

Be watchful of earnings downgrade cycle; positive on auto, BFSI, capital goods, says Amit Nadekar of LIC Mutual Fund

LIC Mutual Fund Senior Equity Fund Manager Amit Nadekar believes that the Indian economy has the potential to move into a structurally higher growth orbit. From an investment perspective, he is positive about the auto, BFSI, capital goods and export-led manufacturing sectors.



Premium

Amit Nadekar is the Senior Equity Fund Manager at LIC Mutual Fund (LIC Mutual Fund)

Amit Nadekar, Senior Equity Fund Manager at **LIC Mutual Fund** says there are still fears of the US economy getting into recession in the second half of 2023 and the poor earnings performance of broader US companies supports this view. He added one needs to be very watchful of the earnings downgrade cycle which will determine the stock market's direction. In an interview with Mint, Nadekar shared his views on the Indian economy and interest-rate trajectory also.

Edited excerpts:

What is your view on the domestic market for the rest of the year? Is the worst behind us?

Over the last one and a half years, the Indian equity market has delivered a flat return. During this period the performance of the equity market was challenged by run-away inflation and a sharp rise in interest rates.

The rise in the cost of capital led to a fall in the equity valuations which dragged stocks down.

However, relatively strong operating performance and strong earnings growth of corporates in the listed space recouped the drag on valuations due to higher interest rates delivering overall flat returns.

I believe the bulk of the drag on the markets due to high inflation and high-interest rates is behind us. However, the double whammy of inflation/higher price levels and high cost of capital are resulting in demand slowdown and sluggish economic growth.

As demand slows down, operating margin recovery from falling commodity prices could be challenged as companies trade pricing power to volume growth.

This phenomenon has thrown the equity markets into a phase which is generally known as the earnings downgrade cycle where the key risk is lower than expected corporate profitability.

In the quarter ahead the returns from Indian equity markets will be governed by how this equity downgrade cycle plays out. For the recently concluded March 2023 results season, earnings downgrades were much less than what the market feared.

Relatively resilient earnings of corporate India coupled with a near consensus that central banks would pause the interest rate hike cycle has led to the recent sigh of a relief rally in the market.

Of course, the reversal of FII (foreign institutional investors) flows in favour of Indian markets has only further aided this rally. Does this mean that the worst is over for the Indian equity markets? Maybe, yes! However, one swallow doesn't make a summer.

It would be premature to declare, based on the relatively strong earnings performance of the March 2023 quarter, that the earnings downgrade cycle which the market is fearful of would not be meaningful.

Globally, there are still fears of the US economy getting into recession in the second half of 2023. The poor earnings performance of broader US companies does support this view.

Any such global slowdown would be counterproductive for Indian businesses not to mention that the consumption side of the Indian economy which accounts for nearly 60 per cent of GDP continues to struggle with the growth. So one needs to be very watchful of the earnings downgrade cycle which will determine the stock market's direction.

India is expected to remain one of the fastest-growing economies in the world. Has the market discounted this possibility? What could derail the economic growth of the country?

Yes! Indian economy today is undoubtedly one of the fastest growing economies in the world and more importantly at a size of \$3.2 trillion GDP.

For the March 2023 quarter, India's GDP growth stood at 6.1 per cent compared to 4.5 per cent for China (\$18 trillion GDP), 4 per cent for Brazil (\$1.6 trillion), 1.6 per cent for the United States (\$23

trillion), one per cent for the Euro Zone (\$14.5 trillion) or 5 per cent for Indonesia (\$1.2 trillion), 6.4 per cent for Philippines (\$0.4 trillion) and 3.3 per cent for Vietnam at \$0.4 trillion economy.

Having said that, I think that the current growth rate of the Indian economy is still not reflecting its true potential.

Over the last five-six years, several initiatives were taken by the Government of India to fundamentally alter the fabric of the Indian economy.

The economy is getting formalised through various measures like demonetisation, GST implementation, Jan Dhan schemes, DBT (Direct Benefit Transfer), consolidation of public sector banks, improved legal measures like the RERA Act for the real estate sector or Insolvency and Bankruptcy Code for the banking sector.

Few of these changes were disruptive in nature and have held back the economy from achieving its full growth potential.

The crisis which snowballed into NBFC and the real estate crisis also didn't help during this period. This was followed by Covid -19 pandemic which first through the lockdowns and then through global supply chain disruptions has led to sub-par economic growth for the country during this period.

I believe, as the domestic and global economy stabilises over the next few quarters, the Indian economy has the potential to move into a structural higher growth orbit.

India is also benefiting from the fact that post-Covid-19, the world is looking for an alternative to China as a global manufacturing hub.

This has expanded the addressable market opportunity and improved the growth prospects for various sectors in India such as pharma, chemicals, textile, and manufacturing across electricals, electronics and engineering products.

Current market valuations with Nifty50 trading at 22.4 times the price/earnings ratio (P/E) based upon trailing twelve-month earnings (trailing twelve-month P/E) is less than the last 10 years' average of 22.6 times trailing twelve-month P/E.

As explained above if the growth rates for the country were to move up structurally, the current market valuations are clearly not fully discounting this higher growth potential of the country.

Relative stress in the rural economy is further challenged by a weak monsoon, fears of a global recession coming true in the second half of 2023, any adverse geopolitical development which disrupts the capital markets or any political instability in the country as we enter an election year in 2024 would be some of the factors which can derail the economic growth of the country.

What sectors are you positive about at this juncture? What sectors are you cautious about?

I am positive about auto, BFSI, capital goods and export-led manufacturing sectors. Some of the consumer-facing companies have also seen valuation normalising during the recent market corrections, which can be looked at. I am cautious about sectors which have high government interference in view of upcoming elections.

Q4 numbers of India Inc. were broadly in line with expectations. Can we see an upgrade in Nifty?

Q4FY23 earnings season was broadly in line with expectations, however, there is a wide divergence across sectors. Uncertainty in demand across sectors is due to the upcoming monsoon, geopolitical scenario, and upcoming elections.

But we can also see margin expansion in a few sectors due to a fall in commodity prices. I prefer a wait-and-watch approach towards the market.

Market sentiment has improved. Is it time to start looking at growth funds?

Growth companies generally have high earnings multiples, which got hurt disproportionately as interest rates rose sharply. The possible end of the rising rate cycle bodes well for growth stocks' valuation.

But like mentioned earlier there are fears of an economic slowdown globally which could hurt the high growth expectations of these companies.

It would be prudent to be stock specific and selective about the growth companies rather than taking a blanket thematic call. Having said this, with valuations offering comfort one can slowly and gradually start allocating to growth funds.

What is your view on the rate hike trajectory? What should be the investment strategy during the period of a prolonged pause in rate hikes?

Given that Inflation is moderating, and the economy is slowing down, there is no great urge to hike the interest rates any further. But given the stickiness of inflation and a very strong labour market, central banks globally would prefer a wait-and-watch policy. This might mean there is a prolonged pause on the interest rates.

Investment strategy during this period should be selective in nature focusing on companies showing growth visibility and valuation at reasonable prices. Having said that interest-sensitive sectors like real estate, auto and NBFCs could be a more direct beneficiary of the rate pause.

From the business perspective, Individual company dynamics on demand and inflationary movement on input cost will be the more dominant factors for earnings and stock price movement.

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