

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

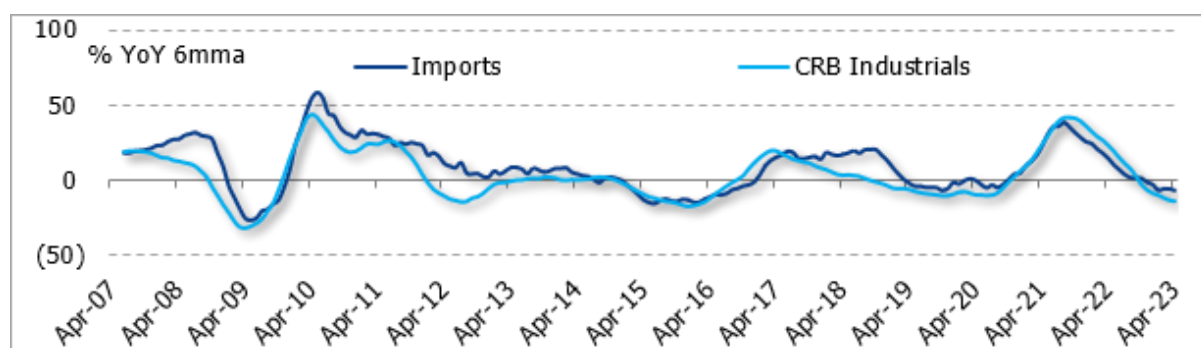
average) since Mar-22, currently at 98.9 vs 100 in Apr-22 indicative of a turn in the business cycle. The world economy is expected to grow by 2.8% in CY23 vs. 3.4% in CY22. The global slowdown coupled with dismal recovery in China post covid lockdowns, improving supply side responses as well as tight 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

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Investment Approach Update

Global markets turned volatile in the month of May, with leading indices ending the month lower in the range of 0%-3.5%. Inflation across most countries continued to edge lower in the month of April on the back of falling energy costs. The US Federal Reserve in its recently concluded FOMC meet hiked federal fund rate by 25bps as opposed to 50bps rate hike earlier. The RBI paused in its last MPC meet guiding that the future rate hikes will be driven by incremental data. The CPI for the month of April slowed down to 4.7%. The Indian markets ended the month higher by ~1% outperforming the global markets.

On the portfolio performance front, the portfolio outperformed its benchmark BSE500-TRI which delivered 3.8%. Outperformance was driven by our financial and consumption exposure. The key outperformers during the month were AU Small Finance Bank Limited, Bajaj Finance Limited, Bajaj Finserv Limited, Sona BLW Precision Forgings Limited, Polycab India Limited and Asian Paints Limited while the key underperformers were Navin Fluorine Limited, APL Apollo Limited, PI Industries Limited and Aarti Industries Limited.

On the portfolio actions, we have exited Aarti Industries Limited given the near-term headwinds on earnings growth. We have increased weight in HDFC Limited.

The Q4FY23 result season has been broadly in line with estimates barring negative surprise for IT companies. Out of our portfolio companies Navin Fluorine International Limited, Sona BLW Precision Forgings Limited and Polycab Limited reported better than estimated results while Infosys Limited and Aarti Industries Limited reported weaker than expected results.

In the near term, we will be monitoring inflation and the volume growth trajectory closely as we believe that acceleration in earning growth in FY24 will be driven by a combination of normalization in margins and acceleration in underlying volume growth.

Over the medium to long term, we believe that various regulatory/fiscal initiatives taken in the past few years coupled with structural transition in the manufacturing sector (favorable policy environment coupled with opportunities from shift in global supply chain) will translate into acceleration in GDP growth.

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