Impact Consultancy Private Limited

Still going strong

The Big Picture

22nd September 2014

Overview

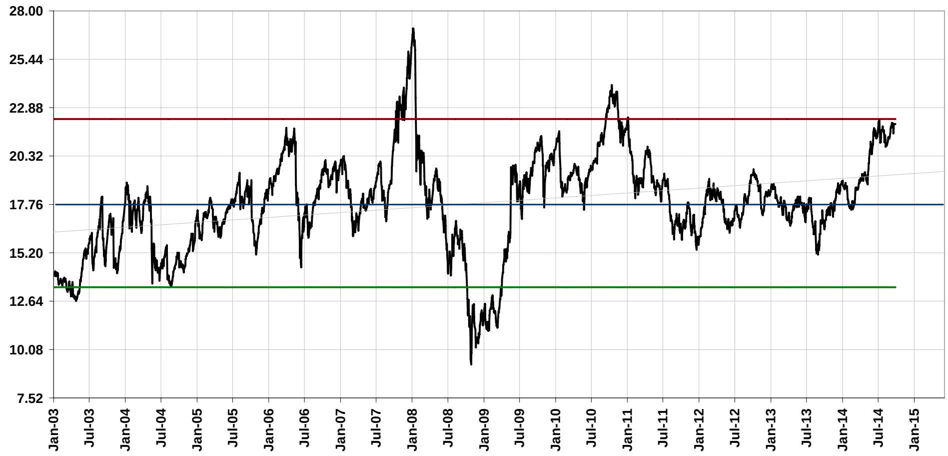
Indian equity markets continued to chug along this quarter registering a gain of around 6%, on the back of reasonably strong global markets. Global markets, and especially the US equity markets, shrugged off the Fed's QE tapering (which is likely to end by next month, as we correctly predicted in 2013) and the several geo-political risks such as ISIS, Ukraine, Libya and Gaza. The last meaningful correction (a decline of 10%) in the US S&P-500 happened over 2 ½ years ago in May-2012. Interestingly, commodities have actually fallen by 17% in that last one year and 8.4% in this quarter.

Nifty gains this quarter

Valuations & Risk

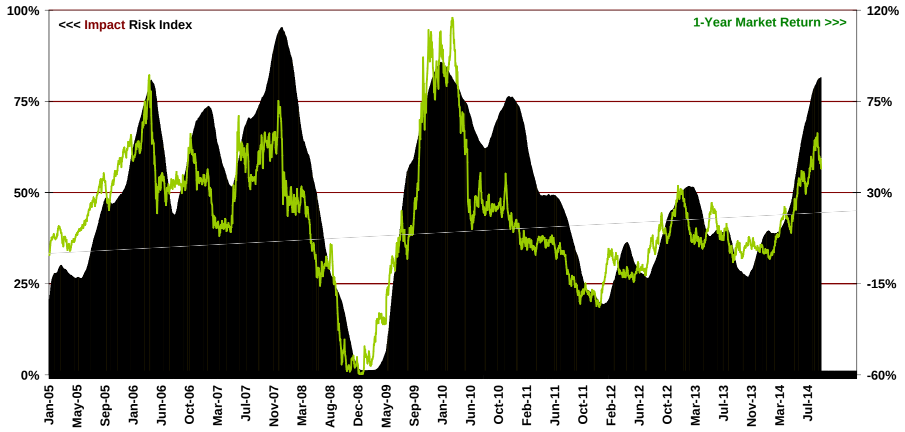
In the absence of any significant increase in corporate earnings in the last quarter, valuations remained at elevated levels and very close to the upper end of the valuation band. Price/ Earnings ratio could fall either due to a fall in prices or an increase in earnings. Although earnings growth (for Nifty-500) is 12.4% and which is better than 10.3% last quarter, it is still not sufficient to clear the froth in the valuations. The Price/Earnings ratio for Nifty-500 continues to be at a three year high – interestingly, the last time valuations were at this levels, the market corrected by 20% (November-2010 to February-2011).

Price/Earnings Ratio for Nifty-500 Index



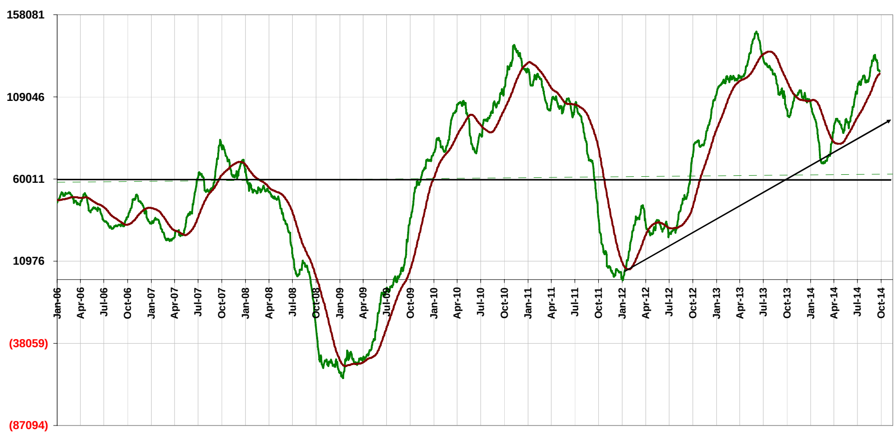
In the last Market Outlook, we had written about our risk measurement and how high risk levels tends to be a precursor to major market movements. The Impact-Risk-Index (IRI) continues to be at a three year high and well past the danger-mark of 75% - in the past, this has preceded major market corrections – 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



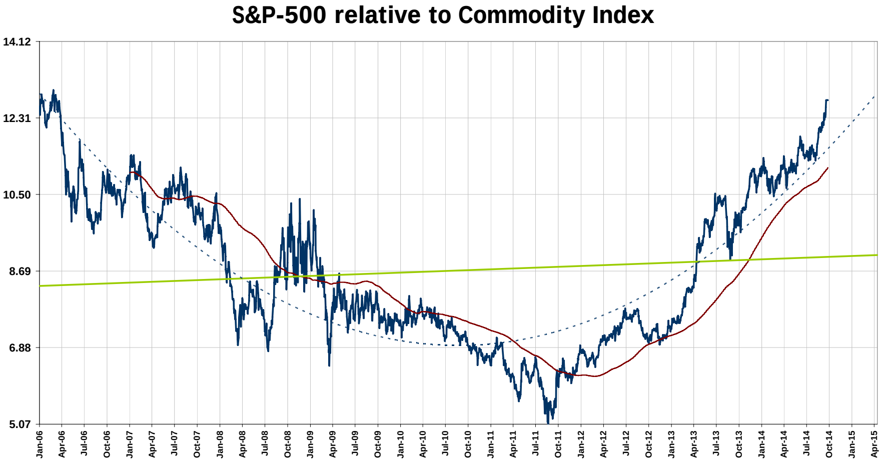
Even Foreign Institutional Investors (FIIs) who put in considerable sums in the equity markets for most part of 2014, seem to be slowing down on their investments. Although current annual investments are still over the long-term average of Rs 60,000 crores, there are signs that this number could be lower.

FII Annual Investments in India



Global Markets

The US S&P-500 has continued a remarkable and an almost straight-line growth rising 55% over the last 27 months and without any meaningful correction. In terms of valuation, the P/e ratio of 19.8X might not appear overvalued on a long-term basis, it is close to a 5-year high. Also from a technical point of view, it does appear to be at the end of a 5-year bull cycle. What is more disconcerting is the S&P-500 relative to commodities is close to a 9-year high. When looked in conjunction with the other economic data and the high likelihood of bond rates hardening through this year, it does appear that the real economy is stalling but the financial markets seem to be ignoring it. Coupled with the fact that QE, and the liquidity it brings, is almost wound down and notwithstanding an extended timeline for rate increases, the S&P 500 looks highly susceptible to a deep correction.



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. We are still bullish in our long-term outlook and remain cautious in the short-term.

Happy Investing.

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