Sanctum View

July 23, 2018

Investment Strategy

The Most Difficult Choice

Investing isn't easy. Invest in equities, and you will lose money when the market goes down. Don't invest in equities, and watch from the sidelines as your friends get infuriatingly rich. Try to time the market, and do it well, and you can add value. Try to time the market and don't do it well, could mean selling too early, not re-entering and losing out.

Invest aggressively in small caps, and you'll do great in a bull market. Invest aggressively in a bear market, and you'll take a beating. Concentrate your portfolio in a bull market, you'll win bigger. Concentrate your portfolio in a bear market, you'll lose bigger. Leverage your portfolio, you'll compound wealth faster in a bull market. Leverage your portfolio in a bear market, and it could lead to permanent loss of capital.

Investing isn't easy. **Moreover, there is a constant urge to sell. There are two instances when investors want to sell: one, when markets go up and the other, when markets go down.** In up markets, fear of losing out on hard earned gains creates the urge to sell. In down markets, fear of large losses creates the urge to sell.

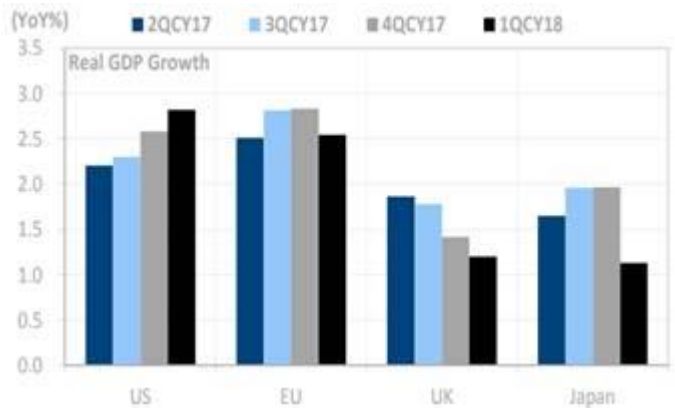
Holding Is Always, the Difficult Choice

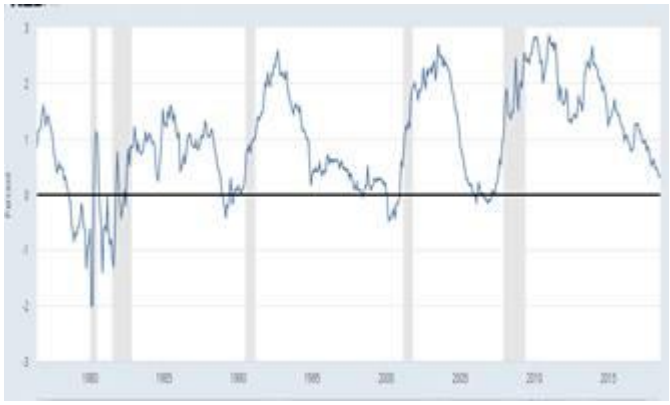
The market has been characterized by doom and gloom, barring isolated periods, for over a decade. Whether it was the Nasdaq bubble, Great Recession, Greek default, the Taper Tantrum, the China bust, Brexit, VIX, the Grand Recession, the Coming Crash, PSU NPAs, there are always reasons to exit. **Holding is often, the difficult choice, and the rewarding one**. With one caveat: you need to have held reasonable quality investments. The biggest winners have been investors that have held on to quality portfolios through thick and thin. Today, the fears are trade wars, Fed balance sheets, election risks and a slow economy. **There is one necessary precondition**, which is owning a sensible portfolio. Surprisingly, that's not as commonly followed as one would expect.

Collateral Damage in Mid & Small Caps

There's mounting evidence that well-intentioned efforts by SEBI - mandating portfolio integrity and restricting market manipulation by leveraged derivative speculation - have contributed to unpleasant near-term consequences for some good quality stocks.

The Global Economy Remains Healthy… U.S. Is Healthy, and the Yield Curve Positive





The Domestic Economy Is Showing an Uptick In June 2018

	Aug-17	Sep-17	Oct-17	Nov-17	Dec-17	Jan-18	Feb-18	Mar-18	Apr-18	May-18	Jun-18
Banking											
Currency in circulation (% YoY)	-9.65	-8.06	-8.04	39.68	80.43	70.97	53.05	37.05	32.92	29.76	26.87
M3 (% YoY)	7.00	6.00	6.50	8.80	10.50	10.80	10.30	9.60	10.60	10.70	9.80
Bank non-food credit growth (%YoY)	5.50	6.09	6.56	8.85	10.04	9.53	9.75	8.37	10.68	11.13	10.39
Personal credit (%YoY)	15.73	16.85	15.99	17.29	18.95	20.02	20.40	17.80	19.09	18.60	16.95
Credit to industry (%YoY)	-0.27	-0.44	-0.21	0.96	2.13	1.10	0.99	0.73	1.01	1.45	1.00
Credit to services (%YoY)	5.01	6.98	9.38	14.04	14.72	13.23	14.18	13.77	20.72	21.95	21.59
Deposit growth (%YoY)	10.27	8.66	9.24	3.46	3.97	5.10	5.87	6.67	8.20	8.55	7.60
10 year G-Sec yields (%)	6.53	6.66	6.86	7.06	7.33	7.43	7.73	7.40	7.77	7.83	7.90
Commercial Paper issuance (%YoY)	-4.82	12.75	23.51	22.75	13.06	19.96	22.11	-6.38	1.75	19.31	49.30
Industry											
Cement production (% YoY)	0.70	0.12	-1.27	16.92	17.65	19.59	23.04	12.95	16.49	5.18	
Steel production (% YoY)	2.18	3.67	8.56	14.52	0.38	1.71	4.98	4.73	3.84	0.52	
Coal production (% YoY)	15.35	10.40	3.94	0.72	0.39	3.75	1.25	9.10	16.03	12.08	
IIP (%YoY)	4.81	4.15	1.83	8.54	7.31	7.47	6.96	4.58	4.86		
Mining (% YoY)	9.30	7.60	-0.20	1.40	1.20	0.30	-0.40	3.10	4.00	5.70	
Manufacturing (%YoY)	3.80	3.80	2.00	10.40	8.70	8.70	8.40	4.70	5.30	2.80	
Electricity (%YoY)	8.30	3.40	3.20	3.90	4.40	7.60	4.50	5.90	2.10	4.20	
Capital goods production (%YoY)	7.30	8.70	3.50	5.70	13.20	12.40	16.60	-5.70	11.90	7.60	
Consumer durables production (% YoY)	4.30	-4.10	-9.00	3.10	2.10	7.60	7.50	4.10	4.50	4.30	
Consumer non-durables production (% YoY)	7.20	10.50	8.20	23.70	16.80	10.70	7.40	12.70	7.90	-2.60	
PMI Manufacturing Index	51.20	51.20	50.30	52.60	54.70	52.40	52.10	51.00	51.60	51.20	53.10
PMI Services Index	47.50	50.70	51.70	48.50	50.90	51.70	47.80	50.30	51.40	49.60	52.60
PMI Composite Index	49.00	51.10	51.30	50.30	53.00	52.50	49.70	50.80	51.90	50.40	53.30
Consumer											
Rural wage (% YoY)	6.31	6.00	4.93	4.21	4.22	3.09	3.37				
Petrol consumption (% YoY)	-1.98	10.30	3.74	6.33	9.52	10.56	7.73	7.17	3.80	3.11	8.66
Diesel consumption (%YoY)	-3.47	16.59	-1.90	7.72	8.35	14.60	6.13	8.01	2.67	0.25	7.75
Foreign tourist arrivals (%YoY)	11.00	18.80	18.10	14.40	15.20	8.40	10.10	13.37	4.40	8.80	
Foreign Trade											
Export growth (% YoY)	10.30	25.67	-1.10	30.60	12.40	9.10	4.48	-0.66	5.17	20.18	17.57
Import growth (% YoY)	21.00	18.09	7.60	19.60	21.10	26.10	10.41	7.15	4.60	14.85	21.31
Non-Oil Import growth (% YoY)	23.07	20.86	4.89	14.57	17.19	20.49	4.11	4.93	-4.32	6.03	11.20
Fiscal											
Central Government expenditure (%YoY)	-2.03	-12.09	16.53	37.05	20.25	-4.68	17.63	-35.31	-7.74	15.06	30.17
Inflation											
CPI (%YoY)	3.28	3.28	3.58	4.88	5.21	5.07	4.44	4.28	4.58	4.87	5.00
Core CPI (%YoY)	4.36	4.47	4.40	4.75	4.98	5.00	5.03	5.23	5.80	6.12	6.35
WPI (%YoY)	3.24	3.14	3.68	4.02	3.58	3.02	2.74	2.74	3.62	4.43	5.77

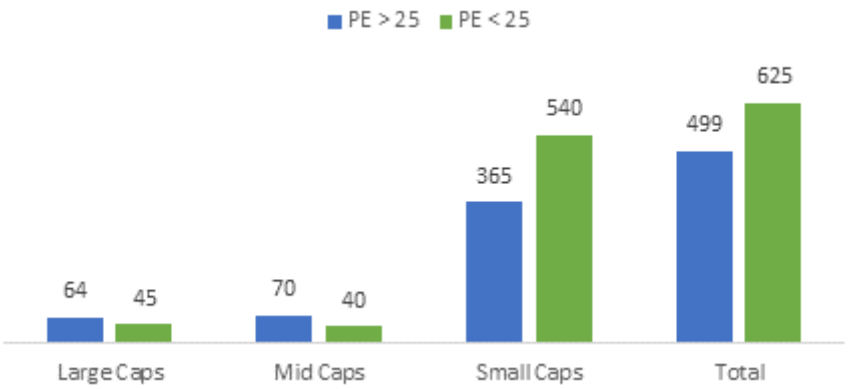
The pressure on small and mid caps as a result of portfolio re-shuffling has led to severe mark downs in the small and mid cap universe. An analysis of the largest decline in fund holdings versus price performance demonstrates a strong correlation (see chart below). In many cases, there is limited fundamental rationale supporting the sharp fall in prices.

Meanwhile, Valuations Have Improved Markedly in Mid and Small Caps

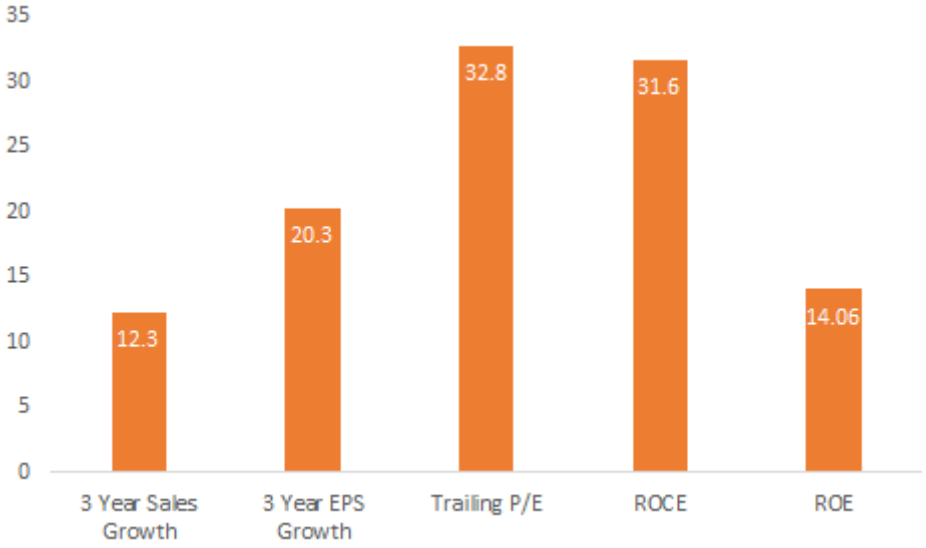
Reviewing the landscape, valuations in mid and small caps have improved markedly. Over half mid and small caps sell cheaper than the market multiple. **Small caps have the most attractive ratio of 60% of companies cheaper than the market.** While 365 small cap stocks sport a P/E multiple above 25, a much larger number - 540 - sport a P/E multiple below 25.

In **midcaps**, 63% of companies, or 70 companies sport a P/E above 25, while 40 are cheaper than the market multiple. In **large caps**, 59% of companies, or 64 companies are selling above a 25 multiple, while 45 companies are below P/E of 25. Finally, 250 companies – or less than 22% - sport a P/E multiple above 40 times.

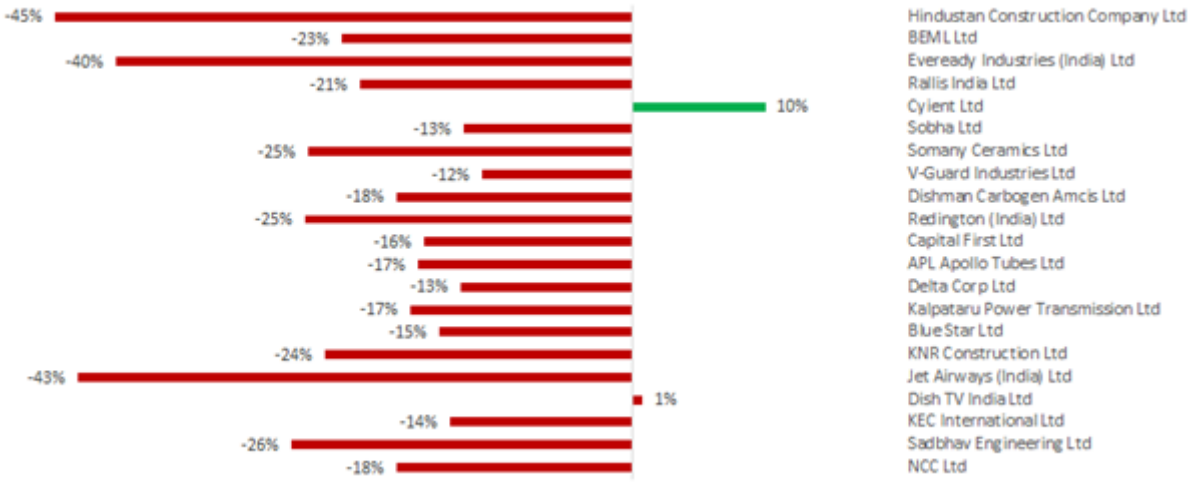
Valuations Have Compressed and 60% of Small Caps are Now Cheaper Than the Market



Mid Caps Trailing P/E is 32.8, While 3 Year EPS Growth is 20.3% and ROIC is 31%...
...Much Lower than the Stated Midcap Index Multiple of 58 Times



Meanwhile, Some Quality Companies Have Experienced Massive Selling For No Apparent Good Reason...



Mid Caps On a Bottom Up Cap Weighted Basis Are Selling at 32.8 Times

The average trailing P/E for the 120 stocks in the Midcap universe on a bottom up basis is 32.8. We use 10,000 to 25,000 Cr as the market cap cut-off. A trailing P/E of 32.8 with expected 20% EPS growth brings the forward P/E comfortably below 30. **That puts mid cap valuations in line with large caps, while offering much stronger growth.** Our number is significantly lower than the multiple shared on the NSE website of 58.7 times.

Further, **midcaps have delivered 20.3% CAGR EPS growth over the past three years, and 12.3% CAGR sales growth**. That's significantly better than the large cap index, which has stayed generally stagnant during this time. We've made no adjustments to the data. Further, midcaps sport an impressive 31.6% Return on Capital Employed, and a respectable 14.0% ROE.

Outlook

Equities

Since May 2018, we've been of the view that equities look better positioned than they have in some time now. (See "Change – In Macro and Equity Investments", May 25, 2018). The Nifty 50 was at 10,605 at the time. Despite the market ready to test new highs, we find generally pervasive angst and concern amongst investors. From our perch, the fundamentals remain generally healthy. We see no reason to alter our positioning, remaining invested but vigilant. Earnings will provide further clarity in coming days.

We're reminded of Peter Lynch's refrain: "Far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in corrections themselves."

The Large Cap Conundrum & Quality

The talk of the investing circles remains the outperformance of large caps. As always, history does not always repeat, but it does rhyme. In times of fear and uncertainty, large caps outperform. As FI selling and SEBI mandated selling abates, and the macro environment improves, we expect performance to revert.

We've been expecting this year to be one where earnings improve but P/Es would provide a headwind. Both those things are happening. Portfolio performance will remain widely dispersed. Despite the doom and gloom, the economy is in the midst of a credit and consumption driven recovery. While holding is the hardest of choices, it is made significantly easier by combining reasonable insights with sound portfolio construction. Time is the friend of the great investment.

Fixed Income

As we stated in our prior fortnightly, fixed income remains attractive on relative yield basis relative to equities, with the yield on bonds at levels that have traditionally resulted in attractive bond returns.

Decline in GST Tax Rates and Rising MSP

The MSP price rise came through in early July, at 1.5 times cost. We estimate the direct impact on CPI to be roughly 50 bps. The costs have already been budgeted into the food subsidy bill, therefore there will no impact to the fiscal deficit. Further, the government's GST rate reduction

announcement this weekend will help as an offset to price inflation and spur volume growth, but could add pressure to the fiscal.

India Well Positioned on Trade Wars

For now, the trade war remains focused on China and the U.S. We are already witnessing rising exports to China from India, as well as the opening of trade negotiations with partners gaining strategic importance, such as Australia, Canada.

Good News on Iran, OPEC

It's been an eventful month on the crude oil front, with India's increasing bargaining power becoming evident on Iranian crude, Russia's dismissal of sanctions and deepening of ties with Iran, alongside the formation of a buyer's cartel that includes India and China and possibly additional Asian countries. **This could be crude's last hurrah,** as Shale will come on in 2019 and India, China and European nations will use the threat of mass deployment of EVs as a bargaining chip. The fall in crude remains supportive of a peak in yields.

RBI Rate Hike

With the RBI raising rates in June and moving to neutral, the bank telegraphed a wait and see approach to further rate hikes. The outlook on growth remains optimistic and it's clear the central bank will not move too aggressively to derail the recovery. The rate hike was also driven by RBI's intent to shore up the currency amidst aggressive FI selling and targeting.

What's clear from the language and positioning is that the MPC is not ready to commit to a prolonged tightening cycle.
One could argue that MPC policy could be front loaded; however, that view is muddled by the recent decline in crude oil. The action in the 10 year g-sec has remained benign.

Short bond yields remain reasonably steady, and the front end continues to be priced for a short hiking cycle. Public sector banks have started to nibble in the market for the first time in weeks. Foreign selling seems to have abated and talk of a bottom in EM assets is coming to the fore. The biggest support to the bond market will be OMO by the RBI, and these are likely to lend support to the market over the second half of the financial year.

With the possibility of a spike in rates abating, our preference remains corporate bonds with low to moderate duration.

Technical Outlook

It was flat close for the week with the Nifty settling at 11010 levels. For the week index has formed doji candlestick pattern indicating indecisiveness in market. After a runup at the start month of the index has been consolidating its gains. For the last eight sessions Nifty has been trading in range of 11080 and 10920 odd levels. Thus, crossing above 11080 market can initially rally towards its all-time high of 11172 and then 11230 levels. While on the downside breaking below 10920 levels, expect decline towards 10850 and 10760 levels. In Nifty options, highest open interest is seen in strike price 11000, 10900 and 10800 suggesting market has good support at lower levels. India VIX measure of volatility has increased from 12.32 to 13.54 levels. If it crosses above 14 levels then market may see selling pressure; whereas decline in volatility is likely to propel markets higher.

Nifty Daily Chart

NIFTY50 Earnings Calendar

Release Date	Company Name	Estimated Net Profit (INR m)	Base Quarter Net Profit (INR m)	Estimated Growth
July 24	Asian Paints Ltd	5,167	4,274	20.9%
July 25	Bharti Infratel Ltd	6,039	6,639	-9.0%
July 25	Hero MotoCorp Ltd	10,099	9,140	10.5%
July 25	Larsen & Toubro Ltd	12,264	8,925	37.4%
July 26	Bharti Airtel Ltd	-4,271	3,673	-216.3%
July 26	Dr Reddy's Laboratories Ltd	2,896	591	390.0%
July 26	ITC Ltd	27,998	25,605	9.3%
July 26	Maruti Suzuki India Ltd	22,685	15,564	45.8%
July 27	HCL Technologies Ltd	22,938	21,713	5.6%
July 27	Reliance Industries Ltd	95,540	91,080	4.9%
July 28	NTPC Ltd	26,910	26,182	2.8%
July 30	Axis Bank Ltd	5,466	13,056	-58.1%
July 30	Housing Development Finance Co	30,727	27,339	12.4%
July 30	Tech Mahindra Ltd	9,077	7,986	13.7%

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