Matthews Asia

Matthews Asia Perspective

Assessing Valuations in India's Stock Market

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When considering the prospects for India's stock market in the coming year, the primary determinants of performance at an aggregate level are the outlook for growth and underlying valuations.

Assuming India's central government remains stable, the outlook for growth continues to improve. Given sustained low consumer price inflation and a reversal in oil prices, it is likely that the central bank (Reserve Bank of India) will ease monetary policy. Leading indicators suggest that nonperforming assets within the banking sector have peaked and are starting to moderate. We believe this should improve the availability of funds to the corporate sector, which has been an issue over the past three to four years.

As the year progresses, the one-time negative impact and initial issues of landmark reforms such as the Goods & Services Tax (GST), Indian Bankruptcy Code (IBC) and Real Estate Regulatory Authority (RERA) will be over and the intended benefits should start to accrue. Lastly, substantial investments have been made on improving logistics infrastructure, which is likely to come online in the next one to two years and should further improve the ease of doing business in India.

Valuations Remain an Issue for Small Caps

Despite the improving outlook for growth, the same can't be said for stock market performance across the market-capitalization spectrum. Valuations continue to be an issue within the small-cap space despite the sharp correction over the past 12 months. Forward valuations for small-cap stocks continue to be higher than normal on fairly abnormal future earnings growth expectations.

Large-capitalization stocks currently represent the most attractive part of the Indian stock market. Valuations are broadly in line with historical averages and expectations for future growth are achievable.

For our India strategy, we have been gradually trimming expensive small-cap stocks over the past couple of years in favor of reasonably priced large-cap stocks, or in favor of turnaround situations where new management is taking the right strategic steps. We continue to stay away from shares of public sector banks despite a capital infusion from the government and despite a better outlook for the resolution of nonperforming assets as the underlying governance-related issues remain unaddressed. The outlook for the private investment cycle is better and a few of our port-folio stocks could potentially benefit from the same.

Possible Risks on the Horizon

Given that India is one of the largest importers of oil globally, oil prices remain the biggest risk to Indian stocks. Higher oil prices are a precursor to a weak Indian rupee (INR) and higher inflation, both of which lead to a higher cost of capital within the country.

In the run-up to elections in India, most political parties are falling over each other to announce populist programs such as agricultural loan waivers, interest subventions to Small and Medium Enterprises and Micro, Small and Medium Enterprises (SMEs/MSMEs), income guarantee programs to farmers, etc. Such programs, over the long term, destroy the country's credit culture and destabilize the financial system. Public sector banks already don't have enough capital to provide for their existing pool of bad loans and it is not clear how the financial system would deal with such problems in the future.

As real estate and gold have underperformed, there has been a tremendous shift in the type of savings to financial assets. This has led to consistent inflows in equity mutual funds over the past two to three years. If small- and mid-cap stocks continue to underperform, however, there is a risk that equity inflows turn to outflows, which might lead to a sharp correction in stock prices.

Crucial Tailwinds for Stocks

A recent change in the central bank governorship likely signals the start of a monetary policy easing cycle. Real rates in India remain higher than anywhere else globally, and there is scope for moderation in interest rates. A lower cost of capital can help spur consumption and private capital creation.

Trade tensions between the U.S. and China, meanwhile, will likely create greater opportunities for exports from India to the U.S. and Europe for all types of manufactured products. More and more developed-market companies are looking for alternative suppliers for much-needed products. The pharmaceutical industry is already beginning to benefit from this trend.

Globally, India remains one of the last bastions of growth. Venture capitalists and private equity investors recognize that the next billion-dollar start-ups in Asia are likely going to come out of India. As a result, there is no dearth of capital for good start-up ideas. India has a very vibrant start-up community, which is growing year after year and is creating job opportunities for many more graduating students. As some of these start-ups become successful in the coming years, we believe they will help drive consumption across the country.