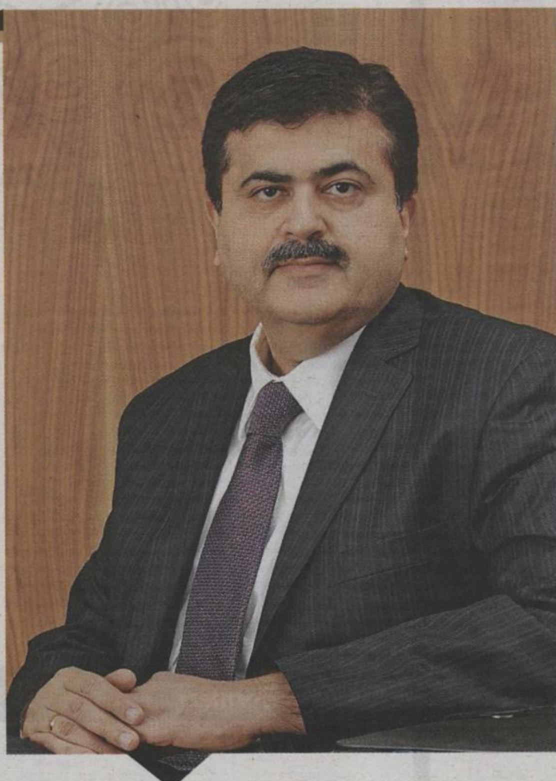
"Time to pick quality stocks for the medium term"



Sandeep Nanda
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Given the current state of the economy, when can one expect a revival in the markets and how should retail investors plan their financial moves? Sandeep Nanda offers timely advice in his discussion with ***Sanket Dhanorkar****.*

When do you expect the economy to come out of the persistent slowdown?
The recovery in growth is likely to take longer than expected. Along with the slowdown in the capex cycle, the consumption momentum in various spheres of the economy is also decelerating. Given that we are approaching the state and the general elections within the next year, the big-ticket reforms will not be too easy to pass. Besides, if the recent interest rate increase sustains, it can slow the recovery. However, we expect an improvement in export and agricultural growth, as well as higher government spending in the coming quarters. The growth for 2013-14 is likely to be marginally higher than 5% (for 2012-13), but to go back to 7-8%, we will need to see a meaningful recovery in investments, including infrastructure, for which visibility is quite low as of now.

How will the proposed tapering of the quantitative easing programme by the US affect the Indian capital markets?
If there is an abrupt change in the quantitative easing programme by the US Fed, it will impact India in the form of lower capital inflow, as it did in June, when FIIs pulled out $1.7 bn from the Indian equities. Given India's large current account deficit (the absolute size of the deficit is the second highest in the world after the US), this will impact India's currency, and through it, a host of other macro variables like interest rates, growth, fiscal deficit, etc.

How much more pain can we expect from the rupee? What will be the fallout for the economy?
The recent depreciation in the rupee is largely due to the dollar's appreciation after the US Fed's comments about ending its quantitative easing programme. Since then, it has specified that any such move will be gradual and data-dependent. Many other emerging market currencies, such as those in Brazil and Indonesia, have also weakened along with the rupee. The RBI has taken strong action over the past fortnight to tighten domestic liquidity, and has also indicated its resolve to soothe the nerves in the currency market and stabilise the rupee at the current level. A falling rupee will help India become more competitive in the global exports market share arena, but in the short term, it will cause inflationary pressures in the domestic economy.

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After the recent reforms push, do you anticipate a decisive move in either direction in the stock market?
The overhang of general elections, which are scheduled to be held within the next 10 months, and the state elections towards the end of the year will prevent any meaningful policy action. The earnings growth for corporates still remains sluggish, though the corporate earnings downgrades seem to have slowed down a lot. However, at the same time, there is no clear visibility on when the earnings upgrade cycle will kick in. The FII flow, which was strong till May-end, has turned sluggish after the Fed announcement of the tapering programme. While the valuations for benchmark indices are not stretched and are in line with historical averages at ~14x-15x forward PE, given the overall macro environment, we believe the markets should remain range-bound in the near term.

Which sectors should one invest in at the current juncture?
The sectors like health care, consumer staples, information technology and select mid-caps should continue to perform better compared with the overall market. While the valuations appear to be expensive, the significantly higher earnings growth, and its visibility relative to the overall market, justifies the premium and should be sustainable. The domestic cyclicals, like industrials, will continue to suffer due to the lack of recovery in the capex cycle and weak earnings, while the high leverage continues to trouble the balance sheets of many infra companies and global cyclicals like metals.

After the recent bond market volatility, can investors play the interest rate reversal that began last year?
We believe that the recent jump in yields is temporary in nature, and once the currency market stabilises, the RBI will focus on trying to revive growth, which is extremely weak. Thus, we expect a reversal of the recent RBI steps in the second half of the year, though the interest rate cuts are likely to be modest. The monetary policy statement on 30 July will provide more clarity on this issue.

What is your advice to investors now?
Equity as an asset class should do better in the coming years. In the past couple of years, we have seen retail investors show a stronger preference for physical assets (gold, property) and have been under-invested in equities. In fact, mutual funds and the insurance industry have seen equity outflow in the past few quarters.

However, gold price has corrected sharply recently and the outlook remains uncertain. The property market in India has been in a linear, multi-year bull market for almost a decade, and has become unaffordable for the end-user in many parts of the country. Within equity, several sectors, such as pharma, IT and consumer, have done well, though the market as a whole has not. Therefore, we think it is a good time to build a portfolio of quality stocks with a medium-term perspective and to stick to a bottom-up approach towards investing.

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