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'FMCG, pharma in favour'

SAURABH MUKHERJEA, head, equities, Ambit Capital, talks about macro headwinds, current valuations, investment strategy and the sectors to invest, in an interview with ***Puneet Wadhwa.*** *Edited excerpts:*

The markets have been trading with a negative bias since quite some time. Has the correction been overdone? How do we compare with the other emerging market peers in terms of valuations?

Over the past ten years, India's premium to the broader emerging market has been around 30 per cent. However, the Sensex currently trades at a 40 per cent premium to the MSCI EM (on a forward P/E basis).

Given the outlook for the Indian economy (rising finance, fuel, labour and input costs), and the economic reform stagnation by a policy gridlock and weaker growth, it makes sense for the Sensex's forward P/E premium to derate by around 10 per cent.

Do you feel this is a "sell-on rallies" market? Do you expect more downside or is the worst behind us?

Over the past few months, we have been highlighting that the Indian stock market is in an over-valued territory and we expect the Sensex to grind to 16,000 over the next few months, given that the consensus estimates are yet to factor in the implications of a moderating growth on the top line and a high inflation on the margins.

However, for the stock-pickers, the current environment provides the most fertile ground seen in recent years to add quality names to their portfolios.

Which sectors, according to you, are likely to do well, going forward?

Our model portfolio derived by applying macroeconomic filters (based on the inflation and GDP growth) suggests automobiles, cement and electrical goods, part of capital goods, need to be underweighted at this stage of the cycle.

We continue to avoid the financial services sector and favour the FMCG, information technology, pharma, oil and gas and refineries sectors.

What are the chances of a third round of quantitative easing after QE2 ends? What is the likely impact on the Indian equity markets?

The Sensex is currently trading at a 40 per cent premium to the emerging markets (EMs) despite powerful macroeconomic headwinds at play.

This anomaly is largely the result of QE2, and the belief that QE3 is in the pipeline. If the US Federal Reserve decides to stop expanding its balance sheet, the equities as an asset class globally and the emerging market equities in particular will be impacted.

Have you changed your year-end targets given the macro-level headwinds? What is your investment strategy at current levels?

Based on our economic modelling, we expect economic growth in India to slow from 8.5 per cent in FY11 to 7.2 per cent in FY12. Further, our growth expectations are clearly below consensus.

The sustained high levels of inflation (and the monetary policy squeeze that entails) are now part of mainstream economic thinking in India. This shift in ours versus consensus' softening growth/hardening inflation expectations has prompted us to revisit our model portfolio.

What is your biggest near-term macroeconomic concern on the domestic and global front?

Two non-economic factors, namely, the quality of the Indian monsoons and the reform momentum will be the key factors affecting the Indian economy. Globally, the Fed's decision to halt quantitative easing will be the key macroeconomic event.