Market Outlook

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Time for a breather

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by BNP PARIBAS

Time for a breather

Premium valuations and absence of earnings growth revival could limit the upside in the near term

Markets resilient despite growing concerns: The Indian benchmark indices recovered quickly from the dip seen earlier in August despite growing concerns related to the disappointing Q1 results, slump in Q1 GDP figures to 5.7% and rising geopolitical risk on the domestic (owing to the Doklamstandoff of India with China) and the global front (with the US and North Korea bickering over nuclear warfare). The surprisingly quick recovery was supported by record inflows of Rs20,000 crore in domestic mutual funds in August alone and the weakening of US Dollar which is supportive for foreign inflows into riskier assets including emerging markets.

Re-rating of valuation multiples factors all positives: The rally (close to 20%) in the benchmark indices during CY2017 is largely driven by expansion in valuation multiples as the earnings growth remains anemic. In fact, over the last nine months, the Sensex earnings estimates have been downgraded by 16% for FY2018 to factor in the near term adverse impact of bold policy initiatives such as demonetization and the implementation of Goods & Services Tax (GST). Despite weak earnings growth the rally in India is largely in line with MSCI Emerging Market Index and other comparable peers where the earnings growth is much relatively superior. The expansion of absolute and relative valuations of Indian market seem to factor in positives like soft crude oil prices, low interest rates and the possible long term gains from recent policy measures.

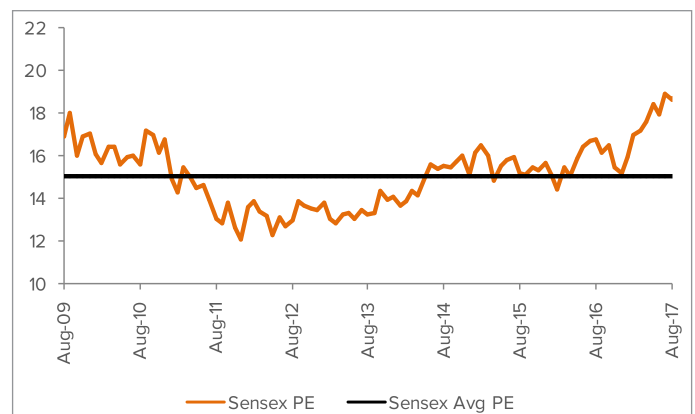
Time to deliver on earnings: The weak earnings growth of low single digit in the past couple of years can be explained by extra-ordinary events like the commodity crash & its fallout on earnings of oil&gas and metal companies, followed by clean up of banks leading to huge provision requirements and finally the adverse near term impact of economically significant moves such as demonetization and GST implementation. As of now, the consensus estimates suggest hopes of a revival in H2 of the current fiscal followed by 20% plus growth in Sensex earnings in FY2019 on the back of revival in demand, low base effect and finally the positive effects of policy actions on the economy. Any signs of delay or a prolonged weakness in economy and corporate earnings could be one of the key risks to markets at current levels.

Valuation – not cheap anymore: Post the sharp rally, the Sensex currently trades at ~18-18.5x one year forward PE which is higher than its historical average multiples of 15.5-16x, which is not cheap anymore. We would advise investors to keep some powder dry for better opportunities. Also, it would be advisable to focus on companies from some key structural multi-year growth theme identified by us.

Investment Themes

- **Financialisation of savings:** Shift from physical assets to financial assets is likely to be a multi-year trend supported by positive real interest rates (interest rates higher than inflation), crackdown on black money(generally flows to physical assets like gold/real estate) and growing investor awareness
- **Affordable housing:** Housing for all by 2022 would require immense amount of investment in housing sector and would benefit allied segments
- **Government spending on infra/fiscal stimulus:** In the absence of private investment and need to boost infrastructure, the government is focusing on capital expenditure on railways, roads, river linking and defense. A whole range of companies would benefit multiple years from expected spending in these select few segments.
- **Consumption:** It is an evergreen and consistent investment theme that has been a key driver of Indian economy for the past few years. We expect both urban and rural consumer demand to recover on the back of good monsoons and shift in market share from unorganized to organized sector in many segments due to recent policy measures.

Sensex PE band (based on one-year forward earnings)

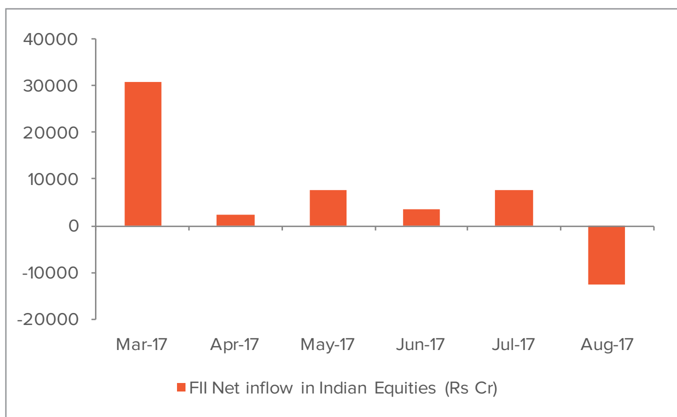


Source: Bloomberg, Sharekhan Research

One offs events like GST, Demonetization, RERA, Geo-political tensions impact markets: One off events have dominated the earnings performance of Indian corporations of late. Events like the implementation of GST, Demonetization, establishment of a real estate regulator under RERA impacted the earnings performance which were weak once again. As a result of the structural policy measures, the Q1 GDP hit a multi-year low of 5.7%. Geo political concerns emerged where on one hand, there was a standoff with China at the border, the drumming up of US-North Korea war rhetoric and weapons strutting dominated the headlines notwithstanding the with weak inflation and recovery in USA adding to uncertainties. Consequently, the Indian equity markets took a breather in August and saw some corrections.

Markets resilient despite growing concerns: However, the correction was short lived and the markets bounced back smartly post the sharp dip in the initial part of the month. With the bounce back, the ability of the markets to absorb negative news flow was surprising, if not intriguing. One factor has been the persistent and strong surge of gushing domestic retail flows into equities markets at record levels of around Rs20,000 crore in August alone which provided support to the markets.

CHART: FII Inflow in Equities

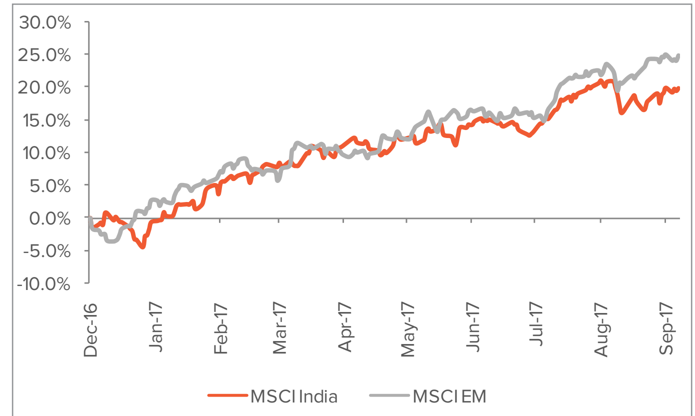


Source: CDSL

Further, the weak core inflation in USA, islikely to delay the much debated interest rate hikes by Federal Reserve (US Fed). This in turn had weakened the US Dollar which was supportive of capital flow to globally riskier assets classes (including emerging market equities). Lastly, the soft agriculture product prices and the continued soft crude oil prices are structurally supportive for India's macro outlook.

Notwithstanding the market rally, earnings growth yet to pick up: Notably, the rally in Indian equities in CY2017 is largely in line with MSCI India Index and other comparable emerging markets index.

CHART: MSCI INDIA AND MSCI EM COMPARISON

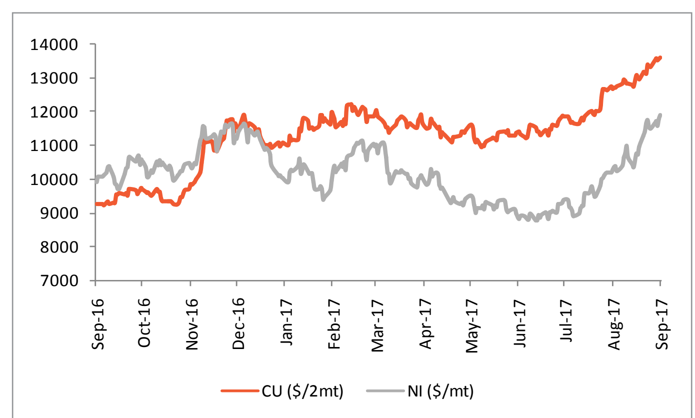


Source: Bloomberg

However, the earnings growth in the Indian markets has been the lowest amongst peers. The low single digit earnings growth in past 12 months means that the markets' rally has been driven more by the re-rating of valuation multiples (price-earnings ratio) instead of earnings growth of Indian companies. We believe that this trend of multiple expansion will provide limited mileage and is not a sustainable trend. Consequently, further upsides in Indian equities would have to be supported by earnings growth.

Rise in commodity prices impacts margins: Rise in commodity prices (steel, aluminum, cooper, lead etc.) resulted in higher input costs for domestic manufacturing companies (auto, cement, paints, etc.), thereby impacting margins. Not only the input cost increase, higher discounts to clear inventory before GST implementation too also impacted contribution margins for most sectors.

CHART: Movement of Commodity Prices



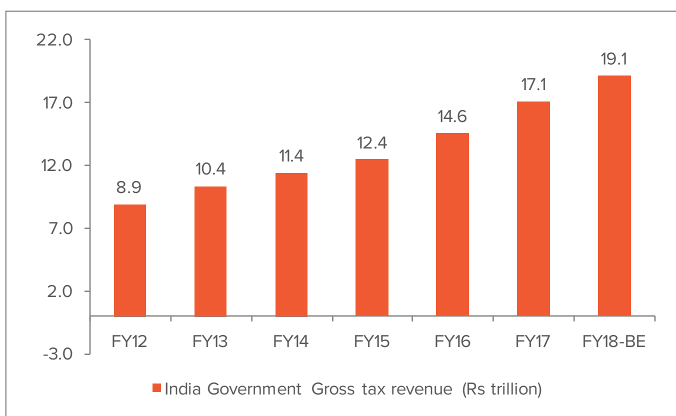
Source: Bloomberg

Banks' accelerated NPA recognition and provision required, and absence of treasury profits resulted in Net Interest Margins (NIMs) shrinking for several players, both in the private and public banking space.

A lot riding on expectations of earnings revival, time to deliver: A positive, clean, stable and reform oriented political leadership at the helm has done well for optimism of investors. As of now, they are pinning their hopes on a strong earnings growth revival, probably from H2 of the current fiscal along with a healthy 18-20% growth in the Sensex earnings for FY 2019E. So far, the earnings disappointment of last couple of years have been explained by a crash in commodity prices, rise in banks' NPLs and the provisioning costs and the more recent near structural events / reforms like Demonetization and GST implementation. However, we believe that incrementally, it would be more difficult to hide behind excuses. We believe that a sustainable earnings revival will hold the key for sustainability of the rally.

Govt. Spending via Fiscal Support is needed: The government has concentrated on sectors like Rail, Roads, Waterway, Defense, Power transmission; Housing, Defense which are employment generating on one hand and also help create demand on the other. Consumption will be further helped by Higher MSP prices (Govt. would be focusing on boosting agriculturural income, as it currently has money from the improving tax collections. There has been a windfall from both the collections from GST and also a boost in the direct tax collections because of rise in individual filings and better compliance).

CHART: TAX COLLECTIONS SO FAR

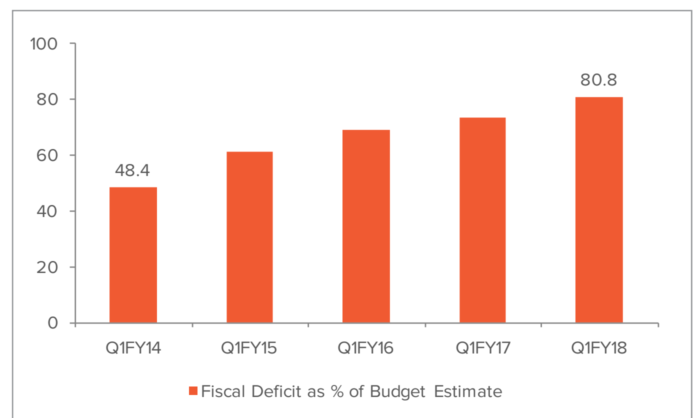


Source: India Budget

Tax collections are expected to rise as GST revenue mopped up Rs92,000 crore from just 64.4% registered tax payers, hence we can expect continued government spending in case of higher revenues. Higher Government spending is likely to be up which may also help kick start private investment sooner or later. Global Monetary stimulus is gradually being withdrawn, and hence the amount of global liquidity as well as commodity inflation may revert to mean.

Despite the noise, Fiscal deficit financed spending will be beneficial for the economy: The Indian economy needsincreased deficit financing, which is important to break the low growth and low inflation situation. Hence, with higher expenses into productive activities are needed as they generate employment along with higher consumption and many a times economies that are in a high growth phase or those who are pushing for higher growth can end up with deficit financing which is acceptable up to certain levels and it may result in higher Fiscal Deficit.

CHART: FISCAL DEFICIT ACCRUED SO FAR



Source: RBI, Sharekhan Research

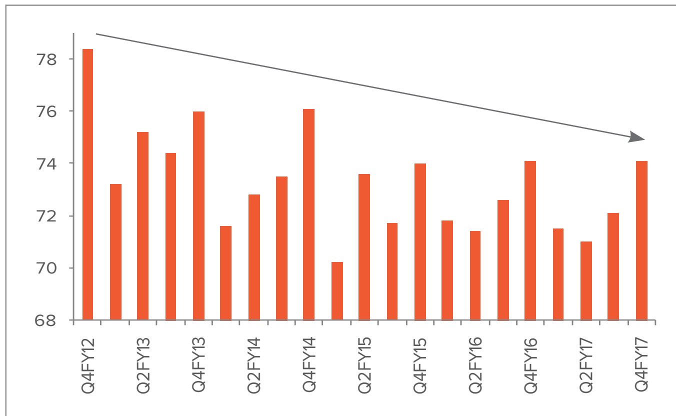
There has been some noise on the lack of pick up from the Private sector but it may take longer time in our view. Similar trends have been noted where public expenditure and deficit spending has helped the economy to remain in better health.

Investment slows due to Low Capacity Utilization, Bank NPA rise:

Services sector, the growth in trade segment will moderate from high levels with GST beginning to be implemented. SME sector has witnessed elongated working capital cycles as they have become increasingly dependent on purchaser complaince with GST and hence claim input credit. However

many of them still have doubts about rates, process etc due to which the purchasers delay payments leading to higher working cap cycles which in turn puts growth under check.

CHART: Capacity utilization remains low



Source: RBI

The relatively strong core sector growth is fueled by household demand and Govt. Policy (expected to continue in light of better tax mop up, Divestments) investments. Oflate, the credit growth in the economy has been struggling to catch pace as demonetization and GST have put some breaks along with NPA troubles in the Banking system due toagri loan waivers, demonetization and existing large corporate defaulters.

Conclusion: Valuations not cheap anymore

At present, valuations of Indian equities are at a premium to long term average multiples and to its peers (other emerging markets). The macros too continue to be favorable with Low interest rates, ample liquidity and benign inflation rates which are positive signs and intuitively a precursor to economic growth. At present, the retail inflows are driven by lack of decent returns in other asset class, and the ample liquidity scenario continues. However, going forward, the markets are in search of near term triggers to grow from here. In our view, side wise movement interspersed with volatility is likely to continue in the near term, though we are positive on the long term structural growth phase for India. In our opinion, investors should stick to our investment themes and use the market volatility to pick quality stocks.

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