TIME TO PAUSE AND TAKE STOCK

The Nifty is up nearly four times from the high it touched before the GFC brought in a clean-up which ended the long bull market in the developed world which started in 1981. India has been one of the best performing large stock markets in the world since then along with the mother market of the US. There is a compelling case for a comparison of metrics between the two time periods.

Then and now

Key Indicators	2007	2024
NIFTY 50 Index	4,464	25,236
Nominal GDP (USD Tn)	1.2	3.9
Per Capita GDP (USD)	838	2,557
Ranking of India by GDP	12	5
Current Account deficit % of GDP	1.0	0.7
Forex reserves (USD Bn)	229	682
Investment (% of GDP)	29.2	33.5
CPI (%)	6.8	5.4
Bank loans (INR Tn)	20	166
GNPA of banks (%)	2.5	2.9
Share of PSU banks in credit (%)	73	57
NIFTY 50 TTM PE(x)	17.5	25.2
NIFTY 50 TTM PB (x)	5.1	4.2
Market Cap to GDP (%)	91	128
NIFTY 50 ROE (%)	23.9	16.3
NIFTY 50 Index 5-year return (%)	34.6	17.8
10-year Govt Bond Yield (%)	7.9	6.9
Yield Gap (bps)	112	167

Note:

1. *NIFTY 50: Price, TTM PE, TTM PB, Market Cap, ROE, 5yr return, 10-year govt yield, yield gap are as on August 30, 2024(For 2007, prices as on 31st August). Yield gap, the earnings yield is inclusive of dividends.*
2. *Rest all are financial year ended March 2024.*
3. *Ranking of India based on CY basis.*
4. *Forex reserves as on 23-Aug-2024.*

Source: Reserve Bank of India, International Monetary Fund, NSE India, ICICI Securities, IIFL Securities, Ace Equity, Bloomberg, World Bank, Avendus, Spark Fund Research

Company	TTM PE(x) As on 31-08-2007	TTM PE(x) As on 31-08-2024
Nestle India	35.3	74.4
Hindustan Unilever	30.2	63.2
Asian Paints	29.4	59.0
Reliance Industries	22.6	29.7
Larsen & Toubro	33.0	38.2
Tata Consultancy Services	23.0	35.1
Infosys	25.6	30.3
Dr. Reddy's Laboratories	10.5	21.1
Maruti Suzuki	14.8	27.1
ICICI bank	27.2	20.5
HDFC Bank	33.8	19.2
State Bank of India	16.3	11.9

Note: Standalone earnings for Banks, Maruti Suzuki and Nestle India
Source: Ace Equity, Spark Fund Research

While these are numbers that tell their own tales and we can see that the company valuations are up across most stocks, let us highlight some qualitative comparisons that numbers do not reveal.

Institutional structures have improved

India's growth was high in 2007 but the growth drivers proved to be on shaky ground. The concessions to players involved in infrastructure buildouts were not backed by processes that could stand up in courts at a later point. This in turn resulted in India's version of zombie entities which eventually went on to create the worst banking downcycle that India witnessed. The current capex cycle is marked by more sustainable capital structures and better regulatory processes. The cycle has a chance of going much further before running into rough weather.

Digital empowerment has led to meaningful changes

Concepts such as direct benefit transfer have revolutionized the way the government delivers services to the citizens. The distribution efficiency of welfare spending has seen a remarkable improvement. India has become one of the cheapest markets for telecom services globally. The growth in mobile broadband has resulted in digitally driven services to explode. Digital empowerment has been the most critical reason for many businesses and activities in India to recover rapidly after Covid. This has led to productivity improvement and this process of mutual reinforcement of the enablers of a virtual cycle is still continuing.

The banking system has become more robust

RBI stood tall as an institution even in 2007 when India escaped much of the ill-effects of the credit bust due to proactive regulation. The role of the RBI has continued to be stellar. The banking system went through an extended down-cycle which was unavoidable in the wake of unsustainable leverage and poor business models post GFC. However, no bank or big institution failed. Confidence in the system and the integrity of the system were kept intact. The bad debt resolution process took some time to work its way through the heaps of doubtful loans, but the banks have ended up having healthy balance sheets. The banking system sits on a multi-year low when you reckon bad loans. Having said that, there is no ballooning and unsustainable leverage as yet. We are most likely in the

mid-cycle stage. Some hiccups surfacing now are likely to be speed-breakers that can let the cycle gather more steam for the journey ahead.

The market has found new sources for oxygenation

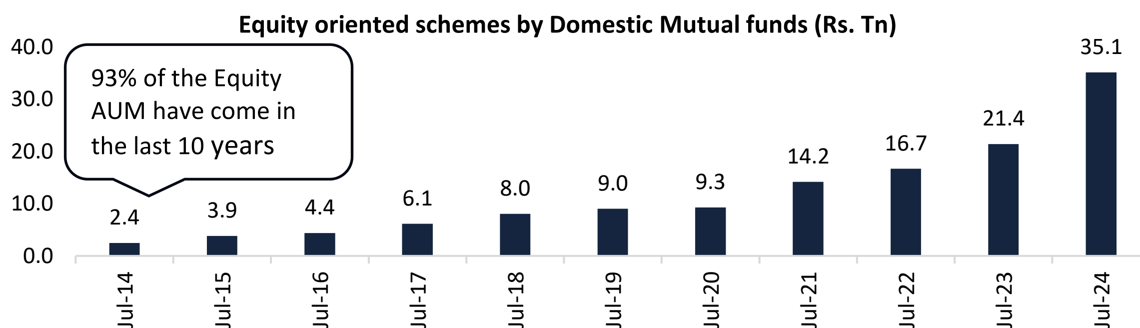
As the market revealed signs of altitude sickness after climbing new highs, new sources of liquidity have emerged which has kept the market juggernaut well-oiled. The flow of domestic savings into equities has gathered pace. The diminishing attractiveness of alternatives such as real estate and fixed income (due to lower rates) has kept the market valuations well-supported.

Up to a certain extent, this is the Goldilocks moment for India playing out. Now onto the challenges that the market is increasingly facing.

Valuations have gone high and it has become blasphemous to question them

The cost of capital has come down over the last two decades and this no doubt calls for higher valuations. However, this adjustment has boundaries. Exponential build-up of expectations on this count is what we are seeing over the last few years. After 2014, we saw this in companies with asset-light business models which was christened the so-called quality trade. After Covid, some asset-intensive businesses joined the party. Now, many concept stocks and almost all newly listed companies have gained exemption from scrutiny based on valuations. The forecasting period over which valuations have been done has elongated even as the fidelity of forecasts is coming under a cloud over longer timeframes. This is a double whammy to which the market has chosen to be blindsided. Narrative is ruling the roost. An echo chamber of perma-bulls is tending to shut out any sensible debate on the matter.

Web of denial



Source: Association of Mutual Funds in India (AMFI), Spark Fund Research

The market narrative and the cheerleaders have spun a web of denial using liquidity as a fundamental factor. Liquidity is a resultant of other factors coming together. For instance, SIP flow does not represent contractual savings. About 93% of the AUM in force in domestic MFs has not seen a true and sustained bearish phase and this is not a set-up that looks great. In an emerging market construct, India's weight in the most followed emerging market index has now crossed 20% as against about 24% for China. The Chinese economy is meanwhile about six times the Indian economy. Even if we agree that the Indian market deserves the much-touted quality premium, the extent of this looks unsustainable. Most importantly, when India had a single digit weight in the EM index, there was considerable upside from smart fund managers who wanted to be over-weight. At present, the adage of fools daring where angels fear to tread may start to play out. The liquidity can bolt out of the door if something were to go wrong. Finally, there is also this myth around market liquidity. Block trades are happening where single sellers are selling large chunks with multiple

buyers biting into slices. The source is in many instances pools of money where the compulsion to deploy is a dominant factor in choosing the stocks. We see instances where positive views emerge if blocks are in sight. The single seller does not mind selling at a discount as he is laughing all the way to the bank. The NAV bump gives a false sense of comfort to the buyers. Exit liquidity projections can show an alarming picture. The risk ascends steeply in small/midcaps. The web of denial is giving a protective cover for now.

What is the way out

A full-fledged bubble

While the echo chamber is vociferous that there is no bubble, we need to understand that one characteristic of the bubble is the echo chamber itself. We agree that everything is not over-valued by heaps. As the sector/theme rotation trade goes on to chase the catch-up in turns, a full-fledged bubble can be the result. If it comes about, it will drown out any voice of reason when we get into the danger zone.

More benign corrective actions

While we cannot chart a path for what constitutes sensible corrections, any correction is adding sense where there is a dearth of the same. If we see supply of paper exceeding demand – either due to insider selling or because of mega fund raises (or both), that can pave the way for an exit from this situation which can turn out to be less damaging than the alternative.

It is truly hard to assign probabilities for these. There may also be developments which we cannot foresee which could act as catalysts for a purge. However, all influential actors in the system are united in their resolve to defend the bull. If the market is not allowed to do its dharma of creative destruction by various interested parties, then we will need a catalyst to come about which we don't know about yet. We can take heart from the first part of this piece which enumerates why the bull is so resilient. In any bull market, it is prudent to keep the feet and ears on the ground. At present, we need to keep both eyes open and one eye on the door just in case.

Warm regards,

P Krishnan (CIO) and Team Spark Fund

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