

EQUITY -TIMES

Annual Equity Outlook - 2021

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HEAD - EQUITY

"Forecasts may tell you a great deal about the forecaster; they tell you nothing about the future."
- Warren Buffett

CY21: Promise of Delivery or Delivery of Promise?

CY20, was a year when most predictions for the year made in December 2019, literally went for a toss. Sars-CoV-2 virus put most, if not all, of these annual predictions to waste. To recommence on a similar journey of future predictions in December 2020, one needs to make the key assumption – the health pandemic caused by the Covid-19 virus will not come with any new twist and the roll out of vaccination programs across the world will lead to "normalization". Though the new "normal" could be vastly different from the "normal" of CY19, when, few, if any had imagined the havoc such a virus would cause.

Here are, what we believe, a few issues which could become the key variables of CY21 for Indian investors:

Promise of Delivery vs Delivery of promise – Earnings Estimates vs Actuals

"If wishes were horses, beggars would ride. If turnips were swords, I'd have one by my side.

If "ifs" and "ands" were pots and pans. There'd be no work for tinkers' hands".

A nursery rhyme, which most of us would have used, especially those with children, on all the birthdays/new year wishes/demands. For equity investors, 2015 onwards, wishing for Index earnings growth has been an annual exercise of ... disappointment. Every December, estimates for the next financial year are compiled and most of these years, the actual vs expected has witnessed a wide gap between Estimates and Actuals.

BSE 100 EPS Est	FY16	FY17	FY18	FY19	FY20	FY21E	FY22E	FY23E
Dec-15	447	571	653					
Dec-16		476	582	673				
Dec-17			503	627	738			
Dec-18				534	663	774		
Dec-19					583	706	830	
Dec-20						497	688	824
Actual		426	486	442	454			

Growth Yr1 Estimated in Dec	27.8%	22.1%	24.6%	24.0%	21.2%	38.3%	27.8%	
Deviation- Actual over forward 1yr est.		-25.5%	-16.4%	-29.5%	-31.4%			
Deviation Actual over forward 2yr est.			-25.6%	-34.3%	-38.4%			

BSE 100 -on Dec End	8,098	8,387	11,030	11,161	12,236	13,732		
Valuation Yr+1 (x)	14.2	14.4	17.6	16.8	17.3	20.0		
Valuation Yr+2 (x)	12.4	12.5	14.9	14.4	14.7	16.7		

Source: Bloomberg

Key observations:

- Consensus have normally estimated a 1-year forward growth of more than 20%
- Past data suggests deviation over 1-year forward estimates and the actual numbers on an average is 25% and is as high as 31%
- Consensus 2-year forward estimates are to be taken with caution as there has been a tendency to over-estimate them over actual by more than 25% and as high as 40%.

Clearly, the markets are primed for a strong revival in earnings, after a dismal FY20. The trajectory of this growth will clearly have the closest correlation to market levels. The delivery of promise, on this front, will be the most critical factor which will influence the markets, as valuations boosted by the benign monetary and fiscal policies are at an elevated level.

What caused the last decade to become a “lost” decade from the point of earnings? We have analyzed, three broad buckets – Deflationary pressures, Regulatory upheavals (Disruption) and Defaults (refer annexure for details) – high credit cost of the Banking system to have impacted growth in profitability of the Nifty and of the broader market during 2105-2019. To add to these factors, the lockdown and the spread of the pandemic in Mar’20 impacted FY2020 results.

	Share of PAT		
Sector	2010	2015	2020
Increase in share of PAT			
NBFC	5.4	10.4	14.3
Information Technology	8.0	14.1	16.9
Banks-Retail	1.7	4.2	9.5
Consumer Staples	3.3	5.3	7.2
Consumer Discretionary	1.4	1.5	2.9
Cement/ Building Materials	3.1	1.7	3.7
Utilities	9.1	7.0	9.1
Decrease in share of PAT			
Deflation			
Auto	5.2	8.9	2.8
Energy	22.3	16.5	12.5
Commodities	10.7	4.4	8.0
Disruption			
Health Care	2.4	5.0	4.4
Telecommunication Services	4.1	2.9	0.5
Industrials	7.6	1.8	3.4
Defaults			
Banks-Corp	15.7	16.1	4.9

	Weight in Index		
	2010	2015	2020
Increase in share of PAT			
NBFC	7.2	9.7	12.4
Information Technology	9.2	12.9	13.5
Banks-Retail	4.3	8.7	12.6
Consumer Staples	7.0	10.3	9.3
Consumer Discretionary	1.9	3.6	5.4
Cement/ Building Materials	2.5	2.6	2.6
Utilities	6.0	3.4	3.3
Decrease in share of PAT			
Deflation			
Auto	6.6	9.7	6.1
Energy	11.4	7.3	10.2
Commodities	9.3	4.0	3.9
Disruption			
Health Care	4.4	8.4	5.5
Telecommunication Services	2.7	2.5	2.0
Industrials	11.9	6.6	4.2
Defaults			
Banks-Corp	13.5	9.8	8.9

Source: Bloomberg

Key observations (please refer annexures):

- Earnings growth has been robust only in a handful of sectors like Retail Banks and Consumer Discretionary
- Growth has been steady in sectors like Staples, IT Services, etc
- Large majority of sectors have seen earnings deterioration due to above mentioned headwinds, resulting in a decade of lost earnings growth

With the spread of the pandemic and the lockdown during Q1 FY21, earnings for the year FY21 were sharply downgraded. GDP estimates forecasted -10% and even -15%, de-growth. However, the swifter than expected economic recovery led to a more robust Q2 FY21. As a result, upgrades exceeded downgrades 3x, a rarity, after years of earnings disappointment. FY21 estimates, quickly rebounded from negative to positive territory, despite the Q1 debacle.

However, FY22 and beyond, is what investors are playing for. In the past, forecasting 2-year forward earnings growth has had a poor track record, with actual earnings lower by 25-30%. As we stand today, estimates for FY23 appear to build growth rates higher than the peak growth achieved in any period during the 2013-19 phase across sectors. Will FY22 and FY23 earnings delivery be another case of “promise of delivery” or “delivery of promise”?

Promise of Delivery vs Delivery of Promise – Growth vs Value, actually, Consistent vs Cyclical Earnings

Over the last five years, since 2014 Government regime change, the debate of Growth vs Value has raged, mainly one sided each year - CY14 and CY17, Value trumped Growth; and in CY15, CY16, CY18 and CY19, Growth has trumped Value. CY20 saw a revival of this debate – after Growth trounced Value in the 1st quarter of CY20, Value has staged a smart comeback.

While in US, the debate of Growth vs Value centers around Technology/ (Internet platform) vs Old Economy. In India, with no technology companies like FAANGM, it has become a debate of Consistent Earnings generators, Companies & Sectors, vs Companies & Sectors where earnings growth has been muted or inconsistent. Even within a sector, a sub-segment of companies has reported consistent earnings, while the rest have languished – Domestic facing pharmaceutical companies, MNC or Indian owned vs pharmaceutical companies with substantial US generic exposure. Infrastructure related sectors, Metals, Automobiles and Auto Ancillaries, Telecom and Corporate lending focused banks, especially PSU Banks are other sectors which have reported inconsistent earnings since FY16.

Investors, world over, worship at the altar of stable, consistent earnings. This segment in a large, developed economy is currently represented by new age Technology companies, which are winning business from established “old economy” companies as well as rolling out their services globally (excluding China). Hence, the steady and consistent earnings growth of most of the FAANGM. In India, investors have “replaced” such a genre with those companies and sectors, which though part of the “old” economy have been reporting steady and consistent earnings, the key variable which differentiates the FAANGM from the rest of the S&P 500, the world is their market, hence the belief of their followers of a long, almost endless runway of growth, from across the world (except China, which stays protected within its own Firewall). The Indian “growth” companies, on the other hand, are being rewarded for their consistency, market leadership, shift from unorganized to organized and the upgradation of next gen consumers, as income level rise and awareness increases, yet largely, if not fully, their growth is exclusively a play on Indian economic growth story. Remarkably, these high valued, become even more important places to hide when economic growth slows and their steady earnings easily, outshines their inconsistent and cyclical peer / rest of the market. During periods, when perception moves to an economic revival this group lags, their inconsistent, cyclical peers – CY14, CY17 and post Q1 CY20.

Value pocket, in our opinion, comprises four basic buckets – PSU stocks - PSU Banks, Refiners, Metal, Mining and Heavy Engineering companies; Corporate lending focused & Mid-sized banks; Cyclical sectors – Industrials, Automobile along with Auto Ancillaries and Metal /Commodity companies. The last segment in this pocket is Small cap. Is Small cap after the battering in CY18, CY19 and Q1 CY20, poised for a sustained revival? It, surely, is the most preferred part of the “Value” segment across our portfolios.

Will CY21, witness a revival of Value over Growth, especially Small caps? Till monetary policies, especially, Indian monetary policy remains accommodative, real interest rates do rival the range in 2016-19 period and economic growth is broader rather than “K” shaped, hope of V outperforming G could be sustained.

Promise of Delivery vs Delivery of Promise – USD Weakening, Rest of World to Outperform US market

The previous decade could easily be tagged as America's decade, not only was USD a strong currency, US markets annihilated Rest of World (RoW). Will the coming decade see a U-turn? USD is consensus to be one of the weakest currencies in the global order. A weak USD, has in the past, led to strong Emerging market flows, with Rest of World outperforming US markets. Already metal and crude oil prices have started to inch up, as a corollary to the weakening dollar. A "global" consensus view on USD weakening in 2021 has been built in the past few months, will it deliver in 2021? Will US markets, after a decade of dominance, cede leadership to RoW? If USD weakens, as being forecasted, how long will INR remain weak – it is among the worst performing Emerging currencies in CY20. Will INR strengthen in CY21? Could RBI actually allow INR to strengthen to cushion the blow of inflation? How will that impact export leaning sectors, especially IT services?

Promise of Delivery vs Delivery of Promise – Will Central Banks blink, as inflation picks up, or not?

CY20, saw a new chapter in the playbook of how to tackle a financial crisis, fiscal stimulus was added in CY20. Unlike 08-09 Financial crisis, which was largely "stimulated" through monetary injection by Central Banks in US and Europe, CY20 witnessed large fiscal stimulus by Governments. Even a fiscally conservative state like Germany, opened up its coffers, offering a large stimulus to its citizens and companies, in an effort to alleviate the problems arising out of lockdowns (UK, even offered subsidized meals in pubs during October). As of now, the US Fed governor has maintained holding on to the interest rates at least till the end of CY22, if required even later, "allowing inflation to overshoot its targeted rate of 2% during this period". Will this resolve be maintained, especially if Senate remains under the control of Republicans – who forced the Obama Administration to follow austerity to cut back on the large fiscal deficit (raked up under the previous Republican President, George W Bush Jr)! Politics can always be a wild card!

While, the monetary injection led to a sharp rally in Government debt paper and a more GDP recovery, what will be the outcome of this "twin" strike? Will economic growth recover at a faster clip and mirror the recovery rates of erstwhile downturns, which were far sharper than post GFC (global financial crisis) economic recovery? Or will it just induce another asset bubble? Will the increase in money supply stoke inflation?

This has made several commentators worried, could the specter of inflation return, just as was the case in 1977 period or will a swift control of the virus and strong fiscal and monetary stimuli spur a strong economic recovery, as was visible post economic downturns in the 1980s and 1990s? Even, if inflation crosses the "inflation target" of 2% in US and Europe, equity may be less impacted unlike Government debt, which would make equity to be the "least" bad option amongst all financial assets (save, the new sensation Bitcoin) in either scenario. However, the trajectory of returns for the equity investor will vary dramatically depending on which of the scenarios plays out.

Promise of Delivery vs Delivery of Promise – Will key Government reforms – IBC, GST, Labor, Agriculture PLI (production-linked incentive) deliver growth?

For most equity bulls, economic reforms have always been a key variable for a sustainable bull market. The series of reforms announced by this Government, rival and exceed even the “reformist” Narasimha Rao Government, yet a sustained bull market eludes equity markets! While reforms, are critical, it is their execution and the mindset of those governing these reforms, which is an equally important element to get economic growth from such reforms. Clearly, sequencing, absorption, implementation is as critical as having the political will to announce such important and difficult measures. Will CY21 be the year, when focus will shift to execution rather than more, new and bold announcements? Will GST system stabilize, will e-way bill be matching move from realm of possibility to reality?

Final Comments – What would be “critical” for CY21?

De-coupling of GDP growth and Corporate profitability? A key concern most investors have is the “broken relationship” between GDP growth and corporate sector profitability. The question often asked is “With GDP growth negative, how are companies reporting higher profitability and sales growth”? The answer to this question is nuanced – every sector has an element of imports and presence of unorganized players. This would vary from 12-20% of a sector’s overall sales. Given that most of the imports are sourced from China, strong tariff barriers and/or restriction on imports imposed during the pandemic across many segments. The second element is the slower than expected revival of the unorganized sector – labor migration to rural areas, has hit availability of trained manpower; the sourcing of raw materials, esp if dependent on imports, esp from China; Capital preservation or usage for family emergencies, thus limiting scaling up of operations to pre-Covid levels. Thus, for the organized players – Large, Mid or Small caps, even if demand goes back to 90%-95% of pre-Covid levels, it represents growth as share of the market which was being lost to these two segments is now reverting to them. Such a play may not last forever, but during a period when demand has not recovered it has allowed organized players to get a benefit – the longevity of such an advantage should slowly reduce as “normalization” returns. Hence, even with 5-10% reduction in demand, organized players have benefitted and reported stronger than expected numbers across several sectors.

How will the large scale unemployment in the unorganized sector impact personal consumption? By various rough estimates roughly 25 to 45 million people “re-migrated” from urban centres to rural areas during the pandemic. How will this impact personal consumption? How long will agriculture sustain such a large population addition? More than manufacturing, which has made a smart come back, how long will it take for Services, the largest element of our economy, to recover? Services account of roughly 70% of the economy, the strength of its revival during CY21 will determine the gradient of economic recovery.

Banks/NBFC, will they face a 2008-09 type of swift recovery or will the NPA pile up reflect the 2015-19 phase? Opinions are divided, most experts believe that NPAs will climb back to 10-11% levels, which will require large scale re-capitalization of banking sector, especially PSU banks. However, the tepid participation from corporates in the restructuring window announced by the banks, gives comfort to others that the NPA pile up could be much lower than what was forecasted by the Cassandra’s at the start of the pandemic. For the

delivery of earnings in FY22, BFSI, again is in the pole position, expected to contribute almost 60% of the incremental growth in profits. Q4 FY21 results will be the most crucial to answer this question and will also set the direction for the revival in profitability of financials for FY22.

Market moves may be shorter, sharper – deeper on the way down and overshoot on the way up, than the docile 1990s. In short, more vicious. The fall during Mar’20 lasted less than 35 trading days, erasing between 36-43% across the indices – Large, Mid and Small Caps. Supportive action from Central Banks was also quicker, in 2008, while Lehman Brothers collapsed in Oct’08, QE (Quantitative easing) was uncorked only in Mar’09, compare it with the response to the pandemic in Feb/Mar’20 by Central banks - within weeks of the market falling, stimulus had been announced. US Fed crossed over from buying government debt to adding corporate bonds in its buying list. Mainly, to stabilize the corporate bond market, especially the high yield bonds, which had spiraled into double-digit territory. Oaktree and other such financiers, lenders of the “last” resort, to such low rated companies, cried wolf. Unlike 2008-09, when they earned handsome returns, this time were unable to obtain the same level of returns – US Fed had calmed a nervous market just by announcing its intention to buy high yield bonds. No wonder, these players are targeting markets like India to earn high yields, as yields in US flattened on such interventions. Could RBI intervene in the corporate bond market in the future?

Quick sector rotation: As investors searched for stable earnings, rotation from one sector to another, as exhibited from Apr-Dec’20 phase was evident – Staples after outperforming in Mar-Apr, have underperformed since then. Pharma and IT services outperformed during May-Sept; Banks/NBFC, after underperforming from Mar-Sept, outperformed during Oct-Dec. With earnings growth compressed across few sectors, investors rushed from one segment to another, sector rotation has been fast and furious.

Looking back, the pattern / rationale behind these manic moves was clear – sectors which were perceived to return to pre-covid level of profitability and sales growth out performed – Pharma, IT services, Telecom at the start and as the level of economic activity surprised, other sectors joined in. As we get closer to “normalization” post the vaccine roll out, will such sector rotation continue?

Time for Small caps to shine? After the debacle of Mar’20, Small caps outshone the rest of the market – for the first time since CY17. If economic recovery is robust and RBI does not move aggressively into high real interest zone, Small caps could benefit the most. This is also reflected in market recovery post a sharp fall in 2009 (GFC), 2014 (General elections) and 2017 (post Demonetization) as well. Will CY21 sustain this move? Will the nascent rally in Value/Cyclicals sustain or peter out? Of course, owning consistent earnings growth company is important, so used to be their valuation, unfortunately, not any more. Will the rally in cyclicals/Value sustain, or as many Growth focused Portfolio Manager believe “90% of all value stocks are crap”?

With PE funds looking to exit investments, eager retail investors/HNI funding could fuel an IPO boom? Success of recent IPOs could reinforce the willingness of PE investors to seek an IPO for partial exit. Retail confidence, after tasting such success, will continue to grow... till an overpriced IPO crashes, such is the cycle. Expect a flurry of IPOs, at least in H1 CY2021.

Will the dream run of retail trader continue in CY21 or a sudden correction impairs most of the recently garnered gains? WFA (work from anywhere), it seems has had an “unintended consequence” - the return of

the retail investor investing directly in the markets, side stepping mutual funds as the preferred vehicle for their equity investment. In the US, this phenomenon is most closely associated with an app based trading platform, which has caught the imagination of the retail trader, esp millennials. Facilitating investment through an app, it focused exclusively on retail investors, encouraging them to trade rather than be long term investors – allowing them to buy fractional shares etc. India, too, has witnessed a surge in retail investing through online brokerages. It would not be out of place to admit, that during the dark days of Mar'20, retail investors who dived into the market to “bottom fish”, while most institutional investors focused on career mitigation, raising cash, the year end results favour the former. With large caps delivering 60% + returns, Small Cap Index registering a gain of 100% from its March lows, the pickings for this segment of intrepid investors has far exceeded what institutional investors have delivered. Success, in stock market, always has followers and the band of retail investors rushing to invest directly has grown “multifold”. Another feature of stock market success is that it begets confidence and belief. Will this initial success, sustain? Will the confidence of increasing the size of one’s “bet” bear the same fruits as it did during Mar/Apr/May'20? Retail participation in option trading is at an all time high. IPO listing, as mentioned earlier, have seen a frenzy, which traditionally have been an indicator of an overheated market with over enthusiastic participants. Will institutional investor regain some “respect” or will the gravy train of monthly double-digit return for retail investor continue to roll on?

Finally, enjoy a healthy 2021, may this scourge disappear from our lives in 2021. Hope, the anxiety of tracking sites on the pandemic on a daily basis fades from our memory. Hope, all the vaccines bring a long term solution against the virus. May we choose WFA as an alternative rather than be forced to use it as a defense against the virus. May the promises be delivered in 2021 rather than we look to 2022, hoping for delivery of these promises.

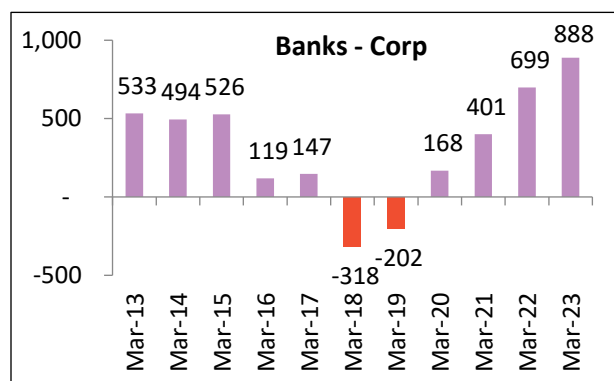
Stay safe and wishing you and your loved ones a safe 2021.

Annexures

The three broad buckets – Defaults, Deflationary pressures and Regulatory upheavals (Disruption).

1) Defaults:

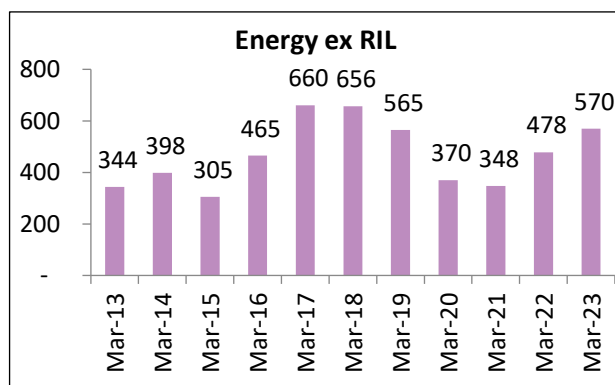
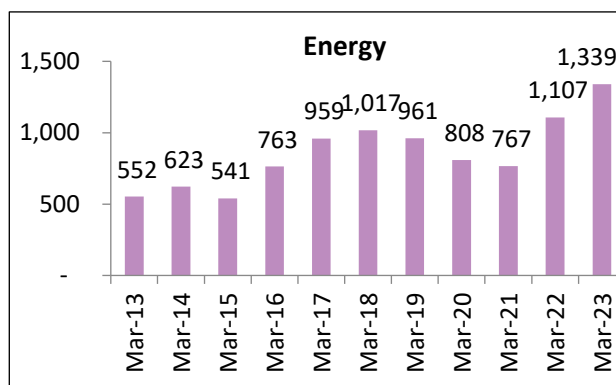
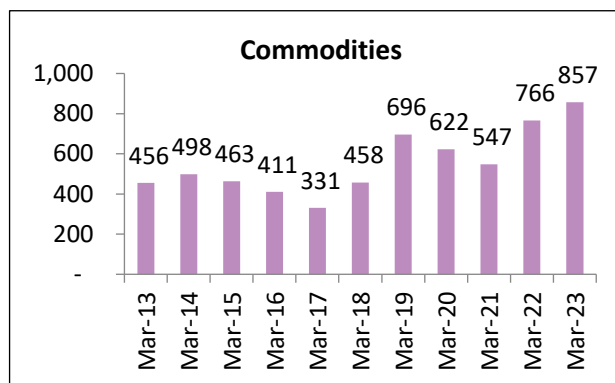
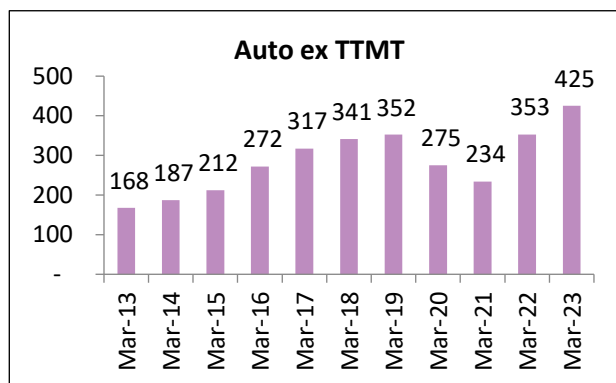
- From FY13-15, PAT growth for Corporate banks remained flattish. While consensus estimates a 74% CAGR over FY20-23 from a lower base of FY20 and a 49% CAGR over FY21-23.



Source: Bloomberg

2) Deflation:

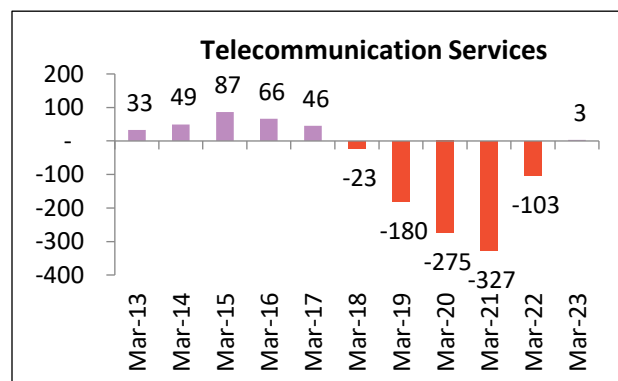
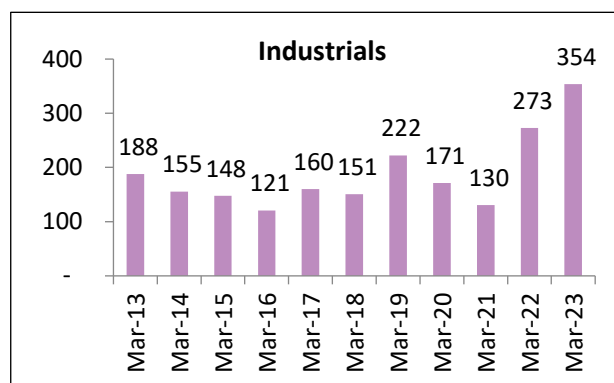
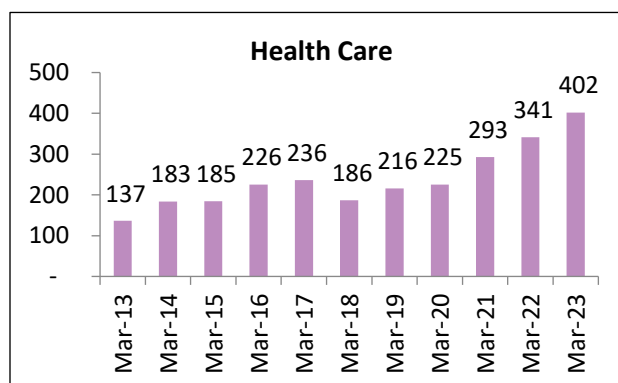
- Auto sector ex TTMT (Tata Motors) grew by 9% CAGR over FY16-19 and consensus estimates a 15.6% CAGR over FY20-23.
- Commodities sector has grown by 19% CAGR over FY16-19 while and consensus estimates a growth of 11% over FY20-23.
- Energy sector has grown by 8% CAGR over FY16-19 and consensus estimates a growth of 18.4% over FY20-23. This growth is however led by RIL and hence Energy sector ex RIL has grown by 6.7% CAGR over FY16-19 with consensus estimating 15.5% over FY20-23.



Source: Bloomberg

3) Disruption:

- Healthcare sector has recorded a growth 13.3 % over FY13-16 while consensus estimates a CAGR of 21.3% over FY20-23.
- Industrials has grown by 22.6% CAGR over FY16-19 while and consensus estimates a growth of 27.4% over FY20-23 and a 65% CAGR over FY21-23.



Source: Bloomberg

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