Equity & Fixed Income Outlook

June 2020

Equity Markets Review

The MSCI India Index started the month at 15.18 and closed at 15.83, increasing by 4.28% over the month. As per latest data, FIIs were net buyers in Equity markets with inflow of USD ~3.08 Bn and net seller in Fixed Income markets with outflow of USD ~0.2 Bn. Domestic Institutions were net seller in equities with net outflow of USD ~0.48 Bn in the month

Commodities and Inflation

NYMEX Crude Oil prices gained by 10.7% from the previous month levels, ending at 39.27 per barrel; the prices were lower by 32.8% yoy. LMEX closed at 2681.7, higher by 8.5% over the previous month (lower by 4.9% yoy). Gold prices closed at USD 1769.93/oz ~2.4% higher than the previous month level (higher by 25.2% yoy). The USD Index fell by 1.0% vs. other currencies over the month; over the year the USD Index was higher by 1.3%.

The NSO did not release the provisional CPI inflation data for May owing to difficulties in data collection (no CPI data was released for April as well). It, however, managed to release the data for certain sub-groups/ groups, following the principles of adequacy. The data showed that CPI food inflation moderated to 9.28% in May (10.5% in April) and the moderation was higher in urban areas. The ease in inflation was largely due to vegetables which moderated to 5.3% YoY from 23.6% in April. One of the reasons for the ease in urban food inflation might be the lower transportation costs. The RBI is likely to draw comfort from the easing of food inflation.

Markets & Real Economy

IIP declined by 55.5% YoY in April 2020, reflecting the impact of the nation-wide lockdown. The decline was led by the manufacturing sector output, which was down 64.3% YoY. Mining was more resilient given its non-urban centric nature and declined by 27.4% YoY. Electricity production declined by 22.6% YoY, aided by demand from non-industrial sectors. The sharpest decline was seen in consumer durables and capital goods given its ‘non- essential’ nature. Consumer durables output was down 95.7% YoY and capital goods output declined 92.0% YoY. Primary goods output was down the least by 26.6%, largely aided by petroleum refinery production while consumer non-durables output was down 36.1% YoY, aided by food products. Among the manufacturing sectors, food processing, petroleum refining and pharmaceuticals were more resilient given the essential nature of these industries and witnessed declines of 20-30% compared to over 90% decline in most other sectors.

As per the latest RBI data, Foreign exchange reserves inched up to USD 505.57 Bn over the month. The Rupee appreciated by ~0.14% over the month closing at 75.5087 Rs/USD vs. 75.6175 Rs/USD last month.

Sector-wise Performance

The key outperforming sector during the month was Oil & Gas. Crude oil prices have seen a sharp recovery driven by supply cuts taken by OPEC+ countries in order to balance the demand-supply equation and expectations of demand picking up as economies across the world open. Stocks of oil marketing companies have also done well due to continuous hikes in retail fuel prices which will help OMCs maintain margins. However, the outlier in the pack was Reliance Industries which has seen a sharp run-up in stock price driven by a series of investments into its technology venture, i.e., Jio Platforms. We do not have any exposure to Reliance Industries as well as the sector as our investment philosophy is to avoid commodity companies as they lack any long-term visibility on earnings growth, return on capital and free cash flows.

The key underperforming sector during the month was Consumer Goods. The sector had been outperforming during the period of the lockdown as demand disruption was the least for companies within the sector, especially for staples companies given the essential nature of products. However, the outperformance has led to valuations becoming expensive and as such, the sector has not participated in the market revival seen during June. We remain positive on the sector as we believe that the long-term growth outlook for the sector is among the best given significant under-penetration of most product categories. Steady long-term improvement in the income profile and living standards for the Indian population shall drive consistent demand for consumption of better-quality branded products over the next many years.

Key Stock Movement

Bajaj Finance Ltd – Bajaj Finance is a non-banking finance company focused on financing mass affluent customers across more than 20 product lines. The company has presence in consumer financing, SME financing, commercial lending and rural lending in India. The stock had corrected significantly over the last couple of months due to a general concern that growth may get impacted and asset quality may deteriorate given the nation-wide lockdown. However, with more clarity on the amount of moratorium being availed by customers and a healthy position on liquidity and capital adequacy, these concerns have receded to some extent and the stock has recovered sharply given valuations had become reasonable post the correction. We remain positive on the stock despite the near-term uncertainty as the company has healthy Return on Assets and enough capital to absorb any deterioration in asset quality. From a liquidity perspective as well, the company is well placed with a comfortable surplus and easy access to the market for raising funds.

Ajanta Pharma Ltd – Ajanta Pharma has witnessed some correction post a sharp reversal from the March lows and has witnessed some profit booking. We remain positive on the company due to its strong execution within focus therapy segments in both domestic and exports markets. The company has been able to ramp-up its US revenues significantly from USD 2.7 Mn in FY16 to USD 70 Mn in FY20 driven by 30 product launches. The growth momentum should continue driven by 23 ANDAs pending for approval and 10-12 new filings every year. Ajanta has also witnessed a revival in growth within the branded generics markets in Asia and Africa. The company’s major capex program would conclude in FY21 and only maintenance capex would be required FY22 onwards, indicating better free cash flow generation.

Comment on Top Holding – Tata Consultancy Services Ltd

TCS is the largest among the Tier 1 IT companies in India and is a part of the diversified Tata Group, one of the largest corporate houses in Asia. It provides a comprehensive range of IT services to industries such as banking & financial services, insurance, manufacturing, telecom, retail and transportation. Since inception, over the past three decades, it has come a long way with deep technical and project management expertise in handling complex client projects and strong offshore processes. Though application services remain the primary services offering, the company has attained credible size in other service offerings such as infrastructure services, BPO and testing services. While US continues to be the most important geography (~50% share of revenues), the company is increasing its presence in Europe and UK (~15% of revenues each).

TCS generated strong free cash flows of USD 4.97 billion in FY2020 at 100% of net profit. Payout ratio at 100% of net profit is impressive and better than peers. The company is efficient on use of capital and does not overspend on capex visible in the fact that it has returned over 100% of FCF to shareholders in the past three years. TCS has done well to invest steadily in business while maintaining judicious use of cash. Large addressable market, best-in-class execution, balanced portfolio of service offerings, leadership in multiple digital competencies, healthy products and platforms portfolio, and ability to stitch together multiple service offerings to create large transformational deals differentiate TCS from peers.

Market Outlook
Global equity markets have seen sharp positive momentum over the month as economies start to open post the lockdown and initial demand trends indicate a strong revival from the March lows. Monetary measures announced by large central banks including the US Fed, ECB, etc., have also turned the sentiment positive. Indian equity market has also taken a cue and seen a sharp revival. A gradual lifting of the lockdown and pick-up in economic activity remains critical and there are measures being taken by the Government and RBI to minimize the impact of the lockdown and ensure a smooth resumption. While near term uncertainties remain, we are confident that there will be no lasting impact on India's long-term growth potential and the current challenges may, in fact, provide new opportunities for growth by participating more meaningfully in the global supply chain. Our strategy is to focus on companies which have a healthy Balance Sheet that enables them to tide through the current challenging environment and possibly emerge stronger once the economy stabilizes. In our opinion, those who survive the current crisis will be able to ride the next phase of growth with higher market shares, well entrenched brands and limited competition as marginal players with leveraged Balance Sheets will find it difficult to survive.

Fixed Income Review

Given the continuation of the lockdown, data collection for India's consumer prices inflation (CPI) for May 2020 has been truncated with data unavailability for most of the core indicators. Food inflation has fallen from 10.5% YoY in April 2020 to 9.3% YoY in May 2020, led by a sharp downward momentum in vegetables and sugar group. The wholesale price index (WPI) for May 2020 slipped into a year-on-year disinflation of 3.2% as compared to inflation of 0.4% in March 2020. This decline in WPI inflation in May 2020 relative to March 2020, while broad-based, was primarily led by a deeper disinflation in fuel and power.
India's current account balance recorded a marginal surplus of USD 0.6 billion (0.1% of GDP) in Q4 of 2019-20 as against a deficit of USD 4.6 billion (0.7% of GDP) in Q4 of 2018-19 and USD 2.6 billion (0.4% of GDP) in the preceding quarter in Q3 of 2019-20. The surplus in the current account in Q4 of 2019-20 was primarily on account of a lower trade deficit at USD 35.0 billion and a sharp rise in net invisible receipts at USD 35.6 billion as compared with the corresponding period of last year.
FX reserves jumped to USD 508 billion, reflecting sharp narrowing of trade deficit to USD 9.9 billion in the first two months of FY21 v/s USD 30.7 billion deficit for the same period last year. Foreign investment flows have also improved with net FPI flows turning positive in June. FDI flows have also improved given the large deal in the tech sector.

Outlook
RBI has undertaken unprecedented conventional and unconventional measures to combat financial stability and support growth. These measures are aimed at lowering the cost of capital, injecting more liquidity and easing financial markets. These measures taken by RBI along with the repo rate cut would assist in encouraging credit flows to the real economy as well as address funding requirements seen by both private players and state governments. We expect continued RBI support to counter any increase in yields in the near-term, given the sharp fall in growth. We believe, the central bank is still left with plenty of ammunition which should help in improving transmission of rates.

On valuation front, the spreads in BBB space in developed markets have tightened a lot in past quarter where as in local debt market, quasi-sovereign spreads are still higher than historical levels indicating the relative attractiveness of local debt paper vs a similarly rated developed market credit. On the FX front, INR is expected to be supported on account of expectation of CAD turning positive in next few months. In addition to that, emerging market currencies including INR will benefit from further dollar index depreciation due to FED balance sheet expansion which can attract flows into the EM debt. Apart from that local Indian debt participants are expecting a positive development in terms of an interest rate cut or possible inclusion in global indices which may push the bond yields further lower.

The entire fixed income component continue to remain invested into sovereign bonds with majority exposure positioned towards the front end of the yield curve in order to generate carry by taking minimal credit as well as lower duration risk.

Guernsey

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