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A Rational Analysis of the Sensex for the Year 2018 (Interim Review)

In our Sensex Rational Analysis for 2018 we had concluded by saying "**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.**" As of 29th June, SENSEX stood at 35,423, which is 9% above our suggested point. The SENSEX traded mostly higher than our stated trading range of around Midband. With the highest closing point being ~12% above midband and lowest point being around midband.

SENSEX movement in 2018 (YTD):

High	36,283
Low	32,596
Close	35,423

2018 had started on a positive note with improving earnings visibility and extremely positive sentiment. But the overall sentiment took a bit of a beating with following macro events:

1. Trump administration went on the offensive in trade negotiations with proposals to introduce trade barriers vs China including US allies.
2. US Interest rates moved closer to 3% and US Fed continued on its interest rate hike trajectory.
3. The above 2 events had severe negative impact on emerging market currencies and equity markets. India was no exception with INR depreciating by 7%. FIIs continued to pull money out of Indian markets.
4. Oil prices also moved up, the impact of which was further accentuated by falling INR.
5. The Indian Government reintroduced the Long Term Capital Gains tax after almost 14 years.

Thus while we had started seeing improvement on the ground in terms of earnings visibility, the overall macro environment turned negative.

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 currently around mid-band of the normalized valuation band of 35,650.

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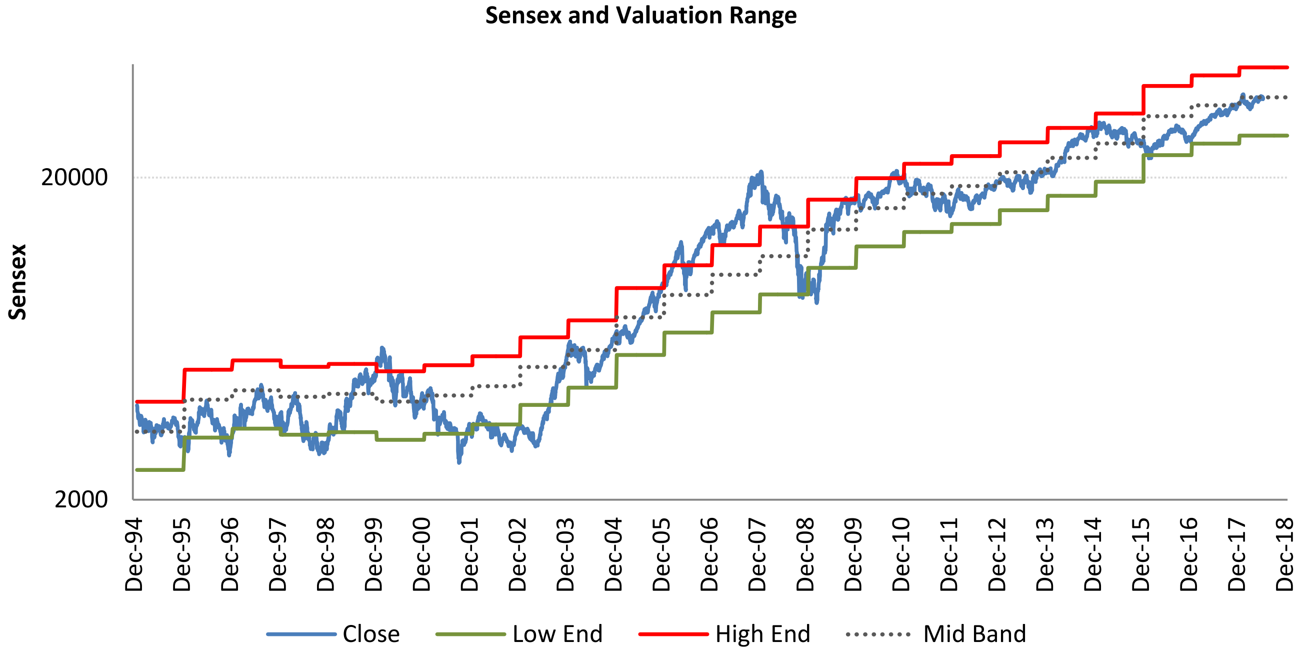
As we have discussed in the past our top down valuation approach assumes normalised earnings i.e. using long term historical average of Return on Equity and the Book value. Thus we are making an implicit assumption that there would be a mean reversion (from current -1 Standard Deviation) of Return on Equity and thus earnings.



B. Bottom up Valuation:

Currently Financial stocks account for 40% weight in the SENSEX. This was much lower earlier. In fact as recently as 2014, the weight of financials was only 30%. As the top down approach uses the headline numbers of the SENSEX without factoring the effect of underlying change in composition, there is a risk of us comparing apples with oranges (using historical multiples of SENSEX to current fundamentals). The valuation methodology that needs to be used for financials (Balance sheet approach: Price/Book Value) is much different than other businesses (Income Statement approach: Price/Earnings). All these factors have reduced the efficacy of a pure top down approach to SENSEX valuation and thus we introduced the bottom up valuation for the SENSEX. 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. The Mid-band would thus be 32,500.

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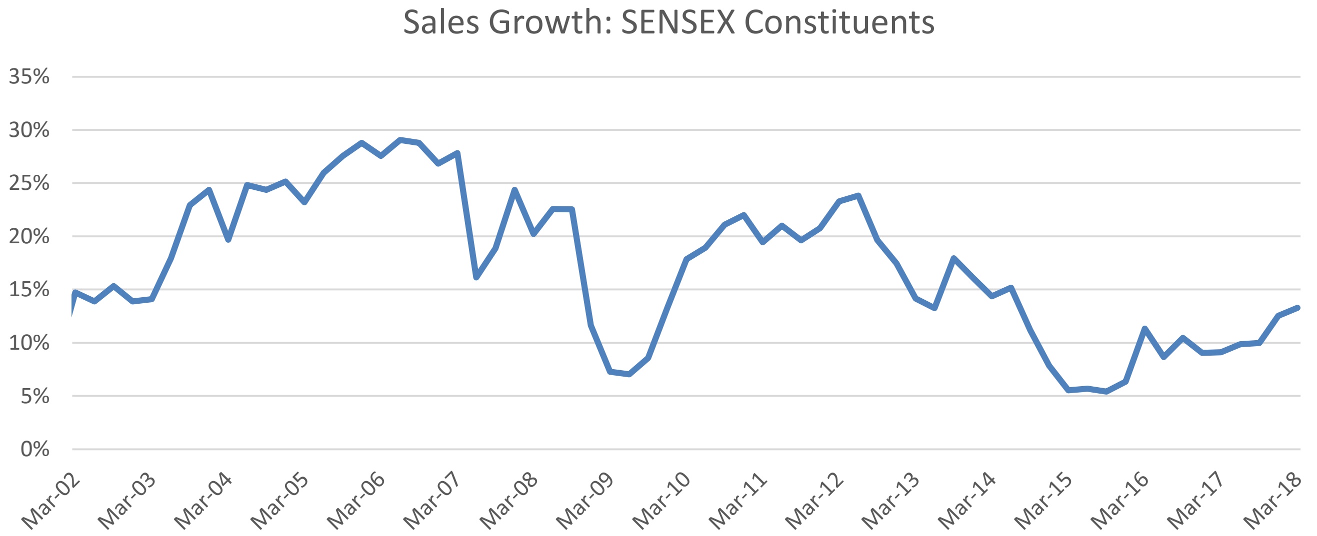
Earnings Momentum:

As discussed in our Jan 2018 report, we were of the opinion that 2018 was starting on a positive note with improved earnings visibility. In both December and March quarter, companies reported improvement in the growth rate (as can be seen from the chart), albeit on a low base due to demonetization.



Above Chart shows the Sales growth of current index constituents. NII 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.

IT Companies have guided for improved outlook for the current year and the same is corroborated by the commentary from global competitors as well. All domestic auto companies, be it Commercial Vehicles, Passenger vehicles or Two wheelers, have all shown improvement in volumes. FMCG companies have also started reporting improved volume pick up with transitory effects of GST on the distribution channels abating.

On the negative side, Credit off-take has bounced back from the demonetization low, but overall growth is still being driven by Non-Corporate credit growth as banks continue to be cautious with respect to lending to corporates. Generic Pharma companies are still facing headwinds in the US, though the severity of the pricing pressure in the US businesses is slowing. Capital goods companies have hinted at possible green shoots. But considering low capacity utilization level across industries barring a few (e.g. Auto) and the overall stress in the banking sector which restricts lending to corporates, would continue to put pressure on capital goods order inflows and limit any broad based improvement.

2018 seems to be the year of consolidation and gradual improvement in earnings momentum. But at the same time macro picture has worsened due to depreciating rupee, increasing inflationary pressures and possibility of a global trade tariff war. It needs to be seen whether the nascent earnings recovery can withstand these macro headwinds and uncertainties.

Technical Analysis:

Even after the recent weakness, the SENSEX looks strong from a technical momentum perspective. Earnings momentum has improved but is not yet strong enough to take the market to the high end. While SENSEX has continued to remain strong technically, broader markets have technically turned weak, with Mid and Small cap indices both showing weakness.

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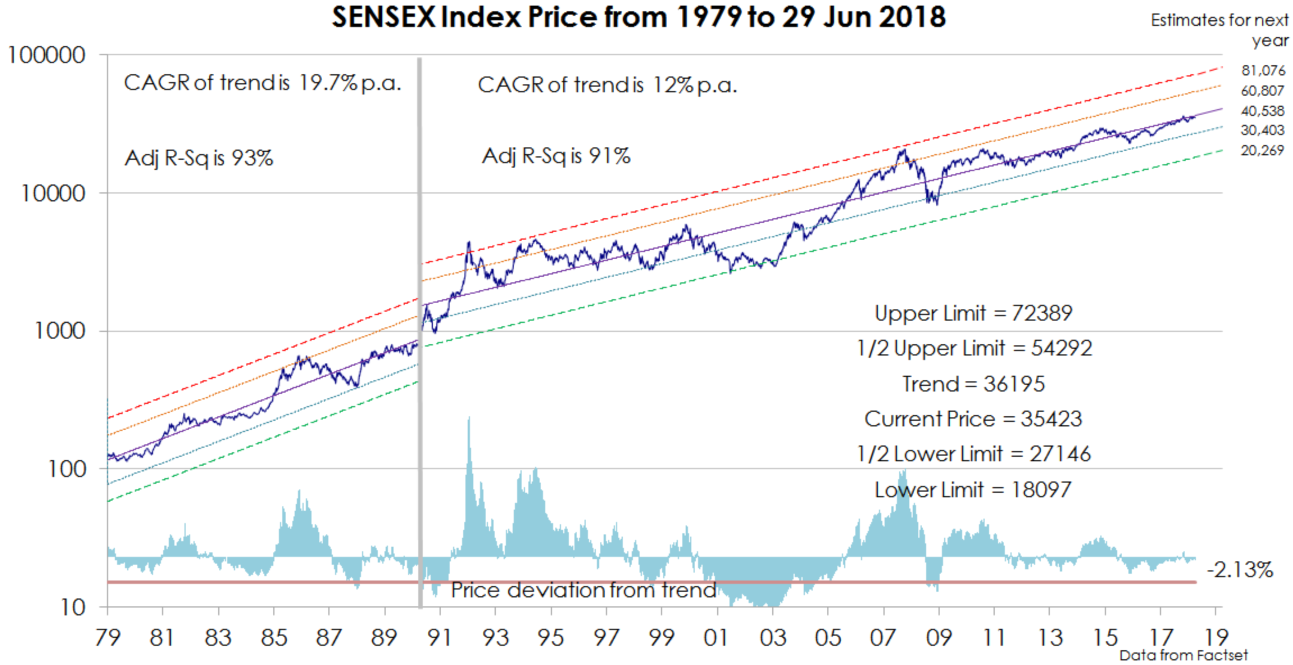
Quantitative Analysis:

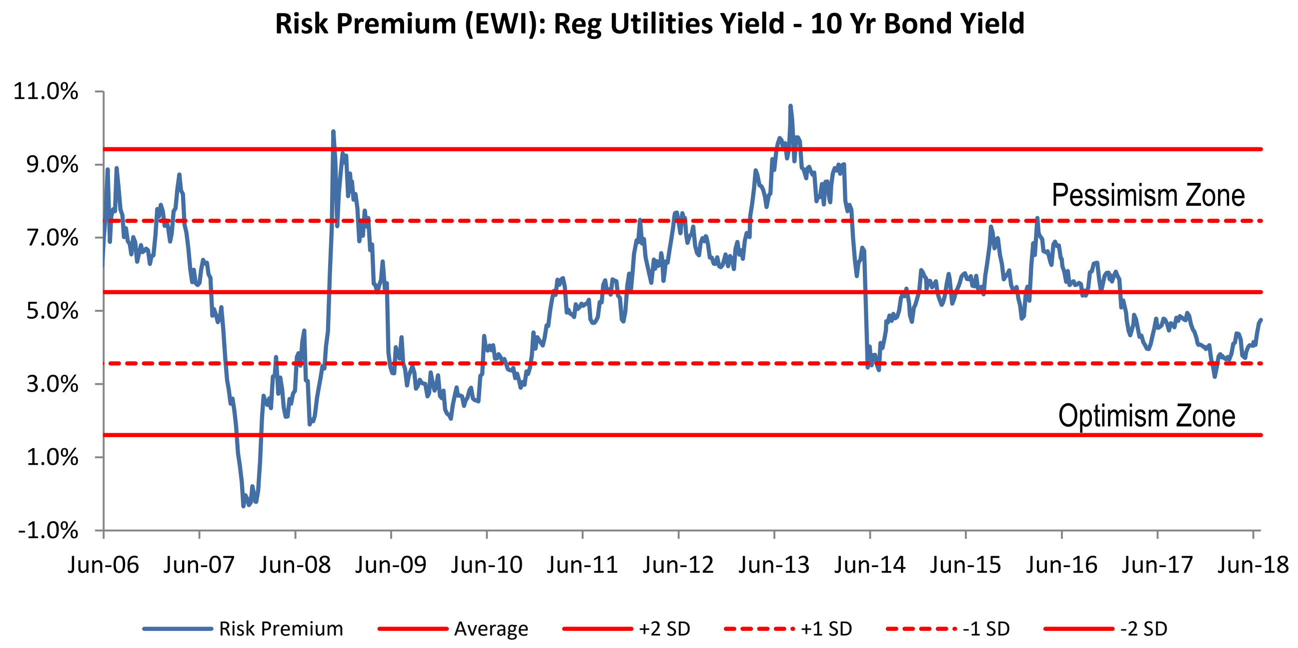


Currently, SENSEX is quoting around historical trend line. We have historically observed that strong technical and earnings momentum would ideally take the market to ½ upper limit (orange line) of the historical SENSEX trend. Currently technical momentum is strong, but earnings momentum is improving gradually and thus movement to the ½ upper limit may not happen in the near future and thus we can assume it could move along the trend. The trend value for the SENSEX as of December 2018 is around 38,300.

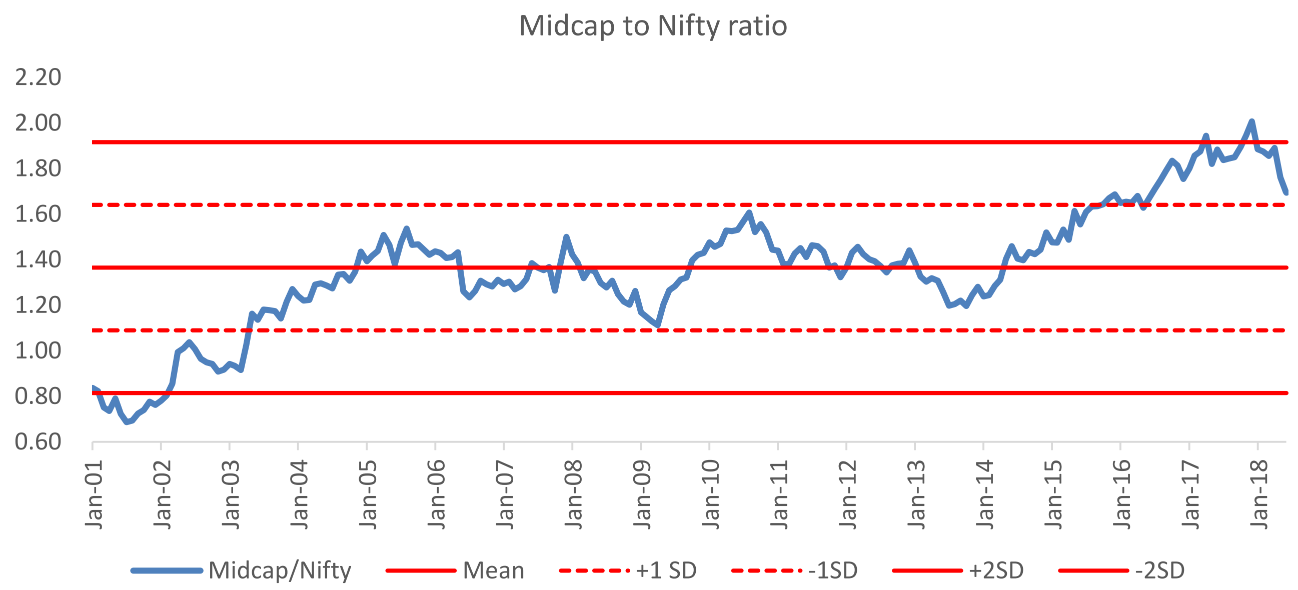
Behavioral Analysis:

Extreme optimism and risk appetite has given way to some sense of rationality. But overall sentiment is still positive which is also reflected in the strong monthly inflows into Equity mutual funds.

Regulated Utilities Risk premium Index captures the risk premium for Equity of Regulated Utilities over the GoI 10 year bond yield. Risk premium which had moved into the optimism zone at the beginning of the year, has corrected and is now moving closer to the neutral zone.



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. This ratio has also corrected from extreme it had touched at the end of last year. Thus broadly sentiment seems to be gradually normalizing.



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 ~-2.2% (or ~34,661) while the worst case downside is estimated at -25.7% (or ~26,298) with an average estimate of -14% (or ~30,479). 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:

Since our January report:

1. Earnings momentum and visibility has gradually improved.
2. SENSEX technical momentum has continued to be strong
3. Sentiment has turned a bit sour, due to macro headwinds.

Earnings momentum has gradually picked up, the sustainability of the same against a deteriorating macro situation needs to be seen. **Considering the improving earnings momentum and the sentiments which (even though moderated) continue to be positive, the probability of downside risk of SENSEX going to the Low End of the Valuation band of 24,200 remains extremely low. That said probability of the SENSEX going to the high end has not improved materially since the last report as the improvement in earnings momentum has been negated by deteriorating sentiment and macros. We believe that with the current set of information, SENSEX should at worst trade around the Mid-band of the valuation range (32,500) by December 2018 while any upside should be capped at ~38,300 which is the historical trend line. Any weakness below 32,500 which is driven purely by sentiment without any deterioration in fundamental momentum should be used constructively.** That said, our relatively positive/neutral stance for the SENSEX should not be extrapolated to the broader market wherein we have been cautious considering extremely high valuations that we have alluded to (Please refer to our past blogs and letters) in the last 1.5 years.

Regards

Rohan Samant
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