Dear Investor,

We live in an extremely volatile world environment. Also, with the urge to focus on short-term performance, markets tend to react to near-term news flow in a more accentuated manner. These news flows can be driven by various factors, including geopolitical, domestic macro, and micro. Markets can get too excited about these events, when looked at from a microscope. However, over the long term, markets are driven by earnings, cash flow, and the sustainability of these parameters. Even now, the expectation of changes in US policies and the slow earnings growth has triggered anxiety in the markets.

After peaking at the end of September 2024, markets have been in correction mode. All indices including large, mid, and small; have corrected in the range of 12% and 15%. This so far is the biggest correction in markets for some time now. We believe that this correction is due to a confluence of factors - global and local.

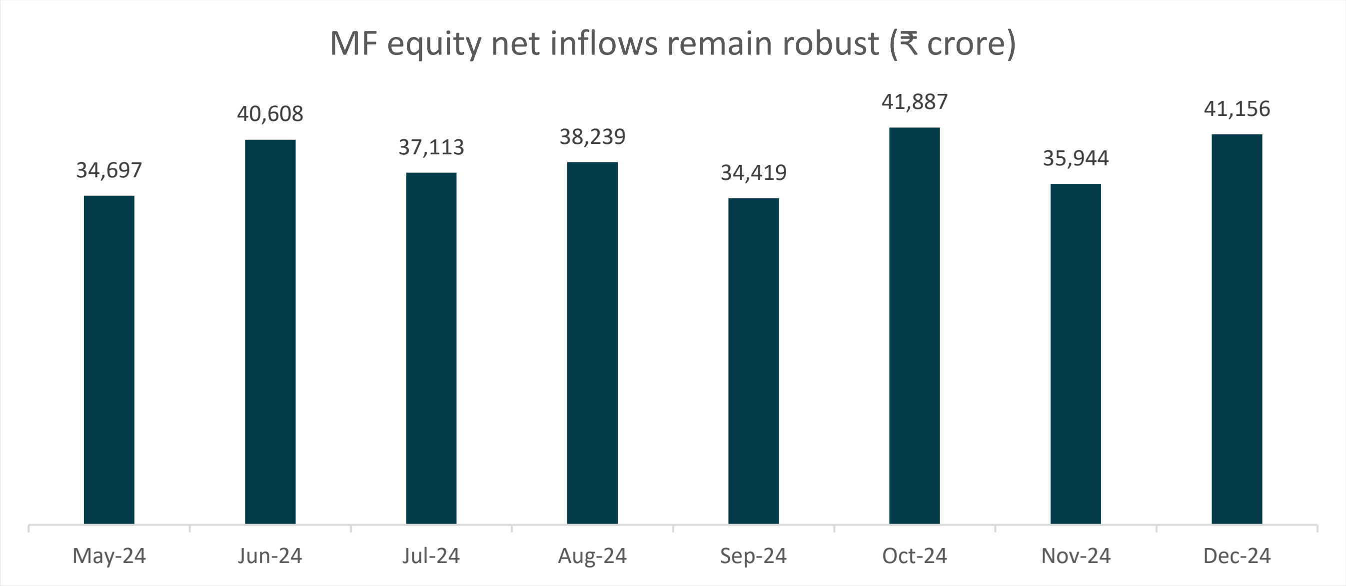
Over the last few months, there has been an outflow of global funds from India. Over the last 18 months, we have witnessed one of the biggest outflows from the domestic markets. Between October 2021 and June 2022, foreign institutional investors (FIIs) sold around ~USD 33 billion. During this period, markets tanked about 16%. So far, FIIs have offloaded about ~USD 18 billion. Also, the relative strength of flows into Indian markets, compared to the other 20 emerging markets (EMs), has been weaker.

Months - USD Million	India	Indonesia	Taiwan	Brazil	S.Korea
Oct-24	-10,428	-719	1,130	-453	-34
Nov-24	-2,680	-1,063	-8,045	-520	-32
Dec-24	1,321	-313	708	147	-16
Jan-25	-8,418	-229	-1,261	697	-10
Total FII outflow	**-20,206**	**-2,324**	**-7,468**	**-129**	**-92**

Source: ASK IM Research
Note: As on 31 January 2025

Currently, US-domiciled funds have been pulling money out from India following Trump's victory. This dollar carry trade reversal is visible across EMs, but India and China are witnessing bigger redemptions.

However, domestic flows remain undeterred despite the big correction in the markets over the last two months. In fact, inflows into small caps hit an 18-month high, defying the market weakness. Inflows in the midcap space also scaled to new record high of ₹5,100 crore in December 2024. Overall, active mutual fund inflows continue to remain robust with a monthly average of ₹38,000 crore since May 2024.



Source: ASK IM Research, AMFI

But it's important to note that a gradual shift is taking place from Thematic/Sector funds to more broad-based funds. Inflows into Thematic/Sectoral funds had given a boost to those stocks. Since that liquidity has slowed down, we have seen weaker trends emerging in these pockets of the market.

We believe FII sell-off in India has been triggered by:

- Global macro-economic conditions: The world is navigating a complex macro-economic environment with changing interest rate projections, rising geopolitical tensions, and an uncertain and diverse global growth outlook. India isn't the only EM that has seen FII outflows since September-end 2024. Since then, other EMs like Indonesia, Taiwan, Brazil, South Africa, Thailand and others have also seen continued outflows.
- USD strengthening: US dollar has seen broad based strengthening across markets. While Indian currency has depreciated by about 3.4% in the last four months, other major currencies have depreciated anywhere between 4% and 8%.

(Currency vs USD)	4-Month
India	3.4%
China	3.2%
Mexico	5.0%
Indonesia	7.7%
Brazil	7.2%
Thailand	4.7%

Source: ASK IM Research
Note: As on 31 January 2025

- Slowdown in corporate earnings: Last and the most important reason is the slowdown in corporate earnings growth.

What is the outlook on FII flows: Are market returns linked to macro or micro?

Many markets have delivered strong long-period GDP growth, but with limited market returns, while India has been different. India's returns have coincided with a strong GDP growth rate. This is a co-incidence. India's returns have performed more in response to strong corporate performance. There can be a lead lag effect, though.

As global volatility increases, we believe we are back to the basics of investing. Returns in businesses are a function of not only growth, but value-adding growth. The growth should be backed by superior return on capital employed (ROCE). And, the ROCE must be higher than the cost of capital. Companies with superior ROCE and their ability to deliver over the long period, are more likely to post superior returns over the long term. This also applies to countries. India scores relatively better than its peers on this count. On the ROCE curve, India is superior to many countries – as the structure of India's growth is not as much commodities but more value-added manufacturing or services – with relatively superior cash flows and return ratios.

Also, India been able to deliver superior returns over a long period, due its entrepreneurial culture. Many entrepreneurs are frugal, adaptive, and focused and have demonstrated their ability to fight the rapidly changing environment and deliver results. The ecosystem of superior demographic profile has helped in hiring employees that can deliver and also reduce costs.

Q3 FY25 business performance:

While the earnings season is in progress, companies primarily from the IT services and lending-oriented financials services have declared their quarterly numbers.

In the IT sector, results have largely met consensus expectations. However, commentary across companies varied significantly, resulting in notable differences in stock price reactions. Many IT firms are signaling a potential pickup in US demand by FY26. While the pickup is expected, it is off the low base of FY25, and most large IT companies would still deliver single-digit USD growth. Current INR depreciation should help margins (profitability) of IT companies in the short term. However, over the medium term, these benefits will be passed on to the clients. A key takeaway from the results is the arrest of declining manpower strength, and we should gradually see it inching up.

	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24
Absolute Change (YoY)	-49,277	-61,841	-68,047	-49,692	-17,200	5,839
Change (YoY)	-3.1%	-3.9%	-4.3%	-3.2%	-1.1%	0.4%

Source: ASK IM Research

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For banks and NBFCs, performance has been broadly in line with, or slightly below the consensus estimates. However, growing concerns about slowing credit growth have emerged.

On the discretionary consumption front, businesses have so far reported continued growth. Quick Commerce, though, has reported strong growth, but increased competitive intensity has resulted in impact on margins. Hotels or aviation companies reported a decent set of numbers. Staples companies have reported continued slow business. While the government capex was slow in the quarter gone by, cables and wires companies have continued with strong business growth.

In an environment of slow earnings growth, it is important to focus on bottom-up ideation – rather than a top-down approach. We believe select businesses in discretionary consumption, manufacturing and pharmaceuticals should do well.

- Consumption could benefit from improved hiring by IT companies (after almost 6 quarters), moderate inflation and continued income growth. Farm rural income should inch up due to high prices of agri commodities like wheat and rice etc. Non-farm-rural income could benefit from an increase in high government spends, driven by welfare expenditure of state and central.
- Manufacturing sector is expected to do well, driven by redrawing of supply lines globally, focus on import substitution and rebuilding or creating infrastructure in India and globally. Businesses operating in electronic manufacturing, energy transition, circular economy and, semiconductor sectors are expected to benefit.
- Pharmaceuticals: The focus is on the entire ecosystem of India branded, US generics, CDMO, Hospitals, Consumables and others.

At ASK, we have a sharp focus on high-quality and growth businesses operating in manufacturing, discretionary consumption and, pharmaceuticals, while being underweight on banks. We have focused on businesses that have execution prowess and ability to increase market share across varied business environments. Also, companies with value-adding (high ROCE) profit growth should continue to command a valuation premium. The focus has to be on growth, rather than pure cigar butt.

Happy investing.

Mr. Sumit Jain
Deputy CIO, ASK Investment Managers Ltd

Source: ASK IM Research and documents available in public domain