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India Equity Strategy Alpha Almanac

The Uphill Climb

MORGAN STANLEY INDIA COMPANY PRIVATE LIMITED+

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Indian stocks are jostling weak emerging markets, rising rates, higher oil prices, an election year and relatively rich mid-cap valuations. The large-cap index has support from an improving growth cycle, strong macro stability and local appetite for equities.

What is in favor of Indian equities?

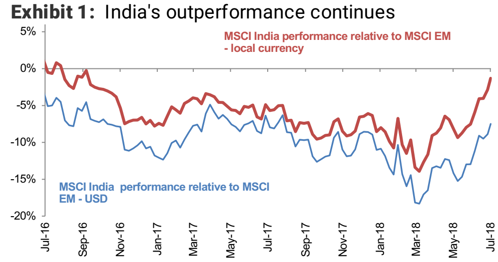
- Strong macro stability evident in a positive BoP and backed by a Central Bank that is committed to keeping real rates positive.
- A bullish steepening of yield curve, which is at post-2010 highs – the yield curve correlates positively with stocks.
- A low and falling beta, which augurs well in a weak global equity market environment as we have seen over the past few weeks.
- India's growth is likely accelerating relative to EM. Our work shows that corporate confidence is at a multiyear high and profits are likely to mean revert from below trend.
- Strong domestic flows, currently averaging around US$2-2.5 billion a month, which we believe are in a structural uptrend.
- Weaker FPI positioning, now at 2011 levels.

What is against Indian equities?

- Likely rising crude oil prices, which could put pressure on growth.
- Upward pressure on inflation from food price hikes making sure that more rate hikes are coming.
- The election cycle, which brings its own set of uncertainties.
- Relatively rich mid-cap valuations (even after the recent drawdown).
- Equity valuations relative to bonds is at the top end of its range, indicating that the market is pricing in some part of the coming growth recovery.
- Rising equity supply.

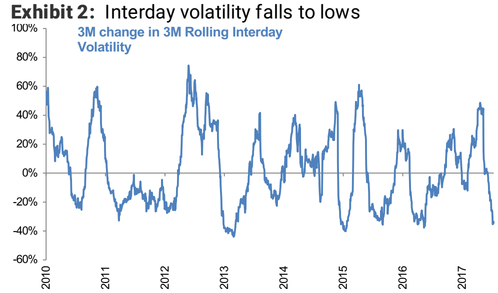
Portfolio strategy: We prefer large-caps over mid-caps. We like Banks (private corporate and retail), Discretionary Consumption, Industrials and Domestic Materials, while avoiding Healthcare, Staples, Utilities, Global Materials and Energy.

Exhibit 1: India's outperformance continues



Source: RIMES, MSCI, Morgan Stanley Research

Exhibit 2: Interday volatility falls to lows



Source: Bloomberg, Morgan Stanley Research.

Exhibit 3: Small and mic-cap price drawdown intense but valuations still rich

Source: Bloomberg, Morgan Stanley Research.

Summary of Our Views

Risks and Catalysts (Exhibits 1-3, 17-22):

The section in this report, "Known Unknowns", outlines the potential risks and catalysts for Indian equities in the coming months. We highlight some of the key ones below:

- **Earnings growth:** At current valuations – especially where equities trade vs. bonds – it is imperative that the growth cycle turns. The market is already anticipating some turn in the growth cycle and hence a feeble improvement will not help stocks.
- **Rates**: We need to bear in mind that the RBI now has an explicit mandate to keep inflation under the lid (unlike the past, when its mandate oscillated between growth and inflation). This means that the historical relationship between short rates and equities cannot be relied upon in the coming cycle. At the minimum, there is likely to be more volatility in stocks as the rate cycle inflects upward. We see a couple of more rate hikes this year with oil and food prices representing a risk to the upside for rates. Also note that the yield curve is undergoing bullish steepening, which correlates positively with equities. The fiscal slippage has been a key source of worry for the bond markets, but a large part of this is already in play in the bond market.
- **Global equities**: While global market performance remains a key to the absolute performance of Indian stocks in the near term, India's beta to the world has dropped to a 13-year low and possibly sets the stage for India's outperformance in a low-return world (Where has the India Story Vanished?).
- **Oil prices:** This remains a key risk to equities given its ability to cause pain to the fiscal deficit and, therefore, growth.
- **Political cycle**: As we approach the 2019 general elections, the market is likely to shift focus on likely outcomes as a key driver for performance (The World's Biggest Democratic Elections: How to Forecast Them & What to Do with Portfolios).
- **Net demand-supply**: Household demand for stocks remains strong, although supply is also rising. There is an active debate on the sustainability of domestic flows, and the monthly number will be widely tracked (India Equity Strategy: Dream Run: What Is the Risk to Domestic Equity Flows?).

Macro and politics (Exhibits 23-28)

We see strong growth in 2018 and 2019 driven by consumption, exports, government spending and a nascent recovery in private capex. We see a tighter monetary policy in 2018 as well as the risk of a higher-than-budgeted fiscal deficit as we approach elections in 2019.

- The policy uncertainty index has been low, but the relative market performance has underperformed, i.e., diverged. The election calendar thickens in 2018/19, and hence

Exhibit 4: Forecasts at a Glance

	F2017	F2018E	F2019E	F2020E
GDP Growth	5.7%	6.1%	6.3%	6.6%
GDP Growth (new)	7.1%	6.7%	7.5%	7.7%
IIP Growth	4.6%	4.4%	4.1%	4.4%
Average CPI	4.5%	3.6%	4.5%	4.3%
Repo Rate (year end)	6.25%	6.00%	6.75%	6.75%
CAD% of GDP	-0.7%	-1.9%	-2.2%	-1.9%
Sensex EPS	1420	1492	1837	2269
Sensex PE	25.7	24.5	19.9	16.1
EPS growth YoY	-0.5%	5.0%	23.1%	23.5%
Broad Market Earnings Growth	0.0%	3.0%	20.0%	22.0%
Broad Market PE	31.0	30.1	25.1	20.5

Source: RIMES, MSCI, Morgan Stanley Research (E) estimates

the market's perception of uncertainty will likely rise in 2018/19.

- Growth indicators are turning up.
- There are nascent signs of a capex cycle evident in order books. Our AlphaWise survey points to a recovery in private capex in the coming months (Corporate Confidence Is Back, Capex to Follow).
- The yield curve has steepened to a post-2010 high and it augurs well for stocks.
- India's macro stability remains strong, and is unlikely to be threatened by a rise in oil prices. However, rising oil prices can bring growth problems for India given the limited fiscal flexibility in an election year.
- The rupee has suffered some real and nominal depreciation over the past few weeks, which augurs well for reported earnings.

Liquidity (Exhibits 29-34)

Liquidity, or the force of the bid, has weakened in recent weeks.

- The pace of the rise in market multiple relative to earnings has fallen in recent weeks to slightly negative territory.
- Our global liquidity proxy is rising and should be tracked closely for a shift in global liquidity conditions.
- Share prices appear neutral relative to M2 growth.
- Financial conditions have eased at the margin.
- Short yields for India have fallen relative to the US. We feel that the historical relationship between relative rates and relative equity performance will be reinforced. Accordingly, India's relative performance should continue to improve.
- The yield curve has steepened, which correlates positively with equities.

Corporate Fundamentals (Exhibits 35-46)

In our base case, BSE Sensex earnings growth is pegged at 5%, 23% and 24% for F2018, F2019 and F2020, respectively.

- Our proprietary models point to robust earnings growth in the next three years. Profits could surprise significantly on the positive side given the low starting point of profit share in GDP, which is almost at 2002 levels.
- Balance sheet recession (which we define as return on capital being lower than the cost of debt) has also ended and may prompt a private capex recovery. Corporate balance sheets have delevered over the past two years, and free cash flows are sitting at all-time highs at over 10% to sales.

- Asset turn has hit a post-GFC high and ROE may have troughed for this cycle.
- The consensus has held its F2019 and F2020 Sensex numbers, generally speaking. We think earnings revisions breadth should turn positive in the coming weeks.
- Profits have trailed GDP since F2011 and are likely coming out of their deepest and longest recession in Indian history.

Valuations (Exhibit 47-58)

The absolute P/B is around average, but mid-cap valuations are still looking stretched despite the recent drawdown. Equities do not look compelling vs. long bonds. India's recent outperformance has lifted relative valuations above average. Our composite valuation indicator suggests low double-digit index returns in the coming 12 months. Valuations, on their own, unless at extreme points, rarely give a clue of where stocks are heading. We also do not think the narrow indices, such as the Sensex or the Nifty, are pricing in a multiyear growth cycle, implying meaningful upside potential to stocks over the next three to five years.

- For long-term investors, valuations are still in the comfort zone.
- Valuations relative to interest rates are not attractive, so we continue to argue for even or better performance for long bonds versus equities (unlike 2017).
- At this point of the cycle, given how depressed earnings are, P/E could be misleading and P/B offers a better valuation perspective, in our view.
- Shiller P/E and market cap to GDP for the broad market are both off highs after multiyear highs in January.
- Share of India's market cap in global market is below its share in global GDP.

Sentiment (Exhibit 59-70)

Overall sentiment appears to be in neutral territory post the rallies off lows made in March. Indian equities just about remain in a bull market with the 200DMA slightly above the 50DMA (golden cross).

- EM positioning in India is also at a multiyear low, and the level of trailing FPI inflows suggest a bounce in FPI demand for stocks. FPIs have also meaningfully trimmed exposure in mid-caps relative to large caps. Domestic equity assets to total assets is close to an all-time high.
- Net demand supply for equities is deteriorating due to likely higher supply even as household balance sheet rebalancing toward equities is unabated. We are expecting equity issuances of around US$45-50 billion in 2018 compared to US$28 billion in 2017.

Portfolio Strategy

We continue to back growth at a reasonable price. The way to construct portfolios is to buy stocks of companies with the highest delta in return on capital. The market's character is most evident in the all-time low correlation of returns across stocks. This tells us that market participants are acutely idiosyncratic in their approach to stocks. A likely mean reversion in correlations warrants wider sector positions. We continue to prefer large caps over mid-caps given relative valuations.

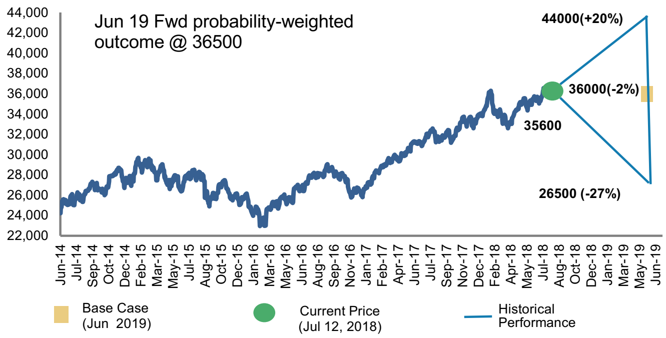
Recap of our biggest sector views:

- *Consumer Discretionary (+500bp):* Strong consumer loan growth and rising real incomes drives our view.
- *Financials (+500bp):* Credit costs are likely to decline, led by M&A activity and a recovery in economic growth. Recapitalization will also help the Corporate banks. Loan growth prospects are looking up as the economy gathers pace. The bankruptcy processes are gaining pace, in our view. Non-banks may face margin pressure as rates rise.
- *Industrials (+400bp): Private capex is likely turning and public capex remains strong.*
- *Technology (+0bp):* Business momentum is recovering and the sector has done well over the past few months contrary to market expectations.
- *Consumer Staples (-600bp):* Stocks look rich and profit growth may trail the market due to lower leverage to an economic recovery.
- *Healthcare (-200bp):* The sector remains challenged by regulatory burden.
- *Utilities (-200bp):* We prefer cyclical exposures.
- *Energy (-300bp) and Materials (-100bp):* Funding source for our overweights.

Index Target: On our June 2019 target of 36,000, the BSE Sensex would trade at just under 16x one-year forward P/E, which below its historical average.

- *Base case (50% probability) – BSE Sensex: 36,000:* All outcomes are moderate. Growth accelerates slowly. We expect Sensex earnings growth of 5% YoY in F2018, 23% YoY in F2019 and 24% YoY in F2020.
- *Bull case (30% probability) – BSE Sensex: 44,000:* Better-than-expected outcomes, most notably on policy and global factors. The market starts believing in a strong election result. Earnings growth accelerates to 29% in F2019 and 26% in F2020.
- *Bear case (20% probability) – BSE Sensex: 26,500:* Global conditions deteriorate and the market starts pricing in a poor election outcome. Sensex earnings grow 21% in F2019 and 22% in F2020.

Exhibit 5: BSE Sensex Outlook: Risk-Reward for Jun-19



Source: RIMES, Morgan Stanley Research (E) estimate

Exhibit 6: Sector Model Portfolio

Sector	OW/UW (bps)	Performance relative to MSCI India (YTD)	(12M)
MSCI India		**0%**	**11%**
Consumer Disc.	500	-7%	-6%
Consumer Staples	-600	11%	6%
Energy	-300	1%	12%
Financials	500	1%	-3%
Healthcare	-200	-5%	-18%
Industrials	400	0%	-3%
Technology	0	15%	14%
Materials	-100	-10%	-5%
Telecoms	0	-29%	-17%
Utilities	-200	-11%	-5%

Source: RIMES, MSCI, Morgan Stanley Research

Exhibit 7: Focus List

Stocks	Sector	Rating	Price as on Jul 12, 2018	MCap ($ bn)	Rel to MSCI India YTD Perf	Rel to MSCI India 12m Perf	2Y Fwd EPS Growth
Bajaj Auto	Cons. Disc.	OW	3,097	13.1	-8%	1%	11%
M&M	Cons. Disc.	OW	916	15.9	21%	20%	19%
Maruti	Cons. Disc.	OW	9,347	41.2	-5%	13%	23%
Zee Entertainment	Cons. Disc.	OW	534	7.5	-9%	-5%	21%
Titan	Cons. Disc.	OW	808	10.5	-7%	38%	29%
ITC	Staples	OW	277	49.4	4%	-24%	13%
Reliance Industries	Energy	OW	1,082	100.1	16%	30%	18%
Bharat Financial	Financials	++	1,177	2.4	16%	39%	110%
HDFC Bank	Financials	OW	2,166	82.3	14%	17%	24%
ICICI Bank	Financials	OW	272	25.6	-14%	-16%	49%
Indusind Bank	Financials	++	1,938	17.0	16%	11%	30%
M & M Financial	Financials	OW	479	4.3	0%	19%	47%
Shriram Transport	Financials	OW	1,213	4.0	-19%	6%	31%
Dr Reddy's	Healthcare	OW	2,357	5.7	-3%	-21%	48%
Adani Ports	Industrials	OW	369	11.2	-10%	-11%	12%
Havells India	Industrials	OW	562	5.1	-1%	6%	23%
Asian Paints	Materials	OW	1,358	19.0	16%	8%	23%
Ultratech Cement	Materials	OW	3,947	15.8	-10%	-15%	31%
UPL	Materials	OW	582	4.3	-25%	-39%	15%
Infosys	Technology	OW	1,294	41.1	24%	21%	2%

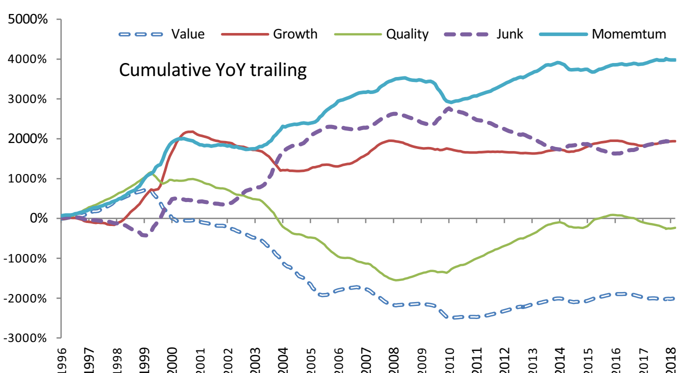
Source: RIMES, Morgan Stanley Research; ++ Rating and price target for this company have been removed from consideration in this report because, under applicable law and/or Morgan Stanley policy, Morgan Stanley may be precluded from issuing such information with respect to this company at this time.

Exhibit 8: Key Themes in Our Portfolio: We Prefer Growth Stocks and Wide Sector Positions

Themes	Implications	Stocks
M&A	Banks, property, infrastructure, materials and telecoms	JSW Steel
Capex	Companies that have done capex over the past 5 years	Reliance Industries, JSW Steel
Unloved and under-owned stocks	Valuations and momentum	Asian Paints
Rising ROCE	Delta in ROCE probably more important than just the level	Asian Paints, MMFS
Earnings revisions	Earnings momentum is a key share price driver	Maruti Suzuki
Growth at a reasonable price	As a style growth is likely to lead performance in the coming months	Bajaj Auto, HDFC Bank, UPL, Zee, ITC

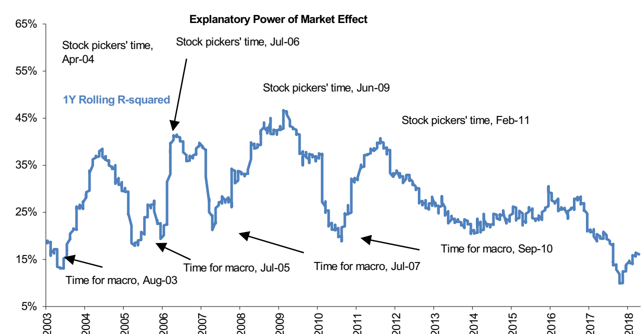
Source: Morgan Stanley Research.

Exhibit 9: Style Performance: GARP in Form



Source: RIMES, Morgan Stanley Research

Exhibit 10: Correlation across Stocks



Source: RIMES, Morgan Stanley Research

Note: Prices as of July 12, 2018. Past performance is no guarantee of future results. Results shown do not include transaction costs.

Portfolio Strategy: Stock Screens

Exhibit 11: Capex Screen

Company	MS Rating	Stock prices (as on Jul 12, 2018)	Cumulative Capex to Total Assets	5 year relative performance
Colgate-Palmolive	Underweight	1,151	0.99	-2%
IPCA	Overweight	745	0.65	-10%
Jindal Steel & Power	Overweight	219	0.71	-12%
Jubiliant Food	Overweight	1,425	0.86	11%
JSW Steel	Equal-Weight	317	0.61	23%
JK Lakshmi	Underweight	348	0.51	18%
ONGC	Underweight	159	0.67	-15%
Power Grid	Overweight	183	0.71	-2%
Reliance Industries	Overweight	1,082	0.80	6%
Shree Cement	Overweight	17,123	0.51	16%

Source: RIMES, Morgan Stanley Estimates, Morgan Stanley Research. Note: Cumulative Capex is sum of capex from F2013 to F2017. For important disclosures regarding companies that are the subject of this screen, please see the Morgan Stanley Research Disclosure Website at www.morganstanley.com/researchdisclosures.

Exhibit 12: Highest 3M Earnings Revisions

Company Name	Sector	Stock Rating	Prices as on Jul 12, 2018	3M Earnings Revisions (FY19E)
Ashok Leyland	Industrials	Overweight	134	9.9%
Coal India	Energy	Equal-Weight	265	6.5%
Jubilant Food	Consumer Disc.	Overweight	1,425	16.8%
JSW Steel	Materials	Equal-Weight	317	24.3%
MindTree	IT	Overweight	1,077	7.8%
MphasiS	IT	Overweight	1,167	7.3%
Oil India	Energy	Underweight	210	6.6%
SAIL	Materials	Underweight	75	14.1%
Tech Mahindra	IT	Overweight	648	7.6%
HDFC Standard Life	Financials	Equal-Weight	479	11.5%

Source: RIMES, IBES Estimates, Morgan Stanley Research. For important disclosures regarding companies that are the subject of this screen, please see the Morgan Stanley Research Disclosure Website at www.morganstanley.com/researchdisclosures.

Exhibit 13: Stocks with Best Two-year Forward Delta in ROCE from Our Coverage Universe – OW Rating

Stock	Price as on Jul 12, 2018	2Yr Change in ROCE	ROA+Operating Earnings Yield (F19E)
Asian Paints	1,121	6.1%	28%
Dabur	338	12.2%	36%
Dr. Reddy's	2,111	10.9%	18%
Godrej Cons.	1,012	6.7%	24%
Havells	504	5.5%	19%
Infosys	1,109	10.0%	25%
ITC	275	7.7%	53%
Titan	784	5.5%	25%
IPCA Labs	573	5.9%	26%
MindTree	717	11.7%	22%
MphasiS	833	7.6%	25%
Gujarat Gas	858	13.7%	25%

Source: RIMES, Company Data, Morgan Stanley Research. For important disclosures regarding companies that are the subject of this screen, please see the Morgan Stanley Research Disclosure Website at www.morganstanley.com/researchdisclosures.

Exhibit 14: Growth at a Reasonable Pricing – OW Rating

Stock	Price as on Jul 12, 2018	Trailing 36M Beta	EPS Growth (F18-20E)	2Yr Change in ROCE	Implied EPS growth (SD from avg)
Asian Paints	1,121	0.78	18%	6.1%	0.6
Dabur	338	0.73	8%	12.2%	0.0
Dr. Reddy's	2,111	0.91	39%	10.9%	-0.4
Godrej Cons.	1,012	0.95	17%	6.7%	0.9
Havells	504	0.85	22%	5.5%	1.1
Infosys	1,109	0.63	7%	10.0%	-1.1
ITC	275	1.00	11%	7.7%	-0.7
Titan	784	0.76	39%	5.5%	0.9
IPCA Labs	573	0.63	48%	5.9%	-0.3
MindTree	717	0.56	31%	11.7%	1.0
MphasiS	833	0.78	20%	7.6%	0.0
Gujarat Gas	858	0.52	61%	13.7%	-0.4

Source: RIMES, Bloomberg, Morgan Stanley Research. For important disclosures regarding companies that are the subject of this screen, please see the Morgan Stanley Research Disclosure Website at www.morganstanley.com/researchdisclosures.

Exhibit 15: Un-loved and Under-owned Stocks

Company	MS Rating	Prices as on Jul 12, 2018	3M/3Y Avg daily traded volume	12M Perf	Beta	3M Change in 12M Beta	200DMA Deviation	Institutional Position	Sell-side Reco
ACC	Overweight	1,350	149%	-21%	1.05	-0.15	-16%	42%	0.24
Ambuja Cements	Underweight	202	114%	-23%	1.02	-0.18	-18%	57%	0.15
Bank of India	Underweight	85	141%	-42%	2.17	-0.23	-37%	71%	-0.69
Colgate-Palmolive	Underweight	1,151	122%	7%	0.38	-0.16	5%	53%	0.18
Cummins India	Underweight	656	130%	-28%	0.86	-0.22	-19%	71%	0.38
G.E. Shipping Co	Underweight	276	39%	-33%	0.86	0.04	-25%	72%	0.50
Indraprastha Gas	Overweight	262	87%	17%	0.43	-0.22	-11%	66%	0.53
JK Lakshmi Cement	Equal-Weight	348	67%	-26%	0.68	-0.12	-14%	53%	0.48
JSW Energy	Overweight	68	32%	5%	1.30	0.25	-15%	36%	-0.27
Oil India	Equal-Weight	210	99%	18%	0.36	-0.06	-9%	14%	0.50
IDFC Bank	Underweight	39	150%	-39%	1.12	-0.15	-23%	42%	0.27
Gujarat Gas	Underweight	778	31%	2%	0.60	0.16	-8%	44%	0.43
Dr Lal	Underweight	897	47%	7%	0.63	-0.25	4%	55%	0.47
Narayana Hrudyalaya	Underweight	247	43%	-19%	-0.08	0.14	-12%	55%	0.78
Future Consumer	Equal-Weight	48	75%	28%	1.25	-0.32	-20%	37%	0.00

Source: RIMES, Bloomberg, Morgan Stanley Research. For important disclosures regarding companies that are the subject of this screen, please see the Morgan Stanley Research Disclosure Website at www.morganstanley.com/researchdisclosures.

Exhibit 16: Over-loved and Over-owned Stocks

Company	MS Rating	Prices as on Jul 12, 2018	3M/3Y Avg daily traded volume	12M Perf	Beta	3M Change in 12M Beta	200DMA Deviation	Institutional Position	Sell-side Reco
HCL Tech	Overweight	1,006	132%	18%	0.61	0.09	9%	91%	0.55
HDFC Bank	Overweight	2,166	145%	29%	0.72	-0.08	13%	57%	0.87
Cyient	Overweight	742	217%	41%	0.43	0.16	16%	78%	0.83
Just Dial	Underweight	585	226%	57%	1.26	0.11	20%	68%	-0.26
Jubilant Food	Overweight	1,425	131%	158%	1.06	-0.16	35%	83%	0.59
Kotak Bank	Overweight	1,390	100%	45%	0.83	0.09	24%	69%	0.68
MphasiS	Overweight	1,167	301%	94%	0.48	-0.01	36%	74%	0.44
Oberoi Realty	Overweight	476	130%	25%	1.08	0.04	-3%	93%	0.71
Edelweiss	Overweight	298	102%	57%	1.30	0.08	5%	48%	1.00
SAIL	Underweight	75	175%	20%	2.12	0.17	-5%	68%	-0.20
TCS	Overweight	1,971	178%	62%	0.72	0.05	31%	85%	0.27
Yes Bank	Overweight	375	84%	24%	1.34	0.35	14%	84%	0.81
Indiabulls Housing	Underweight	1,144	759%	3%	1.33	-0.08	-7%	87%	0.63
Future Retail	Overweight	560	156%	43%	1.30	-0.03	2%	41%	0.90

Source: RIMES, Bloomberg, Morgan Stanley Research. For important disclosures regarding companies that are the subject of this screen, please see the Morgan Stanley Research Disclosure Website at www.morganstanley.com/researchdisclosures.

The Known Unknowns

	Why is this important	What the market could be pricing in	What is our expectation
Growth			
High frequency data	Growth cycle is at an inflexion point in our view	Mixed data with some signs of improvement	Better improvement than what may be priced in
Earnings season	Earnings have persistently disappointed since 2010	Modest improvement in growth QoQ	We are watching for margin improvement as operating leverage kicks in
Earnings guidance	Will set the stage for earnings revisions breadth to turn positive	Neutral to positive guidance	Positive guidance from tech, autos, other disc consumption, private sector banks and industrials
GST collections	GST revenues have been weak and caused fiscal concerns	Likely stabilization of revenues at around the current levels of Rs900-1000 billion	Acceleration possibly to over Rs1 trillion
Loan growth	A lagging indicator of growth	Modest increase led by retail loan growth	Some acceleration in corporate loan growth consistent with our view on the growth cycle
Order books	A signal that capex is returning	No major increase	We think order books are likely to build visibly in the coming months
Rates			
CPI	We expect the RBI to have limited tolerance to a rise in CPI	Range-bound CPI	For the next three months, we expect core inflation to remain stable, food prices should continue to drive the headline CPI. Upside risk to inflation from the MSP hike could (assuming full pass-through) be about 66bp.
Monetary policy	Crucial to protect India's hard earned macro stability	Market is expecting rate hikes though exact quantum is hard to judge	We expect rate hikes at the August and October meetings, with the quantum of rate hikes totaling 75bp for this cycle.
Long bonds	Recent change in government borrowing program and rumors about an increase in foreign limits has calmed the market	Bond prices are likely to be the current range given that the growth cycle has hit an inflexion point. Thus the yield curve is at its highest level since 2010	See: India Equity Strategy: Why and How Long Bond Yields Matter to Equities (22 Mar 2018)
Politics & Policy			
Elections	The market believes that the state elections may provide insight into the general elections	A difficult election for the BJP	We think these elections will have limited bearing on general elections – if the BJP fares well, the market could react positively
Fiscal spending	Higher spending creates inflation risk	Market is expecting higher than budgeted deficit in a an election year	Our economist expects fiscal deficit of 3.4% in F2019, higher than the government's target of 3.3%, and vs. 3.5% in F2018
Monsoons	Rains affect market sentiment more than growth	Normal rains	Normal rains
NCLT process	Important for loan growth	Some acceleration in the fruition of deals	Similar to the market

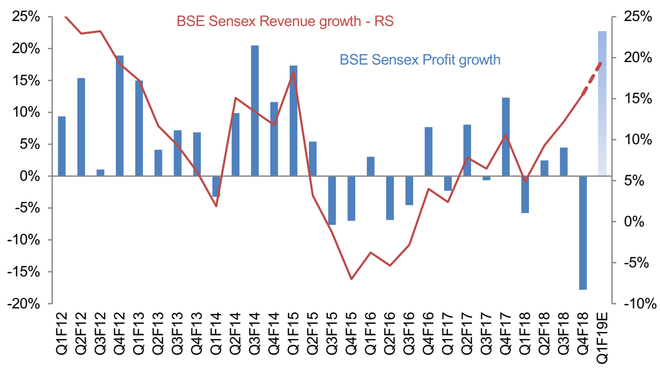
Source: Morgan Stanley Research

	Why is this important	What the market could be pricing in	What is our expectation
Market			
Domestic flows	Domestic flows have been a reliable source of equity demand over the past three years	Some challenge to the run rate of US$2.5 to US$3 billion due to market volatility	See: India Equity Strategy: Dream Run: What Is the Risk to Domestic Equity Flows? (19 Mar 2018)
Corporate activity	Higher supply will drag down share prices, while M&A is an offset	Some increase in supply and M&A	We also expect net demand-supply to deteriorate in 2018 as companies raise growth capital
Global			
Fed rates	Determines risk appetite for EM	One more hike this year	Our US economist expects the Fed to raise once more this year
EM performance	India remains highly correlated to global equities	NA	India's beta has fallen to a 13-year low and thus India is outperforming global equities
Oil prices	Given the fiscal constraints, higher oil could hurt growth	Oil to have a negative impact on the fiscal deficit and growth	Key risk to equities given its ability to cause pain to the fiscal deficit and, therefore, growth. Our oil analyst expects crude to be US$85/bbl for 2H18.

Source: Morgan Stanley Research

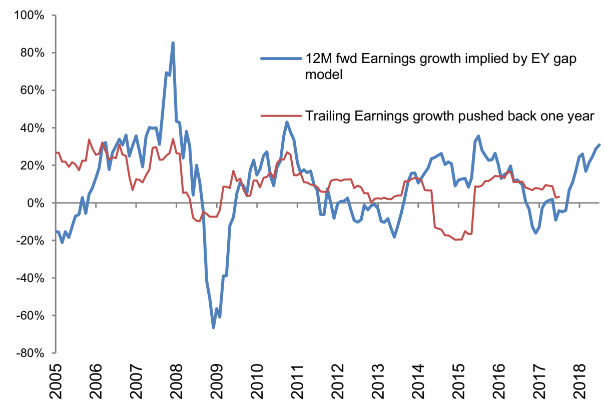
Risks/Catalysts

Exhibit 17: Growth cycle turning? YoY Sensex Revenue and Earnings Growth



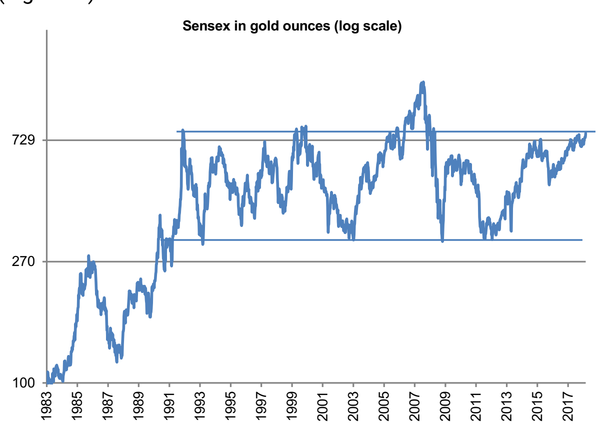
Source: Company Data, Morgan Stanley Research

Exhibit 18: Market anticipating some recovery in growth: Earnings growth implied by EY Gap



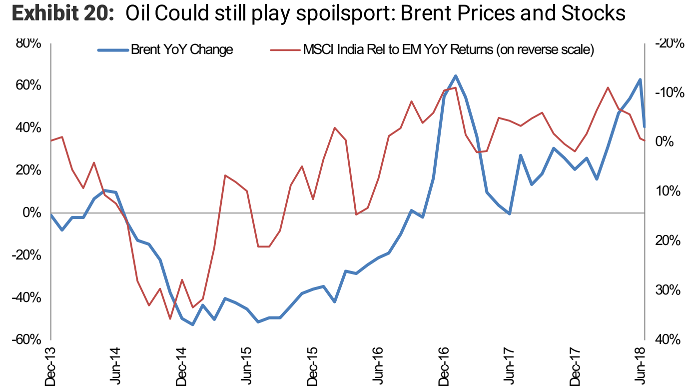
Source: Bloomberg, RIMES, MSCI,, Morgan Stanley Research

Exhibit 19: Sensex at the top end in gold terms: Sensex in Gold Ounces (log scale)



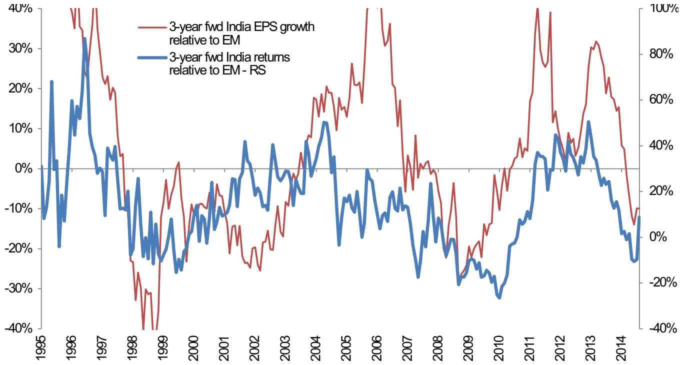
Source: RIMES, Bloomberg, MSCI, Morgan Stanley Research,

Exhibit 20: Oil Could still play spoilsport: Brent Prices and Stocks



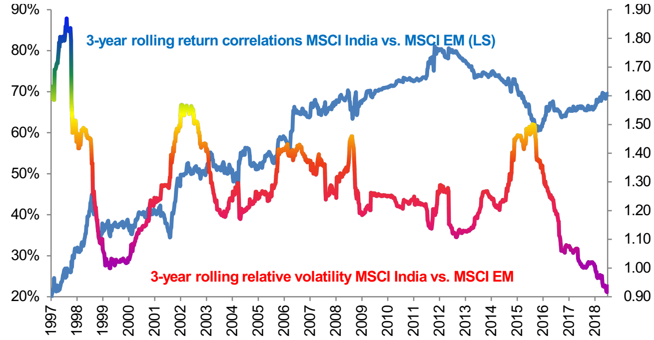
Source: Bloomberg, RIMES, MSCI,, Morgan Stanley Research

Exhibit 21: India's Growth and Performance Relative to EM: Growth Key to India's Outperformance



Source: RIMES, MSCI, Morgan Stanley Research

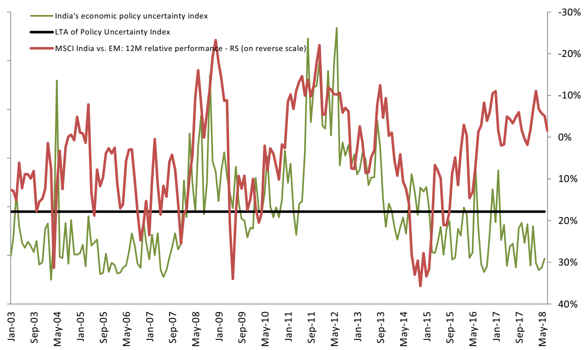
Exhibit 22: India's beta composition to EM: The Fall in Relative Volatility



Source: RIMES, Morgan Stanley Research

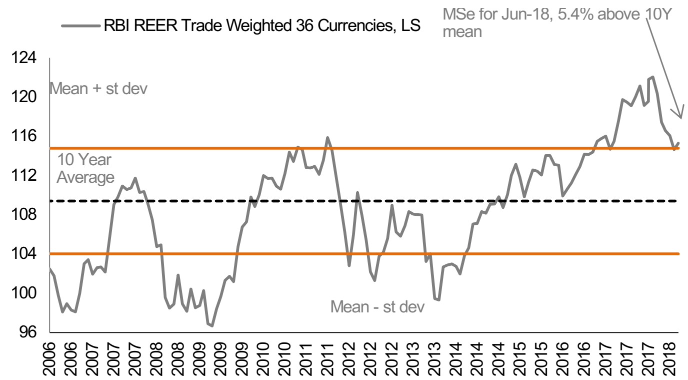
Politics and Macro

Exhibit 23: India's Policy Uncertainty Index



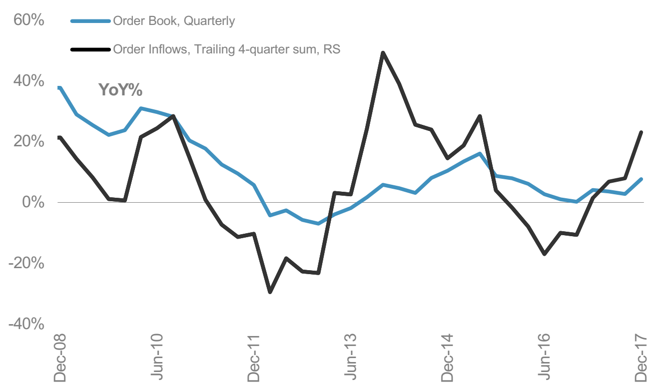
Source: Economic policy uncertainty Index, RIMES, MSCI, Morgan Stanley Research

Exhibit 24: REER Movement



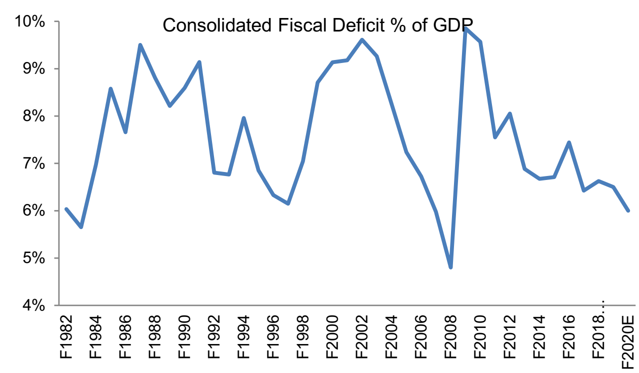
Source: CEIC, Bloomberg, Morgan Stanley Research

Exhibit 25: Order Book



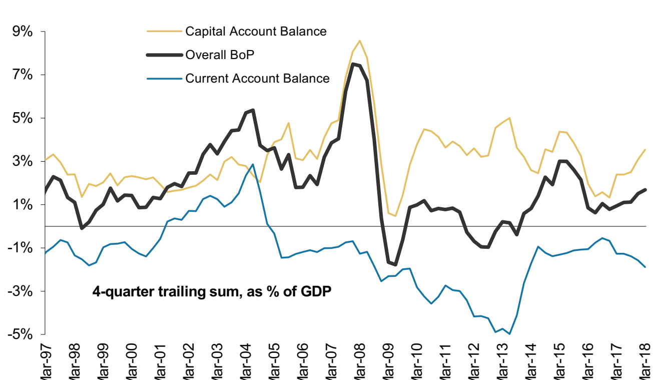
Source: Company data, Morgan Stanley Research

Exhibit 26: Consolidated Fiscal Deficit



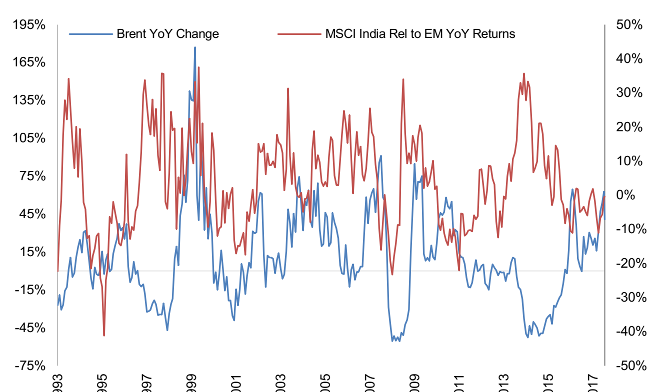
Source: CSO, Morgan Stanley Research , Morgan Stanley estimates

Exhibit 27: India's External Balance Sheet



Source: RBI, CEIC, Morgan Stanley Research

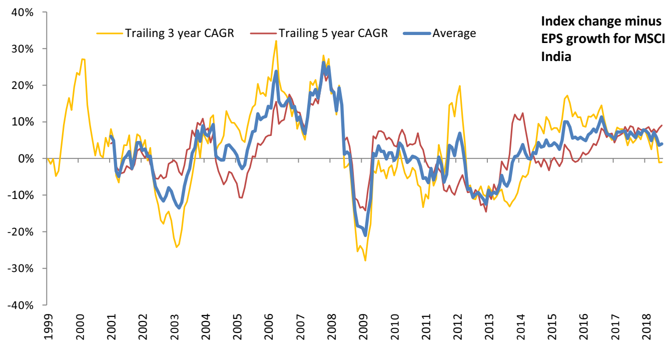
Exhibit 28: Supply Shock in Oil Is Bad for Indian Stocks



Source: RIMES, MSCI, Bloomberg, Morgan Stanley Research

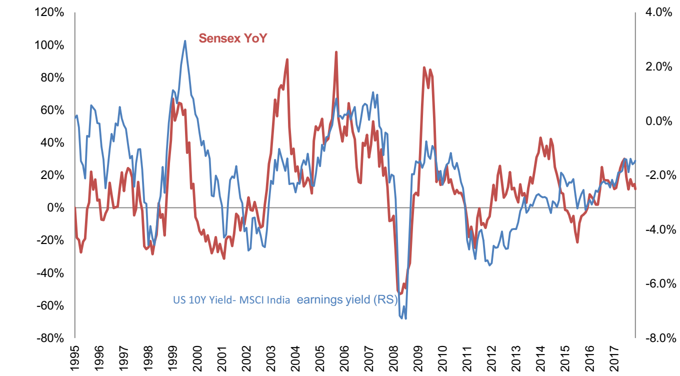
Liquidity

Exhibit 29: P/E Multiple Relative to Earnings Growth – A Measure of the Force of the Bid Over the Offer or Liquidity



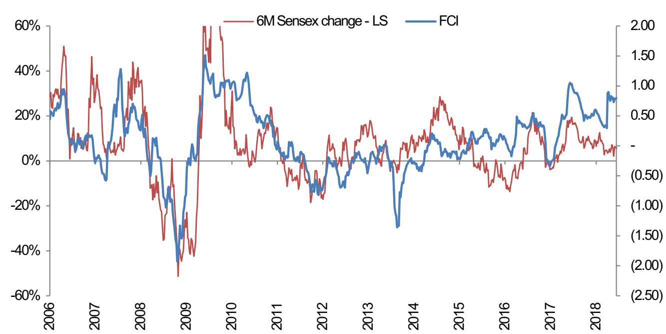
Source: RIMES, Bloomberg, MSCI, Morgan Stanley Research,

Exhibit 30: Global Liquidity Proxy: US Treasury Yield Minus India's Earnings Yield



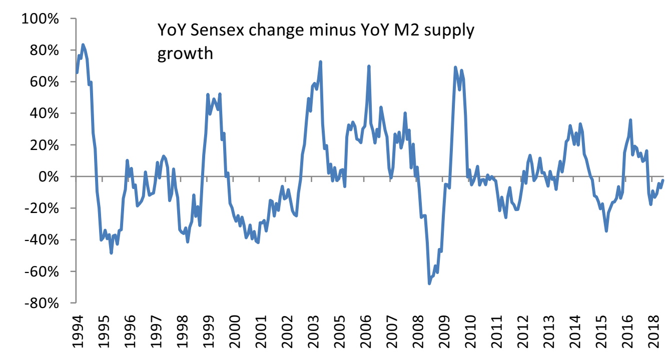
Source: RIMES, Bloomberg, MSCI, Morgan Stanley Research

Exhibit 31: Financial Conditions Index vs. Share Prices: Measure of System Liquidity



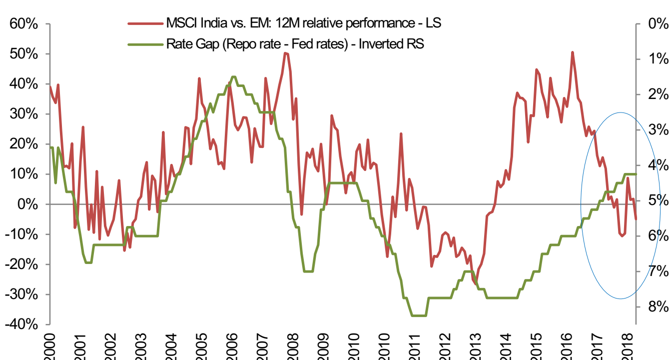
Source: Bloomberg, RBI, CEIC, RIMES, Morgan Stanley Research

Exhibit 32: M2 Supply Growth Relative to Share Prices



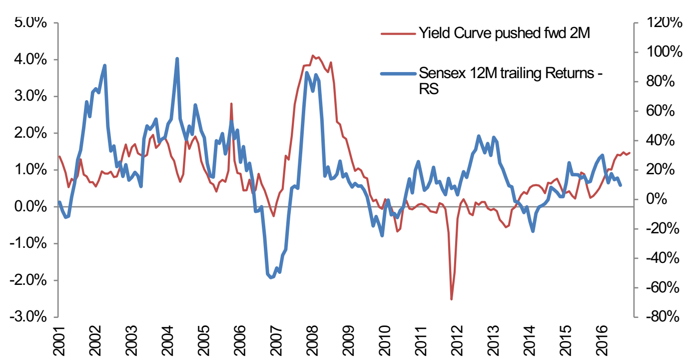
Source: RBI, RIMES, Morgan Stanley Research

Exhibit 33: Fed Rate



Source: Bloomberg, RBI, MSCI, RIMES, Morgan Stanley Research

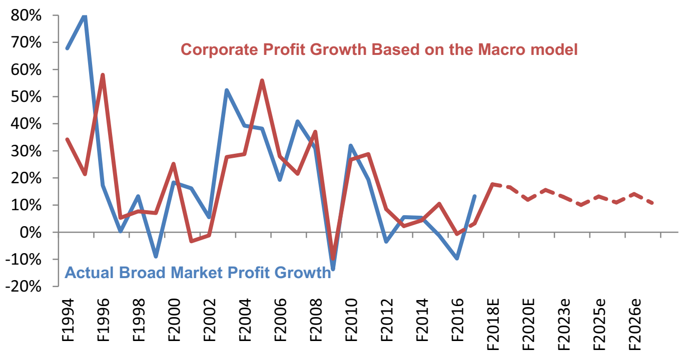
Exhibit 34: Yield Curve vs. Sensex Returns



Source: BSE, Bloomberg, Morgan Stanley Research

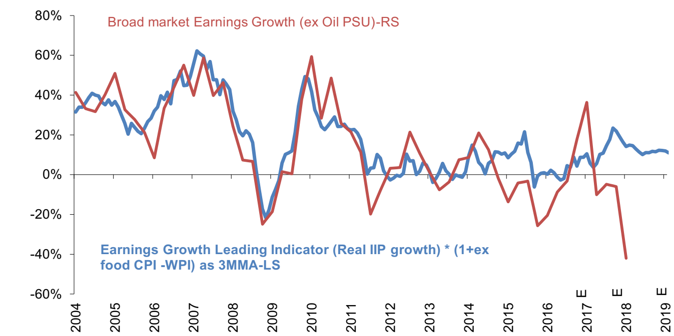
Corporate Fundamentals

Exhibit 35: Macro Earnings Model Based on Kalecki Equation



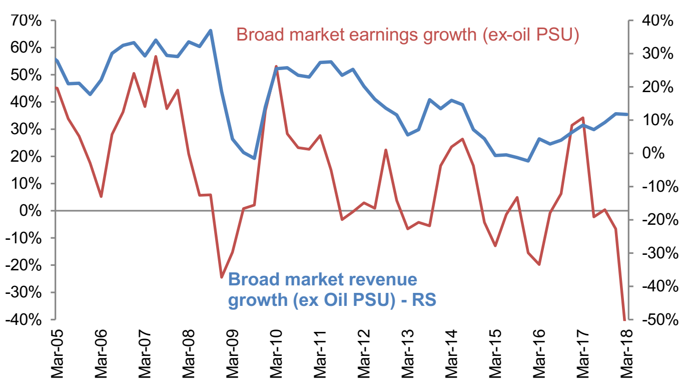
Source: CEIC, Capitaline, Morgan Stanley Research (E) estimates

Exhibit 36: Proprietary Macro Earnings Model Based on IIP/Inflation Differentials



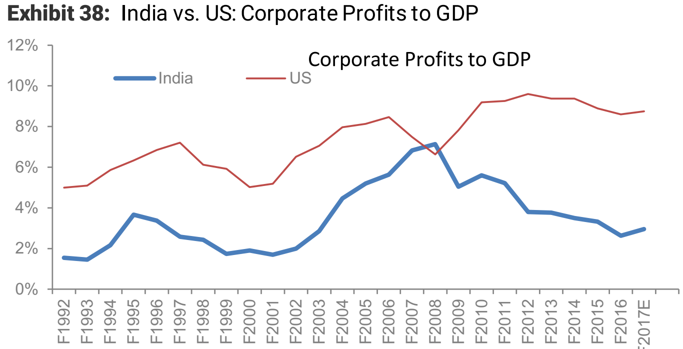
Source: CEIC, Capitaline, Morgan Stanley Research (E) estimates

Exhibit 37: YoY Revenue and Profit Growth for Broad Market



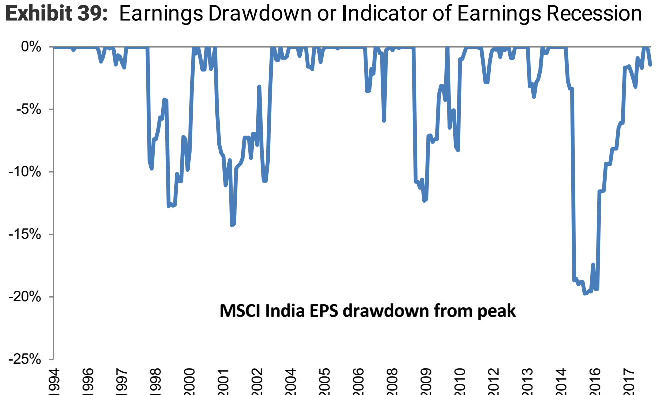
Source: Capitaline, Morgan Stanley Research

Exhibit 38: India vs. US: Corporate Profits to GDP



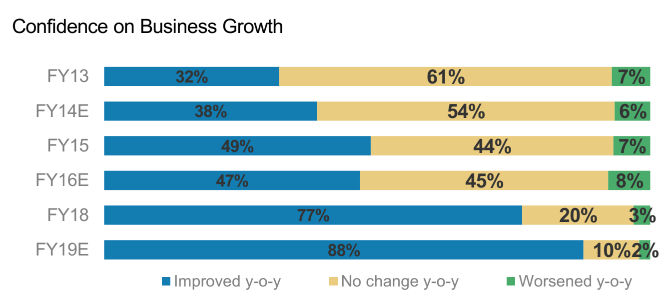
Source: CMIE, Morgan Stanley Research (e) estimates

Exhibit 39: Earnings Drawdown or Indicator of Earnings Recession



Source: RIMES, MSCI, Morgan Stanley Research

Exhibit 40: Corporate Confidence Improves to the Highest Level since F2013



Source: AlphaWise, Morgan Stanley Research

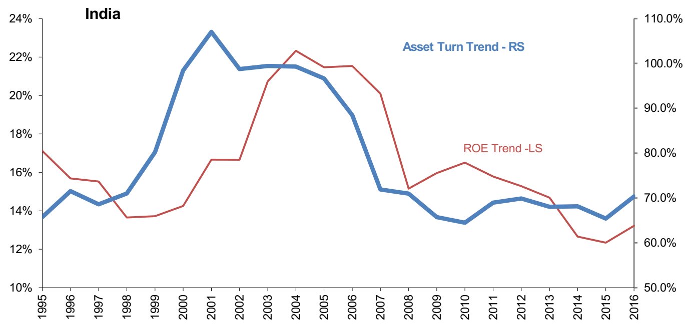
Corporate Fundamentals

Exhibit 41: Morgan Stanley Top-down Sensex EPS Estimates

BSE Sensex EPS	F17	F18e	F19e	F20e
MS Top Down Estimates				
Bear Case		1,387	1,683	2,057
EPS Growth		2%	21%	22%
Base Case	1,366	1,435	1,766	2,182
EPS Growth	-0.5%	5%	23%	24%
Bull Case		1,496	1,925	2,427
EPS Growth		10%	29%	26%
Consensus EPS Estimates		1,536	1,919	2,255
EPS Growth		12%	25%	18%
MS Analyst Estimates				
EPS	1,366	1,462	1,892	2,403
EPS Growth	-0.5%	7%	29%	27%
Broad Market				
MS Top Down Estimates				
EPS Growth	0%	3%	20%	22%

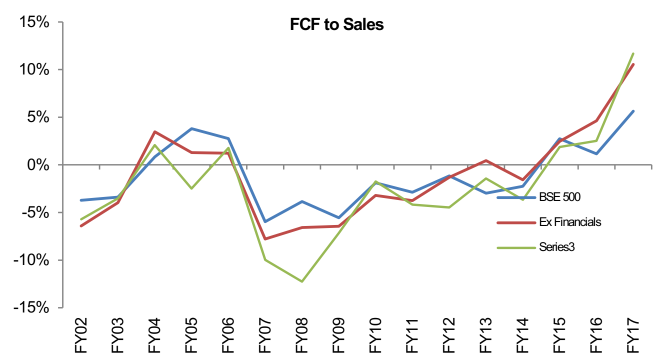
Source: RIMES, MSCI, IBES, Morgan Stanley Research. e= Morgan Stanley estimates except for Consensus estimates, which are IBES estimates

Exhibit 42: India's ROE and Asset Turnover Trend



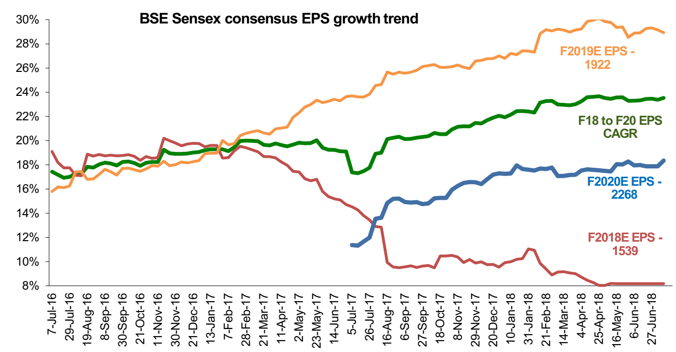
Source: Worldscope, RIMES, MSCI, Morgan Stanley Research

Exhibit 43: Free Cash Flow for Corporate India



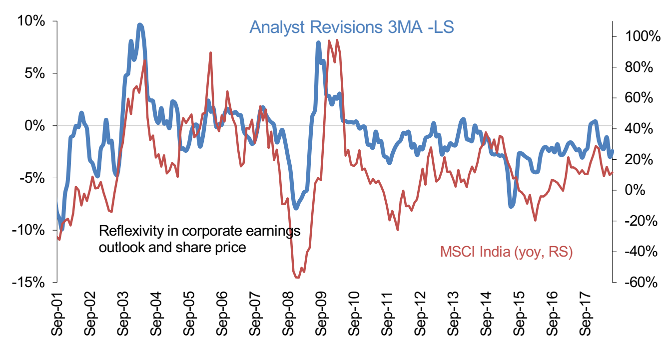
Source: Company Data, Capitaline, Morgan Stanley Research

Exhibit 44: BSE Sensex Consensus EPS Growth Trend



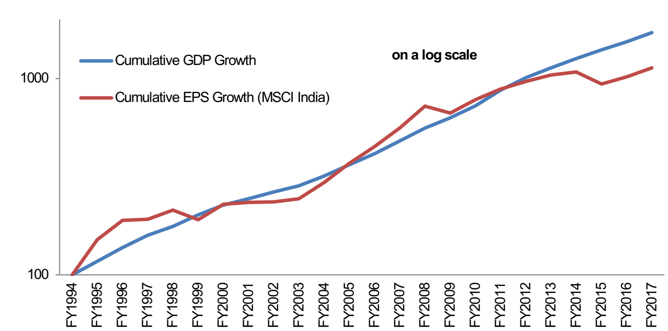
Source: Company Data, Capitaline, Morgan Stanley Research

Exhibit 45: Earnings Estimate Revisions Breadth



Source: RIMES, MSCI, Morgan Stanley Research

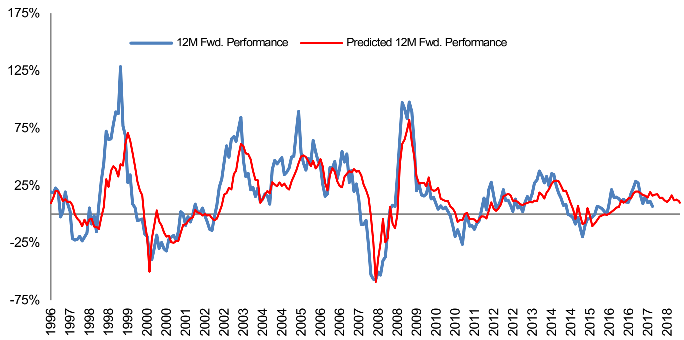
Exhibit 46: GDP Growth vs. Earnings Growth



Source: RIMES, MSCI, CEIC, Morgan Stanley Research

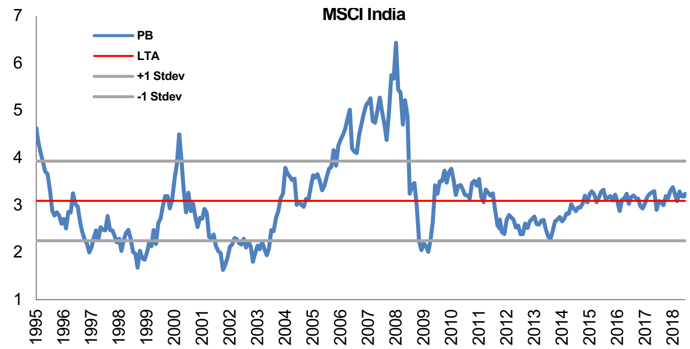
Valuations

Exhibit 47: Average Predicted Performance by All Valuation Tools



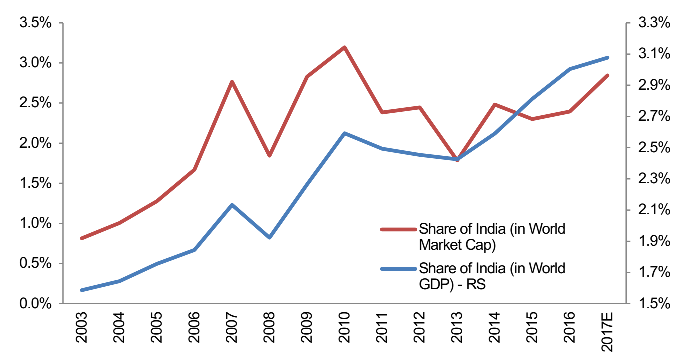
Source: RIMES, MSCI, Morgan Stanley Research

Exhibit 48: Absolute P/B



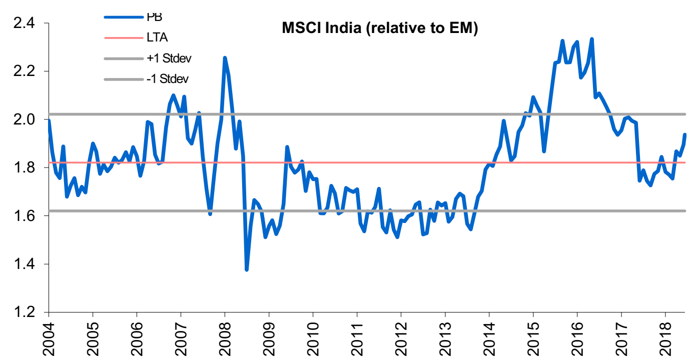
Source: RIMES, MSCI, Morgan Stanley Research

Exhibit 49: Share of India in World Market Cap & GDP



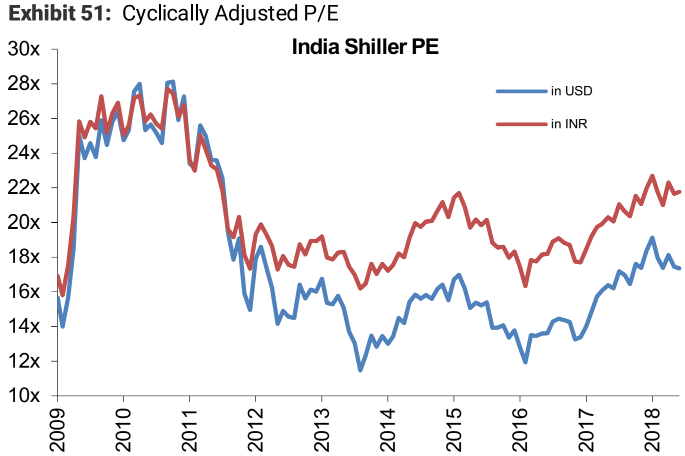
Source: IMF, Bloomberg, Morgan Stanley Research

Exhibit 50: MSCI India P/B Relative to MSCI EM



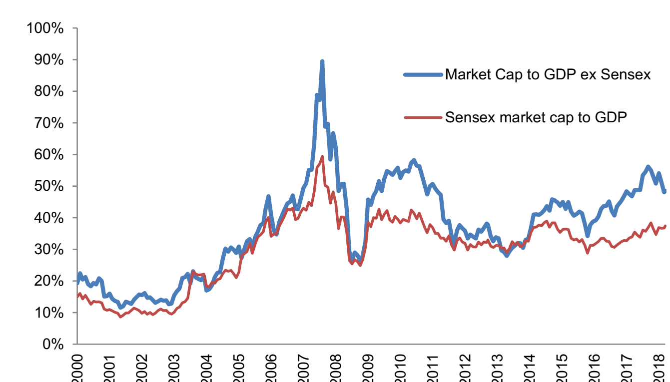
Source: RIMES, MSCI, Morgan Stanley Research

Exhibit 51: Cyclically Adjusted P/E



Source: RIMES, MSCI, Morgan Stanley Research

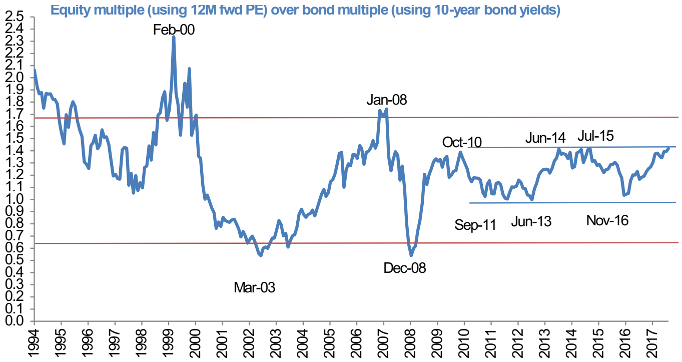
Exhibit 52: Market Cap to GDP



Source: Capitaline, Morgan Stanley Research

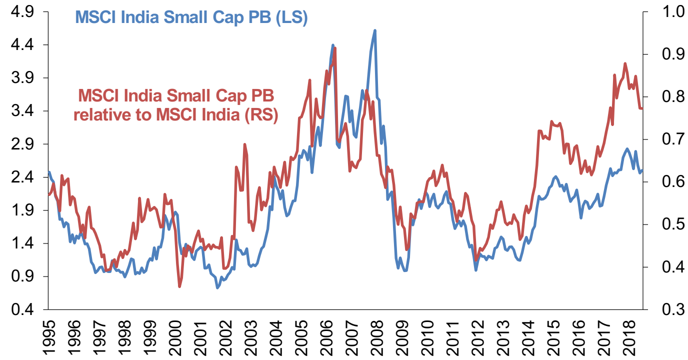
Valuations

Exhibit 53: Equity vs. Bond Multiple



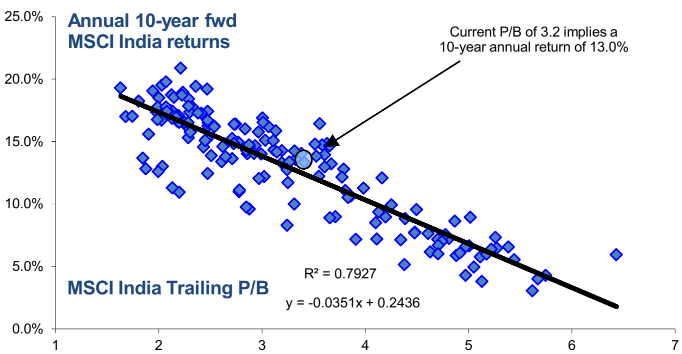
Source: RIMES, MSCI,, Bloomberg, Morgan Stanley Research

Exhibit 54: Small Cap Price to Book



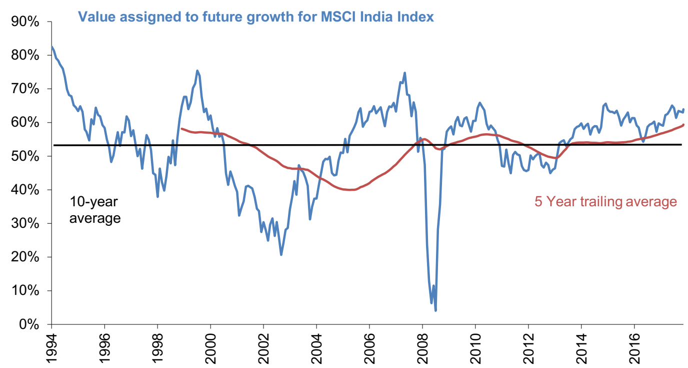
Source: RIMES, MSCI, Morgan Stanley Research

Exhibit 55: P/B Forecasting 10-year CAGR of 13.0% in Returns



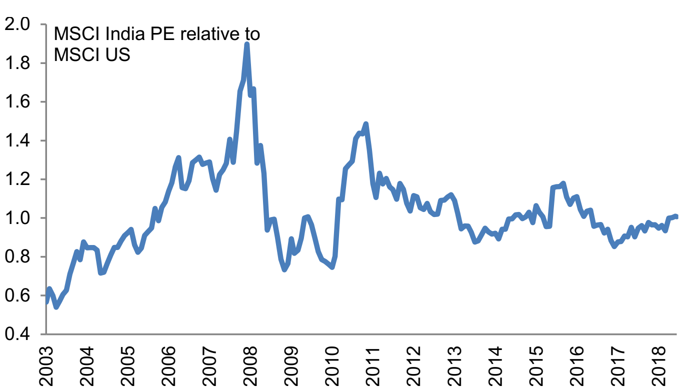
Source: RIMES, MSCI, Morgan Stanley Research

Exhibit 56: Value Assigned to Future Growth



Source: RIMES, MSCI, Morgan Stanley Research

Exhibit 57: MSCI India P/E Relative to MSCI US



Source: Bloomberg, RIMES, Morgan Stanley Research

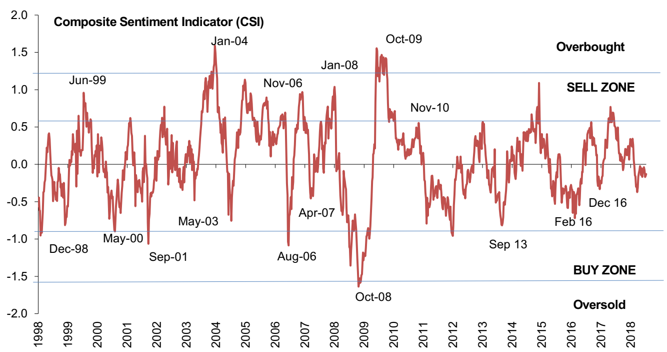
Exhibit 58: Valuation Summary

	Current	Average	z-score	%ile of current reading
		MSCI India		
Trailing PE	23.2	18.1	1.1	91%
12M Fwd PE	18.0	14.4	1.2	92%
Trailing PB	3.2	3.1	0.1	67%
Dividend Yield	1.4%	1.4%	-0.2	45%
VAFG	64%	54%	0.8	86%
Modified EY Gap	-2.2%	-1.6%	-0.3	41%
EY Gap	-3.6%	-1.8%	-1.0	30%
		MSCI India Relative to EM		
Trailing PE	1.7	1.2	1.6	96%
12M Fwd PE	1.6	1.2	1.4	99%
Trailing PB	1.9	1.7	0.9	81%
Dividend Yield	0.5	0.6	-0.4	51%

Source: RIMES, MSCI, Morgan Stanley Research

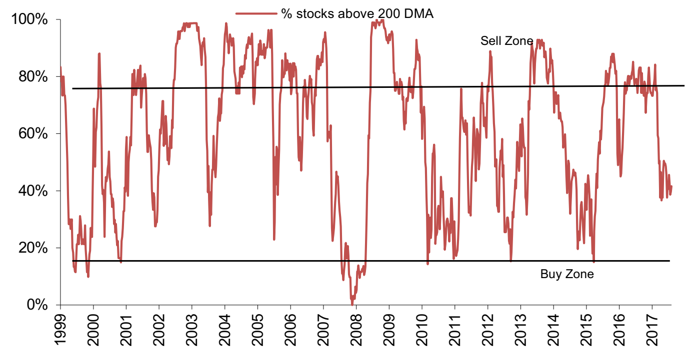
Sentiment

Exhibit 59: Sentiment Indicator



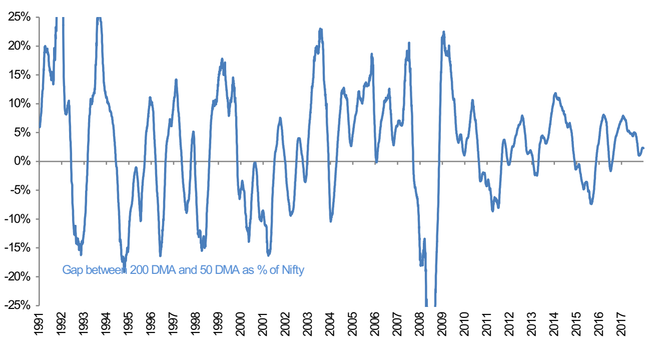
Source: RIMES, Bloomberg, ASA, BSE, CDSL, Morgan Stanley Research

Exhibit 60: Market Breadth



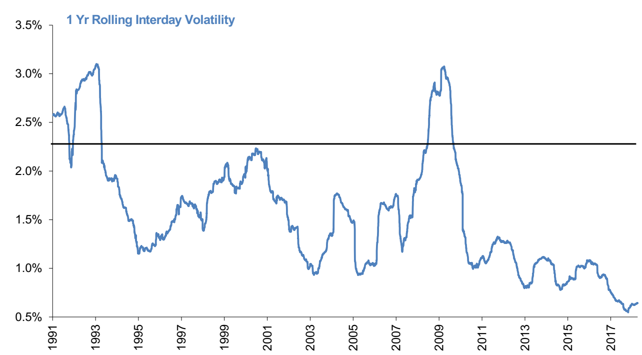
Source: RIMES, Morgan Stanley Research

Exhibit 61: GAP between 200 DMA and 50 DMA



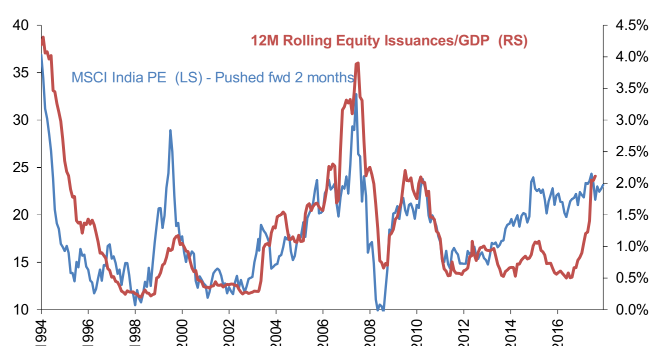
Source: NSE, Morgan Stanley Research

Exhibit 62: Realized Interday Volatility



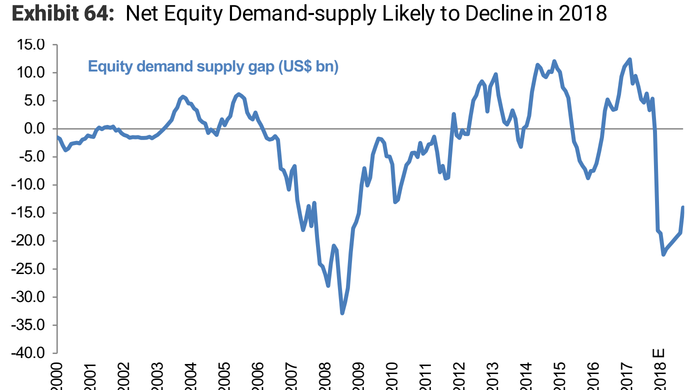
Source: Bloomberg, Morgan Stanley Research

Exhibit 63: Equity Capital Raising vs. Valuations



Source: Capitaline, CMIE, Morgan Stanley Research

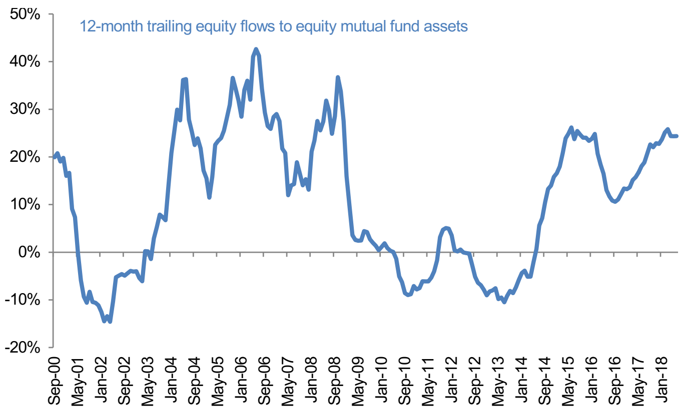
Exhibit 64: Net Equity Demand-supply Likely to Decline in 2018



Source: Capitaline, CMIE, Morgan Stanley Research

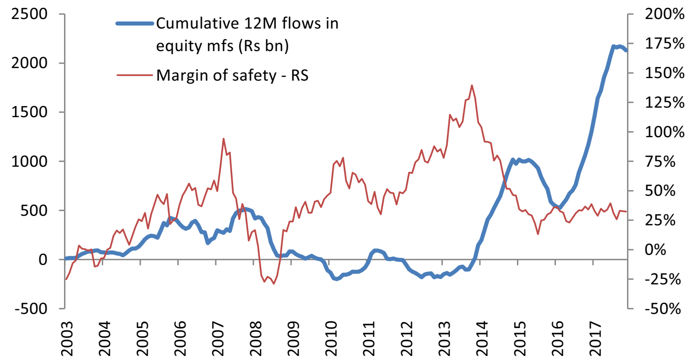
Sentiment

Exhibit 65: Domestic Equity: Flows to Stock



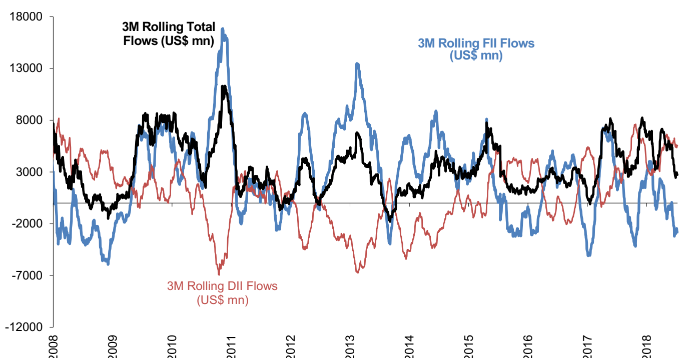
Source: AMFI, Morgan Stanley Research

Exhibit 66: Margin of Safety for Equity Mutual Fund Investors has waned



Source: AMFI, Morgan Stanley Research

Exhibit 67: Aggregate Institutional Flows



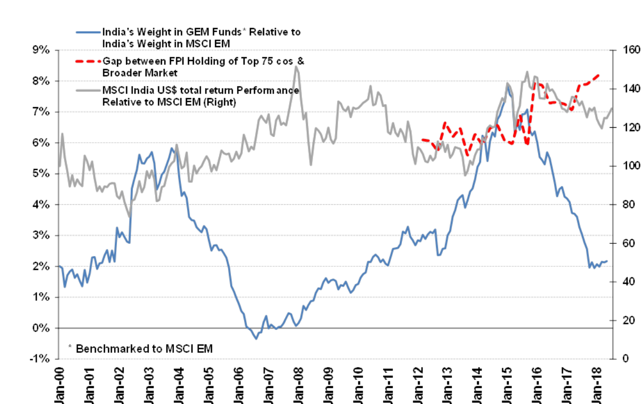
Source: SEBI, CDSL, Morgan Stanley Research

Exhibit 68: Sector FPI Flows

	AUC (in USD bn)	Sector Allocation - Asset under Custody			Year-to-date flows (1st Jan - 15th Jun) US$mn
	6/15/2018	5/31/2018	6/15/2018	Change	
Consumer discretionary	55	14%	13%	-0.3%	-1952
Consumer staples	31	8%	8%	-0.4%	-835
Energy	39	9%	9%	0.2%	-981
Financials	147	37%	36%	-1.3%	1083
Healthcare	19	4%	5%	0.3%	44
Industrials	27	7%	7%	-0.3%	231
Materials	20	5%	5%	-0.2%	-616
Technology	49	10%	12%	2.2%	1073
Telecoms	9	2%	2%	-0.1%	40
Utilities	12	3%	3%	-0.1%	-370

Source: CDSL, Morgan Stanley Research

Exhibit 69: India Ownership in EM Portfolios



Source: EPFR, Morgan Stanley Research

Exhibit 70: Ownership Status (Quarter Ended Mar-18)

Overall Institutional sector positions	FPIs	DFIs	DMFs	Total Inst.	MSCI Weight	Total Institutional Position over MSCI weight	QoQ Change	YoY ^ in Tot Inst. Position
Cons Disc	10%	10%	9%	10%	12.2%	-2.3%	0.1%	-0.2%
Cons Staples	7%	16%	12%	9%	9.7%	-0.3%	-0.1%	-1.3%
Energy	9%	17%	7%	10%	13.1%	-2.9%	-0.8%	-1.4%
Financials	41%	18%	35%	36%	23.7%	12.0%	-0.5%	0.8%
Healthcare	2%	3%	4%	3%	5.4%	-2.7%	0.3%	1.5%
Industrials	4%	9%	8%	6%	6.0%	-0.4%	0.0%	0.1%
Materials	7%	8%	7%	7%	9.4%	-2.4%	0.0%	0.0%
Technology	14%	11%	10%	13%	15.6%	-2.9%	0.7%	0.5%
Telecoms	3%	2%	3%	3%	2.8%	0.0%	0.1%	0.0%
Utilities	3%	6%	6%	4%	2.0%	1.7%	0.0%	0.0%

Source: BSE, Morgan Stanley Research

Sectors

Exhibit 71: Sector Fundamentals

MSCI Sectors	F18 ROE	1Y Fwd Change in ROE	ROE as SD from Avg	F17 Net D/E	F17 FCF/ Sales	Trailing 5Y CAGR in EPS	F18 EPS growth	1M Revision in F18 EPS growth	6M Revision in F18 EPS growth	F19 EPS growth	1M Revision in F19 EPS growth	6M Revision in F19 EPS growth
Consumer Disc.	17.8%	3.7%	(0.1)	29%	5.4%	2.4%	14.8%	0.0%	-2.9%	18.2%	-0.7%	-9.3%
Consumer Staples	28.9%	2.4%	(1.1)	-22%	14.3%	0.2%	10.9%	0.0%	0.1%	17.1%	0.0%	1.0%
Energy	15.7%	1.2%	(0.7)	34%	3.3%	3.9%	12.7%	0.0%	5.1%	18.1%	-0.1%	3.3%
Financials	10.9%	6.2%	(1.6)	241%	6.7%	-1.0%	2.0%	0.0%	-16.1%	47.1%	-3.0%	15.0%
Health Care	12.2%	2.0%	(1.7)	35%	9.5%	1.7%	-27.1%	0.0%	-7.2%	21.5%	0.1%	-7.6%
Industrials	14.1%	1.4%	0.0	65%	7.6%	2.2%	25.8%	0.0%	7.5%	16.0%	-0.5%	-3.6%
Technology	24.6%	-0.8%	0.0	59%	6.1%	1.9%	2.8%	0.0%	1.6%	10.2%	2.8%	1.9%
Materials	13.1%	2.6%	(0.6)	-47%	19.0%	1.4%	40.0%	0.0%	-0.3%	28.6%	-0.3%	-0.3%
Telecoms	-0.8%	-1.1%	(1.4)	137%	4.6%	-5.2%	NM	0.0%	-32.8%	NM	NM	NM
Utilities	12.9%	1.4%	(0.3)	98%	13.2%	0.9%	15.5%	0.0%	-2.6%	15.1%	-0.7%	-2.8%

Source: RIMES, MSCI, Bloomberg, Morgan Stanley Research

Exhibit 72: Sector Valuations

MSCI Sectors	Trailing PE	PE as SD from Avg	Trailing PB	PB as SD from Avg	Div Yield	Div Yield as SD from Avg	Long Term Implied EPS Growth	Long Term Implied Div Growth	Value Assigned to Future Growth
Consumer Disc.	23.3	1.0	4.6	0.8	0.8%	(1.3)	9.4%	18.9%	63.7%
Consumer Staples	52.7	2.1	15.8	1.4	1.1%	(1.0)	21.3%	14.9%	82.0%
Energy	13.3	0.2	2.0	(0.3)	1.8%	(0.2)	-0.8%	9.5%	43.2%
Financials	27.1	1.3	2.9	0.6	1.1%	(0.8)	-9.0%	15.2%	70.3%
Health Care	31.8	0.3	3.4	(1.4)	0.7%	(0.5)	10.6%	21.0%	76.6%
Industrials	27.2	0.8	4.3	0.5	1.0%	(0.7)	8.6%	16.5%	70.9%
Technology	20.1	(0.4)	4.8	(0.3)	1.8%	1.1	5.4%	9.7%	52.4%
Materials	22.1	0.6	2.4	0.3	1.7%	(0.1)	9.8%	10.6%	65.6%
Telecoms	143.8	3.9	1.7	(0.3)	1.3%	(0.2)	NM	13.3%	94.2%
Utilities	13.8	0.2	1.7	(0.0)	2.8%	0.7	12.0%	5.0%	35.7%

Source: RIMES, MSCI, Bloomberg, Morgan Stanley Research

Exhibit 73: Sector Market Dynamics

MSCI Sectors	Abs 3M perf	Abs 12M perf	Abs YTD perf	5 Year CAGR Perf	200DMA Deviation	12M Beta	3M Change in 12M Beta	Institutional Ownership	Sell Side Reco	3M change in Sell Side Reco
Consumer Disc.	-5%	2%	-10%	11%	-2%	0.9	92%	67%	56%	2%
Consumer Staples	13%	15%	16%	12%	14%	0.6	65%	54%	46%	7%
Energy	7%	21%	3%	11%	2%	1.2	122%	61%	63%	16%
Financials	3%	9%	4%	13%	2%	1.1	105%	76%	59%	9%
Health Care	7%	-9%	-4%	3%	2%	1.3	127%	66%	45%	4%
Industrials	-6%	3%	-4%	13%	-4%	1.1	110%	63%	59%	16%
Technology	12%	34%	22%	14%	18%	0.6	63%	75%	33%	13%
Materials	-7%	-4%	-14%	13%	-9%	1.2	120%	62%	62%	13%
Telecoms	-9%	-19%	-32%	-6%	-19%	1.0	96%	90%	32%	22%
Utilities	-7%	1%	-14%	4%	-8%	0.8	80%	70%	37%	9%

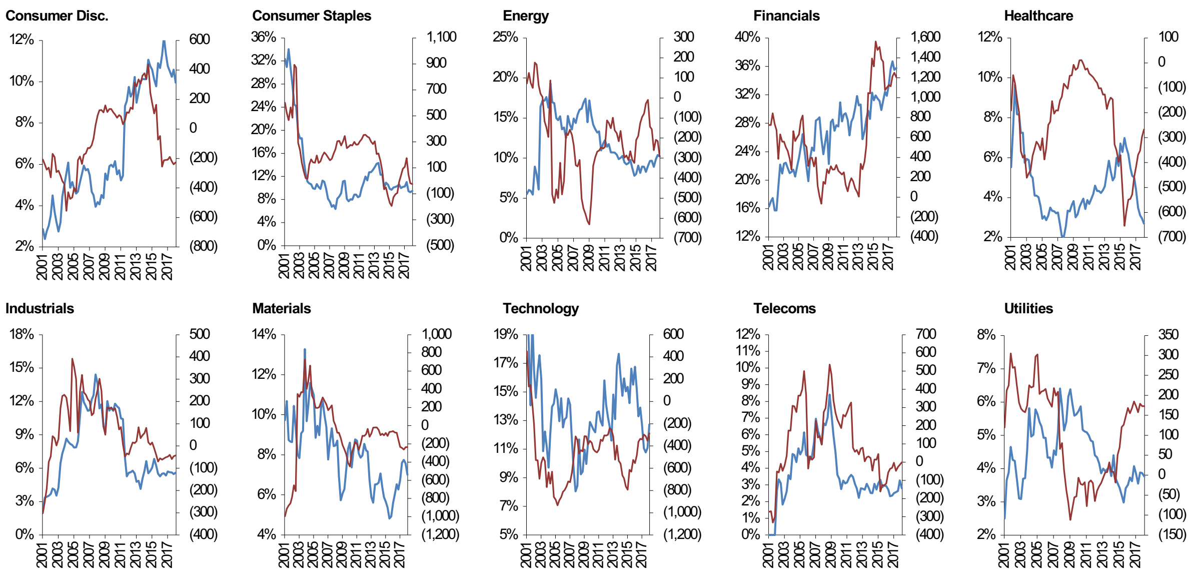
Source: RIMES, MSCI, Bloomberg, Morgan Stanley Research

Sectors

Dark blue Line – Weight in the average Institutional portfolio (domestic + foreign) using our sample of 75 companies – LS

Light red line – Relative Position to MSCI Sector weight (above/below benchmark in bp) – RS

Exhibit 74: Total Institutional Sector Positions – Absolute and Relative over Time



Source: MSCI, Morgan Stanley Research. Historical weights are adjusted for Reliance Ind and Tata Motors, which were earlier classified in Materials and Consumer Disc and later as Energy and Industrials, respectively. Since Sept, MSCI reclassified Tata Motors to Consumer Discretionary from Industrials.

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Underweight/Sell	**544**	**18%**	**81**	**11%**	**15%**	**211**	**15%**
TOTAL	**3,107**		**741**			**1413**	

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