Equity markets: Earnings Season Momentum Fuels Market Performance

RBI surprised the market by maintaining the repo rate at 6.5% instead of the expected 25bps hike – calling this a pause rather than a pivot. Furthermore, they revised the real GDP growth projection for FY24 upward by 10 basis points to 6.5%. Despite these changes, the RBI retained its "withdrawal of accommodation" stance, leaving room for potential data-dependent rate hikes in the future. This decision provided a respite from the rate hike cycle and prioritized financial stability considering recent global bank failures and associated contagion risks.

On the global front, U.S. Federal Reserve (Fed) raised rates by 25 bps in its April meeting. US inflation showed signs of easing with core Consumer Price Inflation (CPI) print coming in at 5.6% YoY and headline CPI print at 5% YoY while in UK headline inflation fell by less than expected, from 10.4% YoY in February to 10.1% YoY in March. Meanwhile, core inflation was unchanged at 6.2% YoY. US initial jobless claims increased by 5k to 245k in the week ended April 15, above consensus expectations, leaving the four-week moving average of initial claims unchanged at 240k and in UK the unemployment rate ticked up from 3.7% to 3.8%, and average weekly earnings demonstrated a re-acceleration in wage pressures after printing at 5.9%, well above consensus expectations for a sequential improvement to 5.1%. With the first signs of dents in the economic growth now visible, and fallout from financial market tensions lingering, markets focus now has shifted to the terminal rate and how long it would sustain.

During April, markets globally remained mostly rangebound, with MSCI World increasing 1.6% for the month in USD terms. MSCI Europe rose ~3.5% during April in USD terms, as optimism about the economic outlook outweighed concerns about interest rates staying higher for longer. However, MSCI Emerging Markets declined ~1.3% in the same period in USD terms, primarily due to weakness in Asian markets.

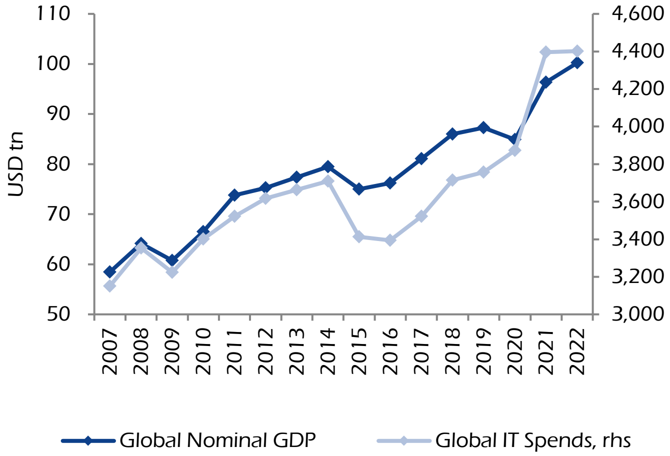
Nifty 50-TRI increased by ~4.1% in local currency terms, in line with broader markets. BSE 500-TRI also grew by ~4.6%, but underperformed compared to BSE Midcap-TRI and BSE 250 Smallcap-TRI, which rose by ~5.9% and ~7% respectively during the same period. The performance was supported by

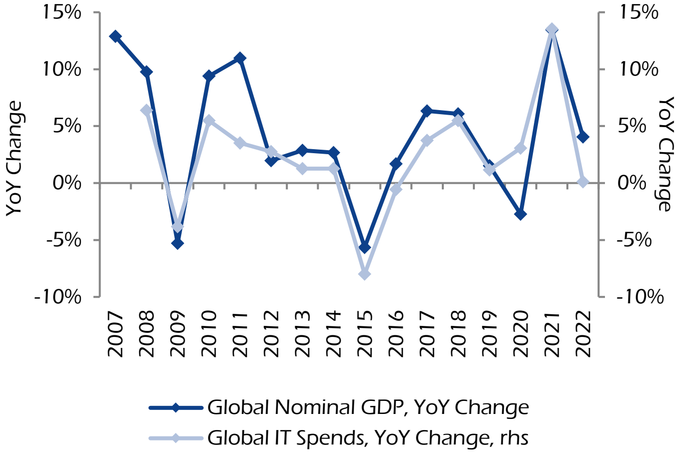
- RBI's surprise rate pause,
- hopes of a strong earnings season following positive quarterly updates from domestically oriented sector,
- easing inflation prints

Sectoral performance was largely driven by domestically oriented sectors faring better. The Auto sector rose by ~7.4%, while Banks and Financials both increased by ~6.5% during the month. Nifty IT, on the other hand, was the biggest loser due to weak earnings reported by large-cap companies, with the index falling by ~3.5% for the month. Nifty Realty, up about 14.9% till date in April, was the best-performing sector, as robust quarterly sales updates and a pause in rate hikes created positive sentiment.

Current quarterly performance of IT businesses have made us question long term return potential of the sector

In the past, IT sector has seen strong correlation between global IT spending, nominal GDP growth rates, and US profit growth. Over the past decade, IT spending declined only twice: once in 2015, and in 2020 as a result of the pandemic-induced slowdown. However, in the two years following Covid-19, IT spending was driven by the need to catch up on under-investment in technology (primarily in digitization and cloud services) and higher-than-usual cost reduction projects, which led to above-trend technology spending that benefited Indian IT services companies. While spending in CY22 remained flat, we believe CY23 could also be challenged due to macro headwinds such as slowing global growth and profits.





Source: Gartner, IMF, ASK IM Research

Global IT spend vs global Nominal GDP and US Corporate profit growth, has a positive correlation. But interesting to note is global IT spend in last 15 years has trailed global Nominal GDP growth and also US profit growth. While growth rates accelerated in post Covid period during last 3 years, it reflects need of corporates to front load investments in IT. Industry now is mired with multiple headwinds due to global growth challenges, outlook for IT Industry seems slows at the current point in time.

Also, another concern emanates from generative Artificial Intelligence (AI) ability and the risk it pose to the business model. Generative AI is a subset of AI that automatically generates text, code, images, etc. In the last few years, the capabilities of generative AI have evolved significantly and is now used in wide gamut of applications. The release of ChatGPT to the public can be an inflection point in its adoption. New use cases are constantly emerging and promises to make a significant impact across varied industries.

Generative AI systems' ability to exhibit logic, reasoning, contextual understanding and creativity enables them to provide significant assistance in software development-related activities. While, from a services standpoint, generative AI can drive considerable productivity gains in software development over the next few years, the impact on the maintenance front could be less significant. Though enterprise adoption of generative AI could drive demand tailwinds, we are concerned about the deflationary risks that the generative AI can bring during the 'transition period'.

Overall, industry is facing uncertainties on multiple front including macro, delivery mechanism etc. Longer term, corporates have no choice, but to continue to invest in technology to survive and thrive. We currently remain underweight in the space.

Valuations back in comfortable zone

Owing to time correction (range-bound markets), Nifty's 12-month forward PE has seen a ~23% correction from its peak in the latest cycle. This has brought valuation into a rather comfortable zone. While global markets saw a fair bit of volatility last year, Indian equities held up owing to strength in earnings as well as a stable growth outlook, which provided strong downside protection.

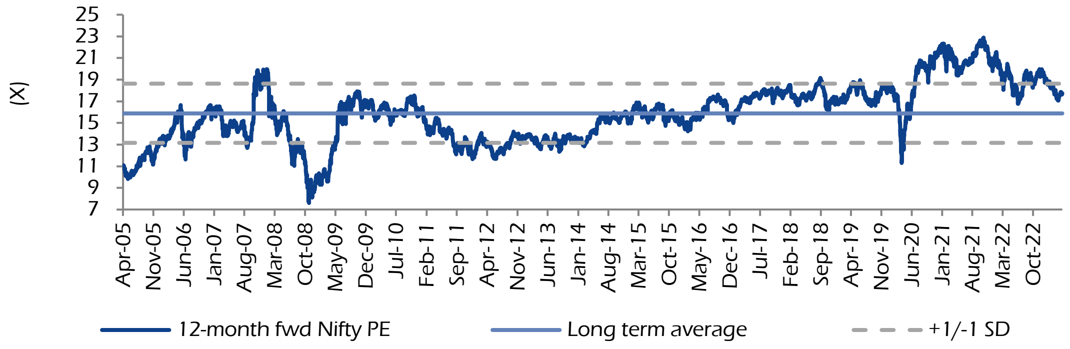
Sharp rate hikes last year, however, kept the upside capped - thus leading to a de-rating in earnings multiples. Going forward, a slew of triggers like

- inflation peaking out,
- Fed hitting terminal rate,

- weak global growth catalysing a rate cut cycle eventually

While the possibility of rate cuts may still be away, absence of rate cut itself should help prevent further de-rating and prices should grow in line with earnings growth expectations.

FII's have invested net of USD 518 mn in April, while DII's have invested its investment momentum, investing net of $226 mn in Indian equities in the same period. Retail participation continues to remain strong with SIP flows touching all time high of USD 1.73 bn in March.



Source: Bloomberg, ASK IM Research

Nifty 12-month forward PE much ~23% below peak. Versus its emerging market peers, India was trading at a significant premium about six months back. Time and price correction in India markets, coupled with continued earnings growth and a sharp rally in Emerging markets led to sharp drop in this premium now. This should lead to reduced headwind vs emerging market peers – supportive of foreign flows.

Outlook

Indian equities should find support from robust earnings outlook owing to strength in domestic economy (financials and consumption segments will be key beneficiaries), even as global growth suffers (implying a weak growth outlook for Indian IT companies). Areas that should do well include beneficiaries of higher manufacturing in India, supply chain dislocation like chemicals etc. Consumer businesses should benefit due to premiumisation trends and fall in commodity prices leading to positive impact on margins. There has been trimming of earnings expectations especially in IT businesses, but given strength in Banks's asset quality, uptick in loan growth, strength in NIM's, strength in urban demand despite rural weakness – India Inc's earnings outlook look alright.

Happy investing.

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