From the CIO's Desk

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TATA MUTUAL FUND

A week is long time in politics. And a month even longer in markets.

In our March newsletter, we had anticipated that a simmering conflict at the border will increase the chances of a clearer verdict in the general elections and will hence reduce the event risk. But the pace and extent of the market gains have surprised us also notwithstanding the lowered risk of a "hung parliament".

While we continue to favour corporate banks (a consensus view now) and closely follow the green shoots in private sector capex, we wanted to highlight a couple of broader trends which could define the markets in the new financial year.

I. Cyclicals vs Defensive

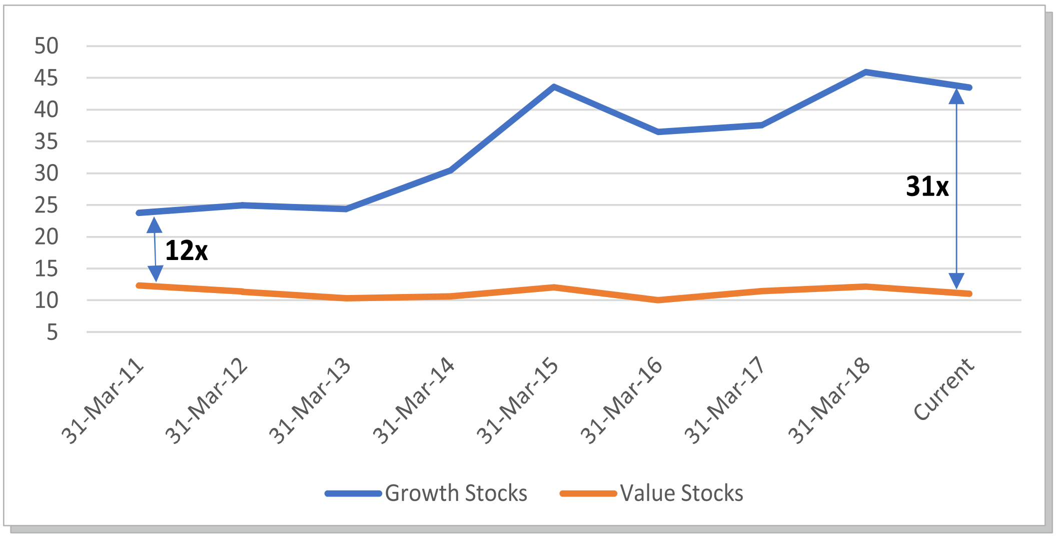
Given the sharp correction in valuations, it can be argued that some of the cyclical sectors like Capital goods, Engineering & construction and real estate were already factoring in a bleak election outcome and hence the upside was/is much more from a clear verdict.

In the meanwhile, the return of easy global liquidity and lower rates could further support the cyclical recovery and respective valuations in India. While this is accompanied by increased probability of a global recession somewhere down the line, that is also contingent on how other events like the outcome of US-China trade talks unfold.

II. Value vs Growth

It is quite clear that valuation re-rating in growth segments have been significant in last few years while "value stocks" have seen virtually no PE expansion (see chart). Low global yields and hence willingness to pay extra for visible growth in a slowing world has often been cited as the reason for this dichotomy but some of the above logic holds true for th value segment too especially as global rates are now likely to stay lower for longer.

12M Forward PB/PE Multiple (X)



Source: Kotak Institutional Equities

The reasons for the above dichotomy between Value & Growth (atleast in the Indian context) have been multi fold but two key factors stand out.

i) Earnings upgrade cycle in consumption - Strong rural growth, GST related cost savings and soft input costs have led to significant beats on earning expectations over last 18-24 months in the consumption related sectors. This has also led to sustained growth in other supporting sectors like retail banks and NBFCs (atleast till the recent liquidity squeeze).

ii) Technical overhang of promoter (read government) selling in PSU stocks - Fiscal constraints have led to a peaking of stake sales through the OFS and ETF routes in PSUs

While the jury is still out on how long the earnings upgrade cycle can continue in consumer staples/discretionary, there is definitely a case for more selective approach as the noise around slowing rural growth and high base effect is now figuring in the discussions. In addition, there could be a hiatus in supply in the PSU stocks some of which are also benefiting from near term triggers, removal of regulatory overhangs and earning upgrades, especially in the utilities and banking space.

Moderate index returns but wider markets

We continue to believe that the new financial year would offer moderate returns at the index level and therefore the continuous search for new segments that can outperform the market. In that context, favourable macro conditions for "Value" and "Cyclicals" to outperform will provide greater market breadth this year vis-à-vis 2018.

Even as the global macro unfolds and domestic risks recede, our basic investment approach remains unchanged i.e. growth at reasonable price. More specifically, we continue to evaluate sectors and stocks that offer

i) value with triggers and,

ii) possibility of earning upgrade cycle vs. expectations.

Happy New (Financial) Year!

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