

Larger rate cuts only if CPI inflation structurally slips to 4%

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MARKET

Interview

Growth in FY17 earnings of Nifty firms, which was expected to be around 10-12 per cent pre-demonetisation move, is expected to now grow at 5-7 per cent, said Jyoti Vaswani, chief investment officer at Future Generali India Life Insurance Company, in an interview with Falaknaaz Syed. Excerpts:



■ **What will be the impact of demonetisation on the economy? When do you expect a recovery?**

The government move to demonetise high-value notes would have a far-reaching impact on the economy. Apart from creating gush of liquidity in the banking system, demonetisation could create a short-term disruption in consumption and lead to behavioural changes in household's saving and consumption demand. The negative impact of demonetisation will be significant, but is transitory and growth recovery could happen in the next few months.

Ground level checks indicate that there is decline in sales especially for consumer discretionary sectors like auto, consumer durables, FMCG and cement, which have large exposure to rural areas where level of e-transactions is relatively low. The benefits of demonetisation will be seen over the medium to longer term. Possible gains through higher tax revenues as unaccounted money makes way to a formal channel would help boost

changed. **How many RBI cuts do you expect by the end of FY17 and why?**

RBI took a prudent decision of not cutting rate in this monetary policy on the back of uncertainty over the inflation trajectory and impending US Fed rate hike. But if CPI inflation remains steady below projected level of 5 per cent for next couple of months and Indian rupee doesn't see volatility after the expected rate hike by US Fed this month, a further repo rate cut of 25 bps could happen during FY17. RBI may go for larger rate cuts only if CPI inflation structurally comes down to near 4 per cent.

■ **What is your outlook on rate-sensitive sectors?**

Though RBI has kept the repo rate unchanged, the abundant liquidity in the system and consequent fall in the cost of funds for banks will ensure that interest rates decline. Banks have started transmission by reducing MCLR (marginal cost of fund based lending rate) on the back of surplus liquidity in the system. So, irrespective of repo rate not being cut, borrowers will be benefited as lending rates decline. A declining interest rate sce-

grades from FY18.

■ **What are the big themes you are betting on?**

The long-term positive India story remains intact and the recent pullback offers opportunities in various sectors. Demonetisation and GST are long-term positives for India growth story. We stay positive and expect the market to rise once the transient impact of demonetisation fades. We will focus on tactical opportunities and longer-term themes. We would look to build our exposure mostly around consumer-facing banks, rate-sensitive sectors, exporters, infrastructure and capex-beneficiary firms. We remain cautious on sectors like telecom where uncertainty looms over pricing power, data volume growth and capex requirement. Similarly, the power sector will still take some time to overcome structural challenges in relation to land buy, funding and lower SEBs' offtake.

■ **Would you follow bottom-up or top-down stock picking strategy?**

In this volatile market, one needs to build a portfolio of good quality stocks, which become available at rea-

medium to longer term. Possible gains through higher tax revenues as unaccounted money makes way to a formal channel would help boost government finances in the long-term.

Demonetisation will move the economy from unorganised to organised sector, dovetailing into GST architecture that is expected to come on board next year. This will stand to enhance the government's ability to tax commercial transactions resulting in a structural improvement in tax to GDP ratio in the economy. The windfall gain could be deployed for recapitalising PSBs and/or infrastructure capital expenditure supporting growth in the medium- to long-term.

■ **How will demonetisation impact Q3 earnings?**

Demonetisation will have a negative impact on company earnings in Q3. While earnings of firms from IT and pharma space may remain insulated, sectors like auto, cement and FMCG could get impacted negatively. Growth in FY17 earnings of Nifty firms, which was expected to be 10-12 per cent pre-demonetisation, is likely to grow at around 5-7 per cent.

■ **How is your reading of the market? How do you see valuations now and where do you see the index in 12 months?**

The market has stabilised after a sharp correction post-demonetisation. The earnings for H2FY17 will now be lower than expected. Nifty is trading at nearly 17x FY18 earnings, which is in line with historical valuation and is not expensive. With a falling interest rate environment and expected return of normalcy post-demonetisation, earnings multiple could expand over next 12 months. So, Nifty could post a 12-15 per cent return over next one year.

■ **RBI has left rates un-**

of surplus liquidity in the system. So, irrespective of repo rate not being cut, borrowers will be benefited as lending rates decline. A declining interest rate scenario augurs well for the rate-sensitive sectors.

■ **If US Fed raises rates, what will be the impact on fund flows in India?**

It is widely anticipated that US Fed will raise rate by 25 bps this month. We think most of the adjustment in FII fund flow has taken place over the past 2 months during which FII outflow from Indian equity market has been \$3.6 billion. But there might be some knee-jerk negative reaction across emerging market equities and currencies when the rate hike actually happens. But in that scenario, Indian equity and currency are expected to outperform other emerging markets owing to our improved macro-fundamentals.

■ **What's your outlook on the banking sector? Are we out of the woods as far as bad loans are concerned?**

While medium- to long-term loan growth outlook stays positive, near-term hiccups due to fall in economic activity in sectors like consumer discretionary, real estate and MSME businesses could emerge. The banking sector had just started to show some glimpse of stability in terms of asset quality. Demonetisation could increase delinquencies in the system in the near-term. But with banks expected to reduce lending rates after getting abundant liquidity post-demonetisation and thrust on infrastructure by the government, corporate credit growth should pick up from multi-year lows from next year onwards. Also with improved CASA and focus on cashless transactions, banks' profitability should improve. Moreover, with a pickup in the economic activity, the banking system should be realising the benefits of higher recoveries and up-

tom-up or top-down stock picking strategy?

In this volatile market, one needs to build a portfolio of good quality stocks, which become available at reasonable valuations. While it's prudent to first identify the sectors to invest in, it's important that you are invested in the right stocks in the sector. Divergence in performance between PSBs and private banks is well known. So a combination of top-down and bottom-up strategy of stock picking is expected to give better result in current environment to enable us to build a quality portfolio.

■ **What kind of returns equity investors could expect over next one-two years?**

Over last couple of years, we have seen retail investments moving out of physical assets like gold, real estate to financial assets like fixed deposits, equity and bond funds. In a low inflation and interest rate environment, when return on fixed deposits and bonds decline, equity market is expected to outperform most other asset classes. So, investor interest on equity market is likely to continue. With a robust inflow and ever improving domestic fundamentals, equity markets are likely to give a CAGR return of 12-15 per cent over next few years. But investors should keep in mind that the equity market is volatile by nature, so investments should be made for medium to long-term only.

■ **When would private capex to pick up?**

The GDP growth over last few quarters has been led by consumption while investment lagged. Gross fixed capital formation, which indicates growth in investment, has been in a shrinking mode since Q4 FY16. Even though government spending has been robust and expected to be strong, private capex has fallen behind.

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