In a world that is increasingly becoming uncertain owing to government and central bank’s intervention into free market, it thus pays to keep an eye on some of the larger trends. As part of our investment process, we believe that macro-economic and broader market indicators play an important role when it comes to managing portfolio risks.

We’ll begin this series with what has transpired with the Indian economy over last few years and what Indian equity market indicators are suggesting currently in terms of broader valuation and sentiment. We shall try to tie all of them towards the end.

Let’s begin with GDP growth. While GDP growth numbers are what they are, there is always a controversy when it comes to how they are measured and how reliable are they. Hence, we have built an indicator to get a sense on state of the economy and not get anchored by a single growth number. Our “GDP High Frequency Indicators Heat Map” has been suggesting a slowdown across major GDP heads i.e. private final consumption, government spending, fixed capital formation and net exports.

Over last few years, India’s GDP growth had been dependent upon private final consumption. Now, even that is witnessing a cyclical slowdown. With fixed capital formation cycle undergoing a correction after huge infrastructure, housing and power sector boom, we have been witnessing a major slowdown in corporate spending and expansion. Thus, the onus to
kick start economic recovery lays with government that has traditionally spent beyond means during such economic slowdowns.

However, government’s finances are not in their best shape.

Fiscal Deficit higher than reported!

Though central government technically met its targeted 3.4% fiscal deficit for FY-19, certain expenses were deferred and were not brought on books. They will have to be met during FY-20. With low tax collections and slower economic activities, chances of combined fiscal deficit (central + state governments) reverting back towards its long term mean levels of 7.5% increases vs FY19E of 5.9%. All this will mean that government’s ability to spend on productive projects stands curtailed if continues to focus on maintaining fiscal discipline.
India’s CPI inflation has started to rise again after bottoming below its lower limit. A lot depends on normal monsoon and oil prices to keep the same under check. Rainfall during current monsoon season appears to have been normal. However, distribution of rain may emerge as a concern. Higher government spending generally has led to higher inflation as well.

With rising inflation and RBI lowering interest rates, real interest rates can revert back towards long term average of around 1.6%. This traditionally has led to lower savings and higher spending in the economy.
Capital formation in India has slowed down significantly after peaking a decade ago. Low capital spending in the economy has also been as a result of low capacity utilisation with manufacturing units as per RBI’s quarterly survey. The same is witnessing a reversal and utilisation levels are above long term average of ~75%. However, we may want to wait for another quarter or two to confirm the trend since RBI survey has been receiving lower responses recently as compared to couple of years back. Higher real interest rates probably also added towards low capacity building.

All this has led to lower credit growth. Above that, bank’s ability to lend has also been curtailed owing to high stressed assets in the system. Low growth rate in corporate bonds and commercial papers also shows stress with NBFCs.
While there are signs of revival in Industry credit, there are evidences that a portion of the same would more be towards distressed businesses as opposed to capacity building purposes. Above that, high growth segments of personal credit and towards services segments are also now witnessing a slowdown. Thus, credit offtake for productive purposes is missing in the economy. This does not bode well for sustained economic growth.

Moving on to India’s international trade. India’s trade deficit has been near its upper limit for some time. Oil plays a major role in India’s trade deficit with the world. Lower oil prices have provide some respite on this front. However, India’s trade position remains unfavourable as of now.
Trade deficit is partially offset by services exports. That along with steady capital flows have let INR find support near its trend line (Trend line regresses USDINR rate against time). However, rising global uncertainties can lead to capital flows towards safer havens like USD and US Treasuries, hurting INR negatively.
Macro Matters – Keeping an eye on macro-economic and market trends that matter

So how are Indian broader market shaped up?

INRUSD Currency Price from 1973 to 31 May 2019

CAGR of trend is 4% p.a.
Adj R-Sq is 85%
CAGR = Trend of India CPI / US CPI

Current values
Upper Limit = 84.61
Current price = 69.69
Trend = 62.62
Lower Limit = 46.34

Data from Factset

Nifty - Valuation

Sensex and Valuation Range

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Our proprietary valuation framework on Nifty is suggesting that it is quoting towards higher end of valuation range. Another valuation metric on Sensex that gives valuation based on normalised earnings and growth assumptions is suggesting that Sensex is near its fair value. Considering Sensex RoE continues to remain near historic lows, current Sensex valuation is already factoring in a significant part of earnings recovery.

We have been warning about the froth in mid and small cap companies for quite some time now. It's now that a large portion of that froth has cleared. However, just like everything that we have observed, higher the upswings, larger can be the downswings. Thus, we continue to maintain our preference towards large cap names.
Valuation gap between Large caps and smaller companies though appears to have narrowed down now as compared to Jan-18 when gap was near its peak. What you see on the slide represents companies that according to us are good quality businesses across market cap classifications, along with their median valuations as measured by Price to our assessment of their “Fair Value”.

Our proprietary High Quality to Low Quality companies’ index and Regulated Utility Index sentiment indicators, along with certain other indicators, are suggesting prevailing caution in...
the market. Market mood appears to be moving towards high pessimism.

Finally, what to make of all this?

Indian economy has been dependent upon consumer and government spending for a large proportion of its growth over last few years. With consumer spending slowing and no signs of pick up in industrial activities, reliance on government spending has increased significantly. With government’s balance sheet and tax collection growth not in great shape, we can expect government’s fiscal deficit to increase. Government’s tone during July-19 budget suggests spending on agri and rural side.

Most economic indicators in India are suggesting slowing economic activities. Slowdown in global economies will have an impact on India as well. We are already witnessing some initial signs with slowing imports and exports. Though India, like most other emerging markets, has benefitted over shorter term on dovish US Fed, this may be short lived. Higher global uncertainties can make fungible foreign capital chase safer assets i.e. US treasuries, US Dollar, etc. To some extent, this is evident from FII outflows from Indian equity markets.

Stocks in India had risen and sustained on improved money flow. Given where we are with respect to economy and valuations, we prefer High Quality businesses that are facing cyclical headwinds and are available at reasonable valuations. We do see cases like these in some 2 wheelers, select FMCGs and select financial institutions. Our preference for large cap continues as we have discussed above as against mid and small cap companies from allocation perspective. We also prefer companies with stable returns generations, having annuity type businesses or Quasi Fixed Income securities at this juncture.

Thanks for reading!