

Daily Voice | This CIO says India is relatively better positioned than peers, outperformance can continue

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Sampath Reddy

Under the export-oriented segment, "pharma and IT are among the preferred sectors now," Sampath Reddy of Bajaj Allianz Life Insurance says in an interview to Moneycontrol.

Even though there are concerns on global recession and a cloudy earnings outlook, valuations are now starting to look reasonable / attractive in pharma and IT sectors, especially after the underperformance in the previous calendar year, he feels.

With market participants and some government officials indicating divergence in capital gain tax between different asset classes, the Chief Investment Officer expects that there may be some announcements on rationalization or harmonization in the capital gains tax structure.

Reddy with more than two decades of experience in managing assets feels that market performance in 2023 may remain be stock-selective, so a bottom-up approach will be useful for investors.

2022 was quite a narrow market in India, with a handful of stocks contributing the bulk of the headline indices gains, and the broader markets being weak.

Is it really a great time to build quality portfolio with 2-3 years perspective to create strong wealth?

The Indian economy and markets were resilient in 2022 compared to a number of other global economies and markets, which were burdened with multi-decade high inflation, sharp slowdown in economic growth, aggressive monetary tightening, rising interest rates and also a healthy correction in a number of global equity markets during the calendar year.

The Indian economy is relatively better placed than peers and advanced economies. In the near term, returns maybe moderate in India due to relatively higher valuations, global growth slowdown (or even recession) and some domestic slowdown as well.

However, we believe that the long-term India growth story remains intact, and that equities remain the preferred asset class for long term wealth creation. Investors should continue to systematically invest in equities.

What are the key investment themes that you can suggest investors at this point of time?

Our key sectoral preferences are as follows:

- a) Private Banks - Extremely strong operating environment with better growth, improving margins and benign asset quality. Most banks are well-capitalized and valuations are still within historical range.
- b) Domestic Plays - Like companies exposed to domestic growth in sectors like Industrials, Cap Goods. Sectors like QSR (quick service restaurants), and other domestic consumer-oriented sectors could do well.
- c) Pharma - Valuations appear attractive now. Most of the negatives pertaining to weakness in US generic market seems to be priced in.
- d) IT - Earnings outlook appears a bit cloudy due to recession fears but valuations are now looking reasonable in many cases.

From a market cap perspective, we presently prefer large-caps to mid-caps from a valuation and risk-return point of view.

Do you think one should avoid export-oriented themes now considering the current volatile global environment?

Not really. As mentioned before, Pharma & IT are among our preferred sectors now. Even though there are concerns on global recession and a cloudy earnings outlook, valuations are now starting to look reasonable / attractive in these sectors, especially after the underperformance in the previous calendar year.

Most of experts feel the year 2023 may not be simple for market participants. Do you feel so? Your thoughts?

Yes, there are some concerns due to global growth slowdown and possibly a recession in certain countries. However, on a relative basis, outlook for India appears better and hence the outperformance for Indian markets may continue, despite the significant valuation premium to peer markets. The fall in crude oil prices is a big positive for net oil importer like India and will keep our trade deficit in check. Lately, FPIs equity flows have also started to pick-up in India after seeing significant outflows in the first half of CY22.

Overall, the market trajectory in 2023 will be largely determined by the monetary policy stance of the major central banks and the magnitude of the global growth slowdown.

Also, 2022 was quite a narrow market in India, with a handful of stocks contributing the bulk of the headline indices gains, and the broader markets being weak. We feel that market performance in 2023 may also be stock-selective, so a bottom-up approach will be useful for investors.

Do you think the potential of PE expansion in India is limited?

Bulk of the market returns in India over the past two years have come primarily from strong corporate earnings growth and some PE expansion. The stronger than expected corporate earnings growth has helped the Indian equity markets to outperform. Nifty aggregate Profit After Tax (PAT) has almost doubled from Rs 3.2 trillion in FY20 to Rs 6.3 trillion in FY22.

We believe that going forward in 2023, the potential of PE expansion in India is limited and therefore returns will be more guided by corporate earnings growth, which are expected to be moderate.

Do you think the global central bankers may resort to interest rate cut cycle in late second half of 2023?

The US Federal Reserve increased the median terminal Fed rate forecast to 5.1 percent in its December policy review, from 4.6 percent earlier. It is also projecting the Fed rate to remain elevated at 5.1 percent through 2023 end. However, Fed fund futures indicate that market participants are pricing in the possibility of rate cuts in the second half of 2023.

Therefore, central bank action will depend on the inflation trajectory and to some extent on the magnitude of the growth slowdown in 2023. If inflation undershoots the Fed projection or if the quantum of growth slowdown is more than forecasted, then it may prompt the US Fed to pivot earlier (with rate cuts). US headline consumer inflation has moderated from a four-decade high of 9.1 percent YoY in June 2022 to 7.1 percent YoY in November 2022. The Fed's preferred gauge of inflation (i.e. Core PCE inflation) has also moderated to 4.7 percent YoY in November 2022 from 5.1 percent YoY in September 2022; and the Fed's projection for Core PCE Inflation at the end of 2023 stands presently at 3.5 percent.

What is your investment strategy for 2023?

Given that the interest rate hikes of previous year will start to impact the economy to some extent in this year, we will position our portfolios accordingly. In developed markets the interest rate hike cycle has still some legs to go. So, in the current environment, we prefer companies with less debt (leverage), better free cash flows and stable earnings. New-age companies whose cash flows & profitability is more back-ended, have been impacted more with interest rates rising over the past year.

Overall, we follow a disciplined bottom-up investment philosophy and focus on "Growth at a Reasonable Price" (GARP) investment approach. We look for companies with strong competitive advantage in terms of brand, distribution reach, cost advantage, barriers to entry, good corporate governance and a competent management team.

We shall continue to follow this investment strategy to help our funds deliver better risk-adjusted returns over the long term.

Do you expect third quarter of FY23 earnings season to be strong and better than previous two quarters in current financial year?

Q2 FY23 Nifty corporate earnings growth were muted, and we expect marginal improvement in Q3 FY23. This should be helped by continued strength in banks & financials sectors, and some recovery in commodity sectors like metals and oil & gas, which had been a drag on earnings in the previous quarter.

Nifty corporate earnings growth for FY23 and FY24 is projected at ~12 percent and ~15 percent respectively, which is still quite healthy.

Will the Union Budget be an eventful or will it be a non-event for the market?

With market participants and some government officials indicating divergence in capital gain tax between different asset classes, we expect that there may be some announcements on rationalization / harmonization in the capital gains tax structure.

Given that India has managed the Covid pandemic crisis quite well (especially from a macro perspective), and with better than budgeted tax collections and healthy tax buoyancy, the government should be comfortably able to meet the fiscal deficit target. Also, with fiscal deficit earlier rising during the pandemic, the government may now go back to the pre-covid fiscal consolidation glide path.

Last budget had seen a healthy growth in capex. Considering that this is the last budget before the general election in 2024, we may continue to see a push towards capex and some major project announcements from the government.

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