

Market Outlook

December 16, 2020

Index

Cautious Optimism

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by BNP PARIBAS

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2021 begins on a positive note: Despite the serious impact of the COVID-19 pandemic on the Indian and global economy, the year 2020 is ending on a positive note for the investors. Markets are at a new high as we are set to enter 2021. The economy is on a strong recovery path, monetary and fiscal policy are supportive and India is a unique country where active cases are steadily declining despite the withdrawal of restrictions and greater mobility. No wonder, India is finding favour with foreign investors and is among the key beneficiaries of easy liquidity conditions globally.

All is not well; sustainability of recovery could be tested: Despite an accommodative monetary stance and supportive fiscal policy, it would take a lot more for recovery to turn broad-based and effectively percolate down to the high employment generating MSME segment. In the near term, hopes are pinned on a rise in government expenditure to support an economic recovery, the continued improving trend in Q3FY21 earnings and above all, a growth-oriented Union Budget.

Is it beginning of a new business cycle? The ingredients are all there, with a supportive macro scenario and strengthened corporate balance sheets at least for larger players. In its recent policy meet, the Reserve Bank of India (RBI) clearly indicated its intention of maintaining an accommodative monetary stance for an extended period time with a focus on supporting growth even if inflation stays exceeds the mandated level. On the other hand, the government is moving towards a policy framework to boost the manufacturing sector, by following up the earlier cut in effective rate with a focussed incentive plan under the PLI scheme. The idea is to create few large manufacturing players with the advantage of policy support (5-8% of value add), scale and world-class technology. Markets would be keenly watching for progress on some of the key initiatives that could trigger a long-lasting business upcycle in the country. We expect that H2 CY2021 may see a sharper business cycle rebound, due to availability of COVID-19 vaccine in Q2/Q3; lower uncertainty and perhaps a stable global environment.

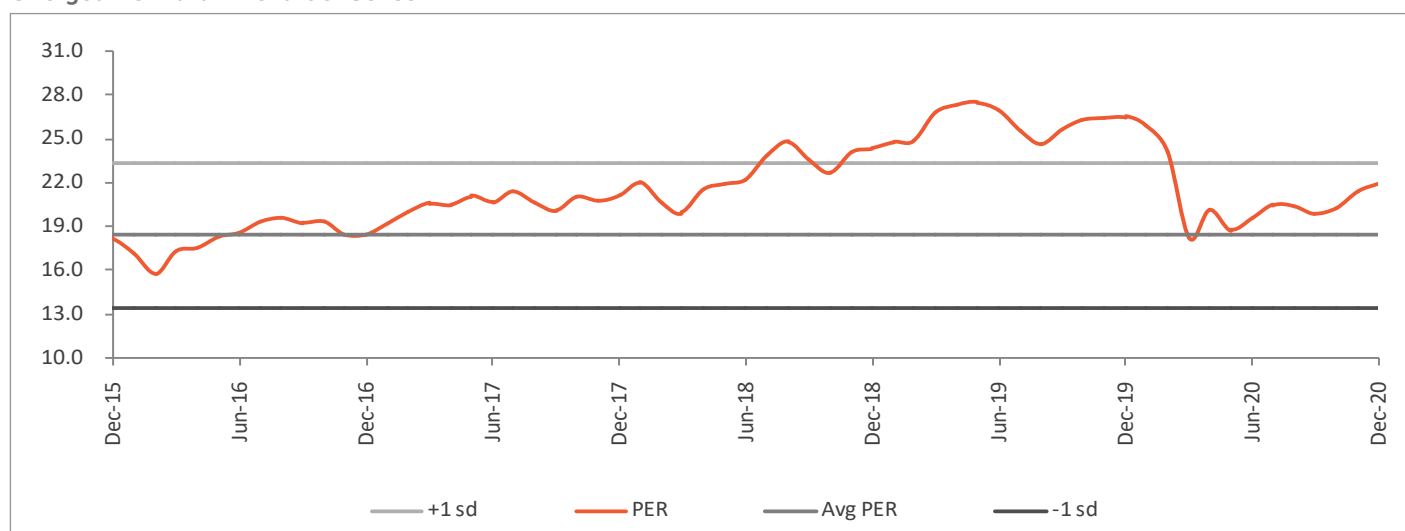
Valuations – Not cheap anymore but supported by global liquidity and earnings upgrade: Valuations are also not in a favourable zone now, with the Sensex trading at ~22x FY22E consensus estimate earnings. Though earnings multiple can be high in the early stages of a new cycle, markets would need to be supported by upgrade in consensus earnings estimates for FY22/FY23 for a sustainable rally. Rollout of vaccine and further doses of stimulus in the major economies globally would also keep the global set up favourable for equities in general. Consequently, we remain constructive on equities as an asset class and look at every dip as an opportunity to buy. Most investors are any way sitting on fence or have created some cash in their portfolios lately. Also, the portfolios could do better with some rejig in terms of partially shifting allocation to value picks and/or those sectors that have lagged and are not early gainers of an economic recovery cycle.

Sector Preference: NBFCs, Engineering, Pharma, IT Services and select companies in consumer and banking sector

High conviction investment ideas:

- ♦ **Large-cap companies:** Bharti Airtel, Cipla, Infosys, ICICI Bank, M&M, SBI and UltraTech
- ♦ **Mid-cap/small-cap:** AU Small Finance Bank, Bosch, Cummins India, GSPL, SRF, Cholamandalam Investment & Finance, Solara Active Pharma Sciences and Tata Consumer Products Ltd

One-year forward PE chart of Sensex

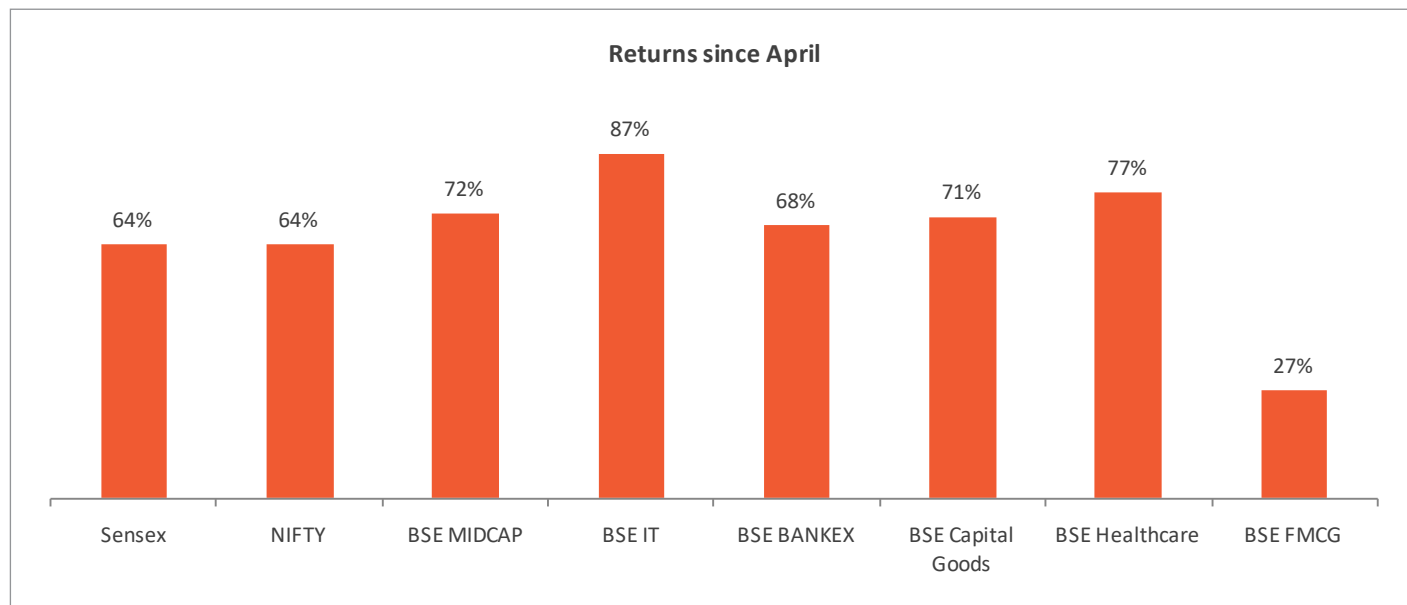


Source: Bloomberg, Sharekhan Research

Massive rally from deep correction earlier this year

Despite the serious impact of the COVID-19 pandemic on the Indian and global economy, 2020 is ending on a positive note for the investors. The markets are at a new high as we are set to enter 2021.

Sharp bounce across sectors from March

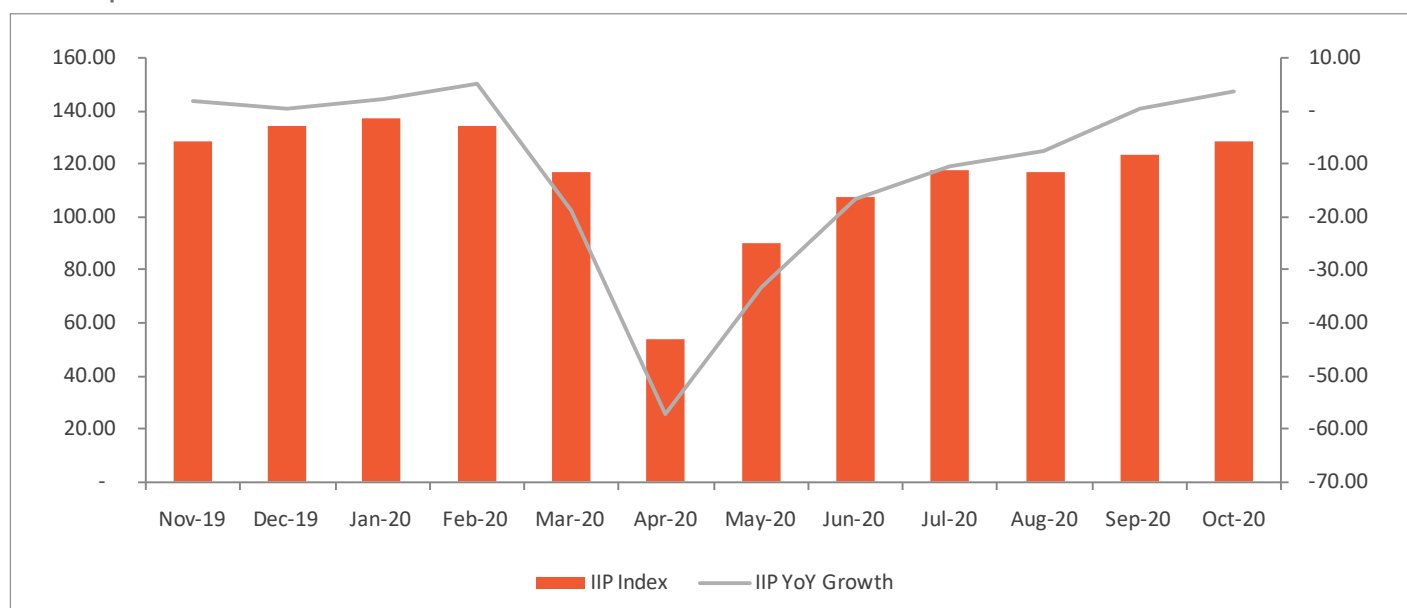


Source: Bloomberg, Sharekhan Research

Rally supported by strong economic recovery and earnings

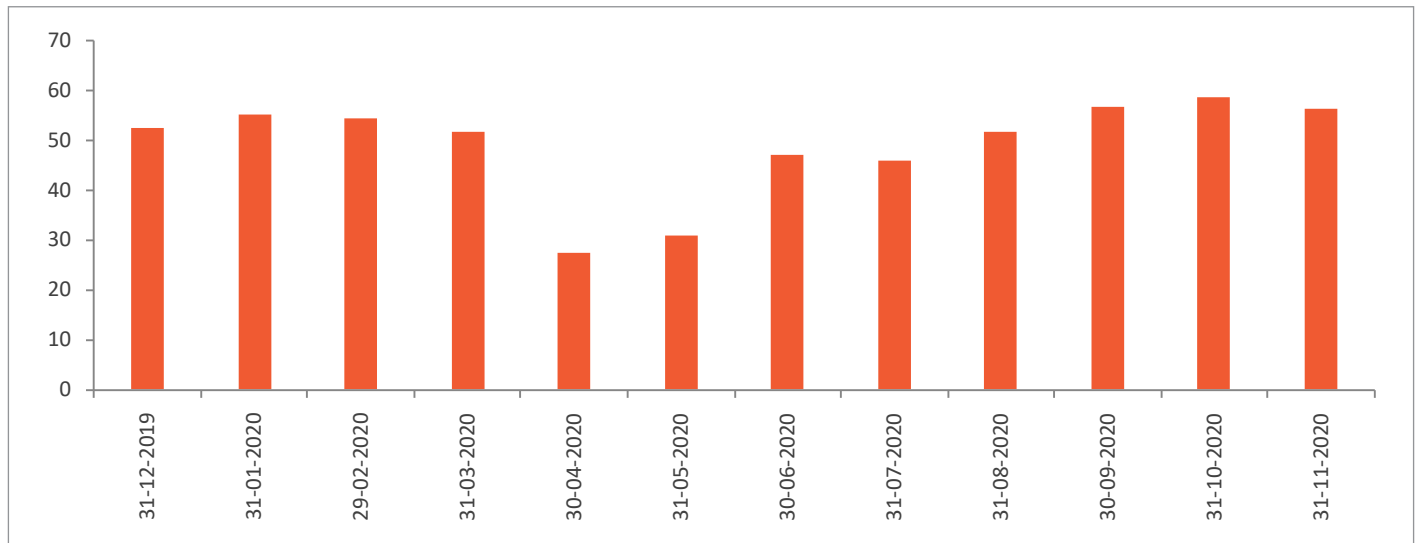
The strong economic recovery has been ahead of expectations. The normalisation of e-way bill generation, rising GST collections and industrial production moving into positive growth zone was not anticipated few months back. From the nadir of a 23.9% contraction in Q1, the decline in GDP growth has narrowed down to 7.5% in Q2 and is likely to move into positive growth territory by Q4 according to projections by the Reserve Bank of India.

India IIP performance data



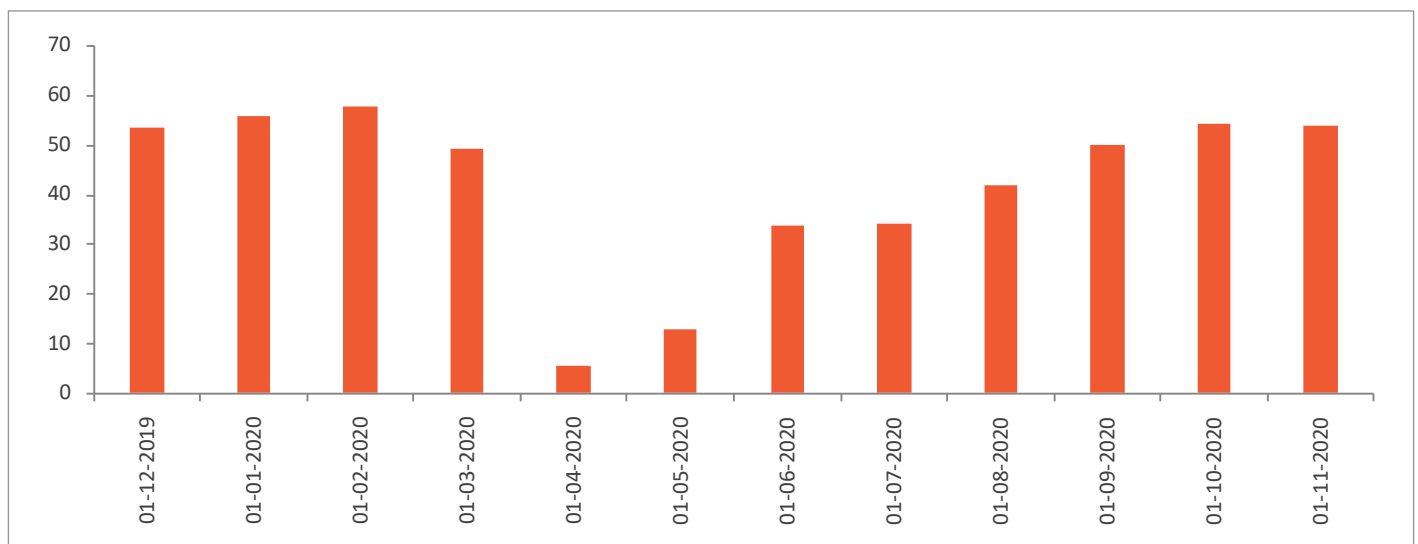
Source: MOSPI, Sharekhan Research

India PMI Manufacturing



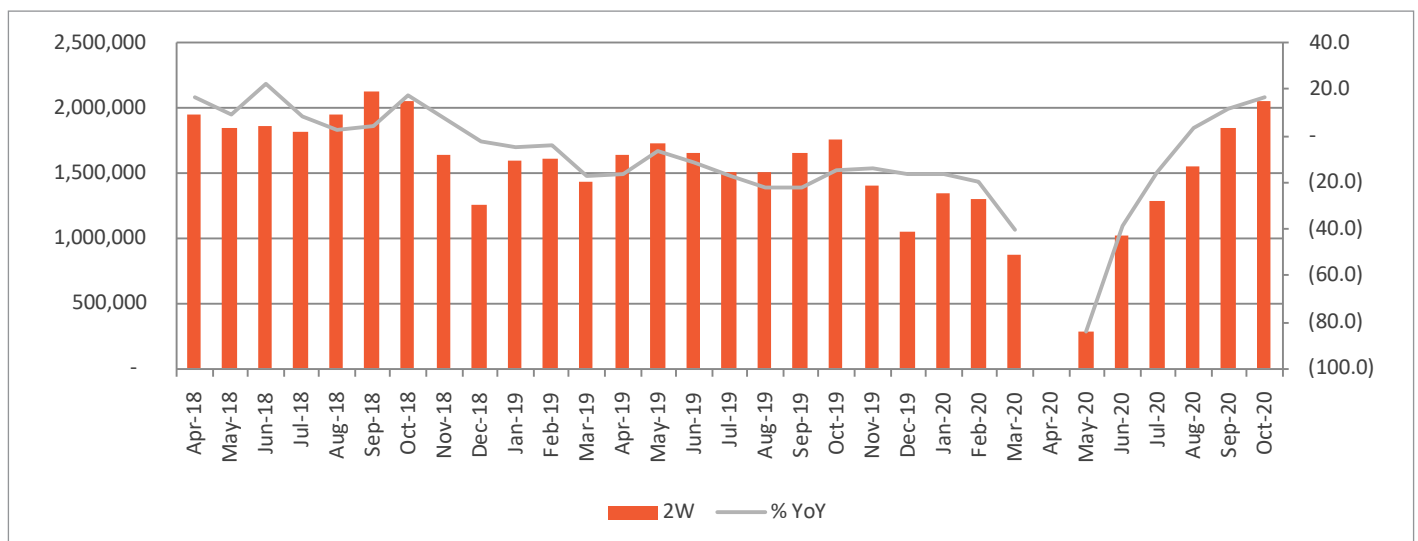
Source: Bloomberg, Sharekhan Research

India PMI Services



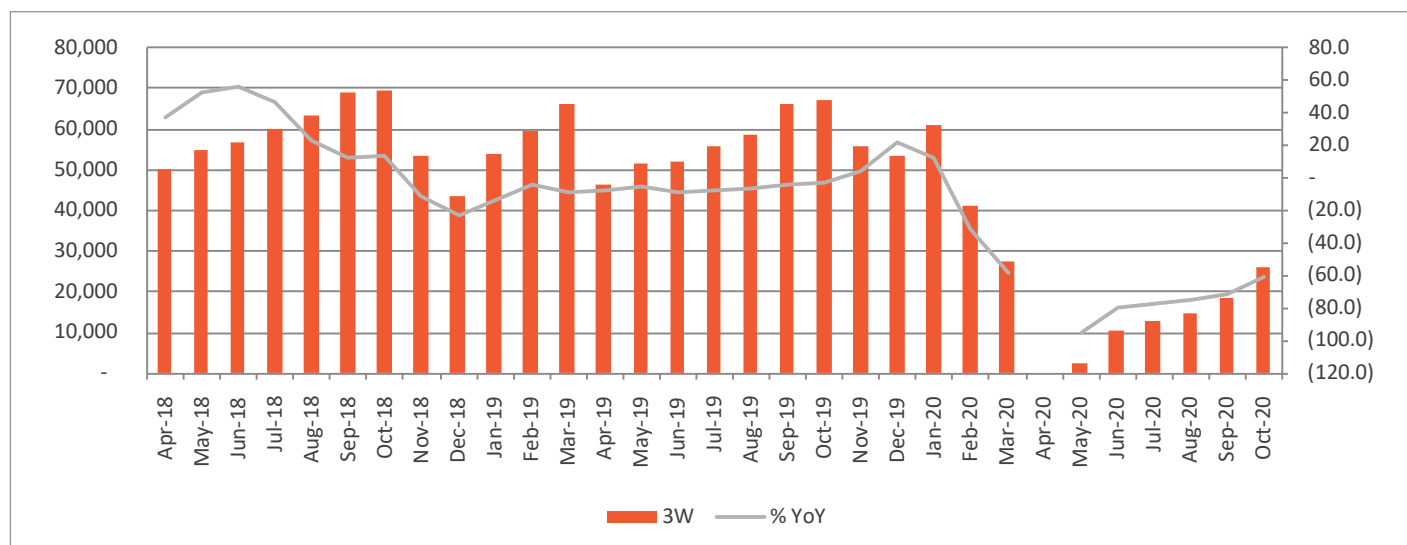
Source: Bloomberg, Sharekhan Research

India 2 wheeler Vehicle sales



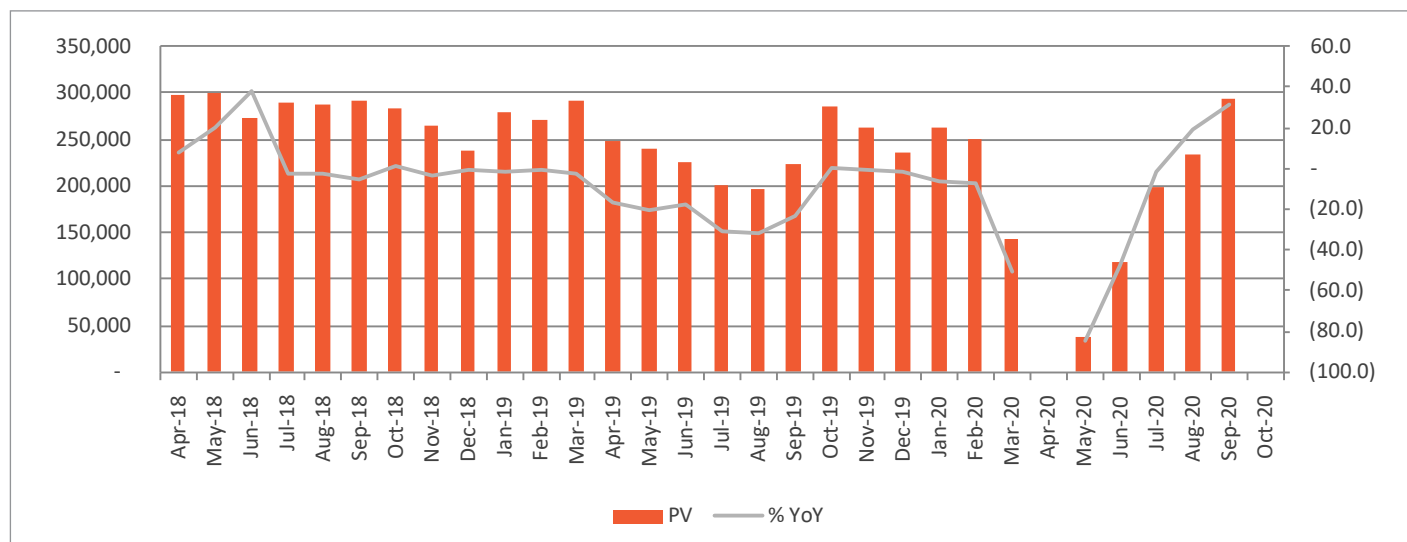
Source: SIAM, Sharekhan Research

India three-wheeler vehicle sales



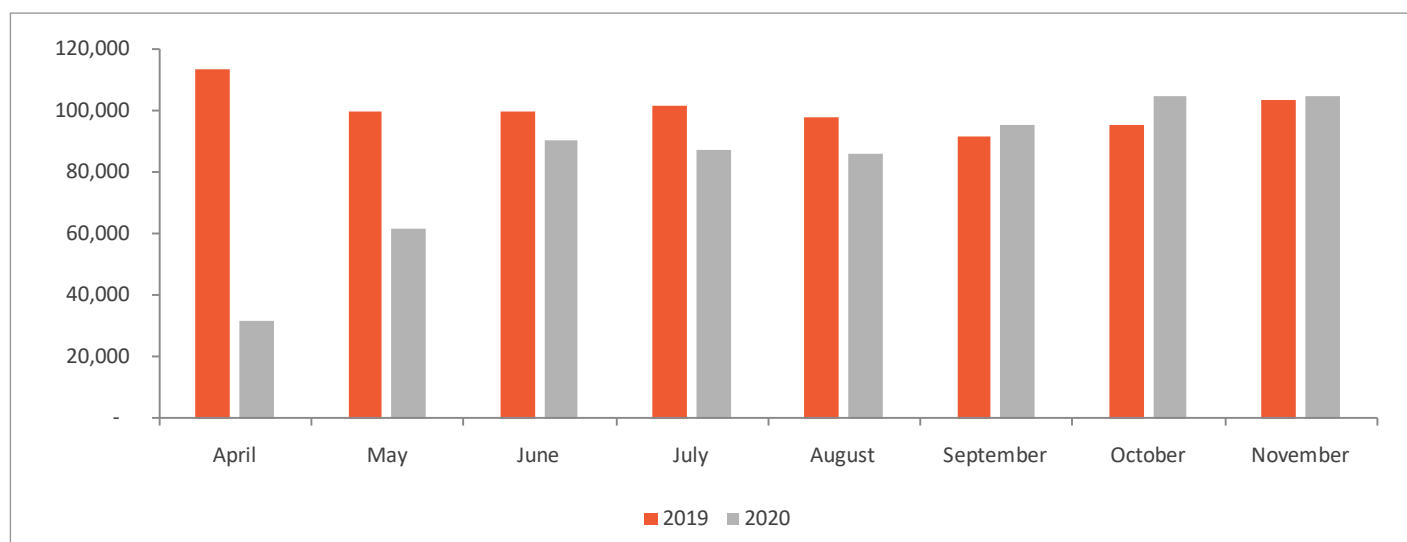
Source: SIAM, Sharekhan Research

India passenger vehicle sales



Source: SIAM, Sharekhan Research

India GST Collections

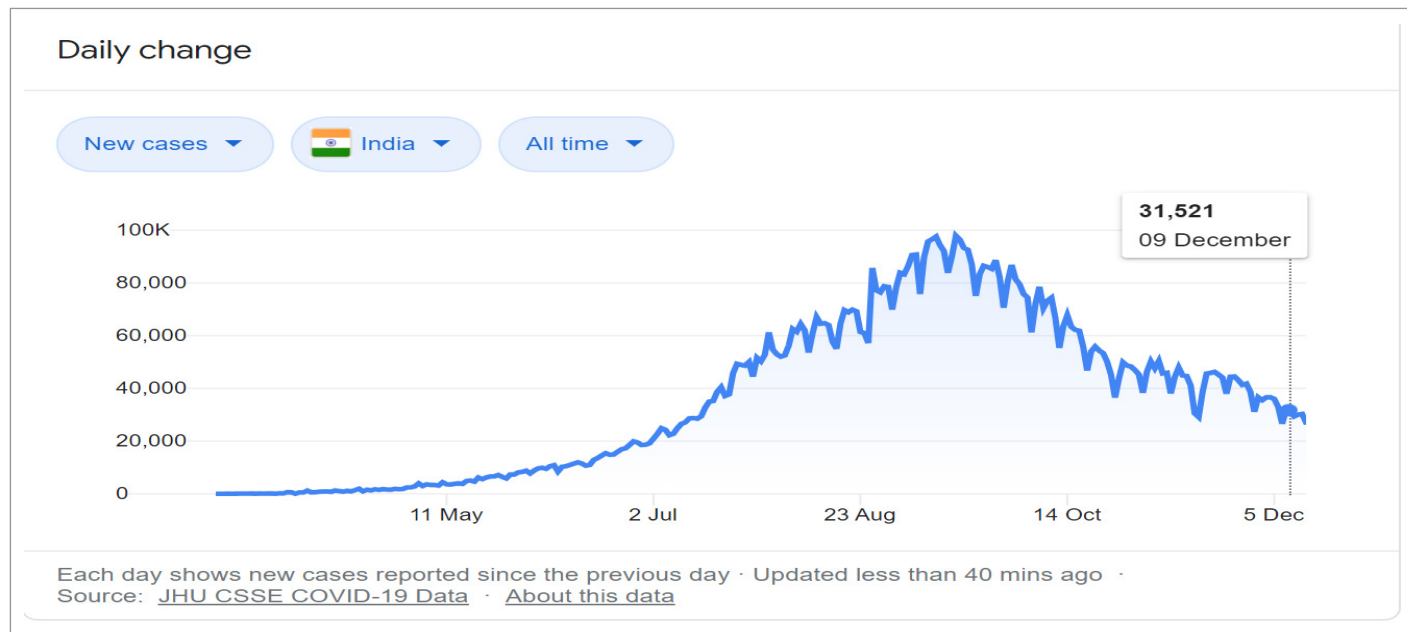


Source: PIB, Sharekhan Research

Fall in active COVID-19 cases boosts sentiments

India is unique in terms of being a country where active COVID-19 cases steadily declining despite a withdrawal of restrictions and increasing mobility. From a peak of close to 10 lakh active cases in mid-September 2020, active cases have steadily declined to 3.5 lakh in the past three months despite easing of restrictions and rising mobility.

Active cases in India

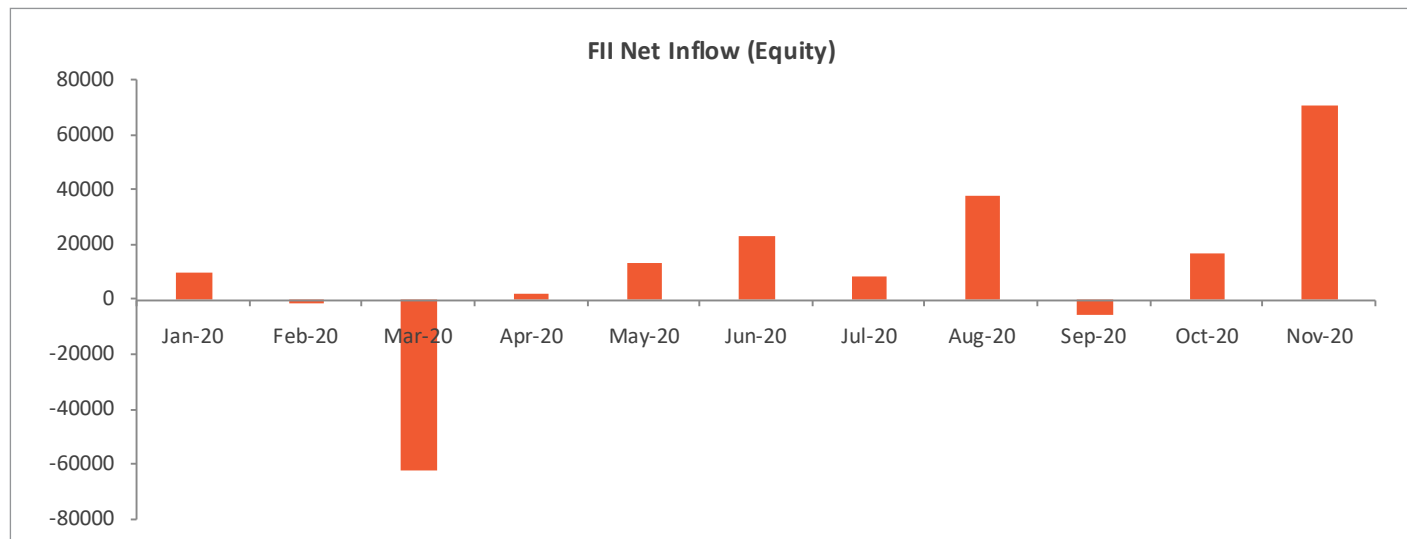


Source John Hopkins, CSSE Data

Gush of liquidity - India gets more than fair share

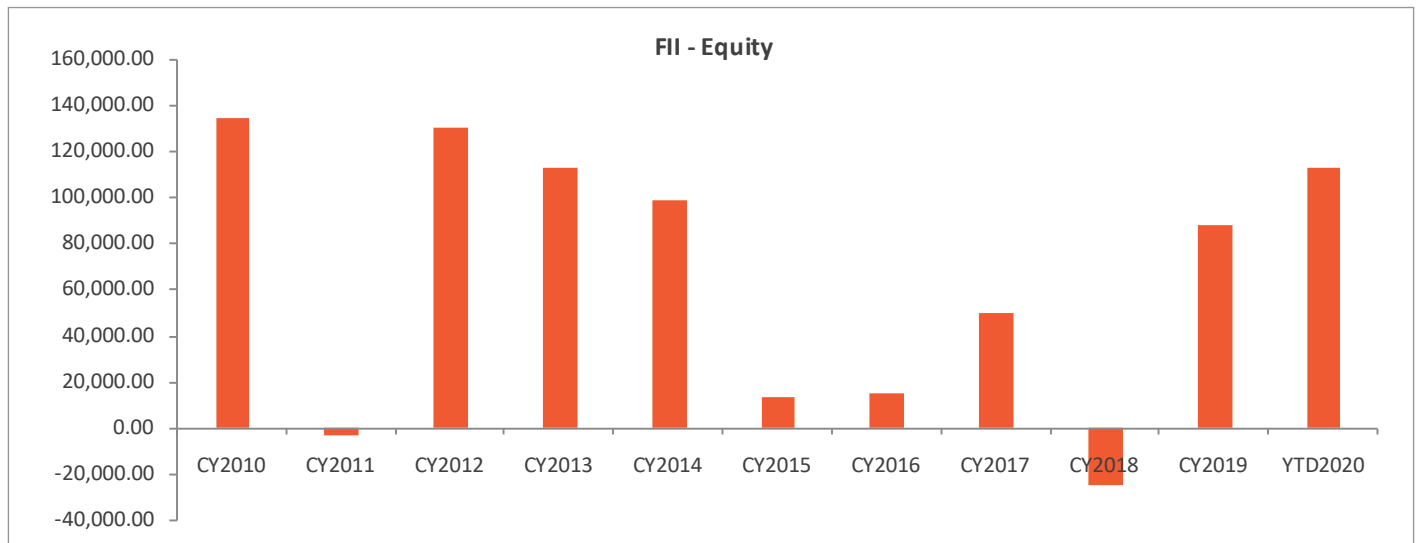
In CY2020, net FII net inflows were unprecedented and were at multi-year highs. Easing global liquidity conditions and a weakness in the US Dollar has led to huge inflows into emerging markets and India has got more than a fair share of it. The improving trend in economies and easing of active cases seems to have triggered an increase in India's weight in the MSCI Emerging Market Index; thereby further fuelling foreign flows into India. In November alone, Indian equity markets attracted Rs. 65,000 crore of net foreign inflows.

Monthly trend in FII inflows



Source: SEBI, Sharekhan Research

Yearly trend in net FII inflows



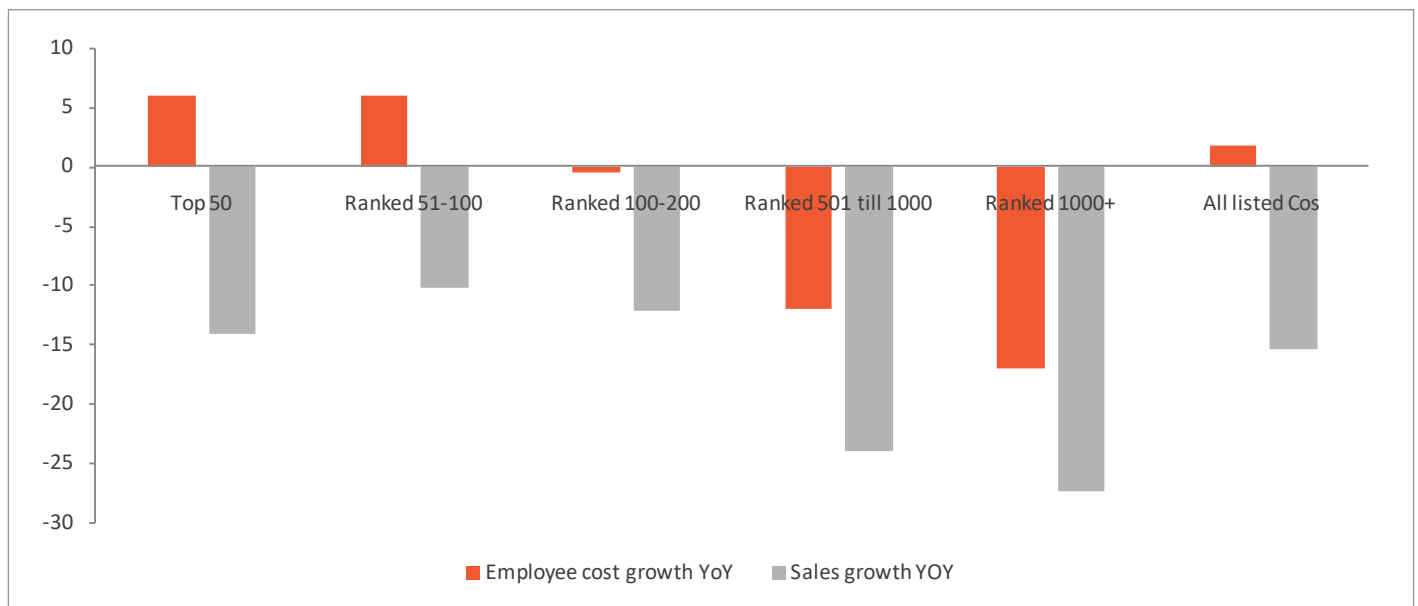
Source: SEBI, Sharekhan Research

All is not well; sustainability of recovery could be tested

Despite an accommodative monetary stance and a supportive fiscal policy, it would take a lot more for the recovery to turn broad-based and effectively percolate down to the high employment generating MSME segment.

While the COVID-19 pandemic has been a major disruptor across geographies and industry segments, large corporates have fared better than their smaller peers, not only due to better technological prowess but also resilience due to size. Hence, while the listed universe has seen near overall sales impact for H1 FY2021 (vs H1 FY2020), growth in employee costs (hiring, salary raises, etc) is seen for larger firms but is muted in smaller firms.

Rising employee costs point to faster recovery for large corporates



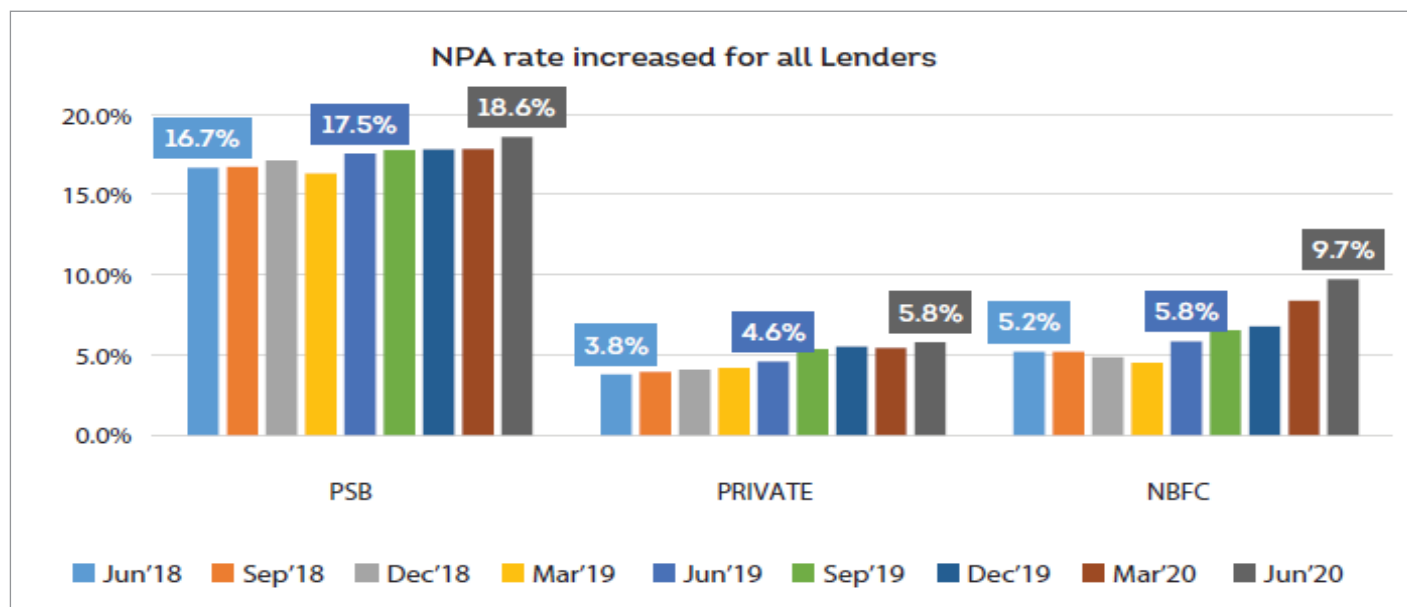
Source: Capitaline, Sharekhan Research

As seen below the MSME sector continues to have elevated levels of GNPA ratios, which indicate the stress the sector is undergoing. As per industry estimates, the MSME sector is expected to see a 400-500 bps increase in stressed loans in FY2021E.

| | GNPA % of MSME sector – still at elevated levels | |
|----------------------|--|--------------|
| | Mar-20 | Sep-20 |
| State Bank of India | 9.40 | 8.20 |
| PNB | 16.80 | 15.90 |
| Bank of India | 15.80 | 13.70 |
| Bank of Baroda | 13.00 | NA |
| Canara Bank | 11.80 | 9.50 |
| Union Bank of India | 16.30 | 17.60 |
| Indian Overseas Bank | 10.70 | 8.20 |
| Indian Bank | 10.60 | 9.30 |
| Bank of Maharashtra | 12.60 | 10.60 |
| UCO Bank | NA | 10.20 |
| Mean | 13.00 | 11.47 |

Source: Banks, Sharekhan Research

NPA rates of lender groups in MSME segment



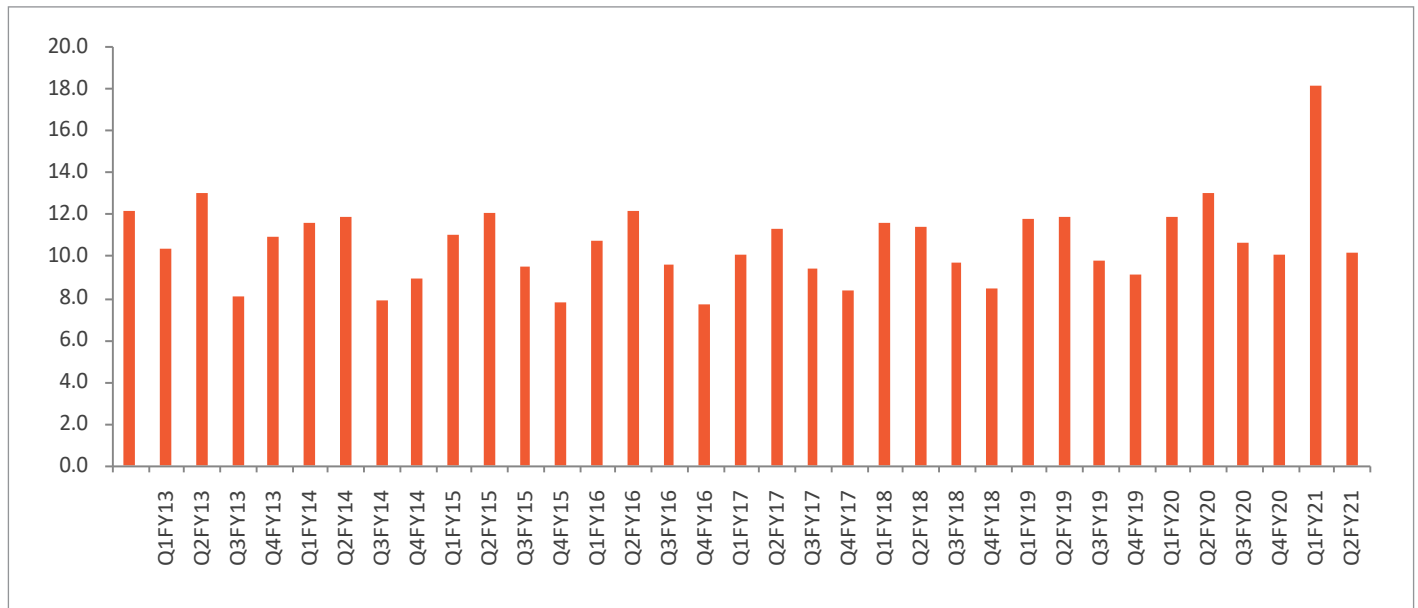
Source: CIBIL, SIDBI

India has around 63.4 million MSME units, which contribute 33.4% to the manufacturing sector GDP and 24.6% of services GDP, according to government data. Hence, alleviating the stress in the sector will be important for the sustainability of the recovery.

Need for rise in government expenditure

The recent economic recovery can be explained by pent-up demand post a long lockdown, inventory build-up and the festive season sales. Thus, private demand could wane off given tough employment conditions and because the recovery still in nascent stage in the MSME and unorganised sectors. Consequently, the hopes are pinned on rise in government expenditure to support the economy in the early 2021.

GCFE as % of GDP

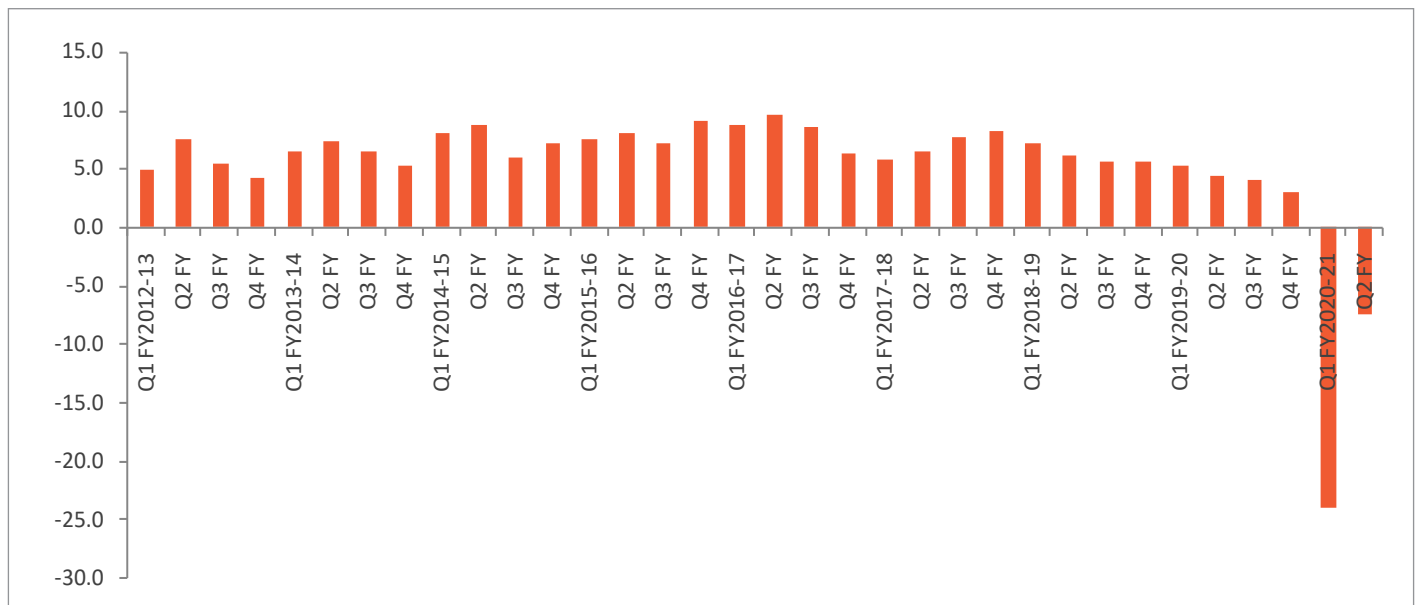


Source: MOSPI, Sharekhan Research

Year 2021 – Start a new business cycle?

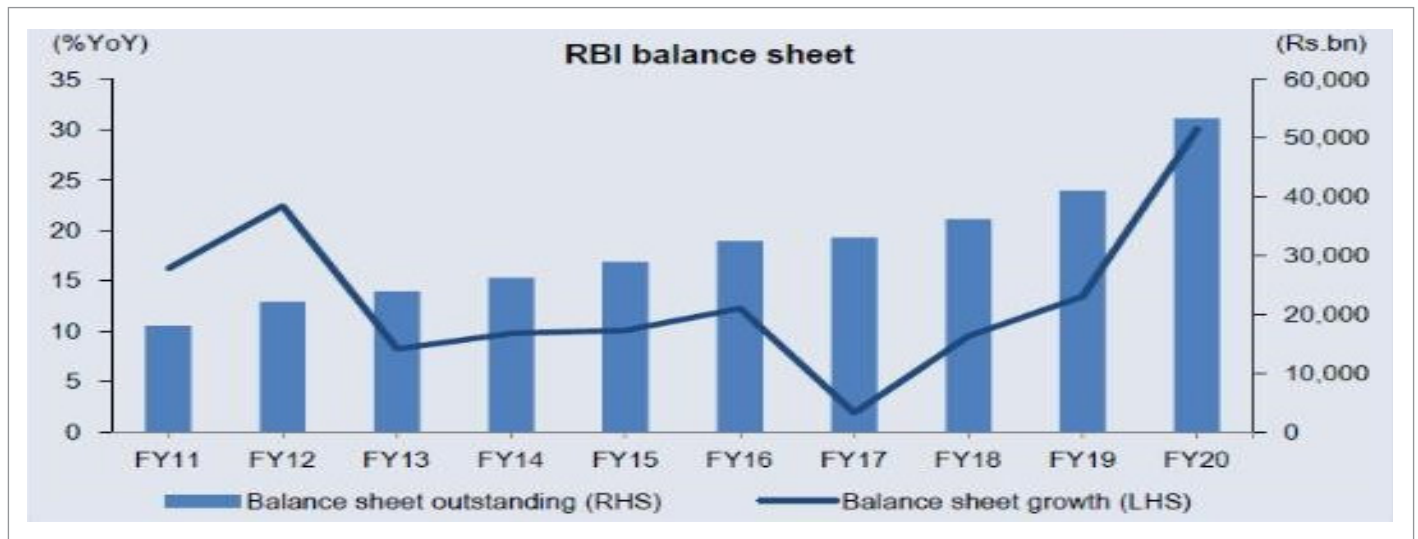
The market is always discounting the future and this time too, we believe it is looking ahead in anticipation of a better picture in 2021. The macro set-up domestically and globally is favourable in terms of ample liquidity and low interest rates. Fiscal policy measures taken to support an economic recovery and easing of active cases despite rising mobility. Thus, economic activity might not be affected by easing of restrictions.

India GDP



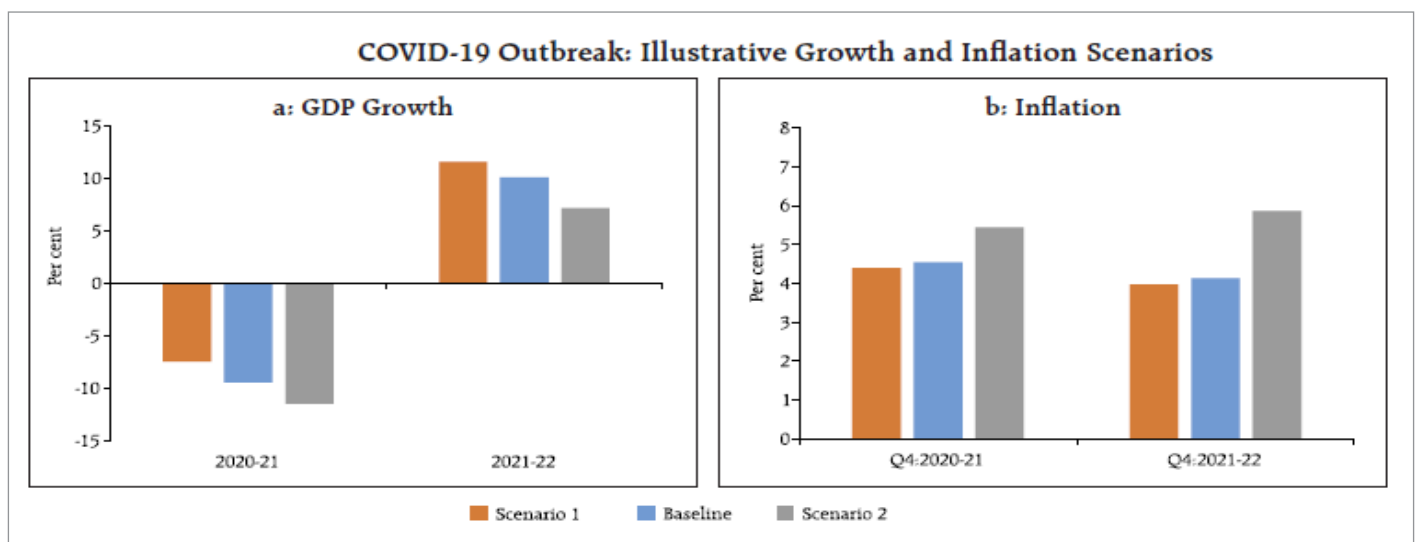
Source: MOSPI, RBI, Sharekhan Research

RBI balance sheet size



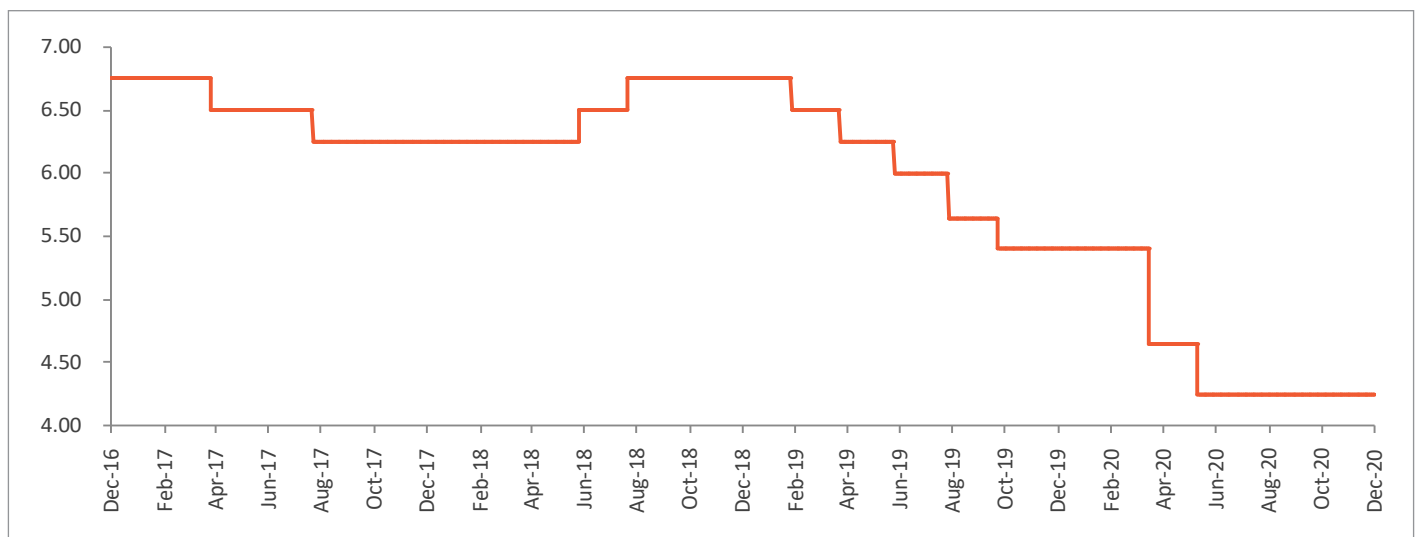
Source: RBI, Sharekhan Research

RBI expects strong recovery in FY22E



Source: RBI, Sharekhan Research

RBI keeps repo interest rates low; spotlight on growth



Source: RBI, Sharekhan Research

PLI Schemes may add ~\$520 billion in five years to GDP

In order to reduce India's dependence on external sources (read China), the government in March announced a Production-Linked Incentive (PLI) Scheme. The aim of the PLI scheme is to incentivise and invite global, capital-rich companies to set up capacities in India.

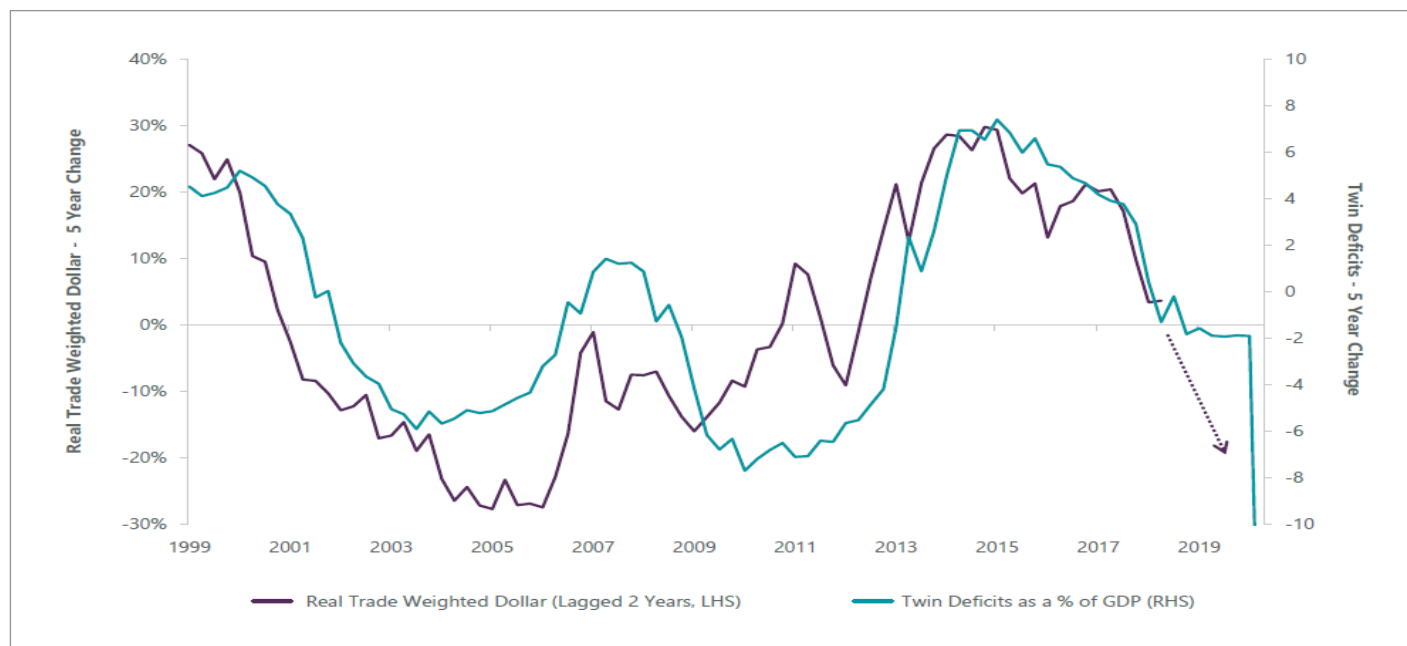
The scheme is applicable for select sectors which are labor-intensive and are expected to cater to the growing employment needs and achieving size and scale in manufacturing, as these schemes incentivize incremental production.

The total budgetary outlay for these schemes is Rs. 1.96 lakh crore or \$26 billion. On an average 5% of production value is provided as an incentive. This implies that minimum production in the country as a result of the PLI schemes stands to be around \$520 billion in five years (as per government estimates).

Weak US Dollar - High FII inflows into emerging markets

The twin deficits indicate that the US Dollar may weaken over next several years. This presents an opportunity for emerging markets, as inflows can pick incrementally, since a Dollar weakening will result in higher returns for investors. The emerging markets rally of 2003-2008 was driven by weakness in the US Dollar. The same can happen again.

US twin deficits budget and trade

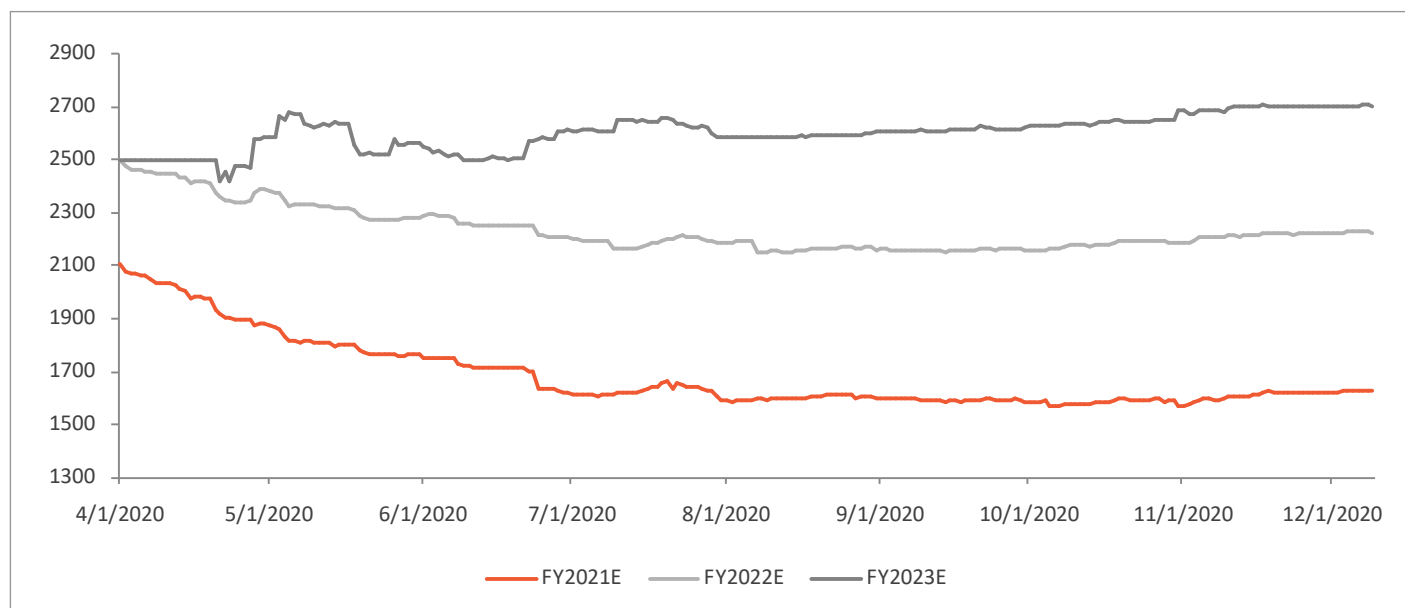


Source: Federal reserve, Bloomberg, Sharekhan Research

Earnings upgrades after a long time

After a long gap, Q2 FY2021 saw corporate earnings upgrade on a consensus basis. We believe that going forward, as recovery and normalization sets in, there is probability of further earnings upgrades as well.

Sensex EPS Consensus Estimates

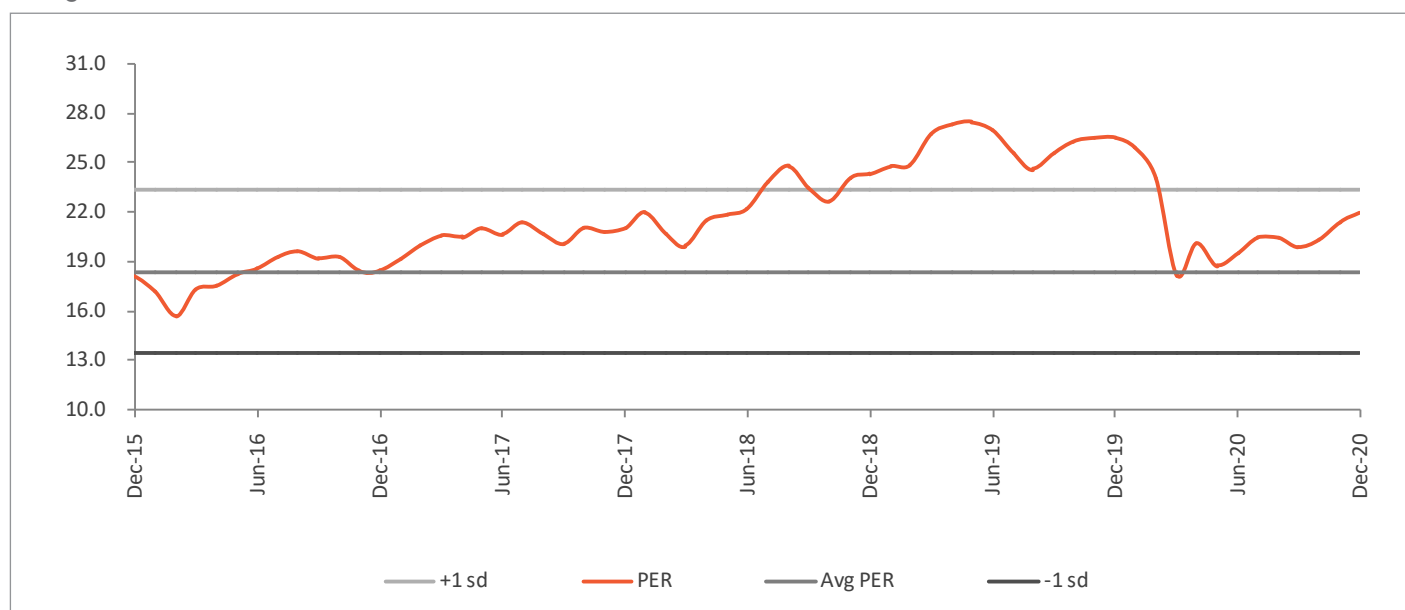


Source: Bloomberg, Sharekhan Research

Valuations – not cheap anymore but enough reasons to stay positive

Valuations are also not cheap anymore. However, our view remains constructive on equities as asset class. India is possibly on a cusp of a new business cycle, which would mean strong growth in corporate earnings and further upgrade of earnings estimates. Consequently, we remain constructive on equities as an asset class and look at every dip as an opportunity to buy. Moreover, there is likely to be a strong liquidity support to Indian equity markets. Domestically, most investors are anyway sitting on the fence or have created some cash in their portfolios lately. Globally, the weakness in US Dollar and extremely low yields on bonds would continue to attract flows to growth markets like India.

One-year forward PE chart of Sensex



Source: Bloomberg, Sharekhan Research

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