

Strong Inside, Soft Outside

Like we said at the beginning of 2022 ([Lasting Impressions](#)), this newsletter is no different and does not provide easy and catchy predictions like "Nifty 50 at end-2023 will be xyz". All predictions in equity markets are some combination of the moving averages of what has happened in the last 12 months (trailing twelve months in the market parlance) and what is expected to happen in the coming 12 months (forward 12 months) or longer. Equity market predictions are a moving target and impressions change, for macros, sectors and investment styles. We therefore devote this newsletter to analysing these changes in (i) sectoral views apart from the (ii) impact of macro scenarios (esp. in Developed markets/China) on Indian equities.

First, let us recap the current sector outlook in brief, which remains critical for generating alpha, more so in 2023. And all our past editions have carried these views at various points of time. Our portfolio actions mirror the below with the broad-based nature of the sectoral trends being reflected in more diversified portfolios across our schemes than 12 months ago.

- Banking sector has started to get its due with all the three levers of profit growth firing i.e. credit growth, margin expansion and lower credit costs. Significant re-rating has happened too in 2022 but there can be more to go in the second tier, mid-size and/or PSU banks if the trends sustain. Risk on margins and credit growth from global slowdown are key risks in 2023 while credit costs may remain under control; a new NPL cycle takes time to develop (assuming no external shocks) and generally happens after 2-3 years of strong growth.
- Capital goods and manufacturing delivered on its promise and looks good for more especially in mid/small caps as India continues to emerge as the sourcing hub across segments. This trend has a lot of tailwinds (China + 1, geopolitics, government policy, domestic capex recovery) and can become the driver of GDP and earnings growth over the medium although one leg of valuation re-rating has happened here too.
- Urban consumption in general has sustained very well, much beyond the "revenge buying" that was supposed to create a peak in consumption some time in the middle of 2022. Impact of inflation and interest rates needs to be watched though. Rural consumption, in contrast has relatively low visibility of a demand recovery but could surprise as the effects of urban activity slowly trickles down.
- IT services growth looks set to slowdown from the heady 15-20% growth to 5-10% in next fiscal year*. Margin pressures will ease but the present valuations still imply some caution barring as IT budgets for 2023 gets scaled down across Hi-tech, retail and EU regions. Trends from IT budgets and full year guidance for FY24 will be key even though profits might be protected somewhat by better margins.
- Real estate became a consensus positive view in 2022 but any demand destruction from higher interest rates needs to be watched although history of a similar rate cycle (2003-08) suggests that might be some time away
- Slew of services sectors like Travel, Leisure/Hospitality and Healthcare (esp. hospitals) continue to do well and have resumed their secular growth trendline which was disrupted during Covid. There is also a return of pricing power in these segments, a trend which was expected to play out in 2020 before the pandemic hit.
- Pharma sector spent another year weathering the price pressures and remains a stock specific sector for now.

There were two other major trends that defined equity markets in 2022 and likely to sustain in 2023.

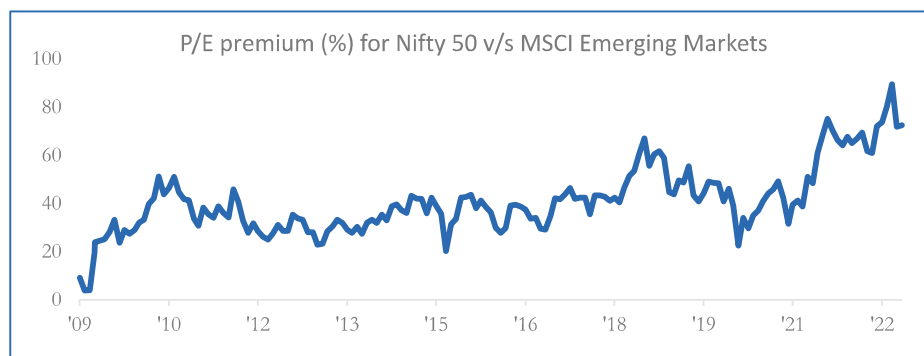
1. **GARP vs. Value vs. Growth:** High interest rates have finally started to seep in equity valuations (less so for India) and the investment decision making. Valuation consciousness has returned as evident in the relative performance of value stocks (PSU, utilities, banks) vs. growth (Internet, Consumer). With Fed insisting on interest rate "Plateau" instead of "Pivot", this behaviour change can last longer.

**Source: Tata AMC estimates*

2. **ESG vs. non-ESG:** The relative need for energy security in the wake of geopolitical uncertainty has somewhat dampened the ESG phenomena which had pushed certain sectors (fossil fuel, defence) in value category. While ESG and green energy as a long-term trend is here to stay, there is a growing realisation to balance it with investments in the legacy energy assets.

Relatively Stable India in an unstable world

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 can drive above-par GDP growth (~6.0%) and earnings growth (~15%) over next 2-3 years*. The 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. It is therefore not entirely surprising that these factors have led India's valuation premium over other emerging markets to reach historical highs (see chart below).



At current valuation premium, India's relative performance in short term and in 2023 becomes a function of what happens to the rest of the world i.e. shallow vs. deep recession in US/UK/EU and the pace of recovery in China post-reopening. A shallow recession in US/UK/EU combined with slow recovery in China may be the best-case scenario for India as it can sustain India's valuation premium with limited impact on corporate profits. A deep recession can have follow through impact on Indian economic growth even though it will reduce the inflationary pressures from input costs. In contrast, a global rebound led by China would reduce India's valuation premium irrespective of strong domestic fundamentals. A simplified view of these scenarios is summarised in the schematic below.

| | | |
|-------------------------------|---|---|
| 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 lower 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 from higher input prices Valuation: Premium will shrink although absolute valuations might sustain |
| | Slow Recovery in China | Sharp Recovery in China |

How are we placed?

The above discussion and framework also brings us back to our inaugural newsletter from November 2018 ([Swimming not Running](#)) which compared equity investing to swimming which has more elements (read valuation rigour, portfolio balance) than just running (read growth..at any price). In the current macro-economic backdrop, Tata AMC's investment framework of Growth at reasonable price – GARP ([How we do what we do?](#)), which relies on risk-reward criteria and defined segments makes it well placed for the current investment climate. This cannot be emphasised enough in the light of what has happened in 2022 and what looks likely in 2023 given the various moving parts as explained in the previous section.

*Source: Tata AMC estimates, Bloomberg

Here's why.

Valuation rigour akin to full body exercise: It is no longer enough to count on earnings growth and ascribe a higher PE multiple. The recent valuation history at the sector and company level will have to be weighed against the longer-term averages and adjusted for a higher interest rate environment vs. last 10 years. In other words, the valuation exercise will become more rigorous, a bit like the full body exercise that swimming requires vs. running.

Breathing: Getting the discipline, coordination and breathing right will be key and not just moving the hands and legs faster. There will always be periods when running faster would deliver better results like in 2021 or 2017, but chances of that appear less in 2023 as we enter higher interest rate regime.

Variety: Our approach is primarily that of bottom-up stock selection with a combination of

- (i) Earnings upgrade cycle leading to re-rating
- (ii) Value with triggers
- (iii) Exposure to emerging macro themes

A bit of variety will therefore help the portfolio construct like the different strokes of swimming.

Float: Lastly, despite best efforts, short term moves in the portfolio stocks may not always make sense as risks arising out of global macros (extent and nature of recession, geopolitics) are inherently unpredictable. The portfolio construction therefore will have to make sure that it stays afloat in an uncertain period ahead of us.

In summary, our advise to investors in 2023 would be to:

- i) Maintain a healthy mix of debt & equity,
- ii) Keep core allocation in Balanced Advantage Funds,
- iii) Look for alpha in funds that are based on GARP/Value
- iv) Exposure to schemes benefiting from broad-based economic growth & investment cycle

Wish all the readers a very Happy New Year.

Happy Investing!



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