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Growth momentum continues in Q3; government on track to meet fiscal deficit target

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- Interest rates throughout much of the global economy are headed lower in 2024 but the aspects of policy loosening in 2024 will differ from the cycles of the past 25 years on account of - the longer gap between the final interest rate hike and the first rate cut, and a more gradual and unsynchronised policy easing across the globe.
- While the (generalised) highest interest rates in roughly 25 years have not plunged the global economy or many major advanced economies into recession, there are signs of strain and stress in select parts of the real and financial economies. The most visible signs of stress are struggling property markets and the deteriorating performance of unsecured credit lines.
- Indian economic growth likely remained on a solid footing in Q3 FY24 primarily on the back of robust festive demand and healthy industrial sector performance.
- The outlook for the remainder of the financial year, while still favourable, is not as rosy as downside risks persist in the form of slowing central government CAPEX ahead of the general election, weaker agricultural growth and recent tensions arising in the Red Sea which could adversely impact India's external trade position.
- Headline inflation inched up to 5.7% in December, up from 5.6% in November and 4.9% in October as prices of certain vegetables, most notably onions and tomatoes, spiked owing to seasonal factors.
- Core inflation on the other hand (which strips out the volatility associated with food and fuel prices) continued to ease in December, reaching its lowest level since April 2020.
- Despite the resurgence of inflation, the RBI is likely to remain unperturbed given that the disinflationary trend in core inflation remains intact. Therefore, we retain our view of no change in interest rates and stance in the upcoming policy meeting.
- In FY24, we expect the absolute fiscal deficit to be slightly lower due to higher receipts offsetting the impact of higher revenue spending. However, we expect the FY24 target to be met at 5.9% due to the lower than budgeted nominal GDP growth.
- The government is expected to present a vote-on-account budget on February 1. We expect the major themes from the FY24 budget to be continued in FY25, which include a push on CAPEX, and expansion of PLI schemes to promote local manufacturing. The target for FY25 is estimated at 5.2%-5.3%.

Christopher Wiegand
Group Head - Economics & Data
christopher.wiegand@dmifinance.in

Bhawna Sachdeva
Economist
bhawna.sachdeva@dmifinance.in

Sarthak Gupta
Economist
sarthak.gupta@dmifinance.in

www.dmifinance.in

+91 11 4120 4444

DMI Finance Private Limited
Express Building, 9-10, 3rd Floor,
Bahadur Shah Zafar Marg,
Delhi – 110002.

Aspects of policy loosening in 2024 will differ from the cycles of the past 25 years

Interest rates throughout much of the global economy are headed lower in 2024 but as these first few weeks of the new year have underscored, the timing, extent, and pace of the prospective decline in rates is uncertain. Heightened expectations for a rapid and pronounced decline in rates have been underpinned in part by the December shift in policy rhetoric by various central banks. Recency bias has also likely contributed, especially in Western economies, as the past 25 years have seen monetary easings and lower market interest rates come quickly on the heels of the final monetary tightening.

The current setting is likely to differ in some important respects from the cycles of the past 25 years. For one, the timeline between the final interest rate hike of the tightening cycle and the first easing of monetary policy likely will be more elongated. Second, the pace of monetary easing – at least initially – probably will be more gradual. Finally, whereas interest rate cycles have been closely synchronised across major advanced economies in recent decades, that will not necessarily be the case in the period ahead.

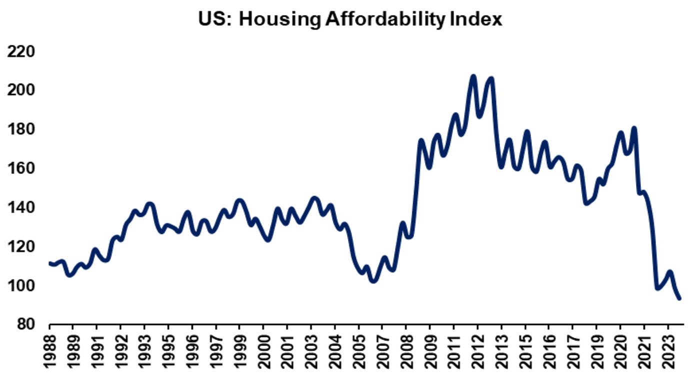
These prospective phenomena are a by-product of the prevailing inflation backdrop and a good-sized differentiation in economic fundamentals across major economies. Amongst the world's largest economies, annualised rates of inflation remain solidly above their respective medium-term targets (although in some countries such as the United States higher frequency measures of core inflation are close to target), service sector inflation remains sticky near multi-decade high rates, and central banks – having massively underestimated inflation in recent years – are cautious.

At the same time, there is substantial differentiation in the current and prospective economic performance among the biggest economies. The US economy, for instance, has proved remarkably resilient with economic growth powering through the most pronounced monetary tightening in roughly 40 years and the probability of a soft landing now appears more likely than not. European and UK growth prospects for 2024, on the other hand, are lacklustre and inflationary pressures – especially in the UK – have not moderated to the extent they have in the US. Meanwhile, the Chinese economy remains very weak, plagued by ongoing property market problems, battered confidence, rising government interference, and tepid countercyclical policy efforts.

Signs of strain and stress are visible in select parts of the real and financial economies

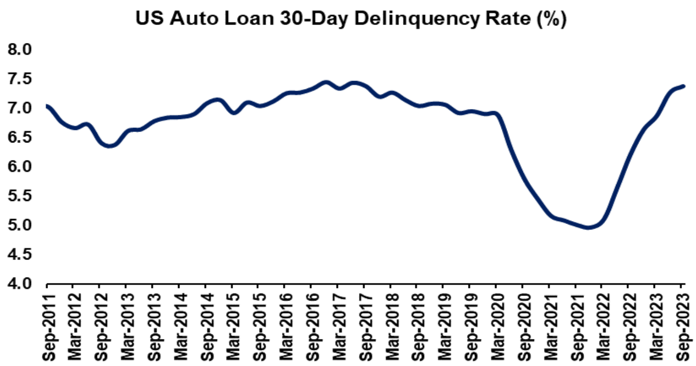
While the (generalised) highest interest rates in roughly 25 years have not plunged the global economy or many major advanced economies into recession, there are signs of strain and stress in select parts of the real and financial economies. Property markets are struggling. The combination of higher rates and more flexible work arrangements in COVID's aftermath has dropped the value of commercial property across much of the world and a bottoming in the sector likely is years away and massive restructurings in some locales are quite possible. Residential property trends vary across economies with countries with floating-rate mortgages experiencing greater weakening in the sector than those with fixed-rate mortgages. Regardless, housing affordability has cratered (see Chart) and lower mortgage rates, lower housing prices, higher incomes and likely the passage of time will be needed to restore affordability to something closer to normal.

Housing affordability has cratered in the US



Source: Bloomberg

Signs of stress visible in Auto Loan delinquency in the US



Source: Bloomberg

Nascent signs of financial stress also are starting to emerge. Higher interest rates and a more challenging broad credit environment tend to show up first in the deteriorating performance of unsecured credit lines and the bottom of the credit spectrum of secured credit. On this score, delinquency rates on US consumer credit cards have doubled from 1.5% to 3% now and are above the level that prevailed throughout the bulk of the 2010s expansion. The same is true for 30-day delinquency rates on US auto loans. They have moved up by more than 2.5 pp at 7.5% and are above the rate that prevailed in the prior expansion. Auto loan delinquencies often are an early warning sign for broader credit issues, as consumers in the US tend to be very diligent about staying current on auto loans (chart above).

Other economies lack similarly detailed data on credit performance but given the historical relationship across countries of rising and higher interest rates plus tighter credit conditions that prevail in many countries, it almost certainly is the case that other economies are experiencing similar erosion in credit performance to that mentioned in the US above. Indeed, given the US economy has outperformed much of the global economy, it likely is the case that credit strains are worse in other advanced economies.

There is a case for lower interest rates, but timing, pace and extent of lower rates are considerably less certain than the markets are currently discounting

Against this backdrop, there is a case for the lower interest rates that are now anticipated. With inflation rates moving in the desired direction – albeit unevenly across different economies and with more moderation necessary – lower rates can help to ameliorate the magnitude of downward pressure on interest sensitive parts of the economy and upward pressure on credit non-performance. Nonetheless, the timing, pace, and extent of lower rates are considerably less certain than the markets are currently discounting.

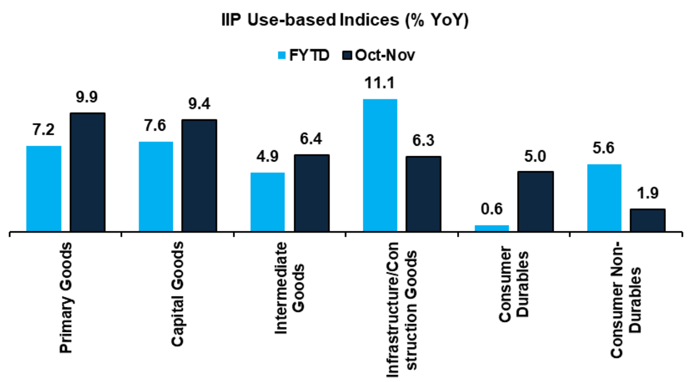
Indian economy likely remained robust in Q3 buoyed by the festive season demand

The Indian economic growth likely remained on a solid footing in Q3 FY24 primarily on the back of a robust festive demand and healthy industrial sector performance. The outlook for the remainder of the financial year, while still favourable, is not as rosy as downside risks persist in the form of slowing central government CAPEX ahead of the general election, weaker agricultural growth and recent tensions arising in the Red Sea which could adversely impact India's external trade position.

Industrial sector growth likely held up in Q3; slowing capital spending by the government could impact the growth ahead

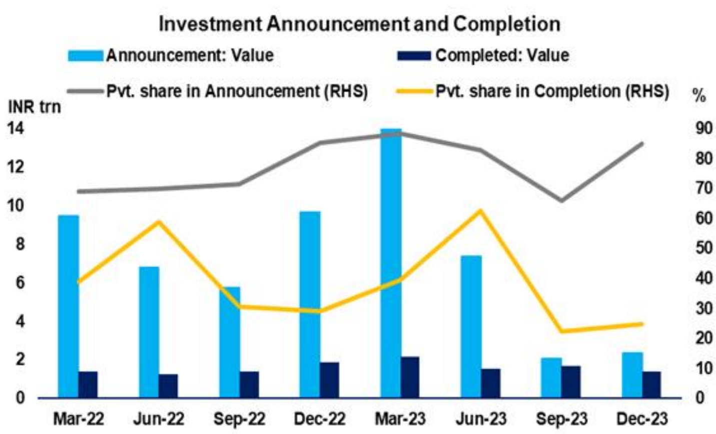
High-frequency data for the Industrial sector suggest that growth likely held up in Q3. Index of Industrial Production (IIP) growth slowed sharply in November to 2.4% YoY from 11.6% YoY in October. However, reading this figure in silos would be misleading as there was a shift in the festive month from October last year to November this year. Hence, using the data for both the months (Oct-Nov) the average growth in IIP was around 7% YoY - remaining largely at the similar level observed in the preceding quarter (7.4% YoY). For the fiscal year so far, the growth in IIP is tracking at 6.4% outpacing the growth of 5.3% recorded in FY23 pointing to strong industrial performance. The growth in FY24 so far has been led by infrastructure/construction and capital goods due to the government's continued focus on capital expenditure and sustained demand in the real estate sector. Indeed, government CAPEX so far in FY24 (Apr-Nov) is tracking an outsized 31% above last year's level. However, the pace of CAPEX spending by the central government seems to be slowing down in the past two months (Oct-Nov) potentially due to the central government's shifting focus to other welfare spending ahead of the general elections. Therefore, for the momentum in industrial sector growth to continue, private spending needs to gather pace, which has remained lacklustre (data for 2023 discussed below) hitherto.

Infrastructure, Construction and Capital Goods have led growth in FY24 so far



Source: CMIE; Note: FYTD refers to the April-November period

Private sector CAPEX is yet to pick up

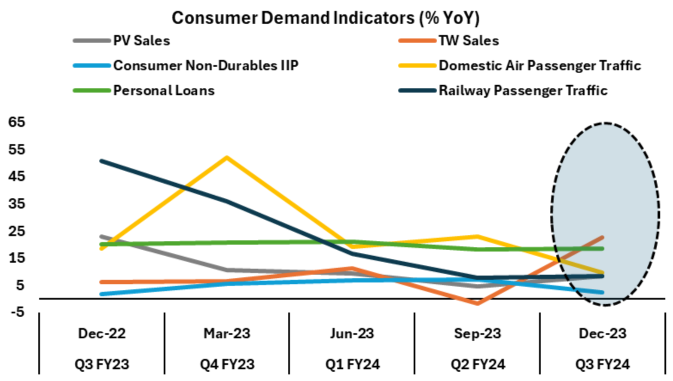


Source: CMIE

Private capex remains a mixed bag. Capital spending announcements (for calendar year 2023 – latest data) continue to be led by the private sector. However, in terms of completion, the share of the private sector has declined even further suggesting a continuation of subdued private investment which has prevailed in India for quite some time.

Investment announcement in the quarter ending December 2023 fell sharply to Rs ~2.4 trillion – although the figure will likely revise upward, it is comparatively much lower compared to the previous three-year average for the same month (Rs 5.4 trillion). Taking a detailed look at calendar year 2023, the new projects announced were much higher in the first half of the year averaging Rs 10.9 trillion and fell sharply in the latter half of the year. However, as per the CMIE, a large chunk of the new investment proposals in the first half of the year (~60%) was driven by the aviation industry (due to the purchase of aircraft). Since the third quarter (September) did not have any such impact, the new investment proposals fell sharply and most of the proposals were fuelled by the central government's Production Linked Incentive (PLI) scheme. Meanwhile, in terms of completion the share of the private sector has continued to decline for a fourth consecutive year at 38% vs the pre-pandemic average of 45% (based on CY 2019). The decline in the value of new investment announcements, a falling share of the private sector in completions and a larger reliance on government incentives suggest there is a lack of animal spirits necessary to build an exuberant investment climate.

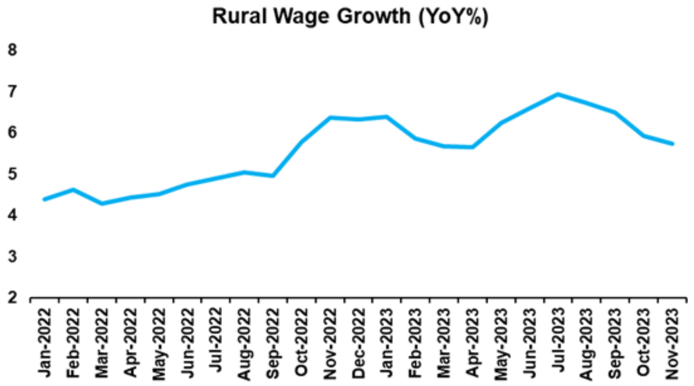
Consumption demand likely remained resilient in Q3 FY24; rural demand is expected to remain subdued



Source: CMIE; Note: For the December quarter values are based on either the Oct-Nov average or Oct based on availability of data.

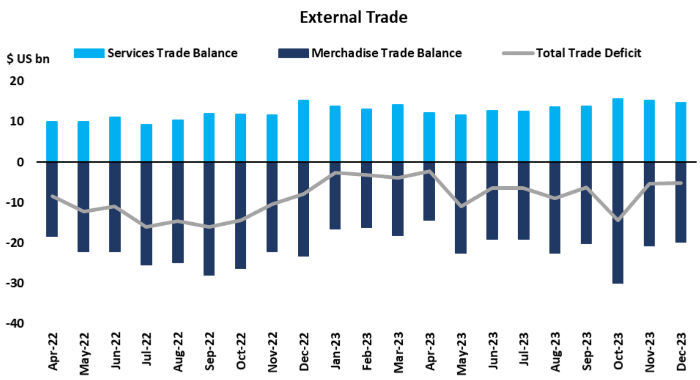
The consumption-related indicators i.e. both consumer durable and non-durables recorded a contraction in November. However, this is likely due to the loss of working days due to the festive season. Meanwhile, other high-frequency indicators suggest that consumption demand remained resilient in Q3 despite some moderation in December – buoyed by the festive season demand. This was supported by sustained improvement in urban demand as reflected in robust PV sales, domestic air passenger, personal credit etc. Meanwhile, some signs of recovery were also seen in rural demand indicators with two-wheeler sales recording a double-digit growth in Q3. However, it continues to trail urban demand. As per media reports, the FMCG sales volume in the rural sector in Q3 has likely remained muted amidst the deficient rainfall. Additionally, the rural wage growth which had observed sluggish growth till now has started to slow down (adverse impact of weaker growth in agriculture), which could further dampen rural consumption.

Rural wage growth has slowed since mid CY23



Source: CMIE

External sector likely remained a drag in Q3; risks from the Red Sea threats impart uncertainty to the outlook



Source: CMIE

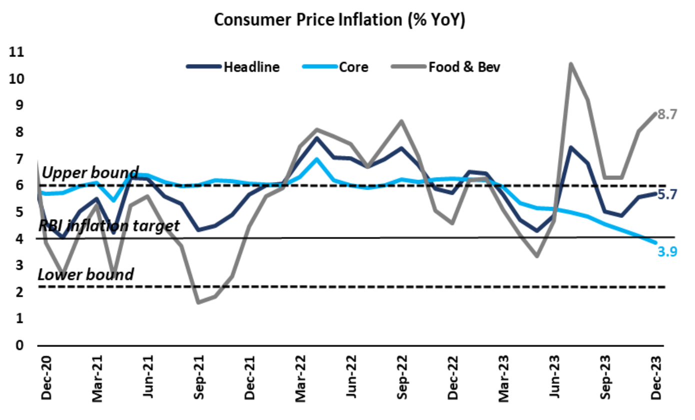
India's merchandise trade deficit widened sharply in Q3 to US $70.4 bn from US $61.6 bn in Q2 on the back of buoyant imports during the festive season (particularly in October). However, a resilient services surplus somewhat offset the impact of the wider merchandise deficit. As per preliminary estimates, the services surplus remained strong at $45.5 bn in Q3, despite a slowdown in the IT sector exports. Looking ahead, the recent geopolitical tension in the Red Sea could drive up commodity prices because of higher freight costs and increased insurance premiums. This poses a downside risk to the Indian merchandise trade and the impact of the same could be visible in the January trade data.

Disinflationary trend in the core intact, but we remain watchful of food inflation

Inflationary pressures again boiled over in Q3 FY24 as prices of certain vegetables, most notably onions and tomatoes, spiked owing to seasonal factors. Headline inflation inched up to 5.7% in December, up from 5.6% in November. Indeed, inflation in the vegetables category shot up from 2.8% in October to 17.7% in November and further to 27.6% in December. Fuel inflation remains in deflationary territory given that oil prices and LPG prices are much lower than a year ago.

Core inflation on the other hand (which strips out the volatility associated with food and fuel prices) continued to ease, reaching its lowest level since April 2020. This is welcome news and absent a sustained rise in food prices, the rate of core inflation is the best metric for the medium-term trend in the overall inflation rate.

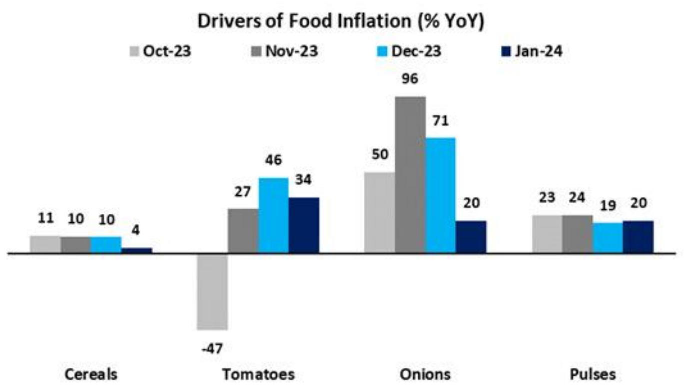
Food price spike drives up inflation in December



Source: CMIE

Food (and beverage) inflation accelerated to 8.7% in December. Apart from the vegetables category, which was the main culprit behind the jump in food inflation over the past two months, price pressures have remained persistent in other categories including pulses, cereals, and spices. We expect vegetables inflation to moderate in January, as daily data suggest significant tempering in prices. However, going forward inflation in the pulses and cereals categories needs to be watched. Inflation in the pulses category has been picking up for a while. It came in at 20.7% in December, compared with 5.3% in April (start of FY24).This reflects poor sowing and production of the crop (Kharif advance estimate is 6.6% lower YoY). Even for the Rabi season the sowing is tracking 4.6% lower YoY(data as of 19th Jan.). For the cereals category, although the latest inflation print (9.9%) is lower than what was seen in the earlier months of 2023, it remains elevated and is the second largest contributor to food inflation. The government recently conducted an open market sale of wheat and rice through the Food Corporation of India to temper prices amid market shortages. Export restrictions on wheat and rice and the arrival of fresh supply from February to March (when Rabi crops are harvested) should help ease the shortages and keep prices in check, but we will keep a close eye on the evolving food inflation dynamics.

Easing in vegetable prices to drive disinflation in January; pulses and cereals inflation need to be watched

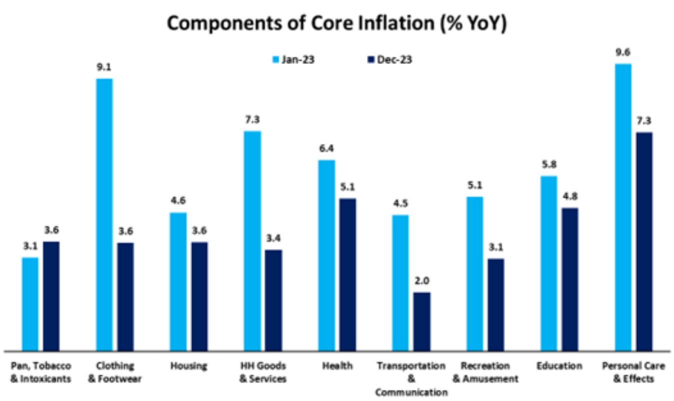


Source: CMIE; Note: Jan'24 data is based on data till the 23rd

RBI to remain on pause; liquidity will be kept tight

Despite the resurgence of headline inflation, the RBI is likely to remain unperturbed given that the disinflationary trend in core inflation remains intact. In December, core inflation eased to below 4% for the first time since March 2020. In fact, all but one category of the core basket saw inflation moderate in 2023. Hence, the central bank is expected to look past the transient surge in inflation owing to food prices and is expected to maintain the status quo in the next policy meeting.

Almost all categories of core inflation have continued to ease



Source: CMIE

Focus Section: Fiscal deficit target for FY24 likely to be met; FY25 Budget to focus on fiscal consolidation

The government is expected to present a vote-on-account budget on February 1 which is essentially just a parliamentary approval for funds required to meet the expenditure of the government until a new government is elected. A full budget will be presented in July. While we expect no new announcement in the interim budget, it will be closely watched for two main things - will the government stick to fiscal deficit target in FY24 and how much fiscal consolidation will be aimed for in FY25?

Fiscal Metrics (Rs lakh crore)					% of GDP				% YoY			
	FY 22 A	FY 23 RE	FY 24 BE	FY 24 E	FY 22	FY 23 RE	FY 24 BE	FY 24 E	FY 22	FY 23 RE	FY 24 BE	FY 24 E
Revenue Receipts	**21.7**	**23.5**	**26.3**	**27.3**	**9.2**	**8.6**	**8.7**	**9.2**	**32.8**	**8.2**	**12.1**	**16.0**
Gross tax Revenue	27.1	30.4	33.6	34.1	11.5	11.2	11.1	11.5	33.7	12.3	10.4	12.2
Tax Revenue (Net)	18.0	20.9	23.3	23.8	7.7	7.7	7.7	8.0	26.5	15.6	11.7	14.3
Non-Tax Revenue	3.7	2.6	3.0	3.4	1.6	1.0	1.0	1.2	75.8	-28.3	15.2	30.3
Non-Debt Capital Receipts	**0.4**	**0.8**	**0.8**	**0.3**	**0.2**	**0.3**	**0.3**	**0.1**	**-31.7**	**112.1**	**0.6**	**-59.3**
Disinvestment + others	0.1	0.6	0.6	0.1	0.1	0.2	0.2	0.0	-61.4	309.9	1.7	-81.7
Total Receipts	**22.1**	**24.3**	**27.2**	**27.6**	**9.4**	**8.9**	**9.0**	**9.3**	**30.6**	**10.1**	**11.7**	**13.5**
Revenue Expenditure	**32.0**	**34.6**	**35.0**	**35.5**	**13.6**	**12.7**	**11.6**	**12.0**	**3.8**	**8.1**	**1.2**	**2.7**
Interest Payment	8.1	9.4	10.8	10.8	3.4	3.5	3.6	3.6	18.5	16.8	14.8	14.8
Subsidy	5.0	5.6	4.0	4.4	2.1	2.1	1.3	1.5	-33.5	11.5	-28.3	-22.0
Capital Expenditure	**5.9**	**7.3**	**10.0**	**9.7**	**2.5**	**2.7**	**3.3**	**3.3**	**39.1**	**22.8**	**37.4**	**33.2**
Fiscal Deficit	**15.8**	**17.6**	**17.9**	**17.6**	**6.8**	**6.4**	**5.9**	**5.9**	**-12.9**	**10.8**	**1.8**	**0.5**
Nominal GDP	234.7	272.4	301.8	296.6								

Source: CMIE; Note: E-DMI Estimates; BE - Budget Estimates; RE - Revised Estimates; A - Actuals

For FY25 we expect the Government to continue with fiscal consolidation and target the fiscal deficit at around 5.2%-5.3% in line with achieving its medium-term fiscal consolidation target of 4.5% by FY26. We expect the major themes from the FY24 budget to be continued in FY25, which include a push on CAPEX, and expansion of PLI schemes to promote local manufacturing. Given the proximity to general elections the government will be barred from announcing any changes in the tax regime or major economy-related policies to avoid its influence on electors.

So far, the Central Government's fiscal deficit stood at 51% of the budgeted estimate (BE) in the first eight months of FY24 (April-November 2023). This is much lower than the pre-COVID five-year average of 103%. Buoyant tax revenue, higher non-tax revenues along a controlled increase in revenue expenditure have limited fiscal deficit growth. The government is likely to meet the fiscal deficit target in FY24. The fiscal slippage risks arising on account of lower than budgeted nominal GDP growth, lower disinvestment collections and higher subsidy bills are expected to be offset by the higher than budgeted direct tax collection and a larger than anticipated surplus transfer from the central bank.

In FY24 until Nov the pace of receipts growth has outstripped the budgeted pace. This is mainly attributed to a jump in direct tax collection, which includes personal income and corporate taxes. Indeed, personal income tax by an impressive 29.4% YoY, compared with a budgeted growth of 8% over FY23 actuals (for the full FY), while corporation taxes grew by 20.1% YoY, compared with a budgeted growth of 11.7% . Indirect taxes on the other hand grew by ~5% in FYTD compared to the budgeted increase of 8.3% led by lower excise and custom collections. Excise duties have contracted by 7.9% in FYTD, likely led by the reduction in the windfall gain tax on the export of petroleum products. GST collections are likely to undershoot the BE due to lower than budgeted nominal growth. On the non-tax revenue front, a larger than expected surplus transfer from the RBI (Rs 87k crore against the budgeted amount of Rs 48k crore for RBI and PSU banks' surplus) has bolstered collection. Non-debt capital receipts are lagging owing to poor progress on the divestment plans and lower recovery of loans. Overall, the government's non-debt receipts growth was tracking at 19.2% YoY, compared with a budgeted growth of 10.6%.

Growth in expenditure as well has been slightly higher than budgeted. This is mainly on account of a higher subsidy outgo, mostly fertilizer, fuel, and food. Interest payments grew by 11.5% in the first eight months of the FY (against budgeted growth of 16.3%). We expect revenue expenditure growth to slightly overshoot the target on account of higher expenditure on subsidies, and additional allocation to ministries of defence, rural development (MGNREGA), home affairs, finance, and law and justice. The first batch of supplementary demand for grants includes additional expenditure of Rs 1.29 lakh crores involving a net cash outgo of Rs 58k crores. There could be additional expenditure over and above the approved grants on account of a larger than expected MNREGA subsidy as expenditure on this scheme is already tracking ~ Rs 86K crores (~12K crore above BE + Grants). According to the latest available data, revenue expenditure growth is tracking at 3.6% YoY compared with a budgeted target of 1.4% (over FY23 actuals). Meanwhile, the pace of capital expenditure has been very strong clocking 31% YoY growth (till November); led by the front-loading of capex spending (for the first three months the growth was above 60% compared to budgeted growth of 35.9%). However, growth has slowed recently given the approaching elections, and the historical tendency of incumbent governments to raise welfare spending in the run up to the elections. Overall, we expect the growth to undershoot the BE on account of lower utilization of center loans to states for capex (~60K crore disbursed so far from the allocation of 1.3 Lakh crores).

On balance, with higher receipts, increase in revenue spending and lower CAPEX, we expect the fiscal deficit in absolute terms to come in slightly lower than BE. However, this is unlikely to translate into a lower deficit in terms of percentage of GDP given that nominal GDP growth is expected to be lower than what was budgeted one year ago. Indeed, according to the first advance estimates of national income released in early January, nominal GDP growth in FY24 is likely to come in at 8.9%, compared with the 10.5% assumed in the budget document.

Moreover, as per the latest projections of the central bank, inflation is expected to remain above 5% till Q1 FY25. Hence, a change in stance at this juncture seems unlikely as it would create room for financial loosening and would be counterproductive to the RBI's battle against inflation. Any shift in policy guidance likely requires a lower headline than currently persists, especially given India's economic growth prospects.

Although the RBI, in October, had hinted at the use of Open Market Operations (OMO) to keep liquidity tight, liquidity has turned out to be tighter than expected. System liquidity deficit widened significantly during December, to levels last seen in early 2016. The main reason for the deepening of the liquidity deficit was advance tax and GST payments.

Moreover, government spending faltered in Q3 (data available till November) which could be another reason for the drop in system liquidity. As such the RBI conducted variable repo rate (VRR) operations in Dec-Jan to shore up liquidity (the latest ones were announced on January 19). In the near term, the usage of OMO tool seems unlikely given that system liquidity as of January 23 is tracking close to Rs 3 trillion deficit. That said, the chances for OMO sales remain alive should the system liquidity improve over the next few months on the back of a pick-up in the government spending in Q4 and potential foreign capital inflows in the debt market ahead of India's integration into the JP Morgan EM Bond Index beginning next year.

Market Update

- Equity Market: Indian equity markets scaled fresh highs in December supported by favorable domestic fundamentals, cooling off of the US inflation print and dovish Fed commentary suggesting multiple rate cuts in 2024. Accordingly, the benchmark indices – NIFTY50 and SENSEX gained 7.9% MoM and 7.8% MoM, respectively, in December. The market was supported by foreign institutional investors (FII) who poured Rs 661 bn into the equity markets. Moving into January, the market participants turned cautious shedding ~1.3% (NIFTY50) until 24th Jan amidst weak global cues due to the intensification of the Red Sea tensions, rising US treasury yields and signs of weak domestic corporate earnings. We expect volatility in the capital markets to persist amid a challenging global environment.

- Bond Market: Domestic bond yields continued to trade in the narrow range of 7.15-7.24% over the past one month. On average, the 10Y bond yield eased to 7.19% between mid-Dec and mid-Jan from 7.26% in the preceding one month, tracking yields in the US owing to a dovish pivot by the Federal Reserve in its policy meeting on December 13. Since then, movement in the yields is attributed to a jump in inflation for November-December, higher borrowing by the states and movement in the US treasury yields. Cautionary comments by monetary policy officials in the US and back home have tested the upside again but the overall trend has remained flat, with the 10Y averaging around 7.19% (data till 24^{th}). In the near term, upward pressure on bond yields may be exerted by higher state government borrowings while resistance will be provided by easing domestic inflation.

- Currency Market: The Indian rupee remained largely stable in December trading at an average of 83.26 (USD/INR) compared to 83.31 in November. Sustained foreign capital inflows, moderating crude oil prices, and receding US dollar strength supported the rupee, while sustained dollar demand by the importers and likely absorption by the RBI weighed on the rupee. Accordingly, the forex reserves of the central bank jumped up by US$ 25 bn to US$ 623 bn in December. The rupee continued to trade around 83 levels in January. The impact of strengthening dollars amidst the increased safe-haven demand due to rising geopolitical tensions and uncertainty among Fed members about the rate cuts (based on the FOMC meeting), rising crude oil prices and weakness in the domestic equity market was likely negated by the RBI intervention reflected in moderation in forex reserves. With increased global uncertainty, we expect the rupee to trade with a depreciation bias in the near term.

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