Impact Consultancy Private Limited

Divergence

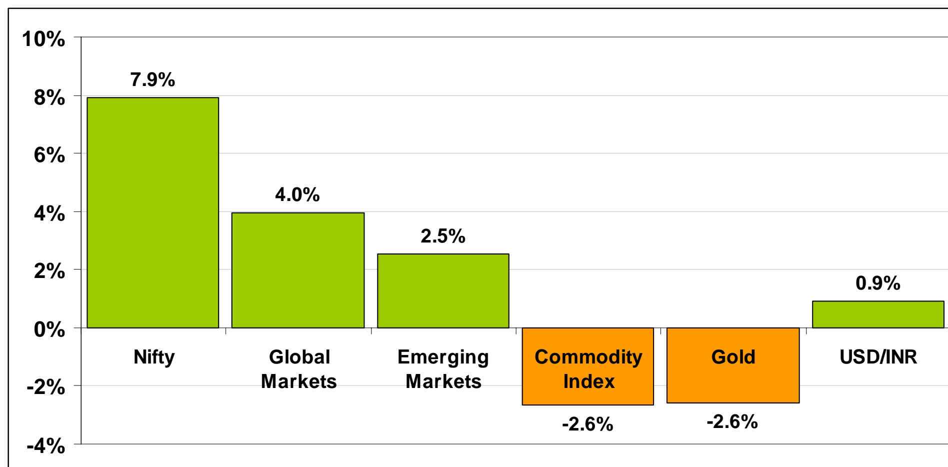
The Big Picture

9th March 2015

Overview

2015 has started reasonably well for the Indian equity markets. The Nifty Index gained 7.9%, the currency gained about 1% and global markets have also been largely buoyant. Normalized WPI Inflation is currently at 3.38% and the Reserve Bank of India has already made two unscheduled rate cuts of 25 bps each in this quarter. Low crude oil prices have improved the Central Government's fiscal position somewhat by drastically lowering fuel subsidies and yields on Government bonds have fallen to 7.7% from over 9% a year ago.

Returns in 2015

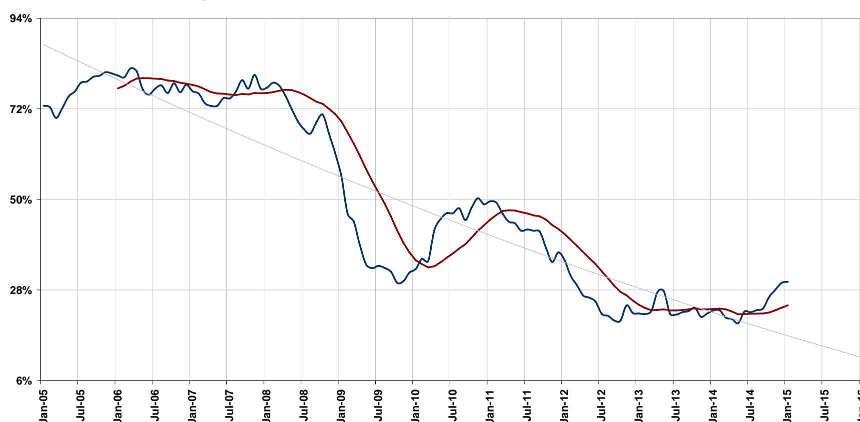


The new government has been on the saddle for about 10 months now, and somehow it doesn't feel like *Achhe Din*, yet. It does appear that the government is looking in the right direction but is taking very few steps in that direction. The first full union budget is symptomatic of that. On the taxation front, while the abolition of Wealth Tax and the promise of removal of corporate exemptions are positive, much of the taxation quagmire remains - and worryingly the path to GST implementation appears as hazy as a year ago. On the policy front, the re-auction of coal blocks (at significant rates) is positive, perhaps full privatization instead of "captive mines" would have been truly reformist. The quantum of "stalled projects" remain almost unchanged from the UPA government days.

So, why doesn't it feel like Good Days?

The Impact Macroeconomic Index (IMI) looks at various macroeconomic parameters, such as Industrial growth, inflation, credit growth, to assess the health of the economy. This has been in a rut for the last two years with very marginal improvement in recent times. Every component of IIP (Index of Industrial Production) is at multi-year lows and there is no sign of any significant pick-up in domestic demand. Investment cycle has still not turned and Bank credit growth is at the lowest level in 12 years (10.5% versus Long-term average of 21.2%).

Impact Macroeconomic Index 2005-2015

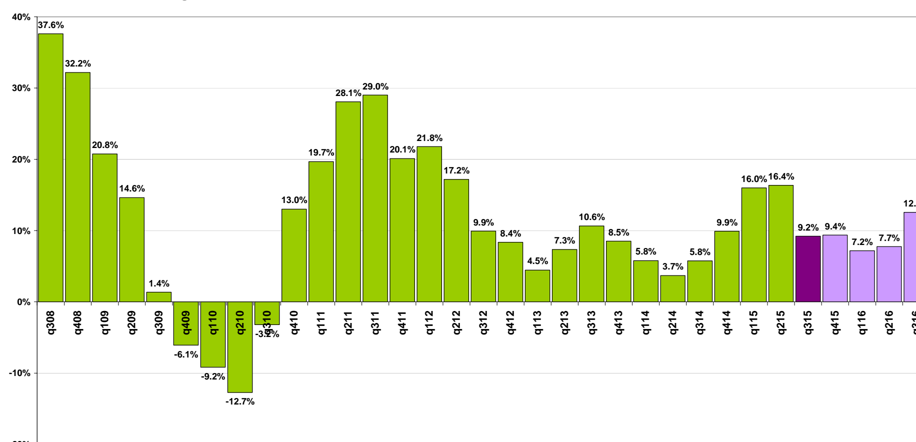


Although the normal cyclicality of economic growth would suggest that things would tick up "automatically", the fact that it has been caught in this rut for almost three years is baffling. It was hoped that the reforms by the new government (both big-bang and low-hanging-fruit) would spur the upturn – but it has been disappointing on both counts.

Why does this market rally feel flaky?

The corporate earnings for the third quarter of FY 2014-15 were a shocker. Earnings growth for Impact-100 companies, which we expected to improve by 50-100 bps, fell sharply to 9.2% (from 16.4% last quarter), sales growth fell to 8.6% (from 10.4%) and profit margins fell 30 bps to a historically low of 9.9%. With the exception of pharmaceutical and technology sectors, every other sector recorded significant deterioration.

Earnings Growth of Impact-100 companies, 3Q 2014-15



Meanwhile, with the equity markets rising by 32% over the last year with slowing earnings growth meant that the Price/Earnings ratio of the Nifty-50 index is now in overvalued range. In fact the

divergence between the current P/e ratio and our benchmark P/e ratio (derived from fundamental factors) is now at a four-year low. Markets usually tend to correct when this divergence spreads this wide. The last time this happened at the end of 2010, the markets corrected by 25% through 2011.

Nifty Current & Benchmark P/e Ratio 2006-15

Outlook

Given that all the other data have been dismal, CSO's revised GDP growth of 7.4% (and 8.1-8.5% next year) appears to be fanciful at best and absurd at worst. Although the equity markets have gone up on a buoyant global environment and persistent optimism on reforms, they do seem to be in an overextended place. In addition, with the likelihood of the Federal Reserve increasing rates before expected, the risk of a global correction is also increasing. In fact, The Impact-Risk-Index at 83, is now at a five-year high, and the risk-reward ratio does not favor continuing long positions.

Happy Investing.

Sashank Vipparthi
sashank@idika.com

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