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From the CIO's Desk

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February marked a shift in global market dynamics as the shine of US exceptionalism is beginning to fade. This evolving narrative coincided with continued outflows from Indian markets as investors shifted their focus to China. Yet beneath these short-term movements, India's economic foundations remain robust, underpinned by healthy GDP growth, easing inflation, and the RBI's first rate cut in nearly five years. The underlying data increasingly points to gathering momentum in domestic consumption and manufacturing activity, strengthening our conviction in an approaching market recovery. In this edition, we examine the key catalysts that could drive this turnaround and analyze the implications of proposed US pharmaceutical tariffs on India's healthcare sector. We hope you find these insights valuable for navigating the current market environment.

Market Review

Indian equities continued to pull back in February, declining 7.99% (in USD terms[1]) as some flows shifted to China and Hong Kong. Foreign institutional investors (FIIs) recorded outflows for the second consecutive month, withdrawing USD 5.4 billion (vs outflow of USD 8.4 billion in January).[2] Conversely, domestic inflows remained strong at USD 7.4 billion in February (vs inflows of USD 10 billion in January).[3] All sectors ended lower for the month, though Financials and Materials were the relative top performers, while Real Estate and IT were the worst performers.

Key macroeconomic indicators during the month showed a stabilizing trend at the aggregate level. Central government capex rose at a softer pace of INR 720 billion in January (vs INR 1.7 trillion in December) but was higher than the monthly average of ~INR 640 billion from April to November 2024.[4] Goods and Services Tax (GST) collections softened to INR 1.8 trillion (~USD 20.7 billion) in February but grew at a robust 13% y/y (after adjusting for the additional leap year day in February 2024) vs 12.3% y/y in January.[5] Manufacturing PMI fell 1.4pts to 56.3 in February, the slowest reading since December 2023, but was still

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[1] Note: All return figures are in USD terms unless stated otherwise

[2] Source: NDSL, March 2025

[3] Source: Ibid.

[4] Source: CEIC, Morgan Stanley Research, March 2025

[5] Source: Ministry of Finance, Morgan Stanley Research, March 2025

firmly in expansionary territory.[6] However, Services PMI rose 2.5pts to 59.0 in February, as India's services sector saw a boost from improving domestic and international demand.[7]

GDP growth stayed robust, with India's economy expanding 6.2% y/y in Q3FY25 (vs 5.6% y/y in the prior quarter), keeping India on track as one of the fastest-growing major markets. Consumer price inflation eased to 4.3% in January, a five-month low and back within range of the Reserve Bank of India's (RBI) medium-term target. Easing price pressures allowed the RBI to cut its policy repo rate by 25 bps to 6.25% – the first rate cut in nearly 5 years.

In political developments, Prime Minister Narendra Modi's Bharatiya Janata Party (BJP) secured a significant victory in Delhi state elections, winning 48 out of 70 seats and marking their first win in the capital in 27 years. While Delhi represents only 7 seats in the 543-member Lok Sabha, the victory in the nation's capital has symbolic importance and lifted market sentiment by reducing uncertainty around coalition stability at the Center.

Portfolio Activity & Outlook

US to enter period of adjustment as exceptionalism story wanes

The US faces mounting fiscal pressures. With a 6.4% deficit and interest payments of almost USD 900 billion in the fiscal year 2024, 18% of government revenues went into servicing debt.[8] As US Treasury bond yields have climbed to ~4.3%, interest payments could consume well over 20% of annual tax receipts in the coming years.[9] This unsustainable trajectory could lead to a debt trap. So it makes sense why the Department of Government Efficiency (DOGE) is now stepping in to cut excess spending. However, this process will lead to a drag on growth and consumer sentiment as adjustments are made.

These structural changes, while challenging, are necessary. We observed similar transformations in China over the past few years with the tightening of the tech and real estate sectors. In India, significant shifts occurred in 2016-2017 with demonetization and the implementation of the Goods and Services Tax (GST). Both countries experienced periods of uncertainty as their economies and markets adapted to these changes, but the benefits manifested in the subsequent years. A similar cycle is now unfolding in the US. If these issues are not addressed promptly, it could lead to more severe global repercussions, as bond yields are likely to spike further.

Our base case remains that the US is likely to achieve a soft landing, avoiding a recession. While consumer spending may moderate and corporate earnings growth slows, robust domestic capital expenditure should sustain some economic momentum. Despite elevated interest rates, we expect strong capital investments to continue, particularly in infrastructure, energy production, and innovative technologies like AI. However, the next 12-24 months represent an uncertainty corridor for the US economy. This raises the question: Where will investors focus their attention?

[6] Source: S&P Global, March 2025

[7] Source: Ibid.

[8] Source: US Congressional Budget Office, January 2025

[9] Source: Ibid.

Markets trade the delta, and Asia signals growth ahead

Market dynamics increasingly favor Asian markets as the narrative of US exceptionalism faces growing scrutiny. This shift illustrates a classic market principle – that prices respond not just to current conditions but to the rate of change in those conditions. During the Asian sell-off in November/December last year, investors remained fixated on US exceptionalism while overlooking attractive valuations and improving fundamentals in Asian. What many missed was that the US would need to address the structural challenges mentioned above before sustainable growth could resume.

The contrast with Asia is becoming more apparent. While the US grapples with fiscal tightening, governments across Asia are moving toward stimulus measures. This marks a significant turn from the past 3-4 years, when Asian consumers faced high inflation and a lack of meaningful government handouts. Many also worked in informal sectors that bore the brunt of COVID-19 disruptions. That challenging period is now behind us. Asian consumer balance sheets have strengthened, and inflation has come down to target range levels, setting the stage for a broad-based economic recovery.

India is nearing the bottom, preparing for a reversal in Q2

Chinese equities have staged an impressive rally this year, surging nearly 13% year-to-date (YTD), attracting foreign investor flows away from Indian markets.[10] However, this recovery in Chinese markets appears to be primarily driven by multiple expansions rather than fundamental improvements in corporate earnings. While early signs of economic stabilization are visible in China, a meaningful earnings recovery may take several quarters to materialize. As this initial phase of re-rating matures, we expect investors to seek markets with more visible earnings growth, and we believe that market will be India.

The technical setup for Indian equities appears increasingly favorable. Since September 2024, India has underperformed emerging markets (EM) by 21%pts, bringing its valuation premium over EM peers back to the 10-year average.[11] Historically, when India's relative valuation premium has mean-reverted to these levels, it has bounced strongly (both in relative and absolute terms) in the subsequent quarters. Additionally, foreign investor positioning in Indian equities is at a decadal low, suggesting limits to further foreign outflows, while any improvements in underlying metrics could lead to a revival in inflows.

In terms of fundamentals, India appears to be approaching an inflection point, with sequential GDP improvements signaling the end of the mini downcycle. The momentum is increasingly consumption-driven, with private consumption growth outpacing overall GDP for three consecutive quarters and consumption's share of GDP reaching a robust 59.6%. And that's all without factoring in the impact of rate cuts, tax cuts, and other measures (more on that below), the benefits of which will flow through in a couple of quarters. Manufacturing activity is also notably accelerating, as evidenced by February 2025's robust 6.6% surge in power demand – particularly impressive given it builds on a strong 7% growth base from the previous year.[12] Power consumption, one of the more reliable indicators of industrial activity, suggests manufacturing facilities are meaningfully ramping up operations.

[10] Return refers to the MSCI China Index.
[11] Source: Bloomberg, Jefferies, March 2025
[12] Source: Grid India, Bloomberg, Bernstein, February 2025

From a portfolio perspective, our strategic focus on large caps has provided crucial downside protection during this transitional period. Looking ahead, we anticipate India's recovery to gain momentum in the coming months, supported by accommodative monetary and fiscal policies bolstering domestic demand, and we will be positioning to increase our exposure to more small and mid-cap opportunities as these catalysts materialize.

Policy coordination positive for credit growth and economic expansion

The government and the RBI appear to be aligned in their objective of accelerating economic growth. While the government has implemented tax cuts to stimulate consumption, the RBI has introduced several measures to promote loan growth. Over the past two months, under the leadership of the new RBI governor, there have been frequent liquidity infusions through open market operations and a 25bps rate cut. Additionally, the RBI reduced risk weights on credit to Non-Banking Financial Companies (NBFCs) and Microfinance Institutions (MFIs) by 25%, effectively reversing the risk weight increase from November 2023. Loans from the banking sector to NBFCs, which peaked at approximately 30% y/y before November 2023, have declined to around 7% y/y as of December 2024.[13]

Although the transmission of rate cuts will likely be gradual due to banks facing challenges in attracting deposits, NBFCs are expected to benefit from improved credit availability and lower funding costs. Banks and Small Finance Banks (SFBs) with significant exposure to MFIs, such as Bandhan Bank, IndusInd Bank, and RBL Bank, will also gain from this move. This decision underscores the regulator's commitment to supporting retail credit growth and signals to lenders to avoid excessive caution when extending credit to the NBFC and MFI segments. A reduction in risk-weighted assets (RWA) for personal loans and credit cards could also be on the horizon, given the significant slowdown in their growth rates. Overall, these measures are positive for the economy, reinforcing the focus on consumption and economic expansion.

Fueling India's future: Strategic moves in trade, semiconductors, and deregulation

Beyond the near-term measures, the government is also implementing strategic initiatives to secure the country's long-term growth. Our checks on the ground have found meaningful progress in the following areas that will position India well for the coming decade:

1. **Bilateral trade agreements:** India is increasingly prioritizing bilateral free trade agreements (FTA) amid challenges in the multilateral World Trade Organization (WTO) framework. Having already secured deals with the UAE, Australia, and EFTA[14] countries since 2022, India is now actively negotiating with major economies, including the US, the UK, and the EU. While some agreements may not achieve comprehensive FTA status, these targeted bilateral partnerships should deliver meaningful economic benefits as India expands its global trade network.
2. **Investing in semiconductor manufacturing:** India is making a decisive push into semiconductor manufacturing with USD 18 billion in investments across five major projects, backed by substantial

[13] Source: RBI, February 2025

[14] The European Free Trade Association (EFTA) is the intergovernmental organization of Iceland, Liechtenstein, Norway, and Switzerland

government support. Under IT Minister Ashwini Vaishnaw's leadership, the country aims to build a comprehensive semiconductor ecosystem, targeting an increase in domestic value addition from the current 18-20% to 35%.[15] This infrastructure build-out is expected to gain momentum from 2025 onward.

3. **Cutting red tape:** India is establishing a deregulation commission to reduce bureaucratic hurdles and improve the business environment for private investment. A national task force has identified ten key sectors, including land and environmental regulations, for streamlining. With Prime Minister Modi's direct involvement, the initiative will require coordination between federal and state governments. The commission is set to launch by mid-April 2025.

Potential US tariffs on Indian pharmaceuticals

Over the last few weeks, Indian pharmaceutical stocks have experienced a dip following President Trump's comments about potentially imposing a 25% tariff on Indian pharmaceutical imports to the US. As no formal announcement has been made yet, uncertainty remains regarding whether the tariffs will be applied reciprocally or as a blanket 25% charge and in what time frame. It's also unclear whether this will target India specifically or all countries with the goal of boosting local US manufacturing.

The market expects these tariffs to negatively affect India's pharmaceutical sector, which is highly dependent on the US market for its revenue. India exported ~USD 8.8 billion worth of pharmaceuticals to the US in FY2024, making up 31% of its total pharmaceutical exports that year.[16] For major listed Indian pharmaceutical companies, approximately 40% of their sales come from the US market.[17]

While these figures suggest India's pharmaceutical sector could be vulnerable to tariff hikes, it only tells part of the story. About 90% of the prescriptions for the US patient population is filled with generic medicines, and the US is heavily reliant on India for the supply of generic medicines.[18] India produces over 45% of the generics and 15% of the biosimilars by volume consumed in the US, primarily due to its cost-effective manufacturing, which ensures affordability.[19] Despite past efforts by the US government to encourage domestic production, these initiatives have yet to succeed, mainly because India's manufacturing costs are less than half of those in the US. It would be challenging for local or other global players to fill this gap quickly.

India's pharmaceutical imports from the US are modest, about USD 400 million. Currently, the US imposes no tariffs on its pharmaceutical imports from India, while India applies a 10% tariff on US pharmaceutical imports. If tariffs are imposed reciprocally, the Indian government wouldn't face significant losses in negotiations, as the total customs duty from US pharmaceutical imports would likely be under $50 million. In the recent Union Budget, India has also shown willingness to exempt pharmaceutical imports from tariffs (reduced duty of 37 life-saving products).

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[15] Source: Jefferies, March 2025
[16] Source: Pharmaceuticals Export Promotion Council of India, 2024
[17] Source: SBI Research, Financial Express, February 2025
[18] Source: Association of Accessible Medicines, 2024
[19] Source: Mint article, 'Bitter pill for Indian pharma as Trump tariffs could hurt exports by $2.25 trillion', February 20, 2025

However, a 25% tariff could cause supply disruptions in the US, with many companies needing to stop selling certain products unless they pass on the tariff costs to end consumers. This would lead to higher prices for generic drugs in the US, making the implementation of such tariffs a difficult proposition. Further, President Trump has announced tariffs for imports from China, Canada, and Mexico, which could prove to be an opportunity for Indian players if negotiations go the right way. But as the situation unfolds, we believe that any overreaction or volatility in Indian pharmaceutical stocks due to tariff concerns could be an opportunity to buy on the dip.

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