Short-term pain; long-term gain

Recent correction is a normal part of any market cycle and should be seen as a buying opportunity

Hitting a roadblock; nothing more than a healthy correction: After a thrilling ride in the past 15-18 months the Indian equities have corrected meaningfully from their highs led by multiple global factors (taxation issues for foreign investors in India, "Grexit" and large issuance of equity in China) and domestic issues (weak corporate earnings, an initial forecast of a sub-optimal monsoon and growing opposition to critical policy reforms). This is largely in line with our expectations that the market would slip into a consolidation range at the lower levels. We remain optimistic and believe that the current phase is more of a pause in the multi-year rally in the Indian equity market. Passage of some important legislatives like the Goods & Services Tax (GST) bill or better than expected monsoon rains could provide upside triggers for the market in the near term.

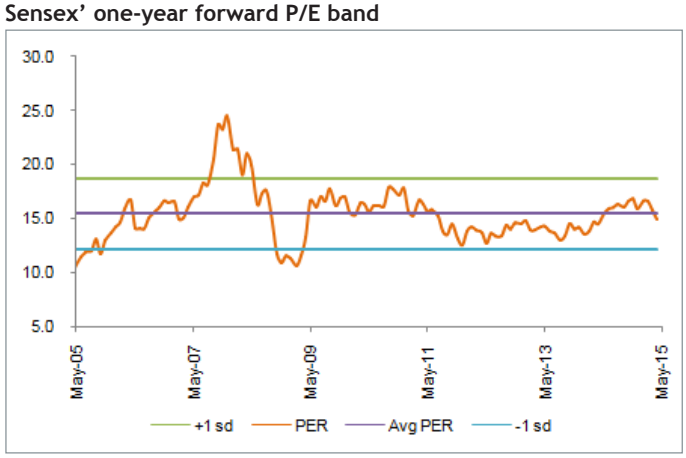
Tax issues come to haunt investors again: Notwithstanding the slower than expected recovery in the economy and corporate earnings, it is the unnecessary and avoidable issues like the demand notices issued to foreign institutional investors (FII) levying the minimum alternate tax (MAT) with a retrospective effect that have caused more damage to investor sentiment. The FII inflows have turned negative and are finding their way to the other emerging markets (EMs). Thus, the tables have turned with the Indian market underperforming its emerging market peers in the calendar year 2015, contrary to a strong outperformance in 2014.

No cheer in earnings, meaningful revival expected in H2 of FY2016: Early trends suggest another quarter (Q4FY2015) of weak results though the expectations were already low to begin with. The consensus earnings per share (EPS) estimates of the Sensex for FY2016 and FY2017 have been downgraded substantially largely due to a sharp cut in the earnings of the base year (FY2015) and a lag in the economic recovery. However, the expected compounded annual growth rate (CAGR) in the Sensex' EPS over the next two years still stands at a healthy 15-16%. Hence, the Sensex' valuation of 15-16x FY2016E earnings is mostly in sync with its growth outlook. Going ahead, the decline in input and financing costs together with a steady pick-up in demand will drive the earnings growth recovery in H2FY2016. Thus, the earnings growth is likely to be back-ended in the current fiscal.

Corrections tend to be an opportunity: Corrections or pull-backs are normal part of any market cycle and tend to be a buying opportunity in a multi-year rally. In the last cycle (2003-2008), the market had corrected by 15% or more on three occasions before resuming the uptrend. We see the current corrective phase in the same light since the macro environment and a more progressive policy framework (under a new and stable government) would eventually reflect in the growth of the corporate earnings as early as in the second half of the current fiscal and drive the next leg of the market rally. Valuations are also in a comfortable zone with the Sensex trading at 15-16x one-year forward earnings (which is in line with its long-term average valuation multiple).

Preferred investment sectors/themes: Private sector banks/niche NBFCs, pharmaceuticals, urban discretionary consumption, and select information technology and auto stocks.

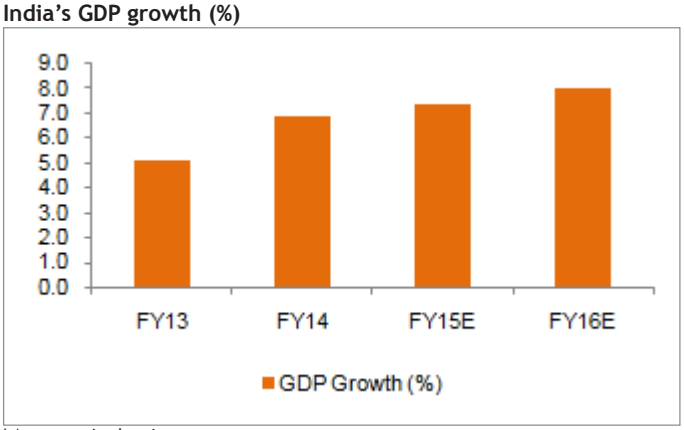
Sensex' one-year forward P/E band



Source: Bloomberg, Sharekhan Research

Recovery underway albeit pace slower than expected: The gross domestic product (GDP) growth in the current fiscal as per the revised series is likely to be slightly higher at ~8.0% for FY2016. This suggests that the growth is picking up, though not at a pace initially expected. The Index of Industrial Production (IIP) and the data on the core sector industries have been quite volatile but the consensus view is that the same should be better in FY2016. The inflation scenario (both retail and wholesale) has been under control which has led to a 50-basis-point interest rate cut by the Reserve Bank of India (RBI). From the macro perspective, concerns emanate from a sluggish corporate credit demand, a delayed revival in the private capital expenditure (capex) and a sub-optimal forecast for monsoon rains all of which pose a risk to the GDP growth. However, the government's concerted efforts to revive the stalled projects and the additional spending of Rs70,000 crore on infrastructure (proposed in the budget) could set the ball rolling and may bring some buoyancy in the economy.

India's GDP growth (%)



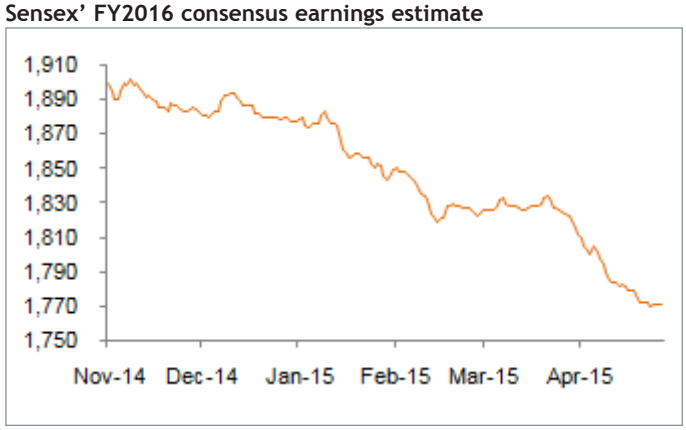
* As per revised series

Source: CSO

Reform expectations becoming more realistic, passage of key legislations could improve sentiment: The delay in the passage of the land acquisition bill due to stiff resistance by the opposition parties conveys a negative impression of the government's reform agenda. The stratospheric expectations are getting more realistic due to political issues and a lag in the revival of the investment cycle. However, it is notable that the government has been successful in passing some key legislations (the coal mining bill, the mines and minerals bill, the insurance bill) as it proves the government is capable of garnering support for the critical bills in the upper house of the Parliament (ie the Rajya Sabha). Going ahead, the passage of the land acquisition bill or the GST bill (already passed by the Lok Sabha) will assuage the concerns relating to the government's reform agenda.

Corporate earnings remain weak but revival ahead: The earnings performance of the Indian corporates had been disappointing in Q3FY2015 and early trends suggest Q4FY2015 will also be a soft quarter. Even as the private sector banks and some index companies have delivered stronger numbers, the earnings growth of the broader market is weak due to several factors including weak rural demand, cross-currency headwinds and inventory loss. All this has resulted in expectations of a single-digit growth in the corporate earnings in FY2015 and a 6-8% downward revision in the consensus earnings estimate for both FY2016 and FY2017. The sluggishness may continue for another quarter and from Q2FY2016 onwards a meaningful revival will be visible. This would be led by a drop in the input cost, a reduction in the borrowings cost (due to a base rate cut by banks and a drop in the wholesale borrowing costs) and a steady recovery in demand.

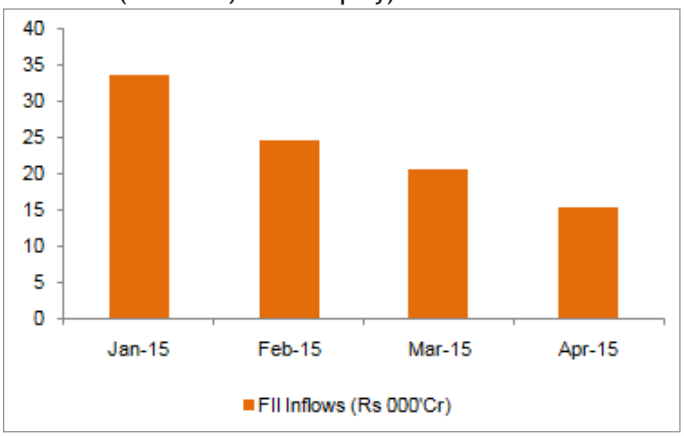
Sensex' FY2016 consensus earnings estimate



Source: Bloomberg

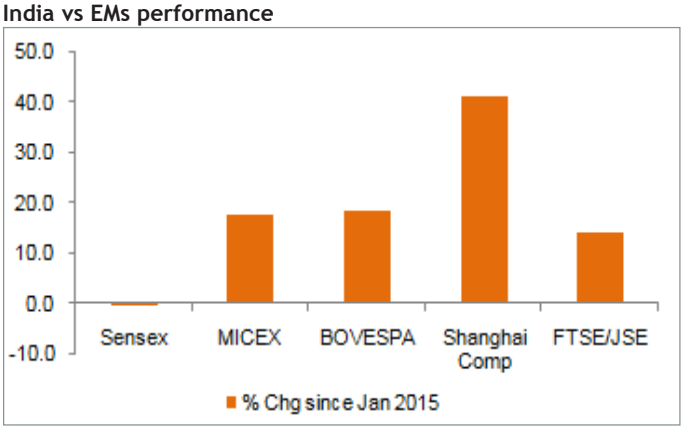
India's underperformance vs EMs is tactical and long-term story is intact: After outperforming its global peers over most part of 2014, India has underperformed the same pack on a year-till-date basis led by the prevailing global and domestic issues. A notable factor has been an increase in the fund allocation towards the other EMs such as China, Taiwan and South Korea due to a valuation comfort, taxation issues (MAT notice to FIIs with a retrospective effect) etc. The expectations of "Grexit", ie Greece's exit from the euro zone, and uncertainty over the US interest rate hikes did cause anxiety in the market. The government has tried to send conciliatory signals to the FIIs on the taxation issue and the same is likely to get resolved, given India's vulnerability to capital outflows. Nevertheless, India continues to be among the favoured investor destinations due to its improving economic fundamentals and political stability both of which has been recognised by several multi-lateral institutions and rating agencies.

FII inflows (Rs 000' cr, debt + equity)



Source: NSDL

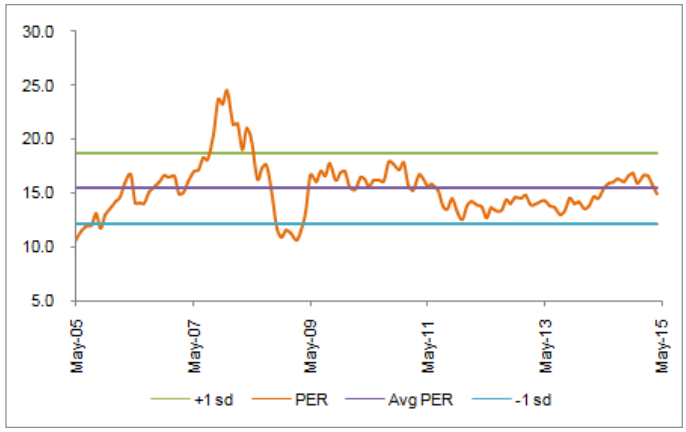
India vs EMs performance



Source: Bloomberg

Valuations turn reasonable, time ripe to build portfolio for long term: While the economic recovery has been slower than expected, there is no denying the fact that growth will pick up, albeit with some lag, despite an adverse global scenario. The ongoing correction is a reality check on the lofty expectations that all have from the Narendra Modi government and offers opportunities to add good stocks at reasonable valuations. The consensus earnings estimate has undergone downgrades and even after factoring that the Sensex trades at 15x-16x FY2016E earnings. Going ahead, policy action by the government, better than expected monsoon rains and a reduction in interest rates will be the key triggers for an earnings upgrade. The investment themes that investors can play in the meantime include cyclicals (private banks, select automobile and industrial companies), and technology and consumer discretionary companies.

Sensex' one-year forward P/E band



Source: Bloomberg, Sharekhan Research

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