Good Entry points for Indian equities in the midst of global & domestic uncertainties

Indian equity markets- Caught up in a whirlwind of global & domestic currents

Although in the run-up to the US Presidential polls there was a sense of anxiety that a Trump victory would lead to a sharp fall in global markets, what has turned the tide is market's reassessment of how the President-elect Mr. Trump's campaign promise to double US economic growth to 4% can speed-up slowing US & global economic engine.

Trump's bold economic renaissance plan for the US economy

Trump's bold economic renaissance envisages massive build-up of new infrastructure ($ 550 bn as per his transition team website), significant lowering of marginal income tax rates, bringing down rates on corporate taxation to 14%, extending a one-time tax holiday to encourage American firms to repatriate hundreds of billions lying idle in their overseas subsidiaries to bolster investments & job creation in the US, lower capital gains tax rate, eliminate federal inheritance & gift taxes completely and loosen regulations that he believes have hobbled growth in sectors as diverse as fossil fuels (coal, oil & gas), manufacturing and banking. These reflationary measures are expected to widen US' fiscal deficit, increase its debt burden and stoke inflationary pressures.

Has US Fed fallen behind the curve?

There is a perception that US Fed has fallen behind the curve by not raising rates fast enough till now and hence would be forced to raise rates sharply (and abruptly) in future. This has led to hardening of US bond yields significantly over the last few weeks. Rising economic growth opportunities and surge in repatriation of dollars by US corporates has lead to the US dollar strengthening.

Triple Triumphs- Rising bond yields, rising dollar and rising equities

US equities have benefited from the optimism of higher economic growth led by sectors like industrials, energy and materials. Steepening yield curve as also expectation of loosening regulatory shackles has fuelled a rally in banking & financials. Technology sector has suffered due to outflows from secular growth sectors to cyclical growth sectors as also a perception that as most technology biggies had vehemently opposed Mr. Trump, he may enunciate policies adversarial to their interests.

Risk-off trade hitting emerging markets with force- Weak bond prices, weak currencies and weak equities

Rising US bond yields and US dollar have triggered a risk-off trade with large outflows from emerging markets (EM) putting downward pressure on their currencies and fall in bond prices (or rise in bond yields). With record-low US dollar denominated interest rates many EM corporates had borrowed in USD and would see their debt repayments rising. As most of the borrowing is usually routed through the banking channels it would put strain on the banks and a consequent spike in risk aversion would force banks to tighten credit disbursal to emerging economies.

Impact of protectionist policies on global trade, currency wars and geo-political concerns worry EMs

EMs are also worried from a rise in protectionist policies that would shrink global trade. A rising dollar may worsen US trade deficit with surge in imports from its trading partners whose currencies have weakened and slowing US exports hampered by strengthening dollar. This may escalate into a trade war with the incoming US Administration retaliating by branding some of the countries as 'currency manipulators' as alleged during the course of the Presidential campaign. An isolationist US insisting on commensurate burden-sharing by its allies on defence can lead to rise in defence spending among its allies and a retaliatory rise in spend from its adversaries. Any spike in geo-political tensions can increase the risk premium for EMs and would weigh on risk assets like EM currencies & equities.

What differentiates India among EMs?

Although the risk-off trade post Trump's election has impacted all the EMs indiscriminately, we believe that once semblance of sanity returns investors will start focusing more closely on those economies that withstand the tremors of this mighty global asset reshuffle.

Many EM economies whose GDP relies most on net exports and whose reliance on domestic consumption is insignificant would be the worst sufferers. Conversely, EMs like

India would benefit as its economy mainly relies on domestic consumption (constituting nearly 70% of its GDP) underpinned by young demographics, rising affluence and aspiration levels, rapid financial inclusion and spread of digital technologies.

It is these domestic-focussed economies that large foreign investments would eventually gravitate to after dust has settled provided the macro-fundamentals are rock solid. India fits the bill perfectly with its economy reckoned to be one of the fastest growing among large economies, record low current account deficit, government's strict adherence to its medium-term fiscal consolidation path and bold pursuance of tough-to-achieve structural reforms, strong forex reserves, softening consumer inflation pointing towards lower interest rates that would fuel aggregate demand both in consumption & investments and aid corporate profitability.

Demonetization to delay robust recovery in earnings by atleast a quarter

The surprise demonetization move of higher denomination currencies by the government on 8th November 2016 took markets by surprise. After witnessing a tepid earnings growth for the last few years, markets were looking forward to a return to robust earnings jump in 2H FY17. The optimism stemmed from consumption-focused sectors riding on cash infusion in the economy due to the VII Pay Commission award to Central government employees and OROP to defence personnel (serving & retired) as well as a boost to rural consumption after a near-normal monsoon leading to bumper kharif harvest after two successive years of drought. The currency crunch in the wake of demonetization and adjustments warranted due to shocks to supply chains and necessity to incorporate tweaks in the mode of conducting business would delay the demand recovery by atleast a quarter.

Reduction in RBI's liability- "Transfer of unaccounted wealth from private sector to government & public sector"

It is widely expected that a certain quantum (guesstimates vary from 10% to 40%) of total currency under circulation in high denominations (approximately Rs 14.5 lakh crores) may not be tendered by the holders back into the banking system due to their inability to explain source of cash. Although doubts remain over the accounting treatment of this reduction in RBI's liability (ranging from Rs 1.45 lakh cr to Rs 5.8 lakh cr), the Chief Economic Adviser to the government Dr Arvind Subramanian has mentioned that "it should be seen as transfer of unaccounted wealth from the private sector to government & public sector". This has given rise to a belief that the liability once extinguished after 31st March 2017 can be transferred from RBI to the government as dividend and used for a combination of increase in infrastructure spend (both physical and social) and fiscal consolidation.

Banks to gain, consumer discretionary sectors to suffer delay in recovery, staples less impacted

With banks witnessing a surge of deposits (Rs 5 lakh crores has already been deposited from 9th Nov till date) mainly in savings & current accounts, the system will be flush with liquidity exerting a downward pressure on both deposit and lending rates. It would also prove to be disinflationary as demand would get crimped in the beginning due to strict currency withdrawal limits. As a sector Banks would benefit with their incremental cost of funds coming down and softening of yields benefiting their investment portfolio in bonds. They would have to closely monitor delays in payments from borrowers due to cash crunch and potential tick-up in NPAs. Banks, in general, would be better positioned to weather this change as compared to NBFCs especially those that deal in cash collections of their repayments and cash disbursals.

Consumption discretionary focused sectors like automobiles, durables, consumer finance, paints & home improvement, cement would witness slow off-take. Consumer staples segments in FMCG especially essential goods would be less impacted. Sectors like Pharmaceuticals and IT would be least impacted.

Some shedding of overweight positions seen in consumer focused sectors. Pharma to gain as worries recede. IT still presents a mixed picture.

Many institutional portfolios had large overweight positions in consumer focussed sectors over the last 12-15 months as this part of the economy was doing significantly better than the investment focused sectors like capital goods and construction as well as export focused sectors like IT and Pharmaceuticals. IT in particular was hard hit due to tepid demand conditions in the US & EU as well as hostile campaign rhetoric in the poll-bound US.

Pharmaceuticals was impacted due to slowdown in approval process for new drugs as well as slow clearance of manufacturing facilities found to be deficient in compliance of good manufacturing practices by US FDA as also the shrill criticism of the sector by Hillary Clinton for alleged excessive hikes in drug prices and threats of punitive actions to curb such practices.

We are seeing a rotation of sectoral allocations with some money moving out of consumer sectors. We expect pharmaceuticals to be beneficiary of this reallocation as fears of punitive actions on price increases has receded with Hillary’s defeat in the US and valuations look more reasonable. Besides the incoming US President would also look favourably at reducing health care costs there by encouraging more generics.

Although a pick-up in banking and manufacturing sectors in the US if the economy takes off would aid demand growth in the Indian IT outsourcing sector as these two are the largest client segments for them, the evolution of policy in favour of H1B visa and migration of skilled workers by the Trump government will be closely watched. During the heat and dust of campaign Trump had adopted a highly bellicose stance on this issue and one would need to watch whether there is moderation in his actual policy position after assumption of power.

Times of uncertainty & asset price dislocations- Best medium-term entry points for Indian equities

We have positioned our portfolios with an overweight stance on Banking and Pharmaceuticals followed by some allocations towards sectors like autos, cement and IT. It is such times of uncertainty and asset price dislocations that, on hindsight, turn out to be excellent entry points for investors and we urge investors to increase allocations to Indian equities with a medium-term perspective.

Ajay Bodke
CEO & Chief Portfolio Manager - PMS
Prabhudas Lilladher Private Limited
November 21, 2016.