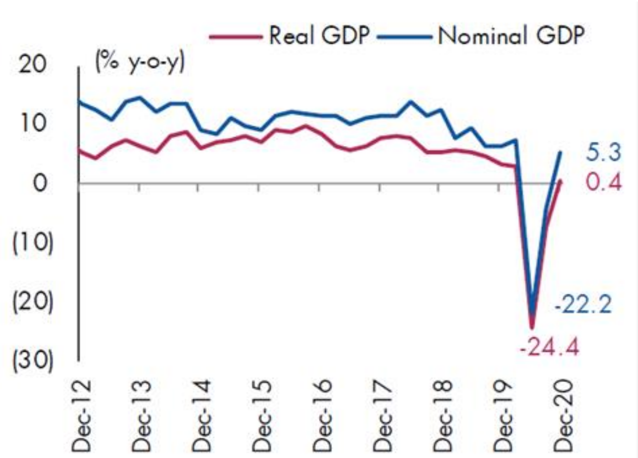
FAITH & *PATIENCE*

February 26, 2021

For the month ended February 26, 2021, Nifty 50 index was up 6.56% over previous month's close. Midcaps and smallcaps outperformed large caps. NSE Midcap 100 Index was up 11.28% and NSE small cap 100 index was up 12.16%. Within sectors, public sector banks, metals, public sector enterprises, energy, realty, banks, and infrastructure outperformed Nifty 50 index whereas pharma, consumer goods, technology and auto underperformed. Foreign investors (FII or FPI) were net buyers again at USD4.1bn in February 2021 whereas domestic funds were net sellers at USD2.2bn. Foreign investors have been net buyers in the first two months of the calendar year 2021 with USD6.1bn.

Fig: India's growth in recovery mode



Source: CEIC, CSO

As per the quarter three FY2021 data released by Government, India's GDP growth turned positive at 0.4%. It marks the first positive print after two consecutive quarters of contraction. With this, India is now technically out of recession.

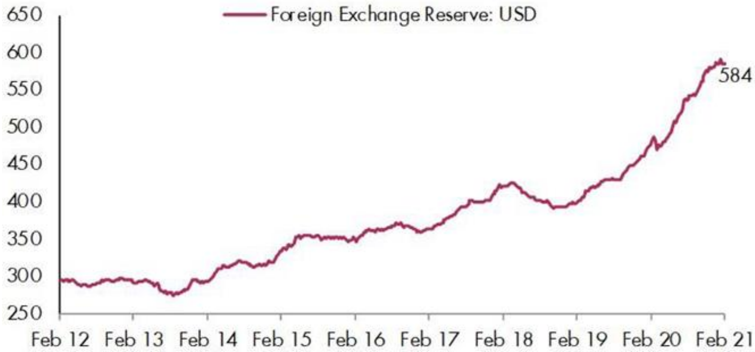
On the supply side, recovery in Q3 FY2021 growth was led by the following sectors: (i) Agriculture (ii) Manufacturing (iii) Electricity & Utilities (iv) Construction and (v) Financial, Real Estate and Professional Services.
Agriculture sector registered a strong growth of 3.9%YoY in Q3 FY2021. Easing of mobility restrictions and festive demand resulted in broad based recovery which got reflected in sharp rebound for the manufacturing sector, construction sector and further improvement in growth of the electricity and utilities sector. Construction sector clocked a growth of 6.2% in Q3 FY2021 after four consecutive quarters of contraction. On the other hand, electricity & utilities sector growth improved to 7.3% YoY in Q3 FY21 from 2.3% YoY in previous quarter. Financial, real estate and professional services picked up to 6.6% YoY after two consecutive quarters of sharp contraction.

On the demand side, the improvement in Q3 FY2021 GDP growth to 0.4% vis-à-vis -7.3% growth in Q2 was led by recovery in net investments, private consumption, Government consumption. Encouragingly, Gross Fixed Capital Formation increased by 2.6% YoY in Q3 FY2021 after three consecutive quarters of contraction amidst demand side recovery, fiscal and monetary policy support. Improvement in private consumption is validated by high frequency indicators like auto sales, auto production, GST collections, PMI manufacturing, BHIM and FASTag volume growth, uptick in consumer sentiment amidst festive led demand. Improvement in government expenditure is visible through monthly increase in centre and state's total expenditure which increased by a sharp 32.7% YoY in Q3 FY2021 as against a contraction of 10.1% in Q2.

Meanwhile, net export remained a drag on overall growth recovery. Exports contacted by 4.6% in Q3 as against a contraction of 2.1% in Q2 FY2021. On the other hand, imports contacted by 4.6% after a contraction of 18.2% in Q2 FY2021. Increase in global COVID-19 cases and renewed lockdowns in key trade partners weighed on export recovery.

We believe, after averaging at -15.9% in H1 FY2021, GDP growth seems poised towards a growth of ~2.0% in H2 FY2021 as indicated by the momentum of high frequency indicators. While 'unlock' and festive demand played an enabling role to support growth in Q3 FY2021, government's fiscal support through increase in capital expenditure expedited the momentum. As such we see this growth momentum to continue through FY2022 with the Union Budget acting as a key growth catalyst. It is expected that FY2022 GDP growth will likely be 11.0% after a contraction of ~7.0% this fiscal. Higher farm sector allocations in the Union Budget would continue to support rural recovery through the year. The strong counter-cyclical fiscal impulse with a supply-side push towards domestic manufacturing industries like autos, chemicals, pharma, textiles, electronics, IT hardware, solar, steel, and telecom.
Continuous focus of the government on sectors related to infrastructure and finance along with timely disinvestment of public sector undertakings. This is likely to channelize private investment in the above-mentioned sectors and assist in long term durable growth recovery.
Looking ahead, while we are optimistic about India's growth recovery, risks to growth trajectory cannot be overlooked. These arise from a steeper domestic epidemiological curve and most importantly, inflation. Monsoon rainfall being normal this year is equally important. Alongside, a rise in commodity prices especially that of oil and cost-push price pressures will have a bearing on GDP deflator and accordingly real GDP growth. As such, we expect the government and the RBI to pre-empt the negative impact of higher prices on purchasing power of consumers and profit margins of producers. Adhering to inflation targeting framework of 4.0% with +/- 2% band for the next five years is a step in the right direction, we believe.

Fig: India foreign exchange reserves USD



We hear/read a lot about India's rural economy, its potential and about Government's focus on the same. We also know that India lives in its villages or nearly 65% Indians are rural based. We found Nestle India's investor briefing quite interesting as it helps us understand the work carried out by the present Government over the last 7years and its impact on 65-70% of India. Nestle India's briefing provides anecdotal evidence, and it illustrates how a business with hitherto mostly urban-focused product-lines is looking at rural expansion as the next growth frontier - this, of course, also speaks of the vast growth opportunity that exists for consumer goods in a country like India. Nestle has set sight on upping the number of villages it covers by one-third over the next four years. Their increase in village-coverage has already gone up from just about 9,000 in 2017 to 51,500 in 2018 and then to 89,000 in 2019. We are reminded of Nestle's August 2016 presentation wherein management had shared that Nestle's target population is the 315mn urban relatively more well-to-do folks out of the total population of 1.28bn. It is interesting to note that the business has come a long way since, given Nestle's recent years' strategy to accelerate coverage of villages and rural centres. Interestingly, nestle now covers a greater number of villages (around 89,000k) compared to a more rural-centric company like Dabur (around 52,000). The universe is much larger, though (around 660,000) and presents a huge growth opportunity if one can understand the highly price as well as value sensitive Indian rural consumer well. Nestle management opined that speedy acceleration of internet to remote corners of the country helped democratize aspirations (rural consumers have access to the same YouTube videos and advertisements that are watched by urban consumers) and e-commerce companies have helped make a lot of these products available to rural consumers who were more difficult to reach earlier. To use management's words, there is a greater convergence of aspirations and availability now due to the deeper penetration of internet and ecommerce in the country. (Disclaimer: This is not a recommendation to buy/sell/hold any stock but simply to get a perspective, from a global corporation, about rural India and the changes in last 7years under new Government).

Our view:

Pent-up demand, driven by the opening of the economy and festive season, had a larger role to play in the areas showing robust demand trends (construction, manufacturing and selectively consumption) resulting in a strong earnings season with a beat/miss ratio of 4.3x during Q3FY2021. We believe, discretionary consumption such as retail and leisure which continue to contract, should see incremental pent-up demand getting released as Covid cases recede, which is evidenced by their mobility trends (-21% below baseline but rising; Google mobility). Robust high frequency data for Q4FY2021 so far, such as PMI & GST collections, indicates that recovery is extending beyond the festive season and does indicate signs of sustainability of demand both for manufacturing and services. Overall, we believe that the environment is turning favourable in terms of a counter-cyclical fiscal policy with focus on capex (higher multiplier effect on demand), growth-oriented policies, lower interest rates, ample liquidity and optimism around a fully operational economy as Covid cases recede. Above environment is conducive for driving the 'invisible hand' which could boost aggregate demand from 'private sector and households' sustainably beyond the pent-up demand seen in Q3FY21.

Q3FY2021 corporate results indicate that aggregate demand showed up in the form of double-digit volume growth for activities like construction, consumption (select consumer products, auto & paints), manufacturing (cement, building material, auto & chemicals). Telecom revenue growth was strong for market leaders (>20%) while utilities showed moderate growth (<10%). Domestic pharma sales ranged from moderate to strong (5-25% YoY). Demand negatively impacted by volume contraction in discretionary consumption (retail, leisure, travel & restaurants) and selectively in manufacturing (regional cement manufacturing and power - capital goods). Exports picture improved with merchandise exports showing improvement (auto, ceramics, chemicals) while IT services were steady; US pharma exports, however, were subdued. Rising prices helped realisations for metal & cement sectors while helping in inventory gains for oil companies.

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