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Matthews Asia Perspective

Q&A: 2018 Outlook for India's Stock Market

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Q. What was behind India's 2017 stock rally? Sentiment or fundamentals?

A. The run-up in stock prices in 2017 was driven largely by sentiment. Contributing to this positive sentiment was increased liquidity across asset classes. Market reforms in India are helping to move "black money" from the informal economy to the formal economy. Reforms are still in their early days, so it will take a few more years for them to fully take effect. As money moves from real estate and other physical assets into financial assets, that liquidity is being used to buy insurance policies, make bank deposits and buy equities. Another layer to the sentiment has been a general feeling of political optimism. Prime Minister Narendra Modi is perceived by markets as having a strong chance for re-election in 2019. His political support remains high, even after the implementation of demonetization and the Goods and Services Tax (GST), and the problems with large Public Sector Banks (PSBs). This optimism helped fuel the market rally in 2017.

Q. How would you describe stock valuations in India? Are stocks currently overvalued, fairly valued or undervalued?

A. As of the end of 2017, stock valuations were at the high end of their historical range in terms of price-to-earnings (P/E) multiples. Stocks in India historically have been priced around 18 to 19 times earnings and trailing multiples at the end of 2017 were almost 24 times earnings. These are closer to their historical highs. The last time P/E multiples were this high was in 2007 and 2009. The only difference has been that earnings were inflated in those days. So we had inflated multiples on inflated earnings. Currently, earnings have been depressed for almost four to five years, while the multiples appear to be inflated.

Q: What is necessary for fundamentals to improve over the coming years?

A. There are only two ways to reconcile current prices. Either earnings catch up to the current prices, or vice versa. If earnings don't catch up, the market rally may end. If we look at the various market setbacks such as demonetization, GST and the problem of impaired loans at banks, there could be a depressed outlook in the near term until things return to normal. At the same time, there could be an earnings rebound in the near term due to a base effect. The recapitalization of banks has been positive, but India still has a long way to go in implementing financial reforms.

Q. Where do you see the most interesting investing opportunities today in India's stock market?

A. As active managers, we seek to buy stocks of companies that we believe have pricing power, which is not limited just to the consumer sector. Let's consider India's banking sector: If a bank is making small retail loans, it may achieve pricing power because small borrowers cannot dictate terms. Accordingly, we are invested in a couple of carefully researched retail-focused banks in this sector that concentrate on profitable growth. In contrast, if a bank is doing bulk lending, then borrowers have pricing power as they can shop around to find the best deals. We avoid investing in such banks. By and large, we are looking for an edge either in terms of business model or management focus. Given the kinds of investment risks—macroeconomics, reforms, politics, currency, inflation, deficit, corruption, corporate governance—we believe that active management can help investors avoid a lot of these risks and find stocks that will do well over the long term. India's market is still not very efficient when compared with the U.S. stock market. Companies in India can remain expensive for a long time but eventually their true value will emerge, which is where active management helps to add value for long-term investors, in our view.

Q: What other sectors seem attractive for long-term investors?

A. Relatively depressed sectors such as health care and technology services look attractive right now. In addition, companies that exhibit pricing power and are better-governed can be found across diverse sectors such as consumer, pharmaceuticals, financial services and even materials. We are looking for quality companies that have a sustainable economic moat and are run by productive and upright management teams.

Q: Within the context of your all-cap approach, how have small-caps performed over the past year and where are you finding both opportunities and value in the current market environment?

A. Indian small-cap companies have experienced a sharp appreciation in their stock prices in the past few years, outperforming their larger-cap peers. Our active approach leads us to be agnostic of the market cap and location of a company, and focus purely on the business and the management fundamentals.

We believe that companies that are masters of their own destiny, where management is in control and not dependent on some policy measures to become favorable, are more likely to deliver above average returns. Currently, small caps are more expensive than large caps, but there are pockets of opportunity within the health care and technology sectors.

What's your outlook for India?

A. Corporate earnings may rebound from their recent lows over the short to medium term as the formalization of India's economy starts to yield positive results. Public spending on infrastructure, including logistics and housing, would possibly increase as the government attempts to make up for the lack of private capital expenditure and creates more jobs to woo voters in the lead-up to next year's national elections. We anticipate this infrastructure spending, along with the government's new program to make direct bank deposits to consumers who are receiving subsidies, should lead to more consumer spending, especially from rural areas. The aftereffects of the country's demonetization and GST implementation might continue to dampen India's private investment climate. In the medium term, however, we believe the GST implementation should lead to better tax collection and mitigate deficit formation.

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