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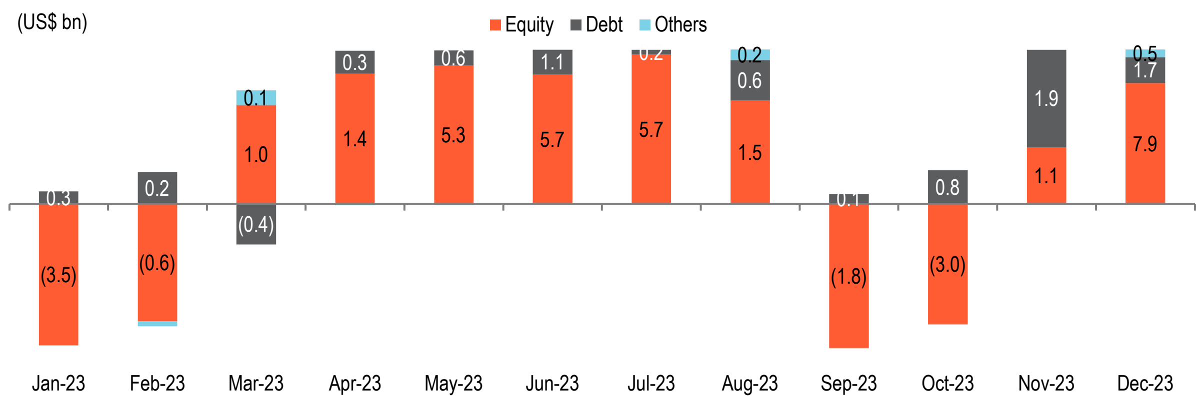
Trend in FPI flows

After a dismal start, FPI flow into India picked up pace, cumulatively totaling US$ 28.7bn in 2023. While equity segment continued to outperform, encouraging trend was also visible in the debt segment, particularly in the last few months of the year. Improved corporate profitability, stable domestic macros, range-bound inflation and a stable political environment favour India as a preferred investment destination. India's inclusion in JP Morgan's bond index in Jun'24 as well as hopes that India might subsequently be included in other bond indices has been a key driver of FPI inflows in the debt segment. The trend is likely to persist and gather more pace in the first 2-quarters of 2024. This will be positive for INR, which is likely to trade with an appreciating bias in 2024.

FPI inflows in 2023:

FPI flows into India witnessed a turnaround in 2023, registering inflows of US$ 28.7bn compared with outflows of US$ 17.9bn in 2022. In fact, inflows in 2023 were the highest since 2017, when FPIs poured in US$ 30.8bn in the domestic market. However, true to their nature, FPI flows exhibited a great deal of volatility throughout the year as can be seen in Figure 1. While the first quarter of the calendar year was marked by outflows to the tune of US$ 3bn, this was more than compensated by inflows of over US$ 14bn in the next quarter. There was a steady moderation in FPI inflows thereafter. This coincided with increased uncertainty over the future Fed rate trajectory, with most investors banking heavily on the Fed's higher for longer narrative. After reaching a peak of US$ 6.8bn in Jun'23, FPI inflows started decelerating and finally turned negative in Sep'23. Outflows intensified further in Oct'23, but recovered in the last two months of the year. Expectations that Fed rates have peaked led to foreign spurred interest of foreign investors. In fact, inflows of US$ 10.1bn in Dec'23 are the highest ever monthly inflows recorded in a single month.

Figure 1: Movement in FPI flows in 2023



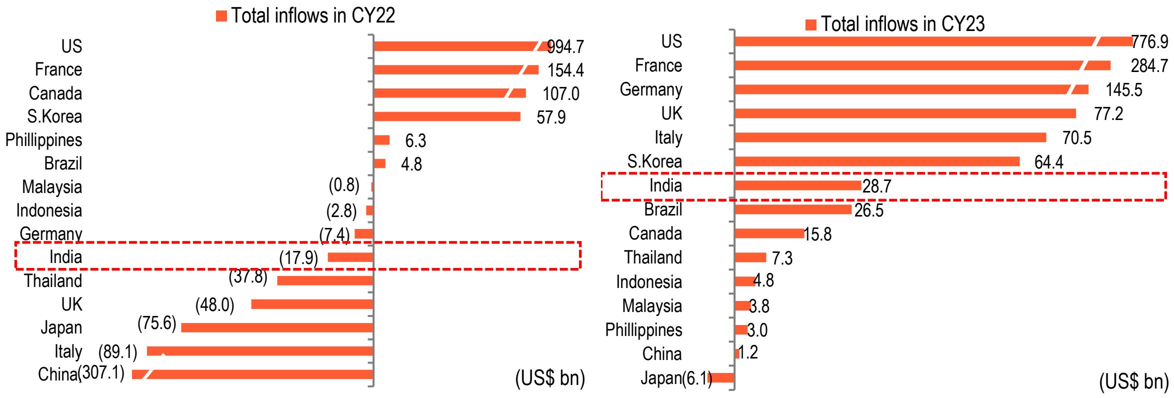
Source: CMIE, Bank of Baroda Economic Research | Note: Debt includes the VRR route as well

Global scenario:

At the global level, the situation is similar. US continues to remain the most preferred choice of foreign investors in 2023 as well, however the quantum of flows is lower this year, so far (data upto Oct'23).

France has also maintained its second spot in 2023, with inflows likely to be substantially higher than last year. Other advanced economies such as Germany, Italy and UK have also been able to pull back foreign inflows, after a disappointing show last year. In Japan, inflows into equity picked up in 2023, but were still not enough to counter the outflows from the debt segment.

Figure 2: Global FPI flows in 2023



Source: Bloomberg, Bank of Baroda Economic Research | Note: Data for China is as of Jun'23 for equity and Nov'23 for debt, For France data is as of Nov'23, for US, Germany and Italy data as of Oct'23, for UK data as of Sep'23

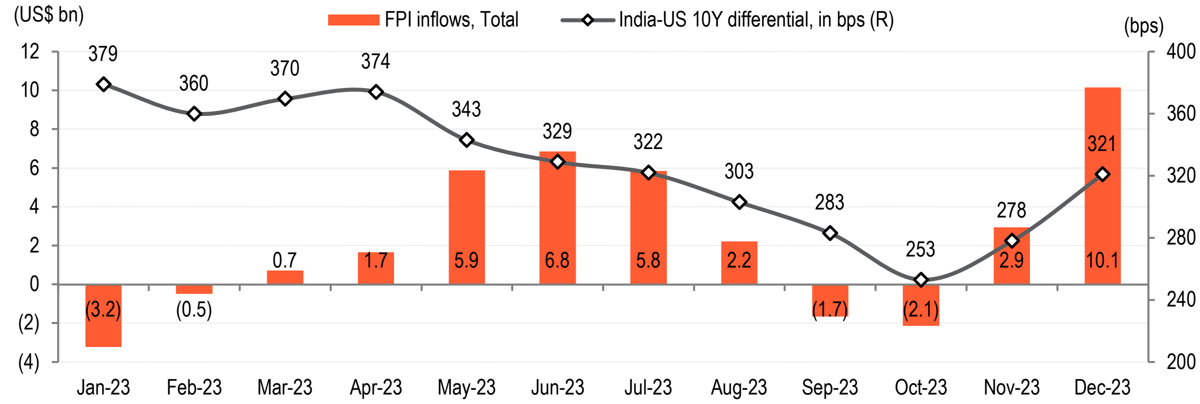
While FPI generally shied away from EM markets in 2022, prospects of lower US rates have led to renewed interest in EM countries. Within EMs, India remained the top pick of foreign investors due to its strong growth fundamentals. Other countries such as Brazil, Thailand and Indonesia also saw a resurgence in FPI inflows in 2023. China, which continues to grapple with economic challenges on multiple front, witnessed huge outflows of above US$ 300bn in 2022. There has been some improvement this year with inflows of US$ 1.2bn so far, led by hopes that fiscal and monetary support will aid economic recovery in the country.

What drove the FPI interest in India:

The primary drivers of FPI movement in India has been market perception of the trajectory of Fed rates and the strong performance of India Inc. While the year started with most market participants believing that the Fed is likely to remain aggressive while hiking rates amidst persistently high inflation and continued strength in labour market. Fed commentary also remained fairly hawkish, signaling a tighter for longer narrative on rates. However, as the year progressed, these expectations were tempered leading to varied conjectures about the timing of a rate cut. These expectations gained prominence towards the end of the year with signs of a slowdown in both US inflation as well as labour market.

Expectations that the Fed is likely to start its rate cut cycle from Mar'24 itself, buoyed investor sentiments. The changing expectations around the Fed rates can be captured to an extent by the movement in US 10Y yield. More importantly, from the perspective of FPI flows, it is the interest rate differentials which determine the direction of flows. Figure 3 plots FPI flows into India with the yield differential between India and US10Y yields. The movement in 10Y yields in turn captures market's expectations of the direction of policy rates. As can be seen, a widening of yield differential in favour of India leads to higher inflows and vice-versa. Apart from this, India's strong growth fundamentals along with range-bound inflation also makes it a preferred choice amongst foreign investors.

Figure 3: Yield differentials and FPI flows

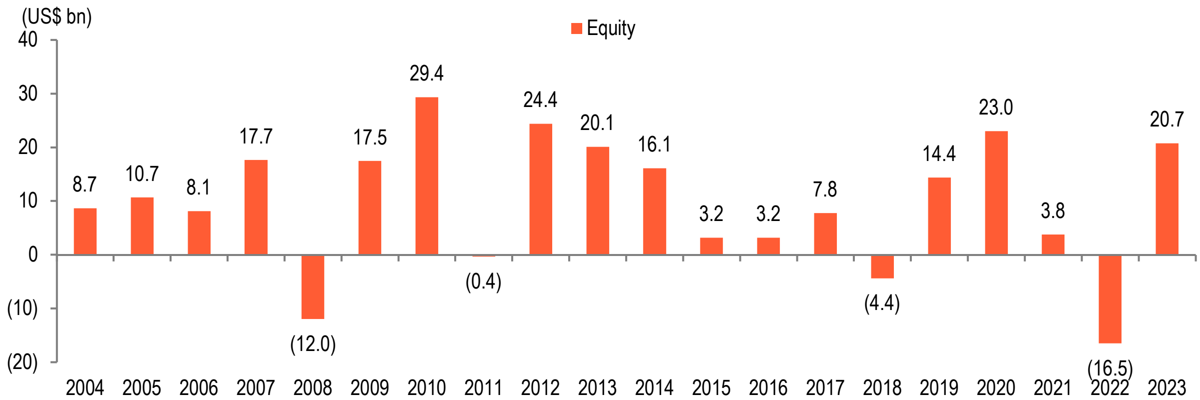


Source: CMIE, Bloomberg, Bank of Baroda Economic Research

Equity inflows:

FPI inflows into equity totaled US$ 20.7bn in 2023, a 3-year high. In the last 20 years, FPI equity inflows have exceeded US$ 20bn only 5 times. The bulk of inflows were concentrated in Dec'23 alone (close to 30%). Strong profitability of India Inc. along with a stable monetary policy regime has increased the attractiveness of India in the eyes of foreign investors. In Rupee terms, 2023 saw the highest even equity inflows on record.

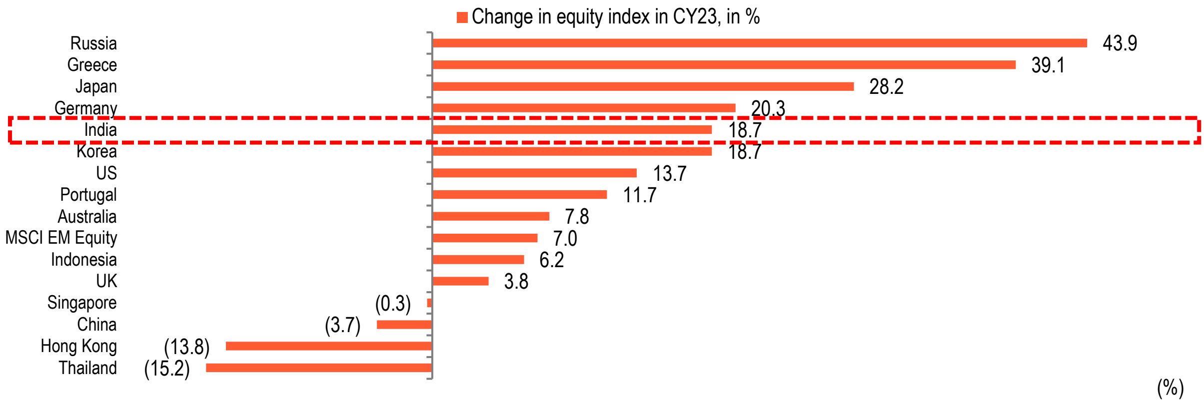
Figure 4: FPI inflows in equity segment across the years



Source: CMIE, Bank of Baroda Economic Research

The buying spree of foreign investors was also reflected in the relative outperformance of Sensex vis-à-vis other global markets. Amongst EM markets, Sensex was the best performer registering a growth rate of 18.7%. EM markets gained about 7%. Even when compared with major developed countries, India did much better. While US stock markets rose by 13.7%, equity markets in UK were only 3.8% higher, suggesting investors' continued confidence in India. Sensex surged to a record high in Dec'23, the same month which saw the highest ever equity inflows in a single month.

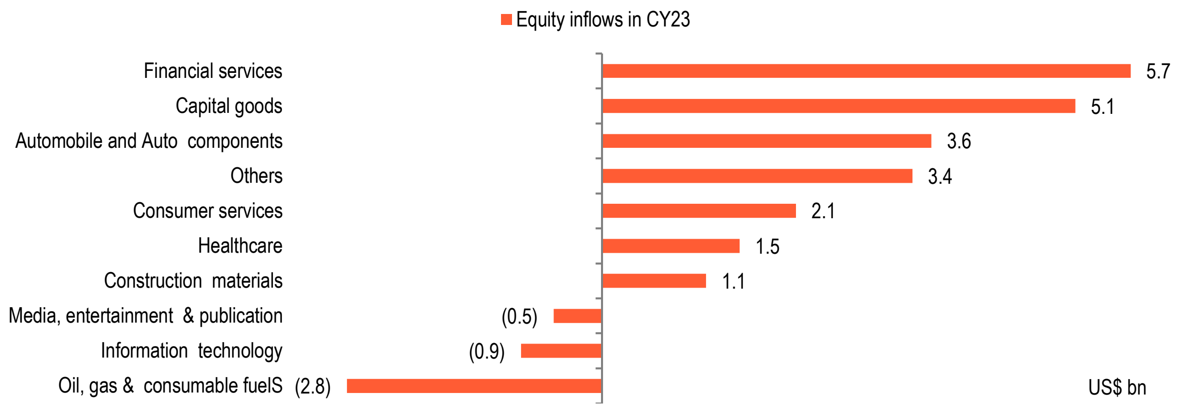
Figure 5: FPI inflows in equity segment across the years



Source: CMIE, Bank of Baroda Economic Research

The sector-wise picture closely mirrors the trend seen in corporate profitability. Sectors which have performed well in terms of profitability have gained the interest of investors and have seen the maximum amount of inflows. Banks and financial institutions have done consistently well this year, and hence have attracted a bulk of inflows this year. At US$ 5.7bn, FPI inflows into financial services accounted for over 27% of total inflows in 2023. Capital goods sector has also attracted inflows of US$ 5.1bn as the government's capex push has greatly benefitted this sector. Auto and auto components also registered stellar financial performance in Q2FY24 and hence ranks high on the investors list with inflows of US$ 3.6bn. Together the top 3 sectors accounted for close to 70% of total inflows. Conversely, sectors such as oil and gas and IT have not been able to elicit investor attention due to their grim prospects.

Figure 4: Sector wise FPI inflows in equity segment

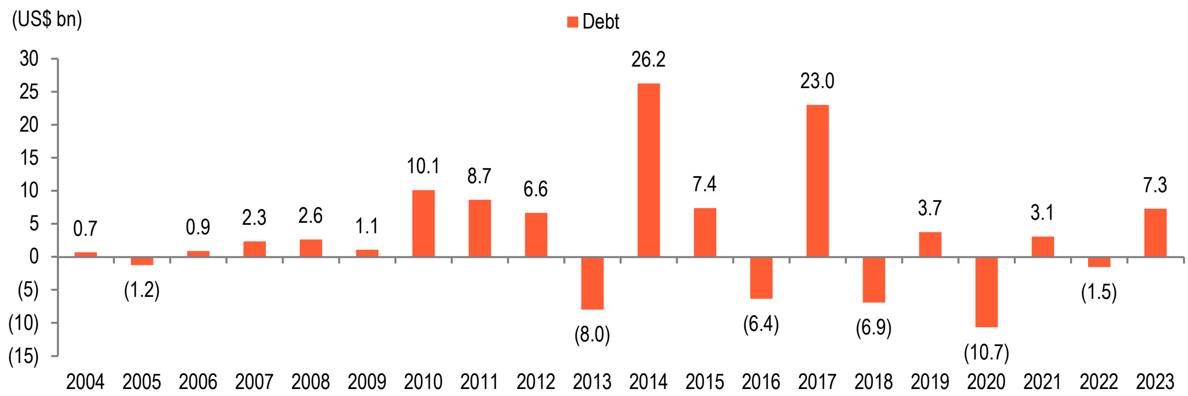


Source: CMIE, Bank of Baroda Economic Research

Debt inflows:

Debt inflows into India witnessed a turnaround in 2023 and recorded inflows of US$ 7.3bn. Of this, almost 50% came in Nov-Dec'23, amidst a sharp correction in US yields. Apart from the correction in global yields, prospects of India's inclusion in JP Morgan Bond index and Bloomberg Emerging Market Index have also spurred foreign investors' interest in India's debt market. This can be gauged from the fact that FPI investment under Fully Accessible Route (FAR) has increased to Rs. 1.3 lakh crore in 2023, compared with Rs. 61,260 crores in 2022.

Figure 5: FPI inflows in debt segment across the years



Source: CMIE, Bank of Baroda Economic Research

For the 23 securities which are eligible for inclusion under the JP Morgan bond index, the holding ratio of outstanding position has shown a sharp improvement. While the share of outstanding position to aggregate holding was in the range of 0.15-5.43% in Sep'23, it has improved to 0.16-8.32% as of 29 Dec 2023, with higher preference for bonds with maturity below 10 years. This suggests that FPI's could be front-loading their investment in these securities, and this trend is likely to gather pace in the first-half of 2024. As of Dec'23, only around 31% of the total limit in the debt market is utilized by FPIs. Hence, there is a sizeable potential for FPIs to invest in the debt market.

Conclusion:

In 2023, FPI inflows into rebounded sharply. The sharp turnaround was attributable to India's buoyant growth macros and improved corporate profitability. This trend is likely to continue even in 2024 as India maintains its place as the fastest growing major economy in the world. In Jan'24 so far, FPIs have poured in US$ 1bn in India. With Fed looking set to start its rate cut cycle from Mar'24 (66% probability as per FedWatch tool), investors' preference is likely to continue favoring high yielding EM securities, with a particular affinity to India. Apart from this, India's possible inclusion in other global bond indices is likely to attract even more debt inflows. Equity inflows are also likely to keep pace, with sectors witnessing improved profitability attracting bulk of inflows. This will be positive for India's external stability, particularly since FDI inflows this year have been lacklustre. This should support INR in the near-term.

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