

Twist in the Tale

India's relative outperformance and premium vis-à-vis other emerging markets has narrowed since the beginning of 2019 (see chart below). Escalating tension over the recent two weeks has added to the macro risks in the form of impending general elections which were anyway becoming part of the investor's decision-making process. As a result and partly due to the existing premium, Indian equity markets did not get the full advantage of a "dovish" Fed.

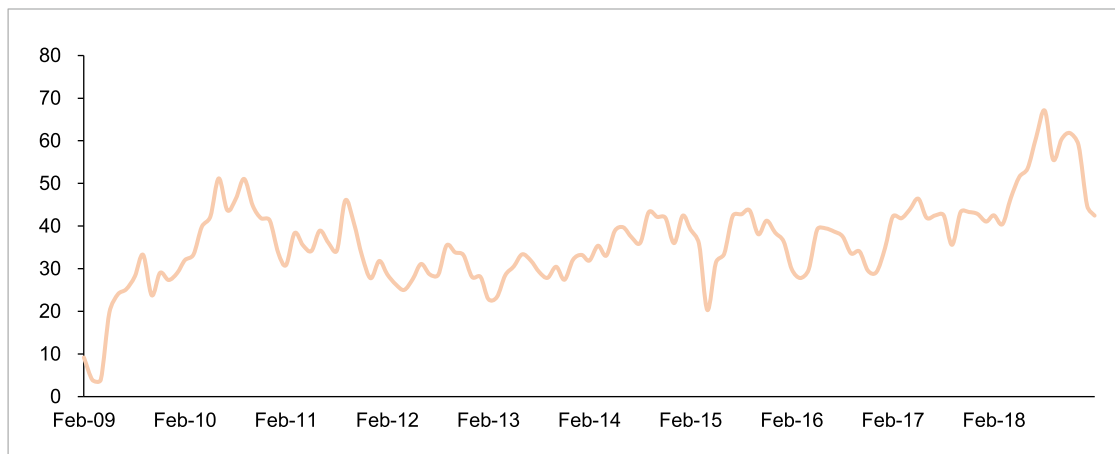
While there are attempts to compare the latest round of escalation to previous instances in terms of the extent of market correction, we believe a firm conclusion is difficult given the (i) changed nature of the political will and (ii) higher probability of a counter response. That notwithstanding, one point which somewhat offsets the concern is that a simmering conflict increases the chances of a clearer verdict in the ensuing general elections. That could, ironically, reduce the equity risk premium.

Speaking of elections, there has been a marked increase in the number of investor meetings/calls arranged with the political analysts and journalists. This is quite normal for this time of the election cycle although the views remain mixed ranging from a hung parliament to a weaker coalition led government. Thus, any swing towards a clearer verdict can be an important development. This of course assumes that the present situation does not escalate into a full-fledged long-drawn out conflict which can impact the economy, fiscal balance and hence corporate earnings.

In the context of elections per se, it's interesting to note how slowly the fundamentals reacted to the last election results in 2014 which delivered a clear mandate. We list two examples which amply highlight the reducing importance of a strong government for fundamentals and earnings.

- Banks:** While the extent of the problem was known in the stressed asset cycle, it took multiple rounds of asset quality reviews and watch lists and finally new round on legislation in the form of Bankruptcy Code to tame the problem. It did not happen in the first year, rather the results are now visible only in the last year of this government's tenure.
- Private Capex:** Despite the initial euphoria and the acceleration in the public sector capex, private capex took its time and it is only now somewhat responding to the gradual rise in capacity utilisations. High leverage in corporate balance sheets and reduced funding support has also resulted in this delayed response. In other words, capex cycle has followed economic logic rather than political sentiment and is even now well short of a big-bang capex cycle.
- Rural consumption:** It has seen a remarkable last 2-3 years and given the focus on the farm incomes is likely to get continued support from the future governments as well.

Forward PE premium(%) – Nifty50 vs. Emerging Markets (MSCI EM)



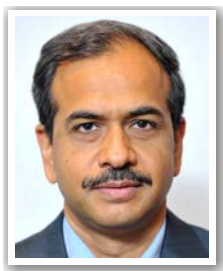
Source: Bloomberg, Kotak Institutional Equities

Similarly, parts of the auto sector have made cyclical highs and are going through a period of uncertainty. Drivers of IT and Pharma earnings in contrast are generally not directly correlated with domestic political scenario except the USD/INR. The earning drivers for FY20 and beyond are therefore dependent on structural trends in each of the sectors which have taken time to unfold and at times independent of the political dispensation.

The above discussion does not imply that country can do with (or market likes) a weak government, but Stability appears to be more important than Strength.

In such a backdrop and given that the India's valuations are still at a healthy premium, we continue to focus on sectors that are likely to lead the earnings recovery in FY20 and companies that are either entering or in the midst of an earnings upgrade cycle. That can be the only insurance for equity portfolios against an evolving macro.

Happy Reading!



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