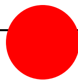

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'Hard to see participants increasing exposure to mid-caps'

The markets put aside global concerns and continued their movement upwards last week. **PRAMOD GUBBI**, managing director and head of institutional equities at Ambit Capital, tells *Puneet Wadhwa* that due to India-specific macro concerns, global liquidity tightening and political risks, foreign flows will likely be neutral to negative going ahead. Edited excerpts:

PRAMOD GUBBI
Managing director & Head of institutional equities, Ambit Capital

Are the markets ripe for a time-wise and a price-wise correction?

Yes, I would tend to agree. At least the former, if not the latter. Given the number of potential negative catalysts on the horizon — both local and global — and given where valuations are, I would reckon there are risks that can take the markets down.

Can you define these risks?

Globally, the biggest risk emerges from the continued tightening of liquidity by central banks, primarily the US Federal Reserve (US Fed), which is on a retreat from its quantitative easing (QE) at a time when the US deficit is rising. This will mean incrementally less money chasing risk assets and that should weigh negatively for financial assets. Furthermore, trade wars, geopolitics and elections in the US in November add to the uncertainty.

Locally, too, politics remains a source of volatility as we get closer to state elections in November, which will be seen as a referendum of sorts ahead of the general elections next year. Any sense of political instability will drive markets lower. Add to it emerging concerns around the twin deficits, inflation and the consequent effects on the rupee might accelerate outflows.

Do you see these risks materialising?

Politics is hard to predict but any perceived adverse result could make people question the 'India story'. Fundamentally, the biggest worry is our inability to implement supply-side reforms, which render any pick-up in growth inflationary, as emphasised by the Reserve Bank of India (RBI). This is also evident in the rising trade deficit as our pick-up in demand is being met by imports rather than locally manufactured goods. This questions the sustainability of economic recovery and makes it short-lived.

What is the road ahead for foreign and domestic flows into equities?

Given the above India-specific macro risks, global liquidity tightening and political risks, foreign flows will likely be neutral to negative. Domestic flows have more than halved from the peak monthly run-rate. Whilst the lump of the flows is sticky in the form of systematic investment plans (SIPs), any adverse reaction from the market can trigger redemptions and create downside risks here as well.

A number of experts now expect the mid- and small-caps to take over from the large-caps in the next leg of the rally. Do you agree?

There will always be opportunities in small- and mid-caps, but to expect the mid-cap index to drive the rally is a bit farfetched. Yes, the index has corrected but valuations aren't cheap by any measure. And given the above-mentioned risks, it is hard to see participants increasing their exposure to mid-caps.

What are your sector preferences?

The consumer (goods sector), especially in an election year and due to the benefits from goods and services tax (GST) implementation, has been a favourite, especially in case of companies with a rural bias. Valuations aren't cheap but earnings visibility stands out at a time when valuations aren't attractive elsewhere either. Similarly, private sector financials with a strong liability franchise in a rising rate regime have been favoured. Finally, information technology (IT), though no longer as attractively valued (as earlier), has been a preferred sector. With the Fed increasing interest rates, the BFSI (banking, financial services and insurance; largest customer segment for Indian IT) will also increase its IT spend. Indian IT companies have invested in building capabilities in new service lines and winning orders; a depreciating rupee provides a nice little tailwind.

How much room does the RBI have to manoeuvre rates in FY19?

The RBI has clearly articulated its concerns on inflation, citing that the output gap is pretty much closed. Its own inflationary expectations survey points to rising expectations of inflation from Indian households. Add to it rising rates globally and risk to the rupee, the RBI would implement at least one more hike this year, if not two. Rate sensitives, other than banks with strong CASA (current account, savings account), should be avoided.

How are you interpreting the macroeconomic data?

Clearly, aggregate demand is recovering strongly in the economy triggered by government spending, GST cuts, etc. But every other macroeconomic indicator — like fiscal deficit, current account deficit and inflation — is showing signs of worry. Earnings growth, too, is in a recovery mode; we reckon we will see the first double-digit growth at the index level in four years. However, given expectations have been high, we may not see the much-needed upgrade cycle to justify valuations.

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