By Invitation

2021 INDIA EQUITIES LOOKING AHEAD

We can summarize the key theme for 2020 as "the great grand disconnect". While on the one hand, observers surmised Covid-19 impact as the worst in the post-WWII history and far worse than the recent Global Financial Crisis (GFC) of 2008, global and Indian markets staged a V-shaped recovery and closed the year significantly positive. How is that even possible? Just to give a historical perspective, back in 2010 when Indian economy clocked one of its highest real GDP growth rate of 10.3%, Nifty ended that year up by 18%. Now during 2020, when the real GDP growth is estimated to be –10.3%, Nifty is up by 13%. Heads I win, tails you lose!

In terms of market outlook for 2021, it is interesting to note first the calls made by brokerage houses. It ranges from a bearish outlook of –5.5% to a bullish outlook of +9%.

In my assessment, there are five things to analyze before we take a call for 2021. They are political management of Covid-19, economic outlook, valuations (including earnings), foreign investment and tail risk.

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Political management of Covid-19

The pandemic has brought to the front the government as a central actor of decision-making and therefore politics matters a lot for markets at least until the pandemic lasts. Governments the world over are compelled to take instant decisions (like closing airports, land, sea and other routes) in matters of hours and impose lockdowns that can last for months. Such quick actions, though is necessitated by circumstances can usurp economy and may cause short-term and long-term repercussions for big and small businesses. In the Indian context, the government was too quick initially imposing draconian restrictions and learned swiftly as they went about containing it. It is always easy to analyze historical facts, but making instant decisions for now and the future is always laden with extreme uncertainty. For a country of our size with 1.4 billion population, there will always be some nasty surprises here and there. Overall, I believe political maneuvering to manage this healthcare crisis of historic proportion was noteworthy indeed though it encountered bad press both inside and outside. Going forward, I feel there is enough political will to take tough decisions, if need be, and this is hugely positive for the market.

Economic outlook

Let us do a quick reality check on the economy. Key positives include strong FDI flows (indicates global investor confidence), burgeoning forex reserves ($500 bn), low interest rates, and almost balanced current account (thanks to lower oil imports). The PMI index, an indication of manufacturing and services activity, has rebounded smartly after the disastrous fall in March. High frequency data like auto sales, steel consumption, cement consumption and railway freight traffic are all higher than pre-Covid-19 levels. However, there are many things not going right currently. As said before, real GDP growth is set to fall by 10.3% in 2020 though it is expected to rebound by 8.8% in 2021 due to low base effect. Due to massive fiscal stimulus initiated to manage Covid-19, fiscal deficit is expected to be –13% for 2020 and –11% for 2021, levels that are considered unsustainable. This will result in increased borrowings or monetization of deficits. Due to this, India's credit rating at Baa3 (Moody's) is tethering on the edge of being rated "Junk". If inflation raises its ugly head (probable in an emerging market), RBI will be forced to increase interest rates which will dent corporate profitability. Bank credit growth at 5.4% is at all-time low and

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will be a key indicator to watch for. Given this overall assessment, 2021 can at best be a "crisis management" year from an economic perspective. The good news is that we are not alone in this and we have plenty of company starting from developed economies to emerging economies.

Valuations (including earnings)

On the valuation front, the P/E ratio is now placed at 28.7 way higher than the MSCI EM P/E of 20 though on par with MSCI World. In the Nifty 50 constituents, we notice two stocks with more than 100 P/E, while 14 stocks have P/E in the range of 50-100. The reason P/E is so high is due to double whammy where the numerator "P" which is the price has moved higher, while the denominator "E" which is the earnings fell. The EPS for the overall market for 2020 at ₹480 is lower by 15% though global investment banks aim for an EPS growth of 20% during 2021 (again low base effect). At these valuation levels, market attractiveness is severely dented.

Brokerage Targets for Nifty in 2021

Brokerages	2021 year-end Target	Implied Upside/Downside
JP Morgan	15,000	9.0%
Credit Suisse	14,200	3.2%
CLSA	14,200	3.2%
Morgan Stanley	14,600	6.1%
Nomura	13,640	-0.9%
Goldman Sachs	14,100	2.5%
Axis Securities	14,000	1.7%
IDBI Capital	13,000	-5.5%

Source: Various; Return expectations based on NIFTY level of 13,761 (Close on Dec 20, 2020)

Foreign Investment

In spite of poor economic picture and high valuations, foreign investment in the Indian equity market remains strong. The foreign portfolio investment or FPI reached $18 bn during 2020 while they invested $38 bn in 2019. India continues to be a hot favorite of foreign investors. Foreign investors are generally bullish on emerging markets and this sentiment may well prevail into 2021 as there are few opportunities in the low-yield world and emerging markets are considered to be a good fishing pond. The sustained interest can keep the market in positive zone though valuations may be a bit of a concern.

Tail risk

This is an unusual factor to look into for coming up with an outlook. Tail risk is defined as an unfolding of a vastly unexpected event that can throw all assumptions out of window like Covid-19. In 2008, it came in the form of GFC and in 2020 it came via a healthcare route, and we do not now know when and where the next tail risk will be from. However, since it has the ability to upset all our calculations, it is instructive to be prepared for one at least in terms of a contingency management perspective.

Investment strategy

In light of the opposing factors, the best way forward is to be systematically investing in order to escape volatility traps. Also sector bets can be good. Analyzing the past trends, it is clear that some sectors like PSU banks, media, real estate, metals, etc., can be clearly avoided as they plotted inferiorly in the risk-return scatter plot. On the other hand, sectors like FMCG, IT, services, and energy enjoyed better risk-reward ratio. Also, the overall Nifty 50 index enjoyed a better payoff than Nifty midcap. The key to successful investing is, and will be, to avoid drawdowns—a sudden market fall and subsequent time taken to recover. ■

Reference # 20M-2021-01-10-01