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CAPITAL MANAGEMENT

Investment Matters

Novemer 2020

EQUITY OUTLOOK

The markets have bounced back sharply. Nifty was up 3.5% in October 2020 with the Nifty Bank leading the way with a 11.5% rally. This was led mainly by strong numbers and the positive commentary from private banks, giving the market greater comfort on asset quality issues. The broader economic recovery was also sharper than expected, and this has helped improve the earnings outlook for many sectors.

The outcome of the US elections - a Biden Presidency and a Republican Senate – is positive for the markets. It removes the uncertainty, and the balanced distribution of power would keep the relatively extreme agendas of the Democrats under control. There is some risk if the court verdicts go in the other direction, but it is an unlikely outcome. History shows us that that the composition of the US government has little lasting impact on Indian markets. The markets are now likely to then focus on the domestic macro, which is incrementally improving.

The normalisation of the economy is progressing faster than expected. Our research of economic activity indicates that we are back to ~96% of pre-covid levels, which is faster than the market anticipated. Goods have recovered faster than services, though the latter too is showing better momentum with the services purchasing managers index(PMI) improving to 54.1 as of Oct-20. We do recognise that normalisation does not mean that growth is back, but the pace of the recovery is, indeed, good news.

We now expect a two-speed economy over the next few quarters. Demand from the higher-income segments is recovering faster, while the lower end of the pyramid is lagging. This is evident from many datapoints: retail car sales doing better than two-wheelers, banks' asset quality holding up better than NBFCs and some consumer companies reporting better growth in premium categories. This is not surprising, as the economic brunt of the lockdown was felt by SMEs and unorganised sector workers. As the economy normalises, the sustainability of growth is dependent on the demand recovery percolating down to the lower-income segments. Two sectors that are critical to this process are now delivering better news.

First, banks seem to be more comfortable with their non-performing loan(NPL) outlook than they were during the lockdown. Private banks seem to indicate that their existing COVID provisioning should largely address any NPL stress during 2HFY21, and limited spill over into FY22. This should then set the stage for a credit recovery in FY22, which would support a broad-based economic recovery. The worry is that these assertions could be premature: it is based on only 1-2 months of loan servicing post-moratorium and the true pictures on incomes and repayment capacities may not be visible until early CY21.

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Second, the real estate sector has staged a smart recovery, with a sharp spike in demand for residential apartments. One-off factors like temporary stamp-duty cuts have helped, but other longer-term tailwinds are also in place. Interest rates are at an all-time low, and tax breaks help narrow the gap between borrowing costs and rental yields. Expectations of falling real-estate prices are also reversing, with the momentum in sales and slowing of discounts by developers. Also, the RBI restructuring package should also help many developers bring back stranded projects, which helps reduce risk perception. Real estate cycles usually take time to turn but also last for long periods. A property industry recovery has many positive externalities – from blue collar employment to demand for industrial goods like cement and steel.

There are risks to the sustainability of the recovery – employment data continues to be dismal (NREGA – National Rural Employment Guarantee Act - demand is a useful surrogate), and lending capacity is constrained with most PSU banks and NBFCs unwilling to ramp up credit. We do not rule out a square-root shaped recovery – i.e., growth starts to taper after the initial bounce-back and we will get a better picture in early CY21.

The earnings season has been a positive so far. 73% of nifty companies have delivered a positive surprise so far, while the Nifty EPS for FY22 has been upgraded 4% since 30-Sep (As of 5-Nov-20). We will get a clearer picture when all companies have reported later this month (weaker earnings tend to be reported late), but this has been a positive driver so far. A key issue is the sustainability of the cost cuts for the companies once the economy normalises.

Our strategy continues to focus on three objectives. We have significantly cut our cash positions and our deployment of new portfolios is speedy. We are also diversifying our sector exposures and avoiding excessive concentration. While the market is in sector-rotation mode, this does lead to short periods of adjustment for us, but our sectoral focus remains on underlying fundamentals and valuations rather than near-term momentum. On banks and financials, we are selectively looking at some incremental exposures, especially in housing finance companies and high-quality private sector banks.

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Source :
Alchemy Research
Bloomberg

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- Market Outlook: Sideways and Volatile

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- Earnings Upgrades Views

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- Views on equities - economy disconnect

  Mr. Hiren Ved to Bloomberg Quint

3. Market Views – Oct 2020

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