Industrial Systems is expected to be driven by the government's focus on manufacturing and infrastructure, energy efficiency, and EVs. The growth in the power business will be driven by strong power demand, increasing alternate energy capacity, and expansion in power grid capacity. Growth in Railways is a key area of growth for the company. CG Power has recently announced its foray into outsourced semiconductor assembly and testing (OSAT), which offers decent long-term scale and profitability as India looks to replace electronic imports with domestic production. The company is expected to more than double its profits over the next three years.

We have bought into Mahindra & Mahindra, an auto company with exposure to SUVs, LCVs, and tractors. The company has improved its capital allocation strategy over the last four years. Its SUV portfolio is expected to grow at an 11% CAGR over FY24-27e, benefiting from tailwinds in SUVs, a reasonable product pipeline, and increasing penetration of EVs. They are also leaders in the LCV goods segment and expected to grow volumes at a 7-8% CAGR over the next few years. Tractors and even non-tractor farm machinery like harvesters offer a good opportunity for growth with a strong monsoon expected. This segment can grow volumes at a 6-7% CAGR. While the stock has been rerated over the last few months in terms of P/E, the future upside will be linked to its expected earnings CAGR of around 13-14% over the next three years.

Outlook

Due to the RBI bonanza and higher tax earnings, the government has a 40-50bps of GDP of fiscal leeway in this year's budget. As a result, they can please everyone with higher capex, social spending, and yet a tighter fiscal. The budget should bring positive news for several domestic sectors (affordable housing, capex plays, consumer, rate-sensitives). Capex budget can see a 20% YoY growth, and strong income tax (IT) collections can result in lowering of IT rates, spurring consumption, and enhancing rural welfare schemes. Recent announcements of ministerial appointments and modest MSP (Minimum Support Price) hikes create an impression of policy continuity, but the budget would be the event to watch in this regard. It is true a good monsoon should water a bumper autumn kharif crop and lead to a rural recovery at the end of 2024. Still, rural India has to get through the next 8-9 months, especially after the hot summer. Key policy areas in the government from their election manifesto are as follows:

- Infrastructure & Manufacturing: Railway, Defense, Make in India & Energy Security
- Housing: Real Estate recovery and Building Materials
- Services: Tourism, Affluent India
- Agriculture: Rural Support

The rate cut by RBI will be preceded by the Fed rate cut in order to protect the currency. Indian bonds have been included in the JP Morgan Global Emerging Markets indices, resulting in strong FPI inflows in bond markets and steady INR. RBI wouldn't want it to strengthen to avoid any impact on exports. Domestic investors continue to be steady investors in the equity markets while FPIs have picked up post the election results. Consensus sees inflation tracking around 4.3-4.5% in FY25e.

From a sectoral perspective, given the continued strong domestic growth, we are positive on domestic themes such as Banks, NBFCs, insurance, manufacturing, hospitals, power, and consumer discretionary. We estimate the banking sector's operating performance to remain robust, driven by steady loan growth, improved operating leverage and controlled provisions. Given the system's credit-deposit (CD) ratio at its peak and intense competition for deposits showing no signs of easing, we remain cautious about funding costs. We estimate that NIM moderation will continue, though the rate of moderation will likely slow in the coming quarters. The outlook for asset quality remains positive, with a reduction in slippages. With interest rates peaking out, Non-housing NBFCs like the vehicle financiers will be a big beneficiary in the near term. Sustained strong trajectories in F&O and cash volumes will continue to be translated into strong performances by the capital market-related players such as brokers and exchanges. However regulatory changes can impact their earnings as SEBI concerned about the rising volumes of F&O in the country. Life insurance is expected to grow APE at the mid-teens level. Majority of easy gains in auto OEM stocks are now behind us, as we have witnessed significant volume growth across segments over the last two years, and input costs also appear to have bottomed out. Hence we need to be selective in this sector. In Capital Goods we are positive about a robust order pipeline given the government's emphasis on capex-led growth. A meaningful uptick is expected in 2HFY25. NHAI's primary focus is on asset monetization as a means to generate funds beyond budgetary allocations. Hence the road awarding activity is expected to pick up new couple of quarters. Cement volume growth is expected to remain strong with housing and infrastructure demand but any price increase is tough to sustain. On the Industrial front, the capital goods companies' managements remained positive on a robust order pipeline given the government's emphasis on capex led growth. Real estate companies are expected to deliver strong double-digit per sales growth. We expect QSR companies to sustain growth weakness in the near term, which will likely keep operating margins under pressure. Burger companies are expected to perform better than Pizza. Food delivery & quick commerce platforms are expected to deliver strong growth and improving profitability. Discretionary spending shows no signs of picking up, and the near-term outlook remains bleak. Yet remain positive on Tier-1 names due to their wider range of offerings and disproportionate benefits in a cost-focused environment. Even valuations are favouring the Tier 1 companies. Telecom companies have taken a tariff hike and the next one may happen in 18 months and hence the stock may not have much upside left.

Overall, the Indian market continues to be around an all-time high but on a broader level, the Nifty is trading at a 1-year forward P/E of 20.2x compared to the 10-year average of 20.3x, and at a P/B of 3.3x compared to the average over this period of 2.8x (Source: Motilal Oswal). The market-cap to GDP ratio for FY25e is at 136%, higher than its 10-year average of 80%. The earnings growth expectations continue to be attractive with FY24-26e earnings CAGR forecast around 15% (Source: Motilal Oswal). We need to keep a close track on the rate cycle in USA and it eventual reaction by the RBI.