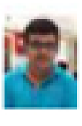
'Expect short-term volatility in equity markets, but deep correction unlikely'

Interview | Sampath Reddy, chief investment officer at Bajaj Allianz Life Insurance



By Nachiket Kelkar | Updated: October 30, 2021 15:09 IST

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After hitting record highs, the markets have seen some correction in the last few sessions; the BSE Sensex closing below 59,500 level this week. What is the outlook ahead? Where are interest rates headed? Which sectors are looking good from growth and valuations perspective? Sampath Reddy, chief investment officer at Bajaj Allianz Life Insurance shares his thoughts with THE WEEK.

Equity markets rallied sharply through 2021, despite warnings on valuations. From what we have seen in the last few days, do you think there is more steam left?

Yes, valuations are quite elevated with the sharp market rally. However, corporate earnings have been quite a positive surprise amid the pandemic. In FY21, we saw India GDP contract by 7.3 per cent but Nifty EPS (earnings per share) grew by a healthy 18 per cent, against earlier expectations of around 10 per cent contraction in earnings growth. Despite the second wave, the earnings for FY22 and FY23 have not seen any significant downgrades and are anticipated to grow by 25 per cent and 20 per cent respectively. Therefore, this uptrend in corporate profitability cycle, helped by cost-cutting initiatives by corporates have contributed to the positive market sentiment and rally, besides the global liquidity surge making its way into capital markets. Economic recovery has also been better than expected and the festive season could provide further fillip to growth and consumption.

In the short term, we could see some market volatility due to Fed taper or rising inflation and commodity prices. However, we believe that any market correction may not be as deep as seen in March 2020. The long-term India growth story remains intact with India remaining a preferred investment choice among peer emerging markets.

What kind of impact will the tapering of liquidity by Federal Reserve and other central banks have on emerging market equities, including India?

Market expects that the Fed taper may be announced in November 2021 policy meet, but it is expected to be in a gradual and calibrated manner. Its not like the Fed will abruptly stop the quantitative easing and withdraw liquidity. Also, rate hikes are expected only in late 2022 and the FOMC forecast as per the September meeting indicates one rate hike of 20 basis points in calendar 2022.

However, as the markets move in anticipation, we may see some short-term volatility in emerging markets (including India) once the Fed starts to taper. However, as mentioned before, India seems favourably positioned among the emerging markets pack from a long-term fundamental perspective.

Also, some of the macro-economic indicators in India are better placed than during the Fed taper tantrum in 2013. For example, the current account deficit for FY23 is projected at 1.5 per cent of GDP versus a high current account deficit of 4.8 per cent of GDP in FY13. Forex reserves are presently at a record high of more than $600 billion (indicating an import cover of 13-15 months) versus reserves of around $300 billion in 2013 (when import cover was around six months). Inflation presently is also much more moderate than the high levels of 9-10 per cent inflation seen in 2013.

In recent monetary policy committee meetings RBI, too, has started slowly mopping up excess liquidity. Are Repo or reverse repo rate hikes around the corner?

Sampath Reddy, chief investment officer, Bajaj Allianz Life Insurance

Yes, RBI has indicated liquidity normalisation going forward as economic recovery continues.

We expect that the RBI may start by reducing the corridor between the repo & reverse repo rate (by increasing the reverse repo rate) in its December policy review or in early 2022. We except the central bank to otherwise remain accommodative for some time still and intervene to manage the yield curve efficiently. Repo rate hike is expected in 2022, depending on the inflation and growth trajectory, and monetary stance of major global central banks.

What's the outlook on interest rates and equity markets in 2022?

We feel that interest rates have bottomed out and expect yields to harden a bit going forward. As mentioned earlier, RBI will try to intervene (via open market operations) and keep long term yields from hardening too much as it needs to manage the remaining part of the large market borrowing programme in an effective manner. Presently we prefer the medium-term part of the yield curve.

For equity markets, we believe that earnings growth momentum will be sustained in FY22 and FY23 and broad-based, and that should help sentiments and support market valuations to some extent. So, the long-term India growth story remains intact and is gaining traction, and therefore we recommend investors to continue to systematically invest in equities. There may be some market volatility in the short term but given the strong earnings outlook we don't expect a very deep correction. From a market cap perspective, we presently prefer the large-cap segment to the mid/small-cap segment, with the valuation premium of the latter widening due to the sharp rally this year.

Given markets have hit records, what are the risks if any from here on, barring of course the easy money tapering?

Besides tapering, one of the other risks is rising commodity prices (especially crude oil prices), which poses some concern for a net oil importing country like India; although as mentioned earlier--our current account deficit is still benign compared to the highs seen in FY13. Globally, inflation has risen quite substantially and domestically too inflation may rear back again, although its moderated in past couple of months due to fall in food prices. Core inflation in India is still a bit elevated. Rising interest rates is also not very conducive for equity markets, although rates are still quite far away from earlier highs. An eye needs to be also kept on any geo-political issues.

Where would you bet your money on now from a sector perspective?

We are positive on select banks, metals and infrastructure and capital goods sector.

With the economic recovery we expect credit growth to gradually pick-up after languishing for a while at five-six per cent. Large private sector banks would lead the credit growth in the economic recovery coupled with the hypothesis of credit cost getting normalised in the latter half of the year. Banking and financial sector has around 40 per cent weight in the Nifty index and accounts for 25 per cent of overall earnings. Healthy profit after tax growth of 25-30 per cent is expected for the sector in FY22 & 23. Valuations also remain reasonable for the sector.

Metals sector has benefited from sharp rise in metal prices, which has helped drive profitability. Also, metal companies have been able to use this uptick in earnings to deleverage their balance sheets, which has been an investor concern for the sector earlier.

With the economic recovery we expect capex cycle to also gradually recover, being initially led by public infrastructure spending. We also expect the government's PLI scheme to provide a boost to domestic manufacturing. Manufacturing contribution in GDP for India has been moderating over the past few years, this could help revive the manufacturing sector. The government has also announced Rs 6 trillion National Monetisation pipeline over a four-year period (FY22 to FY25) for leasing of core central government assets. It is expected that the additional revenues from this will primarily be used for infrastructure spending.

The IPO market has been hot this year, be it the number of issues or funds raised and several issues had bumper listings. What is your outlook? Do you think there is still enough appetite for mega IPOs like LIC and BPCL?

Yes, with the market buoyancy—equity market issuances have been strong this year, and we have seen some large IPOs over the past few months with strong listing gains. This indicates healthy appetite from investors (both retail and institutional). The IPO pipeline remains quite strong in FY22 with net equity supply projected to be at record highs.