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We Advise, You Prosper

India Equity Research — 30th August, 2018

You've got to know when to hold them,
Know when to fold them,
Know when to walk away,
And know when to run.

– Kenny Rogers

Indian stock markets are trading at rich valuations and overvalued zone - We advise investors to Sell Equities and take money off the table before investing again at lower levels.

Indian stock markets resumed their upward journey on 23rd March, 2018 after Sensex touching a low of 32,596 in the aftermath of February 2018 crash to the current levels of 38,723 on 29th August, 2018. It has taken the market less than 5 months to traverse a distance of around 6,100 points thus giving a net benchmark return of 19%. During the same time frame the Market Capitalization of all the listed companies on BSE swelled from Rs. 1,39,30,643 Crs. to Rs. 1,58,95,921 Crs. It is evident that the Market Capitalization of all the listed companies on BSE shot up by approximately 19.65 lakh crores in a short span of 5 months.

Nifty 50 companies were available at P/E multiple of 18.9 times and P/BV multiple of 2.8 times in February, 2016 and then rose to all time high in January 2018 at a P/E of 27.8 times and P/BV of 3.7 times. It then followed by a crash, as anticipated in our January Sell Call Note, and the P/E dived to a low of 24.4 times and P/BV of 3.4 times on 23rd March 2018. However post the stupendous rally in the Indian equity markets since March, Nifty 50 companies are currently trading at a P/E multiple of 28.5 times and P/BV of 3.8 times. It can be seen that Indian stock markets are trading at record high valuations amidst the fact that the risks arising in the system due to elevated levels of oil prices which could result in inflationary pressures, widening fiscal deficits and the spectre of escalating trade wars between USA and China hanging like a sword of Damocles over the entire global financial markets. We believe that political uncertainties arising out of general elections at the centre and impending state elections in three major states of India are not yet priced in by the markets.

Date	P/E Multiple (x)	P/BV Multiple (x)	Market Capitalization (Rs. in Crs.)
31st December, 2007	26.55	6.23	35,45,041
29th February, 2016	18.90	2.81	85,83,144
9th January, 2018	27.19	3.58	1,54,90,659
23rd March, 2018	24.38	3.38	1,39,30,643
29th August, 2018	28.55	3.76	1,58,95,921

(Source: www.bseindia.com and www.nseindia.com)

Indian equity markets have now become one of the world's most expensive market based on the P/E multiple ratio. The Nifty50 P/E ratio is 28.55 times compared with 23.63 times for the Dow Jones, 25.89 times for the Nasdaq, 23.40 times for the FTSE, 18.24 times for Hang Seng Index. Currently the Relative Strength Index (RSI) – a measure of momentum – of Indian Equity markets (Sensex) shows a reading of 68.4. Typically RSI is at record high and is construed as an indicator of overbought market by technical analysis.

Valuations on an Upswing

Index	P/E Ratio
Nifty 50 (India)	28.55
Dow Jones (USA)	23.63
Hang Seng (HK)	18.24
FTSE (UK)	23.40

(Source: www.wsj.com)

Global economic activity has continued to maintain steam; however, global growth has become uneven and risks to the outlook have increased with rising trade tensions. Economic activity in major emerging market economies (EMEs) has slowed somewhat on the back of volatile and elevated oil prices, mounting trade tensions and tightening of financial conditions. Global trade lost some traction due to intensification of trade wars and uncertainty stemming from Brexit negotiations. Trade wars when combined with a build-up in leverage and high asset prices could result in a toxic mix that would be a drag on global growth.

The global macroeconomic conditions have somewhat worsened: interest rates are rising and the fears of liquidity tightening globally. Besides, crude prices are rising, hurting India's current account deficit while inflation is inching up with even core inflation above 5% for the last five months. In 2018 so far, rupee has slipped 11.75% while crude prices have gained 15.82%.
(**Source:** www.investing.com and www.xe.com)

Despite healthy earnings growth, valuations of Indian equities have remained quite expensive in the past few years. With Global Central Banks in a tightening mode. Domestically as well, the Reserve Bank of India (RBI) raised the repo rate by 25 basis points in June after a hiatus of four-and-a-half years. And following the latest hikes in minimum support prices (MSP) for most Kharif crops, another 25 basis point rate hike in August 2018. Going ahead, RBI could be setting the stage for a higher interest rate regime.

We believe that the encouraging first quarter results which have been announced in July 2019 have set the tone for positive earnings growth for the full year, simultaneously fuelling a further rally in Indian Equities which has led to 'lifting' Indian Equities into an overvalued territory. However it is our strong belief that prospects of strong earnings recovery seem to have been well priced into the Equity markets. We believe sectors such as Auto, Metals, NBFCs and FMCG would deliver superlative performance whereas sectors like PSU banks, Infrastructure, Power and Aviation could be laggards in performance. Pharmaceuticals sector although has all the characteristics of a 'hope trade' and the earnings of the pharmaceuticals companies need to be closely monitored for the coming quarters.

We believe Indian Markets may face headwinds in the foreseeable future as political developments foment volatility in Indian Equities, particularly the results of key state elections could be construed as a precursor to the final outcome of the general elections to be held in India in 2019. We believe that this major external change factor in India is not yet priced in by the Indian markets as this major political development has the potential to accentuate a major move either way on the Indian Indices. We believe that Indian Equity Markets have consolidated on the exuberance that the incumbent government would return to power which remains to be seen.

India's current account deficit (CAD) at US$ 13.0 billion (1.9% of GDP) in Q4 of 2017-18 increased from US$ 2.6 billion (0.4% of GDP) in Q4 of 2016-17. We believe CAD in 2018-19 would be much higher than 2017-18 and it wouldn't be surprising if CAD touches 2.3%-2.5% of GDP in 2018-19 due to the twin negative impact of heightened levels of oil prices coupled with the depreciating Indian currency. The adverse implications of a political business cycle on fiscal consolidation should be carefully watched since fiscal consolidation is often a key feature of the adjustment required to contain trade imbalances. This would probably add to the cues of headwinds in the Indian Equity Markets that could be 'lurking' near the corner.
(**Source:** www.rbi.org.in)

Oil prices have risen from a low of \$26 on 11th February, 2016 to a recent high of \$75 in August 2018 coupled with a depreciating currency. The unprecedented rise in oil prices and the continued buoyancy in oil would lead to inflationary pressures in India. The fears of widening deficits and possible drag in performance in corporate earnings due to oil spikes could further dampen positive sentiments in Indian Equity markets. We believe financial markets are complacent about the risks mentioned above and a combination of factors like inflation on an upward trajectory, global crude prices remaining firm, and US Federal Reserve rate increases would also push up global interest rates and gradual winding up of stimulus. Indian economy and Indian Equity markets would not remain in isolation and these global factors acting in unison could have a cumulative negative effect on the Indian Equity markets which could possibly arrest any further upward march of the Indian Equity markets.

Sometimes Equity markets have the tendency to be fundamentally strong and technically weak, however at the moment the equity markets are exhibiting a tendency to be technically in a momentum zone and fundamentally not on a strong wicket. We believe euphoria probably may have set in the markets which could be an indicator of the final lap of the rally. It is time for investors to consolidate their gains, and find the safety of cash.

As more uncertainties manifest a correction is inevitable.

OUR CALL

The valuations and momentum in the Equity markets appear to be in the FROTHY and BUBBLY Zone. We believe that the Sensex levels between 38,800–39,500 (±2%) could act as a RESISTANCE ZONE for the current rally. We strongly advise investors to liquidate their equity holdings and book profits at 38,500 and higher levels. We also advise the investors to take money off the table before investing again at lower levels which could probably be around 35,000-35,500. We believe by adopting the above investment strategy our investors could take advantage of the volatility in the Equity markets netting off handsome returns in the process.

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