Sanctum View

May 14, 2018

Investment Strategy

The Modi Premium

"The future is never clear; you pay a very high price in the market for a cheery consensus. Uncertainty is the friend of the buyer of long term values." – Warren Buffett

Why is the market shrugging off macro-economic concerns? That's the title of an article in today's Mint Markets section. We offer our take on the question this week. Valuations have remained remarkably and sustainably high during the tenure of the Modi regime. We delve deeper into the data to gain insights on the repercussions for investors, forward returns from these levels, to gain a better understanding of the current market scenario, and takeaways for go forward investment strategy.

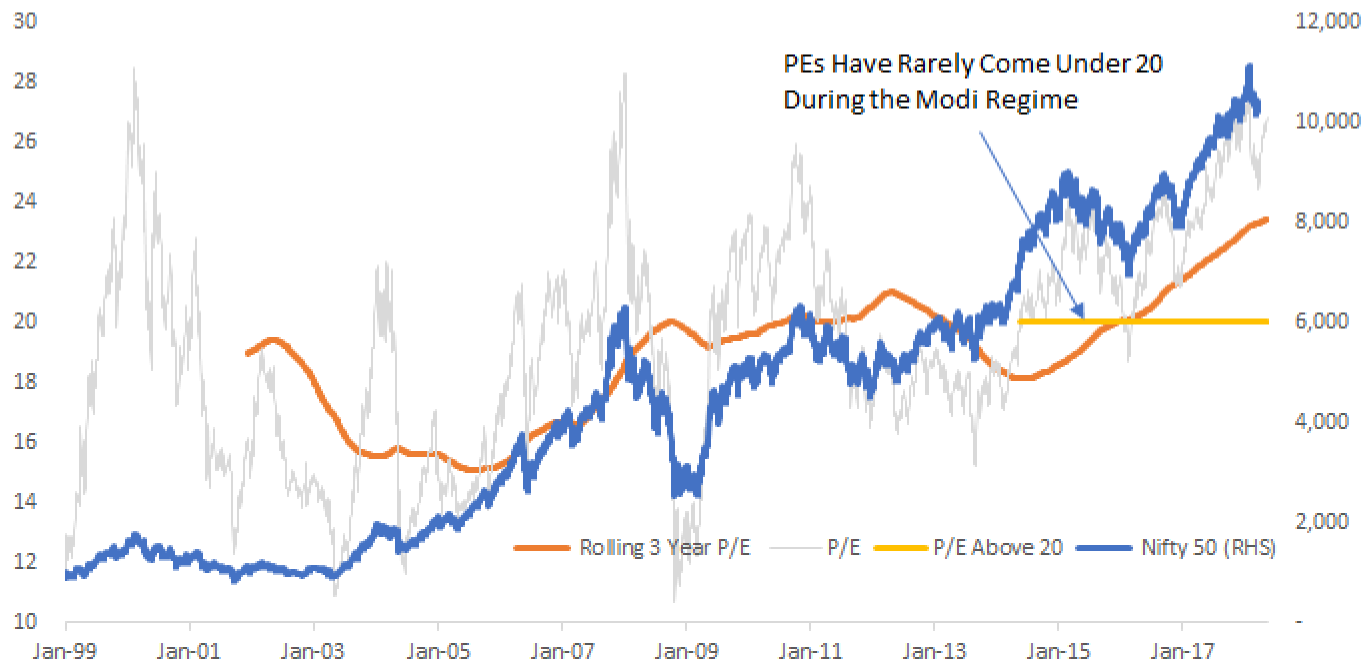
The Average Trailing P/E During the Modi Regime Has Remained 3.5 Points Higher Than the Prior Average

During the past four years under the Modi regime, equity market valuations have shifted meaningfully higher. The average trailing PE for the Nifty 50 during this time – as published by NSE – is 22.96 times. Incidentally, the P/E rose above 20 times just 3 days after P.M. Modi came to office, on May 19th, 2014. The valuation low under the Modi regime for PEs was 18.65, and an average PE of 22.96. By way of comparison, the valuation low during the prior years 2010 – May 2014 was 15.23 and average P/E of 19.52, a meaningful difference in both cases of 3.5 points.

Three Ds – Demographics, Domestic Financialisation & Dominant Equity Performance – Have Contributed

The reasons for these extraordinarily high P/Es have been discussed in detail previously: demographic drivers for growth, domestic financialization, and dominant equity performance. Valuations at the index level have remained elevated.

The Trailing P/E for the Nifty 50 Has Only Once Dropped Below 20...
...And Remained Higher for a Sustained Stretch of Time



Even From Market Tops in Mar 2015 and Sep 2016, Equities Have Delivered a Blended 11.1% and 15.7% CAGR...
...While Gold Has Delivered -0.3% and 5.4% CAGR, and Fixed Income 5.9% and 2.8% CAGR

Asset Class	Mar-15 to date	Sep-16 to date
Gold (USD)	2.8%	-0.9%
Gold/INDIAN RUPEE	5.4%	-0.3%
CRISIL 10Y Bond Index	5.9%	2.8%
NIFTY50	7.9%	14.8%
NIFTY Midcap 100	14.4%	16.6%
NIFTY Smallcap 100	13.2%	20.5%

	16-May-14	4-Mar-15	9-Sep-16	9-May-18
Gold	1,293.8	1,201.2	1,332.4	1,312.4
Gold in INR	75,752.6	74,786.5	88,877.6	88,394.4
Bond Index	2,317.1	2,625.0	3,011.5	3,151.1

There Is No Alternative – Gold, Fixed Income and Real Estate Have Disappointed Investors

Alternative asset class returns have disappointed. As the table above demonstrates, Gold at the start of the Modi regime was at 1293.8. Today it's 1312.4, yielding an annualised return of 0.4% a year. Gold in INR has done better, earning 4.0% a year, but even fixed deposits have beaten Gold handily.

Fixed Income is somewhat better. The CRISIL bond benchmark has returned 8.0% a year since 2014, but returns have been progressively lower as we've moved into 2017 and 2018. Real estate returns are mediocre as well, with residential real estate investors stuck with inventory and bleeding, although commercial seems to hold promise. Therefore, one reason **equities remain elevated is there are limited attractive investment alternatives, and investors aren't compelled by the 4-8% that alternative asset classes offer today.** Rather, investors are willingly taking the call that they can beat alternative asset class returns in the range of 6-8% via equities.

What If Investors Bought Equities at the Peak in 2015?

We make the extreme assumption that investors bought at the top in March 2015. Clearly, they suffered immediate remorse with the ensuing correction. If they held on, however, they bagged a blended 11.1% return – Nifty 50 and Midcap - from equities, far in excess of alternative asset classes.

On Average, Equities Returned 17.1% CAGR If Purchased at the Market Top in March 2015

Using the CNX 500 as our universe, and the assumption an investor purchased at the market top in March 2015, the average CAGR return for CNX 500 stocks is 17.1%. Some may argue that PEs weren't inflated in 2015, but that would be incorrect. The P/E of the market on March 4th 2015 was 24.1 times, very elevated. The 17.1% CAGR would be much higher if the investor simply ignored PSUs and Telecom. 63% of equities in the CNX 500 delivered returns above 8.0%, and 56% of equities delivered returns above 12%.

The Possibility of Large Returns

There have been some home runs, and this opportunity for a home run is also a reason why equities rule the roost. Of the 6 top performing stocks, we incidentally have owned two in the Titans portfolio: Minda Industries, a CAGR of 106.5% and Himadri Specialty, a CAGR of 102.9%. The other winners were HEG, Rain Industries, Indiabulls Ventures, and Graphite.

From the Market Top in Sep 2016, Equities Have Returned 24.1% CAGR on Average

Using the same assumption of a purchase at the market top in September 2016, the average CAGR return is 24.1%. The P/E of the market on September 9th 2016 was elevated as well, at 24.3 times.

Midcaps Beat Large Caps Soundly, Even When Purchased at Market Peaks…
…However, Small Caps Are Clearly Inferior on a Risk Adjusted Basis

Cap	Mar-15 to date	Sep-16 to date	Cap	Mar-15 to date	Sep-16 to date
NIFTY50	7.9%	14.8%	Large cap	15.5%	21.7%
NIFTY Midcap 100	14.4%	16.6%	Mid cap	22.1%	39.9%
NIFTY Smallcap 100	13.2%	20.5%	Small cap	15.8%	20.0%

On Capitalization, Performance Data Favors Midcaps …

The typical expectation would be that midcaps would get hit hard if purchased at market peaks. Surprisingly, the table demonstrates that midcaps have beaten large caps, soundly since 2016, by 18%. Small caps were laggards versus midcaps, and on a risk adjusted basis, clearly small caps are not a good idea at market peaks.

High P/E Growth and Low PE/G Were Dominant Factors

Breaking the data down by factor, high P/E - a proxy for growth - outperformed low P/E - a proxy for value - by wide margins. This is another result contrary to investor expectations. Low PE/G delivered consistent high returns.

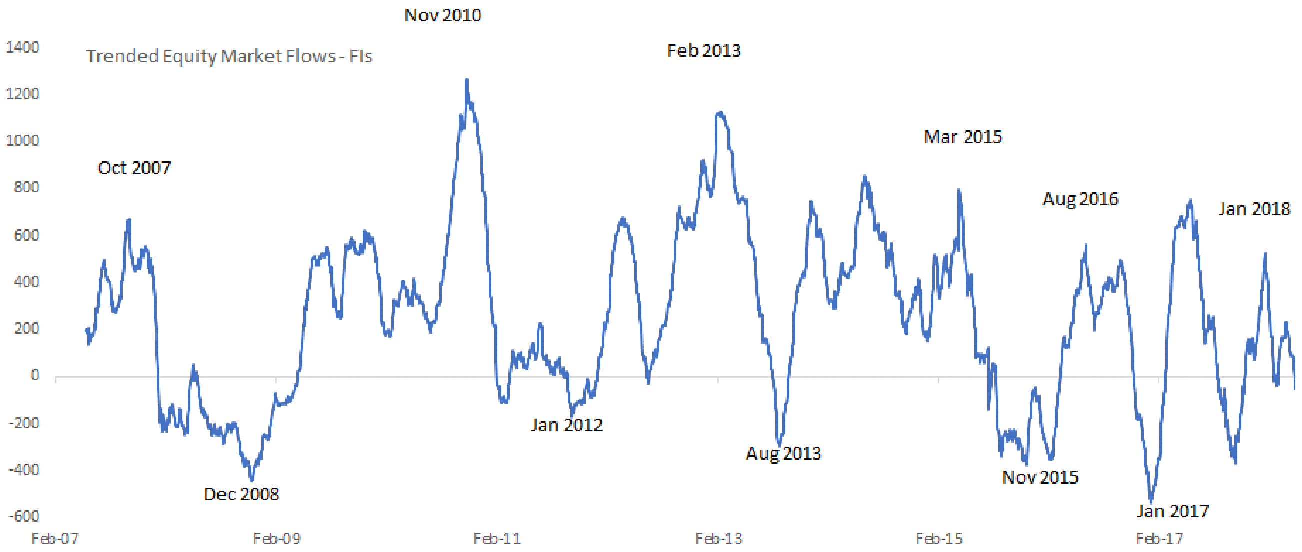
Growth Outperformed Value Even from Market Peaks…
…And Low PE/G Has Outperformed High PE/G

P/E	Mar-15 to date	Sep-16 to date	P/EG	Mar-15 to date	Sep-16 to date
High	17.8%	27.0%	High	17.8%	24.1%
Low	14.2%	19.6%	Low	24.3%	23.9%

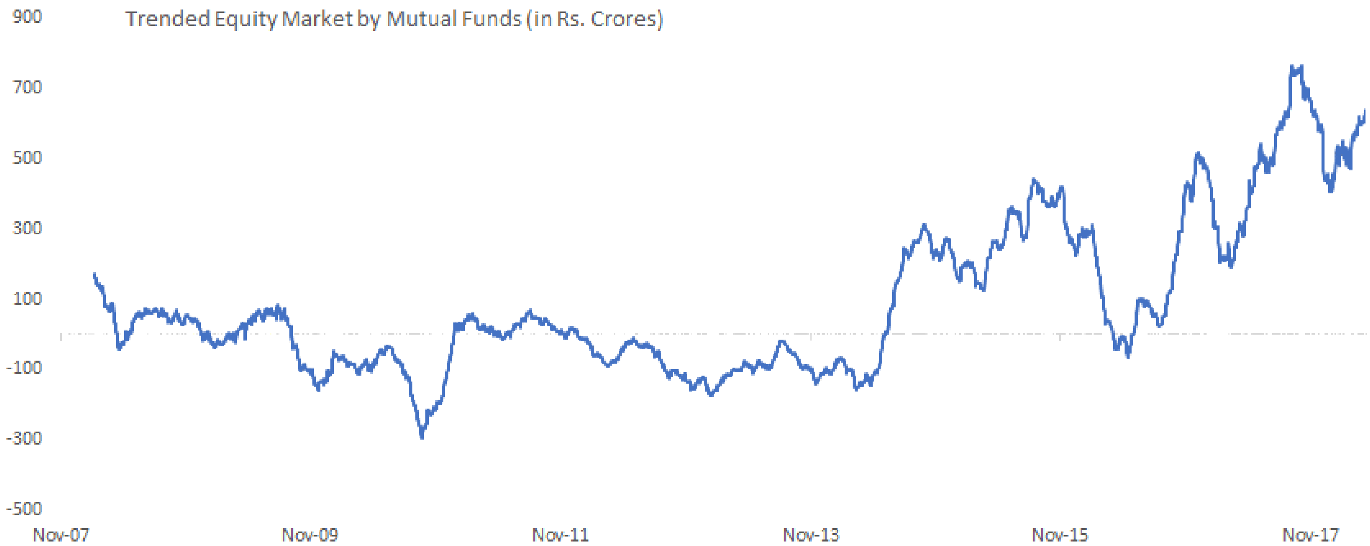
Domestic Flows – Financialization - Have Supported the Market in Recent Sell-offs

Foreign flows ruled the roost and foreign investors were dominant for many years. However, the rapid 50% depreciation of the Rupee in 2013 decimated foreign investor returns. Since 2013, there's been a gradual decline in foreign flows as the chart below highlights. On the other hand, domestic flows have been rising strongly and steadily.

**A Depreciating Rupee Led to Mediocre Dollarized Indian Equity Returns…
…And Declining FI Flows in Equities in Recent Years**



While Domestic Inflows Into Equities Have Risen Strongly Since 2014



Earnings Scorecard

With 27 Nifty 50 companies and 156 NSE 500 companies reporting, the trend in sales growth is strong, with the Nifty 50 delivering a stellar 17.1% sales growth YoY, and NSE 500 delivering 13.9% YoY. Operating profits growth has been equally healthy, at 15.0% and 15.1% respectively. However, net profits are disappointing, at -3.4% and 1.8%. Consumer Discretionary has delivered on the top and bottom line, alongside Health Care and Real Estate.

Despite Double Digit Top Line and Operating Earnings Growth…
… Net Profits Have Been Dismal for PSU Banks, Materials, Telecomm and Industrials…
…And Excellent for Consumer Discretionary

	Sales YoY		Operating Profit YOY		Net Profit YOY		Operating Margin		Net Margin	
	NIFTY50	NIFTY500	NIFTY50	NIFTY500	NIFTY50	NIFTY500	NIFTY50	NIFTY500	NIFTY50	NIFTY500
Consumer Discretionary	5.6%	8.8%	27.5%	25.0%	17.0%	21.0%	18.0%	16.3%	9.7%	8.2%
Consumer Staples	NA	-0.7%	NA	-7.5%	NA	7.2%	NA	15.7%	NA	10.0%
Energy	39.0%	38.6%	45.9%	42.9%	17.3%	12.5%	16.0%	16.0%	7.3%	7.0%
Financials	14.8%	14.5%	17.6%	18.3%	-11.4%	-4.0%	46.4%	48.8%	14.1%	12.6%
Health Care	NA	24.8%	NA	43.5%	NA	15.5%	NA	20.9%	NA	7.2%
Industrials	31.0%	16.7%	13.2%	7.4%	-14.6%	-3.5%	49.8%	24.8%	24.4%	10.4%
Information Technology	4.7%	5.1%	-0.1%	1.3%	-2.1%	-0.8%	27.8%	27.2%	19.0%	18.4%
Materials	17.5%	11.0%	9.5%	8.5%	-16.5%	-6.4%	27.3%	25.0%	8.3%	9.0%
Real Estate	NA	106.6%	NA	261.4%	NA	649.3%	NA	79.4%	NA	60.8%
Telecommunication Services	-9.5%	-12.6%	-6.8%	-9.5%	-34.0%	-89.2%	39.5%	36.0%	4.9%	0.5%
Utilities	NA	-5.7%	NA	8.4%	NA	NA	NA	32.4%	NA	-1.5%
Index	17.1%	13.9%	15.0%	15.1%	-3.4%	1.8%	28.2%	29.0%	11.5%	10.2%

	Sales YoY		Operating Profit YOY		Net Profit YOY		Operating Margin		Net Margin	
	NIFTY50	NIFTY500	NIFTY50	NIFTY500	NIFTY50	NIFTY500	NIFTY50	NIFTY500	NIFTY50	NIFTY500
Small Cap	NA	7.1%	NA	3.2%	NA	-5.2%	NA	20.6%	NA	3.4%
Mid Cap	NA	8.2%	NA	22.8%	NA	63.5%	NA	34.0%	NA	7.4%
Large Cap	17.1%	16.3%	15.0%	14.2%	-3.4%	-3.7%	28.2%	28.9%	11.5%	11.8%
Index	17.1%	13.9%	15.0%	15.1%	-3.4%	1.8%	28.2%	29.0%	11.5%	10.2%

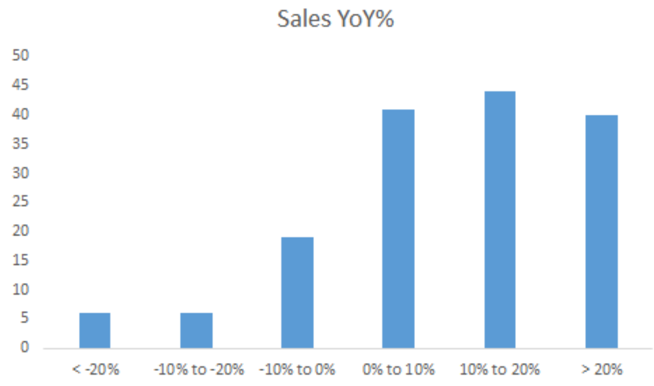
Outlook

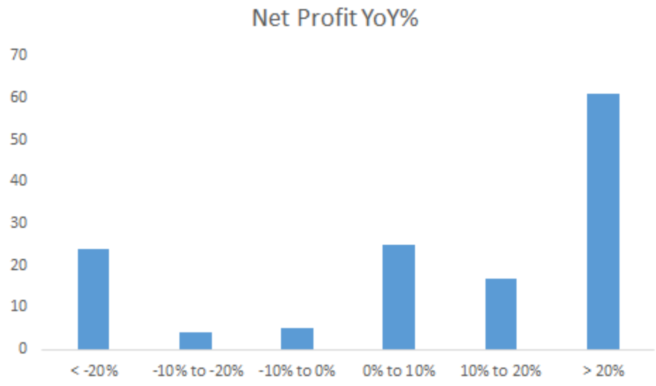
While Macros Are Mixed, the Economy Is Doing Fine

The macro outlook has weakened, with the continued rise in crude oil upsetting the fiscal situation, pushing the Rupee higher and interest rates higher. But macro conditions can change on a dime. On the other hand, auto sales and credit growth remain strong, demonstrating a healthy consumer. Rural appears to be on the path to recovery. Strong top line growth and operating earnings growth by companies is another positive. PMI data – Services and Manufacturing – remains in growth mode. As we've stated earlier, equities can do well in periods with gradually rising crude, to a point. We've not reached that point yet, in our estimation.

With Strong Sales & Profit Growth, the Modi Premium Is Likely to Stay Elevated

Breaking down the earnings data, a majority of companies are delivering strong top line growth, and more than half – 75 of 136 companies – are delivering net profit growth above 12%. 61 companies have reported net profit growth above 20%. It's clear that growth stocks will continue to deliver returns.





Equity valuations are likely to stay high, at least while euphoria around the current regime holds. The analysis of foreign and domestic flows suggests that severe corrections driven by FI factors are unlikely to be as severe going forward. **Finally, while net profit at the index level is woeful, net profit growth at the company level has been good for a majority of the reporting universe.**

Risk Averse Portfolios

For risk averse investors, the adage of loss prevention first holds. For investors with the unwillingness to bear volatility, capital protected strategies are appropriate. These strategies will generate alpha on sell-offs, and peace of mind.

Bottom Up Growth Will Continue to Deliver Returns

Corrections are part and parcel of equity investment, and one could unfold in the near future. We recommend using sell-offs to add to allocations. Equities during the Modi regime have remained a forgiving and rewarding asset class. Even entering at market peaks has resolved into attractive returns, well above returns from Gold and Fixed Income. From a strategy perspective, we recommend portfolio tilts towards quality, predictable, growth companies at reasonable PEG valuations.

Technical

The Nifty saw late rally on Friday to close at 10807 levels up by 1.8% for week. Though boarder markets were subdued in last session as market breadth was in favour of declines with advance decline ratio of 7:11. The Nifty continues to form higher tops and higher bottoms to close at three month high. Index managed to close above resistance level of 10785 levels after seven sessions of consolidation. Now next level for the market is seen at 10910-10940 zone and then 11020 levels. In Nifty Call options 11000 strike price has highest open interest which is likely to act as resistance. On the downside immediate support is seen at 10690 and 10600 levels. In Put Options strike price 10500 has highest open interest followed by 10600 and 10700 suggesting supports for the market. Open interest addition was seen in 10700 Puts followed by 10600 and 10500 indicating support for the market is shifting higher. India VIX fell down by 3.1% to 13.97 ahead of Karnataka Elections, suggesting market participants are not much worried about election.

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