

Equity Outlook 2020 – Darkest Before Dawn or A Long (Economic) Winter?

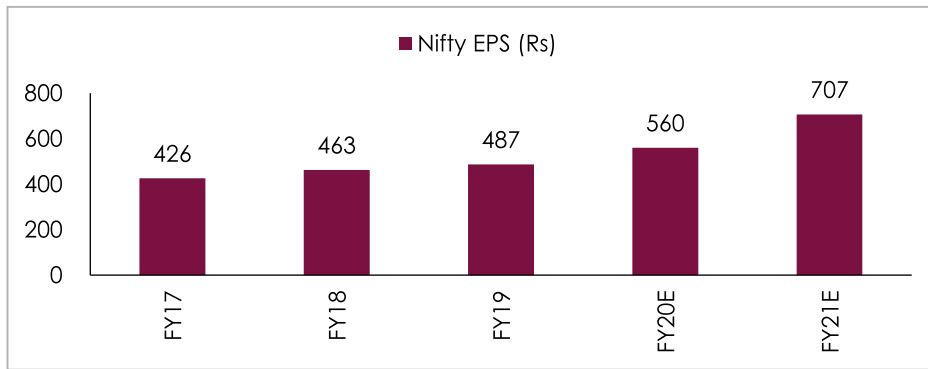
2019 was an interesting year. It saw an accelerated economic slowdown as the funding squeeze faced by the NBFCs combined with the pro-cyclical fiscal policy of the government (which led to expenditure cuts to balance lower revenues). Given that it followed a period where the economy was just recovering from the adjustments post GST and Demonetization, the slowdown has been more severe than expected. The headline numbers are unlikely to improve much in the next 1-2 quarters.

In contrast, the headline indices have done pretty well. Nifty50 is at a near all-time high while the Nifty Midcap and SmallCap indices are down 9% and 15% from their respective 52-week highs. The brunt of the economic slowdown has therefore been borne by the Mid and Small caps and the "Value" segment within the Large Caps. Within the index constituents, performance has been varied and the list of top gainers has changed like every year.

Top 10 Stocks	2019	Top 10 Stocks	2018	Top 10 Stocks	2017	Top 10 Stocks	2016	Top 10 Stocks	2015
BAJFINANCE	60%	BAJFINANCE	53%	BAJFINANCE	102%	HINDALCO	82%	MARUTI	38%
BHARTIARTL	57%	TECHM	44%	TATASTEEL	81%	YESBANK	57%	BPCL	36%
ICICIBANK	50%	TCS	43%	IBULHSGFIN	77%	TATASTEEL	52%	LUPIN	29%
BAJAJFINSV	45%	HINDUNILVR	35%	MARUTI	76%	BPCL	43%	INDUSINDBK	19%
RELIANCE	38%	INFY	28%	HINDALCO	73%	POWERGRID	28%	ASIANPAINT	18%
KOTAKBANK	35%	KOTAKBANK	26%	BHARTIARTL	71%	EICHERMOT	24%	ZEEL	16%
NESTLEIND	35%	BAJAJFINSV	25%	RELIANCE	70%	ONGC	19%	KOTAKBANK	14%
BPCL	34%	RELIANCE	23%	HINDUNILVR	64%	TATAMOTORS	17%	RELIANCE	14%
ASIANPAINT	31%	ASIANPAINT	20%	HDFCBANK	57%	GAIL	15%	HINDUNILVR	14%
TITAN	29%	HDFC	17%	GAIL	57%	INDUSINDBK	15%	HDFCBANK	14%
Top 10 Avg	41%	Top 10 Avg	31%	Top 10 Avg	73%	Top 10 Avg	35%	Top 10 Avg	21%
Bottom 40	-6%	Bottom 40	-12%	Bottom 40	17%	Bottom 40	-4%	Bottom 40	-13%
NIFTY 50	5.0%	NIFTY 50	3.5%	NIFTY 50	28.6%	NIFTY 50	3.0%	NIFTY 50	-4.1%

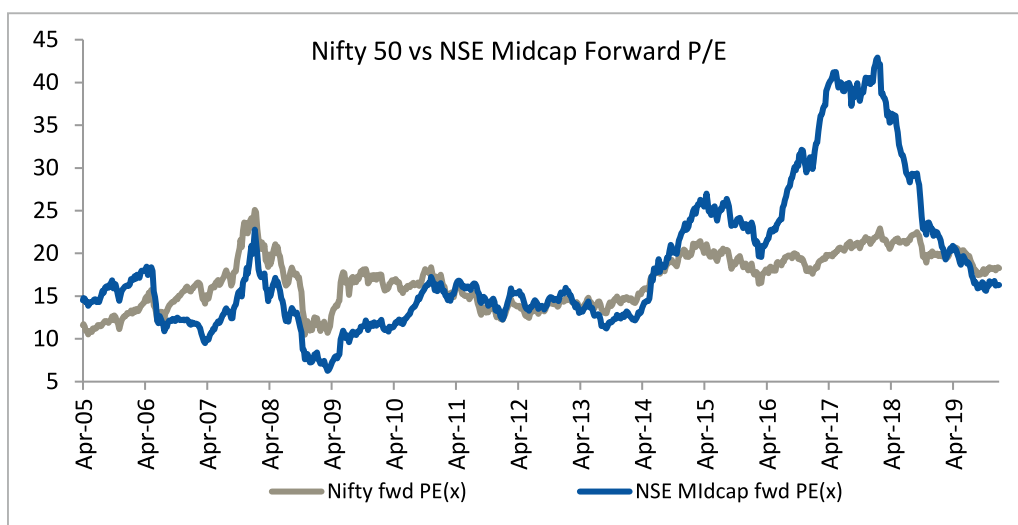
Source: NSE, Capitaline; Data as on 30th December 2019

A large contribution to earnings growth in index performance in particular has come from corporate banks which are witnessing lower bad debts and resolution.



Source: Axis Capital

In addition, certain sectors like telecom are on a turnaround path while select PSU stocks have done well in 2019 due to the privatization initiative. So, while the markets have not been as narrow as in 2018, the broader markets have still struggled with relative valuation of midcap vs. large cap at multi-year lows.



Source: Axis Capital, Bloomberg

So, can the trend reverse in 2020? Can midcaps and small caps come back? Will the market become broader within the Large Caps? How soon can the trend reverse?

The answer to all of the above is linked to the extent and pace of economic recovery in 2020. While there are a lot of possibilities and it depends upon government policy direction, fiscal stimulus, reversion to mean in the credit markets, global trade and geopolitics, we paint two extreme scenarios which will determine the fate of the markets in 2020.

The Bull Case – Darkest before Dawn

In this scenario, NBFC funding squeeze comes to an end quickly leading to a free flow of credit and reduced risk aversion. This alone can be good enough to lift the GDP growth rate to 5.5-6.0% and a revival in discretionary consumption in combination with better rural incomes. The resultant improvement in tax revenues and a big thrust on privatization would give confidence to the government to boost public expenditure with or without loosening fiscal deficit targets. In an ideal scenario, public expenditure cycle will result in improving growth and tax revenues further thus leading to a virtuous cycle.

The government's determination to reverse the economic slowdown can also result in more structural reforms in land and labor along with a focused approach to attract investments and capitalize on the long-term opportunity arising out of the global trade war. In the global context, stable oil prices, low global interest rates and absence of any dramatic developments in the US-China trade negotiations will also be important.

In this scenario, markets could witness EPS upgrades, or at least no further downgrades. Although the index returns may not exceed low double digits given valuations are at 10% premium to long-term averages, the biggest benefit would be a broad-based equity market rally with sharp outperformance of midcaps/small caps. In addition, an aggressive privatization and asset monetization stance of PSUs can lead to re-rating, thus allowing "Value" segment to outperform

after many years of underperformance. Among our funds, Tata Equity PE, Tata Midcap, Tata Small Cap, Tata Large & Mid and Tata Multicap Funds can perform better.

The Bear Case – Long Winter

Risk aversion continues with potential defaults in real estate loans leading to continued funding issues in NBFCs except the top few companies. Rising inflation could reduce the chances of further rate cuts. Tax collection shortfalls force the government to cut public expenditure further (assuming the reluctance to shift to higher fiscal deficit) thus worsening the slowdown even further, hence continuing the present vicious cycle. This will keep GDP growth rate suppressed below 5% in 2020 despite the benefit of low base in second half.

Government's privatization and reform initiatives remain one-off with poor execution and without enough follow through. Global developments like high oil prices (due to geopolitical developments) or breakdown in US-China trade talks can further create a risk-off environment.

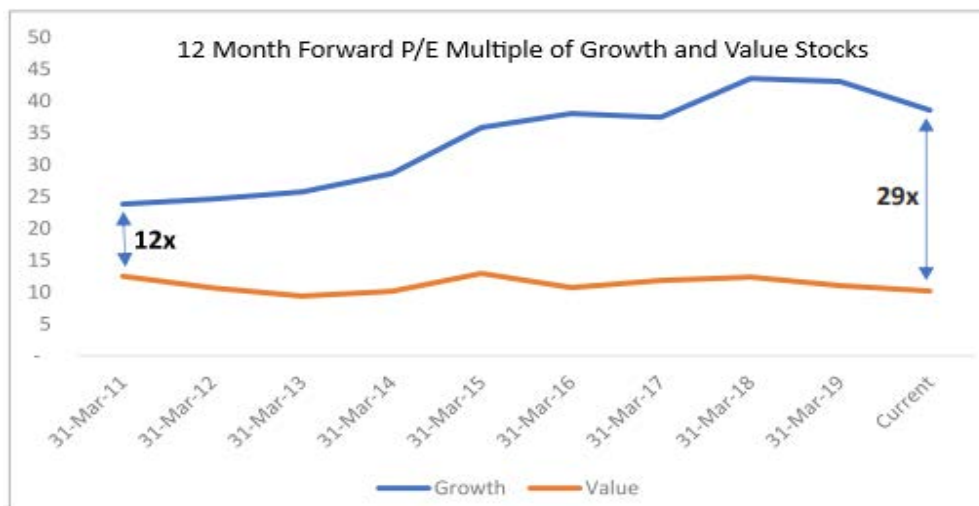
In such a scenario, markets could see further EPS downgrades, mid-single digit returns and flight to quality thus keeping the market breadth narrow. Midcap and small cap performance would be stock-specific like in 2019. Growth/quality will continue to trade at significant premium to Value. In such an outcome, Tata Focused Equity, Tata Hybrid and Tata Balanced Advantage would be better placed.

What is more likely?

Given the range of outcomes, it is difficult to crystal gaze but there is enough evidence to suggest a U-shaped recovery in the economy probably in the second.

- We see plenty of signs of the risk aversion in the funding environment returning to normal. There have been resolutions in the cases of promoter pledges, some of the stressed NBFC/HFC with developer loan exposure have received equity funding and government has moved swiftly to prevent any default risk in telecom.
- Good monsoons and food inflation are usually supportive of rural consumption which should improve discretionary demand.
- While a full-fledged fiscal stimulus is ruled out, the pace of slowdown will force the government to pursue privatization (for revenue) and come up with more radical reforms in land/ labor to attract private investments. Corporate tax cuts and lower interest rates are also supportive. Some of these measures will yield results only in the long run but will keep the equity markets spirited in the short run.

We expect the headline index level returns to be lower than in 2019 (14% for Nifty50), but the broader markets will start participating too in line timed with the economic recovery in second half. We believe corporate banks and turnaround sectors will extend their good performance into 2020 in such an environment. Successful privatization of BPCL & CONCOR could trigger valuation re-rating of other PSUs, especially if government outlines a more comprehensive policy for monetization and privatization. This can also reduce the present "Value vs. Growth" differential too (see chart below).



Source: NSE

So, to sum up, the bull case is that markets climb walls of worry and the rally broadens, while the economy is able to pull itself out of the current slowdown. The bear case or status quo is that the markets continue to obsess over quality while the problems deepen for the economy, making it a long and cold winter. We would urge investors to keep the faith while we navigate this turn by dynamically shifting gears in our portfolios across large and mid & small caps or managing trade-offs between Growth and Value.



Rahul Singh

Chief Investment Officer (CIO) – Equities

Product Label and Risk-O-Meter of the Schemes:

These products are suitable for investors who are seeking*:

Tata Equity P/E Fund: • Long Term Capital Appreciation. • Investment (minimum 70%) in equity & equity related instruments of companies whose rolling P/E is lower than rolling P/E of S&P BSE Sensex.

Tata Large and Midcap Fund: • Long Term Capital Appreciation. • Investment in equity & equity related instruments of well researched value and growth oriented Large & Mid Cap Companies.

Tata Small Cap Fund: • Long Term Capital Appreciation. • Predominant investment in equity/equity related instruments of small cap companies.

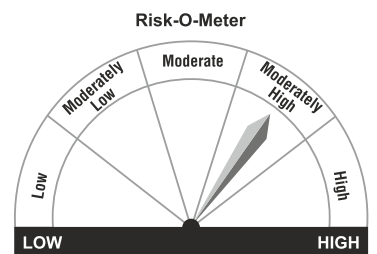
Tata Mid Cap Growth Fund: • Long Term Capital Appreciation. • Investment predominantly in equity & equity related instruments of growth oriented mid cap companies.

Tata Multicap Fund: • Capital Appreciation over medium to long term. • Investment in a diversified portfolio consisting of equity and equity related instruments across market capitalization.

Tata Focused Equity Fund: • Long Term Capital Appreciation. • Investment in equity & equity related instruments in a concentrated portfolio of maximum 30 stocks across market capitalisation.

Tata Hybrid Equity Fund: • Long Term Capital Appreciation. • Investment predominantly in equity & equity related instruments (65% - 80%) & some portion (between 20% to 35%) in fixed income instruments.

Tata Balanced Advantage Fund: • Capital Appreciation along with generation of income over medium to long term period. • Predominant investment in equity and equity related instruments as well as in debt and money market instruments.



***Investors should consult their financial advisors if in doubt about whether the product is suitable for them.**