RELIGARE Invesco Mutual Fund

Insights – Indian Equity Markets

Stock selection assumes significance

Equity markets need the fuel of earnings growth to generate returns. The Sensex companies reported a 5% drop in revenue and a 7% drop in earnings during the quarter ended September. Aggregate revenues for a broad sample of 1378 companies dropped 4% YoY, while earnings dropped 3% YoY. For the broad sample, this marks the third out of four quarters, in which earnings have declined. Earnings before interest, taxes, depreciation and amortization (EBITDA) margins have also registered a marginal decline this quarter as the benefits of lower raw material prices were offset by weak revenue growth.

With the end of the earnings season, consensus has cut Sensex earnings forecasts by 1.8% and 0.6% for FY16 and FY17, respectively. Consensus earnings growth estimates for FY16 are now at single digits. Just 6 months ago, the forecasts still called for earnings growth in the mid-teens. For FY17, earnings growth estimates are once again in the high teens. In our view, the visibility of the FY17 estimates is low.

By many measures, current profits are depressed relative to their long term averages. In other words, profits as a percentage of revenues and Gross Domestic Product (GDP) are at subdued levels. Currently, a number of industries are struggling from lower capacity utilization and high interest rates.

Even as the Indian market is underpinned by strong macroeconomic fundamentals, the outlook for near term growth continues to remain mixed. According to RBI, 'The economy is in the early stages of a recovery, though with some areas of continued weakness.'

In our opinion, the underlying fundamentals combined with policy actions, market forces and a more supportive global environment would enable growth acceleration over time. As and when the economy moves into higher gear, there is scope for profits to recover to historical averages. Over the longer term, we recognize the potential for mean reversion in profits**.** This mean reversion in profits will be led largely by the cyclical sectors, such as Industrials, Financials, Consumer Discretionary and Materials.

In such a scenario, we believe that, identifying the companies which will benefit from a recovery in the economy is more important, as outcomes within a given sector could be very divergent. Our portfolio is more balanced today reflecting the bottom up conviction on specific companies, rather than sector considerations.

Currently, our preferred areas based on valuations and growth are Financials and Consumer Discretionary. Industrials, presently, are not very attractive given their elevated valuations. Further, in our view, the recovery in the investment cycle is likely to be slow given strained balance sheets. As for materials sector, the recovery is largely linked to global economic trends, rather than domestic growth. The metal sector, in particular, is weighed down by the stressed balance sheets.

Investors should remember that, while there is scope for mean reversion in profits - valuations are not a static measure and they too tend to fluctuate. Our comfort zone for equity valuations is in the range of plus or minus 10% of the long term average valuations (P/E), while the attractive zone would be when valuations are below average.

In the early part of 2015, valuations were at over 30% premium to the long term average trailing P/E multiple. The risk–reward looks more reasonable, than it did at the start of the year with the premium dropping to 15%, though it remains above the comfort zone. This is a time for investors to be patient given the headwind from valuations and invest in a systematic manner.

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