India's equity valuations built on fundamentals and rising domestic equity savings[1]

India's equity markets have registered strong performance as the NSE Nifty 50 Index ("Nifty") is up 24% year-to-date (USD), which outstrips both MSCI Asia and MSCI Emerging Markets. Valuations have increased along with the market's rise: the Nifty's current one year forward price to earnings (P/E) ratio is 16.5 times, about 10% higher than its 10 year median[2].

The market run-up has caused questions among some investors regarding valuation levels and the trajectory of the current rally. Our Indian equities specialist Rana Gupta believes that current premium valuations levels are sustainable due to prospects of better earnings starting from the second half of financial year 2018 (i.e. the fourth quarter of calendar year 2017).

Summary

- We believe current equity valuation levels in India need to be viewed in a greater context: strong projected future earnings growth momentum, sustainable economic growth due to transformative economic reforms and increasing capital inflows into the financial system and equity space.

Future projected earnings momentum

India's equity market valuation levels should be assessed in the larger context of projected future earnings. Two main factors will drive future earnings: 1) supportive government policy; and 2) a rebound in corporate profits.

Future earnings momentum will be supported by government reforms such as:

- Efficiency gains as businesses formalise;
- Market share shifts to organised sector as a result of formalisation;
- Better and targeted government investments as a result of improved tax collection;
- Productivity improvement in rural India due to various targeted government programs and spending

Rebound in corporate profits

A rebound in corporate profits will also support earnings growth. Indeed, we believe corporate profits may increase over the next two years from current cyclical lows. As Chart 1 illustrates, corporate profits as a percentage of GDP reached a nadir in 2016 at 2.9%, below the average level of 5%. We expect corporate profits to rebound as cyclical factors, such as droughts and low levels of bank lending, reverse over time.

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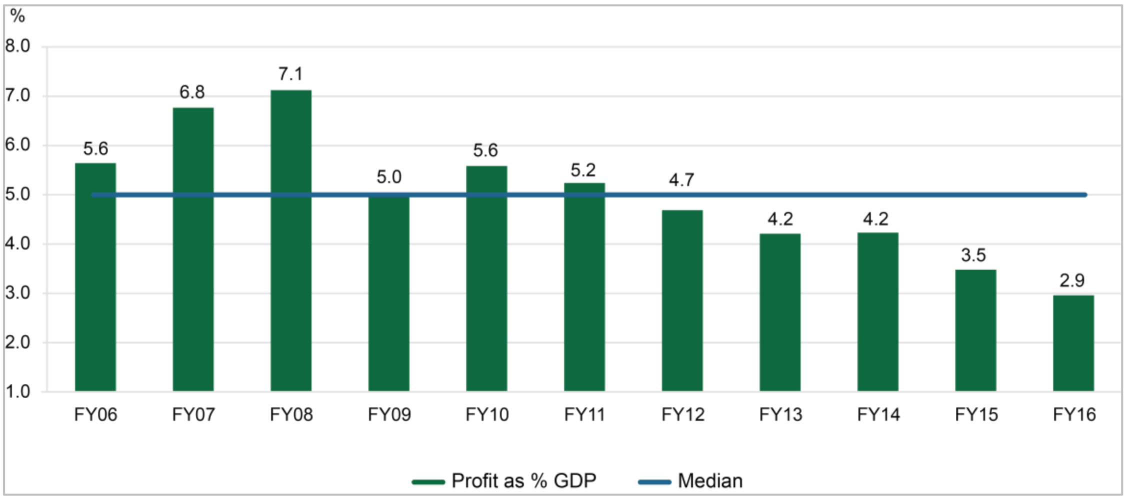
[1] Equity savings refer to Indian household financial savings invested in mutual funds and direct equities.
[2] Bloomberg, as of 1 June 2017. The historical median PE is calculated from April 2006 to May 2017.

Chart 1: Corporate profits as a percentage of GDP, 2006 to 2016[3]

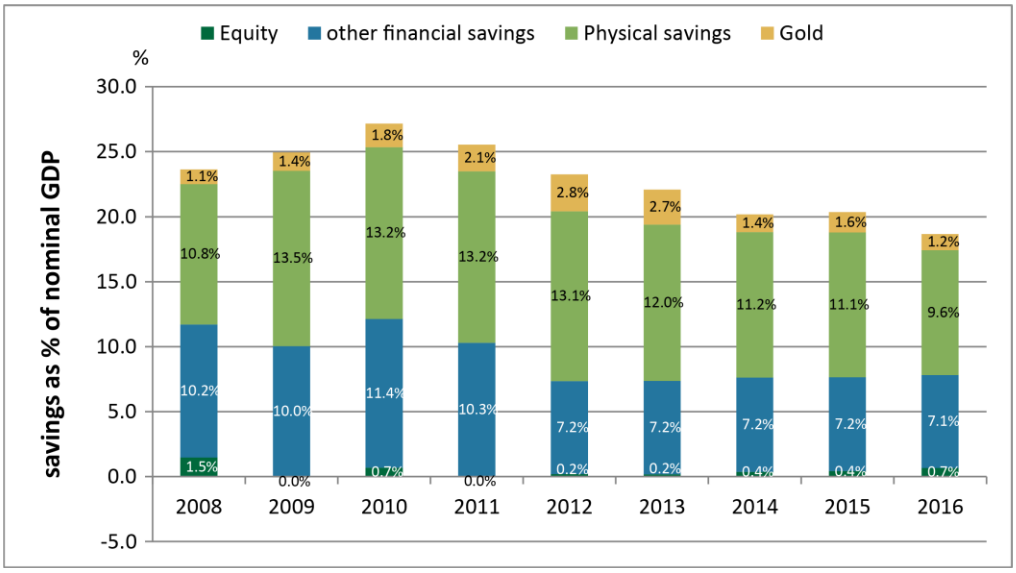


Rise of Equity Savings

Reform promotes financial savings

Due to government reforms, we believe that households' (HH) financial savings are poised to rise. This is due to a crackdown on cash transactions and lower inflation. Higher HH financial savings will result in more flows to the financial sector. As Chart 2 indicates, after hitting a low in 2012, the aggregate of other financial savings and equity's share in savings has gradually increased as a percentage of nominal GDP. This trend may continue as formalisation of the economy deepens.

Chart 2: Savings as a percentage of GDP, 2008-2016[4]



[3] CMIE, CLSA, as of May 2017.

[4] Reserve Bank of India, Ministry of Commerce, Kotak Institutional Equities; savings' data are as of September 2016, GDP data as of January 2017.

Moderate inflation drives financial savings and domestic fund flows

Apart from economic formalisation, moderation of inflation will also be a powerful driver to increase future financial savings. Since the liberalization of the Indian economy in the 1990s, financial savings have had a lagged inverse relationship with inflation: periods of moderate and lower inflation are associated with higher levels of financial savings. Based on that historical relationship, inflation has decreased over the past few years without a substantial change in gross financial savings- an increase in financial savings may be on the horizon.

Furthermore, as rates in the banking sector have come down along with inflation, households have been allocating more savings to domestic mutual funds. With interest rates likely to remain lower over a longer time period due to reduced government borrowing, incentives to invest may increase providing further support for the equity rally.

Portfolio implication

Although current equity valuation levels in India are above their historical median, our view is that they need to be in put in context of potential future earnings momentum. We expect earnings momentum to improve in the near future.

We remain positive on Indian equities, including domestic sectors such as financials (midsized private banks and insurance & wealth management), consumer discretionary (passenger cars, white goods, retail), and building materials/home improvement (cement, plastic, chemicals, light electrical).

We are underweight on numerous sectors: export oriented sectors such as information technology and health care, as well as global cyclicals such as energy and metals. We are also cautious on domestic sectors that include utilities and telecom.

Risks

We will be following numerous issues over the near-term:

- The implementation of GST on 1 July may lead to transient issues, such as trade channels that are expected to destock before implementation and restock after;
- The monsoon season, particularly from July to August, should also be watched. Although its importance to rural growth is declining, it is an important driver of economic and market sentiment;
- Finally, as a large importer of crude, a higher oil price would also pose risks to the economy.