



TM

India Strategy

19 September 2022

INDIA STRATEGY

Market indicators

	Last price
Bank Nifty	40777
Sensex 30	58841
Nifty 50	17531
India 10 year	7.27
US 10 year	3.46
Dollar index (DXY)	109.6
USD/INR	79.69
VIX India	19.8
CBOE VIX	26.3

As on Sep 16, 2022

Please see Systematix Model portfolio perspective and list on page 7.8

Is India immune to global tightening?

We examine the implications of tightening global monetary policies, slower growth and trade, and diminishing forex buffer on India, in the context of rates, INR/USD, and growth outlook. Accordingly, we calibrate our model portfolio.

Stronger case for AE tightening transmitting into EMs: The path of restrictive monetary tightening adopted by central banks in Advanced Economies (AEs) and the narrowing global liquidity reflect the considerable drawdown in forex buffer in Asia by over 550bn from the 2021 peak, mostly contributed by China (-USD 195bn), and India (-USD 89bn). Significant further tightening by AEs could accentuate the transmission of tightening financial conditions into EMs.

Ephemeral gains for Asia from the post-pandemic demand surge in AEs: Emerging Asia, particularly China and India, gained disproportionately from the fiscal and monetary stimulus' in AEs, particularly in the US and UK. Demand surge and supply bottlenecks created new export opportunities, with substantial surge also seen in forex reserves. But those episodic gains are now reversing.

External sector buoyancy now a drag for India: While correction in global commodity prices is impacting price-led exports, higher consumption and crude prices are elevating imports, thereby widening the current account deficit (CAD/GDP) to 3.3% in FY23E, unmatched by capital lows. Thus, RBI will also be compelled to temper demand.

Asia-AE growth differential declining to just 2%: India's growth sensitive to global trade volume growth has risen to 1.73x since 2017 and reflects its large multiplier impact on the post-pandemic domestic recovery and rebound in urban consumption. Thus, we could see significant impact of global slowdown and recession in AEs. We expect India's growth to slow to 5.0-5.5% in FY23E from 8.7% in FY22, aligning with structural trajectory at 4-4.5%. But growth moderation being common across EMs, particularly Asia, could trend towards an average of 3.5-4.0% during 2022-26.

EM currencies have gotten inflexible: EM Asia central banks, mainly India & China scaled up the degree of exchange rate inflexibility in response to Fed's tightening and stronger dollar, which also led to EM currencies outperforming the more flexible AEs currencies. This has been afforded by a significant run down in forex reserves. But this inflexibility could get less sustainable as forex buffer dwindle further.

A case for sharper INR/USD depreciation, and higher rates: RBI would need to continue raising rates to a) suppress domestic demand and stimulate domestic savings, c) attract external capital, and c) narrow the CAD. Assuming it would take a long time for US' core PCE inflation to decline to 2% (currently at 4.6%, core CPI at 6.1%), US Fed rate could rise and sustain at 4.5% (futures market is pricing in 3% for Oct'22 and 4% for 2023). Hence, it would be plausible for India's repo rate to rise to 7.25-7.5% from 5.4% now. The unhinging of INR/USD from a near peg at 79-80 levels, wide gap between optimal reserve and actual (USD 740bn vs USD 540bn), narrowing of India-US interest rate spreads, low growth accompanied by high CAD and inflation, could sharply weaken the rupee. The annual trend depreciation in INR/USD could rise from 3.4% to 7%, with upper one standard deviation variance of 9.6%. Thus, INR/USD could depreciate to 85-86 over the next 6 months, which compares with our earlier target of 80-82 (CMP 79.69). Hence, our portfolio continues to remain focused on domestic themes, avoiding deep cyclical and rate sensitives (*see pages 7-8*).

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Post pandemic bounty for EM Asia is waning

Stronger case for AE tightening transmitting into EMs: The restrictive monetary tightening path adopted by major central banks and narrowing global liquidity reflect the considerable drawdown in forex reserves buffer of emerging markets; China, India and Japan have seen drawdowns of USD 195bn, USD 130bn and USD 89bn, respectively. These are translating into tightening financial conditions across most economies, demarking an episode of US Fed transition from easing to tightening that did not create an enduring surplus liquidity unlike post GFC episodes of QE1, 2, and 3.

The difference this time is that

1) the risk of unbridled high inflation in advanced economies running more than 8%, highest since 1980s, is forcing restrictive tightening by central banks, particularly the US Fed, ECB and BoE, not seen since early 1990s; this is migrating to a wider universe of central banks.

Even if the Fed hikes rate to 4.1% by Dec'22 (in line with the futures market and keeps it unchanged), core inflation till mid of 2023 would still be over 3%, i.e., higher than US Fed's target. Likewise, ECB which faced 9% inflation in Europe, has maintained that aggressive tightening would be necessary, notwithstanding the risk of a recession (see [US Inflation surges unexpectedly belying the risk on trade](#) and [ECB Commits to rigorous tightening](#)).

2) the situation has become complicated due to geopolitical conflicts, and

3) there has been an exponential rise in public debt in the aftermath of COVID. Reflecting the aftermath of the pandemic, the year 2020 saw the largest one-year surge in global debt since World War II; rising by 28% to USD 226 trn, 256% of GDP ([IMF study](#), Exhibit 30). A potential conflict between large debt servicing burden and monetary policy tightening to control inflation could see reemergence of trade protectionism.

These differences present a case for quicker transmission of global tightening into EMs, along with slower post-pandemic growth.

Substantial episodic gains for Asia from the post-pandemic surge in demand from AEs: Emerging Asia, particularly China and India gained disproportionately from fiscal and monetary stimulus' in AEs, G7 in general and particularly in the US and UK, as the contraction in their exports, due to the episodic surge in domestic demand and persistent supply bottlenecks created new export opportunities. China and India experienced 25% and 11% CAGR (2019-21) in export volumes. They also gained in export value from the surge in global commodity prices. The ultra-easy monetary policy of AEs, particularly the Fed, resulted in EM forex reserves bulging; RBI's forex reserve expanded by USD 160bn to the peak in Oct'21, and foreign currency assets increased by USD 140bn. Our select sample of Asian countries (Bangladesh, China, India, Indonesia, Japan, Malaysia, Sri Lanka, Taiwan, and Thailand) saw their combined forex reserves rise from the COVID shock by USD 640bn (to a total of USD 6.5trn), of which, the maximum share of 30% came to India, followed by China at 24%.

Episodic gains are reversing, as AEs curb demand and narrow EMs' net surplus: The big picture emerging from the synchronous monetary tightening, fiscal drag, and inward relocation of global sourcing by AEs is that it would considerably narrow the external surpluses to EM Asia, thereby reversing the episodic post-pandemic gains. Thus, if the adjustments in AE policies are structural, EM Asia could also be exposed to a long phase of tempered global capital flows, narrowing external surpluses, or widening deficits. The pervasive decline in EM and Asia forex reserves reflects this trend.

Unbridled high inflation in advanced economies running more than 8%, highest since 1980s, is forcing restrictive tightening by central banks, particularly the US Fed, ECB and BoE not seen since the early 1990s; this is migrating to a wider universe of central banks.

The situation has complicated due to geopolitical conflicts and the exponential rise in public debt, in the aftermath of COVID

Emerging Asia, particularly China and India gained disproportionately from stimulus in AEs, particularly in the US and UK, as the contraction in their exports, due to the surge in domestic demand and supply bottlenecks created new export opportunities. China and India experienced 25% and 11% CAGR (2019-21) in export volumes. They also gained in export value from the surge in global commodity prices. QE4 of USD 5trn by the Fed resulted in EM Asia forex reserves bulging by USD 600bn, of which, 30% came to India and 24% to China. The ensuing cycle is likely seeing these sporadic gains recede—exports are contracting, forex reserves are eroding, and growth is slowing below the pre-pandemic level. Inherent in this scenario is a case of weakening EM currencies

Moderating capital flows and continuously reducing forex reserves could accentuate the funding issues for EMs. For our sample Asian countries, the combined forex reserve has declined by USD 510bn out of which China, India and Japan have contributed 28%, 17% and 25% respectively. This would continue to force a rise in interest and policy rates

While correction in global commodity prices is impacting India's price-led exports of chemicals, textiles, garments, engineering goods, metals and other manufactured goods, buoyant consumption demand, bolstered by household leveraging and higher crude prices are elevating import growth and widening trade deficit, now at USD 28bn (Aug'22), 2x the pre-COVID level. Thus, the post-pandemic buoyance from the external sector is rapidly turning into a drag

The average growth differential between EM Asia and AE is expected to decline further to just 2% from pre-COVID average of 4% and 8% in 2008. India's growth sensitive to global trade volume growth has risen to 1.73x since 2017, reflecting its large multiplier impact on domestic recovery. Thus, as exports slow and interest rates tighten, we expect India's growth to slow to 5.0-5.5% in FY23E from 8.7% in FY22, aligning with structural trajectory at 4-4.5%

Thus, due to the demand compressing rate tightening adopted by G7 countries (particularly the US, Europe and UK), the post-pandemic rise in CAD/GDP for G7 (1.5% of GDP in 2022, US at 3.6%) and surplus for EM Asia to 1-1.2% (China at 2%, 2021) are likely to narrow going forward (IMF).

The fallout of moderating capital flows and reducing forex reserves could accentuate the funding issues for EMs, particularly those running external deficits. For our sample Asian countries, the combined forex reserve has declined by USD 560bn from the 2021 peak, out of which China, India and Japan have contributed 35%, 16% and 23% respectively.

In effect, the advent of normalisation phase in AEs is transmitting growth dampeners into EMs through declining exports, price realisation on exports, and tighter financial conditions, including higher interest rates.

Correction in global commodity prices leads to doubling of India's trade deficit: India's CAD/GDP is projected at 3.3% (BoP basis, assuming crude at USD 100/bbl) for FY23E. Correction in non-energy commodity prices, reflecting the decline in global PMIs, led to exports contracting 24% from the Mar'22 peak, decelerating to 1.6% YoY in Aug'22 (USD 34bn). However, imports continued to grow at 37% (USD 62bn). Non-oil import growth at 24% YoY compares with 1.8% YoY contraction in non-oil exports; it reflects buoyancy in domestic consumption, resulting from leveraged household demand and negative real interest rates on savings.

Thus, while correction in global commodity prices is impacting price-led exports of chemicals, textiles, garments, engineering goods, metals and other manufactured goods, higher consumption demand and higher crude prices are elevating import growth and widening trade deficit, now at USD 28bn (Aug'22), 2x the pre-COVID level. Thus, the post-pandemic buoyancy from the external sector is now turning into a drag.

Asia-AE growth differential declining to just 2%: Our estimates suggest that India's growth sensitive to global trade volume growth has risen to 1.73x since 2017 compared with 0.73x for China, reflecting its large multiplier impact on domestic recovery. Thus, there can be a significant impact of global slowdown and recession in AEs on India outlook. Despite the recent recovery, the structural trend in India's real private consumption is still 10% lower than the counterfactual pre-COVID trend. Also, high inflation at 7%, unmatched by income growth and negative real rates on deposits imply decline in household savings and surge in personal loans, growing at 19%.

Thus, as exports slow and interest rates tighten, we expect India's growth to slow to 5.0-5.5% in FY23E from 8.7% in FY22, aligning with structural trajectory at 4-4.5% (see [Lesser-than-expected 1Q GDP print forebodes a much slower 2H](#)).

But, this moderation in growth projections is common across EMs, particularly Asia, which could be trending towards an average of 3.5-4.0% for 2022-26 (Conference Board, Aug'22, Exhibit 4). Hence, the average growth differential between EM Asia and AE is expected to decline further to just 2% from the pre-COVID average of 4% and 8% in 2008, respectively. (See [China's growth concerns and the string of stimulus; why it is proving less effective?](#)).

EM currencies get inflexible on narrowing external surplus: Rate tightening and the advent of balance sheet contraction by the Fed have led to US dollar index of AE currencies appreciating more sharply (DXY rose 18% YoY, Exhibit 9) compared to those of Asian currencies, notably Chinese Yuan, Indian Rupee, Malaysian ringgit and Thai Baht (8-10%), despite slowing growth and dwindling external balance surplus or widening CAD (as in the case of India). This outperformance of Asian currencies

resulted from aggressive currency interventions, as central banks ran down forex reserves, hoarded since post-COVID QE4.

Since the series of crisis in 1990s, EM central banks have followed a mercantilist approach of forex management, hoarding balances to fend against potential capital flight. Accordingly, they amassed forex reserves from the post-COVID QE4 (Mar'20-Oct'21) through dollar buying interventions, thereby allowing limited currency appreciation vs USD DXY (INR/USD appreciated just 7% vs 13.4% for AE currency index, Exhibits 7 & 8).

As the US rates started to tighten and capital flows started to wane since Oct'21, our measures indicate that RBI has adopted extreme levels of currency inflexibility to limit INR/USD depreciation. China too has stepped up currency controls (Exhibit 10). Hence, the rundown of forex reserves by RBI (USD 78bn) and PBoC (USD 145bn) cannot be attributed just to the worsening current account balances.

But currency inflexibility will likely get increasingly less tenable: Our framework exchange rate (INR/USD) is primarily a function of domestic growth (and differential over AE) and capital flows (% of GDP); the depreciation impact of widening current account deficit (CAD/GDP) comes as a peripheral variable, relevant only after controlling for growth. There is no monotonic relationship between exchange rate and CAD/GDP (Exhibit 22). Generally, there is a positive relation between the value of Indian rupee and global crude oil prices (commodity prices rise with better growth); it turns negative only when it hurts growth (typically crude price over USD 100/bbl).

In the current context, we have structurally low growth (3-year CAGR for real GDP at 3%), capital flows are inadequate to fund the CAD/GDP, and domestic inflation is high (7%). This is a clear case for sharper depreciation than the controlled 8.2% YoY allowed by RBI.

In our assessment, RBI's currency interventions could get increasingly untenable as a) forex reserve/monthly imports have declined to 8 months, b) aggressive interventions have resulted in the tightening of domestic liquidity, slow money supply and deposit growth vs credit growth (Exhibit 26), thereby resulting in banks scampering for deposits and raising lending rates, and c) significant gap between our estimated optimal forex reserves (~USD 740 bn), and the actual balance with RBI at USD 551bn.

In our view, the rise in bank credit demand is significantly due to the tightening of liquidity and, also due to leveraged consumption. The surplus liquidity of the banking system has shrunk to 0.4% of bank deposits in the face of rising credit growth unmatched by growth in deposits (Exhibit 27). This could decelerate credit growth in 2HFY23 in response to rising lending rates, and a slowing economy; the initial signs of rising fresh slippages in 1Q results of banks, also gather pace in 2HFY23 (we maintain our UW on banks).

Widening forex gap and strong dollar could trigger sharper INR/USD weakening and higher rates: RBI's forex reserves at USD 551bn have sharply declined from the peak of USD 642bn in Oct'22. Hence, as a ratio of monthly imports, it has fallen sharply to 8.6 months from a peak of 28 months in Apr'20, and is a whisker away from 2014 lows (Exhibits 17). Contrastingly, the optimal level of forex reserves has risen sharply.

Our estimated optimal levels of forex reserves derived as a function of volatility of imports/GDP, reserves/imports, and opportunity cost of holding forex reserves (India-US 2-year treasury) is around USD 740 bn, compared with the actual USD 551bn.

Thus, if global liquidity tightens further, as we expect, and US dollar strengthens further, then the receding intervention buffer could imply a sharp depreciation in INR/USD, along with spike in short-term interest rates.

Our measures indicate that RBI has adopted extreme levels of currency inflexibility since Oct'21 to limit INR/USD depreciation. China has also stepped up currency controls

RBI's currency interventions and ability to sustain currency inflexibility could get increasingly untenable as a) forex reserve/monthly imports have declined to 8 months, b) aggressive interventions have resulted in the tightening of domestic liquidity, slow money supply and deposit growth, thereby resulting in banks scampering for deposits, and c) significant gap between the actual and our estimated optimal forex buffer. Thus, if global liquidity tightens further, as we expect, and US dollar strengthens further, then the receding intervention buffer could imply a sharp depreciation in INR/USD, along with a spike in short-term interest rates

FPI flows have revived after having retrenched by USD 37bn during Oct'21-Jun'22. The possibility of extended global tightening and slower-than-expected growth in India will likely continue to impact, keeping the pro-cyclical external capital flows, particularly FPI flows at modest levels

Will the revival in portfolio flows sustain? Unlikely soon, as retrenchment impulses remain: Portfolio flows into India have retrenched by USD 37bn since Oct'21, including USD 33bn in equity. We largely attribute this to a shift in policy stance of the US Fed, initially starting with a benign lift-off before progressing into restrictive tightening. The reversal of portfolio flows during Jul-Aug (USD 7.6bn) was triggered by premature market expectation of Fed reversing the tightening cycle mid-way.

But the scenario has changed significantly with the futures market now pricing in Fed rate at 4% by Dec'22, following evidence that US retail inflation is getting widespread, despite tightening in the past. It is also pricing in the rate to remain unchanged at 4% till the Nov'23 FOMC; In Jun'22 the futures market was expecting a two 25bp cuts after a projected peak at 3.5% in Dec'22.

Thus, there is a possibility that extended global tightening and slower-than-expected growth in India will continue to impact pro-cyclical external capital flows, particularly FPI flows.

RBI will likely need to raise rates to narrow trade deficit and attract capital

Since currency depreciation will have a second order impact on inflation, which is already high, RBI will likely need to continue raising rates to a) suppress domestic demand, b) increase domestic savings, c) attract external capital flows and c) narrow trade deficit.

Due to the sharp rise in global rates, Indian NRI deposits have become unattractive, despite the recently announced scheme by the RBI that allowed banks to offer higher deposit rates and short-term exemption from regulatory encumbrances. Monthly average flows under ECB-FCCB have also declined from USD 4bn (Jul'22 to Mar'22) to a fourth at USD 1bn, and very little has been accruing from NRI deposits (USD 400mn/month vs long-term average of USD1bn). These have also increased demand for bank loans.

Our analysis suggests significant upside to RBI repo rate; 7.0-7.5% looks plausible, if the Fed hikes rate to 4.5%:

- Despite the aggressive tightening, historical trends indicate that moderation in US core PCE inflation from the current high of 4.6% (core CPI at 6.1%, Aug'22) to the targeted 2% could take several years; based on optimistic assumption, we project this could happen at the fag end of 2025 (Fed projects 2.3% by end of 2024).

[From a high of 4.6% in 1989, it had taken core inflation years to come down to 2% (1996). This was preceded by wide-scale global trade policy liberalisation around 1990-93 to reap higher productivity. Contrastingly, in the current scenario of elevated public debt, we expect more of protectionism, Exhibit 18].

- We expect the Fed to increase the policy rate to rise to 4.5% or more (2.25% currently) and sustain it at those levels, which should translate into attainment of a desirable real rate of +1%, above the neutral rate of 0.5% by early 2024. This would be higher than 3.8% projected by the Fed by the end of 2023. Overall, there is a high likelihood that the meeting on 20-21 Sep'22 would culminate into upscaling of both inflation and Fed rate projections in Fed's summary of economic projections (Exhibits 19).
- For India, the real rate is -1.6% (repo rate of 5.4% less CPI inflation of 7%) vs a pre-COVID average of 2.3%. Thus, if we assume CPI inflation softens gradually to 5% by the end of 2023, the plausible repo rate target could be 7.25-7.5%.

Since currency depreciation will have a second order impact on inflation, which is already high, RBI will likely need to continue raising rates to a) suppress domestic demand, b) increase domestic savings, c) attract external capital flows and c) narrow trade deficit.

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We expect the Fed to increase rates to 4.5% or more (2.25% currently) and sustain it at those levels, which should translate into Fed attaining a desirable real rate of +1%, above the neutral rate of 0.5% by early 2024

In sum, if the US Fed rate indeed is increased to 4.5% or above by mid-2023 and kept at those levels then it is highly plausible for India repo to rise to 7.25-7.5% in the current cycle.

- Looking at it from the standpoint of India-US real rate differential, the pre-COVID average (2014-19) is 2.6%. Thus, assuming 1% real rate for the US by the start of 2024, India's real rate should be at 3.6% (1+2.6%). And with an inflation of 5.0%, the nominal policy rate works out to be even higher at 8.6%.
- Lastly, the pre-COVID differential of 4.5% between nominal India-US policy rate would imply 9% repo rate for a peak 4.5% Fed rate.

Thus, in sum, if the US Fed rate indeed is increased to 4.5% or above by mid-2023, and sustained at those levels, then it is highly plausible for India's repo rate to rise to 7.25-7.5% in the current cycle.

INR/USD - Potential for higher average depreciation and rising volatility

The summation of our analysis encompasses a) receding post-COVID impulses, which could lead to growth decelerating (5-5.5% for FY23 and structural at 4.4.5%), b) narrowing surpluses for EM Asia, and widening CAD for India, c) decline in forex reserves cover for India and EMs, d) rise in US rates to 4.5% and other AEs, and d) tightening global financial conditions dollar is likely to make exchange rate management tricky, as central banks in EMs may be compelled to allow greater currency depreciation due to depleting forex reserves.

From India's standpoint, the unhinging of INR/USD at 79-80 levels from a near peg, wide gap between optimal reserve (estimated to be over USD 740bn) and actual at USD 540bn (8 months of imports), narrowing of India-US interest rate spreads, low growth, accompanied by higher-than-commensurate CAD and inflation are likely to sharply weaken the INR/USD on top of what we have seen till now.

Based on these factors and the scenario of continued tightening in AE central banks, we expect the trend depreciation in INR/USD to rise from the current 3.4% per year to over 7%, as seen during the low growth phases of 1997-99 and 2012-13. In addition, the expected decline in currency interventions, resulting from further decline in forex reserves could also increase the volatility towards or beyond the one standard deviation of 9.6% YoY. This rise in volatility and higher currency depreciation will also add to the reason for RBI to raise rates. The Broad REER index for the Indian rupee is about 5% higher than the long-term average. Thus, in the near-term, INR/USD could depreciate to 85-86 over the next 6 months, which compares with our earlier target of 80-82 (CMP 79.69).

We expect the trend level of INR/USD depreciation to rise from the current 3.4% per year to over 7%, as seen during the low growth phases of 1997-99 and 2012-13. In addition, expected declines in currency interventions resulting from further decline in forex buffer could also increase the volatility towards or beyond the one standard deviation of 9.6% YoY. Thus, INR/USD could depreciate to 85-86 over the next 6 months, which compares with our earlier target of 80-82 (CMP 79.69)

What can change the scenario?

Overall, Indian growth outlook will likely need to negotiate the dominant withdrawal symptoms of global slowdown and tightening financial conditions against the incipient post-COVID revival in domestic urban demand to a sub-trend level.

Private capex cycle is still very feeble ([FM Sitharaman asks India Inc why it is hesitant to invest in manufacturing](#), BS Sep 13, 2022), despite the record rise in FY22 profits (Nifty 50 companies saw 38% YoY growth), a bulge in operating cash flows, increase in market share, government attempts to crowd in private sector through spending, tax cuts, etc., and RBI suppressing the post-COVID solvency risk through large surplus liquidity and regulatory forbearance (LAF balance touched a peak of 5.4% of bank deposits in Oct'21 before declining to 0.5%).

Our research a year ago talked about lack of domestic demand ([Is India finally seeing emergence of private investments?](#) Jul 2021). Hence, the recent rise in interest rate cycle, volatility in exchange rates could act as potential drags for the evolving recovery.

What can circumvent this drag is a scenario of:

- An unexpected reversal in the monetary policy trajectory of the US Fed and ECB from tightening to easing.
- Positive supply shocks in India, resulting in higher sustainable growth, along with inflation moderation, better capital inflows and currency appreciation.
- Indian manufacturing gaining from export opportunities vacated by China.
- Historically, India's economy and corporate performance have flourished during the long phase of liberal global trade regime (BSE Sensex profits grew by an average 17% p.a during 1992-2008). Hence, if contrary to our expectation, US and China reconcile on trade conflicts, it could act as a significant counterbalancing trigger.

Systematix portfolio view: Increased focus on domestic themes

- Continue to focus on domestic themes, with an OW on consumption.
- Rising rates and currency depreciation could have growth and valuation implications, specially for rate sensitives, and deep cyclicals.
- Consumption demand exposed to leveraged consumption, viz., housing and autos could also get impacted.
- Reduce exposures in global cyclicals and companies that gained from post pandemic rebound in the US and Europe, specially in consumer and industrial spaces.

Changes in the portfolio:

- Additions: SRF, Aditya Birla Retail, Ramco Cement, Shriram Transport, HDFC Life, Cipla, Indoco Remedies, and HAL
- Deletions: Navin Florine, Zydus Lifesciences, Sanofi India, and Bharat Forge

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Maruti Suzuki has been our non-consensus sell idea.

Overall, Indian growth outlook will likely need to negotiate the dominant withdrawal symptoms of global slowdown and tightening financial conditions, against the incipient post-COVID revival in domestic urban demand to a sub-trend level

Private capex cycle is still feeble. Hence, the recent rise in interest rate cycle, volatility in exchange rates could act as potential drags for the evolving recovery

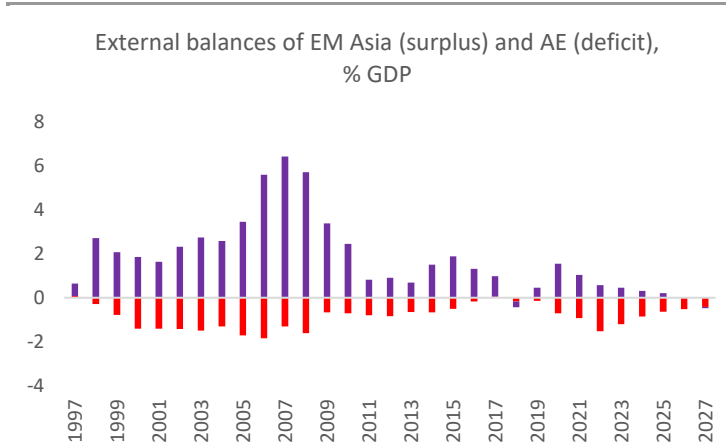
Historically, India's economy and corporate performance have flourished during the long phase of liberal global trade regime. Hence, if contrary to our expectation, US and China reconcile on trade conflicts, it could act as a significant counterbalancing trigger

Exhibit 1: Systematix model portfolio

	Sector weights			Systematix Financial portfolio	Stock weights
	Systematix	Nifty Index	OW/UW		
Agri Input & Chemicals	1.0	0.5	0.47	SRF	1.0
Auto & Auto Ancillaries	7.0	6.0	1.02	Eicher Motors	2.0
				Ashok Leyland	2.0
				TVS	1.5
				Endurance	1.5
Building Materials	0.5	-	0.50	Stylam	0.5
Cement	3.0	2.2	0.82	Shree Cement	1.0
				UltraTech Cement	1.3
				Ramco Cement	0.8
Consumer Durables	3.0	-	3.00	KEI	1.0
				Bajaj Electricals	2.0
Consumer Staples & Retail	13.54	12.2	1.38	GCPL	4.5
				Britannia Industries	1.4
				HUL	3.0
				ITC	2.3
				Aditya Birla Retail	2.3
Industrials	2.0	-	2.00	BEL	1.0
				HAL	1.0
Infrastructure/Construction	2.5	3.6	-1.09	Larsen & Toubro	2.5
IT Services	12.0	15.3	-3.31	HCL Tech	4.0
				Infosys	6.0
				Persistent Systems	2.0
Metals & Mining	-	2.8	-2.76		
Oil & Gas	11.6	12.6	-1.00	Reliance Industries	6.8
				BPCL	1.5
				IGL	3.3
Pharmaceuticals & Healthcare	5.50	3.9	1.58	Dr Reddy's	2.0
				Cipla	2.0
				Indoco Remedies	1.5
Telecom	3.0	2.3	0.68	Bharti Airtel	3.0
Utilities	3.0	2.5	0.46	NTPC	3.0
Financials	32.4	36.2	-3.76	Financials	
Insurance	1.0	1.4	-0.40	HDFC Life	1.0
NBFC	8.0	9.3	-1.33	Bajaj Finance	2.5
				Cholamandalam Finance	1.5
				HDFC	2.0
				Shriram Transport	2.0
Banks	23.4	25.4	-2.02	AXIS Bank	3.6
				HDFC Bank	9.0
				ICICI Bank	8.8
				State Bank of India	2.0
	100.0	100.0		Total	100.0

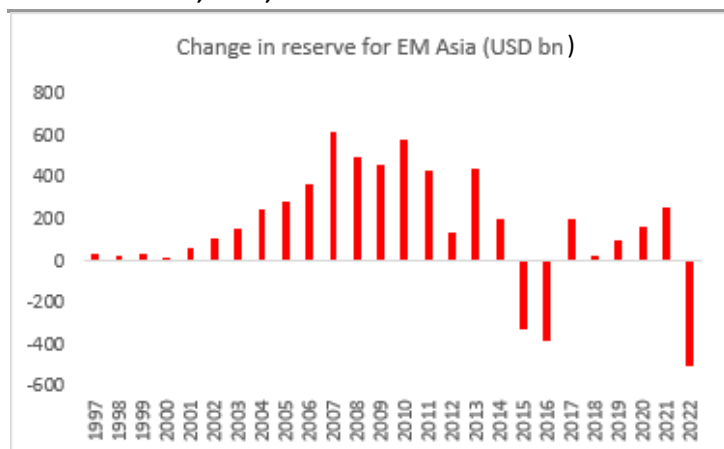
Benchmarked to Nifty 30

Exhibit 2: Monetary tightening, trade protectionism and AE's fiscal drag to temper the post-COVID rise in surpluses for EM Asia



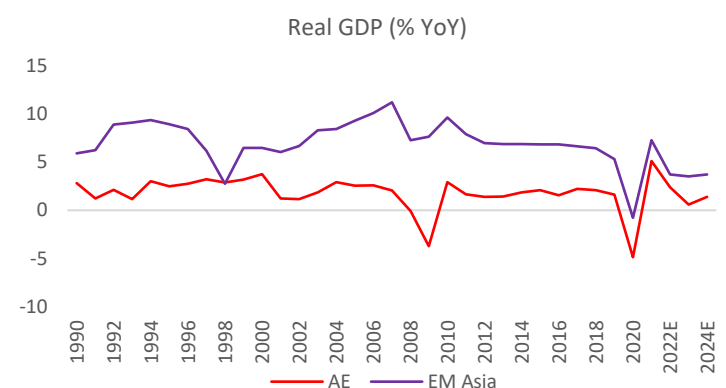
Source: IMF, Systematix Research

Exhibit 3: This has resulted in drawdown in FX reserves of EM and Asian economies; India, and China saw maximum decline



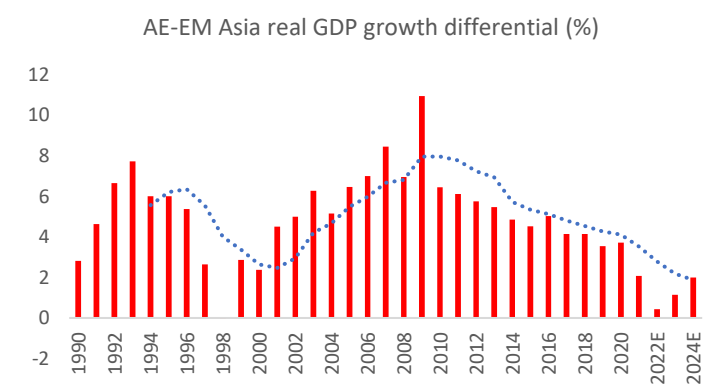
Source: IMF, Systematix Research, 2022 based on data available till Sep'22 from Trading Economics

Exhibit 4: Rising protectionism after GFC 2008 has depressed EM Asia growth from 8-10% to 5-6%, likely 3.5-4% post-COVID shock



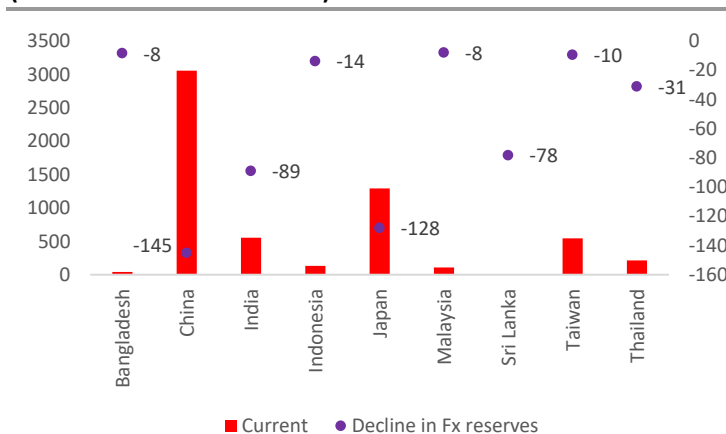
Source: IMF, Systematix Research

Exhibit 5: Structural decline in AE-EM Asia growth differential from 8% to 4% pre-COVID; post COVID likely to be lower at 2%



Source: IMF, Systematix Research

Exhibit 6: EM Asia central banks have run down forex reserves (maximum for China & India)...



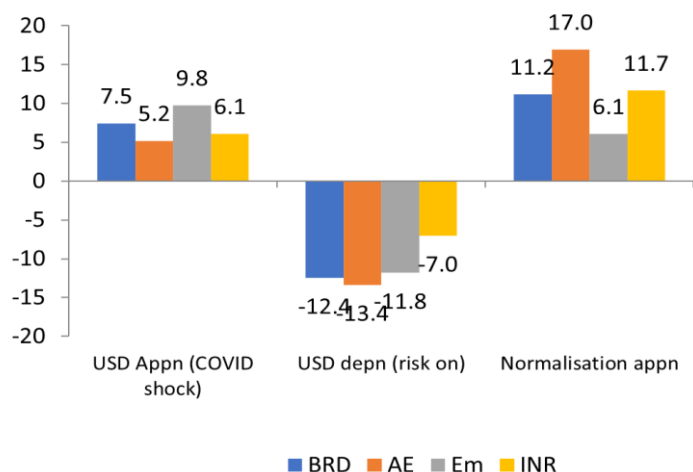
Source: Trading Economics

Exhibit 7: ...to defend their currencies (performance %)

Symbol	1 Month	YTD	1 Year	3 Years
USD/BDT - Bangladesh	10.0	21.9	23.2	23.9
Dollar Index (DXY)	3.0	14.4	17.8	11.7
USD/KRW - Korean	5.4	16.6	17.3	16.7
USD/PHP - Philippine	2.5	12.5	14.6	10.0
USD/THB - Thai Baht	4.1	11.1	10.7	21.0
USD/MYR - Malaysian	1.6	8.9	8.8	8.4
USD/INR - India	0.4	7.0	8.2	11.5
USD/CNY - China	3.0	9.9	8.0	-1.5
USD/IDR - Indonesia	1.3	4.9	5.1	6.1
USD/SGD - Singapore	1.9	4.3	4.3	2.4
XAU/INR - Gold Spot INR	-4.6	-2.1	3.2	24.3
USD/BRL - Brazil	2.4	-5.1	0.0	29.7

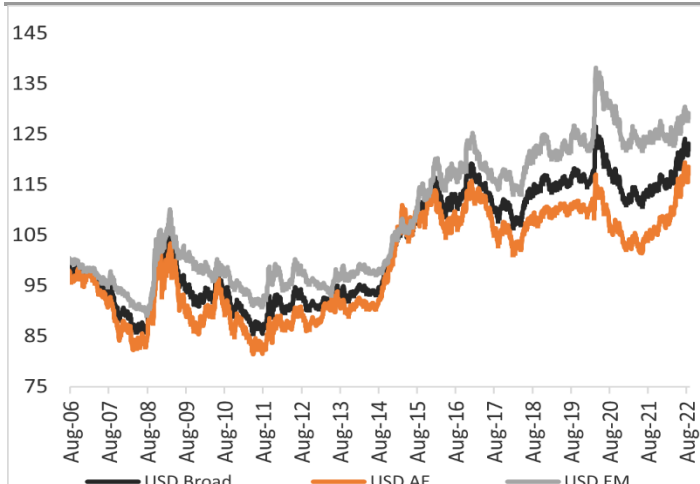
Source: Investing.com

Exhibit 8: INR/USD has shown lesser responsiveness to USD indices post COVID, indicating active interventions by the RBI



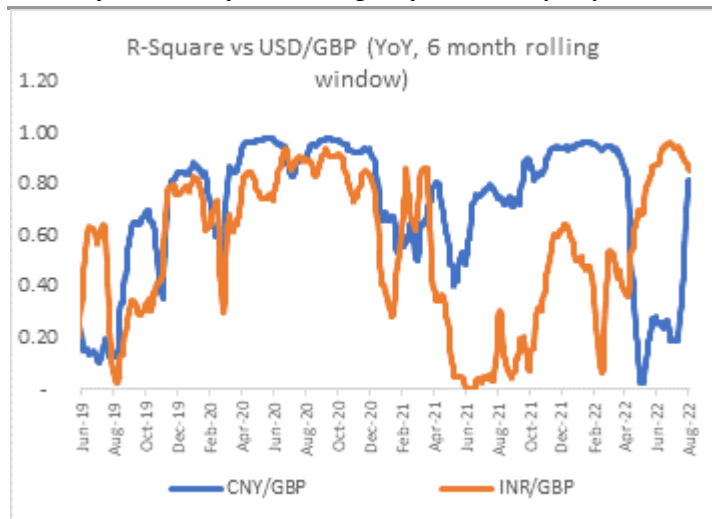
Source: Bloomberg, Systematix Research

Exhibit 9: Dollar indices; USD EM appreciated relatively lesser than USD AE, indicating latent depreciation in EM FX



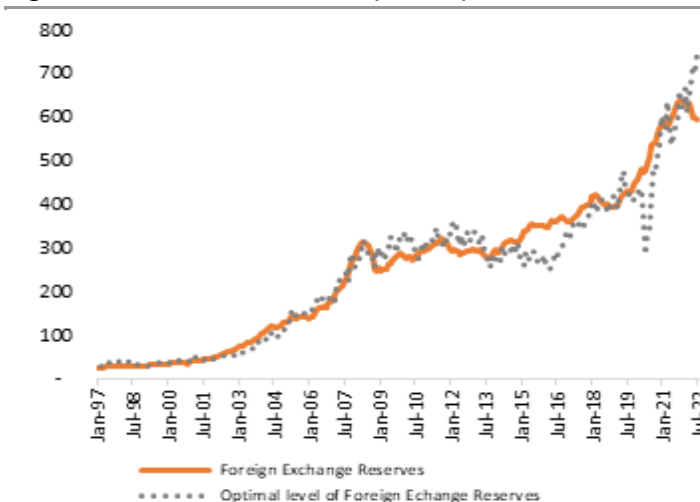
Source: Fred Database, Systematix Research

Exhibit 10: Rising R-square (~1) indicates India and China followed currency inflexibility; unwinding may cause sharp depreciation



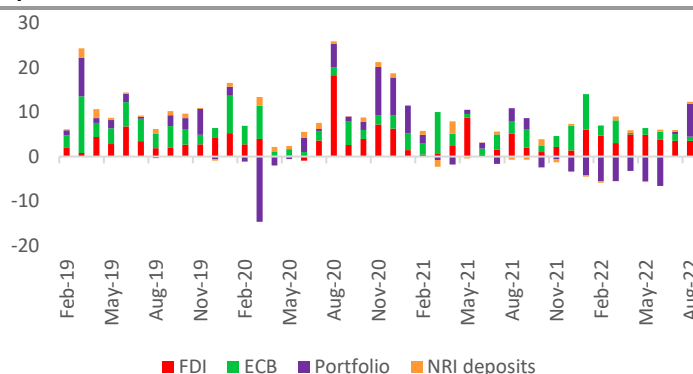
Source: Bloomberg, Systematix Research

Exhibit 11: RBI's estimated optimal reserves now USD 700bn higher than actual at USD 540bn (USD bn)



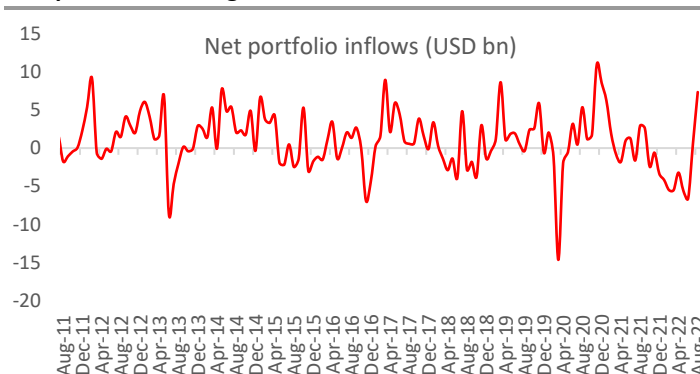
Source: CMIE, Systematix Research

Exhibit 12: High frequency data shows synchronous moderation in capital account flows

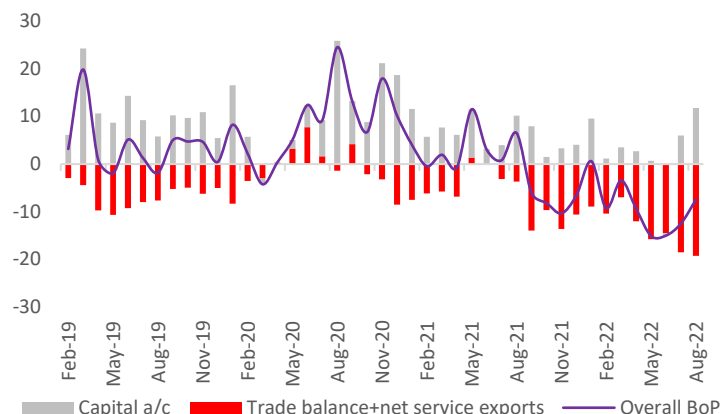


Source: CMIE

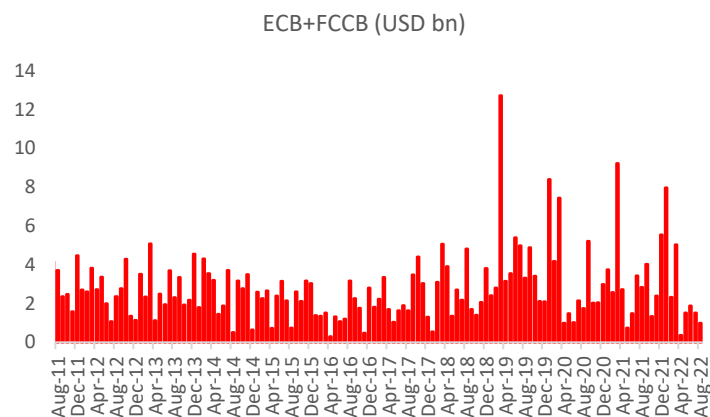
Exhibit 13: High frequency data; Trade deficit and low capital a/c components, leading to BoP deficit; Fx reserves decline



Source: CMIE

Exhibit 14: Overall BoP lead indicator-based aggregates

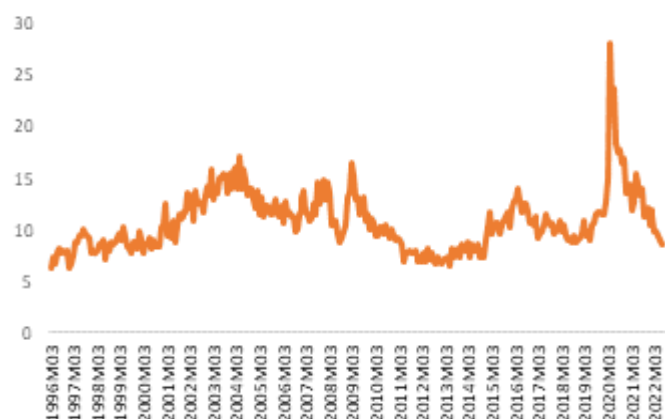
Source: CMIE, above indicators do not represent full components of BOP

Exhibit 15: Rising global rates have reduced ECB flows into India

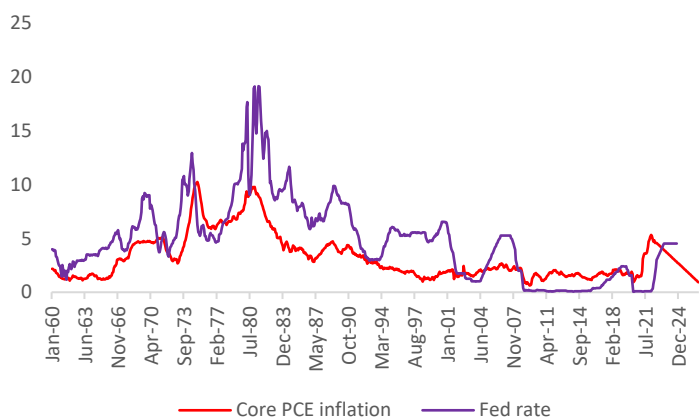
Source: CMIE

Exhibit 16: India-US rates are at low levels; Higher short term US rates and INR/USD depreciation likely to push up India rates

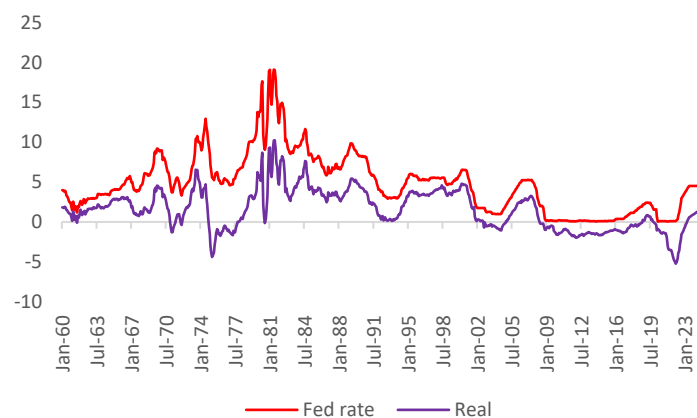
Source: Bloomberg

Exhibit 17: RBI's forex reserves/imports declined sharply due to rebound in imports and fall in reserves

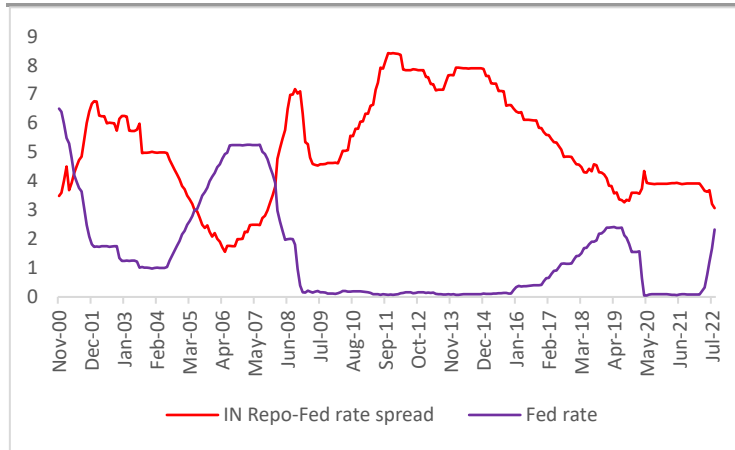
Source: CMIE

Exhibit 18: Moderation of core PCE inflation from 5% to 2% likely to be a long path, Fed rate could stay at 4.5%

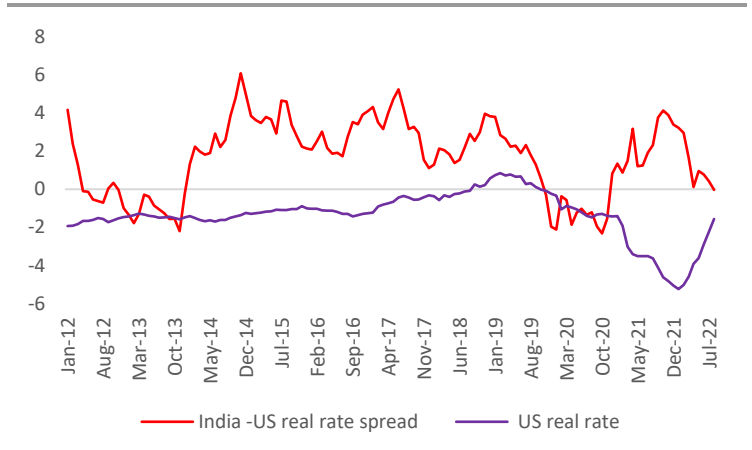
Source: Bloomberg, projected after Aug'22

Exhibit 19: Desirable real Fed rate at 1% above the neutral rate (0.5%) to arrive in 1Q2024 (currently at -2.3%)

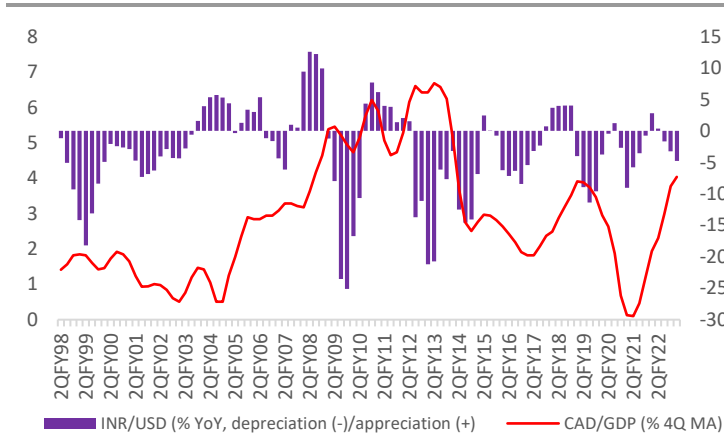
Source: Bloomberg, projected after Aug'22

Exhibit 20: India repo-Fed rate spread, pre-COVID level at 4.25%

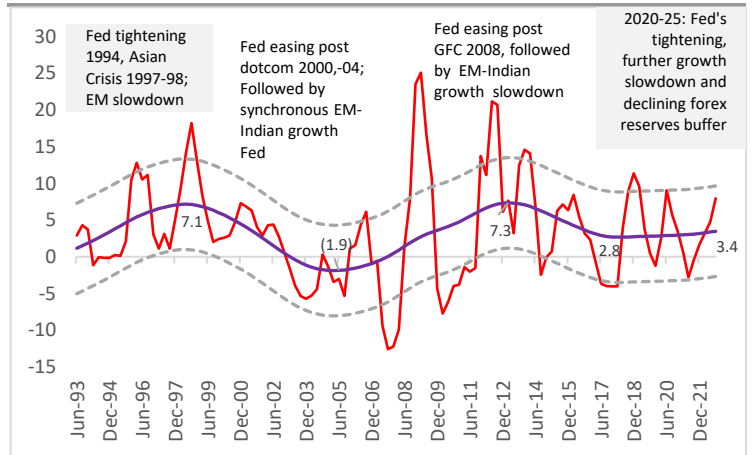
Source: Bloomberg

Exhibit 21: India-US rate spread, pre-COVID average at 260bp

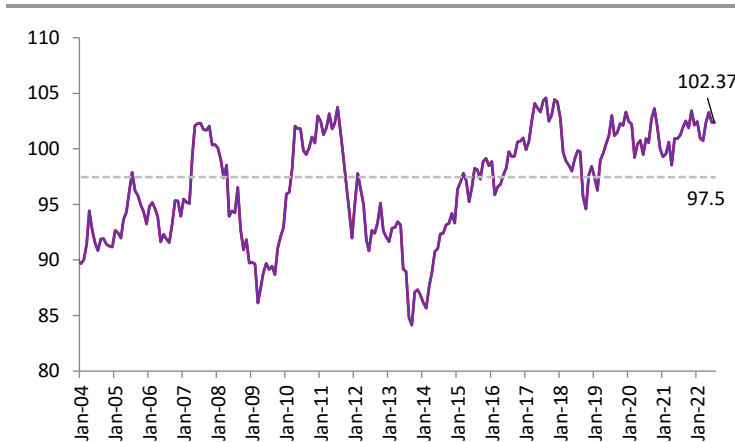
Source: Bloomberg

Exhibit 22: Multiple occasions when INR gained with rising CAD, Low deficit periods (low growth) have also seen INR depreciating

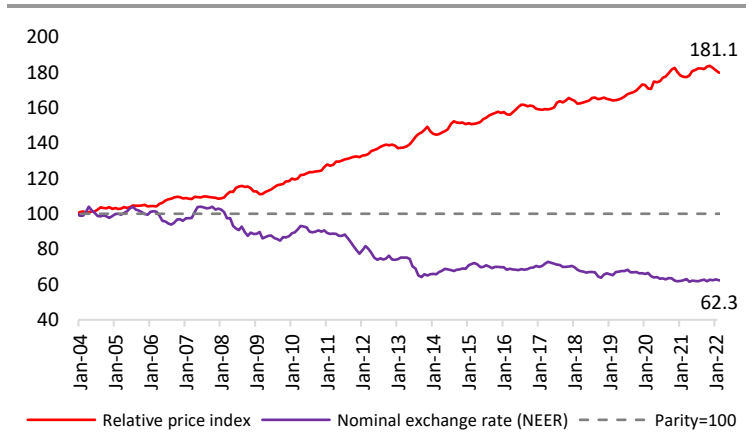
Source: CMIE, Updated till 1QFY23

Exhibit 23: INR/USD (% YoY), future path likely to be characterised by higher depreciation (+7%) and higher volatility

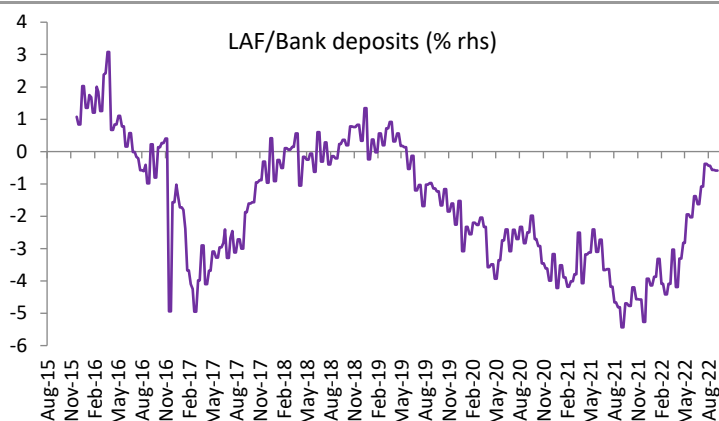
Source: CMIE, Depreciation (+)/Appreciation (-); Legends: YoY (red), trend (blue) & trend +/-1 SD (dashed lines)

Exhibit 24: India REER (broad) - Considerable scope for exchange rate depreciation; 5% above LT average can decline to lower levels

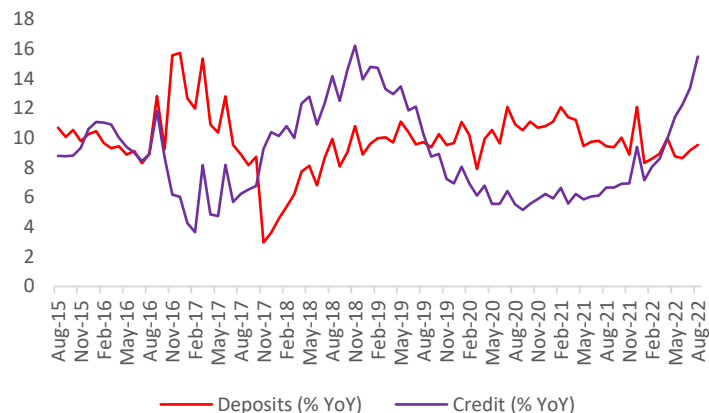
Source: BIS

Exhibit 25: Exchange rate (INR broad index) depreciation (37.7%) much less than relative price rise of 81%; parity is far away

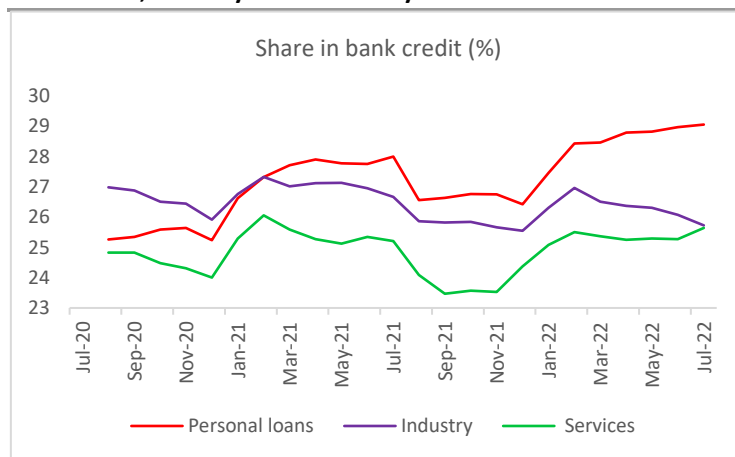
Source: BIS

Exhibit 26: Banking sector surplus liquidity rapidly reducing (0.4% of deposits)

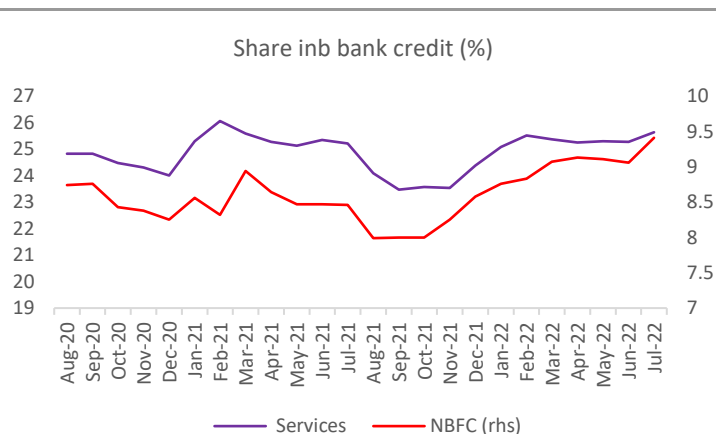
Source: CMIE, Deficit (+), Surplus (-1)

Exhibit 27: Bank credit growth surged beyond deposit growth, significantly contributed by personal loans and loans to NBFCs

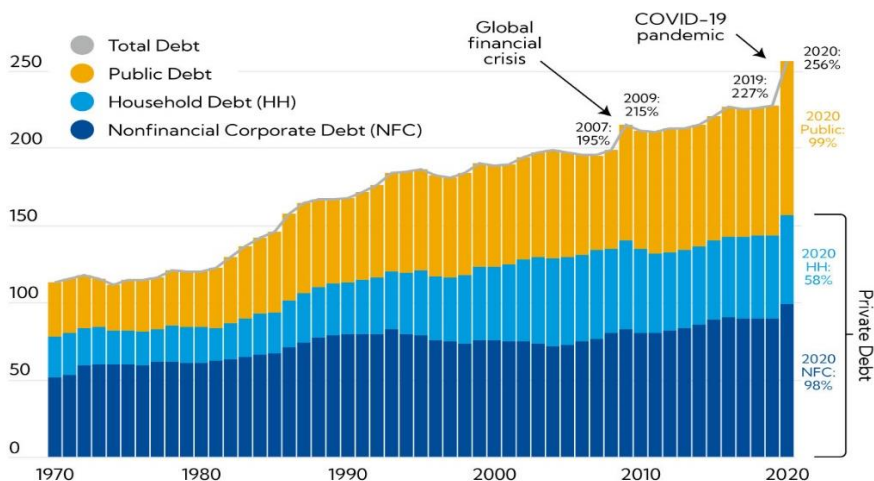
Source: CMIE

Exhibit 28: Bank lending surge led by personal loans - auto and home loans; Industry contributed by MSME sectors

Source: CMIE

Exhibit 29: Services sector credit growth led by bank lending to NBFCs

Source: CMIE

Exhibit 30: Largest surge in global debt in 50 years (debt, % GDP)

Source: IMF

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