Dear Investor,

Positive Earnings and fall in Commodity prices keep Indian Equity Markets buoyant

Less hawkish Central Banks offer respite

After the banking distress in March, contagion risks seem to have eased for now as overall stress and default measures remained subdued. While elevated core inflation measures are still holding central banks back from sounding dovish, an end to the current tightening cycle seems to be in sight. While Federal Reserve, Bank of England (BoE) and European Central Bank (ECB) raised their policy rates by 25bps in their May meeting, several Asian central banks seem to be approaching the end of the hiking cycle. India, South Korea, and Indonesia all decided to keep their policy rates unchanged. New Zealand with a 50bps increase in April and Australia with a 25bps increase in May are the odd one outs.

While equity markets across the globe registered gains in April-May buoyed by positive earnings results. May performance globally has been impacted by slower than expected recovery in China and the debt-ceiling standoff in the US that weighed on the markets during the month. In INR terms, Nifty50 TRI was up 2.9% in May, underperforming broader markets with NSE Midcap 100 TRI and NSE Smallcap 100 TRI up 6.2%/5.1% respectively in the same period in INR terms. Autos, aided by strong FII inflows, up 7.7% (NSE Auto) and Realty on the back of upbeat earnings up 7.6% (NSE Realty), were the top performing sectors. PSU banks were the worst performing sector, down ~2.8% (NSE PSU Banks TRI).

Owing to time correction (range-bound markets for around 20 months now), Nifty's 12-month forward PE has seen a correction from its peak in the latest cycle to 18x. This has brought valuation into a rather comfortable zone – slightly lower than its 5-year average.

Price to Earnings (PE) has contracted not because of price correction, but because of growth in earnings while index remaining almost constant since October 21. Economic parameters have improved since then. Few of the parameters include:

- GST collection is up ~44%, from Rs 1.3 lakh cr in October 2021 to Rs 1.9 lakh cr in April 2023
- Nifty earnings is up ~16% in Q4FY23
- Inflation was 5.7% in December 2021. From there it peaked to 7.8% in April 2022 and now it is down to 4.7% in Apr 2023
- Brent Crude is down from ~85 USD in October'22 to ~73 USD in May'23.
- Credit growth has improved from 6.9% (Oct'21) to 15.6% (Apr'23)
- Monetary tightening cycle globally is all but over, with RBI deciding to keep policy rate unchanged at 6.5%

Source: Bloomberg

FII's have also returned as net buyers of Indian equities for three consecutive months in a row now as they have retreated from China. This has been the first instance of three consecutive months of net FII inflows since March'21. May 23 inflows stand at USD 4.3bn, cumulatively buying USD 8bn in last 3 months now. DIIs on the other hand have been net sellers to the tune of USD 0.3bn. In the same period, IT saw an outflow of USD 0.6bn, the highest among all the sectors, showing preference for domestic businesses vs global ones.

Global commodity market is showing signs of softening and should lead to positive impact on margins

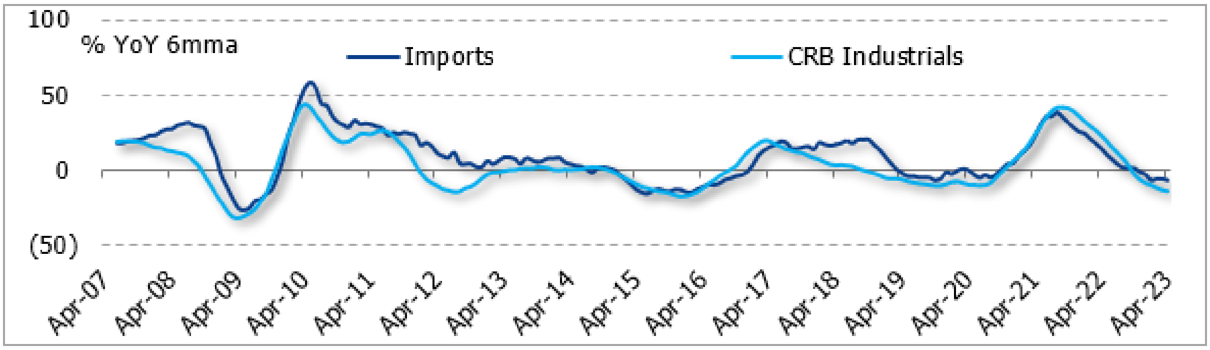
The aggressive rate hikes by global central banks to control inflation and the coordinated tightening of monetary policy which tightened financial conditions globally has led to a sharp slowdown in growth rates across the developed world. Organisation for Economic Co-operation and Development (OECD) composite lead indicator for G20 nations has been below 100 (long term average) since Mar-22, currently at 98.9 vs 100 in Apr-22 indicative of a turn in the business cycle. The world economy is expected to grow by 2.8% in CY23 vs.3.4% in CY22. The global slowdown coupled with dismal recovery in China post covid lockdowns, improving supply side responses as well as tight financial conditions globally have set in motion a deflationary impulse for commodities. The underlying momentum for Reuters Commodity Research Bureau (CRB) index has been on a downtrend with sequential change on 3mma basis declining for 9 of the last 12 months.

Given the current situation of the global economy, we expect the commodity prices to remain on a downward trend due to the following factors:

1. Global financial conditions remain tight and recent bank runs are giving rise to credit risk events in the West. The global central banks, especially in the West are showing affinity to stay at elevated rates for some more period of time. This tightening can impact economic activity (recession probability has increased to 68% in US as per New York Fed) keeping a cap on commodity prices.
2. China's recovery remains questionable with latest macroeconomic data surprising on the downside. Import growth has been declining since Oct-22 (excl Feb-23) and the PBoC has shown limited inclination to cut China loan Prime rate to limit the downside risks to growth.
3. Geopolitical equation currently signals India will continue to buy Russian crude. Even if the price spread narrows between Urals and Brent, expect India to remain a customer of Russian crude rather than increasing the imports of Brent crude. This should help to maintain a sense of balance in global oil markets.
4. While some headwinds to declining commodity prices can emerge from the anticipated El Nino and heatwaves across South-East Asia; the ease in agro-chemical input prices and fertilizer prices along with softer crude oil should help to partly negate the impact of rising global food prices.

The declining commodity cycle should provide significant tailwinds for Indian economy by easing inflationary pressures, moderating current account deficit and allowing MPC to remain on a prolonged pause. India's current account deficit is expected to ease to around 1-1.5% of GDP in FY24 from 1.9% of GDP in FY23. While El Nino continues to be a risk we need to watch out for, global dynamics suggest that inflation may trend lower than RBI's estimate of 5.2% for FY24. The expected softening of commodity prices and likely ease in interest rates should bode well for risk assets.

Reuters CRB Industrial index likely to be in deflationary zone due to dismal China demand:



Source: Bloomberg

Shift in global commodity cycle to supplement margin tailwinds despite tight labour market

The raw material deflation is expected to boost EBITDA margins albeit with a lag across most sectors. The lags can be attributed to factors such as existing inventory costs and fixed contractual agreements.

For metals and cement companies, this effect is particularly pronounced due to higher inventory days, as it takes longer for lower raw material costs to flow through to finished goods and thus to earnings. In the quarter gone by (Q4 FY23), we have already started to see the impact of lower fuel prices for cement companies and have seen profitability improving sequentially. This should be further visible in Q1 FY24.

Auto's, FMCG present a different dynamic, displaying a lag of just one quarter. This shorter lag can be attributed to the sector's typically faster inventory turnover and more flexible cost structures, allowing the companies to quickly respond to changes in raw material prices. In such environment businesses that have relative pricing should show a sharper margin improvement. Lag across industries may vary basis the inventory in the system.

Outlook

Going into FY24, we may see the after effect of sharp rate hikes globally, which may weigh on global growth. Developments in the global banking systems and the de-dollarisation worry can also induce volatility in the markets. However, on the domestic front, outlook for earnings seems alright – with earnings aided by margin improvement as costs stabilizes. India's relative long period growth attractiveness coupled with policy stability, strong demographic profile, improvement in private capex cycle, focus on sustainable growth also are a big differentiating factor – supportive of flows. Macro also is holding up well with external risks moderating.

With the improvement in economic parameters, coupled with inflation turning corner along with expectation of coming rate cuts the trigger for valuation de-rating no longer seem to be valid save for some external bout of risk-off event.

Happy investing!

Mr. Sumit Jain
Deputy CIO, ASK Investment Managers Ltd

Investment Approach Update

Markets continued to move up, with FYTD Nifty and BSE 500 returns at 7.1% and 8.5% respectively. The portfolio outperformed the benchmark during the month. Outperformance continued to be led by superior stock selection effect which contributed more than 80% of the outperformance for the month and FYTD and the rest by sector allocation effect.

The top 3 stock performers include Astral, Cholamandalam Finance and AU Small Finance Bank. Astral and Cholamandalam reacted positively to the stock business performance reported by the company in the quarter gone by. Astral not only reported strong volume performance, but a stellar performance on margins – partly aided by inventory gain, albeit to a smaller extent. Cholamandalam continues to impress with strong market leading disbursement growth along with better-than-expected performance on NIMs. AU Small Finance Bank reacted positively to approval by Reserve Bank of India for reappointment of Mr. Sanjay Agarwal as MD & CEO and Mr. Uttam Tibrewal as Whole Time Director for another 3 years, inline results for Q4 FY23, and a decent outlook for growth in future.

Top 3 underperformers during the month include Aarti Industries, Avenue Supermart and APL Apollo Tubes. While Aarti Industries and Avenue Supermart business performance was underwhelming, APL Apollo reported a performance in line with expectations. We continue to believe in strong growth expectations from APL along with improving profitability backed by solid ROCE.

During the month we exited out of Dixon and trimmed holding in Aarti Industries, Cholamandalam and Metropolis. We have introduced IndusInd Bank in the portfolio, leading to marginal increase in banking exposure in the portfolio. Overall, banking exposure in the portfolio stands at ~12% and finance exposure (banking, NBFC and insurance) at ~31%.

IndusInd bank has navigated through a tough period lately (IL&FS pain in FY19 & COVID stress in FY21). Besides this, the bank has undergone a change in management with many erstwhile top management members (the ABN AMRO team led by Mr. Sobti) leaving the bank. However, under the leadership of Mr. Sumant Khatpalia (the new MD & CEO), the bank has been gaining lost ground after putting the house in order (revised corporate lending framework, intense focus on liability, increased focus on retail loan book etc.). Following key developments are worth noting in the bank:

- **Growth making a comeback:** During the challenging period (FY19 to FY22), the loan growth had dipped to 8.6% CAGR compared with 21% CAGR for last 10 years. The growth slump was led by the bank's own asset quality challenges as well as COVID pandemic. A large part of the asset stress in the corporate loan book and MFI business has been recognized and well provisioned. Consequently, the bank has witnessed revival in loan growth (Q2FY23 growth at 18%). Driven by healthy growth in key domain areas i.e. vehicle finance and microfinance business, the loan growth is expected to improve further. Importantly, the retail: corporate mix of the loan book is expected to move from 40:60 currently to 60:40 over next few years which should be accretive to yields and NIMs.
- **Strengthening Liability:** Liability position of IndusInd bank has been relatively weaker compared with leading private sector banks as evidenced by higher cost of funds (~150bps higher). This was primarily due to high loan growth during Mr. Sobti's tenure. Under the new management, there is a concerted effort to improve liability profile through 1) home markets strategy, 2) scaling up affluent banking and NRI business 3) strengthening position in business owner segment etc. The results are gradually becoming visible: deposits in LCR at 41% from 26% in FY19, deposit concentration being reduced rapidly.
- **Better experience in vehicle finance & MFI:** While the bank has faced asset quality challenges in recent years, large part of this stress came from a few high corporate exposures. Overall experience in the domains of vehicle finance and microfinance has been significantly better than the industry average in terms of NPA. These two segments will remain the key growth drivers for loan growth over next few years.
- **Normalisation of return ratios:** Led by provisioning pressure during COVID, the RoA had dipped to 40bps in Q4FY20 as the bank created high buffers to absorb the stress. Since then, the provisions have been normalizing every quarter

with RoA now at 1.7%. There is material scope of further normalization in provisions cost to come which should boost the RoA further. In addition, the efforts underway to strengthen the asset and liability (discussed above) should create room for further improvement in RoA (beyond FY24).

Overall, quarterly results have tracked well. Most of the portfolio companies have declared inline/better than estimated profits, barring Page Industries and Divis in particular. Page Industries has been impacted by the weak consumer sentiment and impact on primary sales due to the reduction in channel inventory. We believe the growth slowdown in Page Industries is transitory; the company has strength to withstand the challenges and increase its market share. Divis has been impacted by a high base due to sales of Covid related drugs in the base. On a sequential basis, Divis has started to show improvement in the business.

While global macro may continue to remain volatile. Notwithstanding the upmove in markets recently, the after effect of the sharp increase in interest rates may continue to induce volatility in equities. In such an environment it is all the more imperative to focus on businesses that have solid business strength, superior relative pricing power, large and secular opportunity, value adding growth and above all execution prowess. We at ASK have continued to focus on such businesses. In FY24, we expect portfolio at an aggregate level to report profit growth of 25%+ with ROCE of 35%+.