FAITH & *PATIENCE*

August 31, 2020

For the month ended August 31, 2020, Nifty 50 index was up 2.84% over previous month's close. Mid and small caps continued to outperform large caps. NSE Midcap 100 Index was up 7.83% and NSE Small cap Index was up 11.54%. Within sectors, metals were up 12.73%, realty was up 10.82%, banking was up 9.77% whereas IT and pharma were down 0.79% and 0.62% respectively over previous month's close. Foreign funds (FII or FPI) were net buyers at USD6.09bn, which is among the highest monthly in history, whereas domestic funds net sellers at USD106mn. Foreign funds have been net sellers in the debt market throughout calendar year 2020 with USD15bn net outflows.

Flows

(USD mn)	Curr	MTD	CYTD
FII - Cash	(320)	6,096	4,807
DII - Cash	(106)	(106)	8,913
FII - Debt	(31)	(562)	(15,090)

Source: Bloomberg

Foreign fund inflow in India is significantly higher than other emerging markets. This is a big boost to sentiments which are pushing markets higher and increasing momentum in broader markets. Given the likely current account surplus situation in 2020, the RBI has been buying excess dollar inflows to avoid sharp movements in the INR resulting in Forex reserves hitting US$535bn. This has resulted in improving INR liquidity which continues to be at a significant surplus of INR6.5tn (Net absorption by RBI at the LAF window).

If one were to look at the activity in July 2020, then foreign funds buying was concentrated towards some sectors such as energy (Rs42bn), IT (Rs20bn), and auto (15bn). Financials (except insurance) continued to bear the brunt of selling (banks Rs14bn and other financials Rs6bn), along with telecom (Rs14bn) and industrials (Rs11bn). As a percentage of prior foreign funds AUM in the sector, largest buying was seen in energy (1.4%), auto (1.2%), and insurance (1.4%). Selling was highest in airlines (2.8%), media (1.9%), telecom (1.6%), and utilities (1.0%). While domestic funds were net sellers during the month (Rs94bn), the selling was concentrated towards energy (Rs47bn), non-banking financial (Rs29bn), Auto (Rs17bn) and consumer discretionary (Rs17bn). Top buys by MFs were IT (Rs31bn), materials (Rs11bn) and Cement (Rs5bn). FDI flows in FY2020 were at US$50bn.

Equity valuations after hitting -1 s.d. in March 2020 have swung to +1 s.d., a function of the sharp rise in stock prices and equally sharp drop in post COVID-19 earnings. We believe, there is evidence of a slow but surely improving global economic environment and continued commitment by global central banks for further QE while maintaining record low interest rates, have the potential to keep markets expensive in the near term. Equity markets have continued to be expensive in the post QE era (post 2010) with shallow corrections. Having said that, we do acknowledge that the expensive P/E is also a function of bottom of the cycle earnings level (Listed space PAT to GDP of ~2% in FY20) and other broader/ balance sheet valuation metrics like Market cap to GDP and P/B remain below average at 76% and 2.7x respectively.

Source: Bloomberg

The much-awaited GDP growth numbers showed that real GDP growth contracted 23.9% y/y in Q1FY2021, sharply down from 3.1% in the preceding quarter and 5.2% in the corresponding quarter last year. The growth contraction was larger than consensus expectations which was -20%. The surprising 10.3% y/y contraction in public admin against an expected 11% increase was amongst the main reasons for sharply lower than expected growth print. Contrary to expectations of a double-digit expansion, growth in 'public admin, defence & other services' contracted 10.3%. While the government's revenue expenditure (which is the determinant of public admin component) recorded around 11% growth in Q1FY2021, we believe bad performance by other services viz. education, health & social work, entertainment, personal services etc. likely pulled down growth of this sector. This is evident from the fact that the sector's broad proxy on the expenditure side viz. government final consumption expenditure recorded a robust 16.4% y/y growth during the quarter.

We believe that risk of rising NPAs remains a key concern for earnings going ahead. RBI's financial stability report indicates that NPAs in the banking system could rise to 12.5% in FY21 from 8.5% in FY20. We believe this is a key risk to earnings growth. High frequency indicators for India in July indicates slow recovery. India PMI (46 for July 2020 vs 47.2 in June 2020), Google mobility (trends in mobility start to marginally decelerate starting June 2020), e-way bills (388mn GST e-way bills in July 2020 vs 434mn in June 2020), electricity (power demand fall by 4.8% YoY in July 2020 vs 10.9% in June 2020). However, GST collections improved to Rs874bn and will allay concerns about rising fiscal deficit to some extent. Exports fell 12.4% YoY in June 2020 (vs 36.2% in May), imports fell 47.6% in June 2020 (vs 52.4% in May), inflation stands at 6.06% YoY (June 2020), credit growth is at 5.7% YoY.

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India's economic recovery is lagging global recovery and the COVID-19 curve is yet to decline. India's high combined fiscal deficit continues to be a key risk to macro stability. We will be closely monitoring the consumption numbers during the next 2-3 months when there are two major Indian festivals - 'Dasera' and 'Diwali'.

We believe, with round one of QE by US FED may be nearing its end and the initial aggressiveness shown by global central banks may not be visible in the near future unless things turn for the worse. We also note that the exuberance among "Robinhood investors" across the globe (Zerodha is Indian equivalent) and recent reports talking of their participation in Nasdaq and S&P500 stocks/options, including a large PE, could be driving the markets towards a bubble.

We believe Indian economy is best positioned to revive faster than others given the investment focus of Government of India and low penetration levels in virtually all consumer sectors including financial services. We have clearly filtered the noise around Q1FY2021 real GDP growth numbers and the comparison over Q1FY2020 absolute and relative to developed world or even emerging economies.

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