UTI International

THE GREAT ROTATION IS COMING

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In 2023, the Indian economy glittered against the dark global backdrop of wars, energy crises and slowing growth. Right on cue, the Nifty 50 delivered 21.1% return (in USD terms) for the year. However, this headline performance hides a few dramatic excesses. The Small and Midcap stocks have become noticeably expensive. Value and Momentum strategies have outperformed for an unprecedented three years in a row. The pendulum has swung too far. Mean reversion is imminent, and we see a strong case for a return of the Quality-Growth companies led in some measure by large caps. This great rotation should play out in 2024.

Deconstructing Performance

India has been the fastest growing large economy for the last few years and not surprisingly, foreign investors pumped USD 20.5 billion into Indian equities during 2023. India's equity performance came on the back of strong macros, improving earnings, above-trend capacity utilization, hopes of a rate cut in 2024, and the likelihood of Modi government winning the general elections in May'24.

Calendar Year	Nifty 200 Quality 30 Total Return	Nifty 500 Value 50 Total Return	Value Outperformance over Quality
2023	30.9%	61.7%	30.8%
2022	-14.1%	10.7%	24.8%
2021	24.0%	53.7%	29.7%
2020	23.4%	6.0%	-17.4%

Source : NSE, Returns in USD

Yet this equity performance was not evenly spread. The stock prices of Value companies (read typical beaten down stocks) in sectors like utilities, construction, commodities, energy, and public sector enterprises have risen sharply. On the other hand, the prices of Quality-Growth companies (read Charlie Munger type businesses) that deliver consistent high return on capital (and therefore are relatively expensive) did not do as well.

Quality-Growth Companies	Valuation Discount relative to last 5 years (1 Year Forward)
Avenue Supermarts Ltd	-12%
Bajaj Finance Ltd	-22%
Kotak Mahindra Bank Ltd	-25%
Info Edge (India) Ltd	-18%
Aavas Financiers Ltd	-44%
Indiamart Intermesh Ltd	-13%

Source : Bloomberg, UTI AMC Research (As of Jan'24)

Value Companies	Valuation Premium relative to last 5 years (1 Year Forward)
Larsen & Toubro Ltd	53%
NTPC Ltd	71%
Power Grid Corp Ltd	44%
Bharat Electronics Ltd	88%
ITC Ltd	29%
State Bank of India Ltd	17%

Source : Bloomberg, UTI AMC Research (As of Jan'24)

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This is not the first time that this aberration has occurred, and it will not be the last either. Charlie Munger's portfolio underperformed the S&P index for many a year but holding good quality companies unvaryingly delivers better returns than opportunistically trading cheap stocks.

In 2024, we expect a rotation back to quality companies, which are presently available at attractive valuations. On the flip side, many of the traditionally 'cheap' stocks are trading at expensive levels. The difference in Earnings growth between the two groups continues to widen and this should be the primary catalyst for the mean-reversion into Quality names.

Indian markets have priced in most of the positive drivers of Indian economy although we feel that a Modi victory in forthcoming elections is not yet fully priced in. India goes to polls during April-May this year and the Nifty 50 index is trading at a 12-month forward P/E ratio of 19x, a little below its 10-year average of 20x. There is considerable global dry powder waiting to invest in India as soon as Modi's win is cemented. Since foreign investors have traditionally been buyers of Quality Growth businesses, May'24 could be an interesting month to fuel the great rotation.

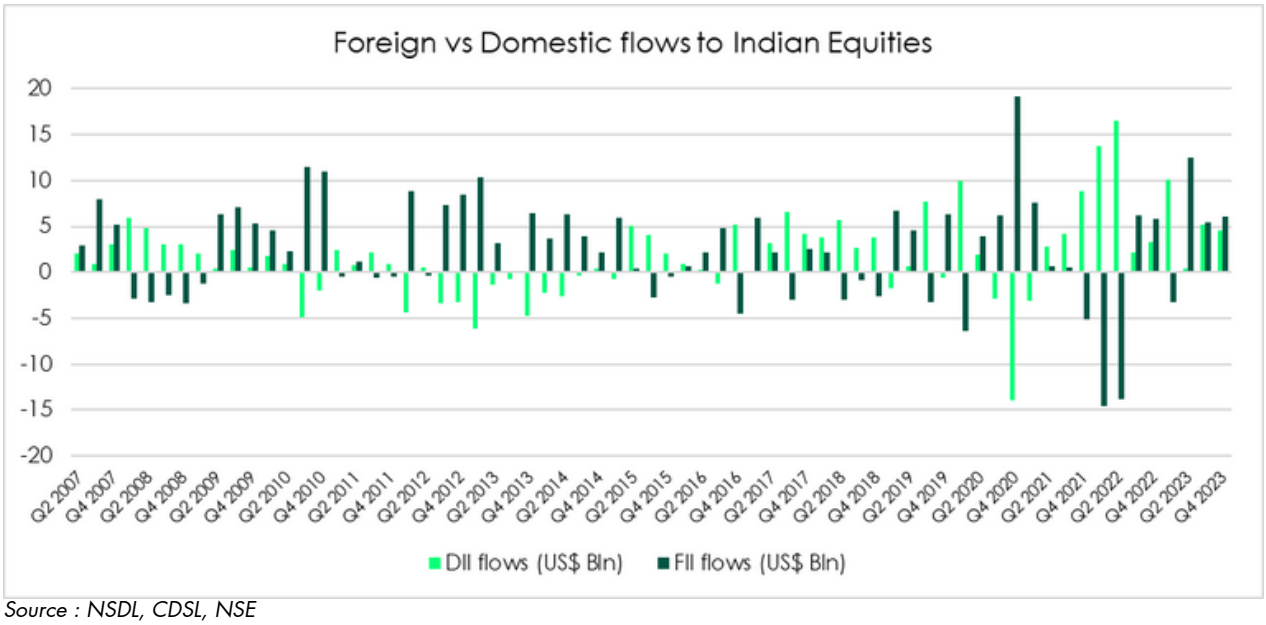
Geopolitics

2024, a year of elections, adds another dimension of complexity to the obscure and forever shifting geopolitical equations. 70% of world's market capitalization is slated for elections including the likes of USA, Canada, UK, Brazil, Mexico, Turkey, and Germany. These outcomes will be pertinent for positioning of risk-assets.

Since the Indian economy is largely self-contained wherein the Demand & Supply of goods and services is principally domestic, it gives India a unique safe harbour. It also allows India space to flex its geopolitical muscle and maintain a fine balance of global relationships. Therefore, on a relative basis, Indian economy is likely to withstand global crises much better than most countries. And there are quite a few crises brewing on the horizon.

Foreign Flows

Foreign flows to Indian equities have been negative only in four years in the past twenty – 2008, 2011, 2018 and 2022. However, that statistic masks the fact that foreign investors no longer play a dominant role in providing direction to Indian markets. They represent only 18% of India's market cap, a far cry from the 26% they commanded at the beginning of this century. The rise of the domestic investor has materially reduced the volatility of Indian markets.



Source : NSDL, CDSL, NSE

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As the graphic shows, domestic flows have invariably been at odds with foreign flows except for a few quarters in 2017 and 2023. How can two sets of investors so consistently interpret a market differently? The answer is quite simply that domestic investors have ringside seats to India's growth while foreign investors are consumed by global issues like China slowdown, Wars , Global Inflation, Fed action among others.

Modi 3.0

Policy continuity is crucial for sustainable economic growth and an election win for BJP will accelerate India's growth momentum along predictable axes. The latest budget reflects a continuation of the classic Modi themes of prioritizing the needs of the poor, women, youth, and farmers.

With the tailwind of massive infrastructure push, the reduction of fiscal deficit and government borrowing, will further incentivise private capex. This should make foreign direct investment attractive in India and strengthen the hand of RBI, India's central bank, to manage the Rupee. Given the alarming US debt burden and the trend of rising bilateral trade in non-USD currencies, our outlook for the INR is reasonably positive.

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