Global Market Outlook 2023

Fidelity India Fund
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India Focus – Structural growth prospects

While the challenging backdrop Indian equities faced this year is likely to persist in 2023, we believe that the market is better placed than most of its peers, as the country's underlying structural growth prospects should support valuations.

Key points

- India will likely be the fastest-growing major economy globally, which will be attractive when cast against a low-growth backdrop.
- The structural shift in supply chains moving out of China is starting to benefit India, particularly in the electronics and chemicals sectors, which have long runways for growth.
- Private sector banks are trading at valuations close to their historical averages, despite being the beneficiaries of robust structural growth at the expense of less efficient government-owned ones.

Under the backdrop of inflation, geopolitical tensions and slowing growth, what is the investment outlook for India in 2023?

Geopolitical concerns, high inflation, rising interest rates, and slowing economic growth created a demanding environment for Indian equities in 2022 that resulted in much volatility. We think this is likely to continue in 2023. While it is hard to predict how markets will behave in a year's time, we believe that India is better placed than most of its peers in such an environment. This is due to its underlying structural growth prospects, which should support corporate earnings and returns over the medium to long term.

Despite the cut in growth forecasts, India will likely be the fastest-growing major economy in the world, which will be very attractive when cast against a low-growth backdrop. This is because India's economic fundamentals remain healthy, with cleaner bank and corporate balance sheets, low debt levels, healthy foreign exchange reserves and high import cover. While the central bank may hike benchmark interest rates by another 50 to 75 basis points, it looks closer to the peak as inflationary pressures are receding.

We will maintain our bottom-up research-driven process and investment philosophy of holding high-quality companies in sectors where structural growth opportunities exist. Top-down macro views will stay relevant in our assumptions as we assess key variables, such as draw-down risk, cost of risk, discount rates and hurdle rates, among others. While we remain aware of broader macroeconomic and political developments, we will keep a sharp focus on the fundamentals of the companies we own or want to own in our portfolio to drive alpha for our investors.

What do you think could surprise the market in 2023, either positively or negatively?

We think negative surprises could come from a rise in global oil prices that could increase inflationary pressures and induce further hikes in domestic interest rates. That said, we do not see any systemic issues on the horizon, and their impact should only be transitionary.

A positive surprise could come from substantial growth in private sector capital expenditure (capex). We already see a rise in credit growth – up from mid-single digits last year to mid-teen levels in recent months. Additionally, the structural shift in supply chains moving out of China is already starting to benefit India, particularly in the electronics and chemicals sectors, which have long runways for growth. We could also see capex rise in other areas where the government has extended production-linked tax incentives. These include sectors such as consumer and white goods, automobiles, auto components, semiconductors and solar panels.

What themes, sectors or regions would offer opportunities and potential risks?

A potential risk is that the Indian market is trading at valuations that are higher than the long-term historical average, as well as relative to its regional and global peers. A significant downgrade in earnings expectations stemming from a higher cost of capital and inputs could lead to a de-rating of Indian equities.

While the valuations of Indian equities look stretched from a top-down view, we continue to see numerous investment opportunities from a bottom-up perspective. One such area is private sector banks trading at valuations close to their historical averages. This is despite their being beneficiaries of robust structural growth at the expense of less efficient government-owned banks due to their ability to improve market penetration and win greater market share. Similarly, we can find high-quality companies in other fast-growing areas, such as consumer electronics, quick service restaurants, premium two-wheelers, hospitals, paints and adhesives, that are trading at a discount to their long-term growth potential.

Within your portfolio, what has worked well in 2022, and what will you do differently in 2023?

Our focus on high-quality, sustainable businesses with well-established corporate governance practices worked well for us in 2022. In contrast, a lack of exposure to certain low-quality utility names detracted. Despite their weak fundamentals and obvious red flags on the corporate governance front, their excessive valuations were buoyed by a sustained rally. Meanwhile, our conviction in private banks and select consumer names seems to be paying off. Also, our underweight to IT services companies that had hurt due to high valuations at a time when global growth was decelerating proved rewarding for the portfolio.

We will stick with our investment approach as we enter 2023. Instead of diversifying our portfolio to counter the demanding macro environment and heightened market volatility, we prefer to deepen our focus and get closer to the businesses we invest in. We will further intensify our engagement with the management of our holdings and other key stakeholders. The idea is to ensure that we fully understand their pricing power and ability to gain market share as they navigate the tough period ahead, one marked by higher cost pressures and slower growth. This deeper understanding of our investee companies should also help us more accurately assess these risks.

How do you expect sustainability factors to influence returns in 2023, and how is this reflected in your portfolios?

Fundamental and sustainability analysis are the bedrock of our due diligence and investment decisions. Staying with businesses with solid or improving sustainability practices will continue to be vital in generating higher returns for our clients and helping to protect the portfolio from downside risks.

Almost 70 per cent of the portfolio is rated BBB and above. In contrast, the remainder are companies that are either better rated by our own analysts or have improved their environmental, social, and governance (ESG) credentials.

The portfolio also continues to maintain a materially lower carbon footprint relative to the investment universe, with carbon emission per million dollars invested at about 60 per cent lower than the index.

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