# Insights – Indian Equity Markets

## Patience is the key

The Indian equity markets today are underpinned by strong macro-economic fundamentals, such as softening inflation, lowering interest rates, improving current account deficit (CAD), gradually rising foreign exchange reserves and a relatively stable domestic currency. In fact, the month of September '15 saw the MSCI India index emerge as the third best performing emerging market index. On the year to date basis too, India is the third best performing emerging market, only behind Hungary and Russia.

The country's outlook for near-term growth, however, continues to remain sluggish for the time-being. For the stock markets, the absence of strong corporate earnings pose a challenge after the sharp run up in valuations from the middle of 2013 to early this year. The global risk appetite too is souring, as is reflected by the petite foreign inflows into the country. Foreign Portfolio Investors (FPIs) continued to remain net seller for the second consecutive month in September '15.

By many measures, the present corporate profits are depressed relative to their long term averages i.e. to say that profits as a percentage of revenues and GDP are at subdued levels presently. A number of industries today are struggling from lower capacity utilization and high interest rates.

But as and when the economy moves into higher gear, there is scope for profits to recover to historical averages. This mean reversion in profits will be led largely by the cyclical sectors, such as the Industrials, Financials, Consumer Discretionary and Materials. India's supportive fundamentals need to be combined with policy actions, market forces and a more supportive global environment to enable growth acceleration over a period of time.

Our preferred areas of investment, in the present context and based on valuations and growth prospects, are Financials and Consumer Discretionary. We do not find Industrials very attractive at this point in time, given their elevated valuations and with recovery in the investment cycle likely to be slow. In the Materials sector, the recovery is largely linked to the global economic trends while the balance sheets in the Metals sector, in particular, are quite stressed.

We nevertheless believe that there is more alpha potential in getting the stock selection right in light of the present valuations and challenging macro environment. Our portfolio is more balanced today reflecting the bottom-up conviction on specific companies rather than the sector considerations.

Our comfort zone for equity valuations is in the range of plus or minus 10% of the long term average valuations (Price to Equity i.e. P/E). While this being a comfort zone, a rather attractive zone would be when the valuations are below the long term average. The valuations of the Indian equity markets were at over 30% to the long term trailing P/E multiple at the beginning of the year 2015. By the end of the month of September '15, the markets were trading at 11% premium to its long term average, after having dipped within the comfort zone during the month.

We believe that the valuations within the comfort zone make a constructive case for equity investments. In fact, the risk-reward proposition looks more reasonable today than at the beginning of the year.

Investors, however, need to think about equities from a long-term perspective and they need to be patient.

**Disclaimer:**