Dear Investor,

While Indian markets corrected sharply during the month, most of the global markets have been relatively stable. The possibility of a trade war has made Indian investors jittery. The Nifty50 index is down ~5% for CY25TD and is down 14% from the recent peak in September 2024.

The broader markets are witnessing steeper correction, with mid-cap and small-cap indices down 20% and 22%, respectively, from the recent peak. The PSU Index is down 28% from its peak on July 31, 2024. Utilities, Energy, Realty, PSU Banks, and Capital Goods have witnessed drawdowns in the range of 25% to 32% from their respective peaks. Financials and Private Banks have declined relatively less – down only 7.5% from their peaks.

In sharp contrast to the Indian markets, the US, European, Korean and Chinese indices are up in the range of 1% to 10% CYTD and the Japanese index is almost flat. The MSCI World Index is up 3% CYTD. Gold is also up 10% in USD terms.

So, let us dwell on key concerns of domestic investors:

1. What are the reasons for this correction?

We believe a confluence of multiple factors has contributed to this decline including:

- Uncertainty in global trade
- Slowdown in India macro
- Slow recovery in India Inc profit growth

Uncertainty in global trade:

- In his second term, President Donald Trump has intensified his protectionist trade policies, implementing significant tariffs aimed at reshaping the United States' economic relationships.
- Trump has also talked of reciprocal tariffs. India exported nearly $74 billion worth of goods to the US, with key sectors being pearls, gems, pharmaceuticals, and petrochemicals. Trump has also declared his intention of imposing a 25% import tariff on automobiles, pharmaceuticals and chips. This could have major ramifications for the Indian pharma and auto-ancillary sectors and could also hit the budding chip manufacturing space.
- The tariff talk, under the Trump administration, has triggered volatility in global currency markets, with emerging market currencies bearing the brunt of trade-related uncertainties. The U.S. dollar has strengthened as investors seek safe-haven assets amid escalating trade tensions.

- However, we do not believe that the final outcome will be disruptive. Supply chains are built over a long period. Change, if any, will also be gradual. India, due to its intellectual manpower and low-cost manufacturing, has advantages in multiple sectors including gems and jewellery, pharmaceuticals, chemicals, automobiles and many more.

Slowdown in Indian macro:

- In Q2FY25, India's GDP growth declined to 5.4% YoY, from close to 7% levels, that it has been maintaining. A major slowdown in government spending in the first eight months of the current financial year has been the key contributor. Also, the subdued consumption growth has continued.
- The 2025-26 Union budget has raised worries regarding the growth trajectory of government capital expenditure. The Budget took a more balanced approach regarding consumption and capex spends.
- That said, we believe the activity levels are gradually picking up. After the lull for the first eight months, central government spending revived in December 2024. It has grown by 1.74% FYTD Apr-Dec 2024 versus a decline of 12.3% FYTD Apr-Nov 2024. Likewise, we have seen some improvement in the pace of spending by 19 large states of India from a decline of 5.8% FYTD in Apr-Nov 2024 to growth of 3.6% FYTD in Apr-Dec 2024.
- Moreover, there is a re-orientation of sectors – from roads and railways to power, urban infrastructure, ports and water due to the higher requirement of infrastructure in these areas. Thus, we see the GDP growth picking up in the coming quarters.

Slow recovery in India Inc profit growth

- Overall, BSE500 stocks reported earnings growth of about 7-8% YoY; this would have been double-digit growth but for the commodity-oriented sectors where we saw a 3% YoY decline in earnings.
- Smallcaps in the BSE 500 index saw a decline in earnings for the second quarter in a row, clearly showing that the time to play smallcap is when economic activity is accelerating and being very selective in small caps when economic activity is slowing down.
- In line with the pick-up in the GDP growth, earnings growth should pick up as well over period. The cement demand is picking up and prices have stabilised; a pick-up in the government capex should help the infrastructure companies; reduction of taxes for the middle class could lead to a demand pick-up in retail, quick commerce, online food delivery, quick service restaurants, hotels, real estate and airlines and also boost automobiles and consumer durables demand.

2. Is the capex cycle losing steam?

While the activity has been slow, it should pick up going forward. We continue to believe manufacturing in India for India and for the world is a long-term opportunity. Sectors like power, energy transition, electronic manufacturing, infrastructure investment and many more should continue to see investment activity going forward.

3. Is urban and rural consumption demand improving?

In the last results season, most of the corporates have spoken about improving rural demand. While urban demand has continued to remain muted, corporates expect urban demand to gradually recover due to lower inflationary pressures. Moreover, the rate cut (and more expected) and the tax sops announced in the recently concluded Union Budget could further aid demand.

4. Will FII equity outflow persist?

While it is always difficult to predict short-term behaviour, India has already witnessed a large outflow. In the last four and a half months, FIIs have already withdrawn more than $20 billion from the Indian market. FII ownership in India is now at 16%, a decadal low. We believe outflow should recede as Indian market valuations are relatively more reasonable, and India's economic and profit growth should improve, driven by fiscal and monetary impulses.

5. In this scenario, what are sectors to focus on at current juncture?

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

- Consumption businesses should benefit from moderate inflation and continued income growth. Government tax cuts and lower interest rates should also help.
- The manufacturing sector is expected to do well, driven by redrawing of supply lines globally, a focus on import substitution and the rebuilding or creating infrastructure in India and globally. The businesses operating in electronic manufacturing, energy transition, circular economy and semiconductor, are expected to benefit.
- Pharmaceuticals: The focus is on the entire ecosystem including India branded, US generics, CDMO, Hospitals, Consumables and others.

6. What should be the investment style?

We believe we are back to 101 of investing. While profit growth for India Inc should improve going forward, we may not be back to the 20%+ growth seen in the last few years. As growth becomes relatively more difficult to come by, markets should start to see valuation polarisation in those businesses that can execute well, keeping a very mindful eye on capital efficiency. Markets should move from pure P&L to P&L and Balance Sheet and Cash Flow, as money raising from markets may get difficult. The growth has to be more self-funded.

At ASK, we have always focused on businesses that have secular opportunities, run by management that have execution prowess, and have the ability to show value-adding growth i.e. growth backed by superior capital efficiency across cycles. The quality of businesses and management continues to remain a strong focus of our investment philosophy. We continue to remain focused on businesses that can stand test of time.

Happy investing.

Sumit Jain
Deputy CIO, ASK Investment Managers Ltd

Source: ASK IM Research and documents available in public domain