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# 2020 Market Outlook

We are constructive on the market performance for 2020 very similar to the way we were for 2019. This positivity of ours primarily rests on our thesis of earnings normalization ahead. Under our base case thesis, we also assume that other macro and market influencing factors will remain similar to the one that prevailed all through 2019.

The key factors impacting the market fortune in 2020 would be: a. Normalization in Indian Corporate Earnings, b. Global sentiments towards risky assets including emerging market equities and c. India's fiscal conditions.

Though the debate on issues such as when economy will turn up and whether we are in a cyclical or a structural decline will continue (our own view is that it's a mix of both cyclical issues owing to formalization push to the economy and some very valid structural issues), the market should limp along as one- the earnings picture looks better and two- there are strong (and structural) fund flows and third- absence of leveraged long positions in the market.

**Base Case (70% probability)**

- Earning growth normalizes as one –offs that has forced the Indian corporate earnings to appear muted recedes. Remember at EBITDA levels corporate earnings have remained very robust (Nifty EBITDA margin is near all-time high), but one-offs mostly related to balance sheet impairments has kept the PAT level growth muted.
- Global sentiment towards risk assets remains calibrated but positive. And
- Government fiscal situation remains in control.
- Under the base case we expect Nifty EPS to grow to 650 (+ 18%) for FY21 and we assign PE of 21 for our Dec-2020 target of 13,650

**Bear Case (20% probability)**

- Earning growth normalizes
- Global sentiment towards risk assets remains calibrated but positive. And
- Fiscal deficit becomes unsustainable high and/or government spending towards demand creation does not come.
- Our biggest worry right now is that government does not bring any serious fiscal stimulus to kick start the demand push. Alternatively government does bring serious fiscal stimuli but in the process the fiscal deficit gets unsustainable. And there are chances for this if large divestment does not come through.
- Under the bear case we expect Nifty EPS to grow to 650 (+ 18%) for FY21 and we assign PE of 18 for our Dec-2020 target of 11,700

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**Bull Case (9% probability)**

- Earning growth normalizes
- Global sentiment towards risk assets gets highly positive
- Government does large capex but fiscal deficit remains well in control due to large divestment
- Though the probability is lower for this but looking at massive underperformance by emerging market over last 10 years along with largely stable global economic growth there are possibilities of emerging market starts outperforming developed economies going ahead. Recent weakness in dollar index adds to the hope for this case.
- Under the bull case we expect Nifty EPS to grow by 18% for FY21 and we assign PE of 24 for our Dec-2020 target of 15,600

**Black Swan (1% probability)**

- Earning growth disappointment continues
- Global sentiment towards risk assets gets negative
- Govt Fiscal deficit becomes unsustainable high and/or government spending towards demand creation does not come
- Though, it is highly unlikely that all the three market impacting factors go negative but as former US secretary of Treasury Robert Rubin has famously said explaining his principle of decision making:'.. the only certainty is that there is no certainty and every decision as a consequence is a matter of weighing probabilities..', we need to be aware of what can go terribly wrong. As is said 'prediction is futile, preparation is indispensable'.

## Normalization in Corporate Earnings Growth Ahead

Indian annual corporate earnings growth over last 5 years had been mere 4.2%which is way below the historical average. Though sales growth for Nifty from FY15 to FY19 had been decent 9.5%, the reported profit growth has consistently disappointed. This disappointment is the key reason why Indian market trades at an apparent high valuation multiple while price gain had been sub-par.

It is important to understand that this slow growth in PAT is not due to some structural issues with the operating environment as operating profit growth (annualized EBITDA growth) had been decent 10.4%. In fact over last 5 years while EBITDA margin has moved up by some 100bps, the PAT margin has fallen by 200bps over the same period. And this change is primarily on account of massive balance sheet impairment that Indian corporate has taken over last 5 years. This balance sheet impairment is routed to the P&L through exceptional items or provisioning and thus hampering the reported profit growth.

We believe that we have seen the peak of balance sheet impairment for Indian listed corporate and from now on mere absence of these one-offs, Indian corporate will exhibit better profit numbers. In an immediate sense with slowing economy the topline growth would be challenging but the profit growth would be decent.

## One-Offs in the recent past:

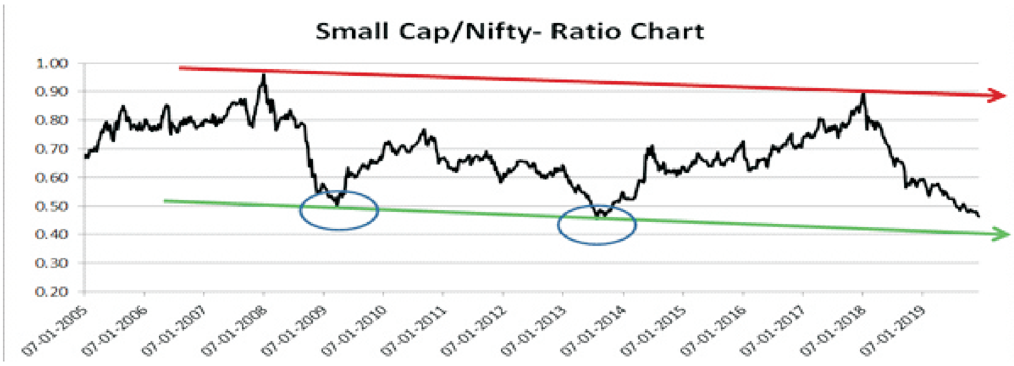
| Financial Year | Company | Exceptional/ One Offs (Rs Cr) | Remarks |
|---|---|---|---|
| H1FY20 | YESBANK | 3,120 | Elevated Provisions due to NPA |
| H1FY20 | BHARTIARTL | 32,180 | Supreme Court judgment on Adjusted Gross Revenue ('AGR') |
| 201903 | SBIN | 53,829 | Elevated Provisions due to NPA |
| 201903 | TATAMOTORS | 29,562 | Impairment in assets in China due to slowdown, rising rates and technology disruption |
| 201903 | ICICIBANK | 19,661 | Elevated Provisions due to NPA |
| 201903 | AXISBANK | 12,031 | Elevated Provisions due to NPA |
| 201903 | YESBANK | 5,778 | Elevated Provisions due to NPA |
| 201903 | GRASIM | 2,575 | Mainly due change in fair value of investment in Vodafone India Ltd |
| 201903 | SUNPHARMA | 1,214 | Settlement amount payable to plaintiffs related to the Modafinil antitrust litigation in the US |
| 201803 | SBIN | 75,039 | Elevated Provisions due to NPA |
| 201803 | ICICIBANK | 17,307 | Elevated Provisions due to NPA |
| 201803 | AXISBANK | 15,473 | Elevated Provisions due to NPA |
| 201803 | BHARTIARTL | 2,212 | due to levies and taxes pertaining to internally restructuring |
| 201803 | YESBANK | 1,554 | Elevated Provisions due to NPA |
| 201803 | SUNPHARMA | 951 | settlements related to the Modafinil antitrust litigation in the US |
| 201703 | SBIN | 35,992 | Elevated Provisions due to NPA |
| 201703 | ICICIBANK | 15,208 | Elevated Provisions due to NPA |
| 201703 | AXISBANK | 12,117 | Elevated Provisions due to NPA |
| 201703 | TATASTEL | 8,188 | Impairment of Assets and losses from discontinued businesses |
| 201703 | BHARTIARTL | 6,255 | Due to regulatory levies related assessment / provisions |
| 201603 | VEDL | 33,785 | Impairment on Assets relating to Rajasthan block due to significant fall in the crude oil prices |
| 201603 | SBIN | 29,484 | Elevated Provisions due to NPA |
| 201603 | ICICIBANK | 11,668 | Elevated Provisions due to NPA |
| 201603 | ONGC | 7,943 | Fall in crude oil prices in the International market and resultant net impairment |
| 201603 | TATASTEL | 3,975 | Write down of fixed assets mainly relating to the European operations. |
| 201603 | JSWSTEEL | 2,125 | Diminution in value of investments and doubtful for loans and Interest relating to subsidiaries |
| 201503 | VEDL | 22,199 | Impairment of the goodwill triggered by significant fall in crude oil prices |
| 201503 | TATASTEL | 3,929 | Write down of Assets of nonperforming units mainly in Europe and investments in Coal assets. |

Severity with which these one-offs have hampered the net profit growth of Indian corporate can be ascertained from the fact that just during Q2FY20 due to losses reported by Bharti Airtel (AGR related provision) and YESBANK (non-performing assets provisioning), Nifty expected EPS growth expectations for FY20 was pulled down by 620 bps.

## Thesis for Small Cap performance ahead

Over last two years small and mid -cap space has provided negative returns. Though Nifty has made new highs, the rally is very narrow. Even inside Nifty performance major contributions have come from handful of stocks. The pessimism surrounding mid and small cap space is so deep that most of the new money that has come to the market over last few months has mostly gone towards large cap consumption stocks. But there are evidences that suggest that we are close to the end of this cycle of sharp underperformance of mid and small cap space.

## Nifty Small Cap to Nifty 50 Ratio is close to historic low levels:

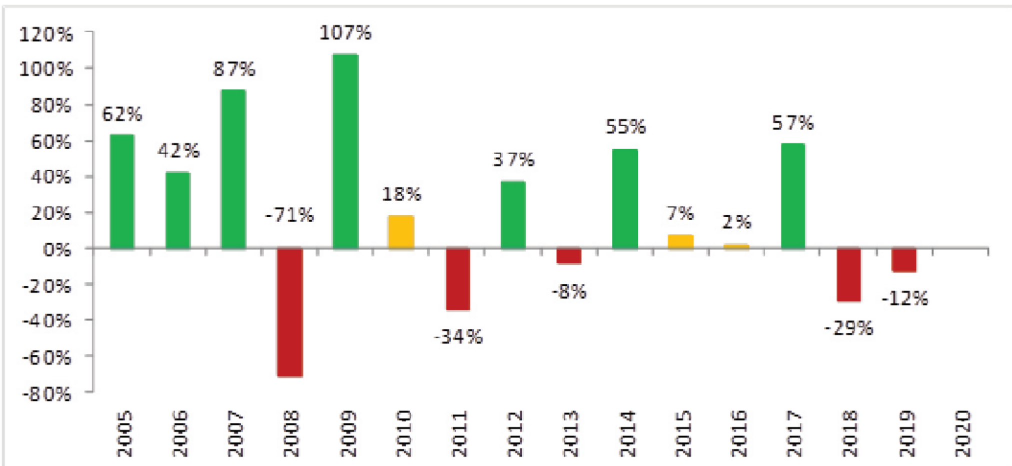



Small Caps are trading at those levels from where out-performance will once again start similar to 2009 and 2013. The ratio is still some 6-7% above the support line suggesting the pace of underperformance will recede and if operative economic environment improves, the out-performance will start.

**Nifty Small Cap poor run has never lasted for more than 2 consecutive years:**

During 2015 and 2016 the small cap index produced returns of 7% and 2%, whereas in the consequent year 2017 saw good 57% returns. Also, the small cap index provided 18% and -34% returns in 2010 and 2011 and in the consequent year in 2012 gave 37% returns. Currently for the past two years 2018 and 2019 the index has provided negative returns of -29% and -12%. This underperformance has come on the back of a multiple macro issues. A liquidity deficit and elevated NPA cycle had plagued the economy, Small caps were the most hit with these problems. Thus a positive banking liquidity, lower interest rates regime and a lower corporate tax cut will bode well for small cap stocks.

## Small Cap Yearly Returns



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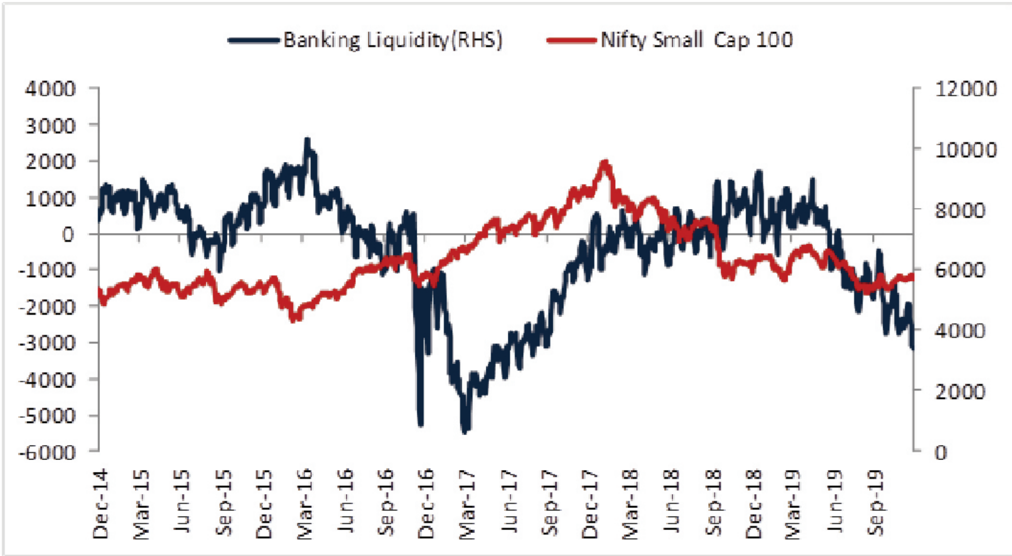
## Banking Liquidity impacts the small cap space the most




Massive rally in 2017 in small cap space had got triggered by liquidity surplus in the economy. At the same time liquidity deficit during 2018 hurt the mid and small cap space the most. Now system liquidity is back in surplus and should again help small cap space find its lost glory.

## HIGH LOW INDEX AND ENHANCED MACD CYCLES

The Chart below shows the Small Cap Index along with the High-Low Index (In MACD from) and Enhanced price MACD. The vertical line shows us cycles when both the Techincal Studies are in confluence and the price movement and the breadth are in confirmity.

The confluence of both these studies have over the years caught cyles of upturns and downturns in the Small Cap Index.

At present the High-Low Index is in positive territory ,the Enhanced MACD on the other hand is on the verge of crossing over the signal line. If that happens it would be start of a new cycle which would be postive for Small Cap Index going forward.

**Early Signs of small cap out-performance is already visible if one looks at Global Small Cap Indices**

## GLOBAL INDICES CONFLUENCE AND INTEGRATION

**A. MSCI World Small Cap Index –** The index broke out of a year long consolidation this November


**B. US RUSSELL 2000 Index –** broke out a few days back. As an estabilsihed rule we give a buffer of 2.5% from breakout point and a breach of 1640 would give a confirmation of the breakout.

**C. MSCI Emerging Market Small Cap Index–** The index is undergoing a year long consolidation in the form of a traingle pattern. The resolution of it on the upside should lead to Domestic Small Cap Index too following suite


The comparisions of these Global indices with the NIFTY Small Cap Index is important as they exhibit significant correaltion , the table below shows us exactly that.

| Correlation of Respective Indices with NIFTY Small Cap 100 Index | |
|---|---|
| Indices | Correlation- Coefficient R |
| MSCI WORLD SMAL CAP | 0.74 |
| MSCI EM SMALL CAPP | 0.79 |
| RUSSELL 2000 | 0.67 |

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| Analyst's ownership of the stocks mentioned in the Report | NIL |

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