QUEST INVESTMENT ADVISORS
SEBI Registered PMS & AIF managers

For India its Heads I win Tails you lose type advantageous situation, amidst a new world order that is taking shape

Dear Investors,

As long term investors in Indian markets, we have always been of the view that one needs to keep the daily noise out and focus on company fundamentals and at the same time keep an eye on macro-economic trends developing as no matter how much we deny, it does play an important role in investing cycle, and their importance has grown manifold in the recent years. Indian equity markets continue their decoupled movement from the rest of the world and as we speak, Nifty has come around a full circle back to 18000 levels after giving bouts of volatility, panic selling and FOMO buying over the last 1 year. Ironically Indian markets had hit a high almost a year back in Oct 2021 and we seem to be at striking distance of that now again.

"If the world is different , we need to think, talk and engage accordingly. Falling back on the past is unlikely to help with the future" – Dr S Jaishankar

As I write this letter to you, new geopolitical events and economic policy announcements are unfolding somewhere in the World as the shaping of **a new world order is underway**. Ever since beginning of 2020 there have been tectonic shifts and disruption in the way the world was growing and shaping up for two decades prior to that since the Technology boom of 1999-2000. Last two decades was all about cheap products manufactured in China and other Asian countries, low interest rates and cheap capital (close to zero interest rates) which drove consumption in developed markets. Also there hasn't been any major military conflict among large countries over the last three decades. **This was a golden period for globalization as we saw the movement of capital and labour across boundaries became the new norm**. However this led to the emergence of China as a regional superpower which started showing early signs of claiming its right to being the heir apparent to the throne for the economic super power. Mr Donald Trump with his anti-China policies awakened the West and for the right reasons made everyone aware of the designs the communist party had which was to challenge the leadership of America. All this is surely known by all of us, but I thought of giving a context because there is a new world order underway and old relations and Geopolitical groups are getting tested everyday and every month and new ones being forged which is also changing the economic environment which affects our investments.

We have entered a new regime with macro factors driving asset prices and contributing to a higher level of volatility which we have not seen for years. The hawkish stance taken by major global central banks (Fed and ECB), has been reflective of the incrementally deteriorating global outlook. **We believe the world has entered an era of higher inflation and higher cost of capital and this is the new norm**, though some cooling off from the peaks are likely to happen but the old normal would not be reached any time soon. The **ongoing transition to a multi-polar world from a largely unipolar world** since the collapse of the Soviet Union in the early 1990s and the rise of several global and regional powers with different agendas and ideologies has fractured global supply chains of energy, raw materials and manufactured goods & services which is **throwing new opportunities for largely neutral countries like India**.

India is not just a bright spot among emerging countries but has become a beacon of hope for many developed nations too in the hour of crisis

India has emerged as a shining star in CY2022 with healthy outperformance amid varied global headwinds on macros, inflation, rates, currency and geopolitics. While most global equity markets are down 20-25% in YTD'CY22, India is flat and steady (in local currency). This outperformance is driven by several key factors such as:

- **Strong corporate earnings growth over the last two years** (Nifty profits up 70% during FY20-22) and expectations of a healthy performance over FY22-24;
- **Resilient domestic equities inflow** (YTD DII equity inflow of USD 29 bn) and this trend is likely to continue due to continuous flow from EPFO and Pension Funds apart from direct investments of HNI and Retail investors
- **Proficient macroeconomic management** by the RBI and the government that has helped India stand out in an otherwise volatile and panic-stricken world.

The **Indian Rupee is also one of the better performing global currencies against the USD** and has infact appreciated against most other global major currencies like Pound, Euro and Yen. The differential between the Indian 10-yr G-sec yield and the US 10-yr G-sec yield at 3.8% is at its lowest in the past 13 years (lower than 15,10 & 5 years average as well). This, along with premium equity valuation vis-à-vis its peers indicates decoupling for Indian bonds and Equity markets which we believe is here to stay. With inflation sky rocketing and fears of recession all around the globe, **India remains amongst very few growth destinations with strong domestic demand and food grain security**. India would have to navigate the emerging geopolitical situation carefully, given (1) its unsettled border disputes with nuclear-armed neighbors (China and Pakistan), (2) its long historical ties with Russia and Russian defense supplies and military support, (3) its deep economic ties with the US and Europe, which are in the 'opposite' camp of China and Russia, (4) growing closeness of China and Russia and (5) increasing strategic partnerships with the US and its allies.

India's emergence as a stable economic powerhouse with large production, services capacity and a large local market is getting attention of all

India continues to need foreign capital for its growth and may have to maintain a healthy cooperative relationship with the West instead of a full alignment in an increasingly multi-polar world. India stands on a sweet spot where it is being pursued by America, Europe, Russia, Japan and Middle East nations alike as a beacon of hope and balance for their differences with other countries. **Our neutral approach has definitely won us many a friends and would be benefitting our businesses too as FTA agreements with various blocs is being chalked out** and many global MNCs are making India their sourcing and manufacturing hub considering the Zero-Covid restrictive policies in China and the astronomical energy prices in Europe. On the other hand **European Union's solidarity is being tested** as Russia's war in Ukraine continues to cause energy turmoil for countries across the bloc. Russia's continuing war in Ukraine is testing EU countries' solidarity not only in how they react to Putin's aggression, but also in how they deal with the after effects of the war for years to come. French people have already started questioning the need to be in NATO and differences between France and Germany are visible. Similar voices would be emerging soon in various energy and food hit nations as livelihoods get impacted. **World is definitely getting re-aligned as we speak**.

Domestic variables point to a stable ground being built for the next few years of growth

Atmanirbhar Bharat is seeing its biggest strides in defence manufacturing within India

Domestic capex cycle and defense led expenditures - In our view, India will need to accelerate its defense modernization programs as global geopolitics is likely to get murkier. India spends 13% of its central budget and 2% of GDP in defense, but spends a disproportionate share to maintain a large standing army. In order to rationalize defense expenditure, the government introduced the 'Agnipath' scheme that will bypass old systems, including long tenures, pensions and other benefits, while maintaining a young army. **The money would be channelized in modernization of the arms and ammunitions**. To modernize defense equipment and ensure domestic manufacturing capabilities, India has mandated a minimum indigenous content of 50% for the most preferred route of defense acquisitions. All this is building the framework for a major capex cycle in the country as large, mid sized and small companies get engaged in the domestic manufacturing process creating jobs and investment. In recent months, many joint ventures have been announced between Indian private sector companies and global defence players and these are good stepping stones for large capex cycle and job creation and self dependence in India.

Rural demand pickup though muted in festive season, to get more boost post Kharif harvest season - Rural economy recovery is slowly recovering as was seen in the recent festive season, albeit not at the pace we would have expected it to. Uneven monsoon distribution, low acreage of major crops like rice, pulses & groundnut and rising inflation has kept the mood somber in rural households. Even as monsoons are 7% above normal as of 30th Sep'22, it remains deficient in large rainfed states of UP, Bihar, WB which accounts for 16% (Including Punjab) area of the nation. Out of 36 meteorological sub-divisions 29 sub-divisions have received normal to excess rainfall till date. With only 7 sub-divisions receiving deficient rainfall. How the Kharif season harvest spans out will determine the near term rural demand which is yet to pick up meaningfully though we seeing some early festive season demand showing green shoots. Also with economy opened up completely, jobs being back in urban areas, we could see labour movements back to pre-covid levels which would also aid in rural demand recovery in the medium term.

Though credit growth to large corporates is still slow, but retail and SME have shown strong credit demand

Credit growth at 8 year highs - After a muted credit growth in the past couple of years, the demand has started to pick up in recent quarters. RBI's sectoral credit data suggests that credit flow is consistently improving. Overall non-food credit registered a growth of 14.8% YoY in Aug'2022 (compared with 6.7% YoY growth in Aug' 2021). YTD'23 credit grew by 5% vs -0.5% YTD'22 credit growth same period last year. Credit growth in the banking system was at a multi-year high of 16.2% YoY for the fortnight ended September 9th 2022 as per RBI. **Retail and SMEs have driven credit growth**. **Amongst retail; the key drivers were Housing, (16.4% YoY), Unsecured Loans (23% YoY Growth) and Vehicle Loans (19.5% YoY) being the primary drivers**. Going forward, as we have entered the festive season, we expect domestic demand recovery to continue and propel discretionary consumption in India after a pandemic-induced hiatus of two years. Coordinated rate hike cycle across the globe is now moving closer towards its final leg, in our view, as we expect inflation to peak barring a major unforeseen spike-up in geopolitical dynamics. **We expect the RBI to hike repo rate by another 50 bps over the next two MPC meetings**. Commodity costs have moderated since July'22 and augur well for a commodity consumer such as India.

GST collections sustain the momentum in Sep'22: The GST collections in Sep'22 were up 26% YoY and 2.8% MoM highlighting the sustained economy recovery post covid. The Q2FY23 collections of Rs.4403bn registered a growth of 27% YoY highlighting continued demand recovery in the economy. The GST collection for Sep'22 stood at Rs 1477 bn, out of which CGST was Rs 253 bn, IGST was Rs 805 bn and Cess was Rs 101 bn (including Rs.9bn collected on imports). **Railway freight, electricity and fuel demand along with credit card spends registered good growth highlighting consumption in the country.**

Way ahead for our markets

Indian equity markets are not cheap but then we don't expect any major price correction unless global events rock the boat. Time correction is something more likely in the near term

Its quite normal for any investor to get nervous in current world environment and its quite tempting to reduce equity exposure and wait for better levels to enter or wait for the dust to settle down. However this has been something we have been saying that wanting to catch the bottom is something none have been able to do ever. Lets not go too far but ask ourselves this question, that in the last 3 years, did we invest aggressively when the lows of March-April 2000 happened, when the 2nd wave of Omicron hit in March 2021 or when Russia attacked Ukraine in Feb 2022? If the answer is No, then you are not alone because majority of investors fall in this camp**. Fear of losing money in the short term takes over the fact that in the medium to longer run these short term events get flattened out**. If we go back in history and look at how markets reacted during major global and local events, and how markets performed post those events in the next 1-2 years, it definitely hits home the point which we all know but don't implement most often – "**buy when there is blood on the street and sell when everybody wants to buy**".

Nifty is now trading at a P/E of 19x 12-month forward earnings, in line with its long period averages (LPA). However**, the premium v/s emerging markets has expanded notably** (MSCI India trading at a premium of 141% v/s MSCI EM) given the relative strength in corporate earnings as well as better macro management (rates/currency/fiscal spending) by the RBI/government, in our view. **Valuations are at a multi-year high premium over EM countries and thus could induce volatility backed by global developments**. **That said, the context has changed meaningfully and thus the relevance of looking at relative country valuations on the lens of LPA has diminished**. Amidst this we are looking for companies in your portfolio at Quest PMS which are a combination of companies: a) which can benefit from stable earnings growth (like banking & financials and consumer staples), b) which can address large domestic market size with long-term growth runway and favorable industry structure (like domestic manufacturing and consumer discretionary) and c) where valuations offer an attractive risk-reward equation (defence, industrials and cement).

Nevertheless the journey from current levels over the next few months is bound to be choppy as winter sets in Europe and Russian patience also starts wearing out. Rate hikes and inflationary noise will also keep the flame of worry burning among investors. We would be patiently waiting it out and keep looking for ideas which can help us make up for some of the lost ground of last 1 years performance owing to the event driven sell off which was seen in various stocks across market caps.

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