

8 Jan 2018

A Rational Analysis of the Sensex for the Year 2018

In our Sensex Rational Analysis Interim Review report for 2017 we had concluded by saying “**With the current set of information that we have, we believe SENSEX would have limited upside from here and there is high probability of SENSEX continuing to trade around mid-band of the valuation range of 30,500**”. As of 29th December, SENSEX stood at 34,056.

SENSEX movement in 2017:

High	34,138
Low	26,595
Close	34,056

The year 2017 started with the backdrop of De-monetisation and the uncertainty of its lingering effect on the economy. In addition we had the implementation of GST which caused short term disruption. Earnings momentum was impacted across companies due to these factors. We were of the opinion that the negative impact of these events would be largely transient and the market would mostly look beyond the short-term impact. The market not only ignored these factors but there was a further rerating in valuation driven by sentiment and liquidity. SENSEX finally ended above the Mid-band of our valuation range.

Fundamental Valuation:

A. Top Down Valuation

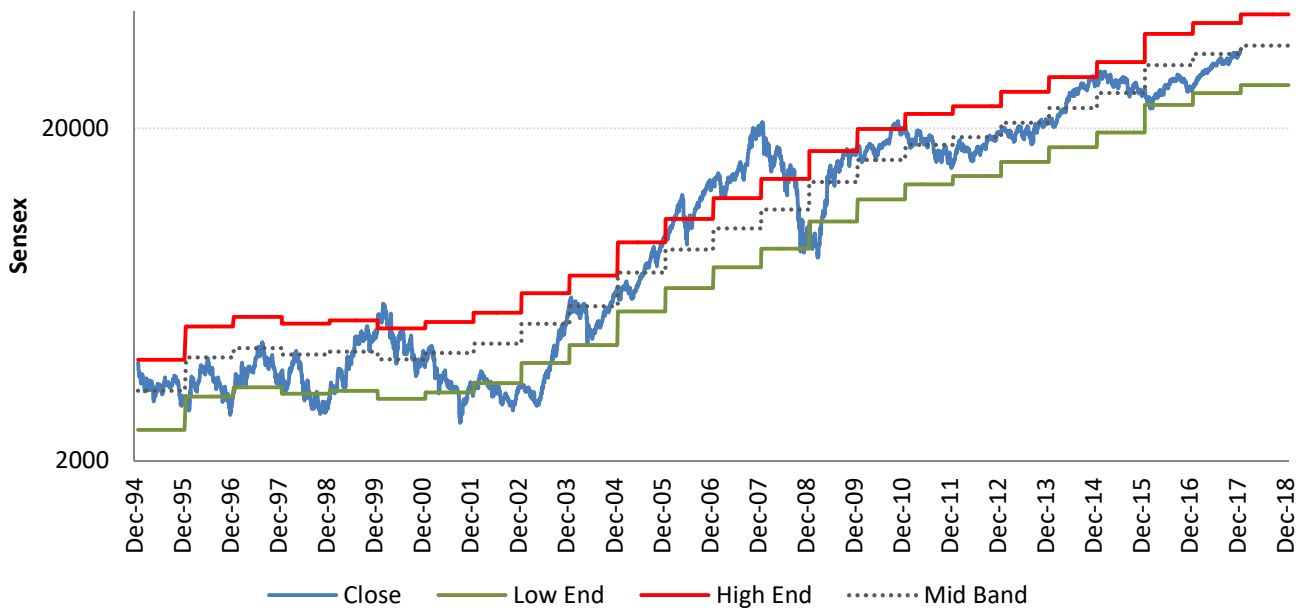
Using our various valuation approaches we estimate the Fundamental Value of the Sensex on a top down basis for Calendar year 2018 as follows:

Sensex Valuation	LOW	HIGH
Historical	29,404	44,512
DCF	24,966	42,569
+1/-1 SD PE Band	27,095	45,386
Average	27,155	44,156

Sensex Valuation range on a Top Down basis for CY 2018: **27,150 – 44,150.**

We are slightly away from the mid-band of the normalized valuation band of 35,650.

Sensex and Valuation Range



B. Bottom up Valuation:

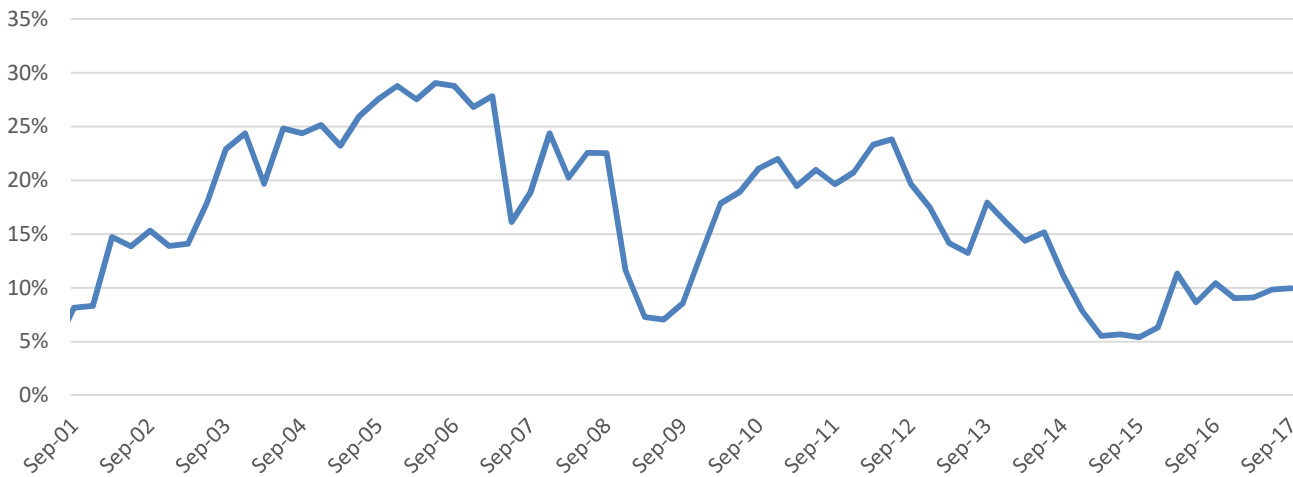
Last year we had started using a bottom up valuation in the report. We started this as we believe that the significant changes in the composition of SENSEX over time has to some extent reduced the efficacy of a pure top down approach to SENSEX valuation. As we have valuation bands for each of the SENSEX Index constituents, we are using the weights of these individual stocks and their respective valuation bands to arrive at the SENSEX Valuation from a bottom up perspective. **Thus based on the bottom up approach the valuation band for SENSEX for CY18 comes to around 21,300 – 37,500.**

If we combine both the top down approach and bottom up approach, the valuation band for SENSEX for CY18 comes to around 24,200 – 40,800

Earnings Momentum:

Earnings momentum has continued to be subdued. We need to breakdown the index constituents into companies focusing on exports (IT and Pharma) and those that are focused on Domestic economy. Both IT and Pharma sector faced headwinds in 2017. On the domestic side, growth rates of Banks was affected by demonetization. PSU banks continued to be constrained by capital and lack of demand from corporate borrowers who are already sitting on idle capacity and high leverage. Auto sector recovered from demonetization disruption, but still has not shown strong growth in volumes. The only sector that showed strong growth in earnings momentum was the commodities sector. But that again was due to significant low base of 2016. To sum up, 2017 was a year of weak fundamental earnings momentum.

Sales Growth



Above Chart shows the Sales growth of current index constituents. Nil growth has been used for Banks and NBFCs. Any aberrations in terms of Inorganic sales growth, divestures etc have been ignored wherever the same have been significant.

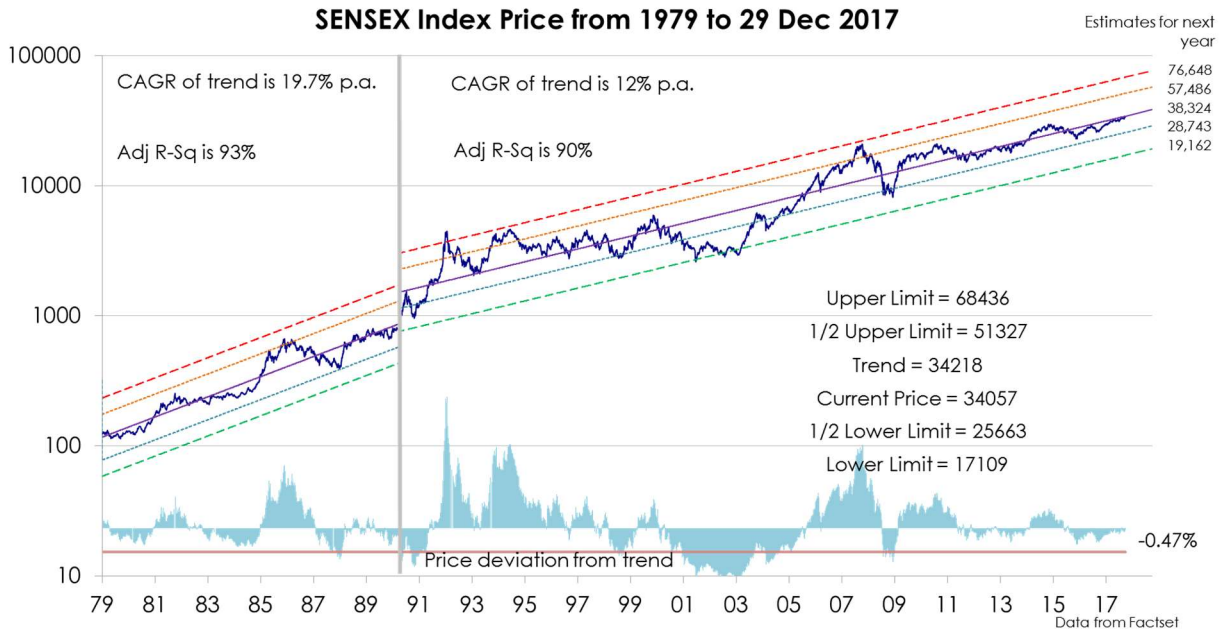
But we believe 2018 is starting on a positive note. On the export side things are looking better than 2017. After couple of years of constrained IT budgets of US corporates, global IT companies have hinted at improving deal pipeline and possible pick up in client IT budgets for 2018. Generic Pharma sector would continue to face pricing pressure but the pace of the decline could come down, thus reducing the overall drag on SENSEX earnings momentum. On the domestic side we have already seen private sector banks recovering sharply post the demonetization impact on growth. PSU Bank recapitalization in 2018 is to a large extent being done for survival. But some of the relatively better run PSU Banks are expected to get growth capital as well under the recapitalization plan. This should help in improvement in credit growth over the coming years. If other sectors continue their current earnings momentum, the lesser drag from the above discussed sectors should in itself help overall improvement in growth. That said, we believe the market at current valuation has already factored most of these improvements.

Technical Analysis:

The chart of SENSEX is under strong Technical momentum. Given the current weak earnings momentum, it is difficult for the market to move to the High End, purely based on sentiment. But as discussed in the earlier section, if some of the positives on the earnings visibility pan out and we see a pick-up in earnings momentum, then we could see market trending to the higher end of the valuation.



Quantitative Analysis:



Currently, SENSEX is quoting around historical trend line. In an environment where earnings momentum is weak but supported by strong technical momentum, the index could move to the Trend. The trend value for the SENSEX as of December 2018 is around 38,300.

Behavioral Analysis:

Sentiment continues to be very strong. Most of our Sentiment indicators are indicating extreme risk appetite.

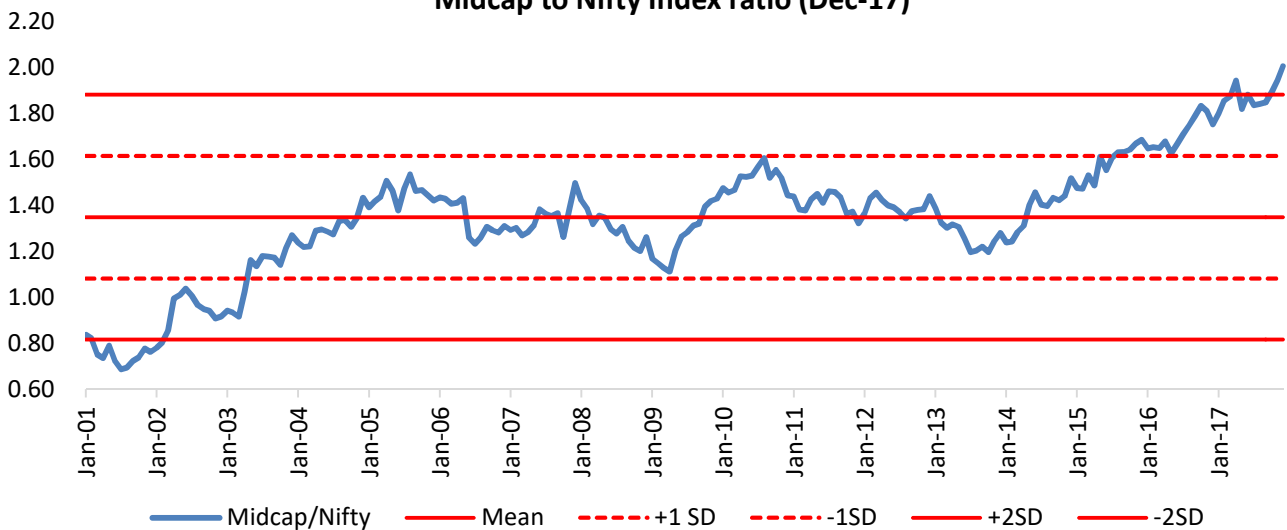
Regulated Utilities Risk premium Index which captures the risk premium for Equity of Regulated Utilities that market is factoring as compared to 10 Year Government Bond has dropped below -1 SD and is now in the optimism zone. This is indicating Greed is the dominant factor amongst market participants at this point with reducing perception of risk.

Risk Premium (EWI): Reg Utilities Yield - 10 Yr Bond Yield



The Midcap/NIFTY ratio is also a good ratio to assess risk appetite in the market. A higher ratio indicates that market participants are relatively willing to take more risk. The ratio has now moved above +2 SD (as can be seen from the chart below) is indicating extreme risk appetite.

Midcap to Nifty Index ratio (Dec-17)





Prospective Return of Constituents:

Based on our rational analysis framework (fundamental, technical, quantitative & behavioral) we arrive at a best case and worst case prospective return estimate for individual stocks. This is more immediate estimate of projected prices of individual constituents in the next 6 to 9 months. This is again a bottom up approach. Using the Sensex constituent and their weights we estimate the prospective return for the Sensex as well. Based on the prospective return of individual constituents, the best upside case for Sensex seems to be ~-0.5% (or ~33,891) while the worst case downside is estimated at -24.5% (or ~25,697) with an average estimate of -12.5% (or ~29,794). Be aware though that this changes every day as new information on valuation, earnings momentum and technical momentum comes in and though can only be used a near term guide.

Conclusion:

Currently SENSEX is slightly above the mid-band of our Valuation range of ~32,500 (Top Down + Bottom up). As discussed in the past, for the movement up to High End of the valuation range we need all the engines to work together i.e. Fundamental (Earnings) momentum AND Technical momentum + Sentiment. For the last 3 years SENSEX movement has been largely driven by sentiment with virtually no support from fundamental momentum. As discussed in the earlier sections, we are starting 2018 on a positive note, for there is improved visibility on the earnings momentum as some of the drag factors are abating. We would have to wait and see if these positive signs on fundamental momentum actually trickle down in terms of numbers, before we stick our neck out on a possible movement of SENSEX up to the High End of valuation of 40,800. We will see the earnings momentum in the next couple of quarters and then evaluate whether there is any improvement of probability of SENSEX going to High End of the band in the midyear review. With the possibility of improving earnings momentum we believe the probability of SENSEX going to the Low End of the valuation band of 24,200 has reduced. We have seen in the past in individual stocks as well as in case of SENSEX that when earnings visibility improves, the downside is restricted to the 40 week moving average from a Technical perspective. Thus any downside for SENSEX could be restricted to the 40 week moving average of ~31,750. **We believe probability of downside risk of SENSEX going to the Low End of the Valuation band of 24,200 has reduced. But at this point it is difficult to assign a high probability of SENSEX going to the High End of the Valuation (40,800). For that we would have to wait for more evidence on fundamental momentum to assign a higher probability. Thus with the current set of information, SENSEX could continue to trade around the Mid-band of the valuation range (32,500) in our opinion. If market starts to see the fundamental momentum picking up is when SENSEX could start trending towards the High End of the valuation.** At the same time though, we continue to reiterate that considering the extreme risk appetite prevalent in the market, one needs to tread carefully. At this point it is better to focus on businesses that could be facing short term issues and are available at reasonable valuation rather than those that are doing well but the valuations of which are more than factoring the best case panning out.

Regards

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