NETRA

Early Signals Through Charts

November 2024

DSP

Section 1

Unprecedent Stimulus, Could Reverse In Unprecedented Way

Easy Money Reversing From Multi-Century Peak

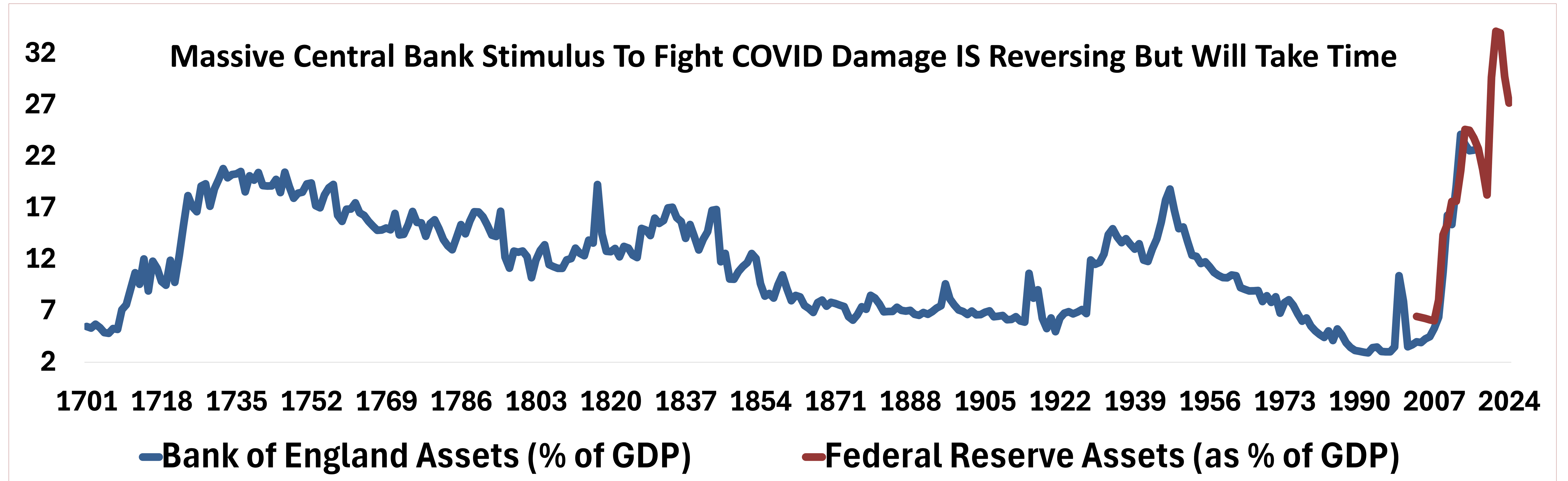
A monetary stimulus that dwarfs everything seen over the past 300 years (and likely ever).

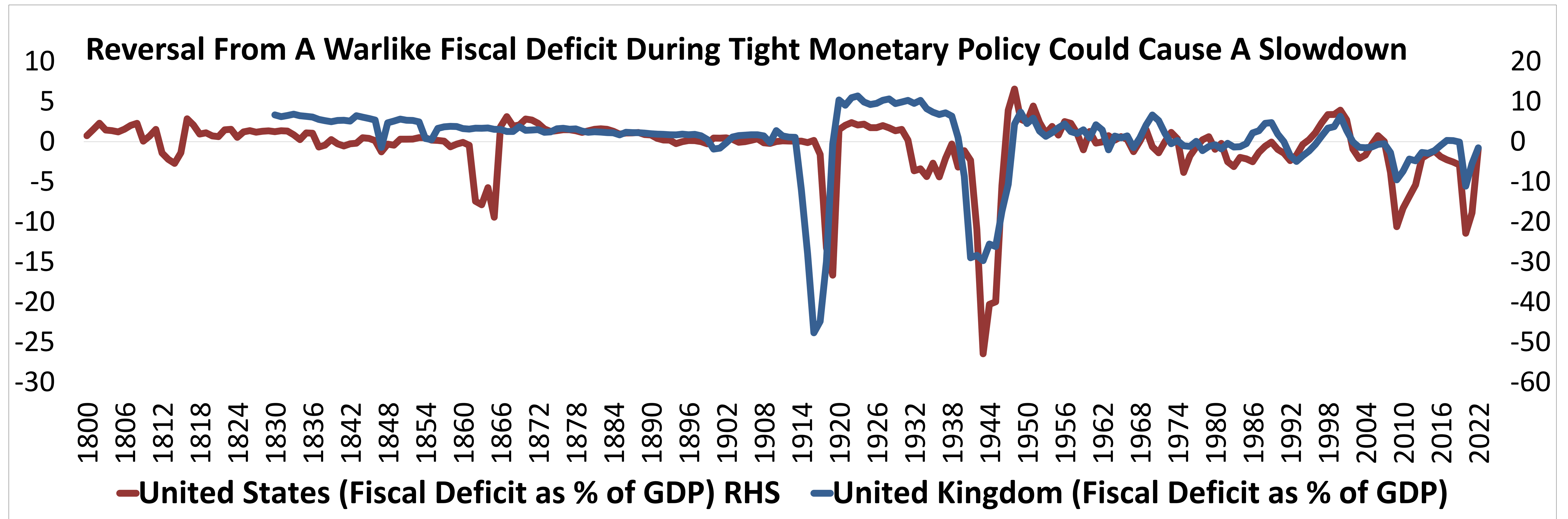
A fiscal expansion last seen during world wars.

This has been the primary driver of easy money, low interest rates, the creation of meme assets, and stratospheric valuations for stocks.

Equity prices follow earnings over the long term. The double bazooka of monetary and fiscal stimulus drove business profits and also expanded valuations (an aberration in the short term).

The belief that this stimulus can continue indefinitely has many parallels in history. None of them ended kindly. The global debt binge lost its easy monetary policy companion of low interest rates last year, but the monetary base is yet to work-off and revert to mean. A policy decision, an unknown event or a credit event can derail this gravy train. A risk that is becoming harder to miss.





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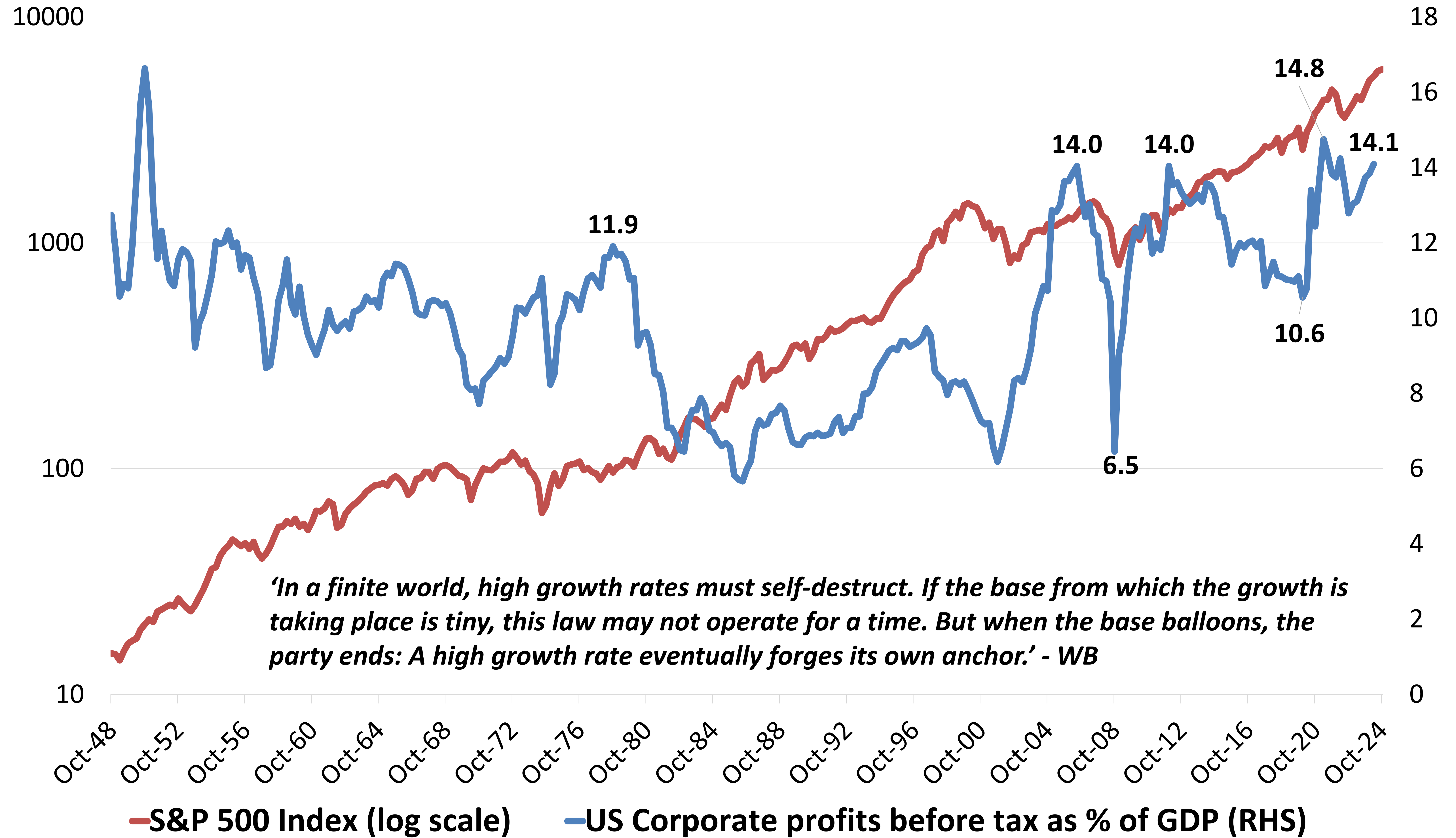
Source: FRED, BOE, DSP. Data as on 31 Oct 2024

Corporate Earnings Could Be Sacrificed To Fix The Fisc?

There are three drivers of US Corporate profitability:

1. A massive dose of monetary and fiscal stimulus drove quick rebound in the economy, resulting in high revenue growth. Corp tax cut added further tailwinds.
2. Corporate de-leveraging, cost controls and margin expansion drove big surge in bottom-line.
3. Surge in exports earnings of the Big Tech which now commands nearly 40% of the headline stock indices.

The three levers of earnings growth are in a mixed spot today. The monetary support has faded. Fiscal support, although at a peak, will come under scrutiny once the next US administration checks into office. Big tech continues to report strong numbers but is now facing the challenges of a high base effect; the base is no longer small, and growth rates are slowing. It's high and the rate change is slowing. Hence, corporate profitability in US is likely to slow.



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Source: FRED, DSP. Data as of Oct 2024

Section 2

India’s BOP Blindspot, Drivers of Growth, Indian Equity Outperformance Driver

BOP Blindspot: Foreign Flows Are A Bigger Driver of Macro Stability Than Equity Markets

Imported crude oil has long been India's problem child. Whenever crude oil prices rise past $100, India begins to look vulnerable due to a ballooning merchandise trade deficit. Over the last decade, a stellar rise in net flows from services and remittances has made India's "oil problem" more manageable. As seen, even with a $100 per barrel crude oil price, services and remittances are able to cover India's merchandise deficit.

This, however, does not eliminate India's vulnerability in the Balance of Payments. In years when India faces an oil shock, foreign inflows come to its aid. Whether it was the $34 billion FCNR deposit scheme in September 2013 or large loan raises in FY13, FY18, and FY19, foreign capital has played a crucial role. In years when India's financial and capital accounts are unable to cover the current account deficit, a currency threat looms, which the RBI must manage.

In the event of a sharp increase in oil prices (causes unknown) combined with large-scale FII sell-offs, India's Balance of Payments could deteriorate rapidly. Therefore, **foreign flows, especially the more volatile FII equity flows, should be viewed as drivers of macroeconomic stability rather than mere drivers of stock prices.**

FDI & FII flows are critical for India's external situation and in shaping India's Macroeconomic Landscape

"It is not the balance of trade in the narrow sense of the world but the balance of payments which matters."

Balance of Payment Components* (USD, Billions)	FY24	FY23	FY15 to FY12 (Average)	FY15	FY14	FY13	FY12
Current Account	**-23**	**-67**	**-56**	**-27**	**-32**	**-88**	**-78**
Merchandise	**-242**	**-265**	**-170**	**-145**	**-148**	**-196**	**-190**
Oil Trade Deficit	**-95**	**-112**	**-96**	**-81**	**-102**	**-103**	**-99**
as a % of GDP	**-2.7%**	**-3.3%**	**-5.1%**	**-4.0%**	**-5.5%**	**-5.6%**	**-5.4%**
India Crude Oil Basket (avg price $/BBL)	**83**	**95**	**101**	**83**	**105**	**107**	**110**
Invisibles	**219**	**198**	**104**	**118**	**115**	**107**	**75**
Services	**163**	**143**	70	77	73	65	64
Remittance	**106**	**101**	65	66	65	64	63
Services + Remittance	**269**	**244**	**134**	**142**	**138**	**129**	**128**
Capital and Financial Account	**86**	**59**	**74**	**89**	**49**	**89**	**68**
Foreign Investment	**54**	**23**	**46**	**73**	**26**	**47**	**39**
Foreign Direct Investment	10	28	**24**	31	22	20	22
Foreign Institutional Investment	45	**-5**	**22**	41	5	27	17
Loans	2	**8**	**15**	3	8	31	19
Banking Capital Balance	41	**21**	**17**	12	25	17	16
Other Capital	-10	7	**0.3**	1	0	0	0
Current Account Balance (as % of GDP)	-0.7%	-2.0%	**-3.7%**	-1.4%	-1.8%	-5.7%	-5.7%

**** Select Component Only***

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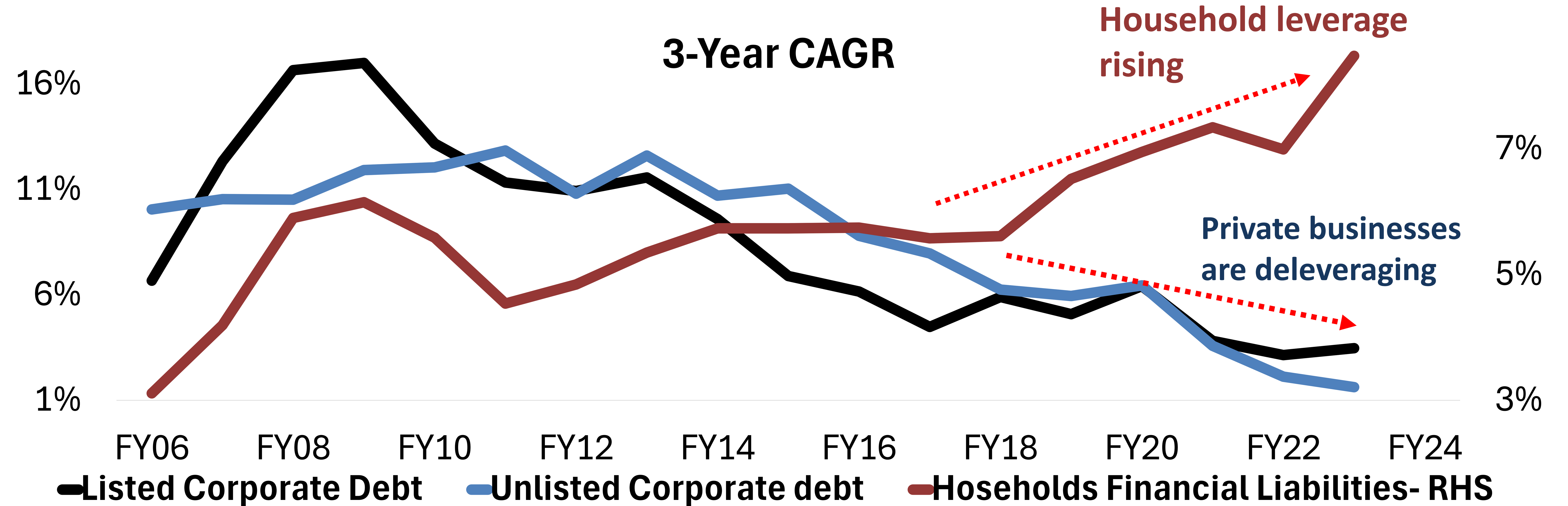
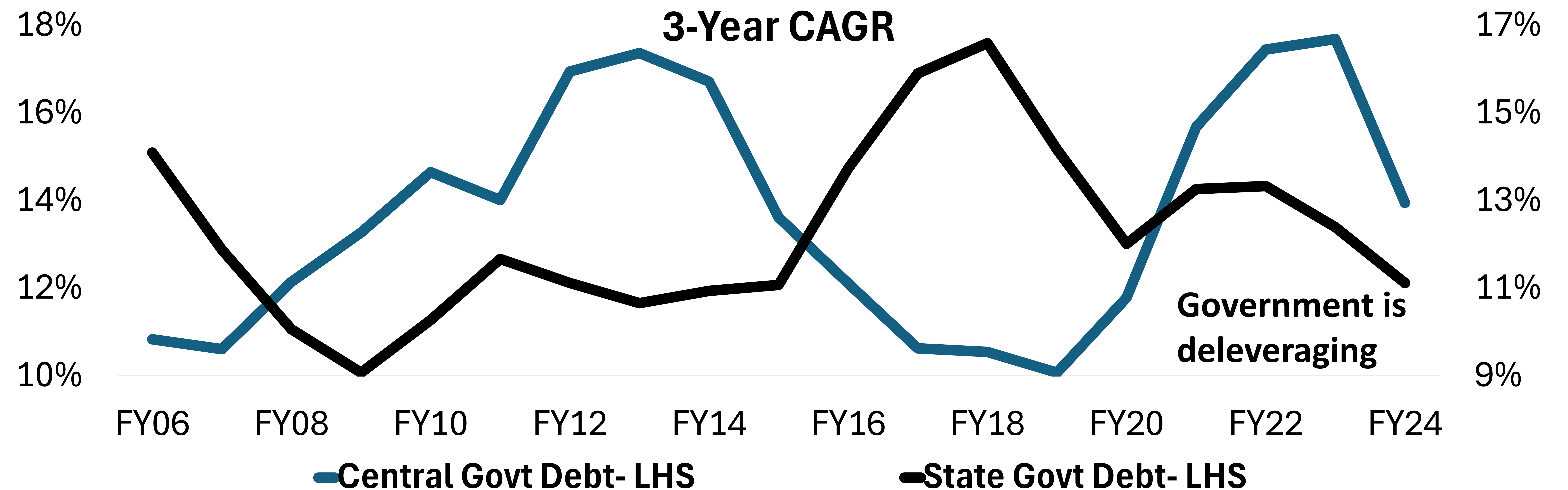
Source: DSP. Data as of Oct 2024

Public & Private Sector De-Leveraging: A Headwind For Growth

What happens when Public & Private businesses de-lever

1. Reduced Government Spending: When governments deleverage, spending cuts in public investment reduce overall demand and job creation.
2. Business Investment Cuts: Businesses prioritizing debt reduction over expansion limits capital expenditure, reducing productivity and slowing economic growth.
3. Limited Household Impact: Increased household borrowing boosts short-term consumption but lacks the long-term economic impact of business and government investment.
4. Higher Debt Servicing for Households: Rising household debt shifts spending toward repayments, limiting broader economic support in the absence of government or business investment.
5. Lower Confidence and Growth Expectations: Simultaneous deleveraging by governments and businesses signals risk aversion, dampening confidence and discouraging spending and growth.





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Source: DSP. Data as of Oct 2024

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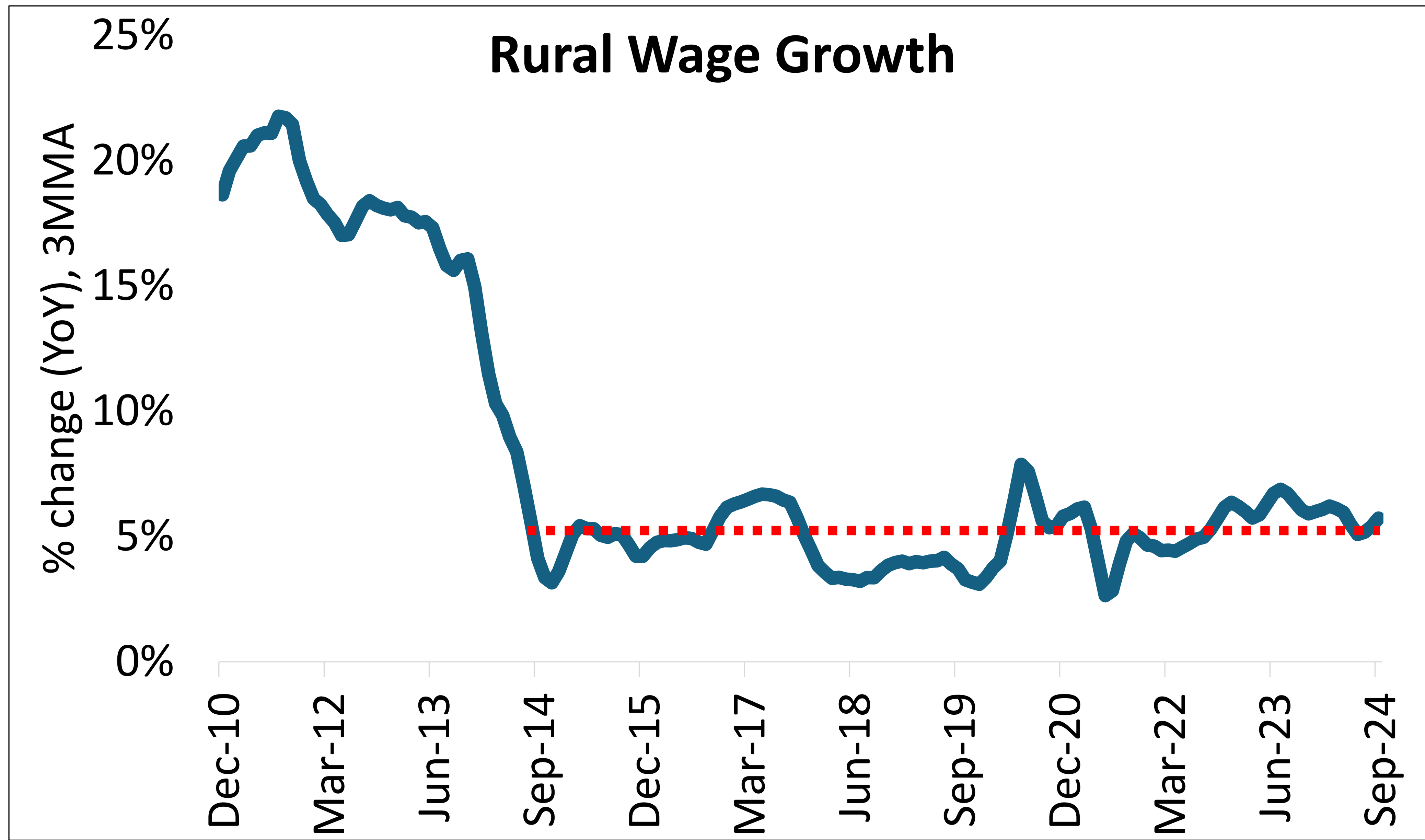

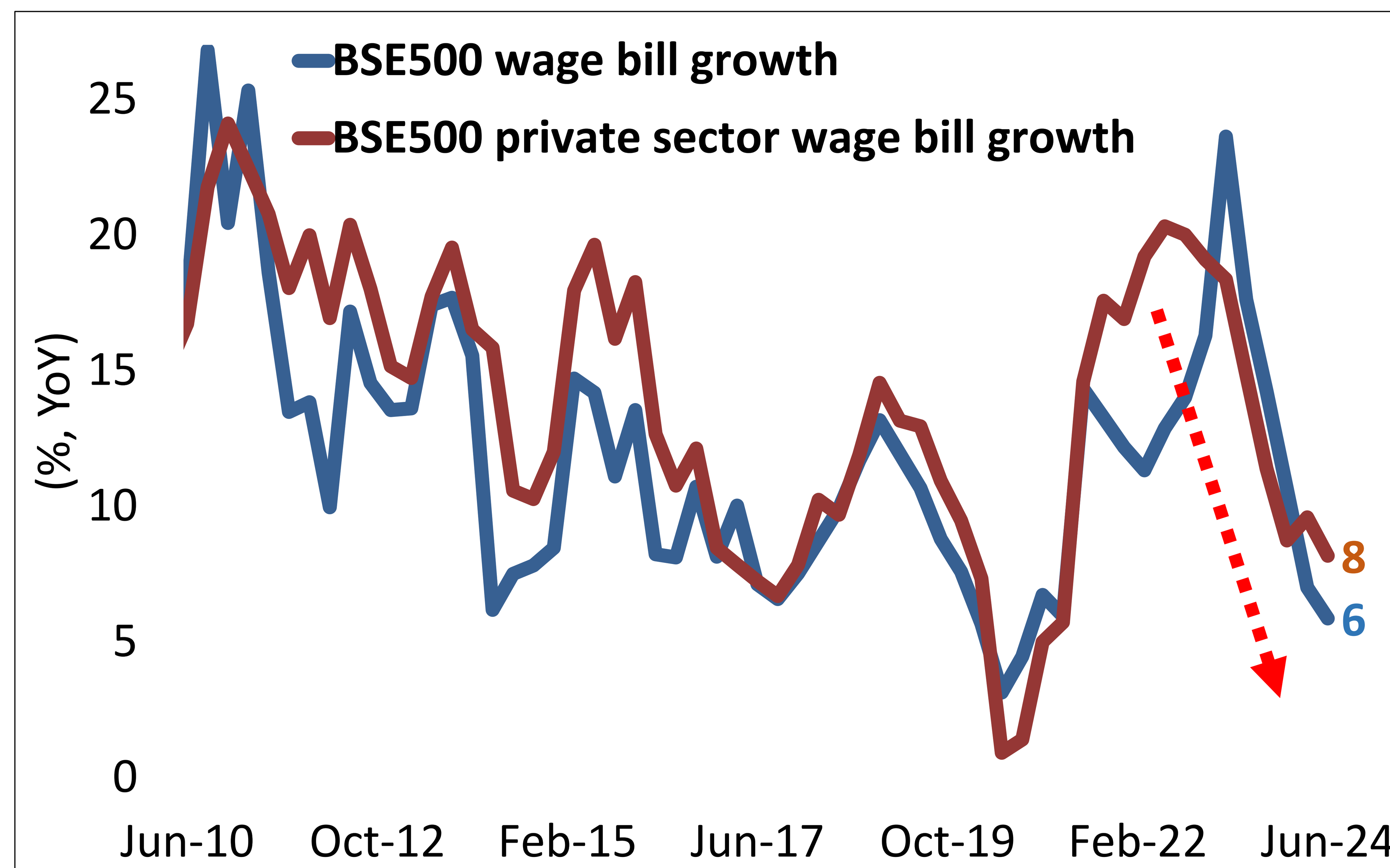

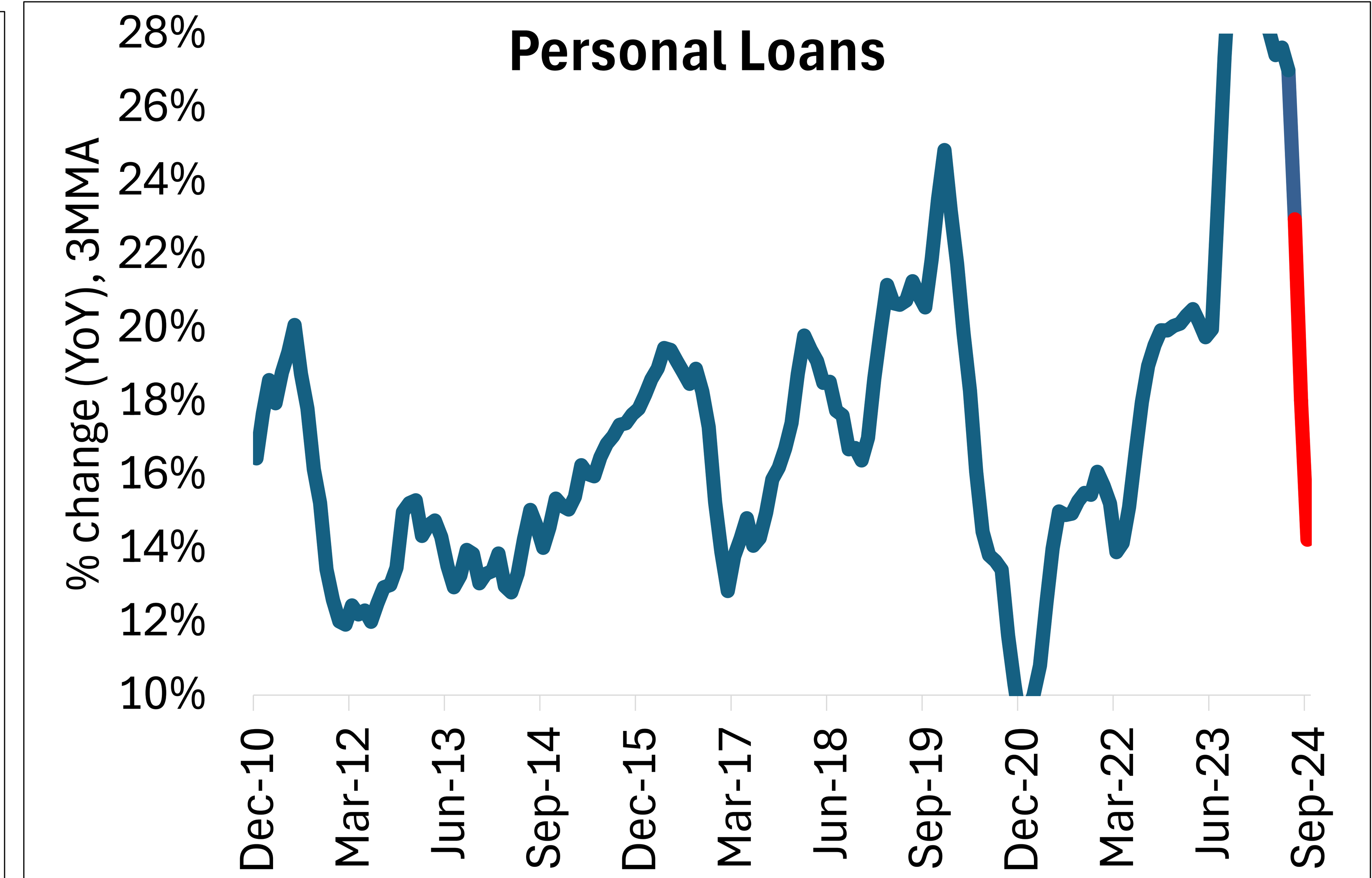

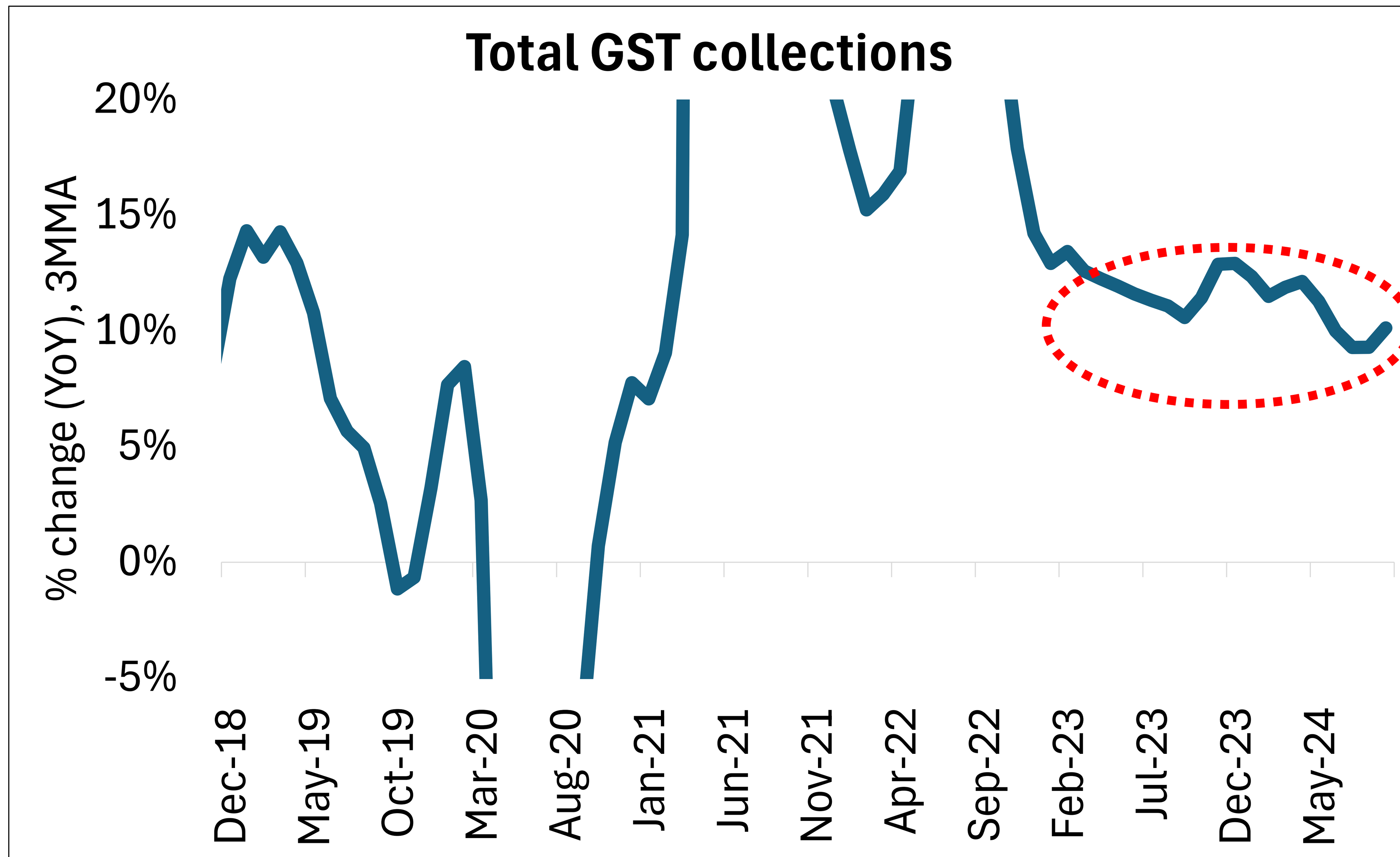

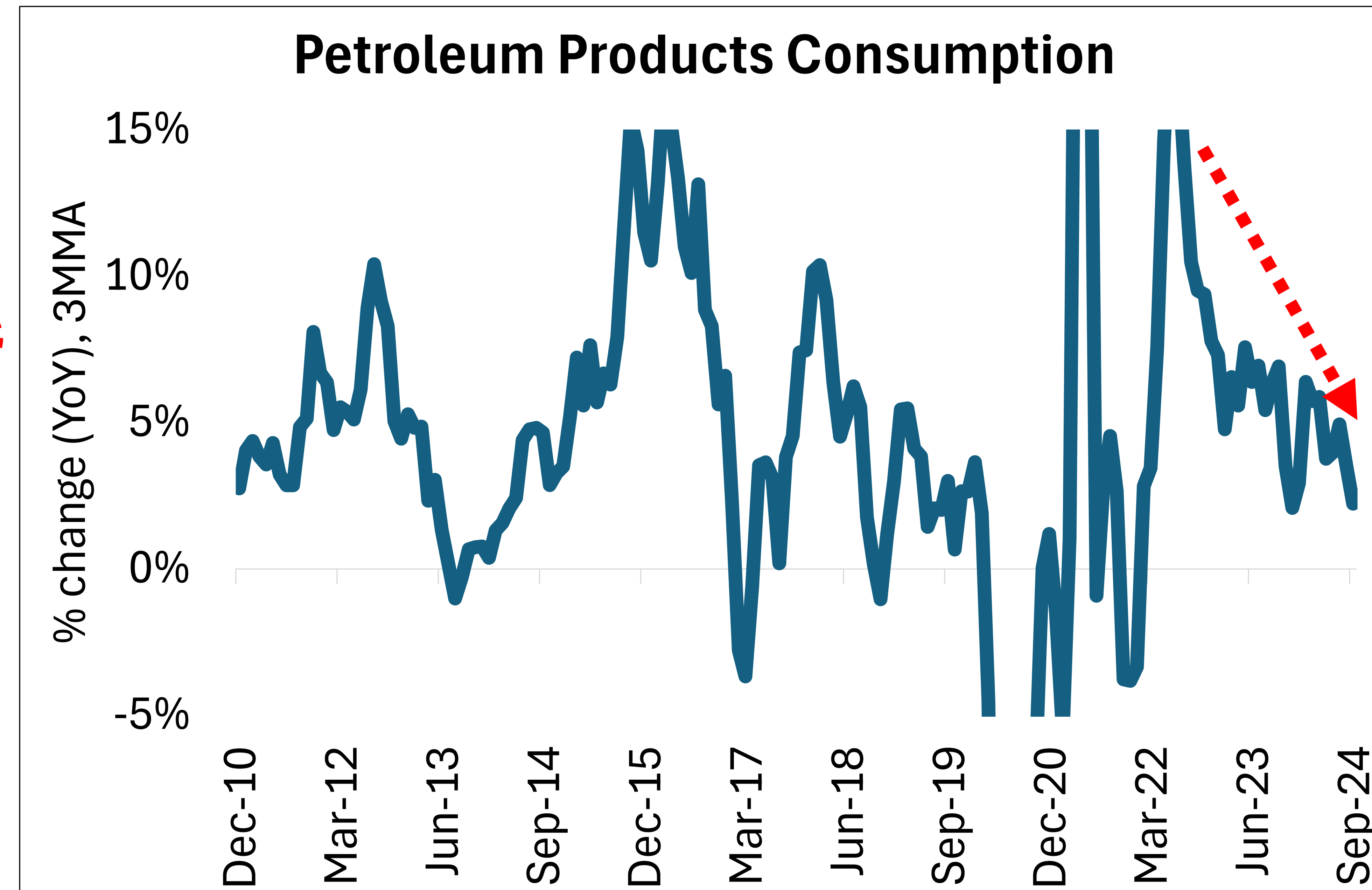

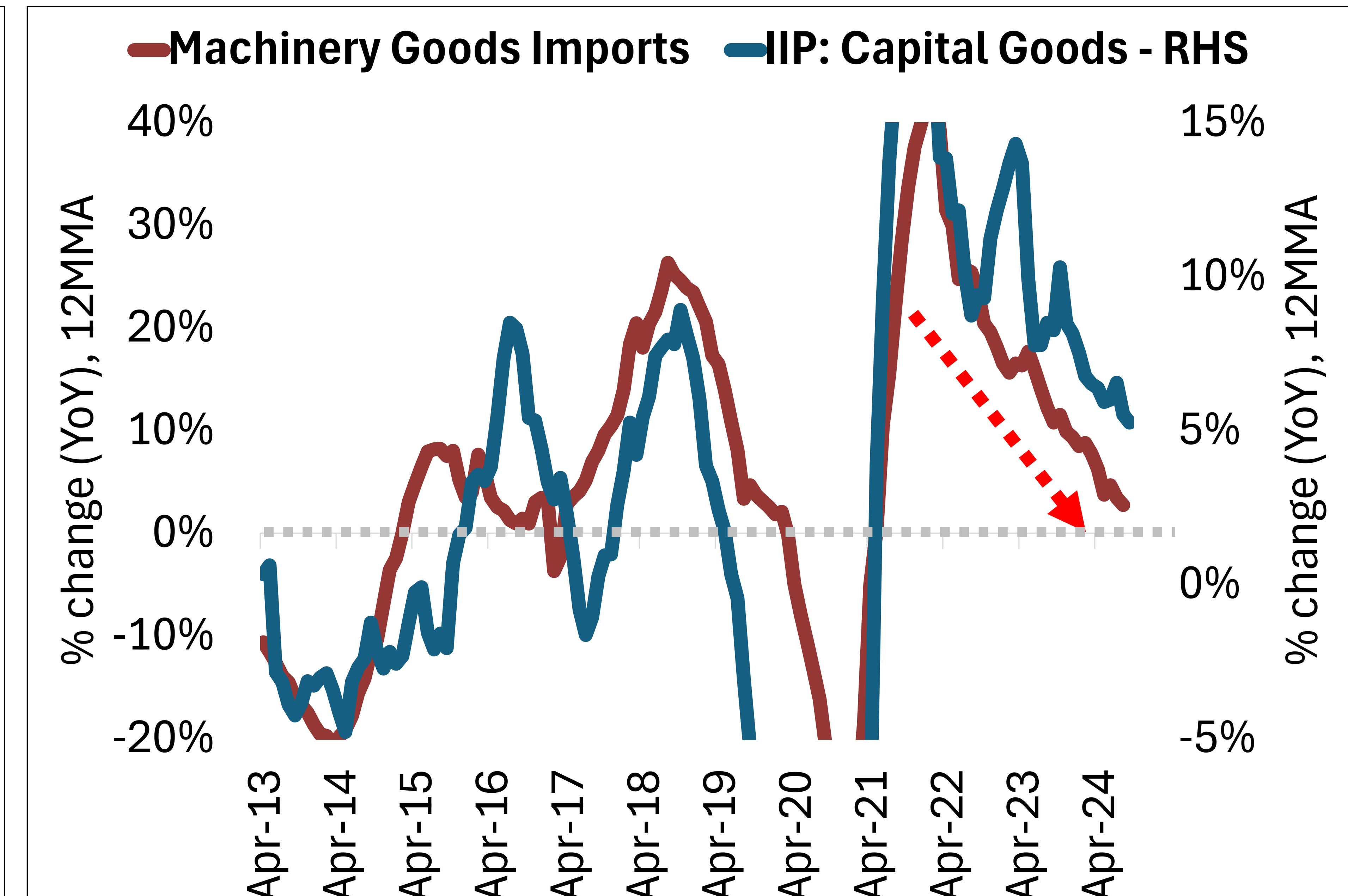

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Source: CMIE, Capitaline, DSP. Data as on 31 Oct 2024

Growth Momentum & Complexion Has Changed

5-Yr CAGR of Top 5 Segments by Weight										
FY14	**FY15**	**FY16**	**FY17**	**FY18**	**FY19**	**FY20**	**FY21**	**FY22**	**FY23**	**FY24**
Trade & Hotels **17.2%**	Trade & Hotels **17.0%**	Real Estate & Prof Services **15.7%**	Real Estate & Prof Services **15.5%**	Real Estate & Prof Services **13.0%**	Trade & Hotels **12.5%**	Trade & Hotels **12.0%**	Pub Admin & Defence **10.5%**	Construction **11.2%**	Construction **12.7%**	Construction **12.0%**
Real Estate & Prof Services **16.4%**	Real Estate & Prof Services **16.7%**	Trade & Hotels **14.1%**	Trade & Hotels **12.7%**	Trade & Hotels **12.3%**	Real Estate & Prof Services **12.0%**	Real Estate & Prof Services **10.9%**	Agricultural Crops **9.2%**	Real Estate & Prof Services **9.9%**	Real Estate & Prof Services **12.3%**	Agricultural Crops **11.2%**
Agricultural Crops **15.2%**	Transport & Communication **13.9%**	Transport & Communication **13.9%**	Transport & Communication **11.9%**	Transport & Communication **10.4%**	Transport & Communication **9.1%**	Transport & Communication **7.9%**	Real Estate & Prof Services **9.1%**	Agricultural Crops **8.9%**	Transport & Communication 9.3%	Transport & Communication **9.9%**
Transport & Communication **13.4%**	Agricultural Crops **12.9%**	Construction **9.4%**	Agricultural Crops **8.6%**	Agricultural Crops **8.4%**	Construction **8.0%**	Agricultural Crops **7.8%**	Construction **6.5%**	Transport & Communication **8.0%**	Agricultural Crops **8.7%**	Real Estate & Prof Services **9.9%**
Construction **12.9%**	Construction **12.0%**	Agricultural Crops **8.6%**	Construction **6.8%**	Construction **7.2%**	Agricultural Crops **6.1%**	Construction **7.1%**	Trade & Hotels **5.2%**	Trade & Hotels **7.5%**	Trade & Hotels **8.7%**	Trade & Hotels **7.7%**

← **High to Mid Teen Growth**

Low Teen to Single Digit Growth →

Services

Agriculture

Industry

DSP

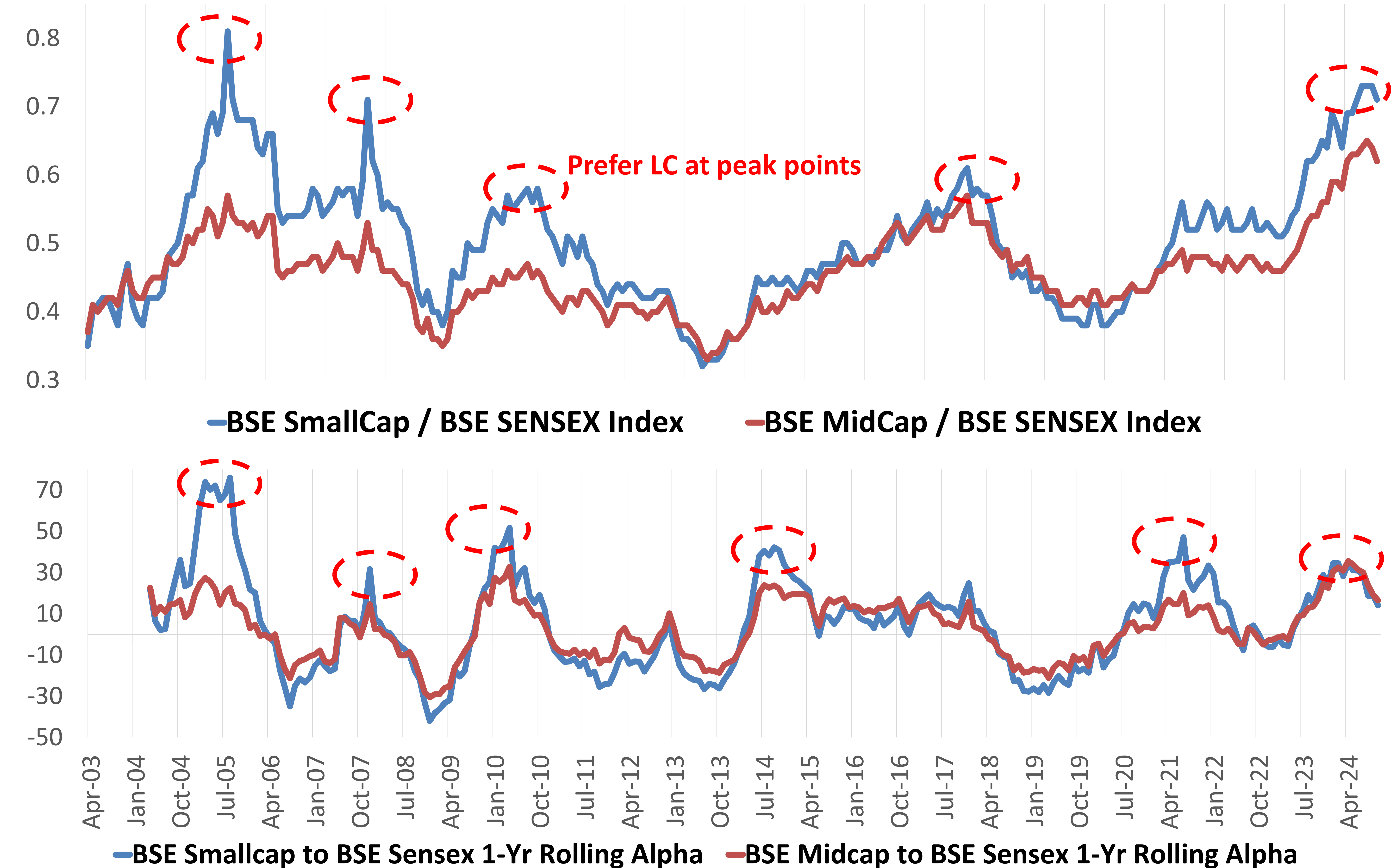
Source: CMIE, DSP. Data as on 31 Oct 2024

Momentum: The Driver of SMID Rally Has Reversed. Advantage Large Caps

The momentum that previously favored Small & Midcap stocks has now shifted, with large-cap stocks beginning to outperform them. Is this the right time to focus on large caps?

Historically, during such transitions, it's often recommended to channel incremental investments into Small & Midcaps primarily through SIPs. Following COVID-19, mid and small-cap indices have outpaced large-cap indices, as demonstrated by the rise in Midcap/Sensex and Smallcap/Sensex price ratios. Currently, the Midcap Index is trading at its highest relative level to Sensex, while the Smallcap Index is near its peak since 2005. This indicates that the Small and Midcap space has performed better than large caps and is at one of its most expensive levels in relative terms.

The 12-month rate of change now shows early signs of reversion, hinting at a potential mean reversion period, which may make larger-cap indices an attractive option. Large caps also appear relatively favorably valued now, though overall market valuations remain above average or expensive.



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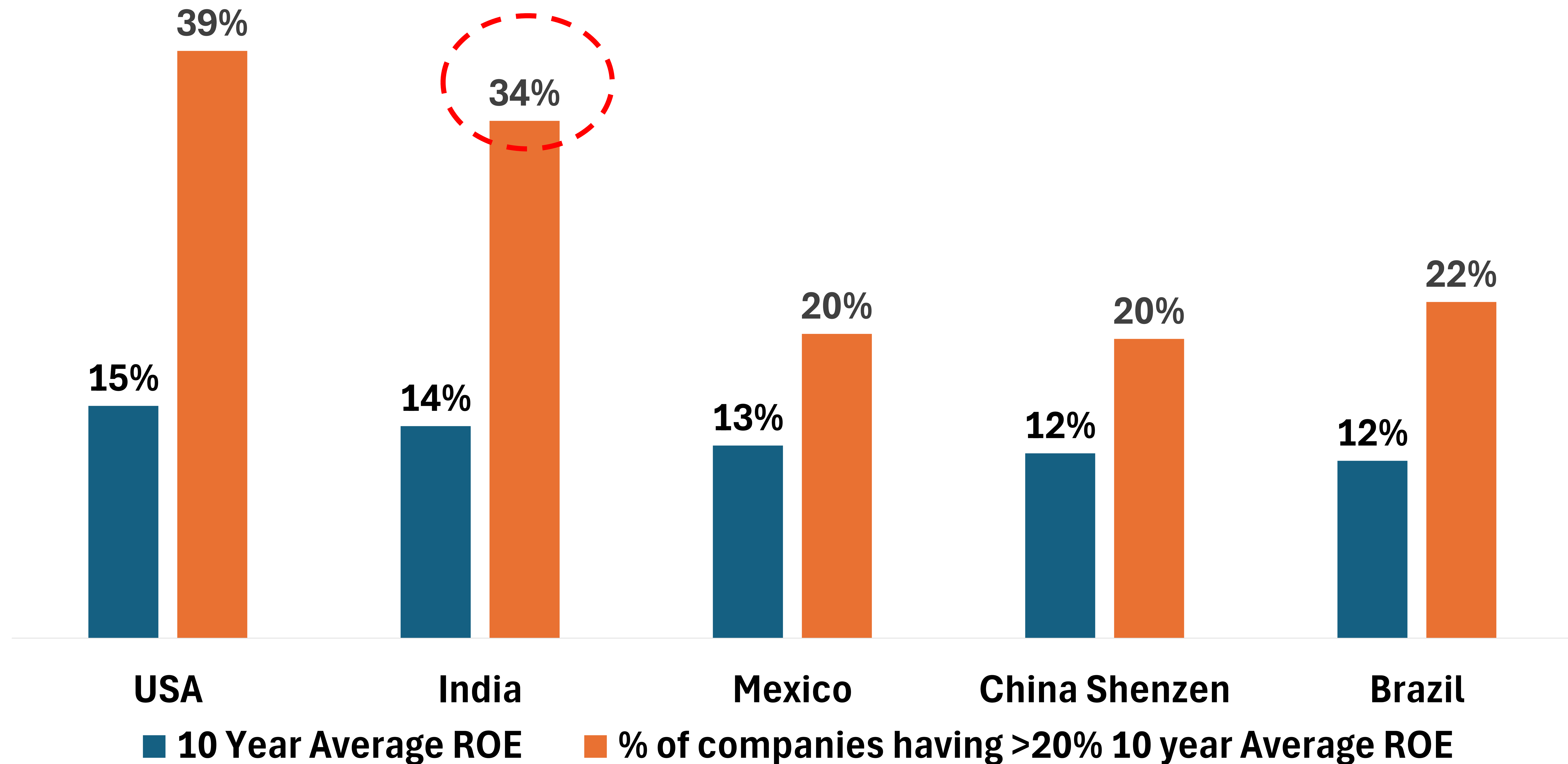
Source: DSP. Data as of Oct 2024

Why India Outperforms Over The Long Term? It's Not Flows, GDP Growth or The Story…

India's long-term outperformance is often attributed to narratives like domestic flows or high GDP growth, but these are merely surface-level explanations.

The fundamental question is why stock investors should expect higher returns than those offered by bonds. The extra return that stocks can provide stems from the ability of management to generate returns exceeding their cost of capital. Therefore, the primary driver of stock prices over the long term is the returns that shareholders earn on their capital. Companies with superior return on equity (ROE) are more likely to deliver higher returns compared to their peers.

India ranks second only to the U.S. in the number of firms consistently achieving an ROE of over 20% for more than a decade. This strong performance in ROE is the true engine behind India's superior stock market results, suggesting that the underlying fundamentals are what truly matter, rather than the popular narratives surrounding market performance.



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Source: Bloomberg, DSP. Data as of Oct 2024. Large cap indices are considered for all countries. USA – S&P 500, India – Nifty 50, Mexico - S&P/BMV IPC (MEXBOL) Index, China Shenzen – CSI300, Brazil – IBOV Index.

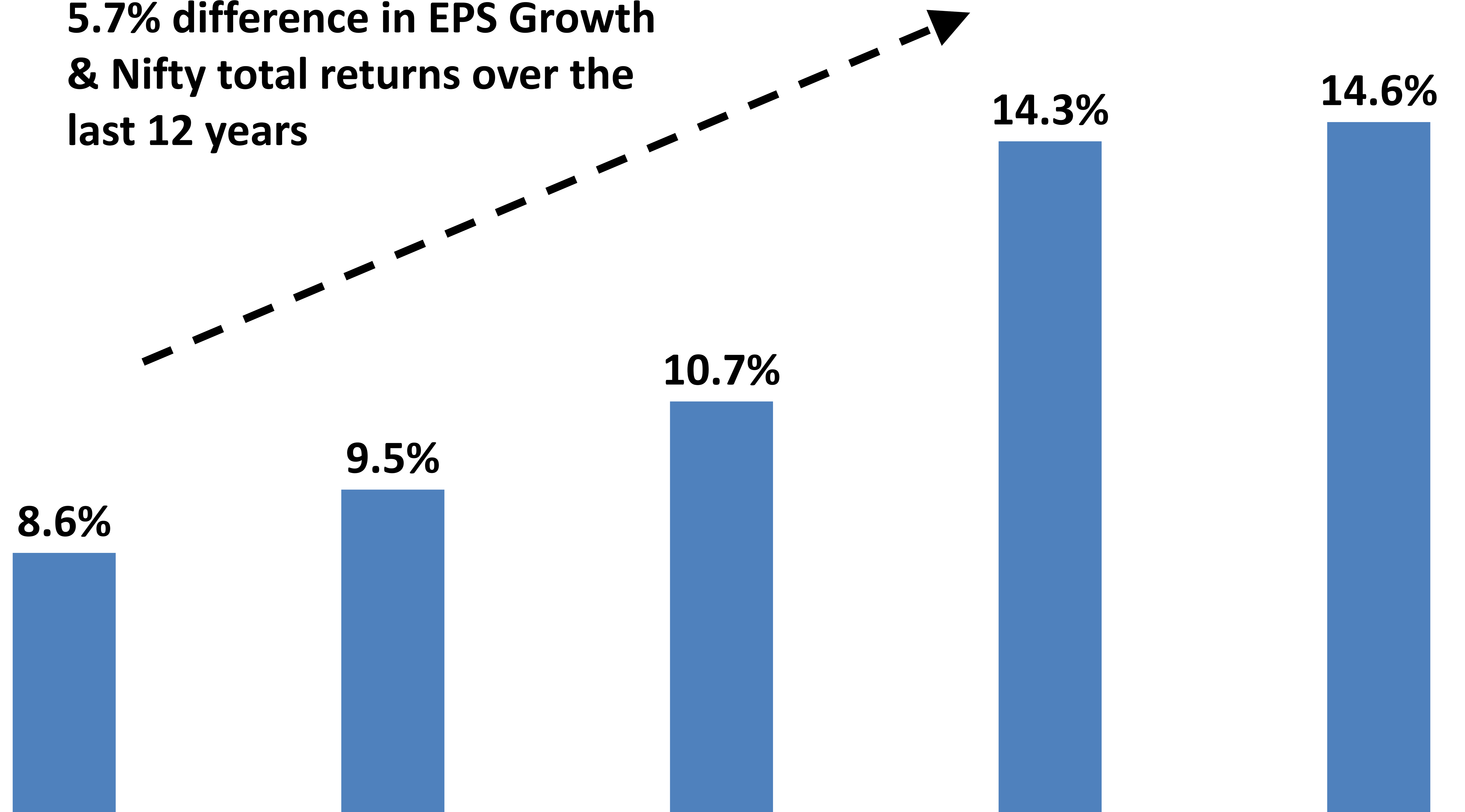
The Large Expansion In India’s Multiples, In Numbers

In the last 12 years, the PE multiple for the Nifty Index has increased by approximately 680 basis points, rising from 17x to 23.8x.Historically, corporate profit growth tends to lag nominal GDP growth. If profits consistently outpaced nominal GDP, (possible only in an economy dominated solely by exporters), then corporate profits will eventually exceed the GDP. That’s unlikely. However, even accounting for exporters, Indian corporate profits do not grow at the same rate as the country's nominal GDP, especially given the slower global growth.

Over time, stock market returns can trail profit growth due to a lack of high-quality business managers, as many firms experience mediocre or poor management that detracts from their growth potential. As a result, investor returns often lag stock performance due to transaction costs and the skills required to generate alpha, as the market largely behaves as a passive, no-alpha aggregation. This means, **if nominal GDP grows at 10%, overtime, corporate profits will lag nominal GDP, stock price total returns will lag corporate profits and investors returns will lag stock price total returns.**

Current returns, as indicated by the Nifty Total Return Index (TRI), reflect a significant increase in price multiples, posing a key risk for investors. This raises the question: why overpay?

‘We’ve long felt that the only value of stock forecasters is to make fortune tellers look good. Even now, Charlie and I continue to believe that short-term market forecasts are poison and should be kept locked up in a safe place, away from children and also from grown-ups who behave in the market like children. However, it is clear that stocks cannot forever overperform their underlying businesses, as they have so dramatically done for some time, and that fact makes us quite confident of our forecast that the rewards from investing in stocks over the next decade will be significantly smaller than they were in the last.’ - WB



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Source: Bloomberg, CMIE, DSP. Data as on 31 Oct 2024

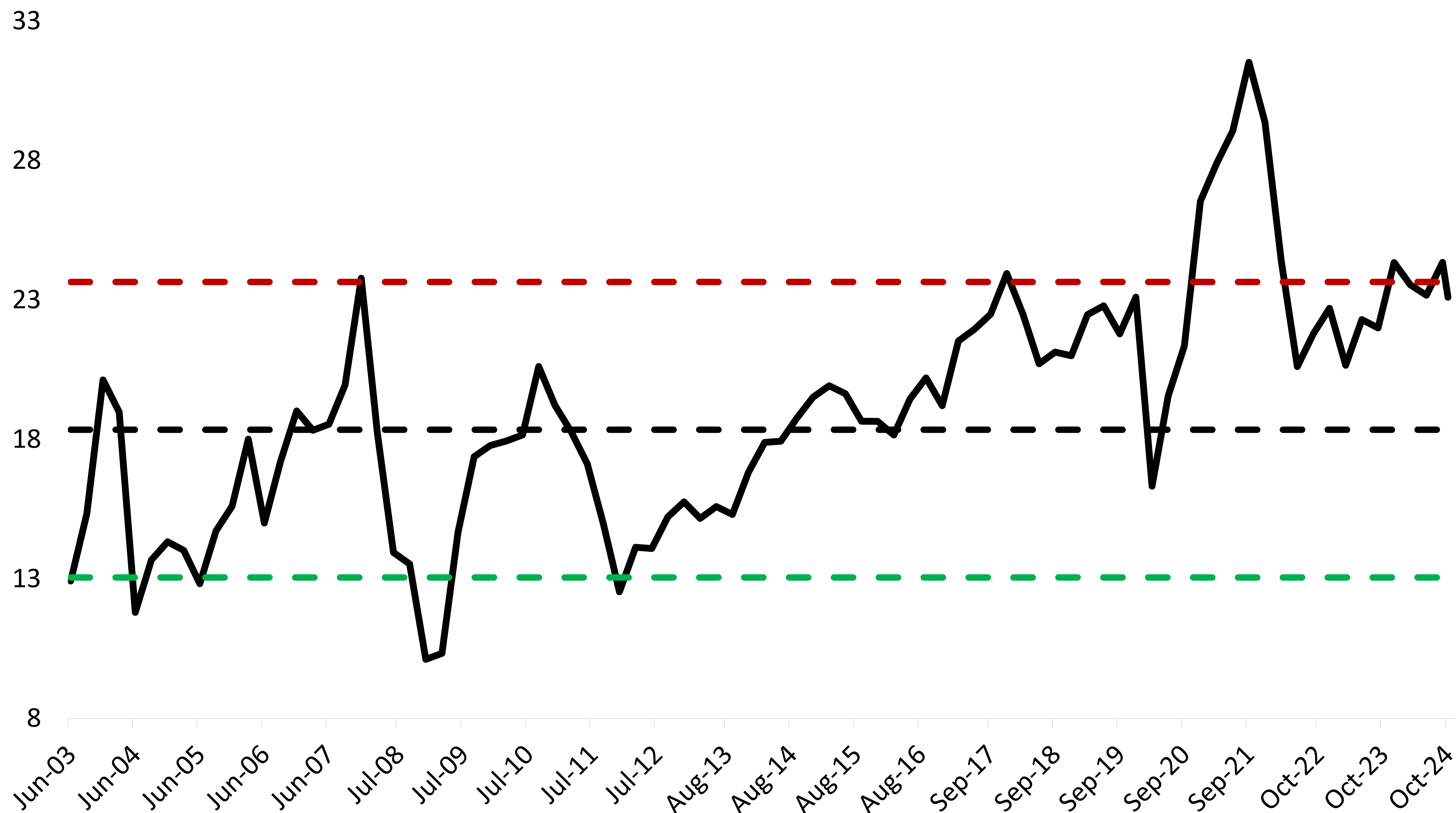
High Valuation Could Continue To Act As A Headwind

Price-to-Peak Earnings (PPE) is a valuation metric that compares a company's current stock price to its highest recorded earnings per share (EPS) over the previous economic cycle. This ratio is used to assess how the current price relates to the company's best historical performance, offering a less volatile measure than traditional price-to-earnings (P/E) ratios. PPE helps reduce the impact of cyclical downturns or temporary earnings fluctuations.

At present, Indian stocks, as measured by the Nifty Index, are trading at 1.5x Std. Dev. of its long-term historical average. Incidentally, this level is also similar to the levels at which the markets peaked in prior bull markets. The expansion in PPE post COVID is now normalizing. Two outcomes are possible:

1. Time correction: Markets consolidate while earnings keep rising, thereby valuations normalize
2. Price correction: Markets correct sharply, as earnings growth slows and hence valuations normalize.

There is no way to know which path the markets take. Wait and watch.



Source: Bloomberg, DSP. Data as of Oct 2024

** 1.5 standard deviation calculated by excluding COVID (FY21,FY22) data spikes in PE ratios*

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SMID Median Valuations Are Double Versus The 2007 Peak

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Source: Nuvama Research, DSP; Data as of Oct 2024

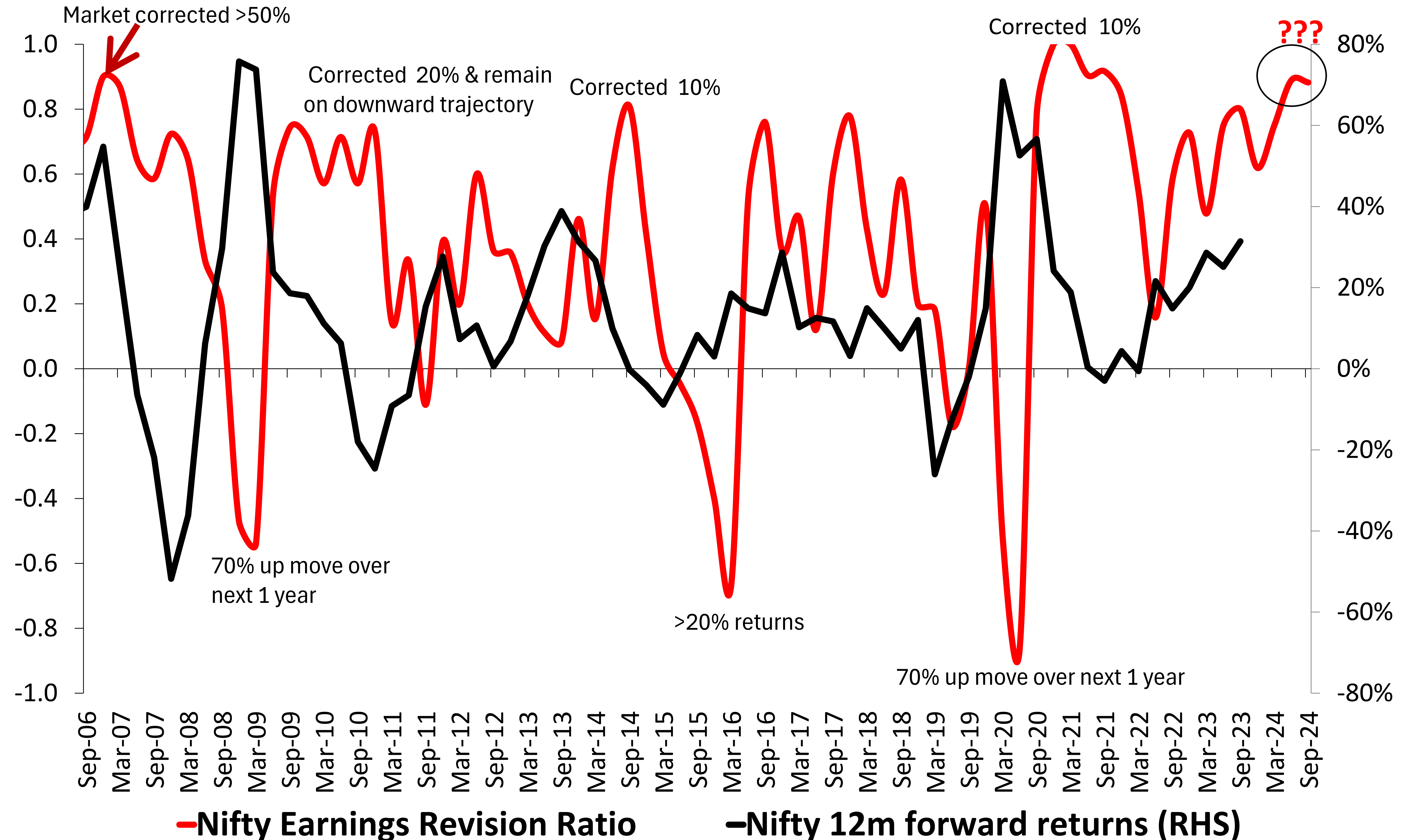
Earnings Expectations Present A High Hurdle For Stock Prices To Cross

Earnings Revision Ratio is calculated as (No. of Upgrades – No. of Downgrades)/ (No. of Upgrades + No. of Downgrades). A higher ratio indicates an increase in earnings upgrades, while a lower ratio reflects more downgrades.

Nifty earnings revision ratio indicates the expectation of analysts for future earnings. A high ratio means analyst are upgrading their forecast for faster earnings growth. Over time, if analysts keep upgrading their estimates, expectations can reach a point where they detach from reality and reported earnings may fail to beat such expectations. These periods represent peak of high expectations extrapolated into the future and often coincides with stock price peaks.

Stocks which are priced to perfection or are overpriced have a burden of performing better than estimates or risk the vagaries of the short-term nature of the market. The investors sentiment for such stocks turn very quickly and magnifies the moves. Currently the ratio is close to the highest readings seen historically, at more than 90th percentile. Caution is advised.

Rising red line (Nifty earnings revision ratio) indicates analysts upgrading their earnings estimates. At ratio peaks, earnings growth expectations are the highest and stocks have a higher hurdle to cross.



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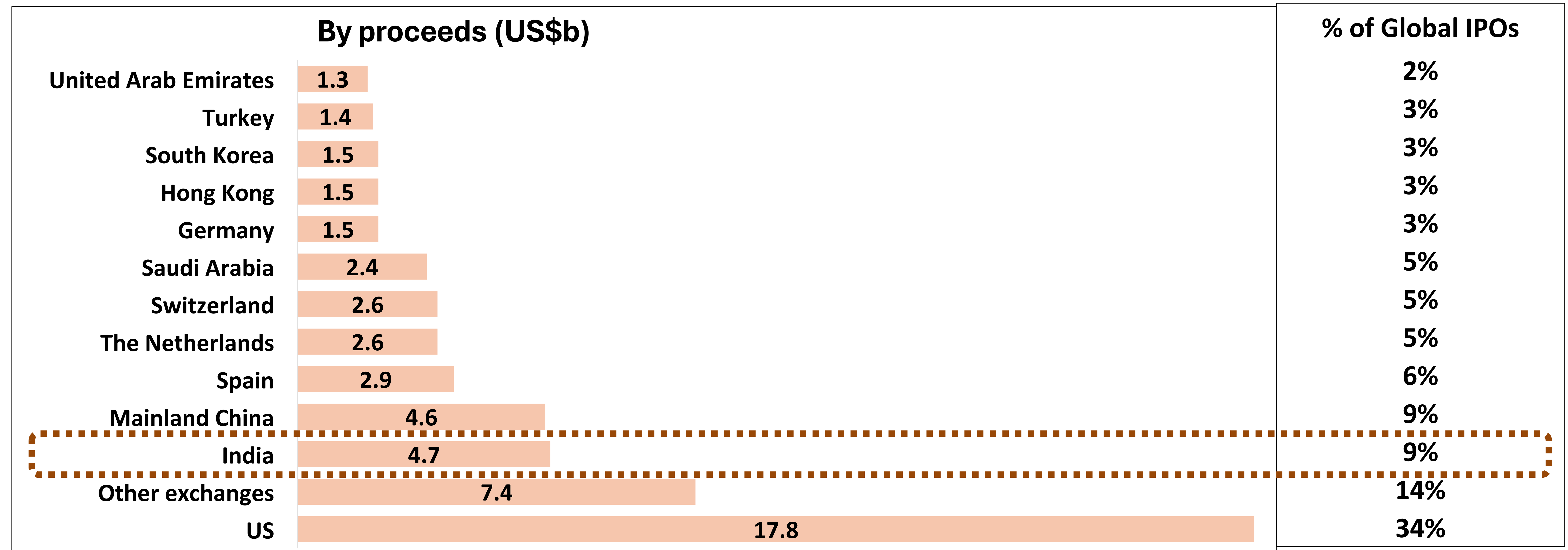
Source: Ambit Capital Research, DSP. Data as of Oct 2024

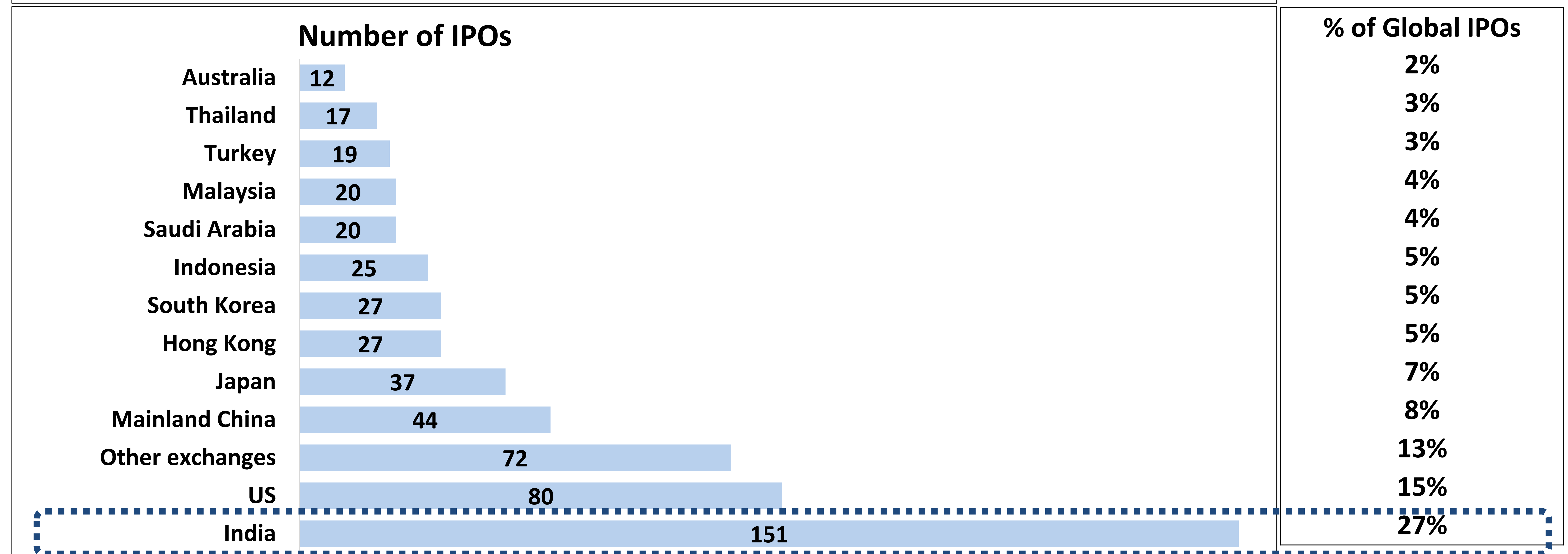
Primary Market Issuance in India: 'Good Times Are Rolling', Beware

India's primary market is now the largest globally by volume and the second largest by value, making new listings particularly noteworthy.

However, exercising caution is essential when analyzing IPOs. They are often overhyped and overpriced, with sellers looking to capitalize on investor enthusiasm, which can pose challenges for long-term investors. Buyers should be cautious about entering the market when insiders are selling and should focus on patience, opting to invest in established companies with proven business models at fair prices instead. IPOs typically lack the historical performance necessary for assessing long-term profitability, so the best investment opportunities often lie in mature companies rather than new offerings.

Moreover, many participants in the IPO market today are mere flippers, speculating on selling to someone willing to pay a higher price. This casino-like environment diminishes the chances of securing a bargain and highlights the risks associated with an ultra-easy money climate, creating fertile ground for investors to make costly mistakes.





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Source: RBI, DSP. Data as on 31 Oct 2024

Learn From Mistakes, Of Others Too…

Lessons from “Mistakes of the First Twenty-five Years” – Berkshire Hathaway, Letters to Shareholders, 1989

1. Avoid "cigar butt" investing; it's better to buy great companies at fair prices than mediocre ones at bargain prices.
2. Good managers can’t overcome bad economics; strong business fundamentals are essential.
3. Focus on simple and manageable investments; avoid complex, high-risk challenges.
4. Be cautious of the “institutional imperative” that pressures businesses to act irrationally and mimic competitors.
5. Partner only with trustworthy, admirable people, as great relationships enhance success.
6. Missing an opportunity is acceptable outside one’s expertise, but failing to act within one's area of knowledge can be costly.
7. Use conservative financial policies; a small risk of distress isn’t worth extra returns.

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