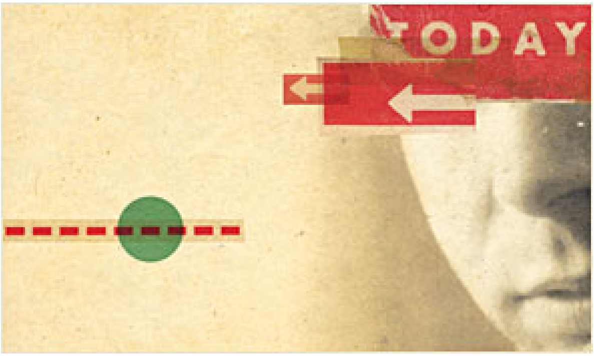
Impact Consultancy Private Limited



That Uneasy Zone

The Big Picture

08th July 2014

Overview

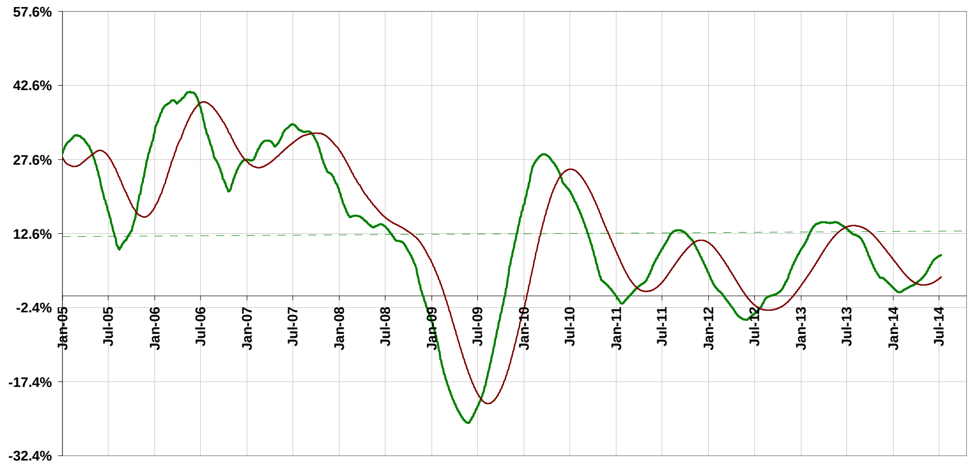
On the back of a decisive election result and the current expectation that a new multi-year bull market has begun, the Indian equity markets remained buoyant. The Nifty-50 index has risen 8% since election result day and 30% over the last one year . Corporate results season for the first quarter of FY 2014-15 will start and it will have to be seen if earnings growth will be able to keep up with the frenetic price rise. In the interim, valuations have risen to the upper end of the band and Risk levels in the market have hit a three year high.

3-Year CAGR for Nifty-500 Index

Corporate Earnings

Due to the economic stagnation of several years, corporate earnings growth has largely been tepid and has averaged 7-8% pa in the last three years. Although in our assessment earnings growth will go above the 25% level eventually, according to our current estimates, earnings growth in the first quarter of 2014-15 will be marginally higher at 9-12% (y-o-y). Going forward, a delayed and deficient monsoon, which appears very likely at the moment, may dampen earnings in the coming quarters.

Annual Earnings Growth for Nifty-500 Index



Valuations & Risk

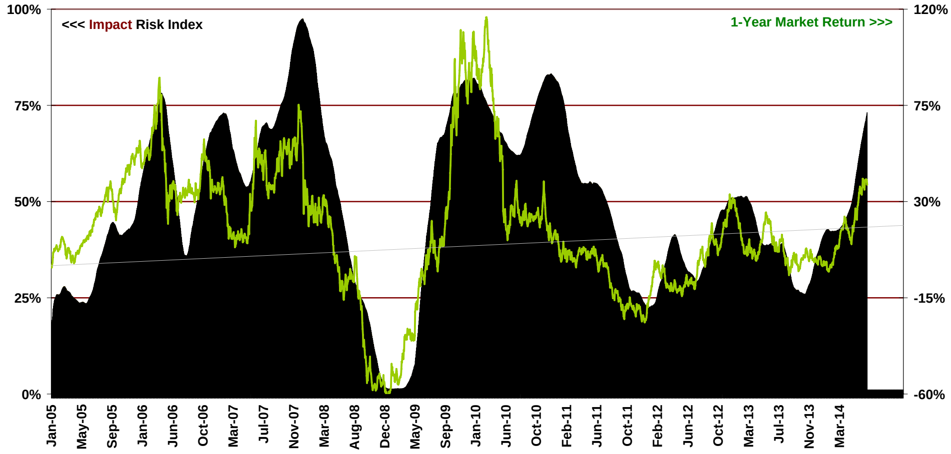
Due to the sharp increase in prices, valuations have hit the upper end the band and are at a three year high. Although and especially during bull markets prices tend to move well ahead of earnings, there still appears to be a fair amount of froth in the price. If earnings growth is only marginally better (as we expect) and therefore below general expectations, that could well be a trigger for a correction. If the poor monsoon affects earnings, that would put further downward pressure on the markets. In bull markets, it is not unusual to see corrections of 15-20%.

Price/Earnings Ratio for Nifty-500 Index

At Impact we place a lot of emphasis on the measurement of **Risk** in the market and base our investment decisions on **Risk-Weighted-Return** rather than just pure return. This measurement of risk is not only based on fundamental metrics but also technical metrics including volatility and liquidity. Tracking risk has also been useful as it has been a precursor to major market movements.

Currently the Impact-Risk-Index (IRI) is at a three year high and approaching the 75% level, which in the past has preceded major market corrections – 30% in 2006, 12% in 2007, 57% in 2008, 10% in 2010 and 26% in 2011.

Impact Risk Index & 1-Year Market Return for Nifty-500 Index



Outlook

Although we are still in a multi-year bull market, the likelihood of an impending correction has increased significantly. This will not change the trajectory of the bull market, but market indices may hit the lower end of the price band. Going forward, earnings growth will be the key driver and the optimism on the economy will have to translate into hard numbers. The impact of poor monsoons has not been factored in and that could be a dampener. We are still bullish in our long-term outlook and remain cautious in the short-term.

Happy Investing.

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