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Investment Strategy I 10 November 2022

# India Market Outlook

## Staying balanced

November 2022

Are key macro drivers improving or weakening?

Should investors rotate into fixed income to tide through near-term uncertainty?

How is the Q2 FY23 earnings season progressing so far?

# Investment strategy and key themes

#### Implications for investors

- We have a diversified asset class preference.
- *In equities:* prefer large-cap equities, value-style equities.
- *In bonds:* prefer short-maturity bonds.
- Gold a portfolio hedge.

#### Key Themes

- Broadening Value Rotation
- India's Investment Revival
- Positioning for higher interest rates

## Staying balanced

- Indian risk assets continue to rally and outperform its major peers, supported by strong earnings delivery in Q2 FY 2023, softening commodity prices and strong foreign investor inflows into equity. Over the last month, the Nifty index is up 5%, while the Nifty Midcap index is up 1.5%. The INR is up 1.2% against the USD after hitting a new all-time low, while the benchmark 10-year IGB yield fell 6bps to 7.40%.
- In the short term, the risk of a pullback in Indian equities has risen as expensive valuations (both absolute and relative to peers) indicates a low margin of safety. Further, slowing global growth and higher policy rates is headwind for India's economic growth and earnings expectations.
- Within equities, we retain our preference for large-cap equities over mid-cap and small-cap equities on relatively better macro fundamentals and greater margin of safety in terms of earnings and valuation. Our key investment themes – India's Investment Revival and Broadening Value Rotation – are likely to benefit from the current macro environment. We prefer a more domestic sector tilt with a mixture of value (financials, industrials) and defensives (consumer staples).
- Within bonds, we maintain our preference for short-maturity bonds over medium and long-maturity bonds given their lower sensitivity to rising interest rates. Gold remains a core holding, and a key portfolio diversifier.

### Key Asset Class Views

| **Equities** | ◆ |
|---|---|
| Developed Markets | ◆ |
| Emerging Markets | ▲ |
| Indian Equities | ▲ |
| Large Cap | ▲ |
| Mid Cap | ◆ |

| **Bonds** | ◆ |
|---|---|
| Short Maturity | ▲ |
| Medium/Long Maturity | ◆ |

| **Gold** | ◆ |
|---|---|

| **Cash** | ◆ |
|---|---|

**Legend:** ▲ Preferred ◆ Core holding ▼ Less preferred

# Perspectives on key client questions

## Are key macro drivers improving or weakening?

**Our net assessment:** On balance, key drivers remain neutral for risk assets

**(+) factor: Low Covid caseload, strong activity indicators, strong earnings momentum, and lower bond yields.**

**(-) factor: Elevated inflation, high trade deficit, hawkish policy guidance by global central banks, depreciating INR**

| | Positive for risk assets | Negative for risk assets |
|---|---|---|
| Covid-19 | • New infection cases fall below 1000 per day (April 2020 levels). Over 90% of eligible population (>12 years) fully vaccinated. | |
| | **Our assessment: Positive –** High vaccine coverage and low caseload. | |
| Macro fundamentals | • Activity indicators like bank credit, power demand, railway freight and E-way bills grew in October 2022.<br>• Manufacturing and Services PMI rose in October 2022.<br>• GST collections stood at INR 1.51trn in Oct 2022, above the INR 1.4trn mark for eight consecutive months. | • September CPI rose to 7.4% (above RBI's upper-bound inflation target).<br>• India's industrial production contracted 0.9% y/y in August 2022.<br>• India's trade deficit remained high at USD 25.7bn in August 2022. |
| | **Our assessment: Neutral** – Activity indicators remain strong. Elevated trade deficit and persistent inflation is a concern. | |
| Policy | • The RBA raised rates by 25bps as expected; forward guidance was more dovish than expected | • The Fed's Powell signalled higher terminal rates after delivering the fourth straight 75bps hike.<br>• The BoE raised rates by 75bps as expected, but signalled a slower pace of hikes going forward amid a deteriorating economic outlook |
| | **Our assessment: Negative** –Hawkish policy guidance by global central banks. | |
| Earnings and Bond yields | • Nifty Q2 FY23 earnings has been better than expected, driven by financials. FY23 earnings revision remained stable over the past month. | • Bond yields edged lower despite concerns given rising policy rates and higher inflation. INR depreciated to a new all-time low. |
| | **Our assessment: Neutral** – Strong earnings momentum offset by elevated bond yields and depreciating INR. | |

## Should investors rotate into fixed income to tide through near-term uncertainty?

Indian equity markets have outperformed its major peers in 2022 with the Nifty index up 4.6% YTD 2022 compared to 22.3% and 26.9% drop for developed markets and emerging markets respectively. However, the journey has been bumpy with two drawdowns of over 15% during the year. Further, rising bond yields (150-200bps) have impacted bond portfolio returns as global central banks and the RBI raised policy rates much higher than market expectations to burnish their inflation fighting credentials amid record high inflation. The risk of a near-term pull-back has increased for Indian equities, as expensive valuations (both in absolute and relative to peers) indicates a low margin of safety. In such a scenario, with cash deposit rates and bond yields above pre-pandemic levels, should investors seek the safety of fixed income instruments as they try to wade through near-term market uncertainty?

In our view, having excessive exposure to any one asset class increases the risk in the portfolio at a time when the outlook remains still highly uncertain. Further, in our view, bond yields appear to have another leg-up in the near-term, driven by the following factors: (i) falling Indian bond yield differential with its global peers as central banks stay hawkish (ii) worsening government bond demand and supply dynamics amid an expansionary fiscal policy and muted institutional investor demand and (iii) bond yields likely pricing in only a part of the expected policy rate hikes by the RBI. Bond yields have remained rangebound despite 1-year Overnight Indexed Swap (OIS) spread suggesting another reset higher in market expectations of RBI future rate action (100bps hike over 12 months currently vs 45bps in mid-October 2022).

We believe a core holding that allocates across major asset classes with a greater focus on themes, sector and tactical opportunities, can help investors tide though the near-term market uncertainty.

## How is the Q2 FY23 earnings season progressing so far?

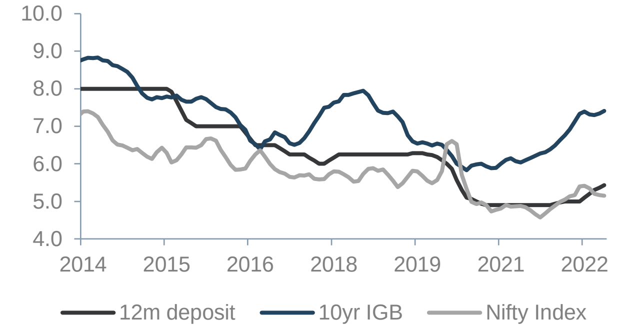
Q2 FY23 earnings season has been strong so far, with 85% of Nifty companies reporting Q2 FY23 earnings and 65% earnings coming ahead of estimates. For the reported earnings so far, Q2 FY23 Nifty revenue growth (ex-banks) and earnings is at 28% and 6.3% (25% ex- commodities) respectively, both ahead of estimates.

Earnings season remains skewed as resilient domestic focused sectors (Financials, Consumers, and Industrials) has off-set the weakness in global cyclicals (Commodities, Energy & IT). Among sectors, bank disbursements momentum has stayed strong amid improving asset quality as NPAs moderates, resulting in lower provisioning and boost to profitability. Consumer companies reported strong earnings on y/y basis as strong discretionary spends and controlled expenditure helped mitigate still elevated raw material cost pressures and muted volume growth. Auto sector earnings benefitted from operating leverage, favourable commodity prices and strong festive season demand. On the other hand, IT and Pharma sector earnings were muted given elevated costs and a challenging global macro environment. Commodity sectors reported weak earnings, impacted by seasonally weak domestic demand, higher input costs and lower realizations.

**Strong earnings delivery is critical to support stretched equity valuations.** The corporate earnings cycle remains strong and ahead of peers, with FY 23 Nifty earnings growth expected to register 14% EPS growth, on the back of a 35% EPS growth in FY22 (highest EPS growth since FY 2004). Corporate earnings in India have shown resilience amid minor downward revisions (see chart below) driven by weakness in external facing sectors. Resilient earnings outlook for domestic focused sectors aided by strong domestic macro fundamentals, is likely to balance the weakness in global cyclicals.

Fig. 2 **Increase in deposit rates and bond yields has improved its risk/reward relative to equities**

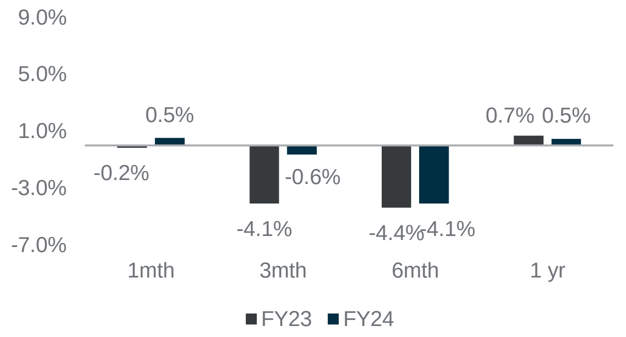
Yields – 12M deposit rate, 10yr Indian Government Bonds and Nifty Index (equity earnings yield)




Source: Bloomberg, Standard Chartered.

Fig. 3 **Pace of Nifty FY23/FY24 earnings downgrade has moderated recently**

Nifty Index FY23 and FY24 EPS chg (%)




Source: Bloomberg, Standard Chartered.

# Macro Overview

## Key themes

We expect India's economic growth to stay above trend in FY 2023 amid a broad-based economic recovery with a revival in consumption and private capex. However, elevated inflationary pressures, higher interest rates and a slowing global growth are headwinds to economic growth. In our view, CPI inflation is likely to stay above 6% in FY 2023 given INR depreciation, persistent supply issues and pent-up demand.

In our assessment, fiscal policy remains supportive with the government's focus on boosting India's medium-term growth outlook through (i) greater public capex spend, (ii) undertaking long-standing reforms related to taxation and labour and (iii) providing incentives to boost manufacturing and infrastructure spending. In our view, the RBI is likely to hike policy rates by an additional 50-75bps given persistent inflationary pressures and rising policy rate differential with our major peers amid INR depreciation concerns. A higher terminal policy rate by the RBI and US Fed are likely to pressurise interest rates and bond yields further in the near-term.

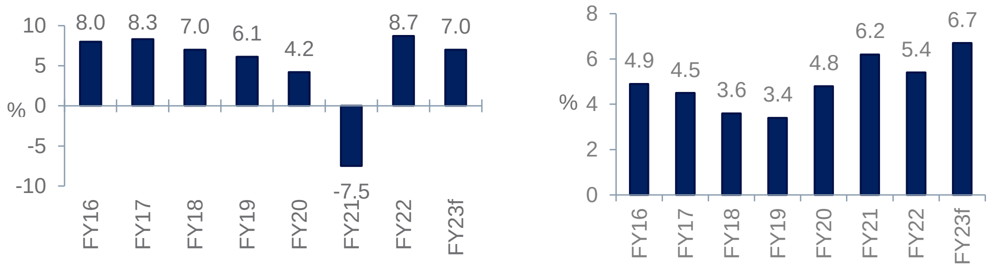
Key risks to our outlook are: 1) Higher commodity prices could weaken consumer demand and dampen the growth recovery, 2) Elevated inflation on surging commodity prices, 3) Aggressive policy tightening by the RBI and US Fed, 4) Vaccine-evading COVID-19 variant.

## Key chart

*India is expected to grow by 7% in FY23, faster than peers. Inflation is expected to stay elevated and closer to 6.7%*

Fig 4 **India to see above trend growth and inflation in FY 2023**

GDP Growth (Y/Y) and CPI Inflation (Year average) – Bloomberg consensus estimate *




Source: Bloomberg, Standard Chartered.

### Macro views at a glance

| Factors | View | Comments |
|---|---|---|
| Economic growth | ◓ | **Economic activity stayed resilient in October 2022.** Services PMI rose to 55.1, while Manufacturing PMI rose to 55.3 in August 2022. Industrial production growth contracted 0.8% in August 2022, weaker than a 2.2% growth recorded in the previous month. |
| CPI Inflation | ◐ | **India's consumer price inflation for September 2022 rose to 7.4% compared to 7% in the previous month**. Core inflation rose to 6.3%, higher than 6.1% recorded during the previous month. |
| Fiscal deficit | ◓ | **The government prioritized growth over fiscal consolidation in the latest budget.** FY23 fiscal deficit is estimated at 6.4% of GDP. FY22 fiscal deficit stood at INR 15.9trn or 6.7% of GDP. GST collections for October 2022 stood at INR 1.51trn, above INR 1.4trn for the eighth month in a row. |
| External | ◐ | **Trade deficit eased marginally to USD 25.7bn in September 2022.** Imports rose by 8.7% y/y to USD 61.2bn, while exports rose by 4.9% y/y to USD 35.5bn. India's current account recorded a deficit of USD 23.9bn (2.8% of GDP) in Q1 FY23, driven by a sharp expansion in merchandise trade deficit (USD 68.6bn vs 54.5bn in Q4 FY22). |
| Monetary Policy | ◐ | **The RBI raised key policy rates for the fourth time in FY 2023.** The repo-rate was hiked by 50 bps to 5.90% in September policy following cumulative rate hikes of 140bps in FY 2023. The RBI reiterated its continued focus on 'withdrawal of accommodation' to contain inflation, while supporting growth. Further, the RBI kept its average inflation forecast for FY23 unchanged at 6.7% and lowered its real FY23 GDP growth forecast by 20 bps to 7% y/y. |

Source: Bloomberg, Standard Chartered India Investment Committee

**Legend:** ○ Not supportive ◐ Somewhat supportive ◓ Balanced ◑ Supportive ● Very supportive

# Bonds at a glance

## Key themes

Bonds remain a core holding as attractive yields are counterbalanced by lower yield premiums, weak fiscal dynamics, and a worsening government bond demand-supply balance. Rising interest rates is key headwind for bonds. Within bonds, we retain our preference for short-maturity bonds given lower sensitivity to rising interest rates.

In our assessment, the recent surge in government bond yields and high quality (AAA) corporate bond yields has improved their overall risk-reward compared to corporate bonds and high-yield (AA/A) bonds, respectively. In addition, Indian bonds' real yields are higher compared to their Emerging Market (EM) peers. Yield premiums (spread between 10-year IGB and repo rate) have moderated from their recent peak and are now trading below average.

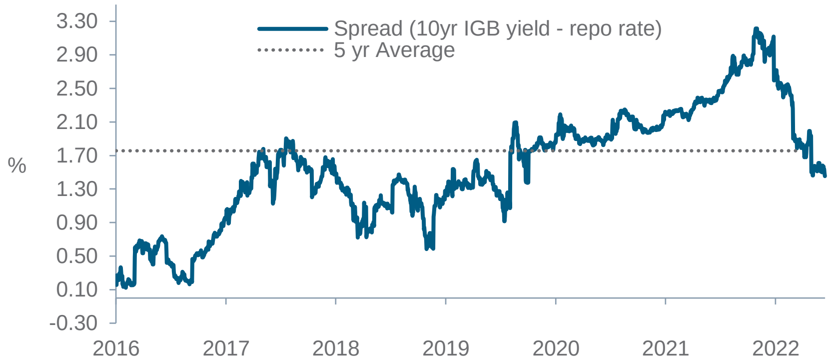
However, three factors for bonds remain unfavourable: 1) Fiscal deficit is likely to remain high over the medium-term, 2) Worsening government bond supply balance given high supply of government bonds amid waning RBI support and muted demand by institutional investors especially foreign investors, 3) Elevated inflation and policy rate hikes by the RBI and US Fed are likely to exert upward pressure on bond yields.

## Key chart

*Yield premiums are below long-term average*

Fig 5. **Yield premiums are trading below average**

Spread between 10-year Indian Government bond (IGB) and repo rate (%)




Source: Bloomberg, Standard Chartered. *Data as of November 9, 2022.

### Bond views at a glance

| Factors | Views | Comments |
|---|---|---|
| Real Yields | ◑ | **India's inflation-adjusted yield though low, is higher compared to other Emerging Markets.** The 10-year IGB real yield at 0% is better than the average real yield of -0.9% for other major EMs. |
| Supply dynamics | ◐ | **Record high bond sales amid an expansionary fiscal policy is a key risk**. The government pegged its net borrowing for FY23 at about INR 11.6trn, with INR 8.45trn planned in H1 FY23 (60% of total borrowings). Improvement in institutional investors' participation especially by foreign investors and OMOs by the RBI will be key to address supply concerns. |
| Monetary policy | ◐ | **Market expectations of rate hikes by the RBI remains elevated**. 1-year Overnight Indexed Swap (OIS) spread suggests market participants expect the RBI to raise policy rates by 100bps over the next 12 months. |
| Liquidity | ◐ | **The RBI's focus remains on normalization of policy and liquidity.** In FY23, the RBI has drained INR 32.4trn of system liquidity via variable rate reverse-repo (VRRR) auctions so far, after absorbing INR 155trn of liquidity in FY22. |
| Demand dynamics | ◐ | **Demand dynamics remain weak** given lower participation of institutional investors. CY 2022, foreign investor flows into bond markets are negative. |
| Yield premiums | ◓ | **Yield premiums trade below average.** The spread between 10-year IGB and repo rate is at 149bps vs. 5yr avg. of 176bps. The surge in high-quality (AAA) bond yields has normalized inexpensive valuations of high-yield bonds relative to them, with yield premiums between AA/A and AAA at 71/262bps (vs 5 yr avg of 56/188 bps respectively). |

Source: Bloomberg, Standard Chartered India Investment Committee

**Legend:** ○ Not supportive ◐ Somewhat supportive ◓ Balanced ◑ Supportive ● Very supportive

# Equity at a glance

## Key themes

Indian equities is a core holding as stretched valuations, both absolute and relative to peers is counterbalanced by above-trend economic growth and resilient earnings expectations amid a less restrictive monetary policy. Within equities, we prefer large-cap equities over mid-cap and small-cap equities on relatively better macro fundamentals and greater margin of safety in terms of earnings and valuation. We prefer a more domestic sector tilt with a mixture of value (financials, industrials) and defensives (consumer staples).

We believe equities continue to be supported by strong positive drivers. 1) Above-trend economic growth is likely to support corporate revenue and profitability. 2) Earnings outlook remains robust as earnings growth expectations outpace its major peers. 3) The recent equity pullback has created some valuation buffer. 4) Stable inflows from domestic investors amid inflows into systematic investment plans is a key support for the market.

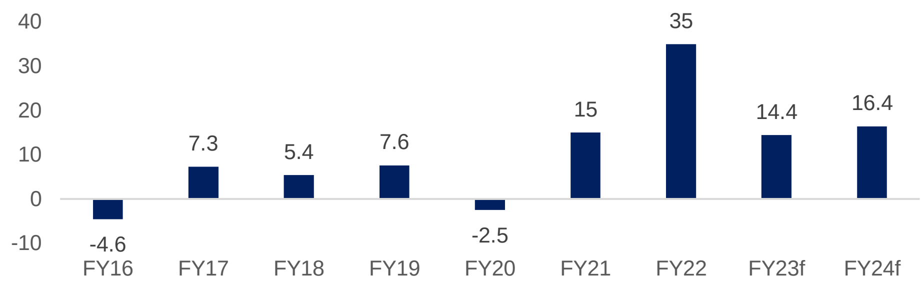
Risks to our positive equity view are: 1) Economic growth concerns and probable earnings downgrades of lofty expectations, 2) Above-average equity valuations, both on absolute and relative to peers, 3) A sharp rise in bond yields and 4) Foreign investor selling and slowing domestic investor flows.

## Key chart

*Bloomberg Consensus expectation is for Nifty earnings to rise by 14% and 16% in FY23 and FY24.*

Fig 6. **Indian equities earnings growth expectations remain robust**

Consensus estimates for Indian equities (Nifty index) earnings per share growth




Source: Bloomberg, Standard Chartered.

### Equity views at a glance

| Factors | Views | Comments |
|---|---|---|
| Economic environment | ◑ | **Growth-inflation dynamics are supportive of equities**. Growth focused fiscal policy, and a broadening economic recovery is likely to support corporate profitability. Weak consumer demand and rising inflationary pressures due to elevated commodity prices are key risks. |
| Earnings growth | ◑ | **Earnings growth expectations remain robust.** Bloomberg consensus earnings growth expectations for the Nifty Index for FY23 and FY24 stands at 14% and 16% respectively. Pace of downward earnings revisions have moderated over the past month. |
| Valuations | ◐ | **Valuations have moderated but trade rich compared to historical averages**. Nifty 12-month forward P/E trades at 19.5x, below its peak of 23x, but higher than its long-term average of 17x. Price to book value ratio (P/B) at 3.3x and Market cap to GDP ratio at ~105%, are significantly above long-term averages. Mid-cap equities trade at a 24% premium to large-cap equities, higher than its 10-year average premium of 8%. |
| Flows | ◓ | **Foreign investors have resumed buying since July but remain large sellers in 2022.** YTD 2022, foreign investors have sold USD 20.1bn worth of equities compared to USD 3.8bn inflows in CY 2021.<br>**Domestic institutional investors remain buyers in 2022**. YTD 2022, domestic institutional investor inflows are at USD 33bn compared to USD 12.6bn inflows in CY 2021. |

Source: Bloomberg, Standard Chartered India Investment Committee

**Legend:** ○ Not supportive ◐ Somewhat supportive ◓ Balanced ◑ Supportive ● Very supportive

# Asset allocation summary

**Tactical Asset Allocation - (12m). All figures are in percentages.**

<table>
<tr><th colspan="3">Summary</th><th>View vs. SAA</th><th>Conservative</th><th>Moderate</th><th>Moderately Aggressive</th><th>Aggressive</th><th>Very Aggressive</th></tr>
<tr><td colspan="3">Cash</td><td>◆</td><td>22.8</td><td>4.4</td><td>4.4</td><td>4.4</td><td>0.0</td></tr>
<tr><td colspan="3">Fixed Income</td><td>◆</td><td>56.6</td><td>55.3</td><td>40.2</td><td>25.1</td><td>15.0</td></tr>
<tr><td colspan="3">Equity</td><td>◆</td><td>15.4</td><td>35.2</td><td>50.3</td><td>65.4</td><td>80.0</td></tr>
<tr><td colspan="3">Commodities</td><td>◆</td><td>5.1</td><td>5.0</td><td>5.0</td><td>5.0</td><td>5.0</td></tr>
<tr><th>Level 1</th><th>Level 2</th><th>Level 3</th><th></th><th></th><th></th><th></th><th></th><th></th></tr>
<tr><td>Cash & Cash Equivalents</td><td></td><td></td><td>◆</td><td>22.8</td><td>4.4</td><td>4.4</td><td>4.4</td><td>0</td></tr>
<tr><td rowspan="2">Fixed Income</td><td>Short-term Bonds</td><td></td><td>▲</td><td>43.4</td><td>37.8</td><td>29.9</td><td>18.2</td><td>10.7</td></tr>
<tr><td>Mid/Long-term Bonds</td><td></td><td>◆</td><td>13.2</td><td>17.5</td><td>10.4</td><td>7.0</td><td>4.3</td></tr>
<tr><td rowspan="4">Equity</td><td>DM Equity</td><td></td><td>◆</td><td>2.1</td><td>4.1</td><td>6.1</td><td>8.2</td><td>10.2</td></tr>
<tr><td>Asia Ex-Japan / Other EM Equity</td><td></td><td>▲</td><td>2.1</td><td>4.0</td><td>6.0</td><td>8.0</td><td>10.0</td></tr>
<tr><td rowspan="2">Indian Equities<br>▲</td><td>Large-cap equities</td><td>▲</td><td>8.5</td><td>20.5</td><td>28.8</td><td>37.1</td><td>45.2</td></tr>
<tr><td>Mid/small-cap equities</td><td>◆</td><td>2.8</td><td>6.6</td><td>9.3</td><td>12.0</td><td>14.6</td></tr>
<tr><td>Commodities (INR Gold)</td><td></td><td></td><td>◆</td><td>5.1</td><td>5.0</td><td>5.0</td><td>5.0</td><td>5.0</td></tr>
<tr><td></td><td></td><td></td><td></td><td>100</td><td>100</td><td>100</td><td>100</td><td>100</td></tr>
</table>

▼ Least preferred ◆ Core holding ▲ Most preferred

Source: Bloomberg, Standard Chartered

All INR converted exposure. For illustrative purposes only. Please refer to the disclosure appendix at the end of the document

# Performance of our calls

| | Open/Closed calls | Open date | Close date | Absolute | Relative |
|---|---|---|---|---|---|
| Bonds | Indian short-maturity bonds to outperform mid- and long- maturity bonds | 17-Dec-21 | Open | | ✓ |
| Equities | Indian large-cap equities to outperform mid-cap and small-cap equities | 17-Dec-21 | Open | | ✓ |
| | India Value equities to outperform Indian equities | 17-Dec-21 | Open | | ✗ |

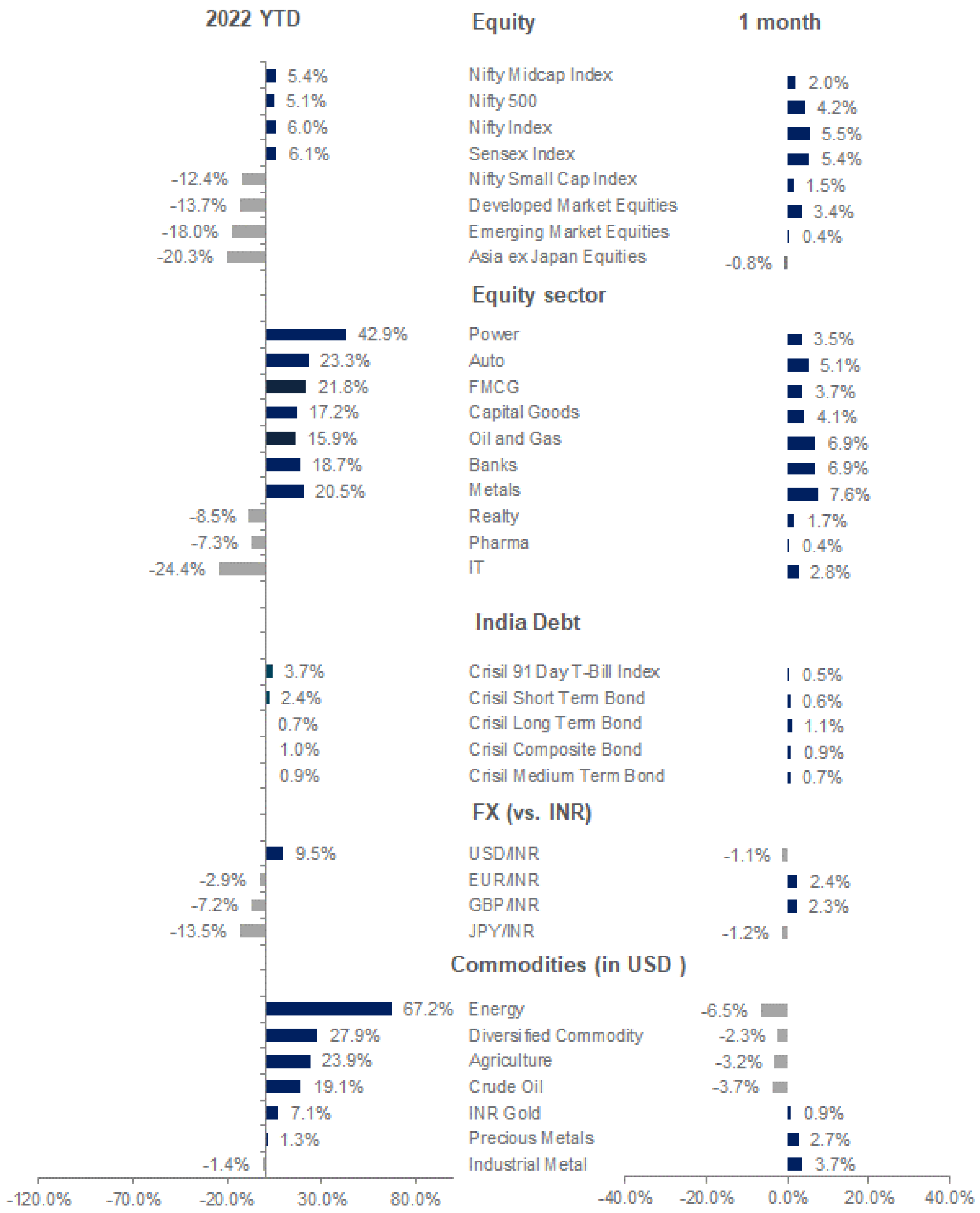
| | Open/Closed calls | Open date | Close date | Absolute | Relative |
|---|---|---|---|---|---|
| Asset Classes | Indian equities to outperform other Level 1 asset classes | 17-Dec-21 | 7-Oct-22 | | ✗ |
| Bonds | Indian corporate bonds to outperform Indian government Bonds | 17-Dec-21 | 7-Jul-22 | | ✓ |
| | Indian high yield bonds to outperform high quality bonds | 17-Dec-21 | 7-Jul-22 | | ✓ |

Source: Bloomberg, Standard Chartered. Performance measured from 17 December 2021 (release date of our 2022 Outlook) to 9 November 2022 or when the view was closed.

**Legend:** ✓– Correct call; ✗ – Missed call; n/a – Not Applicable.

Past performance is not an indication of future performance. There is no assurance, representation or prediction given as to any results or returns that would actually be achieved in a transaction based on any historical data..

# Market performance summary*




Source: MSCI, NSE, S&P BSE, Crisil, Bloomberg, Standard Chartered
*2022 YTD period from 31 December 2021 to 9 November 2022. 1-month period from 7 October 2022 to 9 November 2022.

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