Market Outlook

October 2020

- US dollar index
- Fed Policy
- US Elections
- Covid-19
- Inflation
- Economic Recovery
- Top Picks

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MARKET OUTLOOK FOR OCTOBER 2020

In September month, major markets witnessed profit taking as negative sentiments soured on Fed's comments on weaker-than-expected economic recovery, increase in fresh Covid-19 cases in developed markets (fear of re-imposition of lockdown) and uncertainty over US stimulus package. Going ahead, we expect market volatility to continue as the 2020 US presidential election is just 5 weeks away. Notably, long awaited coronavirus relief proposal has been unveiled by Democrats which is a new slimmer ~US$2.2 lac cr proposal which includes funding for schools, small businesses, restaurants, airline workers, etc. Notably, World Health Organisation said that global COVID-19-led death toll could double from nearly 10 lakh if the countries don't uniformly work to reduce the virus spread. The Fed kept its policy rate unchanged and expects them to stay there until at least the end of 2023, and until the economy returns to maximum employment and inflation has risen to 2% and is on track to moderately exceed 2% for some time. With the rising geopolitical tension, global trade and supply chains will face further challenges more precisely from UK-Europe post-Brexit and China's policy of decoupling.

Expectations of a stimulus package from the government and firm global cues helped Indian markets to recover from the sell-off. The BSE-30 and Nifty-50 indices fell 1.5% and 1.2% in September while BSE Mid-cap and BSE Small-cap indices gained 0.3% and 3.7%. Investors are eyeing the RBI monetary policy and awaiting a second stimulus package from the government side before the festive season. We believe the Monetary Policy Committee's stance will continue to be accommodative and supportive of economic growth, although we may not see any rate cut. Inflation remains at elevated levels, but with normal monsoons and higher agriculture output, it should moderate through Q3FY21. We are now in a critical phase of India's recovery - high frequency data shows that many segments of the economy are moving and are reaching close to 70/80 percent of pre-COVID levels. Demand revival is crucial to sustaining the green shoots in the economy. In fact, more money in the hands of urban poor, greater government spending on healthcare and rationalization of GST rates are the need of the hour. To attract investments, India should leverage the opportunities arising out of the geographical shifts in global supply chains.

FPIs who were consistent buyers between May to August turned net sellers in September with outflows of US$ 58.7 cr. FIIs have been net sellers in most emerging markets in September and calendar year to date while being net investors in developed markets. DIIs who were aggressive sellers in July & August have toned their selling in September with net selling of US$ 63.7 cr. The equity mutual funds had seen outflows between July & August primarily on profit-booking by investors. The redemption pressure could be one of the main reason behind DII selling in July & August months. As per AMFI data, the number of folios with 45 fund houses rose to 9.25 cr in Aug'20 from 9.21 cr in Jul'20. The mutual fund industry added 4.5 lakh investor accounts in Aug'20 primarily on account of contribution from debt schemes.

Earnings Outlook

In Q1FY21 net profits of the Nifty-50 Index declined 31.7% yoy versus our expectation of 29% decline. 1QFY21 net profits of our coverage universe declined by 42% yoy versus our expectations of 46% yoy decline. The continued increase in Covid-19 cases will restrict activity in the labor-intensive services sector, which in turn, will cramp recovery in household income growth and thereby consumption. Household income growth had already started to slow well before the Covid-19 outbreak and Covid-19 pandemic will exacerbate the slowdown. Economic activity is recovering but at a slow pace. India is still to get out of the 'contraction' phase in the crucial labor-intensive services sector. Going forward the steep recovery in FY22E will be mainly driven by automobiles, banks, metals and telecom stocks. Based on updated numbers we expect earnings of Nifty-50 Index to be flat in FY21 and then rise by 34% in FY22E and 19% in FY23E. Our updated Free Float EPS for Nifty-50 stands at Rs.454 for FY21E, Rs.608 for FY22E and Rs.726 for FY23E. Due to consistent cases of coronavirus we may see further earnings revision across the board as we grapple with the pace of economic recovery both globally and domestically. On the economy side we have already seen reduction in FY21E GDP from earlier (-) 5.8% to revised (-) 11.5%.

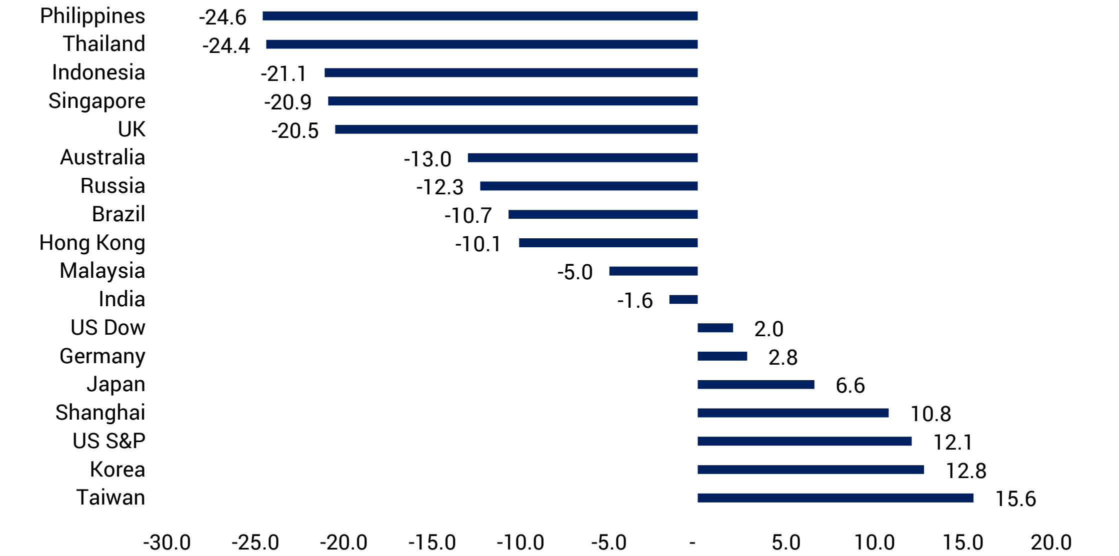
Valuation and Outlook

Quarterly numbers and FY21E may be less relevant with the focus of the market on recovery in demand and valuations already discounting a sharp recovery in the economy and earnings in FY22. The risk-reward balance is muddled at current prices with the Nifty-50 trading at 21.3x on year forward basis. As we go ahead the Fw PE will keep coming down as more months of FY22 get captured in future estimates. Going ahead a lot will depend on the performance of the financial sector as they are one of the major drivers of FY22E earnings. The earnings trajectory of financials in turn will depend on the extent of normalization of economic activity over the next few months. Markets are obsessed with near-term recovery while ignoring medium term growth drivers such as household income, investment and jobs, which are relevant in the context of rich valuations of certain consumption stocks.

'Covid-proof' stocks (i.e. consumer staples, IT, pharmaceuticals, telecom) are fully valued on FY22E basis, 'Covid-recovery (i.e. automobiles, capital goods, consumer discretionary, financials) are under-valued or over-valued depending on the strength of the economy recovery and 'value' stocks are inexpensive but lag triggers in most cases. Unlike the Nifty-50 which is trading at historic peak valuations of Nifty Bank Index is trading near its lowest valuation band. Banks are valued on Price-to-Book Value basis and on Fw basis the Nifty Bank is trading at 1.4x as compared to its ten year low of 1.2x and ten year peak of 2.8x. The Nifty Bank Index is still looking weak due to uncertainties related to potential NPAs and weak lending growth. However, if one takes a 2-3 years contra view similar to what IT and Pharma were trading two years back and keep accumulating banking stocks in every decline then it can provide good returns in the next 2-3 years. The average one year upside of 18 banks that we cover works to 50%.

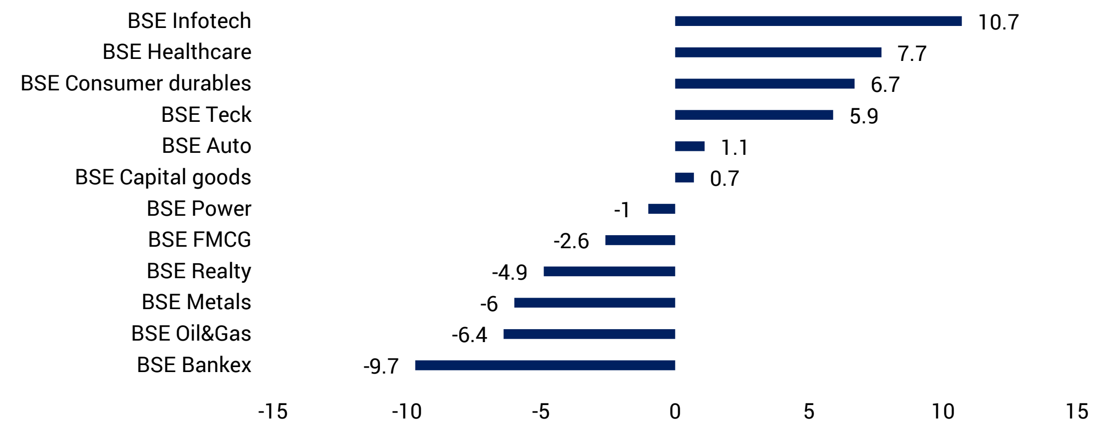
We would be more comfortable assigning a Fw PE of 18-19x to Nifty-50 as our valuation benchmark. This means the market is still not very appealing. It is ideal to have an accumulation strategy at every decline in the next few months as we don't know the outcome of US elections and impact of second wave of Covid-19 in different parts of the world. We advise investors is to remain invested in quality and growth stocks and avoid value traps as we are still not out of the woods and recovery could be uncertain. In terms of market orientation we see less value in mid caps as the Nifty Midcap 100 Index is trading higher than Nifty-50 in terms of valuations. However, in case of small caps there could be many interesting opportunities on a bottoms up basis as the universe of stocks is quite diversified and large. It is worth doing individual stock picking in the small cap space at this juncture with the intention of adding more in case they fall sharply along with the benchmark indices.

1-year performance of benchmark global indices



Source: Bloomberg

1-month BSE sectoral performance



Source: Bloomberg

TOP INVESTMENT IDEAS

Company	Rating	Price (Rs) 30th Sep 20	Fair Value (Rs)	Upside/ Downside (%)	Mkt cap. (Rs Cr)	EPS (Rs) FY21E	EPS (Rs) FY22E	EPS growth (%) FY21E	EPS growth (%) FY22E	P/E (x) FY21E	P/E (x) FY22E	P/BV (x) FY21E	P/BV (x) FY22E	RoE (%) FY21E	RoE (%) FY22E
ICICI Bank	BUY	355	470	32	2,446	27	30	16.6	10.9	13.2	11.9	1.7	1.6	12.9	13.0
Kalpataru Power	BUY	245	470	92	38	39	44	57.4	11.8	6.2	5.5	0.9	0.8	15.4	15.1
L&T	BUY	902	1,210	34	1,266	67	79	91.1	18.0	13.5	11.4	1.7	1.6	13.1	14.2
Berger Paints	SELL	581	430	(26)	565	9.4	11.1	51.7	18.2	62	52	15.6	13.2	27	27
Tata Power	BUY	53	70	32	170	6.3	7.1	42	12.9	8.4	7.5	0.7	0.6	8.5	8.8
HCG	BUY	120	150	25	15	(2.4)	(1.7)	73	27	NM	NM	1.8	1.9	NM	NM
Mindtree	REDUCE	1,339	980	(27)	220	62.5	67.0	14	7	21.4	20.0	4.9	4.2	25	23
Castrol India	BUY	109	165	51	108	8.9	9.7	75.0	9.1	12.3	11.3	7.7	7.6	63.0	67.5
Adani Ports and SEZ	BUY	341	400	17	693	21.9	23.8	16.9	8.9	15.6	14.3	2.1	1.9	14.5	14.0

Source: Kotak Institutional Equities. For details refer to KIE India Daily report dated 30th September 2020; Note: Earnings season has started and KIE would be changing their earnings estimates, price targets and ratings of above companies as and when their results are out in near future.

INTERNATIONAL MARKETS

US Dollar Index rising

During the month, the US Dollar Index has strengthen by ~2% to 93.9 mainly due to concerns over the global second wave of Covid-19 cases, bleak economic outlook for the US & Europe and weak Euro (Euro is ~57.6% of the US dollar basket). Needless to say, a firmer dollar means investors seeking refuge in the greenback amid political uncertainty as US Presidential elections are due in Nov'20.

In general, dollar has inverse relation with commodities. Hence, strong dollar led to fall in commodity prices like Gold, Silver, industrial metals, etc.

In Sep'20, rupee has depreciated by ~0.42% as against US$ to Rs.73.56/US$. Among sectors, IT and Pharma are the key beneficiaries of rupee depreciation as they receive most of the revenue in US$ terms. On the contrary, imports will be costlier.

INR Vs USD

Source: Bloomberg

IHS Markit flash composite index

Source: IHS Markit and Bloomberg.

The IHS Markit flash US composite PMI index stood at 54.4 in Sep'20. US business activity continued to expand at a solid clip in Sep'20, outpacing a stagnant Europe and capping a vigorous third-quarter rebound for the economy. In Japan, business activity contracted for an eighth month.

Accommodative Fed Policy

The Fed kept its policy rate unchanged and expects them to stay there until at least the end of 2023, and until the economy returns to maximum employment and inflation has risen to 2% and is on track to moderately exceed 2% for some time. It will tolerate periods of higher inflation as it tries to revive the labor market and economy. It was the Fed's last meeting before the US presidential election. The Fed said again that the path of the economy will depend on the course of the coronavirus pandemic though.

The Fed also said it will continue to purchase at least US$12k cr per month of Treasurys and agency mortgage-backed securities to help smooth markets and help "foster accommodative financial conditions".

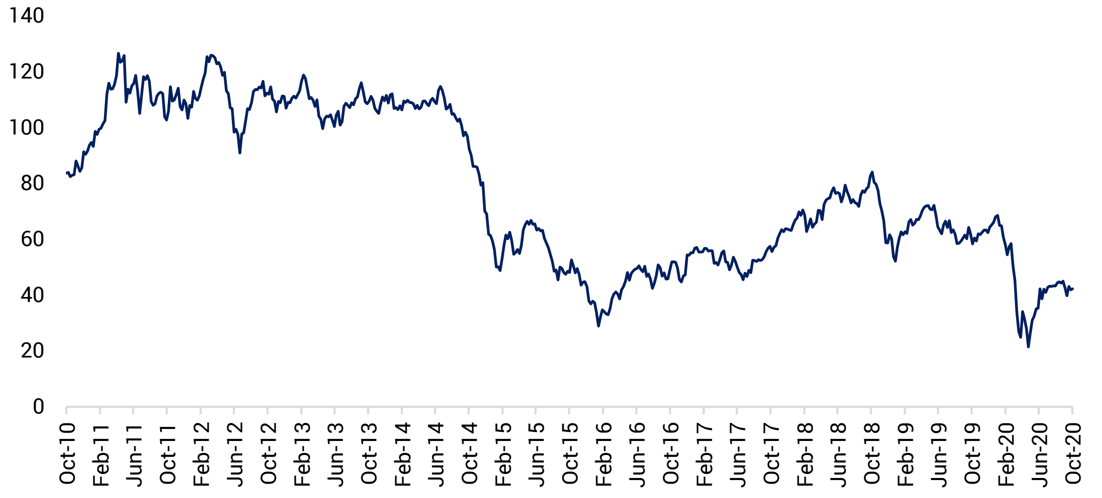
Japan – retained negative interest rate

Bank of Japan (BOJ) retained its policy rate at (-) 0.1% and to continue to cap 10-year government bond yields at around 0%. It pointed out that Japan's economic activity has started to pick up, although it remains in a severe situation due to the impact of Covid at home and abroad. It also expects short and long-term policy interest rates to remain at their present or lower levels.

Crude Oil prices

In Sep'20, Brent crude oil futures has moved lower by 9.56% to US$40.95/bbl due to global demand-supply mismatch. BP in its annual Energy Outlook 2020 said it saw an end to the relentless growth of oil globally. India's primary energy consumption growing by 2.5% between 2018 and 2050. This is better than 0.1% growth in China's energy consumption and 0.3% expansion globally.

Crude oil futures (USD/barrel)



Source: Bloomberg

DOMESTIC MARKETS

Update on economic developments

India's sovereign rating and outlook

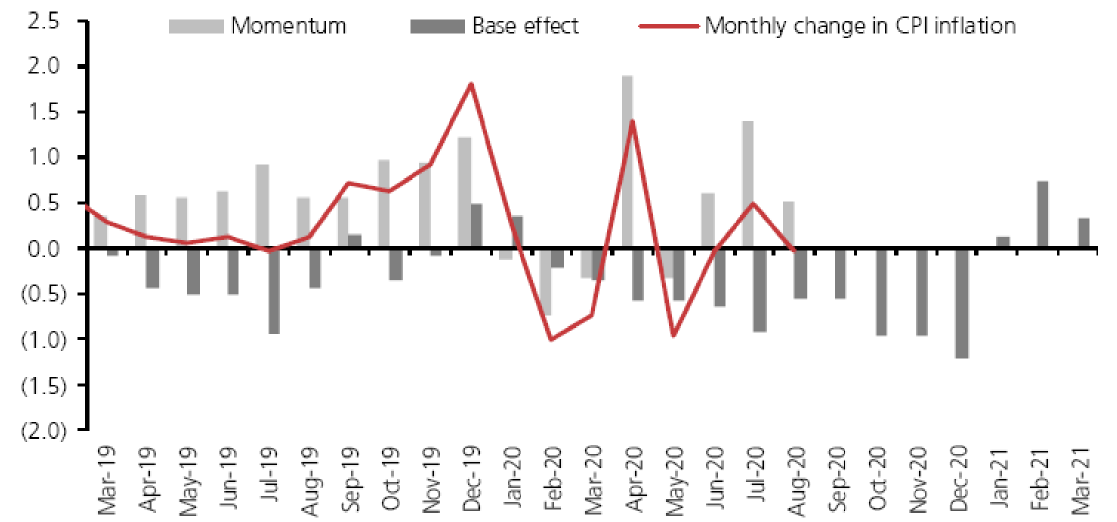
Notably, Standard and Poor's (S&P) has reaffirmed India's sovereign rating at BBB- and retained the stable outlook. It expects India's economy to recover following the resolution of the pandemic and that the country's strong external settings will act as a buffer against financial strains despite elevated government funding needs over the next 24 months. It added India's rating will be at risk if the recovery is significantly slower-than-expected from FY22 onwards or if net general government deficits and debt accumulation materially exceed its forecasts; signifying a weakening of capacity to maintain sustainable public finances.

MPC likely to stay on hold in the October and December policies

Aug'20 CPI inflation moderated to 6.69% as against a downward revised print of 6.73% for July amid a slight fall in momentum and favorable base effects. Food inflation remains elevated at 9.1%, even though it was marginally lower (9.3% in July). Despite weakness in economic activity, core inflation remained unchanged at 5.3%. Core inflation was fueled by inflation in the personal care segment (14.5%) and in the transport and communication segment (11%). Even as the moderation in headline CPI inflation is encouraging, it remains well above the RBI's upper limit of 6%, weighed by supply-side disruptions, gold prices and idiosyncratic factors related to excise duty hikes. Given the MPC's (Monetary Policy Committee) guidance related to awaiting a durable reduction in inflation before easing its monetary policy further, we expect the MPC to stay on hold in the October and December policies.

Slowing momentum and favorable base effects led to a lower CPI reading in August

Trend in momentum, base effect and monthly change in CPI inflation (%)



Notes: (a) Momentum is mom growth while base effect is 12-m prior mom change with signs reversed; Source: CEIC, Kotak Economics Research

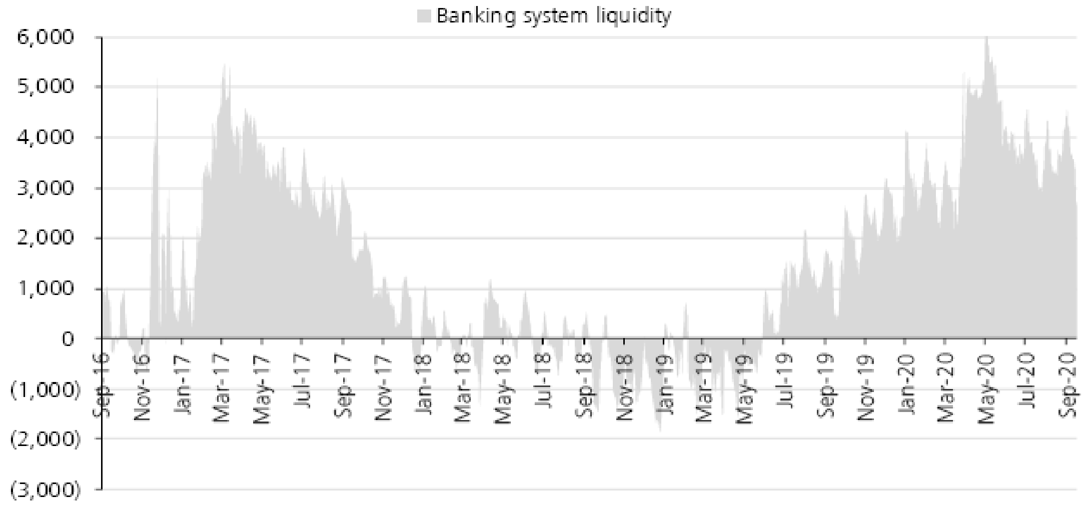
Excessive flows, bond supply and elevated inflation; strong INR. Expect USD-INR 74.2 for FY21.

Currently, RBI faces three excesses - surplus banking system liquidity, huge BOP surplus and risks of higher government borrowing. With downside risks to growth persisting as Covid cases continue to surge, need for further fiscal support and hence RBI's support to bond market becomes more compelling. The dilemma becomes starker as inflation remains above 6% restricting RBI's ability to infuse liquidity. The RBI will need to reduce spot FX intervention. We estimate FY21E current account at 0.9% of GDP. We expect central GFD/GDP at 8%.

Based on the above, we believe the RBI will possibly have to contend with some INR appreciation given the need for supporting fiscal space on the back of downside risks to growth. Hence, we see USD-INR between 72-75 for the rest of FY21E and averaging at 74.2 for FY21E.

Banking system has been in surplus liquidity for past few months

Trend in bank system liquidity (Rs bn)



Source: CEIC, RBI, Kotak Economics Research

India 10-year benchmark yield likely in the range of 5.90-6.10%

We expect the benchmark 10-year G-Sec yield to trade in the 5.90-6.10% range in the near term. The government will raise Rs4.34 lac cr in H2FY21 until January-end, taking the cumulative FY21 borrowing to Rs12 lac cr. While the short end (2-year and 5-year) will have total issuance of 20.3%, bulk of the supply will be concentrated in the belly of the curve (10-year and 14-year), which will account for 44.5% of the total supply

Moving towards an objective, system-driven NPL classification and provisioning

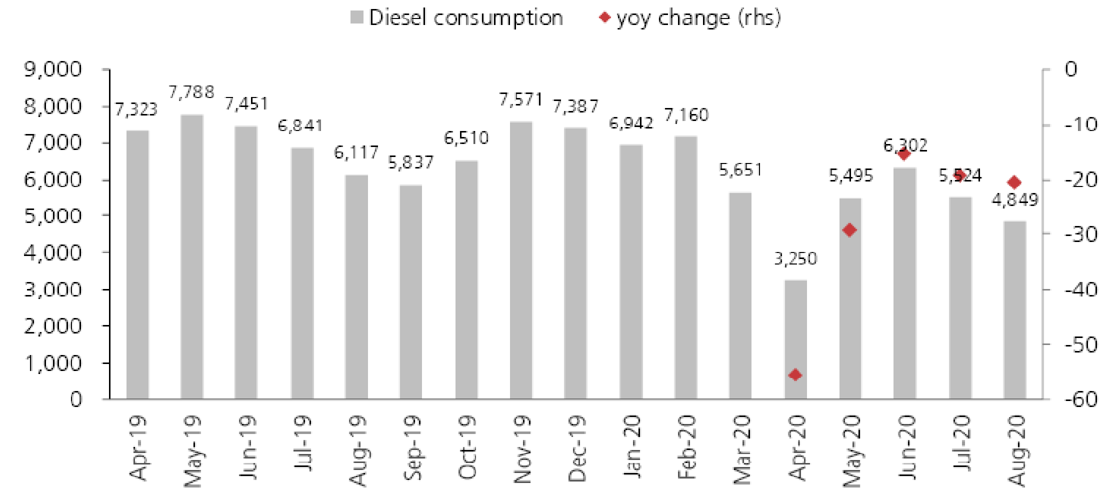
RBI's circular mandates banks to implement automated processes for NPL identification and provisioning through use of IT systems. Further, upgrade/down-grade of accounts and income recognition/de-recognition for NPLs need to be system driven. Banks should ensure that the asset classification status is updated as part of the day end process. Banks need to comply by June 30, 2021. Daily recognition is likely to result in higher movement in NPLs on the back of higher slippage and higher upgrade/recovery. As such, this guideline is unlikely to have meaningful earnings impact as we see it already in place but daily recognition is likely to result in higher movement in NPLs on the back of higher slippage and higher upgrade/recovery.

High frequency indicators shows steady improvement in most indicators

More than six months have elapsed since the announcement of the first lockdown. We find that (1) electricity consumption over the past seven days was 14% higher when compared to a similar period over the previous year; (2) UPI and IMPS transaction values continue to be strong in fourth week of September, (3) daily average import duty collection in September is higher than that of August, and (4) railway freight volume was up both mom and yoy in September.

Petroleum consumption is another proxy of economic activity. We track this using data released by Petroleum Planning and Analysis Cell (PPAC). Monthly data shows that consumption of motor spirit (petroleum) in June was already back to March 2020 consumption level. Petrol consumption increased marginally in August, compared to July. However, diesel consumption declined again in August, and diesel consumption in August was lower than the consumption in May.

Diesel consumption dropped again in August



Source: Petroleum Planning and Analysis Cell, Kotak Institutional Equities. Note: Monthly high speed diesel consumption ('000s metric tons) and year-on-year change in consumption (%).

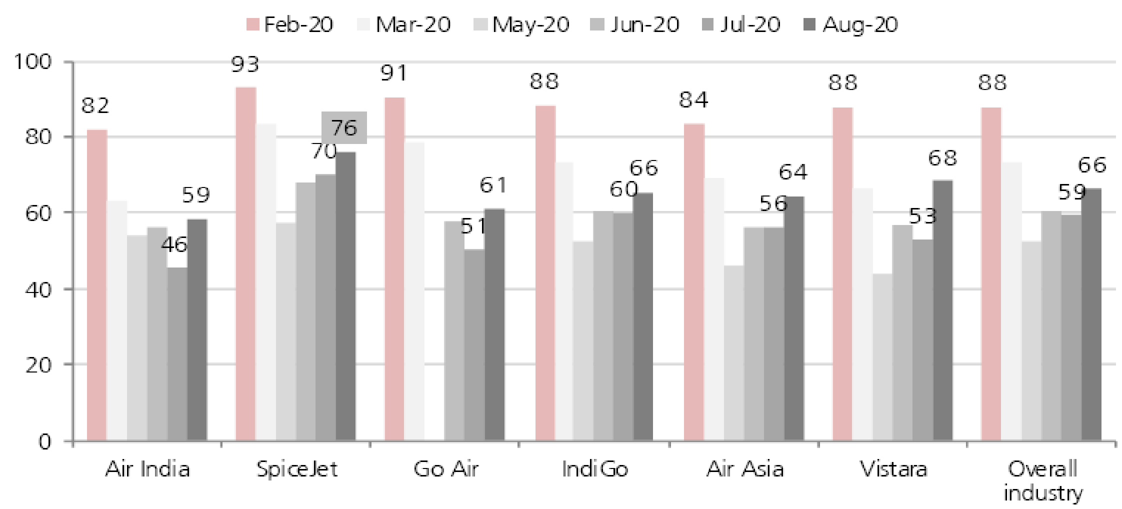
Air travel – gradual move towards normalization

August 2020 data from DGCA for domestic air travel suggests traffic moving to ~25% of pre-Covid-volume levels, a more balanced return profile of passengers and lower instances of flight cancellations.

Domestic air travel declined 74% yoy in Aug'20 versus 82% decline in Jul'20. We note further improvement seen in Sep'20, with yoy decline reducing to 68% on a month to date basis. The bigger improvement in Aug'20 happened in the load factor that increased to ~66% for the market versus ~60% levels seen in the previous two months. Most airlines benefitted in terms of load factors with SpiceJet breaching 75% levels and Indigo/Vistara improving to 66/68% levels. Instances of single-journey air travel on account of the current unlock phase may still be reflecting prominently in the current hollow volume levels for the sector. The recovery in load factors may thus gather momentum during the impending festive season and then sustain at more normalized levels as overall volumes grow.

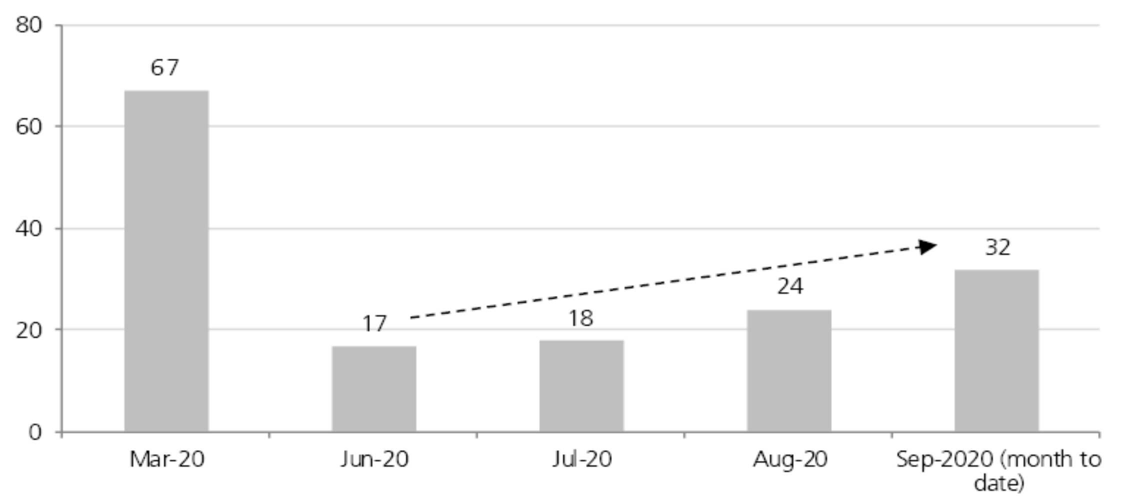
Load factors improve meaningfully in August 2020

Load factors for domestic air travel (%)



Source: DGCA, Kotak Institutional Equities

The sector operates at slightly above 30% of levels seen in the past year



Source: DGCA, Ministry of Civil Aviation, Kotak Institutional Equities

FY2021 monsoon: normal rainfall till now

Till September 23, cumulative rainfall was 8.4% above long-term average (LTA) while weekly rainfall was 39.7% above LTA. On a cumulative basis, spatial distribution of monsoon has been normal across most parts of India though parts of North and West India have been deficient. Out of the 36 sub-divisions, to date, four have received deficient rainfall, 19 have received normal rainfall, and 13 have received excess rainfall.

Cumulative rainfall till 23rd Sep'20

Region	Surplus/Deficiency (%)
All India	8
East & Northeast India	4
Northwest India	(16)
Central India	20
South Peninsula	23

Source: IMD and Kotak Institutional Equities.

Events to watch out in near term

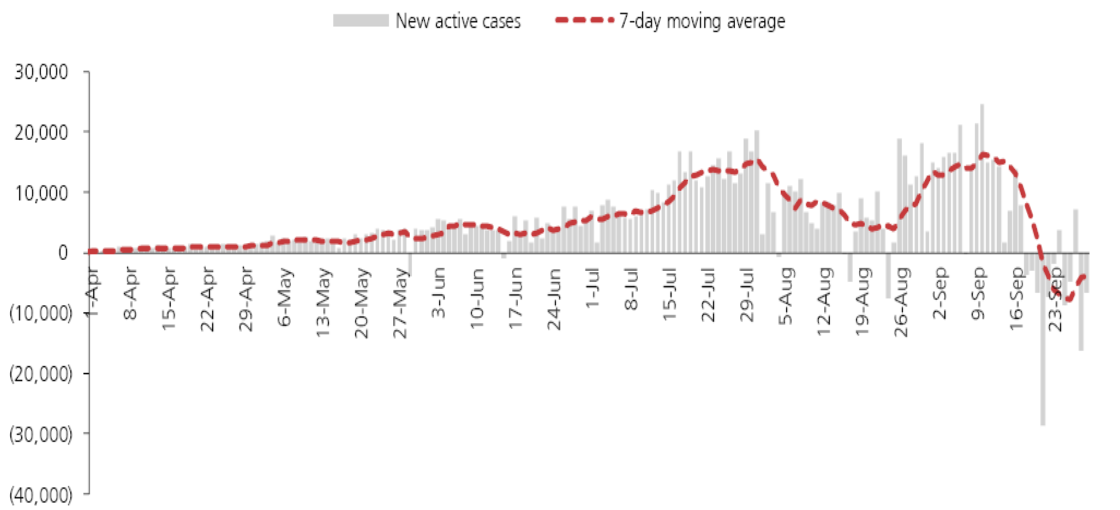
Covid-19 update in India as on 23rd September, 2020

In the recent days, significantly fewer daily new cases are witnessed. This, along with higher recoveries, caused a decline in total active cases in India. We note however that the reduction in daily new cases was driven by lower testing.

Key readings

- We continue to see an increase in the number of new confirmed cases. However, recoveries also continue to rise.
- Three-day moving average of new cases fell to 80,000.
- Unfortunately, the decline in number of new cases over the past week is at least partially driven by lower testing during the same period.
- The seven-day compounded growth rate of confirmed cases has been broadly falling since the announcement of lockdown. However, at this juncture, we believe that absolute numbers are a better metric to track than growth rates.
- Several restrictions were relaxed in lockdown 4.0. From June 1 onwards, there have been a further graded relaxations. We show that the positive sample rate trended downward in lockdown 1.0, stabilized at around 4% in lockdown 2.0, increased slightly in lockdown 3.0 and sharply in lockdown 4.0.
- Bengaluru continues to see a substantial increase in the number of new cases.
- Punjab's mortality rate has increased significantly in past two weeks.
- India's curve remains steeper than other countries; France and Spain are witnessing a second wave.
- India's mortality rate estimate increases to 1.9% if we take only closed cases (recoveries + deaths) in denominator.

Fewer new cases and more recoveries meant that number of active cases decreased in the past seven day



Source: Kotak Institutional Equities Report. Note: Daily change in active cases and their seven-day moving average, as on Sep 23.

Three labor codes approved - Social security, Industrial relations and Occupational safety

The Parliament approved three labor codes: (1) Industrial Relations Code, 2020, (2) Code on Occupational Safety, Health and Working Conditions Code, 2020, and (3) Social Security Code, 2020.

Some of the key changes are:

- Threshold for closure, layoff and retrenchment in firms has been increased to 300 workers from 100 workers with as many as 16 states having already increased this limit,
- Social security fund to cover all workers in unorganized sector,
- Broadening definition of migrant worker along with creation of database,
- Fixed term employees will be eligible for salary and social security benefits and can be hired directly by employers, along with other changes to the labor laws.

Experts believe these codes will allow industries flexibility in doing business, hiring and firing, make industrial strikes difficult while promoting fixed term employment, reducing influence of trade unions and expanding social security net for informal sector workers.

Additional borrowing limits to states. One-nation-one-ration-card system

The Department of Expenditure, under the Finance Ministry, has accorded approval to five states to raise Rs.9,913 cr in additional market borrowings for implementing the one-nation-one-ration-card system (one of the four reform conditions identified for availing additional borrowing window of up to 1% of GSDP (Gross State Domestic Product) in FY21).

- The permission has been accorded after these states successfully met the reform condition of implementation of 'One Nation One Ration Card' system.
- The additional borrowing limits are for Andhra Pradesh (Rs.2,525 cr), Telangana (Rs.2,508 cr), Karnataka (Rs.4,509 cr), Goa (Rs.223 cr) and Tripura (Rs.148 cr).
- In view of the unprecedented COVID-19 pandemic, the Centre had in May'20 allowed additional borrowing limit of up to 2 per cent of Gross State Domestic Product (GSDP) to states for FY21 with certain conditions. This made an amount up to Rs.4,27,302 cr available to the states.
- Of the extra 2%, only 0.5% is unconditional. After that, states will be allowed four increments of 0.25% subject to implementation of four specific state-level reforms, where weightage of each reform is 0.25% of GSDP.
- The four reforms are - implementation of 'One Nation One Ration Card' system; ease of doing business reforms; urban local body/utility reforms; and power sector reforms by privatising power distribution.

MSP for Rabi crops

The Cabinet Committee on Economic Affairs (CCEA) announced the Minimum Support Prices (MSPs) for rabi crops for FY22 marketing season with wheat at Rs.1,975/quintal (increase of 2.6%), barley at Rs.1,600/quintal (4.9%), gram at Rs.5,100/quintal (4.6%), lentil at Rs.5,100/quintal (6.3%), rapeseed and mustard at Rs.4,650/quintal (5.1%), and safflower at Rs.5,327/quintal (2.1%).

The highest increase in MSP has been announced for lentil by Rs 300 per quintal followed by gram and rapeseed & mustard by Rs 225 per quintal each and safflower Rs 112 per quintal.

The increase in MSP for Rabi Crops for marketing season FY22 is in line with the principle of fixing the MSPs at a level of at least 1.5 times of the All-India weighted average Cost of Production as announced in Union Budget FY19.

BP Plc Energy Outlook 2020 present several challenges and opportunities

BP Energy Outlook 2020 forecasts flat global oil demand over 2019-2030 in a business-as-usual scenario and decline in global oil demand in two other scenarios, flat-to-rising global gas demand in all three scenarios and decline in global coal demand in all three scenarios.

The projections of energy demand for 2020-50 by BP in its Energy Outlook 2020 present several challenges and opportunities for investors and policymakers both.

Interestingly, India's energy bill may remain low on the back of lower oil and gas prices and potentially even decline if it was to transition its economy to renewable energy from fossil energy currently. Currently, Fossil fuel energy accounts for 97% of energy demand of India.

Investors will have to grapple with ongoing and potential further loss of value in a portion of their portfolio without new opportunities elsewhere.

Energy companies account for almost 40% of the value of government holding in PSUs

List of PSUs with more than 51% government holding

	Market Cap.		Govt holding	Stake sale	
Company	(Rs bn)	(US$ bn)	(%)	Entire	up to 51%
ONGC	835	11	60.4	505	79
NTPC	818	11	51.0	417	0
Power Grid	834	11	51.3	428	3
Coal India	713	10	66.1	472	108
BPCL	818	11	53.0	434	16
IOCL	678	9	51.5	349	3
GAIL (India)	374	5	51.8	193	3
Others (non-financials)	2,713	37		1,980	596
Total non-financials	7,783	105		4,777	808
Total financials	3,608	49		2,569	729
Total	11,391	154		7,346	1,537
Share of oil & gas and electric utilities (%)	45	45		38	14

Source: Bloomberg, Kotak Institutional Equities. Market cap as on 23rd or 24 Sep'20.

SIPs

Systematic Investment Plans (SIP) flows have were steady, though a tad lower on a year-on-year basis. Strong SIP flows is a positive for the markets as it helps in providing support to the markets in times of FII selling.

Monthly SIP flows

Rs cr	FY21	FY20	FY19	FY18	FY17
Total	40,550	100,080	92700	67190	43920
March		8640	8060	7120	4340
February		8510	8090	6430	4050
January		8530	8060	6640	4100
December		8520	8020	6220	3970
November		8270	7990	5890	3880
October		8250	7990	5620	3430
September		8260	7730	5520	3700
August	7792	8230	7660	5210	3500
July	7831	8320	7550	4950	3330
Jun	7917	8120	7550	4740	3310
May	8370	8180	7300	4580	3190
April	8640	8240	6690	4270	3120

Source: AMFI

KEY SECTORAL OUTLOOK

Automobiles

Auto sector volumes saw recovery across segments (except Medium & Heavy Commercial Vehicle segment) in August 2020. This recovery was led by auto companies filling up of dealer channel inventory ahead of the festive season coupled with improving retail sales trend supported by pent-up demand. Tractor segment demand remained strong amid good monsoon and improving farm sentiments. Two wheeler manufacturers are witnessing recovery in sales volume due to improving retail demand and preference for personal mobility in current situation. For the passenger vehicle segment, demand is expected to gradually improve during the course of FY21. The M&HCV segment continues to be the laggard in terms of volume recovery.

Capital Goods

The sector has grossly underperformed the Nifty in the past six months. Several Capital Goods majors shared a weak outlook on near-term capex. Travel restrictions have been lifted but there is reluctance to travel - especially overseas, which is hindering order flow activity. For ordering activity to revive, the government needs to fast-track investments across segments such as T&D, power, renewables, railways, smart infrastructure, etc. to see results over a longer time-frame.

Consumer Products

The Fear of loss of jobs and income has made people circumspect even as things have started improving post unlock. Macro challenges continue to persist and companies are hopeful of a demand pickup by the end of this year or early next year. While the months of April and May continued to be weak, July/August saw mid-single-digit growth. There is high demand for personal wash products, household care and select food items. Margin outlook is positive with benign crude and other raw material prices (except dairy). Furthermore, low media intensity, strict control of overhead costs and Ind-AS 116 impact should help reported EBITDA margins, even as operating leverage will be a drag for most names. Rural is now growing faster than urban given (a) lower Covid-led disruption, (b) good harvest season and (c) government initiatives. Companies are taking initiatives to support distribution network – judicious deployment of credit to support trade and insurance for distributor partners, among others. They have further accelerated steps to drive digital adoption in the trade..

Construction

Construction companies under our coverage universe reported better than expected operating margin in Q1FY21 largely due to cost saving, though execution of projects took a hit due to Covid-19. We believe that there may not be any substantial improvement in execution in Q2FY21 for our universe despite improved labour availability on sequential basis. Strong monsoon season is expected to impact execution in Q2FY21. Most of the companies under our coverage have indicated significant improvement in performance from Q3FY21 subject to Covid-19 scenario in future. Ordering activity have shown improvement in the recent times and most of the companies are expecting good order inflows in the coming quarters, which will improve future revenue visibility. However, most of our coverage stocks in the sector continue to trade at a discount to their average forward multiple due to Covid-19 led risk on the business.

Cement

Sequential volume recovery has lost momentum and demand remains muted in August-September 2020. As per DIPP, demand declined 14% yoy in July 2020 and declined by 32% yoy YTD FY2021. July demand was sequentially weaker with demand decline of just 7% yoy in June 2020. Historically, cement prices correct by ~2-4% qoq in 2nd quarter (July to September) due to seasonality. Costs have bottomed with continuous rise in pet coke and diesel prices. Factoring consumption lag and inventory, cost inflation should hit cement companies from 4QFY21E. Seasonal headwinds should keep stocks under pressure in the near term.

IT services

We expect a robust September 2020 quarter for IT services companies led by—(1) steady demand in large verticals and (2) negligible supply-side impact, an aspect that impacted June 2020 quarter revenues and margins. We expect yoy increase and stable margins on a sequential basis. The deal pipeline is strong across companies although accompanied by greater scrutiny in select large deals. In our view, IT services spending is set to accelerate, driving (1) elevated growth for well-positioned service providers and (2) multiple expansions.

Metals and Mining

Domestic steel price uptrend continues in Sep'20 with prices now up Rs5,500/ton (+16%) since Jun'20 lows. China's stimulus and relative absence from export markets is supporting steel prices globally. We see India continuing to benefit from domestic demand recovery, declining exports dependence and improving regional competitiveness led by domestic iron ore. Spot steel margins are back to FY19 levels and should sustain in coming quarters.

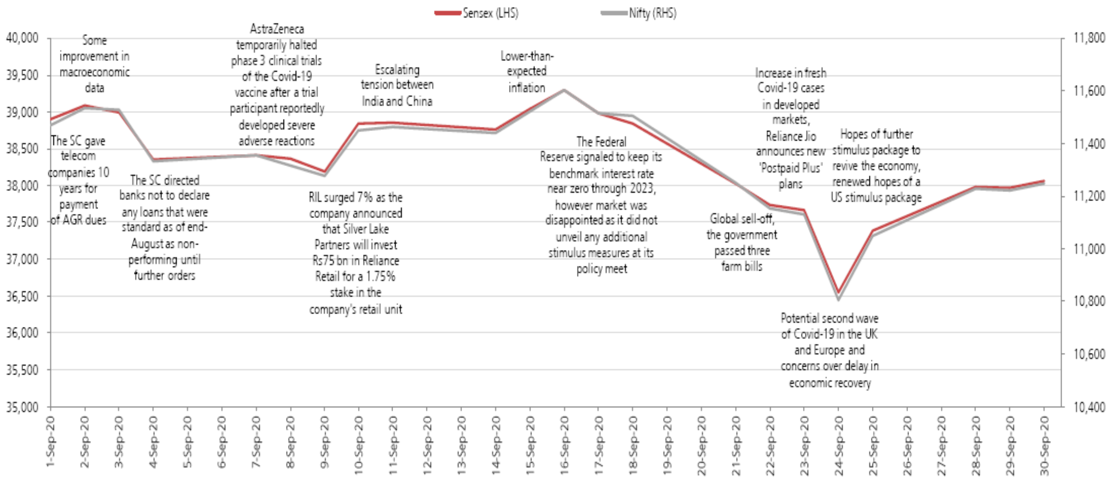
Pharmaceuticals

Most of the pharma companies reported better performance, largely led by significant cost savings and market share gains. However, the benefit was offset to some extent by subdued performance in US. Also API sales showed strong growth trend, this was mainly due to a) less inclination to buy from Chinese players, b) COVID led higher off take of medicines, c) restocking to some extent and d) favourable pricing. As the lockdown eases, marketing spend in the domestic formulation segment is expected to gradually increase. However, the pandemic has led companies to re-evaluate their cost savings initiatives due to increased use of digital mediums. Thus we expect improvement in profitability of domestic formulation segment. Also Q2& Q3 are strong seasons for domestic pharma market. With reduced inclination of buying from Chinese suppliers, we expect better growth prospects in API space for near term.

Real estate

Indian real estate sector is undergoing through consolidation post RERA and demonetization. The pace of consolidation is expected to accelerate further due to turmoil caused by Covid-19. Under the current challenging environment, there is increased risk on sales volume, stress on pricing and delay in completion of projects. Under the current scenario, purchasing decision is more inclined towards completed or near completion projects over projects at initial stage of construction. Also, there is increased preference for branded developers as against standalone developers with higher demand for projects with low to mid ticket size. Amidst these challenges, most of our coverage universe stocks in the sector continue to trade at a discount to their fair value.

Sensex's and Nifty's performance (%)

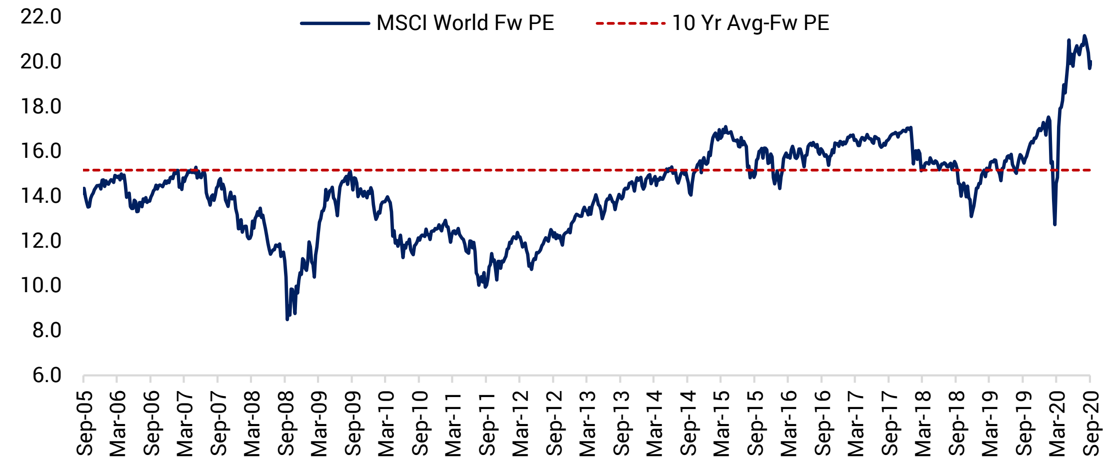


Source: Bloomberg, Kotak Institutional Equities

VALUATIONS

The MSCI World Index valuations have come off a bit from the recent peak. Nonetheless, at 20x Fw PE on Bloomberg consensus estimates, it is still way above the previous peaks of 17x and 10 Yr average of 15x seen in last 15 years.

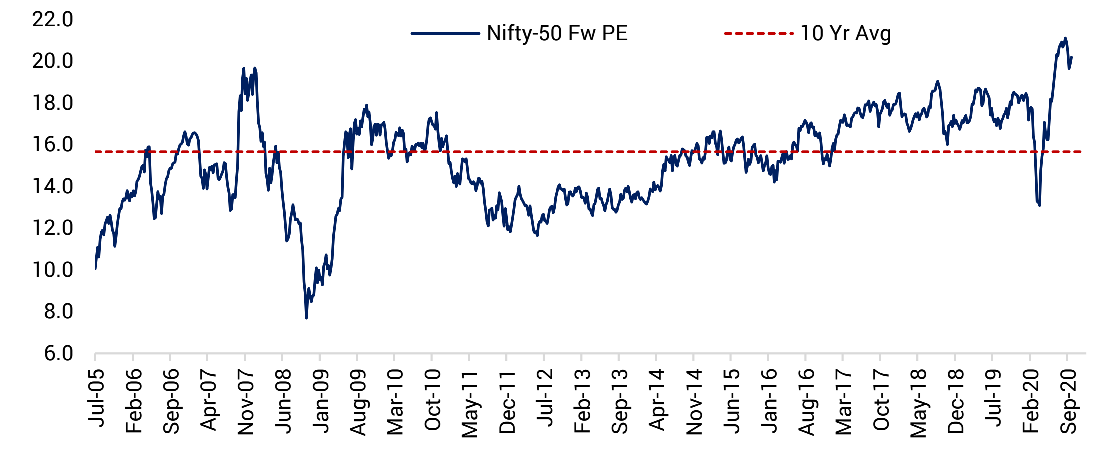
MSCI World Index: Fw PE chart



Source: Bloomberg & Kotak Securities – Private Client Group

On Bloomberg estimates the Nifty-50 trades at 20.2x on 1 Yr Fw basis. On FY22E it trades at ~18.5x, which is still closer to its previous peak of ~19x. Valuations look attractive only on 2 year Fw basis that too after building in 34% earnings growth in FY22E & 19% earnings growth in FY23E.

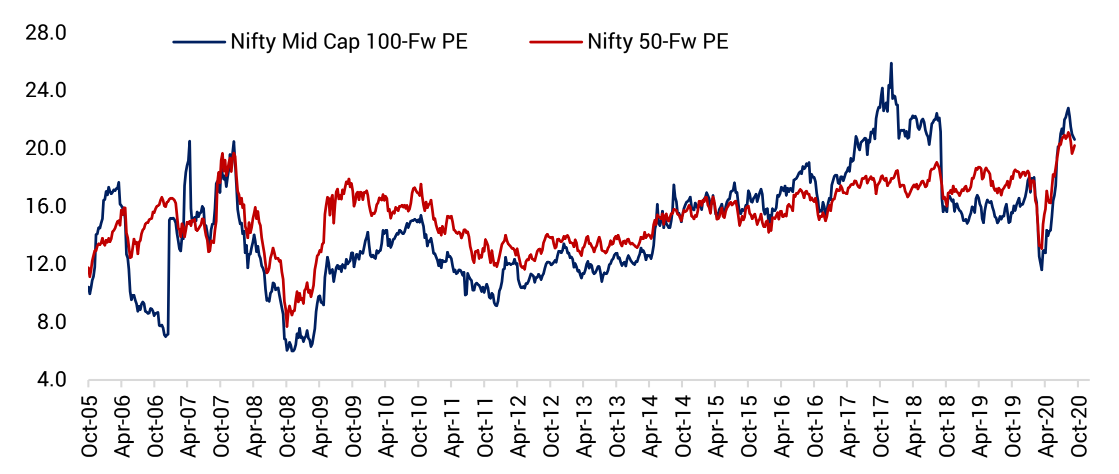
Nifty-50 Index: Fw PE chart



Source: Bloomberg & Kotak Securities – Private Client Group

After six months of rally the Nifty Mid Cap 100 has been trading at a premium to the Nifty-50 on Fw valuations. As compared to 20.2x Fw PE of Nifty-50 the Nifty Mid Cap 100 Index trades at 20.6x (both based on Bloomberg consensus estimates).

One Yr Fw PE chart: Nifty-50 Vs Mid Cap 100 Index



Source: Bloomberg & Kotak Securities – Private Client Group

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REDUCE	–	We expect the stock to deliver -5% - +5% returns over the next 12 months
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NOTE	–	Our target prices are with a 12-month perspective. Returns stated in the rating scale are our internal benchmark.

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