From the CIO's Desk

TATA MUTUAL FUND

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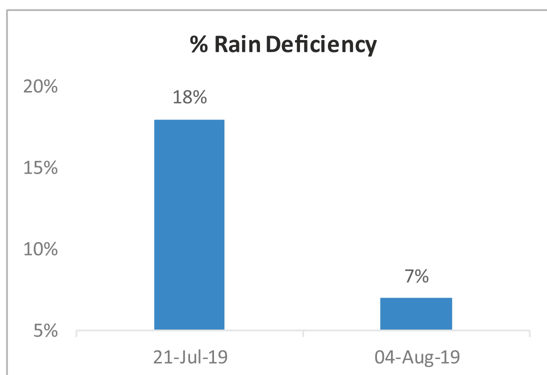
Will the heavens open up one more time

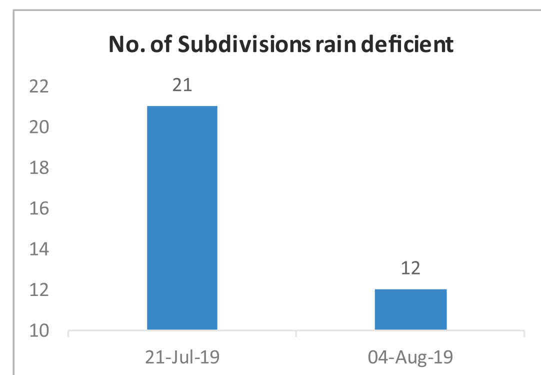
The ongoing results season has confirmed what we have been seeing and saying for a while - broad consumption is slowing down especially in rural areas. But there were two interesting comments in the post-results interaction of the companies that we particularly wanted to focus on in this newsletter.

1. The largest FMCG company hoped for "god send" pick up in monsoons (among other things) for a meaningful recovery in demand.

2. The largest public sector bank hoped for a divine intervention to get one of the large bankruptcy resolution cases to move faster.

While the first wish has been granted with the pickup in monsoons and the deficit narrowing from 18% two weeks back to 7% now, the second issue is more symptomatic of what's plaguing the economy now.





Source: India Meteorological Department

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It is critical for the bad debt resolution to pick up pace as the second leg of non-performing loans (NPL) formation seems to be gradually taking shape, triggered by almost a year-long squeeze in the credit markets. This new phase of NPL formation in corporate loans (although lesser in quantum) has surfaced in some banks during last quarter and included the stress related to securitized lending. Even some of the consumer finance companies have reported moderate slippage in asset quality in personal loans prompting a conscious slowdown in loan disbursements which can further constrain consumption demand. While the amendments to the Bankruptcy Act (priority of creditors, new deadlines including legal process) is a welcome step, it is critical for the older generation NPLs to resolve quickly given the slowing economy and frozen credit markets. While we continue to like corporate banks given the improving return ratios and moderate valuations, markets will likely become more selective in terms of which managements to back.

As of now, domestic economic outlook seems to be worsening faster than the global economy. Also, global trade war dynamics continue to be volatile which can exert pressure on INR. As opinion and evidence remains divided on a pharma sector turnaround, IT services can emerge as a safer candidate with the modest earnings growth outlook getting some support from weaker INR.

Meanwhile, despite the consumer slowdown, certain companies continue to beat the trend either due to superior execution, market share gains or simply, low expectations (which leads to earning upgrades). We continue to look for those opportunities and own them in our portfolios.

The silver lining for Indian equities remains the low interest rates and stable inflation. While Nifty earnings growth in FY20 is unlikely to meet the expectations of ~25% growth (downgrade of 5-10% likely), lower bond yields (read lower cost of equity) will provide floor to market valuations apart from gradually seeping through the economy and helping in demand recovery. In that context, current Nifty P/E of 17x 12-month forward earnings, is trading just above the 10-year average indicating manageable downside. Global slowdown can surprise negatively too given the recent announcement of US tariffs and China's currency devaluation. This can elevate India as a relatively safer investment option. One of the results of the domestic slowdown has been a subtle shift in the leadership within the large caps. Quite a few of market leaders from 2018 have had a mixed 2019 given earning downgrades and macro risks. This phase could continue for a while before a broad market pick-up in mid and small caps, timed together with recovery in economic activity.

Happy Reading!

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