

## Indian Equity: An All-Weather Asset Class

ACTIVE FUNDAMENTAL EQUITY | GLOBAL EMERGING MARKETS | MACRO INSIGHT | DECEMBER 2018

India is the sixth-largest economy in the world, a US\$2.6 trillion powerhouse that has consistently clocked nominal GDP growth rate of 13% over 20 years.<sup>1</sup> It is also the largest democracy in the world, with free and fair elections, an independent institutional framework and a reform-oriented, fiscally responsible regime at the helm.

AUTHORS

INDIA EQUITY TEAM

Reforms such as the Goods and Services Tax (GST) and demonetization are slowly being digested and paving the way for a broad-based formalization of the economy. Corporate earnings are also showing signs of recovery after the twin displacements from these reforms. In this paper, we seek to discuss in detail why the long-term opportunity remains intact despite the near-term headwinds, and why we believe this could be an interesting time to position in India.

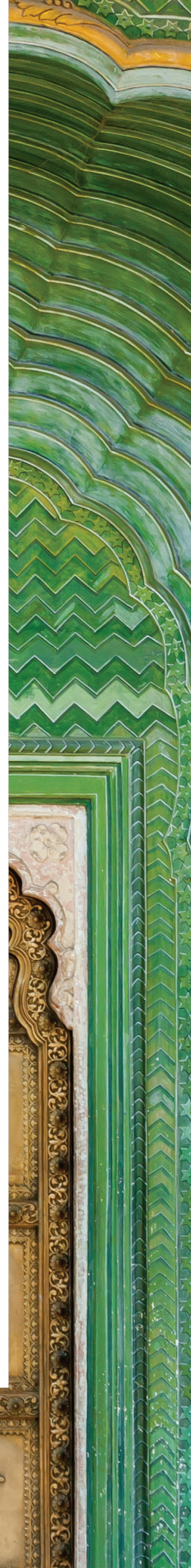
### Why India?

#### SIZE PLUS GROWTH

India as an economy offers a combination of size as well as growth, a rare combination on the world stage today. In terms of size, India is a US\$2.6 trillion economy, with 1.3 billion people.<sup>1</sup> Nominal GDP growth rate has averaged 13% over a span of the last two decades and represents one of the only large countries growing at that clip.<sup>1</sup>

In the late 2016 to mid-2017 phase, real GDP growth rate dipped because of the impact of demonetization and the GST

<sup>1</sup> International Monetary Fund, World Bank Database, as of July 2018.



implementation. Real gross domestic product growth returned to the 7% range in the October-December 2017 period, as the economy shook off these disruptions (*Display 1*). This process of normalization has continued, and India has quickly regained the tag of the fastest growing economy in the world.<sup>2</sup>

**FAVORABLE DEMOGRAPHICS**

India is not only one of the largest populations in the world, but also one of the youngest. Nearly two-thirds of India’s population is under 35 years of age.<sup>3</sup> One million people enter the labor force every month, giving the country a significant edge in terms of productivity.<sup>3</sup> This also means that India is among the highest contributors to the workforce globally (*Display 2*). Therefore, it presents a sharp contrast and investment hedge in the context of a rapidly aging world (*Display 3*).

**LARGE INVESTMENT UNIVERSE, REWARDS ACTIVE MANAGEMENT**

India has around 5,000 listed companies, second only to the United States in terms of investment universe (see *Display 4*).<sup>4</sup> However, the growth in India’s formal corporate sector does not truly represent India’s domestic growth story. While India has clocked a consistent double-digit nominal GDP growth, the earnings for the NIFTY 50 Index (Nifty) for the past three years have grown at a rate of just 1.7%.<sup>5</sup> It is a similar story for the MSCI India Index too. This is because outward-facing companies constitute a large chunk of the indexes. By outward-facing companies, we mean export-oriented sectors like technology and pharmaceuticals companies linked to global commodity cycles and those that derive significant value from their

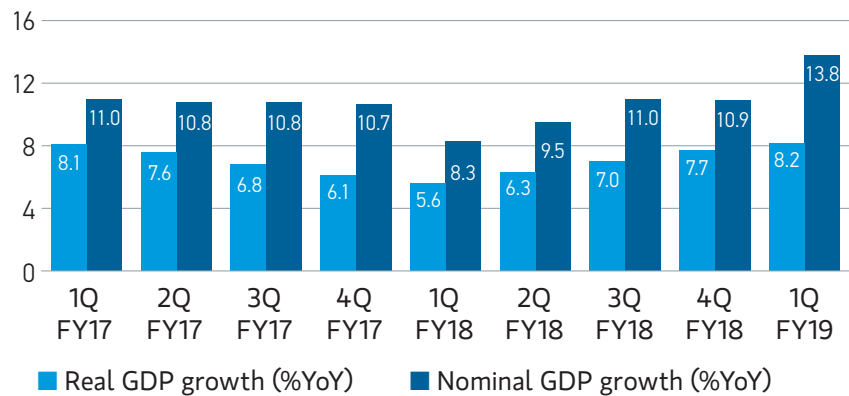
<sup>2</sup> International Monetary Fund, World Bank, as of August 2018.

<sup>3</sup> Organization for Economic Cooperation and Development Economic Survey, 2017.

<sup>4</sup> The National Stock Exchange and The Bombay Stock Exchange, Jefferies Research, as of October 2018.

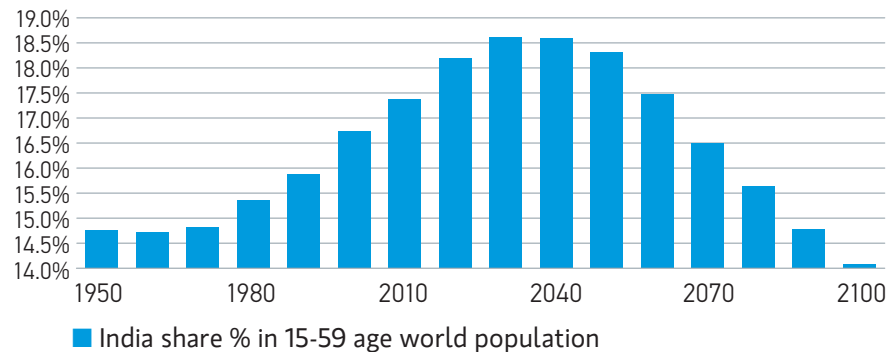
<sup>5</sup> Bloomberg, CLSA, as of October 2018.

**DISPLAY 1**  
**Quarterly GDP growth (%)**



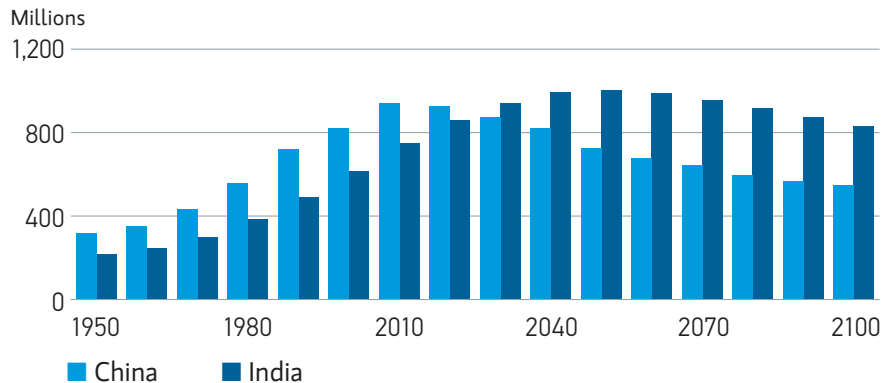
Source: RBI, Kotak Institutional Equities, as of September 2018.  
Fiscal Year (FY) refers to India’s traditional fiscal year which runs for twelve consecutive months from April 1st until the following March 31st. For example, fiscal years referred to as **FY17**, **FY18** and **FY19** are short-hand for **FY2016/2017**, **FY2017/2018** and **FY2018/2019** respectively.

**DISPLAY 2**  
**India contributes c.18-19% of global working-age population**



Source: U.N. data estimates, Jefferies Research, as of October 2018.  
Charts and graphs provided herein are for illustrative purposes only. Forecasts/estimates are based on current market conditions, subject to change and may not necessarily come to pass.

**DISPLAY 3**  
**Potentially making India the world’s biggest supplier of workforce**



Source: U.N. data estimates, Jefferies Research, as of October 2018.  
Charts and graphs provided herein are for illustrative purposes only. Forecasts/estimates are based on current market conditions, subject to change and may not necessarily come to pass.

overseas subsidiaries. As of September 2018, Jefferies Research estimates that such outward-facing companies make up almost 59% of the benchmark Nifty earnings. Therefore, the index is not the best representation of domestic growth opportunities, and one is arguably better off looking for an active manager who can sift through them for higher returns. This is a well-accepted argument and one of the major reasons why active India funds as an asset class have assets in excess of US\$50 billion.<sup>6</sup>

**INDIA HAS REWARDED ‘BUY AND HOLD’ INVESTING**

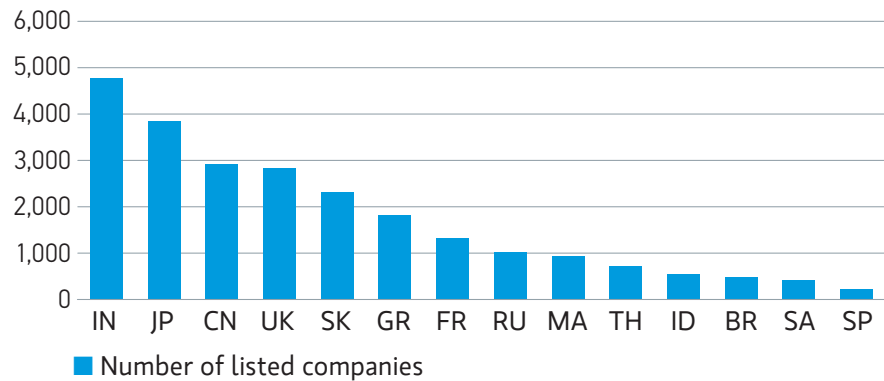
We believe, through the stock-level returns work we have done, that investors may do well in making a strategic rather than tactical allocation to India. As shown in *Display 5*, India has the third-largest number of stocks (349) among the emerging markets, with market cap in excess of US\$500 million. While the decadal MSCI returns for most emerging markets, including India, have been close to zero, there was stock-picking succor in India, as over 30% of those stocks quintupled (went up >5x) in that time frame. This is by far the best percentage for all emerging and developed markets. Further, of the 118 stocks that quintupled in 10 years (17%+ CAGR), we looked for persistency to check how many of those doubled in the last three years (26% + CAGR) and tripled in last five years (25% + CAGR). Of the 118 stocks, 35 stocks met all three criteria (see *Display 5*). This implies that there has been much better persistency in stock returns in India than in some of the other emerging markets. For example, in mainland China, only 14 of the 56 stocks that quintupled in 10 years showed persistency, reflecting a market where tactical timing is important (as depicted in *Display 5*). This further showcases that the same stocks in India may do consistently well and one may not need to tactically time the market

to outperform. The regime in India has rewarded a consistent “buy and hold” style of long-term investment. This is also a reason why we believe that it is important to maintain portfolio holdings irrespective of market environment, as

long as companies deliver on growth and do not dilute quality. A growth and quality portfolio may underperform in environments of macro stress but has generally outperformed benchmarks over longer durations.

**DISPLAY 4**

**Number of companies listed in India is highest ex. U.S.**



Source: Bloomberg, Factset, Jefferies Research, as of October 2018.

**DISPLAY 5**

COUNTRY	NO. OF STOCKS WITH MCAP >500 MM	NO. OF STOCKS WITH MCAP >USD 500 MM AND >5X 10 YEAR RETURN IN USD	NO. OF PERSISTENT STOCKS OVER THE SAME TIME PERIOD	PERCENTAGE OF STOCKS QUINTUPLED (>5X) OVER THE SAME TIME PERIOD
India	349	118	35	34%
China	1,903	171	17	9%
China-H	354	56	14	16%
Korea	295	64	28	22%
Taiwan	265	36	9	14%
Brazil	154	1	0	1%
South Africa	113	8	0	7%
Russia	84	3	2	4%
Mexico	89	4	0	4%
Indonesia	116	25	6	22%
Thailand	134	37	4	28%
US	2,736	293	97	11%
UK	374	64	12	17%
Japan	1,158	181	75	16%
Germany	220	32	14	15%
France	229	22	9	10%

Source: Bloomberg, MSCI Datastream, as of 30 September 2018. Time period for 10-year return is from September 2008 to September 2018. Past performance is not a guarantee of future results. Provided for informational purposes only, not to be construed as an investment recommendation.

<sup>6</sup> Morgan Stanley Research, as of September 2017.

## Why India now?

### A BROAD BASKET OF REFORMS

The central government is currently ruled by the Bharatiya Janata Party (BJP), led by Prime Minister Narendra Modi. Under the leadership of this government, economic and regulatory changes have been put in place which have the potential for enduring long-term change. Some reform initiatives of the government are detailed below:

1. In July 2017, the **Goods and Services Tax (GST)** was implemented. This system of uniform taxation is slowly driving formalization of the economy and creating a common market.
2. The **Aadhaar system** of biometric identification was adopted for a targeted delivery of subsidies to the bank accounts of intended beneficiaries. This is called the **Direct Benefit Transfer (DBT) system**. The DBT has worked to ensure better targeting of government subsidies to the intended beneficiaries, by cutting out middlemen and corruption. As such, it has helped bring down the overall subsidy bill for the government by plugging leakages.
3. The **Insolvency and Bankruptcy Code** of 2017 laid out an institutional and time-bound framework for pushing ailing companies into bankruptcy proceedings. Banks are using the mechanism to seize companies that have consistently failed to pay back their loans and replace founders with professional management. This reform is a big step toward resolving the legacy bad-loan problem that ails the state-owned banks. We are fairly optimistic about the end of the corporate bad-loan cycle in India. Nonperforming loans representing 25% of the total bad-loan stock in the country were referred to the Insolvency and Bankruptcy tribunal mid-2017 for a time-bound resolution (180/270 days). These are now finally getting resolved with the sale of the underlying assets to new management teams and exit of the defaulting promoters/founders. This could mean a system-wide clean-up of bank balance sheets, with the hope that moribund corporate lending in the country may finally revive.
4. The government announced a **bank recapitalization** plan of INR2.11 trillion (US\$33 billion)<sup>7</sup> over the next two years to boost balance sheets of state-owned banks.
5. **Make in India**, one of the flagship programs of the current government, was launched in 2014 with the objective of job creation and skill enhancement across 25 sectors of the economy, and to transform India into a ‘manufacturing hub’ and a top investment destination globally. Post launch, India has received investment commitments worth US\$230 billion and investment inquiries worth US\$21 billion between September 2014 and February 2016.<sup>8</sup> As a positive outcome of this, in 2015, India emerged as the top destination for FDI with US\$63 billion.<sup>9</sup>
6. **“Bharatmala Pariyojana”** is a new umbrella project for road construction by the Ministry of Road Transport and Highways. This project has the stated objective of adding a whopping 34,000 kilometers of roads within a span of five years. Special emphasis will be given to providing connectivity to far-flung border and rural areas,

including the tribal and backward areas. The outlay of US\$84 billion under Bharatmala makes it the single-largest outlay for a government road construction scheme.<sup>10</sup>

7. **Ujwal Bharat** is a joint program of the Ministry of Power, Coal, New and Renewable Energy, which aims to ensure 24/7, affordable clean power supply for every household by 2019.<sup>11</sup> The target of the program is to double Coal India’s production to 1 billion tons/year and to strengthen the ‘One nation, One Grid, One Price’ policy by ensuring electricity for all states at affordable rates.<sup>11</sup> As a result of this, a 40% increase in transformation capacity has been reported in March 2017. Consequently, India became a net exporter of electricity in 2016-17 for the first time.<sup>12</sup>

### Significant macro events, paving the way for long-term change in the structure of the economy

India witnessed a series of significant macro events which impacted the market in the years 2016-2018. We have outlined a few of the important events below, and the structural impact they have had and continue to have on the economy.

#### EVENT #1: DEMONETIZATION

On November 8, 2016, the government of India “demonetized” all high-denomination currency notes (INR 500 and INR 1,000). These denominations ceased to be legal tender and were replaced by new INR 500 and INR 2,000 notes.

Two years on, the report card of the Indian economy reflects mixed consequences from demonetization. The displacement remains largely

<sup>7</sup> Reserve Bank of India, as of November 2017.

<sup>8</sup> Department of Industrial Policy and Promotion, Media articles, as of February 2016.

<sup>9</sup> fDi intelligence, Financial Times, as of April 2016.

<sup>10</sup> Government of India, National Highway Developmental Program, as of November 2017.

<sup>11</sup> Ministry of Power, Coal, New and Renewable Energy, announced in 2014.

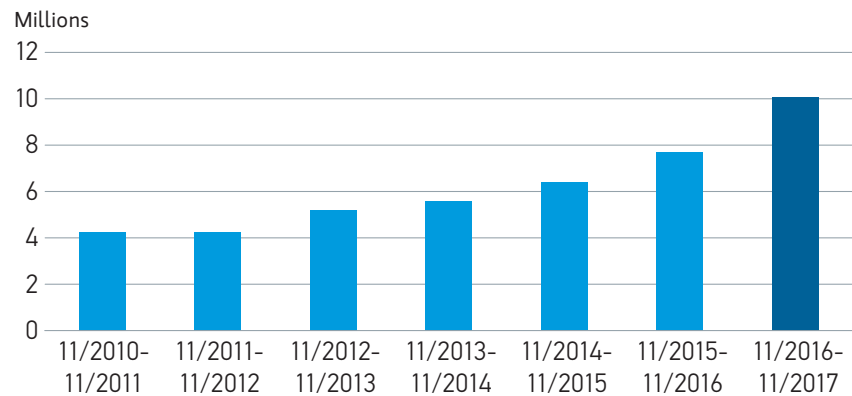
<sup>12</sup> Press Release by Ministry of Power Government of India, as of June 2017.

concentrated in the unorganized sector (which largely dealt with cash). However, we do believe that the short-term upheaval has set in motion a process of long-term “formalization” of the economy. While many of the supply chains in the informal sector broke down as a result of demonetization, listed companies operating in the formal space have been big beneficiaries.

Demonetization has accentuated the process of “financialization” of the Indian economy. Savings were rapidly moving away from the traditional avenues of gold and real estate into financial assets, a trend that has gained momentum post-demonetization. While the overall financial savings of the households as a percentage of Gross National Disposable Income (GNDI) increased from 9.1% in FY2017 to 11.1% in FY2018 (significantly higher than the growth witnessed in any of the preceding five years), savings in the form of currency as a percentage of GNDI continued to remain at lower levels at 2.8% in FY2018.<sup>13</sup> This decline is primarily on account of the withdrawal of high-denomination currency notes in November 2016 and partial “re-monetization” by the end of March 2017. The savings channeled into bank deposits, life insurance funds, and shares and debentures increased by 82%, 66% and 345% respectively, in 2016-17.<sup>14</sup> Within the shares and debentures category, the growth of savings in mutual funds registered a phenomenal increase of more than 400% in 2016-2017, over and above the growth of 126% witnessed in 2015-2016.<sup>14</sup> Thus, within a span of two years, savings in the form of mutual funds registered more than an 11-fold increase.<sup>14</sup>

Another of the unintended, yet extremely salutary impacts of demonetization has been an **increase in the number of taxpayers**. *Display 6* compares the total number of new taxpayers

#### DISPLAY 6 New tax filers (Indirect and direct)



Source: Department of revenue (CBDT), Survey calculations, Economic survey 2017-18, Ministry of Finance, Government of India.

(indirect plus direct) in the 13 months since demonetization (November 2016-November 2017) with previous 13-month time windows. After November 2016, 10.1 million filers were added, compared with an average of 6.2 million in the preceding six years.<sup>14</sup> An improving tax/GDP ratio is extremely positive, as it means more money in the hands of the government for capital/infrastructure spending. There has also been an addition (over and above trend growth) of about 1.8 million in individual income tax filers since November 2016.<sup>14</sup>

#### EVENT #2: GOODS AND SERVICES TAX (GST)

July 2017 was marked by the introduction of the GST, arguably India’s biggest indirect tax reform and longest in the making. It eliminates the cascading impact of various central, state and local body taxes, and unifies them into a single levy. One year on, the “One Nation-One Tax” is still continually evolving in response to feedback. In mid-2018, the Government reduced the GST rate

on several consumer durable products, paints, etc., from 28% to 18%, and has additionally made important changes to the return filing/compliance process in response to feedback, making the reform process more dynamic and better poised to succeed. The E-way bill, which was put on hold in July 2017 during the launch, was also rolled out in April 2018. E-way bill is an electronic invoice generated off the GST network, and is mandatory for interstate movement of goods where the value of the goods exceeds INR 50,000. This has been an important measure toward widening the tax net and cracking down on evasion.

Encouragingly, GST collections crossed the INR 1000 billion mark (US\$13.9 billion) in October 2018 after a gap of 5 months,<sup>15</sup> after the E-way bill was made mandatory.

The GST has set in motion a process of formalization of the economy. As of December 2017, there were 9.8 million unique GST registrants.<sup>14</sup> Adjusting the base for double and triple counting, the GST has increased the number

<sup>13</sup> The Reserve Bank of India preliminary estimates, Jefferies Research, as of October 2018.

<sup>14</sup> Economic Survey 2017-18, Ministry of Finance, Government of India.

<sup>15</sup> Ministry of Finance, Jefferies Research, as of October 2018.

of unique indirect taxpayers by more than 50 percent—a substantial 3.4 million.<sup>14</sup> The Economic Survey 2017-2018, published by the Ministry of Finance, Government of India, notes a large increase in voluntary registrations, especially by small enterprises that buy from large enterprises and want to avail themselves of input tax credits. This is a good indicator of the formalization of the economy and higher tax/GDP ratios going forward.

### EVENT #3: STATE-OWNED ENTERPRISE (SOE) BANK RECAP

The condition of the state-owned banks was an oft-quoted macro worry for India, with bad loans amounting to nearly 10.2% of assets.<sup>16</sup> In October 2017, the government announced that it would recapitalize the state-owned banks with US\$33 billion worth of capital (composed of recapitalization bonds worth \$21 billion, already budgeted fiscal support worth US\$3 billion and banks' own capital raisings worth US\$9 billion).<sup>17</sup> Under the International Monetary Fund classification, this would not be treated as fiscal deficit but only as higher public debt to GDP. Broader macro risk perceptibly receded with the recapitalization. Banks are benefitting from the system-wide unclogging that is slowly occurring with state-owned banks, with shored-up capital taking haircuts on bad assets and moving on.

### EVENT #4: MOODY'S UPGRADE

India's improving growth outlook and structural reforms agenda got a shot in the arm with Moody's upgrading India's local and foreign currency rating to Baa2 (outlook positive), a notch above

its prior rating of Baa3 (outlook stable) in November 2017. It was the first upgrade of India's rating in 14 years. The Moody's upgrade endorsed recent reforms such as GST, measures to address the banking system's nonperforming loans and Aadhaar-enabled Direct Benefit Transfers (a mechanism for transferring government subsidies directly to citizens that is intended to reduce informality in the economy).

### EVENT #5 INSOLVENCY AND BANKRUPTCY CODE (IBC): SALE OF ASSETS UNLOCKING VALUE

Proceedings under the Insolvency and Bankruptcy Code have gained momentum, especially as the Reserve Bank of India/Government recently encouraged banks to take large corporate accounts to resolution.

The IBC process is run in two steps: a) resolution of bankruptcy—through debt restructuring, etc., is attempted within 180/270 days of admission, failing which, b) assets of the company are put up for liquidation. The company is operated by an insolvency professional during the bankruptcy process, guided by a committee of creditors. The incumbent shareholders do not have much say in these plans once bankruptcy is admitted.

The number of cases admitted under the insolvency process has seen a steady rise over the last few quarters. The latest release from the IBC Board of India has reported 977 cases being registered under the insolvency process as of 1QFY19, out of which 25% of cases were admitted only in 1QFY19, reflecting faster resolution of stressed assets by the body.<sup>18</sup> At the end of 1QFY19, 716 corporates were undergoing

resolution, of which, 91 cases closed on appeal/review, while 34 were closed on resolution and 136 were closed on liquidation.<sup>18</sup> This is leading to a system-wide clean-up of bank balance sheets, with the hope that moribund corporate lending in the country may finally revive.

### EVENT #6: FINANCIALIZATION OF SAVINGS

Foreign Institutional Investors (FIIs) were net sellers of the Indian market in 2018. However, continued strong investments by domestic institutions acted as the balancing force for the Indian markets. Domestic Institutional Investors (DIIs) pumped in ~US\$16 billion of net inflows into equities (secondary market) YTD as of 31 October 2018.<sup>19</sup> In essence, financialization—the greater use of formal financial institutions by Indian savers—has reduced the impact of FII selling on the equity market. Some of the important causes and effects of greater financialization of savings are listed below:

- **Jan Dhan Yojana; Government's Financial Push** – The government launched a mass financial inclusion program called the “Jan Dhan Yojana” earlier in its tenure. The scheme was aimed at bringing the excluded sections of the society into the ambit of the formal financial system. Under the scheme, the biometric identification, or Aadhar card issued to citizens, was accepted as an identity proof for opening a bank account. It has been a big success since its launch three years ago, and a staggering 332 million accounts were opened under the scheme since 2015, with total balance in those accounts going up to US\$12

<sup>16</sup> The Reserve Bank of India, Kotak Institutional Equities, as of July 2018.

<sup>17</sup> The Reserve Bank of India, as of October 2017.

<sup>18</sup> The Reserve Bank of India, IBBI, Kotak Institutional Equities, as of October 2018.

<sup>19</sup> The Reserve Bank of India, Association of Mutual

Funds of India (AMFI), Merrill Lynch Research, as of 31 October 2018.

billion (*Display 7*).<sup>20</sup> Savings as a result have moved into financial assets and found their way into insurance products, mutual fund schemes, etc.

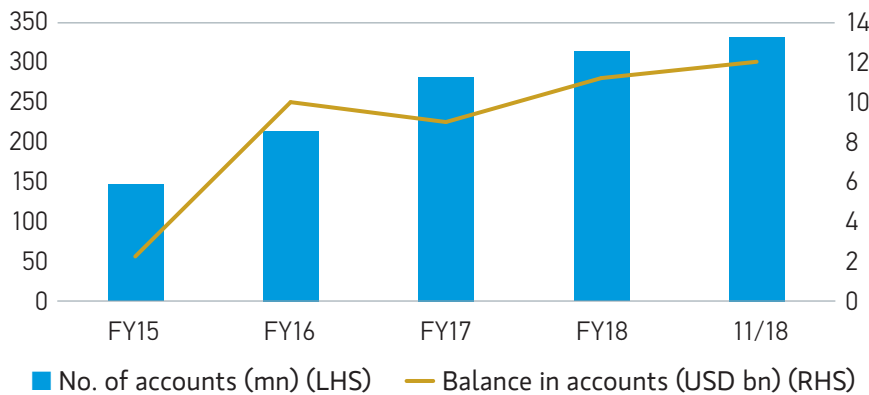
- **Early fintech adoption, increased financialization** – Financialization of savings is receiving an added push because of increasing use of cutting edge technology in the space. India has been one of the earliest adopters of financial technological products, along with China, where more than half of the adult consumers reported

using fintech services on a regular basis (as per the 2017 survey by Ernst and Young Research). The survey by EY also concluded, that 47% of respondents from India were reported to have used a fintech insurance product. Various platforms in India, such as the Unified Payments Interface (UPI) that lets parties exchange money instantaneously, have exponentially grown to join the lending force with traditional banks and have widened the consumer base for digital payments. The transactions through these online

platforms have reached US\$7.5 billion in August 2018, up from US\$0.4 billion in August 2016, as per EY. This also points to an increasing penetration of financial products and noncash financial transactions in the economy, an encouraging trend for the Financials and Consumer sectors.

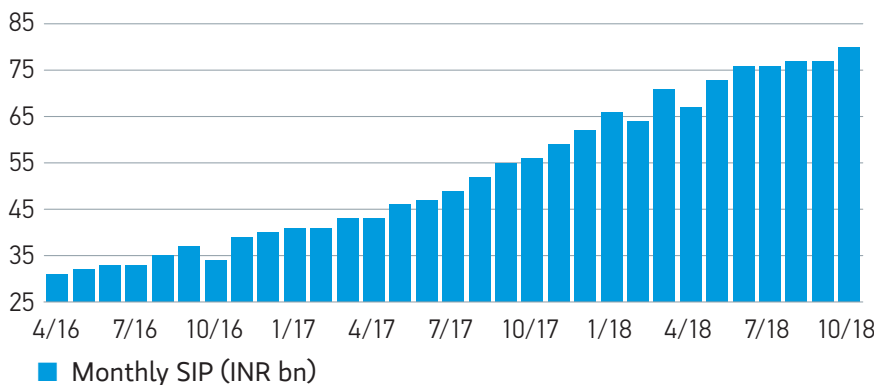
- **Coming of age of the Indian Mutual Fund industry** – The Indian mutual fund industry had a banner year for inflows in 2017. Total mutual fund inflows for the calendar year 2017 stood at US\$30 billion, the second-largest number since 2008.<sup>21</sup> Total inflows into mutual funds stand at US\$19.7 billion YTD to 31 October 2018.<sup>22</sup> Month-over-month strong additions highlight steadiness and stickiness of the flows (*Display 8*).

**DISPLAY 7**  
Increasing number of Jan Dhan accounts



Source: Ministry of Finance, Kotak Institutional Equities, as of November 2018.

**DISPLAY 8**  
Monthly flow via SIP provides stickiness to domestic flows



Source: AMFI, Kotak Institutional Equities, as of October 2018.

**EVENT #7: EASE OF DOING BUSINESS**

In 2018, India climbed another 23 points in the World Bank’s Ease of Doing business ranking to 77th place, becoming the top ranked country in South Asia for the first time and the third among the BRICS (Brazil, Russia, India, China and South Africa).<sup>23</sup> The World Bank has also recognized India as one of the top improvers for the year, with India featuring among the list of top 10 improvers for the second year in a row. Earlier in 2017, India had jumped a record 30 places to bag the 100th spot in the same evaluation by the World Bank. This goes to show the enduring impact of some of the long-term reforms being put in place.

<sup>20</sup> Ministry of Finance, Kotak Institutional Equities, as of November 2018.

<sup>21</sup> Reserve Bank of India, Association of Mutual Funds of India (AMFI), Kotak Institutional Equities, as of December 2017.

<sup>22</sup> Reserve Bank of India, Association of Mutual Funds of India (AMFI), Jefferies Research, as of 31 October 2018.

<sup>23</sup> World Bank Group, as of November 2018.

### Challenges In 2018

Global economic winds shifted in 2018 and with a strengthening U.S. Dollar, Emerging Markets were the first in line to be exposed, and India was no exception. The global headwinds and recent setbacks in certain sectors posed a few challenges in 2018 as summarized below:

**MACRO NARRATIVE TURNS NEGATIVE:**

The narrative in the markets today is that the environment is very similar to 2013; a period of acute underperformance and vulnerability for Emerging Markets. As the Federal Reserve continues tightening, many emerging markets are feeling the pressure on their currencies and the reversal of portfolio flows. The markets fear a redux of the Taper Tantrum situation of 2013, when countries with high current and fiscal deficits saw a run on their currencies. In India, macro variables receding from their 2017 highs reinforced the fear of the 2013 history playing out again (In 2013, India was one of the Fragile Five economies that faced currency pressures because of high twin deficits).<sup>24</sup>

However, today the fundamentals of the economy are in a much better position than they were in 2013. In 2013, India had a high current account deficit (6% of GDP),<sup>25</sup> high fiscal deficit and very high inflation (Consumer Price Inflation consistently averaged double digits and was around 12%<sup>25</sup> when the Taper Tantrum hit). Today the current account deficit is at -2.4%<sup>26</sup> of GDP (Display 9) and the inflation is 3.3%<sup>27</sup> (Display 10). So while these levels for India are off of the best levels we saw last year (CAD was 0.5% of GDP and inflation was 2% in 2017),<sup>28</sup> this is by no stretch of imagination close to the crisis levels of 2013. Additionally, the Indian government has consistently adhered to fiscal discipline with fiscal deficits having seen a sharp improvement since 2009-2010 (Display 11).

<sup>24</sup> International Monetary Fund, as of 2013.

<sup>25</sup> The Reserve Bank of India, as of 2013.

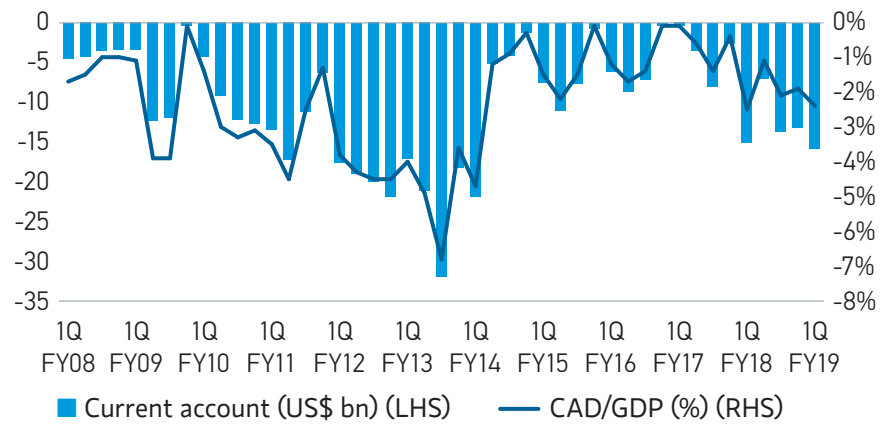
<sup>26</sup> The Reserve Bank of India, Kotak Institutional Securities, as of October 2018.

<sup>27</sup> The Reserve Bank of India, as of October 2018.

<sup>28</sup> The Reserve Bank of India, as of December 2017.

**DISPLAY 9**

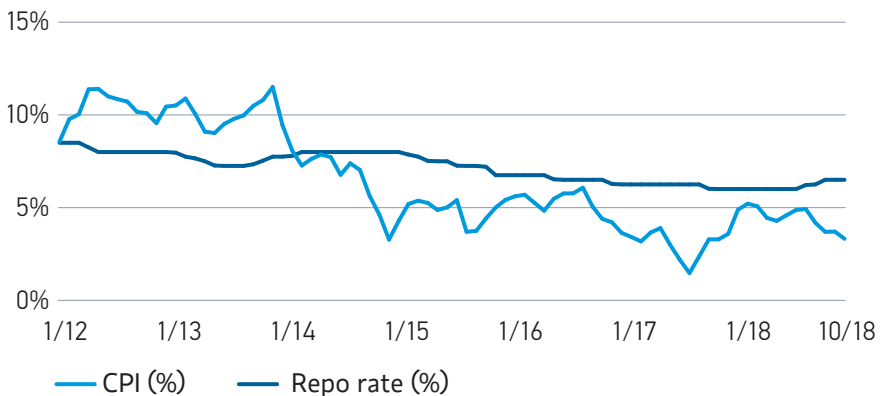
**Current account deficit widening with the spike of oil**



Source: RBI, Kotak Institutional Equities, as of October 2018.

**DISPLAY 10**

**Inflation remains in the targeted range**

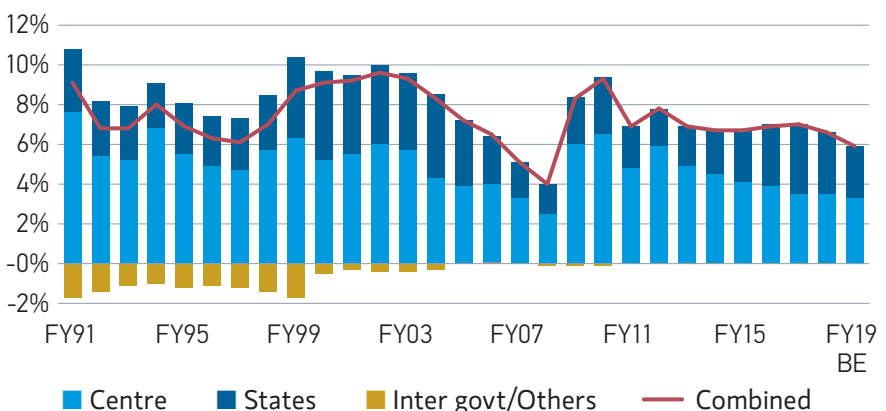


Source: RBI, Kotak Institutional Equities, as of October 2018.

**DISPLAY 11**

**Fiscal discipline not at risk**

Gross Fiscal Deficit (% of GDP)



Source: Ministry of Finance, Jefferies, as of October 2018, RE- Revised Estimates, BE- Budget Estimates.

The peak macro data is likely behind us, but the scorecard for the country overall remains in good shape.

There are also a few big qualitative changes since 2013 that reinforce macro stability for India and can be considered as silver lining.

**Foreign Direct Investment (FDI)**

India’s current account deficit is now being funded more sustainably with FDI, which tends to be stickier and longer term in nature than foreign portfolio

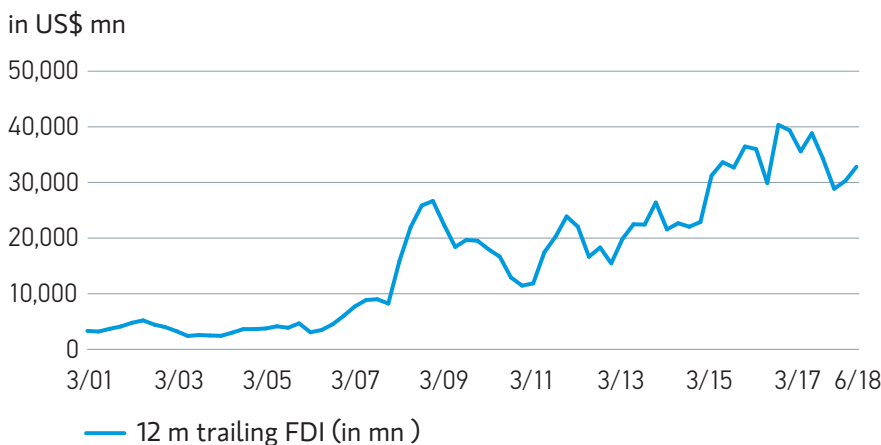
flows. This marks a distinct break from 2013, when the country was highly dependent on foreign portfolio flows to finance the current account deficit.

FDI inflows amounted to 1.3% of India’s nominal GDP on a 12-month trailing basis in June 2018.<sup>29</sup> Gross inflows of FDI into India increased mainly due to higher flows into the communication services, retail and wholesale trade, financial services and computer services (*Display 12*). According to the UNCTAD’s Investment Trends Monitor (2018), India was the 10th

largest recipient of global FDI in 2017 and remained the topmost destination for Greenfield capital investment. Additionally, there was a substantial increase in FPI (Foreign Portfolio Investors) flows in 2017-2018 from the preceding year, mainly driven by higher flows into the debt segment. Net investment inflows of FDI and FPI, which together amounted to US\$52.4 billion and account for 57% of net capital inflows in FY2018, play a large role in external financing.<sup>30</sup> Further, recent easing of norms for investment in retail, airlines and construction by the government is expected to improve ease of doing business and attract more strategic capital into the country.

**DISPLAY 12**

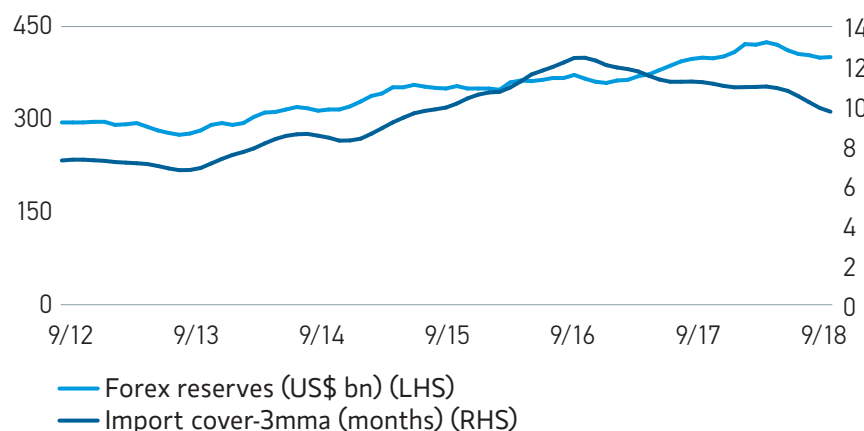
**FDI inflows have remained stable for the last few years**



Source: RBI, Jefferies Research, as of June 2018.

**DISPLAY 13**

**India has a reasonable stock of foreign exchange reserves**



Source: CIEC, Kotak Institutional Equities, as of September 2018.

**Foreign Exchange Reserves and Remittances at comfortable levels**

India’s foreign exchange reserves in September 2018 were at US\$401 billion (over 10 months import cover) compared to US\$277 billion in September 2013 (7 months import cover),<sup>31</sup> which were more than adequate to meet short-term debt liabilities (*Display 13*). India is also expected to retain its position as the world’s top recipient of remittances in 2018, where it is expected to receive a whopping US\$80 billion.<sup>32</sup> Remittances to India in 2017 also had picked up sharply by 9.9%, reversing the previous year’s sharp decline (8.9% in 2016).<sup>32</sup> As against US\$62.7 billion in 2016, it received US\$69 billion in 2017.<sup>32</sup> Remittances to India are positively correlated to oil prices, since many of India’s migrant workers are based in the Middle East where earnings rise with a rise in oil price.

<sup>29</sup> The Reserve Bank of India, Jefferies Research, as of June 2018.

<sup>30</sup> The Reserve Bank of India, Ministry of Finance, as of June 2018.

<sup>31</sup> CIEC, Kotak Institutional Equities, as of September 2018.

<sup>32</sup> The World Bank’s Migration and Development Brief report, as of December 2018.

### CRUDE ON THE BOIL LEADS TO MID-YEAR TENSIONS, BUT THAT SITUATION HAS STABILIZED:

Crude went up from US\$75 per bbl to US\$85 per bbl over a short period from July to September 2018.<sup>33</sup> With India's 90% of oil requirements being catered to by imports, crude price is the one important macro variable that feeds through into all of India's macro vulnerabilities—inflation, current account and fiscal deficit. YTD as of September 30, 2018, INR was down 12% against USD making it 20th out of 24 of the main Emerging Markets currencies, while for September, it was down over 2%, second only to the Argentine Peso.<sup>34</sup>

Since then, crude oil has cooled by ~30% from recent highs (*Display 14*).<sup>35</sup> The currency has also stabilized. Additionally, the bond market ownership in India is largely local which restricts a large flight of fixed income money out of India under distressed situations. So even with the volatility in the currency, India has avoided the added complication of the outflow of the fixed income money, which has led to debt crises in other places. With that, many of the factors that triggered the latest bout of macro volatility have settled down, without being adequately reflected in stock prices.

### NBFC crisis

The market saw high volatility in the month of September 2018 with the Nonbanking Financial Companies (NBFC) crisis, leading to widespread fears of a credit markets freeze. The panic was set off with a key rating agency downgrading the debt of IL&FS (an unlisted NBFC) which was widely held by banks and mutual funds, to junk status. The default by this major NBFC led to a significant liquidity compression in the market. Subsequently, a leading mutual fund sold another popular NBFC paper at a distressed yield to meet redemption. Markets perceived this as a fire sale and the stock was materially hit. Consequently, the selloff spread to other

### DISPLAY 14

#### Brent Crude cooling off its peak



Source: Bloomberg, as of 23 November 2018.

housing finance companies exacerbating panic that liquidity was tight.

To us, it is a liquidity issue more than a solvency issue. The risk of contagion seems contained, but the fear of a severe liquidity stress and credit crunch weighed heavily on the market sentiment which led to a huge selloff across the sector. We have seen concerted efforts from the Reserve Bank of India and the government to unfreeze the liquidity crisis. The government encouraged various commercial and state owned banks to increase their portfolio buyouts from the NBFCs. This was an indirect way of infusing liquidity into Housing Finance Companies that were facing a severe liquidity crunch with mutual funds and other lenders nervous about lending to them post the crisis. From late September when the crisis hit to now, many NBFCs have raised papers at reasonably competitive rates; and we are not overly concerned about solvency issues for a majority of NBFCs in the listed space.

However, there are long-term changes taking place which reinforce the potential for this sector. We are seeing a generational shift in consumption and debt, supporting

consumption at a micro level. This attitudinal shift toward leverage should see the Indian household increasingly level up and spend on consumption. Indian household debt to GDP inched up from 11.2% in FY12 to 15.7% in FY18.<sup>36</sup> This trend has legs to run aided by a confluence of several factors apart from the attitudinal shift. For starters, 15.7% household debt to GDP is fairly low compared to the Emerging Market average of 39%.<sup>37</sup> Another important enabler is the formation of credit information bureaus that lenders can access to check the credit history of their prospective borrowers. Data-savvy lenders, especially banks, are now using their own customers' banking data to extend targeted loans. Along with these immediate tailwinds, better asset ownership records could be a meaningful medium-term driver. All these factors underline the vibrant consumption and lending story in India, despite the near-term hiccup of the NBFC crisis.

### Strong and durable micro uptick

Over 2016 and 2017, the Indian economy went through two self-inflicted shocks (i.e., demonetization and GST). These posed disruptions to the economy and

<sup>33</sup> Bloomberg, as of September 2018.

<sup>34</sup> Bloomberg, as of September 30 2018.

<sup>35</sup> Bloomberg, as of 23 November 2018.

<sup>36</sup> The Reserve Bank of India, Macquarie Macro Strategy, as of July 2018.

<sup>37</sup> International Monetary Fund, the Reserve Bank of India, CEIC, BIS, Macquarie Macro Strategy, as of December 2017.

impacted growth, particularly in the consumer sectors at a time during which global growth was inflecting upwards.

From September to October 2017, the economy began to show signs of coming out of the shocks posed by these two events. Now, real GDP growth has inflected to an 8% handle in the second quarter of FY2019<sup>38</sup> as the economy slowly but steadily recovers from the disruptions. We are seeing durable inflections in some of the high frequency indicators that we track on the ground (e.g., automobile demand remains strong (*Display 15*) and consumer durables demand is also on a pick-up (*Display 16*). Additionally, we are seeing a strong growth in consumer expenditure (at US\$1.8 billion in 2017 and is expected to double to US\$3.6 billion by 2020)<sup>39</sup> led by increasing growth in the retail market. A recent report published by India Brand Equity Foundation (IBEF) says that the retail market is expected to increase by 60% to reach US\$1.1 trillion by 2020, emerging as one of the largest sectors in the economy. With strong investment flows and GST in place, share of organized retail as a percentage of total retail is also expected to increase to 20% by 2020 from less than 10% today, showed the report.

2014-2017 was a period of big macro gains for India, over which current account deficit, fiscal deficit and inflation made big improvements, and this was rewarded by a big macro re-rating for the market. Interestingly, over this period, the bottom-up environment (i.e., micro) stayed insipid because of the challenges posed by demonetization and GST. Now the reverse is playing out, where the macro is turning worse, though not alarmingly so, but bottom-up growth is looking solid. The market narrative is very focused on the macro worries for India and the micro story is being overlooked. In our opinion, the

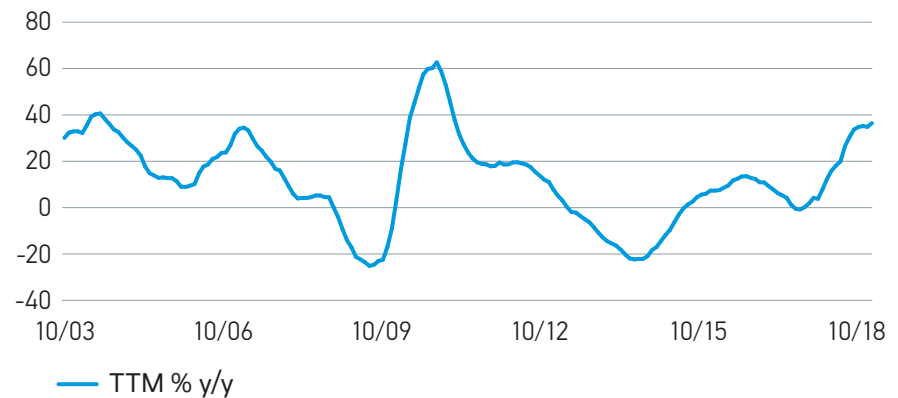
micro uptick and earnings narrative should triumph longer term, especially given that crude and the currency are settling down.

**2018 selloff poses as an opportunity**

In 2018, the narrative for India almost turned on its head as the macro trade for India peaked out. Crude went from US\$60 to US\$85,<sup>40</sup> the current account deficit went from 0.5% of GDP to 2.4%<sup>41</sup> and the INR weakened to a low of 74.3.<sup>40</sup> The consensus view of big macro concerns and a very defensive positioning did well. The classic trade in a macro

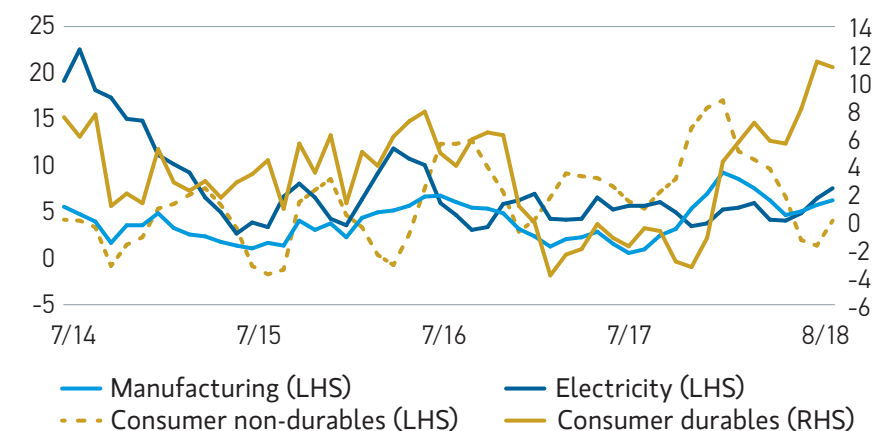
scare environment is to buy Information Technology (dollar earners, hence benefit from a falling INR) and Staples. Both the sectors did well as a negative macro narrative for India dominated. However, these sectors do not truly represent the Indian growth story, which is essentially consumer-centric. Such risk-off periods also coincide with mid-cap selloffs in India, as risk aversion leads to a flight to large-caps. Currently, with recent macro headwinds receding, currency stabilizing and with the inflection in the domestic growth story, we think it could be an

**DISPLAY 15**  
**Commercial vehicles volume growth remains strong (%)**



Source: CMIE, Jefferies, as of October 2018.

**DISPLAY 16**  
**Consumer durables pick up**  
*3m m.a. growth (%)*



Source: CMIE, Jefferies Research, as of August 2018.

<sup>38</sup> The Reserve Bank of India, Kotak Institutional Equities, as of August 2018.

<sup>39</sup> IBEF, as of October 2018.

<sup>40</sup> Bloomberg, as of September 2018.

<sup>41</sup> The Reserve Bank of India, Kotak Institutional Equities, as of October 2018.

opportune time to position in the India growth story.

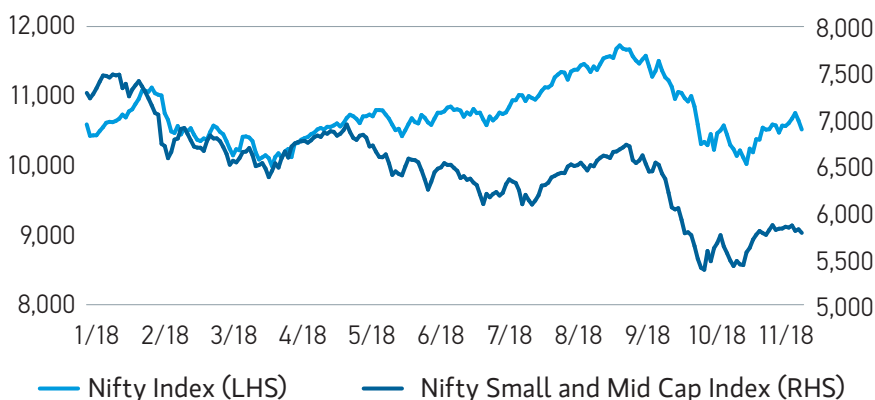
This has been the most concentrated performance for the market that we have seen since 2004. While headline MSCI India was down about 11% YTD as of September 30, 2018, in US\$ terms, MSCI EM was down about 9.5%.<sup>42</sup> This headline index performance hides the carnage that has occurred in the small and mid-cap space (*Display 17*). The month of September was especially bad for mid- and small-caps with declines mirroring September 2008 which marked the doom of Lehman Brothers (*Display 18*). Additionally, within the headline index, performance has been further concentrated heavily in a few large cap stocks. Only 18 out of 51 Nifty stocks outperformed as of September 2018 versus about 25 stocks in a normal year (*Display 19*). Even within the subset of 18 stocks, we have seen the market rally concentrated only in top five index weights.

In our experience, these episodes of narrow outperformance are not normal for India and tend to snapback sharply when the macro headwinds recede. So with a slight cooling of macro worries, moderating crude oil prices and the INR regaining a modicum of stability, it poses a great opportunity for a sharp recovery, particularly in the small and midcap space where valuations are at deep distress levels.

Also more recently, in 2018, concerns on global tech valuations are growing. With this backdrop, India with her strong domestic story and attractive valuations could be a natural beneficiary of a reallocation. We are beginning to see a broad-basing of the rally in the markets, with the small- and mid-cap indices beginning to recover sharply from deeply oversold levels. Growth as a theme has underperformed year-to-date because markets have been dominated by macro factors, but the bottom-up data reinforce that the fundamentals of growth remain sound.

**DISPLAY 17**

**Headline Nifty performance hides mid- and small-cap pain**



Source: Bloomberg, MSIM, as of 21st November 2018.

**DISPLAY 18**

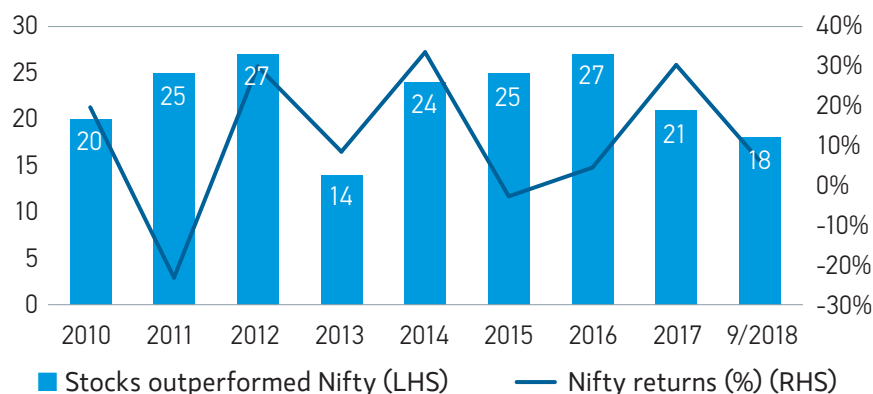
**September 2018 selloff worse than the aftermath of the GFC**

LEHMAN EFFECT		IL&FS EFFECT	
SEP-08	RETURNS	SEP-18	RETURNS
Nifty	-10.06%	Nifty	-6.42%
Nifty Junior	-15.34%	Nifty Junior	-12.69%
Nifty Midcap	-14.18%	Nifty Midcap	-13.89%
Nifty Smallcap	-18.99%	Nifty Smallcap	-19.79%

Source: MSIM, as of September 2018.

**DISPLAY 19**

**Narrowest outperformance since 2013**



Source: Bloomberg, MSIM, as of 30th September 2018.

<sup>42</sup> Bloomberg, as of September 30th 2018.

## Conclusion

We think investors would do well to make a strategic long-term allocation to India. At a macro level, the country offers a rare combination of size and growth. At a bottom-up level, there is a large pond of

stock picking opportunities for a growth and quality investor. In the long term, a growth and quality portfolio has delivered superior returns. Valuations have turned reasonable after the 2018 selloff. We think this could be an opportune time

to position in India with the economy showing green shoots of recovery post the after-effects of the ambitious reforms of 2016-2017 and reasonable valuations after the recent market selloff.

### India at a glance

- Democratic country with elections every five years
- Rising middle class driving consumption
- Rule of law
- Market economy with reforms not crisis driven

	INDIA	GLOBAL RANK
GDP (in USD Tn)	2.6	6
GDP PPP (in USD)	9.4	3
GDP growth rate* (5-year average)	11.0	2
Population (in Bn)	1.3	2
Market Capitalization (in USD Tn)	1.9	
Exports (in USD Bn)	303.3	18
Imports (in USD Bn)	464.8	11
FDI cumulative (in USD Bn)	518.1	24
Reserves (in USD Bn)	393.5	18
Public debt to GDP (%)	45.1	68

\* Nominal GDP growth rate

Source: World Bank, Jefferies Research, as of June 2018. India's global ranking is based on data compiled by the World Bank, which includes 181 countries. For illustrative purposes only.

### IN USD BN

Market Capitalization	1,870.2
FII holding	375.9
Debt Market	1,039.2
Government Bond	699.3
FII Holding Government Bond	33.5
Corporate bond	339.9
FII Holding Corporate Bond	64.0
External Borrowing	514.4
Commercial Borrowing	183.6

Source: World Bank, Jefferies Research, as of June 2018. For illustrative purposes only.

### Political Structure

- India is the largest democracy in the world, with free and fair elections held every five years.
- The states have their own democratically elected governments.
- Equitable division of powers between the Centre and states reinforces independence and efficiency.
- India has a strong institutional framework with an independent Judiciary, Election Commission and central bank (Reserve Bank of India-RBI).
- Frequent checks and balances on the government are conducted through institutions like the Comptroller and Auditor General (CAG) of India, Central Vigilance Commission (CVC) and Election Commission.

LEGISLATURE	EXECUTIVE	JUDICIARY
Democracy— Elections once every five years	CAG	Supreme Court
1 Centre and 28 states	CVC	High Courts – State wise
Centre—BJP • Lok Sabha—BJP majority • Rajya Sabha—BJP minority	RBI	Lower Courts

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There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market values of securities owned by the portfolio will decline. Accordingly, you can lose money investing in this portfolio. Please be aware that this portfolio may be subject to certain additional risks. In general, **equities securities**' values also fluctuate in response to activities specific to a company. Investments in **foreign markets** entail special risks such as currency, political, economic and market risks. The risks of investing in **emerging market countries** are greater than the risks generally associated with investments in foreign developed countries. Stocks of **small- and medium-capitalization companies** entail special risks, such as limited product lines, markets and financial resources, and greater market volatility than securities of larger, more-established companies. **Derivative instruments** can be illiquid, may disproportionately increase losses and may have a potentially large negative impact on the portfolio's performance. **Illiquid securities** may be more difficult to sell and value than public traded securities (liquidity risk). Non-**diversified portfolios** often invest in a more limited number of issuers. As such, changes in the financial condition or market value of a single issuer may cause greater volatility. **Geographic concentration.** The portfolio is more susceptible to such risks affecting Indian issuers than a portfolio that does not limit its investments to such issuers. When investing in **value securities**, the market may not have the same value assessment as the manager, and, therefore, the performance of the securities may decline.

**DEFINITIONS**

**Compound Annual Growth Rate (CAGR)** is the year-over-year growth rate of an investment over a specified period. **Gross Domestic Product (GDP)** is the monetary value of all the finished goods and services produced within a country's borders in a specific time period. It includes all private and public consumption, government outlays, investments and net exports. **Fiscal Year (FY)** refers to India's traditional fiscal year which runs for twelve consecutive months from the April 1st until the following March 31st. For example, fiscal years referred to as FY17, FY18 and FY19 are short-hand for FY2016/2017, FY2017/2018 and FY2018/2019 respectively. The **MSCI Emerging Markets Index (MSCI EM)** is a free float-adjusted market capitalization weighted index that is designed to measure equity market performance of emerging markets. The **MSCI India Index** is designed to measure the performance of the large and mid cap segments of the Indian market. The **NIFTY 50 (Nifty)** is the National Stock Exchange of India's benchmark stock market index for Indian equity market.

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## MACRO INSIGHT

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