Silver lining emerging for markets, with broader markets poised for a recovery

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At the time of writing, the headline Nifty & Sensex indices are close to their record highs, but the broader markets (mid/small-caps) are still quite deep in the red from their record-high at the end of CY 2017. From January 2018 till October 2019, Nifty 50 index has delivered an absolute return of around +13%, while the Nifty Midcap 100 and Nifty Smallcap 100 indices have returned -20% & -36% (absolute) respectively over the same period.

Markets have been very narrow, with a few quality stocks pushing it up

Nifty index has not been an ideal representative of market conditions since end of 2017, with the broader markets underperforming significantly. Even within the Nifty 50 index, it has been a few quality and large companies that have contributed to most of the index gains and there has been a significant rotation of money into these quality stocks. Whenever there has been some risk aversion in markets, we have seen money getting allocated/rotated to these handful of quality stocks, which are perceived to have more stable earnings. Valuations are quite rich for this handful of quality stocks, but excluding them—we feel that the market valuations are quite reasonable at this juncture.

Time to look beyond GARP, at QARP investment approach as well

In past market downturns, some of the growth stocks took a sharp beating due to excessive valuation multiples attached to their growth aspect. As a moderation in growth took place, valuations started crumbling. Hence, investors started to focus on GARP (Growth at a Reasonable Price) investment approach. The difference was that investors were willing to buy growth stocks at a reasonable valuation and not chase growth stocks at any price.

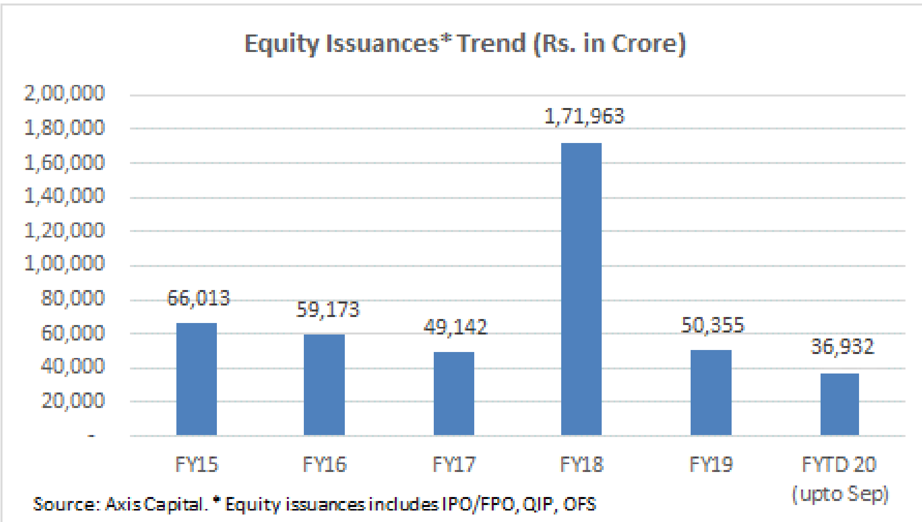
Similar to growth stocks phenomena, there seems to be a strong belief presently in the investing community, to invest in quality stocks at any price as the investor will eventually be rewarded over the long term. As mentioned before, with a lot of money chasing these handful of quality stocks we have seen a sharp P/E re-rating in these stocks not commensurate with the long-term growth potential. Hence, valuations have become quite elevated in this space. To learn from history, it will be wise to look at QARP (Quality at a Reasonable Price) investment style as well, with a blended approach towards 'quality' and 'reasonable valuation'.

Selective mid-caps look attractive post the price and time correction

As mentioned before, the polarized markets and the underperformance of small/mid-cap stocks have kept the market breadth quite negative. In-fact, the 5-year return for the Nifty 50 index and Nifty Midcap 100 index have pretty much converged at this point. With the correction in the broader markets, the Nifty Midcap index is now trading at a healthy discount to the headline Nifty index (from a forward P/E valuation perspective), compared to a steep premium at the end of year 2017. We are now seeing some attractive bottom-up opportunities in the mid-cap segment. As we believe that the corporate earnings and capex cycle are recovering, we also expect the broader markets to recover.

Equity raising / IPO issuances have also slowed down amidst the market correction

The lack of market momentum and correction in broader markets have also led to a slowdown in equity capital raising / IPOs by Indian companies. The chart below shows that equity issuances peaked at around Rs. 1.7 lakh crore in FY18 (when market conditions were more favourable); but slowed down considerably to around Rs. 50,000 crore in FY19. In FYTD20 (for the first six months) we have seen total equity issuances of around Rs. 37,000 crore, which shows some signs of recovery. The government also has indicated its interest in PSU divestment / strategic sale, by clearing strategic sale, and stake sale in 5 PSUs already.



The corporate tax rate cuts will help to provide a boost to manufacturing & investment

The cut in corporate tax rates has been a historic move, and one of the steepest cuts in around 20 years. The revised corporate tax rate of 25% (incl. surcharge & cess) for domestic companies (from 35% earlier) will help to revive manufacturing and investment activity over time, which have slowed down lately, and contributed to the weak Q1 FY20 GDP numbers. The government's focus also is to revive the investment cycle (& especially private investment), and in the Union Budget had announced a large allocation of Rs. 100 lakh crore for the infrastructure sector over the next five years.

The tax rate of 17% (incl surcharge & cess) for new manufacturing units (incorporated after October 2019) also makes India quite competitive with its Asian peers. This could help to attract private investment and FDI, with some manufacturing shifting out of China, amidst the trade war.

Corporate earnings also to get a boost from the corporate tax cuts; lower interest rates to also help

The steep cut in corporate tax rates will also provide a boost to corporate earnings, and this will help to drive the markets--going forward. After the lackluster Q1 FY20 earnings season, we have seen a recovery in corporate earnings for Q2 FY20 (for results declared till now broadly), with most companies delivering results in-line or above expectations. For FY20, we now expect Nifty EPS growth at 21% (after the corporate tax cut), compared to around 16% growth earlier.

The sharp fall in interest rates and bond yields, will also help to reduce cost of capital for companies. Interest rate transmission is also expected to pick-up pace, and there is headroom for more policy action by the RBI (although it will be data dependant).

High-frequency indicators still point to subdued economic activity, but we expect a recovery from H2 FY20 & pick-up in pace in FY21

GDP growth had slowed down quite considerably in Q1 FY20, and high-frequency indicators still point to subdued economic activity. However, with various stimulus measures been taken by the government, we expect GDP growth to gradually recover in H2 FY20, and pick-up pace in FY21. The IMF, in its World Economic Outlook October 2019 report, cut India's FY20 growth forecast to 6.1% (similar to RBI's forecast). However, the IMF expects India's GDP growth to recover to 7.0% in FY21, making it one of the fastest growing major economies in that year.

Global factors:

Major central banks around the world have been easing monetary policy to deal in a pro-active manner with the global growth slowdown. Further dovishness in monetary policy of major global central banks will be beneficial for emerging markets (including India). Crude prices have also corrected, and softer crude prices is a positive for India with it being a large net importer of crude (crude accounts for ~30% of total imports). The US–China trade war has continued to escalate, although it is a developing situation, and there are hopes of some resolution to the same.

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