ETMarkets Smart Talk: Large private banks, pharma top sectors for next 5 years: Sampath Reddy

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"Large private banks are currently experiencing an advantage of fall in the Net Interest Margins (NIMs), although they maintain robust credit growth and stable asset quality," says ***Sampath Reddy****, Chief Investment Officer,* ***Bajaj Allianz Life Insurance****.*

In an interview with ETMarkets, Reddy said: "The pharmaceutical sector is showing resilience with steady performance in the domestic market, and improvements in the pricing environment for the US generic business" Edited excerpts:

A mixed October for markets in the middle of India's festive season. What is capping the upside is it geopolitical concerns or valuations?
The equity market has been quite volatile during the month of October as positives like – resilient corporate earnings and a pickup in domestic economic activity have been countered by geopolitical concerns and rising US bond yields.

The rising geopolitical tensions globally could put upward pressure on crude oil prices and weigh on global equity markets and risk appetite.

These concerns have led to increased uncertainty and volatility and have made investors more risk averse. Indian markets are also trading at relatively high valuations, which is another factor that is capping the upside.

The Nifty 50 index is currently trading at a price-to-earnings ratio (1-Year Forward) of around 21x, which is above the long-term average.

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Rising US bond yields, with the benchmark 10-year treasury yield breaching the 5% mark, is also having a negative impact on global markets.

What is your take on the results which have come out recently? Any company/industry that surprised you? What is the general sense you are getting from the management commentary about future earnings?
The corporate earnings landscape has been quite promising, particularly in sectors other than IT services. IT services companies have been somewhat disappointed in terms of earnings performance.

Outside of the IT sector, the majority of companies have exhibited enhanced margins in their earnings so far. This improvement in profitability can be attributed in large part to the favourable trend of benign commodity prices, which has contributed to cost containment and overall financial health for many companies.

The BFSI sector has especially delivered impressive results. It is characterized by robust profit growth and benign asset quality.

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This suggests that the BFSI segment has been able to effectively navigate the economic landscape, maintain control over asset quality, and achieve sustained growth.

Overall, the corporate earnings backdrop seems to be on a positive trajectory, although there are company-specific variations in performance.

Have you tweaked your holdings recently amid the volatility seen in global markets?
We prefer domestic-oriented sectors, given India's relatively better macro-economic prospects amidst a global economic slowdown. Therefore, we have increased exposure to sectors like private banks, capital goods and autos.

Within export-oriented sectors, we prefer the US generics-focused pharma sector, with pricing pressures normalizing there.

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There are a lot of large-cap stocks that are hitting record highs regularly namely – Bajaj Auto, Tata Motors, Nestle India, Hero, etc. Do you see money moving towards large-caps as mid & small-caps see some profit taking?
The small/mid-cap segment of the market has seen a sharp rally since March 2023 and has significantly outperformed the large-cap segment.

The rally is being fuelled by strong domestic fund flows and increased risk appetite among investors. Small/mid-cap stocks are also reacting sharply to news flow.

AMFI data shows that the small-cap mutual fund category has received the highest net inflow over the past year (among various equity MF categories), and considerably more inflow than the major fund categories like flexicap, large-cap etc, which have higher AUM.

The Midcap MF category has received the second-highest inflow over the past year. The number of folios (indicating approximate investor count) of the small-cap category has now crossed that of large/flexi-cap categories—further indicating the increased investor traction towards this segment.

With the recent sharp rally, we have advised our investors that the risk-reward for small/mid-caps is not looking that attractive and we presently prefer the large-cap segment.

Valuations of small/mid-cap stocks have also gone up on the back of the liquidity fuelled rally but is still lower than the earlier highs touched in late 2021.

We recommend investors with higher exposure in the mid/small-cap segment or funds to pare down some exposure and switch to the large-cap / flexi-cap oriented funds.

Which sectors are you looking at say with a 5-year time horizon?
In terms of sector preferences, large private banks are currently experiencing an advantage of fall in the Net Interest Margins (NIMs), although they maintain robust credit growth and stable asset quality. Most of these banks are well-capitalized, and their valuations align with historical averages.

Meanwhile, the pharmaceutical sector is showing resilience with steady performance in the domestic market, and improvements in the pricing environment for the US generic business.

In addition, companies exposed to domestic growth in sectors like Industrials and Capital Goods are witnessing positive trends, particularly with strong order inflows from government spending.

Also, there is a growth revival in the automobile sector due to the normalization of supply constraints and softer commodity prices.

Turning to emerging themes, there's notable ordering activity in segments such as Railways, Defence, Data Centres etc., offering multi-year growth potential for companies serving these industries.

Healthcare services are showing encouraging signs with diagnostic companies returning to normalcy and hospitals maintaining steady growth while improving profitability.

As for Quick Service Restaurants (QSR) and hotels, changing consumption patterns and a rebound in discretionary spending are expected to benefit companies in these segments. Lastly, the electric vehicle (EV) sector is gaining traction with increasing adoption, leading to value migration within the industry.

What is your ‘sell’ strategy? When do you decide to sell the stock or exit a position?
Our investment strategy primarily focuses on the long term, where we aim to hold positions in companies as long as they continue to exhibit strong business growth and profitability

while maintaining favourable valuations.

We place an emphasis on “Growth at a Reasonable Price” (GARP) investment approach. However, when there is a change to fundamentals or if valuations go significantly above our fair value or at a substantial premium to the relevant sector or markets in general, then we strategically review those holdings and may choose to exit or pare down exposure.

During periods when market conditions or valuations shift rapidly, we are open to adjusting our asset allocation to optimize our portfolio from a risk-reward perspective.

Which sectors are witnessing a rise in ROEs and CAPEX revival?
ROEs for the Indian market have recovered sharply in the last 3-4 years post the lows seen in 2019-20. A large part of this revival is driven by Banks (both Private and PSU), which have witnessed robust earnings in recent times.

Capex so far has been driven by the government sector, initially led by the Centre and then followed by the States. We believe that the Private sector has now kick-started the investment cycle with conviction, which should drive a revival in Private sector capex going ahead.

Amongst sectors, there is a meaningful pickup in power sector capex, both generation and transmission & distribution, along with railway and defence sectors.

Also, there is a strong surge in localization effort across products and sectors driven by manufacturing PLI and other schemes, especially electronics, Electric Vehicles value chain, Data Centres etc.

There is a lot of chatter around the slowdown in China – but is the fear real?
There are growing concerns over economic slowdown in China, and one of the sectors most affected is their real estate industry, whose contribution to GDP is around 30%.

Companies operating in this segment are experiencing challenges. This is compounded by other factors, such as geopolitical tension and “China Plus One” strategy –which involves MNCs diversifying their production and supply chain activities by adding alternative locations/countries.

This situation, presents opportunities, for countries like India, where the economic landscape is more positive, and the government is trying to attract foreign investments in manufacturing via the PLI scheme.

Therefore, China's slowdown might translate into more opportunities for investments in other emerging markets.

In terms of valuation – how is India placed compared to other EM peers? FIIs have pulled out the money in October – is the churn likely to continue?

Presently, the valuation premium of Indian markets to peer emerging markets (represented by the MSCI Emerging Markets index) has further widened, due to the significant outperformance of Indian markets over the past few years.

This has been on the back of relatively better macro-environment in India and stronger than expected earnings growth.

FPI equity flows have picked up since the month of March 2023, but the months of September and October have seen some FPI outflows due to rising US bond yields and some risk aversion.

However, India should continue to garner higher FPI flows within the EM pack, as it is better placed due to its higher growth potential, and stable government and policy environment.

Also, even though rising bond yields are leading to some market volatility in the short term; a rate cut cycle by the US Fed in late CY2024 could contribute to foreign flows increasing to emerging markets, and India is likely to benefit from that.

Flows start to move in anticipation of the rate cut. India’s weight in the MSCI EM index has gone up from around 8%--3 years ago to almost 16% presently (the highest weight increase in the EM index), and that could attract more EM flows to India.