Business Line

'Markets are appropriately valued'

Inflation, oil prices to hit profitability: Canara HSBC

Srividhya Sivakumar
BL Research Bureau

'I think there will be robust growth in revenues. But I expect profitability and margins to take a hit.' — Ms Ritu Arora, CIO, Canara HSBC OBC Life Insurance

Markets are appropriately valued at this juncture, though there may be pockets of value buys in mid- and small-cap stocks, says Ms Ritu Arora, CIO, Canara HSBC OBC Life Insurance. In an interview with *Business Line*, she shares her views on market valuations and earnings expectations for the fourth quarter. Excerpts:

Do you think current valuations make a reasonable entry point for investors?

While current valuations are well-priced, they aren't cheap.

We have seen FIIs pump in money into the markets in the last one month, which has taken the current one-year forward valuations to about 16 times from 14.5 times seen a month ago. While that was a very attractive level to enter the market, at this time, I think markets are appropriately valued.

Large cap valuations, given the current earnings outlook, doesn't look as compelling. There, however, may be some entry points in mid and small-cap stocks, which haven't seen this kind of return and appreciation yet.

Mid- and small-cap stocks haven't had a great run so far. What's your outlook on these stocks vis-à-vis large caps?

There are two factors that have affected the rally this time around. The first one being FII inflow into the markets, which has fuelled the large-cap stocks and moved the market valuations up from 14.5 to 16 times. Two, the headwinds the economy was experiencing hasn't really changed. Be it inflation or the rising interest rates, there's been no significant change.

Besides, fuel at over $120 a barrel is another cause for concern. It is likely to remain high for some time given that the MENA (Middle East and North Africa) crisis is not easing out. These factors put together impact a company that's more leveraged or has less pricing flexibility.

Many of our mid-cap companies fall under this bracket. They are facing a hike in commodity price and costs but aren't in a position to pass it on to customers or consumers. Besides, borrowing is becoming difficult.

Hence, fundamentally, there continues to be pressure across sectors, more in midcaps than large-caps. But if liquidity continues to flow in at the pace that it has been, then mid and small caps can outperform the large caps over the next couple of months. It will have to be largely liquidity driven rather than fundamentals.

How do you see inflation and crude oil price affect the outlook for different sectors? What are the other challenges that markets are likely to face?

High inflationary period started about two years ago with food inflation. But now it has spread to core and manufacturing inflation also. It isn't supply side inflation any more but also manufacturing and demand side inflation. On fuel, the impact is very steep again. Every dollar increase in crude impacts India by roughly about $100 billion a year.

Now Government cannot possibly absorb all of this and if it does our deficit would move from 4.6 per cent to 5.4 per cent. And that's a sharp increase in fiscal deficit, which means the hike will have to be passed on. It will impact profitabilities of companies. Besides, other commodity prices have been on the rise. So these will definitely impact profitability of sectors such as FMCG, automobile and consumer discretionary. Of course, banking is sensitive as well.

The earnings season is starting again. What are your expectations? Which sectors do you think would do well and which wouldn't?

I think there will be robust growth in revenues, of about 19-20 per cent. But I expect profitability and margins to take a hit. The inflation impact was not so much visible in the December quarter. But in March we will definitely start seeing the impact. The extent of impact will vary across sectors.

FII inflows into emerging markets, including India, have been dwindling. Do you see this trend continuing?

The US economy has stabilised and is sustaining its growth indicators. But there are also large challenges ahead. In the Europe, while some economies are showing growth, there are others with sovereign default risks. So to that extent, Europe is a mixed bag, while Japan will take time. As for China, it has been preparing for a soft landing for some time now. Emerging economies such as India are still attractive because we are talking of sustained growth of over 8 per cent.

That said, FII flows are always fickle and move swiftly between economies. If FII flows, which we saw in March sustains, India may see richer valuations. But given the current fundamentals, richer valuations probably may not be justified.