Investment Matters

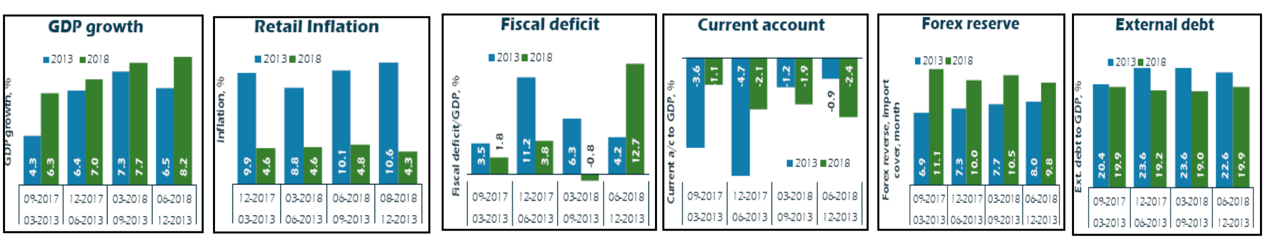
Oct 2018

EQUITY OUTLOOK

Market Overview

Indian financial markets suffered extreme volatility since September, affecting stocks, bonds and currency. There was a confluence of negatives. First, rising oil prices and general EM weakness hit the currency and the rupee depreciated 5.7% in Aug-Sep. The resultant outflows, combined with RBI tightening, impacted bond yields (up 28bp in Aug-Sep). Sentiment worsened after a default by IL&FS, an infrastructure conglomerate with outstanding debt of ~Rs911bn, triggering a downgrade from AAA to D in one go. The credit markets froze and fears spiked on the balance sheet stability of wholesale-funded non-bank financials. All this fed into a sharp correction of the equity markets, with the Nifty correcting 14% from the top – the bank Nifty correction was sharper and select NBFCs like DHFL fell > 50%.

Similarities were drawn with a correction across asset classes in 2013. The good news is that the macroeconomic stability indicators are far stronger now – CAD is ~1.9% in 2QCY18 vs ~5% in 2QCY13, inflation is benign at 3.8% in Sep-18 (10.5% in Sep-13) and the government has stayed disciplined on the fiscal deficit. Moreover, there was a sharp decline in FDI in 2013 which is not the case now.



Source: Anand Rathi, Reserve Bank of India

The regulatory response was also swift. The board of IL&FS was replaced by a government-appointed one led by Uday Kotak, to lend credibility to a restructuring process involving asset sell-downs and the appropriate levels of recapitalization. At the same time, PSU banks stepped up to assure the market that NBFCs would be provided adequate liquidity to NBFCs, even if they were unable to refinance borrowings in the bond and money markets. The RBI stepped up with a series of micro-measures to help cushion the currency fall, apart from its regular intervention.

The regulatory response and the stronger macro fundamentals have calmed the markets. Short-term borrowing rates for NBFCs have fallen to ~8% (from above 9% for a short while). The rupee has receded from its highs of Rs74.50, bond yields have dropped to 7.92% from highs of 8.2%. The Nifty has rebounded from the low by 4.6%, despite weakness in the US equity markets. The bank Nifty is up 4.6% from its lows.

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The underlying growth dynamics of the economy, are however, strong. Consumption has been strong – recovering from the disruption created by demonetization in 2016-2017 and GST in 2HCY17. Monsoons have largely been stable and rural demand is expected to be strong in 2HFY19, aided by a hike in MSPs by the government earlier this year. There is a risk that the disruption to the NBFC sector could drive a credit squeeze which, in turn, would stall the consumption recovery. Any such disruption would be temporary, however, as NBFC funding should normalize in 3-6m and banks would partially step up in the interim.

Disruption of this kind has typically provided entry opportunities in the equity markets. The 2013 correction created a long-term bottom and Nifty was up 39% in the year following the September lows. Similarly, NSEFIN corrected 15% post-demonetization (Nov-16) but bounced back by 41% in CY17. Looking through this temporary disruption, the environment for consumption demand remains strong and should remain a strong support for earnings. The investment cycle is recovering and will benefit from the continuing strength in consumption demand.

Risks remain: a) a further spike in oil prices or an extended credit squeeze could do some short-term damage to the demand and growth cycle and b) the forthcoming elections – a set of important state elections in states held by the ruling BJP in Nov-Dec 2018 followed by national elections in Apr-May 2019. **These events could drive more volatility in the markets and provide similar entry opportunities in the coming months.**

The economy and markets has shown some resilience to these headwinds. We would not worry excessively about these from a long-term perspective, barring extreme outcomes like crude crossing $100 or a highly fractured Parliament post-election. We believe that focusing on strong companies with resilient managements and a track record of execution will deliver results in the coming years. Weaker companies may find it more difficult to cope with the elevated stress and stock selection will play a more important role in the coming years than it did in the last 1-2 years.

Source : Alchemy Research

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