

Panam – September 2026 - Newsletter

THE CONTRARIAN FLIP: WHERE THE NEXT ALPHA MAY EMERGE

THE POLARISATION LEDGER

For almost two years, headline Indian equity indices have appeared remarkably uneventful. The NSE 500 has largely moved within a narrow range since August 2024, despite strong global markets, steady domestic institutional flows and repeated policy support through rate cuts and tax relief. That flat headline, however, conceals a much more important development beneath the surface: one of the widest valuation divergences seen in nearly two decades. India's valuation premium to emerging markets has compressed sharply, large caps now trade at an unusually deep discount to midcaps, and traditional defensive sectors command barely any valuation premium over cyclicals. In other words, the market has not been standing still – leadership, relative valuations and investor preferences have shifted dramatically. History suggests that such extremes rarely persist indefinitely. Episodes in 2007, 2013, 2019 and 2024 were followed by meaningful reversals in market leadership, often after a macro trigger that was not widely anticipated at the time.

THE POLARISATION EXTREME		
30%	-34%	6%
India's valuation premium to EM vs. 75% long-term average	Nifty's valuation premium to midcaps – an all-time low	Defensives' PE premium to cyclicals – matches the 2007 low

In this edition, we examine the forces behind this polarisation and what they could mean for portfolio construction over the next few quarters. We look at how the global AI-capex boom, a weaker rupee, firmer commodity prices and domestic policy stimulus have supported cyclical earnings; why some of these tailwinds may lose momentum in H2FY27; and how three different outcomes for global AI spending could transmit into Indian equities. Our central framework remains unchanged: markets often extrapolate a strong cyclical phase as though it were permanent. When valuations begin to price that extrapolation too aggressively, the opportunity set can shift toward the neglected side of the market. That is the essence of the contrarian flip we discuss in this issue.

1. The Macro Picture: Three Fronts of Divergence

A number of valuation and earnings indicators are now pointing in the same direction: Indian equities are unusually polarised. The striking feature is not merely the size of the gap, but the speed with which the market's preferred leadership has changed. The pre-Covid winners – India relative to emerging markets, large caps relative to smaller companies, and defensives relative to cyclicals – have increasingly been

treated as slow-growth or 'value-trap' exposures. Capital has instead gravitated toward cyclicals, SMIDs and businesses perceived to benefit directly or indirectly from the global AI-capex cycle.

Over the past two years, the Nifty has materially underperformed broader emerging markets in US-dollar terms. This is a sharp reversal from the five years through 2024, when India's stronger post-Covid growth profile justified a substantial valuation premium and helped Indian equities outperform the EM complex. On a price-to-book basis — a useful measure when comparing markets with very different sector and earnings cycles — India's premium to EM has narrowed to roughly 25–30%, compared with a long-term average of about 75%. That places the relative valuation near a two-decade low, last briefly seen in 2007. India's five-year relative return versus EM has also turned negative for only the third time in roughly twenty years. The previous episodes, in 2007 and 2019, ultimately proved to be important turning points from which India resumed multi-year outperformance.

The divergence within India is even more striking. The Nifty's valuation premium to midcaps has fallen to an all-time low of around -34%, meaning large caps now trade at a substantial discount to midcaps. This is almost the mirror image of 2019, when large caps traded at a 67% premium just before small and midcaps began a prolonged period of relative outperformance. Importantly, the recent large-cap underperformance has not been confined to one or two sectors; it has been broad based. Relative-return indicators are now close to the troughs seen in 2007, suggesting that the valuation gap has moved well beyond a normal cyclical fluctuation.

A similar compression has taken place between defensives and cyclicals. IT, private banks and FMCG — sectors historically valued for earnings visibility and balance-sheet resilience — now trade at only about a 6% PE premium to metals, industrials, power and PSU banks. The long-term average premium is closer to 70%, while the premium reached roughly 120% as recently as 2019. That re-rating has now been almost completely unwound. Defensives' share of BSE500 market capitalisation has also fallen to about 22%, roughly ten percentage points below the pre-Covid level and close to levels last seen during the commodity-heavy market leadership of the 2000s.

Q1 vs. current: how the earnings gap has evolved

CYCLICAL EARNINGS MOMENTUM		
22% BSE500 topline growth, latest quarter (vs. 19% a year ago)	2/3 of BSE500 topline directly or indirectly tied to global trade/prices	120% Defensives' pre-Covid valuation premium — now fully unwound

Taken together, the data tell a consistent story. Roughly two-thirds of India Inc.'s topline is directly or indirectly linked to global trade, currencies and commodity prices. As a result, rupee depreciation and firmer metal prices — both influenced by the global AI-capex cycle — have lifted nominal revenue and earnings growth across several Indian sectors even though India has relatively limited direct exposure to

the core AI hardware boom. This distinction is important: the recent cyclical strength has been supported not only by domestic demand, but also by external price and currency effects.

2. What's Driving the Divergence

The recent improvement in cyclical earnings can largely be traced to three reinforcing forces. Each has been meaningful, but each also appears less durable from here than it did several quarters ago.

India is not a major direct beneficiary of the AI hardware spending boom, yet the second-order effects have been meaningful. The global data-centre build-out has supported demand for machinery, power equipment, cables and wires, while stronger commodity prices have improved nominal realisations for trade-linked businesses. At the same time, global capital flows associated with the AI investment cycle have contributed to currency weakness across several markets, including India. Because a large part of the BSE500 is exposed to tradeables, exports or globally priced inputs and outputs, a weaker rupee can mechanically flatter reported revenue growth. The result is an unusual situation in which India may carry an 'anti-AI' valuation discount while still benefiting indirectly from the same capex cycle through exports, currencies and commodities.

Domestic policy support has also helped, but the transmission appears narrower than the headline stimulus might suggest. GST cuts and RBI regulatory easing have supported parts of goods consumption, yet services demand has remained comparatively weak. Imported GST collections are growing at roughly 31% year-on-year on a three-month moving-average basis, versus only around 7% for domestic collections. That gap suggests that the multiplier is concentrated in specific pockets rather than spreading evenly through the economy. Other indicators point in the same direction: listed real-estate pre-sales have slipped into contraction on a trend basis, household income growth remains soft, and easier financial conditions have not yet translated into the kind of acceleration in nominal GDP that followed past easing cycles.

Perhaps the most important distinction is that much of the recent cyclical and SMID earnings outperformance has come from higher margins rather than a sustained acceleration in underlying revenue. Margin-led profit growth can be powerful for a period, but it becomes increasingly difficult to repeat once profitability is already above normal levels. Industrial margins outside infrastructure are stretched, non-ferrous metal margins are near record highs, and PSU-bank RoE has stopped improving despite exceptionally low credit costs. These are signs that several cyclical profit pools may be closer to peak economics than to the beginning of a fresh expansion. If topline growth does not accelerate, the scope for another large earnings surprise becomes more limited.

The post-Covid earnings recovery can be viewed in three distinct phases

Phase	Drivers & Result
FY19–FY22	Global post-Covid stimulus combined with aggressive domestic cost-cutting. The result was a broad-based earnings

	recovery across sectors, supported by both revenue normalisation and operating leverage.
FY24	Falling oil prices, pent-up domestic demand and strong government capex supported the next phase. Growth remained healthy, but leadership became more concentrated in domestic cyclicals.
H2FY26–current	AI-capex spillovers, GST cuts and RBI easing have supported the latest phase. Earnings growth has been narrower and more margin-led, leaving the cycle more exposed to a reversal in costs or external demand.

3. Three Scenarios for AI Capex – and Why It Matters for India

India's current cyclical earnings momentum is increasingly linked to the direction of global hyperscaler capex. The transmission is indirect but powerful: AI spending influences equipment exports, commodity demand, capital flows and the rupee, which in turn affect reported growth and profitability across a wide part of the Indian market. From here, we see three broad scenarios, each with a different implication for relative market leadership:

Scenario	What It Means for Markets
1. Consensus estimates hold (base case)	Even if hyperscalers meet current capex guidance, the growth rate of that spending may already have peaked. That would reduce the incremental earnings impulse to commodities and capital goods, narrow the India/EM and cyclical/defensive earnings gaps, and likely result in mild underperformance by cyclicals and SMIDs.
2. AI capex slumps (rising risk)	A sharper slowdown could emerge if rising chip costs, Chinese competition and weaker free cash flow force hyperscalers to curb or defer spending. In that case, the cyclical earnings impulse could reverse quickly, with weaker metal prices and capital-goods demand causing a more meaningful underperformance in cyclicals and SMIDs.
3. AI capex re-accelerates (low probability)	A fresh acceleration in global AI spending would extend the current cycle by supporting equipment demand, metal prices and India's indirect cyclical earnings tailwind. We view this as a lower-probability outcome in the present rate environment, but it remains the principal upside risk to the contrarian positioning.

4. Global Backdrop: Real Yields Bite Just as Growth Narrows

The global economy increasingly resembles two different economies operating side by side. The innovation economy — led by AI infrastructure, semiconductors and associated supply chains — remains strong. By contrast, the traditional economy of housing, discretionary consumption and broader real activity is far less robust. This split matters because financial markets have increasingly priced the strength of the first segment while paying less attention to the weakness of the second.

GLOBAL STRAINS BUILDING		
20-yr high for US 10-year real yields, with UK, Europe and Japan close behind	13% 2-year export CAGR for Korea/Taiwan/China vs. just 1% for the rest of world	15-yr low for global residential activity — US, Germany and China alike

Retail sales across the US, Europe and China are either slowing or growing only modestly, while residential activity across several major economies remains close to levels associated with the weakest periods of the past fifteen years. At the same time, real interest rates have risen sharply. US 10-year real yields are at a two-decade high, with the UK, Europe and Japan also experiencing multi-year highs. A combination of weak underlying demand and high real yields is typically difficult for both economic growth and equity valuations. The risk is that monetary policy remains restrictive for longer even as wage growth cools, because the inflation challenge being addressed is increasingly supply-side rather than demand-driven.

5. Outlook: The Cyclical Recovery Is at Risk

Our base case is that the cyclical recovery loses momentum as we move through H2FY27. This does not require a recession or a collapse in activity. A more modest normalisation in margins, commodity prices, policy impulse or AI-capex growth could be enough to narrow the current earnings gap between cyclicals and defensives. Five factors are especially important.

The first risk is a delayed margin shock. In Q1FY27, many companies were still benefiting from low-cost inventory accumulated before the Iran-Israel supply shock. That buffer can temporarily protect margins because the higher replacement cost of raw materials only reaches the income statement after cheaper stock is consumed. The 2022 Russia-Ukraine episode provides a useful precedent: the margin impact appeared with a lag, and SMIDs and cyclical businesses saw a much sharper compression in profit growth than large caps and defensives once higher input costs were fully reflected. If the same pattern repeats, Q2 and subsequent quarters could look materially less favourable than Q1.

The second concern is the fading domestic stimulus impulse. GST-related support has not yet produced a broad-based multiplier, while soft household incomes and weak credit transmission continue to constrain

demand. Corporate capex also remains selective, with management teams still focused heavily on margins and returns rather than aggressive capacity expansion. Government capex is constrained by the parallel objective of fiscal consolidation and the need to absorb oil and fertiliser subsidy burdens. Together, these factors reduce the probability that domestic demand alone can offset a slowdown in external cyclical support.

The third issue is the rate of growth in AI capex itself. Even if hyperscalers continue to spend at the absolute levels currently guided, markets are usually driven by the change in growth momentum rather than by the level of spending alone. In our base case, that growth impulse peaks around September 2026. The fact that semiconductor equities and metal prices have stopped re-rating in tandem with stronger capex guidance may be an early sign that markets are already discounting a slower second derivative. If capex growth simply becomes less rapid, the earnings tailwind for AI-adjacent cyclicals can weaken even without an outright reduction in spending.

There is also a growing risk that AI capex could undershoot current expectations. Hyperscalers are facing higher chip costs, greater competition from China and weakening free-cash-flow profiles, which is forcing more of the investment burden toward debt funding. That becomes more challenging when global bond markets are volatile and real yields are already elevated. The recent pause in hardware-stock performance after a sharp rally has some resemblance to the 2000 technology cycle, when a period of stagnation preceded a much deeper capex retrenchment. The relevance for India is the transmission channel: weaker global technology capex would likely reduce demand for metals and capital goods, weakening one of the external supports behind India's current cyclical earnings recovery.

Finally, global monetary conditions remain restrictive. US 10-year real yields are at a 20-year high, while real yields in the UK, Europe and Japan have also risen sharply. High real yields raise the hurdle rate for investment, compress valuation multiples and weaken interest-sensitive parts of the economy. The concern is amplified because global consumption and real estate are already soft. If central banks remain hawkish while wage growth continues to decelerate, policy could stay tighter for longer than the underlying demand environment would ordinarily justify, creating an additional headwind for cyclical assets.

There are, of course, risks to this view. A rapid easing of supply-side disruptions, a fresh round of policy stimulus or a renewed acceleration in global AI spending could extend the current cyclical phase and postpone the rotation. Our argument is therefore not that India's structural growth story is ending. It is narrower: at today's relative valuations, the risk-reward of the crowded cyclical, small-cap and commodity-heavy trade appears less attractive than that of the large-cap and defensive segments it displaced.

6. Portfolio Positioning: Time to Flip

This asymmetry is guiding our portfolio positioning. Where potential upside from further re-rating appears limited but downside from an earnings normalisation is meaningful, we prefer to reduce exposure rather than wait for the cycle to visibly turn. Accordingly, planning to move away from expensive cyclicals and SMIDs and toward large caps and defensives. The approach is consistent with previous polarisation extremes: once valuation gaps become unusually wide, the eventual mean reversion can be rapid, and the market's most crowded leadership can lose momentum before the fundamental data appear obviously weak.

Key Overweight — Large Caps & Defensives

Sector	Rationale
IT	Attractive income support through an approximately 5% dividend yield, with the possibility that the AI opportunity broadens from hardware spending toward software, services and applications.
Private Banks	Valuations are near historical lows while pressure from deposit growth and funding costs is beginning to ease, improving the setup for a normalisation in relative performance.
Consumer	We prefer selective, bottom-up discretionary opportunities where earnings growth can be company-specific, rather than paying a broad premium for traditional staples.
Pharma	Defensive demand characteristics and relatively resilient earnings can provide portfolio stability if the cyclical earnings cycle weakens.
Cement	Competitive intensity is easing and input-cost pressure appears closer to a peak, improving the possibility of a better margin and pricing environment.
Chemicals	Margins are closer to cyclical lows, while a more competitive rupee can support export-oriented businesses and improve the odds of a gradual earnings turnaround.
Internet	The sector retains structural growth characteristics, with several businesses still having scope to improve margins as operating leverage builds.

Sector	Rationale
Industrials	Valuations remain demanding while margins are already above normal levels. Any moderation in order inflow, execution or demand could therefore create disproportionate earnings risk.
Metals	Valuations and margins are elevated, while higher global bond yields and a slower AI-capex impulse could limit further commodity-price upside.
PSU Banks	Return on equity is no longer accelerating despite peak credit growth and exceptionally low credit costs, suggesting that a major part of the cyclical improvement may already be reflected.
Power	The earnings-growth outlook is less compelling, and current dividend yields do not yet provide enough valuation support to offset slower growth.
Autos	The GST-cut benefit is likely to fade while input-cost and margin pressures may become more visible, reducing the probability of another strong earnings surprise.

Then vs. now: the backdrop has flipped

Backdrop	Net Result
Sep'25–Sep'26 drivers	GST cuts, RBI deregulation and a strong global AI-capex cycle accelerated cyclical earnings. Emerging markets, SMIDs and cyclical sectors benefited most from this combination.
H2FY27 drivers	The delayed margin impact of supply shocks, slower global growth and elevated bond yields could reduce earnings momentum. In that environment, India relative to EM, large caps and defensive sectors may regain leadership.

This comparison captures the thesis in its simplest form. The forces that powered cyclical outperformance over the past year – domestic stimulus, regulatory easing and the global AI-capex boom – are no longer strengthening at the same pace. At the same time, the valuation discount in large caps and defensives has become historically wide. We would therefore prefer to reposition before the earnings cycle visibly turns rather than after the market has already recognised the change. Previous episodes in 2007, 2013, 2019 and 2024 show how quickly leadership can reverse once a polarisation extreme begins to unwind.

7. What to Watch Next

Q2FY27 margin prints – The immediate question is whether the delayed impact of higher input costs begins to show up in reported margins. We will be watching not just the direction of margins, but also

whether the compression is materially sharper in SMIDs and cyclical sectors than in large caps and defensives, as occurred after the 2022 supply shock.

Hyperscaler capex guidance — The next spending updates from Amazon, Microsoft, Meta, Google and Oracle will be important. The key variable is not simply whether absolute capex remains high, but whether the growth rate of that spending continues to slow. A deceleration would weaken one of the major external impulses supporting commodities, capital goods and AI-adjacent cyclicals.

GST-collection mix — We will monitor whether domestic GST collections begin to catch up with the much stronger imported-GST trend. A broadening of domestic collections, particularly into services, would provide evidence that the policy stimulus is transmitting more widely through the economy rather than remaining concentrated in goods and import-linked activity.

Global real yields — US, UK, European and Japanese 10-year real yields are all near multi-decade highs. Any further rise would increase the discount rate applied to equities and create additional pressure on long-duration and cyclical risk assets. Conversely, a sustained decline in real yields would reduce one of the major global headwinds in our base case.

Fed policy path — We will also track whether Governor Warsh's hawkish stance on core PCE inflation persists even as wage growth continues to decelerate. The key question is whether the Fed continues to respond to supply-side inflation with policy settings that restrain demand. A prolonged mismatch between the source of inflation and the policy response would raise the risk of a sharper slowdown in the traditional economy.

8. Closing Perspective: Positioning Before the Narrative Changes

The central message of this newsletter is not that cyclicals or SMIDs have suddenly become poor businesses, nor that large caps and defensives are guaranteed to outperform immediately. It is that the balance of probabilities has changed. The segments that benefited most from the last phase now combine richer relative valuations with earnings that are increasingly dependent on strong margins, favourable commodity prices and a still-expanding global AI-capex impulse. At the same time, the parts of the market that have lagged are trading at relative valuations rarely seen over the past two decades.

For long-term investors, that creates a different decision framework from the one that prevailed a year ago. The objective is not to predict the exact quarter in which market leadership reverses, but to recognise when the potential reward from staying with a crowded trend is no longer commensurate with the risk. Our preference is therefore to gradually rebalance toward areas where valuations provide a better margin of safety and where earnings are less dependent on the continuation of today's most optimistic assumptions. If the cyclical trade extends, the rotation may look early for a period; if the earnings cycle normalises, that early positioning could become an important source of medium-term alpha.

*Sources: Bloomberg, Prowess, CMIE, CPB World Trade Monitor, and Nuvama Institutional Equities research .
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