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CIO Viewpoint
Equity

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India: Slowing earnings growth and full valuations prompt caution

Key takeaways

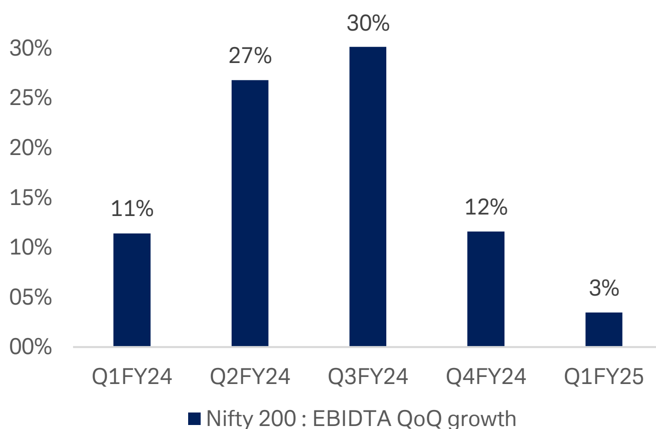
- After 8 continuous years of positive returns, Indian equities have been a top performer in 2024 as well, with the MSCI India Index (up 18.5% YTD) sharply outperforming the MSCI EM Index (up 6.8% YTD).
- This stellar performance has been powered by robust earnings growth, but even more by a massive P/E rerating led by rising domestic inflows.
- Consequently, valuations have soared and with slowing earnings momentum, we may witness a period of consolidation and choppy returns. However, the longer-term story remains intact, particularly for the large-cap segment of the market, of favourable risk-adjusted gains.

Introduction

Indian equity investors have seen a super normal period of returns, as the bellwether Nifty 50 Index, delivered an eighth consecutive year of positive returns in 2023. As 2024 unfolded, India again emerged as one of the top-performing equity markets globally. The MSCI India Index has surged by 18.5%, significantly outpacing the MSCI Emerging Markets Index, which rose by 6.8%, both year-to-date. The most frequent question on investors' minds remains whether this rally will continue? And, if so, in what shape or form.

Past returns have been driven by a combination of strong corporate earnings growth and a surge in liquidity from domestic investors, a phenomenon that's emanating from the financialisation of savings.

Figure 1: EBITDA growth takes a dive!



Source: Bloomberg, Deutsche Bank AG, Data as of August 16, 2024.

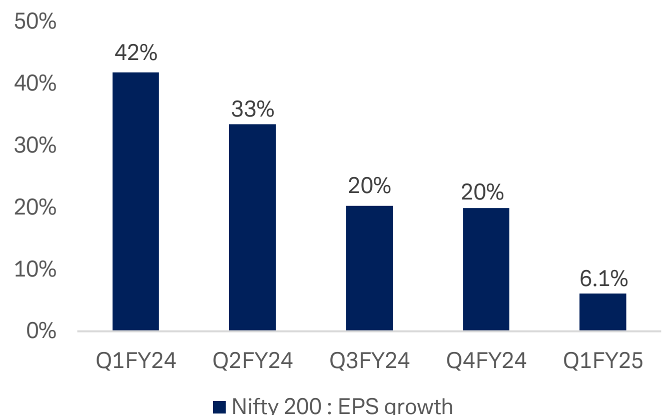
These factors have kept the market buoyant, and without any major correction, since the pandemic outbreak. For the rally to continue, the same pillars would need to remain in place – double-digit earnings growth justifying premium valuations, steady domestic flows, and positive economic sentiment. We dive deeper into corporate earnings for the June quarter 2024 (i.e. Q1 FY2024-25), to decipher trends, look at valuations and also assess the status of domestic flows. We conclude by analysing a number of market indicators to gauge sentiment direction.

First pillar – Corporate earnings growth

In the first quarter of FY24-25, the broader market, represented by the Nifty 200 index constituents, saw its operating profit growth slow to a seven-quarter low of 3%. (Figure 1). Within the Nifty 200 index cyclical sectors such as real estate, industrials, consumer discretionary (retail) and metals were among the top performers. However, communication services shows the highest growth due to telcos posting high growth from a low base. Furthermore, the telecom sector is likely to experience a positive shift due to recent tariff hikes. While consumer staples saw a boost from reviving rural demand, on the flip side, the energy sector dragged down earnings with a significant 42% year-over-year decline on commodity price deflation.

Looking ahead, consensus forecasts project a moderation in earnings growth to 10% in FY25 (Apr'24 – Mar'25) from 18% in FY24. Quarterly data shows that EPS growth softened from above 20% during the past financial year (Figure 2). Sectors expected to drive growth include industrials – benefiting largely from government capex spending.

Figure 2: EPS growth declining



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Additionally, a good monsoon, easing inflation, and the upcoming festive season are likely to sustain the revival in rural demand – benefiting the consumer staples sector. Despite the overall high valuation of the Indian market, the financial sector is trading at a notable discount to its historical average (Figure 3). Banks are enjoying historically low net NPAs and robust credit growth of 15-16%, though the slowing of deposit growth remains a concern. Banks are also focusing on improving operating leverage and profitability. Furthermore, financial services providers such as asset management companies, brokers, wealth managers and exchanges are poised to benefit from the increasing participation of domestic investors in capital markets.

Will corporate earnings justify premium valuations?

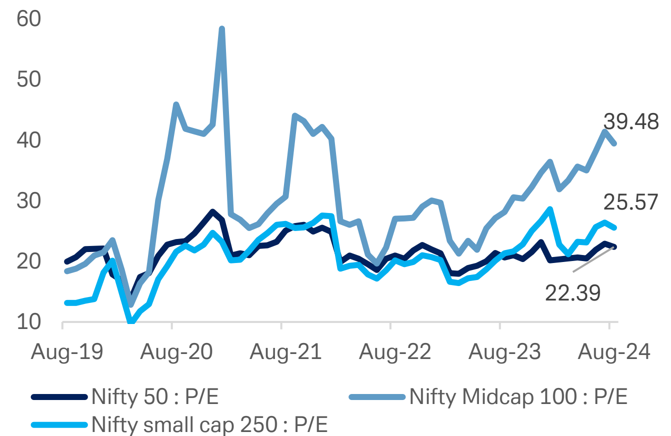
The broad-based stellar performance of Indian equities in 2024 came with a caveat – elevated valuations. In fact, in 2024 the Nifty Midcap 100 Index and Nifty Small cap 250 surged by 23.9% and 22.8% respectively, outpacing the Nifty 50's 12.1% rise. In valuation terms, the Nifty 50's price-to-earnings (P/E) ratio for the next 12 months is projected at 22.39x, only slightly above its five-year average of 21.47x. In stark contrast, the Midcap and Smallcap Index traded at a lofty P/E of 39.48x and 25.57x respectively (Figure 4).

Mid and small-cap stocks usually trade at a discount to their larger peers, primarily because large companies have resilient business models and can achieve economies of scale due to their size. Nevertheless, the current high premiums suggest that the broader market is priced optimistically, leaving little room for any earnings disappointments.

In this regard, let's explore the PEG ratio, the price-to-earnings ratio in relation to the earnings growth rate. The PEG ratio (Price/Earnings to Growth) for the Nifty 200 index is over 3 (Figure 5), which is 3.4 times higher than its 5-year average.

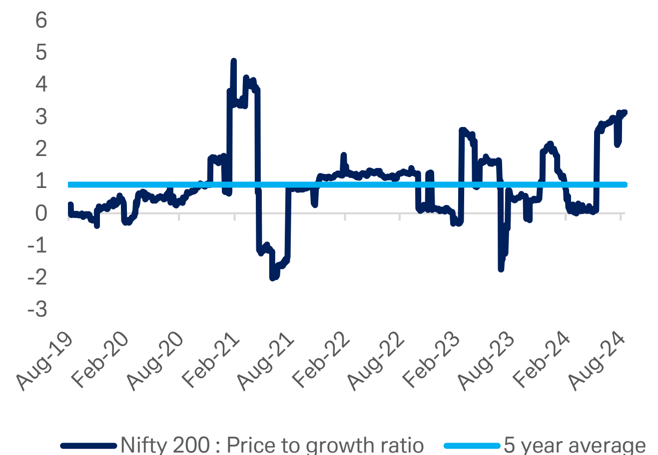
The reason behind this elevated PEG ratio is the anticipated growth rate of around 8%, which is significantly lower than the five-year average of 14%. Despite this, the price-to-earnings ratio remains above 25x, keeping the PEG ratio above 3.

Figure 4: Midcaps and small caps trading at lofty valuations



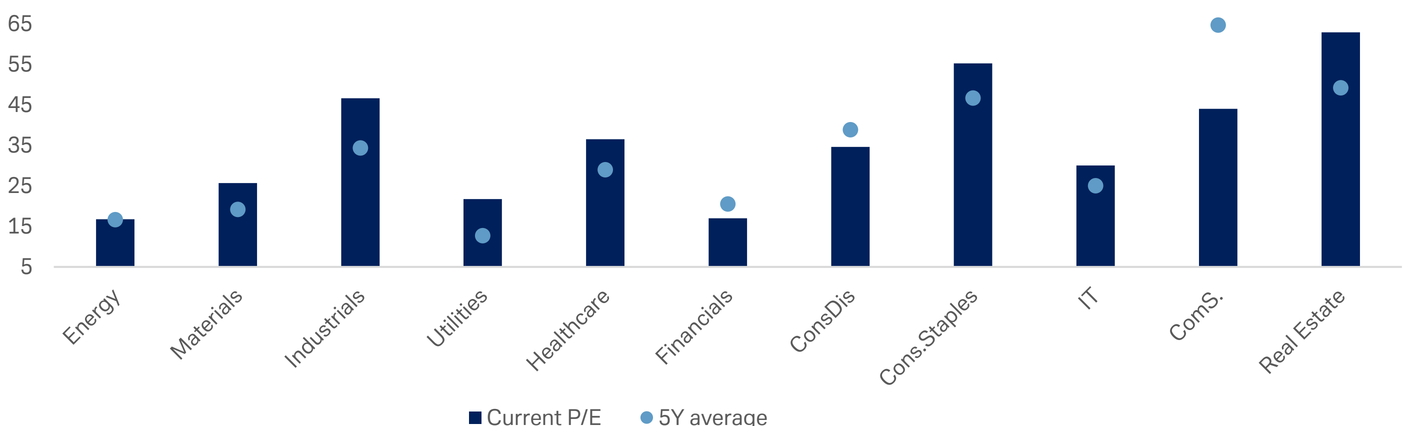
Source: Bloomberg, Deutsche Bank AG, Data as of August 16, 2024.

Figure 5: PEG ratio 3x above 5Y average



Source: Bloomberg, Deutsche Bank AG, Data as of August 16, 2024.

Figure 3: Sectoral Price to Earnings ratio



Notes: ConsDis. = Consumer Discretionary Cons.Staples = Consumer Staples, IT = Information Technology, ComS = Communication Services

Source: Bloomberg, Deutsche Bank AG, Data as of August 16, 2024.

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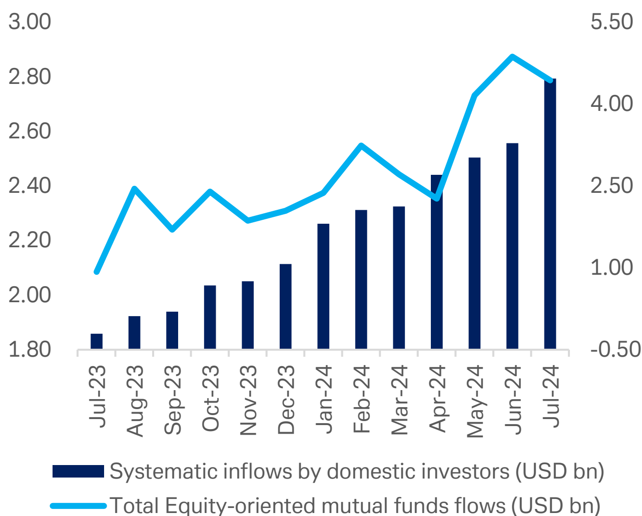
Second pillar – Rise of the domestic investor

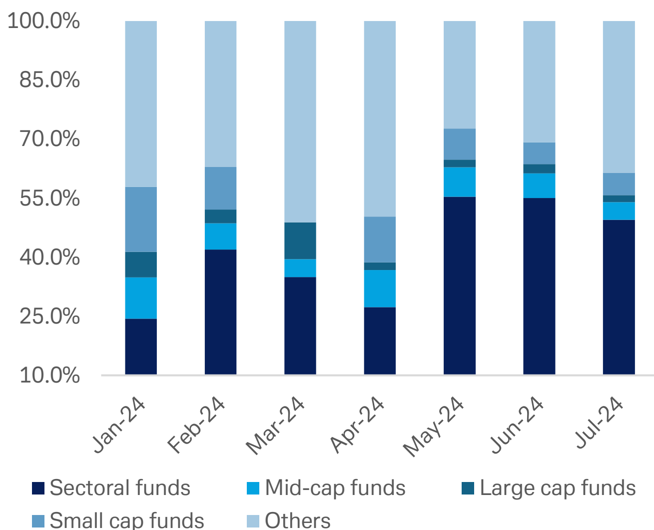
The aftermath of the COVID-19 pandemic brought about a significant and sustained change in the behaviour of domestic investors. During lockdowns, people could save more while fixed income yields plummeted, as the Reserve Bank of India lowered interest rates to support the economy. This environment set the stage for the rise of the monthly Systematic Investment Plan (SIP) flows into Indian equity funds. Since 2020, monthly SIP investments have witnessed a CAGR of 23%, highlighting a structural shift in household savings towards equities in India. In July alone, the inflows to domestic markets only via SIPs hit a record high of USD2.79bn (Figure 6). Despite this growth, domestic household exposure to equities remains relatively low at 7% of financial assets, compared to an average of 30% in other major emerging markets.

Figure 6: Titans of bull market – Domestic investors



Source: Bloomberg, Deutsche Bank AG, Data as of August 16, 2024.

Figure 7: Sectoral funds continues to be the choice of investors

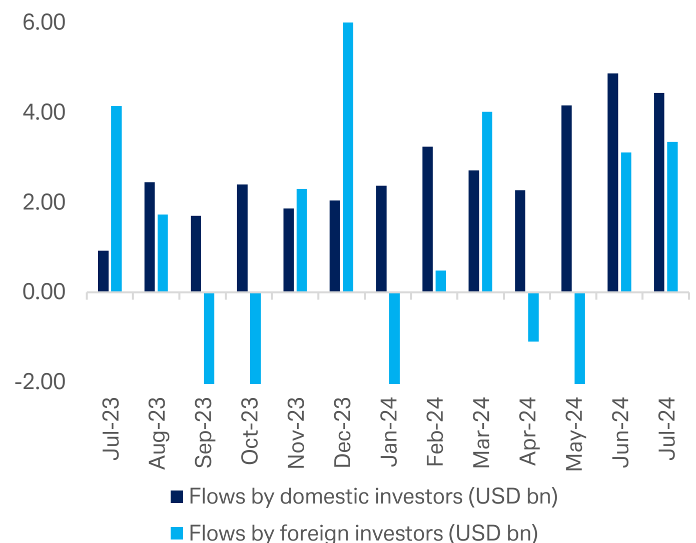


Source: Bloomberg, Deutsche Bank AG, Data as of August 16, 2024.

Within equity-oriented inflows, domestic investors have shown a clear preference for sectoral funds and mid/small cap funds. Inflows into sectoral funds have constituted more than 40% of overall inflows (Figure 7), thanks to a slew of sector-specific and thematic offerings. Meanwhile, mid and small cap funds have been riding high on the wave of impressive returns in 2023, making the retail investor skew flows in their favour.

Historically, the performance of India's equity market was significantly influenced by foreign investors' flows. However, this role is slowly but surely waning – mainly due to the sheer size of domestic flows. According to the National Stock Exchange, the India ownership tracker for the June quarter indicates that foreign investor ownership is at 12-year low – of some 17.5%. Since the start of 2024, foreign investors have contributed a mere USD1.5bn whereas domestic investors have injected over USD24bn into Indian equities (Figure 8). This shift marks a significant change in the dynamics of the Indian equity market, with domestic investors playing an increasingly influential role.

Figure 8: Domestic Bulls, Foreign Bears: A Market Dichotomy



Source: Bloomberg, Deutsche Bank AG, Data as of August 16, 2024.

Diving into market sentiment

The Advance Decline Ratio (ADR) gauges the market's breadth by comparing the number of rising stocks with those that are falling. When the ADR falls below 1, it signals a weak market dominated by declining stocks. Recently, the ADR for the Nifty 200 has plummeted from a robust 8 to below 1 (Figure 9), indicating a weak market with more declining stocks.

Another market sentiment indicator is the percentage of companies trading above their 52-week high, a metric that reflects market breadth. A higher number of stocks near their 52-week high typically signals strong momentum. However, for the Nifty 200, this figure has sharply declined from 17% at the end of July 2024 to a mere 7% (Figure 10). This significant drop suggests a broad-based weakening in market sentiment and momentum, indicating that fewer stocks are maintaining their peak performance levels.

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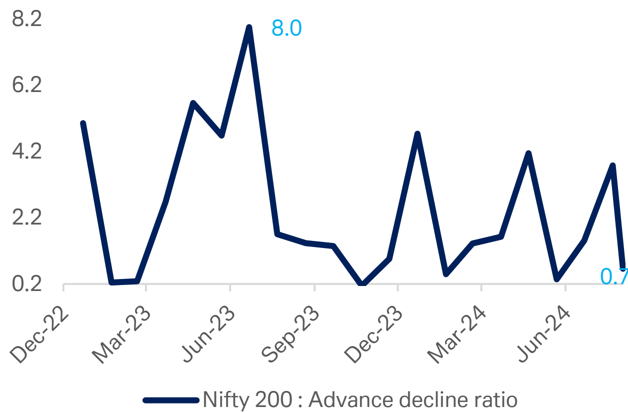
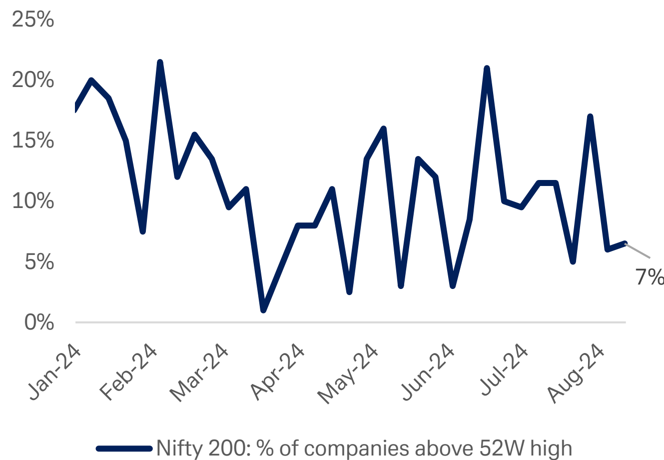
Figure 9: Market Mood Swing: ADR Ratio plunges



Source: Bloomberg, Deutsche Bank AG, Data as of August 16, 2024.

Figure 10: New 52-week highs falling



Source: Bloomberg, Deutsche Bank AG, Data as of August 16, 2024.

Conclusion

The Indian economy's growth narrative remains very much intact, thanks to its demographic advantage and many factors highlighted in the CIO Special – India: why it will be a USD 7 trillion economy by 2030 report. In the realm of the equity market, India's remarkable performance has been driven by strong earnings growth and the emerging domestic investor flows. While we anticipate this earnings momentum will persist, the pace of growth is likely to moderate. After a streak of impressive returns, valuations have soared, and with slowing corporate earnings, a period of consolidation might be on the horizon. Despite this, we believe investors with a medium to long term investment horizon could add exposure to Indian markets during market corrections, particularly in large-cap equities. Given the stretched valuations of small and mid-caps, large-caps offer a more favourable risk-adjusted return.

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Glossary

The NSE 200 or Nifty 200 is a benchmark Indian stock market index that represents the market-cap weighted average of 200 of the largest Indian companies listed on the National Stock Exchange.

Earnings per share (EPS) are calculated as a companies' net income minus dividends of preferred stock all divided by the total number of shares outstanding.

Price/earnings (P/E) ratios measure a company's current share price relative to its per-share earnings.

Price/book value (P/BV) compares a firm's market capitalization to its book value.

Price/earnings to growth ratio (PEG ratio) is a stock's price-to-earnings (P/E) ratio divided by the growth rate of its earnings for a specified time period. The PEG ratio is used to determine a stock's value while also factoring in the company's expected earnings growth.

USD is the currency code for the U.S. Dollar.

INR is the currency code for the Indian Rupee.

The MSCI Emerging Market (EM) Index is a stock market index that captures large- and mid-cap companies across 27 emerging market countries.

FPI stands for foreign portfolio investor.

DII stands for domestic institutional investor.

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Historical performance

Performance	23.8.2019 – 22.8.2020	22.8.2020 – 22.8.2021	22.8.2021 – 22.8.2022	22.8.2022 – 22.8.2023	22.8.2023 – 21.8.2024
MSCI India	5.17%	45.91%	0.45%	4.22%	37.52%
MSCI EM	15.94%	14.62%	-16.80%	0.52%	17.58%
Nifty 50	1.88%	48.15%	-0.46%	7.89%	27.53%
Nifty 200	1.72%	48.51%	-0.97%	6.88%	34.61%
Nifty Midcap 100	4.56%	66.39%	2.04%	22.18%	49.58%
Nifty Smallcap 250	6.30%	82.40%	-4.54%	23.70%	52.49%

Source: LSEG Datastream, Deutsche Bank AG. Data as of August 21, 2024.

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