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2024 India Equity Strategy Outlook | Asia Pacific

A Year of Volatility

MORGAN STANLEY INDIA COMPANY PRIVATE LIMITED+

Ridham Desai
Equity Strategist
Ridham.Desai@morganstanley.com +91 22 6118-2222

Sheela Rathi
Equity Analyst
Sheela.Rathi@morganstanley.com +91 22 6118-2224

Nayant Parekh
Equity Strategist
Nayant.Parekh@morganstanley.com +91 22 6118-1008

With strong earnings, macro stability and domestic flows, it is hard to argue against India's investment case. That said, an event-heavy calendar with potential binary outcomes sets the market up for volatility, after having been less volatile than ever.

Key Takeaways

- Long-term story gaining strength - our key pick in EM and Asia-Pac
- Base case outlook for improving absolute returns and outperformance to EM
- General elections among other events point to higher volatility

In our base case we expect equities to rise into the 2024 general elections, as the market is likely to price in continuity and a majority government: The fundamentals are underpinned by: 1) strong macro stability as a result of improving terms of trade, flexible inflation targeting and stable non-portfolio foreign flows; 2) forecast earnings growth of about 20% annually over the next four to five years, led by an emerging private capex cycle, re-leveraging of corporate balance sheets and unfolding of a structural rise in discretionary consumption; and 3) a reliable source of domestic risk capital. These factors have reduced correlations and volatility of Indian stocks relative to EM. India's beta to EM is <0.4 and India's rate spread with the US has also declined, explaining India's rich headline multiple.

14% upside to BSE Sensex to Dec-24 in base case: In our base case, we assume continuity in a government with a majority mandate resulting in stable policy, the RBI executes a calibrated exit from its current hold stance, robust domestic growth, the US does not slip into a protracted recession and benign oil prices. We forecast BSE Sensex earnings to compound 21.5% annually through F2026E. However, the base case masks the potential for volatility in 2024, which is evident in the spread of our bull-bear scenarios.

Multiple reasons for vols to rise in 2024 from near all-time lows: a) politics – actions from the opposition alliance, which create a view that it is becoming a credible contender to the incumbent; b) cues from US stock and bond markets; c) oil prices – while India remains less affected than in the past, a further rise will present headwinds; d) earnings strength – our base case is 7% and 10% ahead of consensus on F2025 and F2026, respectively; e) monetary policy – shallow rate cuts but Fed moves remain uncertain; f) bond flows further improve BoP; and g) rise in net issuances that could moderate the continuing strong domestic bid.

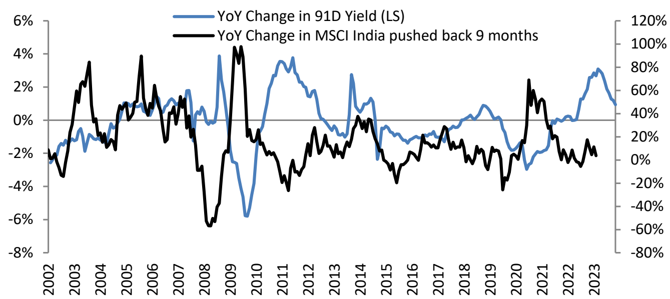
Portfolio Strategy: Cyclicals > Defensives, Large-caps > SMID. OW Financials, Consumer Discretionary, Industrials & Technology and UW other sectors. While we are in a macro market (in contrast to a stock pickers' market) the macro trade could peak in 2024.

Exhibit 1 : Macro & Market Forecasts at a Glance

	F2024E	F2025E	F2026E
GDP Growth	6.4%	6.5%	6.5%
Average CPI	5.4%	4.9%	4.8%
Repo Rate (year end)	6.50%	6.00%	6.00%
CAD% of GDP	-1.7%	-1.7%	-1.5%
Sensex EPS (MS top down)	2998	3713	4403
EPS growth YoY	22.1%	23.9%	18.6%
Sensex PE	21.6	17.5	14.7
Sensex EPS (consensus)	2978	3478	3985
Broad Market Earnings Growth	25%	25%	20%
Broad Market PE	16.7	13.9	11.6

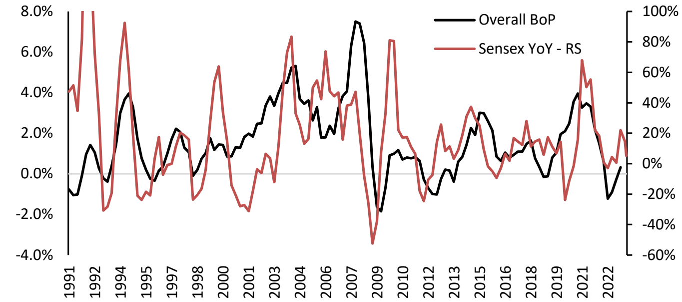
Source: RIMES, IBES, BSE, Morgan Stanley Research (E) estimates

Exhibit 2: Short Rates have probably peaked but likely to stay flat for now



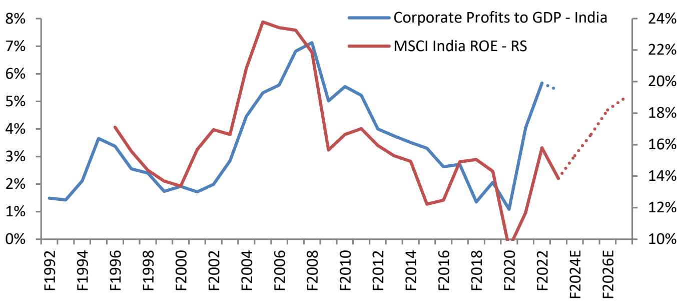
Source: RIMES, MSCI, Bloomberg, Morgan Stanley Research

Exhibit 3: BoP remains strong but gains slowing temporarily



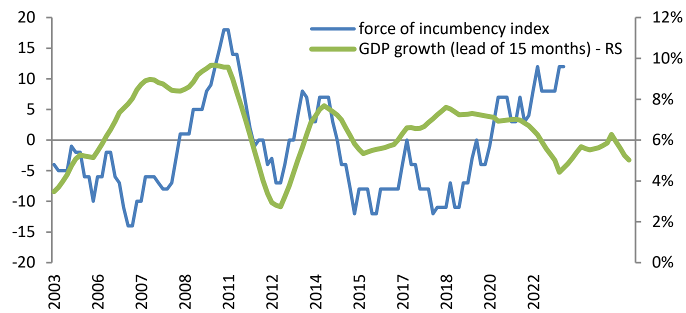
Source: BSE, RBI, Morgan Stanley Research

Exhibit 4: India's Profit and ROE Cycle



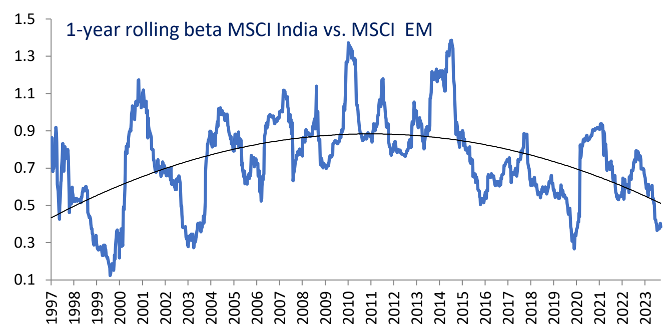
Source: BSE, MSCI, Bloomberg, Morgan Stanley Research

Exhibit 5: Prosperity Leads Election Performance of Incumbent Governments



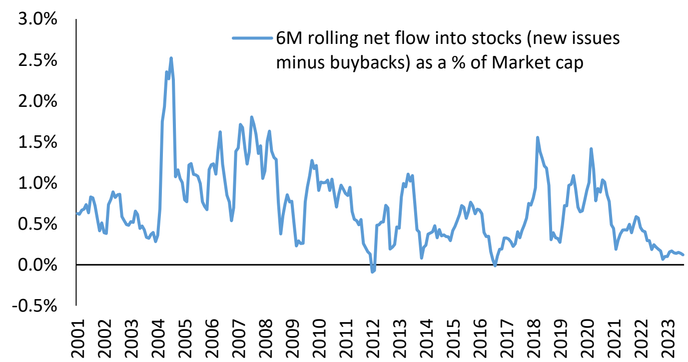
Source: *ECI website, CEIC, Morgan Stanley Research. .*

Exhibit 6: India's low beta ensures outperformance vs. a declining EM



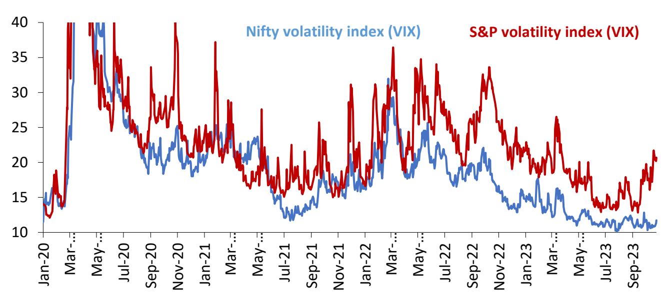
Source: RIMES, MSCI, Morgan Stanley Research

Exhibit 7: Net issuances set to rise and moderate the domestic bid



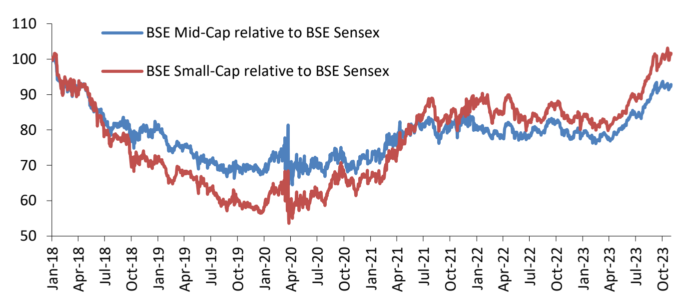
Source: CMIE, Morgan Stanley Research

Exhibit 8: Volatility set to rise in the coming months



Source: Bloomberg, Morgan Stanley Research

Exhibit 9: Relative broad market performance may have peaked for now



Source: BSE, RIMES, Morgan Stanley Research

Equity Market Outlook and Catalysts

Greater volatility seems almost certain even as India's structural bull market has more legs. Election results could be a risk to the trend.

Five Key Drivers to India's Structural Bull Market

Macro stability and a secular positive BoP in the offing: Flexible inflation targeting accompanied by rising exports' share in world exports and falling oil intensity of the economy is creating a benign current account deficit (CAD) outlook. A multipolar world thesis is driving investment flows (mostly FDI) to India leading to a potential balance of payments (BoP) surplus and surplus domestic liquidity. Thus, India can run a lower rate gap to the world and may also experience lower inflation volatility. Hence, the Indian equity market is experiencing lower return correlation with oil prices, Fed Fund rate changes and US growth.

Strong relative and absolute growth: We believe we are only halfway through a profit cycle, with profit share in GDP rising from a low of 2% in 2020 to about 5% currently, and likely heading to 8% in the coming four to five years. This implies about 20% compounding of earnings growth. Underscoring this forecast is the start of a new private capex cycle, under-geared balance sheets, a healthy banking system, lower corporate tax rates, improving terms of trade and structural consumption demand outlook albeit somewhat offset by likely consolidation in government deficit.

India's 401(k) moment has created a reliable domestic source of risk capital: Households continue to be less exposed to equities relative to other asset classes, and we see the domestic bid on stocks being sustained for a long time, as it was in the US from 1980 to 2000 when 401(k) plans were allowed to invest in stocks. India did the same with its retirement funds in 2015 setting the stage for a boom in domestic equity flows. With reducing dependence of FPI equity flows, India's beta to EM is now down to around 0.4 making it a quintessential defensive market in the EM world.

Social equity: India's digital infrastructure has lowered know your customer (KYC) costs and enabled access to the banking system to hitherto unbanked people, who have started receiving transfers electronically easing the leakages that previously existed. On top of this, the open credit enablement network promises to bring several million people into the formal credit system. This combination of access to bank accounts, better efficiencies in social transfers and access to cheaper credit is creating social equity. This is now visible in better gender ratios at birth (i.e., lower female foeticide) lower infant mortality and, most importantly, lower poverty levels in the country.

Consumption boom: The breadth of India's income pyramid lends itself to momentum in consumer spending, which is likely to benefit as India has crossed the crucial US$2,000 per-capita GDP level. This income level signifies rising share of discretionary spending. The number of households earning in excess of US$35,000/year is likely to rise fivefold in the coming decade to over 25mn people, making India an attractive market place for luxury consumption in future. This is a main anchor to multinational corporations' interest in

India. The consumption boom is also aided by a likely rise in private credit to GDP from 57% currently to 100% by the turn of the decade, in our view.

Key risks to structural story: 1) A potential change in government could lead to changes in the direction of policy reform and execution leading to poor investment sentiment; 2) substantially slower global growth adversely affects India's external growth and funding; 3) challenging geopolitics and associated elevation in oil prices; 4) low farm sector productivity, which needs structural reforms; 4) shortage of skilled labor needed to make advances in manufacturing; and 5) AI-related headwinds in services exports.

Key Catalysts for 2024

The seemingly easy call for 2024 is that volatility of returns is heading higher. The starting point of both realized and implied vols are at historical lows and given the below events with binary outcomes, we think volatility seems certain to rise. The following factors, in order of importance, are likely drivers of this volatility and our bullish view on Indian equities:

Politics: In the short run the state election results in December for five states could create volatility, especially if the BJP loses a majority of those states. Key to watch in the 2024 general elections is if the opposition alliance, called I.N.D.I.A., can put up a credible seat-sharing arrangement, which polarizes the general elections and reduces the predictability of the outcome in May next year. In our base case, we expect the market to trade higher in the run-up to the 2024 polls. As we outlined in India Equity Strategy: One Billion Voters: Will They Please the Market? (3 Sep 2023), elections have the propensity to create extreme outcomes for the stock market. Historically, the market has favored continuity and a majority government, as this implies limited policy shifts post elections. In the event, if the results go against the market's preferred outcome, we see the possibility for a draw down of 30% (details in the above note).

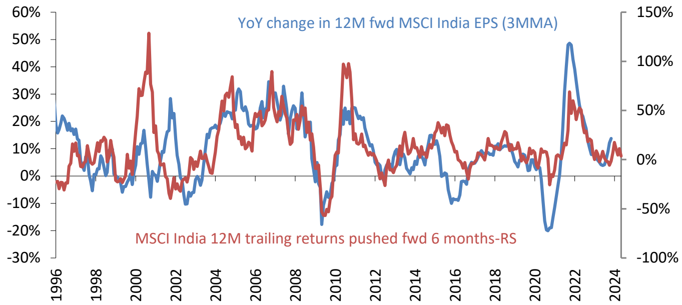
Earnings: We expect F2024 and F2025 earnings to be strong, with an improvement in margins led by a durable rise in capital spending and benign material prices. India appears to have multiple areas for capex, including energy transition, the Internet, climate change, production-linked incentive schemes, growing exports, depleted capital stock, infrastructure, real estate and FDI going into the next few years. Rising capex is good for corporate profit margins until the capex becomes unproductive. The bear case for earnings is a big slowdown in global growth, rising commodity prices and an election outcome that significantly alters corporate investment sentiment.

Exhibit 10: BSE Sensex EPS Estimates: We are well ahead of consensus

	F23e	F24e	F25e	F26e
MS Top Down Estimates				
Bear Case		2,909	3,222	3,779
EPS Growth		18.4%	10.8%	17.3%
Base Case	2,456	2,998	3,713	4,403
EPS Growth		22.1%	23.9%	18.6%
Bull Case		3,089	3,911	4,659
EPS Growth		25.8%	26.6%	19.1%
Consensus EPS Estimates		2,978	3,478	3,985
EPS Growth		21.3%	16.8%	14.6%
MS Analyst Estimates				
EPS		3,008	3,432	3,865
EPS Growth		22.5%	14.1%	12.6%
Broad Market				
MS Top Down Estimates				
EPS Growth	13%	25%	25%	20%

Source: Company data, RIMES, IBES, MSCI, Capitaline, e = Morgan Stanley Research estimates

Exhibit 11: Market pricing in modest earnings growth compared to our forecasts



Source: RIMES, MSCI,, Bloomberg, Morgan Stanley Research

Global markets: India's correlation of returns with global equities continues to decline and is lower than history. That said, India is a large stock market in terms of capitalization in a global context and cannot completely deviate from global equity market trends. Softer global markets could cap absolute returns whereas a strong global bull market could coincide with relative underperformance for low-beta market like India.

Short rates: While rising oil prices and weather volatility create inflation risks, the US Fed has not firmly signaled an end to its own hiking cycle (although Morgan Stanley's view is that it is done). This implies that the RBI is likely to hold its stance. It also means that short rates in India have peaked in mid-2023. If oil prices drop, it may create room for lower domestic fuel prices and may lead to headline CPI moving into RBI's comfort zone of circa 4%. On the flip side, strong domestic growth could create a floor on core inflation. While we expect the RBI to cut rates in the middle of 2024, the rate cycle is likely to be a shallow one given the domestic growth impulses.

Rise in net issuances: Net issuances in India are at all-time lows, even though gross issuances have risen from lows. We believe that companies will now start raising capital more actively as they prepare for the coming capex cycle. We also think some of this fund raising could occur ahead of the elections as some companies may look to mitigate risks around capital market conditions if the results do not favor the equity market. Such a rise in net issuances could moderate the strong domestic bid, which has been the key driver of share prices since 2015. We believe domestic flows are likely to stay strong in 2024 but an adverse general election outcome poses some risk.

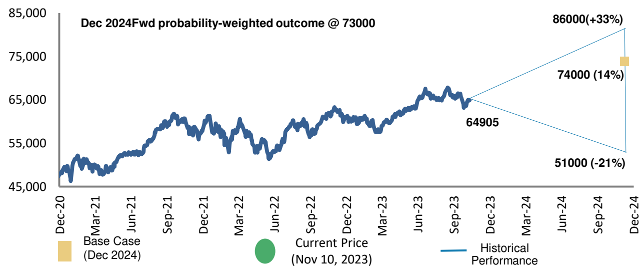
Bond flows: In June 2024, India will join the global bond index, prompting US$30bn in inflows into its G-sec market. India will join the index with 1% and this weight will increase by 1% each month until it reaches 10% in April 2025. We expect investors to pre-position themselves before the index inclusion. In the longer term, this could trigger other index inclusions, such as to the Bloomberg Global Aggregate Index, which could attract another US$10bn in inflows. Our fixed income colleagues believe annual inflows into the G-sec market beyond the inclusion could be US$18.5bn given current low foreign ownership in the India government bond market. The internationalization of INR and the reform of India's capital market could lead to inclusion in the IMF's SDR for the INR eventually. The positive effect of this on BoP should also find its way into the equity markets (see: India Macro Strategy: A Milestone Event for India Bond Market – GBI-EM Inclusion (22 Sep

2023).

Oil prices: While India remains less affected by these than the past, further rises in the oil price especially above US$110 will present headwinds to the macro. Oil affects India in both the current account and inflation, and therefore, interest rates, currency and growth.

BSE Sensex target for December 2024, 14% Upside Potential

Exhibit 12: BSE Sensex Risk-Reward for December 2024



Source: RIMES, Morgan Stanley Research
Past performance is no guarantee of future results.

Our BSE Sensex target of 74,000 implies upside potential of 14% to December 2024. This level suggests that the BSE Sensex will trade at a trailing P/E multiple of 24.7x, ahead of the 25-year average of 20x. The premium over the historical average reflects greater confidence in the medium-term growth cycle in India (India Equity Strategy: An Explanation for India's Rich Multiple).

Base case (50% probability) – BSE Sensex: 74,000: We assume continuity in a government with a majority mandate, robust domestic growth, the US does not slip into a protracted recession and benign oil prices. Government policy remains supportive, and the RBI executes a calibrated exit from its current hold stance. Sensex earnings compound 21.5% annually through F2026E.

Bull case (30% probability) – BSE Sensex: 86,000: In addition to the above, oil prices dip into the US$70s or below resulting in lower domestic inflation and deeper rate cuts from the RBI, the US growth cycle renews with global share prices responding with a strong up move and bond flows surprise to the upside. Earnings growth compounds 24% annually over F2023-26E.

Bear case (20% probability) – BSE Sensex: 51,000: India's elections deliver an unclear mandate with a change in government, oil prices surge past US$110/barrel, the RBI ends up tightening to protect macro stability and a US recession leads global growth lower. Sensex earnings compound 15.5% annually over F2023-25E with meaningfully slower growth in F2025 and equity multiples de-rate to reflect poor macro conditions.

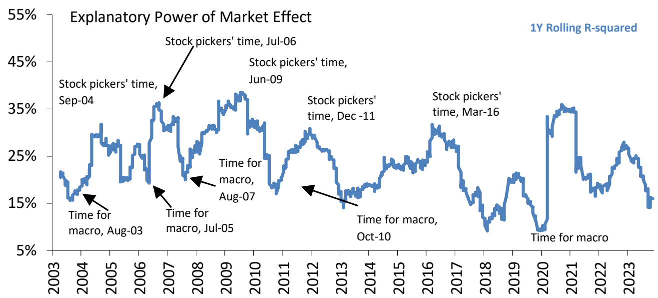
Portfolio Strategy

A macro market with Cyclicals > Defensives, Large-caps > SMID. OW Financials, Technology, Consumer Discretionary Industrials and UW other sectors. That said, the macro trade could peak in the coming months.

Key portfolio themes

- **Buy domestic cyclicals**: Domestic growth is likely to stay strong with benign inflation - which historically has been a perfect combination for domestic cyclicals. Growth is likely to be capex driven and accompanied by improving credit availability. Rates have peaked, albeit may not come down significantly given growth impulses. This sets the stage for outperformance for financials, consumer and industrial cyclicals.
- **Avoid defensives and global cyclicals**: Unless election outcomes prove unfavourable for markets, defensives including consumer staples, utilities, healthcare and telecoms are likely to underperform. Slow global growth likely keeps a lid on the performance of global cyclicals, including energy and materials. That said, we use technology as a barbell in our portfolio just in case our bear case eventuates.
- Return correlations have fallen significantly and are approaching lows. This implies that the market is transitioning from one driven by macro conditions to one where stock-picking will likely add alpha (Exhibit 13). When these correlations trough, sector positions should be narrowed and portfolio building should be bottom-up rather than top-down, in our view. This may happen at some point in 2024.
- Large-caps likely to outperform small and mid-caps – the opposite to our call this time last year.
- We continue to pursue ideas around clean energy spending, defence indigenisation, a new residential property market, auto, and air travel cycle, a multiyear credit cycle for financials and life insurance, digital transformation, and market share concentration, plus horizontal growth for discretionary and staple consumption and electric vehicles as key themes for 2023.
- We are overweight on Consumer Discretionary, Industrials, Financials, and Technology and Underweight all other sectors.

Exhibit 13: The macro trade: a likely peak in 2024



Source: RIMES, BSE, Morgan Stanley Research

Exhibit 14: Institutions vs. Our Positions

Sector	FPI Ownership	FPIs Position over MSCI	Change in FII Position (QoQ)	Domestic Institution Ownership	Dom Ins Position over Nifty	Change in Dom Ins Position (QoQ)	MS Sector Position
Comm Services	3.4%	0.6%	0.1%	4.1%	1.4%	0.3%	-1.0%
Cons Disc	7.0%	-4.3%	-0.2%	7.0%	-0.8%	-0.2%	5.0%
Cons Staples	7.4%	-1.6%	0.8%	11.3%	2.0%	0.0%	-3.0%
Energy	11.5%	0.9%	1.2%	11.9%	0.7%	0.0%	-3.0%
Financials	42.5%	14.6%	-0.5%	31.3%	-4.6%	0.5%	6.0%
Health Care	3.5%	-1.7%	-0.1%	3.8%	-0.3%	0.1%	-3.0%
Industrials	4.5%	-3.0%	-1.1%	7.1%	1.2%	-0.2%	4.0%
Materials	5.8%	-2.7%	0.2%	6.7%	-0.2%	-0.1%	-5.0%
Technology	11.7%	-1.5%	0.0%	12.6%	-1.1%	-0.6%	3.0%
Utilities	2.7%	-1.3%	-0.4%	4.1%	1.7%	0.2%	-3.0%

Source: BSE, RIMES, MSCI, Morgan Stanley Research

Our sector views

Financials (+600bp): Peaking short rates, higher credit growth, and low credit costs imply outperformance for Financials, especially for the non-bank lenders.

Consumer Discretionary (+500bp): We expect a recovery in rural demand to aid overall consumption demand. Key downside risk is another bout of raw material cost inflation.

Industrials (+400bp): Strong government capex and a nascent pickup in private capex drive our overweight.

Technology (+300bp): Position reflects our barbell strategy. Least exposed to domestic growth although US recession is a risk.

Communication Services (-100bp): Pricing power could improve but we find better opportunities elsewhere.

Utilities (-300bp): We are UW given the sector's lack of cyclicality.

Consumer Staples (-300 bps): Fundamentals could improve as rural growth recovers. However, stocks remain richly valued. In our barbell strategy, we prefer cyclical consumption.

Energy (-300bp): We prefer domestic cyclicals over global cyclicals.

Healthcare (-300bp): We are avoiding defensive sectors.

Materials (-500bp): We prefer domestic materials over global. In addition, we take cyclical exposure via industrials.

Focus List Changes: We replace Titan and SBI Cards with Avenue Supermart and Reliance Industries

Avenue Supermart : Our India Consumer Analyst, Sheela Rathi believes DMart is pursuing a grocery-first strategy to re-engineer growth. This is out of consensus, with c60% of ratings being EW and UW or equivalent. DMart's strategy has been to build a profitable business from the start, rather than first scaling up a business and making it profitable later. She believes management has shown sharp focus on store-level profitability, which is the key driver of high throughput per store and the company's high overall profitability. Cost efficiency, economies of scale, and balance-sheet strength are DMart's moat.

In her view, the macro headwinds are behind us and general merchandise should start picking up in the coming quarters, while for apparel (smaller part of the GMA business), DMart has taken measures to fix it. In a worst case scenario, if the apparel segment does not come back to previous levels, then the company will horizontally scale in non-FMCG categories to drive growth. The four-year CAGR revenue growth recovered to c20% in the latest quarter after six quarters of decline. We see profitability benefiting once the growth flywheel kicks in.

Reliance Industries: Our India Energy Analyst, Mayank Maheshwari believes that management commentary of "peak net debt" in F24, OCF funding all of its investments YTD, and a slowdown in capex intensity in 2024 all point to increasing focus on de-gearing RELI's balance sheet. Other catalysts that could help de-gear and help the stock catch up with peers on multiples include: 1) potential hive off for warehouses in retail and significant ramp-up in retail revenues esp. grocery; 2) inventory restocking for chemicals in India; 3) tightening in global fuel markets, as China caps domestic refining capacity until 2025; and 4) gas/oil production step up – all key to NAV expansion as net debt unwinds with higher OCF, despite our US$17bn annual investment forecast for the next three years

Exhibit 15: Sector Model Portfolio

			Perf vs. MSCI India	
Sector	**MSCI Wt (%)**	**OW/ UW (bps)**	**YTD**	**12M**
MSCI India			**7%**	**5%**
Consumer Disc.	11.7	500	22%	16%
Consumer Staples	9.2	-300	4%	5%
Energy	10.7	-300	-2%	-2%
Financials	27.6	600	-3%	-1%
Healthcare	5.3	-300	14%	13%
Industrials	7.4	400	3%	2%
Technology	12.8	300	-6%	-5%
Materials	8.5	-500	-5%	-2%
Comm Services	2.8	-100	7%	7%
Utilities	4.0	-300	-24%	-30%

Source: RIMES, MSCI, Morgan Stanley Research
Past performance is no guarantee of future results.

Exhibit 16: Focus List

Stock	Rating	Sector	Price as on 10 Nov 2023 (INR)	Market Cap (US$mn)	3M ADTV (US$ mn)	12M Perf	12M Perf (Rel to MSCI India)
FSN E-Commerce	OW	Cons Disc	150	5,136	11	-20.4%	-25.1%
Maruti Suzuki	OW	Cons Disc	10,389	37,667	65	14.2%	7.4%
Avenue Supermarts	OW	Cons Disc	3,798	29,667	17	-8.2%	-13.7%
Reliance Industries	OW	Financials	2,315	187,984	199	-0.9%	-6.7%
ICICI Bank	OW	Financials	939	78,946	171	3.1%	-3.0%
SBI Life Insurance	OW	Financials	1,355	16,286	15	9.5%	3.0%
Hindustan Aeronautics	OW	Industrials	2,059	16,527	38	69.4%	59.4%
Larsen & Toubro	OW	Industrials	3,033	50,043	72	53.7%	44.6%
Infosys	OW	Technology	1,369	68,000	93	-8.9%	-14.3%
UltraTech Cement	OW	Materials	8,711	30,128	33	28.1%	20.5%

Source: RIMES, MSCI, Morgan Stanley Research
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	Coverage Universe		Investment Banking Clients (IBC)			Other Material Investment Services Clients (MISC)	
Stock Rating Category	Count	% of Total	Count	% of Total IBC	% of Rating Category	Count	% of Total Other MISC
Overweight/Buy	1337	37%	270	43%	20%	594	39%
Equal-weight/Hold	1664	46%	299	47%	18%	700	46%
Not-Rated/Hold	3	0%	0	0%	0%	1	0%
Underweight/Sell	588	16%	61	10%	10%	220	15%
Total	3,592		630			1515	

Data include common stock and ADRs currently assigned ratings. Investment Banking Clients are companies from whom Morgan Stanley received investment banking compensation in the last 12 months. Due to rounding off of decimals, the percentages provided in the "% of total" column may not add up to exactly 100 percent.

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