2024 – A PROMISING YEAR FOR INDIA

Ashish Gupta - CIO & Shreyash Devalkar - Head Equity, Axis Mutual Fund

If the start of 2023 was any indication of what the year would be, we all would have got it wrong. Despite initial uncertainties, the year unfolded with a surprising trajectory. Markets had a northward bound ride albeit with some speed breakers. It is these speedy bumps that led to a bigger ride ahead particularly in the last 2 months. This was a year of never say never whether in equities, bonds or commodities and even the macros. India raced past the US$ 4 trn mark, on the back of key benchmark indices soaring to all time highs, making it one of the few countries to do so.

The year started with expectations of slowing growth globally, however most economies if not all, stood up to the challenge and surprised with their macroeconomic resilience. In particular, it was widely expected that the US would have a soft landing, but the country defied all odds and expectations resulting in a magnificent rally in equities, a stronger dollar and higher bond yields. Overall, the global landscape was marked by high inflationary pressures across the world, rising interest rates thereof to control inflation, volatile crude oil prices and continuing geopolitical uncertainty. Notwithstanding this backdrop, all countries participated in the spectacular rally of varying degrees in equities led by the US.

2023 turned out to be a standout year for India because the world took notice of India's resilience in the face of an impending slowdown globally. Through the year positive developments such as robust inflows from FPIs and DIIs, strong macroeconomic data and controlled inflation targeting regime held India in good stead. Investors experienced a remarkable year with record high SIP flows ($2 bn) reaping benefits by staying invested regardless of market conditions.

Performance of global indices

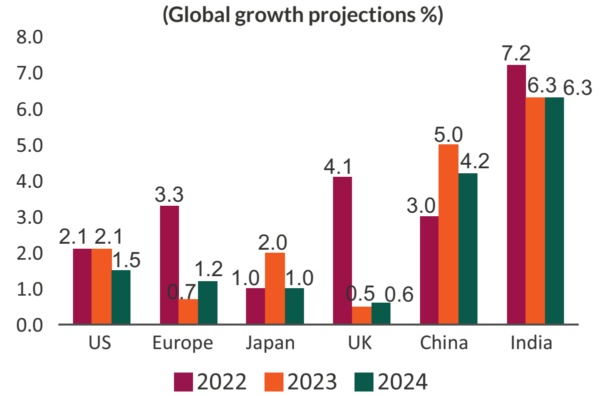
Source: Bloomberg

The above graph is used to explain the concept and is for illustration purpose only and should not used for development or implementation of an investment strategy. Past performance may or may not be sustained in future.

India's show of economic resilience

Global growth surpassed expectations in 2023 challenging initial concerns of a slowdown especially in the US. China was one outlier that started on a strong note but struggled through the year riddled with weak macro data and issues surrounding the real estate sector. In contrast, India emerged as a bright spot, maintaining its growth momentum and positioning itself as one of the fastest growing economies. In essence, India played the role of the "tortoise" outpacing the "hares" in terms of its economic growth. The second quarter GDP growth numbers at 7.6% suggested continued domestic momentum, with growth being well ahead of consensus and driven by manufacturing and construction growth.

Global growth projections



Emerging markets growth projections

Source: International Monetary Fund, HSBC

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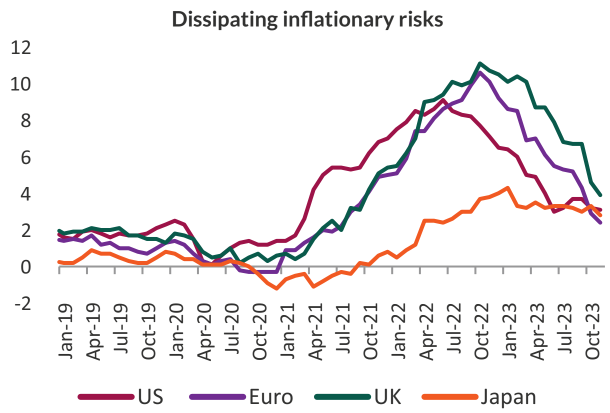
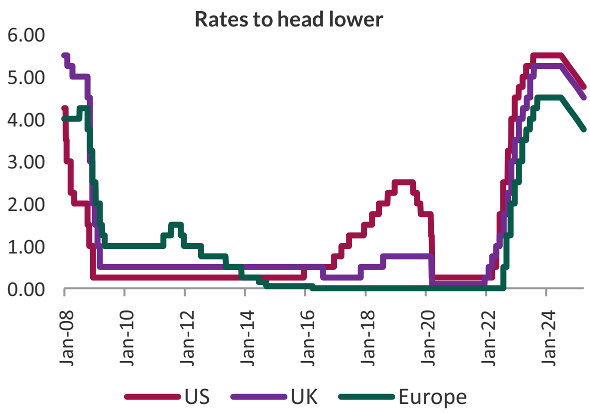
Global inflation and central bank responses

2023 was again driven by rising inflationary pressures and the action of central banks across the globe to temper these pressures. In all economies, inflation remained above target but retreated from the 2022 peaks due to declining food and energy prices. Despite the conflict in Middle East, oil prices successfully weathered the storm and were off their highs. Going forward, headline inflation will gradually retreat as commodity prices remain low. Crude oil too should likely remain low given the ample supply. Core inflation which has been sticky somewhat should start coming down too.

The world saw one of the most aggressive tightening cycles in 2022-23 and finally central banks stayed put on the interest rates. As the lagged effects of the rates transmission continues, gradual slowing of the economies and inflation getting closer to central banks' target should allow enough room for rate cuts.





Source: Bloomberg

Indian Equities performance over the years

Looking back, while it does seem that India delivered a strong performance in 2023, a pictorial snapshot of the last four decades suggest that India delivered such a performance in 7 out of last 30 years since 1993. Furthermore, in the last 8 years, India consistently delivered positive returns. In contrast, the S&P 500 delivered 6 years of positive returns with exception in 2018 and 2022.

India's annual performance between 1993-2023

-20 & below	-20 to -10	-10 to 0	0 to +10	10 to 20	20 to 40	40 to 50	50 & above
				1997			
			1997	2010			
			2013	1994	2014		
2000			2018	**2023**	1993		
1995			**2022**	2020	2017	2007	2009
2011	1998	1996	2002	2019	2012	2006	2003
2008	2001	2015	2016	2004	**2021**	2005	1999

in percent

Source: BSE, Morgan Stanley

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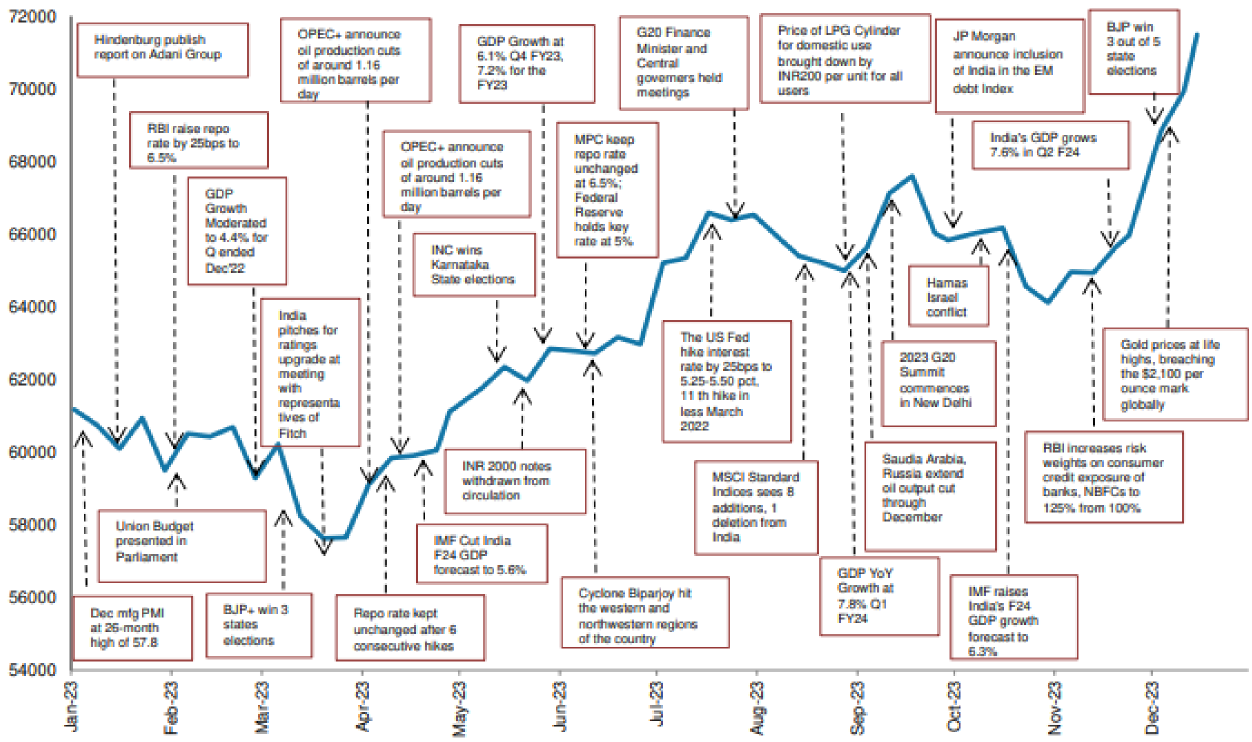
Recap of Indian Equity Markets in 2023

After a slow and negative start in the first three months of the calendar year, equities witnessed some spectacular gains across the market cap. An enhanced earnings outlook, robust macroeconomic backdrop and improvement in balance sheet strength of corporates drove the Indian growth story.

Sensex & Newsflow



Source: Morgan Stanley. Data as of 18th December 2023

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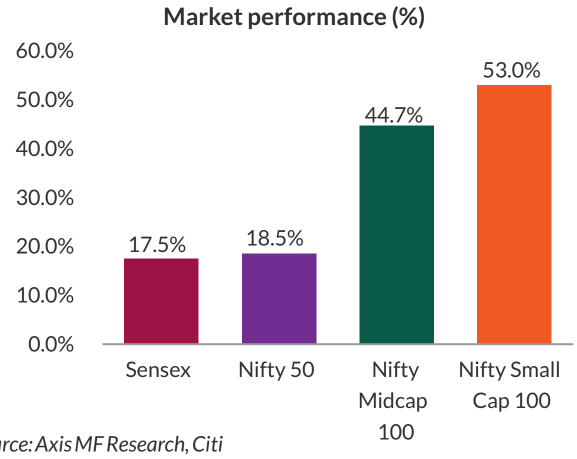
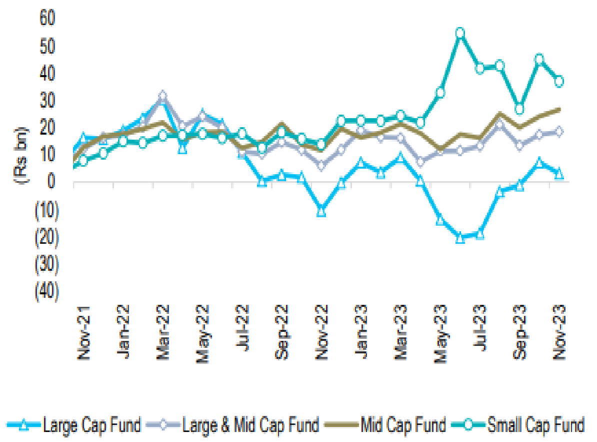
Recap of Indian Equity Markets in 2023 (Contd.)

A noteworthy feature in the strong gains so far this year has been the spectacular performance of small and mid-caps stocks versus the large-caps. It is pertinent to note that while foreign investors tend to be active in large-caps, it is the retail domestic investors that dominate the small and mid-cap space through domestic funds investing in this segment. It can be debated whether the flows chased returns or vice versa, ultimately the beneficiaries were the investors who believed in India's robust growth.

Mid and Small Caps dwarf the key indices



Inflows into equities by MF category



Source: Axis MF Research, Citi

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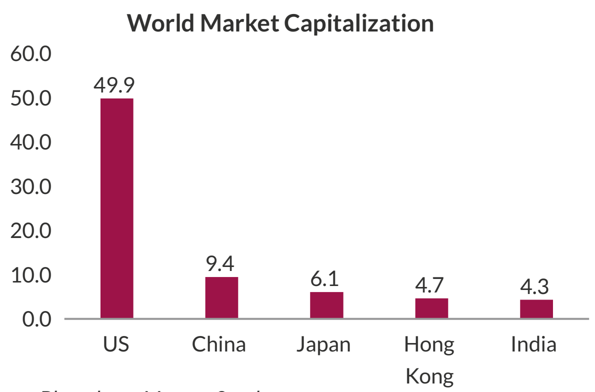
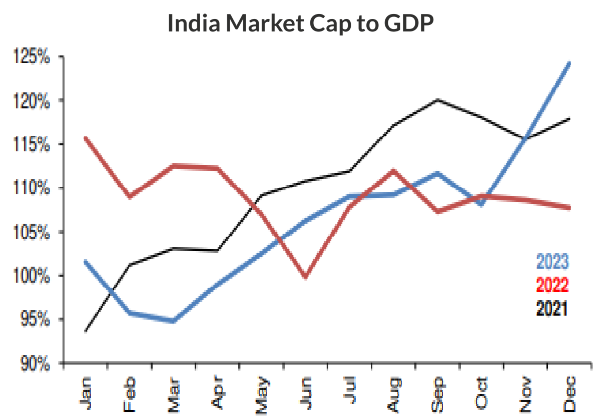
The outperformance in equities led to India joining the coveted $4 trn club, making India the fifth country to do so. The market cap to GDP ratio stands at ~1.25, indicating that the indices have raced pass India's nominal GDP. Separately, India's inclusion in the JP Morgan Global Bond Indices beginning June 2024 was a sentiment booster and eventually will result in increasing FPI flows in equities too. Furthermore, India's increasing weights in MSCI indices also added weight to its growing clout in the world markets.

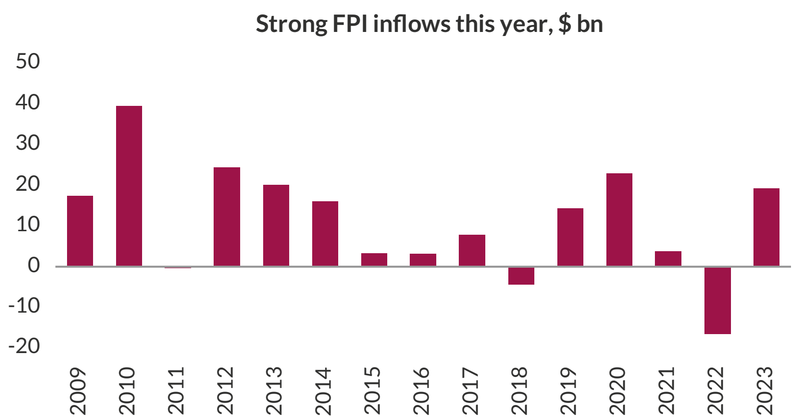




Source: Bloomberg, Morgan Stanley

FPIs turn towards India

While last 2 years saw outflows from FPIs, 2023 turned out to be a year of robust inflows. In fact the year saw inflows worth Rs 147,705 cr or US$ 18 bn (as of 15 Dec 2023) and within the emerging market basket, India was the highest beneficiary of these inflows. The sectors that saw the highest inflows were industrials, consumer discretionary and financials while energy and technology had outflows. Despite the strong inflows, the FPI's ownership in BSE 500 is near lows.

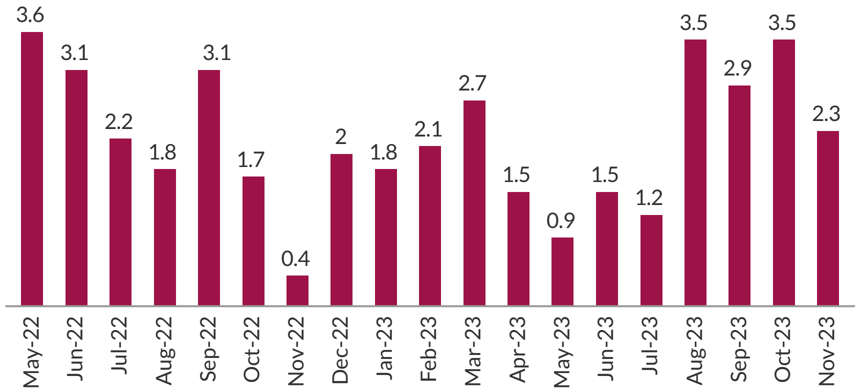


Source: NSDL

Domestic flows too set the ball rolling

While the FPIs returned to the markets, it was the DIIs that took centrestage pouring in funds worth US$ 22 bn. The rapid mobilisation of household savings was another factor that worked in favour of DIIs. Monthly SIP inflows topped the Rs 17,000 cr mark (US$ 2 bn) and most of it was reflected in inflows into mid and small cap funds.

Flows in long only domestic Indian mutual funds (US$bn)



Source: Bloomberg, Morgan Stanley

Valuations

Indian markets trade at premium valuations in context of long-term averages – both in absolute/relative terms. NIFTY EPS growth expectations for FY24E are 17%/20% and FY25E are 14%/15%. Recent earnings revisions have been resilient and better than long term trends. On a yield gap basis, the market looks stretched on valuations.

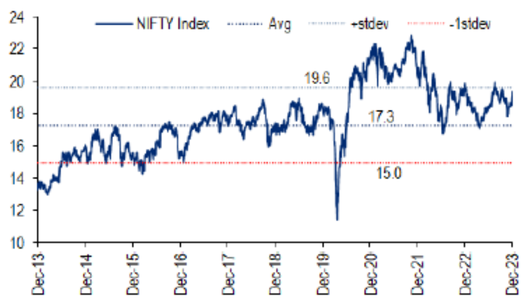
India's Valuations

Valuations at a Glance	India	EM	Premium	India	EM	Relative	India	EM	Relative
PE	24.9	14.4	1.7	25.5	12.2	2.1	26.9	14.0	1.9
Fwd PE	21.9	11.7	1.9	21.4	11.5	1.9	22.5	12.4	1.8
PB	3.8	1.6	2.4	3.6	1.6	2.3	3.8	1.9	2.0
Div Yield	1.1%	2.9%	-1.8%	1.2%	3.4%	-2.1%	1.0%	2.4%	-1.3%
ROE	15.3%	11.1%	4.2%	14.1%	12.9%	1.2%	14.2%	13.4%	0.8%

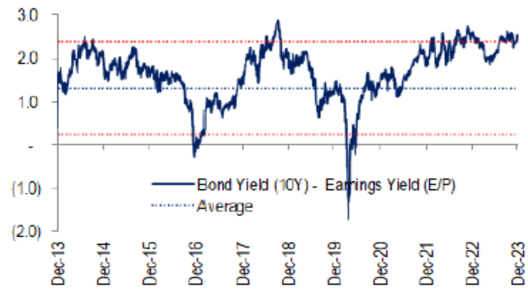
Source: Axis MF Research, Morgan Stanley

Past performance may or may not be sustained in the future.

NIFTY- 1Y Forward Valuation

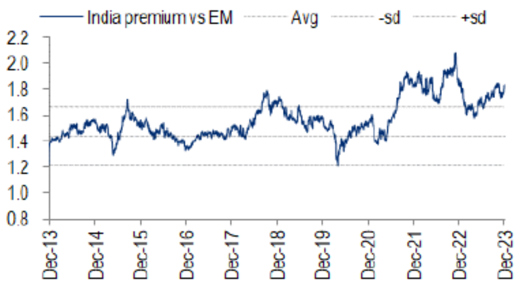


Bond Yield Gap

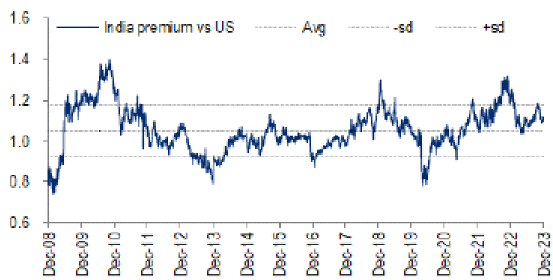


Source: Bloomberg, Citi Research

Valuation Premium Vs. EM: Above +1SD LTA



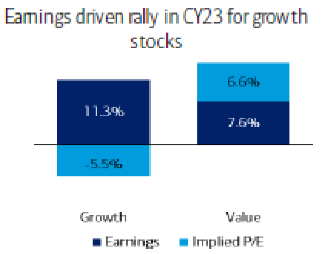
Valuation Premium Vs. DM: Above LTA

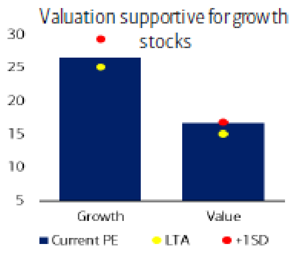


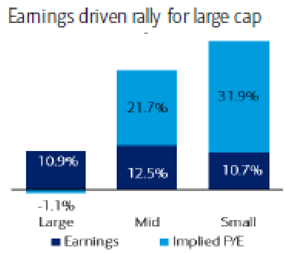
Source: Bloomberg, Citi Research

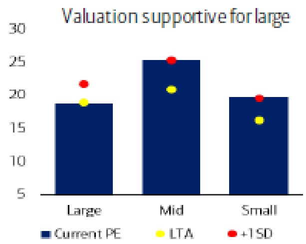
Notable shift in India's corporate earnings trajectory

The slowdown in corporate profits growth in the 2008-20 period meant that its share of GDP declined steadily. From 2021, the share reversed from the lows of 2% to above 4% now. The rebound has been broad-based across sectors, with nearly all sectors seeing a sharp recovery in 12-month-forward EPS after several years of stagnation. Financials, autos, real estate, and industrials dominate this change in trajectory.









Source: BofA Research

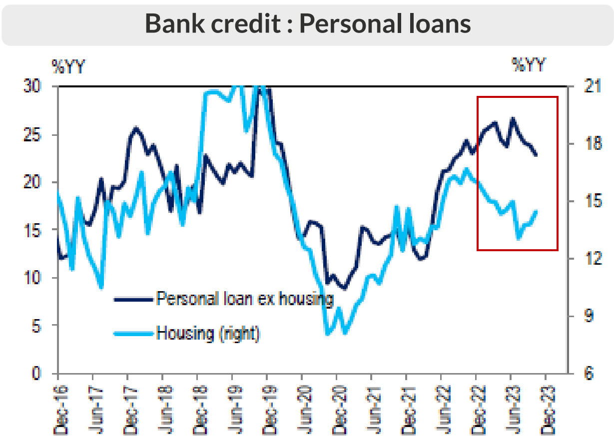
Despite India's persistent outperformance, PE valuations of large-cap indices, e.g. the Nifty50, are close to their five-year means. This suggests that a rotation to large-caps is imminent and some caution in mid-caps is warranted bringing us to the important aspect that's valuations. Currently, valuations in India are expensive relative to the Asian peers and India remains the most expensive market (on both forward P/E and trailing P/B basis).

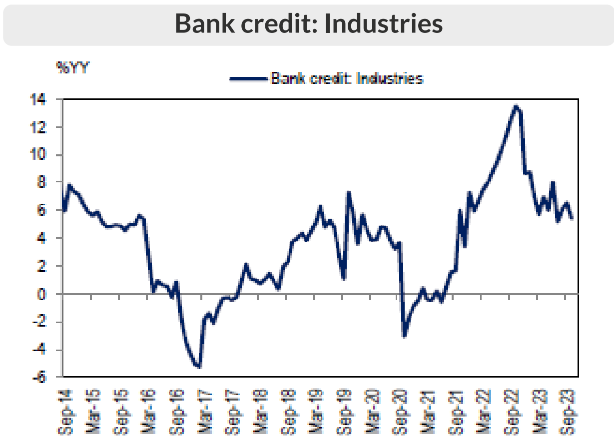
The earnings outlook for India remains strong relative to the emerging markets. In terms of earnings growth drivers, healthy credit demand and bottoming margins in case of banks should lead to high earnings visibility and strong profitability over the next few years. Within non financials, robust high end consumption demand and recovery of private capex cycle recovery in the second half should drive earnings growth.

India chart book

Credit Growth

Since FY23, credit growth has been accelerating led by the retail /personal loans segment while loans to the corporates have been relatively subdued. We expect credit growth to remain strong especially since the transmission of interest rates has improved in the system post the introduction of external benchmark linked rates. One cab expect the industry credit growth to pick up due to structural policy initiatives supporting domestic manufacturing, public & private capex recovery aided by improving utilization, and strengthened balance sheets overall.





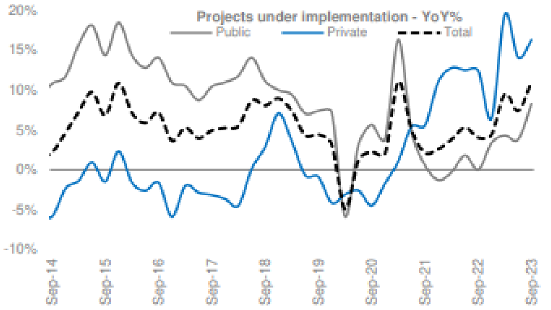
Source: Citi

Capex Cycle

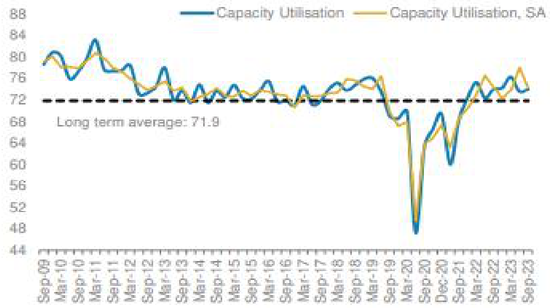
Private sector capex has picked up on absolute levels but remains broadly in line with GDP growth. All eyes are trained towards the pickup in capex cycle post elections. Most of the capex has been concentrated in sectors such as refineries, power and steel, with a large contribution from PSUs. Strong corporate balance sheets, cash flows and a favorable policy environment could help boost the capex trajectory. In addition, the macro construct remains favourable.

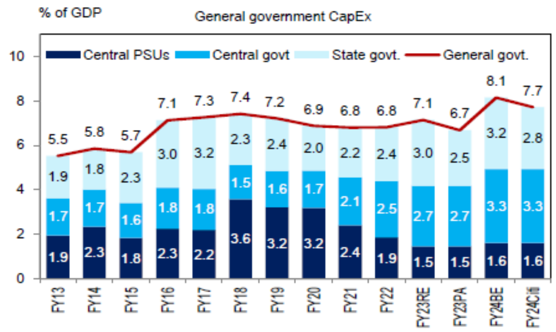
India chart book (Contd.)

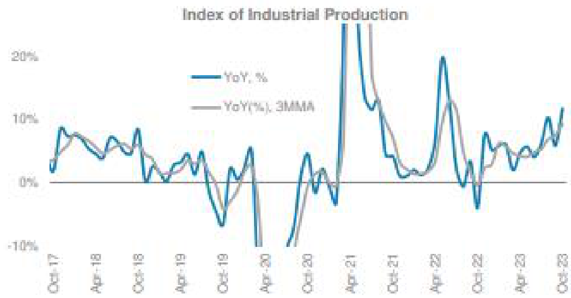
Projects Under Implementation (Quarterly)*



Trend in Capacity Utilization





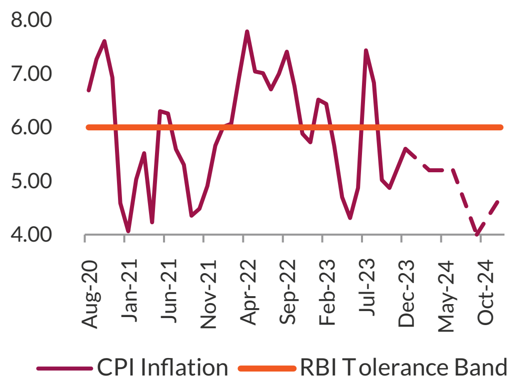


Source: Morgan Stanley, Citi

Inflation and monetary policy

Inflation slowed down giving the central bank some respite and allowing it to remain on hold since February 2023. Going forward, the central bank expects inflation to further cool off in the next one year. The RBI believes that the transmission of the previous rate hikes is still an ongoing process. If inflation is 4% by Sep 2024 as is the forecast, we could see market expectations around future policy build up in that time frame. We expect the RBI to remain on hold till the second half of 2024.

Inflation to fall further lower



Falling brent crude lends support

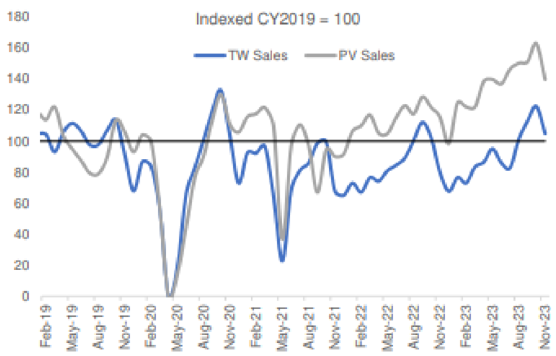
Source: Bloomberg

India chart book (Contd.)

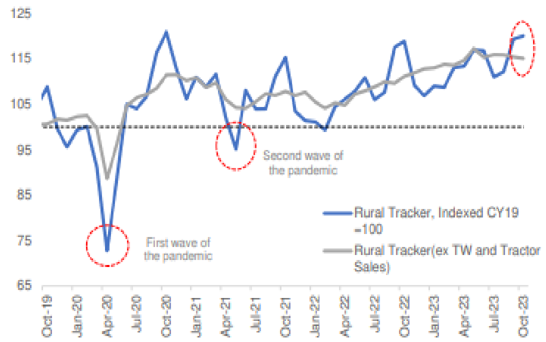
Consumption

Often considered as a boon for India's growth story (given India's large population), consumption, particularly, on the rural side has been a struggle in light of uneven monsoons. Urban consumption on the other hand has been robust as witnessed in car sales, residential property sales etc but could face tighter credit conditions and moderating employment in the formal sector. One surprise could be the election related spending that could boost demand. Consumption could also be impacted by the tightening of regulatory norms for unsecured lending by the RBI.

Trend in auto sales



Rural tracker shows improvement



Source: Morgan Stanley

View for 2024

Heading into 2024, all eyes remain focussed on global growth, inflation and on monetary policy outcomes in major economies. While 2023 saw inflation fall from near double digits to low single digits, 2024 could likely see gradual declines and these will be further supported by falling crude oil orices. The US has yet posted robust growth with the GDP print at 5.2% vs 2.1% in the previous quarter. However, tightening financial conditions and credit standards will weigh on consumer spending and pull down growth. Consequently, there has been a build-up in anticipation of a soft landing sometime mid next year. The euro economy already contracted this year and we expect it to struggle through early next year. Likewise, the UK could succumb to recession. However, growth in the Emerging Markets is expected to hold up relatively well. China will likely remain sluggish, struggling from the impact of a large debt burden of the real estate and infrastructure sectors.

With global inflation finally edging lower, many central banks should begin easing monetary policy by mid-2024. This, in our view, should turn out to be a powerful catalyst for equities. But a look at past cycles of lower interest rates is suggestive of markets rising ahead of rate cuts and falling post rate cuts. Subsequently, 2024 could be the year of two halves – first half that would witness the lagged effects of monetary transmission of interest rates and the second half benefitting from declining inflation and rate cuts thereof.

2024 is an election heavy year and will be held in countries including Taiwan (January), Indonesia (February), Russia (March), India (April-May), the United Kingdom (likely April or May), Korea (April), Mexico (June), the European Parliament (June), Venezuela (sometime in second half), and the United States (November). The outcome of these elections will influence the trajectory of economic performance in these countries and could provide a backdrop to the global geopolitical landscape.

Growth in the first half is likely to be driven by election related spending which should boost consumption demand. Post elections, we expect investment growth to take centrestage particularly from the private sector. If the state elections are any indication, the risks from general elections are quite low and in our view policy continuity would set the stage for a further rally in equities. In the near term, slowing growth in the developed economies could exert pressure on external demand thereby acting as a drag on exports. We expect our currency to remain in a narrow range in light of manageable current account deficit, potential bond inclusion inflows and large forex reserves.

While the government will reduce the fiscal deficit and in its own words achieve the target of 5.9% in FY24, we think this could be challenging. Tighter fiscal deficit and easy monetary policy could provide the right backdrop for falling yields and this will be further aided by the inflows of more than $24 billion through global index inclusion. Current account deficit could narrow further given the Balance of Payment surplus of $30 bn and if crude /commodity prices remain lower.

View for 2024 (Contd.)

Overall, India has the right ingredients in place to set the momentum further over the medium to long term. The big picture is suggestive of an economy that will benefit from long term factors such as improving infrastructure, manufacturing and the China plus one strategy ie curtailing imports and stepping up exports, formalisation of the economy and rising digitisation. India continues to be one of the few geographies globally that continues to record strong GDP growth with multiple positive drivers (as discussed above) in place to sustain it as well. This factor should continue attracting investors to invest in India.

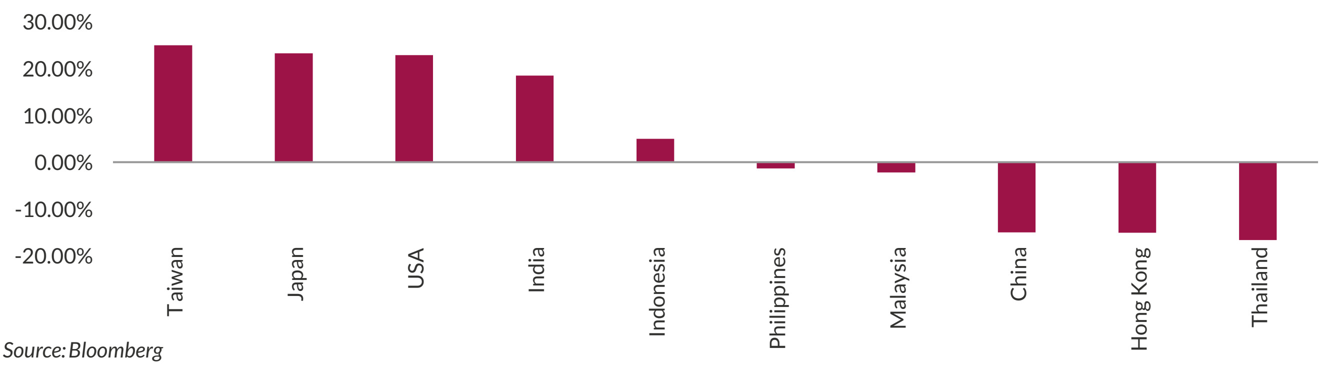
Mid and small cap stocks are trading at 2 standard deviations above their historic premium to large cap indices. However, it is pertinent to note that midcaps and smallcaps have seen last four quarters of earnings upgrade. While there could be apprehensions about the valuations, these are a reflection of the upgrades. Meanwhile, the Nifty, bolstered by a solid earnings trajectory, is currently trading at ~20x on a 1-year forward basis. Assuming there are no significant external disruptions, the existing market multiples are likely to be maintained, supported by strong domestic investment flows. Domestic cyclicals continued to lead earnings growth and one can expect the strong performance of domestic cyclicals to continue for the remainder of FY24, driven by better-than-expected margin improvement in automobiles and stable NIMs for banks. Consumption based sectors would remain under pressure given lacklustre rural recovery.

QUANT-IFYING THE MARKETS

Karthik Kumar, Portfolio Manager – Quant Strategies

2023 has been a good year for equities. Markets had a cautious start to the year with most in the red for the first quarter mainly due to concerns over persistent global inflation, hawkish global central bank policy and issues in the financial sector, particularly in the US. A pro-active stance by the US Fed in addressing issues impacting smaller banks helped stabilize the markets. Since then, moderating inflation trends, higher prospects of soft landing in the US and subsequent softening in language vis-à-vis monetary policy by most central banks proved to be a tail wind for the markets. Year to date, US markets as measured by S&P 500 index was up 22.9%. Most large Asia Pacific markets too except for China eked out positive returns for the year.

Performance YTD (Local Currency)



Source: Bloomberg

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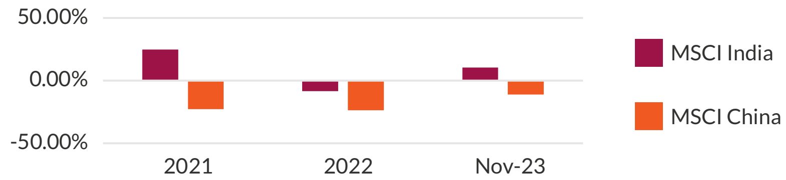
Indian markets continued their good form from last year as Nifty rose by 18.5% and was one of the better performing markets again this year. Our markets continued to outperform the Chinese markets for the third Consecutive year with the total outperformance starting 2021 amounting to almost 70% in USD terms.

India Vs. China Returns (USD)



Source: Bloomberg

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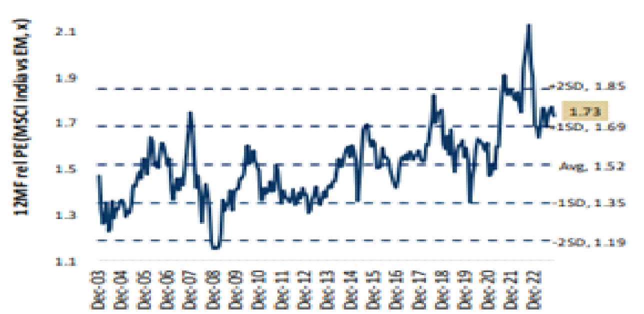
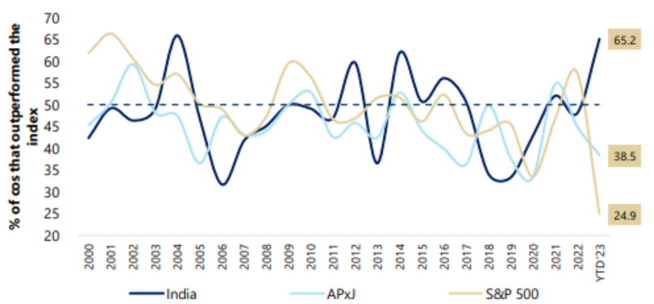
Further what sets apart our market has been the breadth of the rally. In the west, a few stocks account for bulk of the gains; however in our markets 65% of the stocks have outperformed the index. This is evident from the chart below and from the outperformance of mid-cap and small-cap indexes over the headline large cap index. As a result of this outperformance we are also trading at the higher end of the valuation spectrum.

MSCI India vs EM – 12M forward relative PE



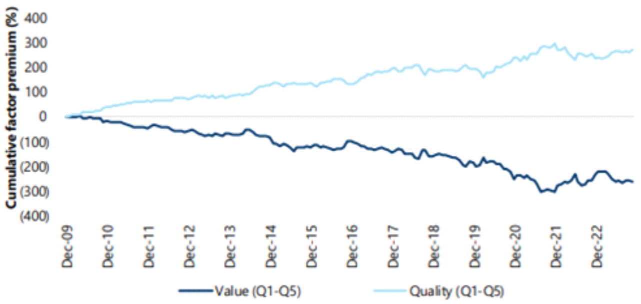
Percentage of stocks outperforming the index



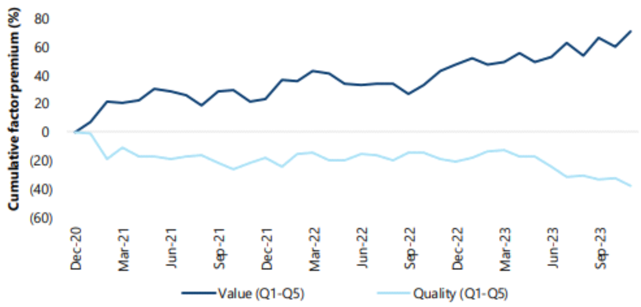
Source: Jefferies

From a style perspective, value was one of the best performing style, followed by growth but quality had another mediocre year. The rebound in value continues to be strong and it now has put in couple of years of strong performance after a decade of underperformance especially in relation to quality.

India: Value vs quality (Q1-Q5) OPF since 2010



India: Value vs quality (Q1-Q5) OPF since 2021



Source: Jefferies

Looking Forward

We believe the US rate cycle has probably peaked and with that the USD as well. This should favor emerging markets through increased fund flows. India's strong macro-outlook and a resilient earnings profile in the face of a global slowdown should justify a premium versus global peers, limiting the overall downside. However, election uncertainty and stabilization in Chinese economy / markets could dampen flows especially given the long underperformance and valuation discount of Chinese markets.

The macro environment we have highlighted i.e. moderating rates, Dollar weakening and soft-landing in US economy historically has meant a conducive environment for our style of Quantitative investing that blends different approaches i.e. Q-GARP, i.e. Quality & Growth at reasonable prices. Further, we expect the markets to continue to be broad based thus presenting us with investment opportunities beyond just the topline index names.

Disclaimer

Source of Data: Axis MF Research, Morgan Stanley, Citi, BofA, Bloomberg, BSE & Jefferies.

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