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TRU INSIGHTS

February 2025

Contents

From the MD & CEO's desk

"Amid global trade tensions and economic challenges, the Union Budget 2025-26 focuses on reviving consumption and maintaining fiscal prudence, while the RBI's upcoming policy decision is anticipated to support domestic growth."

Dear Investors,

On Feb 01, 2025, the finance minister presented her eighth consecutive Union Budget for the fiscal year 2025-26. The Union Budget was unveiled in the backdrop of multiple challenges, including increasing uncertainties surrounding a global trade war following Donald Trump's inauguration as the 47th U.S. President, a slowdown in the Indian economy, continued FPI outflows, and continued rupee depreciation.

The Union Budget was a balanced, well-rounded budget which unequivocally reflected its focus on reviving consumption with favorable income tax slabs changes, increasing planned expenditure on rural development and agriculture while maintaining fiscal prudence and refraining from any populous measures. In a recent interview, I shared my detailed perspectives on the Union Budget (link here) and highlighted key sectors poised to benefit from the budget.

With the Union Budget behind us, all eyes will now be on the RBI Monetary Policy announcement on the 7th of Feb after it announced significant liquidity infusion in the banking system last week, which was seen by the markets as a precursor to monetary easing, thus building in expectations of a rate cut after holding it steady since Feb-23.

While the RBI's intervention and Union Budget will help address domestic growth issues, global landscape continues to remain uncertain and challenging. The European Central Bank (ECB) has reduced its key deposit rate by 25 bps for the fifth consecutive time, bringing it to 2.75%, with indications of further easing. Meanwhile, the U.S. Federal Reserve held rates steady in its January FOMC meeting, citing reflationary pressures and leaving future rate cuts uncertain.

While geopolitical issues have taken a backstage post the Israel-Hamas ceasefire, global tariff war has taken centerstage with the U.S. President increasingly using tariffs as a negotiating tool, first against Colombia, and now against China, Canada, Mexico and may use it against other countries to pursue his America first policy. The trade war, even if short-lived, could lead to near-term uncertainties and heightened market volatility.

This month's edition covers key highlights of the Union Budget, recaps key global and domestic macroeconomic indicators, offers an equity and fixed income outlook, and features a deep dive into "Impact of FII outflows in Indian capital markets". And as usual, you will find a curated collection of insightful essays in our Reading Room.

I am confident that you will find Tru Insights an invaluable tool to keep you well-informed and enable you to help make prudent investment decisions.

Warm Regards

Dhiraj Relli
MD and CEO – HDFC Securities

Budget Highlights

Budget 2025-26: Growth-Driven, Fiscally Prudent, and Consumption-Focused

India's nominal GDP for FY26 is projected at ₹357 lakh crore, reflecting a 10.1% growth. The fiscal deficit is set to decline to 4.4% of GDP, with gross tax revenue expected to rise by 10.8% to ₹42.7 lakh crore. Capital expenditure is pegged at ₹11.2 lakh crore, focusing on infrastructure. Key tax reforms include an income tax exemption up to ₹12 lakh under the new regime and higher TDS exemptions for senior citizens and rent. The government also raised the disinvestment target and extended the time for filing updated tax returns.

Budget Highlights

	Rs. lakh cr			% Growth			% GDP		
	FY25BE	FY25RE	FY26BE	FY25BE	FY25RE	FY26BE	FY25BE	FY25RE	FY26BE
Gross Tax revenue	38.40	38.53	42.70	11.7%	11.2%	10.8%	11.7%	11.9%	12.0%
Direct Tax	22.07	22.37	25.20	13.5%	14.4%	12.7%	6.7%	6.9%	7.1%
Corporation Tax	10.20	9.80	10.82	10.5%	7.6%	10.4%	3.1%	3.0%	3.0%
Income Tax	11.87	12.57	14.38	16.1%	20.3%	14.4%	3.6%	3.9%	4.0%
Indirect Tax	16.19	16.02	17.35	9.5%	7.1%	8.3%	4.9%	4.9%	4.9%
GST	10.62	10.62	11.78	11.0%	10.9%	10.9%	3.2%	3.3%	3.3%
Less States Share	12.47	12.74	14.22	13.7%	12.8%	11.6%	3.8%	3.9%	4.0%
Net Tax revenue(A)	**25.83**	**25.57**	**28.37**	**11.2%**	**9.9%**	**11.0%**	**7.9%**	**7.9%**	**7.9%**
Non-Tax Revenue(B)	**5.46**	**5.31**	**5.83**	**45.2%**	**32.2%**	**9.8%**	**1.7%**	**1.6%**	**1.6%**
Non-Debt capital receipts (,C)	**0.78**	**0.59**	**0.76**	**39.3%**	**-1.3%**	**28.8%**	**0.2%**	**0.2%**	**0.2%**
Total Receipts(A+B+C)	**32.07**	**31.47**	**34.96**	**16.4%**	**12.8%**	**11.1%**	**9.8%**	**9.7%**	**9.8%**
Total Revenues	**48.21**	**47.16**	**50.65**	6.7%	6.1%	7.4%	14.7%	14.6%	14.2%
Revenue Expenditure	37.09	36.98	39.44	4.8%	5.8%	6.7%	11.3%	11.4%	11.0%
Interest payments	11.62	11.38	12.76	10.1%	7.0%	12.2%	3.5%	3.5%	3.6%
Capital Expenditure	11.11	10.18	11.21	16.9%	7.3%	10.1%	3.4%	3.1%	3.1%
Total Expenditure	**48.21**	**47.16**	**50.65**	**7.3%**	**6.1%**	**7.4%**	**14.7%**	**14.6%**	**14.2%**
Gross Fiscal Deficit	16.13	15.70	15.69				4.9%	4.8%	4.4%
Nominal GDP	327.72	324.11	356.98	10.5%	9.7%	10.1%			

Budget Highlights

- Nominal GDP for FY26 is estimated at Rs 357 lakh crore, reflecting a 10.1% growth over FY25.
- Fiscal deficit for FY26 is projected at 4.4% of GDP (Rs 15.7 lakh crore), down from 4.8% in the revised estimate for FY25.
- Gross tax revenue for FY26 is projected to grow by 10.8% to Rs 42.7 lakh crore, with corporate tax collections expected to increase by 10.4% and income tax revenue by 14.4%.
- Non-tax revenue is estimated at Rs 5.83 lakh crore, approximately Rs 52,000 crore higher than the revised estimates for FY25, primarily due to increased dividends, profits, and other non-tax receipts.
- The disinvestment target is set at Rs 47,000 crore for FY26, up from Rs 33,000 crore in FY25.
- Total budget spending is estimated at Rs 50.65 lakh crore for FY26.
- Capital expenditure has been pegged at Rs 11.2 lakh crore as against Rs 10.2 lakh crore in revised for FY25, emphasizing infrastructure development.
- Gross market borrowing through dated securities for FY26 is Rs 14.8 lakh crore. Net market borrowing stands at Rs 11.5 lakh crore.

<u>Others Key announcements:</u>

- No personal income tax up to Rs 12 lakh under the new regime (Rs 12.75 lakh for salaried individuals with a standard deduction).
- TDS exemption on interest for senior citizens doubled from Rs 50,000 to Rs 1 lakh.
- TDS exemption limit on rent increased from Rs 2.4 lakh to Rs 6 lakh.
- TCS threshold on remittances under LRS raised from Rs 7 lakh to Rs 10 lakh.
- The time limit for filing updated returns is extended from 2 years to 4 years from the end of the relevant assessment year.

Macro Economic Highlights

Resilient Domestic Growth Amid Global Uncertainties

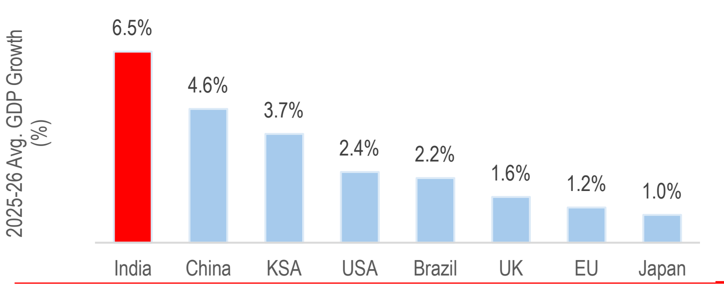
India’s economy remains resilient, supported by strong domestic demand and fiscal discipline, despite global uncertainties. GDP growth is expected to moderate, but inflation is stabilizing, and fiscal consolidation efforts continue. Globally, trade tensions and policy uncertainties pose risks, with central banks taking a cautious approach to monetary easing.

Domestic Macro Highlights

India's economy continues to exhibit resilience amid global headwinds, supported by robust domestic demand, prudent fiscal management, and ongoing structural reforms. While external risks persist, India's long-term growth trajectory—driven by demographics, digital transformation, and manufacturing expansion—remains intact, positioning the country to achieve a $10 trillion economy by 2031.

GDP Outlook: India's GDP growth forecast for FY25 has been revised downward by major multilateral agencies. The IMF's January 2025 World Economic Outlook projects real GDP growth at 6.5% (down from 7.0%), while the RBI has adjusted its estimate to 6.6% from 7.2% in October 2024. The key drag has been an unexpected contraction in government capital expenditure. Despite these revisions, India is set to remain one of the fastest-growing economies globally, with nominal GDP expected to expand by 10.1% in FY26 and the real GDP is projected to grow 6.3%-6.8% in FY26 as per the Economic Survey.

India is projected to be one of the fastest growing major economies in the medium-term...

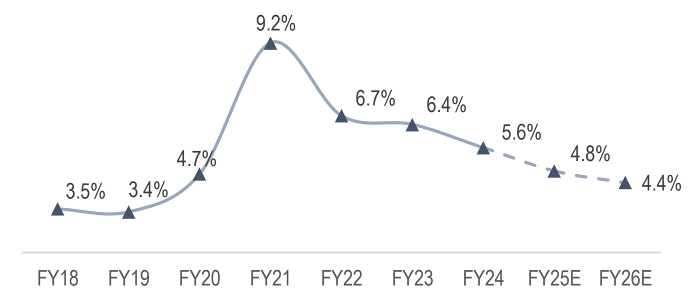


Source: IMF

Inflation Trends The RBI projects CPI inflation at 4.5% in Q4FY25, down from 5.6% in Q3. While headline inflation has stabilized within the 4-6% range, food inflation remains volatile due to supply chain disruptions and weather shocks. Core inflation, however, has held steady at 3.7% for three consecutive months, creating a favorable backdrop for potential rate cuts in FY26.

Fiscal Consolidation– The fiscal deficit for FY26 is targeted at 4.4% of GDP. However, the implementation of the Eighth Pay Commission's recommendations in FY27 could delay fiscal consolidation efforts. The central government aims to lower its debt-to-GDP ratio to 50% by March 2031, from an estimated 56% in FY26.

GOI's Fiscal Deficit relative to GDP:



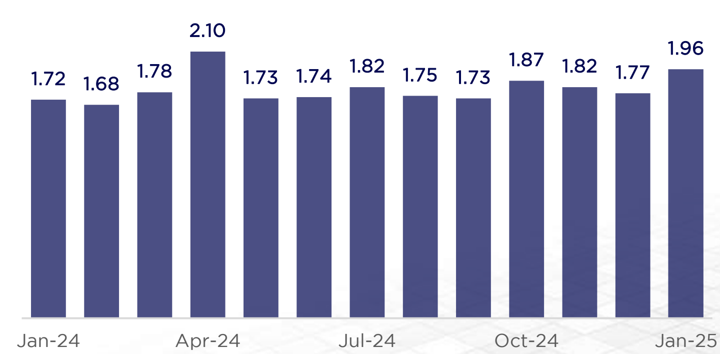
Source: MOSPI

India PMI: January factory activity growth at six-month high; while Services growth weakest in over 2 years– India's manufacturing sector gained momentum in January 2025, with the HSBC India Manufacturing PMI rising to 58 from December's 56.4, growing at the quickest pace in six months in January largely buoyed by resilient demand and strong output. In contrast, growth in India's dominant services sector in January slumped to the slowest in > 2 years to 56.5 (vs. 59.3 in December), on the back of lower demand and a softer increase in sales and output.

GST Collections Strengthen Fiscal Stability: GST revenues continue to bolster fiscal health, with January 2025 collections rising 12% year-on-year to ₹1.96 lakh crore. December's gross GST revenue stood at ₹1.77 lakh crore, marking a 7% annual increase.

India's GST Collections Grow from Rs. 1.96 lakh crore in Jan-25 to Rs. 1.77 lakh crore in Dec-24, Reflecting Economic Resilience.

India's GST Collection in Rs. Lakh Crore



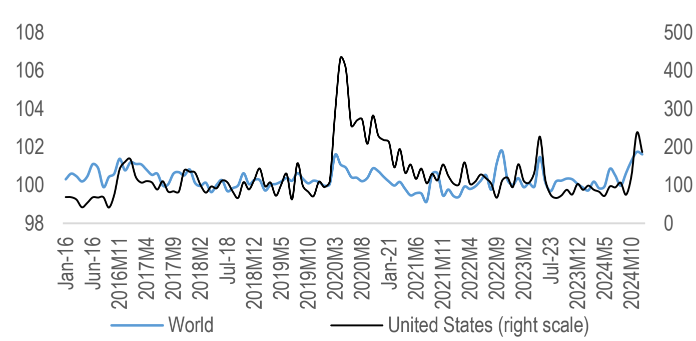
Source: IMF

Global Macro Highlights

Global Macro Summary: The World Bank and IMF forecast global GDP growth at 2.7% and 3.3%, respectively, for 2025-26—below the 2000-2019 average of 3.7%. Economists warn that this pace may be insufficient to sustain long-term economic development, given risks such as policy uncertainty, trade disruptions, geopolitical tensions, and lingering inflation. Global inflation is projected to decline to 4.2% in 2025 and 3.5% in 2026, with advanced economies expected to reach central bank targets sooner than emerging markets. The U.S. and China, which account for over 40% of global GDP, remain critical to the world's economic trajectory.

Economic Policy Uncertainty: Policy-generated disruptions has increased sharply, especially on the trade and fiscal fronts, with some differentiation across countries. Expectations of policy shifts under newly elected governments in 2024 have shaped financial market pricing in recent months. Political instability in some Asian (South Korea) and European countries (Germany, France) have rattled markets and injected additional uncertainty regarding stalled progress on fiscal and structural policies. Geopolitical tensions, including those in the Middle East, and global trade friction remain elevated.

Fiscal Policy Uncertainty Index

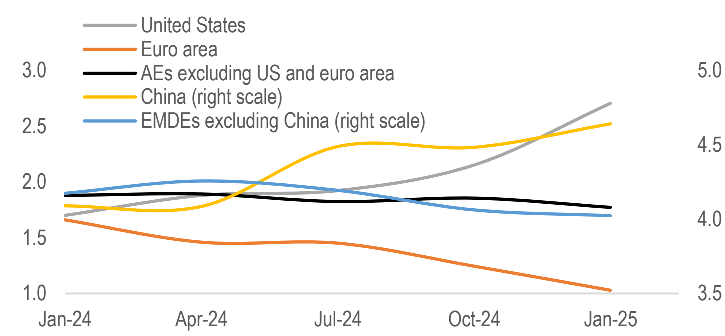


Source: IMF

Diverging trajectories in global GDP growth: The global economy remains on an uneven path, with advanced economies experiencing policy-induced slowdowns while emerging markets maintain a relative growth advantage.

- **United States**: Growth remains resilient, supported by a strong labor market and robust consumer demand.
- **Eurozone**: Economic activity remains sluggish, weighed down by weak manufacturing and subdued domestic consumption. Structural challenges, including the energy crisis, continue to hinder growth prospects.
- **China**: While policy interventions have stabilized growth, structural weaknesses in real estate and trade remain key risks.
- **Emerging Markets**: Growth momentum is expected to hold steady, supported by improved external balances and strong domestic demand.

Evolution of 2025 IMF Growth Forecasts (%)

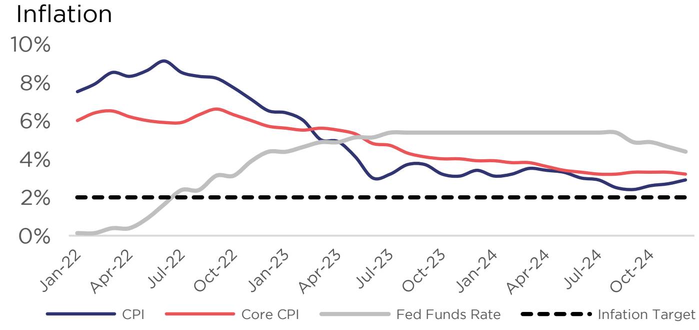


Source: IMF

Central banks expected to move more cautiously in the easing cycle. In its first meeting of 2025, the Fed kept its benchmark rate at 4.25%-4.50%, after reducing the rate by 1% last year. The annual rate of inflation has stayed above the central bank's 2% target, and Fed Chair Jerome Powell said there would be no rush to cut rates again until inflation and jobs data made it appropriate. While the ECB emphasized cutting interest rates cautiously and gradually going forward, given potential inflationary risks from U.S. tariffs as well as exchange rate movements.

US inflation & Interest Rates

Benchmark interest rates and YoY change in the CPI Inflation



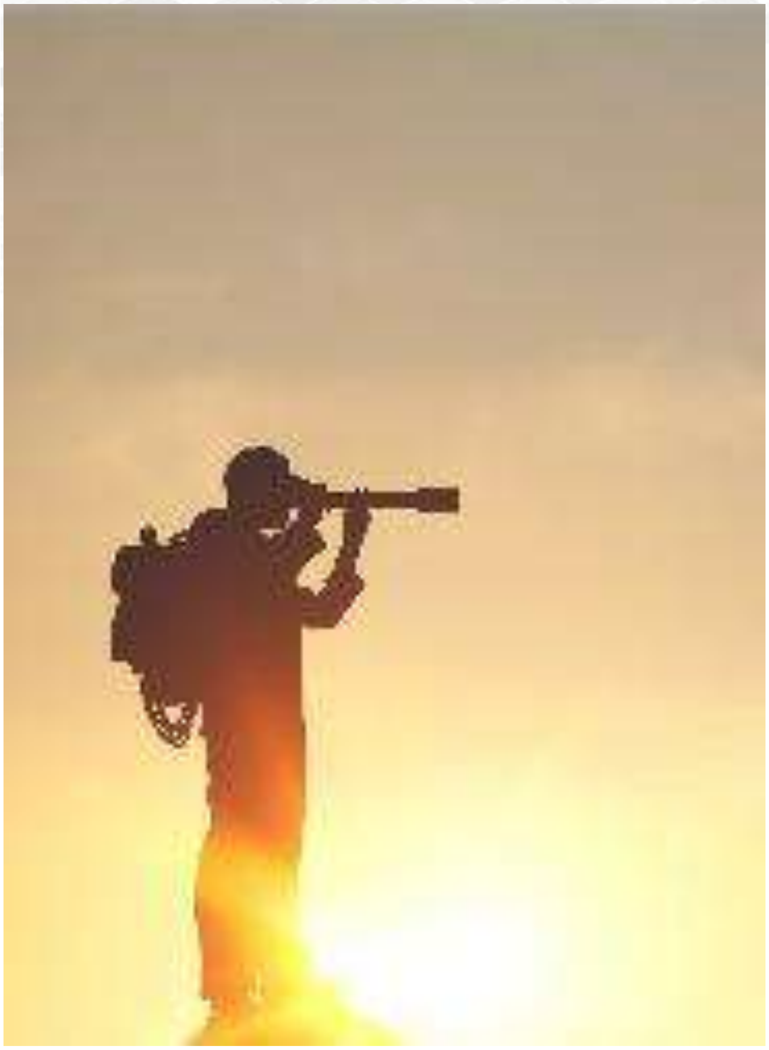
Source: Tradingeconomics, Federal Researve

Equity Market

Homegrown Economic Strength Counters Trade War-Induced Market Volatility

Indian markets remained volatile in January due to FPI outflows and global trade tensions, with mid and small caps facing sharp corrections. The Union Budget's tax cuts and capex push are expected to support consumption and key sectors like real estate and automobiles. However, escalating U.S. trade tariffs pose near-term risks to global market stability.

Equity Outlook



"Despite market volatility driven by global trade tensions and economic slowdown fears, the Budget FY 26 aims to revive consumption and maintain fiscal discipline, offering a balanced approach to economic growth."

Indian markets were volatile in January on back of continued FPI selling due to concerns on a slowdown in the economy and global tariff war as Donald Trump was sworn in as the 47th U.S. president. Though the Nifty was marginally down by 0.6% in Jan-25, the mid and small cap indices fell by 6% and 10% respectively, indicating the pain in the broader markets.

The Union Budget 2025-26 was presented in the backdrop of the uncertain macro environment and the finance minister delivered exactly what the markets were hoping for. The Union Budget was balanced and unequivocally reflected its focus on uplifting struggling consumption in the country with income tax cuts, TDS & TCS limit changes, increased planned expenditure on rural development and agriculture. These are expected to increase disposable income of the middle class and fuel consumption.

Further, ongoing capex strategy of center remains steady with 10.1% growth in FY26BE vis-à-vis FY25RE, in line with nominal GDP growth though there was shift in focus within sectors with significant increase in allocation to Housing (HUDCO, PMAY), urban development (Metros) and rural roads (PMGSY).

All in all, the current budget marks an opportune shift in strategy with a clear focus on reviving private consumption while not losing focus from the capex theme and adhering to fiscal discipline. Consumer discretionary and staples, Automobiles, Real estate, and Agriculture would be the key beneficiary sectors of the Union Budget.

Q3FY25 results have largely been in line with expectations so far. Expectations had been low to begin with and any major downside surprises were unlikely. Consumption push in the union Budget coupled with Monetary easing by the RBI will aid earnings recovery in FY26.

While India's domestic macros are likely to be on an improving trend from here on, global trade war has taken centerstage. The U.S. President used tariffs as a negotiating tool with Columbia to get concessions on immigration related issues. The US President also imposed 25% tariffs on all imports from Canada and Mexico, and a 10% tariff on all imports from China.

While the tariffs on Canada and Mexico have been put on hold for one month as both countries have agreed to implement measures to address border security and drug trafficking concerns raised by US President Donald Trump, a prolonged tariff war with China will be detrimental for the global economy. The likelihood of the U.S using tariffs as a negotiating tool with other countries is a key risk which may lead to near term uncertainty in markets.

Debt Market

Easing Yields and Liquidity Support Amid Global Uncertainty

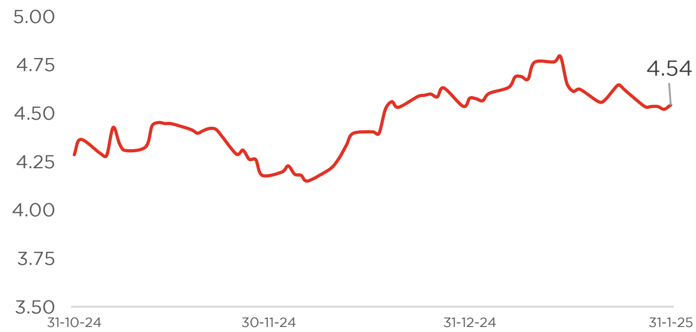
India's 10-year G-sec yield declined, supported by RBI liquidity measures and a stable fiscal deficit target. Inflation is moderating, and a potential repo rate cut remains likely amid global risks. Long-duration bonds are poised to benefit from expected yield declines and favorable demand-supply dynamics.

Fixed Income Outlook

India's 10-year government bond yield declined by six basis points to 6.70% in January 2025 from 6.76% in December 2024. This drop was largely driven by easing U.S. Treasury yields and the Reserve Bank of India's (RBI) liquidity-enhancing measures, including open market operation (OMO) purchases. Following the Union Budget, yields fell further as the government's fiscal deficit target of 4.4% of GDP for FY26 aligned with market expectations. The government has announced gross market borrowings of ₹14.8 lakh crore for FY26, compared to ₹14.0 lakh crore in FY25. Given strong demand from both domestic and foreign investors, the market is expected to absorb this supply smoothly.

US Yields fell by four basis points to 4.54% in Jan 2025

US 10 Year G-Sec Movement (For Last 3 Months)



Source: Investing.com

India's 10-Year G-Sec Yield Falls to 6.7% in January 2025 Amid US Yield Surge

Indian 10 Year G-Sec Movement (For last 3 months)

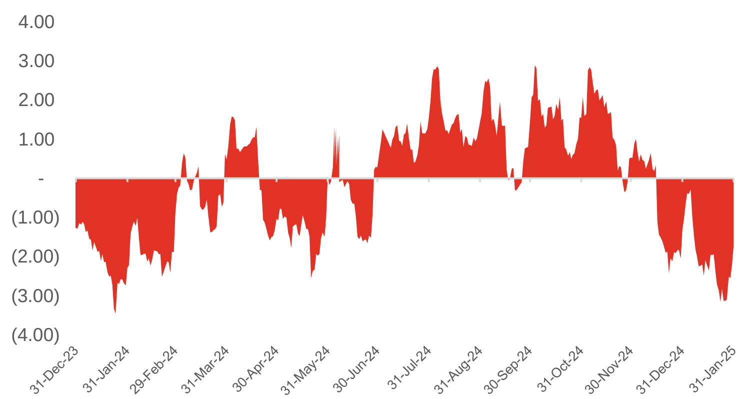
Source: CCIL

To address liquidity constraints, the central bank introduced multiple measures, including ₹60,000 crore in OMO purchases, a 56-day variable rate repo (VRR) auction worth ₹50,000 crore, and a $5 billion USD/INR buy/sell swap with a six-month tenor. These interventions are expected to alleviate pressures, particularly in the overnight and money markets.

In the U.S., the 10-year Treasury yield fell by four basis points to 4.54% in January 2025 from 4.58% in December. While yields briefly spiked to 4.8% mid-month, they moderated toward month-end. The Federal Reserve maintained its policy rate at 4.25%-4.50% in its January FOMC meeting, following cumulative cuts of 100 basis points in the latter half of 2024. The central bank remains cautious, closely monitoring inflation trends and the economic impact of Trump administration policies on tariffs and taxation.

RBI's Measures Fail to Ease Liquidity Crunch Amid Tax Outflows and Forex Operations

India's banking system liquidity (Rs Lakh cr)



Source: RBI

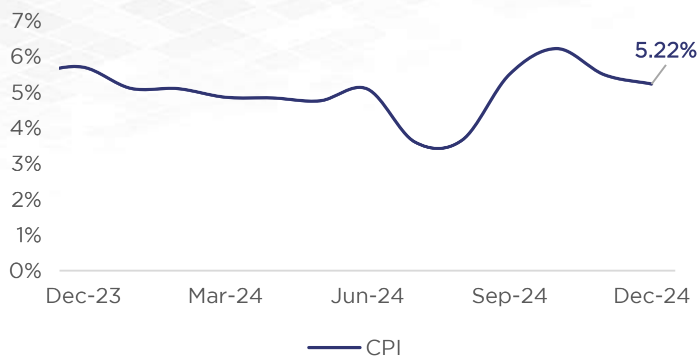
India's banking system liquidity remained under stress, with an average deficit of ₹2.04 lakh crore in January, significantly wider than December's ₹68,000 crore shortfall.

India's CPI inflation eased to 5.22% in December 2024 from 5.5% in November, primarily due to lower food prices. Inflation is projected to average 4.6% in Q4 FY25, with full-year estimates at 4.9% for FY25 and 4.2% for FY26, potentially reaching the 4% target by June 2025.

Fixed Income Outlook

India's Inflation Rates Eases in Dec 2024 Due to Drop in Food Prices

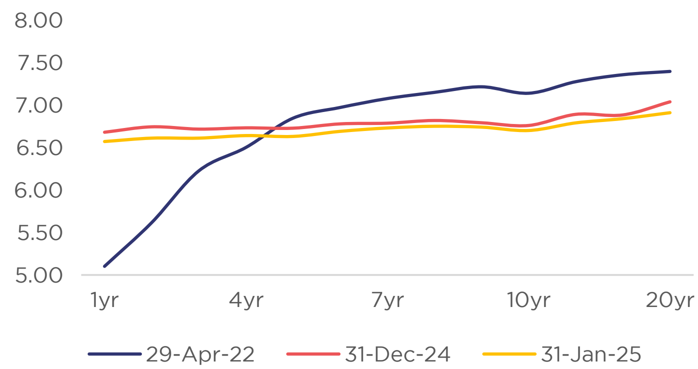
Inflation %



Source: MOSPI

Narrow G-Sec Yield Spread Anticipated to Widen with Easing Monetary Policy

G-Sec Yield Curve



Source: Bloomberg

The RBI's Monetary Policy Committee (MPC) meeting on February 7 is likely to deliver a 25-basis-point repo rate cut, though this remains a close call. Given rising global uncertainties, the central bank may prioritize liquidity management and defer rate cuts to April 2025.

Corporate bond spreads remain attractive, with AAA-rated PSU bonds in the 3-5 year segment offering a 60-80 basis point premium over comparable government securities.

Long-duration G-Secs stand to gain from potential rate cuts and favorable demand-supply dynamics.

Looking ahead, India's fixed-income market will be shaped by global monetary policy shifts, geopolitical developments, commodity price fluctuations, currency movements, bond supply-demand trends, and domestic growth-inflation dynamics.

In Conversation with Manoj Pandey: Head of HDFC TRU North

Q: How do you see the role of the next generation evolving within family offices, particularly in India?

A: The next generation is stepping into family offices with a fresh perspective and a strong desire to make an impact. They are not just inheritors of wealth; they are becoming active participants in shaping its future. It's inspiring to see them engage in discussions about sustainability, innovation, and technology, which shows their readiness to take on responsibilities that align with their values. This shift is crucial as it brings new ideas and approaches to managing family wealth.

Q: What specific skills or knowledge do you believe the next generation should acquire to effectively manage family wealth?

A: For the younger generation, acquiring a blend of financial literacy and technological know-how is crucial. They should focus on investment analysis, risk management, and understanding global market dynamics. It's important for them to cultivate a mindset that embraces continuous learning and adaptability, as these skills will empower them to make informed decisions in a rapidly changing financial landscape.

Q: What investment priorities do you observe among younger family members compared to previous generations?

A: Younger family members are increasingly drawn to digital assets, private equity, and ESG-focused investments. Their priorities reflect a desire for innovation and sustainability—values that resonate deeply with them. This shift indicates a broader trend towards aligning investments with personal values and making a positive impact on society.

Q: How important is succession planning in ensuring the longevity of family offices?

A: Succession planning is vital for the longevity of family offices. It's about more than just transferring wealth; it's about passing down values and vision. Involving younger generations early in discussions about succession strategies helps foster a sense of ownership and responsibility among them, ensuring they are prepared to lead when the time comes.

Q: How is artificial intelligence transforming the investment strategies employed by family offices?

A: AI is truly a game-changer for investment strategies. It allows for the analysis of vast amounts of data to identify trends and opportunities that might not be visible through traditional methods. This technology enhances efficiency and enables more precise insights tailored to clients' unique goals. As family offices embrace AI, we can expect a more data-driven approach to decision-making that aligns with the next generation's expectations for transparency and innovation. While AI offers tremendous potential, it also presents challenges such as data security concerns and the need for skilled personnel who can effectively manage these technologies. Family offices must navigate these issues carefully, ensuring that they leverage advancements while maintaining the personal relationships that are essential for understanding family values and preferences.

Q: In your view, what does the future hold for family offices as they adapt to these changes?

A: The future of family offices is transforming with technological advancements and evolving client expectations. ESG investments and thematic investing in technology and sustainability are increasing. Technological integration, including AI and blockchain, is revolutionizing operations. Flexible governance models are essential for diverse family dynamics, and engaging the next generation is crucial for longevity, with resources provided for their empowerment in wealth management.

Deep Dive

Turning the Tide: What will drive Foreign Institutional Investors (FII) flows back into India?

FII outflows have surged due to global uncertainties, but domestic inflows have helped stabilize Indian markets. Historically, prolonged outflows are rare, and a rebound is likely as macro conditions improve. Large-cap stocks, especially private banks, stand to benefit from returning FII investments.

Deep Dive

Turning the Tide: What will drive Foreign Institutional Investors (FII) flows back into India?

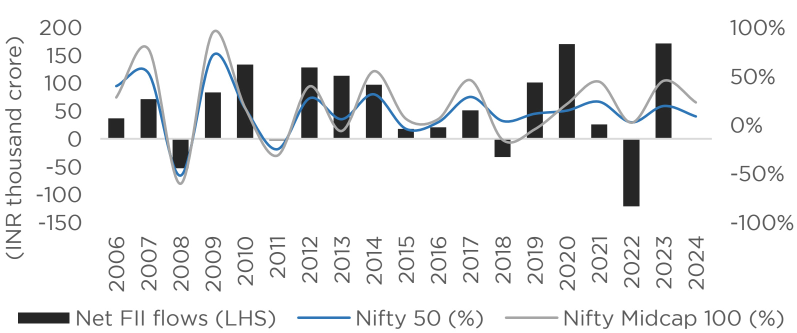
Understanding the Significance of Foreign Institutional Investors (FIIs) in India

Foreign Institutional Investors (FIIs) play a crucial role in shaping the Indian equity market, significantly influencing market dynamics, investor sentiment, and economic outlook. Higher FII participation is often seen as a sign of confidence in a country's economic growth and policy stability. Tracking FII ownership provides key insights into equity market direction.

The Impact of FII Flows on Indian Markets:

- **Positive Correlation with Equity Returns.** Equity market returns have historically moved in tandem with FII flows. During periods of substantial FII equity outflows, Indian equity markets have witnessed sharp corrections. The following chart illustrates a strong positive correlation between FII flows and Nifty returns.

FII Net Equity Flows vs. Nifty Indices (%)



Correlation	FII Equity Flows
Nifty50	+0.5
Nifty Midcap 100	+0.4

Source: NSE, NSDL, Note: Figures based on calendar year performance.

- **Impact on INR Exchange Rate.** Sustained FII outflows have consistently led to strong INR depreciation. Analyzing major historical instances of material FII equity outflows reveals a corresponding depreciation of the INR against the USD.

Year	Event	Duration (Months)	FII Flows (INR Cr)	INR Depreciation (%)
2008-09	Global Financial Crisis	14	59,669	-23%
2013	Taper Tantrum	3	23,037	-14%
2018	LTCG Tax on Equities, IL & FS Crisis	9	55,919	-14%
2020	Covid-19 Pandemic	2	68,857	-4%
2021-22	Russian-Ukraine Conflict	9	2,55,879	-6%
2024-25*	Trump 2.0	4	1,78,210	-3%

Source : Bloomberg, NSDL. Note: CY 2025 is priced till 31 Jan 2025.

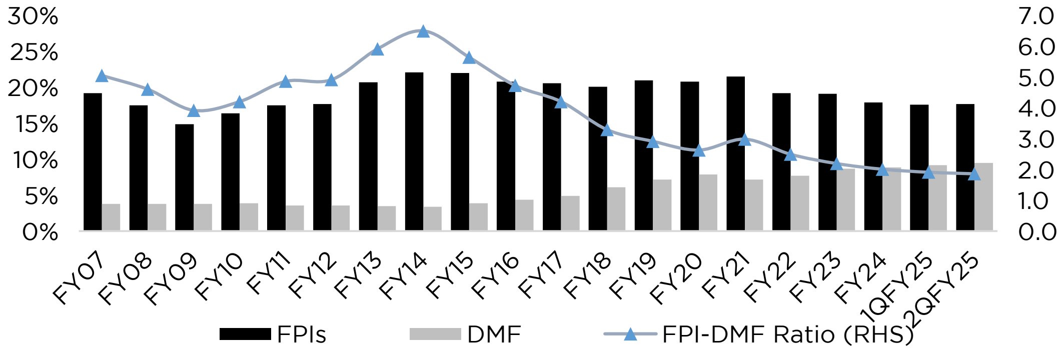
Deep Dive

Are FII Flows Less Relevant Post-COVID-19?

We don't think so. While FPI ownership continues to be a key indicator of investor confidence, their influence on the Indian capital markets has slightly moderated post-pandemic. This can be attributed to two major factors:

- **Decline in FPI Ownership:** Since FY21, FPI ownership in NSE-listed stocks have seen a decline from 21% in FY20 to <18% as of Q2 FY25.
- **Increased Domestic Participation:** Domestic Mutual Fund (DMF) ownership has surged, reducing the FPI-to-DMF ratio from 6.5x in FY14 to 2x in FY24.

NSE-listed Universe: FPI vs. DMF Ownership (%)



Source: NSE

Indian equity markets have become more resilient: To assess the resilience of Indian markets post-2020, we examined the relationship between FII volatility and Nifty 50 fluctuations. The findings indicate that the market's sensitivity to FII outflows has moderated in recent years.

For instance, between Oct-21 and Jun-22 (Russia-Ukraine Conflict), the BSE 500 Index had corrected ~11%, with the cumulative FII outflows during the period at >1% of the BSE 500 Avg. Market Cap. In contrast, during the pre-pandemic periods (2013 and 2018), we observed similar correction in equity markets despite the total FII outflows amounting to <0.5% of the BSE 500 Avg. Market Cap.

Period	Event	FII Net outflows as a % BSE 500 Mkt Cap	% chg. in BSE 500
Jan'08-Feb'09	Global Financial Crisis	1.4%	-62%
Jun'13 – Aug'13	Taper Tantrum	0.4%	-10%
Feb'18 – Oct'18	LTCG Tax on Equities, IL & FS Crisis	0.4%	-10%
Mar'20 – Apr'20	Covid-19 Pandemic	0.6%	-13%
Oct'21 – Jun'22	Russian-Ukraine Conflict	1.1%	-11%

Source: Bloomberg

Key Drivers of FII Outflows in the Past

Historically, FII outflows have been influenced by a combination of global/domestic macroeconomic factors, equity valuations, and earnings momentum. However, macroeconomic indicators have been the primary determinant of FII movements.

Deep Dive

Key Macro-Economic Factors Influencing FII Flows:

1. Global Economic Conditions

- Strong global GDP growth encourages FIIs to allocate capital to emerging markets
- Economic slowdowns lead to risk aversion, reducing FII inflows.
- Ample global liquidity fosters increased capital flows into emerging markets.

2. Interest Rates, Monetary Policy & Bond Market Dynamics

- 10-Year US Treasury Yield – Rising yields reduce the attractiveness of emerging market assets.
- Interest Rate Differential – Higher domestic rates attract FIIs, while lower rates discourage them.

3. Inflation & Commodity Prices

- Inflation Rate (India & Globally) – High inflation erodes real returns, leading to outflows.
- Oil Prices – Rising prices increase India's trade deficit and weaken the rupee, reducing FII confidence.

4. Currency Exchange Rates & Stability

- Rupee Depreciation – A weakening rupee can lead to outflows due to FX losses for FIIs.
- Dollar Index (DXY) – A stronger USD makes emerging market assets less attractive.
- Foreign Exchange Reserves – Higher reserves provide economic stability, boosting FII confidence.

The below table shows correlations between annual FII flows and the equivalent rate of change in macro-economic factors. A positive correlation indicates that factors tend to move in the same direction and a negative correlation indicates that factors move in different directions.

Correlation	Net FII Equity Flows
DXY Index	-0.5
US 10Y	-0.5
Oil Price	-0.2
Bond Yield Spread	0.3

Source: Bloomberg, NSE, NSDL and Investing.com. Data Period: 1 Jan, 2010 to 31 Dec, 2024.

Key findings from the correlation table, as below:

- FII flows have the strongest relationship with the DXY Index and US 10Y Treasury Yields, among all the key macro-variables.
- Oil Prices and Bond Yield Spreads are also important indicators of FII flows direction, but the relationship may vary across different time periods.

Valuations / Earnings Momentum. Equity valuations have also proven to be an important indicator of flows in the past but have lacked consistency at times. To test the relevance of equity valuations on FII volatility, we looked at the MSCI India 12M forward (NTM) P/E vs. the next 3-month and 6-month average FII equity flows.

Deep Dive

Key takeaways from our analysis, as below:

- The highest inflows come in when the valuations are cheap (<15x 12M Fwd. P/E), while flows tend to dry up when valuations become expensive (>21x 12M Fwd. P/E).
- The current MSCI 12M Fwd. P/E is at ~21x, which indicates muted net equity FII flows into the Indian capital markets over the next couple of months, based on past historical trends.

MSCI India 12M Fwd. P/E	Number of Observations	Next 3M Avg. FII flows (INR cr)	Next 6M Avg. FII flows (INR cr)
8-12x	9	5,589	7,158
12-15x	62	5,712	5,822
15-18x	71	4,884	4,994
18-21x	50	4,229	5,111
21-24x	35	1,216	909
>24x	2	-16,133	-25,056

FII equity flows retreat, when stocks get too pricey.

Source: Bloomberg. Data Period: 1 Jan, 2006 to 31 Dec, 2024.

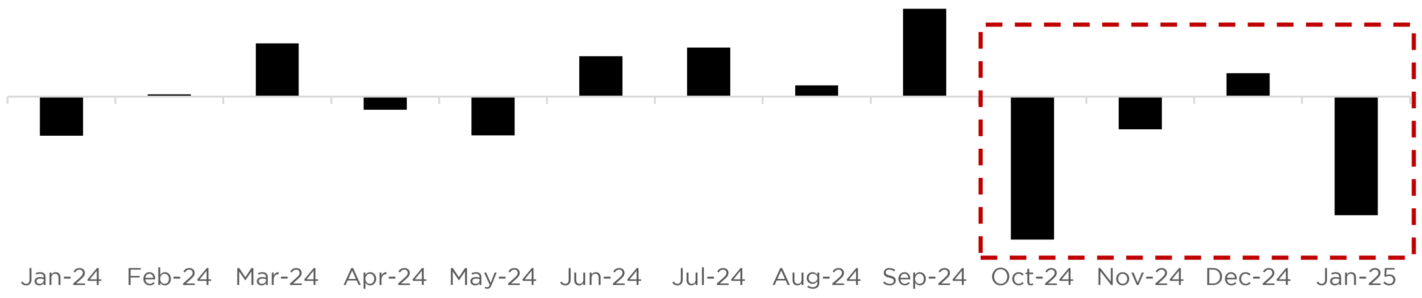
Overview of the recent FII Equity Outflows from India:

Indian markets experienced significant FII outflows in the past few months, with Oct-24 marking the highest monthly equity outflows to date (Rs 94,017 cr). This trend continued into Jan-25, with more than Rs 175,000 cr being pulled out in the last four months from Indian equity markets. Collectively, these outflows have led to c.10-15% correction in India's major benchmark indices.

The major factors driving the FII outflows this time:

- **Elevated valuations.** The MSCI India Index is significantly overvalued as compared to some of the other emerging markets (~100% premium as of Sep-24 vs. long-term median of ~60%).
- **Subdued corporate earnings growth trajectory**. The Nifty50 2QFY25 diluted earnings grew only 4% y/y and declined ~11% sequentially; whereas the Nifty Midcap100 declined on a sequential basis for the fourth straight quarter.
- **Higher global bond yields driven by US policy uncertainty.** Rising US 10Y bond yields and narrowing India-US bond yield spread gap to ~200bps, significantly increases the appeal of safer assets.
- **USD Strengthening;** the DXY Index is currently at 108.5 as of 31 Jan-25 (+7% vs. beginning of CY24).

Net FII Equity Flows (INR Thousand Crores)

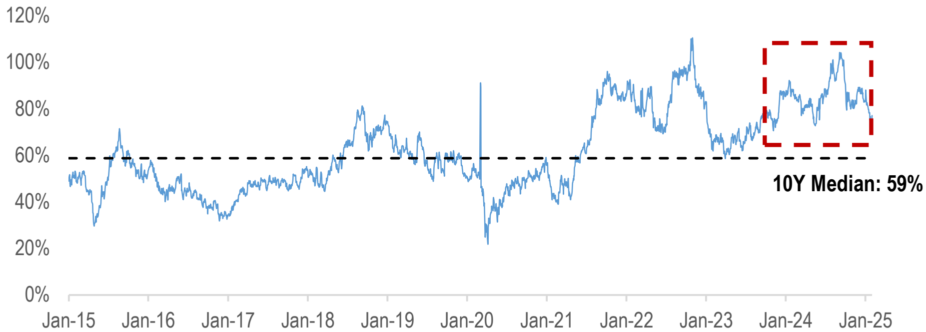


Source: NSDL

Deep Dive

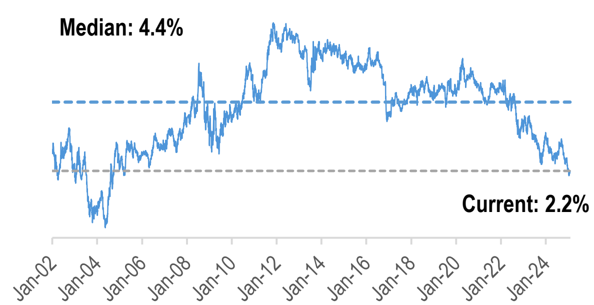
Earnings Growth (%)	1QFY24	2QFY24	3QFY24	4QFY24	1QFY25	2QFY25
NIFTY 50	**243**	**246**	**242**	**254**	**288**	**257**
Growth (YoY)	*12%*	*32%*	*24%*	*17%*	*18%*	*4%*
Growth (QoQ)	*12%*	*1%*	*-2%*	*5%*	*13%*	*-11%*
NIFTY Midcap 100	**467**	**513**	**496**	**406**	**366**	**358**
Growth (YoY)	*25%*	*114%*	*75%*	*12%*	*-22%*	*-30%*
Growth (QoQ)	*29%*	*10%*	*-3%*	*-18%*	*-10%*	*-2%*

MSCI India vs. EM 12M Forward PE Premium (%)

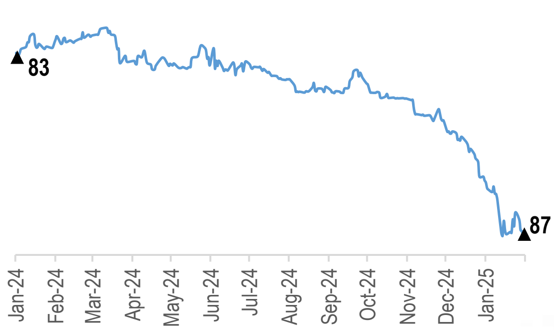


US 10Y Yield (%)

India vs. US 10Y Bond Yield Spreads (%)



INR / USD Spot Price



U.S. Dollar (DXY) Index

Source: Bloomberg, NSDL, Investing.com. Note: Priced as on 31 Jan 2025.

Deep Dive

When Will FII Flows Rebound?

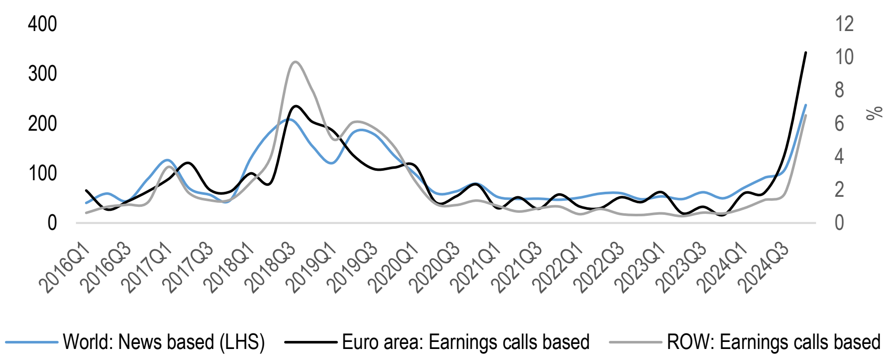
Historically, FII flows have rebounded once key macroeconomic concerns subside, equity valuations normalize, and sustained corporate earnings growth becomes more visible. Since 2002, prolonged net FII outflows for three or more consecutive quarters have occurred only thrice, with most periods witnessing just 1-2 quarters of consecutive outflows.

FII outflows have occurred in three or more consecutive quarters only 3 times in the past 20 years.

Key Triggers for FII Inflows:

- **US Trade Policy clarity**: Policy uncertainties under Trump 2.0, particularly concerning trade tariffs, have impacted investor sentiment. A clearer policy direction could drive FII inflows.

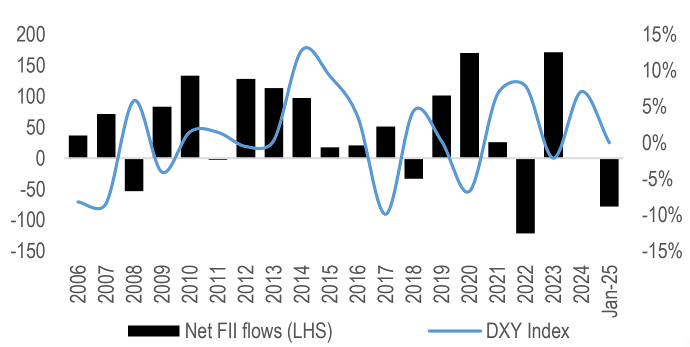
Trade Policy Uncertainty Index



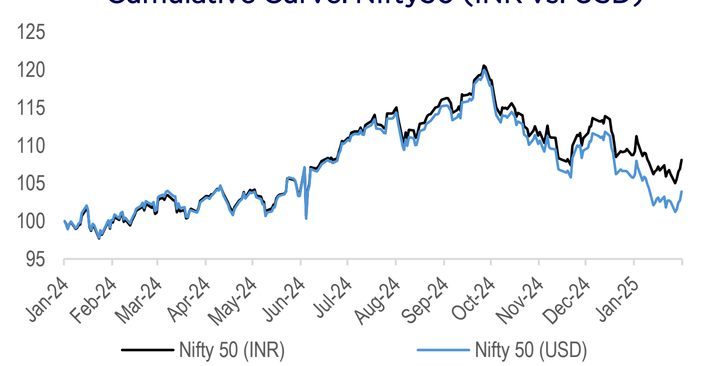
Source: IMF. Note: The uncertainty measures are news-based indices that quantify media attention to an issue, in which a value of 100 corresponds to 1% of news articles that reference the issue.

- **INR Stability:** A more flexible INR strategy under the new RBI governor may impact FX volatility. Stable INR levels are crucial for attracting FIIs.
  - **Impact on Equity Returns:** Rs 100 invested on 1 Jan 2024, would have turned into Rs 108 in INR terms as of 31 Jan, 2025 vs. Rs 104 in USD terms, reflecting ~4% lower returns.
  - **DXY Index:** In the above section, we had highlighted a strong negative correlation between the DXY Index and FII flows. So, whenever the DXY index has weakened, FII flows bounce back.

Net Equity FII flows vs. DXY Index



Cumulative Curve: Nifty50 (INR vs. USD)

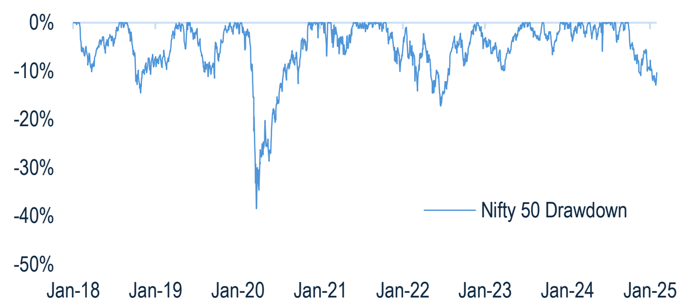


Source: Investing.com, NSE and NSDL.

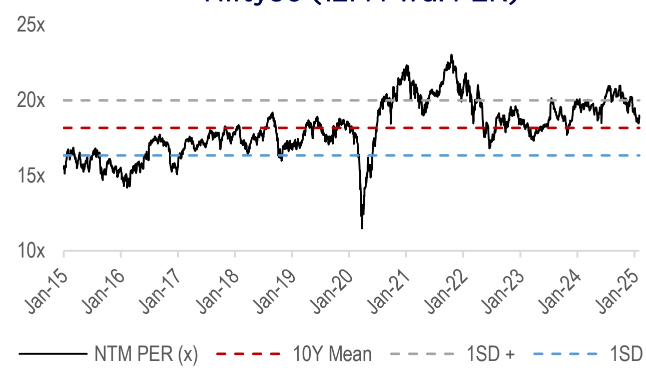
Deep Dive

- **Equity valuations have started to normalize.** Post the significant correction, we notice some signs of improvement in equity valuations, which could slowly drive back FII flows, as follows:
  - **Large-caps valuations attractive.** While, the mid and small-cap valuations still remain frothy, the large-cap valuations have normalized post the recent correction.
  - **MSCI India vs. MSCI World.** The MSCI India 12M Fwd. P/E premium against the MSCI World Index has declined from >30% in Sep-24 to 13% currently (10Y Median: 20%).
  - **Earnings vs. Bond Yield.** The earnings vs. bond yield spread reduced from 2.0% in Sep-24 to 1.4% currently, indicating equities are relatively cheap post-correction.

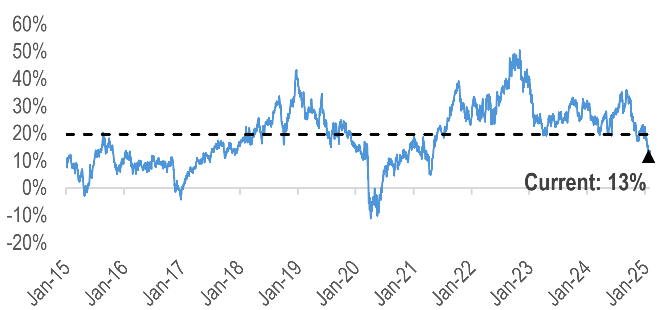
Nifty50 drawdown has come close to the mid-2022 sell off…



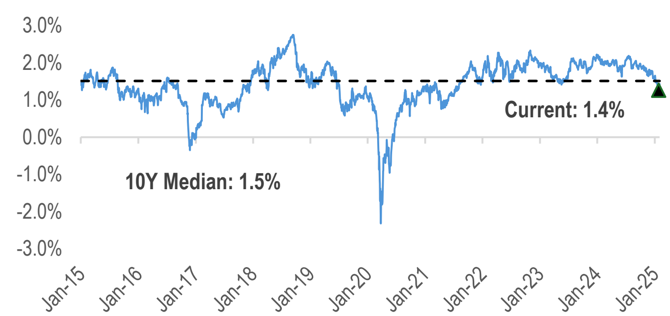
Nifty50 (12M Fwd. PER)



MSCI India vs. ACWI 12M Fwd. Premium (%)



Yield Gap: Bond vs. Earnings Yield (%)



Source: Bloomberg. Note: Priced as on 31 Jan 2025.

Our Take:

FII outflows have weighed on Indian equities in recent months, but historical trends suggest that prolonged outflows are rare, and muted years are typically followed by strong inflows. With 2024 being a subdued year in terms of flows, a strong rebound is expected in 2025. Additionally, macro-economic variables are likely to stabilize in the coming months as markets gain clarity on US policy direction, especially since the DXY Index's current level (>109) has historically been unsustainable. Equity valuations have also become more attractive, with the MSCI India 12M Forward P/E correcting from 24x in September 2024 to ~21x. Given this backdrop, large caps are expected to benefit the most from a potential FII flow reversal, as FIIs typically hold a higher allocation in large caps compared to mid and small caps. The BFSI sector, particularly private banks, stands out as a key beneficiary, given FPIs' significant exposure to financials (~30% as of September 2024). **Overall, a large-cap and private banks-focused strategy appears well-positioned to capitalize on the anticipated recovery in FII flows in 2025.**

Reading Room

Tariffs make dollar supreme, India's choices more difficult than ever

Rising global tariffs and a strengthening U.S. dollar are reshaping trade dynamics, making imports costlier for countries like India. The impact is most evident in energy and raw material costs, straining India's manufacturing sector and trade balance. Navigating these challenges requires strategic trade policies, currency management, and increased domestic production. The growing dominance of the U.S. dollar raises financial vulnerabilities, increasing India's reliance on external economic conditions. As the global economy shifts, India must balance its policy choices carefully to sustain growth and trade competitiveness.

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How Chinese A.I. Start-Up DeepSeek Is Competing With Silicon Valley Giants

China is accelerating AI chip development to reduce dependence on U.S. technology, with DeepSeek emerging as a key player in this space. U.S. export restrictions on advanced AI chips have spurred innovation in China, but also intensified global tech competition. DeepSeek's advancements could reshape AI supply chains, challenging the dominance of Western firms. The escalating AI arms race between the U.S. and China has broader implications for trade, security, and technological leadership. As China strengthens its AI ecosystem, global markets must prepare for potential shifts in innovation and investment strategies.

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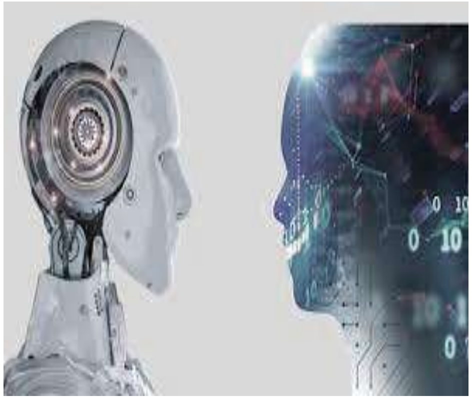

Leaving the W.H.O. Could Hurt Americans on a Range of Health Matters

The U.S. decision to exit the World Health Organization (WHO) marks a major shift in global health policy, raising concerns about international disease management. The withdrawal could weaken pandemic response efforts, disrupt vaccine distribution, and strain global healthcare collaboration. WHO's financial and political challenges may worsen without U.S. support, impacting research and medical aid programs. While some view this as an opportunity for reform, many fear it leaves a leadership void in global health governance. The move has drawn mixed international reactions, underscoring its far-reaching consequences for public health worldwide.

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HDFC securities Limited, I Think Techno Campus, Building - B, "Alpha", Office Floor 8, Near Kanjurmarg Station, Opp. Crompton Greaves, Kanjurmarg (East), Mumbai 400 042 Phone: (022) 3075 3400 Fax: (022) 2496 5066

Compliance Officer: Murli V Karkera Email: complianceofficer@hdfcsec.com Phone: (022) 3045 3600

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Registered Address: I Think Techno Campus, Building, B, Alpha, Office Floor 8, Near Kanjurmarg Station, Opp. Crompton Greaves, Kanjurmarg (East), Mumbai - 400 042.
Tel: +91-22-30753400 Fax: +91-22-30753435 www.hdfcsec.com.

Member of NSE, BSE, MSEI, MCX | Reg No.: INZ000186937 | Member: CDSL | Reg No.: IN-DP-372-2018 | Research Analyst: INH000002475 |
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Compliance Officer: Mr. Murli V Karkera. Ph: 022-3045 3600, Email: complianceofficer@hdfcsec.com.
For any complaints / grievance: services@hdfcsec.com