



## FIRING ON ALL CYLINDERS

### India Strategy

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# Global Economic Cycle Entering Strongest Phase

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- **An economy enters the strongest phase** of growth when stocks, bonds and commodities rally. We believe that India is at the cusp of entering this phase.
- Emerging Markets (EM) outperform when capital chases growth rather than safety. Uncertainty triggers capital flight to safety while stable growth brings capital to EMs.
- **Three distinct cylinders power Indian economy**
  - International trade (Exports)
  - Consumption
  - Investments in fixed assets
- **Two of these three cylinder are now firing**
  - Consumption and Exports are boosting economic growth. Particularly, consumption has displayed sharp recovery after the cash crunch in early 2017
  - Investments are seeing only a government supported recovery which is inadequate but effective for a few sectors like railways, roads and power T&D.

## Low Inflation, Earnings Are Key

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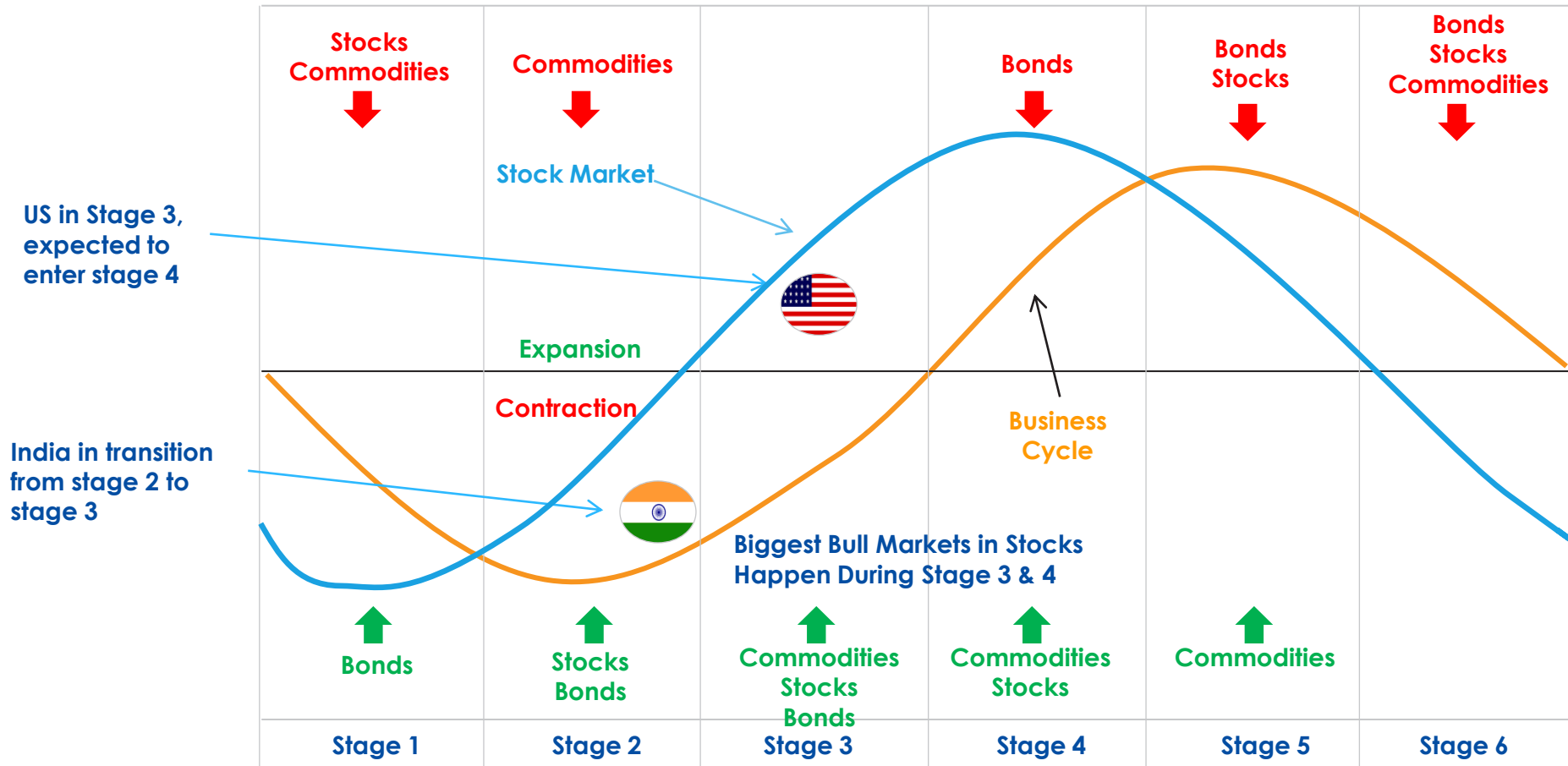
- **Currently stocks markets are driven by**

- Low Inflation- Periods of low inflation are rewarded by high returns
- Profitability
- Increase in Financial Savings

- **Market Valuations appears expensive but only optically**

- Companies which are witnessing earnings growth are the ones which are appreciating in price
- Price to Earnings multiples of Indian stocks have expanded to 18x. The next leg of uptick is expected to be driven by revival in earnings.
- Nifty is likely to touch 11,500 in CY18 based on blended EPS growth of 15-20% over the next one year. Nifty EPS FY17/18 – 535/645.

# Global Economic Cycle Entering Strongest Phase As Demand Picks Up



- Economic cycle can be classified into 6 stages. Stock market leads the economic cycle.
- Stocks, Bonds and commodities all rally in the strongest phase of growth.

**We believe that India is at the cusp of entering this phase and full blown bull market is yet to play out.**

# Commodity Prices Could Be The Next Demand Surge Indicator



- Commodity prices, especially metal prices have displayed emergence of bull markets. Since metal prices are a good proxy for demand, we believe this indicates a surge in growth prospects.

**Commodity prices are at an extreme. Since pendulum always swings back to the mean, we believe its time. This could happen only if demand led growth sustains.**

# What Happens When World Chases Growth? **EMs Outperform**

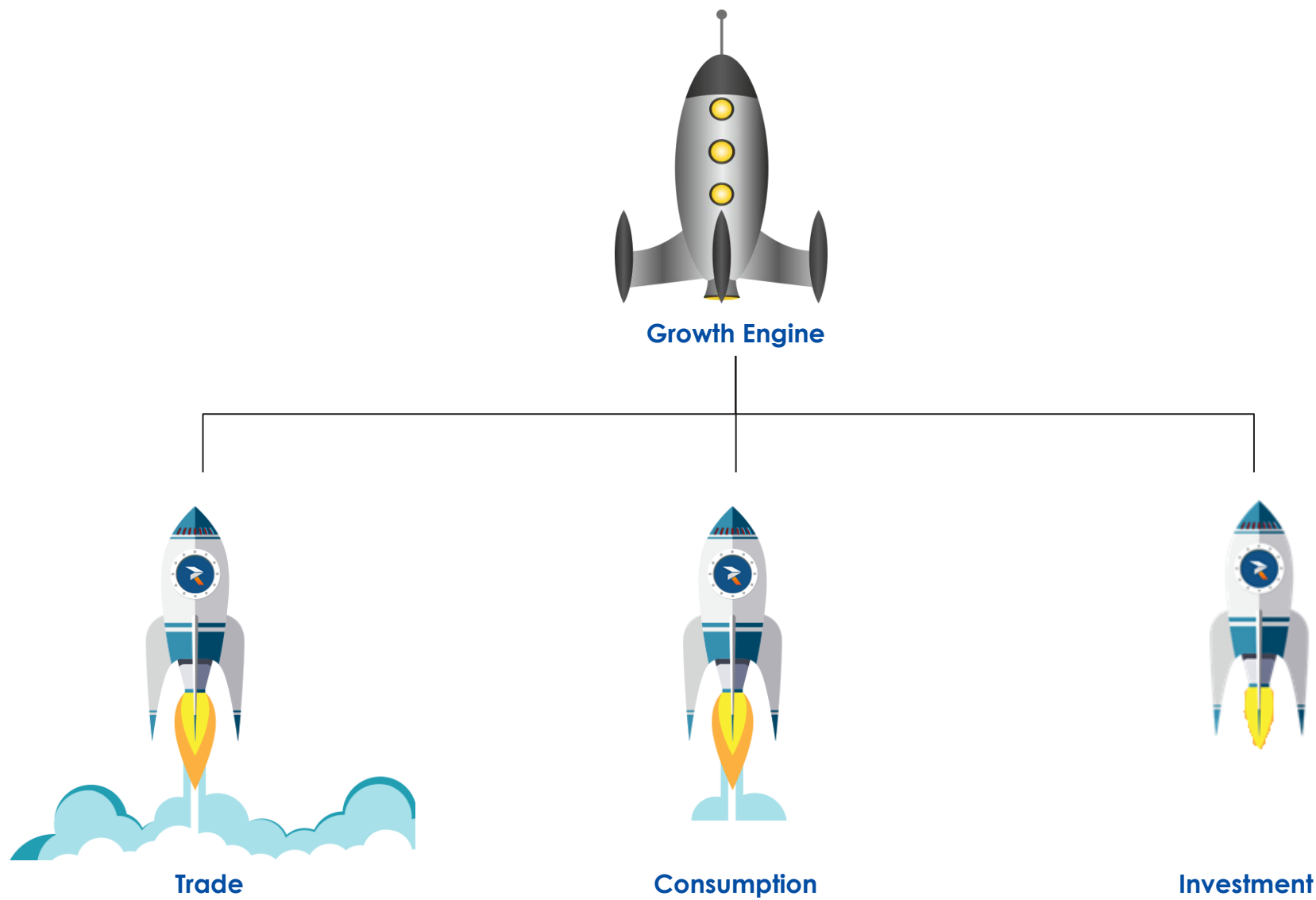


## Exports – Boost From Global Tailwind

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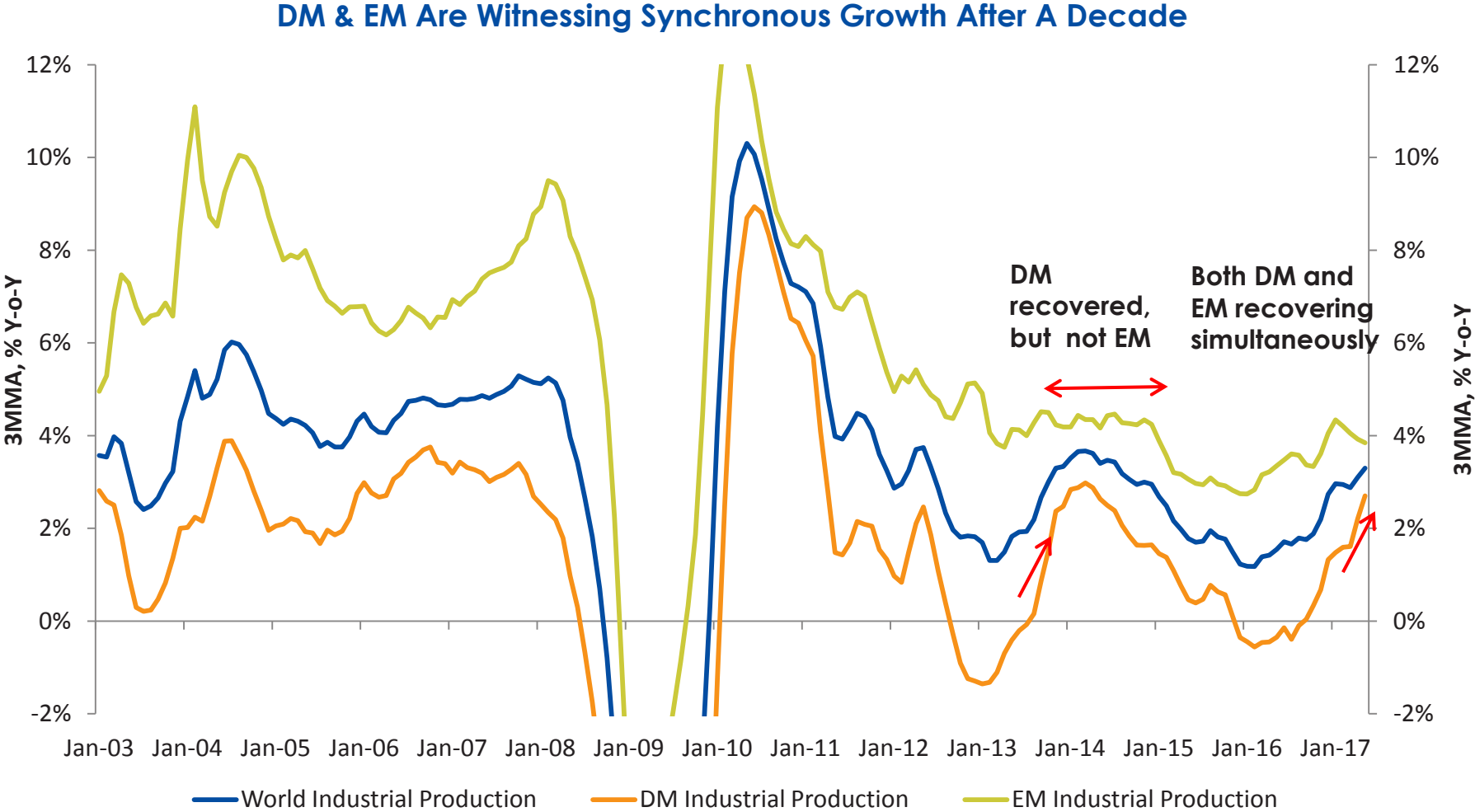
# India Macro Landscape – Key Drivers Getting Aligned.....

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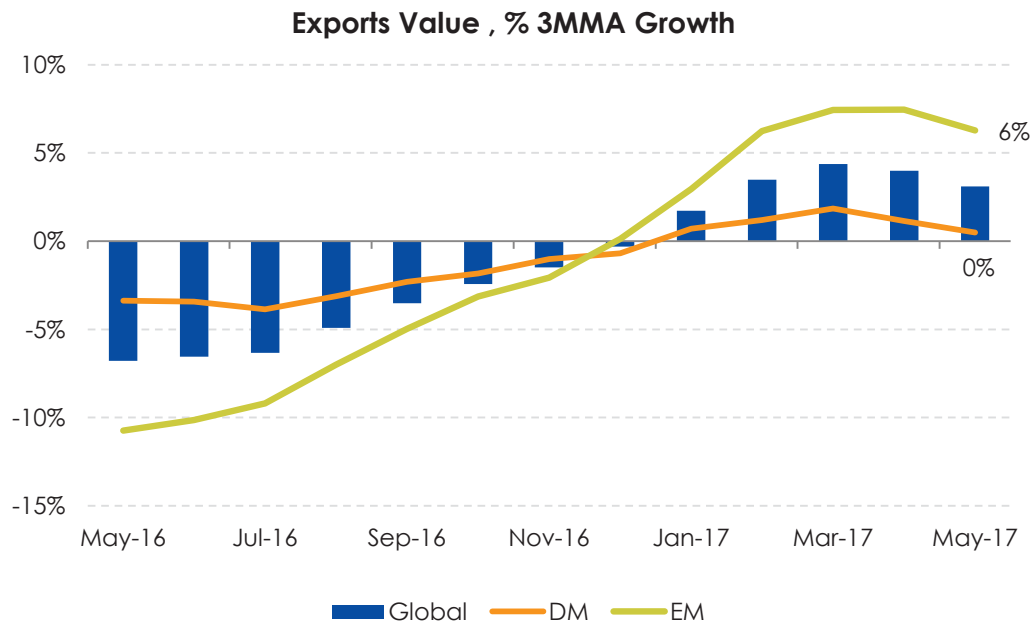
# Synchronous Global Growth To Boost Global Trade, Indian Exports



Source: CPB Netherlands, Edelweiss Investment Research, Edelweiss Research

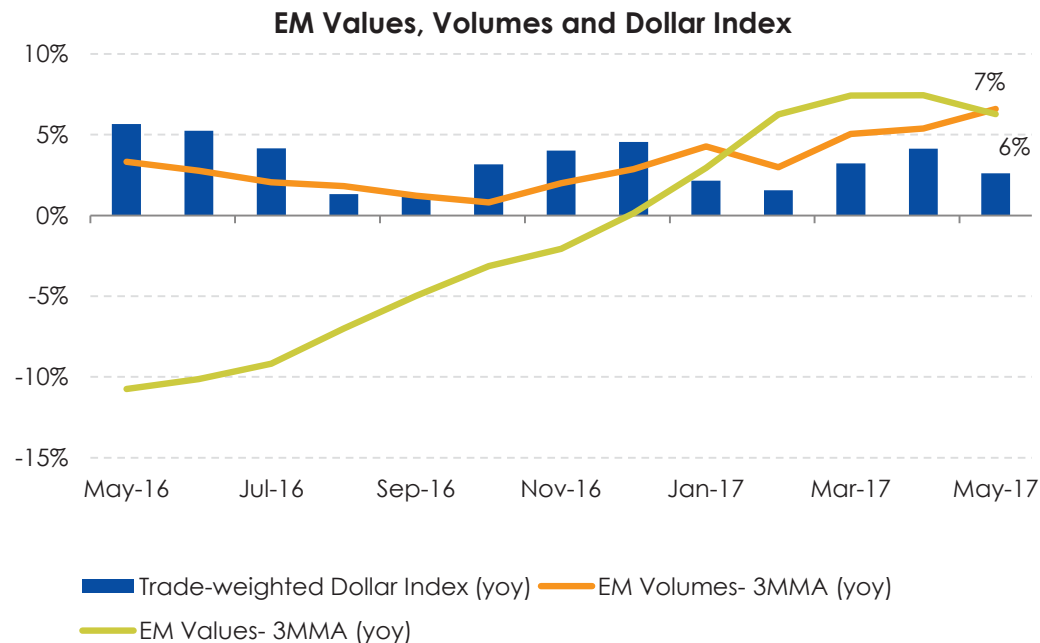
# Global Growth Leading to Trade Revival

## EM Exports Have Outpaced Advanced Economies



Source:: CPB Netherlands, Edelweiss Investment Research

## EM Volume Growth Outpacing \$ Value Growth



Source:: CPB Netherlands, St. Louis Fed, Edelweiss Investment Research

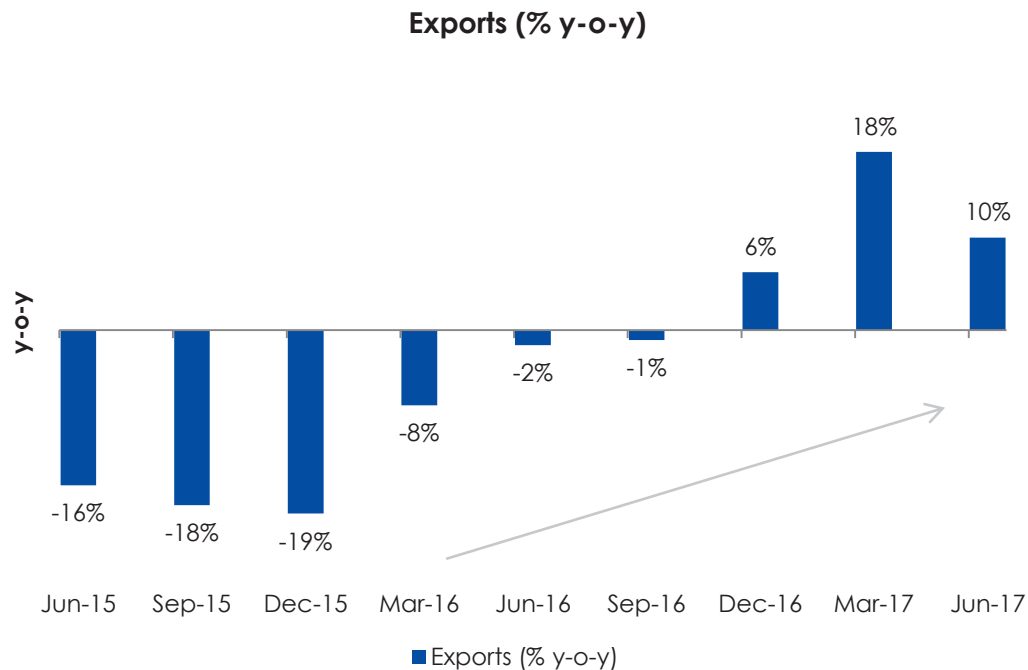
- Exports have picked up globally. Emerging markets exports growth (in \$ value terms) have outpaced that of developed markets.
- Last 2 months have witnessed slowdown in EM exports growth. Closer look reveal that EM exports in volumes continue to grow despite tapering in values.

**Volume Growth in exports indicate fluctuations in prices continue to influence exports value more than any worthwhile slowdown in demand**



# Indian Exports Growing Despite A Strong Rupee...

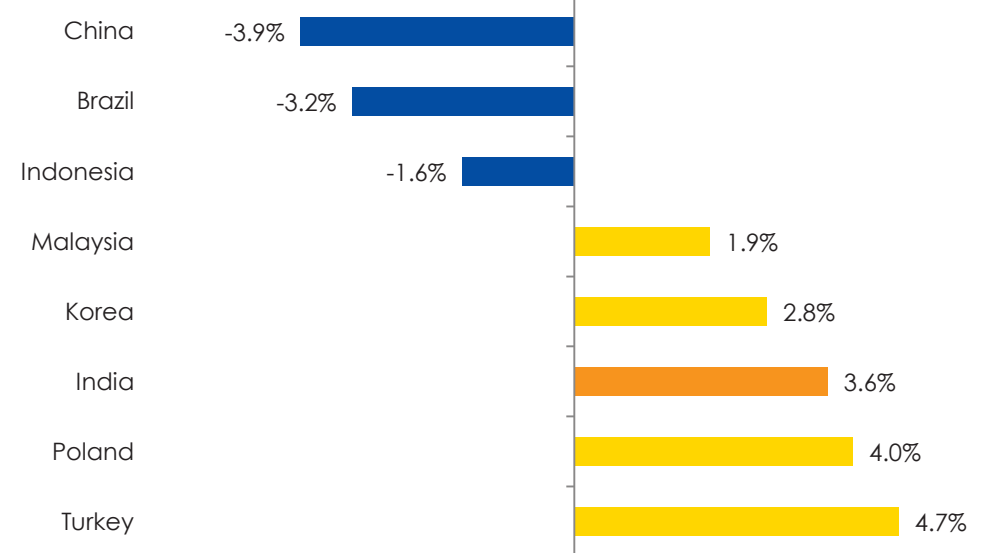
## Indian Exports Have Been Growing Barring Base Effects



Source:: CPB Netherlands, Edelweiss Investment Research

## Strong Rupee has been the major deterrent

### Indian Rupee Has Appreciated The Most on REER Basis (Since Jan'17)



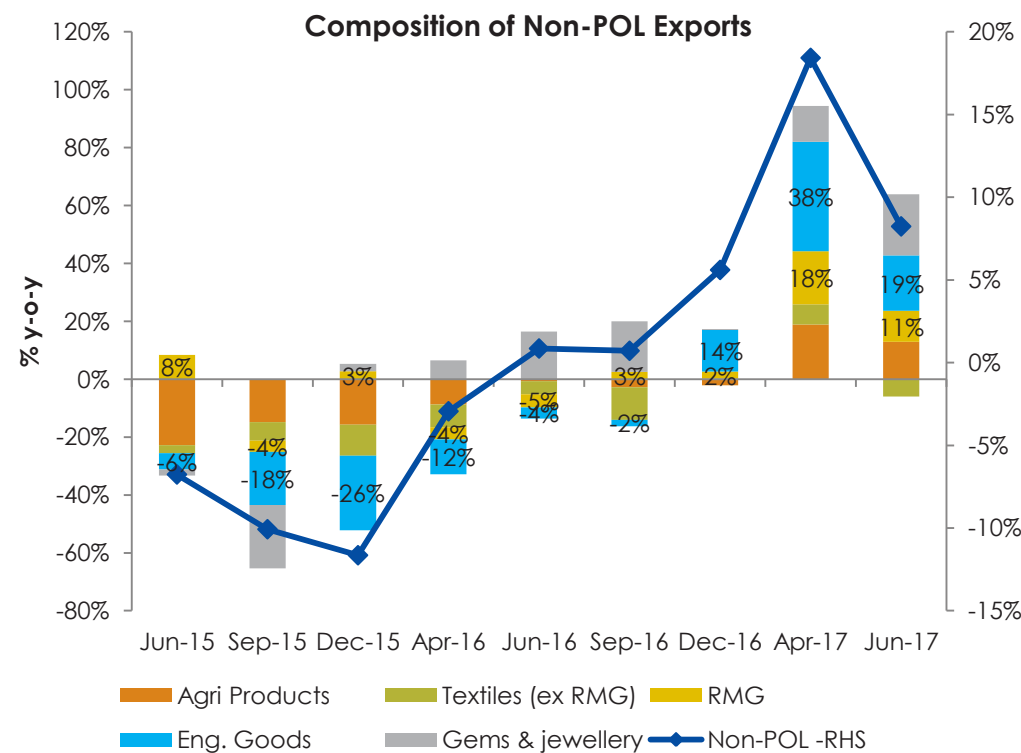
Source:: BIS, Edelweiss Investment Research

- India's exports continued to grow for ninth consecutive month. Though the growth has been slower in past 2 months
- This can be attributed partly to GST transition and partly due to INR appreciation.
- INR continues to appreciate due to strong fundamentals and sky high real interest rates

**Exports growth has held up despite facing pressure from strong rupee. We expect exports to continue to remain healthy with global industrial activity reviving.**

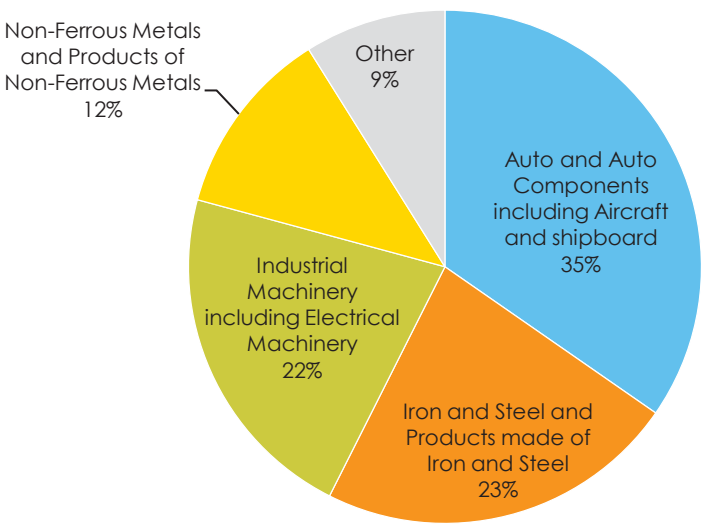
# Largest Component of Exports Growing Strongly

Non POL Exports Growth Driven By Engineering Goods



Source:: CMIE, Edelweiss Investment Research

Composition of Engineering Goods



Source:: EEPC

- Non Petroleum Oil and Lubricants (POL) have seen robust growth. Of which, Engineering goods have led the Non-POL exports growth.

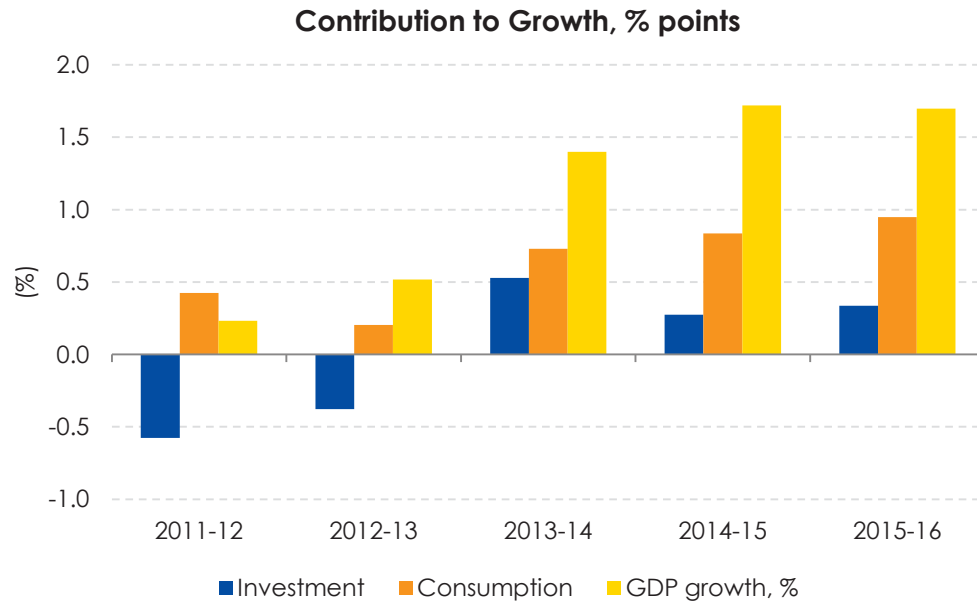
**Global growth , Anti-dumping on Chinese steel products and extensive support from government have aided Non-POL exports.**

## Consumption – The Core Growth Driver

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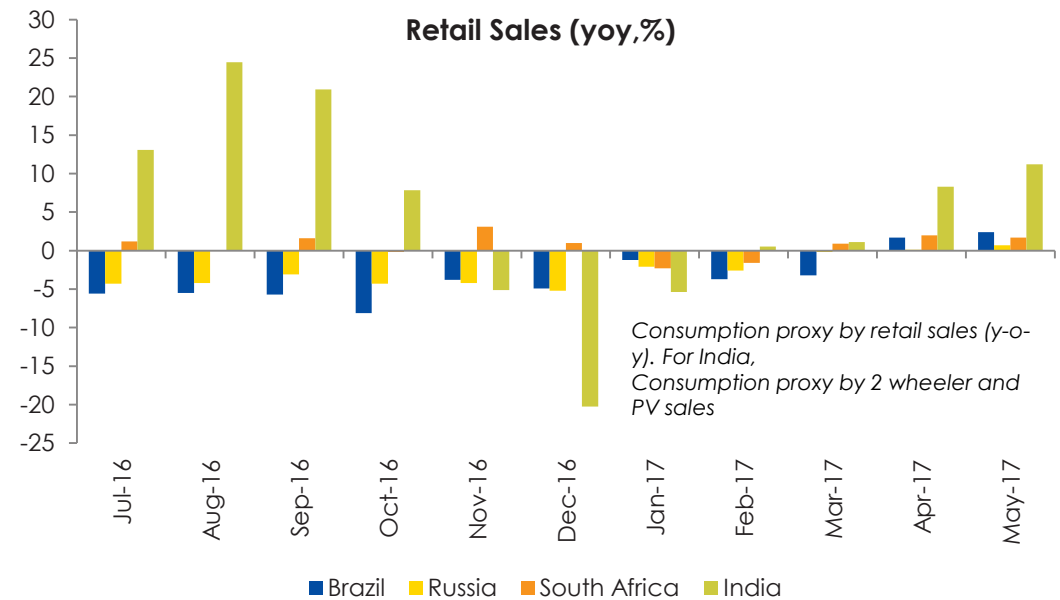
# Consumption is Core To Global Growth

## DM : Consumption was key to Expansion



Source: Consumption led Expansion by Kharroubi and Kohlschen (2017), BIS

## EM : Witnessing Revival in Consumption



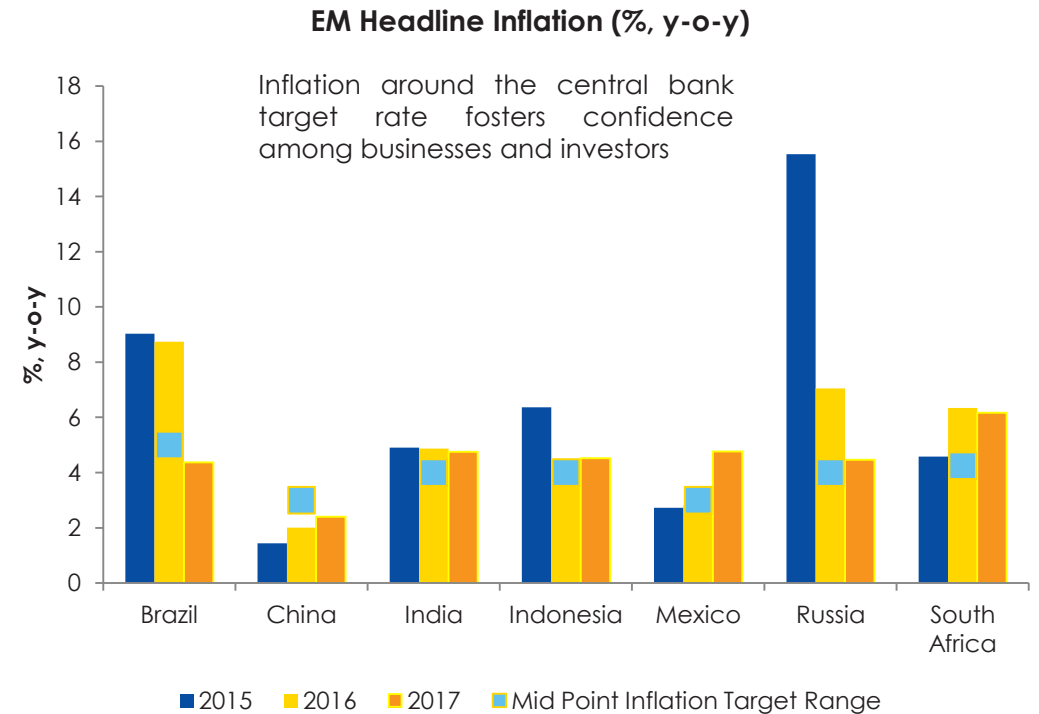
- There has been broad based recovery in consumption across both EM and DM
- Commodity driven economies like Brazil and Russia which had consumption plunging have also seen growth in consumption expenditure.

**Consumption which had slowed post demonetization is slowly picking up in India as reflected in 2 wheeler and passenger vehicle sales**

# Consumption : Wage Growth Key For DM While Ems Driven By Low Inflation!



Source: ILO, Edelweiss Investment Research



Source: IMF, Edelweiss Investment Research

- Because people spend less of food & energy as a percentage of their income, wage growth increases consumption in Developed Economies.

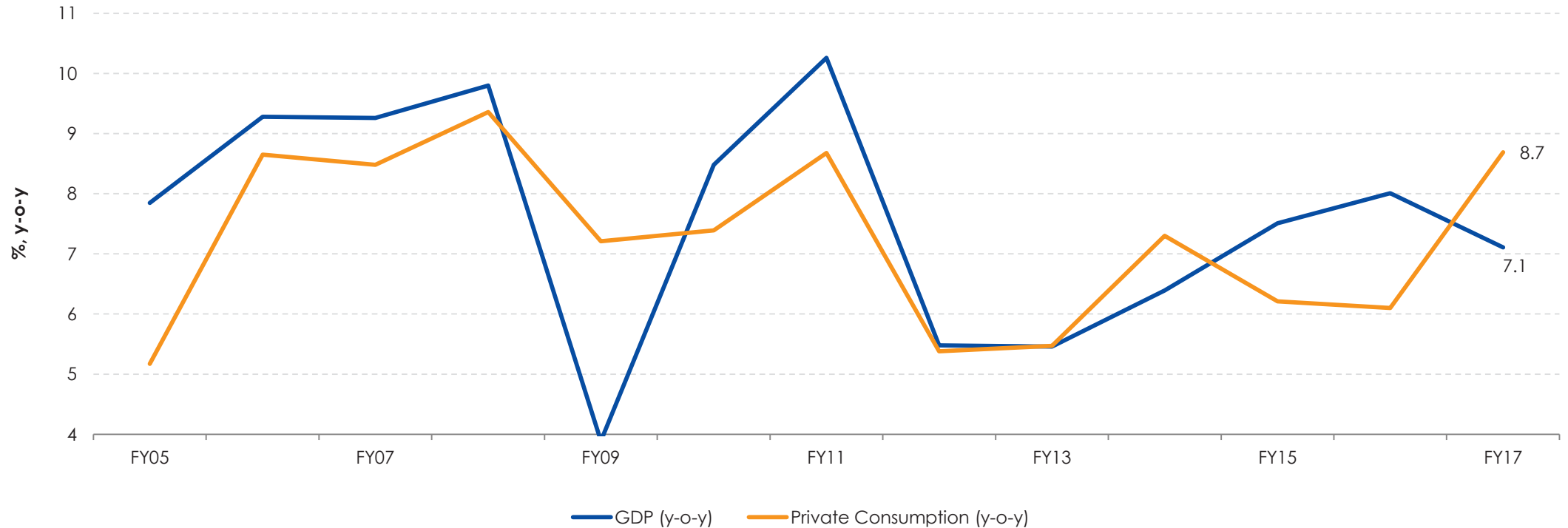
**In Emerging Markets lower inflation enables savings from lower food & energy. These savings flow through to discretionary consumption. Ergo lower inflation means additional consumption and stronger economic growth in EMs**



# Accelerating Consumption Would Fire up Investments

## Consumption Growth outpaced GDP Growth in FY17

### Real Consumption Expenditure and Real GDP Growth



Source: MOSPI, Edelweiss Investment Research

- Investment to GDP ratio has hit a decade low of 29% for India in FY17.
- Consumption expenditure has been growing at faster pace. This is a classic consumption leads investments recovery.

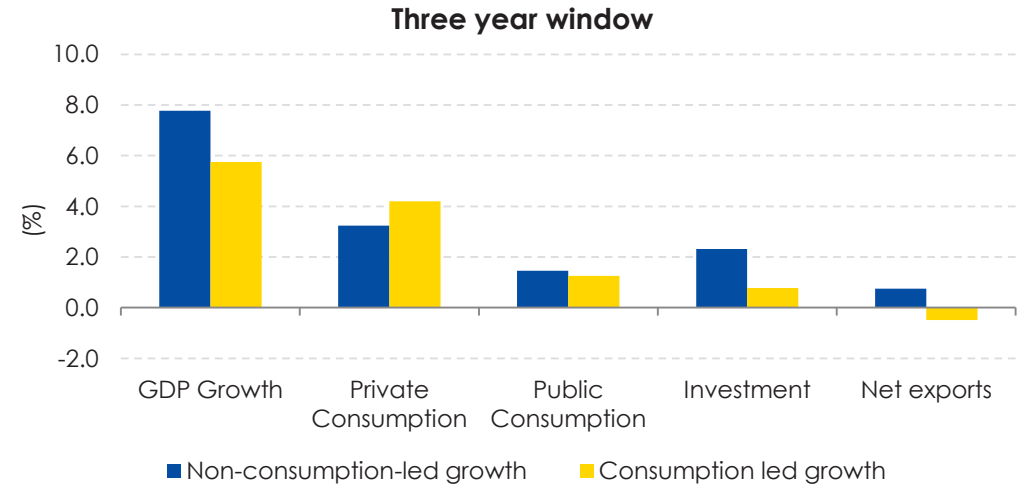
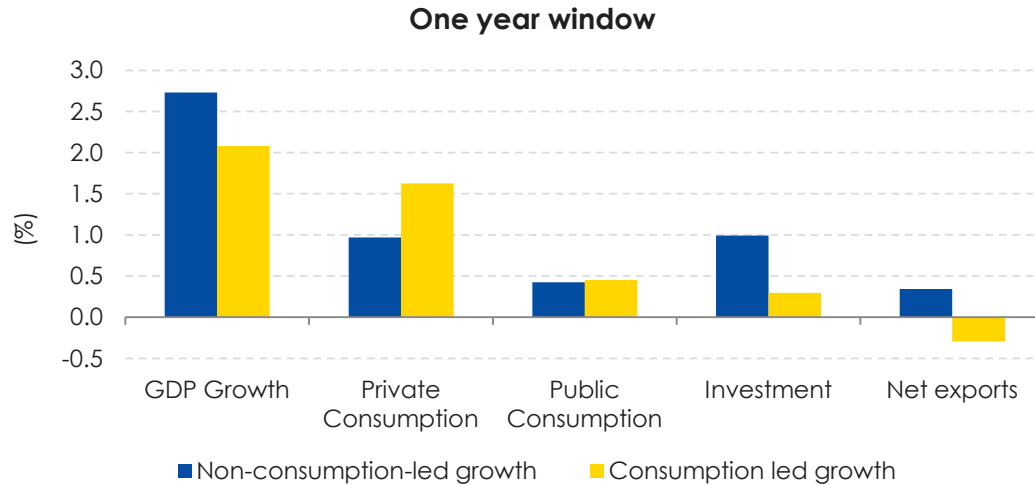
**Consumption growth continues to be the backbone of India's growth narrative**

## Investment – The Growth Accelerator

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# Investment Revival Follows Consumption Uptick

Composition of GDP growth under consumption and non-consumption-led growth for Developed Economies, 1991-2016



Source: Consumption led Expansion by Kharroubi and Kohlschen (2017), BIS

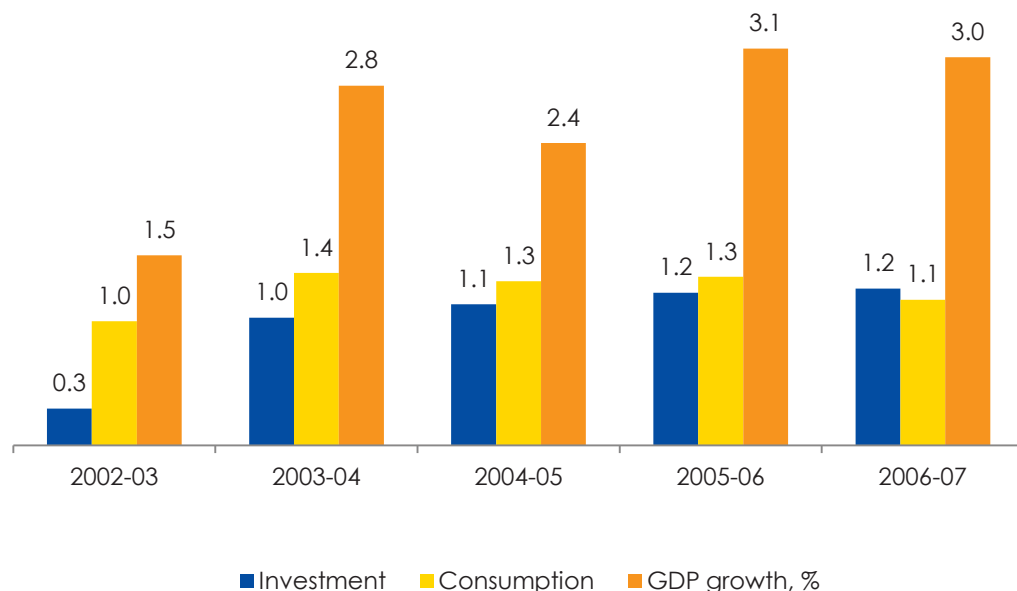
- Kharroubi and Kohlschen(2017), BIS in their research have proven that consumption led growth is systemically weaker than Investment led growth for advanced economies.
- GDP as well as components of GDP, both display higher growth when driven by investment as against consumption.
- The growth gap between both the approaches widen over a three year period. Therefore a revival in investments over the next few quarters is essential.

**Can consumption led growth lay foundation for investment led growth?**

# Investments Pick Up Once Consumption Exhausts Capacities

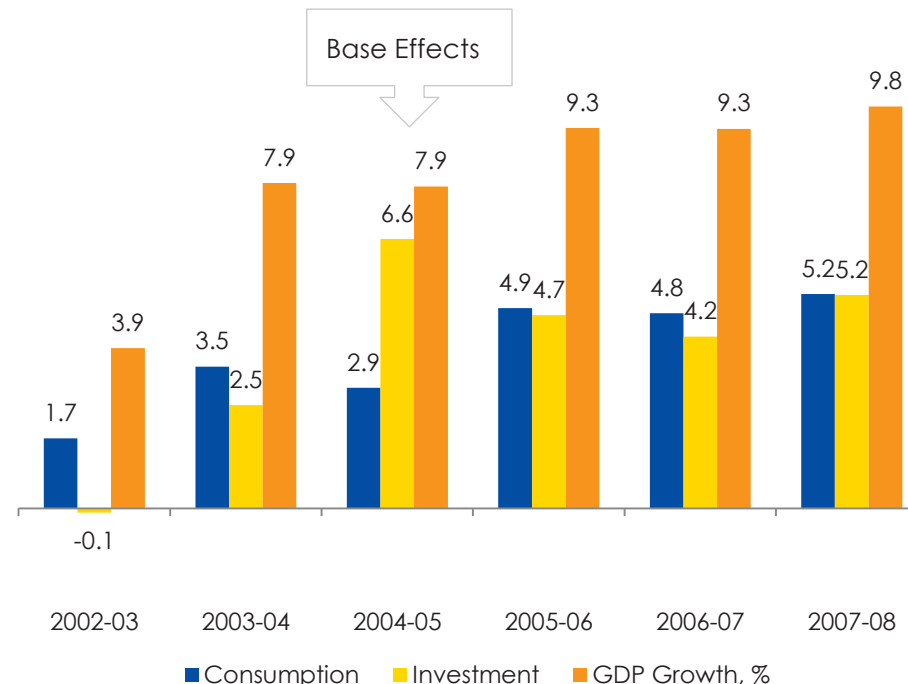
## Consumption pickup is followed by Investment rise as seen from 2003-07

Contribution to GDP Growth in Developed Economies , %



Source: Consumption led Expansion by Kharroubi and Kohlschen (2017), BIS

## Composition of India's growth during the same period



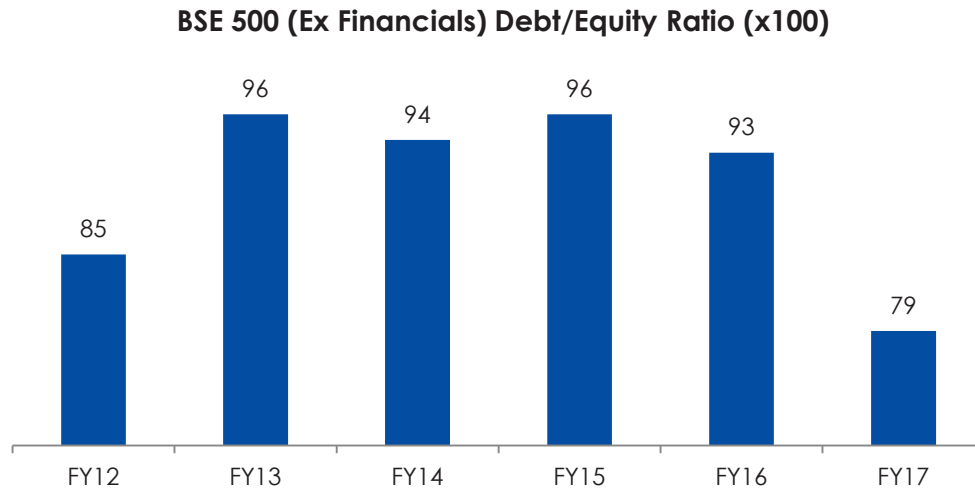
Source: CMIE, Edelweiss Investment Research

- Investment to GDP ratio has hit a decade low of 29% for India in FY17.
- Pick up in consumption is generally followed by rise in investment as displayed in advanced economies in 2003-08 and also in India.

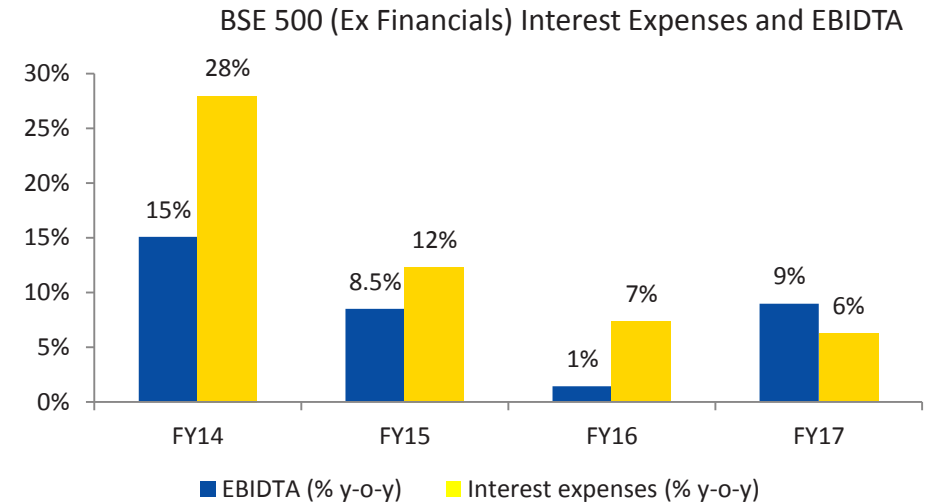
**We believe that India's strong consumption story will drive in investment as witnessed from 2003-08 and earlier episodes**

# India Investment Cycle : BS Strength Beginning To Come Back

## Debt/Equity of BSE 500 (ex Financials) lowest in last 5 years



## Operating Leverage and Borrowing Cost reflecting in higher EBIDTA

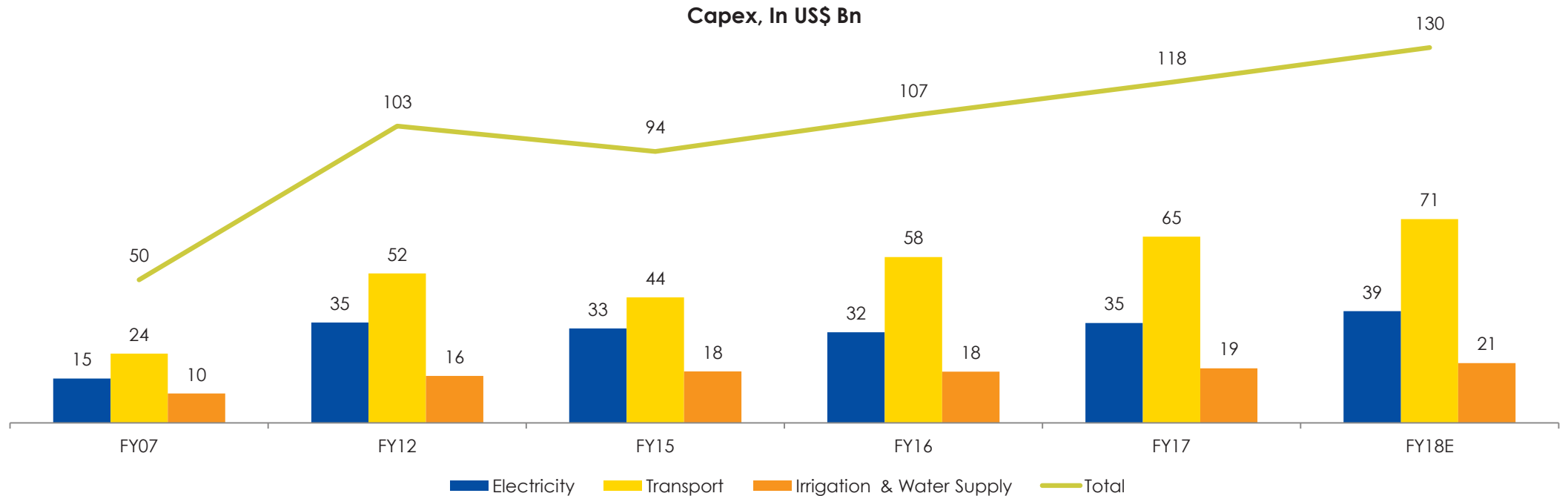


- Corporate leverage is one of the biggest hurdles to capex cycle.
- Access to capital markets for funds have helped corporate deleveraging. Easing Monetary cycle has also helped in reducing Debt to Equity ratio and improvement in profitability.
- Deleveraging takes place in two stages- In the first stage, the “flow” of borrowing falls, GDP growth is weak, and the debt-to-GDP ratio actually rises . This continues until new borrowing has fallen enough. In the second stage, new borrowing stops falling, GDP growth rises, and the debt-to-GDP ratio starts to fall

**We believe that we are at the end of the first stage of deleveraging. Private investments will pick up as profitability rises and capacity utilization improves.**

# Public Capex to lead the Recovery In Investment Cycle

Public Capex beginning to gain traction after slowing down between FY12-15



Source:: Budget Documents, Edelweiss Investment Research

- Public Capex which had stagnated between 2012-15 has been picking up. Higher Spending in roads and railway sector driving public capex.
- Spending on roads and railways is at 3x of 2015 levels. Construction equipment sector is also started to grow again indicating revival.

**Higher public capex on infrastructure, efficient execution and reduction in interest costs to crowd in private investments .**

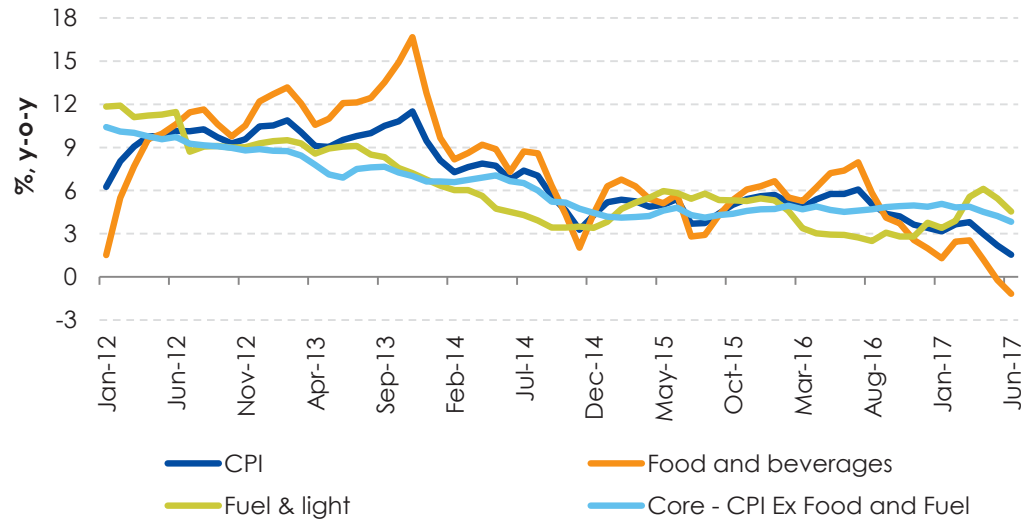
**Markets – Forward, Higher, Stronger .....**

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# Supply Side Anchored Inflation To Keep Rates, Policy Response Stable

## Supply Side Reforms Are Key For Breaking Inflationary Spiral

CPI , Core CPI & Major Heads (YoY, % Chg)

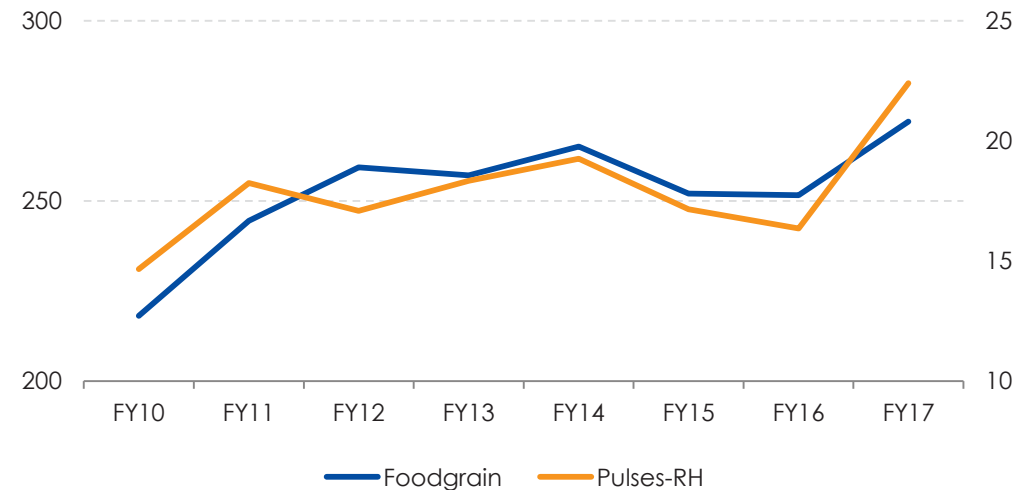


- Inflation has plunged to an all time low to 1.54% (y-o-y) in June.
- Core inflation which is usually sticky, also lowered to 3.5%.

- Disinflation in food dynamics has been the major contributor to lower inflation.
- Supply-side de- bottlenecking, softening commodity prices, lower inflationary expectations have further pulled inflation down.

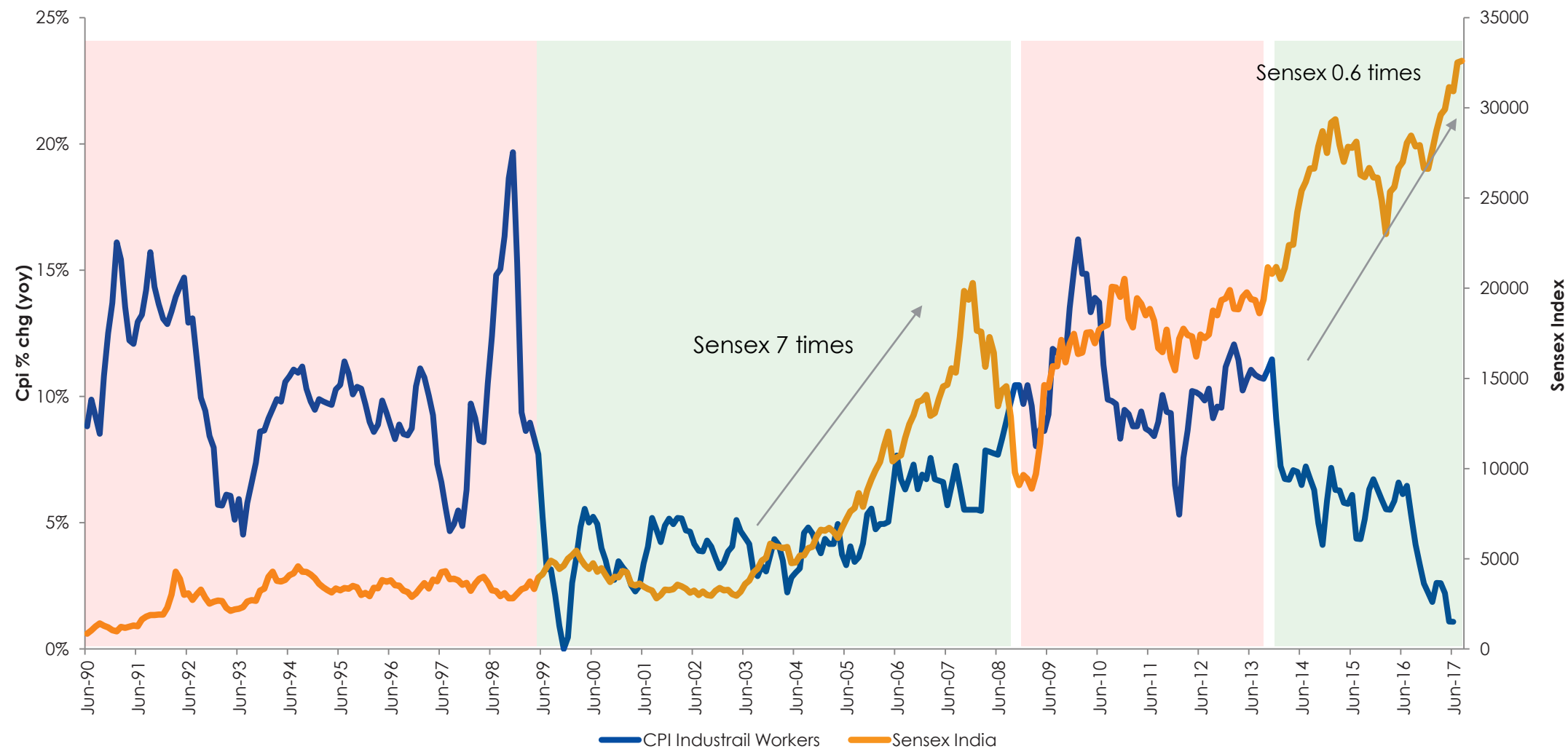
## Food Production Continues To Rise

Production (Million Tonnes)





# Markets to Head Higher As Long Disinflationary Phase Commences

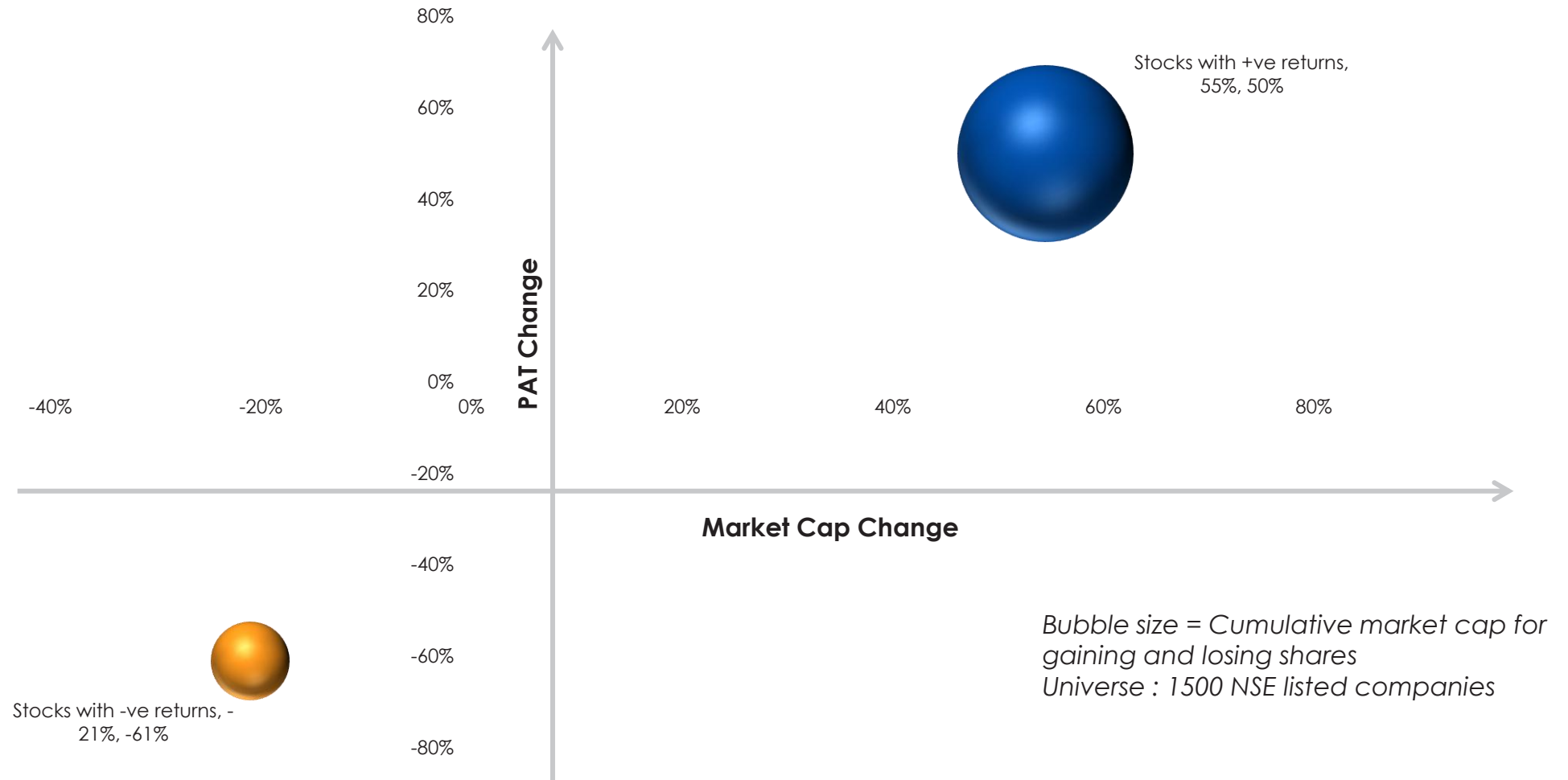


Lower inflation is rewarded by markets. Big Sensex Uptrends coincide with periods of stable inflation.

## Earnings and Valuations

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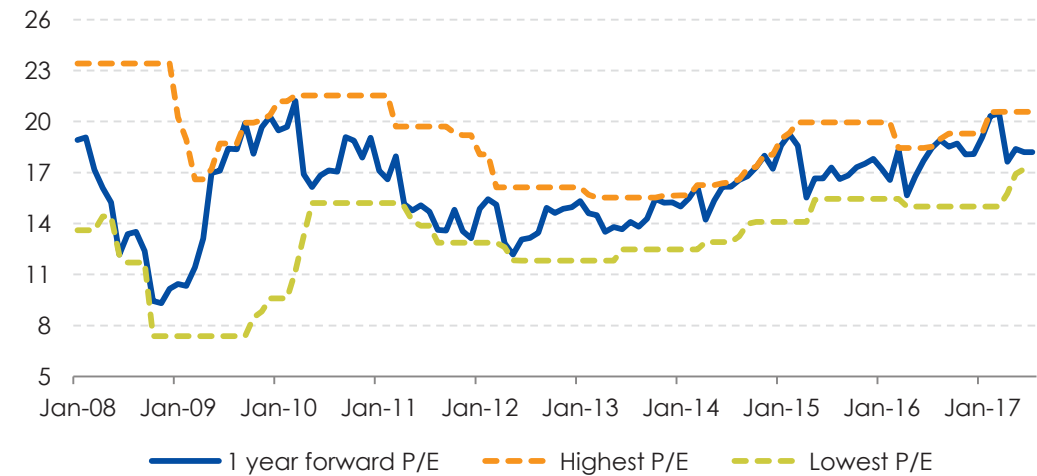
# Only Profitability Being Rewarded In This Bull Run



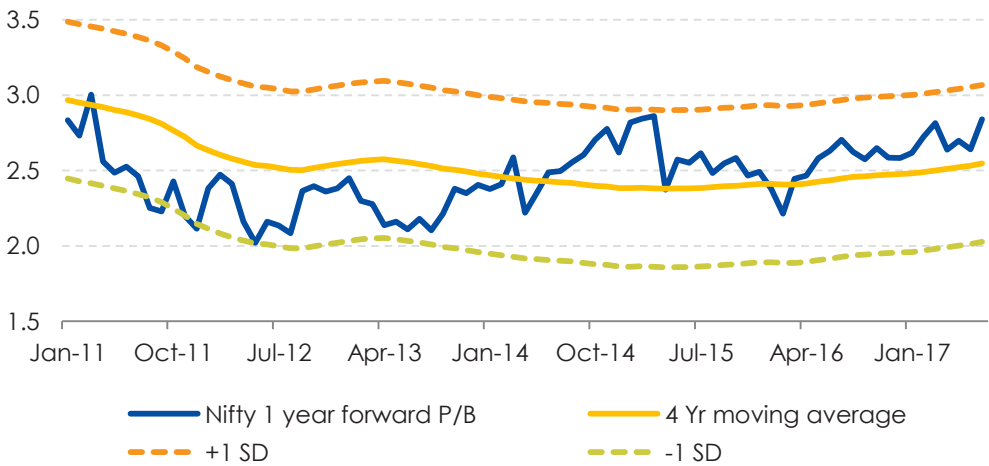
**Contrary to the popular belief that all stocks have been rallying, only companies which have displayed higher profitability have seen higher market capitalization gains**

# Nifty Valuations Rich, But Not So Much Against Peers

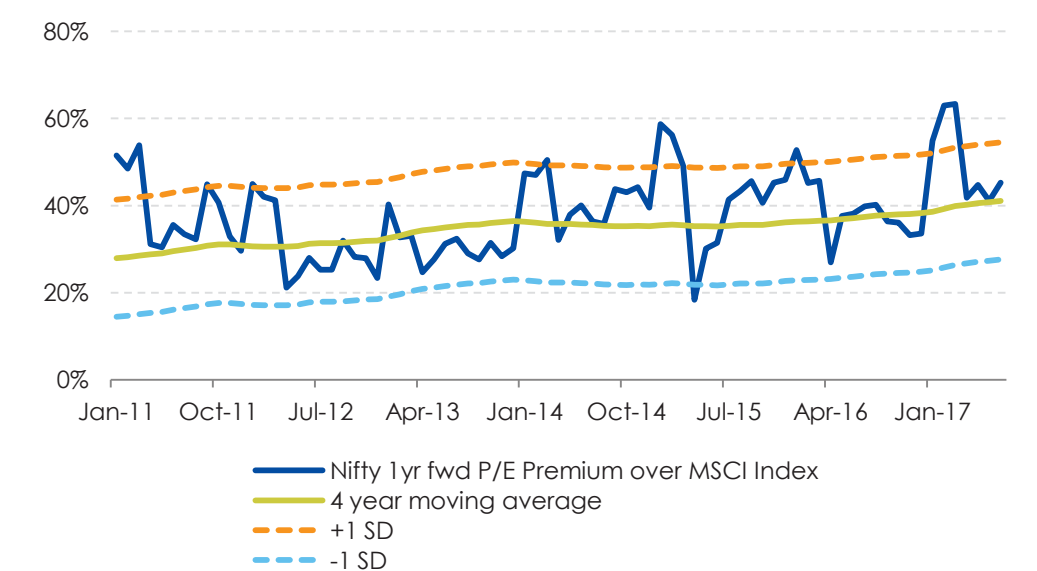
Nifty 1yr Fwd PE at 18, A Premium of ~10% over 5yr Avg



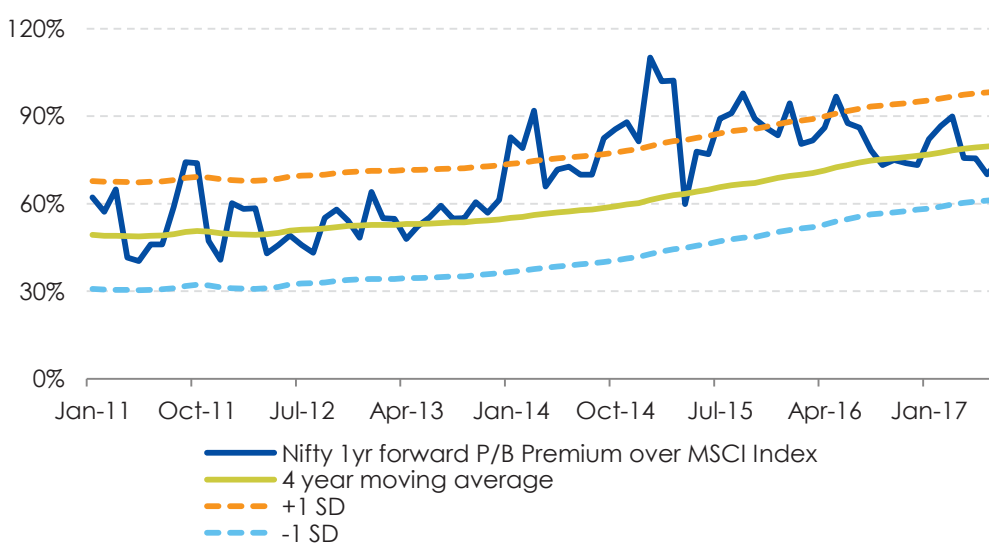
Nifty 1yr Fwd PB Nearing This Decade High



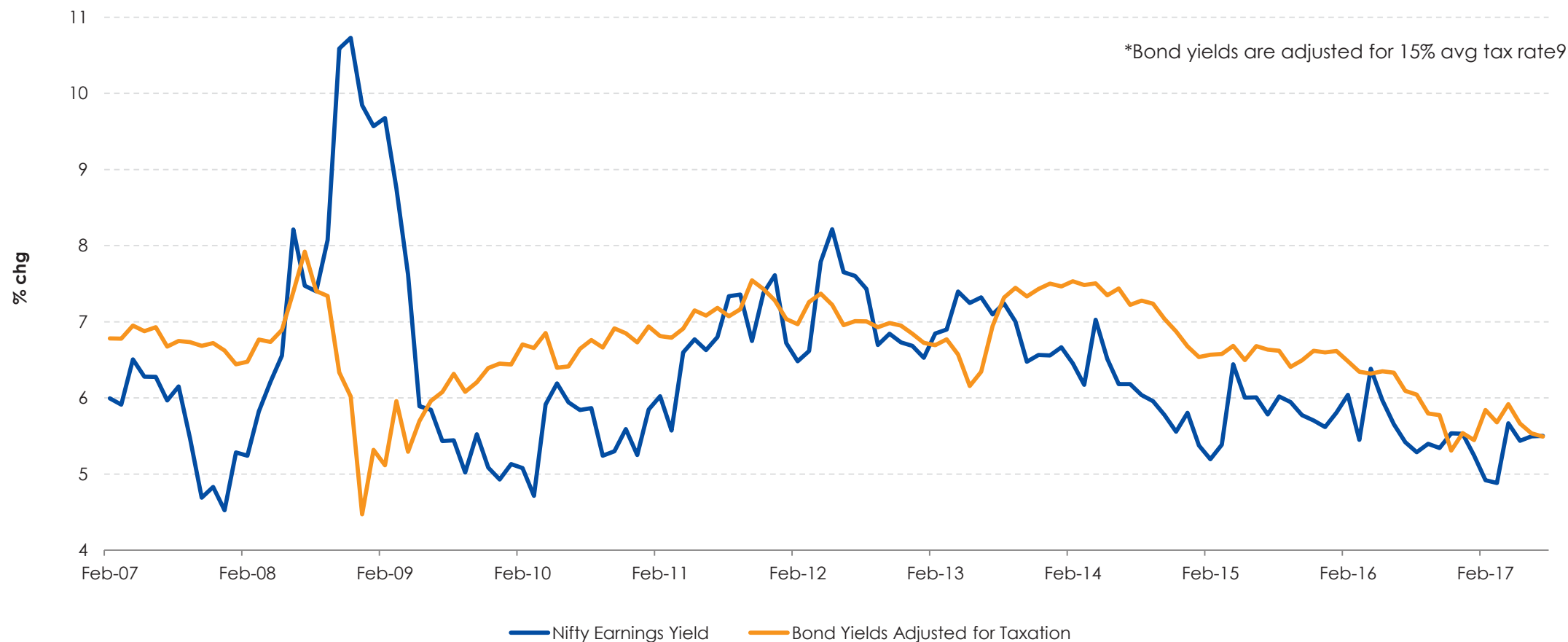
Nifty 1yr Fwd PE Premium Over MSCI Index Near Average



Nifty 1yr Fwd PB Premium Over MSCI Index is Below Average

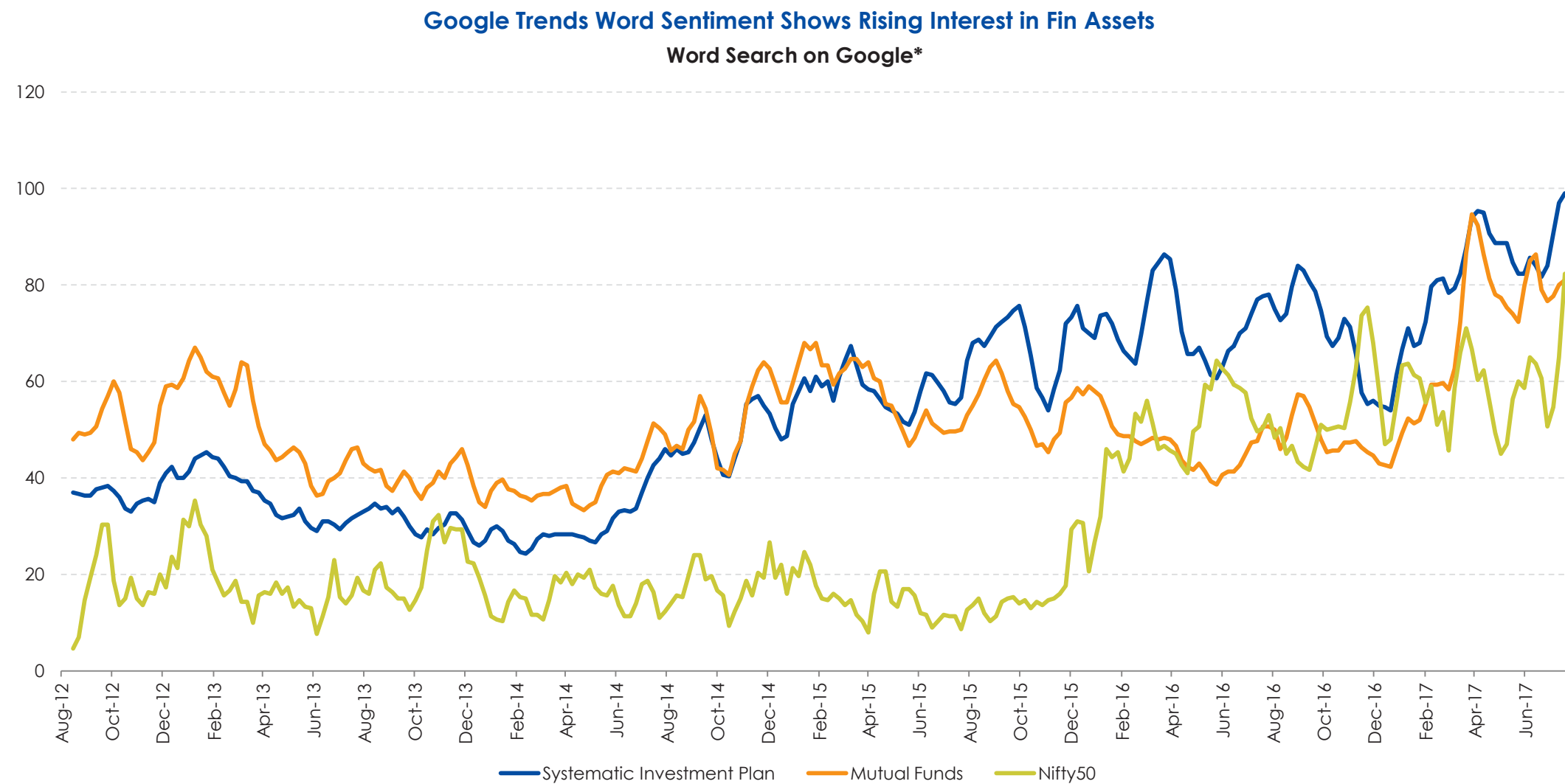


# Equity Earnings Yield Is Still Attractive Relative To Bonds\*



A comparison of Nifty's earning yield v/s the 10 year government bond yield shows that equities are still attractive as compared to debt instruments and we should expect continued to shift in the allocation of funds from debt to equity to continue.

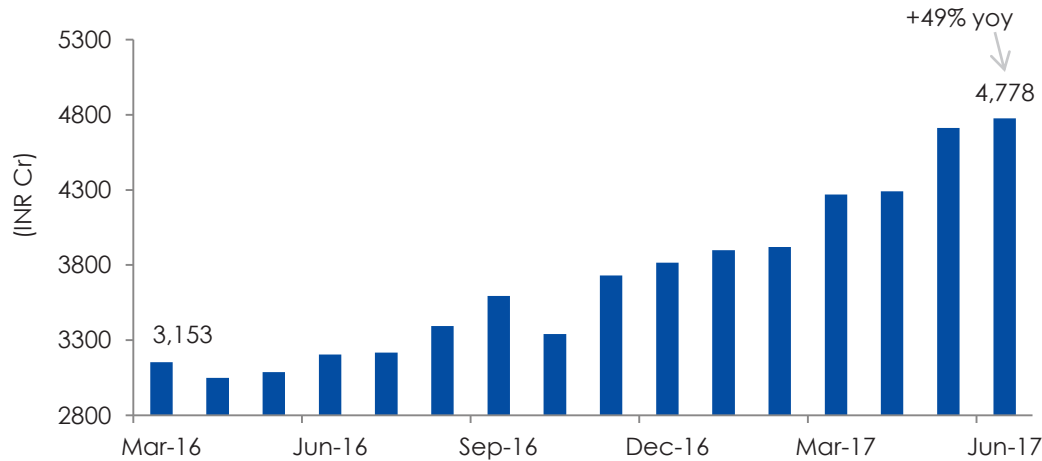
# Financialization of Savings – Increasing Search For Financial Assets



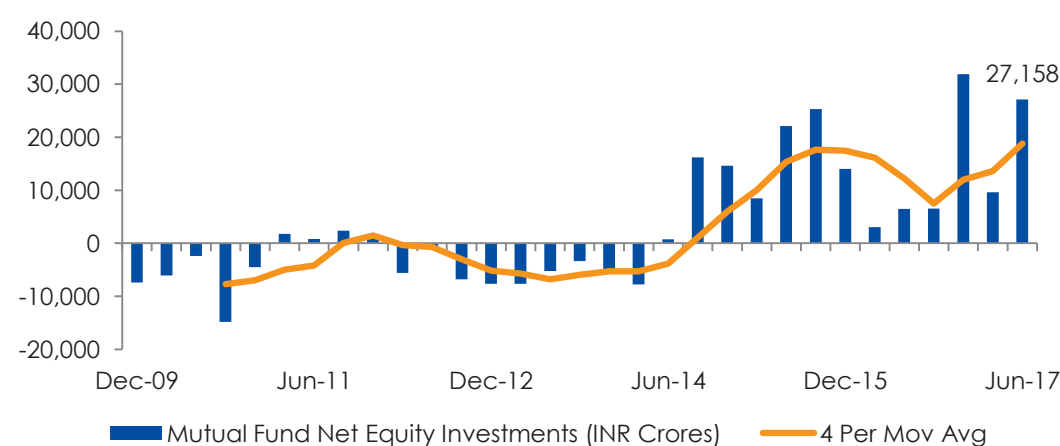
Source: Google Trends, Edelweiss Investment Research

# SIPs +49%, MFs Equity Purchases +53%, Foreign Inflows Nearing Peak

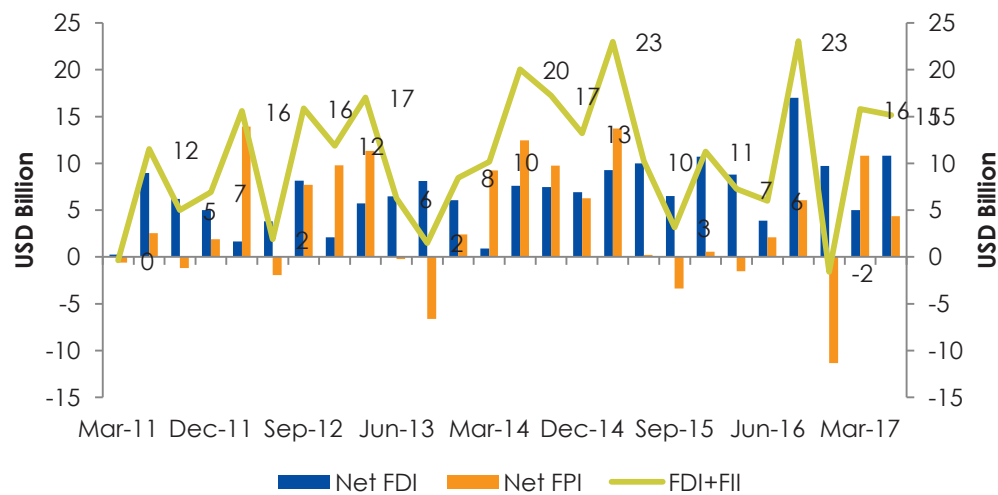
Monthly Flows in Equities through SIP (INR Crore)



Mutual Fund Net Equity Investments (INR Crores)



Foreign Investment Flows Rise

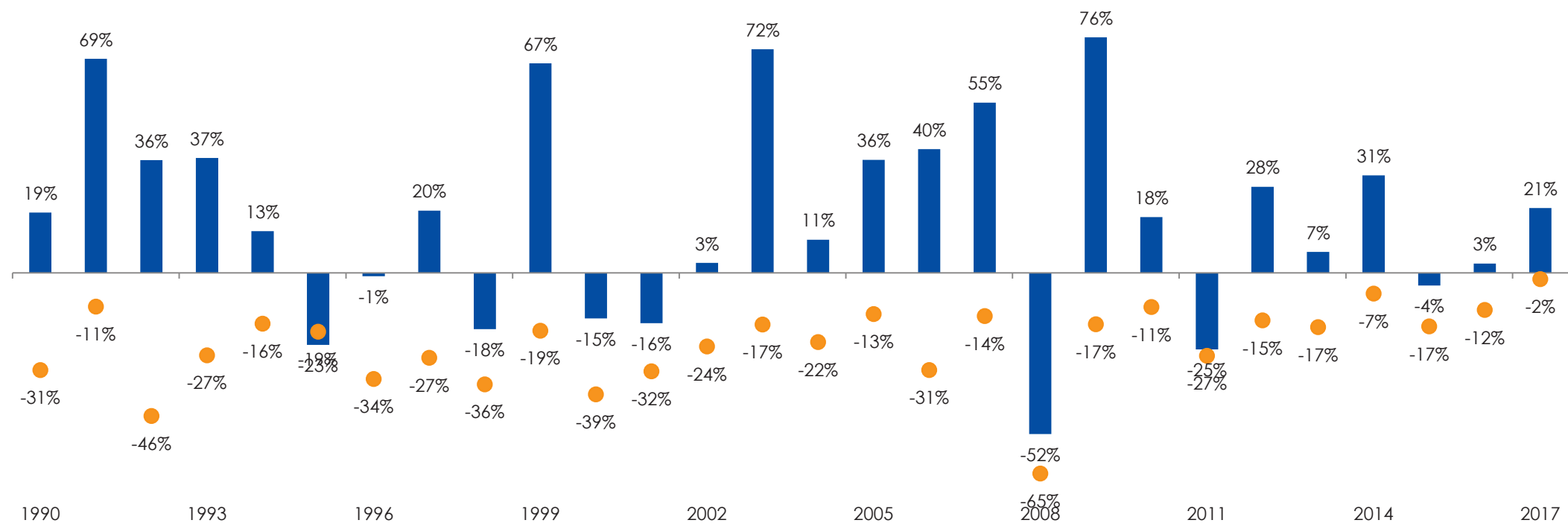


- Financialization of savings and improved market performance has led to consistent DIJ Inflows.
- Additionally , FII inflows have been robust with strong FII.

# Nifty Is In A Secular Uptrend With Low Drawdown

## Nifty 50 Index - Intra-year Declines and Calendar Year Returns

Average intra-year decline in Nifty has been 23%, annual returns are positive in 20 of 28 years



Source: NSE, Edelweiss Investment Research

- A drawdown is the peak-to-trough decline during a specific recorded period.
- Nifty has experienced lowest decline from its peak in about 2 decades



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