ALCHEMY CAPITAL MANAGEMENT

CELEBRATING 20 YEARS

Investment Matters

January 2023

EQUITY OUTLOOK

2023: The Year of Reckoning

Dear Investors,

Happy New Year! Wish you a safe, healthy, and prosperous 2023.

There is much to be optimistic about in the coming 12 months. India's macro should stabilise as rates peak, the currency steadies, and growth continues, albeit at a slower pace. Disinflation should help corporate margins bounce-back, and the continued momentum of mid-teen earnings growth should sustain. We expect a more broad-based rally next year, unlike the polarised markets that we witnessed in the last few months. Quality growth stocks with reasonable valuations should make a comeback. Markets are, however, also vulnerable to adverse, though unlikely, outcomes like a deep US recession or a hike in capital gains tax – we are monitoring these risks closely.

Equity Markets in December 2022

		Performance (%)			
	Dec-22	1M	3M	6M	1Y
Major Indian indices					
Sensex	60,841	-3.6%	5.9%	14.7%	4.4%
Nifty	18,105	-3.5%	5.9%	14.7%	4.3%
CNX-100	18,259	-3.5%	4.7%	14.6%	3.6%
CNX-500	15,449	-3.1%	4.2%	15.4%	3.0%
Mid-cap and Small-cap indices					
BSE Mid-cap	25,315	-2.5%	1.9%	16.6%	1.4%
BSE Small-cap	28,927	-2.0%	1.7%	16.7%	-1.8%
CNX Mid-cap	31,509	-1.7%	2.7%	19.1%	3.5%
CNX Small-cap	9,731	-2.5%	3.1%	15.2%	-13.8%

Source: NSE, BSE

		Performance (%)			
	Dec-22	1M	3M	6M	1Y
NSE sector indices					
CNX Bank	42,986	-0.6%	11.3%	28.6%	21.2%
CNX Auto	12,612	-4.7%	-0.7%	7.8%	15.3%
CNX Realty	432	-4.1%	1.8%	12.1%	-10.8%
CNX Infrastructure	5,252	-3.6%	5.9%	13.7%	6.1%
CNX Energy	25,870	-5.4%	1.1%	3.0%	14.3%
CNX FMCG	44,171	-3.0%	-0.5%	17.3%	17.5%
CNX Pharma	12,598	-4.2%	-2.9%	3.6%	-11.4%
CNX IT	28,622	-5.8%	6.1%	2.8%	-26.0%

Source: NSE, BSE

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Macro Outlook – Stability and Growth

Growth and financial stability are the key macro variables that should define markets next year. Growth is expected to slow but remain resilient and prove the pessimists wrong. Financial conditions should improve as rate hikes pause and the pressure on the currency recedes.

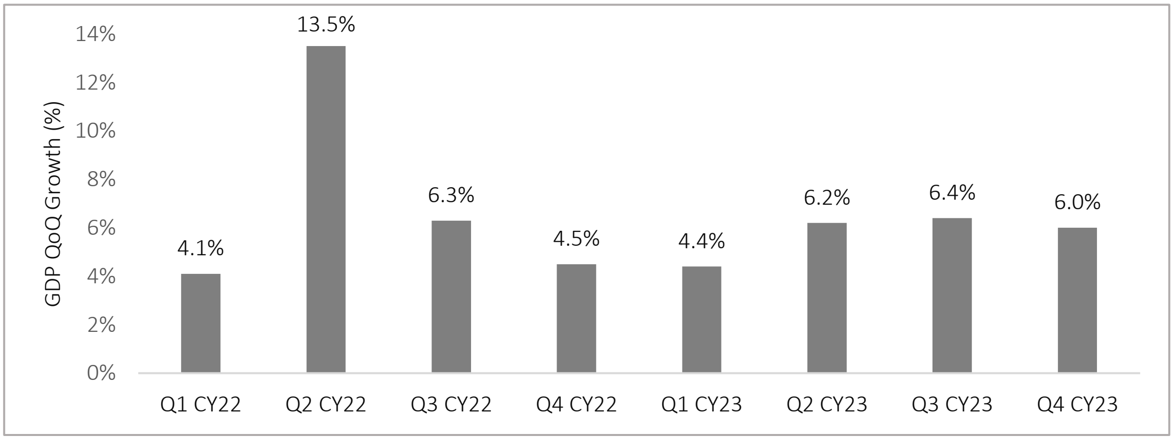
Resilience to growth headwinds

The sharp growth rebound in 2022 may not be sustained in CY23 due to multiple headwinds. The three main challenges that we see are:

- 2022 was the first post-Covid fully-functional year without any impact from lockdowns. This pushed up growth rates, not just from the low-base effect, but also because of a surge in “revenge spending”. A more normalised demand environment in 2023 could see an optical slowdown in growth.
- The global economy, led by the US and Europe, is expected to sharply decelerate on the back of higher interest rates. This is likely to impact export sectors which will face slower demand and probably pricing pressure, too.
- The government is likely to tighten the fiscal deficit in the Union Budget for FY24, which adds to the contractionary impulses.

The Bloomberg consensus predicts 6.0% GDP growth for FY24, but the forecast is down 50bps since May-22 and >10% of contributors have downgraded the forecast to <5.5%. We believe that growth should hold up at ~6%, despite the challenges. The consumption story in India is a multi-year trend driven by an upshift in per capita GDP and a change in aspirations. Moreover, other factors like “China + 1” and a capex recovery should help mitigate the headwinds. The downgrade trend could reverse as we advance through CY23.

Growth to stay resilient



Source: Bloomberg, Alchemy Capital

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Financial stability to improve

The financial markets were caught in a negative vortex in 2022. The sharp hikes by the Fed triggered a massive FII selloff and put pressure on the currency. The RBI managed to offset this by tactical use of reserves but also raised domestic rates significantly. Equity markets were also nervy, especially in 1HCY22, due to the FII selloff.

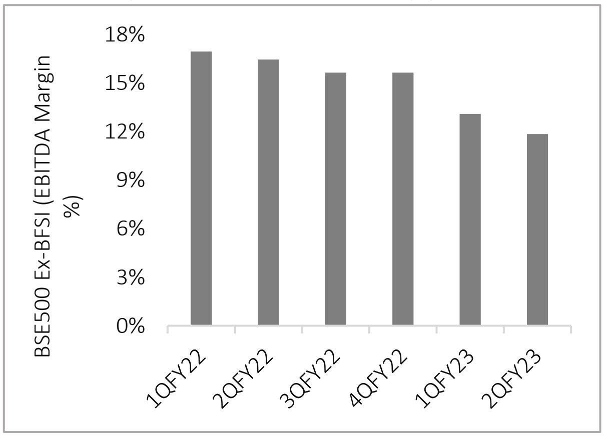
2023 should be much better. FII selling has abated, giving the RBI some headroom to manage the currency. The pressure on the current account deficit (CAD) from global commodity prices should also start to come off. Domestic interest rates should also peak; inflation is abating and the pressure from the external economy is also easing.

This could change if there is a hard landing in the Western world – we will discuss that later in this note.

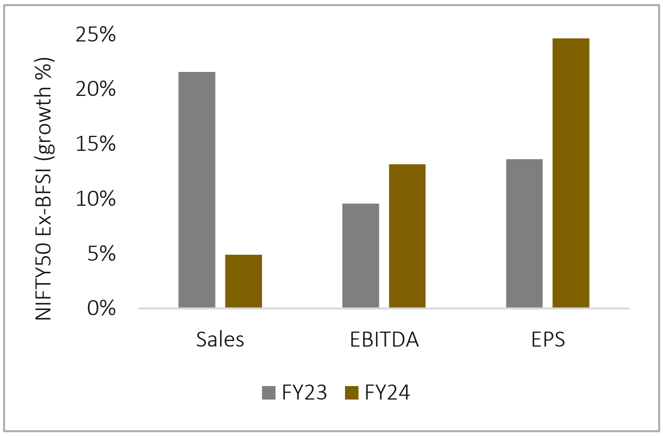
Top-line vs Margins

The decelerating economy would have its impact on corporate earnings. We expect topline growth to slow significantly as we enter CY23. This should, however, be offset by rising margins as the effects of commodity price inflation start to recede. Moreover, companies have taken price hikes through CY22 and that should start to help margins recover. EBITDA margins for BSE-500 (non-financials) had fallen 461bps y/y in 2QFY23, we expect that trend to start to reverse as we progress through CY23.

Margins have taken a beating growth



FY24: margin improvement drives profit



Source: Ambit Capital Research, Bloomberg, Alchemy Capital | Note: FY23/FY24 data are Bloomberg Consensus forecasts

Our constructive thesis on Indian markets is partly based on earnings resilience. Consensus estimates still predict ~17% y/y growth for the Nifty in FY24 – this is largely based on the margin recovery story, in our view. Nervousness around slowing growth driving weak earnings is misplaced because of the scope for a margin bounce-back, we think.

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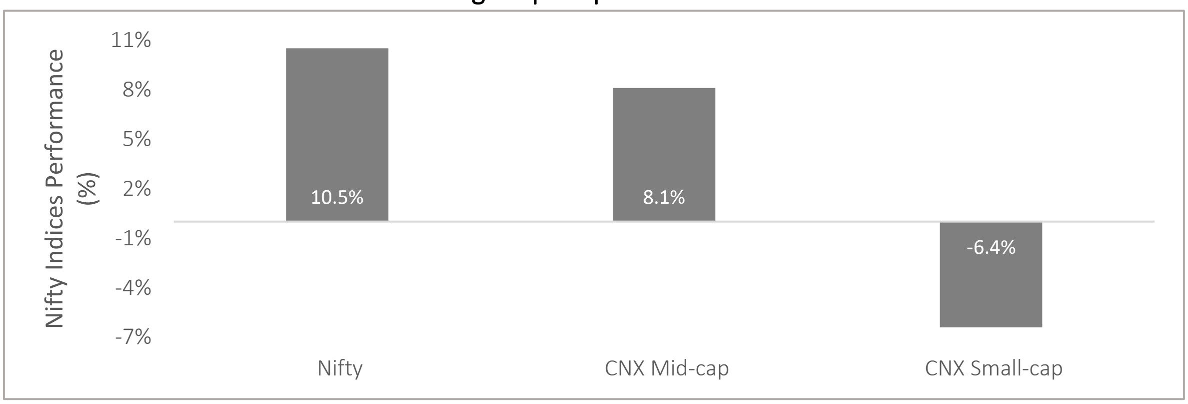
Sector Rotation and Market Imbalance

The narrower indices ended CY22 in the green, which was remarkable given the cumulative headwinds – rising rates, sticky inflation and large FII selling. This, however, hides the poor market breadth. Performance was largely related to a few sectors which rallied for relatively short periods. Moreover, mid and small-cap indices underperformed the narrower Nifty.

Large cap outperformance in CY22



Source: Bloomberg, Alchemy Capital

We expect a broader market rally in CY23 for three reasons. First, worries around the macro should start to ease, especially around macroeconomic and financial market stability. This should reduce risk aversion and spur wider participation in the markets. Second, earnings growth for FY24 is expected to be more broad based than in FY23 (see chart below). Third, some sector-specific headwinds should start to ease, which should spur a broader rally.

More balanced EPSg in FY24

Sector-wise contribution to EPS growth			
Sector	FY22E	FY23E	FY24E
BFSI	25%	83%	34%
IT	5%	6%	11%
Oil & Gas	15%	6%	14%
Consumer	2%	11%	6%
Auto / Auto Anc	4%	27%	16%
E&C / Infra / Cap. Goods	-3%	9%	5%
Metals & Mining	36%	-55%	1%
Utilities	3%	-4%	2%
Pharma	1%	9%	3%
Cement	2%	-2%	1%
Telecom	8%	7%	5%
Retail	1%	1%	0%
Healthcare	1%	0%	0%
Chemicals	0%	2%	1%

Wide range of sector performance in CY22

Nifty Sector Performance (%)	
Sector	CY22 Performance
CNX Bank	21.20%
CNX Auto	15.30%
CNX Realty	-10.80%
CNX Infrastructure	6.10%
CNX Energy	14.30%
CNX FMCG	17.50%
CNX Pharma	-11.40%
CNX IT	-26.00%
CNX Metals	21.76%
CNX Media	-10.22%
CNX Commodity	6.51%
CNX PSU Bank	70.67%
CNX Public Enterprises	13.86%

Source: Ambit Capital Research, Bloomberg, Alchemy Capital

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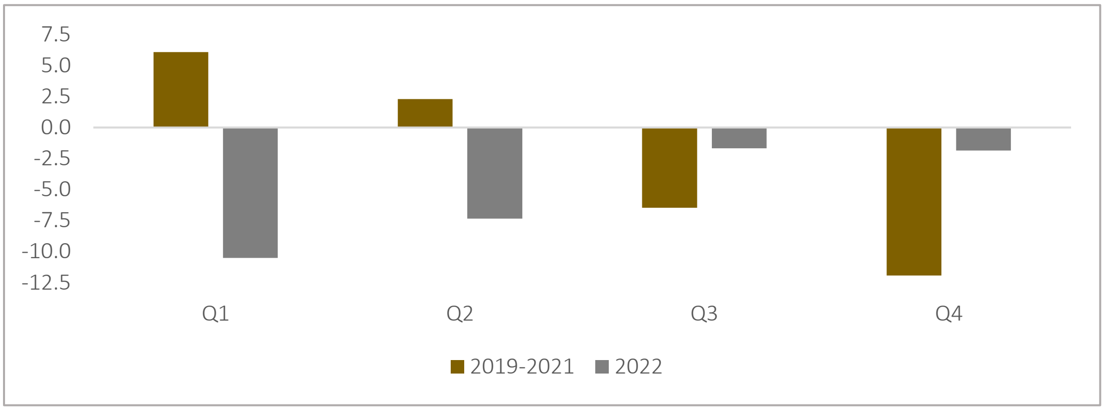
Quality vs Value

Value stocks made a comeback in CY22, the first time in five years. We believe that this outperformance is short-lived, and that quality will come back once the pockets of egregious under-valuation have been re-rated. The medium-term theme for the post-Covid Indian markets is earnings compounding – our preference is for stocks that meet this criterion. Of course, heavily over-valued stocks may still struggle. Our belief is that GARP with a quality overlay should lead the market in CY23.

Low quality stocks outperformed, reversing a 3-year trend



Note: We sorted BSE-500 into four quartiles by ROE. The returns reflect the median returns for each quartile (Qn), relative to the BSE-500 \ Source: Bloomberg, Alchemy Capital

Key Risks

A hard landing in the West

The base case assumption is that the Fed's aggressive rate hikes will, at worst, cause a shallow recession in Europe and the US. If, however, the growth impact is deeper, the markets could be vulnerable to a large drawdown. This would trigger both an earnings and valuation correction and India, despite the strong domestic economy, would not be immune. Central banks would probably respond quickly with rate cuts to ensure that the market correction is short-lived, but the bad news would come first. This is the biggest risk that we are monitoring from the perspective of India's equity markets.

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Budget and capital gains tax

The Union Budget of FY24, slated for 1-Feb-23, will be the next important event. The long-term nature of economic policy has reduced the direct importance of the budget, but it still will be an important marker of the government's approach in the run-up to the general elections of 2024.

There have been some news reports of a possible change to the capital gains tax(CGT), probably with the objective of harmonising rates across asset classes. We believe that minor tinkering (like increasing the threshold for short term CGT from one year) would have a transient impact on the markets. A drastic effective hike would, however, be a strong negative and could provoke a sell-off – as it did in 2018 when CGT was re-introduced.

China opening-up

China has recently lifted its harsh Covid restrictions, and the economy is gradually opening up. This poses multiple threats for the markets – resumption of commodity price inflation, the concentration of emerging market flows into the country (at the cost of other EMs like India) and a disruption of the supply chain diversification benefits. In our view there are, however, offsetting benefits. Supply chain bottlenecks should ease, helping growth and margins for manufacturing sectors. The China recovery should also be an offset to recessions in the western economy, helping global growth. And "China+1" is a long-term trend and is unlikely to be significantly disrupted by the economy opening up.

We believe that a full-fledged China recovery is a net benefit to the economy and markets.

Seshadri Sen
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Alchemy Capital Management Pvt. Ltd.

Source: Alchemy Capital

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MARKET INSIGHTS

Alchemy Capital's view on Market trends, analysis, and way forward; with additional inputs from industry experts about the different aspects to superlative asset management.

1. Market Views: Market Views - Dec 2022 - YouTube

2. Interviews:

- Mr. Hiren Ved in an interaction with CNBC-TV18: Watch the video
- Mr. Hiren Ved in an interaction with ET Now Swadesh: Watch the video
- Mr. Hiren Ved in an interaction with ET Now: Watch the video
- Mr. Hiren Ved in an interaction with CNBC Awaaz: Watch the video
- Mr. Hiren Ved in an interaction with The Economic Times: Read the article
- Mr. Alok Agarwal in an interaction with The Economic Times: Read the article

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