

The beauty of Equities is that it throws up surprises when you least expect it both on the upside and downside

Dear Investors,

The year 2022 will be a year which added little to anyone's equity portfolio gains but will surely be a year which has added a lot of learning when it comes to what to expect in the years ahead with regard to various asset classes. When we had started the year we had entered the year with fears of rate hikes and occasional bouts of early inflation raising its head here and there but little did we know what lies ahead as the year progressed. No one would have factored a geo-political conflict of the scale we saw in Ukraine-Russia at beginning of last year which had then disrupted the global economic balance and shot inflation over the roof to 40 year highs which further prompted the US Fed to raise rates at one of the steepest pace in its history to tackle inflation, which even as we speak now, is much higher than comfort levels.

In a year when you have US interest rates rising by 400 bps, global inflation reaching decadal highs and Russia Ukraine war, one would expect a massive fall in market.... But Voila, Indian market was practically flat

Indian equity markets have survived all these macro events and has been one of the best performing major markets globally. However drilling down and breaking up the market returns in 2022 gives some very interesting highlights:

Skewed performance among largecaps/midcaps and smallcaps –

Top 10 largecap gainers	1 yr return	Top 10 Midcap gainers	1 yr return	Top 10 Smallcap gainers	1 yr return
Bank of Baroda	126.6%	UCO Bank	142.3%	Mazagon Dock Shipbuilders Ltd	184.5%
Adani Enterprises Ltd	125.7%	Indian Bank	104.4%	Fertilisers & Chemicals Travancore Ltd	183.2%
Varun Beverages Ltd	123.3%	Metro Brands Ltd	92.8%	Karur Vysya Bank Ltd/The	148.6%
Adani Total Gas Ltd	114.5%	Union Bank of India Ltd	85.3%	Bharat Dynamics Ltd	142.4%
Hindustan Aeronautics Ltd	109.1%	Solar Industries India Ltd	81.1%	Raymond Ltd	136.6%
Coal India Ltd	54.1%	Indian Hotels Co Ltd	76.3%	Rhi Magnesita India Ltd	129.0%
ITC Ltd	52.1%	TVS Motor Co Ltd	73.1%	Great Eastern Shipping Co Ltd/The	125.0%
Mahindra & Mahindra Ltd	49.2%	Bank of India	71.7%	Shoppers Stop Ltd	114.4%
Adani Transmission Ltd	48.7%	Federal Bank Ltd	67.5%	Swan Energy Ltd	109.8%
Adani Green Energy Ltd	45.2%	Canara Bank	66.7%	JK Paper Ltd	99.5%

As can be seen in the above tables, **among the top 10 gainers in largecaps, four were from Adani group.** Out of these 10 names, we held three in our portfolios and continue to hold them now. The top gainer among largecaps was Bank of Baroda which we avoided and held SBI instead owing to balance sheet strength and quality of book. **These top 10 names collectively have around 7.5% weightage in the index** so adds a meaningful attribution to the index returns to the extent of around 4-5% positive returns. So **practically all the remaining 490 companies together in NSE-500 have given a flat to negative contribution drag on the index** returns. **Among the Top 10 gainers in Midcap names in NSE-500, its interesting to see that five of them are PSU Banks** which again shows the skewed performance of the Index. So anyone not having any of these five names in PSU banks would find it tough to meet index returns. Among the Smallcaps the returns was more sector agnostic but owning or not owning them made little difference as the combined weightage of these stocks in NSE-500 is not even 0.4% so would add little to the attribution.

Breadth of the market was overall weak –

Out of the 500 stocks in NSE-500, nearly 300 stocks have underperformed the Index and out of this nearly 270 stocks have given negative returns during the year 2022.

WHAT TO LOOK OUT FOR IN 2023

We have entered 2023 with a lot of fear and hope as equity investors. Infact **after a long time we see investors having very low expectations from equity markets at the beginning of the year** unlike what was there when we entered 2022 a year back. The **consensus on the street is that 2023 would be as bad as 2022** or could get even worse when it comes to equity returns. However we know that when you least expect on something, that is when it delivers. Our view is that this year is likely to be less tumultuous for markets than last year. Inflation is already trending lower not just in India but in the rest of the world also. Central banks are expected to continue to tighten rates, but not to the extent seen in 2022. As a result, bonds will come under less pressure. Oil and natural gas prices are less likely to gyrate considering the supply chains have been re-organized globally. Lets look at some of the drivers for the market in 2023.

“There is no basis for confident economic prediction. Some of the most stridently made arguments are also the silliest “ – Larry H Summers

A soft landing in the developed economies in 2023 could make the base for a strong global recovery in 2024 and beyond

Recession in developed markets could hurt global growth

Turmoil in financial markets coupled with heightened geopolitical risks **has raised the risks, though not the certainty, of a recession.** Historically, rapid and extensive tightening by the Federal Reserve has led to recession in the US. However as we know, **economists have predicted 10 of the last 3 recessions!** Notably, in his latest press conference, on December 14, 2022, Jerome H. Powell, chair of the Federal Reserve, said “I don’t think anyone knows whether we’re going to have a recession or not. It’s just not knowable.” So we would stay away from predicting a recession in the US. However **what we do believe would happen is a soft landing** wherein we see demand slowdown in developed markets which could hurt global trade to some extent. India would be less affected in this case as India remains more of a domestic story and is less export dependent.

India’s premium valuations vs possibility of Corporate Earnings slowdown in an Active Election year

Indian markets have always traded at a premium to other emerging markets but in recent times the premium has reached new highs. **Currently MSCI India trades at 130% premium to MSCI EM**, though this has come off from 165% premium in recent past. This **premium can be justified owing to the strong growth momentum in Indian GDP** at 6-6.5% whereas in most other emerging markets there is slowdown and instability. However as things improve in other EMs, **Indian markets could see time correction and remain flat for sometime as other markets do catch up.** This could also be seen owing to the fact that India has outperformed all major markets over the last 18 months. Moreover recent RBI economic outlook says some slowdown is expected in corporate earnings in near term and this could put earnings at risk in the near term. **2023 has a busy political calendar with nine states going for elections.** These states contribute 116 seats to Lok Sabha and BJP is currently in power in five states going to elections having 92 seats in Lok Sabha. Investors will be mindful of government’s growth impetus ahead of this busy election calendar as it will set the tone and momentum for 2024 general elections.

Rural economy revival could be the joker in the pack in 2023

Since the pandemic we have observed a divergence between the growth trends in the urban and rural economies, with the former showing a reasonable recovery while the latter lagged. **Some of the rural economy's high-frequency indicators that have been lagging so far are showing an improvement, even though it is not a broad-based recovery.** Tractor sales data and demand for work under the MGNREGA give relatively positive indications about the rural economy. This has been largely led by the economy reopening (resulting in work availability and migrants moving back to cities) and the front loading of central government spending in FY23. Winter crop sowing is also progressing well (up 4.4% up to 23 December 2022), which bodes well for rural incomes. **In the upcoming FY24 union budget, we expect the central government to boost rural/agri spending and maintain double-digit growth in public capex** especially in the run-up to the parliamentary elections due in early 2024. We expect the central government's subsidy burden to ease significantly in FY24, creating fiscal space to reallocate money towards existing rural schemes including the MGNREGA, rural housing and roads amongst others.

Union budget to focus on domestic manufacturing and growth and maintain fiscal prudence

Expectations are running high in terms of delivering another growth oriented budget, especially given it will be the last full year budget before the 2024 union election. I believe that **the budget would have two-pronged focus. One would be on increasing household income for the middle class and lower income groups. The Second focus would be to take India into the next stage of growth into a \$5 trillion economy** over the next 4-5 years. I believe the government’s focus would be on higher capex and rural spending, in order to nurture early signs of capex cycle recovery and alleviate rural slowdown. Any disappointment in the form of higher fiscal consolidation would be construed negatively, especially at the time of the ongoing global macro headwinds. Nonetheless, **I expect a growth oriented budget (while sticking to fiscal discipline) to help cyclical recovery.**

India cementing its place firmly on Global economic table and attracting FDI

With India holding the presidency for the G20 this year, **there would be a concentrated effort from government to position and cement India’s position in global trade which has been growing strong over the past three years.** Focus would be on attracting stable FDI flows to improve the competitiveness of its manufacturing sector and to make it an integral part of the global value chain. **FDI inflows to India largely sustained at ~US\$ 55bn over the past three years** despite the pandemic-induced uncertainty. Historically, the services sector continues to dominate FDI inflows in India, reflecting the services-led growth (52.6% share in nominal GVA as of FY22) and India’s comparative advantage in international trade in services. That said, within services, the digital platforms, e-commerce and education are also catching up as new sources of FDI inflows. Notably, **India has recorded a modest pickup in FDI inflows directed to the manufacturing sector over the past few years.** While this is just a start, an increase in FDI inflows into manufacturing should have a productive spill-over impact on other sectors of the economy.

The divergence between Urban and Rural demand is reducing as green shoots are visible of rural economic revival

Government’s focus on making India self reliant in all critical manufacturing processes is on track

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

Way ahead for our markets

Like the global trend, **the Indian rate cycle looks close to peaking**, and we believe the peak may be 25-50 bps (currently 6.25%) away. India's Forex reserves have risen US\$34bn from recent lows as Dollar Index has weakened. Slowdown in IT hiring & wage hikes implies that urban discretionary growth has probably topped out. On the other hand, rural wage growth has started showing a small improvement. Construction activity has picked up which augurs well for rural income growth. Rate hikes peaking out in the US implies that USD strength is close to peaking out. That, coupled with China reopening up, should drive more flows towards Emerging Markets (EMs). **In the near term we could see the FII flows more towards other EMs which are relatively cheap and have under-performed in the medium term compared to India.** Thus India may end up underperforming in the near term, on an absolute basis, but FII flows would resume once this rebalancing of allocations between EMs is done as India offers growth with stability unlike any other EMs. **Domestic flows have slowed down but an annualized inflow of around US\$ 25bn appears sustainable.**

Nifty P/E multiple has moderated 10% during CY22 to **12 month forward multiple of 19.1x** now and is not as big a concern anymore. **Historically Nifty's 12-month forward P/E has had an average of 19.8x. Currently its 12-month forward P/B stands at 3x which is a premium of 12% to the Nifty's historical average of 2.7x.** Further upside from hereon will be a function of stability in global and local macros and continued earnings delivery v/s near-term expectations. We could thus see time correction in our markets rather than a price correction.

With regard to market capitalization, **we maintain our biasness towards largecaps.** However we have peaked out on our largecap allocation and incrementally we are looking at more midcap and smallcap investment ideas as earnings visibility has improved most of the headwinds of the past one year like rising raw material prices, supply chain disruptions have started improving. Portfolio performance which had started improving from the months of October and November took a dip in the month of December owing to some underperformance in few portfolio stocks as market panic and sell off was seen across market. However with near term uncertainty around budget being around the corner and Q3FY2023 and Q4FY2023 earnings acting as good guidance of what lies ahead, we are expecting event led selling being behind us and fundamentals to drive prices soon. We continue to focus our teams research focus on finding outliers in an otherwise difficult market environment.

Happy Investing !!

Yours Sincerely

Aniruddha Sarkar

Chief Investment Officer & Portfolio Manager



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