

Tilting the balance

As we approach market levels which are now only 10% below the pre-Covid levels, there are questions which this newsletter seeks to answer apart from making sense of what has happened so far in the markets. While the consensus view in the market was cautious (including ours), the incremental positive news flow (listed below) along with liquidity (global + retail) tilted the balance towards a steady climb over the last two months.

First let us look at the negatives (because it is much easier to do so).

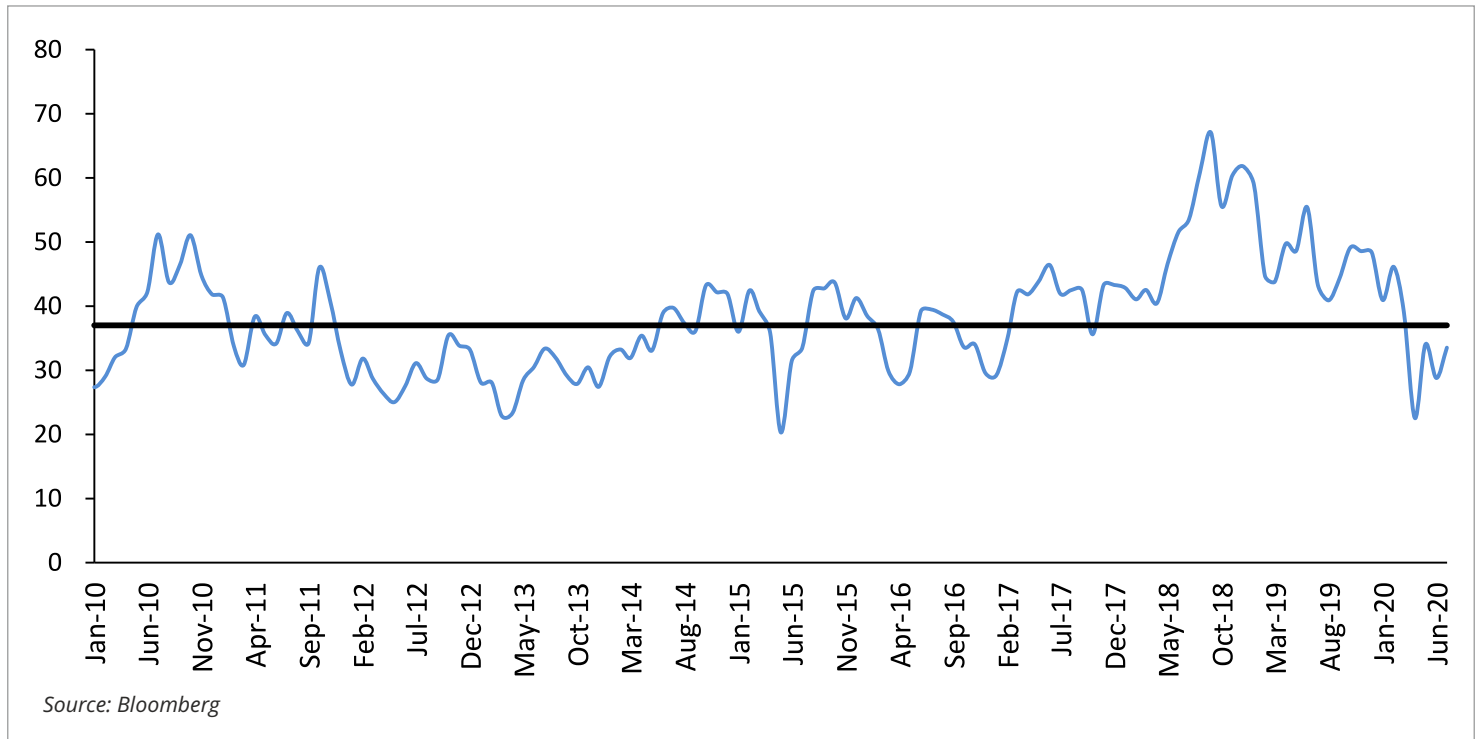
1. The rate of infection continues to climb with positive test rates steadily inched up. This is true for US too post lockdown removals. Infact, from the negligible levels in March-20 (when the markets witnessed sharp correction), the present daily infection rate of 25-28k would have appeared quite ominous.
2. Staggered lockdown removal along with some reversals in large cities
3. The Nifty EPS for FY22 has been 15% so far with the risk of another 5% cut given lack of fiscal stimulus and staggered lockdown removal (ignoring the "extraordinary" nature of FY21 losses)
4. Demand across industries is back at 70-90% of pre-Covid levels but the real picture will emerge in Aug-Sep once the pent-up demand and restocking.
5. India's valuation premium to other EMs which had declined to 20% in March is now at average level of 35-40%. So, there is less room for outperformance and correlation with global markets will be high (either way)

The positives have been building up steadily though – some short term but long term as well.

1. The recovery rates have been climbing up too and may soon match the daily infection rates. The death rate continues to be low too. There is no longer a panic regarding the availability of beds even though situation may not be totally under control.
2. Low bond yields and liquidity (domestic and global) with more promised by the RBI. Response to recent capital raising by banks will bolster the financial system.
3. Long term opportunity for India to gain from the emerging supply chain and geopolitical dynamics
4. Borrowers opting for moratorium are on the decline (need to watch RBI stance on extending moratorium beyond Aug 31 which will be counter-productive)
5. Rising retail participation and volumes in equity markets

6. Good monsoon prospects along with strong demand commentary from the Agri-dependent sectors (agrochemicals, tractors)
7. Agri reforms, PSU privatisation and labour law changes (Centre and state level)

Forward P/E Valuation Premium: Nifty-50 vs. MSCI EM (%)



What will tilt the balance in next 6-12 months?

The key obviously is the risk-on environment in the US as India's current valuation will mean that the correlation with global markets will remain high. Any change in sentiment either due to expectation of Fed's reversal of stance (looks unlikely) or worries nearer to the US elections will have a bearing on Indian equities as well. On the other hand, recovery in China and mild inflationary comeback will be positive for the cyclical components of the market.

Looking beyond the global factors, we believe that the domestic drivers will also determine which way the scales tilt. Since private consumption as a percentage of GDP is a dominant 60%, it is critical to keep an eye on how fast consumption comes back and areas where it might be more difficult to come back to 100% in foreseeable future. While a renewed investment cycle led by manufacturing and easier laws can emerge as big positives in the long term, we pose below some questions pertaining to consumption that are critical in the next 6-12 months.

1. Are we as a society much more risk averse which means we will continue to avoid travel, crowded markets and places for much longer than what the market is factoring currently? One of the large supermarket chains alluded to that in their recent commentary. So, is there say a permanent loss in demand? Or will it come back post vaccine? How much time that will take remains uncertain too.
2. Is this an opportunity for smaller unorganised segments to be more agile and respond to the customer service requirements? For example, standalone shops vs. malls; Kirana stores vs. Organised retail? Digital enablement will however be needed for the small to compete with the big – telecom companies could play an active role here.
3. Rural demand had slowed down Pre-Covid and was expected to pick up post Rabi harvest. That is already playing out and with good monsoon spread across the country, there is more to look forward to in the rural economy. The migrant labour also seems to be coming back and could start demanding higher income levels.

4. However, it should be noted that the urban consumption is still a large proportion and that too from the top 10-20 cities. How much of an impact does an overall slowdown and income levels have will weigh on the economy?

Above is a broad list of issues which will provide clarity only gradually. A full-fledged cyclical recovery will depend on the answers to some of the above questions. In the meantime, certain sectors can continue to outperform

- i) where there are positive demand drivers post-Covid viz. Telecom, Agrochemicals, Speciality Chemicals, Pharma, and
- ii) the less impacted segments viz. Staples, utilities, insurance.

Happy Investing!



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