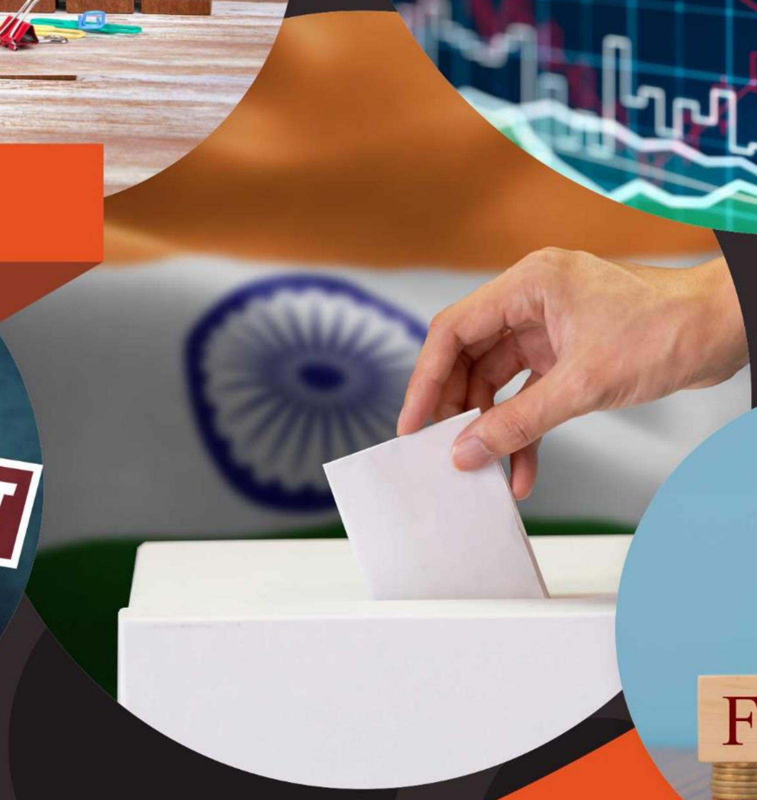
December 2019

MARKET OUTLOOK

2019-20



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MARKET OUTLOOK FOR DECEMBER 2019

Series of intervention by the Finance Ministry in the last two months has changed the mood of the market. After the reduction in corporate tax rate, earnings have picked up in Q2FY20 and FPIs have turned positive on India. There has been a disconnect between the macroeconomic environment and markets, which could stay for some time as high frequency indicators are not showing any signs of macro improvement. The current downturn is partly due to structural factors and thus, mere fiscal and monetary stimulus may not be adequate to revive the economy. Sentiment and FPI inflows are driving markets even though most leading macro indicators are weak and the slowdown looks more structural than cyclical. NSDL data shows, FPIs have infused a net amount of Rs 242 bn into equities in November 2019. Future FPI flows will mostly depend on both the global and domestic headwinds and how the government tackles the ongoing slowdown in the Indian economy.

The Indian market's high valuations are also supported by a combination (1) low global and domestic bond yields, (2) market expectations of a China-US trade deal and possible global economic recovery on the back of that, (3) market expectations of further reforms in India, perhaps emboldened by the corporate tax cut and (4) Street expectations of strong earnings recovery over FY20-22.

In the backdrop of the results of the recent assembly elections in Maharashtra and Haryana and upcoming state elections, it would be interesting to watch the government's response to a weaker-than-expected performance in these two state elections post a thumping win in the national elections less than six months ago. It may push the government to expedite policy measures to address the ongoing economic slowdown. The market is also hopeful of a cut in individual income tax and/or GST rates and several consumer discretionary (automobile) stocks have rallied on the back of rising expectations of a fiscal stimulus to consumption. However, we are not ruling out the central fiscal deficit slipping closer to 4%. versus the budget target of 3.3% as (1) tax revenues have been largely stagnant with GST revenues flattish since the inception in July 2017 and (2) the government cut the corporate tax rate in September 2019. The government may also struggle to meet its non-tax revenues without acceleration in the divestment program. We also believe that, India's high consolidated fiscal deficit may constrain the ability of central and state governments to spend on infrastructure investment. The government may have to implement major reforms in (1) the factors of production to increase investment in manufacturing and (2) the ownership and pricing policies to increase private sector investment in infrastructure.

The Nifty-50 Index is trading at 22.4X FY20E earnings (free-float basis) and 17.7X FY21E EPS earnings. This high valuation is a big risk factor for the market as we remain sceptical about any quick recovery in the economy given structural challenges. The underperformance of the Small Cap index relative to the Nifty-50 has come closer to its three previous instances seen in the last 15 years. Similarly, on valuations, the Fw PE of Mid Cap Index is trading at a 12% discount to the Fw PE of Nifty-50. This portrays the future upside potential in mid & small caps visa-a-vis the large caps.

For the mid & small caps to outperform the large caps we need a broad recovery in the economy with improved credit off take, better print of IIP & GDP growth. Hopefully, if the forthcoming Union Budget provides some incentives to tax payers and investors then we could see a broader rally in the market which could then revive interest in the mid & small cap space. A base for future outperformance of mid & small cap has been set in this calendar year which could fructify in next calendar year as and when we see broader recovery in the economy. It is ideal to increase exposure in mid & small caps vis-à-vis large caps in one's portfolio with a two to three year view.

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