Amundi Investment Solutions

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SBI FUNDS MANAGEMENT LTD.

India Newsletter

August 2024

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- **Did you know?** The economic case for economic growth
- **Hot topic:** Indian Union Budget - fiscal prudence, long-term positive for job creation and micro, small and medium enterprises (MSMEs), short-term negative on tax

MARKET OVERVIEW: Indian equity & fixed income market insights from SBIFM

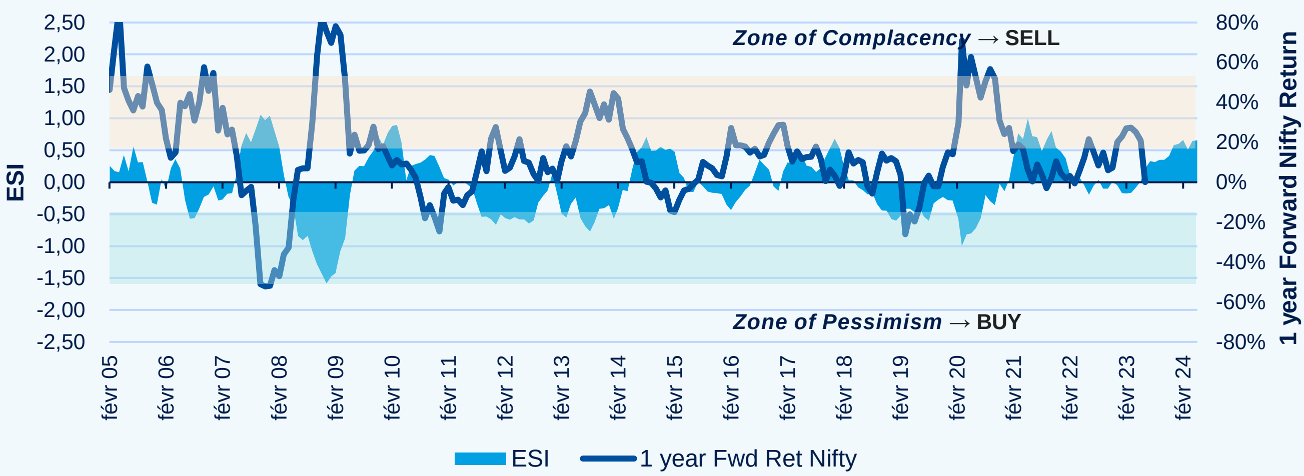
Equity

The Indian equity market continues to perform well, with positive returns over July and year-to-date (YTD). The steady interest in Indian equities both by Foreign Institutional Investors (FIIs), as well as Domestic Mutual Funds (DMFs) suggests that the momentum in equity prices may be sustained. India's share in the MSCI EM Index, after the latest rebalancing, is currently at 19%[1], leading to increasing inflows from foreign investors. In addition, the share of domestic mutual funds in the overall institutional equity assets under management is also at a record high.

The equity market is not only deepening in terms of institutional participation, but also of Initial Public Offerings (IPOs): the first half of 2024 turned out to be the best half in 17 years in terms of IPOs. Thirty-seven companies across various sectors raised over INR 320 billion[2]. This trend, favoured by a combination of regulatory reforms and technological developments, suggests that companies are actively securing fresh capital to fortify their balance sheets in preparation for fresh capacity additions.

SBIFM's ESI sentiment measure for the current market remains elevated and further indicates very high levels of complacency.

Equity sentiment readings reflected high complacency going into the event



Source: Bloomberg, FactSet, SBIFM Research; ESI = Equity sentiment Index. For illustrative purposes only, may be subject to change without prior notice.

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[1] Source: MSCI Emerging Markets Index - MSCI, index factsheet as of 28 June 2024.

[2] Source: www.business-standard.com/markets/ipo/best-first-half-for-ipos-in-17-years-37-firms-mop-up-nearly-rs-32k-cr-124062400687_1.html. Exchange rate as of 31 July 2024: 1 INR = 0.011 EUR.

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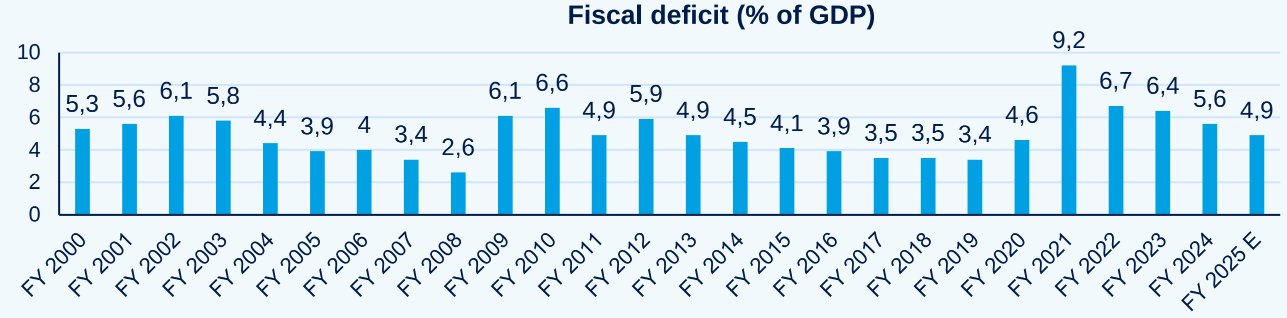
Fixed income

The final Indian Union Budget[3], presented in July 2024, provided positive broader fiscal numbers, as the central government[4] continues its consolidation trajectory and commitment to lower public debt/GDP and stabilise the fiscal deficit below 4.5%.



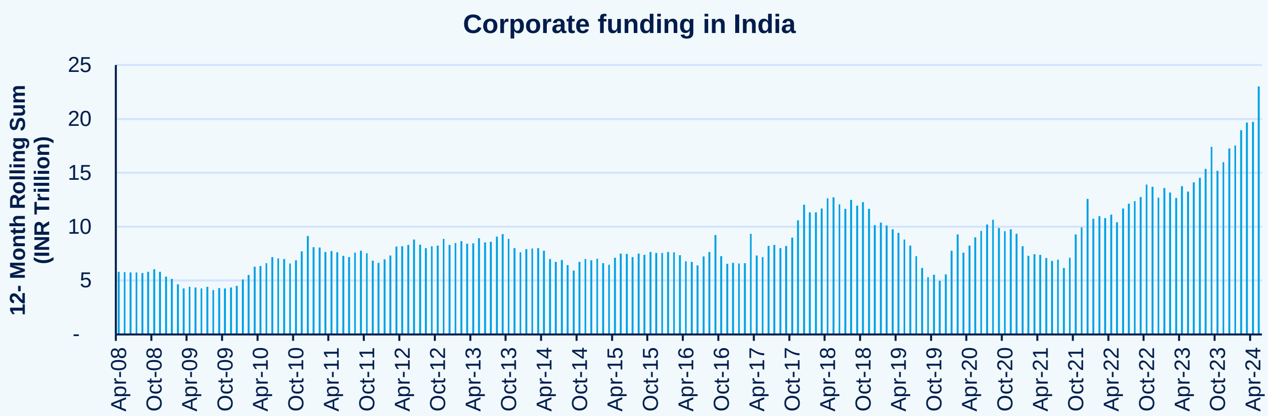
Source: indiabudget.gov.in, SBIFM Research, July 2024. E: Estimates.

Also, with the Reserve Bank of India (RBI) unlikely to move on policy rates in the near term, the fixed income market trajectory should be shaped by external news flows, demand from index flows, and the near-term reading on domestic inflation. Therefore, we believe that duration play should continue to be a tactical opportunity given the spillovers from overseas sentiments and data. A clear visibility on rate easing cycle in India would be subject to continued progress on inflation. A positive macro backdrop including fiscal consolidation, well matched demand supply balance, declining trend on headline inflation provides visibility on slightly longer-term structural story on rates.

DID YOU KNOW? What stood out to us this month

The economic case for economic growth: private investment cycle underway

India must maintain a real investment rate of around 35% (of GDP) to achieve high economic growth rates (7%+) on a sustainable basis, assuming an incremental capital-to-output ratio (ICOR) of 4 or 5. Gross Fixed Capital Formation (GFCF) represented an important driver of growth over FY 2024, with encouraging numbers from private capital expenditure (Capex). The key factors driving the ongoing private-capex cycle are the government's infrastructure push, manufacturing subsidies, capital availability, and an optimistic growth outlook.



Source: Bloomberg, July 2024. This shows total funds raised by firms in India spanning banking credit, equity issuance, new corporate bonds and external borrowings.

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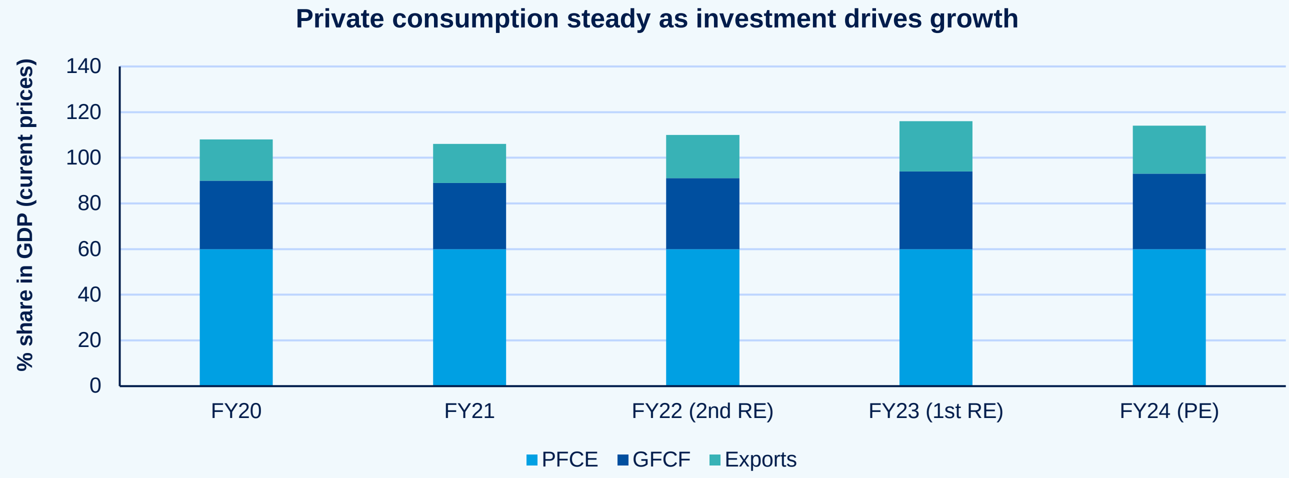
[3] www.indiabudget.gov.in/. *Annual budget of the Republic of India set by the Ministry of Finance for the following financial year.*
[4] *The Central / Union government is composed by the executive, the legislature and the judiciary.*



Source: indiabudget.gov.in, SBIFM Research, July 2024. For illustrative purposes only. RE: revised estimates. PE: provisional estimates.

HOT TOPIC: Union Budget

Indian Union Budget[5]: fiscally prudent, efforts to accelerate jobs and consumption

The Indian Union Budget has always been a key event for financial market participants, businesses, and households alike. This significance persists despite an increasing number of reforms occurring outside it. Given the government's weaker mandate in its third term, there has been intense speculation in the market about whether it would prioritise investment-led growth or favour welfare measures to support lower-income groups and boost consumption. The final Union Budget presented on 23 July turned out to be fiscally prudent with efforts to create jobs, strengthen micro, small and medium enterprises (MSMEs), and in turn, boost consumption, which has been lagging for a few quarters. However, the rationalisation of the tax structure, especially the increase in the tax on capital gains, had unnerved investors, with the equity market seeing some correction post-Budget but recovering later.

Fiscal prudence

Prior to the final budget announcement, two significant developments shaped the backdrop: a higher-than-expected dividend transfer from the Reserve Bank of India (RBI) and Public Sector Undertakings[6] (PSUs), totalling INR. 1.5 trillion, and a surplus cash balance of INR 1.5-2.0 trillion, contrasting sharply with last fiscal year[7]. The Government of India chose to utilise the extra dividend to primarily increase the capex loans and other transfers to states (by INR 360 billion) and reduce the fiscal deficit by INR 722 billion. The latter is expected to consolidate by 70 basis points to 4.9% in FY25, with a vision to consolidate to 4.5% by FY26.

Positive on job creation and strengthening MSMEs

India, home to 1.4 billion people, has surpassed mainland China to become the world’s most populous country, according to UN estimates[8]. While providing a potential demographic advantage over other countries with declining birth rates, the challenge for India is to create jobs for its large young population. The Budget outlined detailed plans for job creation in the organised sector[9] and strengthening MSMEs, which in turn will create jobs.

- **Job creation in the organised sector:** the plan includes three schemes aimed at fostering employment generation and an additional three schemes focused on skill development and internships. The government plans to allocate INR 2 trillion (US$24 billion) over the next 5-6 years for these initiatives, with INR 100 billion earmarked for the current year alone.

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[5] *Source: www.indiabudget.gov.in.*
[6] *PSUs are government-owned entities (51% or more) that perform commercial functions on behalf of the government.*
[7] *In India, the fiscal year starts on 1 April and ends on 31 March.*
[8] *www.un.org/en/global-issues/population.*
[9] *includes businesses that are registered with the government and follow its guidelines and regulations.*

- **Strengthening MSMEs[10]**: one of the key challenges for MSMEs is access to credit. The Budget focused on addressing this challenge and provided a few key measures. These include: (a) a new mechanism to ensure MSMEs' access to bank credit during financial stress; (b) a new credit guarantee scheme for manufacturing MSMEs to obtain term loans without collateral; and (c) increased Limits for TARUN Category MUDRA Loans.[11]

We believe that, if executed well, this will lead to job creation, which in turn will support the consumption engine of the economy.

Short term negative on tax structure rationalization

Over time, the capital gains taxation structure in India has become increasingly complex. Different holding periods were required to classify assets as long-term for various financial and non-financial assets, each with different tax rates for short-term and long-term gains across asset classes. There has been a significant rationalization of this structure.

The proposed changes include standardizing the holding period for listed securities to 12 months and for all other assets to 24 months. Short-term and long-term capital gains tax rates for equity and equity-oriented mutual funds have been increased to 20% (from 15%) and 12.5% (from 10%), respectively, with the exemption limit raised from INR 1 lakh[12] to INR 1.25 lakhs. Other short-term capital gains will continue to be taxed at the applicable rate. Long-term capital gains tax is now set at 12.5% for all asset categories.

Additionally, indexation benefits for calculating long-term capital gains, currently available for property, gold, and other unlisted assets, will be removed. Unlisted debentures and bonds, categorized as debt instruments, will be taxed at the applicable rate for both short-term and long-term gains. In summary, equity investors were surprised by the increases, while the removal of indexation benefits could deter investment in premium real estate. Conversely, gold and silver Exchange-Traded Funds (ETFs) stand to benefit from these changes. There has been a marginal increase to the Securities Transaction Tax (STT) in the derivatives segment, though most measures to curb derivatives flow are likely to be announced by the Securities and Exchange Board of India (SEBI).

While the rationalization in the tax structure, especially the increase in the capital gain tax has unnerved investors, the government has committed to ensure tax certainty and simplify the tax process going ahead[13].

In our view, the comprehensive support to the MSMEs and the detailed plan for job creation should help in a sustainable long-term growth for the economy.

At Amundi - SBIFM, we focus on rigorous on-the-ground research and bottom-up stock selection as key to generating differentiated alpha in a growing market like India.

Important information

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[10] MSMEs in India contribute about 30% of India's GDP, about 45% of exports, and over 60% of employment. Source: pib.gov.in/PressReleaseIframePage.aspx?PRID=1985020.

[11] Loans at low rates to micro-finance institutions and non-banking financial institutions.

[12] 1 lakh = 100000.

[13] www.thehindu.com/business/no-further-changes-to-capital-gains-tax-in-medium-term/article68454520.ece