Dear Investor,

Global equities bounce back

January 2023 witnessed a positive momentum in the emerging as well as developed equities owing to:

- China dropping its zero Covid policy which will open up way for normalized economic activity and supply chains,
- Consumer Price Index (CPI) continued to ease across developed economies - US December CPI print at came in at 6.5% v/s 7.1% in November.
- US Jobless claims fell unexpectedly to 1,86,000 by 6,000 from previous week.
- US economy growing faster than expected at 2.9% amidst stubborn inflation, rising interest rates and battered financial markets
- likes of Bank of Canada increasing policy interest rates by 25 bps and signaling it may be the last while Bank of Japan had a status quo policy.

With more and more data pointing towards a soft landing and a more comfortable inflation landscape, global markets exhibited strength. MSCI EM was up a strong ~7% in January along with a ~7% up move in MSCI World (developed equities index), especially after a weak CY22 for both indices (MSCI EM lost 22% while MSCI world lost ~19% of its market value in USD terms in CY22). Price recovery in emerging markets equity index is driven by North Asian markets (China, Korea, Taiwan) as region sees normalization of supply chains and economic activity owing to easing of China's COVID zero policy, finally. US on the other hand saw strength owing to hopes of soft landing and end of rate hikes in sight. S&P 500 is up 6% this month while NASDAQ posted an up-move of 11% during the same period.

Indian Equities have underperformed their global peers with a ~1% down move in Nifty 50 in USD terms and ~2% down move in local currency terms. Broader markets also remained weak as Midcaps and Smallcaps corrected ~3% and ~2% respectively in this month. In terms of sectoral performance, it was driven by the earnings season so far as seen by IT sector which was up 3% amidst not bad results as feared and supported by global tech buying. Automobile sector in particular has been a performing sector, and was up 5%, on the back of good results (especially on margins) after a long lull with benefits from easing raw material cost seep through. PSU banks underperformed after its stellar performance last year and was down ~7% during the month, partly aided by fear of exposure to a large Indian conglomerate.

Key Sectoral Trends

Inflation has been a persistent challenge for the world post Covid. While the key drivers of inflation have started to turn, yet, it continues to remain a focal point of all discussions among central bankers and investors. We believe, central bankers will be far less hawkish than last year, though may continue to remain in inflation fighting mode for some more time. Amidst this and its impact on global growth, will remain the key events that will be closely watched out for in India and globally. Upcoming General Elections in 2024 will be an additional event in India. While these events can lead to volatility in markets, eventual performance of markets will be driven by growth in profits, cash flows and its longevity.

CY23 is going to be an interesting confluence of slow global macro-economic growth, inflation and probably peak interest rate globally and also pre-election year locally. In this context let we will dwell into key issues for few important sectors:

- **Banking**: 2022 saw sharp improvement in banking credit growth to ~17%. This has been the highest credit growth since 2013. Credit growth has also been positively impacted by lower interest rate differential between India and developed countries. Consequently, the benefit of borrowing internationally has diminished, further accelerating the credit growth for banks. However, going forward, as the differential between real GDP growth and nominal GDP growth reduces, credit growth may settle at a rate lower than what we are witnessing currently. Retail credit growth has been ~20% for a while and we believe this can continue. Net Interest Margins (NIMs) may start to normalize as costs of deposit catch up with a lag, while sweet spot on credit cost may continue.

- **NBFCs**: credit growth momentum picked up in 2022 led by improvement in macro and continuing retail loan demand. Net Interest Margins (NIMs) for NBFCs have been under pressure, however, we should start to see stability as higher rates as fully reflected in borrowing cost. We see improving scenario as credit growth momentum continue, NIMs bottom out shortly before we see improvement and asset quality and credit cost largely normalized, leading to improving performance by the space.

- **Consumption:**
    - Consumer staple companies faced the dual headwinds of elevated input price inflation and a (volume) growth slowdown, as inflation impacted consumers' disposable income. Slowdown was sharper in rural India and at the bottom-of-pyramid in urban, with consumers titrating offtake and downgrading to smaller packs and lower-priced brands. Raw Material (RM) inflation started with crude oil and palm derivatives, although other inputs (notably agri commodities) also firmed up through the year. While companies hiked product prices, it lagged RM inflation and resulted in sharp gross margin contraction which also was visible at operating margins, though the impact was partially offset through cost optimization.
    - While rural and mass discretionary categories were impacted by inflation, premium discretionary categories with a higher urban skew were far more resilient. In fact, with minimal Covid-19 disruption in 2022, mobility and out-of-home consumption recovered. Further, players accelerated network expansion to benefit from the demand recovery.
    - Amidst this environment, we believe, rural consumption should start to bottom out. The winter crop sown area is +6% YoY so far, which along with higher water storage levels YoY, improves the outlook for winter harvest. Agri production has already seen two consecutive weak seasons in 2022 and, hence, the base is low. Also, agri commodity prices are also higher vs last year, particularly for key winter crops of wheat, which is positive for crop margins. Additionally, while the government has given low (2-5%) price hikes for the last 4-years for the wheat and rice crop procurements, the same could see a spike in 2023, ahead of the 2024 national elections. Also, 2023 is a pre-election year. Also, in general, we have buoyancy in rural consumption in a year before general election in the past. Government may also focus on capex in rural area and hence cashflow in last mile may improve.

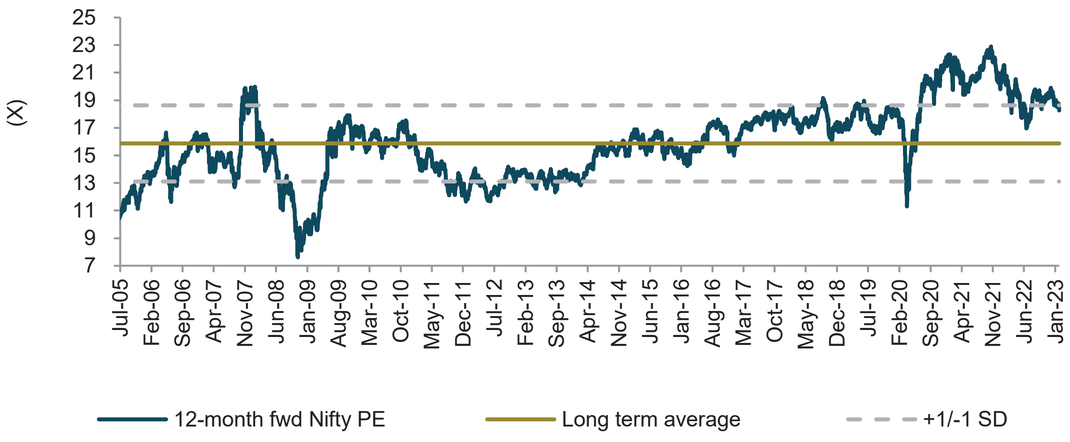
- **IT:** Macro pressures should continue to weigh on IT spends, driving growth rates lower. However, greater offshoring driving market share gains and easing cost pressure supporting margins are the key themes that should play out in the sector. We continue to remain underweight this sector, given relatively better growth opportunity in other parts of market.

- **Telecom:** Over the last couple of years, though large telecom companies’ operational performance has been strong, they lagged in free cash flow (FCF) generation and deleveraging, which posed a key concern for the sector. FCF is a key factor in telecom business as technology upgradation continually keeps capex intensity high. However, we now believe despite the upcoming investments in 5G, the sector is witnessing a strong shift in its FCF generation capability that could translate into healthy deleveraging. Industry dynamics are turning favourable with multiple levers of growth for the sector including shift toward 4G/5G, tariff hikes, market share gains. Also, higher 5G usage can throw open lot of new opportunities.

- **Manufacturing and the supply side challenges:** we are use to seeing globalization and globalization led efficiencies. Companies located production where costs were lowest. This led to very sophisticated supply chains for the industries and low cost for the consumers. However, post covid, there are visible cracks in the system and the trend of supply chain distribution is picking pace. Corporates are realizing that when the supply chain breaks, bills can be atrocious. We are seeing more distributed supply chains, where reliance on one country is reducing. Corporates are shifting from 'efficiency' to 'resilience' of supply chain. Consequently, India can be manufacturing hub in many industries viz. chemicals, pharmaceuticals, API manufacturing, engineering, auto ancillary. Manufacturing in India for 'India' and the 'globe' presents a long-term opportunity after many years. Further policy initiatives like PLI is supporting 'Aatmanirbhar' Bharat. This may help the whole ecosystem of component businesses, logistics, staffing businesses in the country.

Flows and Valuations

FII, in the first month of the year saw USD 3.1 bn of outflows, while China saw inflows on the back of low valuation and economic activity normalization as COVID restrictions ease. However, India continues to offer policy and economic stability and coupled with strong earnings performance, which will continue to provide downside protection to the markets. Retail participation though SIP flows continue to remain strong with USD 19 bn for CY22 (USD 1.6 bn in December was highest ever). DII have invested about USD 2.9 Bn in Indian equities till date.



Source: Bloomberg, ASK IM Research

Nifty's 12 month forward PE has time corrected by ~20% to 18.3x from a peak of 22.9x on account of earnings roll over. CY22 was marked by unprecedently quick rate hike cycle which led to sharp underperformance in global equities while India outperformed handsomely. Indian equities should be driven by earnings growth. Q3 results are ongoing. So far results have been more or less in line with estimates, with banks in particular, reporting strong performance. As commodity prices have softened, going forward, earnings will be driven by combination of revenue growth and margin expansion. It is all the more important to focus on businesses that have relative pricing and the ability to increase market share across varied business environment, in an environment like this.

At ASK Investment Managers, we are focused on businesses that have secular growth, management that have solid execution capability and businesses that have superior Return on Capital Employed (ROCE) – key traits of value creation.

Happy investing!

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