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Why investors should look at Indian assets

Domestic demand, 'Make in India', and possible inclusion in fixed income indices

Document for the exclusive attention of professional clients, investment services providers and any other professional of the financial industry

Confidence must be earned

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- *India is the fifth-largest economy in the world, according to the World Bank, in terms of nominal 2019 GDP in dollars, and ranks second by population (1.38bn). Although it is one of the world's fastest-growing economies, its GDP per capita is more than 29x and 4x lower than the USt or China, respectively (also according to the World Bank, nominal 2019 per-capita GDP in dollars). The potential for a catch-up in income over the next decades looks huge.*
- *There have been* ***several developments that could help reshape initiatives the economy and unlock its long-tem potential****. Different government inititiaves are in place to reinforce and modernise the economic structure to facilitate: 1) a* ***shift from an unorganised to a formal economy****, working in favour of setting up new businesses and attracting investment; 2) financial inclusion and modernisation of the financial sector to channel the highest gross savings rate (30%) after China (46%) into efficient financial instruments; 3) a broad set of* ***structural reforms*** *affecting a vast majority of sectors and offering significant benefits to the country in the medium to long term; and 4) a huge* ***infrastructure development plan of $1.5tn****, which could help to support growth through investment and productivity channels.*
- ***India enjoys favourable demographics.*** *The demographic dividend's opportunity window is available until 2055-56, longer than for any other country in the world. This could support the development of the middle class and a strong domestic market.* ***With over 67% of its population working age, India could supply more than half of Asia's potential workforce over the coming decades.***
- ***The recent budget is a milestone in creating a favourable framework for economic recovery.*** *Capex is increasing, with a focus on infrastructure and initiatives, like the 'Bad Bank', supporting the corporate recovery. Sectors such as construction, steel, power, pharmaceuticals and healthcare should benefit from this pandemic budget.* ***The new fiscal policy stance goes in the right direction to help the long-term growth plan*** *and overcome execution issues.*
- ***We believe the modernisation of the Indian economy may open up opportunities for global investors in the medium term.*** *The equity market is liquid and fast-growing. It includes among the highest number of stocks with market caps above $500m and among the highest number of stocks that quintupled in the last 10 years.*
- ***'Make in India' and 'internal demand play' are our key convictions.*** *Government efforts to ease doing business – the country's rank has improved considerably in the last few years – could impact property developers, healthcare (diagnostics sector), engineering and construction contractors, and, more globally, the retail and consumer sectors. Industrials and manufacturing should benefit most from reforms and 'Make in India' initiatives. Auto and components should also be a significant beneficiary, followed by pharmaceuticals. In industrials sectors, automation for industries is likely to experience exponential growth. Financialisation of savings might have a key role in the development of the asset management industry and insurance sector, playing on the Indian narrative of upscale of mass affluence and elite incomes.* ***One sector in which India is a global champion is IT outsourcing services.***
- *The Indian market could be attractive as a* ***diversifier in a global equity portfolio,*** *as its correlation with global equity has been relatively modest, especially China equity.* ***For investors willing to seek exposure to the EM domestic demand story, India could be a good complement with China equity in the EM universe.***
- *However, the market is very fragmented. Thus, the* ***selection of a good active manager in India equity could make a real difference****, considering the huge performance dispersion between good managers and mediocre/bad ones.*
- ***Global investors could look at opportunities in the fixed income market.*** *This is under-developed compared to the equity market, and is dominated by government securities. Recent reforms to improve liquidity and depth are paramount to make it more attractive to global investors. India is the largest 'off-index' government bond market with the scale to reach a 10% allocation of JP Morgan's GBI-EM Global Diversified index.* ***Based on recent developments, Indian government bonds could eventually be included in the index****, leading to an acceleration of capital flows, as happened for China in 2019-20.*

The Indian way to unlock huge potential

The recent approval of the budget has refocused investors' attention on a country facing a huge transformation. We believe India could play a growing role in the global economy in coming years. The country is ready to unlock strong potential through a number of important initiatives which are often interconnected:

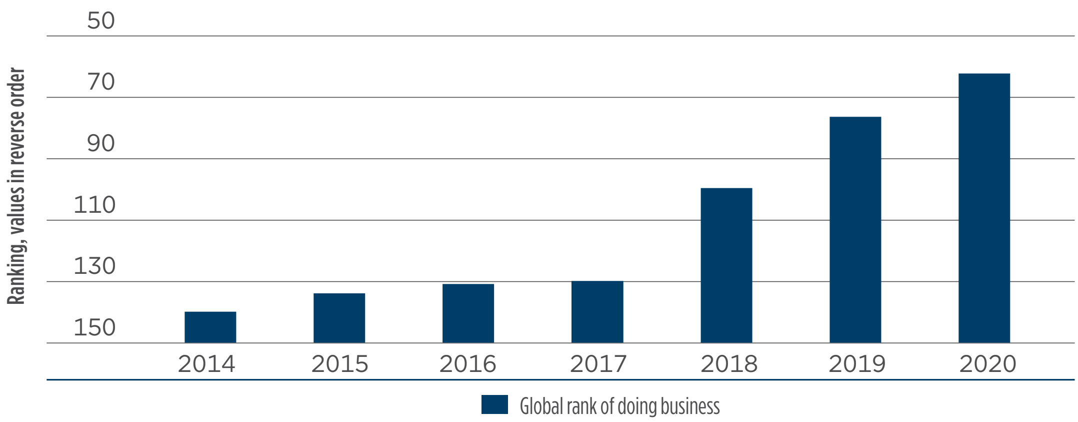
- **A shift from an unorganised to a formal economy**, attracting investment and business;
- **A step towards financial inclusion** and modernisation of the financial sector;
- **A wide range of structural reforms**, with a wide range of sectors involved;
- A large **infrastructure plan**, with a multiplier effects on the entire economy; and
- **A favourable demographic dividend**, supporting growth in the next decades.

Shift from an unorganised to a formal economy, attracting investment and business

"The unorganised sector is contributing nearly 50% to India's GDP and employs a whopping 85-90% of the labour force".

Historically, the Indian economy has been characterised by a relatively high share of the unorganised sector[1] contributing nearly 50% to GDP and employing a whopping 85-90% of the labour force. Key factors contributing to the dominance of the unorganised sector and small firms is a plethora of laws governing large firms. Other factors contributing to the continued persistence of the unorganised sector and small firms were surplus workforce, a high tax regime, and labour regulations/compliance costs. These drivers have not only allowed the informal/unorganised sector to compete vs the formal, but in a number of industries have created extensive linkages between the formal and informal sectors – eg, via contract labour – that reinforce the informal sector. **The game changer for a shift towards a formal economy is the government's various policy initiatives** – streamlining of corporate taxes and business regulations, corporate tax reductions in 2019, and implementation of goods and service taxes, among others – that are likely to propel this shift. The government's **sharpened focus on improving the ease of doing of business in India** and its concrete initiatives – such as tax reforms, single window clearances, and higher FDI – may aid substantially any business setting up in the organised sector.

Figure 1. India's ranking in Ease of Doing Business index



Source: Amundi, Bloomberg. Data as of 26 February 2021.

[1] The terms unorganised/informal sector are used inter-changeably in the India context. According to India's National Commission for Enterprises in Unorganised Sector (NCEUS), the "unorganised sector consists of all unincorporated private enterprises owned by individuals or households engaged in the sale and production of goods and services operated on a proprietary or partnership basis and with less than ten total workers" (GoI, 2007).

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"Thanks to the government initiatives to reduce the weight of the informal sector, India may climb the rank of the Ease of Doing Business index, which should help with attracting investment".

These reforms, in conjunction with booming e-commerce and an expanding aspirational middle class, could undoubtedly move the pendulum emphatically in favour of organised players, offering them opportunities over the next five to 10 years. In addition, there were certain key developments during 2020 that may further catalyse the unorganised-to-organised sector shift.

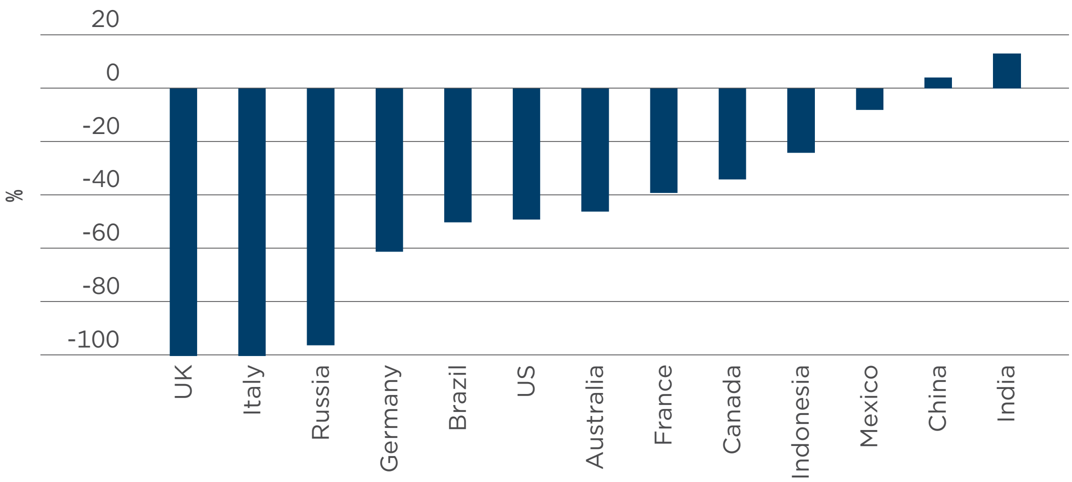
Revamp of labour laws: In 2020, the government laid out a plan to revamp the country's archaic labour laws and consolidate them into four labour codes. Implementation is likely to start from 2021. While the new labour laws bring about a vast multitude of reforms, most importantly, **they reduce the scope of trade unions and allow easy firing policies for firms with fewer than 300 employees as opposed to 100 previously.** They simplify a host of knotty aspects of Indian labour laws that were found to be a major hindrance for foreign firms with regard to setting up manufacturing units in India. Furthermore, **the code envisages an increase in the applicability of social security benefits** to a vast array of workers who are not yet covered and also make it mandatory for companies to provide formal letters of employment thereby driving the formalisation of a documented workforce in India.

Improvement in GST platform: In 2017, India revamped its indirect tax regime to implement a GST (Goods and Service Tax) which was aimed at **creating a uniform tax rate across the various states in India and consolidated multiple taxes into a single tax structure.** In addition, the constituents parts of the GST were aimed at creating a trail of transactions. At every level, traders have to register invoices to claim input tax credits. Also, the entire process could soon move online, bolstered by an IT infrastructure. During the first three years of implementation, the new tax regime experienced several implementation bottlenecks particularly with regard to online tax filing and invoice matching. However, these challenges have been ironed out over the years, and one **could see a significant improvement in compliance and hence tax collection since the latter half of 2020.** Once the tax structure is fully in place, the integration of state and central indirect taxes could also provide a comprehensive profile of taxpayers, making it difficult for firms which had higher profit purely on the grounds of tax evasion.

"700m Indians could be online by FY23, creating fertile ground for e-commerce marketplaces to gain scale".

Surge in FDI: Recent liberalisations in FDI processes have resulted in a **surge in foreign capital flows** into the economy across the manufacturing and services sectors. FDI inflows, particularly in the retail sector, could play an important role in increasing the contribution of the organised sector in the domestic economy by bringing in new scalable business models and technologies.

Figure 2. Changes in FDI inflows for selected top-recipient economies: 2020 vs 2019



Source: Amundi on UNCTAD. Data as of 24 February 2021. Note: UK and Italy saw decreases of over 100% due their negative FDI flows in 2020.

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"Simplification in the labour market and tax collection, along with improving infrastructure and FDI liberalisation, are key drivers of the modernisation of the Indian economy".

Improving infrastructure, booming e-commerce: The government is investing heavily in roads, railways and ports to eliminate India's infrastructure bottlenecks and support economic growth. **This is reflected in the 18% CAGR in infrastructure spending over the last six years (FY15-FY21).** Improved infrastructure is very likely to deepen organised players' reach and help them to compete effectively with regional players. Moreover, the e-commerce boom has revolutionised the distribution reach of organised players and spurred demand for their products. This channel has been surging in India, altering the way people purchase and sell goods and services.

Online favours aggregation and formalisation: With new FinTech companies as well as legacy banking institutions expediting the rollout of infrastructure to support digital payments, the JAM framework (Jan Dhan - Aadhaar - Mobile) is a potentially substantive platform leveraging technology to accelerate momentum further. **Declines in smartphone and wireless broadband prices are expected to bring over 700m Indians online by FY23, creating fertile ground for e-commerce marketplaces to gain scale, similar to the experience in China.** Online economics favour aggregation/formalisation in unorganised segments (like taxis, household services, food delivery, travel bookings, etc) and by extension this improves productivity and wage growth. Also, a preference for branded products is gaining ground, with a rise in consumer preferences for shopping from organised retail locations like malls and large format stores, potentially leading to bright prospects for organised products. Further, the **Covid-19 pandemic appears to have had a more significant negative impact on MSMEs (and unorganised sector firms) while most large corporates seemed to have weathered the crisis well by rationalising their cost structures and adapting faster to the changing operational needs post-Covid-19.**

Owing to all the above factors, we believe that India could continue to witness a gradual shift whereby the organised sector (and particularly listed firms) could see their top lines grow due to increased market shares. Such a situation could already be seen for property developers, healthcare (diagnostic sector), tiles, pipes, engineering and construction contractors, retail and cinema **The organised sector typically tends to be more productive than the unorganised sector, and productivity is higher for larger enterprises vs smaller ones.** Hence, logically, profitability growth in these sectors should be higher than revenue growth, led by economies of scale/operating leverage. The World Bank has found that high growth itself leads to a gradual shrinking of the informal sector, as employment in the formal sector grows with rising demand. **We believe that if India is able to continue on this path of formalisation, minimising the socio-economic disruptions within the process, then productivity gains could be non-linear.** As more and more Indian firms aspire to compete at a global level, they could have to attain economies of scale and productivity thresholds. Government policies to support formalisation would help them to help achieve those objectives.

A step towards financial inclusion and modernisation of the financial sector

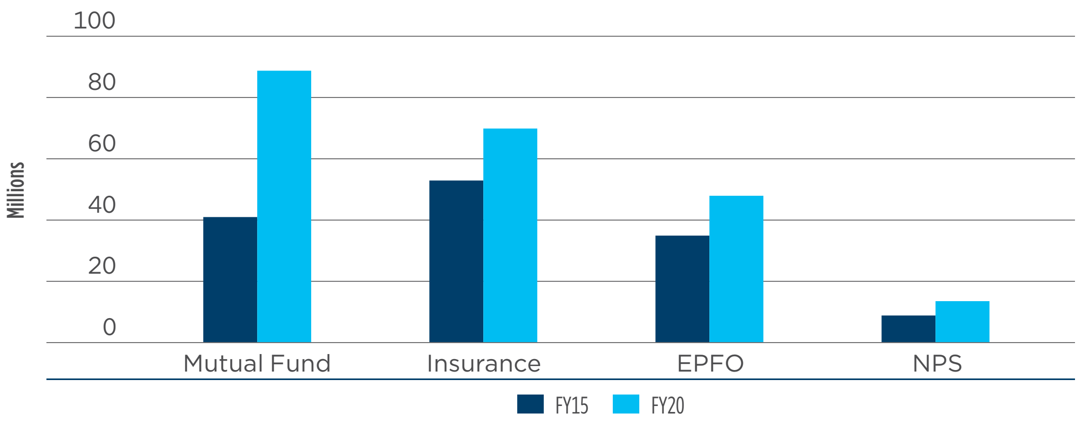
"We believe that India could continue to witness a gradual shift whereby the organised sector (and particularly listed firms) could see their top lines grow due to increased market shares".

India has seen increased traction of long-term financial savings products over the last six to seven years. Consequently, all the channels of financial savings – be they pension funds, insurance or mutual funds – have seen their AuM grow at handsome rates. There was a confluence of factors, such as positive real savings rates (owing to moderating inflation), reduced attractiveness of real estate (and hence bearish real estate cycle) and increased awareness (a behavioural shift), along with government actions to formalise the economy (thereby ensuring a larger worker base for pension and insurance products) that favoured the financialisation of savings. While it is difficult to show concretely, we believe that regulators have also played an enabling role by improving the governance structure of the financial sector, which is extremely critical for revamping credit growth. The code of conduct and governance structures have undergone a sea change across the pension funds, insurance and mutual fund industries. Finally, the adoption of digital platforms and internet penetration have also supported better marketing of financial products, whereby savers could track the performance of their savings and make more intelligent decisions.

"India has the second-highest gross savings rate (30%), after China (46%), yet the penetration of long-term saving products is exceptionally low".

The Indian asset management space is ripe for rapid growth, in our view, due to factors like low penetration, increasing financial awareness, and the move to use of financial assets. **India has the second-highest gross savings rate (30%) globally, after China (46%), yet the penetration of long-term saving products is exceptionally low.** The total number of portfolios held by retail and HNI is just 6.6% of the total population base in India. AuM for the mutual fund industry is 16% of GDP ($42bn) while it is over 100% for the US. Similarly, the number of EPFO and NPS (the two key pension/ provident fund instruments) subscribers stands at 61m, just 15% of the working population. Insurance sector penetration is estimated at 4% of the population.

Figure 3. Long-term investment products still under-owned



Source: Amundi on AMFI. Data as of March 2020. EPFO and NPS are two different pensions schemes, employees' pension fund organisation and the national pension system.

The **government has become aggressive in pushing for the formalisation of jobs and hence asking salaried employees to subscribe to pension, provident and insurance products.** The new labour codes, slated to be implemented this year, envisage a significantly expansion in the scope and coverage of pension and insurance funds in India. **Further, while the last decade was weak in terms of job creation, we think that the coming years hold significant promise for job and income growth in India owing to the infrastructure push, the focus on domestic manufacturing, and signs of a revival in real estate.** These sectors are labour-intensive. The rise in job and income creation could itself act as a natural force for augmenting overall household savings, both physical and financial.

The risks to these expectation could be seen in a stronger-than-expected real estate recovery. So far, while the sale of residential units has picked up post Covid-19, prices are still low and the potential for price appreciation is still a couple of years away. A stronger-than-expected price recovery could lead some investors to shift away from financial savings (particularly mutual funds) to physical assets. Secondly, we do not see any material reflation thesis playing out in India so far. A high inflation environment historically is seen to favour physical over financial assets. While these are a few cyclical risks to be aware of, **the structural forces still appear to favour continued financialisation of savings in India.** At this point, it might also be critical for industry experts to carefully anchor household expectations so that realised returns match expected returns on savings.

A wide range of structural reforms across sectors

Table 1. A wide range of structural reforms

Sector reform	Description and purpose	Main benefits
Re-defining MSMEs (micro, small and medium enterprises)	New definition has increased turnover and investment limits for being classified as a MSME.	Facilitates expansion and could aid growth for MSMEs.
Mining sector measures	Reforms aim to increase participation of the private sector, redefining the norms and standards of exploration.	The main objective is to reduce dependence on imported coal, attracting private investment.
Production-linked incentives	Production linked incentives schemes have been implemented in 10 key sectors to make Indian manufacturers globally competitive.	Make India an integral part of the global supply chain via cutting-edge technology to help ensure efficiencies, create economies of scale, and enhance exports.
Privatisation of public sector enterprises	The proposed privatisation of public sector enterprises in non-strategic sectors recognises the need for efficient allocation and use of resources.	This reform is intended to bolster the productive capacity of the economy and create wealth and jobs, especially at the bottom of the pyramid.
Agriculture	This is mainly intended to a) end the monopoly of APMCs (Agricultural Produce Market Committee) in India when it comes to the sale of food grains and other MSP (minimum support price) based crops; b) allow farmers to sell their produce to anyone across the country (previously restricted to the APMC) and enter into legal contracts with private buyers; and c) ease the limit of stocks of essential commodities, thereby allowing businesses to scale up their warehousing and food processing units.	The new laws are likely to simplify agri-trading, encouraging private players to build their own supply networks, reducing overall procurement costs; reducing the differences in availability in food items across countries; and increasing investment and value added in agriculture.
Labour market	The new labour code, the Social Security Code, and the Industrial Relations Code bring significant changes to enable employment generation by giving employers relatively increased flexibility the and freedom to hire and fire.	The reforms and the simplification of laws allow for easier understanding with regard to both employees and employers.
Product-linked incentives	PLI scheme aims to incentivise domestic electronic manufacturing. It has also been extended to the pharmaceutical sector.	The scheme could influence existing players to add and expand capacity.
Raising FDI in defence	The country is one of the world's largest arms importers. About 40% of the defence budget is spent on capital acquisitions. The government is the sole purchaser of defence equipment, allowing FDI ownership under automatic route (it does not require prior approval from the government or the Reserve Bank of India).	The increase in FDI limits could be positive for technology sharing in the sector.

Source: Amundi, SBI. Data as of February 2021.

"$1.8tn infrastructure pipeline, based on 7,584 projects, with the aim of modernising the country over the next five years".

A large infrastructure plan, with a multiplier effect on the entire economy

In 2020, India approved **a national infrastructure pipeline, with projects guided to be worth 111 trillion rupees ($1.5tn) to be executed over FY2020-25. This has now swelled to $1.8tn, including 7,584 projects, as of 15 February 2021.** As per government-provided details, 40% of these projects is at some stage of implementation (1,752 projects) and 20% under development, with the remaining 40% still in a stage of conceptualisation. **Post Covid-19, the government further realised the importance of stepping up infrastructure spending**, owing to a relatively higher multiplier effect associated with it. The government of India has also developed an initiative, the 'India Investment Grid (IIG)', to showcase investment opportunities across states and sectors in India which is accessible on a single interactive platform. The platform is a repository of various NIP projects.

The government has laid out clear budgetary allocations for various sectors. Further, government proposes to create a Development Financial Institution, with an initial equity outlay of Rs 200bn, to support faster execution of projects that are not facing any other issues. In addition, while the budget does not account for a material pick-up from PSUs' (public sector undertakings) capex, we believe the government is likely to nudge them so that asset monetisation could drive further capex, which could provide further boosts to investor expectations.

Infrastructure development helps support growth through both investment and productivity channels. An increase in spending on investment targeted at infrastructure could lead to higher demand for goods and services, and to job creation in both the building and potentially 'operating' these assets. **The income/wages generated by the increased demand are then spent elsewhere, resulting in a so-called 'fiscal multiplier' effect.** On the other hand, an increase in productive capacity resulting from better roads, faster trains, bigger ports, more reliable power supplies, and broader wireless access could have a longer-term 'supply side' effect on growth.

Three key factors that had adversely impacted India's infrastructure spending in the recent past included: a) stretched government finances for central and state governments; b) onerous land acquisition laws; and c) stringent environmental clearances. In fact, while output market reforms progressed well in India, the situation was not as far along with regard to reforms for input markets. These factors led to delays and cost over-runs at different stages of project completion, thus impacting the viability/returns on existing and new investments. In addition, the availability of crucial inputs (coal, steel, etc) and high interest rates could also be considered to have been dampeners. In the recent cyclical downturn, the twin balance sheet problems of overleveraged infrastructure companies and banks struggling with NPAs also contributed to slow infrastructure spend. That said, both these issues have largely been addressed now.

"Stepping up infrastructure spending is a critical objective, owing to a relatively higher multiplier effect associated with it".

Even though direct support from the government budget for infrastructure sectors is still capped, government has tried to exploit other sources (such as DFI, external financing, and the public-private partnership route) to fund the infrastructure needs of the country. Public and private Infrastructure Non-Banking Financial Companies (NBFCs), like Power Finance Corporation and Rural Electrification Corporation, have also been contributing towards infrastructure funding. Insurance companies could be another provider of long-term infrastructure finance. **Life insurance companies are mandated to invest 15% of their funds in infrastructure.** With better insurance penetration, the insurance premium-to-GDP ratio could move up, further aiding infrastructure funding. This may help in releasing management away from stressed assets recovery and could expedite the process given that a single entity could be driving decision-making as a lender (vs consortiums in most stressed pre-Covid-19 assets). Also, balance sheets of PSU banks could see meaningful changes in optical asset quality in raising external equity capital and focussing on credit growth to riskier sectors (like infrastructure).

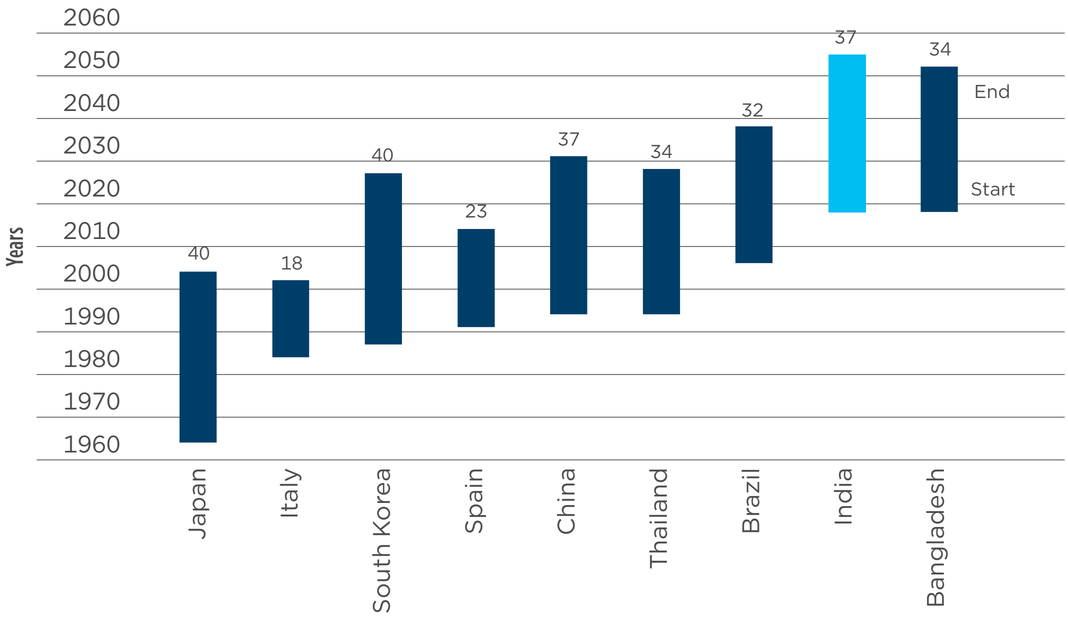
Infrastructure investments are unlikely to be constrained by funding requirements on either the debt or equity side. The orderly execution, profitability and demand for these infrastructure projects might determine whether infrastructure could again become a primary driver of investment growth. **So far, the government has made considerable progress in addressing these execution challenges, such as attempting to create the process of single window clearance, identifying 'shovel-ready' projects.** These continued efforts could be critical for orderly and timely execution, and with regard to avoiding any cost overruns.

A favourable demographic dividend, supporting growth in the next decades

According to the UN Fund for Population Activities (UNFPA), demographic dividend means "the economic growth potential that could result from shifts in a population's age structure, mainly when the share of the working-age population (15-64) is larger than the non-working-age share of the population (14 and younger and 65 and older)". India is on the right side of the demographic transition which provides an opportunity for its rapid socio-economic development, if policymakers align developmental policies with this demographic shift. **The country has one of the youngest populations in an aging world.** In 2020, the median age in India was 28 compared to 38 in China and the US, 45 in Western Europe, and 48 in Japan. **The window of demographic dividend opportunity is available for five decades, from 2005-06 to 2055-56, longer than for any other country in the world.**

"India has one of the youngest populations in an aging world. The window of demographic dividend opportunity in India is available for decades".

Figure 4. Period of demographic dividend across economies



Source: Amundi on United Nations Population Fund (UNFPA) study, data as 2019.

With over 67% of its population working age, **India could supply more than half of Asia's potential workforce over the coming decades.**

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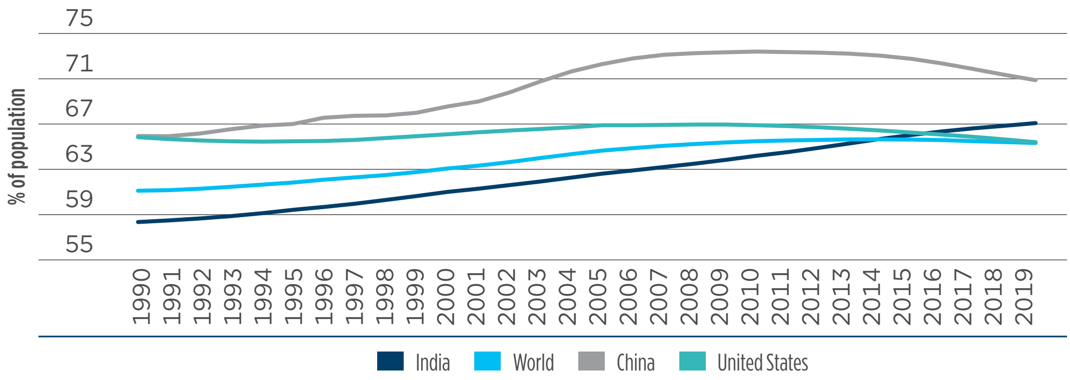
"With over 67% of its population working age, India could supply more than half of Asia's potential workforce over the coming decades".

Figure 5. Working-age population (aged 15-64) as a share of total population



Source: Amundi on World Bank data as of February 2021.

Historically, a country's demographic dividend is seen to be aiding better economic growth brought about by increased economic activities due to higher working age. A larger labour force is expected to enhance the productivity of an economy and should lead to higher domestic savings rates. It also tends to faster development of a middle-class society, ie, a rise in an aspirational class and aspirational spending. **A country with a rising middle class should also see an increase in urbanisation.** The UN agency further states that countries could only harness the economic potential of the youth bulge if they are able to provide good healthcare, quality education and decent employment to its entire population. A relatively higher working age number implies that a government needs to divert resources towards physical and human infrastructure. **India has been slow to reap the benefits of the demographic dividend to the fullest possible extent and hence the pace of urbanisation has been rather lacklustre.** The past decade has been one of jobless growth owing to a down cycle in real estate, which has been the biggest employment generator for the country. In general, capex and export activity had seen relatively lower growth than other levers of demand, which also impeded job creation.

"Government has established the NSDC with the overall target of skilling up 500 million people in India by 2022".

However, the **move towards infrastructure creation should aid job creation**. India has laid out a National Infrastructure Pipeline plan, which aims to invest Rs 100tn over the next five years. The cycle in real estate also appears to be turning. India's improved ranking in the World Bank Ease of Doing Business index is a good sign. Schemes such as Start-up India and Production Linked Incentives (PLI) have gained traction. Recently, the PLI on electronics, announced in July 2020, have started well, with global suppliers for Samsung and Apple setting up manufacturing plants in India. PLI should help to boost manufacturing activity, which tends to be more labour-intensive than services. **To reap the demographic dividend, proper investment in human capital is needed by focusing on education, skill development, and healthcare facilities. The government has established the National Skill Development Corporation (NSDC) with the overall target of skilling up 500m people in India by 2022.** The new education policy laid out in 2020 aims to synchronise the education system with the changing needs of the job sector. The government of India has launched healthcare schemes like Ayushman Bharat and the National Health Protection scheme (NHPS), which have seen reasonable success. The government has announced its intention to increase spending towards the healthcare sector. This **is visible in the rise of the middle class**. According to a World Economic Forum study published in 2018, by 2030, India could move from being an economy led by the bottom of the pyramid to one led by the middle class. In 2030, nearly 80% of households could be middle income, up from about 50% currently. The middle class should drive 75% of consumer spending in 2030. This study was undertaken in 2018 and the Covid-19 pandemic may have extended this outcome by a couple of years. Yet, the direction and trends remain unchanged. As the middle class becomes a driving economic force, spending patterns may shift in favour of higher spending on durables and services, such as healthcare, education and recreation.

Short-term view: new budget to unleash growth

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Head of EM Macro and Strategy Research

"The new and revised fiscal targets are more supportive of the country's economic performance going forward".

On 1 February 2021, India's Ministry of Finance announced the details of the Budget Law for FY22, covering the period April 2021-March 2022, as well as a revision of the fiscal targets for the current fiscal year (FY21, April 2020-March 2021). Following a challenging 2020, when India's government showed relatively higher prudence in comparison with many other EM in terms of fiscal support, **as a positive surprise, the new and revised fiscal targets are more supportive of the country's economic performance going forward.**

On top of the pro-growth bias highlighted in the budget, the Ministry of Finance decided to pursue **significant transparency in the fiscal accounts**, including in the budget off-balance-sheet liabilities accounting for 1.0-1.5% of GDP. Therefore, the fiscal deficits for the current and next fiscal years are now expected to be larger than previously reported: FY21 FD at 9.5% and FY22 FD at 6.8%. The budget assumption of nominal GDP growth of 14.4% YoY in FY22 is ambitious, though, we believe, achievable, with the caveat of not factoring in any strong disruption from further pandemic outbreaks. Beyond the next fiscal year, on a multi-year horizon, the fiscal deficit is planned to decline at a much slower pace than anticipated in previous budget laws.

Besides the fiscal deficit targets, **the component most clearly highlighting the budget's pro-growth bias is the public capex number.** While the overall expenditure is expected to increase only mildly in fiscal 2022, it's the allocation that matters: out of the total, **capex is one of the segments where expenditure has been mostly allocated (the highest increase in more than a decade) and with a higher fiscal multiplier.** As further proof of its commitment, the capex budget for the current fiscal year has been increased, implying that higher expenditure has already been happening in recent months. Mindful of the fact that execution is as important as commitment, in a country penalised by the banking sector's inability to provide sufficient credit to the economy (due to the long-lasting NPL issue), together with the budget announcement, other steps taken are worth mentioning:

- In the current budget, Rs 200bn allocated to the creation of a Development Financial Institution (DFI) to fund the infrastructure sector; and
- A plan to set up a bad bank regarding which details about the regulatory framework and ownership are very important for assessing the ability to work in the Indian credit environment.

In several ways, the budget law and the plans related to it, highlight steps in the right direction and we would mention that the government seems keen to move on a bumpier path (lack of short-term fiscal boost) but with long- lasting results. To start with, the budget execution may matter and, as usual, this could depend on policy-makers' ability to meet targets on revenues – for instance, through the planned strategic assets sales as well as regarding gloomier global economic conditions that, due to a shortfall in revenues, could divert expenditure from more profitable investments to a less profitable allocation.

Investors should look at fiscal deficits and inflation, but not worry at this stage

As stated in the FY22 budget law presentation, any pursued fiscal austerity to meet the pre-Covid FRBM targets would not be advisable. In the current context, a need for higher public spending is believed to be crucial for providing the required impetus to economic growth. According to the authorities, **the new, more gradual fiscal consolidation path does not imply a persistent increase in the government debt trajectory.** The expected fiscal deficit targets could not impair the debt's trajectory as long as the interest rate vs growth rate differential remains negative. Despite the fact that higher fiscal deficits may limit the convergence pace, India's growth rate is accelerating relatively quickly, allowing

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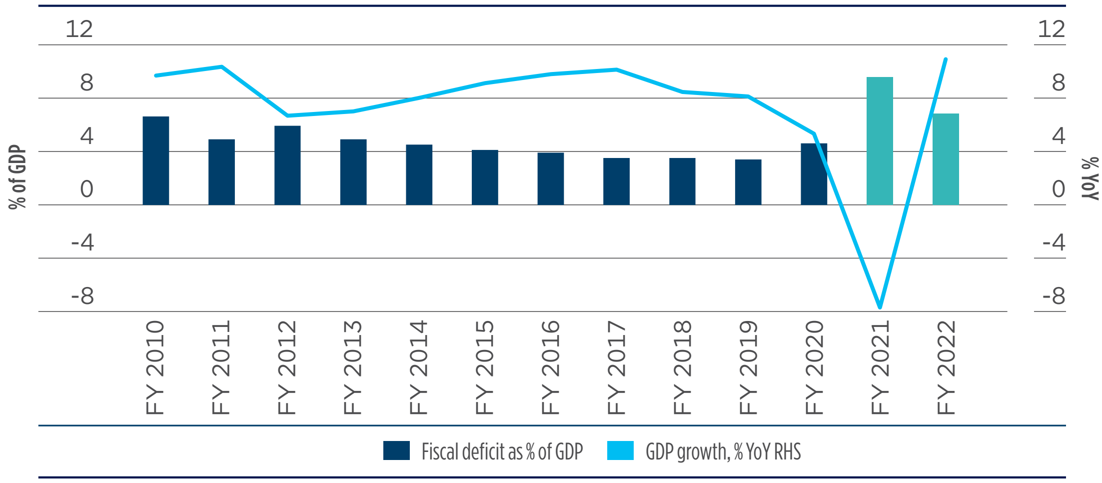
"Where we do see a more supportive fiscal stance we should see a gradually less accommodative monetary policy stance".

"Over the last two and a half decades, India's GDP growth rates have been higher than interest rates, making India's debt sustainable".

the public debt trajectory to revert already in FY22. Over **the last two and a half decades, India's growth has been higher than its interest rates, making its debt sustainable.** In assessing how inflationary the budget is and the upcoming fiscal stance, it is important to highlight the agenda for ambitious public spending (National Infrastructure Plan [NIP]). Implementing the NIP via front-ended fiscal spending could generate higher-paying jobs and boost productivity, keeping inflation under control. **The ability to adjust the fiscal stance to keep it counter-cyclical** should **keep inflation from spiking on excessive fiscal support.** After remaining persistently above the upper target range band since June 2020, finally, headline inflation fell below 6% in December 2020. The December and January figures surprised, both to the downside (4.6% YoY and 4.1% YoY, respectively), driven by favourable base effects and a sharper-than- expected fall in key vegetable prices. Since the first big lockdown, active supply-side interventions have smoothed the supply chain shock. Having said that, the same months saw core inflation remain stubbornly high, at between 5.5% and 6.0% YoY. High core goods inflation has been driven by commodity prices and by an increase in firms' power to pass on higher costs to consumers thanks to the economic rebound. Core service inflation has remained subdued. We expect the cyclical rebound to support inflation – both headline and core – with the headline to average around 5.0-5.5% YoY in FY22 and the core service component picking up on higher demand. The recent oil price spike is adding pressure to the upside. **Our base-case inflation expectations sit quite comfortably within the RBI inflation target range, allowing the central bank to move towards a neutral stance from a dovish one** without rushing in any Reference Policy rates tightening earlier than Q4 of FY22. On the other hand, with demand and credit gaining traction, the RBI should be careful in managing liquidity, starting with a gradual withdrawal. A benign inflation outlook depends on a sound policy mix: **a supportive fiscal stance could imply a gradually less accommodative monetary policy stance.** The government should be reviewing the inflation target for the next five years, presumably in Q2 2021. The adoption of a credible inflation target has been successful in setting the country on a more sustainable inflation path and has given credibility to the monetary policy conduct. The inflation target is likely to stay unchanged. Price stability is paramount for a virtuous cycle while keeping term and risk premia under control.

Figure 6. India's fiscal deficit and GDP growth projections



Source: Amundi, Bloomberg, India's Ministry of Finance. Data as of 24 February 2021.

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India and the Asia-Pacific trade agreement

The Regional Comprehensive Economic Partnership (RCEP) signed on 15 November 2020 could come into effect in 2021, after at least six ASEAN and three non-ASEAN members receive local approvals and notify the ASEAN Secretariat. Once ratified, it would represent the world's largest trading bloc (12% of global trade, 30% of global population and GDP). It includes commitments regarding goods, services, investment, intellectual property rights, competition. Many RCEP members already had bilateral FTAs, but simplified rules of origin may offer additional help. Further, this is a move forward when consensus has moved to expecting steadily increasing tariffs globally. That said, one needs to watch for any contra moves in non-tariff measures that may have an offsetting impact.

While India was a part of the initial discussions around RCEP (which started in 2013), it decided to discontinue its participation in November 2019. It is understood that India was unable to help ensure counter-measures, like an auto-trigger mechanisms to raise import tariffs on products when their imports crossed a certain threshold. Further, it was also felt that the agreement could potentially mandate opening sensitive sectors, like defence, to other countries for investment (without any specific checks and balances). Finally, RCEP also lacked clear assurance over market access issues in countries such as China and non-tariff barriers on Indian companies.

While India has bilateral free trade agreements (either established or in the negotiating process) with most RCEP countries, there are concerns that India's decision not to participate would have a bearing on its bilateral trade ties, as these countries would be more inclined to focus on bolstering economic ties within the bloc. However, India's stance on the deal also comes as a result of the government's own study which estimated that India has been unable to leverage its existing bilateral free trade agreements (and the trade deficit has widened with most FTA partners). Hence, it could be important to simultaneously make the Indian manufacturing sector more competitive and create economies of scale in exports rather than focussing on tariff-related cost advantages alone.

To sum up, the precise estimate regarding lost out trade opportunities may only be known over time. India may need to continue to strengthen its existing FTAs with both RCEP and non-RCEP members and focus on other areas of cost advantage.

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'Make in India' and domestic demand: attractive plays for global equity investors

"'Make in India' and internal demand story: the main appeal in India equities".

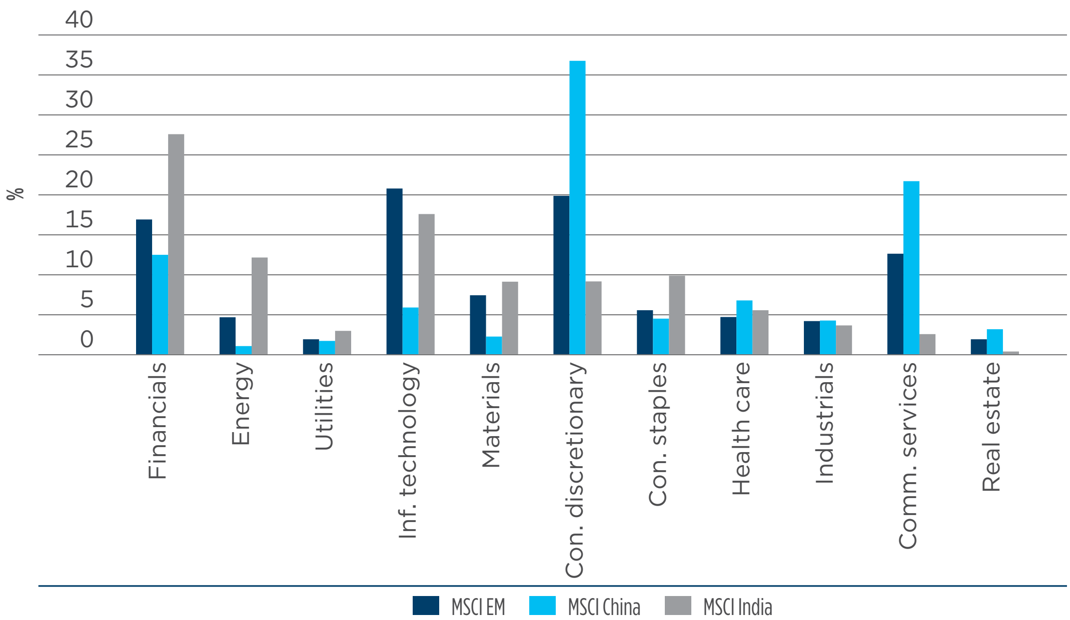
Plenty of sectors should benefit from a long-term shift (unorganised to organised, financialisation of savings and demographics) and structural development (reforms, infrastructure, etc), as detailed in the previous section. **This highlights the conviction themes of 'Make in India' and internal demand play. The long-term shift that could occur in India could also be explained by the government pushing to ease doing business in India** (whose rank has considerably improved in the last few years): direct sectors that have been impacted include **property developers, healthcare (diagnostics sector), engineering and construction contractors, but more globally, retail and consumer.**

Industrials and manufacturing should benefit the most from reforms and the 'Make in India' initiative. The Production-Linked Initiative (PLI) which incentivise investment in the manufacturing sector has identified 11 strategic sectors for India, with details of three schemes (electronics, medical devices and bulk drugs available). **Auto and auto components** should also be a significant beneficiary, followed by **pharmaceuticals**.

In industrial sectors, **automation for industries** (as well as IoT and smart cities among others) is likely to see an exponential change in the J curve in India. In the same government push, **defence should be a key beneficiary which could mean some diversification and attract domestic interest**, as showcased by the oversubscribed IPOs done at the end of last year. **Financialisation of savings could play a significant role in the development of the asset management industry** and the insurance sector playing on the Indian narrative of a rise in mass affluent and elite incomes. Indian equities, compared to China and EM indices could benefit from this upscaling in the financial sector, along with development of information technology and the consumer story.

"Compared to China and EM indices, Indian equities could benefit from a rise in the financial sector, from the development of information technology, and from the consumer story".

Figure 7. MSCI Indian equity index composition vs MSCI China and MSCI EM



Source: Amundi Research on Bloomberg. Data as of February 2021.

"India's IT services have been gaining market share steadily in the outsourced IT industry and the export revenue has almost tripled over the last 10 years".

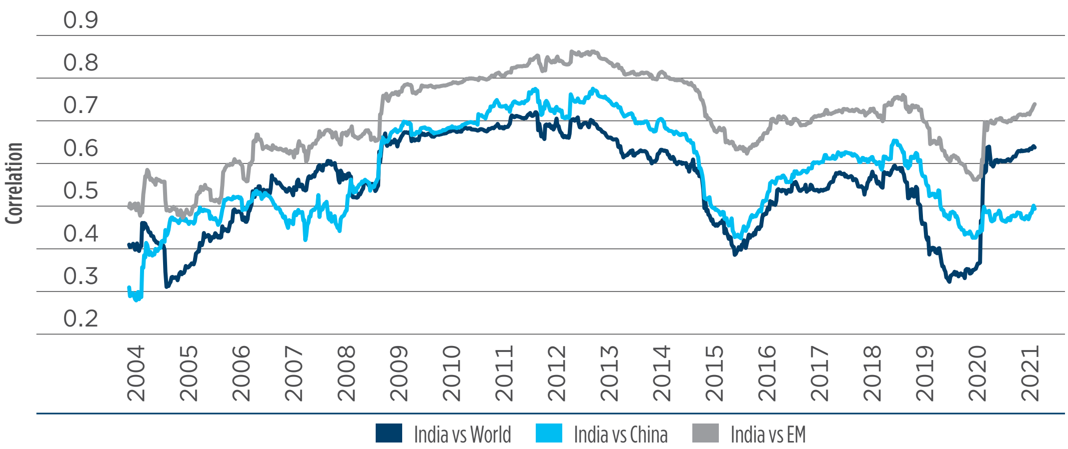
One sector in which India is a global champion is IT outsourcing services. India's IT services industry has been steadily gaining market share in outsourced IT services, with exports of $147bn in 2020. **Export revenue has almost tripled over the last 10 years.** The increase in market share has been happening at the expense of local vendors. The quality and breadth of services has been improving, leading to higher acceptance among clients. With rising scale, the ability of vendors to bid for mega deals has also gone up, including **in the generic pharma industry, as happened** regarding the Covashield vaccine with the Serum Institute of India in partnership with AstraZeneca. India is playing a prominent role in producing Covid-19 vaccine supplies for Africa and some other Asian countries. There are nascent **signs of leadership in some sectors, like electronic manufacturing or chemicals. The singularity of the Indian market is making it attractive as a diversifier in a global equity portfolios.** The correlation of Indian market has been relatively modest with global equities and in particular with China equities. For investors looking to gain exposure to the domestic demand story in EM, India could be seen as a good complement of China equities in the EM universe.

Table 2. Ten-year correlation between Indian shares with other equity markets

	MSCI India	MSCI China	MSCI China onshore	MSCI EM	S&P 500 Index	MSCI Europe	MSCI World
MSCI India	1.00						
MSCI China	0.46	1.00					
MSCI China onshore	0.24	0.66	1.00				
MSCI EM	0.68	0.87	0.52	1.00			
S&P 500 Index	0.57	0.61	0.40	0.74	1.00		
MSCI Europe	0.52	0.49	0.34	0.62	0.81	1.00	
MSCI World	0.60	0.66	0.42	0.80	0.97	0.86	1.00

Source: Amundi on Bloomberg. Calculated based on monthly data for the 10 years to February 2021. The correlations are with indices in local currency.

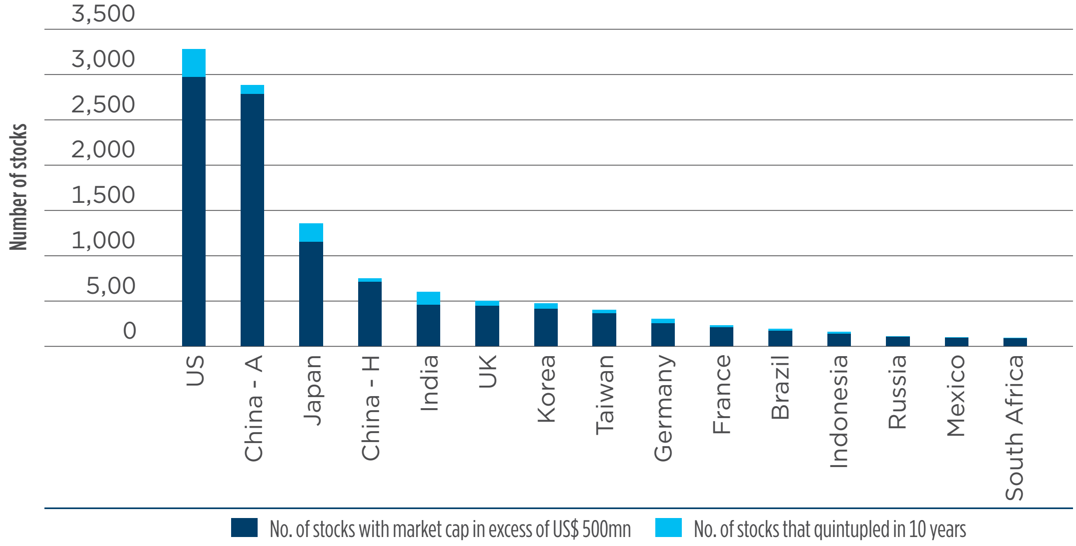
Figure 8. Three-year India equity correlation vs World, China and EM



Source: Amundi on Bloomberg, MSCI indices. Data as of 9 March 2021.

Market liquidity is significant and could make Indian equities appealing for a global investor. If we look at global indexes, we see that the Indian market has one of the highest number of stocks with market caps in excess of US$500m and also one of the highest number of stocks that quintupled in value in the last 10 years.

Figure 9. Indian stock market: an international comparison

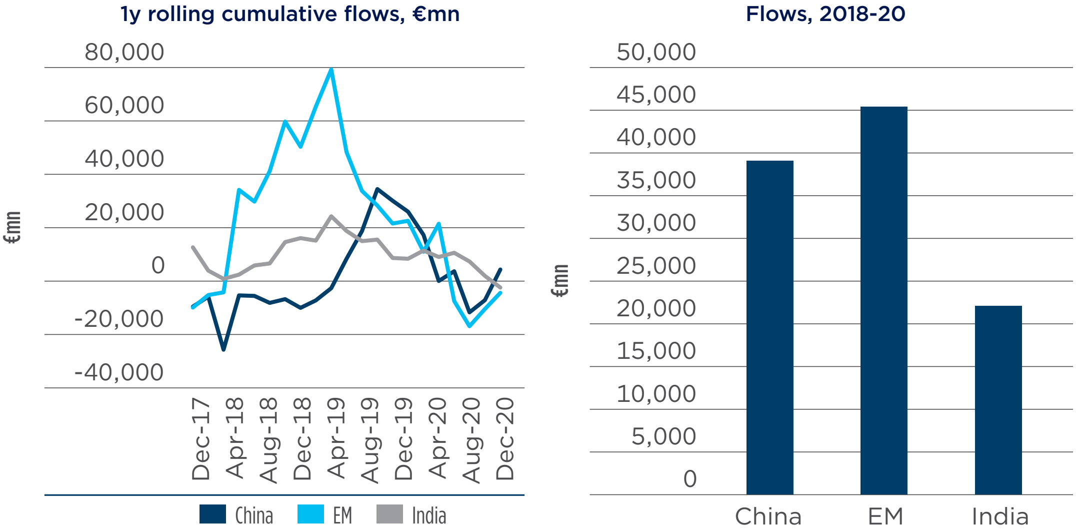


Source: Amundi on Factset and MSCI, data as of February 2021. Note: China A-shares are on-shore stock listings that are denominated in RMB and predominantly traded by a mainland investor base while H-shares are Hong Kong stock listings denominated in HK$ and largely traded by foreign investors.

"The correlation between the Indian and the Chinese markets is negligible. As such, these markets could act as complements in an equity portfolio".

The strong regional investor base has also prevented the market from suffering significant outflows during the Covid-19 crisis, although it is worth noting that the in the last three years the market has underperformed China and EM in terms of net new flows. We believe that the new budget, the reflation story, and the measures implemented by the government to modernise the Indian economy could increase the appeal of the country to global investors and thus result in a rise in direct flows towards this market.

Figure 10. India's flows vs EM and China



Source: Amundi on Broadridge Fundfile, active and passive equity management included, data as of 15 February 2021.

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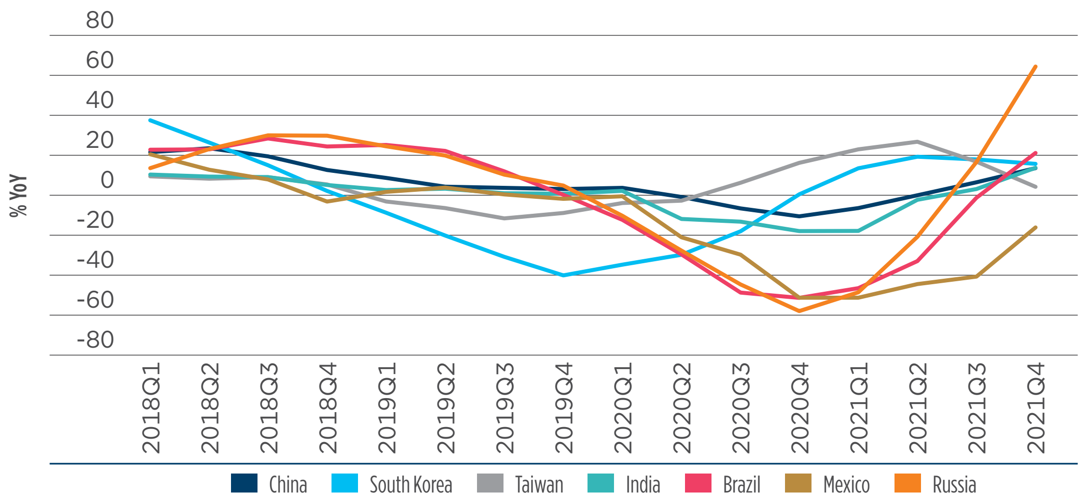
2021 equity outlook

For India, **there is reason to be optimistic regarding an earnings revival going forward.** The recent policy announcements related to the budget and other areas as well should help create an environment supportive of a catch-up in earnings. **The reflation trade** and cyclical recovery expectations could be seen as opportunities to get some exposure **to cyclical sectors**. In addition, the Covid-19 pandemic has accelerated the shift towards digitalisation of the economy, with the main narrative of the India story based on booming e-commerce and IT sectors an important result of this growth.

"Indian equities may benefit from a global reflation trade and rotations towards EM equities lifted by earnings and GDP growth acceleration".

The last few years have also seen a clean-up in Indian banks' balance sheets. Furthermore, corporate balance sheets are now much healthier, cost structures are leaner, and significant reforms have been made regarding corporate taxes, PLIs, labour and farming, among other areas. **The corporate sector looks well-placed to capitalise on a revival in aggregate demand.** Additionally, if the current efforts from global policymakers regarding successful reflation do bear fruit, this should act as a strong tailwind to support the revival of India's corporate profit cycle. The government has already shown that it intends to do the heavy lifting initially to kick-start the growth engine and that should, hopefully, help the private sector. **We see an acceleration of earnings growth in 2021.**

Figure 11. Earnings forecasts look set to improve in 2021



Source: Amundi Research, data as of 10 March 2021.

"The selection of the manager for India equities is even more important if we consider the huge dispersion of returns between good active managers and mediocre/bad ones".

We expect polarisation to remain high regarding low-yield beneficiaries vs pro-economy segments. **Market capitalisation continues to be polarised towards large caps vs mid-/ small caps.** Similarly, relative underperformance of value vs quality is at multi-decade highs. Emerging market equities have been massive underperformers vs developed world peers, especially the US, over the past decade. **These polarisations should shift if successful reflation materialises. This, in turn, could mean greater opportunities for active bottom-up investors.** As we could be seen in Table 3, **there is a huge polarisation in the market between good active managers and mediocre/ bad ones. The top two quartiles have been able to deliver** strong positive excess returns across all time horizons.

Table 3. Median and top-quartile performances of active India equity funds vs benchmark on 1y/3y/5y/10y horizons

Cumulative excess return in base currency, %	1 year	3 year	5 year	10 year
Q1 and Q2	2	6	8	68
Q3 and Q4	-7	-15	-28	-33

Source: Amundi on Mornigstar active management data as 15 February 2021.

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Fixed income: inclusion in major indices could drive market appeal

While India boasts a world-class equity market in terms of market infrastructure, liquidity and depth, **the bond market is a work in progress, especially with respect to liquidity and depth.** While India's debt market is dominated largely by the G-sec (government securities) market, the corporate bond market is comparatively undersized.

Table 4. Key figures for India's fixed income market

Market type	Stock stands (Rs tn as of Sep 2020)	CAGR in the last 6 years
G-Sec and SDL (government securities, T-bills and state development loans)	107	12%
Corporate bonds	34	11%

Source: Amundi, on SBI. data as of September 2020.

"India's debt market is dominated largely by the government securities market; the corporate bond market is comparatively undersized".

The G-sec market has witnessed significant developments over the years. The RBI along with the **Government of India undertook a series of measures since the beginning of 1990s to deepen and widen India's G-sec market.** The government securities market offers a screen-based trading platform (NDS-OM, negotiated dealing system – order matching system) with guaranteed settlement through a central clearing house. Transactions done on the over the counter market are also settled on the NDS. This provides transparency in market pricing. Other initiatives include efforts to increase the investor base (both domestic and foreign), market-based price discovery, the introduction of new instruments, and the establishment of electronic trading and settlement, enabling non-institutional investors to participate in primary auctions, facilitating web-based trading access for all gilt account holders, among others. All these actions have led to significant transformation and development of a relatively strong G-sec market in India. Recently, the RBI also announced the decision to facilitate retail investors' direct access the government securities market.

The government securities market has a diversified investor base. The commercial banks are the largest investors in all three segments (central government. securities, SDLs and T-bills). There has been a gradual broadening of the ownership pattern in the G-sec market, with increased participation by FPIs, primary dealers, mutual funds and financial institutions over the years. **On the credit side**, conventional bank loans have traditionally been the predominant source of funds for businesses in the country which resulted in **corporate bond markets remaining largely stagnant. However, in recent years, there has been a growing need for businesses to tap the bond markets** given the well-known constraints in the banking sector as well as regulatory requirements to access the bond market vis à vis the loan markets.

"The government securities market has a diversified investor base and has developed significantly over the years".

Although the corporate bond market is not as vibrant as the G-sec market, the policy focus has increased on developing and deepening the corporate bond markets as well. Significant measures have been taken to enhance transparency and provide ease of settlement. Actions have included mandatory clearing of trades through a clearing house with non-guaranteed settlement, disclosure of trades on exchange platforms, a central trade repository, primary market bond bidding through an electronic platform, and, recently, a RFQ (request for quote) platform put in place for secondary market trades.

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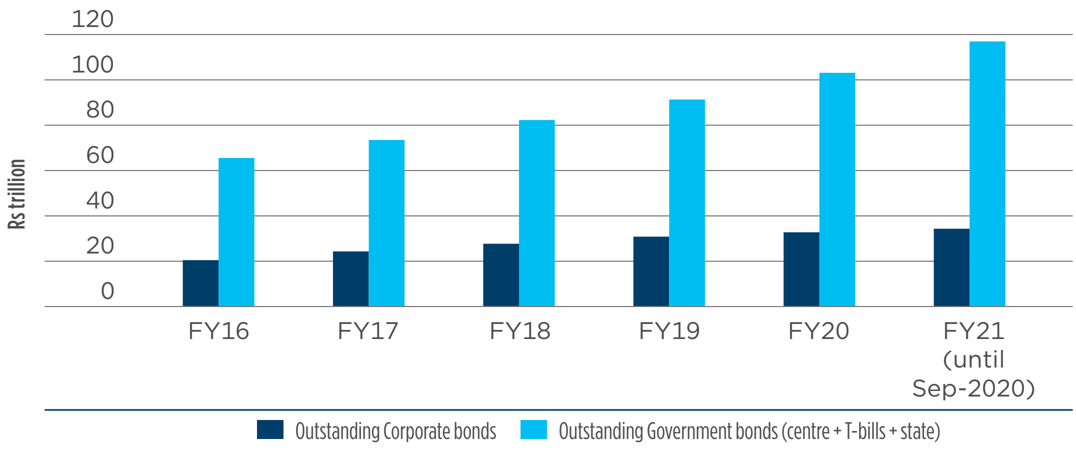
Various measures were initiated by the regulators/governments to increase liquidity and enhance the investor base in the corporate bond market, including: a) consolidation and re-issuance of debt to reduce fragmentation in the primary market and enhance liquidity in the secondary market; b) introduction of partial credit enhancement; c) investment in unlisted securities to enhance the investor base; and d) permitting brokers in repo in corporate bonds so that they could meet their funding and securities requirements arising from market making activities. The RBI also addressed the long pending issue of lack of variety of investment instruments by introducing rupee-denominated overseas bonds (Masala Bond). Recent policy measures include the announcement of the setting up of a limited purpose clearing corporation to settle corporate bond repo trades and a market making institution for investment grade corporate bonds.

The secondary market for corporate bonds has witnessed limited activity. This is in sharp contrast to the market for government securities which has seen robust trading and registered exponential growth over the years. The contribution of corporate bonds to the total turnover in the secondary market remains low, at around 10% vs the 90% share for government securities. Nevertheless, secondary market turnover for corporate bonds has increased over the years (by a 7% CAGR since FY11). For government securities (central, state and T-bill), it has been close to 21% over the same time period.

Figure 12. India's bond market: corporate and government bonds outstanding



Source: Amundi on SEBI and RBI, data as of February 2021.

As a majority of corporate bonds are privately placed, this results in low availability of bonds for trading in the secondary market. The presence of large buy and hold investors, such as the Provident and pension funds, in the bond market also leads to active interest in primary issues but less activity in secondary markets. The investment patterns and norms of these large institutional investors provide little incentive for or flexibility in active secondary market trading. Moreover, the secondary market trading of corporate bonds is heavily biased in favour of higher-rated paper, predominantly by mutual funds.

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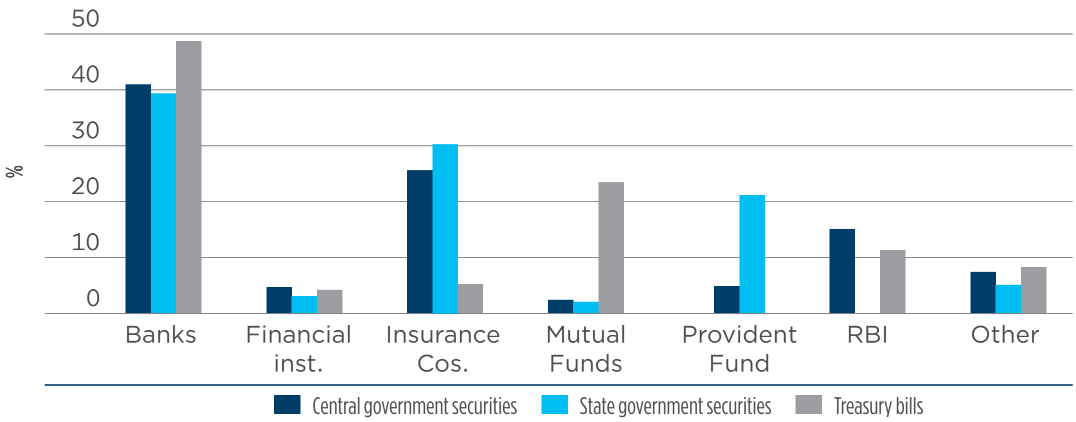
Figure 13. Holders of India's debt



Source: Amundi on SEBI and RBI, data as of September 2020. Note: category Banks includes commercial and co-operative banks, category Financial institutions includes non-bank PDs, corporates and FPIs, and category Other includes institutions such as state governments.

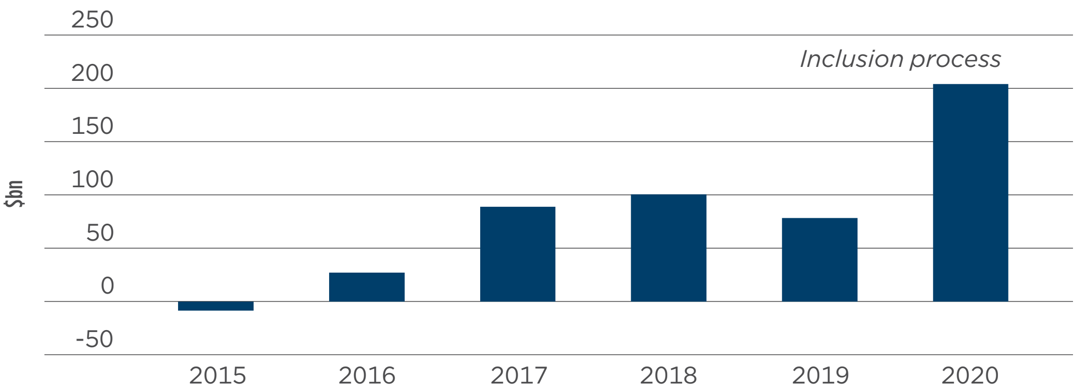
With respect to corporate bonds, corporates entities are the largest investor (holding 30% of the outstanding corporate bonds), followed by banks/financial institutions (25%), mutual funds (20%), trusts (15%), FPIs (7%), and retail investors (3%).

"India is the largest 'off-index' government bond market. We are of the opinion that India's government bonds should eventually be included in the index".

We have seen a considerable reduction in FPI (foreign portfolio investors) participation in the Indian bond market amid concerns about weak growth, negative real yield, and deteriorating fiscal conditions. These factors are expected to improve at the margin in FY22. **India is the largest 'off-index' government bond market with the scale to reach a 10% allocation in the JP Morgan GBI-EM Global Diversified Index. We believe that India's government bonds should eventually be included in the index.** Last year, the government announced the FAR (Fully Accessible Route) initiative to further incentivise offshore investors' participation in government securities. FAR allows investment in specific IGBs (Indexed Government Bonds – typically benchmark) without any security-specific or overall FPI quota restrictions. There remains no entry/exit restrictions for FPIs if they are investing in FAR securities. All new issuances of government securities of five-, 10- and 30-year tenors from the financial year 2020-21 could be eligible for investment under the FAR. In our opinion, this step could be a precursor for the inclusion of India's government securities in bond indices in the future.

China is one example where we have seen huge flows into debt markets post inclusion in all three of the indices (April 2019: Bloomberg Barclays Global Aggregate Index; January 2020: JP Morgan Global Bond Index; September 2020: FTSE Russell World Global Index).

Figure 14. After China was included in main FI indices (2019-20), flows doubled



Source: Amundi on IIF data as of March 2021.

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"The RBI has a delicate balancing task between managing market conditions, normalising excess liquidity, and conducting overall government borrowings in a non-disruptive manner".

Hence, **we could see a rise in flows into India's debt market in FY22. Government bond inclusion could also support yields and consequent increased flow into India's debt market.**

For global investors, India's local currency debt market is deep and liquid, with significant market depth. India's local currency bonds' bid/ask spreads have been relatively stable and moved on a downtrend over the years. General Asian FX volatility has been decreasing over the past decade; even with this stable backdrop, **higher-carry Asian currencies, such as the Indian rupee, continue to provide investors with attractive yield.** Several local bond markets, including India, offer a higher real rate than a year ago. The headline fiscal deficit figures are higher than market expectations. However, the context of this is important. The budget did not seek to downplay the fiscal deficit via unrealistically optimistic revenue forecasts or via borrowings off-balance-sheet. Instead, it added off-balance-sheet items to the headline fiscal deficit. Foreign investors are likely to welcome this higher level of transparency in the budget. This is also likely to give additional credibility to India's plans regarding a medium-term reduction of fiscal deficit numbers.

Once the Covid-19 situation stabilises and if growth/inflation dynamics start to turn more favourable, **India's local government debt could still represent an opportunity for discerning investors in the medium term. Positioning is light. The RBI's language continues to be accommodative which is a relief even though markets expected greater support on bond purchases from its recent meeting.** Looking at the situation from the market's perspective, we could see that the reaction to the budget/borrowings announcement and the policy was clearly reflective of the absorption capacity of markets and the limited appetite to carry larger duration risk in the face of large weekly supply.

Excess system liquidity, which has often been misinterpreted as equivalent to larger demand for dated securities, has had an impact in easing short-end rates and allowing transmission of rate cuts to a large segment of borrowers. **However, the impact of large supply has kept the curve much steeper than normal.** In this context, continuation of market intervention operations would determine the new trading band for sovereign securities. With the larger net borrowing for FY22 and requirement to help ensure normal liquidity conditions to guard against financial stability risks, **the RBI has a delicate balancing task between managing market conditions, normalising excess liquidity, and conducting overall government borrowings in a non-disruptive manner.** While the conservative budget assumptions could potentially cut borrowing requirements **down the line, assuming normal economic conditions, an upward shift in the yield curve seems inevitable. Flexible asset allocation and duration strategies within the fixed income space would be a key factor in navigating the changing landscape.**

In credit, the steady deceleration in economic growth in the years prior to the onset of Covid-19, along with the Non-Banking Finance Company crisis in mid-2018, had provided a weaker landscape even prior to the pandemic. **Credit market dynamics were further negatively impacted post the lockdown.** The subsequent stress in certain sectors of the economy had a negative impact on market liquidity which impacted certain credit-focused products. Credit spreads widened during this period, especially in lower-rated credits. Various regulatory and liquidity support actions have seen spreads tighten over the last few months. At the same time, the impact of the slowdown and resultant impact on consumption demand could take time to filter through. Clearly, at an aggregate level, the **credit markets scenario needs to be watched and credit selection should continue to be bottom up.** Market access remains relatively polarised as acceptable credits in the non-AAA-rated space, especially those with a stronger parentage, continue to be preferred while a larger segment remains more reliant on bank borrowings.

Currency views

We expect India's BoP (balance of payments) surplus to continue into FY22 and remain strong. In addition, the market expects to see mild depreciation in the US$ over the next six to 12 months. Both of these factors make a case for an appreciation bias in the rupee rather than depreciation. However, **the RBI is likely to continue with its strong FX intervention bias to limit any runaway appreciation. We expect to see only mild appreciation from current spot levels**, implying a range of 72-74 for the Rs/US$.

"The RBI is likely to carry on with its strong FX intervention policy to limit any runaway appreciation. We expect only mild appreciation from current spot levels".

Our current account forecasts assume that after turning into surplus in FY21 (1.5% of GDP), it might move to a deficit (-0.5% of GDP). On top of this, if India is able to show a more sustainable growth recovery, steady capital flows could push the BoP surplus to as high as US$60bn+. If this BoP forecast materialises, then, the RBI could have to deal with a problem of plenty to help ensure that the rupee appreciation bias is within acceptable limits. Now, one could argue that despite the large BoP surplus in FY21 (expected to be US$76bn), the rupee's appreciation to date in the FY had been fairly muted and at one of the weakest levels among EM countries. This is because of significant high FX interventions by the RBI. Historically, the strategy has been mostly to keep the rupee in the middle of the EM pack, and, hence, RBI efforts to keep the currency on a relative depreciation bias have surprised markets. In fact, the **RBI's FX reserves built up post Covid-19 have been the highest among EM peers, surpassing even China.**

Most of the reasons for the RBI's recent depreciation bias should be valid for 2021 as well, prompting the bank to continue with FX intervention. But there are two mild constraints on how much the RBI could intervene to prevent rupee appreciation. First, the RBI is currently operating into a large inter-bank rupee liquidity surplus of Rs 6tn. Banking liquidity has been in surplus for 20 months in succession and the Rs 6tn level is significantly above the normal bands. Navigating through a second year of strong FX inflows, coupled with the continued need to manage the government's large borrowing programme, could not be easy. Additionally, keeping the cost of government borrowing anchored could be rather more difficult in FY22, as the anticipated bank credit recovery could limit banks' investment into government paper. On top of that, somewhere into FY22, the RBI is also like to gradually normalise liquidity levels. Therefore, while we expect the bank to try its best to use multiple tools (sterilised FX intervention, Operation Twists in G-sec), at some point, it could have to let go of one of the variable, ie, either allow the rupee to appreciate or allow yields to move higher. We think a mix of both is likely.

Key risks to our assumptions stem from the following:

- Any sharp uptick in crude oil prices could mean negative sentiment regarding the rupee, even though the RBI would sell its reserves to protect the currency from depreciating;
- The BoP flow dynamics could be substantially elevated by another round of lumpy FDI flows or any news flow around possible inclusion of IGBs in the bond indices. This event would be positive for the rupee;
- Risks related to any turn in global liquidity or any abrupt stalling of growth momentum which could have repercussions for equity outflows; and
- Any surge in domestic rupee liquidity should be monitored, as this could have important implications for the RBI's FX intervention strategy.

To sum up, the macro reasons for an appreciation bias regarding the rupee and the RBI's need to keep a check on that to meet its multiple objectives would most likely keep the rupee in a narrow range in FY22. We expect to see only mild appreciation from current spot levels, which would imply a range of 72-74.

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Definitions

- **Carry:** The carry of an asset is the return obtained from holding it.
- **Correlation:** The degree of association between two or more variables; in finance, it is the degree to which assets or asset class prices have moved in relation to each other. Correlation is expressed by a correlation coefficient that ranges from -1 (always move in opposite direction) through 0 (absolutely independent) to 1 (always move in the same direction).
- **Curve steepening:** A steepening yield curve may be a result of long-term interest rates rising more than short-term interest rates or short-term rates dropping more than long-term rates.
- **Duration:** A measure of the sensitivity of the price (the value of principal) of a fixed income investment to a change in interest rates, expressed as a number of years.
- **FDI:** Foreign direct investments.
- **Credit spread:** Differential between the yield on a credit bond and the Treasury yield. The option-adjusted spread is a measure of the spread adjusted to take into consideration possible embedded options.
- **Diversification:** Diversification is a strategy that mixes a variety of investments within a portfolio, in an attempt at limiting exposure to any single asset or risk.
- **FX:** FX markets refer to the foreign exchange markets where participants are able to buy and sell currencies.
- **Liquidity:** Capacity to buy or sell assets quickly enough to prevent or minimize a loss.
- **Market depth:** It is the market's ability to sustain relatively large market orders without impacting the price of the security.
- **P/E ratio:** The price-to-earnings ratio (P/E ratio) is the ratio for valuing a company that measures its current share price relative to its per-share earnings (EPS).
- **Small and medium-sized enterprises (SMEs):** They are businesses whose personnel numbers fall below certain limits.
- **Spread:** The difference between two prices or interest rates.
- **Value style:** It refers to purchasing stocks at relatively low prices, as indicated by low price-to- earnings, price-to-book, and price-to-sales ratios, and high dividend yields. Sectors with dominance of value style: energy, financials, telecom, utilities, real estate.
- **Volatility:** A statistical measure of the dispersion of returns for a given security or market index. Usually, the higher the volatility, the riskier the security/market.
- **Yield curve control:** YCC involves targeting a longer-term interest rate by a central bank, then buying or selling as many bonds as necessary to hit that rate target. This approach is dramatically different from any central bank's typical way of managing a country's economic growth and inflation, which is by setting a key short-term interest rate.

Important Information

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