

In the sweet spot

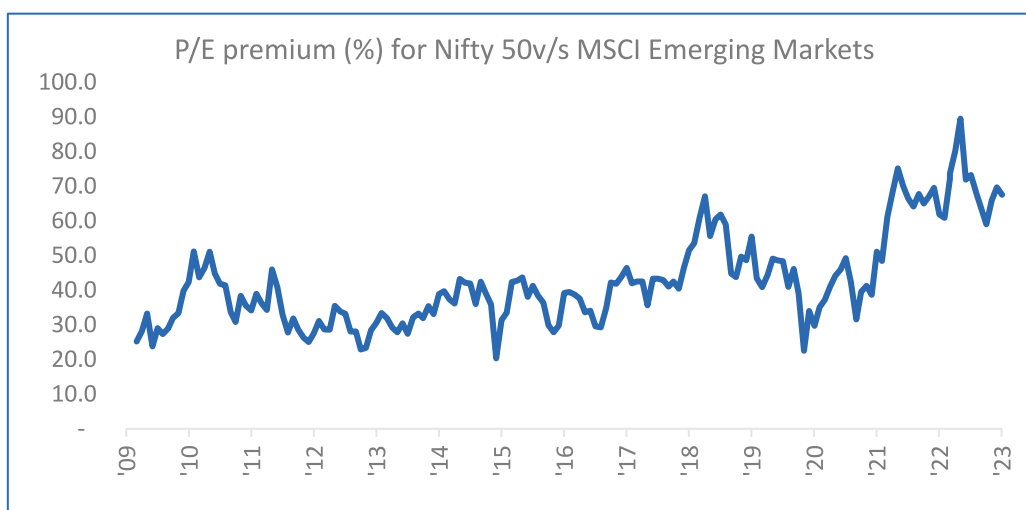
In January this year, we had presented a simple schematic (see below) which summarised the likely impact of Global and China's economic trajectory on India's earnings and valuations in a 2x2 matrix. Of the four scenarios, a shallow recession in US/UK/EU combined with slow recovery in China was painted as the best-case scenario for India as it can sustain India's valuation premium with limited impact on corporate profits. And this is precisely what has played out in the first half of 2023. The post-lockdown recovery in China turned out to be a temporary one and the resultant equity flows to Chinese markets at the beginning of the year have also normalised. On the other hand, the slowdown in developed economies has been a gradual one notwithstanding the unforeseen bank closures leading to a possible "soft landing".

Deep Recession in US/UK/EU	Earnings: Impact likely, especially in sectors with global linkages offset slightly by lower input costs Valuation: Premium can sustain but risk-off will reduce absolute valuations	Earnings: Impact on global sectors, cushion in input prices Valuation: Premium can reduce meaningfully as flows to China increase
	Earnings: Limited impact on India's GDP/Profit Growth Valuation: Growth Premium will sustain	Earnings: Limited impact, some impact on commodity prices Valuation: Premium will shrink although absolute valuations might sustain
	Slow Recovery in China	Sharp Recovery in China

Sweet Spot (indicated by a red arrow pointing to the bottom-left cell)

Why is this a sweet spot for India?

1. A weak global economy and faltering recovery in China keeps commodity and input prices in check leading to minimal impact on India's GDP and profit growth. This is even as the impact on sectors with global interlinkages is manageable. The "soft landing" is evident for example in the way Indian IT Services outlook has changed; while the deterioration is quite apparent, it has not been a complete collapse.
2. If growth remains cyclically depressed in developed economies and structurally subdued in China, India's growth premium can sustain. This is evident in the chart below as India's (Nifty 50) PER premium to Emerging markets has expanded from 45-50% to the 60-70% range. Moreover, there is very little in the horizon which can challenge this narrative with crude/energy prices and any shocks in domestic politics being the key risks.



There have been other medium-term drivers of India's valuation premium too which have picked up pace over the last 2 years.

Stable macro parameters (esp. fiscal deficit, less entrenched inflation), lower interlinkages with the global economy, revival of the investment cycle (including real estate) and India's gradual emergence as a new sourcing hub are important factors which may drive above-par GDP growth (~6.0%)* and earnings growth (~15%)* over next 2-3 years.

In addition, the long-awaited investment cycle revival is spread across traditional corporate sector (metals/cement), renewables, import substitution and real estate and comes after a long period of under-investment and balance sheet repair in corporate as well as banking sector. The building blocks are in place in terms of tax cuts and production linked incentive scheme which together with the changing geopolitical landscape provides India the opportunity to establish its manufacturing & export base vs. its Asian neighbours.

The net result of this has been that while Nifty50 forward PER ratio at ~18.5x* has not corrected as much as rest of the global markets, it is still 10-15% lower than the valuation in end-2021 thanks to an extended time correction. We believe that with the confidence on economic growth, inflation control and profit growth improving, chances of a material correction have reduced and probability of a steady upmove has gone up.

So what should investors do in such a scenario.

- i) Maintain a healthy mix of debt & equity,
- ii) Keep core allocation in Balanced Advantage Funds,
- iii) Seek alpha in funds that are based on present economic cycle i.e. Banking, Infrastructure and Mid/small caps.

Happy Investing!



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*Source: Tata AMC estimates, Bloomberg

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