

From 'Goldilocks' to Stagflation Risk: Middle East Conflict Upends India's Improving Macro Outlook



- The ongoing conflict in the Middle East and the associated Strait of Hormuz closure have posed a dual shock of higher energy prices and supply disruptions to the global economy. After over four weeks of conflict, tentative signs of US–Iran negotiations have emerged, though the path to resolution remains highly uncertain and energy prices remain elevated and volatile.
- India faces this shock from a position of relative strength: record FX reserves of ~USD 728 billion at end-February, ~74 days of combined crude and petroleum products storage at the onset of the conflict, strengthened banking and corporate sectors' balance sheets, and declining energy intensity, all providing meaningful near-term cushion.
- Further, prior to the conflict, India's economy was in a "Goldilocks" phase with resilient economic growth and contained inflation. High-frequency indicators through February pointed to broad-based momentum, with the Composite PMI at a three-month high, auto registrations at a four-month high, and formal sector hiring growing at a healthy pace. Trade deals also reduced external risks.
- That said, the energy price and supply shocks will weigh on the Indian economy, posing downside risks to economic growth, upside risks to inflation, and pressure on both the external account and fiscal consolidation.
- India's vulnerability is compounded by a high import dependence: in H1-FY26, imports of crude oil and petroleum products accounted for ~88% of consumption, and 50% of natural gas and 62% of LPG consumptions were met through imports, with a high degree of dependence on GCC suppliers.
- The duration of the conflict remains the critical variable. A short-lived disruption would leave the macroeconomic impact moderately negative and manageable. A prolonged conflict would lead to a material stagflation shock, weighing on economic growth, inflation, and external and fiscal balances.
- Under our base case (crude oil price averaging ~USD 85/bbl in FY27), we project real GDP growth moderating to ~7.0% (with downside risks) in FY27 from an expected 7.4% in FY26, and CPI inflation averaging ~4.3% (with upside risks) in FY27, assuming partial pass-through of costs while the government absorbing a larger share of the burden through revenue forgone and higher subsidy outlays.
- The government has cut excise duty by Rs 10/litre on petrol and diesel, while imposing export duties on diesel and ATF, with an estimated net revenue loss of ~0.3-0.4% of GDP. Together with the likely higher fertiliser subsidies, this places the estimated FY27 fiscal deficit target of ~4.4% of GDP under meaningful pressure.
- Indian markets came under sustained pressure in March, with FPIs pulling out nearly USD 12 billion from equities and the Nifty 50 Index declining by 9.4% MTD. The rupee depreciated against the dollar by ~4.2% from end-February levels, closing at a record low of ~94.81 on 27th March. The benchmark 10-year G-Sec yield rose to a high of 6.94%, up 28bps from end-February levels.
- We expect the RBI to maintain a pause on the policy repo rate at the April monetary policy meeting, though our conviction on an extended pause has reduced. Should energy prices remain elevated, rising inflation risks and currency pressures could necessitate monetary policy tightening.

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Middle East Conflict Poses Stagflation Risks to the Global Economy

The US–Israel strikes on Iran (February 27-28) and subsequent Iranian retaliation have triggered the most serious geopolitical risk escalation in the Middle East in decades. Reports of impacts on civilian and energy infrastructure in Gulf states highlight the conflict's spillover risks and the wider regional exposure. After over four weeks of hostilities, there are some tentative, though conflicting, signs of US–Iran negotiations. The path to a formal resolution remains highly uncertain, and the risk of miscalculation across parties with fluid and at times divergent objectives remains elevated. Energy prices remain elevated and highly volatile.

Significant Volume of Crude Oil and LNG Flows through the Strait of Hormuz

Volume of Crude Oil, Condensate, and Petroleum Products Transported Through the Strait of Hormuz				
	2022	2023	2024	1H-CY25
Total Oil Flows (million barrels per day)	21.9	21.8	20.7	20.9
Crude Oil and Condensate	16.2	15.8	14.6	14.7
Petroleum Products	5.6	6.0	6.1	6.1
LNG Flows (billion cubic feet per day)	11.0	10.6	10.5	11.4

Source: EIA

The Strait of Hormuz is the central transmission channel of the current crisis to the global economy. As per EIA, ~20.9 mb/d of crude oil and petroleum products transited the strait in H1 CY2025, accounting for a quarter of global maritime traded oil; transit has now come to a near-standstill. Saudi–UAE pipelines bypass capacity could reroute ~4.7 mb/d, leaving the bulk of Hormuz-transiting volumes with no alternative route. Global gas flows are even more exposed: ~11.4 bcf/d, or over 20% of global LNG trade, transited the Strait in H1 CY2025, with the majority destined for Asia. Unlike crude, LNG has no major viable bypass routes, making supply substitution structurally difficult. **The IEA has described the current disruption as the largest supply shock in history**, with Gulf producers cutting crude output by at least 8 mb/d and shutting in an additional 2 mb/d of condensates and NGLs. **The coordinated IEA oil stock release of 400 million barrels provides temporary relief**, equating to ~20–25 days of volumes lost through the Hormuz closure.

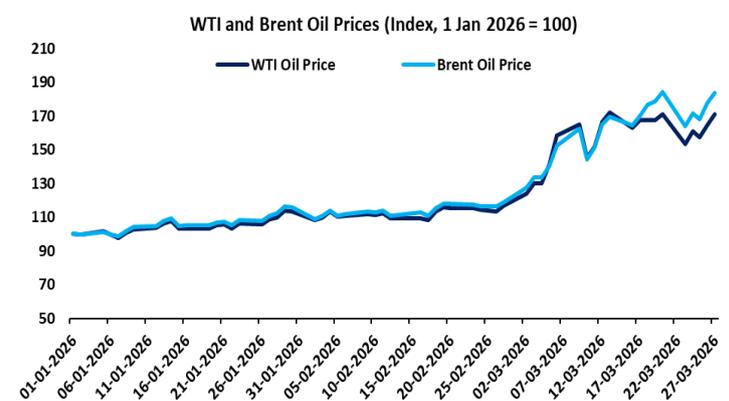
Geopolitical conflict in Iran (and the nearby region) – and the associated spillovers to critical energy prices and supplies – are raising global macroeconomic risks. The likelihood of worsening economic outcomes is rising for countries around the world with an economy's risk(s) a function of its structural idiosyncrasies and underlying macro fundamentals. For select economies, the dominant risk is that higher energy costs sharply reduce the pace of economic activity. For others, the key risk is an

inflationary pickup beyond just the first-round effect of higher energy prices. And, for others who are massive energy importers and running good-sized current account shortfalls, a balance of payments crisis is a potential threat.

An economy's degree of risk is a function of the duration and magnitude of the disruption to the supply of energy from the Middle East and its reliance on such supply. Constrained supply from the region equals higher prices for the underlying commodity – most notably oil and LNG – and the refined / downstream products ultimately used by businesses and households. The upshot will be adverse economic growth and price level effects for (nearly) every major economy (40 largest) in the world.

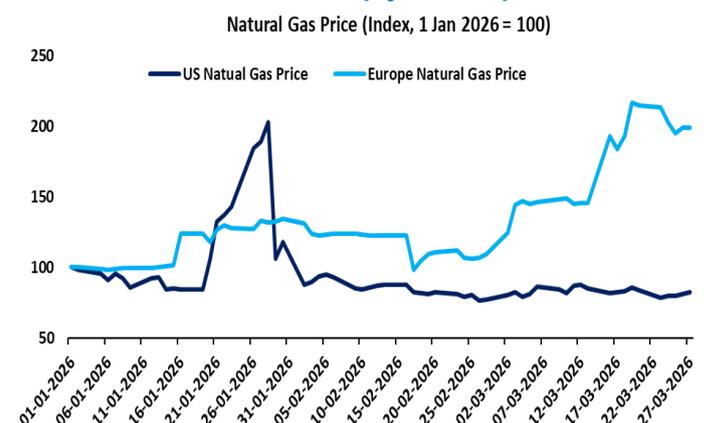
Refined product prices globally have risen notably in the weeks since the conflict began. With such stockpiles now lower, prices of refined products may rise further – even with no further increase in oil / LNG prices – and, at a minimum, likely will have greater upside sensitivity for a given percentage increase in prices of the raw commodity. Refined product prices will have a greater effect than headline oil / gas prices on realized economic activity. In this context, Brent oil prices – most relevant for the world outside the Americas – have risen more than WTI ones in March but the difference is modest in the grand scheme.

Brent Oil Price Rose More than WTI in March Given its Exposure to Middle East Crude Oil Suppliers



Source: Bloomberg, DMI Estimates

Gas Prices Rose More Sharply in Europe than US



Source: Bloomberg, DMI Estimates

LNG prices are another matter: The US, for instance, is not experiencing higher natural gas prices given its plentiful domestic supply, while such prices have surged for the UK and Europe due to their reliance upon gas from the Middle East.

The response in financial markets to higher energy prices, and importantly, the prospect of even higher prices ahead, is an emerging headwind to the pace of economic growth. Benchmark government bond yields have increased by a good-sized amount in many countries, including advanced economies. UK 10-year yields, for example, have jumped by more than 75bps this month and are at their highest level in the post global financial crisis era. Rising risk premium have lifted private sector market interest rates – at which businesses and households borrow – by more than their equivalent maturity government bond yield.

Advanced country central banks – except possibly the Bank of England – have the luxury of not having to endorse bond markets’ pricing of higher interest rates. Decades of established inflation credibility – including the rapid hiking response once they realized they had permitted the post-COVID inflation surge – allow the Fed, ECB, BOJ, and others, to wait for more information to make a measured judgment as to whether the energy price surge is a price level shock (high probability in most advanced economies) or a trigger for a broad-based acceleration in prices, i.e. higher inflation. Central banks whose economies have shorter histories of low and stable prices may have less leeway – but that will depend importantly on the duration of the ongoing disruption.

The conflict eventually will decline in intensity and cease all together. We are in no position to speculate when that may be. **If it were to happen in the next two to three weeks or so, our best judgment is that the resulting adverse macro effects would be mild. Beyond that and/or if the distribution of energy from the region remains impaired even as hostilities ameliorate, the likelihood of adverse consequences will be elevated.**

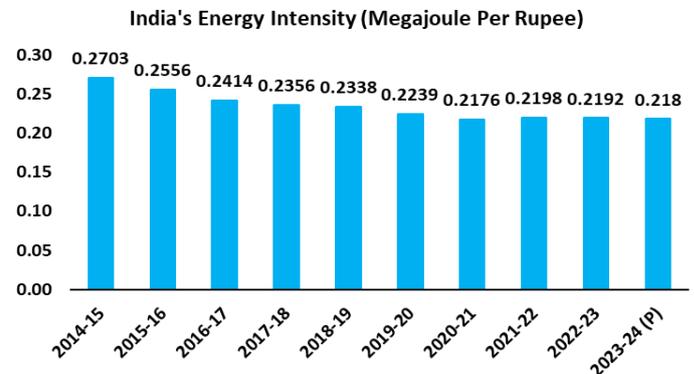
India: Economy Faces Emerging Stagflation Shock from Position of Relative Strength

India faces the emerging stagflation shock from a position of relative strength compared to previous episodes. Prior to the geopolitical risk escalation, the Indian economy was in a "Goldilocks" phase — lower inflation, resilient economic growth, and early signs of easing external headwinds. Policy support through income tax and GST cuts, monetary easing, and regulatory measures had given a boost to cyclical recovery, with visible signs of private consumption improvement and tentative signs of private investment revival, though the latter remained to become broad-based. High-frequency indicators through early Q4-

FY26 pointed to sustained domestic demand momentum following the GST and festival-led boost in Q3. External conditions were also expected to improve, with the interim India–US trade framework reducing the near-term tariff burden, the US Supreme Court ruling on IEEPA tariffs providing further relief, and significant progress on the India–EU FTA. Inflation remained broadly contained despite a recent rise from multi-year lows, and the RBI's February meeting had indicated an extended pause with "lower for longer" policy rates guidance.

Importantly, the current account deficit was also contained (expected to be ~1% of GDP in FY26) and fiscal consolidation had brought the central government budget deficit down from post-COVID highs, placing debt to GDP ratio on a downward trajectory; the S&P's sovereign rating upgrade reflected this improvement. The RBI's FX reserves were at a record high by end-February, covering nearly 11-months of goods imports and ~95% of external debt outstanding. Corporates and banking sector balance sheets have strengthened. India's energy intensity has declined by ~19% over the past decade, and the gradually rising share of renewable energy has reduced the economy's sensitivity to energy price shocks.

India's Energy Intensity has been Trending Downward



Source: MoSPI. FY24 Energy Intensity number is provisional

That said, the geopolitical risk escalation and associated energy price and supply shocks will weigh on India's economic outlook, posing downside risks to growth, upside risks to inflation, and pressure on both the external account and fiscal consolidation. **The extent of impact will critically depend on the duration of the conflict, the trajectory of energy prices, and the persistence of supply disruptions.**

Under our base case, geopolitical uncertainty persisting for a few weeks with some de-escalation alongside sporadic re-escalation, and crude oil price averaging ~USD 85/bbl in FY27, **we project real GDP growth moderating to ~7.0% (with downside risks) in FY27 from an expected 7.4% in FY26, and CPI inflation averaging ~4.3% (with upside risks) in FY27 up from expected ~2.1% in FY26.** This assumes partial pass-through of higher energy costs to

users, with the government absorbing a larger share through excise duty cuts and higher subsidy outlays.

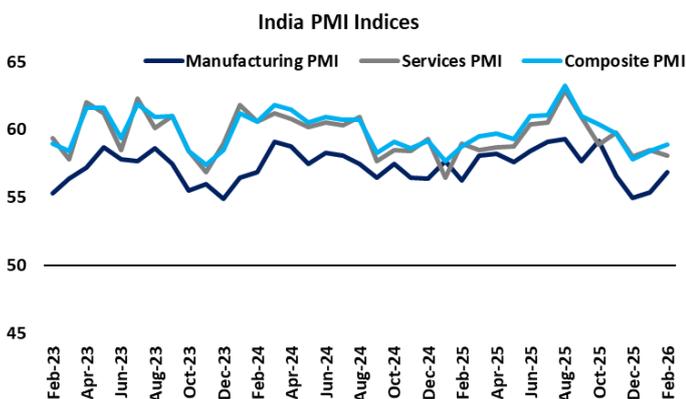
Given this context, the RBI is expected to maintain a pause on the policy repo rate at the upcoming monetary policy meeting in April, however, our conviction on an extended pause has reduced. Should energy prices remain elevated, rising inflation risks and intensifying currency pressures could necessitate monetary policy tightening.

Domestic Economic Momentum Resilient Ahead of the Conflict

The Indian economy continued to show resilience ahead of the conflict, with signs of cyclical recovery supported by policy measures, providing some cushion as the stagflation shock from the Middle East conflict begins to weigh on key economic variables.

As per the second advance estimates from the National Statistics Office, FY26 real GDP is estimated at 7.6%, supported by a recovery in consumption and investment. In Q3 FY26, real GDP growth came in at a resilient 7.8% YoY (Q2: 8.4%), with private consumption contributing over half of headline growth, supported by GST cuts and festive demand. Private investment continued its gradual recovery, partly offsetting a contraction in central government capex, while net exports were a drag amid tariff headwinds. Real GVA grew 7.8% YoY in Q3-FY26 (Q2: 8.6%), anchored by robust manufacturing and resilient services. Agricultural growth was muted on an unfavourable base and uneven monsoon, though healthy rabi sowing points to a Q4 recovery.

India's PMI Indices Firmly in the Expansion Zone



Source: CMIE

High-frequency data through February pointed to sustained economic activity, though the Middle East conflict will increasingly weigh on March indicators. Industrial output growth eased to 4.8% YoY in January from a 26-month high of 8.0% in December, reflecting demand normalisation after the Q3 festive and GST boost. Both manufacturing and services PMIs remained comfortably in expansionary territory and the Composite PMI rose to a three-month high

of 58.9 in February, though flash PMI data indicates some near-term softening in sentiment and activity.

The labour market continued its recovery, with the FYTD unemployment rate averaging 6.9% (April–February), ~118 bps lower compared to the same period last year, as per CMIE data. Formal sector hiring strengthened, with the Naukri JobSpeak index growing ~12% YoY in February and averaging 7.5% YoY in FY26 to date, compared to 1.9% in the same period last year. Corporate earnings data for listed companies in Q3 showed a pickup in employee costs, partly reflecting New Labour Code provisions, consistent with improving urban wages, while rural income remained well-supported by healthy agricultural activity. Together with contained inflation and GST cuts, these factors translated into gains in private consumption. Auto registrations rose to a four-month high of ~25.8% YoY in February, with broad-based momentum across vehicle segments. Retail credit growth also accelerated from Q3 onwards, aided by improving private consumption and ongoing monetary policy transmission.

On investment, central government capital expenditure contracted in January while state governments capex posted robust growth. Private investment continued its gradual recovery, reflected in new project announcements, rising industrial credit growth, listed non-financial corporates net fixed asset growth, and manufacturing capacity utilisation above its long-term average. We are cautiously optimistic about a gradual revival in private investment, though geopolitical risks and elevated energy prices pose significant headwinds to this tentative recovery.

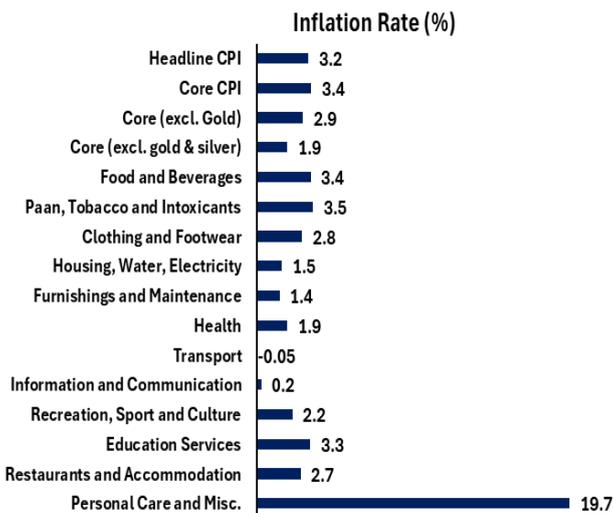
External trade continued to face headwinds. Goods exports contracted ~0.8% YoY in February following modest growth of 0.6% in January. On the import side, goods imports rose to a 42-month high of 24.1% YoY, driven by a surge in gold and silver imports and base effects. FYTD (April–February) trade performance remains weak, with goods exports up just ~1.8% YoY against ~8.5% goods import growth. Services exports surged in February based on preliminary data, leading to rise in the net services surplus and bringing the overall trade deficit down compared to January. Looking ahead, the reduction in US tariffs following the US Supreme Court ruling could support recovery in US-bound exports, but exports to the Middle East are likely to face significant near-term pressure. Factoring these dynamics and higher energy prices, we expect the FY26 CAD at ~1.0% of GDP, widening to ~1.6% in FY27 under our base case.

Inflation Picks Up but Remains Broadly Contained, Elevated Oil Prices Cloud RBI's Extended Pause Outlook

After running at very low levels through much of FY26, headline CPI inflation (2024 base) rose to a 10-month high

of 3.21% in February from 2.73% in January, though it remained below the RBI's 4% target. The uptick was largely driven by Food and Beverages (rising to 3.4% from 2.1%), Paan, Tobacco and Intoxicants, and elevated precious metals prices. **Core inflation stood at 3.4%, broadly stable relative to January, reflecting a comfortable underlying trajectory under the new CPI series; excluding precious metals, core inflation was subdued at ~1.9%, indicating the absence of any broad-based underlying price pressures.**

Inflationary Pressures Remain Muted Outside Personal Care (Precious Metals) Category



Source: CMIE

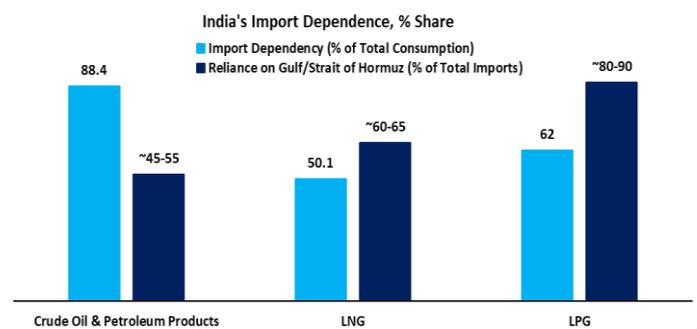
With global crude oil and gas prices rising sharply and continued currency pressures, **we expect CPI inflation to average ~4.3% in FY27 (with upside risks), assuming crude oil prices average ~USD 85/bbl, with partial pass-through of higher energy costs to users while OMCs and the government absorbing a larger part of the burden.** While these projections would ordinarily help the RBI keep a pause on policy rate, the balance of risks suggests that an extended pause will face increasing headwinds from the evolving conflict and energy price and supply dynamics. Evolving El Niño conditions may also pose risks to inflation outlook if the monsoon turns out to be deficient in 2026.

Middle East Conflict: Macroeconomic Implications for India

Brent crude oil price has surged ~55% since the conflict began, trading above \$100/bbl through mid-to-late March from a pre-conflict level of ~\$73. **The Indian Crude Basket has risen even more sharply, hitting a record \$157/bbl on March 23, with the March (till 26th) average of ~\$112/bbl already ~62% above February's \$69 average,** reflecting India's heavy reliance on Oman and Dubai sour grades, both of which have surged as Hormuz transit collapsed.

Further, with energy supplies from the Gulf region significantly constrained, India faces a dual shock of higher energy prices and disruption to supply channels. **India's vulnerability is compounded by high import dependence: crude oil and petroleum products imports accounted for ~88% of consumption and natural gas for ~50%, with LPG meeting ~62% of consumption through imports in H1 FY26.** Around half of India's crude imports transit the Strait of Hormuz, while exposure is materially higher for LPG and LNG, with limited buffers and no major bypass infrastructure in the Gulf region.

India's High Import Dependence on Fuels Imports from Middle East Poses Risks



Source: PPAC, PIB, S&P Global, IEA. Import Dependence estimates are based on data for H1-FY26.

As per media reports, India's crude imports slipped 23% in the first 18 days of March to 81 million barrels from 105 million in the same period last month, driven by a nearly 60% fall in Middle East inflows. Russia stepped up sharply to account for 44% of total crude imports during this period, aided by the US granting a temporary waiver to purchase Russian crude. African producers, led by Angola, have also increased supply. Imports of Iranian crude oil could rise following the US Treasury's temporary waiver on purchasing Iranian oil already at sea. LNG and LPG imports from the Middle East have fallen sharply, with efforts underway to diversify sourcing toward the US, Argentina, and other non-Gulf suppliers, but sourcing and receiving products from these suppliers will take time.

India's combined crude and petroleum products storage buffer has declined to approximately 60 days from ~74 days at the start of the conflict, providing near-term cushion but with diminishing runway. On a positive note, as per the government, crude oil supplies for the next 60 days have already been secured by Indian oil companies, providing near-term comfort on crude availability. Supply management pressures for LPG and LNG, however, have already begun to emerge despite increases in domestic production and active diversification efforts. The government has indicated that approximately one month of LPG supply has been arranged, with additional procurement being finalised on an ongoing basis. Any prolonged disruption would nonetheless

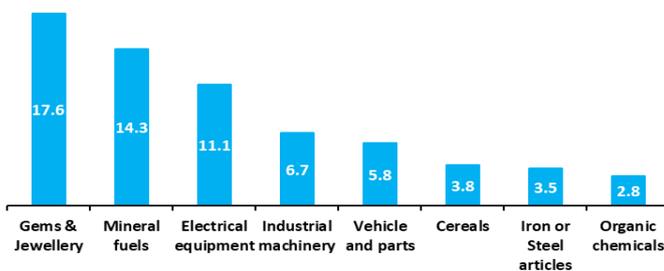
generate greater logistical and price stress in these fuels than in crude oil.

GCC Trade and Remittance Risk

Beyond energy, India faces headwinds from disruption to exports to GCC and a potential decline in remittances. The **GCC accounts for ~13% of India's merchandise exports** (April–December 2025), with key categories including gems and jewellery, mineral fuels, electrical equipment, machinery, vehicles and parts, and cereals. A prolonged conflict would weigh on MSMEs and employment in these sectors.

Gems & Jewellery, Mineral Fuels and Electrical Equipment Highly Exposed to Middle East Disruption

Share of India's Top Export Items to GCC Countries in FY26 (Apr-Dec),%



Source: DGCIIS

On remittances, India received an estimated USD 135.4 billion in FY25, providing consistent counter-cyclical support to the external accounts. **The GCC contributed ~38% of total remittances in FY24 (down from ~47% in FY17), with a structural shift underway toward advanced economies, which now account for over half of total inflows.** While this diversification provides some buffer, GCC-linked flows remain material, and any prolonged conflict could pose meaningful downside risk to remittance inflows and private consumption in remittance-dependent states.

Oil Price Shock: Macro Transmission Channels

Higher oil prices affect India through three key channels: the external channel (wider trade deficit, weaker rupee); the inflation channel (fuel and input-cost pass-through to CPI); and the fiscal channel (higher subsidy burden, compressed fiscal space).

Macro Sensitivity to Oil Prices

Macro Variable	Per Unit Change in Crude Oil Price	Variable Sensitivity
CPI Inflation	Per 10% Rise in Price	+30 bps
Real GDP Growth	Per 10% Rise in Price	-15 bps
Current Account Deficit	Per \$10/bbl. Increase in Price	~+0.43% of GDP
Fiscal Deficit	Per \$10/bbl. Increase in Price	~+0.43% of GDP

Source: RBI October 2025 MPR and Mint Street Memo 2019

RBI sensitivity estimates suggest a 10% rise in crude oil price raises CPI inflation by ~30 bps and reduces real GDP growth by ~15 bps, while a \$10/bbl increase in price widens both the CAD and fiscal deficit by ~0.43% of GDP.

The impact on inflation will depend on the extent of pass-through to end users and the share absorbed by OMCs and the government. **The government has already reduced excise duty by Rs 10 per litre on both petrol and diesel with immediate effect.** The government has also levied an export duty of Rs 21.5/litre on diesel and Rs 29.5/litre on ATF, which will partly offset the revenue loss from the excise cut, leaving an estimated net revenue loss of ~0.3-0.4% of GDP. Fertiliser subsidies are also expected to rise in FY27. These fiscal pressures will weigh on the deficit target of ~4.46% of GDP under the budget assumption of 10% nominal GDP growth (or ~4.4% under our assumption of 11% nominal GDP growth in FY27).

Under our base case (crude oil price averaging ~\$85 in FY27), with partial pass-through to users and the government absorbing a larger share, CPI inflation is projected at ~4.3% and real GDP growth at ~7.0% in FY27. The CAD is expected to widen to ~1.6% of GDP, and the fiscal deficit to edge up to ~4.8–4.9% of GDP in FY27. Under this scenario, CPI would be moderately above the 4% target, allowing the RBI to maintain its policy rate pause while deploying liquidity management tools. Should crude oil price escalate to average ~\$100, inflation is likely to exceed 5%, economic growth could drop to ~6.5%-6.7%, and the CAD could rise to ~2.3%-2.5% of GDP, a scenario in which the RBI would likely need to consider rate hikes.

Overall, the Middle East conflict carries stagflation implications for India, with higher energy prices and supply disruptions as the primary transmission channels. If the conflict proves short-lived and energy supply corridors resume normal operations in the coming weeks, the overall macroeconomic impact is expected to be moderately negative and manageable. A prolonged conflict and sustained disruption to energy and trade flows, however, would pose significant and simultaneous risks to economic growth, inflation, the external account, and fiscal consolidation.

Markets Update

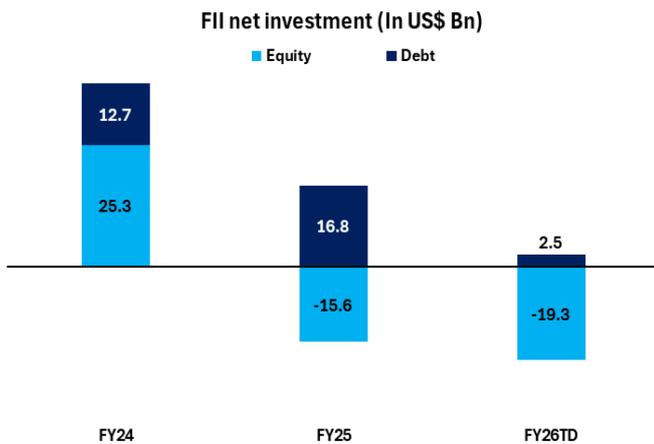
Bond Market: Banking system liquidity improved in February, with average surplus rising to ~Rs 2.55 lakh crore, supported by RBI OMO purchases, forex buy-sell swaps, and VRR operations. Conditions tightened sharply in the second half of March as advance tax, GST outflows, and RBI FX intervention drained liquidity, with systemic liquidity

falling to (average) ~Rs 0.26 lakh crore during March 16–26 from (average) Rs ~2.5 Lakh Crore in the first half of March.

The 10-year G-Sec yield has risen ~28bps since end-February to a high of 6.94% on March 27, as markets repriced macro-fiscal risks amid elevated crude prices and the government announced excise duty cuts. Near-term yield direction will depend on the pace and durability of RBI liquidity and bond purchase operations, the trajectory of crude oil prices and their pass-through to domestic inflation, and FPI debt flows.

from April 10 could provide near-term support to the rupee. However, the rupee is likely to remain under pressure as long as crude oil prices stay elevated; a material de-escalation could trigger a corrective rally.

FPI Outflows from Equity Market Accelerate in FY26TD



Source: CMIE, FY26TD is data till 27th March.

Equity Market: Markets came under sustained pressure through March. The stock market had found support in early February from the India–US trade framework, the SCOTUS IEEPA ruling, and healthy Q3 earnings, with FPIs turning net buyers at USD 2.5 billion in February after months of sustained selling.

The onset of the conflict reversed this sharply: FPIs pulled out nearly USD 12.3 billion from Indian equities between March 1 and March 27, remaining net sellers on virtually every trading day. The Nifty 50 Index declined 9.4% in March through March 27. DIIs provided support through net purchases. Sentiment improved marginally following news of the initiation of peace talks, though conflicting reports kept markets cautious. Markets will continue to be driven by Middle East developments and the crude oil price trajectory in the near term.

Foreign Exchange Market: The rupee recovered in February, appreciating ~1.1% MoM to approximately Rs 90.98/USD, supported by improved risk sentiment and FPI inflows. The Middle East conflict precipitated a sharp reversal — the rupee closing at a record low of Rs 94.81/USD by March 27, reflecting a depreciation of ~4.2% from end-February levels. Foreign exchange reserves fell to USD 698.3 billion in the week ending March 20 from a record USD 728 billion on February 27, as the RBI intervened actively to support the currency. The RBI's directive capping authorised dealers' onshore NOP-INR at USD 100 million

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