5th MAY 2023

INDIA EQUITY OUTLOOK

The macro issues of high inflation and the consequent hike in interest rates appear to be peaking out. For the whole of last year and since August 2021, global equity markets faced issues of inflation, supply chain disruption, high freight costs etc and then the consequent rise in interest rates by Central Banks. These are expected to get reversed, which should support risk assets like equities going forward.

If one observes, March headline inflation has moderated to 5.6% after two consecutive above 6% readings. Core inflation too has surprised on the downside. So lower oil and commodity prices are a reflection of inflation trending down. As such, **we estimate a prolonged pause by RBI and even a possible run cut stance, preferably in 2HFY24.**

On the US economy - given resilient consumers and strong economic data, there is higher probability of the US economy facing only a soft landing versus a sudden crash or a deep recession. However, given slow down stress in western markets, we expect **emerging markets to find favour.** Emerging markets (EM) are under owned asset class globally and have better growth, lower inflation and less sovereign debt. So we expect a gradual flight of risk capital from slowing developed markets to relative higher growth, stable currency emerging markets. And we expect India will be a favoured destination for global investors to attract flows.

The Indian economy is witnessing multiple levers of a secular growth cycle. These include private capex, govt-backed PLI programme and sustainability of credit growth. The credit growth for public sector banks at 15% and for private banks at 20% reflect buoyancy in business and consumer lending. So, India's domestic consumption will partly offset any adverse export market conditions due to global slowdown. While a complete decoupling is not possible, due to trade linkages, but rising credit growth, move from un-organised to organised sector and increase in consumer spending will help the Indian corporate sector.

Another important component that is structurally changing and that has not happened for decades is the Rise of India's manufacturing – The key drivers for manufacturing are seeded in place – PLI in 14 sectors with focus on Atma Nirbhar Bharat along with reduction in tax rates for new factory units. These, along with China + 1 (as globally US is looking at supply alternatives to China) will lead to strong manufacturing growth in the years ahead.

A come-back year of mid-small caps, that has under-performed over the last 12 to 15 months v/s large cap index. Small mid-cap companies have historically tended to outperform large-cap companies over the long term as the segment has the potential to grow more quickly, which can lead to higher returns for investors. Though, as a category, small-mid-cap companies are also more volatile and less predictable in the short run. Assuming our probable scenario of receding inflation and interest rate concerns going forward, we expect small-mid-cap companies could come back and outperform large caps as risk perception decreases.

Risks and challenges to India's economic or manufacturing activity could potentially come from a global slowdown and the lag impact of monetary tightening.

Our Investment strategy and opportunities are more domestic-oriented.

India's export business is very much coupled with global economies. Hence our portfolio focus is more on domestic-centric businesses. We are avoiding companies that are largely dependent on exports - as such, we are underweight on IT (recent validation by large companies' results that reflected project delays/cancellations and lower growth guidance) and metals (though there could be a bounce due to China recovery, but we are still unsure whether it will sustain, given the developed market slowdown).

Themes like banking & financial services, travel & tourism, engineering & manufacturing are interesting opportunities. We do like select pharma and specialty chemicals which could come back as their profit margins are close to bottom.The 4th quarter results will again reflect cost and margin challenges, but the market may have largely discounted it.

Capital goods sector will be driven by capex cycle recovery. We expect the execution of all capital goods companies and most EPC companies to remain healthy, led by strong order book accretion in the past 5 to 6 quarters. Also, operating margin will improve from the recent moderation in commodity prices. There is healthy enquiry pipeline and broad-based capex recovery across the sectors such as Railways, metros, cement, power (waste heat recovery and waste to energy, de-carbonisation, hydrogen, EVs and data centres are all emerging capex areas driving order book. Besides, higher capex is observed in mining, sugar and ethanol, water treatment, chemicals, etc.

Defence PSUs are doing extremely well and there is long run way to growth due to reducing import content with restricted list by govt and more localisation efforts. Pvt. capex shows signs of further recovery while govt tender momentum continues to be strong. PLI and China+1 are supportive of long term outlook for India's manufacturing. This augurs well for capital goods sector.

Banking and financial services sector is witnessing improved performance with higher credit growth, stable net interest margins, low credit costs and better return on assets. There is limited concern on asset quality as borrowers appear to be in a comfortable position. Banks are reporting strong NII growth along with healthy loan growth. And there is negligible risk on asset quality with lower credit costs.

In case of housing finance companies, interest rates have moved up meaningfully, but no sign of any asset quality concern so far. Housing loan interest rates have moved up by about 150 bps since March 2022 and this segment of portfolio has seen the highest interest rate transmission to borrowers.

Overall, the broad sentiment reflects caution. However, a change in inflation-interest rate trend along with corrected valuations suggest a prospective rally and a favourable risk-reward equation. Earnings of our portfolio companies continue to give us confidence in their respective business models & outlook.

The key to making money is to stay invested. - Suze Orman

Dhiraj Sachdev
Managing Partner & CIO
Roha Asset Managers LLP