

Insights – Indian Equity Markets

Reasonable valuations- Time to be constructive on largecap equities

Equities are a growth asset, tracking earnings over the long term. The fluctuations in stock prices are more extreme than the changes in earnings because they are accentuated by changes in valuations. The valuation levels reflect the collective confidence in growth. We note that consensus earnings expectation for the Sensex for this year have now dropped to low single digit compared to high teen earnings growth forecasts for FY16 a year ago. This relentless decline in expectations of earnings growth combined with elevated valuations in Q1CY15 has played their part in the market outcome over the past 12 months (Sensex down by 21.7% over 12 months).

The risk-reward looks more reasonable now, with the valuation premium dropping to 6%. In the early part of 2015, valuations were at over 30% premium to the long term average trailing P/E multiple. We think this is the time to be constructive towards large cap equities given the fact that valuations (as reflected in the Sensex) are far more reasonable now.

Notably, the correction in valuations is not as sharp as the decline in prices because earnings continue to fall on a yoy basis. In the quarter ended December, Sensex profit after tax dropped 5% yoy and Nifty companies' profits were down 12% yoy.

By many measures, current profits are depressed relative to their long term averages. In other words, profits as a percentage of revenues and GDP are at subdued levels. Currently, a number of industries are struggling from lower capacity utilization and high interest rates. As and when the economy moves into higher gear, there is scope for profits to recover to historical averages driven by the levers of higher capacity utilization and lower financial leverage. Over the longer term, we recognize the potential for mean reversion in profits, but this will be a gradual process. The exact timing of this may be uncertain, but the levers certainly exist.

Furthermore, over the past year, Corporate India has accelerated its efforts to put its house in order by de-leveraging. The pressure from Government, RBI and lenders is also contributing to this process. Along the way, changes in norms by government, regulators and RBI is also proving an enabling framework for the deleveraging. We see this as a welcome clean-up of the undergrowth that is an impediment to a new capex cycle taking root. This will be gradual process and lender's capacity to absorb loan losses will play a critical role in speeding the clean-up.

Importantly, the Indian economy remains underpinned by strong macro-economic fundamentals. The budget presented on the last day of the month reinforced India's determination to maintain its hard earned macroeconomic stability. By maintaining the target to rein in India's fiscal deficit, it also provides headroom for RBI to maintain its accommodative approach.

From the current perspective, the Indian economy is in the early stages of a recovery. The trend is uneven at this point, as various growth indicators suggest - there is a pick-up in the growth trajectory in a few areas, but in others, the gloom persists.

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Our portfolio is more balanced today reflecting the bottom-up conviction on specific companies, rather than sector considerations. This is crucial as we are in an environment where outcomes within a given sector could be very divergent. We are willing to invest in good companies experiencing cyclical headwinds if the valuations are attractive. At the same time, we remain wary of risks in balance sheets.

Note: Data as of end February 2016.

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