



TM

India Strategy

28 August 2023

Growth optimism hinged on fragile fulcrum

STRATEGY

Market Snapshot

	Last price	1 Wk	1 Mo	YTD	YoY
BSE Sensex 30	64887	-0.6	-2.7	6.7	10.3
Nifty 50	19266	-0.6	-2.6	6.4	9.7
Nifty Bank	44231	-0.6	-4.0	2.9	13.5
India 10-Year	7.21	0.0			
US 10-Year	4.28	1.0			
US Dollar Index	104.3	0.3	3.3	0.7	-4.2
USD/INR	82.70	0.1	0.9	-0.1	3.4
India VIX	12.1	3.3			
CBOE Vol	17.2	0.1			

Source: Systematix Research, as on Aug 25 2023

The infatuation with the contrived Goldilocks hypothesis is waning with rising risk-free rates, a strong dollar, and an overheated US economy prompting a hawkish Fed last week. As reality dawns, we outline the structural East-West divergence, declining global savings, and market implications. Our portfolio thus aligns with the implications for India, the trajectory of rising ruralisation, muted endogenous demand, and the heavy lifting by government capex even as signs of private capex remain elusive. Gaining US labour productivity bodes well for Indian IT firms.

Deepening East-West dichotomy to challenge the contrived Goldilocks: Incremental data indicates that the forward path isn't a gliding one, but a bumpy road. On the one hand, the US is emerging stronger indicating the persistence of an over-heated situation, on the other both China and India are facing slower endogenous growth, particularly China. Strong US consumption on the back of fiscal expansion and rising protectionism can risk an inflation upturn. Mexico is emerging as the "New China" as Chinese share in US import of goods has declined sharply. Indian manufacturing will likely face intensified competition from Chinese dumping. These trends align with our earlier note: *Markets sprint on contrived goldilocks, but for how long?* See [here](#)

Hardening yields key monitorable for valuations: The financial ramifications of the East-West divide and the associated decline in global savings, reflected in USD 400bn drawdown of US treasury holdings by China & Japan (since Jan'22) and decline in US money supply/GDP (67% in FY24E) will likely mean higher US yields amid above-trend US consumption and elevated fiscal deficits. This would prevent the US Fed from cutting rates; they may be forced to hike it further and keep it higher for longer. As a corollary, the US dollar may strengthen further. For Indian markets, higher risk-free rates and tempered earnings growth, risk scaling down of Indian benchmark indices in our global ranking. Expect India's 10-year G-sec yield at 7.30-7.40% and INR/USD at 85-86. Forex selling interventions by RBI to tighten domestic liquidity. ([Page – 08](#))

Projected Nifty EPS could still be downgraded despite 1Q margin expansion: The 1QFY24 earnings results summary of Nifty 50 companies point towards a contraction in sales of non-finance companies accompanied by margin expansion as firms roll back raw material expenses. Trailing NIFTY EPS growth has decelerated to 3.5% YoY. We continue to believe that the 38% deviation in NIFTY EPS during FY22-FY23 from its pre-covid trend is ephemeral laying the backdrop for a significant earnings downgrade for FY24E and FY25E from the consensus projection of 16% on average. Largest adjustments to come from the BFSI sector and deep cyclical sectors. ([Page – 12](#))

Why we are less sanguine on growth? Our expectation of a modest 5.0-5.5% real GDP growth expectation for FY24E (downside bias) contrasts RBI's optimistic projection of 6.5% is rooted in a weak endogenous private sector growth trend around 2-3% and restrained government consumption spending. Recent contractions in the trade of goods and services indicate a reversal of the episodic global bounties, the primary driver of post-COVID recovery. This is impacting most leading indicators for the domestic services sector which is the linchpin for household incomes. Lead indicators continue to suggest a lack of private capex. Elevated headline real GDP growth driven by heavy government capex growing at 35-40% is difficult to sustain. We expect 1QFY24E print to be around 5.4%. ([Page – 17](#))

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Agri sector-Rising cash flows amid high inflation and credit: Surge in food inflation including vegetable prices, cereal prices, etc., in the context of bountiful agriculture sector performance (nearly 4% in FY23 and 4% 4-year CAGR), looks incongruent. While this is commonly attributed to weather anomalies, in our view it is led by structural factors. We think that there has been a meaningful rise in terms of trade for the agri sector. The improved cash flows from rising agri sector terms of trade have also seen a surge in agri lending by banks, rising to a high of 20% YoY (Jun'23) ([Page – 20](#)).

Employment: Rising ruralisation presages demand pattern towards essentials: Recovery in high-income jobs viz. urban services and manufacturing has been modest, which implies modest gains in household incomes. Net of increase in employment, the real per capita income growth in the non-finance sectors could be in the order of 2-3%. The recent spurts in food inflation may have aggravated the budgetary constraints for households, thereby impacting demand for manufactured consumer products. Additionally, it has forced leveraged consumption. This has led to a rise in demand for non-agri rural jobs under MNREGA which is 28% higher than in 1QFY20 with the wage allocation up by 69% in 1QFY24 compared to 1QFY20. Hence, India's consumption pattern will also be driven by the ruralisation theme ([Page – 24](#)).

Private capex continues to remain elusive: Given that the project announcements during FY22-23 are twice as much as the FY09 peak and the rate of conversion in key sectors has declined in 2HFY23 in line with the moderation in Industrial Outlook Survey, there is a high likelihood of cutback in investment intentions in the coming years. The latest data on sanctioned projects from RBI shows a contraction in sanctioned project costs outside of the infrastructure and metals sector. FDI inflow has also halved during 1H 2023 ([Page – 29](#)).

Govt capex doing the heavy lifting but lacks the crowding in effect: Counterbalancing the enfeebled household spending and private capex, the demand side continues to be buffered by large government capex. As per the latest RBI's monetary policy statement, government capex remained strong in 1QFY24 with central capex up 59.1% YoY and state capex up 74.4% YoY ([Page – 31](#)).

Our portfolio positioning remains: From the equity markets standpoint, weak endogenous growth, potential earnings downgrades, moderation of RoEs, and hardening of the G-sec yields pose risks to valuations and our global comparative ranking for Indian benchmark indices. Tightening liquidity could pose a risk to illiquid stocks; small-cap valuations can get vulnerable.

The above possible scenario reinforces our UW view on deep cyclical and rate-sensitive sectors such as banks, real estate, commodities, and industrial capex and focuses on sectors or companies that would continue to exhibit margin expansion, mostly in the consumption space and those aligning with our ruralisation theme.

Also, with the expectations of the near-term outperformance of the US, the recent gains in labour productivity hint at an improving outlook for the technology sector, hence we have moved to OW IT. [see [page 4](#) for our sector view and [page 3](#) for our model portfolio]

Exhibit 1: Systematix model portfolio

	Sector weights			Systematix Financial portfolio	Stock weights
	Systematix	Nifty Index	OW/UW		
Agri Input & Chemicals	2.0	0.4	1.6	PI Industries	1.0
Auto & Auto Ancillaries	7.0	6.2	0.8	Coromandal International	1.0
				Hero Motocorp	2.0
				Maruti	1.5
				TVS	1.0
Cement	1.0	2.0	-1.0	Escorts	2.5
				Shree Cement	0.5
				UltraTech Cement	0.5
Consumer Durables	1.0	-		Bajaj Electricals	1.0
Consumer Staples & Retail	15.5	14.4	1.1	Nestle	3.0
				GCPL	2.5
				Dmart	2.5
				ITC	3.5
				Marico	2.0
				Asian Paints	2.0
				BEL	0.5
				HAL	0.5
				Larsen & Toubro	3.0
				HCL Tech	4.0
Industrials	1.0	-	1.0	Infosys	6.0
				Zensar Technology	3.5
				LTI Mindtree	1.5
Infrastructure/Construction	3.0	4.4	-1.4		
IT Services	15.0	14.2	0.8	Reliance Industries	9.0
				GAIL	2.0
				IGL	1.0
				Sun Pharma	3.5
Metals & Mining	-	3.8	-3.8	Indoco Remedies	1.0
Oil & Gas	12.0	13.7	-1.7	Balarampur Chini	1.0
				Bharti Airtel	3.8
				NTPC	2.0
Pharmaceuticals & Healthcare	4.5	3.8	0.7		
Ports & Logistics	-	1.4	-1.4		
Sugar	1.0	0.0	1.0		
Telecom	3.8	3.0	0.8		
Utilities	2.0	1.0	1.0		
Financials	26.2	31.7	-5.5	Financials	
Insurance	1.0	1.4	-0.4	HDFC Life	1.0
NBFC	1.2	3.1	-1.9	Shriram Finance	0.6
Banks	24.0	27.3	-3.3	Muthoot Finance	0.6
				AXIS Bank	4.0
				HDFC Bank	10.0
				ICICI Bank	8.3
				State Bank of India	1.7
10 year Gsec @ 7.4%	5.0				5.0
	100.0	100.0		Total	100.0

Source: Systematix Research

Recent changes to the portfolio:

Autos: Removed Tata Motors, added Escorts

Consumer Staples and Retail: Removed Britannia, Titan and added GCPL, DMart

IT: Removed Persistent Systems, added Zensar Technologies

NBFCs: Removed Bajaj Finance, Cholamandalam and added Shriram Finance

Increased Gsec allocation to 5% from 4%

Key OW: Agri, Autos, Consumption & Retail, Pharma, IT, Utilities

Key UW: Financials, Cement, Infrastructure, Metals, Ports

Exhibit 2: Systematix top picks (see [here](#))

Company	Sector	Mcap (INR bn)	Company	Sector	Mcap (INR bn)
Apollo Pipes	Building Materials	28	Indraprastha Gas	Oil & Gas	304
Avenue Supermarts	Retail	2,297	Muthoot Finance	NBFCs	505
Balarampur Chini	Sugar	83	Nestle India	FMCG	2,093
Carysil	Building Material	17	Prince Pipes	Plastic Pipes	75
Dodla Dairy	FMCG	47	Raymond	Retail	131
GAIL	Natural Gas	747	Shriram Finance	NBFCs	691
Greenpanel Industries	Building Materials	41	Stylam Industries	Building Materials	27

Source: Systematix Research

Exhibit 3: Factors feeding into our portfolio

Sectors	Sector stance
Macro backdrop	<ul style="list-style-type: none"> Downside risk to growth and earnings vs optimistic consensus outlook Global headwinds from housing and financial sector contagion in China Currency and rates risk; EMs can be vulnerable to a strong US dollar and retrenchment in FPI flows Rise in credit risk and market risk premium Rising ruralisation translating into higher agri terms of trade, specially for the food sector
Agri Input & Chemicals	Increased demand for agri produce, and inputs, improved terms of trade
Cement	Volume growth remains strong due to government projects, however, realization has been tepid resulting in earnings disappointments; Price actions suggest that urban housing demand may have peaked, and possibly weakened
Insurance	The sector has seen significant derating due to rising yields on G-Sec and the recently announced tax measures in the Union Budget 2023 relating to non-ULIP schemes. Significant underperformance of insurance companies since mid-2021 and YTD. At the current levels, the valuations are undemanding.
Metals & Mining	Enthusiasm around the China reopening has waned; China's housing sector woes are enduring, declining exports, elevated local government debt problem likely to get worse; Risk of financial sector contagion from the meltdown in the real estate sector; Multiple stimuli have failed to reverse China's down cycle. Chinese meltdown can have global repercussions. We have maintained a cautious view on China's outlook and an UW view on metals for a long time.
NBFC	A rising proportion of retail and short-term lending, rising reliance on borrowings from banks; Auto cycle is peaking, high retail lending is emerging to be a source of NPAs; Market sentiment favoring rate easing has reversed as scope for further rate hikes have re-emerged leading to rise in money market rates. This could accentuate margin pressure for the BFSI sector, including NBFCs.
Oil & Gas	PSUs susceptible to elections-related risks; CGD companies better placed
Telecom	Digitization theme, tariff rate hikes, lesser industry competition now
Ports & Logistics	The anticipated slowdown in freight movement is widely evidenced, in data on ports, EXIM, railways and road transportation
Consumer Staples & Retail	India will remain a large consumption story, both rural and urban, near-term cycle for urban is peaking out, rural demand to become critical; increased public spending. Rising share of essentials in urban consumption, improving terms of trade in the agri sector; margin expansion to strengthen in FY24.
Banks	Bounties for banking sector have peaked out as reflected in a) pervasive decline in margins due to the rising cost of funds and weak pricing power, b) Operating leverage constrained by lack of corporate borrowing, including corporate lending & reduction in working capital demand, c) initial signs of NPAs in the retail segment, rural and MSME segments are witnessing a rise and d) benefit of higher YoY CD Ratio likely to go away, as it has remained stagnant over the last three quarters. Valuations are at risk due to INR depreciation and weakening of trading profits because of the bear flattening of the G-Sec yield curve. We maintain our UW on banks.
Pharmaceutical & Healthcare	Sector at the lowest end of the cycle; healthcare spending needs to rise both in India and globally, Indian companies moving up the value chain, companies investing in R&D, and large compounding potential
Auto & Auto Ancillaries	Key drivers - volume recovery, premiumization, and margin expansion; volume momentum has peaked out, especially for commercial vehicles; margin expansion triggers likely to be the major drivers in anticipation of a correction in metal prices. Improved agri terms of trade can induce volume support for two-wheelers and tractors.
Infrastructure/Construction	Housing to slow, government capex has been dominant in recent years and may slow going forward as they would have to focus more on revenue expenditure due to upcoming elections
Utilities	Defensive
IT Services	Structural drivers for IT spending by companies in AEs are still relevant despite the near-term headwinds. Near-term outlook impacted by the recent banking sector debacles. Spending by large banks remains resilient. Constrained spending by US companies in the space of Hi-tech, mortgages, and telecom. As expected, 1QFY24 was a weak quarter. Tailwinds from retrenchment in US tech, improved utilization, lower retrenchment to improve efficiency performance.
Industrial and Cap goods	Export orders are likely to weaken due to the ongoing global slowdown. Government capex on railways has been a major support for various EPC projects. With increased focus on productivity, companies are increasing investment towards automation. Manufacturing company's requirement for the EPC projects remains modest as highlighted by the Thermax results.

Source: Systematix Research

The enervating contrived Goldilocks presumptions

Earlier we highlighted that the markets were presumptuously factoring in a global (& domestic) Goldilocks scenario of rate easing, softening in risk-free rates, and sustained economic expansion. These manifested in the contraction of market risk premium, a weak dollar, and ratcheting up of valuations.

These assumptions are being challenged as incremental data indicate that the forward path isn't a gliding one, but a bumpy road. On the one hand, the US is emerging stronger, indicating the persistence of an over-heated situation, on the other both China and India are facing slower endogenous growth, particularly China.

China's slowdown is structural: The world is getting worried over the possible ramifications of the steep deceleration in China, which is likely to miss the official 5% growth target even in 2023 as the momentum hasn't been strong enough after the opening up. The fact that the Chinese housing sector woes and financial fragility continue even after successive stimulus over the past 1.5 years and numerous rate cuts, points towards the pronounced vulnerability to contracting exports and trade conflicts. The nearshoring by advanced economies (AEs) as they lower dependence on China is weighing on China's structural growth which appears to be trending toward sub-4% vs our earlier estimate of 4.7%.

India is not China+1, Mexico emerging as the next China: The perception that India's growth will pivot on China's slowdown is not borne out by pieces of evidence.

Mexico is emerging as the "New China" as Chinese share in US import of goods has declined sharply. Chinese manufacturing will likely scale up access to the US market through their Mexican investments. Indian manufacturing will likely face intensified competition from Chinese dumping

- a) The contraction in external trade that is weighing on China is also reflected in contractions in India's exports, and imports of goods and a considerable slowdown in services exports. These are permeating into broader deceleration in the labor-intensive domestic services sector indicators.
- b) India's growth sensitivity to global trade volume growth is estimated at 1.78x (post-GFC 2008). The impact will likely intensify due to near-shoring by the AEs along with the scaling down of global merchandized trade volume growth (2% for 2023E, down 40bp, IMF).
- c) Despite the modest consumption demand, India's trade balance for non-oil products with China widened to USD 84.4bn, up 50% from FY19.
- d) The structure of the trade with China remains unchanged i.e India's exports are dominated by low-value-added products while China exports high-value-added manufactured products (see [here](#)).
- e) The impact of near-shoring by the US to Mexico and Canada and friend shoring to Europe is borne out strongly as the post-COVID bounties for China and India are receding.
- f) Mexico is emerging as the "New China" for US sourcing of manufacturing products even as Chinese share in US import of goods has declined sharply to 13.5% from 25.2% in 2015.
- g) Hence, as China's growth fades further in 2H2023 and faces intensified trade diversions, Chinese companies will scale up their access to the US markets through their Mexican facilities.
- h) Indian manufacturing will likely face intensified competition from Chinese dumping, especially in sectors such as chemicals, metal products, electrical & non-electrical machines, and electronic goods.

A stronger US contrasts slowing China and India: Contrasting the vulnerabilities of China and India, the US economy appears to have gained momentum with the Atlanta Fed nowcast for 2Q GDP growth being scaled up to 5.8% (QoQ SAAR, or 2.9% YoY) on the back of a robust 4.8% gain in private consumption expenditure. Unlike China, US residential investment remains robust (11.4%), and in contrast to China and India, the US trade of goods and services remains strong. And unlike elevated India's unemployment levels, the US labor market continues to remain strong with wage growth rising back to 6%, declining unemployment claims, and a rise in private sector jobs.

Notably, US private consumption expenditure continues to trend higher than the pre-COVID trajectory and the estimated post-COVID potential trendline by 3.4%. Evidently, the strength of wage growth, asset price inflation, and the lingering impact of the post-covid dole outs has kept the household demand growing above potential, thereby sustaining the high inflation levels (core CPI inflation at 4.7% in Jul'23). The federal government fiscal expansion (2x rise in YTD deficit at USD 1.6tn), following the lifting of the debt ceiling logjam, is creating another round of indirect stimulative impulses.

Contrastingly, India's real private consumption has seen a trend decline since the pre-covid levels (6.3% in pre-covid vs 2.9% in Mar'23) and has converged with the US average. Consequently, the trend line for post-COVID personal consumption expenditure in India is 11% below the pre-COVID trend and the actual in 4QFY23 is 0.7% below the post-COVID trend.

The surge in India's retail inflation to 7.4% (Jul'23), therefore, is a homegrown problem emanating from the rising ruralization theme (read [here](#)), characterized by increased basic food consumption and gains in Agri terms of trade.

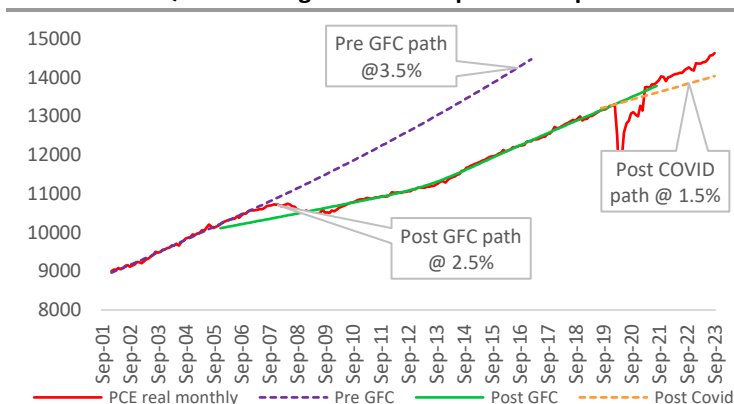
Comparatively, US personal consumption expenditure at 2.9% YoY in 3Q 2023[E] is higher than the post covid potential. Also, the latest data releases in the US foretell a strong 3.2% YoY real GDP growth in 2023 (Atlanta Fed GDP Nowcast).

Deepening East-West dichotomy to challenge the synchronous goldilocks: In sum, the confluence of the faltering Chinese economy amid weakening global trade impacted by re-intensification of trade conflicts and a shift of the US manufacturing axis towards Mexico and the West is creating headwinds for Emerging Asia. As the trade conflict deepens the East-West demarcation will be discernable. Hence, if the financial conditions tighten the growth divergence would challenge the synchronous Goldilocks assumption.

The US economy is clocking in stronger momentum notwithstanding the monetary tightening thus far. The indirect fiscal impulse from the latest lifting of the debt ceiling along the above trend consumption demand and changing trade dynamics can lead to a renewed upturn in inflation. Conversely, household situations in both China and India remain fragile

As the trade conflict deepens the East-West demarcation will be discernable. Hence, if the financial conditions tighten the growth divergence would challenge the synchronous Goldilocks assumption.

Exhibit 4: US personal consumption (real annualized, USD bn): 2.9% YoY in 3QE is 3.4% higher than the post covid potential



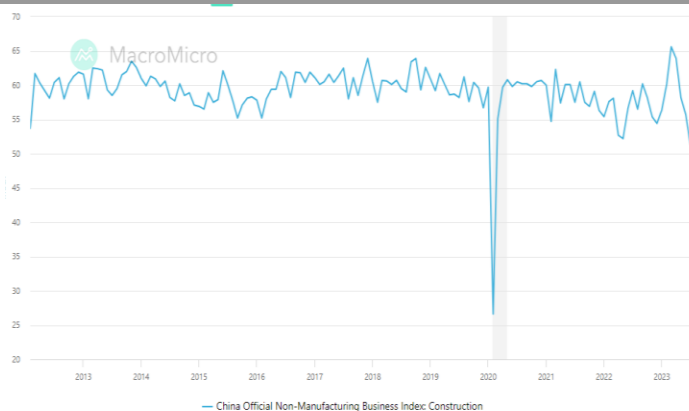
Source: Fed database, Atlanta Fed nowcast, Systematix Research; post covid trend estimated based on near-term FOMC's real GDP growth projection of 1%

Exhibit 5: Latest US data have strengthened, upside bias for 3Q 2023 real GDP growth (5.8% QoQ annul) converting into 3.2% YoY

Date	Major Releases	GDP	PCE	Equip ment	Nonr es. Invt.	Resid Invt.	Govt.	Exports	Imports
27-Jul	Latest BEA estimate for 23:Q1	2.0	4.2	-8.9	15.8	-4.0	5.0	7.8	2.0
27-Jul	Latest BEA estimate for 23:Q2	2.4	1.6	10.8	9.7	-4.2	2.6	-10.8	-7.8
28-Jul	Initial GDPNow 23:Q3 forecast	3.5	3.1	0.0	-3.2	-1.9	2.9	4.7	2.9
1-Aug	ISM mfg, Construction spending	3.9	3.5	0.5	-2.3	-1.6	2.9	5.2	3.6
3-Aug	Auto sales, ISM Nonmanuf, M3-2 Mfg	4.0	3.5	2.5	-2.2	-1.5	2.9	5.4	3.7
4-Aug	Employment	4.0	3.2	1.6	-2.7	-1.4	2.7	4.7	3.0
8-Aug	Trade-International, Wholesale	4.1	3.2	1.5	-2.7	-1.6	2.7	5.0	3.1
10-Aug	CPI, Treasury Statement	4.1	3.2	1.6	-2.7	-1.6	2.5	5.0	3.1
11-Aug	PPI	4.1	3.2	1.5	-2.7	-1.6	2.5	5.0	3.1
15-Aug	Retail trade, Import/Export Prices	5.0	4.4	1.6	-2.7	-0.5	2.5	4.9	3.1
16-Aug	Housing starts, IP	5.8	4.8	2.1	-2.8	11.4	2.5	5.4	3.5

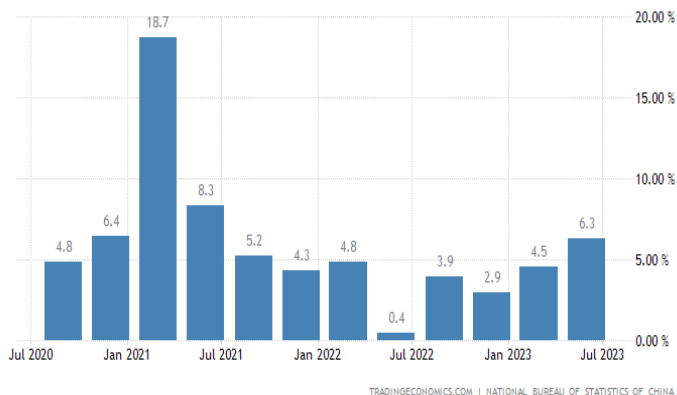
Source: Atlanta Fed GDPNow Estimate for 2023: Q3, Systematix Research

Exhibit 6: China's housing sector woes and compounding financial sector drags



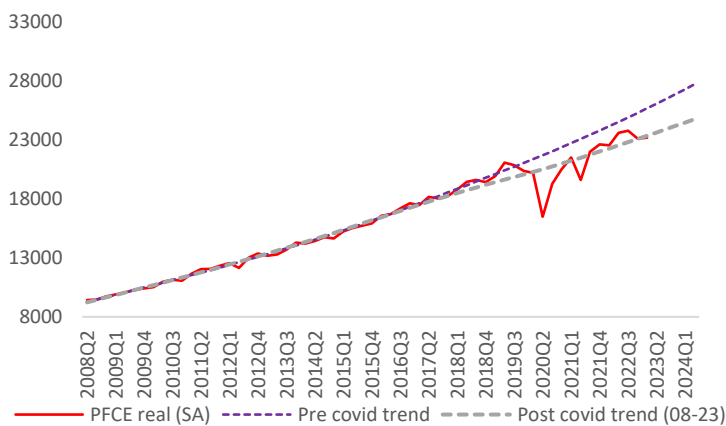
Source: MacroMicro

Exhibit 7: China's GDP growth; underwhelming recovery hints at sub-5% average for 2023; weak exports and HH situation weighs



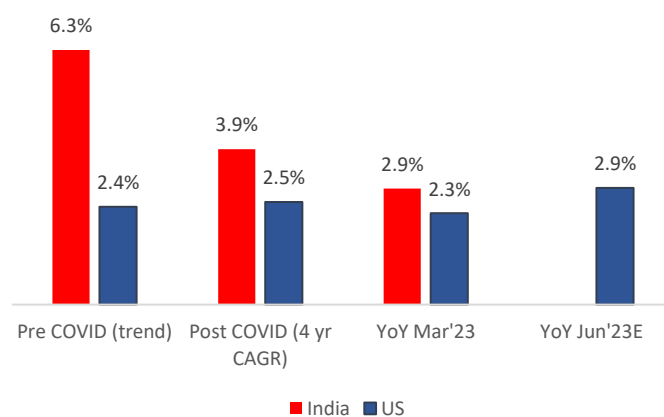
Source: Trading Economics

Exhibit 8: India's personal consumption expenditure; post covid trend 11% below pre-covid; actual 0.7% below post covid trend



Source: CSO, Systematix Research

Exhibit 9: Relative to the US, India's consumption growth has converged with US average, decelerating to 2.5% in 2HFY23



Source: CSO, Systematix Research

Hardening yields key monitorable for valuations

The East-West real economy dichotomy has a financial twin as well engendering from the accompanying narrowing global savings.

The lower core PCE US inflation for Jul'23 at 4.1% should have translated into a weaker dollar and softening in the treasury yields. But the trend has been the converse.

The US long-end treasury yield has hardened (10-year is up 90bp since Mar'23 at 4.31%) and the dollar is strengthening (DXY at 103).

We think there is a fundamental change in factors guiding the financial markets, away from the common equation embedded in the presumed Goldilocks scenario.

First, the US consumption remains robust and above trend despite the Fed's tightening. Thus, far from presaging a recession, the steepest treasury curve inversion in 40 years is now reversing with the hardening of the long end yields.

Second, the recent US sovereign rating downgrade (see [here](#)) captures the worsening fiscal position. The fiscal deficit at USD 1.6tn in FY23 (Oct'22-Jul'23) has doubled over the same period last year. Following the expansion of the debt ceiling, the supply of treasury has risen. As per the Fitch Rating, the shortfall in revenue over the outlays is likely to continue in the coming years.

Third, at 5.6% of GDP US savings have declined from the post-covid peak of 25.8% and lower than the pre-COVID levels of 9.3%. It is also the lowest since 2008.

Fourth, the external demand for US treasury has declined with holdings of China and Japan collectively declining by USD 400bn since Jan'22. In particular, the biggest global saver and forex reserve holder, China is at the forefront of the East-West divide.

Fifth, the run-down of assets by the US Fed and a strong GDP has resulted in a decline in the US money supply/GDP ratio to 77% from the post-COVID peak of 90%. If the Fed's run-down continues at the current pace (currently total assets stand at USD 8.2tn vs post-COVID peak of USD 8.9tn) it can decline further to 67% by the end of 2024.

Thus, the real economy and financial ramifications of the East-West divide together will likely reflect a sustained rise in government bond yields in the US and generally across the world. Consequently, a stronger US economy will also mean a stronger dollar. Hence, in the context of declining global savings, a strong domestic economy, and elevated fiscal deficit will prevent the US Fed from cutting rates; they may be forced to hike it further and keep it higher for longer.

Q.E.D, the presumed Goldilocks scenario is indeed contrived!!

Implications for India: Case for higher risk-free rates and tempered earnings

- With the tightening global liquidity and savings, RBI's forex reserves have tapered from the peak and are likely to moderate, in line with EM Asia.
- Foreign investments will continue to remain modest. The post-SVB crisis revival in FPI is reversing now and FDI flows continue to decline (-USD 0.5 bn in Jun'23, 6 monthly averages of USD 1.8bn vs. pre-COVID at USD 3.6 bn)
- Stronger USD and higher US yields will continue to weigh on the INR/USD; we maintain that average annual depreciation for the rupee has risen to 6.5-7.0% vs 3.0-3.5% in 2018.

The real economy and financial ramifications of the East-West divide together will likely reflect a sustained rise in government bond yields in the US and generally worldwide. A stronger US economy will also mean a stronger dollar. Hence, in the context of declining global savings, a strong domestic economy, and elevated fiscal deficit will prevent the US Fed from cutting rates; they may be forced to hike it further and keep it higher for longer

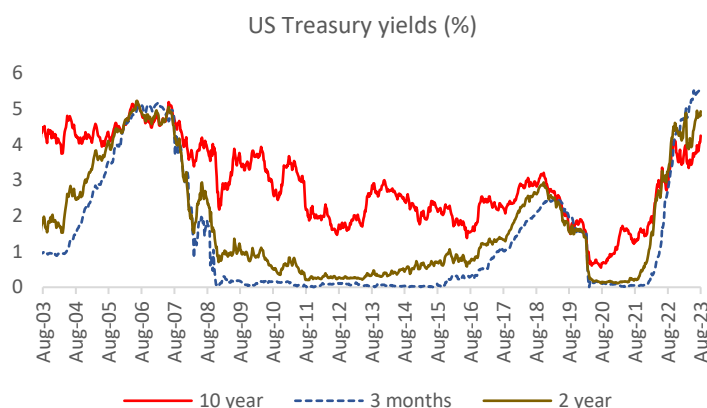
- d) Hence, the rupee can depreciate to 85-86 levels soon (6 months). The weakening INR view also aligns with the slowing India's endogenous growth (determined by private demand trajectory, ex-governments) that has decelerated to 2-3% on a structural basis. RBI's forex interventions to tame INR/USD weakening will tighten domestic liquidity.
- e) India's long-end Gsec yields will also exhibit a hardening basis given the historically low India-US 10-year yield spread, rising US rates and potential weakening INR/USD. It has already hardened to 7.2% and could rise to 7.40-7.50% in the near future. We attribute the compression in India-US yield spread to difference in India-US consumption trends.
- f) From the equity markets standpoint, weak endogenous growth, potential earnings downgrades, moderation of RoEs, and hardening Gsec yields pose risks to valuations and our global comparative ranking for Indian benchmark indices.

The above possible scenario reinforces our UW view on deep cyclical and rate-sensitive sectors such as banks, real estate, commodities, and industrial capex and focus on sectors or companies that would continue to exhibit margin expansion, mostly in the consumption space and those aligning with our ruralisation theme.

Also, with the expectations of the near-term outperformance of the US, the recent gains in labour productivity hint at an improving outlook for the technology sector, hence we have moved to OW IT.

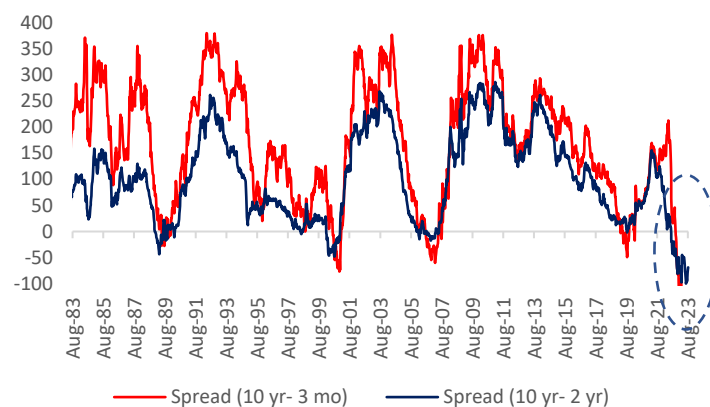
The above possible scenario reinforces our UW view on deep cyclical and rate-sensitive sectors such as banks, real estate, commodities, and industrial capex and focus on sectors or companies that would continue to exhibit margin expansion, mostly in the consumption space and those aligning with our ruralisation theme. The near-term outperformance of the US and the recent gains in labour productivity hint at an improving outlook for the technology sector

Exhibit 10: US 10Y rose 90bp since SVB crisis> 3 months (up 66bp); strong consumption demand reversing the curve inversion



Source: Fred data

Exhibit 11: Strong and resilient US economy defying the yield curve inversion



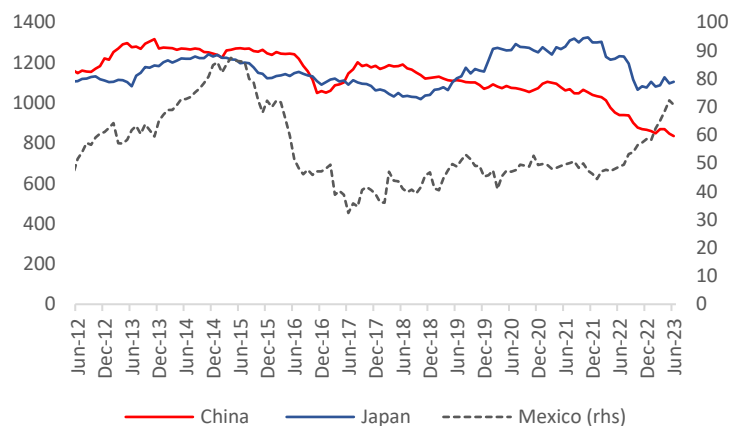
Source: Fred data

Exhibit 12: Forex reserves of select Asian countries (USD bn)

	Current	Peak	Covid lows	Decline from the peak	Rise to the peak
Bangladesh	30	48	32	-18	16
China	3204	3250	3060	-46	190
India	602	642	460	-40	182
Indonesia	138	146	120	-8	26
Japan	1254	1420	1320	-166	100
Malaysia	113	117	102	-4	15
Sri Lanka	4	80	62	-76	18
Thailand	221	246	225	-25	21
Total	5565	5949	5381	-384	568

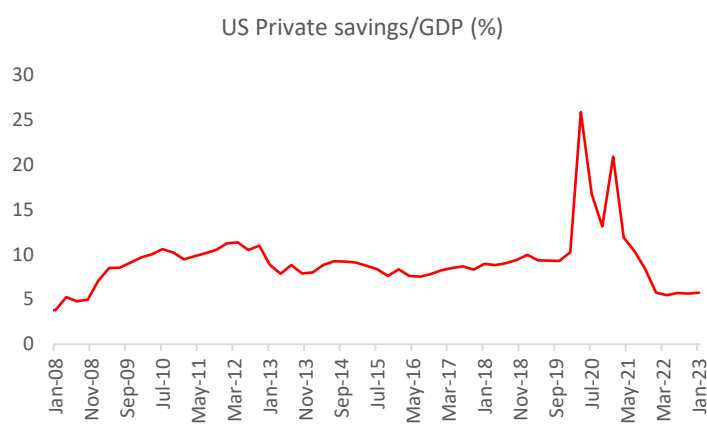
Source: Bloomberg, Systematix Research

Exhibit 13: Holdings of US treasury by China & Japan have declined by USD 400bn since Jan'22



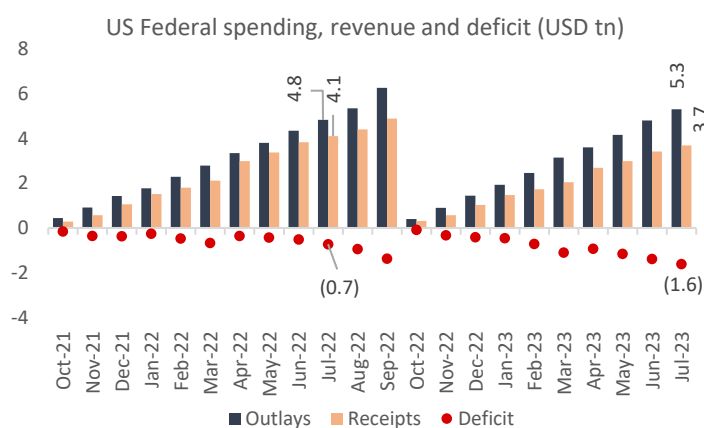
Source: US govt, Systematix Research

Exhibit 14: US private savings/GDP has declined to 5.7%, vs pre-COVID at 9.3% and is currently at a 14-year low



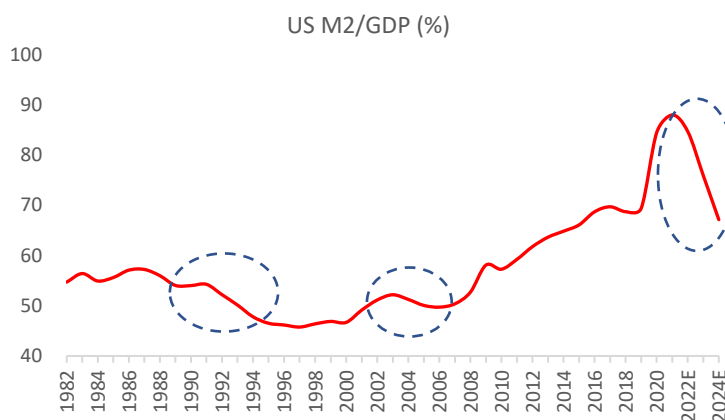
Source: US govt, Systematix Research

Exhibit 15: Rising spending (10% YoY) and contracting tax revenue (-10% YoY) resulted in YTD FY23 fiscal deficit of 1.6tn or 2x of FY22



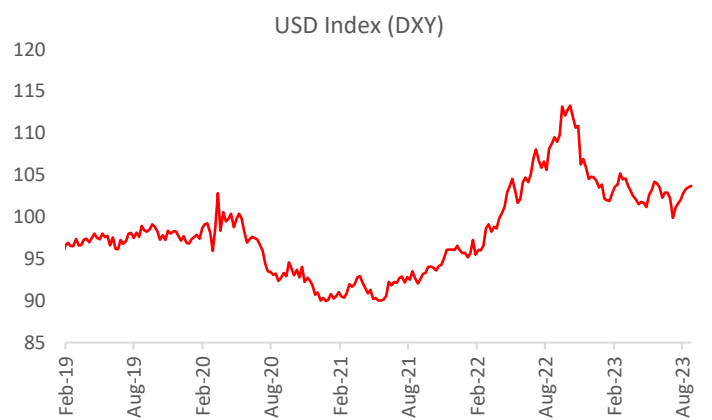
Source: US govt, Systematix Research

Exhibit 16: US money supply/GDP (%) has declined from 90% to 77.6%; Projected at 67% in FY24E, vs pre-covid at 69%



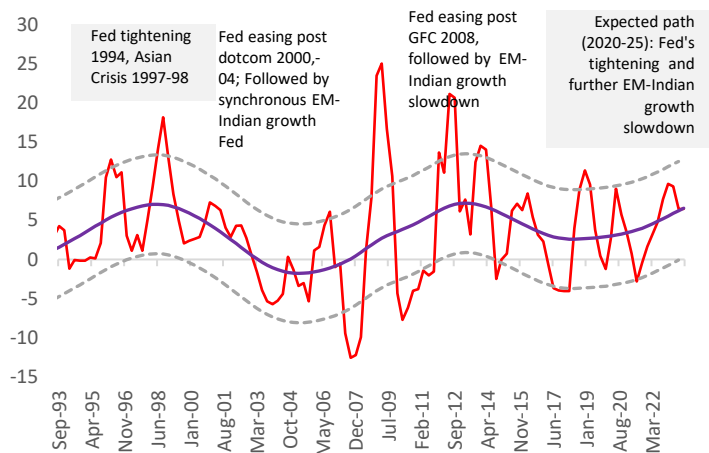
Source: US govt, Systematix Research

Exhibit 17: Potential rebound in US dollar pivoted on a stronger than expected economy



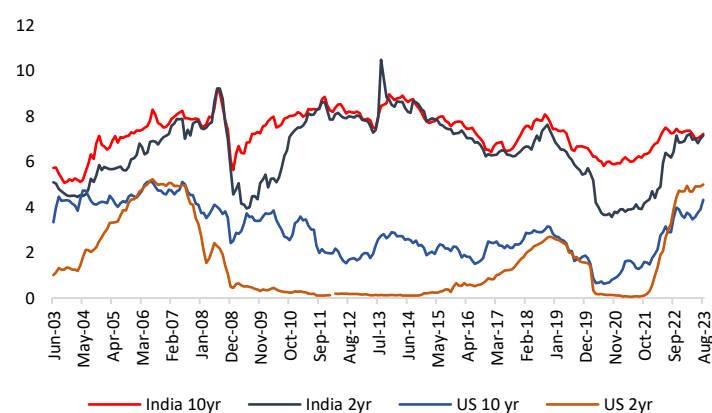
Source: Bloomberg, Systematix Research

Exhibit 18: INR/USD (%YoY), future path likely to be characterized by higher volatility and a subsequent depreciation



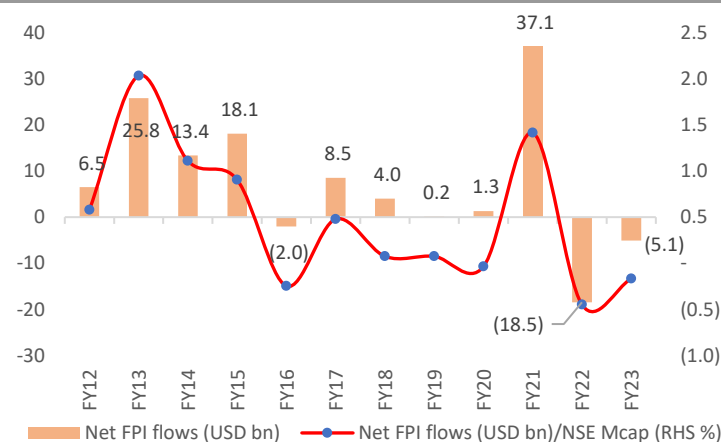
Source: Bloomberg, Systematix Research

Exhibit 19: India G-Sec yields are likely to be more responsive to hardening US yields (%)



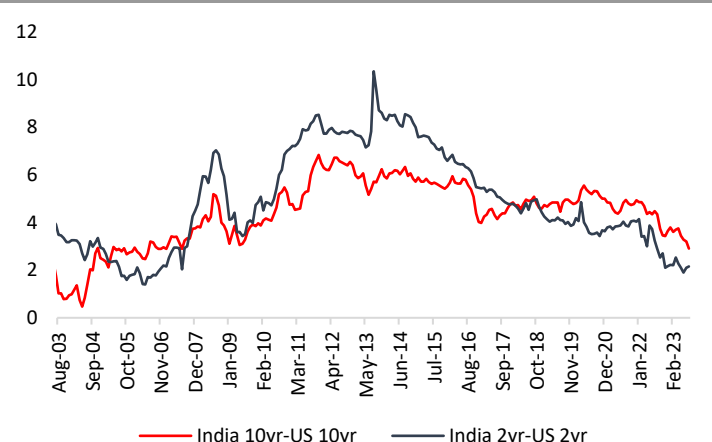
Source: Bloomberg, Systematix Research

Exhibit 20: FPI flows into India can remain modest with a stronger dollar, higher US rates and declining global savings



Source: Bloomberg, Systematix Research

Exhibit 21: India government bond yield spreads at historical lows (%)



Source: Bloomberg, Systematix Research

Market performance: Risk from tightening liquidity to SMIDs valuation

- Global equity valuations have corrected since end-Jun'23 with the average global PE valuation declining by 5% to 15.2x after the post-SVB crisis bounce.
- While India benchmarks have been average performers (up 7%) China (and Bank Nifty) have been significant underperformers.
- Within the Indian sector indices, the momentum has generally waned over the past month with the big picture indicating continued outperformance from autos, consumer staples, capital goods, and pharma sector indices.
- The traction in the small caps index continued till late and we think the stretched valuations and tightening liquidity there can be a significant correction in this space.
- Metals, Banks, Power, and Energy sectors have been major underperformers.

Exhibit 22: Global indices performance: YTD performance led by Japan, and Europe; India underperformed (+6.8%, bank Nifty flat) **Exhibit 23: Indian sector indices: YTD led by Cap goods, Realty, FMCG, Autos; underperformance by Metals, Banks, O&G**

		1 week	1 Month	YTD	1 Year
HUN	Budapest SE	-1.6	4.9	26.1	28.5
JAP	Nikkei 225	-3.1	-4.4	20.6	8.8
UK	FTSE MIB	-2.2	-3.7	16.6	22.7
TAI	Taiwan Weighted	-0.9	-3.9	16.3	6.7
US	S&P 500	-2.1	-4.3	13.8	3.4
SPA	IBEX 35	-2.2	-2.4	12.1	10.7
SKOR	KOSPI	-3.4	-4.0	12.0	0.5
POL	WIG20	-4.8	-7.7	11.9	19.8
GER	DAX	-1.7	-3.4	11.8	14.9
EUR	Euro Stoxx 50	-2.9	-3.8	10.6	12.5
ITA	CAC 40	-2.9	-2.7	10.1	9.7
RUS	RTSI	3.8	2.4	7.0	-11.2
IN	BSE Sensex	-0.4	-3.0	6.9	9.1
IN	Nifty 50	-0.6	-2.6	6.7	8.8
BRA	Bovespa	-2.6	-2.2	4.8	3.1
US	Dow Jones	-2.3	-1.7	4.0	2.3
CA	S&P/TSX	-2.9	-3.3	2.2	-1.5
ISR	TA 35	-3.2	-3.8	1.8	-11.0
AUS	S&P/ASX 200	-2.6	-2.4	1.6	0.5
CH	Shanghai	-1.8	-2.1	1.4	-3.9
IN	Nifty Bank	-1.3	-1.0	1.3	31.1
AUST	ATX	-1.4	-2.6	-0.7	3.0
UK	FTSE 100	-3.7	-4.5	-2.8	-4.0
BEL	BEL 20	-2.8	-4.5	-3.2	-5.0
HK	Hang Seng	-6.1	-5.5	-9.5	-9.4

Source: Bloomberg, Systematix Research

Indices	1 Week	1 Month	YTD	1 Year	3 Years
S&P BSE Capital Gds	-0.3	3.5	29.8	37.4	207.3
Nifty Realty	-0.1	-1.0	22.9	17.9	140.9
Nifty Auto	0.0	-0.9	21.9	18.8	93.6
Nifty Pharma	-0.7	8.2	21.0	19.1	32.2
Nifty Smallcap 250	-0.4	2.5	19.5	25.3	135.0
Nifty Midcap 150	0.1	3.1	19.5	21.4	123.7
Nifty FMCG	0.2	-3.9	16.5	19.8	62.9
S&P Manufacturing	-0.4	-1.1	13.8	15.0	69.4
Nifty Infrastructure	-0.6	1.0	13.7	17.1	83.3
Nifty Media	2.2	13.9	12.8	8.9	45.0
Nifty MNC	-0.3	-2.3	10.1	11.1	53.1
Nifty Consumption	-0.2	-2.6	8.7	5.5	59.0
Nifty IT	-0.7	-2.4	6.9	1.9	68.1
BSE Sensex 30	-0.6	-3.2	6.7	8.9	68.2
Nifty 50	-0.7	-2.7	6.6	8.6	69.1
Nifty PSU Bank	0.8	1.6	6.3	61.2	214.0
Nifty Commodities	-1.7	0.0	3.9	6.7	92.3
Nifty Private Bank	-0.9	-3.0	3.5	13.5	85.5
Nifty Financials	-1.3	-4.5	2.5	7.4	76.2
Nifty Bank	-0.9	-4.1	1.9	12.4	96.6
Nifty Energy	-0.3	1.8	1.6	-4.3	67.2
Nifty Services	-1.0	-3.7	-1.1	0.5	66.4
S&P BSE Power	0.6	5.5	-2.7	-15.4	161.7
Nifty Metal	-2.9	0.3	-3.4	10.4	158.4
S&P BSE Oil & Gas	-1.1	-2.2	-7.7	-4.3	41.4

Source: Bloomberg, Systematix Research

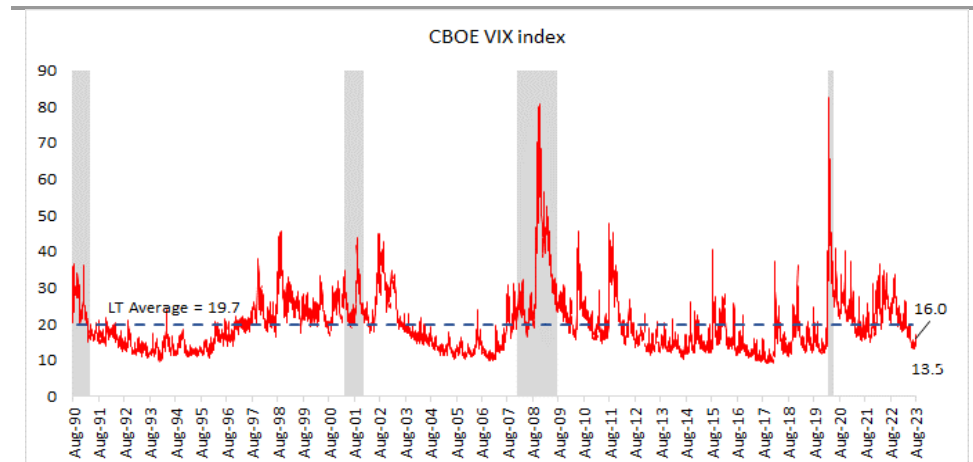
Exhibit 24: Global composite ranking: India ranks high on growth and low on value; Earnings expectations are optimistic and hence the overall ranking can be vulnerable to downgrades and rise in risk free rates

Country	Bloomberg code	ROE (F1)-rf	1 Month change in EPS (F1%)	PE (F1)	EPS growth (F1)	Premium (vs average)	Rank ROE	Rank change in EPS	Rank EPS growth	Rank valuation	Composite ranking (LATEST)	Composite ranking (-1MO)	Change in composite ranking
ITA	FTSEMIB Index	10.6	5.4	8.5	-4.7	-39	5	1	17	4	1	1	0
CH	SHCOMP Index	8.8	0.2	11.4	25.8	-18	10	9	1	10	2	5	3
SPA	IBEX Index	8.5	2.3	10.3	1.9	-26	11	4	9	8	3	4	1
ISR	TA-35 Index	10.6	-0.7	8.6	6.0	-39	6	16	6	5	4	3	-1
EUR	SXSE Index	10.8	0.7	12.7	-0.9	-9	4	7	12	12	5	6	1
FRA	CAC Index	13.5	1.1	13.1	-6.3	-7	3	5	18	13	6	8	2
HUN	BUX Index	4.4	3.6	6.2	-4.2	-55	22	2	16	1	7	2	-5
GER	DAX Index	8.5	-0.3	11.7	5.5	-16	12	14	7	11	8	12	4
HK	HSI Index	6.8	0.0	10.0	0.5	-28	17	11	10	7	9	9	0
JAP	NKY Index	7.9	0.9	20.5	9.9	46	14	6	5	21	10	13	3
IN	NIFTY Index	6.7	0.3	20.6	16.5	47	18	8	2	22	11	6	-5
POL	WIG20 Index	7.8	-0.3	8.0	-11.2	-43	16	13	19	3	12	9	-3
BEL	BEL20 Index	4.2	0.0	16.2	15.7	15	23	10	3	17	13	13	0
US	SPX Index	13.8	-0.5	21.3	-3.5	52	2	15	14	23	14	13	-1
AUST	ATX Index	8.0	-1.1	7.6	-23.4	-46	13	18	25	2	15	18	3
US	INDU Index	15.8	-2.9	20.2	-1.6	45	1	25	13	20	16	18	2
AUS	AS51 Index	9.6	-2.7	15.7	-0.9	12	9	24	11	16	17	20	3
UK	UKX Index	10.3	-2.1	11.1	-15.5	-20	8	20	23	9	17	17	0
IN	SENSEX Index	6.4	-0.1	21.5	15.2	54	20	12	4	24	17	11	-6
SKOR	KOSPI Index	2.8	2.4	15.5	-12.2	11	25	3	20	15	20	20	0
CA	SPTSX Index	7.9	-2.5	14.6	-4.0	4	15	21	15	14	21	22	1
SG	SET Index	5.7	-1.7	16.9	5.3	21	21	19	8	18	22	22	0
TAI	TWSE Index	10.5	-2.7	18.9	-12.8	35	7	23	21	19	23	24	1
BRA	IBOV Index	6.5	-2.6	8.9	-17.3	-36	19	22	24	6	24	16	-8
NZ	NZDOW Index	3.1	-0.9	30.9	-14.1	120	24	17	22	25	25	25	0

Source: Bloomberg, Systematix Research

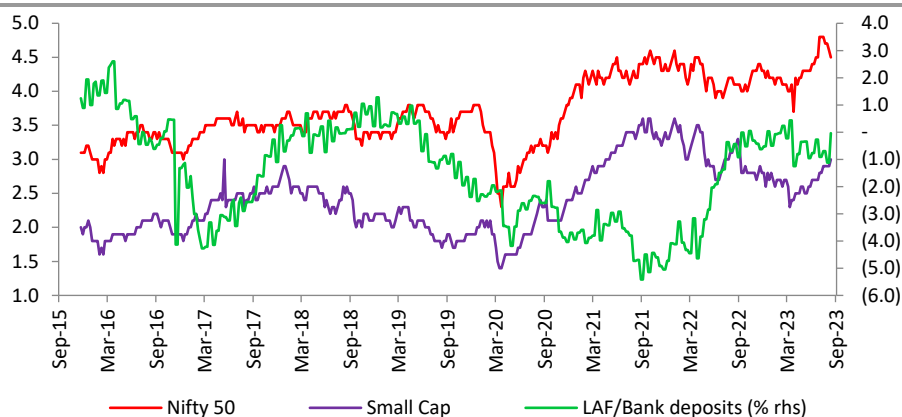
Exhibit 25: Market risk premium (CBOE VIX at 17) recent lows that priced in a goldilocks scenario

Market risk premium appears to have bottomed out



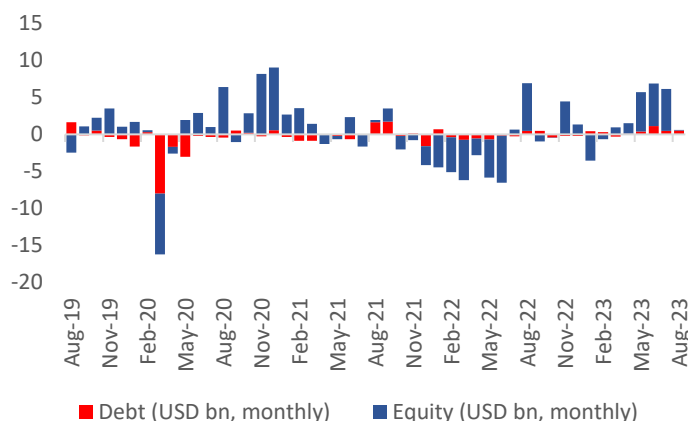
Source: Fred database, Systematix Research

The temporary rise in domestic liquidity enabled by recent demonitisation has reversed due to RBI's ICRR hike and FPI & FDI outflows. This may cause a reversal of the significant surge in small and mid-cap indices

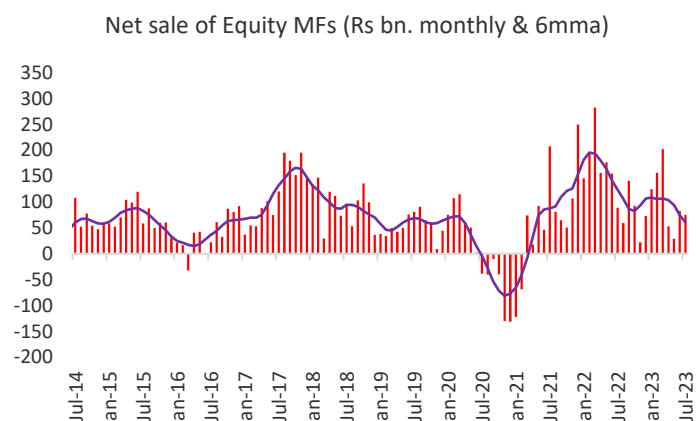
Exhibit 26: Domestic liquidity has reverted to zero thereby presaging risk to the outperforming small-cap indices and stocks, Correction in NIFTY PB is a precursor

Source: CMIE, Systematix Research

FPI flows have turned negative in line with our expectations ([The FPI flow pivot, how strong can it get?](#))

Exhibit 27: Monthly FII flows (USD bn)

Source: CMIE

Exhibit 28: Net investments in mutual funds

Source: CMIE

Projected Nifty EPS could still be downgraded despite 1Q margin expansion

Following the 1QFY24 results consensus Nifty earnings have undergone a modest downgrade. Of the Nifty companies, 24 saw downgrades in FY24 downgrade with 8 major companies contributing 51% of the downgrades. 23 companies saw upgrades of which 5 major companies, ex HDFC contributed 51% of upgrades.

Companies that saw major upgrades: M&M, Tata Motors, BPCL, Dr Reddy's and UltraTech

Companies that saw major downgrades: Bharti, Bajaj Finserv, JSW Steel, SBI Life, Hindalco, Tata Steel and Tech Mahindra

The 1QFY24 earnings results summary points towards a sharp deceleration in sales growth of non-finance companies accompanied by margin expansion as firms roll back raw material expenses. There are initial signs that employee expenses are flattening sequentially. Most industries are facing pricing pressure due to weak demand conditions reflected in product discounts.

Notwithstanding the margin expansion-led profit gain in 1QFY24, the trailing 4-quarter EPS for Nifty continues to remain flattish since 2QFY23, rising by an average of 1.4% QoQ or an annualized 5.9%. And based on the latest numbers the trailing EPS growth has further decelerated to 3.5%. Given the evolving trends the 16% average consensus growth projection for FY24-FY24 looks facile

The major contributors to the overall index performance continue to be Autos (PAT 86% YoY, 4Q average 68%, due to margin expansion) and Banks (PAT 64% YoY, 4Q average 40% due to higher YoY CD ratio over-riding the impact of margin compression).

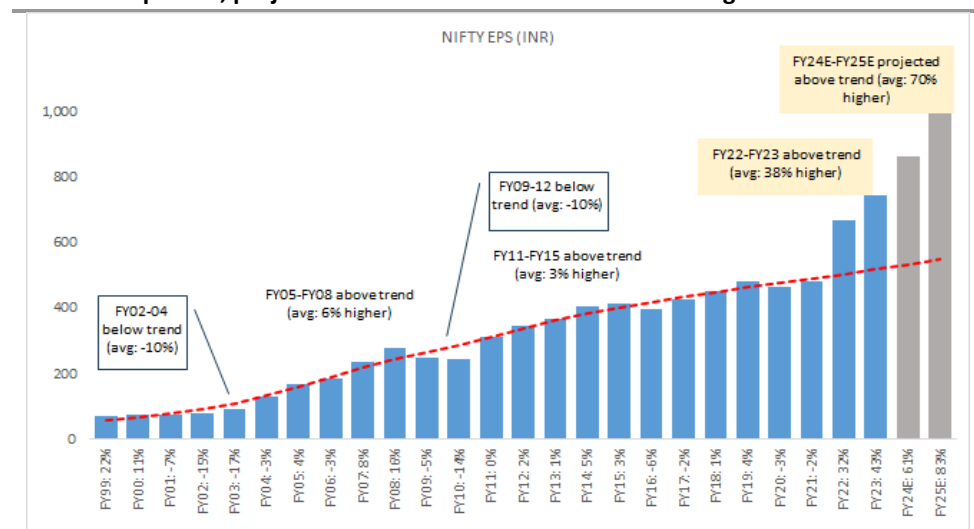
Whereas Metals and O&G continue to be the laggards, FMCG and IT companies have seen some margin expansion as well despite a modest demand situation.

Notwithstanding the margin expansion-led profit gain in 1QFY24, the trailing 4-quarter EPS for Nifty continues to remain flattish since 2QFY23, rising by an average of 1.4% QoQ or an annualized 5.9%. And based on the latest numbers the trailing EPS growth has further decelerated to 3.5%.

Thus, after the post-COVID episodic bounce (average of 26.5%YoY), as a mean reversion, Nifty EPS growth is trending back towards the pre-COVID average of 2.7% and much lower than the FY11-FY14 average of 11%.

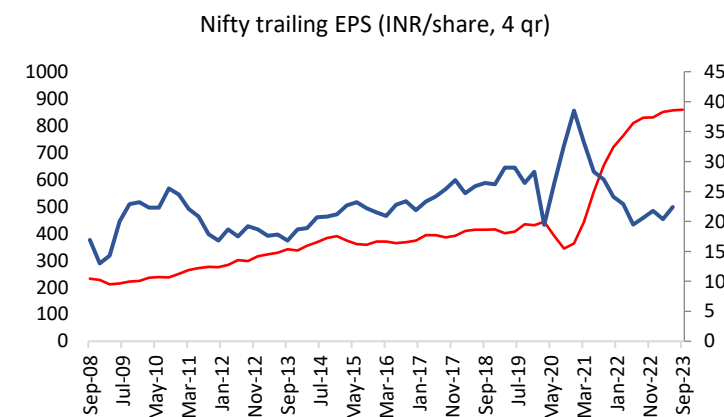
Considering these trends and our macro assessment we continue to believe that the 38% deviation in NIFTY EPS during FY22-FY23 from its pre-covid trend is ephemeral. Hence, the average projected growth of 16% in FY24-FY25 translating into a wider 70% deviation from the pre-COVID trajectory looks untenable. This is laying the backdrop for significant earnings downgrade for FY24E and FY25E.

Exhibit 29: Extraordinary surge in post pandemic Nifty EPS, 38% higher than pre-covid LT trend was episodic, projected 70% deviation for FY24-25E is fraught with risk



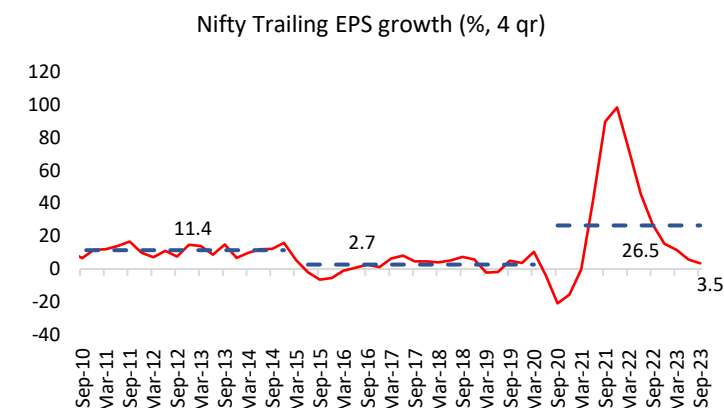
While the post pandemic GDP growth loss for India has been higher than for the US, inflation deviations has been similar. But while the US household consumption growth trend is higher than pre-pandemic, for India it slowed sharply. These imply that the elevated profits/earnings trajectory for Indian companies is aided by substantial rise in market power and at the cost of household real income. It is quite the opposite for the US; higher consumption led to higher earnings. These trends sharpens the sustainability question

Exhibit 30: NIFTY EPS flattening after the post-covid surge; PE at 22x has derated compared to 2017-19 average of 26.5x



Source: CMIE, Systematix Research

Exhibit 31: Trailing earnings growth at 3.5% converging with pre-covid; significantly lower than consensus 16% each for FY24, FY25



Source: CMIE, Systematix Research

Why we are less optimistic on the growth outlook?

Exhibit 32: Optimistic consensus vs Systematix Research on growth outlook

	Consensus view	Systematix Research
Growth Projections for FY24	<p>RBI: 6.5%, Q1FY24 at 8%</p> <p>CEA: 6.5-7.5%</p> <p>Less optimistic Global Agencies with growth averaging 6-6.5%</p> <p>JP Morgan, Nomura, CMIE - 5.5%</p>	<ol style="list-style-type: none"> 1) 5-5.5% (with a downside bias) 2) Rising Agri sector contribution with a 3-year CAGR of 3.9% compared to overall real GDP at 3.3% 3) 90% of the domestic demand is growing at 2-3% due to slowing consumption, weak private sector capex and restrained govt revenue spending 4) Recent contractions in trade of goods & services indicate reversal of the episodic global bounties, the primary driver of post-COVID recovery 5) Elevated headline growth driven by heavy government capex (7% of spending) growing at 35-40%. This distorted performance is difficult to sustain.
Agriculture	<p>Positives</p> <ol style="list-style-type: none"> 1) Strengthening rural demand on the back of good rabi crop <p>Negatives</p> <ol style="list-style-type: none"> 1) Impact of El Nino on monsoon 2) Depressed rural income poses downside risks to consumption demand 	<ol style="list-style-type: none"> 1) Net sowing areas have been flat over the last year. But the area under paddy is higher by 4.3%. 2) Rising ruralization translating into higher demand for agri produce, particularly cereals 3) Ruralisation trend leading to reduced average labour productivity, impacting household earnings & spending.
Household Situation	<p>Positives</p> <ol style="list-style-type: none"> 1) Household consumption and investment activity to remain buoyant 2) Rural demand is expected to strengthen on a good rabi crop 3) Services to benefit urban demand 4) Household consumption to remain elevated due to declining inflation <p>Negatives</p> <ol style="list-style-type: none"> 1) Fading pent-up demand 2) Elevated cost of living, high interest rates 	<ol style="list-style-type: none"> 1) Consumption demand to be a big drag on the overall growth scenario. It grew modestly at 2.5% in 2H FY23, slower than 4.7% 3-yr CAGR. 2) Long-term trends indicative of a sharp deceleration in PFCE due to significantly lagging real income growth of households, particularly after FY12. It decelerated to a 27-year low of 3.5% in FY23 on a 4-year CAGR basis. 3) Slackening household income impacting consumption capability 4) High cost of living and weak real incomes impacting consumption patterns in favour of essentials and basic food items
Credit Growth	<ol style="list-style-type: none"> 1) Credit growth to remain robust 	<ol style="list-style-type: none"> 1) Booming retail lending of banks and NBFCs, growing at 20-30% may be compensating for the lack of income growth 2) As companies focus on retaining profitability amid contracting sales, growth in salaries and wages will likely slacken thereby leading to rising NPAs on retail lending

Capex Story	<ol style="list-style-type: none"> 1) Government thrust on capital spending, robust credit growth, and moderation in commodity prices is expected to boost investments. 2) According to agencies like JPM and Nomura government capex is unlikely to translate into an appreciable rise in investment demand 	<ol style="list-style-type: none"> 1) Despite post-covid episodic bounties, corporate profits failed to convert into capex. 2) RBI data on projects sanctioned by banks show steep contraction for sectors beyond roads and metals (see here). 3) The backdrop of a decline in sales growth and falling commodity prices along with weak demand, and elevated uncertainty to keep companies away from capacity expansion.
External/Global	<p>Negatives</p> <ol style="list-style-type: none"> 1) Weak external demand to weigh in on overall growth 2) Volatility in financial markets and sustained tightening by central banks <p>Positives</p> <ol style="list-style-type: none"> 1) Fall in crude prices 	<ol style="list-style-type: none"> 1) Weak global demand and trade fragmentation are having a significant impact on the growth in domestic demand and overall GDP. 2) India's elasticity of real GDP growth with respect to global export volume growth has risen to 1.78x from 1.13x in 2008 3) China is losing out in global trade with the intensifying trade war scenario with the US and as the declining dependence of several countries on China gains momentum, China's friend shoring activities will intensify with the rise in dumping in India to reduce its losses.

Source: Various, Systematix Research

Exhibit 33: Real GDP growth components (% YoY)

Real GDP	Q1F22	Q2F22	Q3F22	Q4F23	Q1F23	Q2F23	Q3F23	Q4F23	Q1FY24E	4-year CAGR
GDP	21.6	9.1	5.2	4.0	13.1	6.2	4.5	6.1	5.4	3.4
PFCE	17.6	14.2	10.8	4.7	19.8	8.3	2.2	2.8	3.3	4.2
GFCE	(2.1)	11.7	5.8	11.8	1.8	(4.1)	(0.6)	2.3	0.5	2.6
GCF	67.0	21.4	5.1	3.0	20.8	6.5	5.2	7.8	6.8	3.9
GFCF	61.0	12.4	1.2	4.9	20.4	9.6	8.0	8.9		
Change in stocks	974.6	655.9	619.0	613.8	7.5	(2.6)	(0.1)	5.9		
Valuables	481.2	156.6	44.5	(51.7)	58.7	(19.5)	(38.0)	(23.4)		
Exports (Gds & Ser)	46.1	25.1	27.8	22.4	19.6	12.2	11.1	11.9	(2.5)	6.2
Imports (Gds & Ser)	44.8	26.6	19.7	6.7	33.6	23.1	10.7	4.9	(2.7)	4.4
Discrepancies (% identified GDP)	-1.8%	-3.8%	-3.0%	-2.9%	-3.3%	-1.8%	-1.4%	-2.9%	-2.4%	
GDP Ex Discrepancies	27.5	16.1	9.6	7.6	14.8	4.0	2.8	6.0	4.4	4.3
Domestic expenditure	27.2	16.5	8.5	4.8	18.0	6.5	2.9	4.5	4.2	4.0

Source: Systematix Research

Exhibit 34: Real GVA growth components (% YoY)

Real GVA	Q1F22	Q2F22	Q3F22	Q4F23	Q1F23	Q2F23	Q3F23	Q4F23	Q1FY24E	4 year CAGR
GVA	20.2	9.3	4.7	3.9	11.9	5.4	4.7	6.5	4.9	3.8
Agri	3.4	4.8	2.3	4.1	2.4	2.5	4.7	5.5	5.5	4.5
Industry	49.1	8.1	1.6	2.3	9.4	(0.5)	2.3	6.3	6.5	3.6
Mining	12.2	10.6	5.4	2.3	9.5	(0.1)	4.1	4.3		
Manufacturing	51.5	6.6	1.3	0.6	6.1	(3.8)	(1.4)	4.5		
Power, utilities etc	16.3	10.8	6.0	6.7	14.9	6.0	8.2	6.9		
Construction	77.0	10.8	0.2	4.9	16.0	5.7	8.3	10.4		
Services	12.5	11.1	7.6	4.9	16.3	9.4	6.1	6.9	3.9	3.7
Trade, hotels, transport, etc	41.4	13.1	9.2	5.0	25.7	15.6	9.6	9.1	2.0	2.2
Financial services etc	2.8	7.0	4.3	4.6	8.5	7.1	5.7	7.1	7.0	5.1
Public services	6.5	16.8	10.6	5.2	21.3	5.6	2.0	3.1	0.3	3.5

Source: Systematix Research

Agri sector-Rising cash flows amid high inflation and credit

Surge in food inflation including vegetable prices, cereal prices, etc., in the context of bountiful agriculture sector performance (nearly 4% in FY23 and 4% 4-year CAGR), looks incongruent. While this is commonly attributed to weather anomalies, in our view it is led by structural factors (See [High Food Inflation Has Deeper Roots Than Meets The Eye](#), July 20, 2023). This has attracted policy interventions including bans on exports of cereals (rice and wheat), limited diversion of rice for ethanol production, and increased open market sales to moderate inflationary pressures. Recently, advocacy for the imports of food grains has also gathered momentum (See [Go for the unthinkable; import wheat to curb food prices inflation](#)).

We think that there has been a meaningful rise in terms of trade for the agri sector given the moderation in prices of manufacturing sector inflation reflected in the WPI. This would have benefitted large and mid-size farmers who have multiple income channels, cultivation, trading, and transport services.

Structural factors aiding the agri sector's resilience to rainfall deficiencies are:

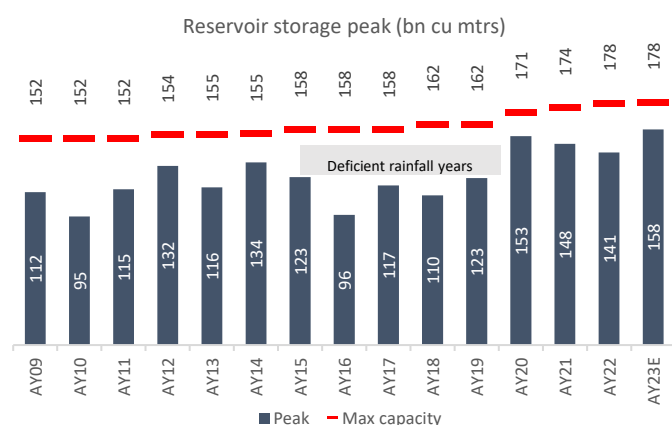
- Decreasing share of rainfed rice cultivation & rising share of reservoir-dependent wheat cultivation,
- 9% increase in reservoir capacity to 178bn cubic meters since 2018,
- rise in net irrigated area from 1.0% 5-year CAGR in 2013 to 4.7% in 2020. Mainly due to increased dependence on tube well irrigation (50% of irrigated area), aided by increased power availability and subsidy in major states amid rising diesel prices.
- Hence, notwithstanding the weather anomalies, the net sown area has been higher than last year (0.1% YoY for the ongoing Kharif season at 1022lac hectares, Aug 18, 2023).

The improved cash flows from rising agri sector terms of trade have also seen a surge in agri lending by banks, rising to a high of 20% YoY (Jun'23). Tractor sales growth at 8% YoY in May'23, remains robust, aided by strong agri production and liberal financing.

Overall, the combination of agri GDP growing faster than other non-government sectors, rising terms of trade, and rising bank credit bodes well for agri-dependent sectors.

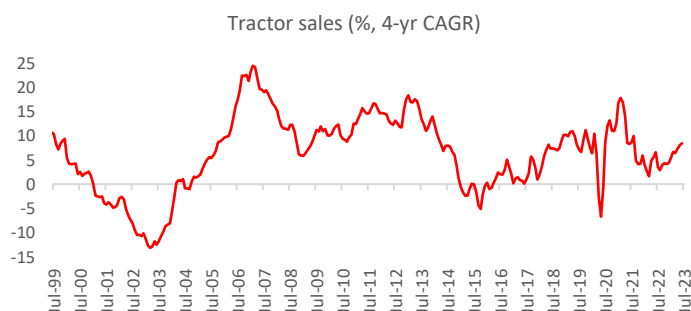
Overall, the combination of agri GDP growing faster than other non-government sectors, rising terms of trade, and rising bank credit bodes well for agri-dependent sectors.

Exhibit 35: Rising reservoir capacity aided agri sector resilience



Source: RBI, Systematix Research

Exhibit 36: Tractor sales growth remains robust, aided by strong agri production



Source: RBI, Systematix Research

Services sector: Reversal of the major contributor to the post Covid rebound

S&P Global India services PMI for the month of July came in strong at 62.3 rising from 58.5 in June on the back of a record upturn in service exports and a rise in total global sales rising at the quickest pace since June 2010.

However, evidence from multiple indicators shows a contraction or a significant declaration. Here are some of them:

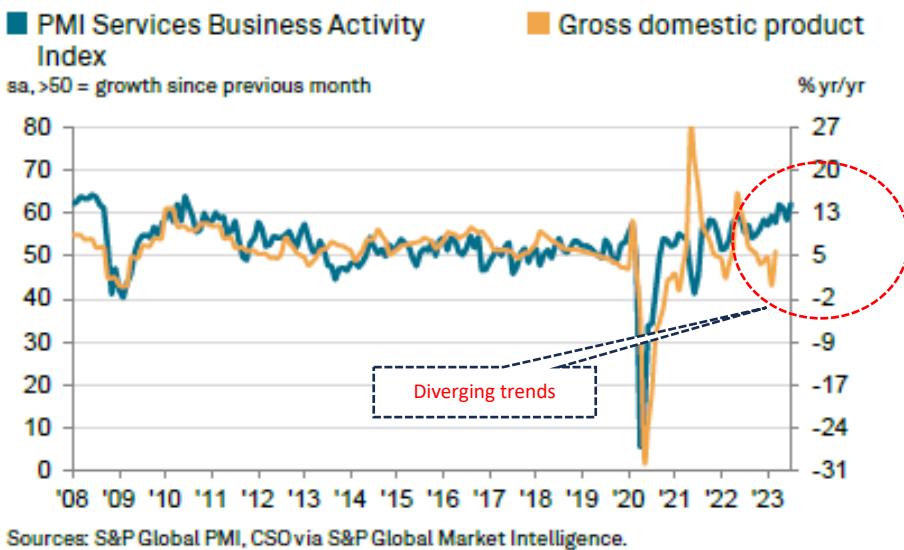
Since the post-pandemic episodic surge in global trade of goods and services was the most important factor behind India's growth rebound the optimism exuded by the S&P PMI would mean a significant positive spillover for India's general services activities, employment situation, and household incomes.

However, evidence from multiple indicators shows a contraction or a significant declaration

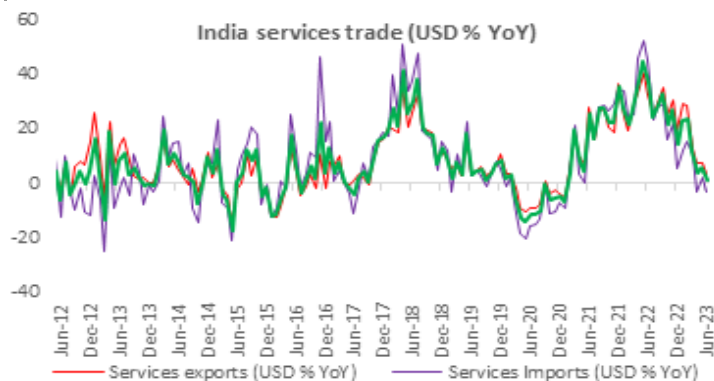
- a) **Services trade, both exports and Imports has seen a sharp deceleration:** India services trade (exports+imports in dollar terms) has decelerated sharply in Jun'23 to 1% YoY; exports decelerated to 3.5% YoY and imports contracted 3.4% YoY. On a seasonally adjusted basis services exports have contracted by 5.8% from Sep'22 peak and 4.1% since Dec'22.
- b) **Contracting goods trade has a bearing on the services sector:** Merchandise trade in both exports and imports has been contracting, on average by 11% since Feb'23. Contraction in non-oil non-gold imports is reflective of the weak domestic demand scenario. This overall has a bearing on domestic services sector activities.
- c) **Freight movement at ports is declining now:** 4% YoY decline for minor ports and 2% YoY decline for major ports.
- d) **Freight movement at Indian airports 10% lower than pre-covid:** Freight movements across Indian airports have seen sub-optimal recovery and are now contracting -0.8% in Jun'23.
- e) **Railway freight contracted by 2% YoY in Jun'23** reflecting domestic movements of goods impacting railway transportation services.
- f) **Commercial vehicle sales in contraction, reflecting feebleness in transportation services:** Aligning with the decline in external trade and freight movement in Indian ports and railways, volume growth for commercial vehicles, both LCVs (-7.3% YoY, Jun'23) and M&HCVs (-0.3%) are also in contraction zone now.
- g) **Buoyancy in real lending could result from the contraction in the broader services sector:** The credit growth (real & nominal) for the employment-intensive services sector has been on the rise, despite a pervasive decline in the broader services sector.

The combination of slackening domestic and global services sectors has implications for household incomes and spending power as the services sector remains the biggest source of non-agri employment (40% to total employment, CMIE).

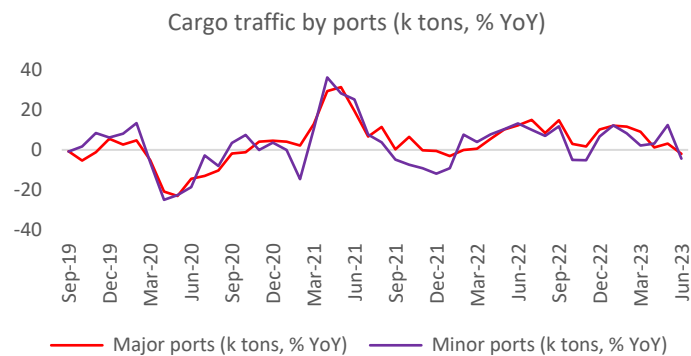
These contrasting trends imply that the recent reemergence of asset quality concerns may get larger in the coming quarters.

Exhibit 37: PMI services a poor lead indicator for tracking economic activities

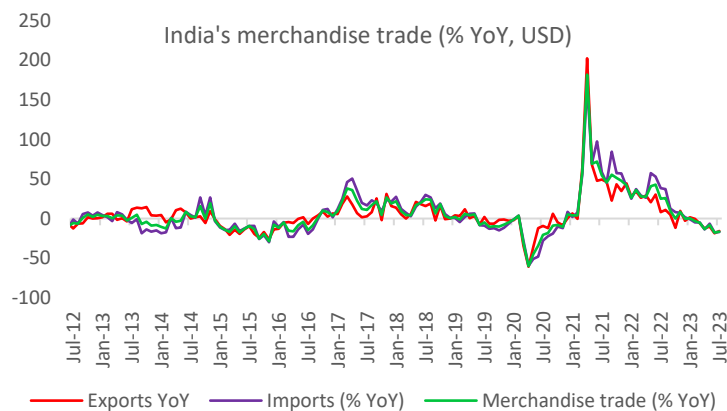
Source: S&P Global

Exhibit 38: Sharp deceleration India services trade (USD bn, YoY)

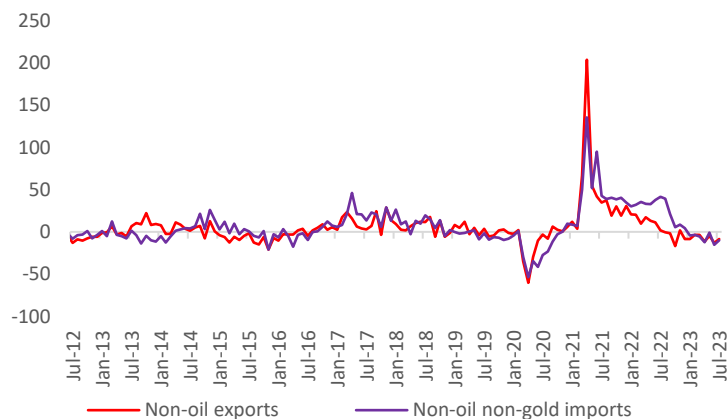
Source: CMIE, Systematix Research

Exhibit 39: Cargo handled-major ports -2% YoY, Minor ports -4%

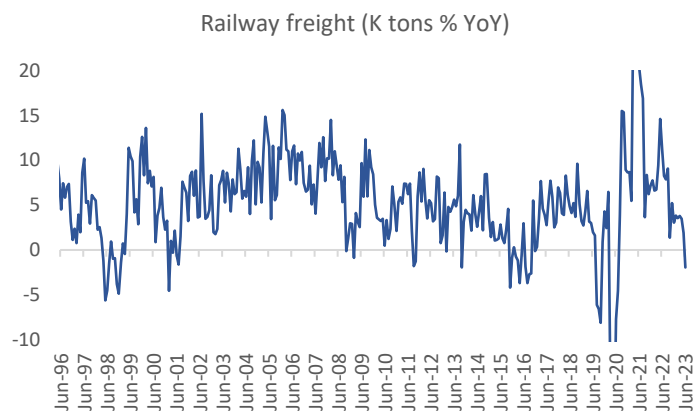
Source: CMIE, Systematix Research

Exhibit 40: India's merchandise trade, exports & imports in a contraction zone since Feb'23 (down 11% YoY on average)

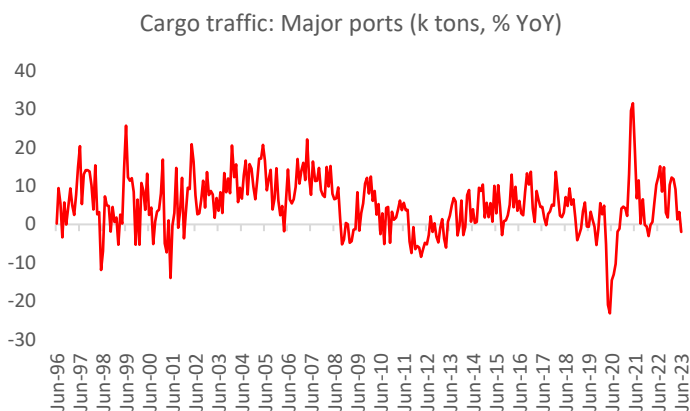
Source: CMIE, Systematix Research

Exhibit 41: Weak external and domestic demand reflecting from non-oil non gold trade (% YoY, USD)

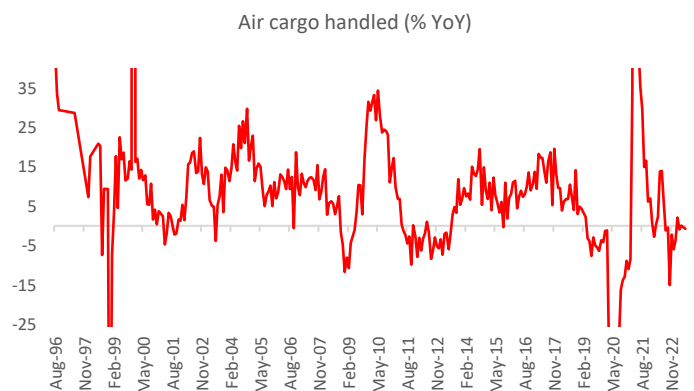
Source: CMIE, Systematix Research

Exhibit 42: Railway freight contracted by 2% YoY in Jun'23

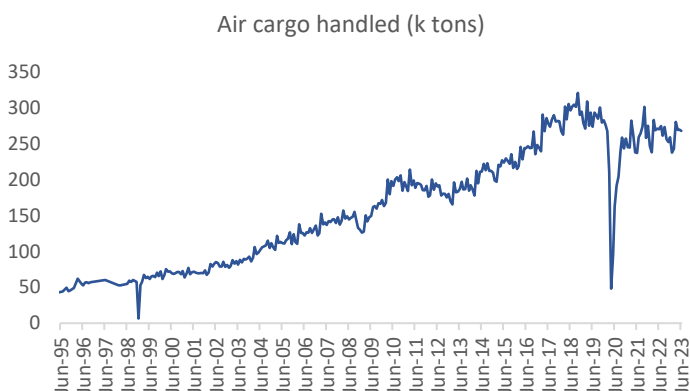
Source: CMIE, Systematix Research

Exhibit 43: Major ports cargo handled contracted 2% YoY, Jun'23

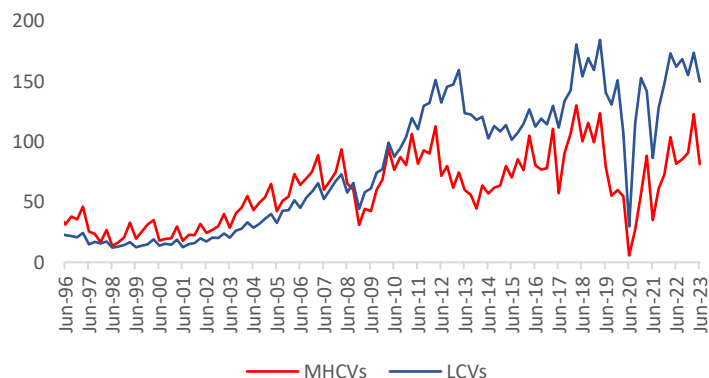
Source: CMIE, Systematix Research

Exhibit 44: Cargo handled by airports contracted by 0.8% YoY

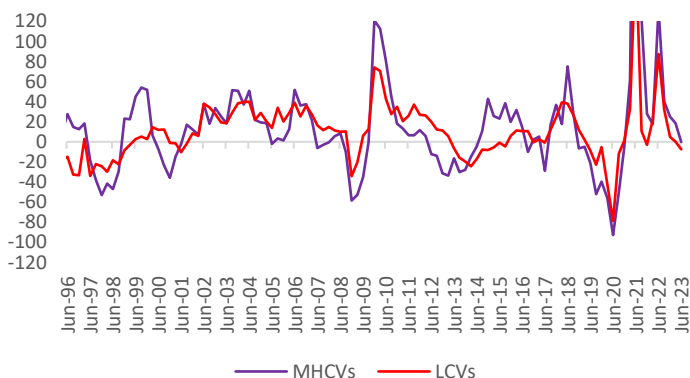
Source: CMIE, Systematix Research

Exhibit 45: Cargo handled by airports is 10% lower than 2018

Source: CMIE, Systematix Research

Exhibit 46: Commercial vehicle sales (thou/qr); lower than pre-COVID peaks; current levels for MHCVs lower than 2010

Source: CMIE, Systematix Research

Exhibit 47: Contraction in CV sales (% YoY); LCV -7.3% & MHCV -0.3%, Jun'23 quarter

Source: CMIE, Systematix Research

Employment: Rising ruralisation presage a reciprocal change in demand

Recovery in high-income jobs viz. urban services and manufacturing has been modest, which implies modest gains in household incomes and higher reliance on rural, both non-Agri and Agri sectors. This has led to a rise in demand for non-agri rural jobs under MNREGA which is 28% higher than in 1QFY20 with the wages up by 69% in 1QFY24 compared to 1QFY20. This recent spike of 10-11% during the period Apr-Jun'23 has led to a rise in real rural wage growth.

If the trends of decelerating sales growth of non-finance companies and the services sector activities continue, urban compensation growth and remittances to the rural areas may slacken further.

In line with our ruralisation theme, there are clear rising trends towards rural employment, particularly in agri sector. The recent spurts in government allocation towards MNREGA, hikes in MNREGA wages, and gains in agri wages imply that India's consumption pattern will also be driven by the ruralisation theme.

Growth in salaries and compensation derived for non-finance companies at 8.7% (3-year CAGR) shows a modest lagged recovery. Net of increase in employment (say 1-2% CAGR) and inflation (3-year CAGR of 6%) the real per capita income growth in the non-finance sectors could be in the order of 2-3%.

The recent spurts in food inflation may have aggravated the budgetary constraints for households, thereby impacting demand for manufactured consumer products. Additionally, it forced leveraged consumption, as reflected in the boom in retail lending across institutions.

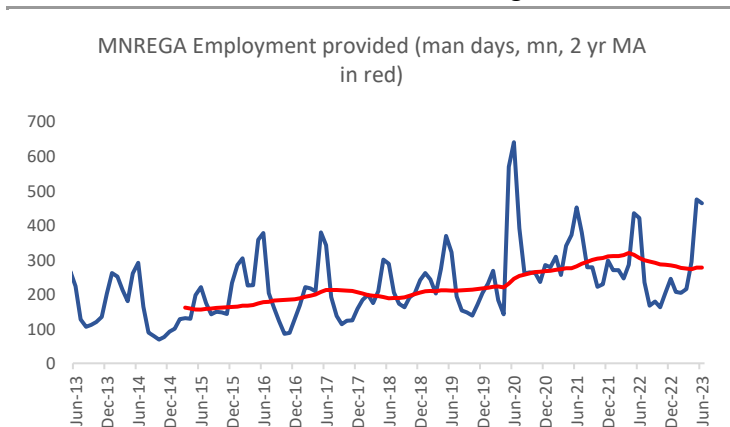
All put together, the trend in real private final consumption expenditure has seen a step-down, growing at 4.5% on 4-year CAGR and an average of 2.5% in 2HFY23. This reflects the lack of income growth, which is estimated to be growing at a meager 3.5% on a 4-year CAGR basis.

Services employment has recovered to the pre-covid levels, led by a rebound in retail and wholesale trade, BFSI health care, and hotels. A significant other portion is lagging considerably. The latest trends indicate that even retail trade (45% of urban and 48% of rural services jobs) is beginning to peak in line with the deceleration in the services sectors.

If the trends of decelerating sales growth of non-finance companies (-2.6% YoY in 1QFY23) and the services sector activities continue, urban compensation growth and remittances to the rural areas may see further slackening.

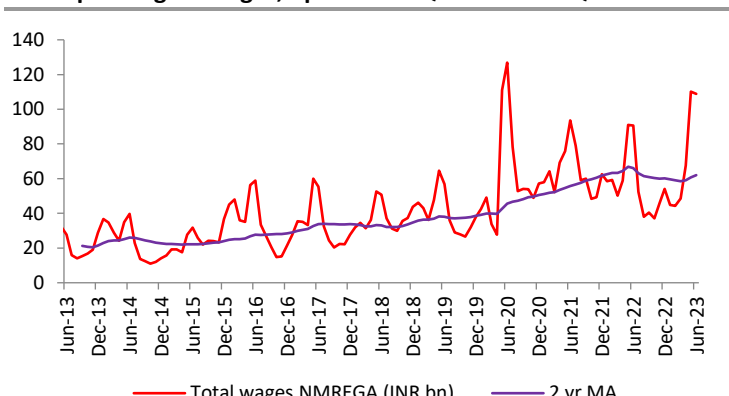
Overall, in line with our ruralisation theme, there are clear rising trends towards rural employment, particularly in agri sector. The recent spurts in government allocation towards MNREGA, hikes in MNREGA wages and gains in agri wages imply that India's consumption pattern will also be driven by the ruralisation theme.

Exhibit 48: MNREGA work in 1QFY24 is 28% higher than in 1QFY20

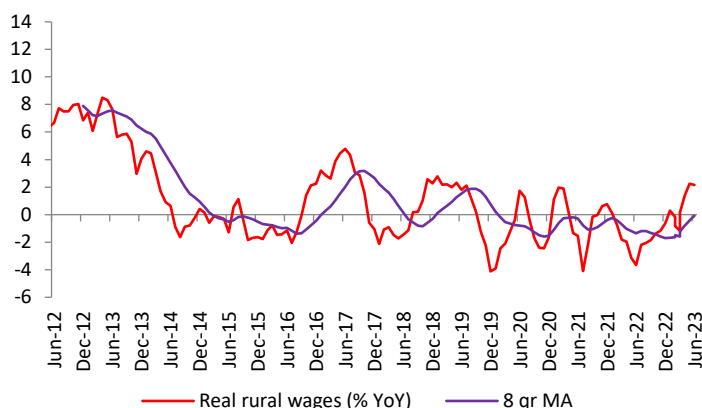


Source: CMIE, Systematix Research

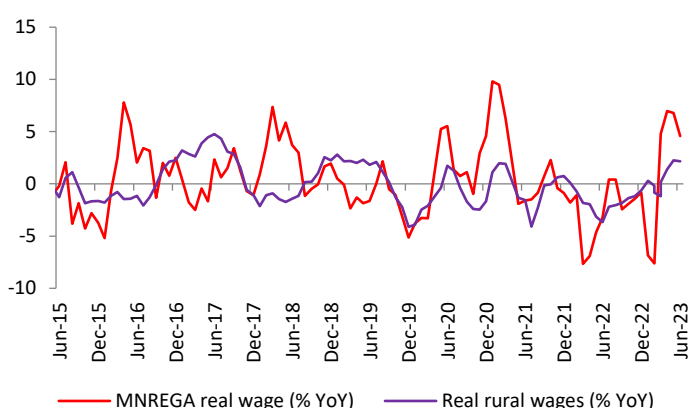
Exhibit 49: Higher wages and MNREGA work mean a rebound in total spending on wages, up 69% in 1QFY24 from 1QFY20



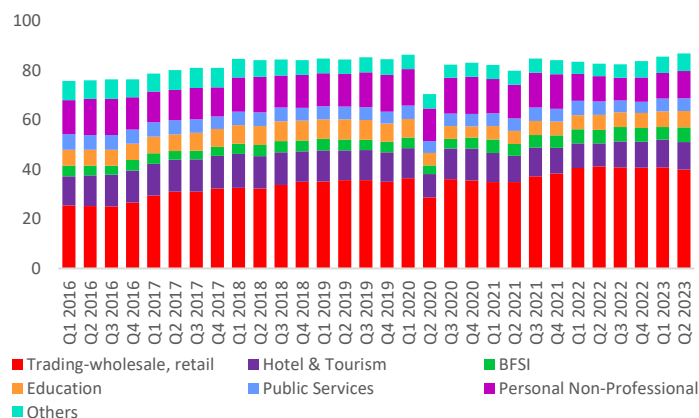
Source: CMIE, Systematix Research

Exhibit 50: Real rural wage growth averages gradually turning positive

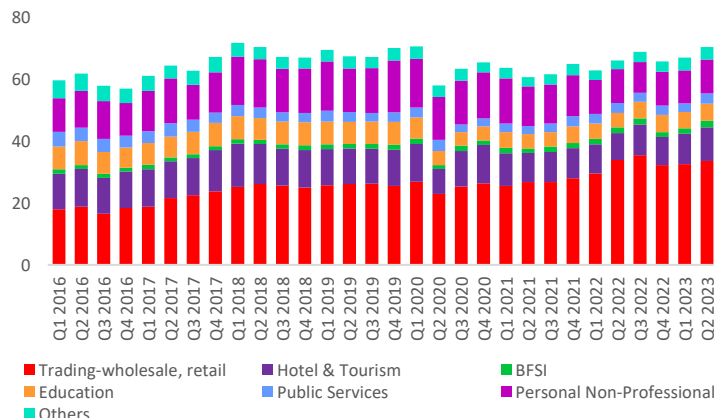
Source: CMIE, Systematix Research

Exhibit 51: Recent spike in NMREGA wage growth to 10-11% (Apr-Jun) turning up the real rural wages growth

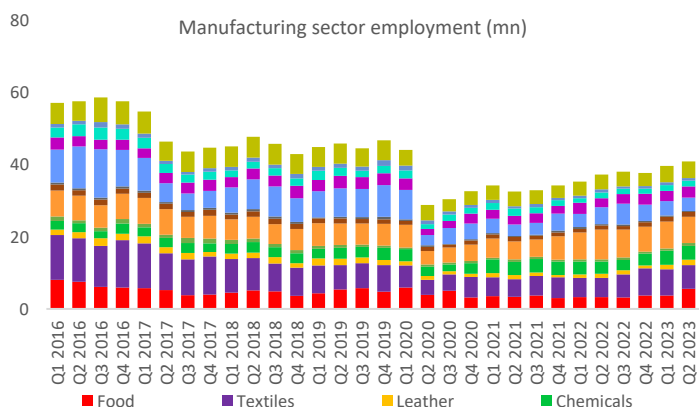
Source: CMIE, Systematix Research

Exhibit 52: Urban Services: Back to pre-covid (0.8% CAGR) led by BFSI, Trading and IT; tourism, & non-professional services lagging

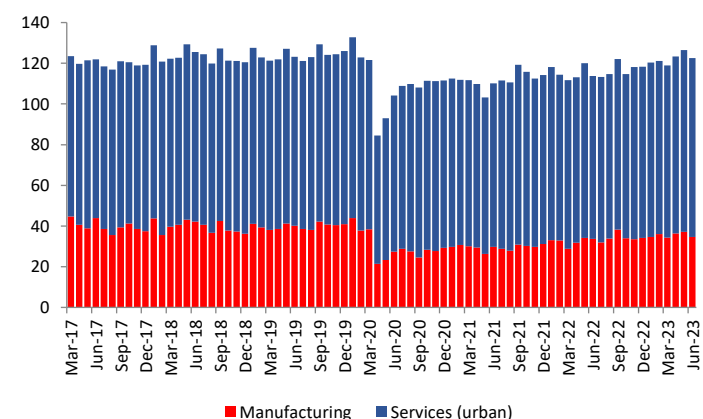
Source: CMIE, Systematix Research

Exhibit 53: Rural services: Leading-trading, BFSI, health-care; Lagging: Tourism, Edu, pub-ser, non-professional services

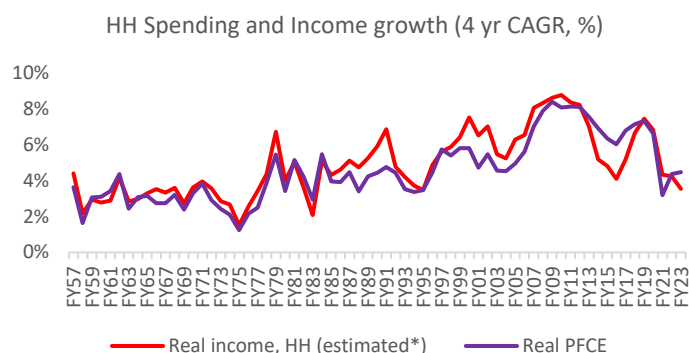
Source: CMIE, Systematix Research

Exhibit 54: Manufacturing sector job recovery has been incomplete; Slackness sustaining since 2016

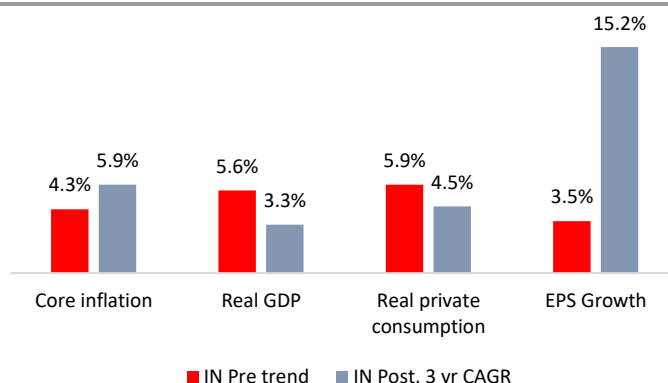
Source: CMIE, Systematix Research

Exhibit 55: Urban Services plus manufacturing (mn) employment still at sub covid levels implying income gains has been modest

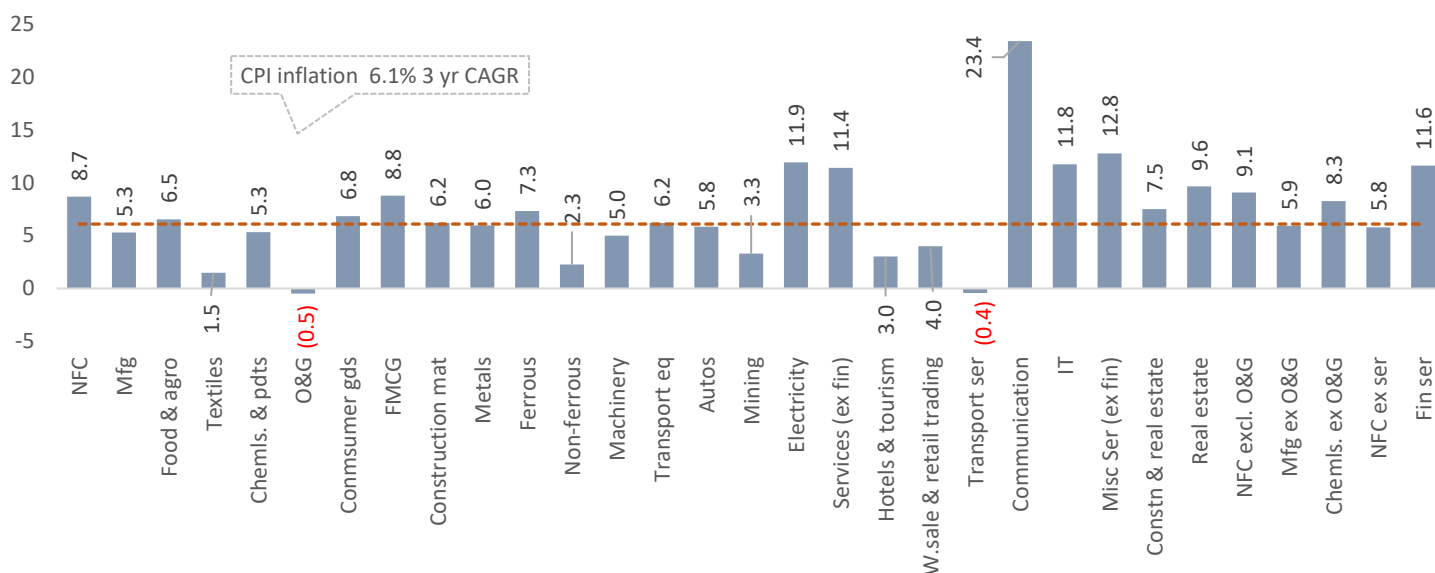
Source: CMIE, Systematix Research

Exhibit 56: Significantly lagging HH income dragging down consumption and savings

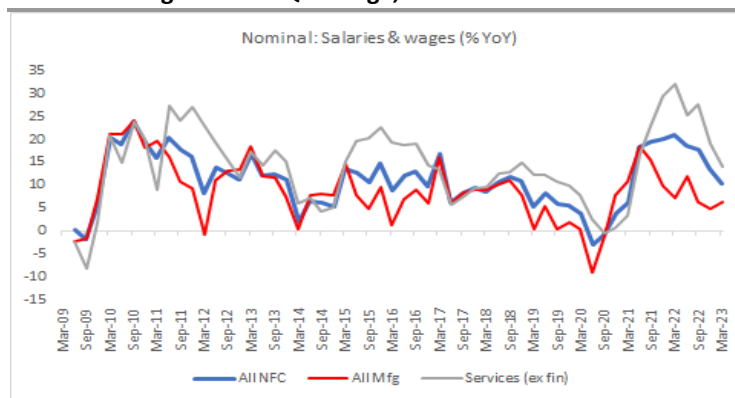
Source: CMIE, Systematix Research; Note: 2004-05 series taken till FY12 and 2011-12 series thereafter; * HH income derived from savings and consumption data

Exhibit 57: Lower post covid GDP YoY (-230bp), lower consp (-140bp), & inflation (+160bp) -> Higher Nifty EPS (1117bp)

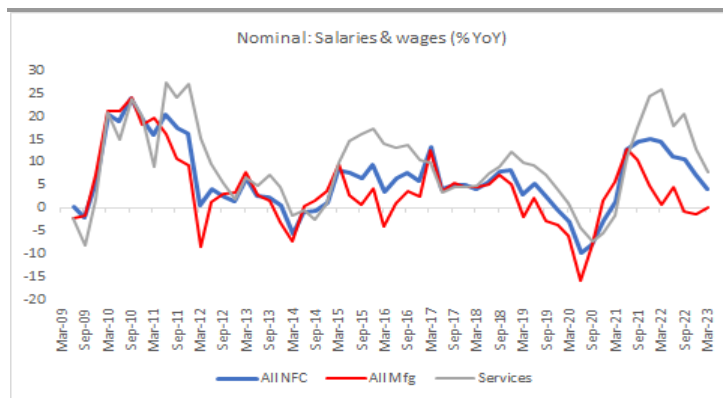
Source: CMIE, Systematix Research; Pre covid, EPS 2013-19 avg 3.5% YoY

Exhibit 58: Salary and compensation of non-finance (NFC) and Finance cos. (3-year CAGR)

Source: CMIE, Systematix Research

Exhibit 59: Employee compensation has been slowing, manufacturing at 5.5% 2Q average, services at 12%

Source: CMIE, based on quarterly results, does not account for number of employees

Exhibit 60: Real employee compensation growth around 5%

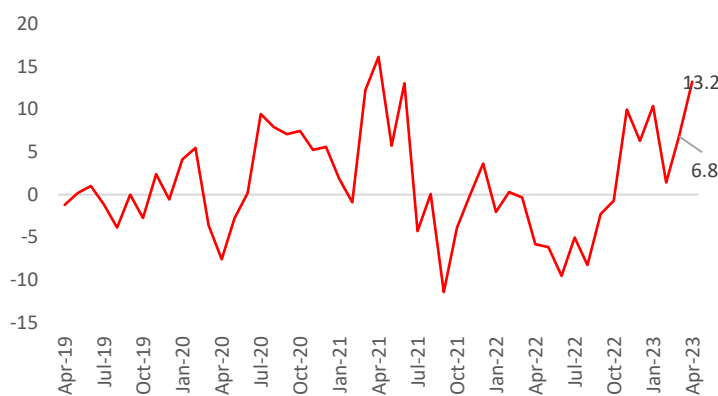
Source: CMIE, based on quarterly results, does not account for number of employees

Consumption-Rapid borrowings backfills for lack of income growth

Average consumption growth has moderated to 2.5% in 2HFY23 following an average of 4.2% (4 year CAGR) and considerably lower than 8% in FY09. This is due to the slackening in income growth estimated at 3.2% 4 year CAGR and the decline in savings. Hence, the recent surge in bank lending has created a partial backfill for the lack of income growth. However, despite the leverage consumption boom, there is a clear disparity; two-wheelers have contracted while passenger cars have regained pre-covid levels. And while production of cereals has rebounded, items relating to FMCG segments have contracted. The recent surge in food inflation is hurting consumption at a broader level.

Exhibit 61: A significant factor behind the recent upswing in consumer non-durables growth is led by cereals (rice production)

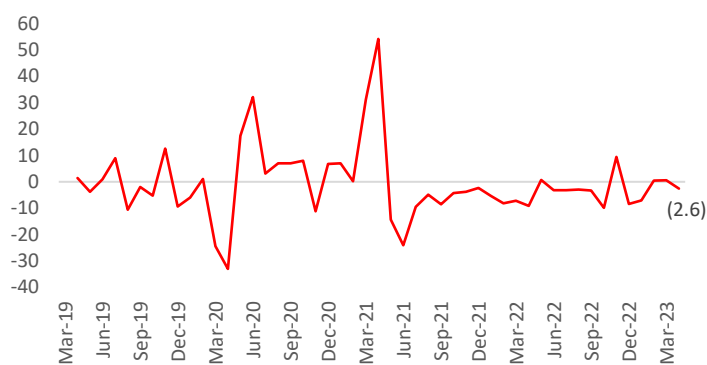
IIP: Cereals related products (% YoY)



Source: CSO, Systematix Research

Exhibit 62: But typical FMCG products have been in the contraction zone, contrary to market gains by large FMCG companies

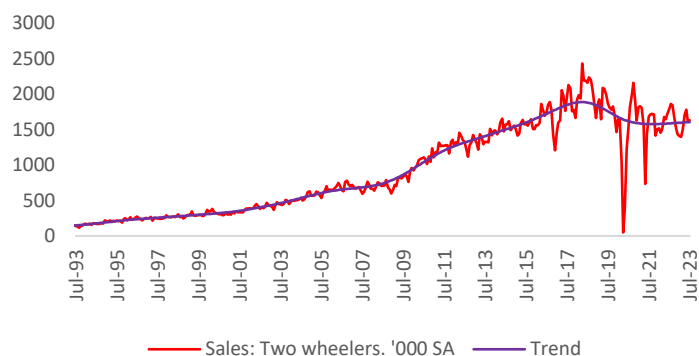
FMCG product: Soaps detergents, toothpaste etc (% YoY)



Source: CSO, Systematix Research

Exhibit 63: Two-wheeler sales; 25% lower than the 2018 average, -6% YoY in Jun'23)

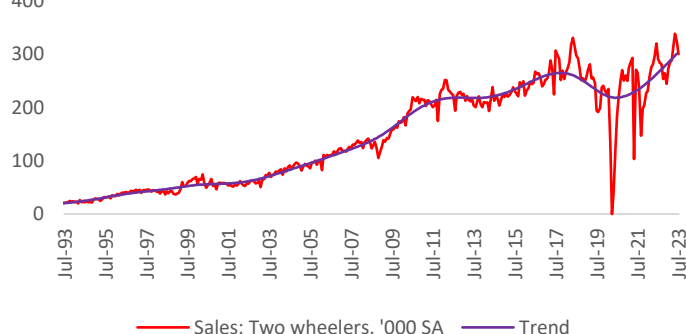
Two wheeler Sales ('000, SA)



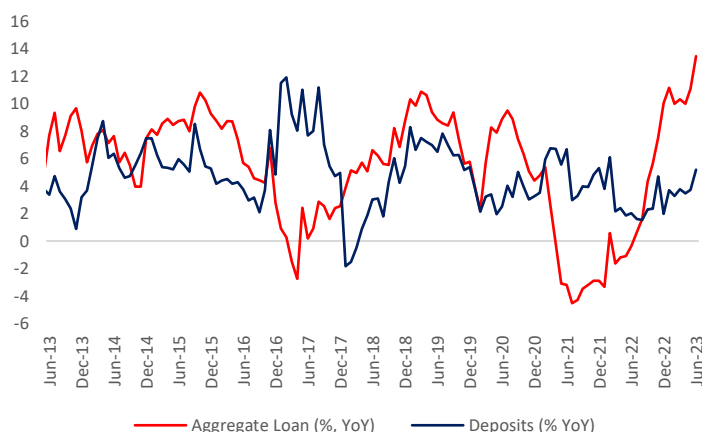
Source: Industry

Exhibit 64: PVs have rebounded better than 2Wheeler, (2% YoY in Jun'23)

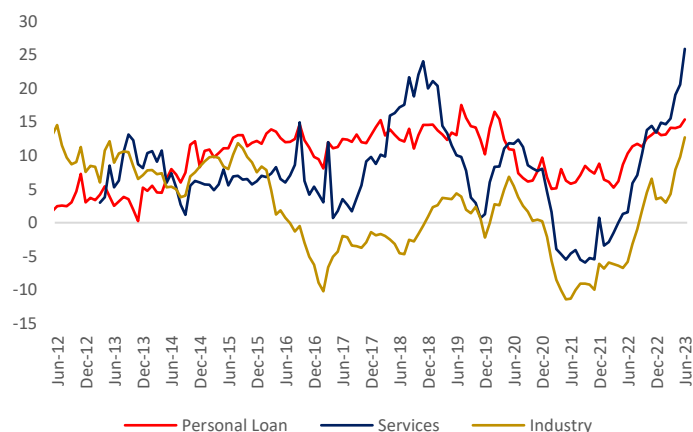
Domestic sales: Passenger cars, vans, jeeps & utility vehicles ('000, SA)



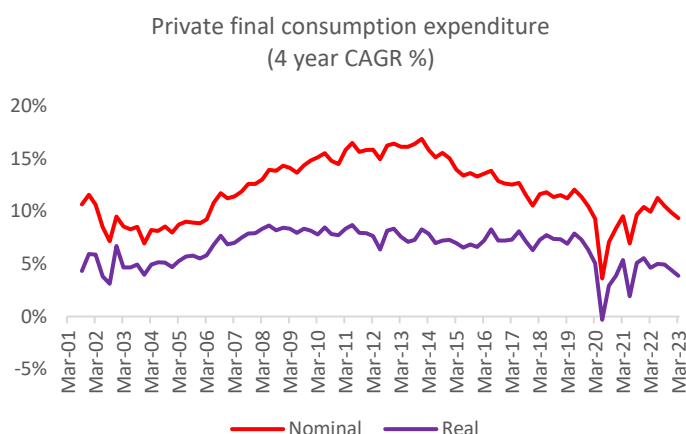
Source: Industry

Exhibit 65: Surging real bank lending growth indicative of leveraged private sectors, significantly fueling HH spending

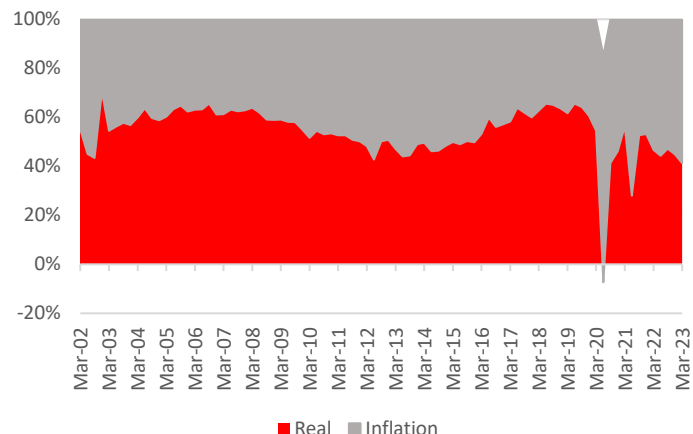
Source: RBI, Systematix Research

Exhibit 66: Sector real bank credit growth; mainly driven by services (NBFCs) and

Source: RBI, Systematix Research

Exhibit 67: Considerable deceleration in both nominal and real private consumption from pre-covid trends

Source: CMIE, Systematix Research

Exhibit 68: Only 40% of nominal spending is going into real spending, the lowest level in the 20 years preceding the covid

Source: CMIE, Systematix Research

Private capex turnaround continues to remain elusive

Our assessment of investment projects data from CMIE and trends in net fixed assets of NFCs indicates that the crowding in effect of large government spending on roads, railways, and defense on private capex has not worked till now, thereby reinforcing that the private capex cycle will remain elusive. The latest banking sector results also indicate a lack of demand for corporate credit and a decline in interest rate spreads are indicative of the continued lagging of private capex.

We note that:

- a) In the manufacturing sector, project announcements expanded 4x to INR 11-12tn from pre-COVID, and projects completed fell sharply in FY22-FY23 by 30% to INR 980bn, 3.5% YoY in FY23. The rate of completion of investment projects (% of the average 2-year project announced) has fallen sharply to 8.3% in FY23 from 32% in FY20. Project announcements during FY22-23 are twice as much as the FY09 peak and the rate of conversion in key sectors has declined in 2HFY23.
- b) Major project announcements have happened in Chemicals, Machinery, Electricity, and Metals; transportation in services. However, the actual projects completed across these sectors declined in FY23 (Metals -80% YoY, Machinery -33%, Electricity -66%; all manufacturing is up 3.6% or ~0% in real terms).
- c) The number of projects announced declined to 1,110 in FY23, down from 1550 in FY21 even as the average project size rose to INR 11.6mn in FY23 from INR 3.4mn in FY20.
- d) Long-term trend indicates that during times of announcement boom and up-cycle, the rate of withdrawal of project (% of announced in past years) falls. But it rises during the ensuing down cycle.
- e) The pace of implementation of the announced project will depend on business cycle perception. We rely on RBI's Industrial Outlook survey (4QFY23), which indicates a clear sense of moderation in operating variables. This indicates a higher likelihood of cutback in investment intentions in the coming years.
- f) Another sign of moderation in private capex is the contraction in FDI inflows to USD 1.8bn/month during Jan-Jun 2023 from USD 3.8bn prior to COVID.
- g) RBI's latest note on projects sanctioned by banks & financial institutions and funded through other sources sounds optimistic about private sector turnaround. However, our assessment highlights a significant skew in the roads and metals sectors. Outside of the infra and metals sectors, growth in sanctioned projects has been -1.6% on 3 year CAGR or -9.6% in real terms (see [How realistic is RBI's optimism on private capex turnaround?](#), Aug 23, 2023).

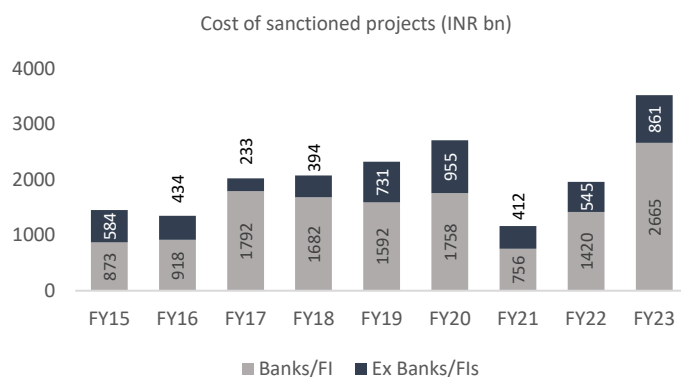
Given that the project announcements during FY22-23 are twice as much as the FY09 peak and the rate of conversion in key sectors has declined in 2HFY23 in line with the moderation in Industrial Outlook Survey, there is a high likelihood of cutback in investment intentions in the coming years. The latest data on sanctioned projects from RBI shows a contraction in sanctioned project costs outside of the infrastructure and metals sector. FDI inflow has also halved during 1H 2023

Exhibit 69: Industry-wise distribution of projects sanctioned by banks/FIs: 2013-14 to 2022-23

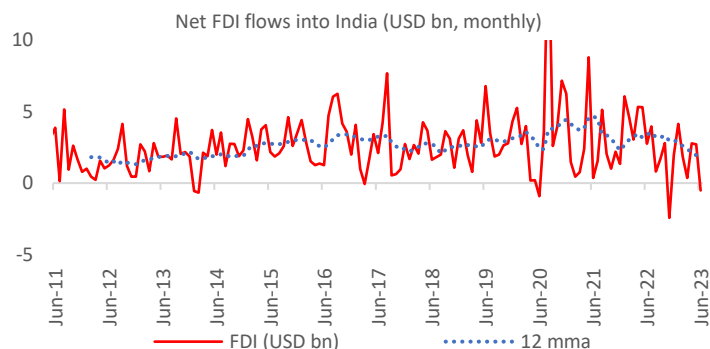
Sectors		FY14	FY15	FY16	FY17	FY18	FY19	FY20	FY21	FY22	FY23	FY24	FY25	3 yr CAGR	9 yr CAGR
Infrastructure		505	427	661	1,120	870	960	1,081	561	801	1,597			13.9	13.6
Of which	Power	447	368	524	814	614	427	578	373	412	541			-2.2	2.1
	Roads	15	3	70	131	170	166	325	162	287	973			44.1	58.7
	Other infra	43	56	67	176	86	368	177	26	102	83			-22.5	7.4
Metals		222	152	14	88	163	48	14	6	60	389			202.5	6.5
Construction		27	35	17	215	89	37	200	36	105	107			-19.0	16.6
Cement		90	33	17	41	10	81	2	10	47	21			129.8	-14.8
Others*		195	83	77	129	143	255	227	78	116	80			-29.3	-9.4
Total project cost (INR bn)			873	918	1,792	1,682	1,592	1,757	756	1,420	2,665			14.9	8.6
- of which Ex Infra & Metals		539	293	218	577	649	584	663	188	558	632			-1.6	1.8
Industrial bank credit (INR bn)		2516	2657	2730	2679	2699	2885	2973	2934	3156	3336			3.9	3.2
Sanction % of Industrial credit		5.1	3.3	3.4	6.7	6.2	5.5	5.9	2.6	4.5	8.0				
Ex Infra & Metals % industrial		2.1	1.1	0.8	2.2	2.4	2.0	2.2	0.6	1.8	1.9				
Phasing of sanctioned projects		1906	1403	1386	1431	1332	1467	1430	1359	1448	1589	1172	724	3.6	-2.0
Phasing % of industrial credit		7.6	5.3	5.1	5.3	4.9	5.1	4.8	4.6	4.6	4.8				

* Comprise industries like Transport Services, Transport Equipment, Hotel & Restaurants, Paper & Paper Products, Agricultural & Related Activities, Manufacturing of electric and non-electric machinery, Sugar and allied products, Entertainment, Trading of services, Printing & Publishing, other manufacturing and other services.

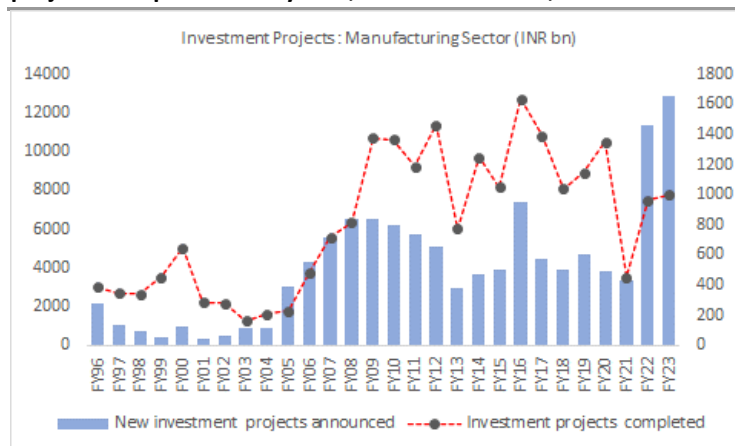
Source: RBI (see [here](#)), Systematix Research

Exhibit 70: Overall cost of projects sanctioned, RBI

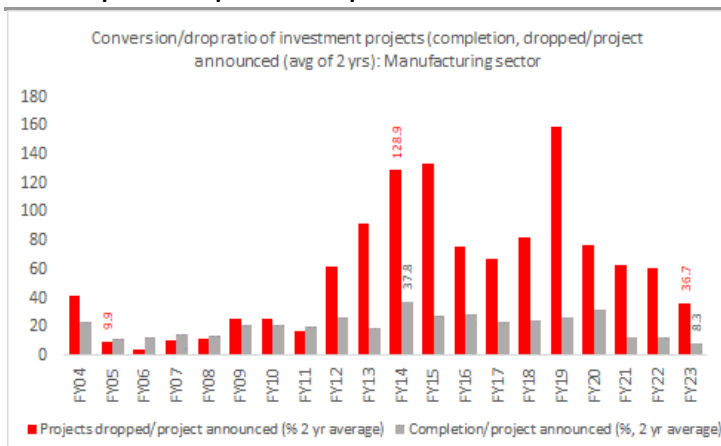
Source: RBI, Systematix Research

Exhibit 71: FDI flows into India averaged at USD 1.8bn/month vs. pre-covid at USD 3.6bn and less than 2014 levels

Source: CMIE, Systematix Research

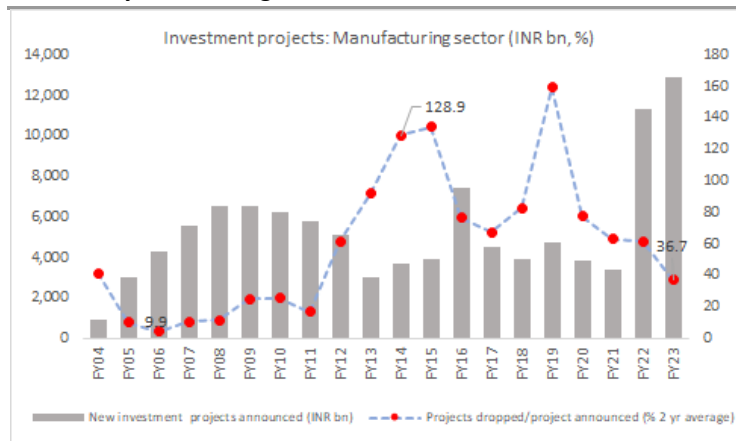
Exhibit 72: Projects announcements expanded 4x from pre-covid, projects completed fell by 30%, 3.5% YoY in FY23, -21% in 2HFY23

Source: CMIE, Systematix Research

Exhibit 73: While the rate of projects dropped has declined from FY14-15 peaks the pace of completion has also declined

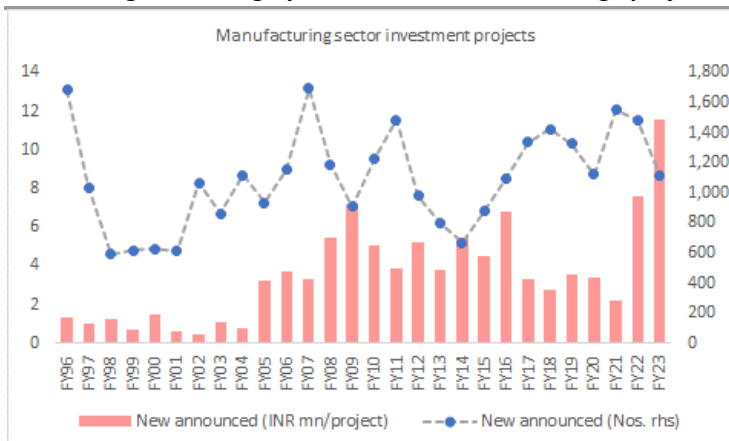
Source: CMIE, Systematix Research

Exhibit 74: Project dropped cycle is counter-cyclical to the business cycle; slower growth translates into withdrawals



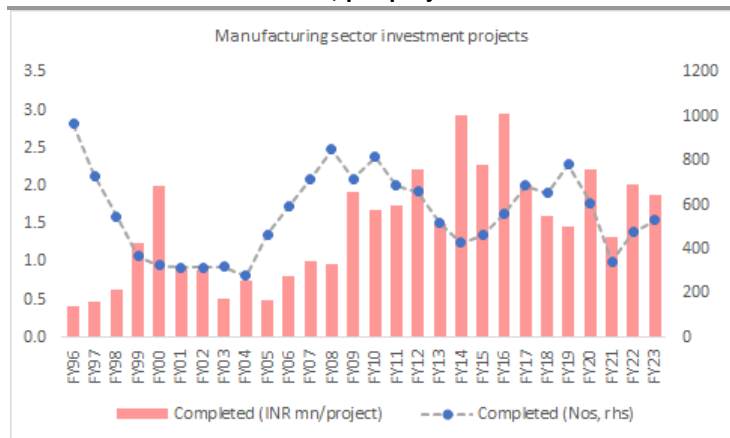
Source: CMIE, Systematix Research

Exhibit 75: Number of projects announced declined 25% in FY23 with average size rising by 52%; dominance of few large projects



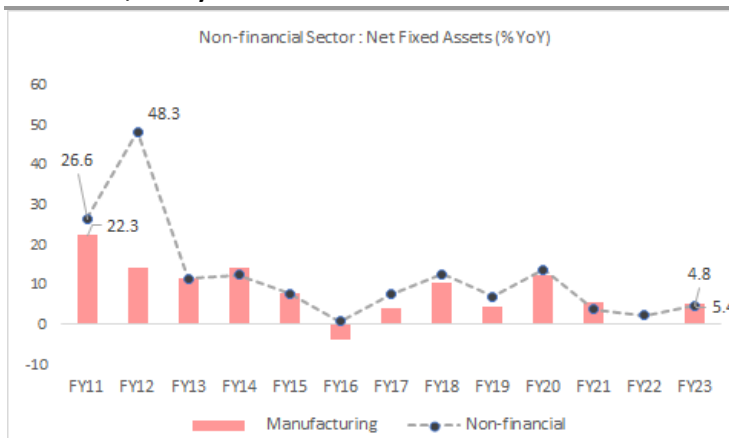
Source: CMIE, Systematix Research

Exhibit 76: Number of projects completed: FY23 11% YoY but 23% < FY17-20 and 32% < FY07-10; per project size declined 7%



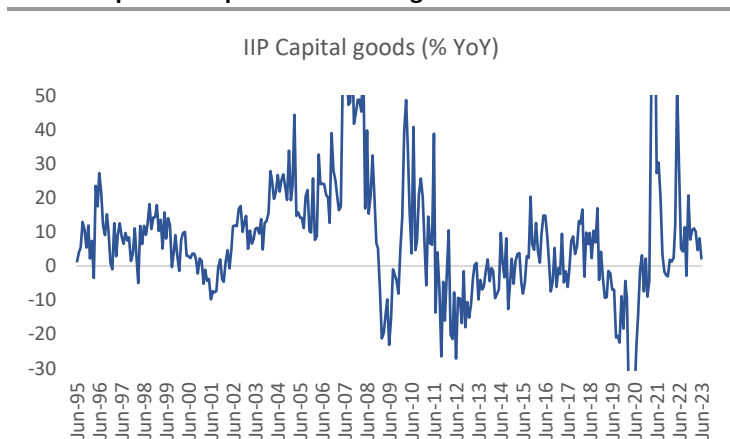
Source: CMIE, Systematix Research

Exhibit 77: Growth in net assets of non-finance companies at sub 5% in FY23, nearly zero in real terms



Source: CMIE, Systematix Research

Exhibit 78: Despite the heavy lifting by govt capex its crowding in effect on private capex seems lacking



Source: RBI, Systematix Research

Exhibit 79: The post covid rebound in the capital goods index has not been strong enough



Source: RBI, Systematix Research

Govt capex doing the heavy lifting but lacks the crowding in effect

Counterbalancing the enfeebled household spending and private capex, the demand side continues to be buffered by large government capex. As per the latest RBI's monetary policy statement, government capex remained strong in 1QFY24 with central capex up 59.1% YoY and state capex up 74.4% YoY. These have had a skewed impact on recent real GDP numbers.

Working with the IIP capital goods index growth of 4.9% in 1QFY24, an average government capex of 65% in nominal terms and 68% in real terms would imply a huge contraction in private capex in real terms of say 20-25%!!

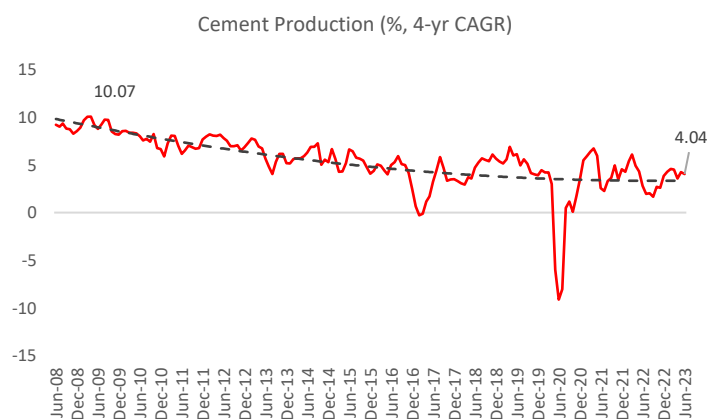
Public sector capex has benefitted certain sectors such as steel (15% YoY in 1QFY24) and cement (12.2%)

Working with the IIP capital goods index growth of 4.9% in 1QFY24, an average government capex of 65% in nominal terms and 68% in real terms would imply a huge contraction in private capex in real terms of say 20-25%!!

The renewed decline in most services sector indicators suggests that the impact of large public sector capex has been limited to certain sectors such as steel (15% YoY in 1QFY24) and cement (12.2%). Nevertheless, on a 4-year CAGR basis, the growth in these sectors has been modest (6.5% and 4% respectively) compared to historical trends.

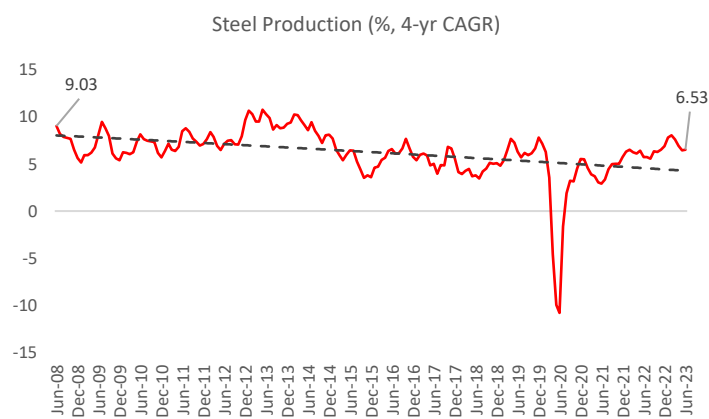
Hence, with sagging private investment and consumption demand remaining imminently weak fiscal multiplier impact has been facile thus far.

Exhibit 80: Cement production rising above a falling trend on the back of government capex



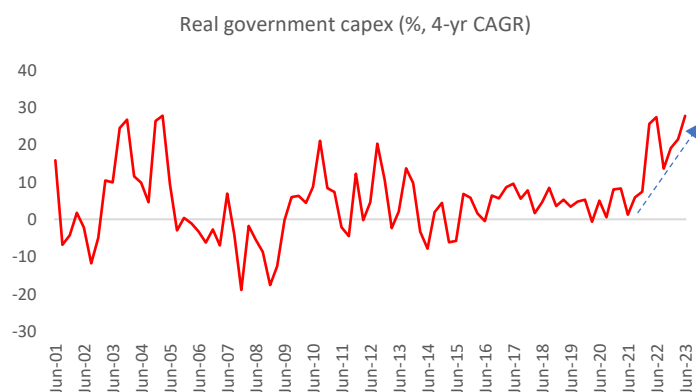
Source: RBI, Systematix Research

Exhibit 81: Steel production rising above a falling trend on the back of government capex



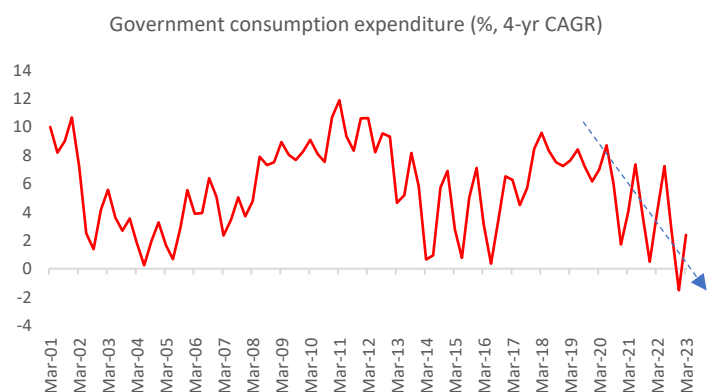
Source: RBI, Systematix Research

Exhibit 82: Surge in central government real capex (26.7% total spending in 1QFY24)

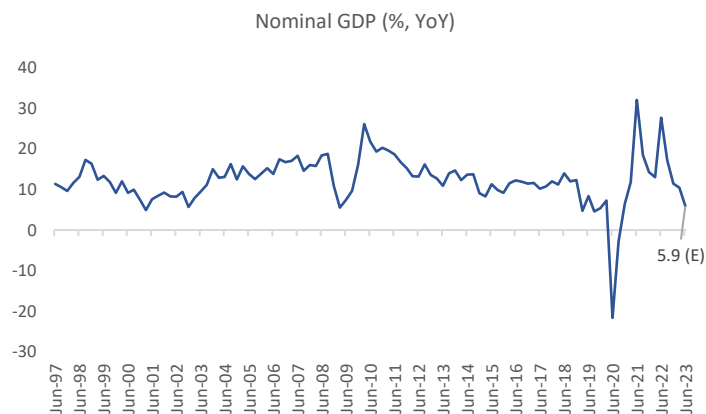


Source: RBI, Systematix Research

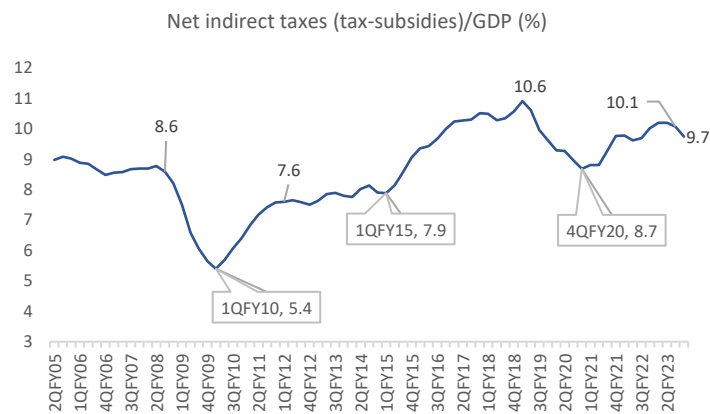
Exhibit 83: Real revenue expenditure of central government remains modest (73.3% of total spending in 1QFY24)



Source: RBI, Systematix Research

Exhibit 84: Decline in nominal GDP growth could impact organic growth in tax collection


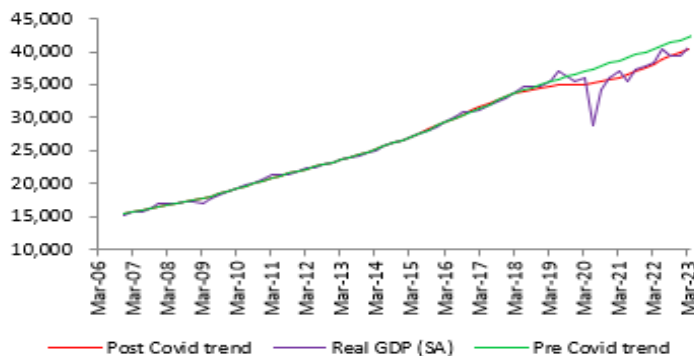
Source: RBI, Systematix Research

Exhibit 85: Rising indirect tax incidence impinging on household consumption, even as govt consumption remains modest


Source: RBI, Systematix Research

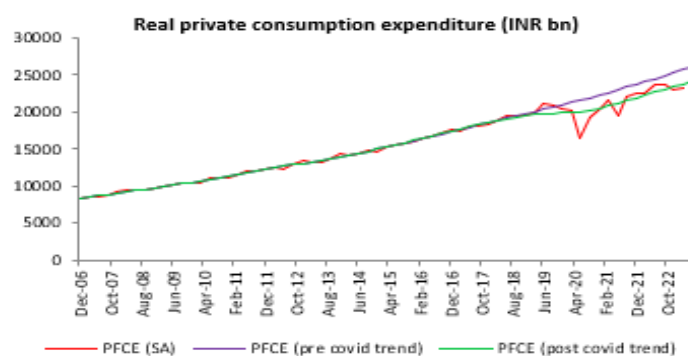
Additional exhibits

Exhibit 86: Real GDP 6.1% YoY, 2QFY23 is still 4% below the pre-covid trend at 4.5% (INR bn)



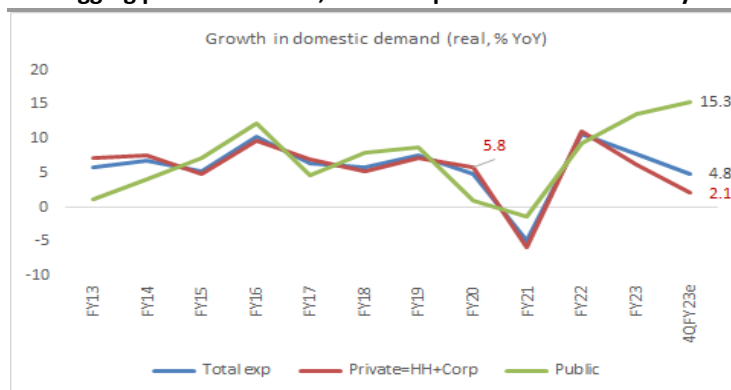
Source: CMIE, Systematix Research

Exhibit 87: Private consumption: post-Covid trend 10% lower than pre-covid, 4Q actual 2% lower than the new trend



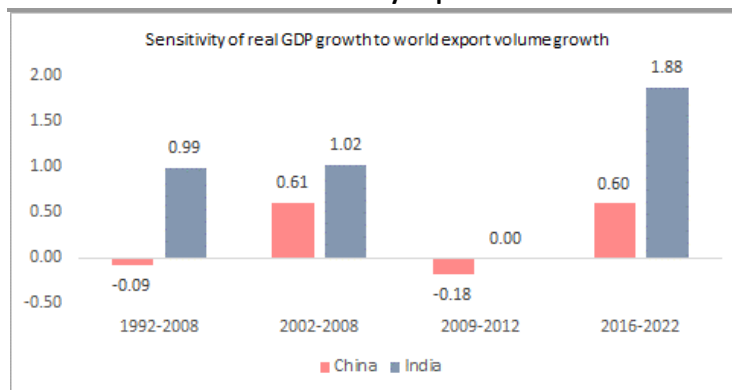
Source: CMIE, Systematix Research

Exhibit 88: Sustained capex by Govt has not been able to resurrect the sagging private demand; the multiplier effect not visible yet



Source: CMIE, Systematix Research; Private= consumption and investment demand of households (HH) and corporate; Public=govt+PSE

Exhibit 89: Delays in recession in AEs is a silver line, but gaining evidence of slowdown can critically impact India's outlook



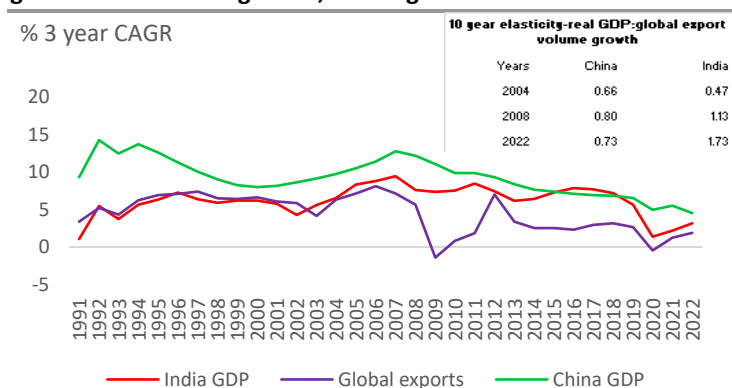
Source: CMIE, Systematix Research

Exhibit 90: Global trade volume is slowing due to weakening



Source: WTO, Systematix Research

Exhibit 91: Both India and China have been highly sensitive to global trade volume growth, now higher for India



Source: WTO, Systematix Research

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