Midcaps, smallcaps likely to further scale up: Alchemy Cap

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The market has been on a roll recently notching up stellar gains for itself. This run can be attributed to the dramatic improvement in liquidity, says Hiren Ved, director and chief information officer of Alchemy Capital Management. He says broader markets are likely to further scale up from these levels.

However, he says, crude continues to remain a significant concern for the market. "We will see some moderation in earnings on quarterly basis," he feels.

Below is a verbatim transcript of the interview on CNBC-TV18. Also watch the accompanying videos.

Q: How are you feeling about the market now — cautious or bullish?

A: I would say cautiously optimistic. Optimistic because I think a lot of the concerns that dogged our markets, which is high inflation, tight liquidity, a lot of governance issues — while all of them have not gone away but at least they have abated to a certain extent. I think liquidity is clearly, what we are seeing from the short-end rates, is that liquidity has improved dramatically and we are seeing that the interest rate sensitive sectors like banks, which had corrected significantly, have come back again.

There was almost a near consensus around the budget that nothing will happen on the policy front. While a lot needs to be done, I think we have seen incrementally government take a few steps — they were able to table a couple of bills in parliament in the budget session.

Incrementally, from the absolutely lows both from a sentiment perspective and from a policy front perspective, we have seen things improving incrementally. So things have come back. Secondly, I think that global liquidity seems to be back in. A lot of emerging markets (EMs) have received money and so also has India and that has kind of helped markets to claw back some of the gains that it had last year which it had given up.

Q: Would you take any profits here because of this 10-12% rally that we have seen or do you think we have turned into a bit of a trending kind of market here?

A: My own sense is that we have turned into a bit of a trending market at this point in time. Booking profits really depends on what kind of a view you have on the company and so purely looking at the market levels I would not be in hurry as yet because I think a lot of people are still playing catch up with this rally.

Q: Over the course of the next few weeks then will there be more expansion in the market performance as well because there were some concerns about the narrowness of the rally. Will that begin to open up do you think?

A: I guess so. Our markets peaked in November and then we saw a correction while the narrow market or the index corrected by 12-15%. The midcaps actually corrected by 30-40% and typically there is always this move with a lag and I think now that the index has caught up you will see a lot of catch up. The breadth have been improving and my sense is that at least for some time into the future I think the breadth will continue to improve, so the broader market should also scale up because they had really corrected very sharply from November onwards.

Q: Even for institutional investors who are choosing to buy this market or increase weightage on this market now, they do admit that crude is the biggest problem for us. At what point do you think it will come back and bite us because USD 120 per barrel is not comfortable for our market by any long shot?

A: Yes, crude continues to remain a significant concern. But the funny thing is that, if you go back and look really at markets even in 2008, I think we have seen a situation where all asset classes have gone up together. It means when crude has rallied, even in the past, our markets have rallied and it is only when it gets to level like maybe on a sustainable basis at about USD 140-150 levels, it has really impacted our markets.

This whole move ever since we have come off the lows 2008 is basically very strong liquidity driven. It means that all asset classes are moving together. While fundamentally rising crude prices is not good for us but the fact of the matter is that today liquidity is driving all asset classes together.

I agree that our economy has gotten bigger and stronger. We do have some cushion to take higher crude oil prices but I don't think that we have that luxury if this price remains here or moves higher for a long period of time. It is definitely going to impact on interest rates and growth going forward and even corporate earnings as far as margins is concerned.

One has to keep that at the back of the mind. While we all can be happy about the rally in the market right now which is liquidity driven but we cannot take the eye off the crude oil prices.

Q: What do you expect from earnings now? We are about to enter a season where there is divergent opinion on what will come out of. Do you think earnings will support the positive trend that we have been in for the last two or three weeks?

A: If you really look at ever since Q3 onwards, we have seen a mix of earnings performance. There have been sectors which have been able to deliver strong performance like banks. There are other sectors which have got impacted in terms of earnings because of rising costs.

This quarter, clearly, some of that increase in commodity prices and costs are likely to catch up in the fourth quarter. So we will see some moderation in earnings on a quarterly run rate basis that we have been seeing. But it will still be positive. We will end the year with 23-24% kind of overall earnings growth for FY11. If we look at FY12, while consensus is about 18-19%, it would be safe to assume with the way commodity prices are that we will at least grow by 15% next year.

Q: With the 15% earnings outlook then, I mean how much more upside would you be comfortable giving this market?

A: At current consensus earnings estimate for FY12, which is now almost the current year, the market is trading at about 15 times. Have we gone in the past to close to 18-20 times? The answer is yes. That would really depend on a lot of how the overall environment is, how the liquidity situation is, whether this government is able to take forward some of the reforms that we have been expecting.

So basically what I am saying is that you can get back some of that premium that India has always traded at provided a lot of things fall into place over the course of the year. At this point in time, it looks like that on the commodity and reforms front a lot needs to be done.

It's difficult to make a case whether the market can trade at 18 or 20 times current year earnings. So I would say that basically it would be fair to assume that the valuation expansion may not happen right away and what you could get in terms of upside is what you will have from earnings growth purely, so maybe 15% from here.

Q: Just to look downwards from that level then, on which sectors do you think there is the scope for significant valuation expansion right now?

A: It's quite interesting the way the market has placed itself in the last few months and quarters. Sectors, which have done well, where the balance sheets are clean, the return on equity is higher, the kind of businesses that you would really like to own over the long-term are now trading at reasonably good or rich valuations. It's very difficult to make a case that there will be a further significant PE expansion in those sectors — the consumer sector, the FMCG, the branded companies and so on and so forth.

On the other hand, we have the infrastructure and the capital goods and that entire space, which has considerably lagged, rightly because of rising interest rates. We haven't seen much movement on the policy front and the whole concerns about environmental issues, execution issues still continue to dog there.

If any case has to be made about rerating it has to be at that end of the market but for that to happen a lot of things have to happen. I mean if this market was to believe that inflation is topping out and interest rate are topping out and that we will actually see a much milder interest rate regime in the second half of the year, then that could be one reason why there could be a PE rerating there.

The second thing is that we need to have more projects awarded. We need to have execution pick up. We need to have to solve a lot of these environmental issues that these companies are facing have to get solve. So if those things fall in place, I think that is where we can say that, incrementally, we could make a case out where valuations could increase. But that's still sometime away. While we are seeing a little bit of positive movement on that front, it's too early to blow the bugle.

Q: That is the point, how much of this fundamental analysis is actually working for the market. Does it just boil down to global liquidity? Are we in one of those phases now because the number of positives that one can recount can also be offset by number of negatives like crude at USD 122 a barrel, sticky inflation, patchy earnings etc? You could argue both ways about the market from 6000 Nifty. Does it boil down to mapping what this flood of global liquidity is going to be like over the next five or six-months and that holds the key to the market rather than any of the fundamental factors we are discussing?

A: I think in the short-run definitely yes because with the kind of liquidity that is there globally, the short-term movement or flows of how the global macro pans out and how people position themselves in EMs — there are times when there is risk off trade, there are times when there is risk on trade. That is something which is driving global liquidity.

Having said that, in the longer run, I think fundamentals will stay out. So what happens is that as these liquidity cycles play out then you have these corrections and rallies, the companies which really stand out in terms of net performance at the end of the cycle are the ones which are fundamentally strong. The other ones go up with the market and they give up the gains when there is correction.

That is the overall game that is being played out in the markets right now that while liquidity is reasonably responsible for short-term movements, but in the end, the last man standing are the companies, which are delivering growth, which have better balance sheets, which have quality and they are able to survive these cycles in the markets that we are seeing.

Q: What do you hear in the environment about people that you talk to you about what the liquidity situation is like in the West? What is triggering off in the last two-three weeks this move to EMs and how durable that trend might be?

A: I am not an expert on global macro but I think talking to people, a) it looks like that the divergence that was there between the developed markets and emerging markets had had gotten a bit far. b) I think that post Japan earthquake, I think the yen had rallied and we had seen very strong intervention in the currency markets and the yen has again weakened.

That people are talking about that there is enough liquidity that has been pumped by the Japanese central bank and some of that liquidity could be finding its way back into riskier assets, that is, EMs. So some of those things seem to be playing out at this point in time but it's very difficult to point at a particularly single factor.

But these are global macros to events which are playing out across markets. We have seen flows happening to all EMs including India.

Q: Due to the strength of those flows or the momentum of them would you say this is the biggest opportunity for the market to make a shot at its new high?

A: It is difficult to take that call but if you really look at the EM index, it peaked in November then it corrected by about 11-12% from peak to trough and today the Emerging Market Index is already at a new high. India corrected far more than the EM universe because of our own issues we had since November; with domestic market, the politics so on and so forth and we are back.

So at this point in time looking at other things like oil prices, commodity prices, it would be difficult to make a case that India would immediately get into a new high. Can the markets go back to from where they started 6100-6200 given this liquidity drive? Yes maybe, I can't rule that out.

Q: How much are you expecting to see in terms of policy impetus because even that hasn't shaped up too well for the first half of the year?

A: There my view is that and unfortunately what happens is that it is only when there is a lot of pressure and people are on the backfoot that we tend to start working towards those policy moves. I think very clearly into the latter half of last year and early this year the political environment had gotten very challenging. The government was clearly on backfoot and they were busy trying to figure out how to get the budget session up and running.

Now that now that those issues are behind us, we are seeing positive flow towards that though I think the pace will not be what we expected to be. But the direction is definitely pointing towards a better move there.

I am hoping and I do believe that we will see policy initiatives gather momentum. We are already seeing that. The Cairn-Vedanta deal from where it was; today we are seeing forward movement from there. A lot of the environmentally sensitive projects which had an issue are now getting resolved slowly and steadily. We are now hearing that the awards for new road projects will also speed up going forward from here. We are seeing incrementally positive things happen. Whether how far we will sustain this and what the pace will be is something that we have to watch out for.