

Global Pivot and Slowing Growth

September has been an eventful month for global markets. We have had 2 big global pivots during the month:

Fed Rate Cuts:

US fed finally did a 50bps rate cut as inflation moderated and markets are pricing in another 50bps rate cut in CY24 and 100 bps rate cut in CY25 in US. The last time we had a rate cut in US was during the covid pandemic 4 year ago. The US economy seems to be in goldilocks as the growth is still resilient and we have the fed pivot. Thus, the fed has been able to tame the inflation genie without pushing the economy in to recession.

Chinese Bazooka:

Also, after many false dawns and piecemeal approach, the Chinese government announced significant fiscal and monetary stimulus to stabilise growth, put a floor to property markets and revive the capital markets. It appears that after many failed attempts the Chinese govt this time has got itself ahead of the economy and markets with a commitment to do more, if needed.

The CSI 300 index was up 25 % in a week and some the leading names across property and internet are up 50-100%. Despite such sharp moves, the CSI trades at 11x forward earnings and is still at 25% discount to MSCI EM. There is compelling case for a cyclical recovery in Chinese equities and given the cheap valuations, China will attract disproportionate capital allocation in EM as most global investors are significantly underweight China. This could lead to redemptions from other EM's as investors rebalance their portfolio's.

As far as Indian markets are concerned, the ongoing leg (started in March 23) of this bull market has been as ferocious as the first leg (March 20- Oct.21) of this bull market. During this leg, the nifty index has gained 51% during the 18month period March 23- Sept24 as compared to 105% gains during the first 18 months rally during March 20- Oct.21.

The participation, breadth, capital raising in this leg has been far higher than the first leg which itself was very ferocious starting from the lows of Covid. The sectoral drivers of this last leg – Defence, PSU, Capital Goods were much different than the sectoral drivers of the first leg – Consumer, IT & Banks. In fact, all the sectors leading the first leg have been the underperformers in the last 18 months.

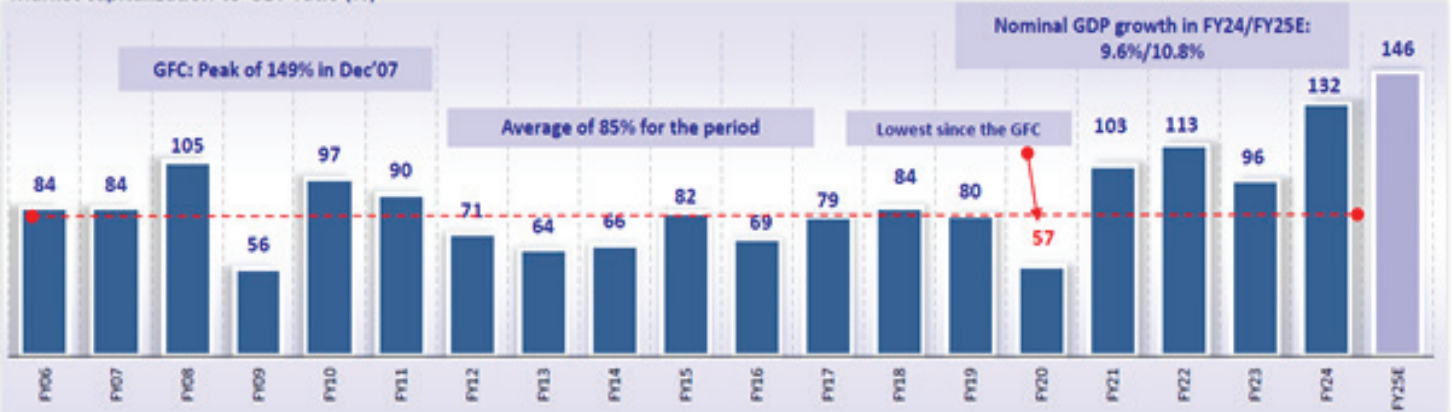
But it seems, we have reached a pivot point in this bull market. While, we firmly believe the overall construct of the bull market remains intact, but it appears that in the near term the markets have run out of breadth and are nearing exhaustion. They need to pause and catch their breath just as they did during Oct21- March 23. During that 18month consolidation, the nifty index delivered negative 2% returns. We believe, we are in for similar consolidation move in the nifty index over the next year.

During this ongoing bull market, Nifty earnings have grown at a CAGR of 21% from 429 in Fy20 to 1090 in Fy25e. But it seems the drivers of earnings growth over the last 5 years – pent up demand, low-capacity utilisation, tailwinds of deep economic reforms like GST, RERA, IBC etc during 2018-19 have all played out and have exhausted. The economic reforms post covid; especially PLI driven manufacturing revival is playing out well but is not sufficient to translate into break our growth for India.

There has been visible slowdown in economic activity – GST collection for Aug.24 was up by 6.5% - the lowest growth in 40 months; HSBC manufacturing PMI has fallen to 8month low of 56.5 in Sept.24 and the Services PMI as declined to 10month low of 57.7. While the 1HFY25 has been slow for corporate India due to heatwaves and election cycle impact, the pickup in economic activity in the 2Hfy25 is modest. Some consumer companies have already given advance warnings of growth slowdown.

Broader earnings growth for corporate India has started slowing down and the sectors which have demonstrated strong growth over the last 3 years are priced for perfection with little room for disappointment. The operating leverage that existed in corporate India has played out as most companies across industries are near optimum capacity utilisation. While this sounds good omen for revival of private investment cycle, but the pickup in private investment is slow and gradual and defies any sign of animal spirit which is completely missing. In this backdrop, given that India is the most expensive equity market in the world and valuations are 10% above India's own long-term averages, it looks probable that Indian markets need to consolidate and let earnings catchup with the price momentum. The global back drop for equities remains favourable with rate cut cycle in US and India continues to remain a long-term secular growth story. This will ensure that Indian equities continue to remain a compelling asset class from a medium term to long term perspective.

Market capitalization-to-GDP ratio (%)



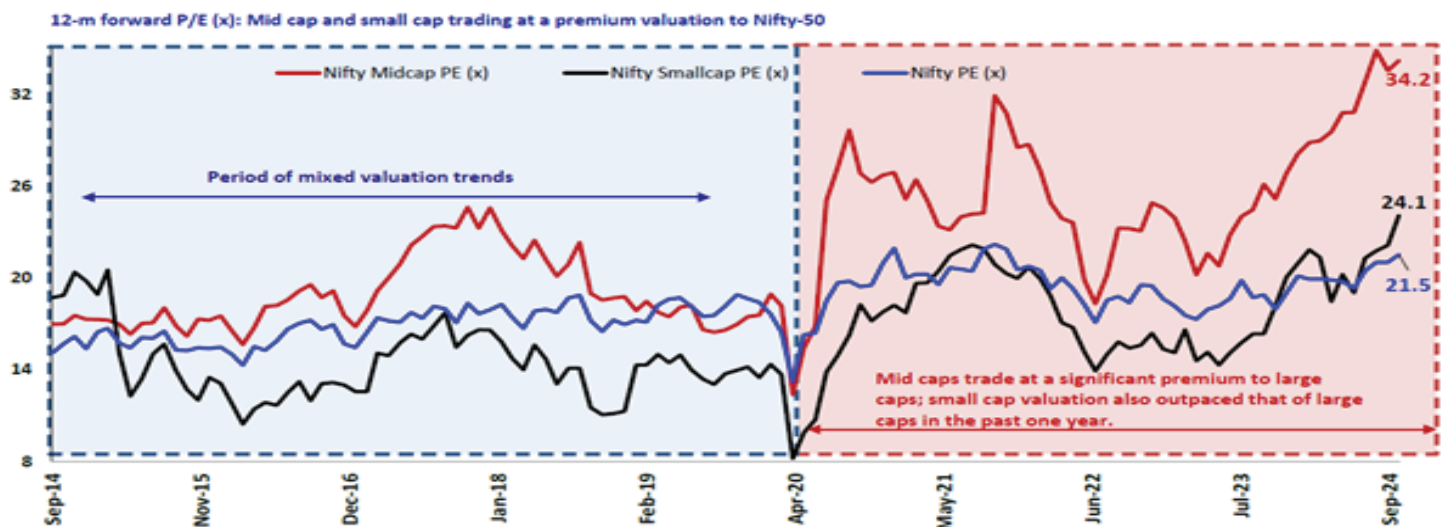
Source: MOFSL

Also, given the election setback, it is apparent that the political capital of this government has peaked and is on a declining curve. The recent exit poll outcome of loss in Haryana and J&K would add to the political challenges of the government. The government might use its residual and declining political capital to pursue other politically beneficial reforms rather than squandering them on hard economic reforms. It appears that hard economic reforms are out of the window in the residual term of this government and there are visible signs of government peaking out in terms of new ideas. The reforms momentum seems to be slowing down. The CEO of a leading private sector bank mentioned in an interview with the leading business newspaper that IDBI Bank disinvestment is dead. This has been in the making for few years and was highly expected, but it seems unlikely.

India yet remains favourably placed to deliver 6.5% - 7% real GDP growth over the next 3-4 years, but a breakout growth is unlikely.

From the stock markets perspective, the gains in the indices from here on will track earnings growth as the significant valuation rerating is already in the base and we are unlikely to witness further valuation related uptick in the medium term, unless India executes further structural reforms. We remain constructive on the Nifty Index as we expect corporate India to deliver 14% nominal earnings growth over the next 3-5 years.

There are many pockets of markets where growth expectations are mispriced and unlikely to be met, or current stock prices are building growth far too out in the future. Narratives have overtaken fundamentals and the frenzy is palpable. While we continue to remain constructive on the overall outlook for equity markets from a medium-term perspective, we believe there could be some near-term headwinds. More importantly, we certainly believe that there shall be sectoral rotations in the market and the drivers of the next leg of the bull market could be different than the last leg. We continue to remain selective and cautious on midcaps and small caps given the rich valuations.



Source: Bloomberg, MOFSL

We have been disciplined in our approach to investing within our framework of **Sustainable Quality Growth at Reasonable Price (SQGARP™)** and making appropriate changes to our portfolios to steadfastly focus on executing our core philosophy. There is very wide dispersion in growth prospects and valuations across sectors. Given our framework, we are disciplined in booking profits in companies where stock prices are far too ahead of fundamentals or in case of companies facing growth headwinds. Some of these stocks could have strong price momentum in the near term but as long-term fundamental investors, we shall exit stocks where current stock prices cannot be rationalised with the future earnings potential of the business, even at the cost of short-term fund underperformance.

We have exited our exposure to defence companies and have pared our exposure to capital goods sector as we find the valuations are expensive despite strong growth prospects.

We have been under weight financials as a sector and private sector banks in particular. After significant under performance, we believe the valuations in the sector are far more reasonable now and are more appropriately aligned to the medium-term growth curve of the sector. As a result, we have increased our exposure to some of the private banks.

We have been overweight IT as a sector as we believe that there should be recovery in Global IT spends in CY25 and that should augur well for prospects of Indian IT companies. We continue to retain our overweight in IT and Pharma.

At aggregate, our portfolios reflect our core philosophy of High Growth, High Quality and Reasonable/ Fair Valuations. Consequently, though we expect markets to consolidate in the near term, we feel our portfolios are well placed to deal with cyclical growth moderation.

Pankaj Murarka

Date: 7th October 2024

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